OECD Multi-level Governance Studies

Maintaining the Momentum of Decentralisation in Ukraine

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Foreword

Beginning in 2014, the Ukrainian government embarked on an overhaul of its multi-level and territorial governance structures, including through decentralisation reform. For decentralisation to work effectively, a simple transfer of responsibilities to lower levels of government is not enough. A number of other conditions must be met, starting with the sufficient and appropriate resources to fulfil new responsibilities. Resources need to be complemented by adequate capacities at the subnational level, proper co-ordination mechanisms, effective monitoring systems and a good balance in the way various policy functions are decentralised.

The Ukrainian government and its Ministry of Regional Development, Construction and Utilities requested the OECD to support the successful implementation of decentralisation reform by following up on the OECD Territorial Review of Ukraine conducted in 2013. The current work is undertaken as part of the OECD's three-pillar Action Plan for Ukraine, signed in April 2015. The Action Plan covers three pillars: i) anti-corruption; ii) governance and rule of law; and iii) investment and business climate. The second pillar on governance issues includes, among other areas, support to the decentralisation reform agenda.

This report updates and extends the OECD’s prior regional economic analysis of Ukraine with development trends since the Donbas conflict, offers insight into Ukraine’s territorial and decentralisation reform agenda, and explores the impact of fiscal decentralisation. The report’s analysis of the structure and implementation of Ukraine’s multi-level governance and decentralisation reform highlights successes, identifies areas for additional improvement, and offers recommendations for short, medium and long-term action.

The work has been undertaken as part of the programme of work of the OECD’s Regional Development Policy Committee (RDPC), a leading international forum in the fields of regional, urban, and rural development policy and in multi-level governance, and served by the Centre for Entrepreneurship, SMEs, Regions and Cities. It is the result of a partnership with the OECD Global Relations Secretariat’s Eurasia Division.

The RDPC has long advocated for recognising the importance of multi-level governance and place-based approaches tailored to local and regional needs. To support the RDPC's leadership in this area, the OECD created the Multi-Level Governance Studies series in 2016. This report dedicated to Ukraine and its reform experience contributes to the body of knowledge contained in this series.

This report was discussed at the RDPC’s 38th Session on 8 December 2017 and was approved on 15 January 2018.

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The report was coordinated and edited by Maria-Varinia Michalun, Policy Analyst, under the supervision of Dorothée Allain-Dupré, Head of the Unit for Decentralisation, Public Investment and Subnational Finance in the Economics, Statistics and Multi-level Governance Section of CFE. Chapter 1 was written by Antoine Comps and Jibran Punthakey. Chapter 2 was written by Maria-Varinia Michalun. Chapter 3 was written by Isabelle Chatry. Chapter 4 was drafted by Jibran Punthakey with input from Antoine Comps. The report benefited from significant contributions from Jörn Grävingholt, Senior Researcher, German Development Institute/Deutsche Institut für Entwicklungspolitik (DIE) for Chapter 2 and Rosario Macario, Professor, CERIS, Insituto Superior Técnico, Universidade de Lisboa, Portugal for Chapter 4. Valuable research and translation was provided by Lyudmyla Tautyeva, and equally valuable comments, input and support on the report and report process were received from Luke Mackle, Gabriela Miranda, Joaquim Oliveira Martins and William Tompson (OECD). In Ukraine, operational, logistical and administrative support was provided by Mykhailo Semchuk, and interpretation and translation provided by Liudmilla Taranina.

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The report is based on a variety of information sources, including interviews during the missions, information and presentations shared during the seminars, OECD reviews and research on Ukraine's governance and finance practices published by the international community, as well as good practices and evidence collected during the two study visits organised for a selected group of Ukrainian stakeholders as part of this project, one to Flanders, Belgium (April 2017) and a second to Lublin and Rzeszów, Poland (September 2017).

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Acronyms and abbreviations

AATC	Association of Amalgamated Territorial Communities
ACU	Accounting Chamber of Ukraine
ASC	Administrative service centre
CBA	Community-Based Approach to Local Development
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPT	Corporate profit tax
DRT	Demand-responsive transport
EU	European Union
FDI	Foreign direct investment
FUA	Functional urban area
GDP	Gross domestic product
HDI	Human Development Index
IDP	Internally displaced person
IMC	Inter-municipal co-operation
IMF	International Monetary Fund
JVC	Job vacancy rate
km^2	Square kilometre
NAPA	National Academy for Public Administration
NGCA	Non-government controlled area
PIT	Personal income tax
PPP	Public-private partnership
RDA	Regional development agency
SES	State Employment Service
SFRD	State Fund for Regional Development
SME	Small and medium-sized enterprise
SSRD	State Strategy for Regional Development
TL2/TL3	Territorial Level 2/Territorial Level 3
UAH	Ukrainian hryvnia (currency)
USD	United States dollar (currency)
UTC	Unified territorial community

Executive summary

When the OECD published its *Territorial Review of Ukraine* in early 2014, the country faced many significant and inter-related territorial development challenges. These included large regional disparities; productivity shifts; high levels of unemployment and informal employment; poor public services; and top-down, centralised multi-level governance structures rooted in pre-independence practices. The social unrest, political change and armed conflict that Ukraine has experienced since then served to amplify these challenges and highlight the need for greater state resilience. To help address these challenges and harness the potential of regional economic development, territorial reform – including more decentralised subnational governance – became a pressing need.

Since 2014, Ukraine has made significant advances in regional development, territorial reform and decentralisation. The Cabinet of Ministers launched a multi-level governance reform that includes an extensive decentralisation process. In a short period of time, successful steps have been taken toward achieving municipal mergers and greater fiscal, administrative and political decentralisation. This process is complemented by the State Strategy for Regional Development 2015-2020.

Yet, multi-level governance and regional development challenges persist. These range from a need to address rising disparities to adjusting multi-level governance practices and territorial structures, and better conceptualising fiscal decentralisation. This report offers a diagnosis of the multi-level governance mechanisms in place and provides a set of recommendations for action to better ensure Ukraine's ability in meeting the conditions for successful decentralisation reform.

- **The asymmetric nature of economic shocks across Ukraine's regions highlights the need for a differentiated policy response and appropriate multi-level governance arrangements to support regional development.** The differences in performance of individual sectors had a clear impact on the spatial distribution of economic growth. While industrial production in 2016 reached only 82% of its 2010 level, the agriculture and fisheries and high-end business services sectors demonstrated consistent growth and remained above 2010 levels. These patterns of development clearly favour regions with an agricultural specialisation, and the Kyiv agglomeration. Almost 60% of national growth over the 2004-14 period was generated by Kyiv city and Kyiv *oblast*, which together generated 28% of GDP in 2015.
    - Opportunities to address the challenges arising from asymmetric shocks include strengthening agglomeration economies in Kyiv and the largest cities (including by allowing the amalgamation large cities with neighbours); adjusting the urban planning system; revising labour market policies to reduce informality and close the skills gap.
- **Directly linking amalgamation to fiscal and administrative decentralisation as an incentive mechanism is a double-edged sword.** This approach has led to a successful voluntary merger process: between 2015 and October 2017, over 2 000 local self-governments merged to form 614 unified territorial communities (UTCs) and the process continues. Yet, implementation has not always generated

municipalities with sufficient capacity to meet the challenges of decentralised local governance. In addition, it has created parallel territorial administrations with the intermediate government level (*rayons*) in a number of instances, further confusing the allocation of service and administrative responsibilities and inequality in public service quality, type and access at the local level.

  - Opportunities to further reinforce territorial reform processes include improving the stability and clarity of the amalgamation and decentralisation process to ensure the formation of more capacitated UTCs, reforming the *rayon* level, including a revised and clearly established set of responsibilities.

- **Horizontal and vertical co-ordination mechanisms to support reform implementation could be strengthened,** aiming to better promote more coherent planning and programming. Doing so could also ensure better aligned cross-sector and national/subnational priorities, and clearer lines of responsibility and accountability.
  - Opportunities to strengthen co-ordination mechanisms include boosting co-ordination capacity by introducing an explicit decentralisation policy, more clearly assigning responsibilities among levels of government, strengthening centre-of-government practices and establishing dialogue mechanisms, such as a high-level inter-ministerial council for decentralisation and a multi-level, cross-sector dialogue body.
- **Tools to support regional development based on more competitive regions have been introduced, although there is room for greater balance between "hard" and "soft" infrastructure projects.** Project planning capacities require further development. In addition, with changes introduced in 2017 to the funding and allocation methods of the State Fund for Regional Development, care should be taken to avoid a return to counterproductive practices from the past.
  - Opportunities to establish a better balance between hard and soft infrastructure projects include strengthening subnational civil service capacity in development-project design; reintroducing the original funding and disbursement stability associated with the State Fund for Regional Development.
- **Ukraine's subnational expenditure structure remains quite centralised: 78% of subnational government spending is executed on behalf of the central government.** Greater progress in fiscal decentralisation will require a clearer definition of spending responsibilities and better adjusting these according to delegated tasks. More subnational spending autonomy would permit these authorities to prioritise spending as appropriate to their needs and objectives.
  - Opportunities to advance in fiscal decentralisation include better articulating a strategic fiscal framework and implementing it with a clear road map, as well as tools and indicators to monitor progress and assess reform outcomes.
- **Subnational government revenue is limited – as is autonomy in revenue generation and management – with subnational governments controlling only about 30% of their resources.** This affects their ability to meet "exclusive" responsibilities, such as infrastructure maintenance and provision of municipal services and amenities.
  - Opportunities to support subnational governments to meet their "exclusive responsibilities" can extend to improving the system of intergovernmental grants, including a close monitoring of the new equalisation system; improving the tax system with adjustments to tax-sharing arrangements (e.g. personal income tax) and increasing own-source taxes.

Way forward

Ukraine has made significant progress in modernising its approach to regional development and territorial administration. Continued progress down the path of reform will mean institutionalising the positive advances made, ensuring that the conditions for successful decentralisation are met, and further building a culture of capacity and commitment to reform.

Assessment and recommendations

Overview

The OECD *Territorial Review of Ukraine* published in February 2014 identified municipal mergers, decentralisation and regional development as mechanisms that could help address a series of inter-related challenges at the territorial level. These challenges included regional disparities; significant shifts in productivity; high unemployment and informal employment; demographic change; poor quality services; and top-down, centralised multi-level governance structures that remain rooted in pre-independence practices. In addition, the conflict in the east that began in 2014 has amplified the territorial challenges and underscored the need to build greater state resilience. The *Territorial Review* stressed the need first for territorial reform in order to ensure subnational capacity to meet greater administrative and service responsibilities, followed by a comprehensive decentralisation reform.

In 2014, Ukraine's Cabinet of Ministers adopted the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power. This launched a multi-level governance reform based on a far-reaching decentralisation process. In a short period, successful steps have been taken toward achieving municipal mergers and greater fiscal, administrative and political decentralisation. The reform process, however, faces obstacles and implementation challenges, which should be addressed. The purpose of this 2017 report is four-fold: to update and extend the OECD's 2013/14 territorial economic analysis; to provide insight into Ukraine's current territorial reform and approach to decentralisation; to explore the impact of current fiscal decentralisation measures; and to illustrate what this means in practice using Ukraine's transport sector as a basis.

Regional development trends in Ukraine

With territorial disparities on the rise, it is becoming increasingly clear that Ukraine needs to continue modernising its approach to regional development policy. There is room to extract further benefits from agglomeration economies, by focusing efforts on functional urban areas (FUAs) and horizontal co-operation across administrative boundaries. Accurate territorial indicators, particularly population statistics and commuting flows, are essential to help Ukraine's policy makers adapt infrastructure and spatial planning to an ageing and declining population. Increasing the efficiency of labour markets, upgrading transportation infrastructure and improving transparency can also help further unlock regional performance.

Fractures in Ukraine's economy have widened since 2014

Ukraine's regions have faced significant challenges over the past decade. After suffering a severe contraction during the 2008-09 global financial crisis, a weak and short-lived recovery gave way to an even sharper recession in 2014-15, brought on by the Euromaidan events, the annexation of Crimea, and the eruption of a separatist conflict in the eastern regions of Donetsk and Luhansk. The crisis highlighted a number of fragilities inherent in Ukraine's economy: over-reliance on commodity-based exports as a driver of growth, consistent delays in implementing structural reforms to improve the business environment, and weaknesses in the integrity and efficiency of public institutions.

Recently, the government has introduced a number of measures to strengthen public finances and put the economy back onto a more sustainable growth trajectory. The signing of a four-year programme with the International Monetary Fund (IMF) and an Association Agreement with the European Union has encouraged further progress in structural reforms and allowed growth to return, reaching 2.3% in 2016 according to the IMF. Ensuring a sustained recovery in the long term will require concerted efforts to boost productivity, diversify the export base, attract foreign direct investment, and strengthen the institutions of public governance at national and subnational levels.

Urban agglomerations are driving aggregate growth in Ukraine

Population ageing and decline are reshaping Ukraine's economic geography. Eighty per cent of Ukrainian cities are experiencing population decline as a result of low fertility rates and net migratory outflows, which is particularly pronounced in eastern and northern-central Ukraine. Regions and cities should take this into account in their development plans and urban planning documents. The planning system should aim at mitigating the negative side effects of population decline, while adapting infrastructure and service provision to an ageing population. Conversely, the few urban agglomerations where population is growing – Kyiv and some cities in Central and Western Ukraine – should plan to scale up public services and infrastructure to accommodate new arrivals. In light of these shifts, it is of paramount importance to increase the accuracy of population statistics, including inter-municipal travel-to-work community flow data. Thus, it is critical to conduct the next population census as soon as possible. Distortions in population statistics result in inaccurate allocations of public funds to local budgets, because subsidies, transfers and fiscal equalisation mechanisms are tied to official population numbers. A gradual reform of the residence registration system is also necessary, since it leads to the gap between official statistics and the actual population numbers in many areas.

Ukraine's index of geographic concentration of population stood at 19% in 2015, compared to the OECD median of 37%. There is room for further concentration of population in Kyiv and the most dynamic urban agglomerations. If well managed, this could boost productivity and growth. Given that the largest urban agglomerations extend across administrative boundaries, Ukraine's policy makers need to focus on FUAs rather than administrative entities. Defining urban areas as functional economic units can help improve a wide range of public policies in urban agglomerations, including transport, infrastructure, housing and schools, and space for culture and recreation. It can also foster much needed horizontal co-operation between large cities and adjacent districts and towns.

Interregional disparities have increased and reflect regional specialisation

Territorial inequalities are high by OECD standards – in terms of gross domestic product (GDP) per capita, disposable household income per capita and living conditions. Ukraine inherited substantial regional imbalances from the Soviet era, which were exacerbated during the transition recession in the 1990s. Interregional disparities have continued to rise since the turn of the century, with a marked increase since the Donbas conflict erupted in 2014. The rapid economic development of the Kyiv agglomeration is a major factor behind rising territorial disparities: Kyiv city and the surrounding *oblast* (region) accounted for almost 60% of national GDP growth in 2004-14. Kyiv will continue to play a leading role, and the possibility of greater interregional disparities should not be excluded.

At the same time, some Central-Western regions have been "catching up", forming a central growth cluster to the west and south of Kyiv. This reflects the good performance of the agricultural sector but also the resilience of light manufacturing during the recent economic crisis. By contrast, heavy manufacturing sectors and mining, which are highly concentrated in Eastern Ukraine, have underperformed since 2010. Recently, the disruption of trade with separatist territories, rising energy prices and reduced access to the Russian market have further damaged the outlook for heavy manufacturing. Western and Central Ukraine are well-positioned to benefit from closer integration into cross-border, EU-wide manufacturing supply chains.

Labour market inefficiencies constrain regional growth

The 2014-15 recession triggered a drop in activity, with the official unemployment rate rising to 9.3% – the highest level since 2005 – and youth unemployment reaching 16% in 2016. The functioning and economic integration of regional labour markets has therefore become a major concern. Integrating internally displaced people into the labour market is a challenge in many regions, particularly in the government-controlled areas of Donbas. To improve the efficiency of labour markets, policy makers could do more to bridge the gap between the skills needed in the workplace and the formal education and training systems, and to reduce labour market informality. High levels of informality can impact fiscal sustainability, particularly local budgets, which rely heavily on personal income tax receipts. The government should refrain from any further increase in the minimum wage, because this could jeopardise small and medium-sized enterprises in some of Ukraine's less developed regions, and push them toward the informal sector.

Citizen engagement and electoral participation are low

Electoral participation is low in Ukraine and displays strong spatial patterns. Western regions have a higher voter turnout, and there is a negative correlation between electoral participation at local elections and the perceived corruption of city administrations. Results from the Ukrainian Municipal Survey conducted in 2017 suggest positive trends in the perceived quality of local public services and in citizen satisfaction with city administrations. If sustained, this trend could translate into increased trust in government and increased citizen engagement at the local level.

Recommendations to strengthen Ukraine's regional development policies

To realise the full productive potential of Ukraine's regions and boost aggregate growth, the OECD recommends that the government:

- Strengthen agglomeration economies in Kyiv and the largest cities, by:
  - Considering functional urban areas as a basis for the design of urban policies, such as transport, infrastructure development and spatial planning.
  - Fostering horizontal co-operation between large cities and adjacent districts and towns.
- Adjust the urban planning system to mitigate the negative side effects of population ageing and decline, by:
  - Adapting infrastructure and service provision for an ageing population.
  - Conducting the next population census as soon as possible, to improve the accuracy of population statistics.
  - Reforming the residence registration system, so that registration statistics more accurately reflect internal migration patterns.

To address territorial inequalities and foster regional growth, the OECD recommends that the government:

- Increase efforts to integrate internally displaced persons into the labour market through targeted labour market programmes, such as a fast-track access for unemployment registration.
- Reduce labour informality by bridging the gap between skills needed in the workplace and the formal education and training systems.
- Refrain from any further increases to the minimum wage, as this could jeopardise the operations of many small and medium-sized enterprises, pushing them towards the informal sector.
- Strengthen revenue administration and scale up efforts to tackle low tax compliance.
- Foster citizen engagement in local affairs and higher electoral participation through increased transparency and reduced corruption.

Advances in territorial and multi-level governance reform since 2014

Since 2014, Ukraine has made great strides in modernising its approach to territorial governance: the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power in Ukraine outlines a strategy for boosting democratic governance at the subnational levels through broad-based decentralisation; voluntary municipal mergers launched in 2015 are rapidly addressing problems of administrative fragmentation at the municipal level; and an approach to regional policy is evolving in a practical fashion. Local leaders and citizens are starting to notice a positive change in the administrative and service capacities of municipalities. All of this helps to strengthen

Ukraine's development, improving quality of life and well-being, and building a more resilient state.

Ukraine's decentralisation reform nevertheless faces some important obstacles, and conditions for effective decentralisation are not clearly in place. Additionally, certain framework conditions for better public governance, such as more effective government and control of corruption, need to be addressed if Ukraine's reform process is to succeed. Primary among the obstacles faced is a constitutional block, rendering it necessary to implement the vision contained in the Concept Framework by passing individual pieces of legislation that advance at different speeds and are subject to the intervention of diverse interests. Implementation challenges are compounded by the limited extent to which conditions for effective decentralisation are being met, including the clear assignment of responsibilities, appropriate co-ordination mechanisms and sufficiently capacitated municipalities.

Ensuring an enabling environment for decentralisation reform

Ensuring an enabling environment in which decentralisation reform can flourish will mean taking a stronger approach to building government effectiveness and controlling corruption, both of which continue to be chronic challenges in Ukraine. Between 2006 and 2016, Ukraine dropped from 37th to 32nd place for government effectiveness and from 25th to 20th in percentile rank for control of corruption according to the World Governance Indicators. Of particular concern is that 72% of Ukrainians do not feel that citizens can do much to prevent or stop corruption, and citizens in regional capital cities consider municipal authorities to be powerless in fighting corruption, perceiving anti-corruption efforts to depend on the central government. There is no easy solution, and in-depth analysis and concrete recommendations in this area are outside the scope of this report. Nonetheless, a well-designed and implemented decentralisation process has the potential to increase transparency and accountability by leaders and enhance democratic governance, particularly at the local level. This, in turn, could go a long way in helping improve government effectiveness and fight corruption, thereby contributing to better conditions for successful reform implementation.

Striking a new territorial balance: Unified territorial communities and **rayon**

In the absence of the constitutional reform necessary to implement the Concept Framework, Ukraine's decentralisation process is driven by a trio of laws introduced between 2014 and 2015. Through the creation of unified territorial communities (UTCs) via voluntary amalgamations, inter-municipal co-operation and changes in the budget code to promote greater fiscal decentralisation, Ukraine has started building the territorial and fiscal capacity to transfer responsibilities and resources to local governments. The voluntary amalgamation process can be considered highly successful by international standards. Between 2015 and October 2017 over 2 000 local self-governments had merged to form 614 UTCs. At the same time, the heavy emphasis on municipal amalgamation is creating a territorial imbalance, resulting in at least two distinct challenges for decentralisation.

First is the need to maintain the momentum of amalgamation. The UTCs form the cornerstone of Ukraine's decentralisation process, as only the UTCs (together with certain categories of city) are empowered to take planning and development decisions for their territories, to assume service responsibilities devolved from the intermediate – *rayon* – government level, and to negotiate their budgets directly with their corresponding regional government, the *oblasts* (TL2 equivalent).

However, amalgamations may face limitations arising from current eligibility criteria, a distrust of the reform process among communities and structural obstacles linked to incomplete reform. Unless all relevant communities amalgamate, decentralisation risks remain a patchwork across the territory. One way to avoid this is to set a time limit for voluntary amalgamations, after which they should be required. In addition, unless a constitutional reform is passed, consideration will need to be given to extending decentralisation benefits to local self-government units which are currently excluded from the process (e.g. cities of *oblast* significance). A subsequent step would be to consider the development and activity of FUAs as mentioned earlier.

Second, the emphasis on transferring responsibilities and resources to the UTCs has created an administrative imbalance with the *rayon* level. Decentralising public services and administrative functions by devolving responsibilities from *rayon* to the UTCs without attributing new competences to *rayon* has amounted to "hollowing" them out. The process is creating parallel administrations, skewing the allocation of responsibilities, and generating inequality in service quality, type and access at the local level between the UTCs and the local self-government units that remain under *rayon* tutelage. This is inconsistent with several conditions for successful decentralisation reform, including the need to clearly delineate the assignment of responsibilities among levels of government, and to generate a capacity to manage change. It can also create an obstacle to amalgamation by those *rayon* state administrations that feel a political and administrative threat. Ultimately, it is also leading to inefficient and ineffective subnational administration at the intermediate level and less than potentially efficient and effective administration at the local level.

To continue supporting the municipal amalgamation process, the most expedient and effective way to address the territorial imbalance might be to introduce reform at the intermediate level. Two approaches are immediately apparent. The first is to re-evaluate *rayon* borders along functional lines, creating "catchment" areas or districts for specific higher level services, such as hospitals. Another option is to promote *rayon* amalgamations as a means to upscale and create the conditions for the delivery of multiple second-level services (e.g. specialised healthcare, education and social services), ensuring also a clear set of responsibilities and stable incentive structure. Both of these alternatives could either be introduced uniformly across the territory or in an asymmetric manner that reflects settlement or functional patterns. An "experimental" or pilot approach could also be taken, testing for size, population, resource, responsibility and service criteria.

Ensuring that effective horizontal and vertical co-ordination starts at the top

Successful implementation of a reform as complex as Ukraine's requires effective horizontal and vertical co-ordination mechanisms, starting at the highest levels. Institutionalised guidance from a centre-of-government co-ordinating body could be strengthened. Such an entity could help minimise the possibility of overlapping activities, inefficient use of resources, policy incoherence, misaligned priorities, and poor policy and programming integration. While the Ministry of Regional Development, Construction and Utilities (henceforth Ministry of Regional Development) has been instated to implement the decentralisation agenda and ensure that its objectives are reached, it faces resource challenges and a siloed institutional culture. Stronger co-ordination among stakeholders at the national level and among central and subnational authorities is necessary to reach decentralisation goals. A high-level, cross-sector decentralisation council could provide necessary support in this area. Committees to support multi-level governance and decentralisation reform have been successfully established in countries as diverse as Denmark, Japan and New Zealand.

Through Ukraine’s reform process, subnational governments are becoming increasingly responsible for – and successful at – development planning for their regions and communities. However, ensuring that objectives and priorities are aligned, particularly in areas where responsibilities and/or interests overlap (e.g. economic development, transport, health and education) requires clear communication and dialogue. Reinforcing vertical co-ordination mechanisms that foster a partnership-based relationship among levels of government will, therefore, become increasingly important, especially as communities become more empowered. Dialogue bodies can help accomplish this, while also building trust in a reform process.

An explicit decentralisation policy that supports the implementation of the strategy outlined in the Concept Framework would be another powerful co-ordination tool. It would support reform implementation in light of the constitutional block, establish a consistent course of action for government and other institutional actors to follow with respect to the key activities supporting the reform, and provide guidance on how to address challenges that arise. An accompanying action plan would also be important for establishing priorities and guiding implementation as well as sequencing. To better reinforce the National Strategy for Development and to increase potential for success at a territorial level, such a policy should be articulated with the input of diverse government and non-government stakeholders. When there is agreement on what is to be achieved and how, the process becomes more collaborative, integrated and likely to succeed.

Reinforcing advances in the amalgamation process

Ukraine’s amalgamation process faces a gap between the rationality of the planning exercise and the realities of the implementation process. The “prospect plans” established by *oblast* state administrations granted the UTCs sufficient capacity to meet the administrative and service requirements associated with decentralisation. Amalgamating communities were not required to follow the plans when selecting amalgamation partners as long as they joined with contiguous communities. This has resulted in creating UTCs that are under capacitated for their responsibilities. In light of this, there is also a question as to whether the UTCs will be able to meet additional, and costly, delegated responsibilities, especially in healthcare and education. The situation could be better managed with an implementation framework to guide the process at the ground level.

Inter-municipal co-operation is rapidly gaining ground. The number of agreements rose from 43 in mid-2016 to over 80 by July 2017. The increase in UTCs contributed to this as they have a broader mandate than non-amalgamated communities to deliver services in areas where co-operative agreements are popular. Such agreements, generally most successful when supported by higher levels of government (e.g. *oblast*), serve as a precursor to amalgamation. They are particularly valuable in overcoming challenges associated with delivering basic but costly services, such as waste management, to support under capacitated UTCs, and to encourage co-operation in “second-tier” services, for example the Internet, “back office” administrative services and finance functions. More active dissemination of the possibilities contained in the inter-municipal co-operation legislation and the dissemination of achievements and good practices would further support such co-operative activity.

Embedding advances in regional development, 2014-17

Ukraine has quickly refined its approach to regional development. It has introduced new perspectives by building capacity for regional development policy design at the *oblast* level. The government has also introduced new methodologies and has elaborated its State Strategy for Regional Development according to European planning standards and synchronising this with EU planning and budget cycles. Activities to build capacity and capability among subnational authorities should remain on the agenda. Moving forward, consideration should be given to identifying techniques that balance the current emphasis of development via "hard infrastructure" investment with development through "soft infrastructure" (e.g. innovation, research and development, skills, entrepreneurship, etc.).

Establishing the State Fund for Regional Development, which links planning to financing, was a strong step forward for regional development. Yet changes introduced in 2017 to the fund's own financing mechanism eliminate the stability and planning capacity associated with the initial disbursement method and render medium- and long-term development planning even more difficult for subnational governments. There are also concerns arising from a change in the fund's management practices that signal a potential limitation on subnational autonomy in development-policy prioritisation, decision making and financing. The change may also lead to clientelistic practices given a politicisation of the mechanism to attribute funds. Overall, care should be taken to avoid back-sliding into counterproductive practices of the past. It is important to institutionalise the positive advances made in regional development and further build a culture of capacity and commitment to reform.

Key recommendations for maintaining momentum in Ukraine's decentralisation process

To reinforce and maintain the momentum of amalgamation, and expand the progress of decentralisation, the OECD recommends:

- Improving the stability and clarity of the amalgamation and decentralisation processes, including by:
  - Establishing a legal basis for the administrative, territorial and institutional status of unified territorial communities, which includes a minimum size (i.e. population, territorial coverage or both).
  - Ensuring consistency in the incentive structures offered for amalgamation: once they are introduced they should remain solidly in place.
  - Setting and communicating a clear time frame for voluntary amalgamation after which amalgamation becomes a requirement.
- Addressing problems of insufficient capacity after amalgamation, which undermines the decentralisation process, by:
  - Encouraging amalgamations that yield capacitated municipalities by continuing the new approach of limiting amalgamations that are not in accordance with a prospect plan; facilitating additional or "second-generation" amalgamations.
  - Reinforcing inter-municipal co-operation to encourage future amalgamation and address service capacity gaps by offering incentives for projects that generate co-operation in innovative and second-tier services; legally facilitate co-operation between the UTCs and their non-amalgamated neighbours; diversify incentive mechanisms for co-operation through financial means (e.g. additional funds for joint public investment proposals) or non-financial means (e.g. consulting or technical service assistance).

To strike a better balance in territorial reform and to ensure the conditions for successful decentralisation, the OECD recommends:

- Reforming the *rayon* level to continue supporting the amalgamation process, by considering:
  - An adjustment to responsibilities targeting delivery of higher level services by introducing functional districts for a specific higher level service (e.g. hospitals), or by promoting cross-jurisdiction co-operation, or piloting *rayon* amalgamation in one or two select *oblast*.
  - Minimising the incentives and opportunity for clientelistic behaviour and patronage in the provision of services at the *rayon* level through civil service reform, strong contractual agreements between levels of government and enhancing open government practices.
- Strengthening co-ordination mechanisms to ensure that actors in the reform process are moving in the same direction and that priorities are well aligned. This includes:
  - Strengthening centre-of-government practices to better manage horizontal and vertical co-ordination needs, for example by reinforcing the capacities of the Secretariat for the Cabinet of Ministers or expanding the remit of

another existing body to undertake centre-of-government office activities (e.g. the Reforms Delivery Office).

- Establishing a high-level inter-ministerial council or commission specifically for decentralisation to boost inter-ministerial co-ordination capacity and better support an integrated reform process across sectors.
- Launching a cross-sector, multi-level dialogue body dedicated to decentralisation reform (strategy, policy, programming, etc.) to strengthen dialogue and co-operation among different levels of government, build synergies, and boost trust in reform.
- Introducing an explicit decentralisation policy to establish a consistent course of action for decentralisation stakeholders, using it also to guide institutional actors with respect to decentralisation activities and managing challenges that arise.

- Clearly assigning responsibilities and functions to different levels of government to help build efficiency in service provision and policy making, and to support greater accountability of government, by:
  - Identifying and distinguishing clearly responsibilities in sector-, service- and development-related tasks (e.g. transport, education, infrastructure, economic development), and operational functions (e.g. strategic planning, financing, regulating, implementing, monitoring).
  - Ensuring that ascribed responsibilities are legally supported.
  - Including and maintaining minimum services standards to be met, and strengthening monitoring and evaluation practices.

To continue promoting regional development, the OECD recommends:

- Addressing recognised weaknesses in the project planning and approval phases:
  - Continue initiatives to strengthen civil service capacity and skills in designing, presenting and implementing project proposals with added economic development value for the local and regional levels.
  - Rectify structural aspects in the project approval phase that may favour certain municipalities or carry a political bias.
  - Strike a balance in the types of projects being approved and funded to ensure that both “hard” and “soft” infrastructure development is promoted.
- Addressing the challenges relating to the State Fund for Regional Development, by:
  - Reintroducing stability into the fund’s own financing mechanism.
  - Returning to the original formula system of fund disbursement which gave subnational governments visibility with respect to available development funds; increased funding certainty; and facilitated short-, medium- and long-term development planning.
  - Reducing the possibilities of patronage and clientelism by eliminating political representation on the project approval committee.

Moving beyond amalgamation with fiscal decentralisation and enhanced local management

Fiscal decentralisation is at the core of Ukraine's decentralisation process. It is supported in Ukraine's 1996 Constitution; the 1997 Law "on Local Self-Government"; the 1997 ratification of the European Charter of Local Self-Government; and the Budget and Tax Codes, which establish the basic rules concerning local government funding, budgetary relations and equalisation mechanisms. However, the principles contained in these frameworks have not been fully carried out, despite moves to increase subnational government fiscal resources and improve the transparency and predictability of inter-budgetary relations. Until the introduction of Ukraine's most recent fiscal decentralisation reform in 2014-15, local financial autonomy was low, indicating the need for profound changes to advance genuine decentralisation in Ukraine.

Ukraine has a centralised structure of spending and revenues at the subnational level

Basic fiscal indicators suggest a decentralised country where subnational governments are responsible for 33% of public spending and 67% of investment, employ a large number of public servants, and collect 18% of tax revenue, a relatively high level. In reality, these indicators are misleading. As in many cases around the world, these numbers do not reflect the true degree of decentralised power.

Closer analysis shows that Ukraine remains a centralised country. First, despite their classification in national accounts as subnational governments, *oblasts* and *rayon* are not full self-governing entities. Their councils have very few powers, while their executive bodies are in fact territorial arms of the central administration. This means that all fiscal ratios are significantly overestimated.

Second, 78% of subnational government spending is executed on behalf of the central government to finance "delegated functions" (i.e. health, education and social protection). Subnational governments are responsible for running schools and hospitals and providing social protection, including social benefits and services. They are also responsible for paying teachers and medical/social staff, which explains why 56% of total public staff spending is subnational. By contrast, subnational governments have few resources to carry out their "exclusive functions", i.e. constructing and maintaining local roads and housing, providing municipal utilities (i.e. water and sanitation, waste collection, heating, etc.) and local transport, as well as developing cultural and leisure facilities and activities. Similarly, burdened by the weight of current expenditure, their investment capacity is low.

Third, subnational governments have a low level of autonomy in the management of their revenues. The subnational funding system is dominated by central government transfers, representing 60% of revenues, while the share of tax revenues decreased from 62% in 2001 to 30% in 2015. Moreover, tax revenues are mainly composed of shared taxes (personal income tax, corporate profit tax, excise and environmental taxes, etc.). Own-source tax revenues, together with other sources of own revenue (e.g. user charges, administrative fees, revenues from assets, etc.) are quite limited. Overall, subnational governments only have control over about 30% of their resources.

Finally, access to external funding is almost non-existent. It is reserved for large cities, controlled by the central government (i.e. requires prior authorisation) and subject to strict prudential rules. Borrowing is under-developed, accounting for 0.5% of GDP and

0.6% of public debt. This is understandable given the pressure from the international community to reduce the debt. Nevertheless, in the future there may be room for some adjustment in this area.

The 2014-15 fiscal decentralisation reforms have introduced changes

The 2014 Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power took full measure of the importance of the fiscal challenges to advance the decentralisation agenda. However, it was not supported by a specific strategy and implementation plan dedicated to fiscal decentralisation. Reforms addressed intergovernmental grants, shared and own-source taxes, non-tax revenues, borrowing, and financial budgeting and management. In addition, with the amalgamation process, the UTCs now have their own budgets comprised of personal income tax and own-source taxes, grants and non-tax revenues, and have direct fiscal relations with the state budget.

The inter-governmental grants system has been substantially modified to improve the equalisation mechanism and the funding of key subnational responsibilities. It aims at ensuring more permanent, stable and efficient funding as well as enhancing predictability and transparency through clearer allocation of rules.

The large vertical compensation system has been replaced by a horizontal equalisation system (basic and reverse subsidies). Several formula-based central government grants have been earmarked to fund the education and health sectors, in addition to existing social grants. Capital grants and subsidies have also been established or reformed to support investment projects aimed at fostering regional development (State Fund for Regional Development) and improving social and economic territorial development and infrastructures in the UTCs (two new funds).

On the tax side, changes in the distribution of the personal income tax have decreased its weight in subnational revenues. At the same time, it has led to an increase for some subnational governments (e.g. cities of regional importance and the UTCs). However, it is no longer distributed to non-amalgamated communities. Overall, personal income tax remains the largest source of subnational tax and fees revenue (54% in 2016), but the method of “at-the-source” collection (i.e. where people work or where the employer is registered, and not where they live) creates a disconnect between the place where local services are delivered and the place which enjoys the personal income tax revenues. At the same time, new shared taxes have been introduced: the corporate profit tax for the regions and Kyiv and the retail excise tax for cities of *oblast* importance, the UTCs and other local communities. The list of local own-source taxes has been modified and local governments were given more tax and more ability to modify tax rates and bases.

Subnational governments also enjoy more freedom in managing their non-tax revenues, the share of which is increasing in their total revenues. Finally, borrowing rules have been loosened, and budgeting and financial management have been improved. For example, since 2015, subnational governments are authorised to open accounts in state banks (not only in the state treasury) to deposit their own revenues. In addition, they can roll over unspent funds originating from state grants from one year to the next instead of sending them back to the central government.

Fiscal decentralisation should be better “conceptualised” and monitored

The 2014-15 reforms have started to bring positive results for subnational budgets, nevertheless some important issues remain and new challenges have emerged.

Fiscal decentralisation reforms have been used as a transformation tool for the overall governance system. This has led to a new balance of power among subnational governments. The budgets of cities of *oblast* significance and the UTCs have increased substantially; *oblast* revenues have shrunk; and *rayon* revenues appear, to date, unaffected by the reform.

This pragmatic approach to reform has advanced the decentralisation agenda, shifted subnational organisation and responsibilities, and is leading to a new balance of power. But it may also produce outcomes that may be difficult to correct in the future. For example, the reduction of *oblast* budgets (and less visibly of *rayon* budgets) could contradict the initial decentralisation reform objective to create full self-government entities at the *oblast* and *rayon* levels. It also generates some instability and uncertainty. At this stage, fiscal decentralisation needs to be better conceptualised in a shared strategic fiscal framework and implemented according to a clear road map. This must include tools and indicators to permanently monitor its progress and assess reform outcomes. A "fiscal decentralisation committee" to improve the dialogue and co-ordination between central and subnational governments on fiscal matters could be established as a sub-committee of the "decentralisation committee" (recommended earlier).

Despite some real progress in fiscal decentralisation, the reform still tends to promote a subnational financing model based on grants and subsidies more than own revenues. Spending responsibilities should be more clearly defined and adjusted for delegated tasks. This could ease the burden of some delegated functions imposed on subnational governments (e.g. distribution of social benefits), and also enlarge their spending autonomy in delegated functions (e.g. investment in education) as well as other areas (environmental protection, transport, economic development, etc.). A review of competences and functions at all levels of government should be undertaken to clarify the breakdown of responsibilities and to assess the relevance of delegating or recentralising some tasks to subnational authorities. This reflection is urgent because numerous tasks are being transferred to the UTCs without a clear view of the impact in terms of charges and constraints.

The system of inter-governmental grants needs further improvement

The new horizontal equalisation mechanism aims at equalising subnational government tax revenues rather than expenditures needs. It is based on two taxes: the personal income tax (for regions, *rayon*, regional towns and communities) and the corporate profit tax (only for regional budgets). The main elements are a basic grant from the national budget to the local budget, and a reverse grant, i.e. funds transferred from the local budgets to the national budget to ensure horizontal equalisation. Local governments with tax capacity above average by at least 10% keep 50% of the revenue surplus. Local governments with tax capacity below 90% of the national average will receive a basic grant amounting to 80% of what is required to catch up with the average. Local governments with revenues between 90% and 110% of country's average are not subject to either compensation or deduction.

Despite early positive results, there are some concerns with this new system, particularly the low amount of the basic grant (1.3% of all subnational revenue in 2016), the reduced basket of taxes taken into consideration, the exclusion of Kyiv from the equalisation mechanism and the risks associated with an equalisation system based only on horizontal mechanisms. This "Robin Hood" system may be efficient in terms of "solidarity" (redistribution of tax resources from the "richest" to the "poorest" subnational governments) but not necessarily in terms of equity (fairness) across subnational governments, especially if the basket of tax sources for redistribution includes own-source taxes in the future. It may also have some counterproductive effects on local and regional development and be economically inefficient. If this trend is confirmed, adjustments would be needed in the medium term to combine solidarity, equity and economic efficiency principles. The impact of the equalisation system on these three aspects should be closely monitored to correct potential adverse effects.

The reform of sectoral grants is still in progress. Therefore, new funds continue to be distributed according to old methods, based on input indicators and historical data, which leads to a misuse of resources. New allocation mechanisms are urgently needed, but their design and implementation will require new capacities, procedures and data collection mechanisms at the central government level.

To move such a process forward, a comprehensive assessment of the quality of local public services would be necessary, including information about the actual effects of policies on service quality. This information is essential to ensure services better meet population needs, and supports a more efficient use of resources. Some progress has been made in the social services sector, for example, with a definition of state standards of social services. Overall, however, several adjustments are necessary across sectors. For instance, the level of sector funds should be guaranteed to adequately fund basic service provision based on minimum standards of delivery across the national territory, as these are still underfunded mandates. In addition, funds should integrate the need to finance capital investment in education, health and other sectors. Finally, the government should make the system more stable and coherent: 2017 saw funding instability and risks of inconsistencies between the new expenditure obligations of local governments and the revenue sources assigned to them.

The subnational tax system needs to continue to advance

In the medium and long term, the personal income tax should be collected where the taxpayers live, not where they work. This can be incorporated into a wider national tax administration reform which would reduce technical obstacles by introducing mandatory personal income tax filing by taxpayers. In addition, the excise tax on retail sales of excisable goods should be stabilised as a tax to benefit subnational governments.

Ukraine could undertake a comprehensive review of its own-source tax system to identify the main options for reform. The objective would be to develop a basket of taxes providing local governments with increased, stable resources, and flexibility to cope with economic, social or political changes. New national taxes could be also transferred to subnational governments. Existing local taxes should be optimised, in particular the transport tax, the land tax and the real estate tax other than land, which are still under-exploited, because of narrow tax bases, numerous exemptions, and the limitations of the current cadastre and real estate property register. The reform to build a modern unified cadastre and property register should be completed and valuation methods of lands and real estate properties should be improved to integrate market values. More globally, it is necessary encourage reluctant local governments to fully use their taxing power (generally not pursued for political reasons), in particular by rewarding local government tax effort.

Delivering better local public services through more transparent and efficient management tools

There are a number of municipal management tools that Ukraine could consider in order to improve service delivery while also building transparency. This includes a stocktaking of municipal companies in light of decentralisation in order to identify areas of potential reform that could increase their transparency, accountability and effectiveness. Support for inter-municipal co-operation could also be reinforced through stronger incentive mechanisms, including special subsidies or bonuses for inter-municipal projects, privileged access to capital funds, provision of subsidies for technical assistance, etc. The government could also consider supporting the creation of joint co-operation bodies under private or public law to ensure more financial stability, sustainability and long-term planning. Finally, inter-municipal co-operation could be fostered at the level of FUAs, in particular in metropolitan areas with dedicated funding.

Revenues generated by the delivery of public services could be optimised, as they are currently quite low and largely insufficient to cover service costs. The decentralisation of tariff setting in the heating and water sectors launched in March 2017 is a positive step, but it should be accompanied by a capacity-building programme in order to disseminate modern management and monitoring tools and practices within local governments. Besides tariff regulation, the system of privileges should also be revised to more fairly compensate local governments and to provide them with more powers to apply differentiated user charges and tariffs according to local characteristics rather than according to nationally defined social needs.

Further developing revenues generated by the use and improvement of public domain is another option. Doing so would require first completing the demarcation of local boundaries over the national territory and, second, strengthening the role of subnational governments in land management. To this end, the adoption of draft Law No. 4355 on the decentralisation of land management could be accelerated. The 2017 draft Law No. 7118 granting the UTCs the right to manage state-owned lands that are located within and beyond the boundaries of populated areas, and transferring to them the ownership of these lands goes in the right direction and should be also adopted as soon as possible. Ukraine could also consider developing further land value capture instruments, in particular the system of "shared participation in infrastructure development", already well developed in Kyiv. It could also draw inspiration from international practices in land-based financing instruments.

More effective public investment would further support regional development

Ukrainian subnational governments play a significant role in public investment and as a shared responsibility there is a need for effective co-ordination among levels of government. Ukraine should consider adhering to the OECD *Recommendation of the Council for Effective Public Investment across Levels of Government*, which could help it address systemic challenges for public investment in the context of the ongoing decentralisation reform. Meanwhile, four specific areas could be addressed by Ukraine to improve co-ordination mechanisms and establish sound framework conditions.

First, capital transfers, in particular the State Fund for Regional Development, should be more stable and more properly used for effective public investment. The project selection process should be more neutral and less sector-oriented. At the regional level, the criteria for fund allocation could be linked to state-region contracts and regional development plans. At the local level, technical assistance and capacity building should be provided to help the UTCs design and implement projects for territorial development and infrastructure.

Second, other financial instruments should be further mobilised to support investment. For example, the use of public-private partnerships (PPPs) at the subnational level could be developed to attract much-needed investment in local utilities. Based on the new PPP Law adopted in 2016, which aims to increase certainty and protect investors, this should be done with caution and reserved to regions, large cities and metropolitan areas with greater capacities. Several recommendations can be made to maximise the likelihood of success of subnational PPPs: a PPP unit specialised in subnational projects; a central registry of PPP projects; a training and capacity-building PPP programme; standardisation of subnational PPP projects; financial support for technical assistance, etc.

Third, efforts to promote transparency and the strategic use of public procurement at all levels of government should be pursued. The 2016 Law “on Public Procurement” is a step in the right direction. It approved the full transition of public procurement to the new electronic platform “ProZorro”, according to which all public procurements would be carried out electronically. A focus on the specificities of subnational procurement could help better assess the needs of the subnational public sector, provide guidance to subnational governments for procurement and support the professionalisation of procurement through training programmes and recognition of procurement officials as a specific profession.

Finally, the fiscal responsibility framework needs to be renewed. On budget rules, Ukraine could reform municipal budgeting to mitigate or even reverse the use of unfunded or underfunded mandates, setting the basic principle that there is no transfer of charges without the adequate transfer of funding and that the compensation should be consistent over time. As far as fiscal supervision is concerned, external and internal audit mechanisms should be adapted to the decentralisation context. In particular, internal audit should be compulsory and specific tools should be developed, thanks to specific financial support. The Ukrainian authorities should consider an extension of the remit of the Accounting Chamber of Ukraine to subnational governments. Finally, financial democratic oversight and accountability by local councillors, citizens and the civil society should be reinforced through specific instruments.

Fiscal decentralisation could be better supported with improved data quality and access

The lack of access to systematic and comprehensive data limits the scope of analysis and overall assessment of the fiscal decentralisation reform. In the context of decentralisation and the need to bring more transparency, consultation, and accountability to citizens and civil society, such data would be instrumental. Although some progress is underway, such as the Unified State web-portal of open data, more can be done to disseminate appropriate information in an appropriate manner. Ukrainian authorities may consider further harmonising Ukrainian data with international standards; improving data availability by categories or levels of subnational government for every budget item, including debt and over time; developing a website giving access to an easy database with government statistics covering all levels of government over time; developing a web portal with micro-data with individual accounts; and undertaking a comprehensive, clear and updated inventory and developing monitoring tools of local assets.

Advancing further in building subnational government human capacities

One of the most critical challenges facing Ukraine's decentralisation reform, and a key condition for reform success, is the human capital and capacity to effectively carry out responsibilities at the local level, especially in the UTCs. It is expected that the decentralisation reform will reduce the number of central government civil servants by about 30%. In turn, subnational governments will have to absorb part of this staff and recruit new workers to carry out the transferred functions. It will generate important challenges in terms of status, salaries, working conditions, mobility, etc. The shortage of staff may become problematic in some regions.

As a result of the decentralisation reform and the reallocation of responsibilities, there is a particularly pressing need to improve skills at the community level, especially in the UTCs. Mechanisms are in place to support subnational capacity building (e.g. National Agency of Ukraine on Civil Service, and the National Academy for Public Administration under the President of Ukraine, etc.) but they will need to be substantially strengthened to meet the challenges brought by the decentralisation process and to adapt the Ukrainian training system to European standards.

Key recommendations for improving fiscal and human capacities

As general principles to sustain and further deepen fiscal decentralisation, the OECD recommends:

- Better conceptualising fiscal decentralisation in a shared strategic fiscal framework, implemented according to a clear road map that includes monitoring tools and indicators.
- Setting up a permanent sub-commission dedicated to fiscal issues, this could be part of the decentralisation committee or council recommended earlier.
- Acting on the side of revenues, in particular by increasing own-source revenues, but also on the expenditure side. Undertake a review of competences and functions to clarify the breakdown of responsibilities across levels of government and to assess the relevance of further delegating or recentralising some tasks.
- Avoid creating a "two-speed system" between dynamic UTCs and the other local communities which continue to resist amalgamation and increase the UTCs' fiscal capacities.

To improve the system of intergovernmental grants, the OECD recommends:

- Closely monitoring the impact of the new equalisation system on solidarity, equity and economic efficiency to be able to correct potential adverse effects.
- Designing and implementing new allocation mechanisms of sectoral grants according to a demand-driven approach, based on output indicators and quality standards.
- Supporting line ministries to increase their capacities, procedures and data collection mechanisms to manage their new responsibility as fund managers.
- Developing a comprehensive assessment of the quality of local public services.
- Guaranteeing the level and stability of funds to adequately finance delegated functions and avoid underfunded mandates and inconsistencies from one year to the next.
- Integrate capital funding in sectoral grants.

To improve the subnational tax system, the OECD recommends:

- On tax-sharing arrangements:
  - Changing the system of personal income tax collection to the place of residence instead of the place of work.
- On own-sources taxes:
  - Undertaking a comprehensive review of the Ukrainian own-source tax system to identify the main options for reform and create a balanced "basket of local taxes": creating new taxes, new transfers of national taxes, optimisation of existing local taxes. In particular, enlarging the tax base of the real estate tax other than land and setting-up a minimum tax rate to avoid under-taxation.

  - Completing the modernisation of the unified cadastre and property register and improving valuation methods of lands and real estate properties to integrate market values.
  - Encouraging reluctant local governments to fully use their taxing power, in particular by rewarding local government tax efforts.

To deliver better local public services through more transparent and efficient management tools, the OECD recommends:

- Taking stock of the situation of the "municipal economy" and municipal companies, considering the challenge faced by decentralisation, and designing a reform for more transparency, accountability and effectiveness.
- Further reinforcing inter-municipal co-operation to make it a common and efficient tool for delivering public services through increased incentives, promoting "joint co-operation bodies" and developing inter-municipal co-operation in metropolitan areas with dedicated funding.
- Optimising revenues generated by the delivery of public services to better cover costs of services; decentralising tariff setting accompanied by a capacity-building programme at the local level to carry this out in a modern and efficient manner; and revising the system of privileges.
- Developing revenues generated by the use and improvement of the public domain:
  - Completing the demarcation of local boundaries over the national territory.
  - Strengthening the role of subnational governments in land management by accelerating the adoption of draft Law No. 4355; adopt draft Law No. 7118 concerning land management in the UTCs.
  - Further developing land value capture instruments.

To improve the governance of public investment across levels of government for regional development in Ukraine, the OECD recommends:

  - Adhering to the OECD *Recommendation of the Council for Effective Public Investment across Levels of Government*.
- Reviewing how the State Fund for Regional Development and funds for territorial development and infrastructure are distributed to better support regional development and decentralisation.
- Developing state-region contracts for regional development.
- Developing subnational borrowing by loosening borrowing rules and developing a more diversified local debt market (loans and bonds).
- Developing, with caution, subnational PPPs for regions and large cities with adequate capacities and with special support (e.g. a PPP unit specialised in subnational projects, a central registry of PPP projects, a training and capacity-building PPP programme, standardisation of subnational PPP projects,

financial support for technical assistance, etc.).

- Promoting transparent and strategic use of public procurement, especially at subnational level through specific guidelines and strengthening human resources.
- Improving the budgetary and fiscal rules framework:
    - Introducing a budgeting rule forbidding unfunded or underfunded mandates.
    - Making internal audit compulsory and developing tools and financial support to help local governments to this end.
    - Improving external audit by extending the remit of the Accounting Chamber of Ukraine to subnational governments.

To improve quality and access to data on subnational finance and assets, the OECD recommends:

- Continuing to harmonise Ukrainian data to international standards and improving data availability by categories/levels of subnational government for every budget item, including debt and over time.
- Developing an easy-to-use database with government statistics covering all levels of government over a long period, accessible on line and establishing a web portal with micro-data with individual accounts.
- Undertaking a comprehensive, clear and updated inventory of local assets and developing monitoring tools for these.

To support decentralisation with improved human resource capacity, the OECD recommends:

- Designing a subnational strategy for human resources management.

- Significantly stepping up support for training regional and local officials:
    - Enlarge the National Academy for Public Administration's mission to develop training programmes targeted at subnational governments.
    - Support the establishment of a national consultation platform on reforming the training system for local authorities.
    - Request and support (technically and financially) subnational governments to build an annual training plan.
    - Establish specific training actions for senior managers in local government.
- Set up an observatory of local employment, remuneration and competences.
- Reinforce the human resources management function in subnational governments with HRM professionals. In smaller local authorities this could be accomplished through inter-municipal co-operation (i.e. municipal association and shared back offices).
    - Favour mobility across levels of government (central and subnational governments) and within subnational governments.

Decentralisation in Ukraine's transport sector: A case study

While significant progress has been made in advancing the decentralisation reform in Ukraine, carrying this forward in the transport sector will require a more co-ordinated approach to boost investment in transport infrastructure, strengthen local capacities to improve public transport services, and leverage new technologies based on mobility-related data. Across the country, legacy public transport systems inherited from Soviet times are in a dilapidated state, and after years of underinvestment, public transport services are struggling to cater to complex and evolving travel demand patterns.

Transport infrastructure suffers from chronic underinvestment

Ukraine's economy is highly transport-intensive (more than ten times the EU average), and transport infrastructure suffers from decades of chronic underinvestment, high wear and tear, and increasing gaps between supply and demand. Investment in fixed assets in the transport industry (excluding pipeline transport) has declined progressively since 2011, reaching 0.2% of GDP in 2016 (compared with an average level of 0.75% across the OECD in 2015).

The poor quality of transport infrastructure constrains economic growth and productivity, with the country ranking in the lower half among OECD and non-member European countries with respect to the perceived quality of road, rail, sea port and air transport infrastructure in 2016. Road development and repair have lagged behind traffic growth – 50% of roads do not meet national roughness standards, and 40% do not meet national road strength standards. Consequently, the average speed on highways is one-third to one-half of the average speed observed in Western Europe, and car accidents and fatality rates are significantly higher than levels observed across the OECD.

The railway network has a higher density than in most OECD countries, and accounted for 58% of freight turnover throughout Ukraine in 2015. The infrastructure is often shared between passenger and freight trains, decreasing the average speed of service. The average age of locomotives and passenger cars owned by the national railway company Ukrzaliznytsia is above 40 years. Additionally, the vast majority (80%) of the infrastructure in Ukraine's 13 sea ports is either obsolete or in a depreciated state. An estimated 11% of berths are not functional, and the lack of multimodal logistics infrastructure and underdevelopment of container facilities raise the cost of shipments.

Air transport is mostly used by international passengers, with the Kyiv agglomeration accounting for 75.6% of all air passengers in 2016. The regional airport infrastructure is obsolete and financially dependent on municipal or regional (*oblast*) administrations. In most cases, local authorities as owners of airport infrastructure lack the necessary funding to invest in airfield repair and modernisation, and therefore lobby the central government to obtain the necessary funds.

Governance structures are overly centralised and there is a lack of clarity in the allocation of responsibilities across institutions

The governance of Ukraine's transport sector remains highly centralised at state and regional levels. While the share of the central administration in total transport spending has fallen substantially, from 74% in 2015 to 52% in 2016, much of this decline was absorbed by regional (*oblast*) administrations, the Kyiv city administration and cities of regional subordination, whose combined share in transport expenditures rose from 20% in 2015 to 37% in 2016. The contribution of the UTCs to transport expenditure reached

1.3% in 2016, and can be expected to continue increasing as further progress is achieved in municipal amalgamations and fiscal decentralisation.

The management of the extensive network of state roads is currently centralised under Ukravtodor and its 25 regional branches. Local authorities have limited capacity to ensure local road operations and maintenance: approximately 69% of paved roads in Ukraine are classified as local roads, yet subnational administrations accounted for just 40% of spending on roads. The maintenance and operation of most state roads will be transferred to the regional level in 2018, and the state road agency Ukravtodor will focus on motorways of national significance. A new national road fund is being set up to finance road maintenance and repairs: 35% of the fund will accrue to the regions.

The scale of urban public transport often extends beyond the administrative boundaries of cities, creating significant obstacles to the co-ordination of transport policy across municipalities. A top-down approach to transport planning prevents local governments from responding to spatial expansion and changing mobility patterns in urban areas. However, the ongoing decentralisation reform and voluntary municipal amalgamations are helping to build scale and capacity at the local level, allowing for the provision of higher quality and more affordable public services. Fiscal decentralisation is providing a strong stimulus for urban transport infrastructure and services by allowing autonomous and empowered local administrations to generate sustainable sources of income and improve the efficiency of public expenditures.

At present, there are no inter-ministerial working groups or official mechanisms for cross-ministerial co-ordination on transport policy in place. In large metropolitan areas such as Kyiv, effective planning of public transport services is hampered by inadequate co-ordination between the central government, *oblast* and city administrations, subsidiary organisations, and neighbouring municipalities. New laws and regulations relating to transport infrastructure and mobility should be developed in consultation with the relevant line ministries and local authorities.

The new Transport Strategy 2030 can help to strengthen the co-ordination of transport policy

The new Ukraine Transport Strategy 2030 can be an effective tool to structure and co-ordinate interventions relating to the sector. It is vital to develop realistic targets and milestones for implementation, ensuring that transport master plans are fiscally constrained and therefore likely to be fully funded. For instance, the transport strategy estimates annual road investment needs to be about UAH 35-40 billion, which is significantly higher than the current level of spending on roads (UAH 25 billion in 2016).

Given the complexity of existing institutional structures, urban transport development in metropolitan areas requires effective co-ordination within administrations (across departments) and across different levels of government. City administrations could work more closely with municipal companies and private transport operators to establish an integrated public transport system. In the Kyiv agglomeration, co-ordination on land-use planning and housing developments with the municipalities surrounding Kyiv city is essential, as many of their residents make frequent trips to the city to access employment and services.

Further promotion of inter-municipal co-operation (IMC) on public transport provision is also needed. Out of the 133 ongoing IMC projects listed on the website of the Ministry of Regional Development, 3 relate to transport service projects and 16 are road repair and maintenance projects. The government could also consider expanding IMC agreements between the UTCs and non-amalgamated communities. Such agreements can act as a precursor to amalgamation, by helping to better integrate isolated populations with neighbouring localities.

Public transport is hindered by weak financial and managerial capacities at local levels

Local governments in Ukraine lack the financial capacity to invest adequately in the maintenance and renewal of urban public transport infrastructure. Low density in rural areas is a particularly challenging issue, leading to weak physical and operational integration of transport networks. This is compounded by the limited operational and managerial capacity at local levels. Traditionally, transport policy and spatial planning were not undertaken by municipal authorities in Ukraine, and were only partially undertaken by regional administrations.

Ensuring that local administrations have sufficient funding and adequate capacities to manage local roads, particularly in small towns and rural areas, should be a central part of the road decentralisation agenda. However, revenues from transport-related taxes and charges are extremely low across all regions. The government could bridge the financing gap by developing toll roads and leveraging road user charges, parking fees and speed enforcement charges. Introducing value capture taxes can also help cities to raise revenues to finance the construction and maintenance of transportation infrastructure. In large urban agglomerations, taxes and charges should reflect the costs of negative externalities, such as congestion and pollution.

Public transport in Ukraine is highly affordable when compared with cities in OECD member countries, even after accounting for relative differences in incomes. About 50% of passengers are eligible for generous fare discounts and exemptions, which reduces the sustainability of public transport financing. Subsidies for public transport operators are also high, leading to fewer available funds for maintenance, inspections, upgrading of infrastructure and replacement of rolling stock. Introducing zonal fare systems and improving fare integration across different modes of transportation can help to put public transport financing on a more sustainable footing. Care should be taken when increasing public transport fares in order to mitigate the impact on low-income populations and avoid creating incentives for increased private car usage.

Better enforcement of regulations in a more competitive environment can improve the quality of public transport services

Weak enforcement of parking controls and traffic regulations creates congestion in urban areas, leading to lower operating speeds for public transport services. Public transport often competes with privately owned minibus services (*marshrutka*), resulting in inefficient service duplication and fewer revenues for local administrations to recover the costs of public transport provision. The lack of co-ordination across jurisdictions on public transport provision is compounded by the limited capacity in city administrations to undertake inspections, impose appropriate sanctions, and encourage operators to conform to performance standards and regulations. Inspection teams are often understaffed and do not have adequate supervision and enforcement powers.

Poor road safety and a high number of road traffic accidents also leads to reduced mobility in urban areas, creating strong incentives for private car use. Better enforcement of vehicle and emissions standards can help to encourage more non-polluting modes of transport, such as walking and cycling. Establishing strong environmental standards for public transport could help to reduce air pollution and further increase efficiency in transport networks. It could also help to reduce inefficient competition between unlicensed private operators and official public transport routes.

The rights to operate public transport services are typically held by municipal enterprises. Incumbent providers are the only applicants for some 90% of tenders for existing routes, reflecting the high risk and lack of a competitive environment for new entrants. Allowing city administrations to franchise routes and attract private operators that adhere to standards and regulations can help to improve the quality, efficiency and financial sustainability of public transport services.

Mobility data can revolutionise public transport provision in Ukraine

Incorporating commuter flows and travel cost data into sophisticated transport models would allow for more detailed analysis of transport flows and help to monitor the impact of any changes implemented in public transport systems. Mobility-related data can help public transport authorities to identify periods of low demand, areas that are poorly served by public transport, or specific segments of the population (e.g. elderly, handicapped) in need of specialised mobility solutions. Strong data literacy and sufficient capacities to exploit new streams of data are necessary for local administrations to take full advantage of new technologies.

Demand-responsive transport provides flexible transportation services in response to customer demand, and has strong potential to improve the provision of public transport services in rural areas. The design of demand-responsive transport schemes (e.g. routes, location of stops, frequency of services, etc.) should be developed in close consultation with users, and it is essential to select vehicles in line with the density of demand.

Managing shrinking cities, ageing and declining rural populations will be an important challenge for Ukraine in the years ahead. As the scale of service provision declines in rural and low-density areas, cost savings can be channelled into strategic investments to improve the quality of transport services, leading to more efficient, reliable and affordable transport solutions. Successful interventions to improve passenger comfort and convenience have included reducing seat density, using smaller vehicles and improving service reliability (e.g. by making transport timetables and live traffic information available through mobile applications). Not-for-profit community bus services can also be an effective mobility solution for rural areas.

Improving logistics performance and port-city relations

Much can be done to strengthen the performance of logistics systems in Ukraine. According to the World Bank's Logistics Performance Index, the weakest performance is observed in the areas of customs efficiency and quality of trade and transport infrastructure. The OECD Trade Facilitation Indicators identify the areas of border formalities (automation, documentation and procedures), co-operation between internal border agencies, and governance and impartiality as important priorities.

Commercial seaports remain under state ownership and are administered by the State Seaport Administration. Port directors have insufficient management flexibility (small capital investments must be approved by the Cabinet of Ministers), and there is insufficient co-ordination between the seaport administration and local administrations of port cities. In Ukraine as elsewhere, port-cities face the challenge of getting more local value-added out of their ports. Field research suggests that increased co-operation of the

State Seaport Administration with local city administrations is required to deal with the negative externalities of port activities (such as rapid deterioration of road infrastructure, or environmental and health impacts from grain dust).

Key recommendations for decentralisation in the transport sector

To further support decentralisation in Ukraine's transport sector, the OECD recommends:

- Strengthening cross-ministerial co-ordination on transport policy, by developing new laws and regulations in close consultation with relevant line ministries (e.g. Ministries of Economic Development and Trade, Finance, Ecology and Natural Resources, Infrastructure and Regional Development).
- Fostering horizontal co-operation across jurisdictional boundaries, where the scale of urban public transport extends beyond the administrative boundaries of cities.
    - Encouraging further use of inter-municipal co-operation (IMC) as a tool to develop mobility solutions across administrative boundaries by expanding IMC agreements between the UTCs and non-amalgamated communities.
    - Developing transport networks and mobility solutions in metropolitan areas in line with functional urban areas.
- Encouraging vertical co-ordination across levels of government, with municipal transport companies and private operators, to improve the planning, operations and management of public transport services.
    - Clarifying the attribution of responsibilities relating to transport across levels of government, with clear delineation of responsibilities for financing, operations, management and maintenance.
- Implementing the Ukraine Transport Strategy 2030, ensuring that local transport plans are adequately funded and based on realistic targets and milestones.
- Boosting financial and managerial capacities for transport at local levels, by:
    - Increasing the collection of transport-related taxes; developing road tolling systems; and leveraging road user charges, parking fees and speed enforcement charges.
    - Improving the balance between low public transport fares and the allocation of fare discounts and exemptions.
    - Introducing zonal fare systems, setting public transport costs based on the distance travelled.
    - Improving fare integration, with single tickets applying across multiple modes of transportation.
    - Conducting regular assessments of mobility systems through stated and revealed preference surveys.
    - Leveraging new sources of revenue, such as value capture taxes, to finance the construction and maintenance of transport infrastructure.
- Strengthening enforcement of parking rules, traffic regulations and

environmental standards, by:

- Encouraging operators to conform to performance standards and regulations by undertaking regular inspections and imposing sanctions when appropriate.
- Ensuring inspection teams are appropriately staffed and have adequate supervision and enforcement powers.
- Ensuring better enforcement of vehicle and emissions standards by city administrations, police and the National Inspectorate for Public Transport.
- Improving the infrastructure for walking and cycling.

- Stimulating a competitive environment for the provision of transport services, by allowing city administrations to franchise routes and attract private operators that adhere to standards and regulations.
- Establishing a logistics observatory, based on detailed commuter flow and travel cost data. The logistics observatory can help to inform:
  - Social research and evaluations of mobility provided by transport networks.
  - Cost-benefit analysis and feasibility studies for new infrastructure investment projects.
- Leveraging new technologies, such as big data, demand-responsive transport, car-sharing and ride-sharing schemes, in order to generate innovative mobility solutions. This implies:
  - Strengthening data literacy and capacities to exploit new streams of data in local administrations.
  - Using mobility-related data to identify periods of low demand, areas that are poorly served by public transport or specific segments of the population (e.g. elderly, handicapped) in need of specialised mobility solutions.
  - Developing adequate funding models for demand-responsive transport and designing schemes (e.g. routes, location of stops, frequency of services, etc.) in close consultation with users.
  - Improving mobility by combining existing mass-transit schemes with privately operated services in a single platform.
  - Managing population decline through strategic investments to improve the quality and efficiency of public transportation services.
- Boosting the performance of logistics systems, by:
  - Focusing on much-needed improvements to customs efficiency and the quality of trade and transport infrastructure.
  - Harmonising regulations with neighbouring countries and providing accurate estimates of travel time and reliability, which can help to encourage investments in efficiency-enhancing logistics technologies.
  - Strengthening co-operation between ports and port-cities, to minimise the negative externalities incurred by cities as a result of port traffic and infrastructure, and ensure that port-cities are able to share in the economic benefits of port activities.

Chapter 1. Regional development trends in Ukraine in the aftermath of the Donbas conflict

Chapter 1 provides an overview of Ukraine's economic performance, strengths and challenges at the subnational level. It analyses regional economic trends from the mid-2000s to 2015-16 and compares them with those observed in OECD countries and beyond. This chapter, which updates the 2014 OECD Territorial Review of Ukraine*, focuses on issues relevant to the decentralisation process, analysed extensively in Chapter 2.*

Introduction

The previous OECD *Territorial Review of Ukraine* (OECD, 2014b), completed just before the Euromaidan events and the eruption of a separatist conflict in the east of the country, concluded that Ukraine was both administratively and fiscally over-centralised. It argued that a more decentralised form of territorial governance was essential to making strength of the country's size and diversity and to overcoming the much-discussed east-west divide, which was reflected not only in its politics but also in the structure and performance of regional economies. This report updates and extends that analysis. It argues that the geopolitical and economic shocks of recent years have had asymmetric impacts, both sectorally and geographically. To a great extent, they seem to have accelerated a number of trends that emerged in the years following the global financial crisis of 2009. The structural shifts that began after the financial crisis present new opportunities for some regions, especially in the west of the country, but daunting new challenges for others, particularly in the east, where the consequences of armed conflict have exacerbated an already difficult structural adjustment. The asymmetric nature of these shocks across Ukraine's regions points to the need for a differentiated policy response and thus reinforces the case for more decentralised governance. However, it also underscores the importance – and difficulty – of getting decentralisation right, given the problematic institutional, political and economic environment in which it is being implemented.

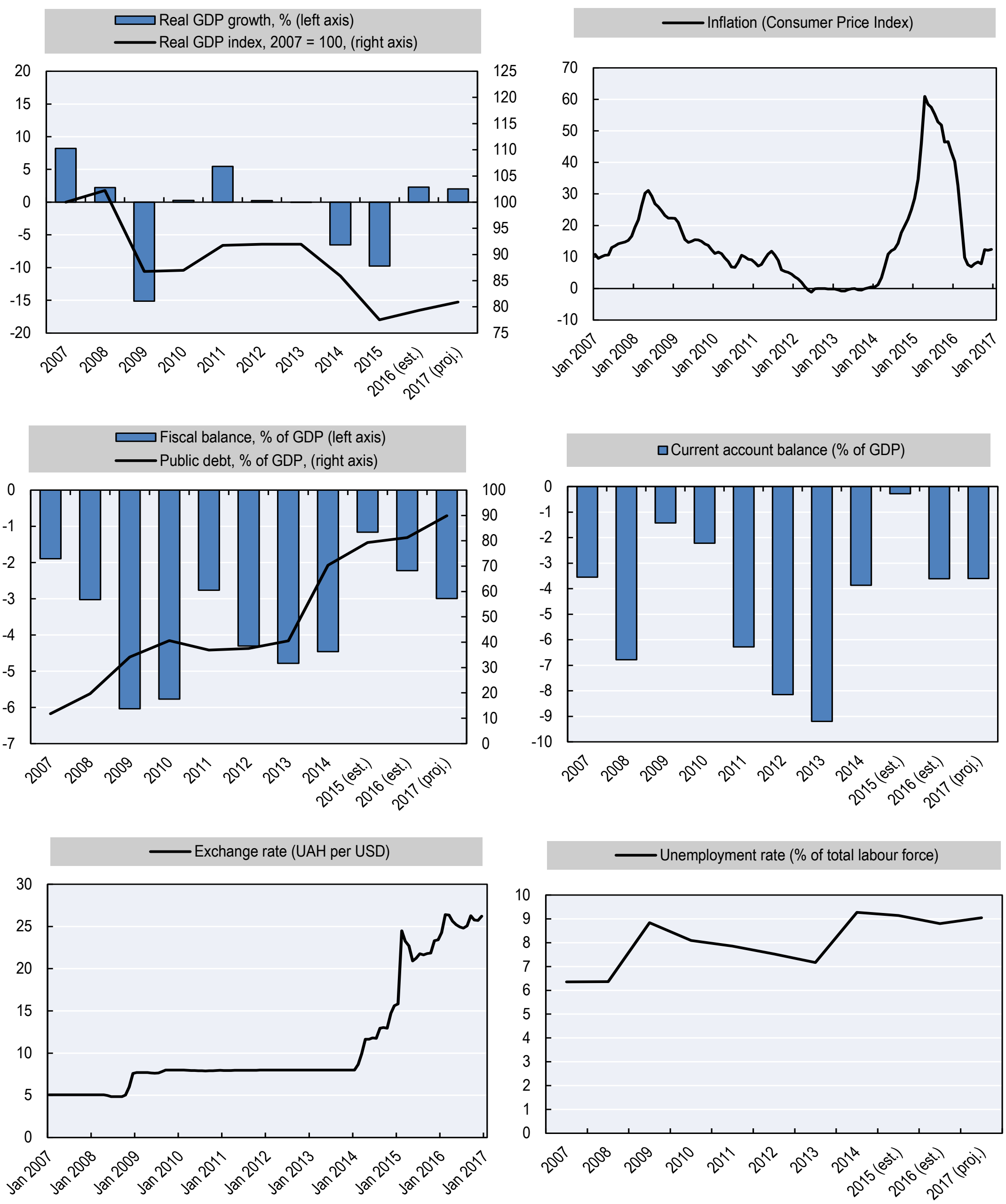
The first section of this chapter provides an overview of the macroeconomic context and the state of ongoing structural reforms. The second analyses demographic and economic trends at subnational level, including the evolution of Ukraine's settlement patterns, production structure and growth performance. This is followed by an analysis of key drivers of economic performance with a strong regional dimension: the functioning of labour markets, transport infrastructure and changes in the manufacturing sector. It formulates diagnoses and recommendations that are relevant to both central and subnational authorities. The final section looks at changing patterns of civic engagement and governance at the subnational level, which are important aspects of decentralisation in Ukraine.

Macroeconomic overview

Ukraine is the largest country in continental Europe and, with 42.6 million inhabitants in 2016,[1] one of the most populous. Ukraine has access to the Black Sea mainly through ports in Odessa, Iuzhnoe (in Odessa *oblast*) and Mykolaiv. It has a comparative advantage in agriculture, particularly in grain production (it is among the top ten exporters of wheat and corn worldwide). Its approximately 320 000 km² of fertile arable land are equivalent to one-third of the arable land of the European Union (OECD, 2014b). Ukraine is also home to abundant mineral resources: it has the second-largest quantity of mercury deposits and sizeable reserves of coal (the seventh-largest in the world) and iron ores, mainly concentrated in Eastern Ukraine.

Ukraine has faced large challenges over the past decade. The global financial crisis hit Ukraine hard, with gross domestic product (GDP) falling by 15% in 2009 (Figure 1.1). The recovery that ensued was weak and short-lived, and gave way to a major economic, financial and political crisis that has been aggravated by the annexation of Crimea and the conflict in the eastern regions of Donetsk and Luhansk (the Donbas). GDP contracted by 16% in the two-year period from early 2014 to late 2015, while inflation surged, reaching a peak of 61% in April 2015; the exchange rate weakened; and the terms of trade deteriorated. The crisis of 2014-15 highlighted a number of fragilities inherent in the Ukrainian economy. Growth in incomes during the decade before the crisis was largely driven by favourable prices for commodity exports (particularly steel and chemicals) rather than much-needed improvements in productivity and competitiveness (OECD, 2014b). Consistent delays in implementing structural reforms and recurrent political instability left the economy stuck in transition and overly exposed to external shocks.

Figure 1.1. **Selected economic indicators, Ukraine**



Source: IMF (2017b), *World Economic Outlook* (database), https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx (accessed April 2017).

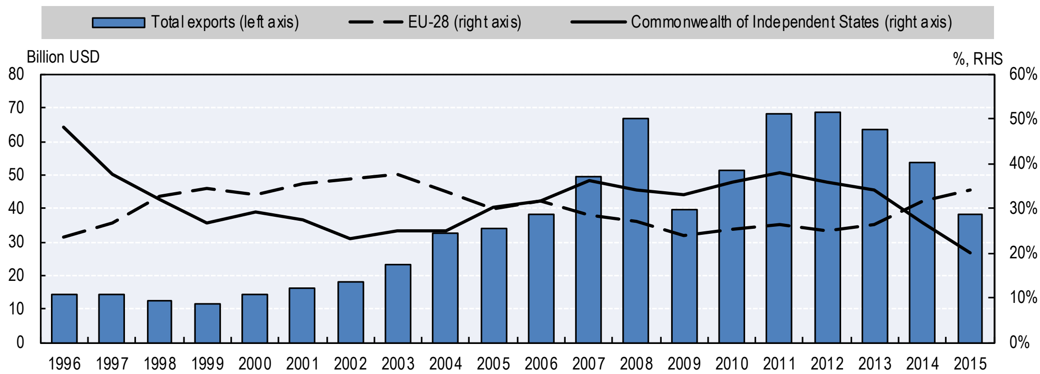
With the introduction of a flexible exchange rate regime, strong fiscal and monetary policies, and essential energy and financial sector reforms, the economy appears to have returned to modest growth in 2016, with real GDP rising by an estimated 2.3%. The government took important steps to reduce the fiscal deficit, which reached 10% of GDP in 2014 (including the state-owned gas company's deficit) before falling to 2.2% in 2016, thanks to tight fiscal policies and the imposition of market-based gas and heating tariffs. The external position also strengthened, with the current account deficit falling from 9.2% of GDP in 2013 to 3.6% in 2016. Gross reserves remain low but have doubled to USD 15 billion.

Continued recovery will depend on the government's ability to address important structural weaknesses in the economy. Public debt has risen sharply and is forecast to reach 90% of GDP in 2017. To help restore external sustainability and strengthen public finances, the government negotiated a four-year USD 17.5 billion IMF Extended Fund Facility, which has been operational since March 2015. Continued IMF support remains contingent on the implementation of structural reforms to reduce public sector inefficiencies, improve the business environment, increase labour market participation and boost productivity. Reform priorities highlighted by the IMF include attracting foreign direct investment (FDI), reforming the state-owned enterprise sector, developing a market for agricultural land, accelerating anti-corruption efforts, improving fiscal sustainability, further reducing inflation and rebuilding reserves, repairing viable banks, and reviving sound bank lending. To improve medium-term fiscal sustainability, the IMF recommends further fiscal consolidation and the adoption of a comprehensive pension reform, including increasing the effective retirement age to address the pension fund's large deficits and allow for higher average benefits (IMF, 2017a).

Over the past decade, Ukraine has made important efforts to open up its economy through trade and investment liberalisation. It became a member of the World Trade Organisation in 2008 and signed an Association Agreement with the European Union (EU) in 2014, including a Deep and Comprehensive Free Trade Area, which entered in force on 1 January 2016. Exports to traditional markets in the Commonwealth of Independent States (CIS) have declined markedly in recent years and the EU accounted for more than one-third of export revenue in 2015. In spite of the ongoing conflict, however, the Russian Federation still accounted for the largest share of Ukraine's exports – at 13% in 2015, followed by Turkey (7.3%), the People's Republic of China (6.3%), Egypt (5.5%) and Italy (5.2%). Imports predominately originate from the EU (41% in 2015) and CIS countries (28%; Figure 1.2).

Ukraine's average tariff rate is not particularly high, and the tariff regime does not present a significant obstacle to increasing trade. However, addressing non-tariff barriers such as customs regulations and border clearance issues can play an important role in reducing trade costs (OECD, 2016c). Ukraine ranked 80th out of 160 countries in the 2016 World Bank Logistics Performance Index, scoring below the average for the Europe and Central Asia region across all six dimensions (customs, infrastructure, international shipments, logistics competence, tracking and tracing, and timeliness). Similarly, the 2017 World Bank Doing Business assessment ranked Ukraine 115th out of 190 economies in the trading across borders dimension, which measures the time and cost of logistical procedures associated with exporting and importing goods. Ukraine also came out below the average for the Europe and Central Asia region on 10 out of 11 dimensions of the 2015 OECD Trade Facilitation Indicators. Performance is particularly weak in the areas of governance and impartiality, internal and external border agency co-operation, and document formalities.

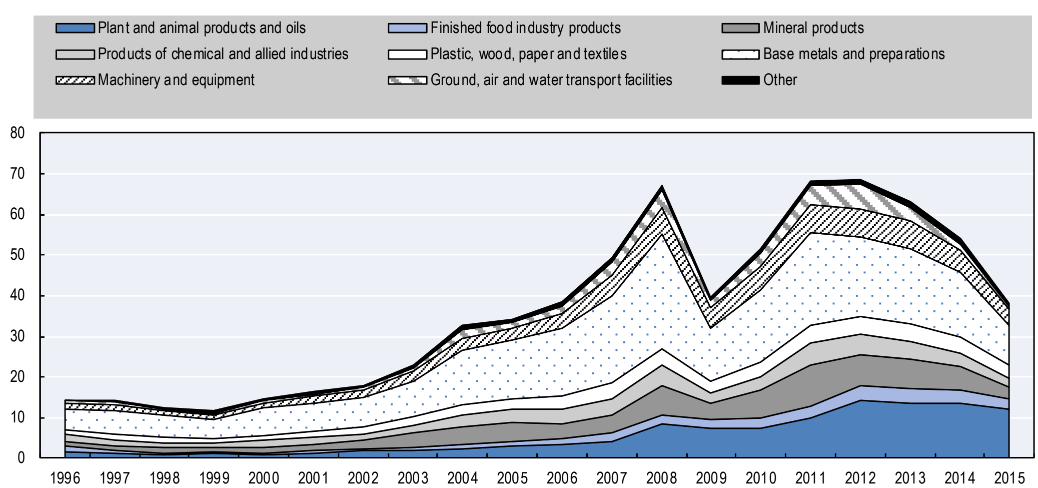
Figure 1.2. **Evolution of exports, Ukraine**



Source: *UN COMTRADE Database*, https://comtrade.un.org/data (accessed April 2017).

Ukraine's exports are dominated by primary commodities, particularly agricultural products (cereals) and base metals (iron and steel). The global economic slowdown and ongoing conflict have had a severe impact on the steel industry – base metals constituted 42% of exports in 2008 but just 26% in 2015. By contrast, the share of primary agricultural products has nearly tripled, from 12% in 2008 to 32% in 2015 (Figure 1.3). Exports of sophisticated manufactures are minimal and mainly consist of railway cars, aircraft parts and components, and car parts, predominantly oriented towards the Russian market. The recent adoption of a flexible exchange rate has allowed for a substantial devaluation of the Ukrainian hryvnia (UAH) against the dollar, which has helped to maintain demand for Ukrainian exports. Given the country's exposure to international markets, weak internal demand, and constraints on labour and capital supply, ensuring a sustained recovery in the long term will require concerted efforts to diversify the export base, attract FDI and support Ukraine's integration in global value chains.

Figure 1.3. **Composition of exports, Ukraine**



Source: *UN COMTRADE Database*, https://comtrade.un.org/data (accessed on April 2017).

FDI inflows increased rapidly after the turn of the century, from USD 600 million in 2000 to USD 10.7 billion in 2008. However, Ukraine has faced substantial difficulties in attracting FDI since the onset of the global financial crisis. Gross FDI inflows declined by

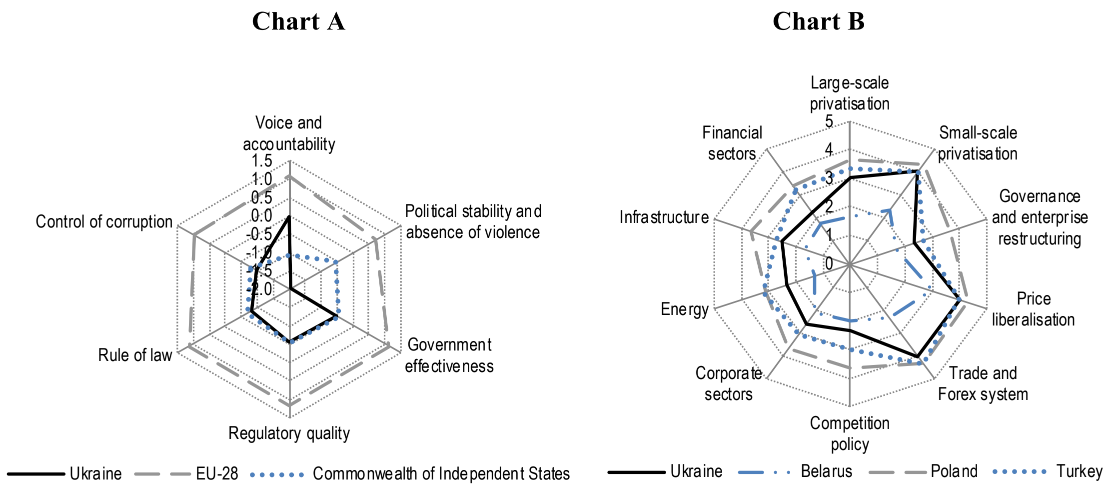
55% in 2009 and recovered slightly in 2010-12, before dropping by a further 45% in 2013 and a staggering 81% in 2014, reflecting growing concerns around the escalating conflict in the Donbas and the unstable domestic political situation. A sharp rebound was observed in 2015, bringing FDI inflows up from USD 847 million to USD 3.05 billion. However, this was largely due to the recapitalisation of foreign-owned banks through debt-to-equity conversions (OECD, 2016c). Furthermore, FDI statistics should be treated with a certain degree of caution, due to the prevalence of investment by special purpose entities[2] and round tripping (when funds transferred abroad by domestic investors are returned to the home country in the form of direct investment). The extensive use of round tripping is visible in the high share of offshore and low-tax jurisdictions such as Cyprus[3], the Netherlands and the British Virgin Islands in the total inward FDI stock (44% as of 31 December 2015).

FDI can play an important role in upgrading Ukraine's ageing capital stock, supporting job creation, increasing productivity, and facilitating the transfer of knowledge and new technologies. However, Ukraine has faced difficulties attracting FDI in high value-added and technology-intensive sectors. Foreign investors have mainly targeted the domestic market through investments in non-tradable sectors such as financial and insurance activities (27% of the total inward FDI stock in 2015), wholesale and retail trade (13%), and real estate (8%). FDI in manufacturing is highly concentrated in metallurgy (12% in 2015), which is strongly influenced by commodity price fluctuations and global economic conditions. Moreover, inflows predominantly consist of mergers and acquisitions, and there is a need to facilitate efficiency-seeking greenfield investments that will foster the development of export-oriented activities (OECD, 2016c).

With GDP per capita in PPP terms standing at just 21% of the EU average in 2015, Ukraine needs a long-term strategy to accelerate growth and facilitate sustainable improvements in living standards. Currently, efforts to diversify the structure of exports and attract FDI are stymied by the poor investment climate, weak institutions and endemic corruption. There is, therefore, a pressing need to accelerate the pace of structural reforms in order to support productivity growth, particularly in light of the rapidly ageing population and the gradual decline of the working-age population. Figure 1.4 shows important gaps in Ukraine's performance across key areas of structural reform, particularly when compared with the EU and benchmark countries such as Poland. The World Bank's Worldwide Governance Indicators highlight political instability, corruption and the rule of law as the three most important issues. According to the European Bank for Reconstruction and Development's Transition Indicators, the most crucial priorities include financial sector reforms, governance and enterprise restructuring, competition policy, and energy sector reforms.

There is a broad consensus that reforming the Ukrainian economy will require significant improvements to the integrity and efficiency of public institutions. General government expenditure, which stood at 49% in 2012, has been declining, to a projected 41% in 2016 – but even this is a very high level for a country at Ukraine's level of per capita income. The public sector accounts for 25% of total employment. Privatisation and the reform of inefficient state-owned enterprises are needed to foster competition and reduce the influence of large and oligarchic business conglomerates. Creating a business environment conducive to competition will also require streamlining the legal and regulatory framework, strengthening the judiciary, and tackling systemic corruption. Corruption remains one of the most significant impediments to doing business, with Ukraine ranking 131st out of 176 economies in Transparency International's Corruption Perceptions Index for 2016.

Figure 1.4. **Worldwide Governance Indicators (2015) and European Bank for Reconstruction and Development's Transition Indicators (2014), Chart B**



Sources: World Bank Worldwide Governance Indicators, http://info.worldbank.org/governance/wgi/index.aspx#reports (accessed May 2017); European Bank for Reconstruction and Development (2014), "Transition report 2014: Innovation in transition", www.ebrd.com/downloads/research/transition/tr14.pdf.

Improving the policy environment for small and medium-sized enterprises (SMEs) is also necessary to support local development and allow the emergence of a more vibrant and diversified private sector. Access to finance remains a key constraint on SME development, due to the prevalence of high interest rates and collateral requirements, heavy dollarisation of the financial system, high levels of non-performing loans, and the lack of alternative sources of financing. The government should also focus on improving institutional support for SMEs, encouraging innovation through co-operation with research institutes, and supporting the development of linkages between multinational enterprises and domestic companies. The introduction of a targeted export promotion programme could also help Ukrainian SMEs to reap the benefits of the Association Agreement and the Deep and Comprehensive Free Trade Area with the EU (OECD et al., 2015).

Subnational trends

The political and economic shocks of the last few years have affected regions very differently

The country's administrative structure (Table 1.1) is a legacy of the Soviet era, but is undergoing a significant reform discussed in detail in Chapter 2. According to the 1993 Constitution, Ukraine comprises:

- At the TL2 level[4], 24 regions (*oblasts*), the Autonomous Republic of Crimea and 2 cities with special status and prerogatives: Kyiv (the capital) and Sebastopol.
- At the TL3 level, 490 districts (*rayon*) in rural and suburban areas, and 184 cities of *oblast* significance. These are the largest cities – with very few exceptions their population is greater than 10 000 inhabitants.
- At the municipal (lowest) level, the territory is made up of more than 10 000 local councils: rural councils, councils for urban type settlements and councils of small cities (called cities of district significance) located within a district.

Table 1.1. **Ukrainian administrative units as of 1 December 2017**

TL2 level (*oblast*)	Districts (TL3) (*rayon*)	Cities with *oblast* significance and special status (TL3)	Other cities	Unified territorial communities[1]	Rural councils	Councils of settlements of urban type	Councils of urban districts[2]
Ukraine	**490**	**186**	**235**	**665**	**9 411**	**719**	**47**
Crimea (Aut. Rep.)	14	11	5	–	243	38	3
Vinnytsya	27	6	8	33	658	28	
Volyn	16	4	6	39	355	19	
Dnipropetrovsk	22	13	5	53	231	33	15
Donetsk	18	27	24	9	239	75	9
Zhytomyr	23	5	7	45	530	35	2
Zakarpattya	13	5	5	6	302	19	
Zaporizhia	20	5	8	34	223	19	
Ivano-Frankivsk	14	6	8	20	420	22	
Kyiv	25	13	13	6	601	28	
Kirovohrad	21	4	5	13	368	27	2
Luhansk	18	14	23	8	195	87	4
Lviv	20	9	34	33	590	31	
Mykolayiv	19	5	3	21	285	17	
Odesa	26	7	10	23	402	31	
Poltava	25	6	7	32	427	19	3
Rivne	16	4	6	24	314	15	
Sumy	18	7	6	27	351	19	
Ternopil	17	4	9	40	426	8	
Kharkiv	27	7	10	12	376	59	
Kherson	18	4	5	24	255	30	3
Khmelnytskiy	20	6	4	33	368	13	
Cherkasy	20	6	8	24	516	14	
Chernivtsi	11	2	8	22	224	7	
Chernihiv	22	4	7	33	508	25	2
City of Kyiv	–	1		–			
City of Sebastopol	–	1	1	–	4	1	4

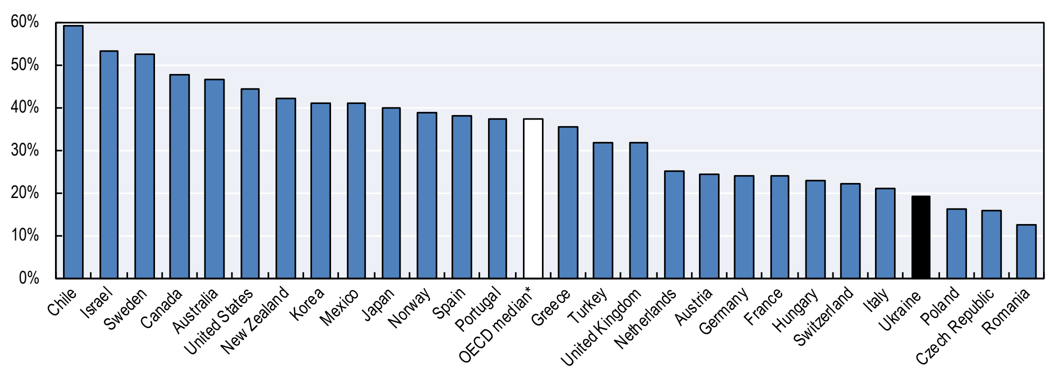
1. Newly amalgamated communities result from the merger of local councils. This table includes only local councils that have not merged into an amalgamated community.
2. Twenty-four large cities (including Kyiv and Sebastopol) are further divided into city districts.
Source: OECD research based on Verkhovna Rada of Ukraine (2017), Адміністративно - територіальний устрій України (*Administrative and territorial system of Ukraine*), http://static.rada.gov.ua/zakon/new/NEWSAIT/ADM/zmist.html.

Ukraine is currently engaged in amalgamating (merging) these numerous local councils into larger municipal entities called unified territorial communities (UTC). This amalgamation process is one of the pillars of the decentralisation reform. All statistics and comparisons with OECD countries in this chapter are based on the TL2 level (*oblasts* and cities of Kyiv and Sebastopol) and in a few cases on the TL3 level (districts and cities of *oblast* significance).

While population is ageing and declining, its concentration remains lower than in most OECD countries

The median population density of Ukraine's TL2 regions (63.4 inhabitants per square kilometre [km²]) is somewhat lower than the median density of TL2 regions in OECD countries (87.6 inhabitants/km²). Ukraine has a relatively low concentration of population across TL2 regions, meaning that the population is relatively dispersed across all regions. Only three OECD countries (the Czech Republic, Poland and Slovak Republic) have a lower population concentration (Figure 1.5). Many countries in Central and Eastern Europe, such as Bulgaria and Romania, also display low population concentration. The concentration of population increased slightly during 2005-15. The fact that it is still much lower than in OECD countries could reflect both the Soviet legacy of territorial planning and a relatively low rate of interregional labour migration: relatively few workers in Ukraine move to opportunity (i.e. to more affluent regions with better job prospects) (World Bank, 2015). Overall, the low concentration index of population compared to OECD countries suggests that there is still room to increase the size of Ukraine's largest urban clusters, with substantial benefits for Ukraine's productivity if urban growth is adequately managed.

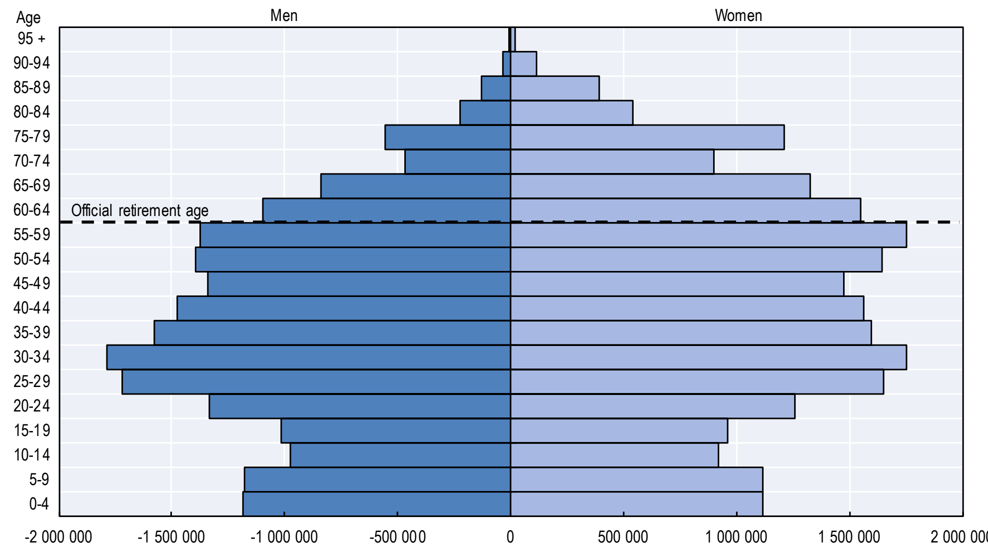
Figure 1.5. **Geographic Concentration Index of population among TL2 regions, 2015**



* Twenty-five OECD countries for which 2015 population data are available.
Note: Geographic Concentration Index formula detailed in Annex 1.A.
Sources: State Statistics Service of Ukraine, Demographic database; OECD (2017c), "Regional demography", *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/region-data-en (accessed 7 April 2017).

Ukraine has experienced population ageing and population decline since independence in 1991. During 2000-16, the working-age population (i.e. 15-64 year olds) fell by 7.8%, while the population as a whole fell by 8.1%. Ukraine's population is already older than those of most OECD countries: the 65+ age group accounted for 21% of the population in 2016. Among OECD countries, only Germany, Greece, Italy and Japan had a higher share of residents aged 65 and more the same year, while the OECD median reached 17.7%. As illustrated by Ukraine's age pyramid in 2016 (Figure 1.6), this trend is expected to continue and even amplify in the coming years, because the relatively large cohorts now in their 50s will soon be replaced by much smaller cohorts born in the 1990s and early 2000s. According to both Ukrainian[5] and UN population projections, the overall population will drop by approximately 7-8% over the 2015-30 period (UNDESA, 2015). Another striking feature of Ukraine's demography is the higher number of females compared to males in the age ranges 35-39 and older (Figure 1.6). Indeed, men have significantly higher mortality rates[6] than females after the age of 35: this results in a very high gender gap in life expectancy at birth (around 10 years, i.e. 76.2 years old for females versus 66.4 for males).

Figure 1.6. **Age pyramid of Ukraine, 2016***



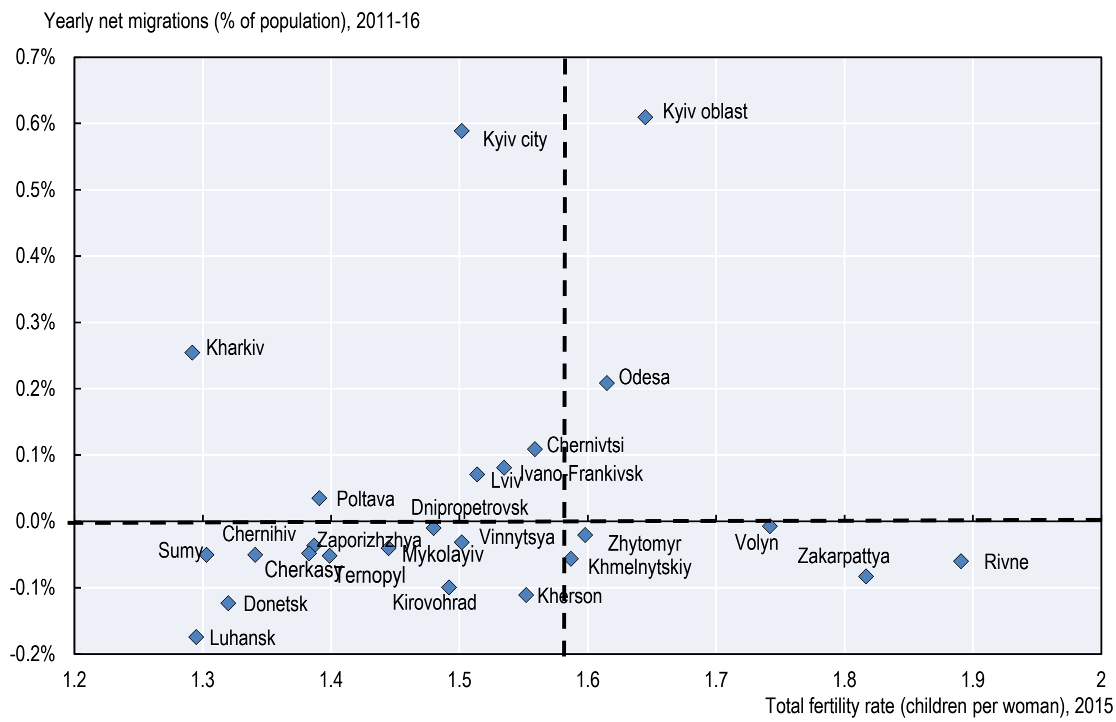
* Without Crimea and Sebastopol.
Source: OECD calculations based on data from the State Statistics Service of Ukraine.

Population ageing and population decline have widely varying effects across regions and cities. Out of Ukraine's 27 TL2 regions, only Kyiv city, and two *oblasts* in the north-west (Volyn and Zakarpattya) experienced demographic growth during 2007-17. Population in the Eastern and Central-East regions, such as the Donbas, Dnipropetrovsk and Zaporizhia, and the north-eastern regions of Sumy and Poltava has been both declining and ageing more rapidly than Ukraine as a whole, with the exception of Kharkiv – Ukraine's second-largest urban agglomeration, and the only region in the east to benefit from significant positive net migration. In Western Ukraine, the rural border *oblasts* of the north-west (Volyn and Rivne) and several regions of the Carpathians (south-west) had roughly stable populations, chiefly because of higher fertility rates. No Ukrainian region has a total fertility rate higher than the population replacement rate of 2.1 children per woman (Figure 1.7). Kyiv city and (to a lesser extent) the surrounding Kyiv *oblast* are the main destinations of interregional migration flows, and their populations are growing rapidly. In Kyiv *oblast*, this growth is strongest in cities close to Kyiv and thus belonging to the Kyiv urban agglomeration (such as Bucha, Boryspil and Brovary).

Strong demographic decline, be it through low fertility rates or net migratory outflows, or both, are most evident in Eastern and Central Ukraine (Figure 1.7). Regions in the lower left quadrant are the most likely to experience the strongest population decline in the near future, given that they combine low fertility rates and net migratory outflows. Another striking feature is that net migration tends to be positive in *oblasts* hosting the largest urban agglomerations in Ukraine, such as Kharkiv, Odessa and Lviv, though to a lesser extent. Given the scale of population decline in many regions,[7] regional and urban development strategies of Ukrainian *oblasts* and city master plans need to take more into account future population decline and population ageing and assess its impact on public services, urban infrastructure and regional labour markets.

More generally, however, the accuracy of population statistics is problematic in Ukraine. This is due in part to the fact that a large share of the population does not actually reside at its place of permanent registration, leading to distortions in official statistics regarding the spatial distribution of the population (Box 1.1). These distortions result in an inadequate allocation of public funds because subvention and transfers (such as the healthcare subsidy) to local budgets, as well as the fiscal equalisation mechanism, are tied to official population numbers (CEDOS, 2017). To solve this issue, one priority should be to conduct the next population census as soon as possible (for instance, in 2018 instead of 2020) to provide an accurate picture of the spatial distribution of the population. In the medium term, an overhaul of the residence registration procedure (*Ukr. Propiska*) is necessary for registration statistics to more accurately reflect internal migration patterns.

Figure 1.7. **Regional demographic trends, Ukraine**



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

Urban agglomerations are drivers of economic and demographic growth

Overall, 80% of Ukrainian cities experience population decline, and are disproportionately concentrated in Eastern Ukraine while growing cities are disproportionately found in the west. In traditionally rural Western Ukraine, many regions are still urbanising, driving the demographic growth of many medium-sized cities and of Lviv city. Rural-urban migration is still a significant factor in urban growth in Western and (to a lesser extent) in Central Ukraine. Unsurprisingly, economic and demographic growth are associated: the 22% of Ukrainian cities that are characterised by growing economic activity (using satellite night lights as a proxy) also record lower declines in population than other cities, or even population growth (World Bank, 2015). Population growth in Kyiv and other cities in Central and Western Ukraine could be positive for national economic development, by fostering further agglomeration economies (Box 1.2). However, for urban growth to translate into enhanced prosperity, it must be managed well (i.e. a scaling up of public services and infrastructure to ensure the integration of newcomers) (World Bank, 2015). Conversely, it is important that public service plans and urban planning in shrinking places take falling population densities into account, as these phenomena create challenges in maintaining and operating urban infrastructure due to decreasing economies of scale. The combination of an overall ageing urban population and declining fertility rates will also likely shift demand from education to health services (World Bank, 2015).

Box 1.1. Population statistics and residential registration (*Ukr. Propiska*)

The State Statistics Service of Ukraine compiles all official population figures on the basis of administrative data from birth and death certificates and data on permanent residence registration from the State Migration Service of Ukraine. The number of residence registrations and residence "deregistration" with the State Migration Service is the basis to take into account migrations, particularly migrations between different territorial entities. However, several studies based on household surveys found that a major share of the population does not register their actual place of residence. According to a 2010 survey of 1 216 households conducted in 12 regional centres, more than a third of respondents declared that their actual place of residence did not match their permanent residence registration. The Ptoukha Institute for Demography and Social Studies used indirect methods to assess Kyiv's population at the beginning of 2010 and 2011: it found that the actual population of Kyiv is higher than the official estimate, with a difference ranging from 3% to 22% depending on the year and assessment method.

Existing research points to internal labour migrants as the main category that does not register officially, and is therefore not adequately accounted for in official population and migration statistics. According to an International Organisation for Migration survey conducted in 2014-15, the number of internal labour migrants in Ukraine would reach 1.6 million people (without Crimea, and Donetsk and Luhansk *oblasts*), equivalent to around 4.4 % of the population and 10.4% of the employed population of the survey regions (i.e. excluding Crimea, and Donetsk and Luhansk *oblasts*). The current system of residence registration hinders the registration of internal labour migrants at their new place of residence due to the complicated procedure which creates obstacles for people who live in households not owned by them or their family members. Indeed, the rental housing market is small and largely informal in Ukraine, and landlords usually refuse to allow their tenants to officially register with the State Migration Service. Migrants not officially registered at their place of residence often face obstacles accessing various administrative and social services, accessing public healthcare, or participating in local elections.

These issues with permanent residence registration translate into substantial inaccuracies and distortions in official statistics regarding the spatial distribution of population. This is compounded by the lack of a recent national census. Indeed, national censuses usually provide a reliable basis for official population estimates and statistics. However, Ukraine conducted its last national census in December 2001: therefore data on natural growth (births and death certificates) and migrations (residence registrations) play a decisive role in shaping official population statistics.

Sources: Solodko, A., A. Fitisova and O. Slobodian (2017), "Residence registration in Ukraine: Issues for public governance and consequences for society" ("Reєstracija miscja prozhivannja: vikliki dlja derzhavi ta naslidki dlja suspil'stva"; in Ukrainian), www.cedos.org.ua/uk/migration/reyestratsiya-mistsya-prozhyvannya-v-ukrayini-problemy-ta-stratehii-reformuvannia; IOM (2016a), "Migrations as a factor of development for Ukraine" ("Migracija jak chinnik rozvitku v Ukraïni"; in Ukrainian), www.iom.org.ua/sites/default/files/mom_migraciya_yak_chynnyk_rozvytku_v_ukrayini.pdf.

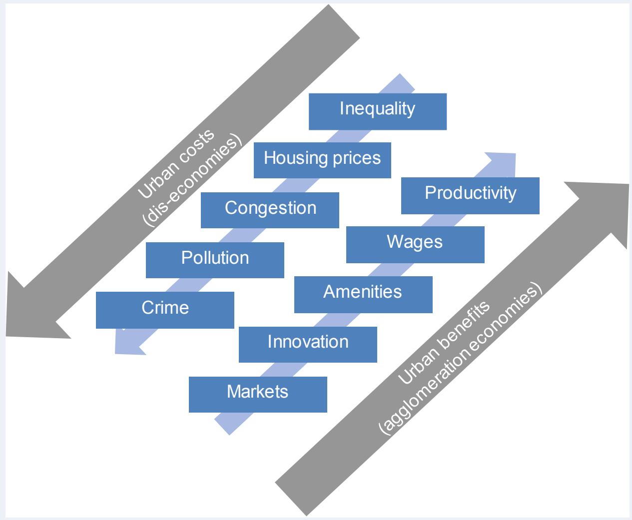
Box 1.2. Agglomeration economies: Costs and benefits

Large urban agglomerations and dynamic medium-sized cities have enormous potential for job creation and innovation, as they are hubs and gateways for global networks such as trade or transport. In many OECD countries, labour productivity is measured in terms of gross domestic product per hour worked and wages are seen to increase with city size. Stronger productivity levels are a reflection of the intrinsic value of being in a city, known as the agglomeration benefit. On average, a worker's wage increases with the size of the city where he/she works, even after controlling for worker attributes such as education level. OECD estimates suggest that the agglomeration benefit in the form of a wage premium rises by 2-5% for a doubling of population size (Ahrend et al., 2014).

Higher productivity is due in part to the quality of the workforce and the industrial mix. Larger cities on average have a more educated population, with the shares of both very high-skilled and low-skilled workers increasing with city size. A 10 percentage-point increase in the share of university-educated workers in a city raises the productivity of other workers in that city by 3-4% (Ahrend et al., 2014). Larger cities typically have a higher proportion of sectors with higher productivity, such as business consulting, legal or financial services, etc. They are also more likely to be hubs or service centres through which trade flows and financial and other flows are channelled. These flows typically require the provision of high value-added services.

Living in a large city does provide benefits, but it also has disadvantages (Figure 1.8). While productivity, wages and the availability of many amenities generally increase with city size, so do what are generally referred to as agglomeration costs. Some agglomeration costs are financial: for example, housing prices/rents and, more generally, price levels, are typically higher in larger cities. In addition, a number of non-pecuniary costs, such as pollution, congestion, inequality and crime, typically also increase with city size, while trust and similar measures of social capital often decline. Survey data from European cities confirm that citizens in larger cities – despite valuing the increased amenities – are generally less satisfied with the other aspects mentioned, notably air pollution. To some extent, city size is the outcome of a trade-off between agglomeration benefits and agglomeration costs.

Figure 1.8. **Agglomeration costs and benefits**

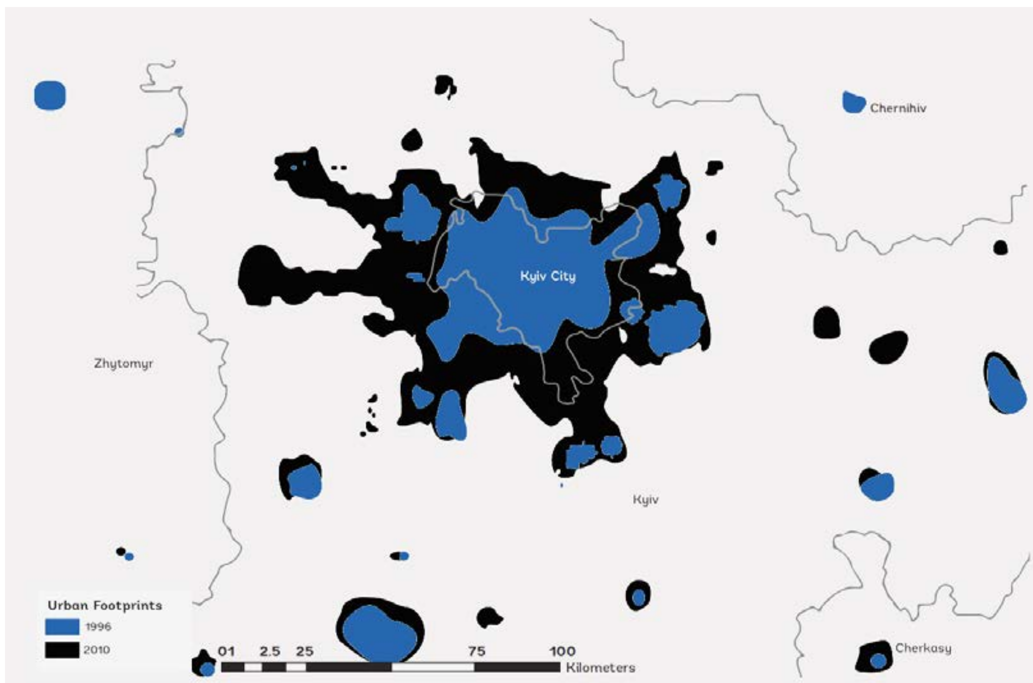


Sources: OECD (2014a), *OECD Regional Outlook 2014: Regions and Cities: Where Policies and People Meet*, http://dx.doi.org/10.1787/9789264201415-en; Ahrend, R. et al. (2014), "What makes cities more productive? Evidence on the role of urban governance from five OECD countries", http://dx.doi.org/10.1787/5jz432cf2d8p-en.

Cities in all regions have been losing population, mostly to the largest urban agglomerations, which are concentrating the little urban demographic growth that has been taking place in Ukraine. The largest urban centres also display higher productivity per capita and per km^2, based on night light measurements (World Bank, 2015). The Kyiv agglomeration is the most prominent example. Kyiv city (2.9 million inhabitants at the beginning of 2017), the largest city in Ukraine, is also one of the fastest growing (0.7% per year during 2007-17). Kyiv attracts significant net population inflows from the rest of Ukraine. Since 2011, Kyiv *oblast* has also attracted significant net migration inflows (including from Kyiv itself) and its population has been growing again. This demographic growth is concentrated in the cities surrounding the capital, and in the neighbouring rural districts. This suggests that the Kyiv urban cluster is increasingly becoming a large urban agglomeration that spans across administrative units, encompassing both Kyiv city and many areas of Kyiv *oblast*. World Bank (2015) confirms this by measuring Kyiv's urban footprint through satellite night light data. The urban footprint of Kyiv city has expanded to merge with the surrounding city and form an urban agglomeration encompassing 11 cities.[8] These cities usually have separate geographic and political boundaries and initially had separate markets as well, but they grew together as they developed: their urban footprint was separate from Kyiv in 1996 but they have grown to become a single urban footprint in 2010 (Figure 1.9).

Satellite night light studies tracing the evolution of urban footprint found that 11 out of the 15 largest cities in Ukraine are part of an urban agglomeration (World Bank, 2015). Furthermore, urban agglomerations in Ukraine are not limited to central cities and their suburban secondary cities. Rural districts (*rayon*) on the outskirts of large cities (such as Kiev-Sviatoshyn *rayon* to the west of Kyiv or Ovidiopol *rayon* to the south of Odessa) often displayed higher growth than the central city to which they are functionally related, suggesting a pattern of peri-urban growth. As in OECD countries, urban agglomerations in Ukraine often encompass different administrative units. The OECD-EU definition of functional urban areas (FUAs) allow for a more accurate delimitation of urban areas as functional economic units, which can be a good basis to co-ordinate public policies across administrative entities (Box 1.3). Efficient co-ordination among subnational governments responsible for the same urban agglomeration (core city, suburban secondary cities, rural districts experiencing peri-urban growth and *oblast* administrations) is critical to the efficiency of subnational public investment, as explored in Chapter 2 of this review. Therefore, applying the OECD-EU definition of FUAs to Ukraine could inform the current municipal amalgamation process, particularly around the largest cities.

Figure 1.9. **Kyiv's agglomeration night light urban footprint, 1996-2010**



Note: Agglomerations are defined using night light data and are formed by cities that in 2013 had a merged night light urban footprint.
Source: World Bank (2015), "Ukraine: Urbanization review", http://documents.worldbank.org/curated/en/213551473856022449/Ukraine-Urbanization-review.

Regional economic performance: Along with Kyiv, western regions are now the main drivers of national growth

Following the Euromaidan revolution and the political transition in the spring of 2014, the armed conflict that erupted in the Donbas area has resulted in the relocation of an estimated 1 million people from the conflict area (UNOCHA, 2016). Box 1.4 provides more details on internally displaced persons (IDPs) and the impact of the conflict on Ukraine's regions. Furthermore, the Russian Federation's subsequent trade and transit restrictions against Ukraine, together with the countermeasures adopted by Kyiv, have had a severe impact on industrial activities in Eastern and Southern Ukraine, particularly machine building.

Box 1.3. The OECD-EU definition of functional urban areas

The OECD-EU definition of functional urban areas (FUAs) consists of very densely populated urban centres (“city cores”) and contiguous municipalities with high levels of commuting (travel-to-work flows) towards the core municipalities (“commuting zones”). This definition resolves previous limitations for international comparability linked to administrative boundaries. FUAs are computed by combining geographic (cartographic) information about the administrative boundaries of municipalities and census data at the municipal level. Defining urban areas as functional economic units can help guide how national and city governments plan infrastructure, transport, housing and schools, and space for culture and recreation. Improved planning will make these urban areas more competitive, helping to support job creation and making them more attractive for its residents.

The methodology identifies urban areas as functional economic units, with densely inhabited “city cores” and commuting zones whose labour markets are highly integrated with city cores. In the first phase, the distribution of the population at a fine level of spatial disaggregation – 1 km^2 – is used to identify the urban clusters, defined as contiguous aggregations of highly densely inhabited areas (grid cells) with an overall population higher than 50 000 inhabitants. High-density grid cells have more than 1 500 inhabitants per km^2 (1 000 inhabitants per km^2 in Canada and the United States). City cores encompass all municipalities where at least half of the municipal population lives within the urban cluster.

The commuting zones of these internationally comparable city cores are defined using information on travel-to work commuting flows from surrounding municipalities. Municipalities sending at least 15% of their resident employed population to a city core are included in its commuting zones, which thus can be defined as the “worker catchment area” of the urban labour market, outside the densely inhabited core. The size of the commuting zones relative to the size of the city core gives a clear indication of a city’s influence on surrounding areas.

The definition is applied to 30 OECD countries* and identifies 1 198 urban areas of different sizes. Among them, 281 metropolitan areas (including 81 large metropolitan areas of more than 1.5 million inhabitants) have a population higher than 500 000 and are included in the *OECD Metropolitan Database*. As of 2014, they accounted for 49% of the OECD overall population, 57% of gross domestic product and 51% of employment. Other FUAs include 411 medium-sized urban areas (with a population of between 200 000 and 500 000) and 506 small urban areas (50 000-200 000). Digital maps and details about functional urban areas in each country are available at: www.oecd.org/cfe/regional-policy/functionalurbanareasbycountry.htm.

The OECD has already applied the OECD-EU Methodology of functional urban areas to non-member countries such as Colombia and Kazakhstan. For instance, the OECD *Urban Policy Review of Kazakhstan* found that the country contained 26 FUAs in 2009, among which 3 metropolitan areas (Astana, Almaty city and Shymkent). Applying this methodology requires a high degree of co-operation between the OECD and the national statistical office and the existence of inter-municipal travel-to work commuting flow data in the national census database.

* Data are not available for Iceland, Israel, New Zealand and Turkey.

Sources: OECD (2016b), “Functional areas by country”, www.oecd.org/gov/regional-policy/functionalurbanareasbycountry.htm; OECD (2016e), *OECD Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en; OECD (2012), *Redefining “Urban”: A New Way to Measure Metropolitan Areas*, http://dx.doi.org/10.1787/9789264174108-en.

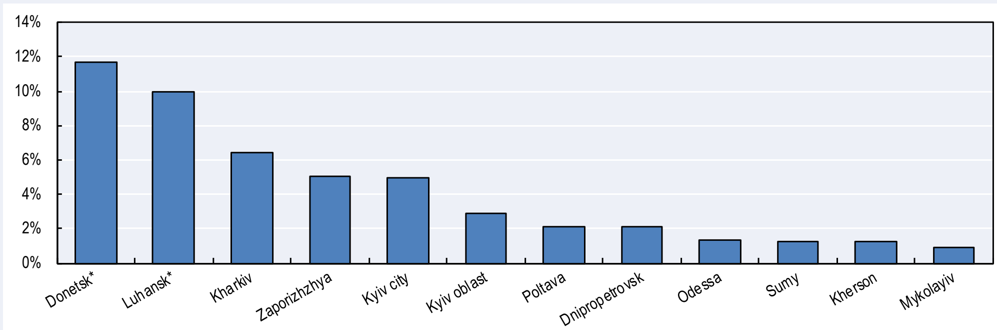
Box 1.4. **The regional impact of the Donbas conflict and internally displaced persons**

The Donbas conflict saw intense fighting in the eastern *oblasts* of Donetsk and Luhansk (the Donbas area), until a fragile ceasefire was brokered in February 2015. According to the UN High Commissioner on Human Rights, the total death toll is estimated to be at least 10 000, with at least 23 455 people injured. The conflict caused tremendous economic damage and the loss of at least 1.6 million jobs in the Donbas area alone, mainly in heavy industry sectors (mining, machine building and metals) and in services. In 2016, industrial production in government-controlled areas of Donetsk *oblast* amounted to only 47% of its 2013 (pre-conflict) volumes, and only 27% of 2013 volumes in government-controlled areas of Luhansk *oblast*.

Firms located in separatist territories were at the epicentre of the war and endured the most damage. An estimated 78% of the industrial capacity in Donetsk is located outside of the government-controlled areas, and the estimate is higher in Luhansk (84%). Economic activity in government-controlled areas of Donetsk and Luhansk *oblasts* was also severely affected: between 2013 and 2015, gross domestic product per capita fell by 58% in real terms in government-controlled areas of Donetsk *oblast* and by 70% in Luhansk. Industrial facilities still in operation are extremely vulnerable to any sort of escalation of the conflict. Beyond that, non-government controlled areas (NGCA) were economically integrated with nearby regions of Ukraine (particularly in Dnipropetrovsk and Zaporizhia *oblasts*), where many industries suffered from supply chain disruptions, for instance in the energy (coke plants for electric power and heat generation) and steel subsectors that both relied on coal supplies from mines in the NGCAs. The unofficial economic blockade and subsequent ban on all trade (except humanitarian assistance) with the NGCAs in early 2017 (as well as the separatist takeover of Ukrainian assets located in the NGCAs) broke the already weak economic ties of the NGCAs with the rest of the country. This further disrupted manufacturing activities in nearby regions in 2017.

The Russian Federation's annexation of Crimea and the conflict in the east also triggered a massive influx of internally displaced persons (IDPs). Entire families abandoned their homes and fled to government-controlled areas. It is estimated that around 1 million IDPs reside permanently in government-controlled territory, while several hundred thousand more live in the NGCA while periodically entering government-controlled territory to claim pension and social assistance payments. The actual number of IDPs is unclear, because some do not register at all. Three-quarters of the IDPs are registered close to their homes, above all (40%) in government-controlled areas of their *oblasts* of origin. Outside of the Donbas, the neighbouring *oblasts* of Kharkiv, Zaporizhia and Dnipropetrovsk received the most significant influx of IDPs (amounting to more than 4% of their 2016 populations in Kharkiv and Zaporizhia). Many IDPs also moved to the city of Kyiv and the surrounding *oblast*, which offers good employment opportunities in the service and trade sectors. The impact of IDPs on regional labour markets, and their ability to find new jobs matching their skills is a key issue for host regions.

Figure 1.10. **Registered internally displaced persons (share of regional population), January 2017**



* Many internally displaced persons register in these *oblasts* while still residing in the non-government controlled areas: these figures therefore overestimate the actual number of permanent internally displaced persons.
Source: Ministry of Social Welfare, State Statistics Service of Ukraine.

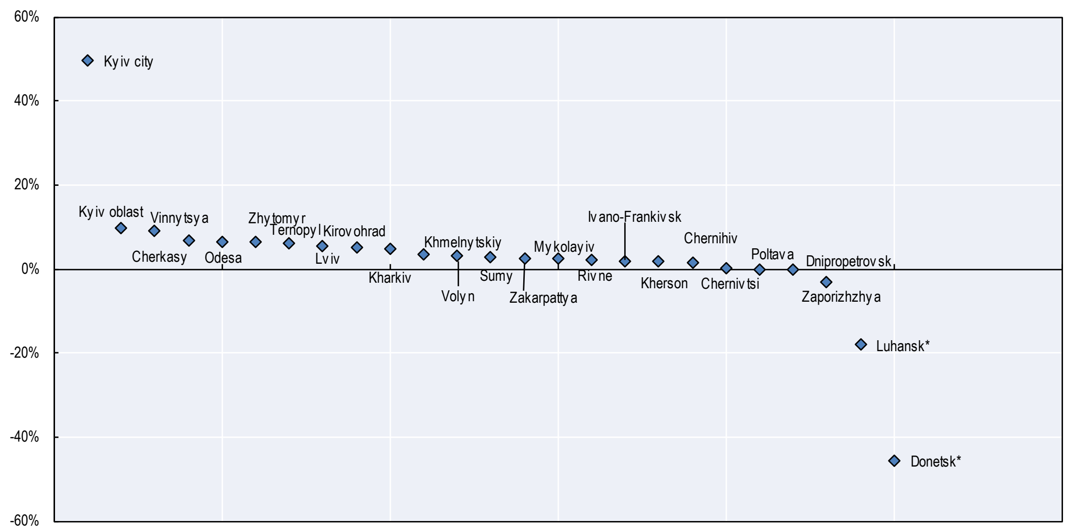
The government has been providing some emergency housing to IDPs and a very limited welfare payment (UAH 884 – approximately USD 35 – for individuals unable to work, half of that for the others) for a six-month period. It should be noted that pensioners make up a large share of registered IDPs (more than half of the IDPs registered by the Ministry of Social Welfare), but many of them still live in the NGCAs. The government has recently tightened the rules to register as an IDP (for instance, IDPs shall not reside in the NGCAs for more than 60 days) and introduced checks and controls to ensure that the IDPs actually live at their stated places of registration, resulting in the suspension of pensions and social payments for some.

In the government-controlled areas of Donetsk and Luhansk *oblasts*, the influx of IDPs led to rapid population growth in cities such as Kramatorsk, Severodonetsk and Sloviansk. There is evidence that the influx of IDPs led to a rise in rental prices. The IDPs have complained about the high level of refusals on the side of lessors due to mistrust of IDPs and about inadequate quality of rental housing. The IDPs face challenges to find employment: according to the International Organization for Migration Monitoring Survey, only 31% of IDPs who worked before displacement could manage to find jobs at their new places of stay. Given the severe economic downturn in government-controlled areas of Donetsk and Luhansk *oblasts* in 2014 and 2015, the Donbas conflict resulted in a concentration of IDPs in host areas that are poorly prepared to receive them.

Sources: UNOCHA (2016), "Ukraine 2017 humanitarian response plan", https://www.humanitarianresponse.info/system/files/documents/files/humanitarian_response_plan_2017_eng.pdf; European Union, World Bank and United Nations (2015), "Ukraine recovery and peacebuilding assessment: Analysis of crisis impacts and needs in Eastern Ukraine", http://www.un.org.ua/images/documents/3738/UkraineRecoveryPeace_A4_Vol2_Eng_rev4.pdf; Smal, V. (2016), "A great migration: What is the fate of Ukraine's internally displaced persons", https://voxukraine.org/en/great-migration-how-many-internally-displaced-persons-are-there-in-ukraine-and-what-has-happened-to-them-en; IOM (2016b), "National monitoring system of the situation with internally displaced persons: March-June 2016", www.iom.org.ua/sites/default/files/iom_nms_cumulative_report_eng.pdf.

In addition to the Donbas conflict and its consequences, regional economic specialisation and international metal prices were major factors determining the economic performance of Ukrainian regions after 2004. Prior to the global crisis in 2009, Ukraine enjoyed sustained economic growth, while Kyiv and the surrounding *oblast* grew consistently faster than most other regions. Affluent industrial regions in the Donbas and Pridneprovsky areas also contributed significantly to national growth. Meanwhile, poorer agricultural regions in Central and Western Ukraine failed to converge towards the national level in terms of GDP per capita and productivity (OECD, 2014b).

Figure 1.11. **Contribution to national growth*, Ukraine, 2004-14**



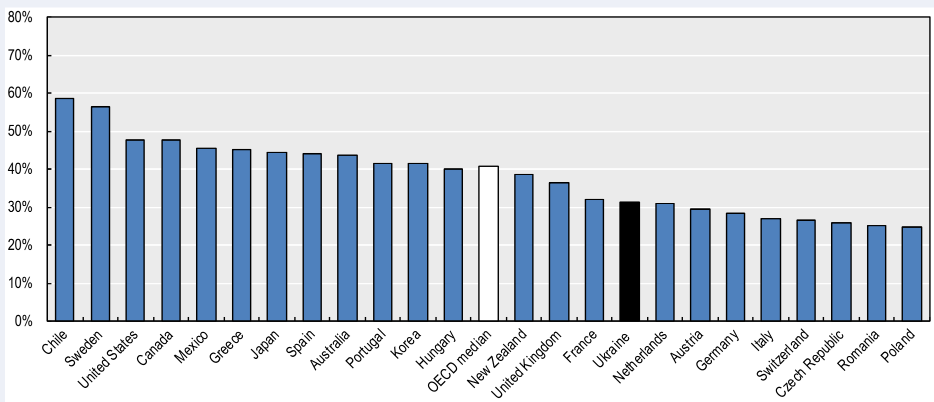
* The contribution of Luhansk (-18.1%) and Donetsk (-45.5%) reflect the negative impact of the Donbas conflict on these regions. 2014 growth rates do not take into account territories controlled by separatists. National growth has been adjusted to reflect the absence of data for Crimea and Sebastopol after 2013.
Source: OECD calculations based on data from the State Statistics Service of Ukraine.

After 2010, the geographic pattern of development reversed: Western regions have generally fared better than industrial strongholds in Eastern Ukraine. A clear "growth cluster" emerged in Central and Central-Western Ukraine, comprising Vinnytsya, Ternopyl, Khmelnitsky and Zhytomyr *oblasts* to the west of Kyiv and Cherkasy and Kirovohrad *oblasts* to the south of Kyiv (Figure 1.11), along with the Kyiv urban agglomerations itself (Kiyv city and the Kiyv *oblast*). These rural regions of Central and Western Ukraine, which display lower productivity than the national average, became the main contributors to national economic growth (Box 1.5). By contrast, affluent industrial regions, such as Zaporizhia, Kharkiv, Dnipropetrovsk and Poltava, as well as the Donbas area, entered in a recession as early as 2012 and therefore were a drag on national GDP growth (Figure 1.11). The recession was driven by low metal prices on international markets, but also structural issues related to declining heavy manufacturing subsectors (metals, mining and machine building), such as an outdated capital stock and a lack of investment (Saha and Kravchuk, 2015). The Donbas conflict, of course, made matters much worse in the east (Figure 1.11). The Donbas was already underperforming before the conflict began: like in other industrial strongholds of Ukraine, its GDP has contracted continuously since 2012. Meanwhile, some Western and Central regions (Vinnitsa, Zhytomyr, Volyn and Ternopyl) benefited from the growth of "light" industrial subsectors such as food processing, automotive parts and wood processing. As a result, during the 2004-14 decade economic growth was extremely concentrated in a few fast-growing regions in Ukraine compared to many OECD countries (Box 1.5).

Box 1.5. **Low spatial concentration of GDP, but highly concentrated GDP growth**

The Geographic Concentration Index of gross domestic product (GDP) (a measure of geographic concentration of economic activities) across Ukraine's TL2 regions (31.4%) is somewhat lower than the OECD median (Figure 1.12), although as one could expect it to be higher than the Geographic Concentration Index for population (Figure 1.5), reflecting agglomeration economies. In a majority of OECD countries, economic activity is more spatially concentrated than in Ukraine.

Figure 1.12. **Geographic Concentration Index of GDP in TL2 regions, 2014**



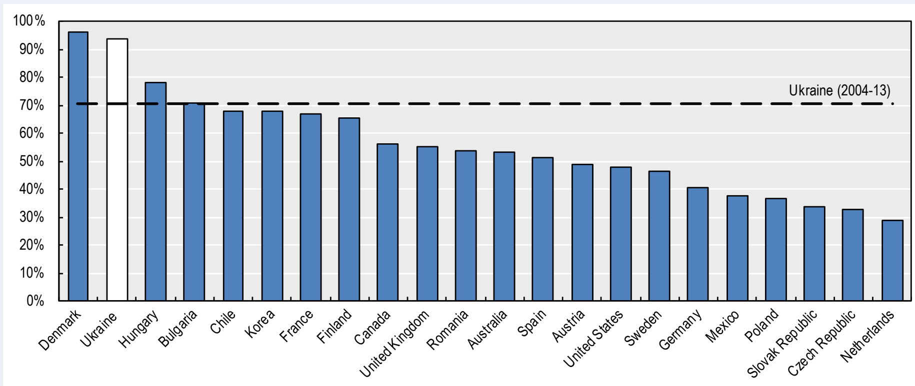
Notes: Data for Japan, New Zealand and Switzerland for 2013. The OECD median is for 22 OECD countries for which 2014 data are available. Geographic Concentration Index formula detailed in Annex 1.A.
Sources: State Statistics Service of Ukraine, *regional GDP database*; OECD (2017a), *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/region-data-en (accessed 7 April 2017).

In spite of a geographic concentration of GDP that is lower than many OECD countries, GDP growth has been extremely concentrated in recent years, i.e. national aggregate GDP growth has relied upon a handful of regions only. From 2004 to 2014, the six *oblasts* with the highest GDP growth rate (Ternopyl, Cherkasy, Zhytomyr, Vinnytsya, Kirovohrad, Kyiv *oblast* and Kyiv city) accounted for 93.5% of national GDP growth. Among 21 countries (19 OECD countries, Bulgaria and Romania) with available data, only Denmark displayed a higher concentration of economic growth among TL2 regions (Figure 1.13). In the case of Ukraine, this high spatial concentration is due to: 1) the dismal economic performance of the largest regional economies located in the east, in the conflict-ridden industrial Donbas of course, but also in Dnipropetrovsk and Zaporizhia *oblasts*, even before the beginning of the Donbas conflict; 2) the strong economic dynamic of Kyiv city and Kyiv *oblast* (these two regions accounted for 60% of national growth during the 2004-14 decade).

It is worth noting that, if the same calculation is done for 2004-13, excluding 2014 when the Donbas conflict happened, the same *oblasts* still accounted for around 70% of national growth (dashed line). Thus, even before the conflict, Ukraine displayed a high level of spatial concentration of economic growth compared to OECD countries.

Figure 1.13. **Contribution to national GDP growth by the fastest growing TL2 regions, 2004-14**

Regions with the highest GDP growth rate accounting for at least 20% of national population



Note: The regions with the highest GDP growth are included until the equivalent of one reaches a threshold of 20% of the national population.

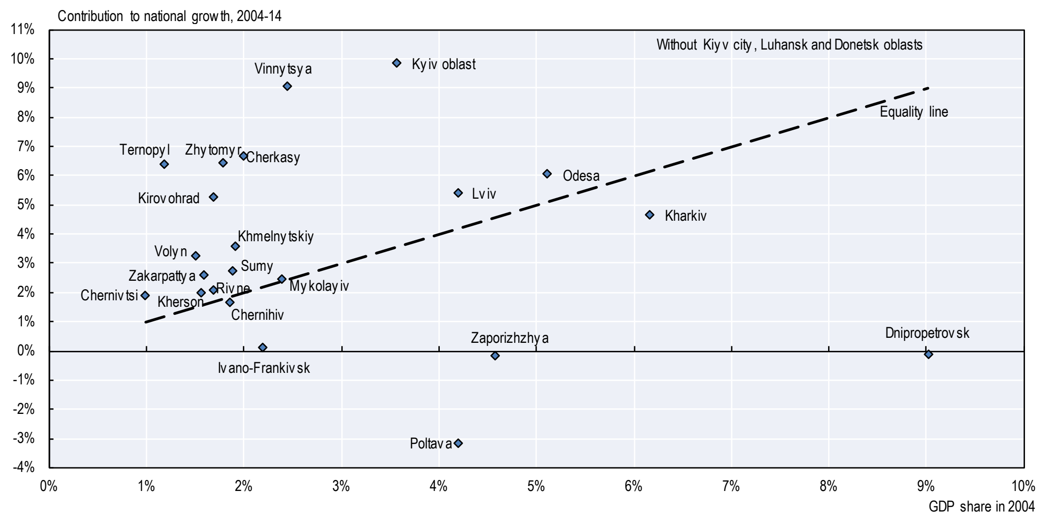
Sources: OECD research based on State Statistics Service of Ukraine (2017), *National Accounts database*, https://ukrstat.org/en/operativ/menu/menu_e/nac_r.htm (accessed 28 March 2017); OECD (2017c), "Regional demography", *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/a8f15243-en; OECD (2017d), "Regional economy", *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/6b288ab8-en.

In Ukraine, the main driver of regional disparities during the last decade has been the strong growth of the Kyiv metropolitan region. Kyiv city alone accounted for 50% of Ukraine's aggregate GDP growth during 2004-14, even though its share of national GDP was only 18.4% in 2004. Kyiv *oblast* was the second-largest contributor to national growth (Figure 1.14). Together, Kyiv city and the surrounding *oblast* accounted for almost 60% of national growth; their combined share of Ukraine's nominal GDP increased from 22% in 2004 to 28% in 2015. This clearly points to the strong dynamics of the capital's urban agglomeration, which benefits from powerful agglomeration economies (see Box 1.2). Ukraine displays a high concentration of economic growth in the capital's urban agglomeration by OECD standards, but this situation is not unique: in France and Chile, the metropolitan capital regions accounted for 59% and 55% (respectively) of national economic growth during the same period. Capital regions also accounted for 70% of national growth in Romania and Bulgaria.[9]

This dominance of the metropolitan capital region with a core-periphery pattern of development is actually widespread among European Neighbourhood Policy countries[10] (with the partial exception of Belarus and Morocco). Metropolitan regions benefited greatly from a catching-up process in market services in all the transition economies, and capital regions generally did best of all, as the main seats of central public services and higher education and research facilities. They all benefited from being the most attractive to FDI inflows and to the most educated part of the population because they typically hosted the central offices of the main domestic and foreign firms and had the best transport connections domestically and to foreign destinations. In Ukraine, the experience of Kyiv fits into this paradigm very well given its level of economic development and ongoing structural changes arising from economic integration with advanced European partners (Petrakos, Tsiapa and Kallioras, 2016). Therefore, it is expected that Kyiv agglomeration will continue to be a strong growth driver for the country in the near future.

Figure 1.14. **Contribution to growth vs. share of GDP, Ukraine, 2004-14***

A region higher (lower) than the equality line grew more (less) than the national level



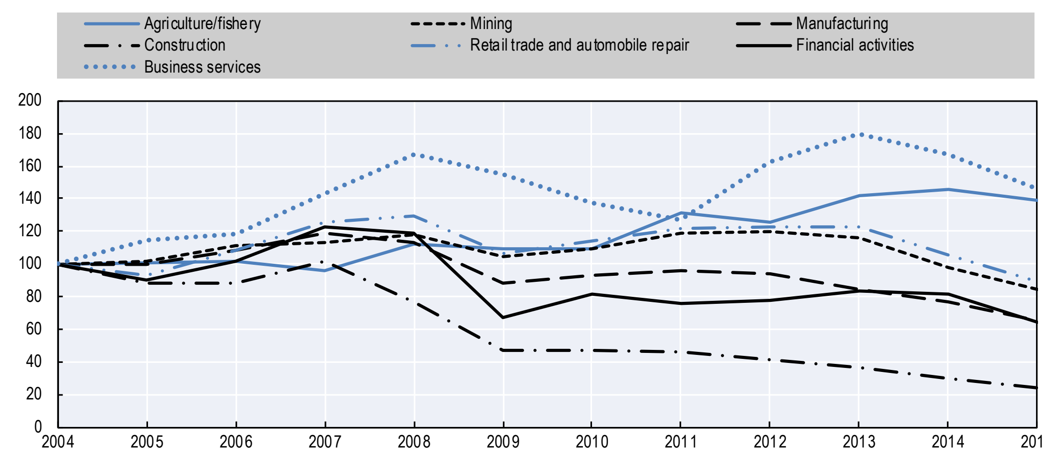
* 2014 growth rates do not take into account territories controlled by separatists. National growth has been adjusted to reflect the absence of data for Crimea and Sebastopol after 2013.
Source: OECD calculations based on State Statistics Service of Ukraine.

Differences in the performance of individual sectors had a clear impact on the spatial distribution of economic growth. After an impressive expansion prior to the 2009 crisis, manufacturing stagnated and then suffered a deep downturn (Figure 1.15). The financial sector also shrank after years of rapid expansion in the 2000s, while the 2014-15 reduction of households' real incomes depressed retail and service activities. By contrast, high value-added business services recovered after the global crisis, beginning in 2012, but declined in 2014-15. Since 2009, the agriculture and fisheries sector has demonstrated the most consistent growth (Figure 1.15). These patterns of development clearly favoured Kyiv agglomeration (high-end business services) and regions with agricultural specialisation.

The analysis of productivity growth during the decade to 2014 illustrates these patterns (Figure 1.16). OECD (2016d) uses a specific catch-up indicator based on the idea that a region needs to grow faster than the national frontier (the regions with the highest productivity levels) in order to reduce its productivity gap. In Ukraine, the national frontier is composed of Kyiv city and Poltava *oblast*. This allows us to differentiate three groups of regions: 1) catching-up regions (where productivity grew faster than the national frontier); 2) regions keeping pace with the frontier's productivity growth; 3) diverging regions, where productivity growth was lower than the frontier or even negative (catch-up indicators and a detailed explanation are available in Table 1.B.1 in Annex 1.B). Most of the regions catching up with the national frontier specialise in agriculture (although some have benefited from light manufacturing, such as Zhytomyr);

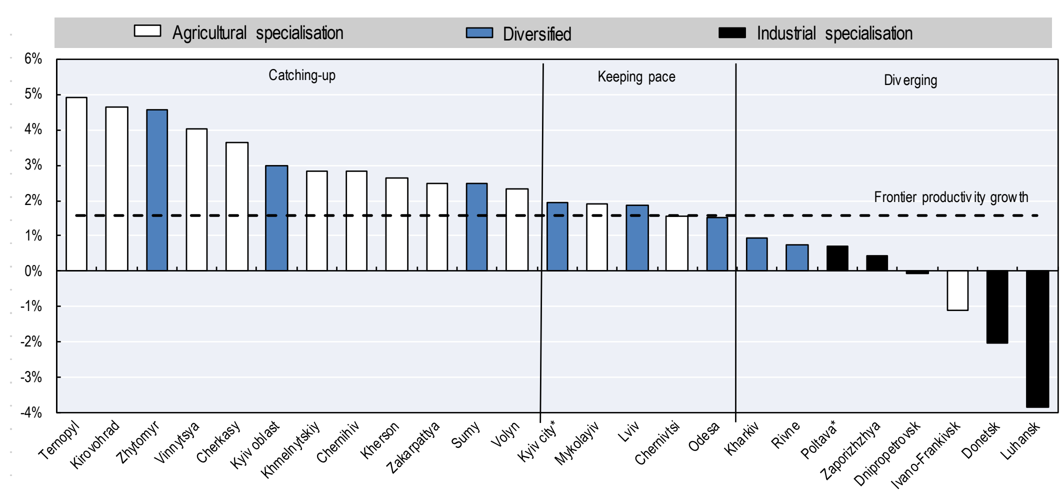
Ivano-Frankivsk in Western Ukraine is the only agricultural *oblast* in the diverging group. The decline in productivity in this region with a productivity level among the lowest in Ukraine is atypical and poses a challenge to Ukraine's regional development policy. By contrast, all regions specialised in mining and heavy manufacturing have been diverging (Figure 1.16). In many cases, regional productivity growth may also have benefited from population shrinking (because the capital per worker ratio increased in the short term), but this is likely to be reversed in the long run, as declining demography reduces incentives for investment and negatively impacts on GDP growth (World Bank, 2015).

Figure 1.15. **Real gross value added by sector (index, 2004=100)**



* Professional and technical activities (legal, accounting, engineering, R&D and architecture services).
Source: OECD calculations based on data from the State Statistics Service of Ukraine.

Figure 1.16. **Annual productivity growth across Ukraine's regions, 2005-14**



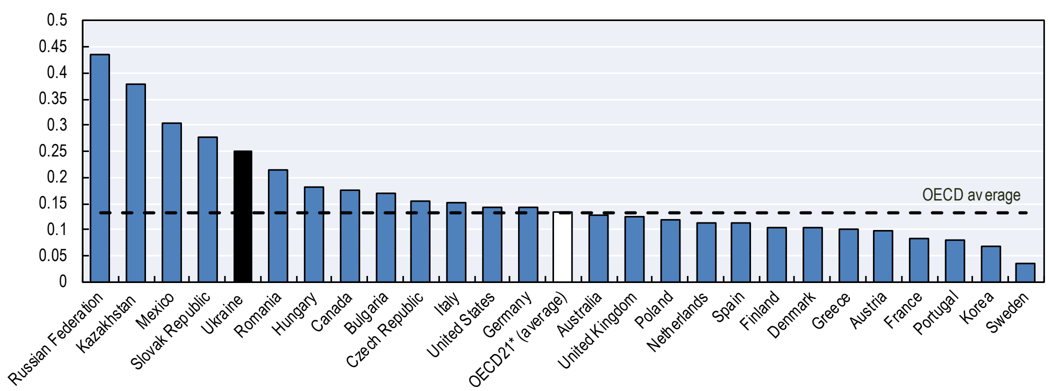
* Frontier regions (regions with the highest GDP per employee accounting for no less than 10% of employment).
Notes: Productivity is defined as regional GDP per worker. The strong decrease in productivity in 2015 is not reflected on this graph.
Source: State Statistics Service of Ukraine, National Accounts and Employment series.

Interregional disparities are high and keep increasing, partly because of the Donbas conflict

Economic inequalities among regions are high in Ukraine compared to most OECD countries. The dispersion of GDP per capita across regions as measured by the Gini Index of TL2 regions is comparable to OECD countries with high territorial inequalities, such as Mexico or the Slovak Republic (Figure 1.17). It is also close to countries in Central Europe, but much lower than in the other large post-Soviet countries.[11]

Since 2004, interregional economic disparities in Ukraine have increased substantially (Figure 1.17). During 2004-14, the interregional Gini Index of GDP per capita rose from 22.3 to 25.1 in Ukraine, a larger increase than was observed in any OECD country except Australia (which has far lower levels of territorial inequality). In 2015, the interregional Gini Index rose again to 26.7 because of the armed conflict and severe economic downturn in Donbas, which caused GDP per capita to fall well below the national average in Donetsk and Luhansk *oblasts*.

Figure 1.17. **Gini Index of GDP per capita in TL2 regions, 2014**



* Twenty-one OECD countries for which 2014 data are available, excluding countries with less than four TL2 regions.

Sources: OECD research based on data from the State Statistics Service of Ukraine and OECD (2017a), *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/region-data-en (accessed 16 February 2017).

The rise of interregional economic disparities in Ukraine is not unique. Like other transition countries, Ukraine inherited significant territorial imbalances from the Communist era: Southern and Eastern Ukraine were specialised in mining and manufacturing (machine building, steel and chemical sectors) and by 1989 had reached a higher level of urbanisation than the Central and Western regions. After the deep economic recession of the 1990s, interregional inequalities in GDP per capita increased continuously from 2000 to reach a peak before the 2008 financial crisis (OECD, 2014b). The rise of territorial inequalities during the 2000s is a common pattern among many European Neighbourhood Policy countries (Petrakos, Tsiapa and Kallioras, 2016). Many Central and Eastern European countries that joined the EU in 2004 and 2007 (particularly Bulgaria, Romania and the Slovak Republic) experienced a similar pattern. In Central Europe, rising territorial inequalities were often associated with intense structural change in the economy, economic convergence with more advanced EU members and the strengthening of the metropolitan capital region. This may be related to some extent to a broader empirical regularity known as the “Williamson curve” (Box 1.6), which suggests that interregional disparities may grow as incomes rise up to a relatively high level, only to decline thereafter.

Box 1.6. **Is the Williamson curve applicable to transition economies?**

Rising interregional disparities in Ukraine reflect in part an observed regularity discussed in the literature on economic geography since the 1960s – the so-called "Williamson curve". Williamson (1965) extended the Kuznets hypothesis, which describes the relationship between income inequality and development, to the explanation of regional disparities. Kuznets found that income inequality tended to increase at low levels of per capita income and to decrease at higher levels of development, forming an inverted "U" shaped curve (Kuznets, 1955).

Williamson found a similar pattern at the regional level: national development created increasing regional disparities in the early stages of development, but later on it led to regional convergence, resulting in an inverted U-shaped curve. The primary explanation for Williamson's finding is that, in a catching-up country, a few regions typically drive growth, and capital and skilled workers are increasingly drawn to them. Rapidly rising productivity causes growth to accelerate still further in these regions, leading to increasing regional disparities. Given the importance of agglomeration economies and the fact that rising investment goes with increasing concentration, there is an obvious link with urbanisation here: fast-urbanising regions will tend to pull away from others. At later stages, higher factor costs and/or agglomeration diseconomies emerge in the leading regions, prompting capital to shift to places where the potential returns to capital deepening are higher (i.e. those with lower capital per worker). Knowledge spillovers and a shift from a growth model driven by capital deepening to one more dependent on human capital may also play a role in this reallocation of productive factors.

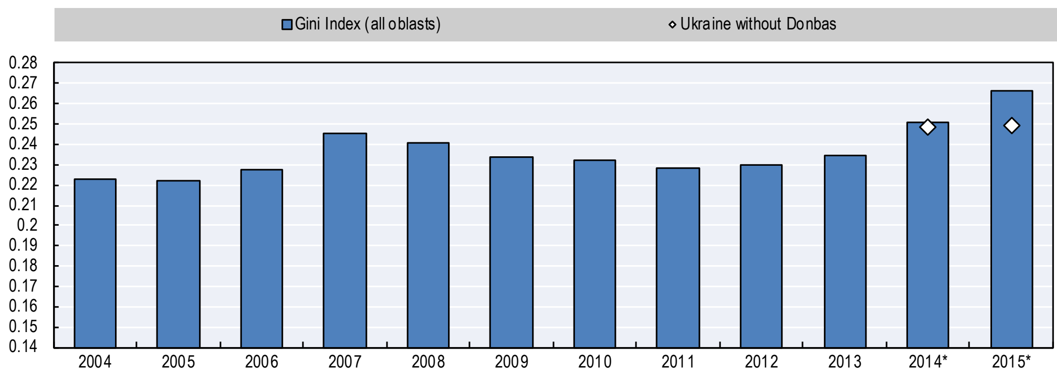
Recent research on Central and Eastern Europe suggests that the Williamson curve (or regional Kuznets curve) may not (yet) apply to transition economies. Monastiriotis (2014) compares regional convergence in labour productivity in EU-15 and the ten Central and Eastern Europe countries (CEE) that joined the EU in 2004. His research suggests that while CEE countries faced rising regional disparities, there has so far been no "return to regional convergence" at higher income levels. At comparable levels of development, regions in the EU-15 were already converging. However, since those processes took place a generation or more ago, the countries of the EU-15 were much closer to the leading economies than the CEE-10 are today; in short, they are still converging economies at national level, moving closer towards the international productivity frontier. Monastiriotis concludes that, despite strong growth up to 2009, CEE economies could still be in a phase of development and restructuring where cross-regional inequalities become more acute and persistent. In other words, non-convergence would be attributable to "centripetal forces" instigated by the process of transition.

For Ukraine, this leaves open the question of when the Williamson turning point might be reached. It is possible that even a resumption of strong growth would only lead to a reduction in interregional disparities over the longer term. However, provided that growth is strong and broad-based, both geographically and sectorally, it could provide a boost to prosperity even in lagging regions. It is, moreover, clear that the war in the east has reinforced interregional disparities; a settlement of the conflict could contribute to their rapid reduction, at least to pre-war levels, if not below.

Sources: Williamson, J.G. (1965), "Regional inequality and the process of national development: A description of the patterns"; Kuznets, S. (1955), "Economic growth and income inequality"; Monastiriotis, V. (2014) "Regional growth and national development: transition in Central and Eastern Europe and the regional Kuznets curve in the east and the west", https://doi.org/10.1080/17421772.2014.891156.

In Ukraine, high economic growth in the Kyiv urban agglomeration, boosted by the strong dynamic of the tertiary sector (notably financial intermediation and real estate), was the driving force of widening economic disparities among regions, a pattern that was reinforced by the crisis in the east of the country (Figure 1.18). It is not clear whether Ukraine reaching a higher level of economic development will favour a more equal allocation of income across its territory in the near future. However, it should be noted that Ukraine has mechanisms to stimulate the growth of lagging regions, such as the formula-based allocation of funds by the State Fund for Regional Development.[12]

Figure 1.18. **Gini Index of GDP per capita in Ukraine's TL2 regions**



* For 2014 and 2015, Crimea is not included due to a lack of data.
Source: OECD calculations based on data from the State Statistics Service of Ukraine.

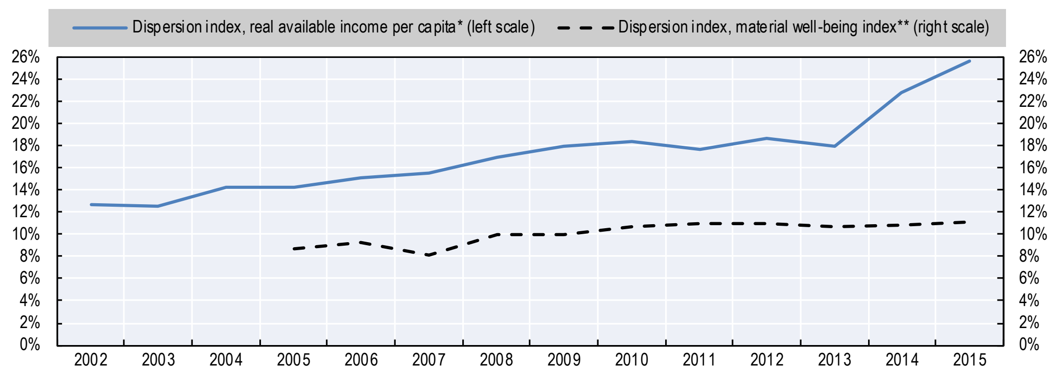
Economic disparities between Ukraine's regions have also increased from the standpoint of households. The dispersion index of real disposable income per capita has been on an upward trend since 2002, with a sharp increase in 2014-15 (Figure 1.19). This increase in dispersion is in great part driven by higher growth of real disposable income per capita in Kyiv compared to the national level. However, real disparities in material well-being are lower once the substantial differences in the cost of living across regions are accounted for: price levels are higher in prosperous regions. For instance, there is a rather good correlation (63%) between the price of wheat bread and available income per capita in each region. The largest disparities in price levels across regions are observed in the non-tradable sector, particularly real estate prices and rents, which is as one would expect. Nevertheless, the material well-being sub-index (part of Ukraine's official regional development index),[13] which attempts to measure material living standards beyond household monetary income, also suggests an increasing dispersion in material well-being across Ukraine's regions (Figure 1.19). Unfortunately, the index is not available for Kyiv city, and therefore underestimates interregional disparities.

In contrast to real disposable income per capita, the dispersion in real wages fell during the 2000s, up until 2014. It is likely that wage adjustments to economic shocks take place largely in the informal labour market, including through the practice of unregistered wages (OECD, 2014b).

Tackling obstacles to growth across Ukraine's regions

Regional growth can be influenced by a myriad of interconnected factors such as amenities, geographic location, demographics, size, industry specialisation and agglomeration economies. Like national growth, regional growth is dependent on the availability of inputs – capital, labour and land. The supply of labour is unlikely to support economic growth in the medium term: Ukraine's active population is gradually decreasing and projected to decrease by around 39% up to 2060 because of low fertility and widespread out-migration (Kupets, 2014). However, improving the functioning of regional labour markets can help mitigate the effects of population ageing and the gradual decline of the working-age population.

Figure 1.19. **Regional dispersion trends in Ukraine**



*. Base year: 2002.
** The material well-being index is a component of the regional Human Development Index published by the State Statistics Service of Ukraine and Ptoukha Institute for Demography and Social Studies. It is a composite index of material living standards in each region. It encompasses monetary poverty; the availability of durable consumption goods; and the relative purchasing power of households, GDP per capita, and the share of households able to save money or invest in real estate.
Notes: The dispersion index is measured as the sum of absolute differences between regional and national values, weighted with regional share of population and expressed as a percentage of the national value. For 2014 and 2015, Crimea is not included due to missing data.
Sources: OECD research based on data from the State Statistics Service of Ukraine (2014), *Regional Human Development Index*, http://idss.org.ua/ukr_index/irlr_2014_en.html (accessed 28 March 2017) and National Accounts of Ukraine, www.ukrstat.gov.ua (accessed 15 January 2017).

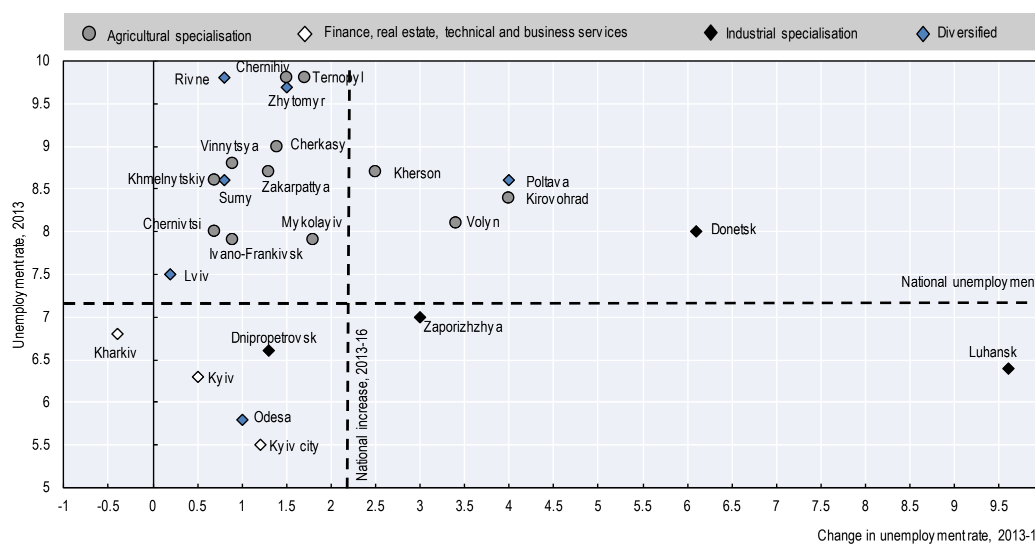
Labour productivity growth is a key driver of performance among OECD regions (OECD, 2016d). Increasing labour productivity in Ukrainian regions from its currently low level (10% of the EU-28 average) is critical to support sustainable economic growth. Beyond labour markets, this would require an improvement in external and internal connectivity, through modernisation of the outdated manufacturing sector, and sustained investments to upgrade the country's transport infrastructure (discussed in more detail in Chapter 4).

Improving the functioning of Ukraine's labour markets should be a priority

As a result of the 2014-15 economic downturn, the unemployment and youth unemployment[14] rates in 2016 reached their highest levels since 2005 (9.3% and 16%, respectively). The 2014-15 recession led to a drop in employment and a sharp increase in unemployment in all regions, except Kharkiv. In 2013, as in the past, regions specialised in agriculture (largely in Western and Central Ukraine) exhibited higher unemployment rates (Figure 1.20). Two years of recession and the Donbas conflict somewhat altered this pattern: in 2016, the two Donbas regions (Donetsk and Luhansk) had the highest unemployment rates in Ukraine, 16% in Luhansk. Poltava and Zaporizhia, with strong manufacturing and mining sub-sectors, also recorded relatively high unemployment rates (12.6% and 10%, respectively). Employment in regions surrounding large urban centres was usually lower, particularly Kyiv, Kharkiv (the lowest unemployment rate in Ukraine) and Odessa (Figure 1.20).

In all but one of Ukraine's 25 regions, labour force participation rates have decreased since 2013.[15] The higher the unemployment rate in a given region, the sharper the drop in labour market participation.[16] This suggests that the drop in labour market participation is mostly due to discouraged workers, who could join the labour force again if it became easier to find a job. The decrease in labour market participation has been particularly strong in Donetsk *oblast* and in some agricultural *oblasts* of Western Ukraine (Volyn, Khmelnytskiy and Ternopyl), where labour force participation fell below 60% (corresponding to the 15% of TL2 regions in the OECD with the lowest labour market participation rates). In some *oblasts* (Odesa, Donetsk), female participation rates fell as low as 52% (this is lower than all OECD countries except for Turkey). Therefore, increasing the female labour market participation in these regions could help mitigate the effect of a declining labour force over the next few years.

Figure 1.20. **Impact of the 2014-15 recession on regional unemployment, Ukraine**



Source: State Statistics Service of Ukraine (2017a), "Labour Force Survey", www.ukrstat.gov.ua.

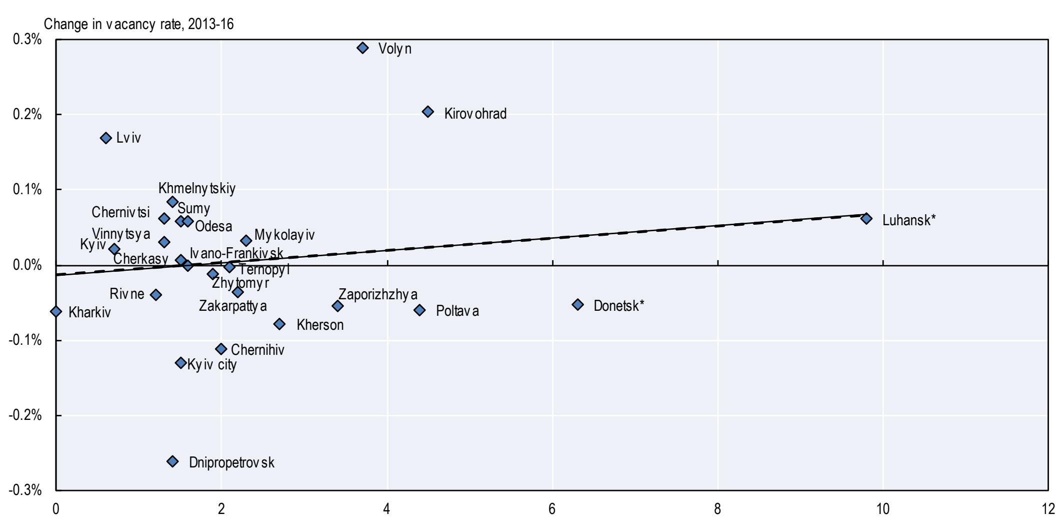
The Donbas conflict contributed to increasing spatial fragmentation of Ukraine's labour market: the dispersion index of regional unemployment rates, which went down after 2009 because unemployment increased particularly in low-unemployment regions, reached 24% in 2016, the highest level since 2005 (Figure 1.21). This would place Ukraine in the upper quartile among OECD countries as regards the dispersion index of unemployment rates.[17] Annex 1.C provides an analysis of regional labour markets based on vacancy statistics from the State Employment Service. While further research and more reliable data are needed, analysis of the limited available data provides further evidence of spatial fragmentation and of inefficiency in some regional labour markets. For instance, a few *oblasts* – such as Zhytomyr, Ternopyl and Poltava – have a higher unemployment rate than the national average while their vacancy rate (an indicator of firms' labour demand) is also above the national level (Figure 1.C.1 in Annex 1.C). This could be due to mismatches between workers' skills/qualifications and labour market needs.

Figure 1.21. **Regional dispersion of unemployment rates, Ukraine**

* Holding the 2013 unemployment rate and population share constants in 2014-15-16 for Luhansk and Donetsk.
Notes: The dispersion index is measured as the sum of absolute differences between regional and national values, weighted with regional share of population and expressed in per cent of the national value.
Source: OECD calculations based on data from the State Statistics Service of Ukraine (2017a), "Labour Force Survey", www.ukrstat.gov.ua.

There is also evidence that the matching between labour demand and labour supply degraded during 2013-16: contrary to what one would expect, while unemployment rates increased in all regions, vacancy rates also increased in 12 regions out of 25. Moreover, there is a positive correlation between the increase in unemployment and the rise of vacancy rates (Figure 1.22). Three regions (Volyn, Kirovograd and Luhansk) entirely determine this correlation, because they experienced both a substantial increase in unemployment and in their vacancy rate, suggesting an increasingly poor matching between firms and workers. In the case of Luhansk this could be due to the relocation of many qualified workers to other regions of Ukraine in the context of the armed conflict.

Figure 1.22. **Change in unemployment and vacancy rates by region, Ukraine, 2013-16**



* Data for government-controlled territory.
Source: State Statistics Service of Ukraine, State employment Service of Ukraine, Labour market indicators, www.ukrstat.gov.ua.

Addressing this skill mismatch and improving the functioning and economic integration of regional labour markets are key objectives to lower structural unemployment and boosting productivity. This means that Ukraine needs to tackle three major obstacles: low interregional labour mobility, widespread labour market informality, and substantial education-job mismatch and graduates' skill gap.

Low interregional labour mobility

Internal labour market mobility is low in Ukraine because substantial constraints increase migration costs and reduce the incentives to move to other regions with better economic prospects. It is estimated that, controlling for the size and number of regions, internal migration rates in Ukraine are about half of what would be expected compared to other countries (Koettl et al., 2014). This is confirmed by findings from the EBRD/World Bank "Life in Transition" Surveys: in 2010, only 0.9% of Ukrainians intended to move to other parts of the country, one of the lowest rates among 32 countries in Europe and Central Asia. Besides, the few Ukrainians contributing to interregional labour mobility are not always seeking better labour opportunities: "push factors" (economic constraints and cuts in public spending in the regions of origin) appear to be stronger drivers of internal migration than "pull factors" (better education/job opportunities). This limits the efficient reallocation of human resources within the country (Koettl et al., 2014; World Bank, 2015).

The primary factors limiting internal labour migration in Ukraine are the lack of access to credit and underdeveloped mortgage and housing markets, combined with the overall high cost of housing and considerable interregional housing price differentials. Ukraine has a very high rate of home ownership: according to the 2010 Household Budget Survey, 95% of households owned the home they lived in, while only 2.4% were tenants from private owners and the rest tenants from public institutions (such as city administrations, universities, etc.). Extremely high home ownership discourages mobility because the perceived cost of staying in one's home is low compared with the high transaction costs of relocating (Koettl et al., 2014). This translates into an underdeveloped rental housing market, which increases the cost of rental housing. Substantial regional housing price differentials are another obstacle: housing in economically attractive urban areas is significantly more expensive (as a share of local annual average income or local average wage) than in other regions. For instance, research indicates it can take 21.2 years of average salary to buy a 2-bedroom apartment in Kyiv and 19.7 years average salary in Odessa, the highest ratios in Ukraine (Komarov, 2012). Therefore, the sale of residential property in a lagging region is not enough to finance the acquisition of new housing in a destination with better economic prospects. Ukraine's residential mortgage market reached a peak of 11% of GDP in 2009: this is well below the EU average (51.8% of GDP), making it one of the smallest mortgage markets in Europe, along with Bulgaria and Slovenia (Koettl et al., 2014).

An overreliance on social networks and informal labour and housing arrangements, as well the cumbersome residence registration system, are additional obstacles to internal labour mobility. In Ukraine, the small rental market is predominantly informal, i.e. most landlords and tenants do not conclude formal rental agreements. Over the long term, this increases uncertainty about the risks of the rental agreements, inciting migrants to rely on personal networks such as family and friends, which increases the transaction costs linked to migration (Koettl et al., 2014). It also means that migrant tenants usually cannot register with local authorities at their new place of residence because a copy of the rental contract is required for migrant tenants to register. In Ukraine, residence registration is compulsory (after 30 days) and is a condition of access to a wide range of administrative procedures and public services, such as social assistance, voting in local elections, applying for official documents, etc. Although *de jure* residence registration is not a condition to access essential public service such as healthcare, it *de facto* plays an important role as hospitals often require local registration certificates from patients (CEDOS, 2017). Residence registration seems to present more acute problems for low-skilled migrants (Koettl et al., 2014).

Internally displaced persons present specific challenges (Box 1.4), because they are not typical "normal" economic migrants but migrants that have moved as a result of forced relocation. Geographic proximity to the region of origin is the most important factor determining the allocation of the IDPs across regions. Despite this, economic "pull" factors (such as the number of vacancies or the wage level) also played a role in the IDPs' destination choices: they tend to move to relatively prosperous regions (Benzel, Betliy and Robert, 2015). This is positive and should ease their integration into regional labour markets. However, given the low share of IDPs that found a job in their new regions (31% in 2015), additional targeted labour market programmes are probably necessary. A fast-track access could be designed for the IDPs to register as unemployed even if they do not have all the required documents (such as labour books), as is common.

A set of policies aimed at easing labour mobility is necessary to increase economic gains from rising productive sectors, such as finance, IT technologies and light manufacturing and to decrease the spatial fragmentation of the Ukrainian labour market. This requires eliminating or smoothing some of the obstacles to internal labour mobility, beginning with the housing market. Koettl et al. (2014) and World Bank (2012) make practical policy recommendations to develop rental housing markets. For instance, the Austrian model of social housing and its financing, with limited-profit housing associations acting as a third sector between state-owned social housing and the private market, yielded positive results in Central and Eastern Europe. The imposition of a stronger real estate tax based on market values (rather than apartment size in the current system) and with fewer tax exemptions could stimulate housing supply in the higher demand areas while providing local budgets with an additional source of revenue. Beyond housing, improving access to finance, stimulating the mortgage market and reforming the residential registration system (*Ukr. Propiska*) would be key next steps. In this regard, a gradual evolution of residential registration towards a fully declarative system, without any requirement of "landlord consent" in the case of tenants, is necessary to encourage citizens to register at their actual place of residence (CEDOS, 2017). Such a reform of residence registration in Latvia led to positive results, i.e. Latvian citizens can now easily declare their new place of residence (in person or via an e-declaration process) and have it recorded in the electronic population registry when they move inside the country (CEDOS, 2017).[18]

Widespread labour market informality

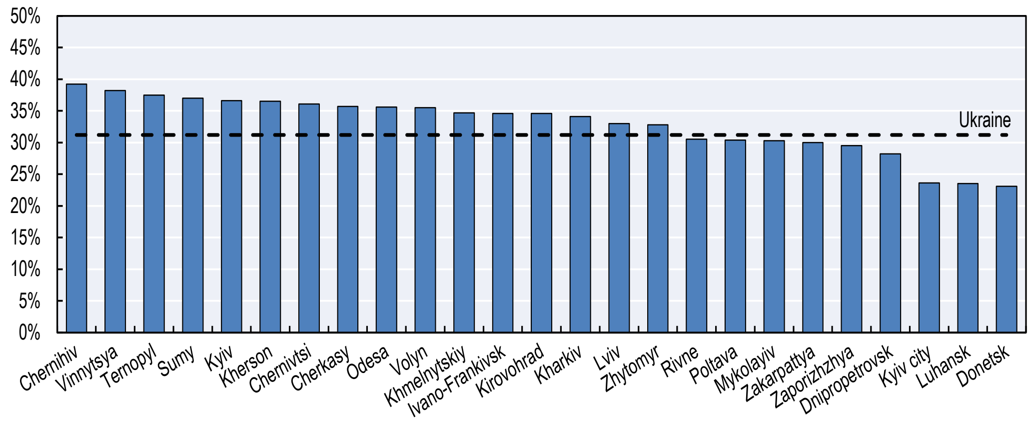
Ukraine combines a very stringent formal employment protection system[19] with a high level of *de facto* labour market informality (an estimated 24.4% of employees were in the informal sector in the first half of 2016). Such a high level of labour market informality is detrimental to productivity growth because it reduces incentives to invest in human capital and hampers business innovation. Informality is also a factor in low interregional labour mobility because it is associated with uncertainty over the actual payment of wages and other abuses of power by employers. This increases the risks and reduces the expected pay-offs from labour market migration (Koettl et al., 2014). Last but not least, widespread labour market informality leads to fiscal sustainability challenges, contributing to the extremely high deficit of Ukraine's pension fund, which reached 6.25% of GDP in 2016 (IMF, 2017a). Moreover, because the personal income tax is a major source of income for local budgets, labour market informality (including the widespread under-reporting of formal wages by employers) is a challenge for local government finance.

Most informal workers are employed in the agricultural sector, either on private or family farms. This means that 1.5 million people are not covered by any sort of social security; the labour informality rate in rural areas reaches 41%. The main motive for informal labour in rural areas seems to be the lack of alternatives to subsistence farming and small-scale informal activities (World Bank, 2011). In urban areas, informal workers (accounting for 17% of employment) are common in the trade and construction sectors, most often in micro or small enterprises with fewer than ten employees. Informality decreases with education: it is widespread among the unskilled, individuals with low educational attainment and the skilled trades, and comparatively rare among employees with higher education. Labour informality is particularly widespread in certain areas of Western and Central Ukraine (Vinnytsya, Ternopyl, Khmelnitsky, Cherkasy and Kirovohrad *oblasts*).

The estimated prevalence of informal jobs has risen moderately since 2011: from around 22% of employment to 26% in 2014-15, possibly due to large-scale job losses in the formal sector in conflict-affected regions. The rate of informality stabilised around an estimated 24.4% in the first half of 2016. In January 2016, the government halved the social security contribution rate paid by firms from around 44% to 22%, one of the lowest levels in Europe. The government introduced this reform with the hope that it would incite informal businesses to join the formal sector. However, based on 2016 social contributions data, it is estimated that the improvement in payment compliance has been very modest so far (IMF, 2017a). In January 2017, the government doubled the minimum wage to UAH 3 200 (about USD 120), with the objective of tackling the under-reporting of formal wages (so-called "envelope wages") and boosting revenues to the pension fund from social security contributions. The rationale is that a large share of actual private sector wages (including the cash supplement) is already above UAH 3 200. However, this sharp increase could negatively affect small and medium-sized enterprises (SMEs) in some of Ukraine's less-developed regions, driving them out of business or into the shadow economy. Figure 1.23 plots the share of workers with a wage below UAH 3 000 (i.e. below the new minimum wage) before the new minimum wage entered into force in January 2017. In many *oblasts*, almost a third of official wages were below the new minimum (almost 40% in Chernihiv). The impact of the new minimum wage on the SME sector in these regions should be carefully monitored.[20] The government should resist pressures to raise the minimum wage further: the ratio of the minimum wage to the average wage is already high in Ukraine (53% in January 2017 versus on average 40% in OECD countries in 2016).

Informality is a multivariate problem, and it is doubtful that the minimum wage hike or the decrease in social contributions alone will be sufficient to discourage informal employment or massive under-reporting of formal wages. There is a need to strengthen revenue administration and upscale the efforts to tackle low tax compliance (IMF, 2017a). Due to the very limited number of labour inspectors, it is estimated that the probability of inspection in each enterprise is about once every 20 years (World Bank, 2011). As part of its 2017 Memorandum of Economic and Financial Policies with the IMF, the Ukrainian government committed to enhancing labour inspections and abolishing the current moratorium on tax and labour inspections of small businesses, which account for the bulk of non-agricultural informal workers (IMF, 2017a). The adoption of a modern labour code introducing more flexibility for employers could also help reduce labour informality over the long term.

Figure 1.23. Share of official wages below UAH 3 000 in the wage structure, Ukraine, December 2016



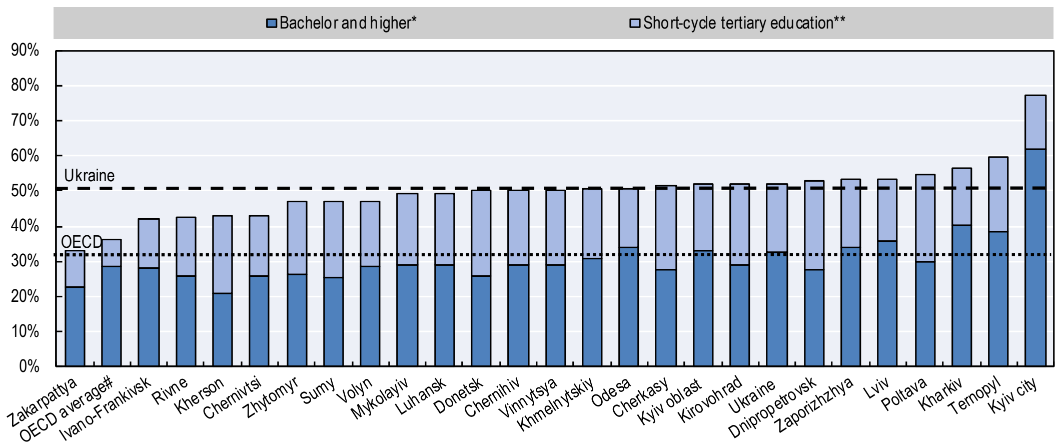
Notes: Share of wages below UAH 3 000 among workers with at least half-time employment. Official wages might not reflect actual wages paid by employers because of widespread under-reporting ("envelope wages").
Source: State Statistics Service of Ukraine.

Substantial education-job mismatch and graduates' skill gap

Ukraine has achieved almost universal literacy and nearly universal primary education. Average basic cognitive skills are comparable to OECD country averages, and reading proficiency in urban areas is higher than in many middle-income countries (Del Carpio et al., 2017). In 2015, less than 1% of the active population had completed only primary education. The formal educational achievements of the Ukrainian workforce increased continuously during the 2000s. Younger cohorts have high enrolment rates in the higher education system: after 12 years of continuous increases, the gross tertiary enrolment rate (the ratio of total enrolment in tertiary education to the population of the corresponding age group) reached 82% in 2014 (against 65.4% in 2002). This is partly due to the increased popularity of long-cycle programmes, such as Master's degrees, compared to short-cycle tertiary education with a technical specialisation. Indeed, the number of graduates from long study programmes has more than doubled since the fall of the Soviet Union (from 137 000 in 1990 to 485 000 in 2013), while the number of graduates of short-cycle technical tertiary education fell by more than half during the same period (from 229 000 in 1990 to 91 200 in 2013). In 2015, 32% of Ukraine's economically active population had the equivalent of a Bachelor's degree or higher (Figure 1.24). If those completing short-cycle tertiary education with technical specialisations are included, then 52% of the active population had some sort of higher education in 2015, far higher than the OECD average (36.2%; Figure 1.24). The figure for Ukraine is comparable to the OECD countries with the highest tertiary attainment rates, such as Canada (55%) and Japan (50%).

After 2005, the share of active population with tertiary education rose in almost all regions (except Ivano-Frankivsk *oblast*), driven by the increased popularity of long-cycle academic programmes (roughly equivalent to Bachelor's and Master's degrees). However, in some agricultural *oblasts* of Western Ukraine, the share of the workforce with only a secondary education is still high (55% in Zakarpattya, for instance). Urban areas, and particularly large cities, have a higher share of university graduates: in Kyiv, 61% of the employed population has an advanced degree, which is double the national level (32%). Kharkiv *oblast* has the second-highest share of advanced degrees in its active population (Figure 1.24).

Figure 1.24. **Share of active population with a tertiary education, Ukraine, 2015**



Notes: *: Advanced degrees include Ukrainian *Povna vyshha osvita* and *bazova vishha*. **: Short-cycle tertiary education includes Ukrainian *Nepovna vishha*. #: Percentage of 25-64 year-olds (instead of active population) with a tertiary education.
Sources: State Statistics Service of Ukraine; OECD (2016a), *Education at a Glance 2016: OECD Indicators*, http://dx.doi.org/10.1787/eag-2016-en.

Despite a growing share of graduates and increased access of younger cohorts to higher education, per capita income and average labour productivity in Ukraine are very low, much lower than in OECD countries with a similar stock of human capital. Corruption in the education system is a major issue, with a strong negative impact on the quality of education. According to a 2013 poll, 77% of respondents answered that corruption is pervasive or widespread in higher education (OECD, 2017b). Moreover, curricula in the formal education and training system are focused on theory rather than on skills relevant to the workplace. Some 60% of firms in four key sectors (i.e. food processing, IT, agriculture and renewable energy) report that graduates do not meet the skills needs of employers; as they lack up-to date knowledge and practical skills (Del Carpio et al., 2017). In business surveys, 40-50% of Ukrainian companies report that skills shortages are a major constraint to doing business, a higher rate than in most countries in Europe and Central Asia. Business surveys also show that skill gaps are a major constraint on hiring, especially regarding high-skill positions such as technicians or professionals (Del Carpio et al., 2017). Beyond the quality and labour-market relevance of education, the Ukrainian labour market experiences an acute education-job mismatch (Kupets, 2016). Existing evidence and research points to an oversupply of university graduates with a formal education in "fashionable" fields (such as finance, economics and law) and a deficit of engineers, physicists and skilled craftsmen (Koettl et al., 2014). The first assessment of the prevalence of education-job mismatch across Ukrainian regions revealed substantial heterogeneity, with the highest incidence of over-education in agrarian regions located in Western and Southern Ukraine (Kupets, 2016). This confirms some of the findings of the analysis in Annex 1.C, which suggests that many of these agrarian regions have "inefficient" labour markets.

There are several reasons for the education-job mismatch in Ukraine, including a low demand for skilled workers in several regions. Over the long term, macroeconomic instability, a challenging business environment and an outdated and rigid labour code are constraints on the development of skill-intensive firms and sectors (Del Carpio et al., 2017). Several measures focused on skills and the education and training system could help to improve labour market efficiency and productivity. As Ukraine is decentralising its education system, regions and local governments will bear an increased responsibility in this regard.

- To reduce the mismatch and the skills gap between employer expectations and graduate abilities, the education and training system needs to be more responsive to labour market needs. This requires building systematic partnerships with the private sector to adapt curricula and increase their relevance to the workplace. Another priority should be to develop on-the-job training and life-long learning, as currently few working-age Ukrainians take part in trainings outside of the formal education system.
- Workers and students need better access to labour market data, including prevailing wages, vacancy rates and advancement opportunities. Reducing information asymmetries could stimulate internal labour mobility and favour a more relevant choice of fields of study by prospective students. Setting up regional labour market observatories analysing vacancies from both the State Employment Service and leading private job portals could be a first step.
- Given the shortage of skilled craftsmen across Ukraine, vocational and professional training should be modernised and must become more attractive. Since local governments are now in charge of maintaining professional and vocational training institutions, they should have the opportunity to influence the number of students in each specialty. They could also be involved in reforming curricula based on partnerships with local industry to adapt the profile of graduates to local labour market needs.

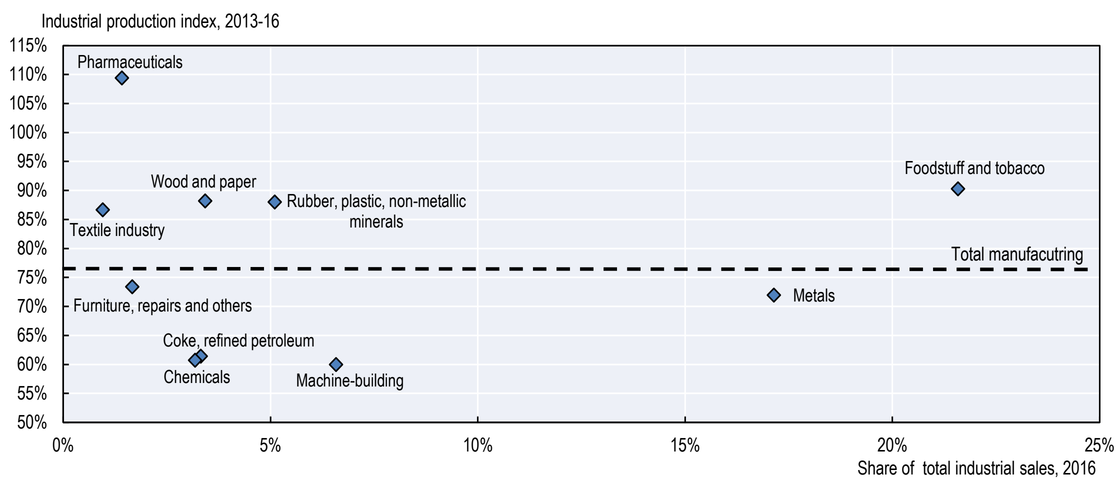
Confronted with a strong asymmetric shock, Ukraine's ailing heavy industrial complex requires modernisation

The 2014-15 economic crisis and the Donbas conflict led to considerable disruption of Ukraine's industrial sector. Industrial production began to decline in 2013 and huge losses were registered in 2014 and 2015. Despite a modest recovery in 2016, the volume of industrial production only reached 82% of its 2010 level. However, the decline of mining and, above all, of the manufacturing sector is a long-term trend. The manufacturing share of GDP has more than halved since 1999, reaching 14% in 2015. Unlike some countries in Central and Eastern Europe, such as Hungary, Poland and the Slovak Republic, Ukraine did not manage to modernise its industrial sector and stabilise the manufacturing share of GDP during the 2000s. Inside the industrial sector, the Donbas conflict has accelerated an ongoing structural shift towards light manufacturing – textiles, food and wood processing, rubber and plastic. The heavy, capital-intensive subsectors were the strongest component of Ukraine's industry, accounting for 50% of industrial sales as recently as 2013. Since 2010, however, lighter subsectors have been growing faster.

The Donbas conflict and collapsing exports to the Russian Federation due to trade sanctions (and the Russian Federation's import substitution policy) hit Ukrainian heavy industry hard, especially in the Eastern and south-eastern regions. The economy of the NGCAs (separatist-controlled areas) is highly concentrated in heavy subsectors of metals, mining, coke and petroleum (Saha and Kravchuk, 2015). The 2017 economic blockade stopping the movement of goods to and from the NGCAs is putting further pressure on metallurgical production. The conflict thus caused a sharp contraction in the metals and coke subsectors (Figure 1.25). The heavy machine-building sector (particularly the railway machine-building and machinery and equipment subsectors) had the highest exposure to the Russian market, which absorbed around 22% of their output in 2012. The disruption of trade ties with the Russian Federation thus constituted a further blow to heavy industry (Movchan, Guicci and Ryzhenkov, 2014). Indeed, production volumes dropped by 40% in machine building from 2013 to 2016 (Figure 1.25).

By contrast, in Western and Central Ukraine, industry is dominated by food processing and other light subsectors (wood processing and furniture, plastics and pharmaceuticals). These did not suffer as much from the 2014-15 recession: in four *oblasts* (Vinnitsa, Zhytomyr, Volyn and Ternopyl) manufacturing value added even increased in real terms between 2010 and 2015. Initially small, the industrial sector in Western and Central Ukraine has been increasing its economic weight (Saha and Kravchuk, 2015).

Figure 1.25. **Manufacturing sub-sectors through the 2013-16 downturn, Ukraine**



Source: State Statistics Service of Ukraine.

Thus the Donbas conflict and 2014-15 crisis resulted in an asymmetric shock, weakening the traditional heavy industrial complex in Eastern and (to a lesser extent) Southern Ukraine. In contrast, in all *oblasts* where manufacturing volumes increased as compared to 2010, the food processing sub-sector was the main component, in conjunction with smaller light manufacturing sectors, including wood, paper and printing in Zhytomyr, Lviv and Kyiv *oblasts*, and rubber and plastics in Lviv *oblast*. All of these regions are located in Central and Western Ukraine, with the exception of Mykolaiv.[21] While machine building was facing a crisis nationwide, Volyn (in the north-west of Ukraine) was the only region where the sector continued to grow.

The spatial asymmetries in the impact of recent shocks mean that different regions of Ukraine will face very different challenges in the future. Western and Central Ukraine (including Kyiv) are best positioned to benefit from trade integration with the EU. Western Ukraine stands to gain significantly from increased participation in cross-border, EU-wide production networks, which played a crucial role in the convergence of Central and Eastern European countries towards the more advanced EU economies (Adarov et al., 2015). This is already happening in some Western *oblasts*: for instance, Lutsk (Volyn *oblast*) is home to a growing cluster of companies supplying the EU automotive manufacturing industry, including foreign investors such as Kromberg End Shubert (board electrical cable system) and SKF (tapered roller bearing). The depreciation of the hryvnia after 2014 (the real effective exchange rate fell by 22% between January 2014 and January 2017)[22] further increased the comparative advantage of labour-intensive light industrial production in Ukraine.

Setting up of “cluster councils” could be a sound instrument to stimulate cross-border production networks (Saha and Kravchuk, 2015). They would aim to enhance cluster visibility to international investors and foster intra-cluster co-operation. This is all the more relevant in Western Ukraine because its industrial structure is characterised by smaller companies, with less influence from oligarchic business conglomerates. For instance, in the Czech Republic, the Klastry programme led to the creation of 25 clusters based on a self-selection process co-ordinated by the national agency Czech Invest.[23] A gradual upgrading of transport infrastructure, particularly roads, is also necessary to ensure that the least developed agrarian regions are well connected and can fully benefit from their comparative advantage of cheap labour and affordable land.

The industrial sector of Eastern and Southern Ukraine presents daunting challenges. Industry still accounts for a large share of employment (32% in government-controlled Donbas, 25% in Dnipropetrovsk *oblast* and 19% in Kharkiv *oblast*, for instance). Many companies focusing on steel, machine building, coke and refined petroleum operate with an outdated capital stock, old technology and a weak corporate governance culture. Because of challenging ownership structures (state companies with a “strategic” status or Ukrainian and Russian business conglomerates, often with a vertically integrated structure), most of the required investments have not taken place.

Machine building is the subsector facing the most acute challenges, partly because it relies on long-term supply chains (unlike commodities such as steel) that make it difficult to find alternative export markets. One indicator of the challenges facing the sector is that labour productivity in Ukrainian machine building in 2012 was only at 79% of overall manufacturing productivity and 67% of national average productivity for all sectors. This is something of an anomaly, since labour productivity in manufacturing is usually higher than the national average and machine building, being a capital-intensive sector, usually has higher labour productivity than many other branches of manufacturing. This suggests that there is a large capital and technology gap *vis-à-vis* global competitors. (Naūrodski and Babicki, 2016). Indeed, underinvestment ensured that in Ukraine’s machinery sector, the depreciation rate of fixed assets reached 85% in 2015 (against 60% on average in all sectors).

Saha and Kravchuk (2015) outline options for the modernisation and restructuring of the machine-building sector, which could be relevant to the rest of Ukraine’s heavy industry. This programme involves export promotion to help firms find alternative export markets and investment facilitation, which is crucial to attracting much needed foreign investment to renew the capital stock and introduce new technologies. In many ways, the success of long-term modernisation will depend on nationwide institutional reforms, such as improving corporate governance, strengthening competition policy, opening industrial state-owned enterprises to foreign capital through a revision of their “strategic” status, and strengthening the rule of law. Greater transparency and better corporate governance could help attract FDI into industrial sectors (Naūrodski and Babicki, 2016). This is paramount for the machine-building sector, which unlike the metals or food processing industries has not benefited from significant foreign capital inflows: in December 2016 it accounted for only 2.2% of Ukraine's overall FDI stock.

Civic engagement and local governance

Despite corruption and low electoral participation, trust in local government is gradually growing in most cities

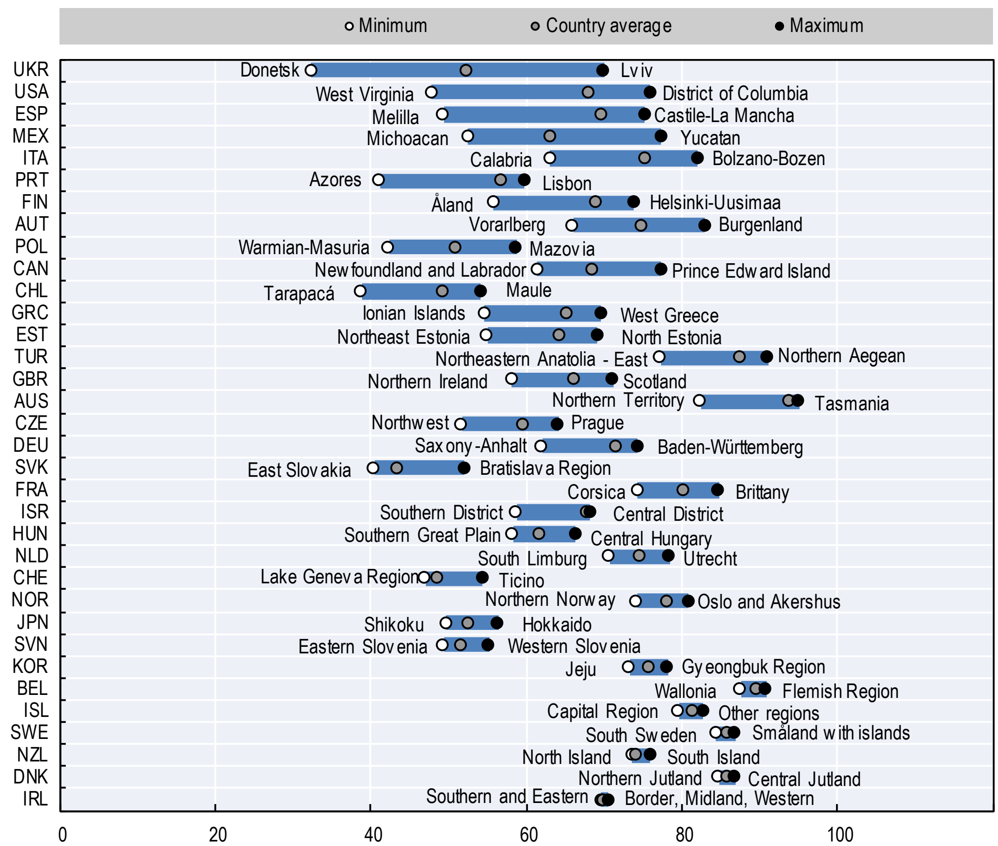
Institutional conditions and governance matter for individual well-being and regional development. A study focused on 169 EU regions demonstrated that the quality of local government is a key factor in the efficient use of EU Cohesion and Structural Funds. This suggests that the quality of subnational governments could be a strong determinant of the return on public investment at the subnational level (Rodriguez-Pose and Garcilazo, 2013).

Civic engagement and participation are necessary conditions for effective governance, while good governance can enhance citizen participation (OECD, 2016e). Both vicious and virtuous circles are possible: poor governance and citizen disengagement reinforce one other, as do good governance and citizen participation. Voter turnout is an indication of the degree of public trust in government and of citizens' engagement in the political process. In Ukraine, voter turnout in national elections has been lower than the OECD average (69.6%) in the last two general (parliamentary) elections, e.g. in 2010 (58%) and 2014 (52.4%). As of mid-2016, only five OECD countries registered a lower electoral participation in their latest national election. Turnout was slightly higher in the last presidential elections (59.5% in 2014), but still below most OECD countries.[24]

Moreover, the last national elections (i.e. the 2014 parliamentary elections) exposed very substantial regional disparities in electoral participation: there is a gap of 37.6 percentage points between the region with the highest turnout (Lviv) and the one with the lowest (Donetsk). This gap is higher than in any OECD country (Figure 1.26). Turnout was the lowest in the government-controlled territory of the Donbas (around 33%). Nevertheless, even excluding Luhansk and Donetsk *oblasts*, the gap between the highest and lowest reached 30.5 percentage points, still higher than in any OECD country (the United States had the highest gap in the OECD with 28.1 percentage points; Figure 1.26). Electoral participation was much lower than the national level in many other regions of Eastern Ukraine (Dnipropetrovsk, Zaporizhia, Kharkiv, etc.) and in the Southern Black Sea regions of Odesa, Mykolaiv, Kherson, but also in Zakarpattya (Western Ukraine). Voter turnout in almost all regions in the 2014 parliamentary elections was below the levels of the previous elections in 2012.

Wide disparities in levels of citizen engagement have important implications for the regional and local level, especially in the context of the current decentralisation reforms. A large and increasing range of public activities which directly affect citizens' everyday lives are now managed by subnational authorities. Effective local accountability – including competitive, transparent and fair local elections – will be critical to ensure that decentralisation leads to better public service delivery, improved governance and a greater ability for citizens to affect policies enacted at the local level. However, turnout for local elections in Ukraine has tended to be far lower than for national elections, as is the case in many OECD countries. Turnout for the October 2015 elections for *oblast*, district (*rayon*) and city councils, and for heads of city and rural administrations, was just 46.6%, significantly lower than the level of 52.2% recorded at the previous local elections in 2010. In Kyiv, electoral participation fell to 41.9% (one of the lowest levels in Ukraine), from 54.2% for 2008 city council elections. Electoral participation displayed the same geographic pattern seen at national level, with higher turnout in Western and Central Ukraine (except in Kyiv city) and low turnout in the Black Sea area, in government-controlled Donbas (32% in Donetsk *oblast*) and in other Eastern regions. Low (and decreasing) electoral participation in local elections might be a concern for the success and local ownership of the ongoing decentralisation reform.

Figure 1.26. **Regional variation in last national elections turnout, 2014**



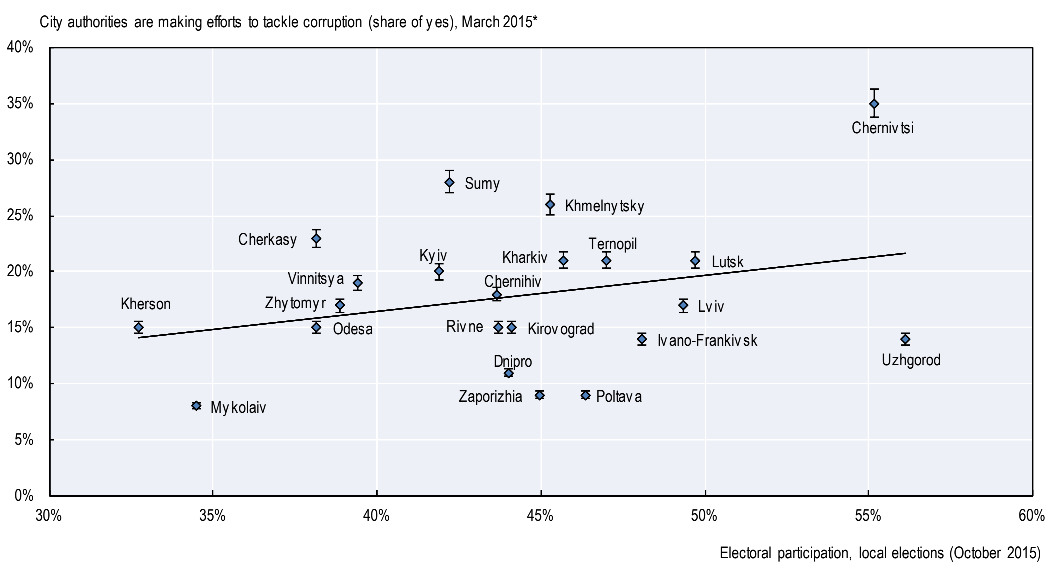
Note: Luxembourg, the OECD country with the highest electoral participation (91.1%), is excluded. Countries are ranked from the highest disparity in regional turnout to the lowest.

Sources: Data from Ukraine's Central Election Committee, www.cvk.gov.ua/pls/vnd2014/wp063?PT001F01=910 (accessed 3 May 2017); OECD (2016e), "Well-being in regions", *OECD Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en.

People have the most direct interaction with local public authorities. Research on corruption, democratic representation and well-being suggests that trust in local government tends to be higher than trust in national governments. However, experiences of corruption in local public services can undermine trust, affecting people's behaviour and well-being (Tavits, 2008). In Ukraine, corruption is a major concern for a vast majority of citizens, and the dispersion in electoral participation across regions is much higher than in OECD countries. Across OECD regions, people living in areas with higher voter turnout in national elections often perceive lower levels of government corruption (OECD, 2016e). One reason might be that less corruption, better quality public services and more efficient public institutions might motivate people's participation and trust in institutions' capacity to generate positive change (OECD, 2016e).[25] The degree of effective electoral competition is also important: voter turnout tends to rise when contests are competitive, while strong competition means that officeholders are more likely to face an opposition committed to exposing corruption and malfeasance.

In Ukraine, a correlation of similar magnitude exists between the perceived level of corruption at the local level and electoral participation in local elections. Data from the first Ukrainian Municipal Survey (conducted seven months before the October 2015 local elections), suggest that in cities where a higher share of citizens felt that corruption was a significant problem, subsequent electoral participation was lower (Box 1.7).[26] Moreover, the higher the share of citizens who believed that city authorities were tackling corruption at the municipal authority level, the higher the subsequent participation in the October 2015 local elections (Figure 1.27). Even though voter abstention has many causes and no causal relationship can be established without further research, this suggests that mistrust in local government's willingness to tackle corruption is one of the drivers of low electoral participation in local elections in Ukraine. This is a critical concern in the context of the ongoing administrative and fiscal decentralisation process.

Figure 1.27. **Electoral participation and trust that local government will tackle corruption, Ukraine**



Notes: * Margin of error: maximum 3.5%.
No data available for Donetsk and Luhansk *oblasts*. Survey conducted between 2-20 March 2015. Statistical correlation between the two series: 28.7%.
Sources: OECD calculations based on data from the Central Election Committee, "Local elections 2015 Database", www.cvk.gov.ua/pls/vm2015 and data from International Republican Institute/Rating Group Ukraine (2015), "Ukrainian Municipal Survey", www.iri.org/sites/default/files/wysiwyg/2015-05-19_ukraine_national_municipal_survey_march_2-20_2015.pdf.

Data from the Ukrainian Municipal Survey also point to a gradual improvement in the quality of public goods and services in Ukraine's largest cities. The city-level composite indicator of the quality of public goods and services is based on survey answers assessing the quality of 22 public goods and services (sidewalks, trash collection, roads, sport facilities, etc.). During 2015-17, 20 out of 24 cities saw moderate improvements in their composite indicators, with some noticeable positive shifts. For instance, in just two years residents of Poltava and Dnipro substantially upgraded their assessment of the quality of local roads, while the perceived quality of trash collection improved in Odesa and Zaporizhia. There were also setbacks: in Lviv, the perceived quality of trash collection fell sharply, due to a fire at the city dump which covered Lviv in ash and resulted in four deaths. The survey also reveals some improvement in citizens' satisfaction with interactions with local authorities for administrative services. It should be noted, however, that these trends rely on observations of survey data covering a very short time frame (two years after March 2015): conclusions should therefore not be drawn before these positive trends are confirmed in the coming years.

Box 1.6. The annual Ukrainian Municipal Survey

Survey data are a precious source to assess the perceived quality of local public services, such as local public transport or street lighting. In Ukraine, such an assessment relies on the annual Ukrainian Municipal Survey. "Rating Group Ukraine" has conducted 3 annual waves of this survey in 24 cities* (all 22 *oblast* centres, Kyiv, Mariupol in Donetsk *oblast* and Severodnietsk in Luhansk *oblast*) on behalf of the International Republican Institute since March 2015. The annual Ukrainian Municipal Survey is funded by the Department of Foreign Affairs, Trade and Development of Canada.

The first wave was conducted in March 2015, the second in January-February 2016 and the third wave was conducted in January-February 2017, with a sample of 19 200 permanent residents of Ukraine (800 respondents were interviewed in each city regardless of the size of its population). One drawback of the Ukrainian Municipal Survey is its exclusive focus on *oblast* centres and Kyiv city, i.e. the largest cities in Ukraine, excluding rural Ukraine and smaller towns, but also all of the newly amalgamated communities. Another issue is that the survey covers a very short time frame (less than two years), which is barely sufficient if data are to be used for public policy impact assessment. Using the same methodology to conduct municipal surveys in Ukraine on an annual basis would ensure that a comparable dataset is developed over time.

* The first survey in March 2015 was conducted only in 22 cities (n = 17 600), without Mariupol and Severodnietsk.

Sources: Center for Insights in Survey Research (2016), "Ukrainian Municipal Survey", www.iri.org/sites/default/files/wysiwyg/municipal_poll_2016_-_public_release.pdf; Center for Insights in Survey Research (2017), "Third Annual Ukrainian Municipal Survey", http://ratinggroup.ua/en/research/regions/tretiy_vseukrainskiy_municipalnyy_opros.html.

Furthermore, the survey reveals a positive trend regarding local governance. In 16 out of the 24 cities surveyed, the proportion of respondents who think things are headed in the right direction in their cities has increased since 2015. This contrasts with more pessimistic assessments at the national level (IRI, 2017). Another positive trend is the decline in the share of respondents citing corruption as a significant problem in their cities, which fell between 2015 and 2017 in 21 out of 22 surveyed cities. The data confirm that corruption is still a major issue in local governance in Ukraine, but the perceived severity of bribery and graft is gradually declining. This trend could contribute to higher participation in local elections, which is necessary to increase local accountability.

These positive developments translated into a higher approval by citizens of the activities of city heads (many were elected in October 2015), which once again contrasts with the low or falling approval ratings of many other institutions. Data from the Ukraine Municipal Survey reveal a gradual increase in trust (average approval of activities) in mayors and (to a lesser extent) local city councils.[27] Evidence of increased trust in local government is very positive for the ongoing decentralisation process. Further research is necessary to disentangle the role of the decentralisation process in these positive outcomes, but a study of 29 European countries suggests that, when properly conducted, decentralisation can contribute to higher citizen satisfaction with political institutions (Diaz-Serrano and Rodríguez-Pose, 2012). The successful completion of the ongoing decentralisation reform and the establishment of sound multi-level governance mechanisms is therefore all the more important. Indeed, the ongoing decentralisation reform could enhance local officials' ability to design and conduct local policies tailored to the specific needs of their community, while improving the efficiency of subnational investments through better horizontal (with other municipalities) and vertical (with higher levels of government) co-ordination. Such positive results may influence Ukrainians toward more civic engagement (including through higher electoral participation).

Notes

1. Average estimated population for 2016 from the State Statistics Service of Ukraine. This does not include Crimea or the city of Sebastopol, for which official statistics are not available after 2014.

2. Special purpose entities are entities with little or no physical presence in the host economy, which provide services to a multinational enterprise such as holding assets and liabilities and raising capital (OECD, 2016c).

3. Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
   Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

4. This analysis is based on the OECD regional typology. The OECD has classified two levels of geographic units within each member country: large regions (Territorial level 2 or TL2) composed by 389 regions, and small regions (Territorial Level 3 or TL3) composed by more than 2 241 small regions. TL3 regions are further classified as predominantly urban (PU), predominantly rural (PR) and intermediate (IN).

5. 2014 population forecasts published by the Ptoukha Institute for Demography and Social Studies, available at: http://idss.org.ua/index.html ("Population forecasts").

6. Medical and economic studies highlight alcoholism, unhealthy lifestyles and risky behaviour on the roads as possible causes of high male mortality rates. See, for instance:

www.pewresearch.org/fact-tank/2015/08/14/why-the-former-ussr-has-far-fewer-men-than-women.

7. According to a forecast by the Ptoukha Institute for Demography and Social Studies, eight regions would lose more than 10% of their population by 2030 (compared to the 2015 level), with the highest decline in Luhansk and Kirovohrad regions (around 17%). For details, refer to http://idss.org.ua/dir.html ("Population projections").

8. This includes, for instance, Brovary, Boryspil (east of Kyiv) or Vyshneve (west of Kyiv).

9. In Bulgaria and Romania, the high contribution of the metropolitan capital region is also due to the small size of these countries and their limited number of TL2 regions (compared to Ukraine).

10. European Neighborhood Policy countries covered in Petrakos, Tsiapa and Kallioras (2016) are Armenia, Azerbaijan, Belarus, Georgia, Moldova, Morocco and Ukraine.

11. The high level of territorial inequalities in Kazakhstan and the Russian Federation is largely due to the strong spatial dimension of natural resource activities (mainly in the oil and gas sector). For a comparison of territorial inequalities in Kazakhstan, the Russian Federation and Ukraine see Zubarevitch and Safronov (2011).

12. Twenty per cent of available financing under the State Fund for Regional Development is reserved for "lagging" regions with GDP per capita below 75% of Ukraine's national level.

13. Ukraine's official regional development index is computed according to a national definition and should not be assimilated to a regional version of the Human Development Index published by the UNDP.

14. Youth unemployment here focuses on the 15-34 year-old age group, instead of 15-24 in international statistics.

15. The exception was Ivano-Frankivsk, which has a specific demographic profile, with a large amount of young cohorts entering the labour market.

16. The Pearson correlation coefficient between the decrease in labour participation rate (2013-16) and old-age dependency ratio (60+ year old) in 2015 is -0.35. In contrast, the Pearson correlation coefficient between the decrease in labour participation rate (2013-16) and the rise in the unemployment rate (2013-16) is -0.67.

17. In 2015, the dispersion index of regional unemployment rates (22.7%) in Ukraine corresponded to the 75th percentile with the highest dispersion index in the OECD (23%), for instance the Slovak Republic or Spain.

18. For the procedure to declare a new place of residence in Latvia, please refer to: www.pmlp.gov.lv/en/home/services/declaration-of-residence-place/first.html.

19. This might change when a new labour code, under discussion in parliament for more than two years, will finally replace the current one, which was drafted in Soviet times.

20. A study conducted in April 2017 found a short-lived drop in employment in January 2017, which was almost entirely reversed in February. No causal relationship could be established with the minimal wage hike. A presentation of this study is available at: www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/04/PB_05_2017_en.pdf.

21. Mykolaiv *oblast* benefited from a strong recovery of industrial production in 2016, mainly thanks to the food processing subsector.

22. *Source:* National Bank of Ukraine, available at: https://bank.gov.ua/control/en/publish/category?cat_id=7693083.

23. For more details on Czech cluster programme, please refer to OECD (2007) and to the cluster webpage on Czech Invest webpage: www.czechinvest.org/en/czech-clusters. Some Czech clusters received co-financing from the EU Structural Funds.

24. In Chile, Poland, the Slovak Republic, Slovenia and Switzerland electoral participation was lower than in Ukraine in the last national elections.

25. There is a negative statistical correlation between the perception of government corruption (based on microdata from the Gallup World Poll) and voter turnout in 348 OECD TL2 regions (Pearson r: -33.4%). For details refer to OECD (2016b).

26. There is a negative statistical correlation between the share of respondents perceiving corruption as a significant problem and electoral participation in the subsequent 2015 local elections (Pearson r: -29.7%). The first Ukrainian Municipal Survey was conducted seven months before the October 2015 local elections.

27. The average approval rate of mayors increased from 35% in March 2015 to 49% in January 2017 across the 24 cities surveyed.

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Annex 1.A. Geographic Concentration Index

The Geographic Concentration Index of population is defined as:

$$\left(\sum_{i=1}^{N} \left| p_i - a_i \right| \Big/ 2 \right) * 100$$

where p_i is the population share of region *i*, a_i is the area of region *i* as a percentage of the country area, *N* stands for the number of regions and $| \; |$ indicates the absolute value. The index lies between 0 (no concentration) and 1 (maximum concentration) in all countries and is suitable for international comparisons of geographic concentration.

Likewise, the Geographic Concentration Index of GDP is defined as:

$$\left(\sum_{i=1}^{N} \left| y_i - a_i \right| \Big/ 2 \right) * 100$$

where y_i is the GDP share of region *i*, a_i is the area of region *i* as a percentage of the country area, N stands for the number of regions and $| \; |$ indicates the absolute value. The index lies between 0 (no concentration) and 1 (maximum concentration) in all countries and is suitable for international comparisons of geographic concentration.

Annex 1.B. Additional graphs and tables

The catching-up indicator (Malmquist Index) is based on the idea that a region needs to grow faster than the national frontier to reduce its productivity gap. In Ukraine, the national frontier (the *oblasts* with the highest productivity level) is composed of Kyiv city and Poltava *oblast*. The catching-up index (CU Index) is the ratio between regional productivity growth and the productivity growth of the country's frontier. Ukraine's frontier is an employment-weighted average of Kyiv city and Poltava *oblast*. Catching-up regions have a CU Index higher than 1.05; keeping pace regions between 0.95 and 1.05; and diverging regions lower than 0.95.

Table 1.B.1. **Patterns of catching up and divergence across Ukraine's regions, 2005-14**

Oblast	Group	CU Index	*Oblast*	Group	CU Index	*Oblast*	Group	CU Index
Ternopyl	Catching up	1.34	Mykolayiv	Keeping pace	1.03	Kharkiv	Diverging	0.94
Kirovohrad	Catching up	1.31	Lviv	Keeping pace	1.03	Rivne	Diverging	0.93
Zhytomyr	Catching up	1.30	Chernivtsi	Keeping pace	1.00	Poltava	Frontier (diverging)	0.93
Vinnytsya	Catching up	1.24	Odesa	Keeping pace	0.99	Zaporizhia	Diverging	0.91
Cherkasy	Catching up	1.20				Dnipropetrovsk	Diverging	0.86
Kyiv *oblast*	Catching up	1.13				Ivano-Frankivsk	Diverging	0.79
Khmelnytskiy	Catching up	1.12				Donetsk	Diverging	0.72
Chernihiv	Catching up	1.12				Luhansk	Diverging	0.61
Kherson	Catching up	1.10						
Zakarpattya	Catching up	1.08						
Sumy	Catching up	1.08						
Volyn	Catching up	1.07						
Kyiv city	Frontier	1.03						

Source: OECD research based on State Statistics Service of Ukraine, National Accounts and employment series.

Table 1.B.2. **Road Infrastructure by region: Quality and density indicators**

Regions	Perceived quality of roads, 2013*	Density of all-purpose paved roads (2015)	Average road wear over five years (2006-10)
Ukraine	**2.4**	**275**	**47**
Rivne	4.17	252	45
Donetsk	4.06	302	42
Kyiv	3.99	306	55
AR Crimea	3.85	245	20
Kharkiv	3.78	299	35
Vinnytsya	3.72	339	34
Dnipropetrovsk	3.59	287	44
Zaporizhia	3.54	251	72
Odesa	3.44	242	26
Volyn	3.35	288	49
Zakarpattya	3.3	261	51
Zhytomyr	3.28	280	30
Poltava	3.25	308	64
Kherson	3.22	174	39
Khmelnytskiy	3.22	346	51
Mykolayiv	3.18	195	51
Chernihiv	3.08	227	74
Cherkasy	3	284	39
Lviv	2.98	376	42
Ternopyl	2.98	361	74
Luhansk	2.89	219	49
Ivano-Frankivsk	2.82	296	46
Kirovohrad	2.79	252	47
Chernivtsi	2.76	355	55
Sumy	2.69	282	51

* Perceived quality of roads on a scale from 1 to 7 based on business executive survey in each region. For methodology and details refer to Foundation for Effective Governance (2013).

Sources: State Statistics Service of Ukraine (transport and communications in Ukraine, 2015); Foundation for Effective Governance (2011a), "Quality of roads indicator", www.feg.org.ua/en/reports (accessed 10 April 2017); Foundation for Effective Governance (2013), "Ukrainian national competitiveness report 2013: Towards sustained growth and prosperity", www.feg.org.ua/en/reports; Foundation for Effective Governance (2011b), "The current state of transportation infrastructure impedes economic growth", www.feg.org.ua/docs/sostoyanie_en.pdf.

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Annex 1.C. Labour market efficiency in Ukrainian regions

This annex makes use of the official job vacancies from the State Employment Service (SES) of Ukraine and official unemployment statistics (based on the Labour Force Survey) to assess the efficiency of matching between employers and workers in Ukrainian regions. Only a few of the available jobs are actually reported by employers to the SES. However, it can serve as an instrument to capture an impression about the labour demand in Ukrainian regions. The job vacancy rate (JVC) in each region is:

JVC = number of SES job vacancies/(total employment + number of job vacancies)

This estimate of the job vacancy rate is not internationally comparable. In the future Ukraine could adapt its vacancy rate statistics to bring it closer to Eurostat's statistical definition of job vacancies,[1] notably by estimating job vacancies through business surveys instead of relying on administrative data from the SES. This would improve the reliability of labour market statistics across Ukraine's regions.

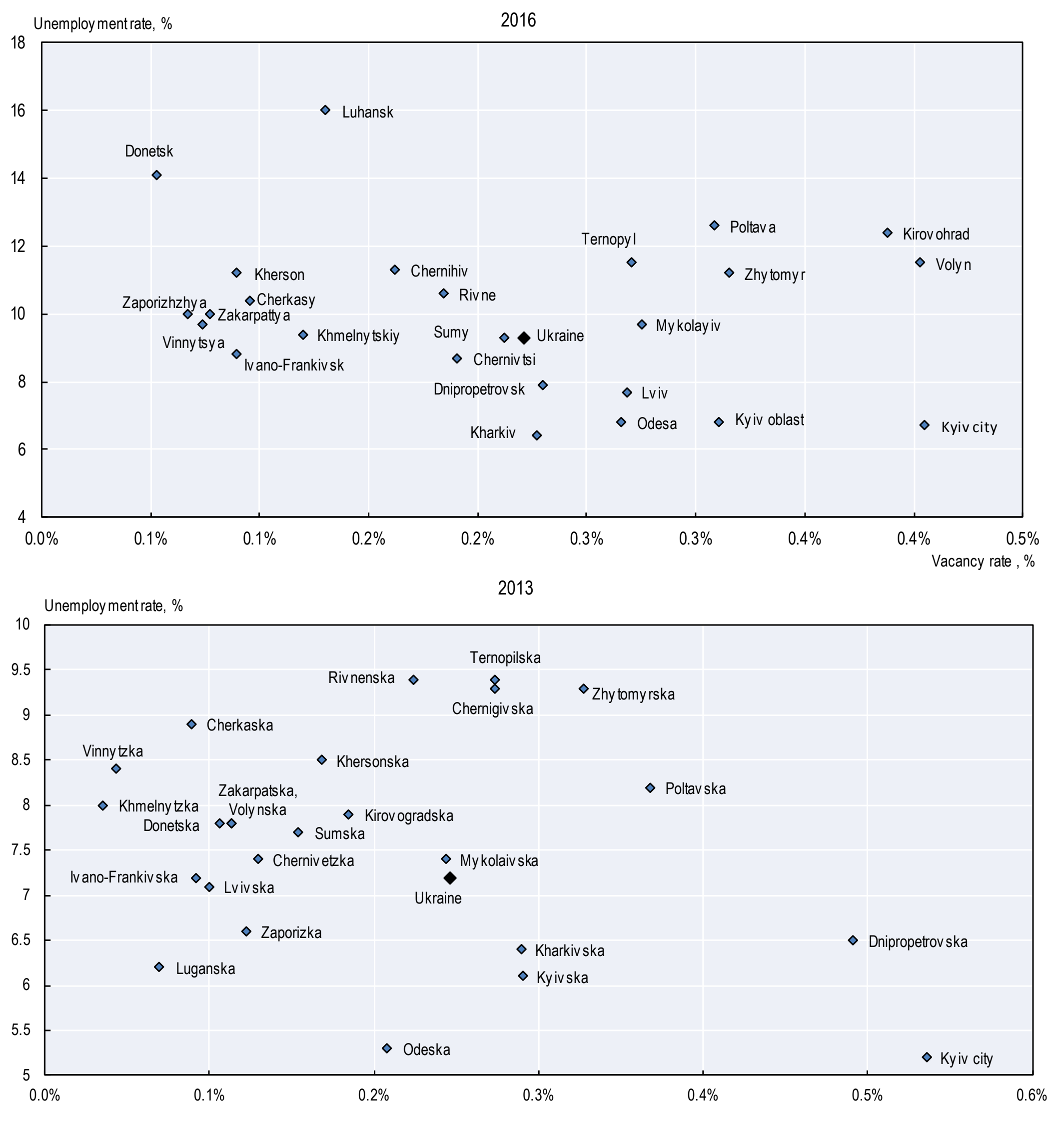
Comparing unemployment/vacancy rates at a given time

In both 2013 (i.e. before the Donbas conflict) and 2016, there is only a weak negative statistical correlation between the job vacancy rate and the unemployment rate across Ukraine's regions.[2] In 2013, Kyiv city and the industrial Dnipropetrovsk *oblast* display low unemployment and high vacancy rates; in 2016 this is only the case of Kyiv city, while Luhansk and Donetsk *oblasts* have both low vacancy rates and the highest unemployment rate. In Kyiv city, the high job vacancy rate could be a sign of a deficit of skilled professionals, which is a top concern of Ukrainian firms according to business surveys. In between, many *oblasts* display high unemployment and job vacancy rates, pointing to inefficient matching between vacancies and (unemployed) workers. This is particularly the case in Zhytomyr, Ternopyl (agricultural regions in the centre-west of Ukraine) and Poltava in both 2013 and 2016, and in Kirovohrad and Volyn in 2016. Overall, this analysis suggests that the efficiency of labour markets differs substantially across regions, due at least in part to substantial education-job mismatches and low interregional mobility. Because this analysis focuses on SES job vacancies, discrepancies could also reflect differences in SES performance or/and in employer's propensity to report vacancies to the SES across regions.

How the vacancy rate reacted to the rise in unemployment across regions?

Between 2013 and 2016, the unemployment rate increased in all Ukrainian regions. However, in 12 regions out of 25, the vacancy rate increased during the period, contrarily to what one could expect. There is even a weak positive correlation between the change of the unemployment rate and of the vacancy rate across regions (Figure 1.C.1). Regression analysis show that three regions determine this positive correlation: Luhansk (where the vacancy rate was stable while the unemployment rate increased by almost 10 percentage points, the strongest increase in Ukraine); Volyn and Kirovograd (where a substantial increase in unemployment led to a solid increase in vacancies, contrarily to what one could expect. This suggests that the functioning of the labour markets might have degraded in these three regions between 2013 and 2016.

Figure 1.C.1. **Regional labour market efficiency (cross section)**



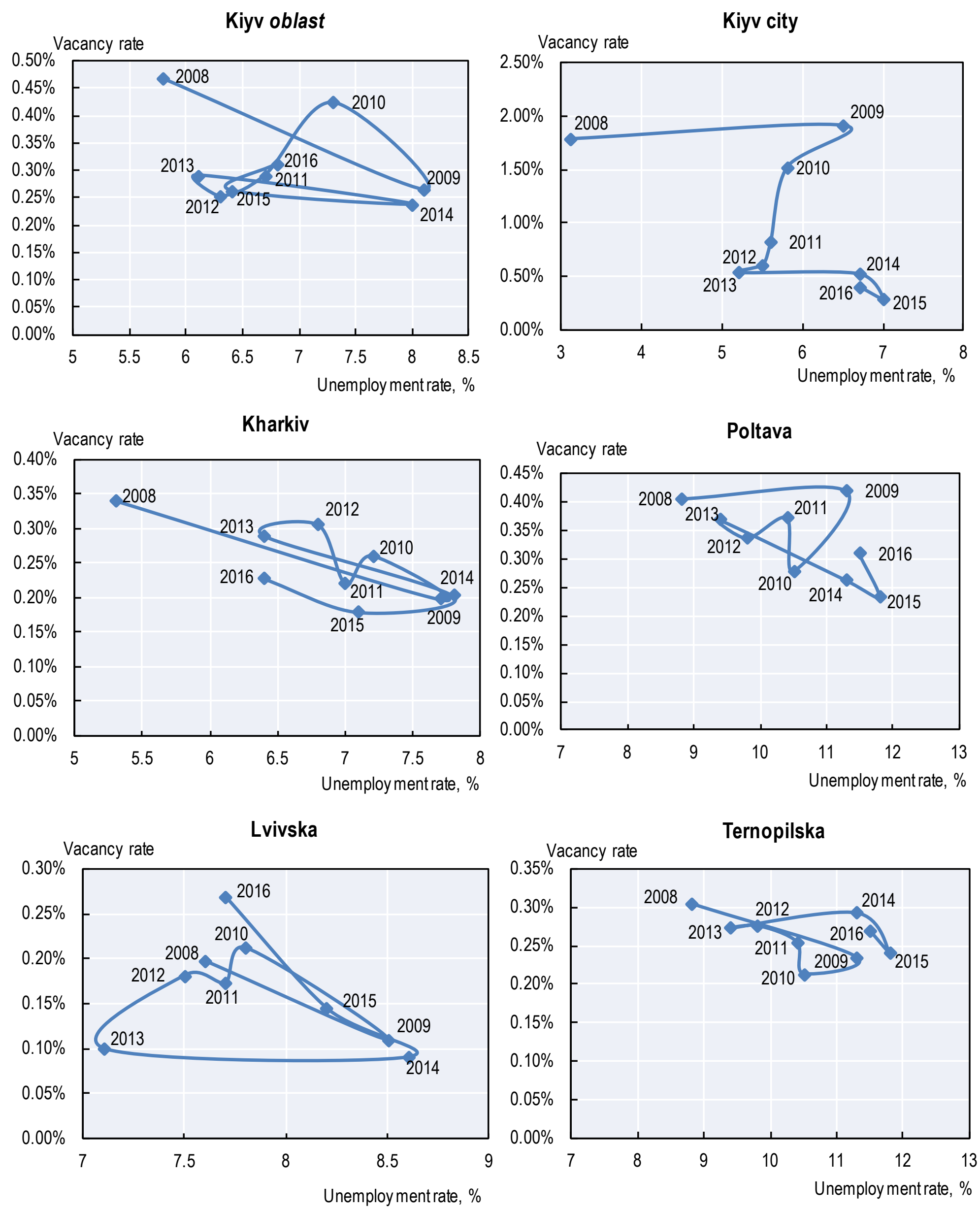
Source: State Statistics Service of Ukraine, State Employment Service of Ukraine, labour market indicators, www.ukrstat.gov.ua.

Beveridge curves for selected regions[3]

In order to assess the efficiency of regional labour markets and its evolution over time, we also analysed Beveridge curves at *oblast* level. Beveridge curves measure the relationship between unemployment and the vacancy rate and are thus an indicator of labour market efficiency. In contrast to the static presentation used in Figure 1.C.1, Beveridge curves present change over time. The Beveridge curve typically slopes downward – higher rates of unemployment tend to occur with lower vacancy rates, as one would expect. Large movements along the curve are typically associated with cyclical shocks. In contrast, when the curve shifts rightwards (away from the origin) over time, a given level of vacancies would be associated with a higher level of unemployment, implying decreasing efficiency of the labour market. This might reflect, *inter alia*, mismatches between available jobs and the skills of the unemployed or an immobile labour force. Conversely, leftward shifts in the curve (towards the origin) are associated with increases in labour market efficiency. In the case of Ukraine, it is important to note, however, that the shifts in the Beveridge curves between 2013 and 2014, when large numbers of internally displaced persons were on the move, may look rather odd – i.e. even the influx of labour would, other things being equal, affect the relationship between vacancy rates and unemployment.

Beveridge curves based on SES job vacancies yield very different patterns across Ukraine's regions, including among neighbouring regions, pointing to high spatial fragmentation of labour markets. Figure 1.C.2 displays the Kyiv agglomeration (Kyiv city and the surrounding *oblast*) and neighbouring regions in Western Ukraine (Lviv and Ternopil) and Eastern Ukraine (Kharkiv and Poltava). The main common patterns are the rise in unemployment and the drop in vacancy rate corresponding to the 2009 crisis (2008-09) and to the Donbas conflict in 2014 (however, in the agricultural Ternopil *oblast*, the vacancy rate actually rose, pointing to structural labour market issues). However, the most striking feature is that even neighbouring regions display sometimes sharply divergent trends (particularly in 2016), suggesting that labour markets are highly fragmented. The sharp drop in vacancy rate of Kyiv city (the region with the highest vacancy rate) is striking (no equivalent drop is recorded in the surrounding *oblast*) and could be related to a change in firms' propensity to report vacancies to the SES rather than to a real improvement of labour market efficiency. Overall, caution is warranted in interpreting these Beveridge curves based on administrative data from the SES, which does not account for substantial parts of Ukraine's labour market.

Figure 1.C.2. **Beveridge curves in selected (neighbouring) regions**



Source: State Statistics Service of Ukraine.

Notes

1. For the methodology of Eurostat's vacancy rates, see: http://ec.europa.eu/eurostat/cache/metadata/en/jvs_esms.htm.
2. The Pearson correlation coefficient amounts to -21% in 2013 and -22% in 2016.
3. The national Beveridge curve is not reported here because of a major statistical break in employment series in 2014-15 due to the Donbas conflict.

Chapter 2. Advances in territorial and multi-level governance reform in Ukraine since 2014

This chapter is dedicated to exploring the advances in territorial and multi-level governance in Ukraine since 2014, including in regional development. It focuses on the current decentralisation reform, situating it within the context of Ukrainian governance practices, and presents the government's approach to its implementation. It identifies areas where multi-level governance practices could be strengthened to better ensure reform sustainability, including enhanced co-ordination mechanisms. Since voluntary municipal mergers are a fundamental component of the reform, the chapter explores the strengths and weaknesses of the Ukrainian model and identifies lessons thus far. The chapter concludes with a discussion of Ukraine's evolving approach to regional development.

Introduction

In 2013, Ukraine was confronted by a series of interrelated challenges at the territorial level, including regional disparities/inequalities; significant shifts in productivity; high unemployment and informal employment; demographic change; poor quality services; and a top-down, centralised, multi-level governance structure that remains rooted in pre-independence practices. At the time, the OECD recommended a phased approach to decentralisation. It stressed first the need for territorial reform at the local level in order to build municipal capacity, and then for a move toward decentralisation. A number of these challenges remain, as analysed in Chapter 1, particularly interregional disparities. Most critical to decentralisation reform are the ongoing challenges, identified in 2014, of administrative fragmentation compounding disparities in access to basic services, and high levels of fiscal, policy, legal and regulatory uncertainty, combined with a lack of predictability of public institutions (OECD, 2014a). In addition to these one can add missed growth opportunities resulting from the lack of a clearly articulated, place-based regional development policy.

In 2014, Ukraine's Cabinet of Ministers adopted the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power in Ukraine. This launched a multi-level governance reform based on a far-reaching political, administrative and fiscal decentralisation process. Since then, Ukraine has made great strides in modernising its approach to territorial governance: the Concept Framework outlines a strategy for boosting democratic governance at the subnational levels through broad-based decentralisation; voluntary municipal mergers launched in 2015 are rapidly addressing problems of administrative fragmentation at the municipal level; and a place-based approach to regional policy is evolving in a practical fashion. Local leaders and citizens are starting to notice a positive change in the administrative and service capacities in their municipalities. All of this contributes to strengthening Ukraine's development, improving quality of life and well-being, and building a more resilient state. Nevertheless, the reform process faces obstacles to its further development and challenges to its implementation which should be addressed.

This chapter is based on information collected through stakeholder meetings, fact-finding missions and OECD seminars held in Ukraine between December 2016 and July 2017,[1] as well as publicly accessible literature and data. It provides an update on the advances made in territorial organisation and multi-level governance since 2014.

Building a more resilient state by advancing towards decentralisation reform

In 2014, the OECD commented on the apparently strong demand in Ukraine for a reform of the state in a decentralised manner (OECD, 2014a). Ukraine's multi-level governance reform and decentralisation strategy is detailed in the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power in Ukraine (Concept Framework) of April 2014, and it extends to all three areas of decentralisation: political, administrative and fiscal. The approach is comprehensive and theoretically strong, set up to lead the country towards the modernisation and reform results it wishes to achieve.

If successful, these reforms could also help enhance Ukraine's state resilience (i.e. its ability to absorb shocks and adapt to changing circumstances without losing the ability to fulfil its basic functions (Brinkerhoff, 2011; Grävingholt and von Haldenwang, 2017; Grävingholt, 2017). By transferring responsibilities, resources and decision-making authority to intermediate or local levels of government, decentralisation and local governance reforms are directly related to the areas of legitimate and inclusive politics, revenue generation, and service provision. Economic development has been associated with such reforms for a long time.

It is undeniable that since its independence Ukraine has suffered significant economic, civic and political shocks: an economic rollercoaster starting with the breakup of the Soviet Union and from which, arguably, Ukraine is only now beginning to recover; civic instability beginning with the Russian Federation's annexation of Crimea and the occupation of parts of Eastern Ukraine; and a lack of political stability – evidenced by 15 governments since 1992[2] – that has affected the state's ability to consolidate and implement sustainable policies that can win electoral support. These shocks highlight the state's need to improve its resilience. For this to happen, however, it will also need to make improvements in the three areas that contribute to a better functioning state: 1) authority – the state's ability to preserve a monopoly of force; 2) capacity – the state's ability to provide basic services and administration for its people; 3) legitimacy – the state's ability to ensure that its claim on defining and implementing binding rules is widely accepted.

To date, Ukraine's score card with respect to the three dimensions of statehood is moderate at best. Criminal violence has declined since 2013, but the conflict in the east poses a long-term challenge to the state's authority. Ukraine's ability to deliver services is in the middle range according to the United Nations Development Programme's Human Development Index (HDI), which has not seen the same level of growth as such regional peers as Georgia and Poland (UNDP, 2017). At a local level, Ukraine's regional capital cities score an average of 3 (where 5 is the highest possible score and 1 is the lowest) when residents are asked to rate the quality of 22 different public goods and services in their city (Center for Insights in Survey Research, 2017).[3] In general, the state capacity to provide basic public and administrative services is weak. There are also signs pointing to weaknesses in legitimacy. Two popular upheavals in a ten-year period (2004 and 2013), leading to changes in government signal difficulty in ensuring support for government policy and action. In addition, perceptions of corruption are high, and can erode trust in government institutions. This was heard repeatedly during OECD interviews, supported by recent findings in Transparency International's Global Corruption Barometer Survey (2017), and illustrated as well by Transparency International's Corruption Perception Index, where Ukraine ranked 131 out of 176 countries (scoring 29 out of 100 possible points)[4] in 2016, placing it together with Iran, Kazakhstan, Nepal and the Russian Federation also ranking 131. At the local level, more than 60% of residents surveyed in 24 regional capital cities considered corruption a problem in their city (Center for Insights in Survey Research, 2017). A well-functioning state combines both administrative competences with a constructive relationship between the state (government) and society; this relationship is at the core of state resilience (Box 2.1).

Improving the state/society relationship is an important step toward building Ukraine's resilience. Decentralisation can contribute significantly to strengthening the legitimacy and inclusivity of politics, but it must be accompanied by other legitimacy-enhancing tools, including citizen ability to hold government – local, regional and national – accountable. A well-designed and implemented decentralisation process is more likely to engender democratic governance, transparency and accountability by leaders, particularly at the local level, which can then contribute to better framework conditions for reform success. There are, however, a number of conditions and practices for effective decentralisation, identified by the OECD as a result of its territorial work (Box 2.2), that are not sufficiently present in the government's reform programme. Unless these are in place to a greater extent, successful decentralisation reform, and the benefits it brings for state resilience, will be harder to realise.

Box 2.1. Five pillars of a resilient state

An international dialogue process including fragile and conflict-affected states as well as the OECD identified five specific pillars of state/society engagement that are particularly important to achieving resilient statehood, calling these "Peacebuilding and State-building Goals":

1. legitimate politics based on inclusive political settlements and conflict resolution
2. people's security and the ability of the state to establish and strengthen it
3. access to justice and ensuring everyone fair and equal access
4. economic foundations for generating employment and improved livelihoods
5. building capacity for revenue management and accountable and fair service delivery.

Sources: OECD (2011a), *Supporting State-building in Situations of Conflict and Fragility: Policy Guidance,* http://dx.doi.org/10.1787/9789264074989-en; International Dialogue on Peacebuilding and Statebuilding (n.d.), "A new deal for engagement in fragile states", https://www.pbsbdialogue.org/media/filer_public/07/69/07692de0-3557-494e-918e-18df00e9ef73/the_new_deal.pdf.

Many of the challenges confronting the successful implementation of Ukraine's decentralisation process stem from the limited extent to which these principles are practiced. This is particularly true with respect to the clear assignment of responsibilities and functions across levels of government, an alignment of responsibilities and revenues, the capacity of local authorities to meet devolved responsibilities, and co-ordination mechanisms.

This chapter elaborates on Ukraine's position with respect to these conditions and to the multi-level governance reforms underway, particularly decentralisation. It begins by putting Ukraine's reform process in the broader context of governance challenges and the need to ensure a more enabling governance environment to solidify reform success. It then describes Ukraine's frameworks for subnational reform and the challenges they face, and identifies several areas in multi-level governance that require additional attention. It also takes a closer look at Ukraine's reform implementation process, as well as how advances made in regional development support and are supported by greater decentralisation. This chapter aims to provide insight into mechanisms and approaches that could help maintain reform momentum and help Ukraine meet its decentralisation goals. To this effect, each section ends by offering a series of policy recommendations for consideration by Ukraine's policy makers as they move forward with decentralisation reform.

Box 2.2. **Ten guidelines for effective decentralisation in support of regional and local development**

Through its work on regional and local development, the OECD has created a set of guidelines to support more effective decentralisation when undertaken to strengthen regional and local development. While the ideal is to have all of these dimensions in place before undergoing a decentralisation process, this is difficult to achieve in practice. Therefore, in order to maximise the possibility of success, governments should assess which areas may be weak and take steps to address these, while also reinforcing those areas that are already strong. Successful decentralisation will depend on the presence of these factors.

1. **Clarify the sector responsibilities assigned to each level of government.** Most responsibilities are shared across levels of government, and spending responsibilities overlap in many policy areas. Therefore, it is crucial to ensure adequate clarity on the role of each level of government in the different policy areas in order to avoid duplication, waste and loss of accountability.
2. **Clarify the functions assigned to each level of government.** Clarity in the different functions that are assigned within specific policy areas – e.g. strategic planning, financing, regulating, implementing or monitoring – is as important or even more so than clarity in assignment of tasks.
3. **Ensure coherence in the degree of decentralisation across sectors.** A degree of balance or coherence in the level of decentralisation (i.e. what is decentralised and how much it is decentralised) should be ensured across policy sectors. In other words, decentralising one sector but not another can limit the ability to exploit cross-sector complementarities and integrated policy packages when implementing regional and local development policy. While decentralisation may apply differently to different sectors, there should be coherence and complementarity in the approach.
4. **Align responsibilities and revenues, and enhance subnational fiscal autonomy.** The allocation of resources should be matched to the assignment of responsibilities to subnational governments. Unfunded mandates or a mismatch between responsibility and financing capacity should be avoided.
5. **Actively support capacity building for subnational governments with resources from the national government.** Additional financial resources need to be complemented with the human resources capable of managing them. This dimension is too often underestimated, if not completely forgotten, in decentralisation reform, and is particularly important in poor or very small municipalities. At the very least, subnational governments should have the responsibility and be able to monitor employee numbers, costs and competencies.
6. **Build adequate co-ordination mechanisms across levels of government.** Since most responsibilities are shared, it is crucial

to establish governance mechanisms to manage these joint responsibilities. Creating a culture of co-operation and regular communication is crucial for effective multi-level governance and long-term reform success. Tools for vertical co-ordination include dialogue platforms, fiscal councils, standing commissions, and intergovernmental consultation boards and contractual arrangements.

7. **Support cross-jurisdictional co-operation through specific incentives.** Subnational horizontal co-ordination is essential to encourage investment in areas where there are positive spillovers, to increase efficiency through economies of scale, and to enhance synergies among policies of neighbouring jurisdictions. Intergovernmental bodies for horizontal co-ordination can be used to manage responsibilities that cut across municipal and regional borders. Determining optimal sub-central unit size is a context-specific task; it varies not only by country or region, but also by policy area – efficiency size will differ based on what is under consideration, for example waste disposal, schools or hospitals.
8. **Allow for pilot experiences and asymmetric arrangements.** Allow for the possibility of asymmetric decentralisation, i.e. giving differentiated sets of responsibilities to different types of regions/cities/local governments, based on population size, rural/urban classification and fiscal capacity criteria. Ensure implementation flexibility, making room for experimenting with pilot programmes in specific places or regions and constantly adjusting through learning-by-doing.
9. **Make room for complementary reforms.** Effective decentralisation requires complementary reforms at the national and subnational levels in the governance of land use, subnational public employment, regulatory frameworks, etc.
10. **Improve transparency, enhance data collection and strengthen performance monitoring.** Data collection should be undertaken to monitor the effectiveness of subnational public service delivery and investments. Most countries need to develop effective monitoring systems of subnational spending and outcomes.

Source: Allain-Dupré, D. (forthcoming), "Assigning responsibilities across levels of government: Challenges and guiding principles", forthcoming.

Situating decentralisation reform in the Ukrainian governance context

Decentralisation reform is ultimately a political choice and thus should be pursued as part of a larger political reform process, including, for example, reforms of the judiciary, civil service and regulatory frameworks, while also building greater accountability and a broad reform coalition. If pursued in isolation from other reforms, decentralisation in Ukraine could exacerbate existing problems of corruption and clientelism (OECD, 2017a). If Ukraine's objective is to build productivity, prosperity and citizen well-being across its territory using decentralisation reform and regional development policy as vehicles, it will need to ensure a more stable reform environment.

Decentralisation is frequently undertaken in an effort to improve or strengthen democratic governance. Some shifts at the local level can be seen, particularly as noted earlier that average approval ratings for mayors and municipal councils is rising, at least in regional capital cities. Decentralisation can certainly contribute to strengthening the legitimacy and inclusivity of politics but it must be accompanied by other legitimacy-enhancing tools, such as integrity among public officials, local level civic activism and engagement, and an ability for citizens to hold government – local, regional and national – accountable. Ensuring an enabling environment for decentralisation can mean taking a stronger approach to addressing institutional impediments to reform, including corruption. Unless this is managed more effectively, decentralisation reform will be at risk.

Taking stock of government effectiveness and the control of corruption

Overcoming resistance to decentralisation can be difficult. This may be particularly true in Ukraine, where vested interests are part of a larger problem of effective public governance. This is highlighted by the World Governance Indicators. Out of six categories of composite indicators for public governance, Ukraine's governance score between 2006 and 2016 is consistently in the negative range, with the exception of voice and accountability. Although there were some positive shifts between 2014 and 2016, since 2006 there has been no significant improvement in the percentile rankings (Table 2.1).

Government effectiveness has dropped in the last decade

While the dramatic drop in the political stability category is to be expected, the fact that Ukraine's percentile rank has not improved very much over the past ten years is worrying and can reflect structural challenges in the public governance system, as well as difficulties implement lasting reform. With respect to decentralisation reform, Ukraine's performance is especially troublesome in the areas of government effectiveness (Table 2.2) and control of corruption.

Government effectiveness captures the perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (Kraay, Kaufmann and Mastruzzi, 2010). The fact that these remain low in Ukraine even after reform is noteworthy. While Ukraine has been reforming under exceptionally difficult circumstances, the fact that its neighbours have improved government effectiveness overall by a minimum of five points raises the question of where things have broken down. There is hope that decentralisation reform with time can start to reverse this trend, but for this to happen the framework conditions must be more supportive of reform.

Table 2.1. **Worldwide Governance Indicators: Ukraine and its neighbours**

A. Governance score (-2.50 to 2.50 scale)

	Ukraine			Belarus	Georgia	Moldova	Poland	Russian Federation
	2006	2014	2016	2016	2016	2016	2016	2016
Voice and accountability	0.05	-0.14	0.02	-1.39	0.22	-0.03	0.84	-1.21
Political stability and absence of violence/terrorism	-0.04	-2.02	-1.89	0.12	-0.29	-0.28	0.51	-0.89
Government effectiveness	-0.49	-0.41	-0.58	-0.51	0.51	-0.62	0.69	-0.22
Regulatory quality	-0.52	-0.63	-0.43	-0.94	1.01	-0.12	0.95	-0.42
Rule of law	-0.80	-0.79	-0.77	-0.78	0.37	-0.54	0.68	-0.80
Control of corruption	-0.75	-0.99	-0.84	-0.29	0.67	-0.96	0.75	-0.86

Note: Higher values (i.e. closer to +2.5) indicate better governance.

B. Percentile rank (0-100)

	Ukraine			Belarus	Georgia	Moldova	Poland	Russian Federation
	2006	2014	2016	2016	2016	2016	2016	2016
Voice and accountability	47.6	43.4	47.3	10.3	53.7	45.8	72.4	15.3
Political stability and absence of violence/terrorism	44.0	5.7	6.2	50.5	35.2	36.2	63.3	16.7
Government effectiveness	36.6	39.9	31.7	36.1	71.2	29.8	73.6	44.2
Regulatory quality	31.9	29.3	36.1	16.4	81.3	50.5	79.8	37.0
Rule of law	24.9	23.1	23.6	22.1	63.9	32.2	74.5	21.1
Control of corruption	24.9	14.9	19.7	47.6	73.6	14.4	76.4	18.8

Note: 0 is lowest percentile rank; 100 is highest.
Sources: Kraay, A., D. Kaufmann and M. Mastruzzi (2010), "The Worldwide Governance Indicators: Methodology and analytical issues", https://doi.org/10.1596/1813-9450-5430; data for Ukraine from: World Bank (2017b), "Ukraine", *The Worldwide Governance Indicators* (database, table view), http://info.worldbank.org/governance/wgi/index.aspx#reports (accessed 29 October 2017).

Table 2.2. **Percentile rank in government effectiveness: Ukraine and its neighbours**

	2006	2016
Ukraine	36.59	31.73
Belarus	11.71	36.06
Georgia	47.80	71.15
Moldova	24.39	29.81
Poland	65.85	73.56
Russian Federation	39.02	44.23

Note: 0 is the lowest and 100 is the highest percentile rank.
Source: World Bank (2017b), "Ukraine", *The Worldwide Governance Indicators* (database, table view), http://info.worldbank.org/governance/wgi/index.aspx#reports (accessed 29 October 2017).

Trust is low and corruption is widely perceived

The control of corruption may be one of the most significant needs with respect to ensuring appropriate framework conditions for successful decentralisation reform in Ukraine. Corruption wastes public resources, widens economic and social inequalities, breeds discontent and political polarisation, and reduces trust in institutions. It can perpetuate inequality and poverty, impacting well-being and the distribution of income, and undermine opportunities to participate equally in social, economic and political life.

At a global level, it is now reported as the number one concern by citizens, of greater concern to them than globalisation or migration (Edelman, 2017).

Ukraine ranks in the top five countries in Europe and Central Asia where corruption is perceived to be one of the three largest problems facing the country, indicated by 56% of people surveyed by Transparency International.[5] It is preceded by Slovenia (59%), Spain (66%) and Moldova (67%), and followed by Bosnia-Herzegovina (55%) and Lithuania (54%) (Transparency International, 2016b). Overall, the perception of corruption in Ukraine's government and public institutions is consistently higher than global perceptions, and sometimes significantly so (Table 2.3) (Transparency International, 2013a).

Table 2.3. **Perceptions of corruption by institution, 2013**

Institution	Ukraine	Global score
Religious bodies	3.0	2.6
Non-governmental organisations	3.2	2.7
Media	3.4	3.1
Military	3.5	2.8
Business/private sector	3.9	3.3
Education system	4.0	3.1
Political parties	4.1	3.8
Parliament/legislature	4.2	3.6
Medical and health	4.2	3.2
Public officials/civil servants	4.3	3.6
Police	4.4	3.7
Judiciary	4.5	3.6

Note: Aggregated, by country; scale of 1 to 5, where 1 means not at all corrupt and 5 means extremely corrupt.
Source: Transparency International (2013a), *Global Corruption Barometer: 2013*, https://www.transparency.org/gcb2013/report.

In 2013, 87% of citizens surveyed perceived the judiciary as the most corrupt institution in Ukraine, making judicial reform an urgent matter and a critical component of the overall reform process, including decentralisation (Box 2.3). The police, as well as public officials and civil servants, are also perceived as corrupt by 84% and 82% of citizens, respectively (Transparency International, 2013b).

Confidence and trust in leadership is a weakness in Ukraine. This is evident in perception surveys undertaken in the 24 regional capital cities, which highlight a generally low approval rating for the work of the president, the parliament and *oblast* state administrations, as well as *oblast* councils. Mayors have slightly higher levels of approval (Center for Insights in Survey Research, 2017). In 2013, 77% of responding Ukrainians perceived that parliament was corrupt or extremely corrupt and 74% had the same perception of political parties (Transparency International, 2013a). In 2016, 64% of Ukrainians surveyed for perceived that "most" or "all" members of parliament were corrupt (Figure 2.1) (Transparency International, 2016a). These results point to the same issue: the pillars of a democratic society are perceived to be among the most corrupt institutions in Ukraine (Transparency International, 2013a).

Ukrainians have a generally low opinion of how the government handles corruption within its ranks. Among European and Central Asian countries, Ukraine registers the highest number of people who rate their government "badly" when it comes to fighting corruption in government: 86% in Ukraine. While this is similar to some EU and non-EU countries, it is significantly above EU+ and Commonwealth of Independent States (CIS)[6] averages (Figure 2.1) At the bottom of the list are Sweden and Switzerland (Transparency International, 2016b). In other words, the government either does little to stop corruption in government administrations or its methods are not effective.

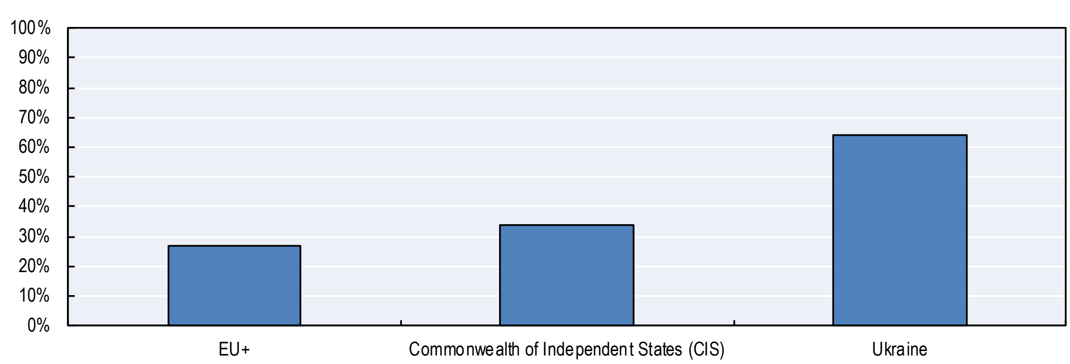
Box 2.3. **The importance of judicial reform to support decentralisation progress**

A basic tenet of democracy, in addition to free and fair elections, is the adherence to the rule of law – meaning that no one, including government, is above the law, where laws protect fundamental rights and justice is accessible to all. Ukrainian courts enjoy little popular trust and confidence in their work. Among residents of Ukraine's *oblast* capital cities, approval ratings for the work of the courts range from a high of 30% in Ternopil to a low of 2% in Uzhgorod.

The lack of trust in the court system makes it difficult for courts and court officials to serve as effective arbiters when there are disputes, including over government powers and competences. Strengthening the political and financial independence of the judiciary and improving the standards of training and admission of judges should be a priority for the Ukrainian government. The 2014 Law on Restoring Trust in the Judicial System of Ukraine returned some power to the judiciary, for example by authorising judges in each court to elect the court's president (previously centrally appointed); but in most courts this did not lead to a change in court leadership. While the 2014 law is a good step, more could be done to ensure that courts at all levels of government are independent and trustworthy. This includes defining objective criteria for judicial appointment and promotion, ensuring that vacant posts are filled through a competitive procedure, and that the transfer of judges within the court system – at national and subnational levels – is based on a set of objective and transparent criteria. All of these steps could help fill gaps left by the 2014 law.

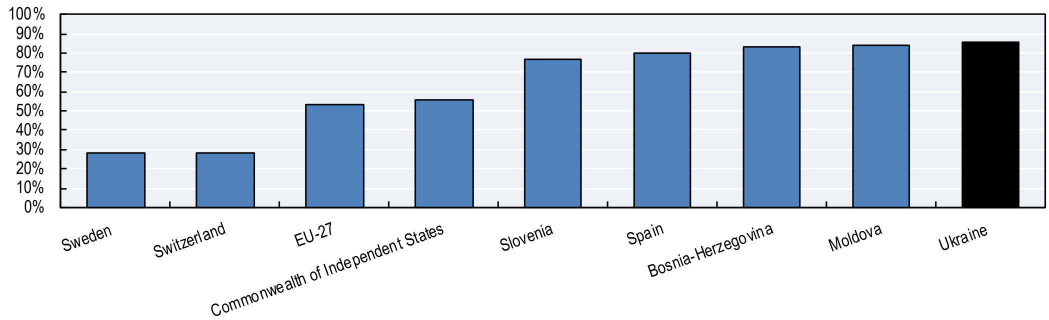
Sources: Bertelsmann Stiftung (2017), "BTI 2016: Ukraine country report", https://www.bti-project.org/fileadmin/files/BTI/Downloads/Reports/2016/pdf/BTI_2016_Ukraine.pdf; Center for Insights in Survey Research (2017), "Third Annual Ukrainian Municipal Survey", www.iri.org/sites/default/files/ukraine_nationwide_municipal_survey_final.pdf; Grävingholt, J. (2017), "Decentralisation and resilience in Ukraine", unpublished.

Figure 2.1. **Perception of corruption among parliamentarians is high in Ukraine, 2016**



Note: Percentage of respondents perceiving that "most" or "all" parliamentarians in their country are corrupt.
Source: Transparency International (2016a), "Corruption Perception Index", https://www.transparency.org/news/feature/corruption_perceptions_index_2016#table.

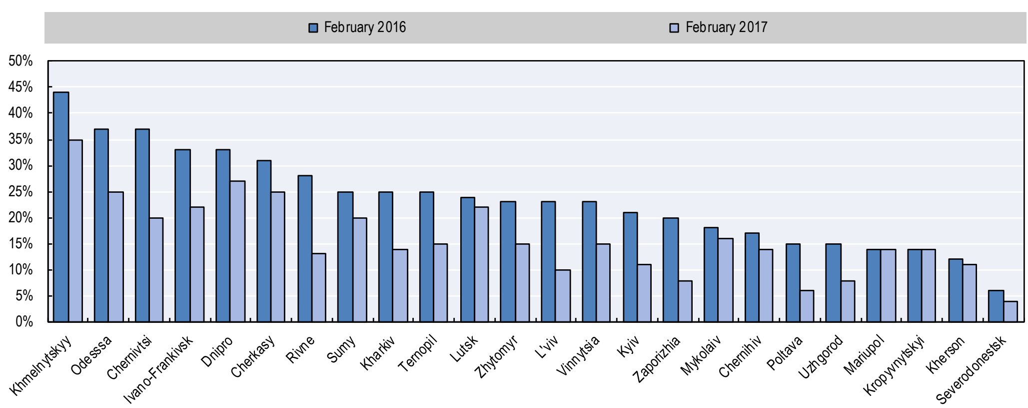
Figure 2.2. **Fighting corruption in government**



Note: Percentage of people who rate their government "badly" when it comes to fighting corruption in government. CIS: Commonwealth of Independent States.
Source: Transparency International (2016a), "Corruption Perception Index", https://www.transparency.org/news/feature/corruption_perceptions_index_2016#table.

These perceptions are consistent in surveys focused on local government as well. Between 2016 and 2017, the percentage of citizens in Ukraine's regional capital cities who think their mayors make an effort to end corruption at the municipal authority level generally dropped (Figure 2.3) (Center for Insights in Survey Research, 2017).

Figure 2.3. **Citizen perception of mayoral efforts to end corruption**



Note: "Yes" responses to the question: "Do you think that your mayor is making an effort to end corruption at the municipal authority level?"
Source: Center for Insights in Survey Research (2017), "Third Annual Ukrainian Municipal Survey", www.iri.org/sites/default/files/ukraine_nationwide_municipal_survey_final.pdf.

Equally worrisome is that citizens report feeling powerless to address corruption themselves. When asked "To what extent do you agree that ordinary people can make a difference in the fight against corruption",[7] 72% of respondents felt that citizens could not do much to prevent or stop it (Transparency International, 2013b). When questioned about the measures that might be the most effective in decreasing corruption in their city, out of 11 possible options the highest levels of responses were:

1. "Simplifying to the greatest possible extent the process for issuing permits, references, etc."
2. "Nothing will help because municipal authorities are powerless, as anti-corruption efforts fully depend on central authorities."

3. "Obligatory and periodic public accountability of municipal and law enforcement authorities for anti-corruption efforts." (Center for Insights in Survey Research, 2017)

Moving forward in minimising the impact of public governance challenges

Weak public governance practices contribute to an unstable environment for achieving reform objectives. Without an enabling environment, supported by good governance practices, and a public sector – including a centre of government – that is capable of ensuring these, outcomes in regional development, service delivery, public and private investment, and the protection of property rights, for example, will be weakened rather than strengthened (World Bank, 2017b), and reform objectives will be left unattained.

Creating such an environment will mean more actively addressing the vested interests and better controlling the corruption that hold back government effectiveness – and through this hold back reform. It also means ensuring that integrity and trust become cornerstones of public institutions and services (Transparency International, 2013a). For this to happen, rule of law and judicial reform must be strengthened. It will also require improving transparency and establishing accountability and integrity frameworks, among other things.

Ensuring integrity in the public sector is fundamental to Ukraine's success, as it can promote greater public confidence and trust in government. It can also support successful decentralisation reform. In the current context of decentralisation, subnational governments are particularly exposed to areas associated with a high risk of corruption, such as pubic procurement and public infrastructure projects. In addition, they are vulnerable to policy capture, where public decisions over policies are directed away from the public interests towards a special interest, thereby exacerbating inequalities, and undermining democratic values, economic growth and trust in government (OECD, n.d.). Democratic processes need to be reviewed, including disclosure laws and codes of conduct for political officials and civil servants, with enforceable sanctions if necessary.

A cultural shift in the attitude of citizens is also necessary, particularly if citizens are to hold government to account for its actions. While in Western European countries citizens are more likely to think it is socially acceptable to report a case of corruption, this is not necessarily the case in Ukraine (or in other European countries, such Croatia, Hungary or Lithuania) (Transparency International, 2016b). When organised, people can exert significant influence through their voting and spending patterns; but they also are likely to need more formal mechanisms (e.g. whistle-blower laws) and encouragement to come forward and report cases of corruption and bribery at all levels of government and in the private sector.

Box 2.4. Recommendations to strengthen public governance frameworks

To strengthen public governance frameworks that otherwise can undermine decentralisation reform, it is recommended to focus on addressing issues of government effectiveness and anti-corruption, including by:

- establishing integrity and accountability frameworks
- reviewing democratic processes, including disclosure laws, and codes of conduct for political officials and civil servants
- introducing formal mechanisms and a sense of "safety" to encourage people to come forward and report cases of corruption and bribery.

Ensuring a balanced approach to territorial reform

Ukraine is a unitary country with three levels of constitutionally guaranteed subnational government (Table 2.4). It is comprised of *oblast* (regions – TL2), which are subdivided into *rayon* (districts) and further into *hromada* (local self-government units that range from cities to villages and rural hamlets). Within these levels there is a degree of definitional overlap: some cities, for example those of *oblast* subordination, are on equal footing as the district level – the *rayon* – and among the *hromada* there are cities, towns, villages and settlements with local councils. There are also settlements (generally rural) with no local councils.

Table 2.4. **Subnational government structure in Ukraine: A simplified perspective prior to reform, up to 2015**[1]

Level of territorial unit	Name of territorial unit	Number	Other territorial entities at the same level	Number of other entities	Total number of entities at territorial level
Regional	*Oblast*	24	Autonomous Republic of Crimea Capital city of Kyiv City of Sevastopol	3	27
Intermediary (district)	*Rayon*	490	Cities of *oblast* subordination	187	677[2]
Local self-government	*Hromada*	11 520[3]			

1. Since 2015 there have been a series of municipal amalgamations, which has reduced the total number of *hromada* by more than 2 000.
2. This does not include the 108 urban districts that act as administrative divisions in Ukraine's largest cities.
3. *Hromada* include cities of *rayon* significance, towns, and rural settlements and villages having councils. If one includes settlements without councils, there are a total of 29 533 local self-government units (271 cities of *rayon* significance, 885 townships [Ukrainian Селища міського типу or СМТ] and 28 377 rural units).
Sources: Adapted from OECD (2014a), *OECD Territorial Reviews: Ukraine 2013*, http://dx.doi.org/10.1787/9789264204836-en originally in Coulibaly, S. et al. (2012), *Eurasian Cities: New Realities along the Silk Road*, https://openknowledge.worldbank.org/handle/10986/11877; Nehoda, V. (2014), "Concept of the reform of local self-government and territorial organisation of power".

Administrative structures at the *oblast* and *rayon* level are deconcentrated, representing the central government, and are responsible to a presidentially appointed *oblast* governor. Popularly elected councils at the *oblast* and *rayon* levels are dependent on their associated *oblast* or *rayon* executive committee for the implementation of council priorities in terms of policy and programming. The *oblast* and *rayon* function more actively in a deconcentrated rather than a decentralised manner; in other words, these subnational entities act as "branches" of the central government (e.g. subnational offices of a ministry) rather having full responsibility for delegated fiscal and administrative functions, and being popularly elected. Meanwhile, at the *hromada* level, leaders and councils are popularly elected, but as administrative entities they have traditionally depended on their *rayon* administration for resources. The result is restricted subnational autonomy (e.g. to identify and execute community priorities) and limited responsibility and capacity for management, administration and service delivery.

The Concept Framework of Reform of Local Self Government: Proposals and limitations

The Concept Framework takes a "whole-of-system" approach to reform. It introduces change at all three levels of subnational government and proposes to restructure the country's multi-level governance dynamic (Cabinet of Ministers, 2014a). Its strength lies in its proposal for broad political, administrative and territorial restructuring, including by:

- altering the political power structures at the *oblast* (region) and *rayon* (district) government levels to make room for stronger democratic governance
- differentiating mandates and supporting decentralised administration and service delivery by *hromada*
- simplifying the territorial administrative structure into subnational tiers into three main categories with only one category of local self-government unit (Annex 2.A)
- clarifying and adjusting the responsibilities assigned to each level of government (Annex 2.B).

The constitutional amendment required to implement the reform package as proposed by the Concept Framework – adjusting territorial structures (e.g. reducing the number of *rayon* administrations), redefining territorial administrative powers (e.g. normatively establishing more empowered local self-governments), clarifying the attribution of responsibilities and establishing a prefect-based system for deconcentrated state administration – has stalled since 2015. This delay has resulted in significant challenges to reform implementation and affects the reform's stability over the medium and long term. It also affects the sustainability of achievements to date, as the gains made at the local level in terms of structures, finance and responsibilities are not constitutionally entrenched.

The inability to fully implement the Concept Framework has not stopped the government from advancing territorial and administrative reform. However, it has meant abandoning a "whole-of-system" approach, where change would extend to all three levels of subnational government in a balanced manner. Instead, the reform process has emphasised local self-government. The aim is entirely logical: to build scale at the territorial level in order to ensure that local governments have sufficient capacity to assume devolved responsibilities. The impact, however, has been to generate a disequilibrium between the district and local levels that can undermine reform. It also has meant using decentralisation as an incentive for territorial reform, rather than undertaking territorial reform to ensure capacity and then introduce decentralisation evenly across the territory.

Introducing decentralisation one law at a time

Between 2014 and 2016, the government introduced a trio of mutually supportive laws that paved the way for decentralisation reform by promoting municipal amalgamation, inter-municipal co-operation and greater fiscal autonomy (Box 2.5).

These three laws facilitate the implementation of Ukraine's decentralisation reform. Their passage facilitated territorial and administrative adjustments to local self-government units in order to build scale, laying the foundation for administrative decentralisation. The changes to the State Budget Code represented a fiscal decentralisation package that encourages amalgamation by significantly enhancing revenue capacities and offering greater autonomy in expenditure decisions to communities that chose to amalgamate under Law No. 157-VIII. While fiscal decentralisation can improve the revenue capacity of local communities, the expectation was that it would also help improve tax collection compliance, the climate for business and innovation, and assist in fighting corruption. The driving logic being that as direct recipients of tax receipts, local authorities gain more by ensuring that taxes are collected and funds are appropriately used in order to encourage tax compliance, rather than by being lax in collection responsibilities and turning a blind eye to evasion. It should be noted that administrative and fiscal decentralisation benefits (i.e. additional service responsibilities, access to increased resources through the changes in the State Budget Code, and an ability to negotiate their budgets directly with the *oblast* administration rather than depending on transfers from the *rayon* state administration) reach only those communities that amalgamate.

Box 2.5. A trio of laws drives decentralisation reform

Law No. 1508-VII of 17 June 2014 on Co-operation of Territorial Communities: permits municipalities to co-operate in order to fulfil three aims: 1) to better support the social, economic and cultural development of their territories; 2) to more efficiently carry out their responsibilities; 3) to enhance the quality of services provided. Co-operation can, legally, be structured in one of five ways:

1. delegation of one or more tasks from one entity to another with the transfer of resources to perform the task
2. co-ordinated implementation of joint projects between entities with common resources accumulated for the duration of the project
3. co-financing of enterprises, institutions, communal entities or infrastructure facilities destined to provide the service
4. creation of joint communal enterprises, institutions and organisations, as well as common infrastructure facilities
5. establishment of a joint management body for the joint execution of authority.

Law No. 157-VIII of 5 February 2015 on Voluntary Consolidation of Territorial Communities:[1] established the capacity for small cities, villages and rural communities to amalgamate. The objective being to build scale at the local level in order to provide higher quality and more affordable public services, and improve capacity to meet new fiscal and administrative responsibilities.

Changes to the State Budget Code realised in the 2016 state budget facilitated revenue generation at the local level and budget negotiations directly with *oblast* administrations for communities that amalgamated, forming a solid incentive structure for local territorial reform.

1. Commonly referred to as the Law on Amalgamation or the Amalgamation Law.

Sources: Verkhovna Rada of Ukraine (2014a), Law No. 1508-VII of 17 June 2014 on Co-operation of Territorial Communities, http://zakon0.rada.gov.ua/laws/anot/en/1508-18; Verkhovna Rada of Ukraine (2015a), Law No. 157-VIII of 5 February 2015 on Voluntary Consolidation of Territorial Communities, in Ukrainian at: http://zakon3.rada.gov.ua/laws/show/15719/print1469801433948575; OECD interviews.

As these laws have gained momentum and generated change, they have been followed by proposed amendments as well as other laws intended to further the decentralisation process. For example, while initially communities could not amalgamate across *rayon* boundaries, with the Law on Introducing Amendments to Certain Ukrainian Legislation Concerning the Peculiarities of Voluntary Consolidation of Territorial Communities Located on Territories Adjacent to Rayon[8] passed in April 2017 (Association of Ukrainian Cities, 2017), this is now possible – helping bring together communities that have economic, cultural or historical ties.

This legislative-driven approach was initially powerful enough to provoke significant change in Ukraine's subnational administrative landscape. It, however, may be difficult to maintain as a long-term approach for reform implementation. While draft laws that could strengthen the territorial and decentralisation reform processes are frequently proposed in the *Verkhovna Rada* (national parliament), their rate of approval and passage is not commensurate with their rate of introduction. This becomes evident when looking at parliamentary and stakeholder websites that keep track of the process, including in the areas of land management, the categories of communities that can amalgamate, and local power structures (Verkhovna Rada of Ukraine, 2017a; Ministry of Regional Development, 2017c; Association of Ukrainian Cities, 2017). In addition, the government has stalled or backtracked on some of its reform efforts, particularly in the area of land-use reform, local revenue sources and support to local communities for regional development. Thus, Ukraine's reform process is characterised by legislative/political intransigence, vested public and private interests that prevent complete reform and result in a patchwork of individual laws and actions, and an unstable reform environment. The result is a reform process that has a strong strategic and theoretical basis, but is facing challenges for full implementation.

Successful multi-level governance reform requires empowered co-ordination mechanisms

Implementing a reform as complex and far-reaching as Ukraine's is easier when there is strong institutional co-ordination beginning at the highest levels. This includes a centre-of-government office that champions and communicates a clear vision of the reform's distinct pieces (e.g. strategy, legislation, sector policies, financing mechanisms, government and non-government stakeholders, monitoring and evaluation, etc.) and can steward the mechanisms that ensure everything fits together; a lead co-ordinating ministry for the reform that is not only mandated, but also fully resourced, for its implementation; and effective horizontal and vertical co-ordination mechanisms to ensure that each player in the reform process is moving in the same direction. At the base of this are co-ordination mechanisms that, with time, can evolve into more co-operative, and ideally collaborative, practices (Box 2.6).

Box 2.6. Co-ordination, co-operation and collaboration

Co-ordination, co-operation and collaboration build on each other, where co-ordination forms the platform from which co-operation and then collaboration can grow.

- Co-ordination: joint or shared information insured by information flows among organisations. “Co-ordination” implies a particular architecture in the relationship between organisations (i.e. centralised or peer-to-peer; direct or indirect), but not how the information is used.
- Co-operation: joint intent on the part of individual organisations. “Co-operation” implies joint action but does not address the relationship among participating organisations.
- Collaboration: co-operation (joint intent) together with direct peer-to-peer communication among organisations. “Collaboration” implies both joint action and a structured relationship among organisations.

Source: Adapted from OECD (2005), *e-Government for Better Government*, http://dx.doi.org/10.1787/9789264018341-en.

Among the challenges that Ukraine’s reform process faces are limited stewardship and co-ordination from the national level. This is compounded by limited co-operation among political, administrative and other Ukrainian institutional stakeholders to guarantee success. Ensuring effective and coherent action requires co-ordination and clear lines of responsibility as well as accountability. The multiplicity of policies, projects and programmes generated by domestic and international stakeholders is significant and there is a strong risk of overlap, sub-optimal use of resources, and limited tracking of the reform’s actual impact or effectiveness. For example, during OECD interviews, Ukrainian officials indicated that currently there is no single entity with a comprehensive list of the programmes implemented by the actors in the decentralisation field. This in turn makes it particularly difficult to determine whether the activities underway are working in harmony, and if they are supporting broader government objectives while also yielding programme-specific desired results.

The centre-of-government could play a stronger role

A clearly mandated centre-of-government body, one that can manage “day-to-day” horizontal and vertical co-ordination needs, is not evident in Ukraine’s governance structure, which affects the multi-level governance and decentralisation reform process. Without such an entity there can be overlapping activity, inefficient use of resources, policy incoherence, misaligned priorities, and poor policy and programming integration in government reform.

The primary objective of the centre-of-government is to ensure strategic, evidence-based and consistent policy implementation across government. While each country’s centre-of-government will depend significantly on its historical, cultural and political forces, there are similarities that emerge with respect to their functions (Box 2.7). The centre-of-government does not command or control what should be done by other ministries, agencies or levels of government. Its role is rather one of stewardship – guiding, supervising and managing government processes to ensure that integrated policy efforts (e.g. regional development, decentralisation, etc.) and sector policy (e.g. agriculture, education, energy, etc.) are coherent and consistent rather than contradictory; that policy priorities are acted upon and that government objectives are met. Depending on the country, the body may be linked specifically to the executive structure (e.g. the Department of the Prime Minister and Cabinet in Australia, the Ministry of the General Secretariat of the Presidency[9] in Chile, the Prime Minister's Secretariat in Sweden) or a functional institution, such as Canada's Treasury Board Secretariat, or the Office of Management and Budget in the United States. While in Ukraine there is a Secretariat for the Cabinet of Ministers, which would be the logical choice for such activities, its main focus appears to be centred on ensuring the legal conformity of acts and legislation.

There are two immediate ways to strengthen Ukraine's centre-of-government practices that do not require creating new institutions. One option is to reinforce the Secretariat for the Cabinet of Ministers with a group that could perform additional centre-of-government functions. The second would be to house centre-of-government functions with another existing body. The Reforms Delivery Office is a strong candidate for such a role, as it is already fulfilling some centre-of-government functions (Box 2.8). In both instances, functions could be assumed gradually, for example focusing on specific reforms or areas of the government programme (e.g. decentralisation) and then extending into a more complete centre-of-government role. This could satisfy the current need, and might also serve as a first step towards improved governance practices overall.

Box 2.7. The centre-of-government: What it is, why it is important, what it can do

The term centre-of-government refers to the administrative structure that serves the executive (president, prime minister or governor at the subnational level, and the executive Cabinet collectively). It does not include other units, offices, agencies or commissions (e.g. offices for sport or culture) that may report directly to the executive but are, effectively, carrying out line functions that might equally well be carried out by line ministries. An effective centre-of-government is essential for steering policy development and implementation. It can help overcome ministerial and departmental silos that thwart co-operation and create wasteful duplication of policies and institutions. A well-functioning centre-of-government helps sustain a comprehensive long-term vision, manage risks and crises, and ensure an integrated approach to policy and reform. It plays a key role in communicating, as well as securing support and monitoring action. Who is at the centre-of-government varies by country. It will always include the body or bodies that serve the head of government and/or head of state, and is often accompanied by the Ministry of Finance.

Among the various roles for the centre-of-government are to:

- provide a strategic overview of government policy activities, including a foresight function aimed at identifying emerging issues and building anticipatory capacity
- increase policy coherence by ensuring that all relevant interests are involved at the appropriate stages of policy development
- communicate policy decisions to all concerned players and to provide implementation oversight
- apply effective regimes of performance management and policy evaluation
- ensure consistency and coherence in how policies are internally debated and how they are delivered and communicated to the public.

Centre-of-government responsibilities can include:

- strategic planning
- policy analysis
- policy co-ordination
- risk management/strategic foresight
- regulatory quality and coherence
- monitoring policy implementation
- preparing the government programme
- preparing Cabinet meetings
- communicating government messages
- human resource strategy for the public administration
- public administration reform
- relations with subnational governments
- relations with the legislature
- supra-national co-ordination/policy.

Sources: OECD (2014b), *Slovak Republic: Developing a Sustainable Strategic Framework for Public Administration Reform*, http://dx.doi.org/10.1787/9789264212640-en; OECD (2015), *Government at a Glance 2015*, http://dx.doi.org/10.1787/gov_glance-2015-en.

Box 2.8. The Reforms Delivery Office in Ukraine

The Reforms Delivery Office is responsible to the prime minister and serves as an advisory body for the Cabinet of Ministers. Its primary tasks are analysis and reporting for government and international partners in diverse policy sectors (e.g. decentralisation, economic development, regional development, etc.). It is also responsible for the project management of different reforms on the government agenda. For example, the team dedicated to public administration reform is working with eight ministries to pilot a new structure; other teams work on the privatisation of state-owned enterprises, improving the business climate, etc.

With respect to decentralisation, the Reforms Delivery Office has identified a need for better information flows regarding implementation activities by ministries and donors. It has been working on mapping the institutional architecture to gain a better understanding of projects and programmes across the territory in order to identify duplication of effort and ensure better coherence.

Source: OECD interviews.

Strengthening central level co-operation mechanisms in support of reform

Limited co-ordination across and among levels of government is challenging the implementation of Ukraine's reform agenda. Co-ordination is needed to identify and harmonise policies and priorities, as well as to ensure effective regional development planning and the public investment to support it. Among OECD governments, legislation and laws for co-ordination tend to be the most frequently used co-ordination mechanisms, followed by co-ordinating bodies. Other popular ways to manage national/subnational relations are co-operative agreements and contracts (Charbit and Michalun, 2009). At the subnational level in Ukraine, agreement-based co-operation is gaining traction in the form of inter-municipal co-operation, but there is room for stronger horizontal co-ordination at the central level. In addition, reinforcing vertical co-ordination mechanisms, particularly ones that foster a relationship based on partnership among levels of government rather than hierarchy, will become increasingly important as local communities become more empowered.

Introducing an inter-ministerial council to ensure reform and sector co-ordination

There is a strong need to boost inter-ministerial co-ordination capacity for multi-level governance and decentralisation reform. Very few reforms are likely to touch so many areas of government, and action in one sector or area can easily trigger a domino effect that requires co-ordinated action in another area. Added to this is the visibility of decentralisation reform in Ukraine. It is a priority of the current government and is on the agenda of most government actors and institutional stakeholders, with extensive programming planned and already underway.[10] The Ministry of Regional Development is responsible for implementing the country's decentralisation process and ensuring that its objectives are reached, but it is confronted by resource challenges and an institutional culture that traditionally works in a siloed manner.

Many countries undertaking reforms as complex as Ukraine's establish a high-level inter-ministerial council or commission with a mandate to ensure or support a co-ordinated reform process across ministries and agencies. Often these bodies are chaired by the prime minister and are composed of ministers from the relevant ministries and high-level agency representatives when appropriate. Some countries, such as Japan and New Zealand, establish more broad-based entities, and include subnational government associations and non-government stakeholders (OECD, 2017a). Reform implementation is usually assigned by this body to the most relevant line ministry, helping to legitimise its mandate to co-ordinate other line ministry activities that relate to territorial reform. Such bodies are essential for identifying priorities, outlining reform sequence and ensuring that the various different parties involved buy into the process, thereby minimising obstacles at each stage. They are well-placed to support coherent reform implementation, and can sponsor ongoing dialogue among relevant stakeholders. This helps identify what works and what does not, potential risk factors, as well as relevant – and ideally more integrated and innovative – solutions.[11] These entities can be established strictly to steward decentralisation reform (and disbanded at some point in the future), or they can be already established inter-ministerial regional development councils responsible for overseeing and co-ordinating regional development more broadly, and then tasked with taking up decentralisation reform as part of their portfolio. Poland supports the implementation of its development policy with a high-level Co-ordinating Committee. This is a consultative and advisory body of the prime minister, chaired by the Minister for Economic Development (Box 2.9). While the Polish example emphasises regional development, Ukraine could consider establishing a similar body strictly for decentralisation – supporting reform implementation and helping address barriers to the Ministry of Regional Development's capacity to act.

Box 2.9. Poland's Co-ordinating Committee for Development Policy

Poland's Co-ordinating Committee for Development Policy is a body of the Council of Ministers, led by the Minister of Economic Development and with the Minister of Agriculture and Rural Development as the first deputy. It is composed of ministerial representatives and invited representatives (e.g. local governments, academia, etc.) on an *ad hoc* basis. The committee analyses the strategies, policies, regulations and other mechanisms associated with implementing Poland's Strategy for Regional Development, and assesses their efficiency and effectiveness. Sub-committees, for example on the territorial dimension or rural areas, can be designated. On an annual basis the committee assesses work in progress and outcomes, including with respect to funding, and prepares recommendations for the Council of Ministers.

At least once a year the committee performs an assessment of the works' progress and the results achieved (including the regional dimension) of the Strategy for Responsible Development, its course of funding including co-funding from the EU funds, an analysis of the complementarity of support from various operational programmes, EU and national developmental programmes, and private funds. Using the assessment as a basis it prepares recommendations for the Council of Ministers on programme, legal and institutional adjustments.

Source: Government of Poland (n.d.), unpublished documents, Department for Development Strategy, Ministry of Economic Development.

A high-level decentralisation council or committee could support the Ministry of Regional Development's position as a co-ordinating body for cross-sector government reform. The Ministry of Regional Development has been officially tasked with implementing decentralisation reform, but it apparently has not received clear guidance or a mandate to pull together the diverse government interests (Tkachuk, 2017). This ability is fundamental to ensure that decentralisation priorities are acted upon, and that sector decentralisation reform is coherent within and across sectors, as well as properly sequenced to correspond to local authority capacity to absorb new administrative and service challenges and responsibilities. It could also increase capacity to influence the process with other stakeholders, particularly subnational (*oblast* and *rayon*) governments and strong political as well as private sector interests, none of which are always in favour of reform.

Second, a decentralisation council or committee could help address an apparent resource (human and financial) gap that the Ministry of Regional Development faces. If the implementing body lacks the necessary resources (human, financial or infrastructure) to implement reform or ensure that reform priorities are implemented by other institutions, then reform success may be limited. A high-level decentralisation council or committee could help address such an issue, by finding ways to bridge a resource gap.

Building stronger vertical co-ordination and collaboration mechanisms

The limited co-ordination among and between government levels is another significant challenge that impedes the successful implementation of Ukraine's decentralisation agenda. Frequently used tools for co-ordination include laws and legislation, planning requirements, contracts and other binding agreements, and dialogue bodies. Ukraine's multi-level governance dynamic has traditionally been top-down and driven by laws, legislation and plans. Through Ukraine's reform process, particularly at the local level, subnational governments are becoming increasingly responsible for the development of their territories and communities, including development planning. Success at all levels of government will depend on a clear communication of objectives and priorities, both top-down and bottom-up; agreement on development and investment priorities; and co-ordinated action, particularly in areas where competences and/or interests overlap (e.g. transport infrastructure, urban development and land use, etc.). Therefore, reinforcing vertical co-ordination mechanisms, particularly ones that foster a relationship based on partnership among levels of government rather than hierarchy, will become increasingly important, especially as communities become more empowered.

Strengthening co-ordination through multi-level dialogue

Ensuring that different levels of government are aware of each other's vision for development, priorities and planned activities is fundamental to coherent policy implementation. This does not seem to occur in Ukraine with respect to decentralisation reform. Ministries are aware of the decentralisation reform and are pursuing decentralisation in their own sectors (e.g. health, education, social services, land use, transport) with minimal cross-sector dialogue, and even less multi-level dialogue. This will only serve to reinforce traditional ways of working in a context where one success factor is adequate co-ordination mechanisms. This can be aggravated by a mismatch in the "territorial logic" of the subnational bodies (e.g. agencies) of ministries or other central level institutions. There is a significant need for solid horizontal and vertical co-ordination when the territorial boundaries of these entities do not match each other or subnational administrative boundaries, which is frequently the case in Ukraine. Greater co-ordination of their policies and a more co-ordinated territorial approach could improve coherence between the agencies that must intervene in the territory, and among the various government levels.

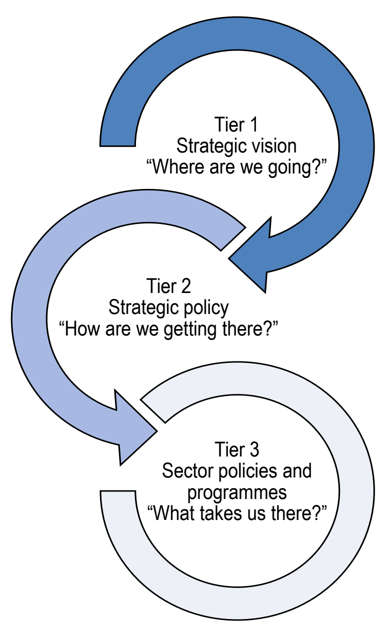
Consideration should be given to a dialogue body that brings together representatives from all levels of government. Ideally this type of mechanism should be as much part of the political level as the administrative or technical level, bringing together civil servants from different levels of government who are also involved in implementing the decentralisation reform. This has proven successful in Poland with the Joint Central Government and Local Government Committee and in Sweden through the Forum for Sustainable Growth and Attractiveness (Box 2.10).

A cross-sector, multi-level body such as those found in Poland or Sweden could help Ukraine build stronger ties among levels of government. *Ad hoc* meetings with representatives from different levels of government are called together by the Ministry of Regional Development to address specific topics of urgency. This can be extremely useful to gather opinions and find solutions to an already identified problem. However, it does not easily support ongoing dialogue and policy implementation. Building inter-institutional, multi-level mechanisms could not only help clarify government intentions and objectives, but build trust in the reform process by other levels of government as well.

Using policy and planning documents to better support vertical co-ordination

Planning documents, including vision-setting documents, integrated national level strategic policies, sector policies, and subnational development plans are co-ordination mechanisms that build vertical and horizontal links between government actors and their actions. Such documents also connect the various levels of a policy cascade (Figure 2.4) and help co-ordinate diverse interests when implementing a new or reformed policy.

Figure 2.4. **From strategic vision to sector policies and programmes**



Box 2.10. Dialogue bodies in Poland and Sweden

Poland supports dialogue between levels of government with its Joint Central Government and Local Government Committee. This body is composed of the minister responsible for public administration and 11 representatives appointed by the prime minister (at the request of the chair), together with representatives of national organisations of local self-government units that work in 12 "problem teams" and 3 working groups. It considers issues related to the functioning of municipalities and to the state policy on local government, as well as with issues related to local government within the scope of operation of the European Union and the international organisations to which Poland belongs. It develops a common position between levels of government and contributes to establishing the economic and social priorities of national and subnational government on matters such as municipal service management and the functioning of communal and district government, as well as regional development and the functioning of *voivodeship* (province) government. The Joint Commission develops social and economic priorities that can affect subnational development, evaluates the legal and financial circumstances for operating territorial units, and gives an opinion on draft normative acts, programmes and other government documents related to local government (Lublinska, 2017).

In **Sweden**, the Forum for Sustainable Growth and Regional Attractiveness facilitates and maintains a continuous dialogue among a wide and diverse array of stakeholders (e.g. central government, central government agencies, regional governments, municipalities, third-sector actors and the private sector). The forum is part of the implementation of Sweden's National Strategy 2015-2020 and is considered an important tool for multi-level governance and to support national and regional level policy development through dialogue and co-operation. It is divided into two groups: one that promotes dialogue between national and regional level politicians, and one that fosters dialogue between national and regional level civil servants (director level). Associated with the forum are networks and working groups, such as an "Analysis Group" that brings together 16 state agencies. The forum is led by the state secretary responsible for regional growth policy, and participants are regional leaders and civil servants with regional development responsibilities in their portfolios; there are about 50 regular participants at the political level. Additional participants, such as ministers, state secretaries and directors within state agencies, can be invited on an *ad hoc* basis, depending on the agenda topics. The forum can serve as a "regional lens" or "prism" through which to consider diverse sector initiatives, e.g. in housing, innovation and transport.

Sources: Adapted from: Lublinska, M. (2017), "Decentralisation and multi-level governance in Poland: Ensuring coherence between national and subnational development strategies/policies"; Government of Poland (n.d.), unpublished documents, Department for Development Strategy, Ministry of Economic Development; OECD (2017b), *OECD Territorial Reviews: Sweden 2017: Monitoring Progress in Multi-level Governance and Rural Policy*, http://dx.doi.org/10.1787/9789264268883-en.

An explicit decentralisation policy that complements and supports the implementation of the vision established in the Concept Framework would be a useful tool in Ukraine's reform process. It is the missing link in Figure 2.4. In Tier 1 is the Concept Framework and in Tier 3 are sector decentralisation approaches, government and donor-sponsored implementation programmes, etc. An explicit national decentralisation policy (Tier 2) would link these other two levels, establish a consistent course of action for government and other institutional actors to follow with respect to the key activities supporting multi-level governance and decentralisation reform, and to address the challenges that arise. Without a road map or guide for action that all actors can turn to, reform implementation becomes *ad hoc*, without a clear sequencing of actions or capacity for stakeholders to fully identify the degree to which progress is being made. Such a document, complemented by an action plan articulating a timeline for concrete action associated with measurable, targeted results and monitoring mechanisms, could help prioritise activities and give structure to the next steps of the decentralisation process (e.g. sector decentralisation). It would also provide greater stability, consistency and clarity for stakeholders – they would be able to identify where the process is, what remains to be done, etc. In addition, it builds transparency into the decentralisation process. Such documents become particularly important given that the Concept Framework faces a constitutional block, and no updates have yet been proposed.

An explicit decentralisation policy should be articulated with the input of different national and subnational government stakeholders, including the Committee on State Building, Regional Policy and Local Self-Government of the *Rada*; relevant line ministries; the subnational government associations; leading academic thinkers; and should incorporate consultation with other relevant stakeholders. This is particularly important to ensure that the strategy and supporting policies and plans are not prescriptive, but are collaborative and shaped with the input of diverse stakeholders who will also be responsible for implementation. When there is agreement surrounding what is to be achieved and how, the process becomes more collaborative, integrated and more likely to succeed.

A decentralisation policy and action plan could also help mitigate the impact of other issues affecting the progress and stability of reform. For instance, the government recognises that amalgamation and fiscal decentralisation are first steps in a larger process. However, it has not clearly established what the larger process is (the job of a policy); resulting in an increasingly *ad hoc* decentralisation process characterised by significant instability, as the government advances and then retracts proposals and benefits associated with decentralisation. This is clearly visible with respect to the State Fund for Regional Development, but also with the excise tax on petrol, land-use rights and the use of subventions in education, for example. Furthermore, it is not clear how the government wants to continue decentralising beyond institutionalising sector-based decentralisation (e.g. in education, healthcare, transport and land use). While sector decentralisation is likely to be necessary, it is not certain that the communities formed from the amalgamation process – unified territorial communities (UTCs) – are ready to accept or absorb more responsibilities. Many are having difficulty absorbing those they have been given – particularly the smaller ones. An explicit decentralisation policy could help guide the development of solutions to these issues, particularly important as constitutional reform, while still necessary, seems increasingly distant.

An associated action plan for decentralisation would also help prioritise and sequence the various third-tier activities – i.e. sector decentralisation policies and decentralisation-associated programmes – that distinct decentralisation stakeholders intend to implement, such as capacity building among subnational civil servants, infrastructure development, supporting small and medium-sized enterprise development, etc. In a context such as Ukraine's, where structures are traditionally hierarchical, risk taking is often low and vested interests are such that there is an incentive to ignore or bypass actions for the "greater good". Therefore, it is essential to give clear guidance on what needs to be done, provide incentives to do it and establish mechanisms to that ensure accountability. If these elements are in place, it is likely that even more can be accomplished.

Box 2.11. **Recommendations for strengthening co-ordination mechanisms and ensuring successful decentralisation**

To strike a better balance in territorial reform and ensure the conditions for successful decentralisation, the OECD recommends:

- **Strengthening co-ordination mechanisms** to ensure that actors in the reform process are moving in the same direction and that priorities are well-aligned. This includes:
  - Introducing an explicit decentralisation policy to establish a consistent course of action for decentralisation stakeholders, using it to:
    - bring together input from different national and subnational stakeholders to ensure that decentralisation policy and plans are not prescriptive, but collaborative, thereby gaining broader ground for support
    - guide sector or other institutional actors with respect to decentralisation activities and managing challenges that arise
    - establish a road map for reform (action plan) with a timeline for concrete action, establishing overall desired outcomes (that are measurable), and giving structure to next steps in the decentralisation process (prioritisation and sequencing).
  - Strengthening centre-of-government practices to better manage horizontal and vertical co-ordination needs by:
    - clearly mandating a centre-of-government office, for example by:
      - reinforcing the Secretariat for the Cabinet of Ministers with a group that could perform additional centre-of-government functions, or
      - expanding the remit of another existing body that already exercises some centre-of-government office activities, e.g. the Reforms Delivery Office.
    - Ensuring that centre-of-government office functions include strategic overview of government policy activities; oversight of policy coherence and implementation; internal communication of policy decisions; application of performance management and policy evaluation; ensuring consistency and coherence in internal policy debate and communication with the public.
    - Assigning functions in a phased manner, either focusing

on reforms linked to the Government Programme or National Strategy for Development (e.g. decentralisation) and extending to a more complete centre-of-government role, or focusing on assigning a limited set of strategic tasks, such as strategic planning, policy analysis, policy co-ordination, monitoring policy implementation, relations with subnational governments and with international donors.

- Establishing a high-level inter-ministerial council or committee specifically for decentralisation to boost inter-ministerial co-ordination capacity and better support an integrated reform process across sectors, in order to:
  - support coherent reform implementation, sponsoring ongoing dialogue, establishing reform priorities and sequencing, etc.
  - legitimise decisions for a co-ordinated reform process across ministries and agencies
  - incorporate the interests of line ministries and high-level agencies when appropriate, as well as subnational government and non-government shareholders; ideally led by the prime minister.
- Strengthening dialogue among different levels of government to build synergies, trust in reform and strengthen co-operation, by:
  - launching a cross-sector and multi-level dialogue body dedicated to decentralisation reform (strategy, policy, programming, etc.) that meets on a regular basis. Consider first developing a dialogue body for the political level and then determining the need to introduce a similar body at the senior civil service level.

- **Clearly assigning responsibilities and functions** to different levels of government to help build efficiency in service provision and policy making, and to support greater accountability of government, by:
  - identifying and clearly distinguishing responsibilities in sector-, service- and development-related tasks (e.g. transport, education, infrastructure, economic development) and operational functions (e.g. strategic planning, financing, regulating, implementing, monitoring)
  - ensuring that ascribed responsibilities are legally supported
    - including and maintaining minimum services standards to be met, and strengthening monitoring and evaluation practices.

Municipal amalgamation as a platform for decentralisation

Foremost among Ukraine's territorial challenges highlighted in 2014 was the high degree of fragmentation at lower levels of government, making it impossible for many local authorities to realise economies of scale or effectively perform basic service provision functions (OECD, 2014a). Before 2015, there were 11 520 municipalities in Ukraine, ranging from large cities to small rural settlements, with an average size of about 3 950 inhabitants. Just over 10 000 of these communities were villages, 92% of which had fewer than 3 000 residents, and of these 47% had fewer than 1 000 residents (Sydorchuk, 2015). Such degrees of administrative fragmentation – i.e. many local authorities in a given district or region – can reduce territorial productivity and limit development. The OECD average population concentration is just over 9 600, more than twice that of Ukraine.

Amalgamation as a first step in decentralisation

In the 2014 *Territorial Review of Ukraine*, the OECD suggested focusing first on territorial reform to address the issue of fragmentation before embarking on a process of decentralisation. By doing so, a stronger local level platform could be built for a better quality, more cost-effective and more accessible delivery of basic public services. Once this was accomplished, decentralising functions to lower levels of government would be easier to implement. Such a reform, it was noted, should promote the development of new forms of inter-municipal co-operation, including by simplifying the legal procedures involved in transferring responsibilities to joint bodies or companies, providing greater incentives to implement new types of co-operative relationships among local authorities, and facilitating municipal mergers (OECD, 2014a). To a large degree this approach is reflected in the trio of laws supporting decentralisation in Ukraine (see Box 2.2). However, rather than sequencing territorial reform and then decentralisation, Ukraine elected to use the possibility of administrative and fiscal decentralisation as an incentive for amalgamation. This has certainly spurred the amalgamation process, but it has also created uneven amalgamation across the territory, leaving a patchwork of local authorities with greatly varying resources and competence.

Making significant progress in territorial reform through a process of fully voluntary municipal mergers counts as one of Ukraine's most visible successes to date in territorial reform and the decentralisation agenda (Box 2.12). As of July 2017, approximately 2 000 local self-governments had merged to form 413 UTCs, covering 17% of the national territory and representing 8% of the population. By October 2017, the figure reached 614 UTCs with at least another 45 to be formed by the end of the same year (Kramar, 2017; Ministry of Regional Development, 2017a).[12] The Ministry of Regional Development has targeted a total of approximately 1 500 local self-governments to be created from the current 11 500 with local councils (Nehoda, 2014).

The rate of success in voluntary amalgamation is unusual compared with the experience of OECD countries, where voluntary mergers have difficulty gaining traction. At the outset it was driven by a strong fiscal decentralisation package linked to the changes in the State Budget Code and the approved 2016 state budget (which subsequently changed in 2017). Another draw was the opportunity for a restructured, more empowered relationship with higher tiers of government. Once officially operational (i.e. with a newly elected mayor and municipal council), the UTCs are eligible to negotiate their budgets directly with their *oblast* administrations, rather than negotiate and receive funds from the *rayon* state administration. Communities that do not amalgamate, however, are not eligible for additional revenue sources or negotiation benefits and remain under the tutelage of their *rayon*. An additional driver of success was the ability for the merging communities to maintain their original identities and elect a local community leader – the *starosta*. This helped convince smaller towns, villages and settlements to engage in the amalgamation process (OECD interviews).

Box 2.12. Ukraine's voluntary amalgamation process

Ukraine launched its voluntary amalgamation process in March 2015 and by early December 2016 there were already 159 newly amalgamated communities. Prospect plans developed by the *oblast* state administrations were developed as a guide for establishing new administrative units by identifying potential amalgamation partners for all communities. Local authorities, however, do not have to adhere to these plans. The law permits local self-government units (*hromada*) to amalgamate if their territories are: 1) contiguous; 2) located within the same *oblast*; 3) have historical, natural, ethnic, cultural or other unifying characteristics. Community members or local authorities can initiate the amalgamation process, which must undergo public consultation and approval by each of the local councils involved. Final amalgamation plans can be (and often are) subject to local referenda and must be approved by the *oblast* council. They also must be approved by the Cabinet of Ministers, which determines whether the new community can perform its functions. In addition, the Ministry of Finance checks to see if the resources will be sufficient to cover education, healthcare, social protection, and the basic administration and operation of the new municipality. As soon as the approval process is complete, the Central Election Committee of Ukraine authorises the election of a mayor and municipal council. Thus far, elections for new local governments appear to be held twice a year, and the Election Committee can choose not to authorise such an election (as it has done with communities wishing to amalgamate across *rayon* borders). All eligible citizens vote in the elections for the new mayor and council members, and once elected the council appoints an executive committee. The objective of this process is to ensure that all communities across Ukraine are sufficiently capable of providing the same list of delegated services, meeting the same list of responsibilities and enjoying the same financing benefits.

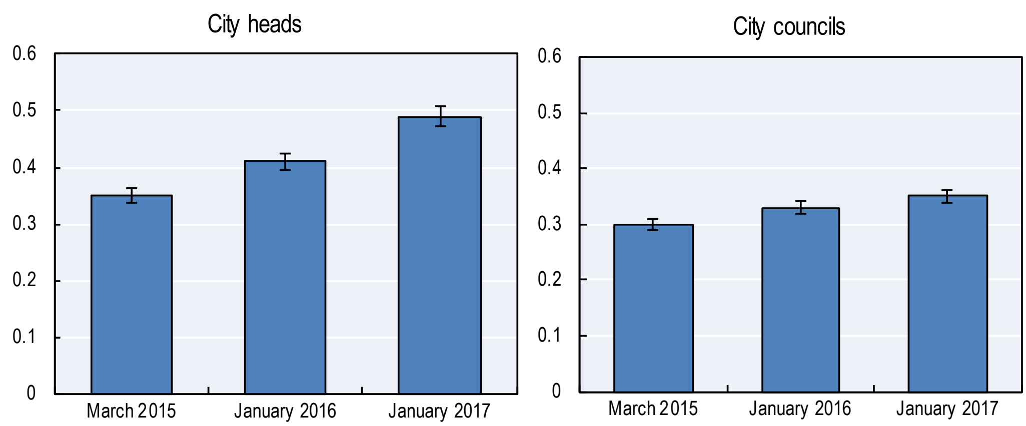
Sources: OECD interviews; Verkhovna Rada of Ukraine (2015a), Law No. 157-VIII of 5 February 2015 on Voluntary Consolidation of Territorial Communities, in Ukrainian at: http://zakon3.rada.gov.ua/laws/show/15719/print1469801433948575; World Bank (2017a), "Ukraine: Public finance review", http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review.

The relative success of amalgamation

There is no doubt that amalgamation has strengthened the local communities that engaged in the process. UTC community leaders in different regions highlight greater capacity to meet the needs of citizens, and improve and maintain services and infrastructure. They also report enhanced access to business opportunities. One fundamental and positive change that community leaders remark upon is the increase in budgets and revenues (see Chapter 3). Local communities that have amalgamated for the first time have money in their budgets to invest according to their priorities. In the past, investment decisions and funding were managed by the *oblast* and *rayon* levels. In addition, local leaders are noticing that citizens' attitudes toward the management of their municipalities is changing – where before there was an effort to keep a school open no matter the cost, now people are considering where it is more effective to have a hub school and how to work on transporting the children there. There is a greater sense of responsibility with respect to community funds on the part of the officials as well as the citizens (OECD interviews).

The capacity to directly address pressing infrastructure and service needs, for example in road reconstruction, schools and medical clinic buildings, has a positive impact on building the relationship between citizens and the local government. In fact, evidence indicates a rise in citizens' approval of local leaders in *oblast* capital cities between 2015 and 2017 (Figure 2.5).

Figure 2.5. **Average level of approval of local institutions**



Note: Average of the share of respondents approving the mayor's (or city council's) activities in each city; N = 800 validated answers in each of the 24 cities (22 in 2015).
Source: Center for Insights in Survey Research (2017), "Third Annual Ukrainian Municipal Survey", www.iri.org/sites/default/files/ukraine_nationwide_municipal_survey_final.pdf.

While approval does not equate to trust, a government that receives the approval of its constituents is also more likely to be trusted by them, and this tends to occur most strongly at the local level, where services are delivered and where the link with government performance is most concrete (OECD, 2013a). Therefore, ensuring that the local level has the autonomy and resources to act in the best interests of residents, free from pressure by higher level political and other vested interests, is critical for good governance and for the implementation of reform. Unfortunately, this is not always the case in Ukraine – reflected in anecdotal evidence from local leaders trying to secure votes for amalgamation, and changes by the national government that have effectively politicised the selection process for funding projects through the State Fund for Regional Development (explored later in this chapter).

Lessons from amalgamation so far

Since the amalgamation process began in 2015, several lessons stand out. First are the characteristics that make a successful UTC. It is reported that UTCs which amalgamate around towns are stronger and have more progressive leaders and more experienced public officials. The UTCs that have formed with a limited number of residents, often in rural areas, or with economically inactive populations risk a limited capacity for development and the provision of required services due to a persistent lack of scale (World Bank, 2017a). This difference between successful and less successful UTCs is critical as it can aggravate territorial inequalities.

An expanding capacity gap

There appears to be an expanding capacity gap between the UTCs and non-amalgamated communities in terms of financial resources and the ability to deliver services. The UTCs with more resources and responsibility are tackling (either on their own or through inter-municipal co-operation) the need for basic services such as potable water and sanitation, sufficient heating for schools, and adequate medical attention for residents, as well as turning their attention to such connectivity needs as roads, public and school transport vehicles, and emergency and safety services (e.g. fire, snow, etc.). This is more difficult for communities, especially smaller ones that have not amalgamated. They face being left behind not only in terms of service delivery, but also with respect to the capacity to improve economic and societal well-being.

These differences also reach into administrative services, particularly those that are functions of the community (e.g. leasing land, residential registration, etc.) and functions of the state executive bodies (e.g. issuing passports, permits, licensing, etc.). Administrative service centres (ASCs) are the equivalent of "one-stop shops" for citizens. These centres can be established by *hromada*, including the UTCs – in which case the community finances the centre with its own resources – or by *rayon* administrations that finance the ASCs with state transfers. In addition, the Ministry of Economy, in co-operation with the Ministry of Regional Development and with the support of the government of Canada's EDGE project, are piloting "re-engineered" ASCs in 15 UTCs. The objective is to streamline back-office functions and deliver administrative services in a more "citizen-centred" way. The ASCs established by individual communities appear to be better off financially and there is an incentive for a locally elected mayor to make sure that they are effective. Centres under the responsibility of *rayon* executive committees are said to be under-resourced. However, there also seems to be little incentive for communities to use their funds for such centres. While there are 715 ASCs around the country, only 250 (about 35%) are in *hromada* and of these 44 are in a UTC (Ministry of Regional Development, 2017b).

A need to reconsider amalgamation partners

While amalgamations have proceeded quickly, and continue, the communities formed have highly varied capacity levels. This problem is rooted in numerous decisions taken early in the reform process,[13] including: to override technically solid planning, a lack of basic guidance for communities selecting amalgamation partners and an early choice to permit *ad hoc* amalgamations. Managing the results of this will require adjustments in the planning and authorisation process, as well as mechanisms to better support those UTCs facing capacity constraints.

When embarking on the amalgamation process, *oblast* administrations developed "prospective plans" for their territories as the basis for the administrative boundaries of the UTCs. They identified clusters or groups of *hromada* to be amalgamation partners, so that when they merged, outlying communities would be no more than 25-30 kilometres away, assuming a paved road, or a 30-minute ambulance ride, from the community centre. Generally, the community centre would be a city of *oblast* or *rayon* significance or another large local government with the necessary infrastructure in terms of access, connectivity and services (e.g. healthcare and higher level schools, etc.) already in place. Also considered when identifying community groups were total population; area; estimated budget from local taxes; the number of educational institutions, medical institutions and infrastructure; social service needs; and administrative and social infrastructure (OECD interviews). The plans were based on the socio-economic relationships of the communities, as well as traditional relationships. The intention was to create *hromada* sufficiently large as to be able to ensure better public services but also to generate socio-economic growth (Box 2.13). The initial Prospective Plan for Mykolaiv *oblast*, for example, divided the territory into 32-33 UTCs from an original 313, as the majority of these communities prior to amalgamation were subsidised from the state budget – something that amalgamation could alleviate.

The prospective plans, however, were considered difficult to follow and municipalities amalgamated with neighbours on a more *ad hoc* basis. The difficulty is due in part to the process's voluntary nature, in part a result of prospective plans being potentially too rational, and in part due to strong political and economic interests at play. In addition, while there were significant incentives to amalgamate, there were no specific incentives (or disincentives) to amalgamate according to the prospective plan. Using Mykolaiv again as an example, of the 21 total UTCs that were formed between 2015 and March 2017, only 2 followed the prospective plan. The remaining 19 amalgamated with different partner combinations (OECD interviews). Based on data from the Ministry of Regional Development up to April 2017, this is not necessarily unusual. However, it permitted communities to form that still do not have sufficient scale or resource-generating capacity to meet the devolved responsibilities associated with decentralisation. The World Bank notes that the average UTC is composed of only five original local self-government units, and that many of the UTCs approved to date are formed from an original two to four *hromadas* (World Bank, 2017a). This calls into question the ability of a majority of UTCs to execute decentralised responsibilities, especially in healthcare and education. In an attempt to return to a more rational process, *oblast* prospective plans have been redrawn to account for the already formed UTCs and to indicate new possibilities for amalgamation partners. As of 2017, in order to be recognised and receive the fiscal incentive package associated with amalgamation, the communities must follow the partnerships identified in revised prospective plans. This does not mean they must amalgamate, but it puts a limit on their capacity to choose amalgamation partners.

This is a welcome shift as, moving forward, it could help minimise the formation of under capacitated municipalities even after amalgamation. However, it does not necessarily tackle the problem of the under capacitated UTCs already formed. One way to address this is through an asymmetric approach to the decentralisation of tasks, where communities that are larger and thus have greater resource capacity are also given more responsibilities. This could take the form of a tiered allocation of responsibilities based on a minimum threshold of residents for all communities (explored by Japan). It could also be accomplished through "certification" processes as in Colombia, through experimentation and pilots seen in Denmark, or contracts as in the case of the Czech Republic (OECD, 2017c). Italy's Law 56 of 2014 "Reordering the Territorial Organisation of the Country" defines different types of territorial divisions (provinces, metropolitan cities, municipalities), based on set criteria (e.g. strategic development of the territory, efficient provision of public services, existing infrastructure and communications networks, and institutional relations). It also facilitates municipal mergers and inter-municipal co-operation for the provision of public services (Global Legal Monitor, 2014).

Box 2.13. "Expert", "compromise" and "consensus" plans for amalgamation

A 2017 study in spatial planning highlights the capacity of initial prospective plans to ensure well-capacitated local self-government units – thereby better supporting the decentralisation process in terms of meeting delegated responsibilities and generating additional, necessary revenues. Using Kyiv *oblast* as the model, the study evaluated the successive elaborations of the prospect plan (19 in total) developed by Kyiv *oblast*, grouping these into three variants: "expert", "compromise" and "consensus", and evaluating them based on the same set of indicators.[1]

Table 2.5. **Prospect plan variants for newly amalgamated communities in Kyiv *oblast***

Indicator	Variants of prospect plan		
	Expert	Compromise	Consensus
Number of unified territorial communities	45	77	61
Average area (m^2)	569	333	411
Population (average)	39 930	23 445	26 918
Number of settlements (average)	26	15	19
Percentage of subsidised communities	25	49	47
Percentage of communities with facilities for state bodies and institutions	80	74	90

The quality of results from the "consensus" variant is intermediate between "expert" and "compromise" – most significantly because about half of the communities remain subsidised. It is through the "expert" model where the resulting territorial system reflected the highest possibility of ensuring long-term sustainable development; and so despite imperfections it was the "… best possible, scientifically sound option." Under the "expert" variant, 89.9% of the proposed UTCs would have been fully able to provide appropriate facilities for housing state administrative institutions and agencies, if necessary, and the remaining 11.1% would have been partially able to do so; that the vast majority of communities would have had sufficient financial capacity;[2] and only 25% of the newly formed communities would have one income per person less than the official minimum wage. Ultimately, it was the "consensus" variant that was adopted by the Kyiv Regional Council.

Notes: 1. The variants refer to: *i)* "expert", i.e. the plan as developed by a working group within the Kyiv regional state administration in consultation with economists, economic geographers, and specialists in state and municipal management; *ii)* "compromise", i.e. those proposals that the *oblast* working group began to receive from local governments and the public while the prospect plan was being developed (fully permissible according to law) and which the working group agreed to maximally consider despite the fact that some of the proposed communities did not meet the requirements established by the *oblast* methodology for community groupings; and *iii)* "consensus", i.e. a variant that implies consideration of all stakeholders in the proposed community configuration (Udovychenko et al., 2017). 2. The authors measure this in terms of the ratio of the maximum and minimum profitability indices (to the regional average). This would have varied from 5.11 in the Boryspil community to 0.41 in the Poliske community – considered relatively positive given the spatial segregation of economic development in the region (Udovychenko et al., 2017).

Source: Udovychenko, V. et al. (2017), "Decentralization reform in Ukraine: Assessment of the chosen transformation model", https://www.degruyter.com/view/j/esrp.2017.24.issue-1/esrp-2017-0002/esrp-2017-0002.xml.

Any of these approaches, however, would require a more clearly articulated assignment of municipal responsibilities.

Another, more immediate, possibility to address the issue of under capacitated UTCs is to facilitate additional or "second-generation" amalgamations. Little consideration, however, seems to have been given to whether UTCs could amalgamate with other UTCs. Encouraging UTCs to grow, either by merging with nearby non-amalgamated communities or by permitting the amalgamation of two under capacitated UTCs, could continue to build scale. To do so, however, may require an adequate incentive structure, for example by extending the infrastructure subvention, or permitting greater flexibility in terms of use of state transfers.

Speed bumps that can slow the reform process

There are some speed bumps slowing the pace of Ukraine's amalgamation process. These include a territorial disequilibrium with the *rayon* level, insecurity among the UTCs regarding their legal status, legal constraints preventing amalgamation combinations that would ensure greater scale, insufficient communication of expectations from the top, an unclear attribution of new competences for which the UTCs are responsible, and incomplete land-use reform.

Changes in the territorial equilibrium

Territorial reform via amalgamations has strengthened the political and administrative power of local authorities at the expense of *rayon* administrations. While under the Concept Framework their future was clear, the implementation of decentralisation reform through discrete laws that focus on municipalities has created a territorial disequilibrium that can slow the reform process.

The decentralisation agenda is at odds with rayon *administrations*

The Concept Framework supports political decentralisation at the district level by introducing elected executive committees to support each *rayon* council, effectively replacing the administrative, operational and management activities of the *rayon* state administrations. It also promotes administrative decentralisation by devolving day-to-day service delivery tasks from the *rayon* to the UTCs, leaving the districts with responsibility for services that are more cost-intensive and require greater scale (e.g. second-tier medical care and specialised schools).

The reform as outlined above would have given the *rayon* a clearer purpose and function within the territorial administration. Instead, a gradual "hollowing out" of the *rayon* level is occurring. This poses a threat to the political, administrative and other power structures entrenched in the *rayon*, and in turn it can threaten the success of reform. *Rayon* state administrations are losing their resources and authority as UTCs take on what were previously *rayon*-level responsibilities in areas such as education, healthcare, social services, transport, etc., together with the ability to directly negotiate budgets with the *oblast* state administration. Eliminating the *rayon* from service delivery and budget negotiations can deprive *rayon* authorities of clientelistic ties that have formed in the past, and put them into direct competition with the UTCs for funds and influence. In addition, the *rayon* are expected to transfer their assets (e.g. buildings) to the UTCs, although this does not systematically occur (Lankina, Gordon and Slava, 2017; OECD interviews). This adds up to a resistance to change by many *rayon* state administrations (OECD interviews). At the same time, there are also *hromada* that have not amalgamated and thus remain under the tutelage of the *rayon*. The result is that in some areas rayon state administrations exist to serve a handful (sometimes only one or two) (very small) communities.

Ukraine is facing a number of problems with respect to territorial balance:

1. As of October 2017, 14 *rayon* have been fully "hollowed out": all *hromada* in their territory have amalgamated, either to form a single UTC (in 9 *rayon*) or several UTCs (in 5 *rayon*) (Ministry of Regional Development, 2017a). When there are no more *hromada* to support and thus no need for a dedicated budget, the *rayon* is "eliminated" from the state budget by being given a "0" in its corresponding state budget line (OECD interviews). It is, according to the government, a parliamentary decision to maintain or liquidate a *rayon* (Ministry of Regional Development, 2017a). Until the decision is taken, they are in a form of limbo, in place though in some cases with few to no administrative or service responsibilities.
2. There is an inefficient use of state resources. *Rayon* increasingly lack the scale needed to make their operation and service provision cost-effective. This is true not only where a *rayon*'s territory is partially covered by a UTC – the case in 308 of Ukraine's 490 *rayon*, 103 of which have more than 50% of their territory covered by UTCs – but also in *rayon* where there is complete territorial coverage by UTCs (Ministry of Regional Development, 2017a). While inefficiencies are likely to have existed before amalgamations took place, the situation has become more acute, for example, by creating a need to support *rayon* state administrations, provide funds for certain services, and maintain transfers for the UTCs. This also affects the quality of services the *rayon* can provide to the non-amalgamated communities in their territories for which they are still responsible.
3. There is institutional resistance to amalgamations by *rayon* administrations. While the intention was for *rayon* civil servants to be hired by UTC administrations, this does not always occur. When such transfers are made, they are reported to be successful and considered a win-win situation: the former *rayon* employees bring their capacity and capabilities to the UTC administrations, and in turn the UTCs offer a new and often more dynamic work environment (OECD interviews). Unfortunately, it is not realistic to expect that all former *rayon* staff will find a place in UTC administrations. This creates insecurity among *rayon* civil servants and generates greater resistance to reform – they are worried not only about potentially losing their jobs, but also about their capacity to find new ones since they may lack the skill set necessary to find work elsewhere (OECD interviews). Significantly, and unfortunately, there does not seem to have been a plan put in place to address the need for *rayon* staff transition, retraining, skills upgrading, etc. This is something that could be addressed with the support of such institutions as the National Academy for Public Administration under the President of Ukraine or other appropriate training institutions.
4. There is political resistance to reform. It is acknowledged that vested interests, clientelism and corruption can be significant at the *rayon* level (OECD interviews), and thus any limit to powers of patronage is antithetical to the interests of many *rayon* representatives. One reason constitutional reform did not pass, some observers argue, was that it threatened interests within *rayon* administrations (OECD, interviews). There is also evidence – anecdotal and from international studies – of *rayon* officials undermining the reform process in their districts.

As it currently stands, the reform is creating parallel administrations by attributing the same responsibilities to UTCs as to the *rayon*. This further skews the allocation of responsibilities, negatively affecting already weak transparency and accountability to citizens. It also generates inequality in service quality, type and access, something that the decentralisation agenda is trying to rectify. Furthermore, it is financially inefficient. Overall the situation is inconsistent with the conditions for successful decentralisation reform, including ensuring clearly delineated assignment of responsibilities and functions among levels of government, and capacity for managing change. The result is inefficient and ineffective subnational administration at the intermediate level, less than potentially efficient and effective administration at the local level, and a negative impact on the decentralisation process.

While in some countries there has been discussion to eliminate the intermediate level, this view tends to be met with strong opposition. Many countries instead opt for ways to transform or modify it, as has been seen in Italy (Box 2.14) (OECD, 2017a).

Box 2.14. Reforming Italy's intermediate level of government

In a move to rationalise the intermediate level without abolishing it, Italy passed a law in 2014 that transformed its provinces into inter-municipal bodies (and into metropolitan cities in the country's ten metropolitan areas). According to the law, regional administrations are in charge of determining which responsibilities and functions should be transferred from the provinces up to regional or down to municipal governments within their jurisdiction. This will likely lead to a variety of regional local-government systems across the country. The reassignment of provincial human resources (around 8 000 employees) and provincial assets and liabilities was considered a complex question, with potentially costly changes needing implementation in a period of budgetary restriction. Although initial progress with reform was slow, by late 2015 almost all regions had adopted such agreements.

Source: Adapted from OECD (2017a), *Multi-level Governance Reform: Overview of OECD Country Experiences*, http://dx.doi.org/10.1787/9789264272866-en.

It is reported that some UTCs are transferring some of the funds they receive back to the *rayon* administrations to pay for services the *rayon* still provide, particularly in social services (World Bank, 2017a; OECD interviews). This illustrates two points: one is that UTCs do not have sufficient human resources and/or infrastructure capacity to meet all of the services transferred; the second is that there is a role for *rayon* – but perhaps *rayon* of a different size or configuration.

Given the current situation, a strong argument can be made for re-evaluating the structure and role of *rayon*. This could mean: 1) increasing *rayon* size in terms of area and population in order to build capacity for second-tier services and administrative functions allocated by transferring responsibilities down from the *oblast* level or up from the local self-government level; 2) reconceptualising the role of *rayon* into functional service providers according to catchment areas, such as hospital districts.

There are at least three options that might be considered to accomplish these shifts. The first is to retain deconcentrated *rayon* but to promote cross-jurisdictional co-operation (i.e. inter-*rayon* co-operation) for the delivery of higher level services, reflective of inter-municipal co-operation agreements. These services could include second-tier hospitals, vocational education, high-level athletic and cultural facilities, higher cost social services, broader public health services, emergency services (e.g. fire prevention, winter road maintenance, flooding, etc.), illegally dumped waste, higher level administrative, library services, etc. Some of these, such as library services or fire prevention services, could be undertaken in collaboration with local communities; others would be fully the responsibility of the *rayon*. Promoting inter-*rayon* co-operation for a redesigned list of services could support future *rayon*-level amalgamations.

The second option, *rayon* amalgamation, could be undertaken either in a "big bang" format affecting the entire territory at once or by reforming *rayon* administrations in one or two pilot *oblasts:* assigning them a new set of responsibilities and an appropriate institutional and fiscal structure – which may or may not be decentralised – while also experimenting with optimal scale. The experiment could be undertaken for a predetermined period of time after which the central government would decide whether to continue with the model and introduce it in other parts of the country or to suspend the experiment. In Finland, such an experiment was run in the Kainuu region, lasting seven years, after which the government chose not to pursue the reform in other regions. Sweden, however, tested and further developed an asymmetric approach to subnational governance at the regional level. County governments have both deconcentrated bodies (county administrative boards) and decentralised bodies (county councils responsible to directly elected assemblies). The responsibilities attributed to county councils can differ by county, depending on capacity and desire to take on additional tasks. This technique has permitted Sweden to adjust governance structures and competences according to territorial capacity. The result has been a strongly context-dependent approach to regional governance and development rather than a "one-size-fits-all" approach (OECD, 2017b). While this approach has been taken at the regional level in Finland and Sweden, Ukraine could consider adapting it to the *rayon* level.

In both cases – co-operation or amalgamation – an appropriate incentive structure would need to be introduced. Such a structure could be financial, and within a deconcentrated, co-operative context it could mean ensuring that new responsibilities also have sufficient resources. In a decentralised scheme (an option with amalgamation) it could mean introducing opportunities to generate own-revenue at the *rayon* level. Either way, increasing autonomy in priority setting and decision making within the defined areas of responsibility could be an important incentive. At the same time, it would be essential to minimise the opportunity for clientelistic behaviour and patronage in the provision of services. This could be accomplished in part through civil service reform and appropriate remuneration levels, but also via interesting placement and promotion schemes between levels of government. This is one way to increase the buy-in of senior civil servants without compromising reform logic. Greater open government activity at the subnational level would also be of value for increasing transparency and accountability. In addition, service responsibilities between *rayon* and the UTCs would have to be clearly delineated, with limited overlap in service provision. In cases of shared services or potential overlap, strong contractual agreements would be necessary between the two government levels to clearly identify and define responsibilities, funding mechanisms, etc. To be able to enforce such agreements, however, a functioning judiciary would be critical: one to adjudicate both competing competence claims between levels of government and citizen complaints against any of them.

The third approach would be to focus *rayon* responsibilities on one specific higher level service, taking a functional approach both to their territorial definition and to the attribution of their competences. This means re-evaluating *rayon* borders along the lines of a service catchment area or district for the provision of specific, higher level, more resource-intensive services, such as hospitals. Scandinavian countries take this approach with their hospital districts, though there are challenges to ensure efficient and effective service access in remote and underpopulated areas. These catchment areas could be independent entities with administrative and fiscal capacities seen in some parts of the United States, or they could be a joint co-operative body, owned by a group of participating municipalities as is practiced in Finland (Box 2.15).

Box 2.15. Hospital districts in Florida and Finland

The **Palm Beach County Health Care District** in Florida (United States) was established in 1988 when county residents decided to invest in their community's health. They voted to create an independent taxing district that provides an array of healthcare services, including primary care clinics across the county, a hospital, school healthcare, a trauma system, skilled nursing care and health coverage. The district is governed by a seven member Board of Commissioners serving four-year terms, on a voluntary basis. Three commissioners are appointed by the state governor, three by the county Board of Commissioners, and one from the Florida Department of Health. The District Board is responsible for the comprehensive planning and delivery of healthcare facilities, including hospitals and health services.

In Finland, the **Central Finland Healthcare District** is owned by 21 municipalities and provides services in almost all medical specialties. It is run by an Administrative Council of 49 members and directed by a 9-member Board of Directors. The district is divided into 6 operating areas, with 25 areas of responsibility between them. Additionally, the Central Finland Reginal Health Centre, which is operated as a public utility, provides eight municipalities with basic healthcare services. Meanwhile **HUS Group** is the Joint Authority of the Helsinki and Uusimaa Hospital District, plus its subsidiaries and associated enterprises. The Joint Authority is composed of five hospital areas, seven businesses that provide patient and non-patient support services (e.g. pharmacy, hospital maintenance), group administration, and property management services. The council has ultimate decision-making power, and the Executive Board, which is appointed by and reports to the council, is responsible for the administration and finances of the Joint Authority.

Sources: Health Care District of Palm Beach County (n.d.), "About us", www.hcdpbc.org; Central Finland Health Care District (n.d.), "Health Care District", www.ksshp.fi/en-US/Health_Care_District; HUS (n.d.), "About HUS", www.hus.fi/en/about-hus/Pages/default.aspx

Given the current context in Ukraine, building scale at the *rayon* level and giving them more concrete responsibilities may help recalibrate the territorial equilibrium. Depending on the approach taken – a functional service (e.g. hospital) or a multi-service joint co-operative body, be it through co-operative agreements or amalgamation – it could relieve some pressure for the UTCs to deliver higher level services for which they are under capacitated. This could be applied all at once, or through a "pilot" which will permit experimenting with optimal size, structures, responsibilities and operational approaches.

The government is aware of the problems arising from lack of reform at the *rayon* level. In June 2017 a draft law – No. 6636 on the Procedure of the Creation, Liquidation of Districts, Setting and Changing their Borders – was introduced to facilitate a step-by-step transformation of *rayon* administrations in terms of size, task allocation, administrative responsibilities and institutional structure (Ministry of Regional Development, 2017c). This was followed by a July 2017 meeting that convened *oblast* governors together with representatives of the UTCs to address the issue of parallel administrations. Of the four options for *rayon* reform that the government is considering (as of October 2017), one focuses on *rayon* amalgamation, where two or more adjoining *rayon* would combine into a new one. The other three propose to: 1) change the administrative territorial structure of the *rayon* across the country; 2) eliminate the *rayon* in which all *hromada* have amalgamated; 3) legislatively regulate and provoke an early termination of powers of *rayon* councils where all *hromada* have amalgamated into a single UTC (Ministry of Regional Development, 2017a).

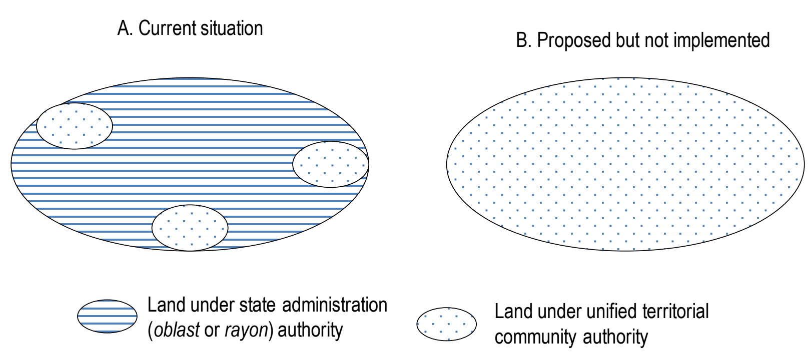
Uncertainty caused by legal constraints and a lack of guidance

Legal uncertainties and a lack of guidance "from the top" can make amalgamation potentially uncomfortable for *hromada,* limiting their interest in or ability to build support for amalgamation.

Among the legal constraints amalgamation faces are limitations in the categories of municipalities eligible to merge. Cities (including of *rayon* significance), towns, villages and rural settlements can amalgamate with each other, but they cannot amalgamate with cities of *oblast* significance. Furthermore, non-amalgamated communities which initially decided against amalgamation cannot subsequently request amalgamation with initially identified partners. This can be limiting among communities that wish to amalgamate and reduces the potential "reach" of decentralisation. The lack of legal protection for newly amalgamated communities is a worry among UTC leaders. The UTCs are not constitutionally recognised, nor are they integrated into municipal law as official local self-government units. Acknowledgement of the UTCs as a form of *hromada* is *de facto*: the Law on Amalgamation allows them to form, but it does not guarantee their status as an official territorial administrative unit. Thus, there is a fear among UTC leaders that with political change at the national level, the gains made thus far could be lost or at least significantly diluted (OECD interviews). This is a valid concern and one not limited to changes in government, as there has already been back-tracking on the part of the government with respect to initially established funding mechanisms (e.g. excise tax allocations and the State Fund for Regional Development). While reversals in the process may be increasingly less likely as more and more communities amalgamate and the local administrative landscape changes, it is a factor in the decision-making process of local communities (OECD interviews).

One of the most pressing statutory matters in amalgamation is land use and land rights. There are numerous reasons for this, including the lack of a reliable cadastre system and unfulfilled government intentions to change legislation, combined with what appear to be few ready (and no easy) solutions. It is even more critical, given its impact on the economic development of the UTCs due to the revenue-generating capacity associated with land and land development. In Ukraine, the land outside of the administrative boundaries of local self-government units belongs to the state, and its management – as well as any revenues generated – falls to the relevant state administration (i.e. *oblasts* and/or *rayon*). The land within the territorial/administrative boundaries of a local self-government unit is under the control and management of that community, and revenues generated are considered part of the community's own-source revenue. One of the incentives for local self-government units to amalgamate was the initial proposal that property and land-use rights for the entire territory formed by the amalgamation of the communities (i.e. land within the individual administrative boundaries, and the land in between them) would be put in their hands. This situation also affects service delivery. For instance, roads that pass between settlements forming a UTC may be under the responsibility of the *rayon* administration, which may or may not have the capacity or incentive to maintain the roads. This fragments service attribution and responsibility in a relatively small area and potentially creates differences in service quality. With a change in land rights, the roads would fall under the responsibility to the UTC, as communities are responsible for the roads within their administrative boundaries. Currently, the land within the administrative boundaries of each individual community forming a UTC falls within their authority, including income from that land, but not the land in between the individual units forming the new local government (Figure 2.6).

Figure 2.6. **Current and proposed land management and revenue allocations**



Source: based on OECD interviews with Ukrainian officials.

Such changes in land management rights would give the UTCs greater decision-making capacity over what happens in their territory and increase revenue gains from property/land-use and business taxes. This would ultimately increase their ability to better support territorial (including economic) development plans. The proposal, initially part of the amalgamation incentive package, remains unfulfilled as the framework for such a shift has not passed into law and thus there is no legal basis for a transfer of rights by *oblast* or *rayon* administrations, or for a claim to rights by the UTCs. The result is unclear property rights, fragmented land management in the UTCs, and limitations on own-source revenue and decision-making capacity by local authorities.

Signals from above could build greater certainty and trust in reform

A framework for the implementation of amalgamation is missing and there is limited guidance on the part of the central government with respect to expectations, including expected outcomes. This is despite the "prospective plans" established by *oblast* administrations (discussed in the next section). On numerous occasions, the OECD team heard either that local leaders were ready to amalgamate but would not take the risk without instructions from above, or that they would wait until the state left no other option for village heads (i.e. compulsory amalgamation). One reason for this may be the loss of local power and influence to a new municipal council. The other could be the insecurity associated with amalgamation. Many communities that amalgamated in 2015 and 2016 characterised themselves "risk takers" (OECD interviews).

A lack of explicit criteria to guide the amalgamation process – i.e. a set of basic and fixed (required) parameters for selecting amalgamation partners – on the ground, can generate uncertainty. There is a vaguely understood objective of 1 500 local self-governments in Ukraine by the end of the amalgamation process (Nehoda, 2014). This, however, does not seem to be widely communicated, and there is some question as to whether it is a fixed or moving target. The result is that it is very difficult to determine real progress *vis-à-vis* an objective and it is not clear what evidence was used to arrive at a figure of 1 500 communities.

In addition, there does not appear to be a timeline for the amalgamation process. Expectations are based on hearsay (OECD interviews). This makes it very difficult to determine a deadline for the formation of the presumed 1 500 communities. In late 2016 and early 2017, discussion among decentralisation experts and stakeholders in Ukraine indicated that as of early 2018 the government would begin requiring amalgamation. By mid-2017, the speculation was that this would not occur until late 2018 or beyond (OECD interviews). This adds uncertainty to the process, especially for *hromada* which may be willing to amalgamate but do not want to do so without "instructions from the top". It also means that the government risks not meeting its own objectives.

Finally, a clearly communicated and statutorily supported set of responsibilities for the UTCs would be valuable. This is critical, as clarity in the assignment of responsibilities is a key driver of successful decentralisation. The only mention of public service responsibilities in the law governing the formation of UTCs is in Article 1, Section 4.5: "… the quality and accessibility of public services provided in the united territorial community cannot be lower than before the unification" (Verkhovna Rada, 2015a). However, currently there are not any defined mechanisms for establishing quality or service standards. UTC functions are still governed by existing laws on state administration and local self-government units, which indicate a responsibility for the social and economic development of their territories (OECD interviews). Therefore, while the UTCs may be responsible for these tasks, they are not legally mandated.

One of the most fundamental ways to address these concerns is for the government to clearly communicate its intentions for amalgamation – for example the number of UTCs to be created, a clear time frame by which this needs to be accomplished, and a targeted or minimum community size in terms of territory and/or population. In support of this, it would also be valuable if basic guidelines for standards and/or service levels were established to give communities an idea as to the level of resource capacity they need to reach when amalgamating. This does limit the voluntary nature of amalgamations, but it would set parameters for the process. Such guidance – an implementation framework – could be helpful for communities when thinking through the amalgamation process. In addition, it could help inject some certainty into the process, make sure amalgamations continue and signal additional government support for moving forward with decentralisation. It could also reduce a seemingly *ad hoc* approach to the amalgamation process thus far.

Some communities do not immediately recognise the benefits of amalgamation, feeling that their current budgets are sufficient to cover their basic needs. There is also a degree of distrust in the reform among citizens, which can prevent a vote in favour of amalgamation

(OECD interviews). There has been dialogue-generating activity surrounding amalgamation in individual *hromada* – often sponsored by the Association of Ukrainian Cities and the donor community – in order to explain amalgamation and its benefits. However, this was early in the process, when there was less capacity to share experience among peers. Generating ongoing opportunities for dialogue and discussion between amalgamated and non-amalgamated communities, where there can be an exchange of experiences, concerns, successes, etc., could help manage distrust and uncertainty. To the extent possible, it may be best if these fora were organised or sponsored by bodies that are not perceived as gaining from the amalgamation process itself. This could include subnational government associations or other groups that can mobilise both amalgamated and non-amalgamated communities.

Inter-municipal co-operation is gaining ground

Law No. 1508-VII of 17 June 2014 on Co-operation of Territorial Communities, supporting inter-municipal co-operation (IMC), is a fundamental component of Ukraine's reform process. It provides a means to manage fragmentation and promote more effective service delivery between large cities and surrounding communities. It can also promote more capacitated communities, amalgamated and otherwise, thereby working through the capacity problem noted in the section above. IMC has taken root slowly in Ukraine due to a variety of common factors, including a lack of awareness; limited experience in initiating, organising and implementing projects; resource limitations; a lack of trust between municipalities; and insufficient practical support from higher levels of government. It is, however, quickly gaining acceptance. Between the law's introduction in 2014 and 1 July 2016, there were only 43 IMC contracts registered with the Ministry of Regional Development. By October 2017, however, there were 103 inter-municipal co-operation agreements in place, up from 81 in April 2017 (Ministry of Regional Development, 2017d; 2017b). In addition, by October 2017 almost 490 *hromadas* were using tools for inter-municipal co-operation (Ministry of Regional Development, 2017b). It is a solid mechanism to help Ukraine's local communities overcome capacity limitations, particularly in public service delivery, thereby becoming a powerful tool to simultaneously promote and support municipal capacity in the face of multi-level governance and decentralisation reform.

Inter-municipal co-operation is a precursor to and result of amalgamation

The increasing popularity of IMC arrangements is strongly linked to the increased number of UTCs. Only communities that have been attributed more tasks through the law on amalgamation and have greater autonomy in their execution have a sufficiently broad basis on which to co-operate. Non-amalgamated communities only have a limited set of responsibilities where co-operation can be beneficial (often cultural and sports-oriented). This said, there are numerous reported instances where non-amalgamated communities have used the law in order to co-operate, primarily for cultural fairs and sporting events, but also in education. For example, the first IMC agreement in Zhytomyr was to set up a kindergarten. The experience helped demonstrate the benefit of working co-operatively, increased the level of trust and built a degree of comfort in working together, and ultimately served as a precursor to amalgamation (OECD, 2017d).

Inter-municipal co-operation is frequently used in OECD member and non-member countries needing to build territorial scale but either seeking an alternative to amalgamation or wanting to "test" the inter-community relationship with an agreement prior to a union through amalgamation. The popularity of IMCs rests on a number of factors, including potential efficiency gains and cost savings. In Spain, for example, there were clear benefits observed in the case of joint management of waste collection, especially for small municipalities where cost savings were estimated to be 20% in towns with less than 20 000 inhabitants and 22% in towns with less than 10 000 inhabitants. In England, the Local Government Association has reported that 416 shared service arrangements among councils had resulted in efficiency savings of GPB 42 million (as of September 2015) (OECD, 2017a). Results associated with IMC extend to better local public services, including improved processing times; more innovative, high-tech or specialised services (e.g. through the application of shared technologies); increased staff performance; access to expertise, especially in remote locations with a skills shortage (Box 2.16) (Local Government New Zealand, 2011; OECD, 2017a).

Box 2.16. Sustainable waste management in Korça, Albania

In 2008-09, in the framework of the German-Albanian financial co-operation, the governments of Albania and Germany developed a joint project to establish a modern, environmentally sound and sustainable waste management system in the Korça Region of southeast Albania. For this purpose, the KRWM Company was created to provide comprehensive solid waste management services to about 320 000 inhabitants in 28 local government units. This required investment measures, for constructing new facilities (a new regional sanitary landfill and transfer stations) and for developing capacity: the Consulting Consortium IU-RWA-FLAG has supported the project through the institutional strengthening of the new waste company and the development of an initial business plan.

The project has delivered promising results thanks to continuous collaboration between key stakeholders, the strong leadership of mayors that initiated the enterprise, a rigorous analysis of the waste situation, the set-up of a monitoring and control system ensuring cost recovery, as well as awareness-raising of the general public. Improvements were observed in local solid waste management, especially the collection stage, as KRWM and local bodies have become more efficient in delivering solid waste management services. In terms of strategic planning, logistics for long-distance hauling to the new regional sanitary landfill, waste monitoring and planning systems, as well as concepts for equipment maintenance have been thought out and put into practice. This project has also fostered closer co-operation with the local community, and public companies and non-profit organisations have shown interest in designing pilot schemes for on-source separation, reuse and recycling.

Source: Dakoli-Wilson, A. (2017), "Inter-municipal co-operation in solid waste management", http://www.oecd.org/regional/regional-policy/Agenda-Zhytomyr-seminar-ENG.pdf; Gopa infra (2017), "Solid waste management in South-East region", webpage, https://www.gopa-infra.de/projects/solid-waste-management-south-east-region.

Another motive for strengthening IMC can be to help fulfil new compulsory service (or other) requirements arising from shifts in task attribution and/or decentralisation reform. In Iceland, for example, IMC became compulsory for small municipalities (under 8 000 inhabitants) following the decentralisation of social services for disabled persons

(OECD, 2017a). As in Ukraine, IMC in the Netherlands developed parallel to municipal amalgamations and has gained momentum with the decentralisation of a number of additional responsibilities to local governments, particularly in the areas of employment and social welfare services. To comply with these new and complex responsibilities and to improve financial management, many Dutch municipalities created new co-operative structures, for example inter-municipal social services.

IMC does have its downside, however, including high transaction costs and the generation of externalities. It can be difficult to measure; faces transparency challenges; and can engender political, organisational and operational difficulties. Overall, the efficiency of IMC will depend on a range of factors, including the number of participating municipalities, the extent of the transaction costs and the characteristics of the public good in question (Bartolini and Fiorillo, 2011; OECD, 2017a).

Despite the challenges, OECD countries are continuing to refine their approaches for encouraging the use of IMC among local authorities. For example, most OECD countries have passed laws in support of inter-municipal co-operation, as has Ukraine. In some cases, the legal frameworks have been adjusted to reinforce IMC by encouraging or requiring that municipalities participate in co-operative agreements. This was seen in Austria in 2011, in Chile in 2011, in New Zealand in 2013, and in the Slovak Republic in 2012 and 2013 (OECD, 2017a). In a few countries, IMC has become compulsory for small municipalities and/or for specific services (e.g. Greece for waste management) (Box 2.17) (OECD, 2017a).

Expanding areas where to apply inter-municipal co-operation

While IMC is growing in Ukraine, the emphasis remains on basic service needs, with most contracts established for a two- to three-year period. This is attributed to the cautious attitude of local authorities with respect to co-operation and a fear of long-term commitment. By August 2017, IMC agreements had been applied to local road repair; reconstruction of community social infrastructure (e.g. schools and hospitals); collection and disposal of solid waste; creation or restoration of local fire protection infrastructure; reconstruction of local basic infrastructure (e.g. water protection dams and coastal fortifications) (Ministry of Regional Development, 2017d). An October 2017 evaluation broadly classified the areas of most active co-operation (Figure 2.7), reflecting some of the most pressing services needs in Ukrainian communities.

These areas are solid starting points for co-operation, particularly given that the mechanism is reasonably new to Ukrainian multi-level governance. Moving forward, government support of “second-generation” IMC agreements, for example in public transport, integrated economic development activities, larger infrastructure projects and technology (e.g. Internet). IMC arrangements are also applicable to procurement, front office activities such as customer service, as well as in “back office” administration such as payroll, finance, compliance and control activities. Co-operative arrangements in these areas could help expand on the quality and quantity of services offered to citizens, and improve quality of life and support Ukraine’s regional development objectives. The Polish experience with IMC for public transport and the Brazilian experience with regional economic development may provide some additional insight (Box 2.18).

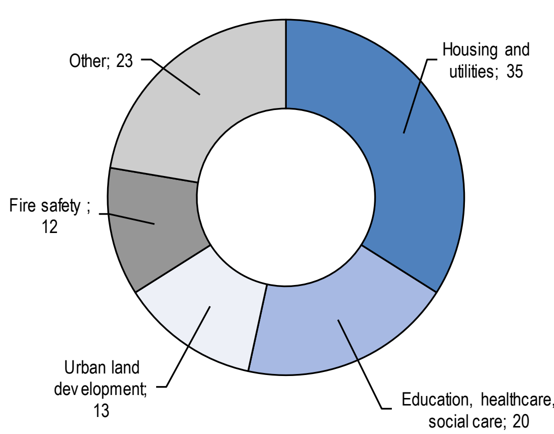
Box 2.17. Examples of compulsory inter-municipal co-operation in OECD countries

In **Hungary**, the Cardinal Act of December 2011 requires municipalities of less than 2 000 inhabitants to regroup their administrative services within local government offices. A proposed **Estonian** law could lead to compulsory inter-municipal co-operation in some areas. The law would also expand the responsibilities of inter-municipal groupings. In **Italy**, Law 56/2014 on Municipal Unions significantly reinforced IMC (widespread since 1990) in approximately 500 municipal unions and mountain communities. A minimum population threshold was established: municipalities of less than 5 000 inhabitants now must be members of a municipal union. The responsibilities of these unions were extended to include all basic municipal functions. **Portugal's** Law 75/2013 created 23 compulsory inter-municipal communities, as sub-regional bodies responsible for "NUTS 3" territorial strategies (regrouping previous urban communities, inter-municipal communities for general purpose and some previous metropolitan areas). In **France**, since the NOTRe law, all municipalities must include an inter-municipal structure – public establishments for inter-communal co-operation – funded with own-source taxes. Despite a very good coverage of the French territory by inter-municipal structures, there were some remaining "grey areas" with "isolated" municipalities. Many of these "isolated" areas were concentrated in the Île-de-France region, and then had to become part of the greater Paris metropolitan area.

Source: Adapted from OECD (2017a), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, http://dx.doi.org/10.1787/9789264272866-en.

Figure 2.7. **Inter-municipal co-operation agreements in Ukraine: Number by service category**

Period up to October 2017



Source: Ministry of Regional Development (2017b), "Monitoring of the process of power decentralisation and local governance reform", https://www.slideshare.net/oleksandrvirnyk/monitoring-of-decentralisation-17102017-en?next_slideshow=1.

Box 2.18. Examples of "second-generation" inter-municipal co-operation arrangements from Poland and Brazil

The city of **Gdynia**, **Poland**, established ZKM Gdynia, a public transport authority, in 1992. ZKM Gdynia created a unified network by setting up contracts with several surrounding communes, including inter- and intra-communal lines. Each contract states the required frequencies and quality levels, is tendered to an operator separately, and is settled with the partner commune separately. The network provides passengers with the option to buy a single ticket for the entire network, and to get unified information on public transport in the area. **Upper Silesia**, also in Poland, offers another example. This is an old mining and industrial region with large commuting flows between residential towns and places of work. As no state or regional financing was provided, municipalities had to make a financial contribution to the Public Transport Municipal Association of Upper Silesian Industrial District, calculated as a fixed percentage of their total income. There was widespread disagreement on the size of the percentage contribution, as smaller communities were unable to afford more than half of the proposed level, and ultimately threatened to leave the union. In the late 1990s and early 2000s, the quality of public transport deteriorated significantly, because responsibilities had been transferred to the association; as a result public transport was no longer politically important for mayors. A new model was introduced in 2007, with contributions calculated based on the individual deficit of a given line. A municipality's contribution is now calculated based on the number of passengers (from representative passenger counting) multiplied by an average income per passenger (uniform across the network) minus real costs. The deficit is split between the municipalities, based on the number of vehicle-kilometres within the territory of the commune. While the new model is far from perfect, it has created more of a customer service-oriented system.

In **Brazil**, the Inter-Municipal Consortium for the Greater Region of ABC in the state of São Paulo offers a good example of inter-municipal co-operation for economic development. This consortium is comprised of seven municipalities (about 2.4 million inhabitants). It was established by community leaders in the 1990s to identify solutions to an economic contraction that the region was experiencing. Through the consortium integrated strategies were established for a number of sectors, increasing the ability of the municipalities to meet strategic objectives in administrative co-ordination and inter-institutional/actor co-operation. The consortium is responsible for co-ordinating the region's strategic planning, economic development and other policy areas that cross the inter-municipal boundaries of the associated communities. The ABC region is the third leading industrial centre of Brazil, comprised of the following cities: Santo André, São Bernardo do Campo and São Caetano do Sul. Together with the cities of Diadena, Maua, Ribeirao Pires and Rio Grande da Serra, they form the Greater ABC region, represented by the inter-municipal consortium (Gray, 2015).

Sources: Wolanski, M. (2017), "Inter-municipal co-operation as a tool to foster road infrastructure development and efficient public transport service delivery"; OECD (2013b), *OECD Urban Policy Reviews, Chile 2013*, http://dx.doi.org/10.1787/9789264191808-en; Original sources: Slack, E. (2007), "Managing the co-ordination of service delivery in metropolitan cities: The role of metropolitan governance"; Gray, D. (2015), "Transforming Brazil's industrial heartland", www.the-report.com/reports/brazil/education-in-brazil/transforming-brazils-industrial-heartland (accessed 23 October 2017).

Mechanisms to support stronger co-operation between municipalities

A key element to successful IMC arrangements is leadership and support from higher levels of government. Such support helps overcome impediments to collaboration across jurisdictional boundaries, some of which may be rooted in national policies and all of which may be easier to correct if the higher level governments are involved (OECD, 2016; 2014c; 2013c).

As amalgamations continue, and there are more relevant opportunities to establish IMC agreements among Ukrainian communities, the government may wish to consider different ways to support greater and diversified co-operative activity, including in metropolitan areas, for better managing a variety of urban development issues (e.g. in economic development planning, spatial planning, housing policy, public transport, urban infrastructure development, Internet access, etc.). Incentive mechanisms are often used to encourage co-operative arrangements among communities, to enhance inter-municipal dialogue and networking as well as information sharing. These incentives are frequently financial, for example special grants for inter-municipal co-operation, a special tax regime (applied in France), additional funds for joint public investment proposals (seen in Estonia and Norway), bonus grants for municipalities that generate savings through co-operation (practiced in Spain). Incentive structures can also be more practical, including the provision of consulting and technical assistance, procuring guidelines and measures, and promoting information sharing. These techniques are practiced by Canada, Norway and the United States, for example.

Some governments also introduced new types of contracts and partnership agreements to encourage IMC. Poland and its territorial contracts are a good example, as are Portugal's multi-level contracts. Japan, where the focus is on amalgamation rather than co-operation, is also starting to reconsider the importance of co-operative agreements and has introduced partnership agreements, a new type of contract embedded in the 2014 Local Autonomy Act (OECD, 2017a). In Ukraine, the importance of higher level support and incentive mechanisms is clearly illustrated by the experience of Poltava *oblast*, where the role of the *oblast* council is considered one of the factors driving successful co-operative agreements (OECD interviews) (Box 2.19). In light of this, there is room for additional support or encouragement by the government, both at the national and regional levels.

In addition to supporting more effective public service delivery, IMC can also be valuable in Ukraine to overcome challenges associated with limitations to amalgamation possibilities (for example the impossibility, and often lack of desire, of smaller communities to amalgamate with higher order cities, such as those of *oblast* significance), encourage co-operation in areas beyond basic public services, build trust among potential amalgamation partners, and generate benefits associated with agglomeration economies and urban/rural linkages. It may also be useful to consider experimenting with co-operative arrangements at the district level for appropriate secondary level services.

Ukraine's decision to promote municipal amalgamation is a logical first step to decentralisation. Without greater size and stronger revenue-generating capacity, Ukraine's local self-government units would be unable to assume the more direct responsibility for service delivery, local administration and development that comes with decentralised institutional and managerial structures. In addition, by addressing administrative fragmentation through mergers and, to a lesser degree, through IMC, Ukraine is tackling some of the growth-constraining dimensions associated with administrative fragmentation. Moving forward, Ukraine will need to maintain the momentum of amalgamations, ensuring that they create communities with sufficient capacity to meet the challenges and requirements of decentralisation.

Box 2.19. Inter-municipal co-operation in Poltava *oblast*

Poltava *oblast* leads the way in inter-municipal co-operation (IMC) in Ukraine. By July 2017 it was the site of 34 of the country's 81 signed IMC (42% of total) and by mid-August 2017 accounted for 52 of the country's 92 IMC (56% of total). Poltava regional representatives attribute this success to a number of factors, primary among which is Poltava *Oblast* Council's support and co-ordination. For example, the *oblast* council held a contest where one entry category was dedicated to IMC projects, with the winner receiving UAH 600 000 (Ukrainian hryvnia). It also supports innovation by looking for new topics and ways to use IMC. Of the 34 projects, 15 are in waste management – a sector where IMCs are traditionally strong. However, Poltava also has IMC agreements for ensuring Internet availability in each small community, which is the most complex type of agreement, as well as arrangements in infrastructure and roads and environmental concerns. Management and how IMC are organised are also critical to success. Poltava is seeing IMC capacity extend beyond local self-governments as they report that three *rayon* have developed co-operative agreements, and there is also some co-operation between Poltava and Kyiv.

Source: Comments by representative from Poltava *oblast* during OECD seminar in Zhytomyr, Ukraine, 18 July 2017; Ministry of Regional Development (2017d), "Register of contracts on inter-municipal co-operation between amalgamated territorial hromadas" (in Ukrainian), www.minregion.gov.ua/wp-content/uploads/2016/03/reestr-01.07.2016.pdf (accessed 1 July 2017); www.minregion.gov.ua/wp-content/uploads/2017/04/reestr-21.08.2017.pdf.

Box 2.20. Recommendations for reinforcing the amalgamation process

To reinforce and maintain the momentum of amalgamation, and expand the progress of decentralisation, the OECD recommends:

- **Reforming the *rayon* level** to continue supporting the amalgamation process by considering:
    - An adjustment to responsibilities targeting delivery of higher level services, achieved by:
        - introducing functional districts for a specific higher level service (e.g. hospitals), or
        - promoting cross-jurisdictional co-operation for one or more services using either contractual arrangements or the dedicated joint co-operative bodies, or
        - piloting *rayon* amalgamation in one or two select *oblast*, keeping lessons from *hromada* amalgamation (and experimenting with appropriate size).
    - Establishing a stable incentive structure to promote co-operation, including:
        - financial mechanisms:

      - increasing transfers to ensure funded mandates if *rayon* remain deconcentrated
      - introducing opportunities to generate own-revenue if *rayon* become decentralised.
    - non-financial mechanisms:
      - increasing autonomy in priority setting and decision making within assigned areas of responsibility.
  - Minimising the incentive and opportunity for clientelistic behaviour and patronage in the provision of services, by implementing:
    - civil service reform, including appropriate remuneration levels, interesting placement and promotion schemes between levels of government
    - strong contractual agreements, clearly identifying and defining responsibilities, financing mechanisms, monitoring and evaluation systems, quality standards, etc., in areas where there is overlap of responsibility between *rayon* and united territorial communities (UTCs) or where services are shared
    - enhancing open government and e-government practices.
- **Improving the stability and clarity** of the amalgamation and decentralisation processes, including by:
  - establishing a legal basis for the administrative, territorial and institutional status of newly amalgamated communities
  - ensuring consistency in the incentive and financing structures offered for amalgamation and to newly amalgamated communities – once they are introduced they should remain solidly in place
  - setting a clear time frame for voluntary amalgamation after which amalgamation becomes a requirement
  - providing a basic framework or explicit guidance for implementing amalgamation processes by communities, particularly in terms of a time frame, a minimum size (i.e. population, territory or both) of the community to be formed, service standards to be met, etc.
- **Addressing problems of insufficient capacity after amalgamation**, which undermines the decentralisation process, by:
  - encouraging amalgamations that are more likely to generate capacitated municipalities by:
    - continuing the new approach of limiting new amalgamations that are not in line with a prospective plan.
    - taking an asymmetric approach to the decentralisation of tasks and give communities that are larger and have greater resource capacity more responsibilities
    - facilitating additional or "second-generation" amalgamations where two neighbouring and under capacitated UTCs can amalgamate, or a non-amalgamated community can join a UTC

    - facilitating amalgamations that strengthen urban/rural linkages and/or support the generation of agglomeration economies.
  - generating ongoing dialogue and discussion among communities to foster the exchange of experiences, concerns, successes, etc., that can help manage distrust and uncertainty of the process and of each other (in support of future amalgamations).
- Strengthening inter-municipal co-operation as a means to encourage future amalgamation and address service capacity gaps, including in metropolitan areas, by:
  - continuing to promote inter-municipal co-operation for critical basic services
  - offering incentives for projects that generate co-operation in innovative and second-tier services (e.g. public transport, integrated economic development, larger infrastructure projects, technology, administrative services, etc.)
  - legally facilitating co-operation between non-amalgamated communities and between UTC and non-amalgamated neighbours, as such co-operation is often a precursor to amalgamation
  - diversifying incentive mechanisms, giving consideration to:
    - financial mechanisms such as special grants for certain types of projects, or additional funds for joint public investment proposals
    - non-financial mechanisms such as consulting or technical service assistance, promoting information sharing, providing procurement guidelines and measures, new types of contracts and partnership agreements.

Advances in regional development, 2014-17

A whole-of-system approach to multi-level governance cannot occur without the regional level. Stronger regional development outcomes will be critical for mitigating the existing socio-economic inequalities in Ukraine's territorial system and those that may arise from the decentralisation process. Regional level authorities are in a good position to lead economic and social development as appropriate to their contexts, while also supporting municipal growth. Just as local governments have a better understanding of citizens' needs in terms of services, for example, regional governments are well-placed to identify their territory's productive and development requirements, as well as the unique territorial characteristics that can help fulfil these. Regional governments also have strong links to political, social and economic players in their areas, and thus are well-positioned to bring together actors and target key local assets for greater competitiveness.

The *OECD Territorial Review* highlighted a need to clearly define policy priorities – for example growth and equity – and to define or redefine major goals for regional development (OECD, 2014a). It also recommended to shift the planning method from one that was static, taking a top-down technocratic approach of creating a plan and requiring its fulfilment, to one that was more dynamic, using plans as co-ordination instruments involving public and private players, including in goal setting (Box 2.21) (OECD, 2014a).

Box 2.21. Applying the "new paradigm" to regional development policy

Over the past couple of decades OECD countries have shifted their focus in regional development from top-down, infrastructure-driven policies focused on lagging regions towards more integrated and market-oriented approaches to solve national growth challenges. This has resulted in a "new paradigm" driving regional development policy, one that concentrates effort and resources on building competitive regions by bringing together actors and targeting key local assets, rather than ensuring the redistribution from leading to lagging regions.

Table 2.6. **Old and new paradigms of regional development policy**

Action	"Old" paradigm	"New" paradigm
Objectives	"Balancing" economic performance by compensating for spatial disparities	Tapping under-utilised regional potential for competitiveness
Strategies	Sector-driven approach	Integrated development projects
Tools	Subsidies and state aid	Development of soft and hard infrastructure
Actors	Central government	Different levels of government
Unit of territorial analysis	Administrative regions	Functional regions
Focus	Redistribution from leading to lagging regions	

Sources: OECD (2009a), *How Regions Grow: Trends and Analysis*, http://dx.doi.org/10.1787/9789264039469-en; OECD (2009b), *Regions Matter: Economic Recovery, Innovation and Sustainable Growth*, http://dx.doi.org/10.1787/9789264076525-en; OECD (2011b), *OECD Regional Outlook 2011: Building Resilient Regions for Stronger Economies*, http://dx.doi.org/10.1787/9789264120983-en.

Ukraine's regional development policy – from paper to practice

Ukraine has made significant progress in its approach to and planning of regional development at the national, regional and local levels. The difficulties often lie in making the shift from paper to practice, and implementation can be a challenge for Ukraine, as it is for many countries. The State Strategy for Regional Development 2015-2020[14] aligns with broader government objectives by underscoring the need for the decentralisation of state powers and financial resources to the local level and calling for greater co-ordination between national goals and sector policy priorities (Cabinet of Ministers, 2014b). It acknowledges that effective outcomes are linked to, among other things, the territorial executive and administrative structures that are established in the Concept Framework, which is still not operational. Thus, Ukraine's regional development strategy faces the same problem as its multi-level governance and decentralisation reform: the need to find alternative approaches for full implementation while also building implementation capacity among subnational actors.

There is, in theory, a mutually reinforcing dynamic between Ukraine's multi-level governance and decentralisation reforms, the State Strategy for Regional Development

(SSRD), and subnational development strategies. Voluntary mergers, inter-municipal co-operation, and fiscal decentralisation can build subnational resource capacity, for example in planning, infrastructure development and service delivery. This, in turn, supports more dynamic and balanced regional development, economic competitiveness, and better living standards – all of which are strategic objectives at the national and subnational levels. The SSRD, with subsidiarity as one of its operating principles, supports greater authority in development decisions among subnational governments – a component of administrative decentralisation. In addition, the SSRD stipulates not only that that regional development plans be designed at and by the *oblast* level, but that they take into consideration local government interests.[15] At the subnational level, some *oblast* regional strategies make explicit mention of decentralisation (e.g. L'viv), strengthening inter-municipal co-operation (e.g. Kharkiv, L'viv and Poltava) and supporting amalgamated communities (e.g. Odessa and L'viv). Development planning is not limited to *oblast* administrations, however. Larger local governments in Ukraine, for example L'viv and Odessa, establish strategic development plans for their cities, including economic development (Box 2.22). Smaller cities such as Mykolaiv and Zhytomyr also develop "investment passports." These serve as road maps for economic development and also provide information to businesses and potential investors on development priorities, available land and development opportunities, the business mix, and investment support offered by the local administration.

Box 2.22. Development planning in Odessa city

The Odessa City Economic and Social Development Strategy to 2022 is the management tool for the city's socio-economic development. It establishes a vision for the city's future and outlines ten strategic areas of action ranging from competitiveness and infrastructure to technology and children. It also establishes indicators with baselines and targets that can help guide monitoring and evaluation of the strategy's achievements and outcomes in each area of action.

Complementing its Development Strategy, Odessa city launched "Odessa 5T", an investment strategy focused on building activity in: transport, tourism, trade, technologies and trust. The Odessa 5T team, led by the deputy mayor, works on improving the investment climate in co-operation with the executive authorities and the business community, and is preparing a broad range of municipal infrastructure projects, including in public transport, air transport, industrial parks, modernisation of the seafront and an innovation cluster.

Sources: City of Odessa (2013), Odessa Economic and Social Development Strategy to 2022, http://omr.gov.ua/images/File/DODATKI2013/strategia_eng.pdf; Odessa 5T (2016), "Municipal investment projects", Odessa 5T Investment Agency, Odessa, Ukraine.

Strengthening the project planning phase

On a practical level, regional development in Ukraine is confronted by some broad implementation challenges that are intrinsically linked: insufficient and a limited number of appropriate project proposals from subnational governments, difficulty in identifying clear priorities (a challenge also noted in 2013), and unstable funding, despite statutorily identified mechanisms and sources.

Ensuring adequate project proposals

The SSRD stipulates that each *oblast* must develop its own regional development plan, which in turn is supported by local development plans prepared either by the governments of cities of *oblast* and *rayon* significance, UTCs, or by *rayon* administrations for smaller, non-amalgamated communities. Once the proposals are approved by the relevant *oblast* administration and then by the Ministry of Regional Development's Review Committee, the subnational authority presenting the project can apply for funds.

One of the challenges that the Review Committee reportedly faces is the quality and nature of the proposals themselves, particularly those submitted by the UTCs. Among the funding eligibility criteria is the creation of "value added". For example, is the project attractive for private investment, can it generate private investment, does it improve the quality of services such as education, or does it support increasing "soft" infrastructure such as start-ups, SMEs, etc. It was reported that in the first year most projects targeted development in terms of basic construction and repairs. The capacity challenges are not surprising, and there are several factors at play. First, there is no extensive history or experience among subnational governments for regional development planning and implementation responsibility – administration and planning has traditionally been a top-down exercise in Ukraine. Therefore, a more modern approach is a relatively new phenomenon and the skills need to be built to meet the planning demand. Second, the majority of local governments had limited responsibilities, and local planning was a task of the *rayon* administrations. Third, local governments had limited revenue, impacting their ability to invest in individual community priorities. All of this, in turn, restricted the capacity of most local governments to build the skills necessary to design and implement integrated development programmes.

Moving forward attention needs to be paid to the pipeline of projects. While the lack of capacity or experience in designing project proposals at the UTC level may be a limiting factor, there may also be an issue with the structural aspects of the approval system. Each year the central government puts out a call for proposals to *oblast* administrations, that in turn request and receive proposals from capacitated local governments. While the proposals are approved by *oblast* administrations, all proposals end up at the central level to ensure they are aligned with the regional development strategy. The system is reported to provide another incentive to merge by favouring projects submitted by UTCs (over those of other categories of municipalities) and to have some political bias which may discourage subnational authorities from proposing plans that are more innovative in case they are not met with approval (OECD interviews).

Prioritising development projects: Moving past "hard infrastructure"

Infrastructure has a positive impact on regional growth when other key factors are in place, such as human capital and innovation (OECD, 2012). To ensure that infrastructure – and infrastructure investment – plays a positive role and yields a better return for regional development, consideration must also be given to policies that address human capital formation (including skills building), innovation, agglomeration economies and distance to markets. Without development planning and strategies that support these additional dimensions, an investment in infrastructure be will less effective (OECD, 2012). At the same time, many OECD regions have discovered that large investments in human capital formation do not necessarily stimulate regional growth, and limit brain-drain unless other growth constraints such as barriers to private sector development are addressed (OECD, 2014a).

It is incontestable that "hard" infrastructure in Ukraine needs to be improved, and that good infrastructure can attract, facilitate and improve the creation and maintenance of productive factors. However, the heavy emphasis on such infrastructure that characterises development project proposals put forth by Ukraine's subnational authorities requires some consideration. This emphasis can reflect a combination of pressing need, and a more "traditional" approach to regional development. However, it may also reflect the poorly defined attribution of responsibilities among levels of government in Ukraine, where there is confusion with "who is responsible for what" (Lankina, Gordon and Slava, 2017). For example, municipalities are responsible for certain infrastructure and its maintenance. At the same time the road agency of the national government is responsible for roads, including their paving and repaving. In the case of a bridge (infrastructure), if its road surface requires repaving, there is a high risk of inaction as neither level of government is compelled to act. Is repaving the bridge's road a function of bridge maintenance and thus a municipal competence (requiring the use of municipal funds), or is it a function of road maintenance and thus a central government responsibility covered by the state budget? The answer is not clear, and the result is that the bridge's road remains in disrepair. Thus, infrastructure investment is more likely to focus on the concrete and what is clearly attributed, in order to easily move forward in the investment project. In addition, infrastructure development is easily seen and appreciated by voters, especially when infrastructure deficits are high, making the project and investment decision easy for politicians and popular with communities.

Consideration should be given to rebalancing the project equation, particularly between *oblasts* and empowered local authorities, such cities and UTCs. In other words, projects promoting basic "hard" infrastructure development may make sense where the deficit is acute and most keenly felt by citizens (e.g. in electricity, sewage and wastewater treatment, heating systems, school and healthcare facilities, roads in and out of the community, etc.). In these cases, significant levels of hard infrastructure development are easily identified priorities that most effectively and efficiently meet community needs and improve quality of life. Once basic needs are met, consideration can – and should – be given to second-tier and "soft" infrastructure projects in these communities.

Meanwhile, more capacitated local self-governments, such as cities, and higher levels of subnational government (together with the national level), should continue to support "hard" infrastructure development, but may be more successful in their development efforts by also promoting "soft infrastructure" – i.e. elements supporting regional productivity and competitiveness, costly services and amenities, etc. Local self-governments with greater capacity, such as L'viv and Odessa, are already acting along these lines, as evidenced by their development plans. In time and as capacity is built, an increasing number of local self-governments will be able to play a dynamic role in their territory's development. It is here, in the field of regional development policy, that Ukraine's *oblast* and local self-governments could begin to build a relationship that is based on a partnership for development and growth.

Ensuring adequate funding for development projects

Oblast and local development projects are eligible for funding through the State Fund for Regional Development (SFRD), and can also turn to co-financing (assuming sufficient resources), and private funds, including public-private partnerships (PPPs). The SFRD, however, is the main financing lever for regional development and the first tool that links policy and resources for policy implementation. It requires that the project proposals it funds align with the SSRD. Its application as a funding mechanism, however, poses two specific challenges.

The first issue concerns the stability of the fund's own funding. By law, the SFRD should be composed of at least 1% of the revenues from the General Fund of the State Budget (Verkhnova Rada, 2010). Previously this 1% was used to subsidise socio-economic development and its disbursement was discretional, thus open to high levels of political influence. With the introduction of the SSRD, the allocation of this 1% shifted to the SFRD, which, according to Article 24.1 of the Budget Code, would be disbursed to each *oblast* according to a formula: 80% of attributable funds would be distributed based on *oblast* population and GDP, the remaining 20% would be based on the proportion of the population that fell below 75% of the country's average GDP per capita (Verkhnova Rada, 2010). Each *oblast* would be allocated, annually, a percentage of the SFRD based on the formula, bringing greater certainty and transparency to the process. These benefits were realised in several ways. First, a formula-based system gives *oblast* administrations better visibility with respect to available development funds, thereby increasing funding certainty. Second, since the formula had clear and stable criteria, each region could calculate how much they would receive every year, thereby facilitating development planning in the short, medium and even longer term.[16] This is how the fund functioned in 2015 and 2016.

However, as of 2017, the state budget did not clearly allocate the full 1% via the General Fund, but rather the government determined that a certain percentage of the funding would come from other government revenue sources, including an "asset confiscation fund" (Verkhova Rada, 2017b). This effectively links funding for the SFRD to the ability to finance a second fund that in turn is linked to something as volatile as the ability to confiscate assets. The result is an elimination of the stability, visibility and certainty associated with a clear, formula-based disbursement of a fund consistently financed by 1% of the General Fund of the State Budget. In the end, it renders medium- and long-term development planning more than difficult for any subnational government.

A second concern arises with a change in the SFRD's management practices. Initially, proposals presented for SFRD funds were brought before a Review Committee within the Ministry of Regional Development. The committee's composition prior to 2017 was non-partisan in that committee members did not hold elected office. Beginning in 2017, the composition changed to include members of parliament. In addition, a percentage of the fund is now set aside for disbursement at the discretion of these parliamentarians. This signals a return to pre-2015 funding practices and opens the door again to the patronage and clientelism that characterises political/constituent relationships in Ukraine. Also in the 2015 and 2016 financing periods, projects were evaluated and selected irrespective of the sector which they sought to develop (though ideally those projects taking an integrated approach to development would be prioritised and thus multiple sectors would benefit). After 2017, following a draft instruction by the Cabinet of Ministers, project proposals need to fulfil sector quotas: 10% dedicated to energy efficiency of state and municipal education institutions; 10% to energy efficiency of state and municipal health institutions; 10% to sports infrastructure; and 10% to administrative services (Verkhovna Rada, 2017b). The remaining 60% can be non-sector specific (OECD interviews). Such a move limits the capacity for local governments to design and fund projects that meet their specific needs, effectively reducing autonomy in decision making and development prioritisation. Overall, these changes represent a step backward, and the government is undermining its own efforts of regional development and decentralisation reform. It is also antithetical to the anti-corruption movement in Ukraine.

Different approaches to better use SFRD funds in light of regional development and decentralisation goals could be adopted. For example, the allocation formula could be further adjusted to focus more on the socio-economic challenges and capacities facing particular types of areas (e.g. rural regions, mountainous western regions, etc.). SFRD funding could prioritise development projects that promote inter-municipal co-operation, and support not only "hard" infrastructure projects, but "soft" infrastructure proposals as well (i.e. those that support human capital development policies such as education, the digital economy and innovation). Another possibility is to establish criteria for fund allocations at the regional level that is linked to state-region contracts and regional development plans. 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 could be envisioned. Contract priorities could form the basis for project selection under the SFRD, among other sources of funding (OECD, 2013a). A growing number of countries have found such contracts to be a useful way to structure co-operation between central and subnational governments as they can combine the need for balance across the whole of the territory with the need to allow for regionally specific approaches. The state-region planning contracts in France, the *contratos plans* in Colombia and the "territorial contracts" in Poland are good examples.

These types of adjustments, given the current governance context in Ukraine, are not necessarily suitable to advance the reform process and government agenda. For example, the Ministry of Regional Development may choose to prioritise funding development projects that promote inter-municipal co-operation. However, the project proposal must pass the *oblast* level; and if this layer of government does not agree with the co-operative agreement, there is a risk it will not be moved up the line to the ministry. This can also create opportunities for approval bodies to impose unexpected conditionalities on the approval of funds. Such adjustments to the SFRD are all the more problematic as it is the most solicited form of funding, and the one that is most accessible to the widest number of most subnational governments.

Institutional bodies supporting regional development and decentralisation

The international donor community is a critical player for insuring that reform is implemented and its benefits reach Ukraine's citizens. More strongly institutionalising the knowledge it imparts at the central and subnational levels could strengthen the country's culture of reform. In addition, Ukrainian organisations such as the various associations of subnational governments, through lobbying, communication and capacity-building campaigns, have made and can continue to make significant inroads in ensuring the executive and legislative branches keep advancing the reform agenda. The challenge is to make sure their voice continues to be heard. Finally, regional level bodies dedicated to development can also help to embed reform by supporting the achievement of development objectives.

The international donor community is bridging capacity gaps

International donor organisations are actively working with the Ministry of Regional Development and subnational authorities to build capacity in regional development policy design and implementation while also supporting decentralisation. This EU project "Support to Ukraine's Regional Development Policy", and the U-LEAD programme[17] that concentrates on building effective multi-level governance mechanisms at the subnational, and especially local, levels are examples (Box 2.27).

Box 2.23. **International programmes supporting regional development and decentralisation**

Launched in January 2013, the EU-funded project "Support to Ukraine's Regional Development Policy" aims to strengthen the Ukrainian government's capacity to reduce regional disparities and implement effective regional development policies. It works with the Ministry of Regional Development, regional administrations, local authorities, relevant subnational associations and representatives of civil society to provide methodological and legal support for regional development in line with EU and international best practices. One of the project's largest achievements is a process for regional administrations to independently prepare their own development strategies based on their own policy priorities. Previously, regional development strategies were prepared by researchers in academic institutes, relying heavily on statistical data and with little to no stakeholder consultation. Important results achieved by the project include the development of a National Policy on Regional Development, a new State Strategy for Regional Development through 2020 and an action plan grant programme supporting the successful implementation of over 30 regional development projects, including 18 supporting internally displaced persons.

Regional local government development centres have been established in 23 *oblasts* (excluding Kyiv) with the support of U-LEAD. These centres are dedicated to enhancing the capacity of subnational authorities in implementing regional development policies and decentralisation reform. The centres offer training on regional development planning, budgeting, administrative services, communications and spatial planning. They also act as fora for the exchange of experiences and building dialogue between communities. Centres also provide advisory/consulting services to local authorities, support strategic planning and provide technical know-how to develop and write project proposals. In addition, they help set up local administrative service centres, working with communities to improve the delivery of local administrative services (OECD interviews). These centres also undertake analytical work to help build evidence bases for reform. In Odessa, for example, the region's local government development centre identified the comparative advantages of municipal authorities, identifying what areas could generate resources, with the idea of revealing the hidden potential of the *hromadas*' territory (e.g. if they are by the sea, exploring the ability to support recreation) (OECD interviews).

Sources: SURDP website, www.surdp.eu/en/About-Project; EU in Ukraine (n.d.), "Social and economic disparities between Ukraine's regions far greater than in the EU", https://euukrainecoop.com/2017/02/20/regional-develop2; OECD interviews.

There is significant donor activity in regional and local development dedicated to supporting the territorial and decentralisation reform process in a proactive, "on the ground" manner – building the capacities and skills necessary for local authorities to effectively execute new responsibilities (e.g. strategic planning, budgeting, etc.). Honing these "soft" skills strengthens governance capacity as well as human capital, preparing subnational administrations to meet the challenge of greater autonomy in decision making and implementation so that they can move forward on their own. Other donor initiatives, such as the Community-Based Approach to Local Development Project (CBA-III)

(Box 2.24) led by the European Union and the UNDP also support development projects with quick impact on the quality of life in communities.

Box 2.24. **Community-Based Approach to Local Development Project, Phase III**

The Community-Based Approach to Local Development (CBA) project was developed to promote sustainable socio-economic development at local levels by strengthening participatory governance and fostering community-based initiatives throughout Ukraine. Decentralisation and local governance reforms were a key focus of CBA Phase III. The project provided technical assistance, capacity building and funding to strengthen the autonomy and institutional structures of local authorities, and to build community engagement across the country. This was accompanied by investments in basic social and communal infrastructure in rural and urban areas. Support was provided to diverse local development initiatives, including 70 rural economic co-operatives, 46 drinking water schemes, 52 healthcare centres, 200 energy efficiency schemes, 413 urban dwelling schemes and 473 energy efficiency projects. The CBA project provided a noticeable impetus to territorial reform, with a strong correlation observed between communities that partnered with CBA and their subsequent involvement in the amalgamation process.

Sources: UNDP (2017), "Project summary", www.ua.undp.org/content/ukraine/en/home/operations/projects/democratic_governance/CBA-III.html; UNDP (2016), "Annual progress report 2016: Community-based approach to local development", www.ua.undp.org/content/dam/ukraine/docs/DG/CBA-III/CBA_Annual_Progress_Report_2016.pdf; "Meeting of donor community", presentation of Final Evaluation of CBA-III, Kyiv, 19 July 2017.

This external support is invaluable for the advancement of Ukraine's regional development policy. However, there seems to be a disconnect with capacity building at the national level. It is undeniable that ministries need support to implement regional development policy, multi-level governance and decentralisation reform. Yet, some have expressed concern that international support may be replacing human resource gaps within ministries rather than guiding ministry staff to build the frameworks and competences necessary to move the reform forward on their own.

There are at least two risks in this approach. First is that it provides little incentive to ministries and their staff to build or hone strategy setting and reform implementation capacities. Second, it can limit results if donor attention suddenly shifts. This thinking was echoed in the same 2017 independent report which positively evaluated the CBA-III project. In their recommendations presented to the international community and decentralisation stakeholders in Kyiv in July 2017, the EU evaluators who authored the report stressed that the Ministry of Regional Development needs to find or develop its own resources to address its responsibility to reform and through this to support socio-economic development at the subnational level.

Consideration should be given to strengthening partnerships between donor community experts and local public sector academic institutions (e.g. the National Academy for Public Administration under the President of Ukraine [NAPA] and leading Ukrainian universities) as a means to support these national organisations in building curricula and training national and subnational civil servants in the necessary techniques for strategic development planning and implementation – be it overall or in specific sectors. This could further bridge capacity gaps at all levels of government.

Continued activity by subnational government associations further embeds reform

National level associations support regional development and subnational reform and actively represent subnational interests in the regional development and decentralisation process: the Association of Ukrainian Cities (AUC), the All Ukrainian Association of *Oblast* and *Rayon* Councils, and the Association of Amalgamated Territorial Communities (AATC). The first two are statutorily capacitated as lobbyists before the government (the executive and the *Rada*). They actively comment on draft legislation and serve as "watchdogs". In November 2016, the AATC was established to help these UTCs work through unique challenges, such as developing administrative frameworks.

These associations are strong voices for reform. For example, the AUC regularly comments on progress and challenges in territorial reform and decentralisation through a weekly newsletter, informing members and reform stakeholders about government decisions, co-operation with ministries, relevant programming and training sessions. The AATC provides capacity-building workshops on administrative management, for example, and constantly communicates with government to ensure its members' specific challenges are kept top of mind. Finally, the regional level offices of these associations are very much in tune with the successes, challenges, needs and concerns of local officials, and are well-positioned to present these to *oblast* administrations.

By supporting development and reform at the national and subnational levels, working with the donor community (e.g. USAID's PULSE project, GIZ, U-LEAD, SKL), and serving as fora for subnational leaders to meet, share experiences and learn from one another, these associations are helping build a critical mass of knowledge and experience. This can further embed regional development and reform principles, consolidating change and limiting the adjustments that can come with changes in government.

In total, there are four national municipal associations, the three mentioned above plus the Association of Small Cities of Ukraine, which was the former Association of Village and City Councils. Each has its members, which can overlap (for example some members of the AATC are also members of the AUC). While not necessarily a problem, too many associations can fragment membership and ultimately reduce the strength and coherence of their communication, thus weakening the ability to represent subnational interests before the government. It is therefore in the best interest of the local authorities, and the associations, not to over-fragment and create multiple specialised associations with a potentially ever smaller membership base.

Supporting regional development with regional development agencies

Ukraine's law governing regional development provides for elected councils and relevant regional administrations to establish regional development agencies (RDA) to support the implementation of the SSRD. These agencies can be co-founded by chambers of commerce, regional business associations, regional representatives of subnational government associations (e.g. the Association of *Oblast* and *Rayon* Councils), academia, and non-governmental organisations. These agencies are non-profit partnerships between the state, the private sector and civil society organisations (e.g. non-governmental organisations, employer organisations, etc.) (Verkhovna Rada, 2015b). The establishment of these agencies is slow. The reasons why are unclear, but may include a lack of additional guidance, or because the idea was incorporated into a strategy that was developed based on the expectation that the Concept Framework would be approved.

According to Ukrainian officials, their RDA model draws heavily from that in Poland, but there are important differences. Polish RDAs were established in the early to mid-1990s, are statutorily limited companies whose shareholders are the government of the region, and can include banks, regional institutions and companies. They launch initiatives in the support and promotion of socio-economic development, taking regionally differentiated approaches with the common goal of regional development (Box 2.25).

Box 2.25. **Regional development agencies in Rzeszow and Torun, Poland**

The Rzeszow Regional Development Agency supports improving the quality and standard of life for residents, and works to promote the region as a modern, innovative and economically developed area as well as a tourist destination. Its activities include training for entrepreneurs, managing EU-funded projects, co-ordinating a technology transfer centre and managing an enterprise development centre, among other things.

In Torun, the Agency for Regional Development (64% of which is owned by the regional government) aims to support small and medium-sized enterprises and co-operate with local authorities and stakeholders in order to strengthen regional development. It prepares feasibility studies and business plans for infrastructure and investment projects; offers training, seminars and conferences; and acts as a financing agency for EU programmes in the region. Among its primary activities are implementing EU Structural Funds, offering advisory services, managing regional cluster projects. It is also the driver behind the Torun Technology Park, which aims to attract investment and create favourable conditions for economic activity and entrepreneurship.

Source: European Commission (2017a), "Rzeszow Regional Development Agency", https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/organisation/rzeszow-regional-development-agency; European Commission (2017b), "Torun Agency for Regional Development", https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/organisation/torun-agency-regional-development.

The crucial difference between the Polish and Ukrainian models lies in the fact that Poland's RDAs are closely linked to, and often majority owned by, regional or self-government bodies, and the majority are registered as joint-stock companies (Kilianski, 2011). In the Ukrainian model, each *oblast* is called upon to either directly, or in kind, support the establishment of an RDA. This is logical and can be considered in keeping with international practice. The problem arises in the funding modality. Ukraine's *oblasts* could use their revenue sources (primarily grants and transfers from the central government) to fund their agencies, but these are limited and it would most likely require an additional transfer from the government. RDAs are also entitled to apply for funds from the SFRD. Ultimately, the government expects that the majority of funding for Ukraine's RDAs will come from activities and projects that the RDAs undertake to promote regional development, from the donor community and from the private sector, for example by working on a PPP basis[18] (OECD interviews). This is markedly different from the Polish model, where the regional development entity is closely connected and often significantly funded by the regional government with which it is associated. This approach exposes the RDA to conflict with vested interests and potential corruption. To limit this possibility and avoid opening doors to former, counterproductive practices, it would be advisable to re-evaluate the RDA funding scheme.

In sum, Ukraine has advanced quickly in regional development. Now it is a matter of honing implementation practices, and continuing to support multi-level governance and decentralisation reform so that regions, and the communities that form them, can move as rapidly to build their capacities for sustainable growth and development.

Box 2.26. **Recommendations to reinforce advances in regional development**

To continue promoting regional development policy, the OECD recommends:

- **Addressing recognised weaknesses in the project planning and approval phases**:
  - continue initiatives to strengthen civil service capacity and skills in designing, presenting and implementing project proposals with added economic development value for the local and regional levels.
- **Rectifying structural aspects in the project approval phase** that may favour certain municipalities or carry a political bias:
  - strike a balance in the types of projects being approved and funded to ensure both "hard" and "soft" infrastructure development is promoted.
- **Addressing the challenges relating to the State Fund for Regional Development**, by:
  - reintroducing stability into the fund's own financing mechanism
  - returning to the original formula system of fund disbursement which gave subnational governments visibility with respect to available development funds, increased funding certainty and facilitated short-, medium- and long-term development planning
  - reducing the possibilities of patronage and clientelism by eliminating political representation on the project approval committee.
- **Considering funding schemes for regional development agencies** that support strategic processes and limit the possibility of conflict with vested interests and potential corruption.

Conclusions

Ukraine has made considerable progress in updating its approach to territorial administration. The Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power in Ukraine outlines a vision for greater democratic participation in subnational government, and has elements that could also support greater state resilience. The reform proposal rationalises the approach to subnational government structures while also building scale and capacity among local governments to meet the demands of a decentralised administrative and service structure. Regional development policy in Ukraine supports – and is supported by – these proposed adjustments in multi-level governance. For the strategic vision to be implemented, constitutional reform remains necessary. In the meantime, the government is focusing on implementing its decentralisation agenda.

Continued progress down the path of reform will mean ensuring that the conditions for successful decentralisation are met and address multi-level governance challenges that fall in four broad areas. The first relates to mechanisms that could ensure a balanced approach to territorial reform. This includes increased co-ordination across and among levels of government, and among stakeholders to help promote greater policy coherence, facilitate implementation and build trust in the overall reform concept. The second concerns the fundamental need to maintain the momentum of amalgamations, as they are the cornerstone of decentralisation reform. Without amalgamated communities there is no decentralisation – administrative, fiscal or political – and thus barriers to amalgamation, real or perceived, should be addressed. The third is to keep evolving in regional development practices, particularly in building subnational government capacity to design and implement effective policies while also monitoring their outcomes. It is important here to avoid backsliding into practices that could jeopardise the advances made thus far. Finally, without appropriate framework conditions, especially with respect to effective governance and anti-corruption, the impact and success of reform will be limited. This is a question larger than the scope of this report, but there is general academic and practitioner agreement that corruption is one of the largest threats to Ukraine's overall reform agenda of Ukraine (Williams and Polityuk, 2017; World Bank, 2017a; Lankina, Gordon and Slava, 2017).

Notes

1. These are cited as "OECD interviews" in the chapter.
2. Governments are counted by changes in prime ministers, thus, prime ministers who have held office for two non-consecutive terms between October 1992 and September 2017 are counted as separate governments. In this same period there have been six presidents.
3. Polling was conducted in the 22 reginal capitals of Ukraine not under control of separatist forces, as well as in the cities of Mariupol and Severodonetskin in the Donbas region. N=19 000 (Center for Insights in Survey Research, 2017).
4. Both Denmark and New Zealand ranked number one in 2016 with scores of 90 out of 100; Somalia ranked last (176) with a score of 10 (Transparency International, 2016a).
5. N=1 500.

6. The Commonwealth of Independent States (CIS) is comprised of nine member states (Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Uzbekistan).

7. Thirty-one per cent disagreed that ordinary people could make a difference and 41% strongly disagreed with the statement.

8. This is an amendment to the Law on Amalgamations, with the corresponding Draft Law No. 5520 (Association of Ukrainian Cities, 2017).

9. Ministerio Secretaría General de la Presidencia.

10. Decentralisation is one of the dimensions of the government's five-pillared National Development Strategy, which includes: economy (with a focus on privatisation, land and energy sector reform), governance (i.e. decentralisation), human capital development, rule of law and the fight against corruption, and defence and security.

11. It should be noted that these bodies not only have a narrower scope of action than the aforementioned centre-of-government office, but they also can be *ad hoc*, established for a specific period of time.

12. As of 10 April, 2018 728 Unified Territorial Communities had been formed, including 40 in which first elections for appointment were to be held on 24 April 2018 and 23 were waiting for the resolution of the Central Election Committee on the first elections (Ministry of Regional Development, 2018).

13. To ensure that the amalgamation process would proceed, the government found itself needing to juggle diverse voices, and in the interest of reform compromised on its planning process, which is inherently logical, but has led to some shortfalls in capacity.

14. Ukraine's State Strategy for Regional Development 2015-2020 serves as a framework policy that sets out the overarching approach to building national competitiveness by ensuring the strength of each region as a unique building block. In addition to increased competitiveness, the strategy targets a more integrated and balanced territorial development and supports more effective governance structures for regional development (Cabinet of Ministers, 2014b).

15. Article 16.1 of the Law of Ukraine on Fundamentals of State Regional Policy (Verkhova Rada, 2015b).

16. This would be greatly facilitated with multi-annual budgeting, which has yet to be officially introduced in Ukraine, though is under consideration as part of the draft Budgetary Policy for 2018-2020.

17. This programme is a collaborative initiative among the EU and Denmark, Estonia, Germany, Poland and Sweden; and implemented by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH and the Swedish International Development Co-operation Agency (Sida). The local partner is Ukraine's Ministry of Regional Development, Building and Housing (Ministry of Regional Development, n.d.)

18. It should be noted that PPPs are not yet a well-developed financing mechanism in Ukraine, particularly at the subnational level.

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Annex 2.A. Territorial administrative structure proposed by the Concept Framework

The Concept Framework of Reform of Local Self-Government calls for a territorial and institutional reorganisation in all three subnational government layers. It sets out to simplify territorial administrative divisions into three main categories: regions (*oblast)* including the cities of already accorded regional status; districts (*rayon*); and creates a category of local self-government unit (Table 2.A.1). The intention, as is often the case when building territorial scale, is to improve resource, institutional and managerial capacity among subnational authorities.

Table 2.A.1. **Territorial administrative divisions in Ukraine as proposed by the Concept Framework**

Territorial level	Territorial unit	Appointed state administration body in territorial unit	Elected administrative body in territorial unit
Regions	Regions (27), *oblast* (24), AR Crimea, Kyiv city, Sevastopol city	*Oblast* state administration Territorial branches of central executive authorities (ministries)	*Oblast* council *Oblast* executive committee
Intermediary	*Rayon* (c. 100)	*Rayon* state administration Territorial branches of central executive authorities (ministries)	*Rayon* council *Rayon* executive committee
Local self-government	Communities (c. 1 500)		Mayor (head of municipality) Municipal council Executive committee Heads of rural communities (*starosta*)

Sources: Adapted from: Nehoda, V. (2014), "Concept of the reform of local self-government and territorial organisation of power", presentation to European Committee on Democracy and Governance by Viachelsav Nehoda, First Deputy Minister, Ministry of Regional Development, Construction and Municipal Economy of Ukraine, 3 April 2014, Strasbourg, France.

Annex 2.B. The assignment of responsibilities across levels of government

Country size, particularly in terms of population and geography, are the primary determinants of a country's territorial distribution of authority. Countries with large populations tend to have more layers of autonomous intermediate government, which increases the level of regional authority *vis-à-vis* the centre. With a population of over 45 million in 2014, Ukraine is the largest country in Eastern Europe and among the former Soviet republics. Large countries, ultimately, tend to be more decentralised (OECD/UCLG, 2016). However, at each tier of subnational government there are common threads in the types of responsibilities attributed to distinct levels of government, as summarised in Table 2.B.1 (Allain-Dupré, forthcoming).

Table 2.B.1. **Breakdown of responsibilities across subnational government: A general scheme**

Regional level	Intermediary level	Municipal level
Heterogeneous and more or less extensive responsibilities, depending on country characteristics (e.g. unitary vs. federal)	Specialised and more limited responsibilities of supra-municipal interest	A wide range of responsibilities: – general clause of competence – eventually additional allocations by law
	An important role in assisting small municipalities	
Services of regional interest: – secondary/higher education and professional training – spatial planning – regional economic development and innovation – health (secondary care and hospitals) – social affairs (e.g. employment services, training, inclusion, support to special groups) – regional roads and public transport – culture, heritage and tourism – social housing – environmental protection – public order and safety (e.g. regional police, civil protection) – local government supervision (in federal countries)	Responsibilities determined by the functional level and geographic area: – secondary and/or specialised education – supra-municipal social and youth welfare – secondary hospitals – waste collection and treatment – secondary roads and public transport – environment	Community services: – education (nursery schools, pre-elementary and primary education) – urban planning and management – local utility networks (water, sewage, waste hygiene, etc.) – local roads and city/local public transport – social affairs (support for families, children, elderly, disabled, poverty, social benefits, etc.) – primary and preventative healthcare – recreation (sport) and culture – public order and safety (municipal police, fire brigade) – local economic development, tourism, trade fairs – environment (green areas) – social housing – administrative and permit services

Source: OECD (2016), *Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en.

Ukraine's Concept Framework clearly delineates the responsibilities of each level of subnational government (*oblast*, *rayon* and *hromada*). It also promotes greater subsidiarity by reassigning responsibilities, particularly in public service delivery, to local authorities, thus promoting greater administrative decentralisation. The attribution of responsibilities as proposed in the Concept Framework is roughly in keeping with trends in multi-level task attribution identified more generally at the subnational government level (Table 2.B.1), though it attributes fewer functions to the *oblast* and *rayon* administrations than is frequently seen (Table 2.B.2). Such activities as social protection, treasury services, civil registration and public health protection would be attributed to central executive territorial bodies at the basic level of government (Cabinet of Ministers, 2014a).

Table 2.B.2. **Main responsibilities of distinct government tiers as proposed by the Concept Framework**

Central level	First tier: Regional level	Second tier: District level	Third tier: Municipal level
State administration body (*oblast* and *rayon*)	*Oblast* council and executive committee	*Rayon* council and executive committee	Communities
Control over administrative, social and other services to population and legal entities	Maintenance of joint property of region and municipalities	Maintenance of joint property of *rayon* and municipalities	Local economic development (investment attraction, entrepreneurship development)
Co-ordination of territorial branches of executive authorities	Transport infrastructure of *oblast* significance (e.g. *oblast* roads, network of inter-*rayon* and inter-*oblast* public transport routes)	Transport infrastructure of *rayon* significance	Organisation of public transport
Co-ordination of all public administrations in case of state of emergency	Tertiary (highly specialised) medical care	Secondary medical care	Ambulance, primary health protection, disease prevention
Supervision of activity of local self-government bodies (in compliance with law)	Professional, technical and specialised secondary education	Residential schools	Secondary, pre-elementary, primary and alternative education
	Regional development planning		Territorial development planning (strategic and general planning, zoning)
	Development of sports, culture and tourism		Culture and physical training: maintenance and organisation of municipal clubs, libraries, stadiums, sports areas
	Environmental protection		Local infrastructure development[1]
			Housing and utilities services[2]
			Provision of central administrative services through relevant centres
			Maintenance of municipal roads
			Building sites[3]
			Landscaping and amenities
			Social assistance through territorial centres
			Fire safety
			Public security (district police, patrol guard service)

1. Includes: supply of roads, water, heat, gas, electricity; wastewater management; informational networks, social and cultural facilities.
2. Includes: centralised water; heat supply and wastewater management; garbage disposal; maintenance of housing and municipal property.
3. Includes: allocation of land plots; issuing construction permits; acceptance of buildings for maintenance.
Sources: Adapted from: Cabinet of Ministers (2014), "Concept of Local Self-Governance and Territorial Power Reforming", http://despro.org.ua/en/news/partners-news/detail.php?ELEMENT_ID=1381 (accessed 8 August 2017); Nehoda, V. (2014), "Concept of the reform of local self-government and territorial organisation of power", presentation to European Committee on Democracy and Governance, 3 April 2014, Strasbourg, France.

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Chapter 3. Strengthening fiscal decentralisation in Ukraine

Chapter 3 presents the fiscal component of Ukraine's decentralisation reform. It highlights how the reform has developed and the implementation process. It offers an in-depth examination of the impact that fiscal decentralisation is having on subnational government revenue and expenditure, and equalisation systems, as well as the fiscal challenges that local communities are facing in light of the reform. Insight is provided into the management and public investment tools that could better support the delivery of public services, including the role of public enterprises, inter-municipal co-operation, and the need for more effective capital transfers for subnational investment. The chapter ends by exploring opportunities to reinforce human capital at the subnational level and the impact the decentralisation is having on the subnational government staff.

Introduction

Fiscal decentralisation is not new to Ukraine. It began at independence, was codified into the 1996 Constitution, the 1997 Law "on Local Self-Government", and the Budget and Tax Codes that establish the basic rules for local government funding, budgetary relations and equalisation mechanisms. It is supported by the 1997 ratification of the European Charter of Local Self-Government. The principles contained in these instruments have not been fully implemented, however, despite important fiscal reforms to increase subnational government fiscal resources and improve the transparency and predictability of inter-budgetary relations. While fiscal decentralisation is at the core of the decentralisation process, it seems to have slowed, stagnated and even regressed, especially between 2010 and 2014.

The Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power, published in April 2014, took full measure of the importance of these challenges and set fundamental principles and ambitious goals for political, administrative and fiscal decentralisation (see Chapter 2). In terms of fiscal decentralisation, the Concept Framework addresses the need of sufficient resources to cover statutory responsibilities; a reform of the intergovernmental grants system, including equalisation; a reform of taxation, including the need to develop tax autonomy over rates and bases; easier access to borrowing; balanced state control on local finance; increased budget transparency and efficiency; and more ability to manage land resources (see Annex 3.A).

The implementation measures adopted to realise the fiscal component of the Concept Framework started in December 2014 with major changes to the Budget and Tax Codes.[1] Amendments were introduced to expand the revenue bases of several categories of subnational governments, change the tax-sharing arrangements, establish new local taxes and introduce a new equalisation system, modify the system of grants, relax borrowing constraints, and improve budgeting and financial management.

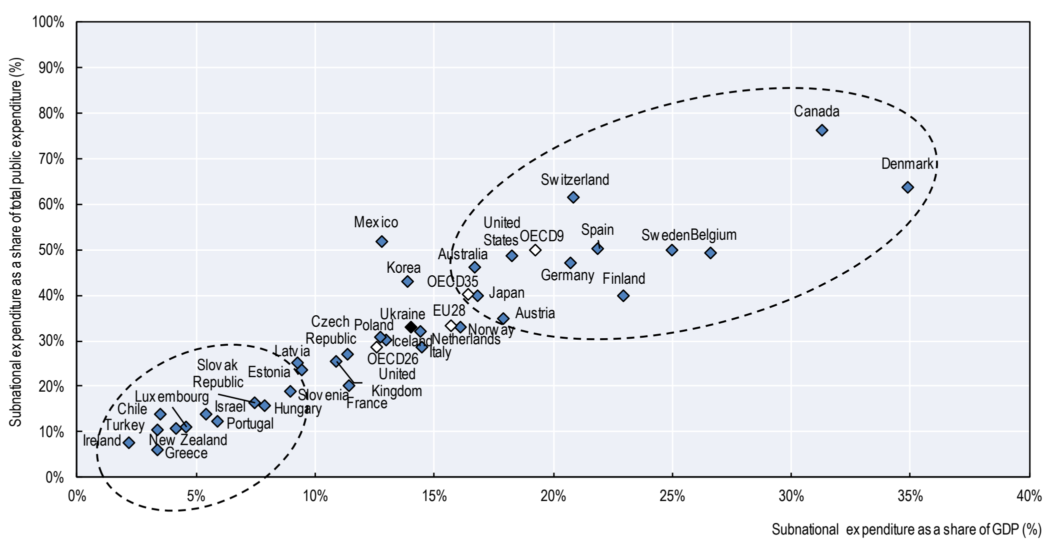
Reforms take time to translate into significant changes, but the impact of these measures gradually became evident beginning in 2015, and especially in 2016 and the beginning of 2017. The most significant changes thus far observed primarily concern a reallocation of powers and resources across subnational levels of government rather than a true transfer of competences and resources from the central government to lower levels of government. It should be noted, however, that the *oblast* (regional, TL2) and *rayon* (intermediate) levels function most frequently as territorial entities of the central government, which makes changes more difficult to identify and assess in terms of decentralisation. With the emergence of more powerful cities and communities, the situation could rapidly evolve if the central government effectively continues to deepen its decentralisation policy and addresses political, administrative and fiscal in a balanced way.

This chapter is comprised of two parts. The first part describes fiscal decentralisation in Ukraine as of end-2014, confirming the country's still centralised nature in fiscal matters. It provides an analysis of the main reforms which have been adopted since late 2014 in numerous areas, including the reforms of inter-governmental grants and the equalisation system, the tax-sharing arrangements and own-source taxation, non-tax revenues, and borrowing and financial management frameworks. The second part is dedicated to assessing the progress of reform thus far. It provides recommendations for strengthening fiscal decentralisation in Ukraine, covering measures which could be adopted to improve the grants and taxation systems, the assignment of responsibilities, the delivery of local public services through transparent and efficient management tools, the level of public investments and its governance across levels of government as well as the quality and access to data on subnational government finance and assets.

Fiscal decentralisation in Ukraine: Contextual data and 2014-15 reforms

On paper, basic fiscal indicators suggest a relatively decentralised country. Ukrainian subnational governments represented one-third of public expenditure in 2015, in line with the EU-28 average and just 7 points below the OECD average of 40%. Ukraine compares with the Netherlands, Italy, Poland and Iceland, where subnational expenditure accounts for between 11% and 16% of gross domestic product (GDP) and between 27% and 33% of public expenditure (Figure 3.1).

Figure 3.1. **Subnational government expenditure as a percentage of GDP and general government expenditure in the OECD countries and Ukraine, 2015**



Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en. For Ukraine: OECD calculations based on IMF database.

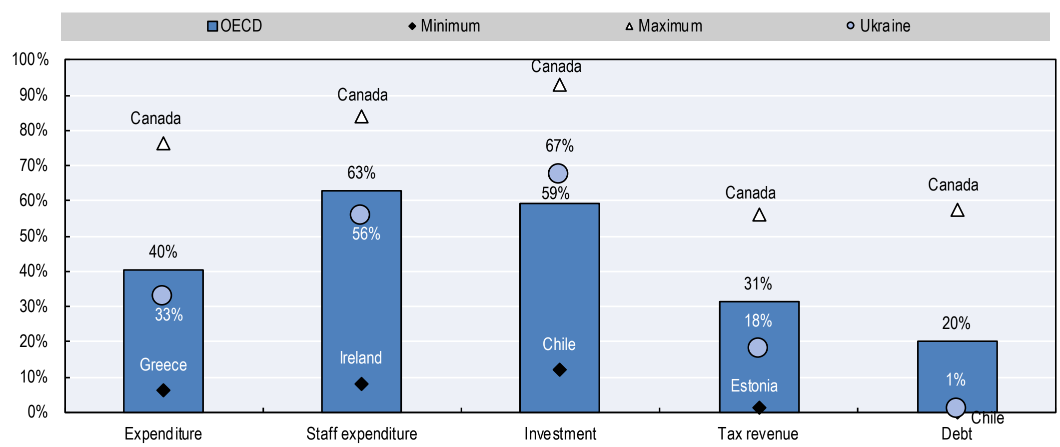
Subnational governments are also important public employers: subnational staff expenditure accounted for 56% of public staff expenditure in Ukraine, above the EU-28 average of 51%, and close to the OECD average of 63%. In terms of fixed investment, Ukraine is above the OECD and EU-28 averages. In 2015, subnational investment amounted to 67% of public investment, compared to 59% in the OECD and 53% among the EU-28. Subnational tax revenues represented 18% of public tax revenue. This is lower than the OECD average of 31%, but not too low when compared to the EU average (23%) or certain OECD countries (Figure 3.2).

In reality, closer analysis shows that Ukraine remains a centralised country. Fiscal indicators are somewhat misleading and should be interpreted with caution. Two main factors that mask the real situation:

1. ***Oblast* and *rayon* accounts are not fully "decentralised".** *Oblast* and *rayon* administrations are composed of both deconcentrated and decentralised entities. This means that parts of their budgets, although categorised as "local government sector" in national accounts, should in reality be classified as "central government sector", as executive committees are not elected, represent the central government and are responsible to a presidentially appointed *oblast* governor while *oblast* and *rayon* councils have very few powers (Chapter 2). As a result, the usual indicators tend to overestimate the weight of the subnational sector.

2. **Most local government accounts cannot be properly identified**. Data reported in the national accounts cover approximately 700 budgetary entities (*oblast* and Crimea, the cities of Kyiv and Sevastopol, *rayon*, and cities of *oblast* significance). This means that most municipal budgets, i.e. those of cities of *rayon* significance, towns, villages and rural settlements, are not individualised in the national accounts but managed according to the traditional *matrioshka* budgetary model and embedded in their *rayon*'s budgets, on which they depend for allocations. This "trickle-down" budgeting system is also open to political and economic games (OECD, 2003). The creation of unified territorial communities (UTCs), in the framework of the current administrative-territorial reform, is fundamentally changing the situation. The UTCs now have independent budgets, made of tax, grants and non-tax revenues, and have direct fiscal relations with the central government via their *oblast* administrations, although they can continue to receive subsidies from the *rayon*.

Figure 3.2. **Subnational governments as a share of general government in the OECD and Ukraine (2015)**

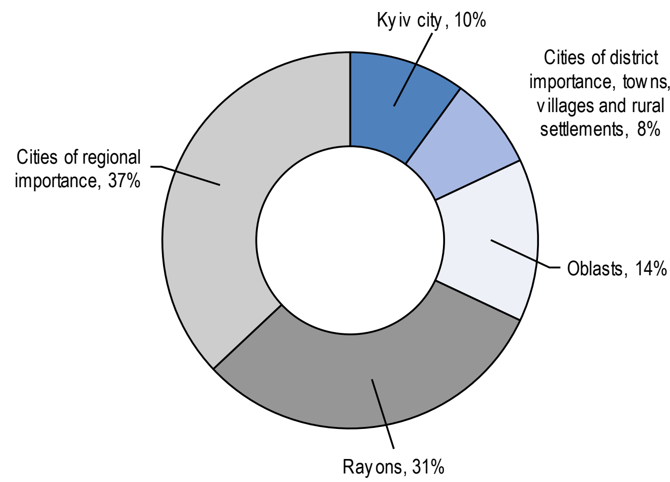


Notes: The general government sector includes central government, state and local governments, and social security sub-sectors. Investment for Ukraine is defined as acquisition of fixed capital. For OECD countries, the definition includes gross capital formation and acquisitions, less disposals of non-financial non-produced assets. Debt definition is based on that of the OECD. It includes, in addition to "financial debt" (currency and deposits, loans and debt securities), insurance reserves and other accounts payable.
Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en.

The ambiguity of the administrative and budgetary structure of subnational government explains why it is difficult to have a clear picture of subnational financial autonomy in Ukraine. Legally, there are two budget tiers: state (central government at national level) and local. The local tier is divided in two categories: regional (*oblast*) with very limited financial autonomy, and local budgets pertaining to *rayon*, cities of regional importance, cities of district importance, towns, villages, etc., whose financial status is not clearly defined (Standard & Poors, 2013).

The financial weight of each category of government is difficult to capture. It was not possible during the study to obtain data by tiers and categories of subnational governments, so figures were gathered from diverse, external sources (e.g. World Bank [2017a]; Levitas and Dkijik [2017]). A comparison of the data gathered reveals that the regional level is weak, the intermediate level – i.e. *rayon* and cities of *oblast* significance – represents 68% subnational spending (78% if Kyiv city is included), and the local level (cities of *rayon* importance, towns, villages and rural settlements) represents only 8% of the total (Figure 3.3).

Figure 3.3. **Breakdown of spending by category of subnational government, 2016 (estimates)**



Source: OECD estimates based on World Bank (2017a), "Ukraine: Public finance review", http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review and Levitas, T. and J. Djikic (2017), "Caught mid-stream: 'Decentralization', local government finance reform, and the restructuring of Ukraine's public sector 2014 to 2016", http://sklinternational.org.ua/wp-content/uploads/2017/10/UkraineCaughtMidStream-ENG-FINAL-06.10.2017.pdf.

Subnational government expenditure and investment are constrained

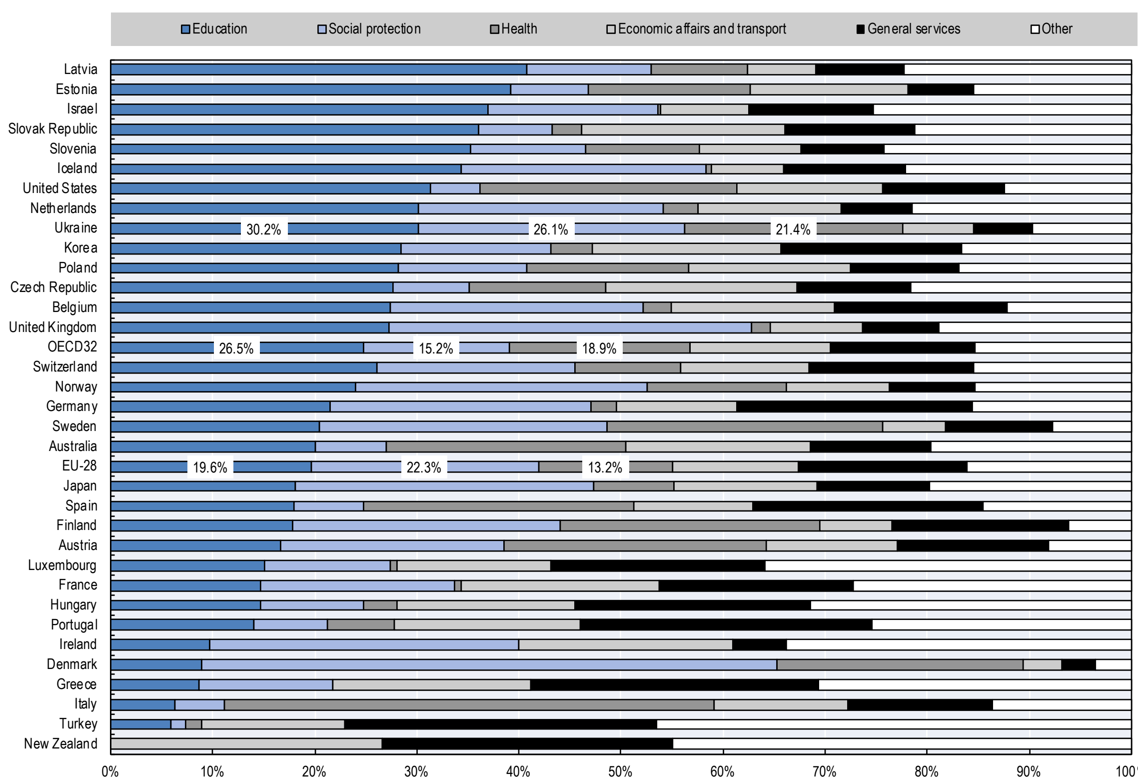
Subnational government spending power is restricted

Subnational government functions are broadly described in numerous statutes and regulations (Annex 3.C)[2] and spending responsibilities are divided into delegated functions and exclusive or own 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. They "transit" through local budgets but subnational government authorities have limited authority over them. Subnational governments also have limited autonomy in the management of their functions. Legal obligations, service organisation, financing, human resources, performance standards, etc., are all defined and monitored by the central government, leaving little or no discretion for subnational governments in the performance of delegated functions.

The ability of local governments to allocate expenditures between and within sectors is quite limited. The budget formation at the service facility level and its aggregation in the local budget are based on norms set by line ministries. For example, local governments are in charge of all of the functions of education except for higher education. However, the Ministry of Education retains full control over the norms that govern staffing, teaching hours, non-teaching personnel ratios and class sizes – based on an oversized network of schools instead of on the actual demand for the service, e.g. enrolled children or school-age population in the jurisdiction (OECD, 2014a). Delegated functions represent the bulk subnational expenditure: education, social protection and healthcare amounted to 78% of subnational expenditure in 2015. This means that about three-quarters of all subnational spending are made on behalf central government. Most public expenditure for health and education is channelled through subnational governments: 83% for health and 74% for education, well above the EU and OECD averages.

By contrast, "exclusive functions" mainly concern local public goods such as utilities, housing and social protection for which subnational governments have more autonomy and which are financed from general transfers but also own resources. They are vaguely defined and represent a minor portion of subnational expenditure, particularly in comparison to OECD countries (Figure 3.4): 7% for economic affairs and transport, 6% for housing and community amenities and general public services (administration), 3% for recreation and culture, and 1% only for environmental protection. Almost all public spending on housing and community amenities (supply of potable water, public lighting, cleaning, urban heating, urban planning and facilities) also passes through subnational governments.

Figure 3.4. **Breakdown of subnational government expenditure by area (COFOG): OECD and Ukraine, 2015**



Note: 2015 COFOG data are not available for Canada, Chile or Mexico. 2014 COFOG data for Japan, Korea, New Zealand, Switzerland and Turkey. For the United States, data in the function "housing and community amenities" include the "environment protection" function data.

Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en. For Ukraine, OECD calculations based on IMF database.

This breakdown of responsibilities also explains the weight of staff expenditure in public staff spending in Ukraine. Subnational staff expenditure accounted for 38% of subnational spending, slightly higher than in the OECD and the EU, on average, and close to Sweden or the Czech Republic. Most of this expenditure is for the remuneration of teachers, medical staff and social workers (delegated functions). Thus, subnational governments act as paying agents on behalf of the central government.

There has been little progress in spending decentralisation

Progress in spending decentralisation is not fully reflected in figures. Rather, it appears that decentralisation has resulted in a reallocation of spending responsibilities across subnational levels (particularly from the *rayon* to cities and the UTCs) instead of a reallocation of charges between the central (ministry) and subnational levels. Between 2001 and 2016 in Ukraine, the growth of subnational government expenditure was quite significant, rising from 11.7% to 14.7%. However, the share of subnational government expenditure as part of total public expenditure hovered around 33% (Figure 3.5).

This analysis of local government expenditure at the macro level does not reflect a fiscal decentralisation process over the 2001-16 period. Since 2015, there seems to be movement towards more decentralisation in spending as the decentralisation of new responsibilities and charges progresses, although this remains to be confirmed.

Ukraine's subnational governments have low investment capacity

Public investment in Ukraine has fallen relative to GDP since 2000, despite temporary boosts in 2012 (due to FIFA/Euro 2012 and the parliamentary elections) (OECD, 2014a) and general agreement that infrastructure investment is a priority. As of 2015, it appeared to be on the rise, however, accounting for 1.8% of GDP in 2015 and 2.2% in 2016 (Figure 3.6).

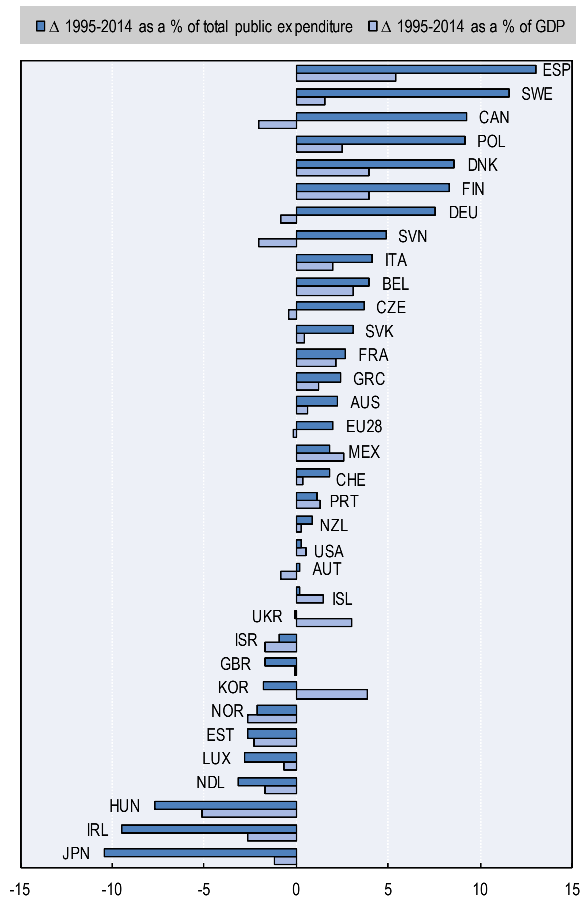
The level of public investment of Ukraine is particularly low for a low middle-income country. In fact, Ukraine is well below the average of many other lower middle-income countries in the world, where investing heavily in public infrastructure is considered to be a key structural driver of growth. Many have recently found themselves boosting their public investment to fill the infrastructure gaps. In emerging markets and low-income developing countries, public investment rates peaked at more than 8% of GDP in the late 1970s and early 1980s, declined to around 4-5% of GDP in the mid-2000s, but have recovered since then to 6-7% of GDP (IMF, 2015). Public investment in Ukraine is also very low compared to OECD countries. In the Czech Republic, Estonia, Hungary and the Slovak Republic public investment exceeded 5% of GDP in 2015.

Ukraine's subnational governments do not have the fiscal capacity to heavily invest

Subnational government investment amounted to 1.2% of GDP in 2015, far lower than in most middle-income countries. On average, subnational governments in lower middle-income countries invest around 1.4% of their national GDP. In upper middle-income countries, the figure is 1.7% (OECD/UCLG, 2016). Subnational investment as a share of public investment is significant in Ukraine, at 67% of public investment in 2015 (Figure 3.7). This is significantly higher than the OECD average of 59% and the EU-28 average of 53%. This confirms that investment is a shared responsibility across levels of government, making its governance particularly complex as recognised by the OECD *Recommendation of the Council on Effective Public Investment across Levels of Government*.

Figure 3.5. **Subnational expenditure as a share of total public expenditure and of GDP, 1995-2014**

Changes expressed in percentage points

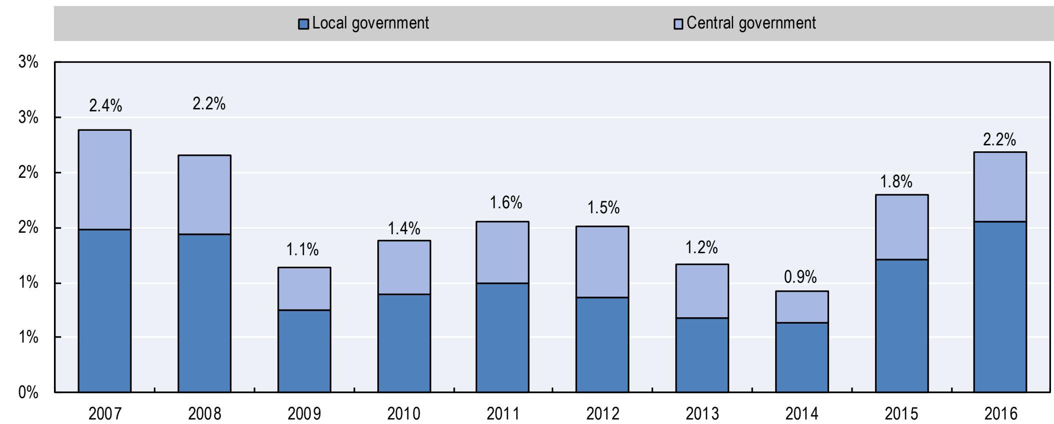


Note: 1995-2012 for Australia; 2003-13 for Mexico; 1995-2013 for New Zealand; 1998-2014 for Iceland; 1996-2014 for the Netherlands; 2005-14 for Ireland. No data for Chile and Turkey due to missing time series. For Ukraine, the series is more limited but ends in 2016, taking into consideration the last reform (2001-16, estimation).

Source: adapted from OECD (2016c), *Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en. For Ukraine, OECD calculations based on IMF, "Government finance statistics", www.imf.org/en/Data and the State Treasury Service of Ukraine.

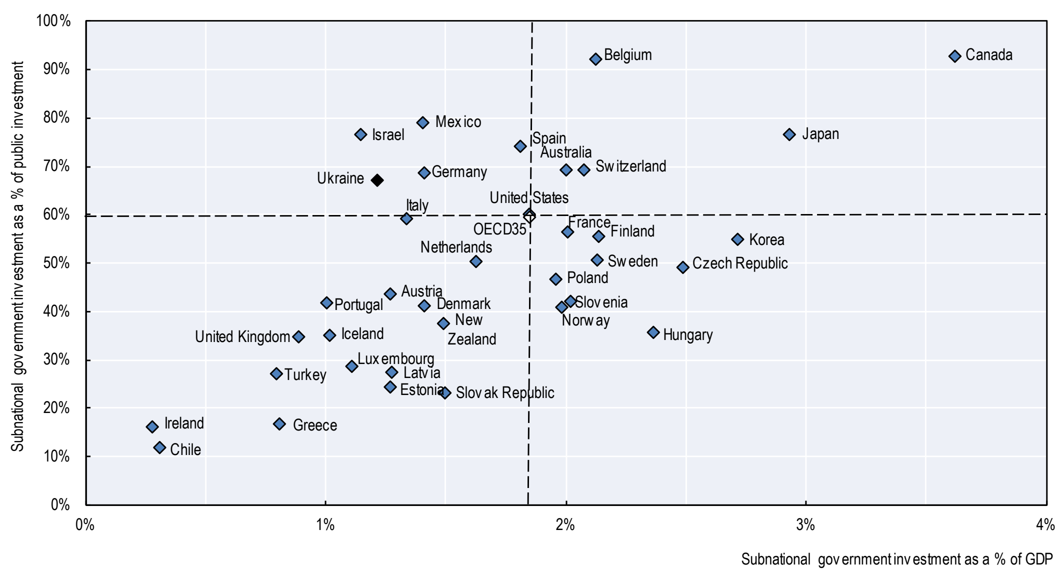
Despite the strong role that local governments play in public investment, they do not have the fiscal capacity to invest heavily: their self-financing capacity is limited by the weight of current expenditure. Meanwhile, capital transfers and investment subsidies are lacking and access to borrowing is limited. As a result, the share of direct investment in their total expenditure is low, despite recent improvement (from 4.5% of local expenditure in 2013 and 2014 to 10.5% in 2016). In addition, subnational governments lack financial stability and predictability – they cannot afford the large-scale multi-annual investment projects that are needed for building or renovating large infrastructure (EBRD, 2014). As a result, infrastructure is heavily underfinanced, and municipal infrastructure needs overshadow the size of local budgets.

Figure 3.6. **Public investment in Ukraine as a percentage of GDP**



Source: OECD calculations based State Treasury Service of Ukraine, www.treasury.gov.ua.

Figure 3.7. **Subnational government investment as a percentage of GDP and public investment in OECD and Ukraine, 2015**



Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en. For Ukraine, OECD calculations based on State Treasury Service of Ukraine, www.treasury.gov.ua.

The limited fiscal capacity of the subnational level is a concern given the large need for infrastructure investment. Fixed capital stocks in the public sector are ageing and of mediocre quality, and the country's infrastructure needs are tremendous. In the area of transport, despite progress over the last three years, Ukraine has one of the lowest road network densities in Europe, together with a significant portion that is obsolete and does not comply with European standards (OECD, 2016b). Rural roads are state- or municipally owned. Their maintenance and modernisation are funded from the state and local budgets. According to the state agency charged with overseeing road development, Ukravtodor (under the Ministry of Infrastructure), in late February 2015, 88% of roads out of a total of 169 647 km required repairs or reconstruction, with almost 40% of them failing to meet requirements for durability. Only 46% of the bridges and overpasses were in satisfactory condition with the rest being in poor to dangerous states due to their extreme age, with as many as 21% of bridges and overpasses being built prior to the Second World War and 51% built during the 1950s through the 1970s (OECD, 2015a; Ukravtodor, 2015). Municipal utilities, such as water and heating, have also suffered from decades of underinvestment. Estimates based on the household survey (World Bank, 2017b) indicate that in 2013, only 27% of the bottom 40% of the population had access to district heating and 23% to hot water, compared to 43% and 38%, respectively, of the top 60% of the population.

Subnational governments have access to various tools for delivering public services which are being improved

Subnational governments can choose between direct or indirect management to deliver a wide range of services, including waste collection, water provision, heating, maintenance of the housing stock, transportation, etc. Direct management means that the service is delivered by an internal municipal service (budgetary organisations). Indirect service provision is in the hands of public bodies or delegated to private actors or via public-private co-operation (Box 3.1).

Box 3.1. Forms of indirect service providers in Ukraine

- Public bodies: either local enterprises 100% owned and controlled by municipal or *oblast* administrations or an inter-municipal co-operation body that pools the material and financial resources of different communities in order to deliver or establish additional services.
- Joint ventures or joint stock companies in which the local government owns shares: subnational governments provide local services jointly with the private sector through an entity combining public and private capital, or partnerships with the commercial sector.
- Private actors: subnational governments may outsource service provision to private enterprises on a contractual basis (e.g. waste disposal), through licencing, concessions or consumer associations. Several laws define key legal principles applicable to municipal concessions, including the applicable sectors (e.g. urban public transport, water, sanitation, seaports, public catering, etc.). The most sophisticated form of public-private co-operation are public-private partnerships (PPPs); however, they are not frequently used at the subnational level in Ukraine.

The sector of municipal-owned enterprises lacks profitability and transparency

The municipal enterprises sector – still large in Ukraine despite shrinking in the past ten years[3] – displays a low aggregate profitability. Municipal assets are less efficient (in terms of profitability) compared to other sectors of the national economy. This could be attributed mainly to the composition of municipal assets, but also to the low quality of local asset management. According to NISPAcee (2010), the collection of payments for municipal services extended only to 50-60% of the payments due because of corruption, low qualifications and the poor discipline of managers. One of the many issues surrounding Ukraine's municipal companies is limited data to assess performance and a lack of transparency and accountability. While the law requires all local governments to publish their budgets and budget performance reports (not always done), reporting does not cover the financial transactions of government-related entities. Despite some technical progress in budget accounting and monitoring, transparency remains low (Standard & Poors, 2013).

Many municipal companies are also underfunded due to low tariffs and weak financial support from the mother municipality. It appears that public underinvestment also results from underinvestment in utility enterprises that provide services at subsidised rates despite needing to maintain an extensive infrastructure network. This contributes to the degradation of municipal physical assets.

Inter-municipal co-operation is still in its infancy but is being promoted

The promotion of inter-municipal co-operation (IMC), now supported by the 2014 Law No. 1508-VII on Co-operation of Territorial Communities (see Chapter 2) can help improve the efficiency of public service delivery when municipalities are too small, and/or have overlapping or redundant functions. There are various formats for IMC in the OECD, ranging from very informal agreements with no judicial framework to highly formalised arrangements. There are also different forms of funding (Box 3.2).

Box 3.2. Forms of inter-municipal co-operation and funding in the OECD

Most OECD countries have enacted regulations to encourage inter-municipal co-operation. IMC arrangements are now well developed and extremely diverse, varying in the degree of co-operation. They range from the softest (single or multi-purpose co-operative agreements/contracts, e.g. shared services arrangements or shared programmes in Australia, Ireland, New Zealand and England/the United Kingdom) to the strongest forms of integration, e.g. supra-municipal authorities with delegated functions in France, Portugal and Spain and even with taxation powers. For instance, in France, public establishments for inter-communal co-operation (*EPCI à fiscalité propre*) have their own sources of tax revenue and are based on a territorial development project. Between the two, there is a range of different forms of co-operation.

The dividing lines are between the public law model and the private law model: the private law model is based on the freedom of local authorities to pragmatically opt for the areas and forms of IMC based on the modalities and entities envisaged by this law, such as contracts, associations and commercial enterprises. The public model means that co-operation is regulated in some detail by public laws, including the contractual and financing arrangements, the type of delegated functions (with even mandatory functions), the governance structure, the supervision and control, etc.

In terms of financing, IMC structures are most often financed through contributions from municipality members. They usually complement these subsidies by other revenue sources related to the services they provide, i.e. they charge for local public services via user fees – transport, water provision, waste collection, etc. They can also receive grants from the central government, which is a way for central government to favour IMC. In fact, in some cases in the OECD, IMC has even privileged access to central government grant funding. IMC can also attract EU funds and private capital for public-private partnership initiatives between several municipalities and one or several private investors.

Figure 3.8. **From soft agreements to more formalised forms of co-operation**

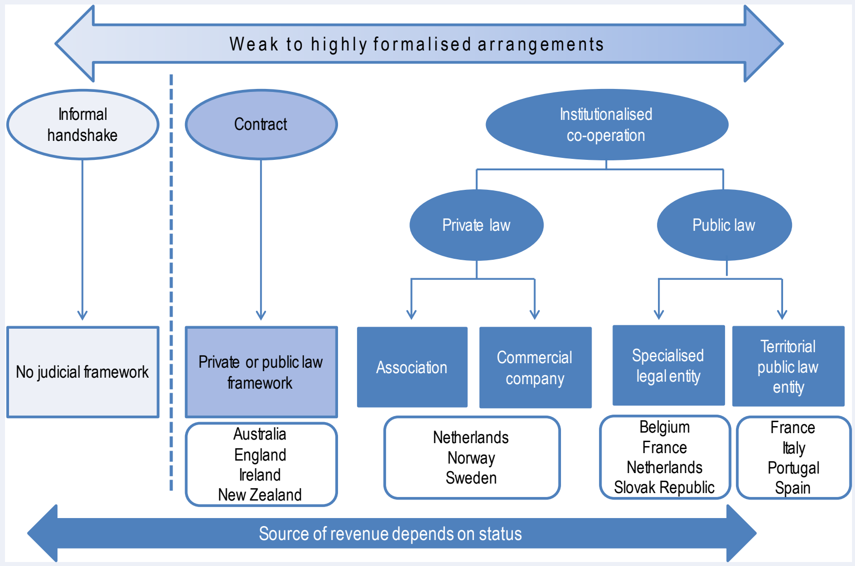


Figure source: Adapted and completed by the OECD based on www.municipal-co-operation.org.

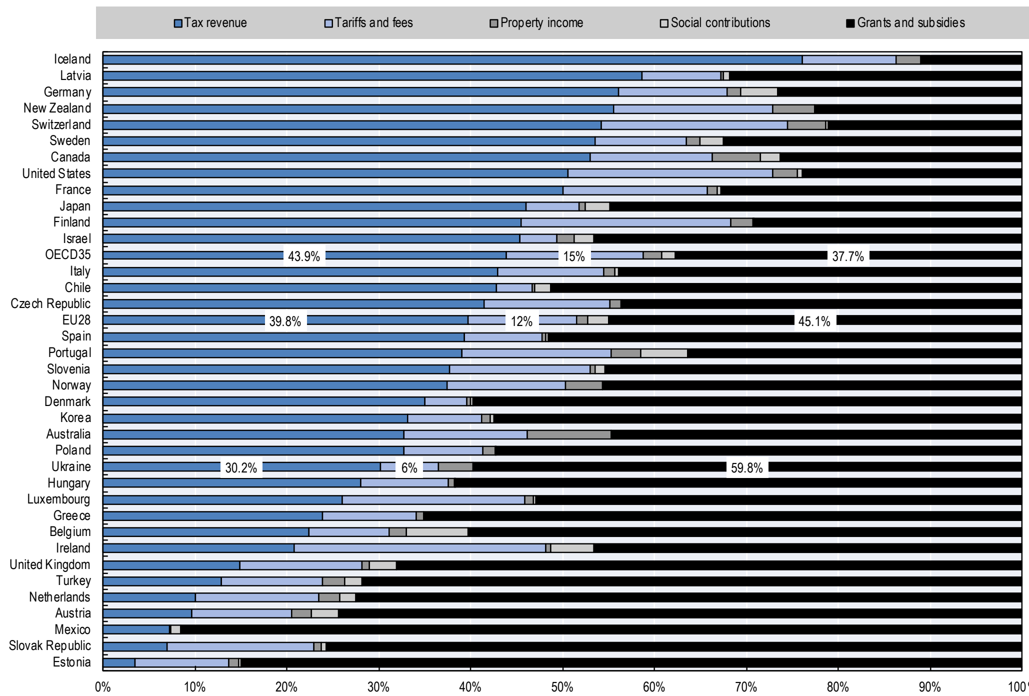
Box source: OECD (2017e), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, http://dx.doi.org/10.1787/9789264272866-en; www.municipal-co-operation.org

Subnational governments have a low level of autonomy in revenue management

The funding system is now dominated by central government transfers

Sixty per cent of subnational resources come in the form of transfers from the central government. This is significantly more than the OECD (38%) and the EU-28 (45%) averages (Figure 3.9). Tax revenues represent 30% of subnational government revenues, compared to 40% in the EU-28 and 44% in the OECD. Over the last 15 years, the respective share of transfers and tax revenue has changed significantly. In 2001, tax revenues accounted for 62% of subnational revenue and grants 30% (Figure 3.10).

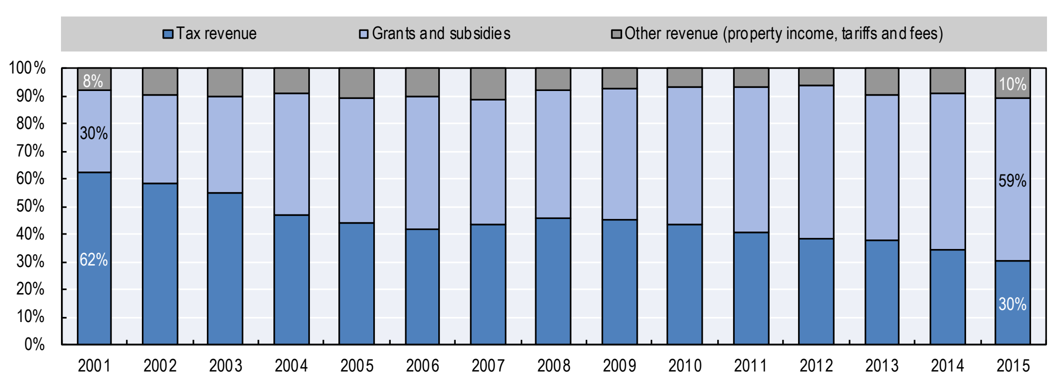
Figure 3.9. **Structure of subnational government revenue: OECD countries and Ukraine, 2015**



Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en. For Ukraine, OECD calculations based on IMF, "Government finance statistics", www.imf.org/en/Data.

Figure 3.10. **Change in the share of each source of subnational revenue**

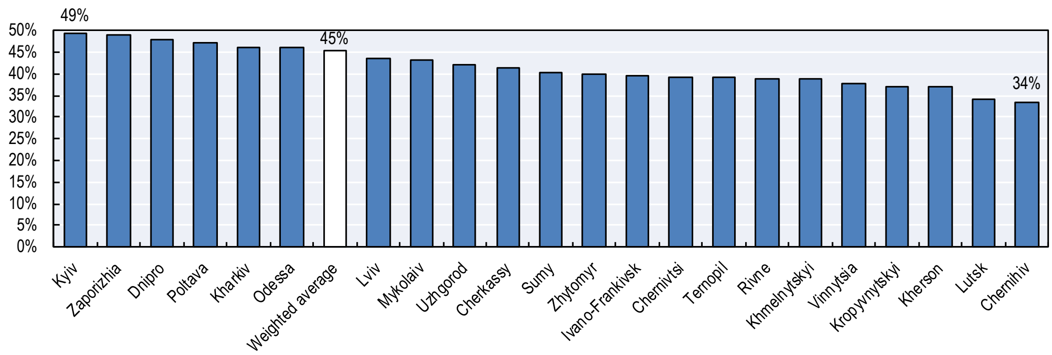
Percentage of total subnational revenue



Source: OECD calculations based on IMF, "Government finance statistics", www.imf.org/en/Data.

Local governments in rural areas rely most heavily on central government transfers, which represent more than 75 % of their revenues (World Bank, 2017a). By contrast, in cities, taxes generated 45% of revenues[4] in 2015 (INEKO, 2017). In Kyiv, tax revenues represented almost 50% of the city's total revenues in 2015 (Figure 3.11).

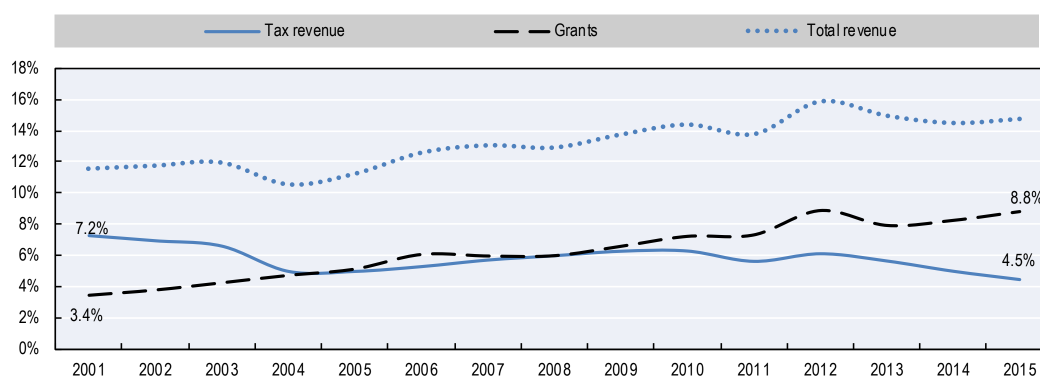
Figure 3.11. **Tax revenue as a percentage of total revenue in 22 regional capital cities of Ukraine, 2015**



Note: No data available for Donetsk and Luhansk.
Source: OECD calculations based on data provided by INEKO, http://budgets.icps.com.ua.

Relative to GDP, central government transfers have strongly increased while tax revenues have decreased (Figure 3.12). The growing dependence of subnational governments on central government resources can reduce incentives to improve service delivery and strongly limits accountability at subnational level.

Figure 3.12. **Changes in tax revenue and grants in relation to GDP**



Source: OECD calculations based on IMF, "Government finance statistics", www.imf.org/en/Data.

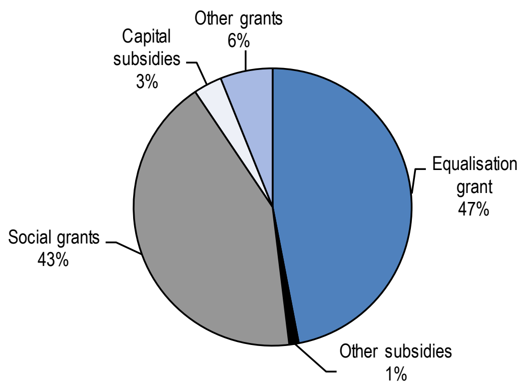
The inter-governmental system of grants was substantially reformed in 2014-15

Prior to 2015, the grant system was comprised of one equalisation grant and one social grant, together representing 90% of all transfers. This system had several important drawbacks (OECD, 2014a). These led the OECD to recommend reconsidering the equalisation system in terms of the amount of tax revenues that each local government could count on. It was also suggested to revise the allocation formula in order to make it simpler and less discretionary, by reducing the number of indicators and to use indicators based on the needs of the population in each area to determine resources allocated for the provision of local public services, instead of input indicators.

After the 2014 reform, there are still two main categories of grants, but their composition is very different than before. There is the equalisation grant and several formula-based central government transfers earmarked to fund sectoral expenditures, particularly in the education and health sectors. Capital grants and subsidies have also been established or reformed to support investment projects aimed at fostering regional and local development and improving infrastructure (Figures 3.13 and 3.14). The new system of grants aims at ensuring more permanent and stable funding for key responsibilities, as well as enhancing the predictability and transparency behind the allocation of transfers through clearer allocation of rules. One major objective is to improve efficiency in the use of the resources.

Figure 3.13. **Inter-governmental transfers, 2013**

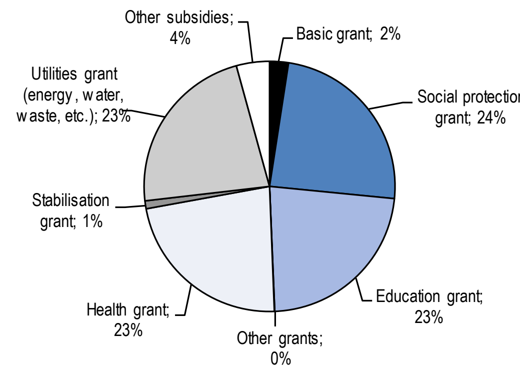
% of total grants



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

Figure 3.14. **Inter-governmental transfers, 2016**

% of total grants



Source: OECD calculations based on State Treasury Service of Ukraine.

The grants remain very constraining. First, they are, for the most part, earmarked to finance delegated functions and pay staff. They are also associated with guidelines, norms and strict controls. While the intention is certainly justified – to avoid irregularities and inequities related to the provision of education, health and social services across the national territory – they also reduce subnational decision-making power, especially when norms and controls are excessive and not adapted to local specificities.

The equalisation reform

The December 2014 amendments to the Budget Code introduced an equalisation mechanism for subnational government revenues rather than expenditures, basing it on two taxes: the personal income tax (PIT) (for *oblasts*, *rayon*, regional towns and communities) and the corporate profit tax (CPT, only for regional budgets). The mechanism has simplified the calculation formula and now takes revenue performance into consideration when calculating the equalisation grants (Box 3.3).

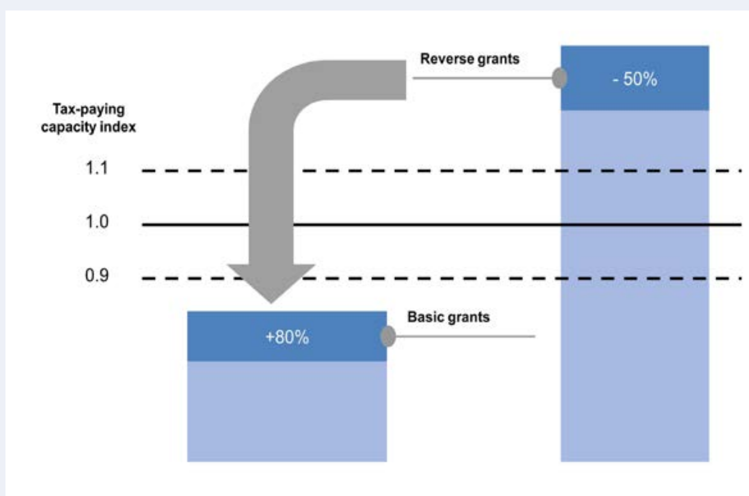
The basic grant amounted to 2.4% of inter-governmental transfers in 2016 and 1.3% of all subnational revenue. In 2015, in 18 regions, the difference between basic and reverse subsidies of all subnational governments was positive (they were net beneficiaries) while it was negative in six others (net contributors). Kyiv city is excluded from the system, despite its high level of PIT and CPT. By levels of government, cities were the biggest donors in 2015 and the *rayon* were the biggest beneficiaries of the equalisation process. The balance for regional administrations was slightly positive, meaning that, on average, they received more that they contributed. In 2016, it was foreseen that the UTCs would also benefit from the system (PwC, 2016).

Box 3.3. Ukraine's equalisation grant mechanism

The equalisation system's main elements are basic and reverse grants. The basic grant is a transfer from the national budget to the local budgets. The reverse grant is composed of funds transferred from the local budgets to the national budget to ensure horizontal equity. The equalisation mechanism is determined by the tax capacity index, which is the ratio between the tax capacity per person of a local budget and the average tax capacity per person of the same level budgets. This tax capacity index determines which local governments will receive basic grant, which will pay the reverse grant and which will be unaffected by the mechanism. The tax capacity index is also used for the calculation of the basic and reverse grants.

The mechanism is represented in Figure 3.15: 50% of revenue surplus is withdrawn from the budgets of local governments that earn more than they spend, but on condition that the tax capacity index is more than 1.1. The withdrawn funds are used to provide basic subsidies. The basic subsidy is only 80% of the required amount (provided that the tax capacity index is less than 0.9) for local governments that do not have sufficient revenue to cover their expenses.

Figure 3.15. **New equalisation mechanism: Basic and reverse grants**



Source: Reanimation Package of Reforms (2015), "Reforms under the microscope".

Said differently, local governments with tax capacity above the Ukrainian average by at least 10% will keep 50% of the revenue surplus. Poorer local governments, with tax capacity below 90% of the national average, will receive a basic grant which amounts to 80% of what is required to catch up with the average. Local governments with revenues between 90% and 110% of country's average will not be subject to either compensation or deduction.

Source: PwC (2016), "Local taxation diagnostic review of local revenues in Ukraine"; Reanimation Package of Reforms (2015), "Reforms under the microscope".

The reform of the education, health and social grants

The misallocation of resources in the education, health and social sectors resulting from the funding system is particularly problematic (Box 3.4). Prior to reform, the system of grants was not conducive to rationalising and improving the quality of the services, as it was based on expenditure gaps and historical data. In fact, any efficiency improvement would result in fewer resources for the local government.

Since 2015, there have been moves to reform the system. In 2015, a flexibility measure in education and health grant management was introduced, allowing for subnational governments to keep unspent funds from state grants at the end of the year for use in the following year to upgrade the material and technical base of educational and medical institutions. Previously they were withdrawn and sent back to the central government, which could encourage an inefficient use of funds. In 2016, four major sectoral grants were created or adjusted: the social protection grant, the education grant, the health grant and the utilities grants. These four funds are represented in the same proportion in total transfers and in total subnational revenues. Line ministries can allocate these grants directly to subnational governments, and new "principles" for the allocation of funds have been introduced. These principles are based on a formula-based calculation according to sectoral service delivery standards (for services guaranteed by the state) and norms per user. However, these principles have not yet been implemented. The allocation formula used in 2015 and 2016 has been in operation for over 15 years, initially as a part of gap-filling calculation, and for the last 2 years as a stand-alone formula allocating education/medical subvention.

Introduction of new capital funds for regional and local development

Capital investment subventions, which are one of the key sources of funding for capital projects, have long been unpredictable and determined on an annual basis using non-transparent criteria and priorities (OECD, 2014a). This situation is changing thanks to the creation of the State Fund for Regional Development (SFRD) and the introduction of two new funds for subnational public investment: the subsidy for development of infrastructure and the subsidy for social and economic territorial development.

The SFRD was established in 2013 to support the State Strategy for Regional Development. It finances investment programmes and development projects prepared and submitted by subnational governments. Initially, the attributable funds were allocated to the regions on the basis of a simple formula: 70% was allocated among all regions, according to population, and 30% was allocated based on the proportion of the population falling below 75% of the country's average GDP per capita. These proportions have changed recently to an 80/20 split.

In 2016, the state budget also introduced a subsidy for social and economic territorial development (UAH 3.3 billion, 3 711 projects) and the subsidy for development of infrastructure in the UTCs (UAH 1 billion, 1 383 projects) to finance development and infrastructure projects in targeted UTCs. Funds are allocated among the UTCs in equal proportions to their area and the size of the rural population, and are destined to fund the construction of administrative service centres, the renovation of social and educational infrastructure facilities, the construction and repair of roads, water supply facilities, the introduction of energy efficient measures, etc. In 2017, these two funds increased to UAH 1.5 billion and UAH 4 billion, respectively.

Box 3.4. An inefficient use of central government transfers in the social, health and education sectors

The health, education and social sectors are oversized and fragmented in Ukraine in terms of network size and staffing, as well as quite inefficient and deliver poor results. Ukraine has about 40% more hospital beds per capita than the EU average. Despite this over-developed infrastructure, only basic services are provided. Ukraine's score is among the lowest of all transition economies. A survey conducted in 2015 indicates that only 10% of Ukrainians had a good opinion of the quality of care in Ukraine. Eighty-five per cent consider the quality of healthcare services bad or very bad and deteriorating. In education, the school network is large but does not correspond to the pupil enrolment rates, which are declining, especially in rural areas. In the social sector, social assistance spending (cash transfers) is high – among the highest in the region – but Ukraine ranks low in terms of effectiveness of support. By contrast, social care services (support to old age, disability, child services, etc.) are underfunded.

While education and health networks have excess capacity, they lack equity. Schools and medical units in small communities are often understaffed and cannot provide quality services to the local population. Per capita expenditure on education and social services is not homogeneous across territories. The welfare system tends to increase inequities, and social assistance is insufficiently focused on the most vulnerable. Instead, the system tends to favour "categorical benefits" and a "privileged population" that is not, on average, poor.

Education, health and social assistance services are also inefficiently managed. The World Bank found over 70 local government welfare programmes and 39 central government programmes that lack monitoring, management and co-ordination. In the social care area, a significant share of resources is managed by *oblasts* but not in an efficient manner.

The grant system is partly responsible for the situation, as transfer levels are determined by norms and input-driven indicators based on historical data, rather than on demand-driven indicators based on assessed service needs. For example, the number of doctors is based on the existing number of beds in healthcare facilities and in schools, non-teaching staff is based on the number of square metres of a school facility. In addition, there is a high level of current expenditure that leaves very few resources for capital investments and quality-enhancing projects. Poor municipalities often do not have the capacity to maintain and repair their medical and education facilities, as all their resources are dedicated to operating expenditure. Only the wealthier municipalities can use their own-source revenues to cover financing and operational gaps, and renovate and invest in new infrastructures.

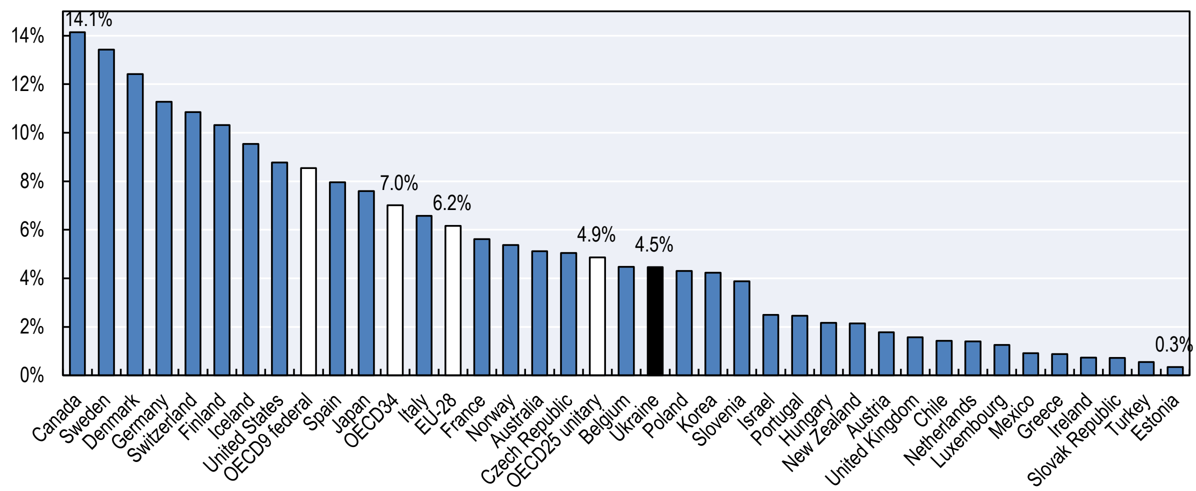
The consequences are paradoxical: a high level of expenditure but a low level of satisfaction in terms of access and quality of services.

Source: World Bank (2017a), "Ukraine: Public finance review", http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review; OECD (2014a), OECD Territorial Reviews: Ukraine 2013, http://dx.doi.org/10.1787/9789264204836-en.

Tax reform has impacted shared and own-source taxation systems

Subnational government tax revenues are low and do not result from their exercise of taxing power. In 2015, subnational tax revenue in Ukraine amounted to 4.5% of GDP, below the OECD and EU-28 averages of 7.0% and 6.2%, respectively (Figure 3.16). Subnational tax revenue amounted to 18% of total tax revenue – compared to 38% in 2001 – well below the OECD average (31%) and the EU-28 average (23%).

Figure 3.16. Subnational tax revenue as a percentage of GDP: OECD countries and Ukraine, 2015



Source: OECD (2017a), "Subnational governments in OECD countries: Key data" (database), http://dx.doi.org/10.1787/region-data-en. For Ukraine, OECD calculations based on IMF, "Government finance statistics", www.imf.org/en/Data.

Tax-sharing arrangements are particularly important in Ukraine, as it appears that tax revenues are mostly generated from tax sharing with the central government. This represents a further limitation on subnational fiscal autonomy. Approximately 67% of subnational government tax revenue comes from the PIT. The allocation of shares to subnational governments is set in the Budget Code according to a fixed percentage of tax collected locally. Percentages vary according to the category of subnational government: subordinate governments are unable to adjust tax rates or bases. Own-source taxes are limited and all tax receipts are administered and controlled by the State Fiscal Service.

The reforms introduced in 2014 and effective in January 2015 affected shared taxes and own-source taxes. On the one hand, tax-sharing arrangements were modified between the central government and subnational governments and across subnational jurisdictions. Shared taxes now represent a lower share of total subnational government tax revenue. On the other hand, the list of local taxes was modified: some taxes were abolished while others were created or reformed. Furthermore, subnational governments were given more ability to modify tax rates and bases (Annex 3.D). Despite these reforms, it should be noted that globally the level of subnational tax revenues has diminished relative to GDP, to public tax revenues and to subnational revenues.

A new distribution for shared taxes

The reform has also modified tax-sharing arrangements between and across levels of government, especially with respect to the PIT, the CPT, the excise tax on retail sales of excisable goods, environmental taxes and rents for the use of natural resources.

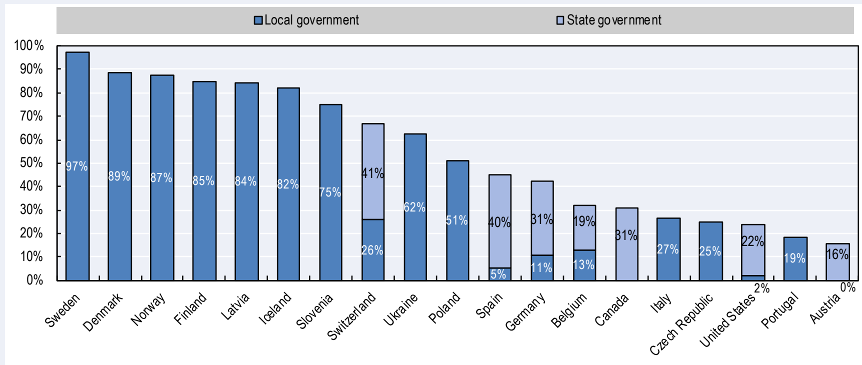
The 2014 amendments to the Budget Code modified the PIT vertically and horizontally. Vertically, the share attributed to subnational governments has decreased in favour of the central government. Prior to the reform, PIT receipts were fully redistributed to the subnational governments (except for Kiev). With this reform, the central government now receives 25% of the PIT as a general rule. Horizontally, PIT shares for each category of subnational government have changed. Overall, the weight of the PIT in subnational tax revenue dropped between 2014 and 2015, from 79% to 62%. Towns of *rayon* significance, villages and rural settlements which have not merged have lost their share of the PIT. Despite the share of the PIT redirected to the central government,[5] in 2016 it still represented 54% of subnational tax and fee revenue, which is not unusual for some OECD countries (Box 3.5).

Box 3.5. Personal income tax in OECD countries: A significant source of revenue for subnational governments

In OECD countries, the personal income tax (PIT) can represent a significant proportion of subnational tax revenue. In countries such as Denmark, Finland, Iceland and Sweden, where the share of PIT in subnational tax revenue ranges from 82% to 97%, it is a local own-source tax, not a shared tax. In Denmark, the local PIT is collected by the central government together with the national PIT. In Finland, the base of the local PIT tax is determined by the central government, but municipalities have full control over the rate. In Sweden, subnational tax revenues come almost entirely from the local PIT, which is an own-source tax, levied independently from the national PIT. Municipalities and counties have the same tax bases but decide independently to set their tax rate. In Norway, the revenue from the PIT on ordinary income is collected by the municipalities for the central government, the counties and the municipalities. The split of PIT revenues between the three levels of government is determined by parliament as part of the national budget. The tax level is set annually by the Norwegian parliament as the maximum level of municipal income tax. In principle, counties and municipalities can lower the income tax rate for their municipality, but in practice all use the maximum rates. In Portugal, the two autonomous regions enjoy a certain degree of tax autonomy. They are able to retain nearly all of the PIT generated within their territories, and exercise strong control over the rate and base. Portuguese municipalities receive a local PIT surtax capped at 5% of tax receipts collected from local residents, though municipalities can decide to reduce this percentage. In Italy, the PIT is a shared tax and an own-source tax. Part of the PIT receipts are shared and local governments can also choose to levy a surtax on the PIT.

Finally, in some unitary countries such as Latvia, Poland and Slovenia, the PIT is shared and accounts for more than 50% of subnational tax revenue. In Estonia, Lithuania, Romania and the Slovak Republic, until a reform of the System of National Accounts, the PIT was considered a shared tax between the central and subnational governments. With the new methodology, PIT receipts have been reclassified as central government transfers and no longer as tax revenue.

Figure 3.17. Personal income tax receipts as a share of subnational tax revenue in selected OECD countries and Ukraine, 2015



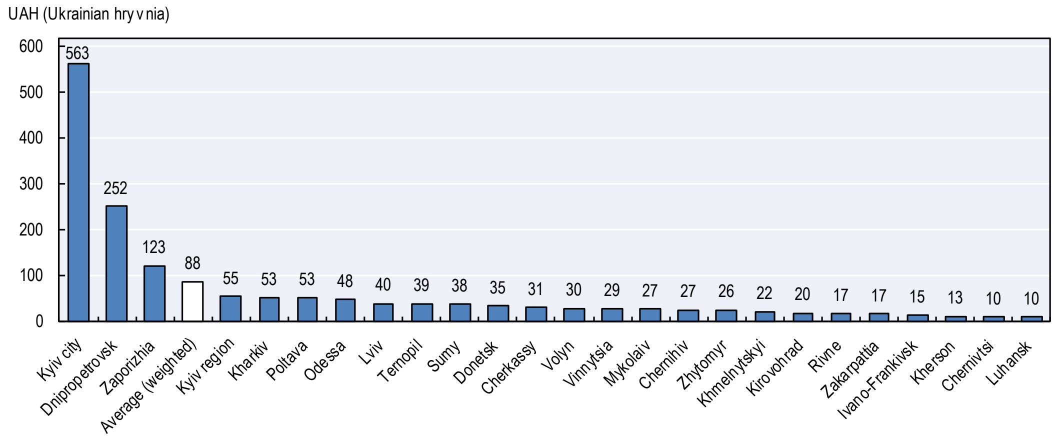
Source: based on OECD National Accounts and State Treasury Service of Ukraine, www.treasury.gov.ua. Execution of the budget (revenues). The definition used is "taxes on individual or household income including holding gains".

Source: (OECD, 2018), OECD Tax Database, OECD, Paris, http://www.oecd.org/tax/tax-policy/tax-database.htm and https://www.oecd.org/ctp/tax-policy/personal-income-tax-rates-explanatory-annex.pdf.

Since January 2015, the corporate profit tax is shared, with *oblasts*, ARC and Kyiv receiving 10% of CPT receipts.[6] The CPT is paid where a company is registered. This generates considerable disparities between regions, in particular a rather unfortunate bias in favour of larger cities, especially Kyiv (Figure 3.18). The CPT represented 4% of subnational tax and fees revenue in 2016.

As part of the reform, the retail excise tax on alcoholic beverages, tobacco, petroleum and gas was introduced in subnational budget revenue in January 2015. All receipts are allocated to local governments, including Kyiv. In 2016, it accounted for 7.9% of subnational tax revenue, 3.2% of total subnational revenue and 0.5% of GDP, which is quite significant. In addition, subnational governments receive a share of environmental taxes (i.e. ecological tax and pollution charges) as well as rents for the use of natural resources (water, forest resources, subsoil) whose shares were modified in 2015.

Figure 3.18. **Corporate profit tax receipts per inhabitant per region and Kyiv, 2015**

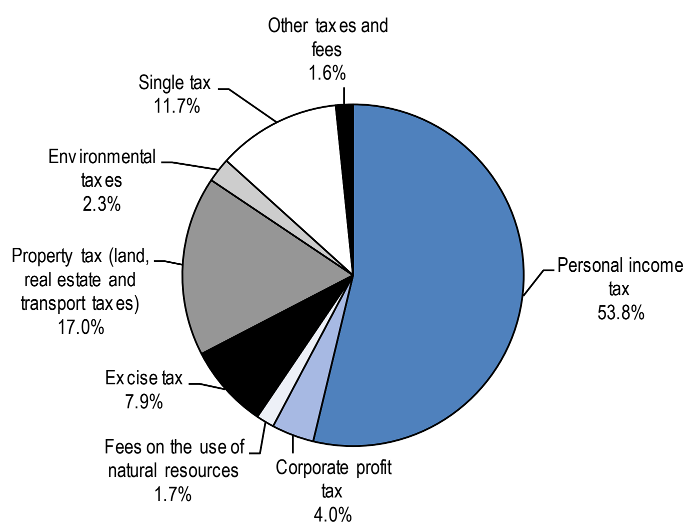


Source: Based on data from INEKO, http://budgets.icps.com.ua.

A renewed system of local taxes and fees with an increased taxing power

Some minor taxes were abolished in January 2015 and new local taxes were introduced by the Tax Code. In addition, the local government taxing power on local taxes and fees was enlarged, as they now have greater freedom to set rates and establish exemptions. The new system of local taxes and fees comprises four main local taxes: the single tax (also called the unified tax), the property tax, the parking fee and the tourist tax (Figure 3.19).

Figure 3.19. **Breakdown of taxes and fees in total subnational taxes and fees, 2016**



Source: Based on based on data from State Treasury Service of Ukraine, www.treasury.gov.ua, Execution of the budget (revenues).

However, local taxes and fees still represent a small share of subnational tax revenues and total revenues, respectively 29% and 12%. They also amounted to only 1.8% of GDP. In addition, rates remain capped and there are some other limitations concerning the ability to set rates and modify bases. For example, the tax rate of the single tax for individual entrepreneurs is decided by local councils, but is capped, while for the other groups of taxpayers there is no taxing power: it corresponds to a fixed percentage of value-added tax (small businesses) or value of agricultural land (agricultural producers). The rate of land tax and the real estate tax other than on land are capped while the rate of the transport tax is fixed (Box 3.6).

Box 3.6. The reform of the property tax in Ukraine

In 2015, Ukraine reformed its property tax (Article 265 of the Tax Code of Ukraine), which is now composed of three different sub-taxes:

1. The land tax/rent: existing since 1992, it is a mandatory "local" tax or rent (depending on the legal status of the land plot) since 2015. It is levied on legal entities and individuals. The tax rate is set by local authorities but capped (between 1% and 5%), while the amount of the rent is also capped. The land tax/rent is the main component of the property tax, representing in 2016 around 93% of its receipts, 15.9% of subnational tax revenue, 6.4% of subnational total revenue and just under 1.0% of GDP.
2. The real estate tax other than on land, has been effective since 2015 in its new form. It is now paid by owners of residential real estate properties as well as by owners of non-residential properties, both individuals and legal entities, including non-residents. Cities may impose tax rates on properties based on location (locations bands) and type of real property, from 0% to 1.5% of the minimum wage per square metre of the taxable base as of 1 January. Local authorities can also decide on exemptions and reduced rates. In particular, they can determine the area of the property that is not taxed. Only "extra square metres" are taxed. Tax assessment is based on the state register of property rights, but since 2015/16 also on information collected through the certificate on property rights. This tax accounted for 5.7% of the property tax receipts in 2016, 1% of subnational tax revenues, 0.4% of total subnational revenue and 0.06% of GDP.
3. The transport tax was also introduced in January 2015. It is paid by individuals and legal entities who own cars registered in Ukraine. Cars not older than five years and with an average market value more than 750 times the minimum wage are taxed by UAH 25 000 per year. This tax is minor, accounting for 1% of the property tax receipts, 0.2% of subnational tax revenue, 0.07% of total subnational revenue and 0.01% of GDP.

The reform of the property tax, with the introduction of a real estate tax, is a positive step for Ukraine, and is aligned with both economic theory and tax practices in many other countries (Box 3.7).

Non-tax revenues are quite constrained but are increasing

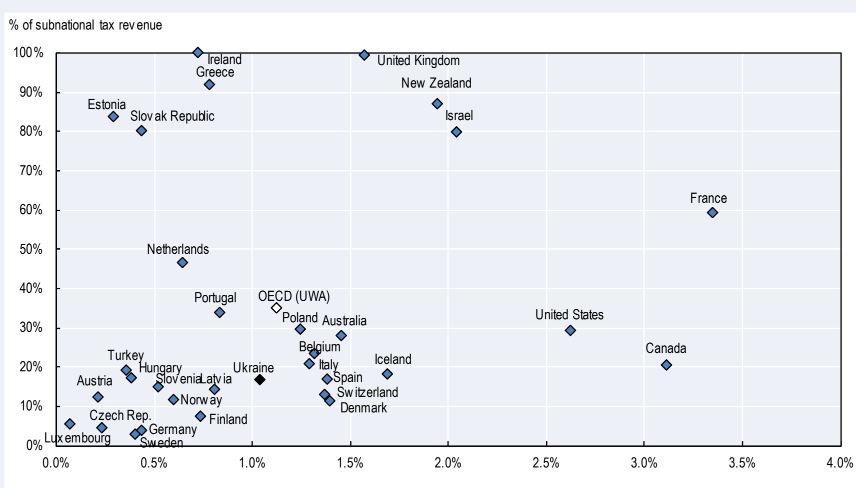
Non-tax revenues, which represent 10% of subnational revenues, are generated by property (6%), and administrative fees and revenues from "business activities" (4%). The share of non-tax revenues in total revenues increased from 6% in 2012 to 10.5% in 2015.

Box 3.7. The subnational property tax in the OECD

The property tax is a cornerstone of local taxation in many countries but its implementation and management face many obstacles. The merits of the property tax are regularly praised by economists: visibility, lack of tax export, productivity thanks to the stability of tax bases and solid return on tax collection, lack of vertical tax competition by exclusive or priority allocation to the municipal level, implicit progressivity (property values rise alongside the revenue of their owners), and horizontal equity (OECD, 2017b). These merits do not conceal the weaknesses and limits inherent in its practical application and management, which raise debates and encounter many difficulties. These obstacles explain that the significance of recurrent taxes on property in subnational tax revenue and GDP remains modest, although it varies considerably across countries.

In the OECD, recurrent taxes on property represent 35% of subnational tax revenue on unweighted average but between 90% and 100% of local tax revenue in Australia, Ireland, Israel, New Zealand and the United Kingdom, which are mostly Anglo-Saxon countries. At the other end of the spectrum, it is a minor local tax revenue source (less than 10%) in Nordic countries (Finland, Norway and Sweden), Estonia, Luxembourg, Switzerland and Turkey (OECD, 2016c). It represented 17-30% of local tax revenue in Hungary, Iceland, Japan, Korea and Poland. As a percentage of GDP, recurrent taxes on property range from 0.1% in Luxembourg to 3.1% in Canada and 3.3% in France, the unweighted OECD average amounting to 1.1%.

Figure 3.20. **Subnational recurrent taxes on property in the OECD and Ukraine**



Note: 2016 is the year of reference for Ukraine; 2013 and 2014 are the reference years for the other countries. Includes: taxes on land, buildings or other structures (D29a) and current taxes on capital (D59a).
Source: Based on data from OECD National Accounts for Ukraine and State Treasury.

Source: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, http://dx.doi.org/10.1787/9789264279049-en; OECD (2016c), *Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en.

Revenues from property[7] tend to be increasing. For example, revenues resulting from the lease of public land could increase in the short term thanks to the June 2017 Cabinet Resolution on Land Resources Management System at the Local Level. The resolution provides that lands will be leased out through auctions only, and a period not to exceed seven years. The amount of land which may be transferred free of charge should not exceed a quarter of the land plots forming the object of the auction. The objective is also to reduce abuses and corruption related to lease of land, ensure more transparency and increase local revenues (Despro, 2017).

Another example of revenue generation from land is the introduction of a land value capture instrument called "shared participation in infrastructure development" allocated to subnational governments in the Urban Planning Law of Ukraine. The law has created a procedure for determining the amount of shared participation (contributions) that developers (investors) need to pay when they engage in construction, reconstruction, rehabilitation, overhauls, re-equipment, etc. of any property. These revenues are directed at developing city infrastructure. In Kiev, the shared participation is charged under the agreement with Kyiv based on the customer's application and supporting documents. Between 2014 and 2015, the total value of shared participation agreements increased by about 190% in Kyiv.

The revenue from the administrative services fees has also been increasing since the amended Budget Law extended the list of services to be delivered by local governments[8] instead of the central authorities. These local governments now collect the associated fees. A network of administrative service centres (ASCs) was created to help improve administrative service delivery. There were 713 ASCs functioning in 2017, 208 of which were created by local governments and 22 in the UTCs with the support of U-LEAD.[9]

Revenues from business activities are generated by the delivery of local public services, i.e. user charges and tariffs. Here, local governments can establish some charges and tariffs, but this ability is regulated by a complex system which includes legislated limitations to the local government's powers. Significant reforms are ongoing, including that of local public service tariff setting. Specifically, in March 2017, when the National Commission for State Regulation of Energy and Public Utilities passed a resolution on the expansion of powers of local governments in tariff setting. Local governments can now set tariffs for heat energy production, transportation and supply. Of the currently operating licensees in this area, 74% will become subject to licensing by local authorities. The same will apply in the water supply and sanitation sector: 67% of the currently operating licensees will be supervised by local authorities.

Borrowing and financial management frameworks are becoming more flexible

Subnational government debt is very low and highly restricted

Local government borrowing is underdeveloped in Ukraine. In 2016, it accounted for 0.5% of GDP and 0.6% of public debt (Figure 3.21). Moreover, subnational debt has decreased regularly since 2007, both as a share of GDP and in relation to public debt. Compared with OECD countries, Ukraine has a very low level of subnational debt, close to that of Chile (where there is no official local debt), Greece, Hungary, Ireland and Slovenia.

Box 3.8. Local public service tariff setting in Ukraine

The system of tariff setting is regulated by several laws, in particular the Law "on Housing and Communal Services" No. 1875 of 2004, Law No. 2479 "on State Regulation in the Communal Services Sector" of 2010, as well as sectoral laws on heat supply, water and drinking water supply. In addition, the Tax Code is part of the framework for tariff setting of utilities as well as decrees of the Cabinet of Ministers and resolutions of the national regulatory commission.

The 2010 law in particular established a new system of state regulation in the sphere of municipal services, based on a new national regulatory body: the National Commission for State Regulation of Public Utilities. It took over from local governments the power for setting tariffs for publicly provided water supply and wastewater collection and treatment, transportation, and heating services. However, local governments are in charge of setting tariffs for utilities that are not regulated by the national regulator. These local tariffs must be approved by the Cabinet of Ministers of Ukraine.

In September 2016, a new long-awaited law was adopted setting up a new National Commission for State Regulation of Energy and Public Utilities. It shall become the independent public authority for state regulation, monitoring and control of the energy and public utilities sectors, for granting licences and for establishing tariffs.

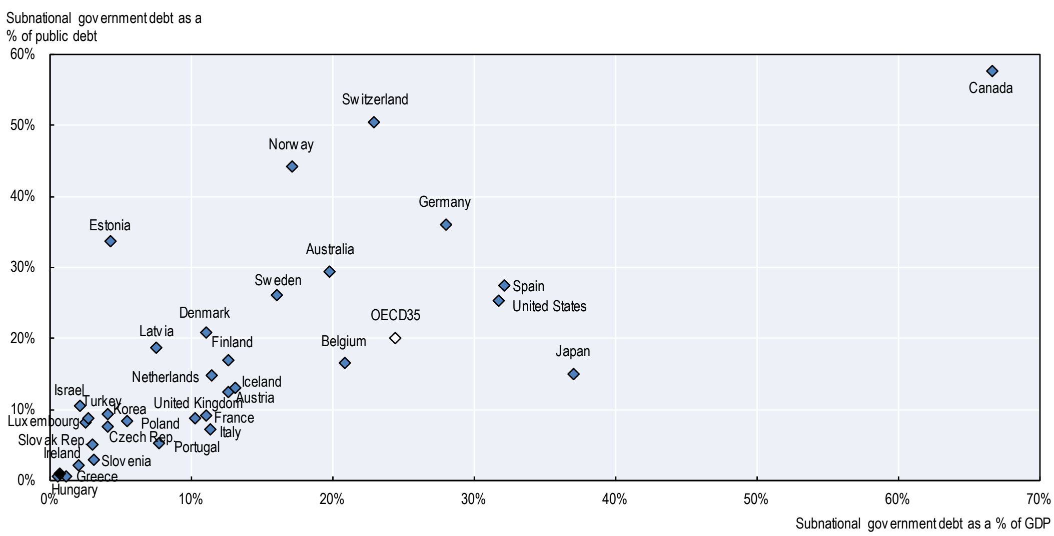
In March 2017, the national government passed the resolution on the expansion of powers of local governments in tariff setting. These later will set tariffs in the areas of heat energy production, transportation and supply. Seventy-four per cent of the currently operating licensees in this area will become subject to licensing by local authorities. The same will apply in the water supply and sanitation sector. Sixty-seven per cent of the currently operating licensees in this area will be supervised by local authorities.

Source: Shugart, C. and A. Babak (2012), "Public private partnerships and tariff regulation in the water, wastewater and district heating sectors", http://ppp-ukraine.org/wp-content/uploads/2015/03/Tariff-Regulation-Report-ENG.pdf; DESPRO (2017), "Decentralisation in Ukraine", http://despro.org.ua/library/Decentralization%20Newsletter_March_2017_ENG.pdf.

Subnational government debt is composed of internal debt (77%) and external debt (23%). It composed mainly of loans, as the share of securities is very low (2% of debt stock as of 1 January 2017, a decrease from previous years). This is linked to debt restructuring and partial redemption of domestic bonds. Within loans, the share of banks and financial institutions is limited compared to the Treasury (26% vs. 74% in 2016). International financial institutions (e.g. the European Bank for Reconstruction and Development, the European Investment Bank, the World Bank, the Nordic Environment Finance Corporation, the International Finance Corporation, KfW Development Bank, etc.) are among the major investors in Ukraine's municipal service sector, including in transport, infrastructure, heat, water, waste management and energy efficiency measures (EBRD, 2014). Debt is very concentrated, with Kyiv representing around 40%. The debt per inhabitant reached UAH 2 229 in 2015 in Kyiv, ten times more than the weighted average of the other 21 regional capital cities (Figure 3.22).

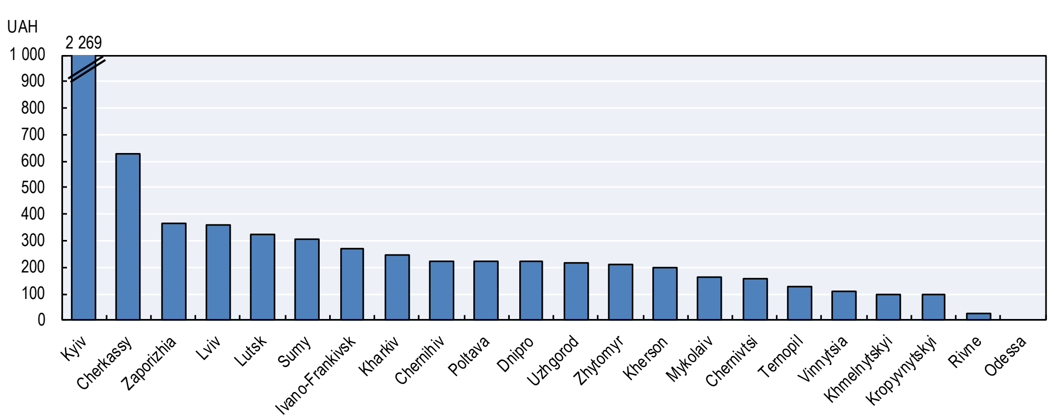
The low level of debt and its characteristics reflect the constrained legal framework that surrounds borrowing (Box 3.9). It also arises from a conservative stance in authorising municipal borrowings since 2013. Borrowing is strictly controlled and co-ordinated by the central government, and all decisions on municipal borrowing are taken by the Ministry of Finance. Most municipal bond applications have been rejected over the past several years, in response to international pressure on the Ukrainian administration to lower its public debt (Storonianska, 2013).

Figure 3.21. **Subnational public debt as a percentage of GDP and public debt in the OECD and Ukraine, 2015**



Source: Based on data from IMF database (Government Finance Statistics - www.imf.org/en/Data) and State Treasury Service of Ukraine, www.treasury.gov.ua.

Figure 3.22. **Debt per inhabitant of regional capital cities, 2015**



Source: Based on data from INEKO, http://budgets.icps.com.ua. No data available for Donetsk and Luhansk.

Box 3.9. Subnational government fiscal rules in Ukraine

The Budget Code provides a legal framework for the local government budget system. It includes the underlying principles, budgeting process and relationships between the state budget and local budgets. It is complemented each year by the Law "on the State Budget of Ukraine". Local budgets are comprised of two parts, the General Fund and the Special Fund:

1. The General Fund is formed by the personal income tax, the property tax, the single tax (since January 2015), the corporate profit tax, some non-tax receipts and operating transfers from government. It is allocated for operating spending (e.g. salaries, maintenance, interest, etc.).
2. The Special Fund is formed by non-tax revenues (own revenues of budgetary entities, assets sales) and capital grants. Resources are earmarked going mostly to capital spending and debt repayment. It comprises the development budget (for capital expenditure and big repairs), the Special-Purpose Fund (special-purpose programmes, such as capital expenditure, repayment of borrowings, creation and rehabilitation of green belt areas, provision of urban amenities, etc.) and the Environmental Fund (environmental programmes) and others. The law allows for transfers from the General Fund to the Special Fund, but not vice versa.

Table 3.1. **Budgeting and fiscal rules applying to subnational governments in Ukraine**

	General Fund	Special Fund
Revenues	Taxes, including a share of personal income tax and operating subsides.	Property taxes and earmarked fees, assets sales and capital grants.
Expenditure	Operating expenditures, including salaries and interest payments.	Development-related expenditures, including capital spending and debt repayment.
Deficits and surplus	Deficit is not allowed, unless it can be covered by free cash. Surplus is allocated to the development budget, repayment of outstanding borrowings and maintenance of the operating balance of budget funds at a predetermined level.	Deficit is allowed and must be financed by asset sales, borrowings, free cash or transfers from the General Fund. Any Special Fund surplus is allocated to repayment of municipal debt and/or acquisition of securities.
Direct debt plus guarantees	Not allowed.	Must not exceed 200% of the average forecast revenue in the development budget over the next two years (excluding multilateral loans guaranteed by the state). Must not exceed 400% for Kyiv.
Interest payments (as % of expenditure)	10%	Not allowed.
Borrowing	Must be authorised by the central government.	Must be authorised by the central government.
Borrowing in foreign currency	Not allowed.	Allowed. Bonds and loans allowed for cities of regional significance. Loans from international financial institutions allowed for all.
Budget payment	Via State Treasury for all budgets.	Via State Treasury for all budgets.
Default	No right to borrow for five years after default.	No right to borrow for five years after default.
Oversight	State Treasury, Ministry of Finance.	State Treasury, Ministry of Finance.

Source: Adapted from Standard & Poors (2013), "Public finance system overview: Ukraine local government system is volatile and underfunded".

While still strict, the 2014-15 reform loosened the regulatory framework for subnational borrowing. It offers a simplified procedure for local government borrowing and guarantees based on the principle of "tacit consent".[10] In addition, the scope of borrowers has been extended: all cities of *oblast* significance are now allowed to borrow long term using both loans and bonds, as well as in foreign currency from banks and international financial institutions. *Oblasts* and *rayon* are still not allowed to borrow, with the exception of the Autonomous Republic of Crimea. It must be also noted that since 2011, all municipalities, regardless of population size, have the right to borrow, but only through loans and only from international financial institutions.[11] To ensure compliance with the threshold of the public (local) debt and government (local) guarantee, the central executive body keeps a Register of Local Borrowing and Local Guarantees – an information system that contains details on the local borrowing incurred and local guarantees granted.

Budgeting and financial management are being improved

Different local management reforms have been undertaken to improve administrative and executive processes. They cover diverse areas, including human resources management, financial management (i.e. budgeting, accounting and debt management), organisational management, optimisation of administrative process, e-government, quality management, open government, citizen participation, etc. which are beyond the scope of this report.

In Ukraine, subnational financial management is constrained by a number of restrictions and limits imposed by the national legislation, the Ministry of Finance and the State Treasury. Subnational government revenues are directly administered by the State Treasury. In addition, they have little ability to manage their own revenues, due in part to a degree of regulation, and in part to a lack of human, financial and technical capacity to administer resources, except in very large cities.

Several measures were introduced in 2015 that introduced greater flexibility to financial management and budgeting. For example, subnational governments are now authorised to open accounts in state banks, not only in the State Treasury, in order to deposit their own revenues derived from budgetary institutions and development funds. This has eliminated, or reduced, the prior dependence that subnational financial operations had on decisions of the government (EBRD, 2014). Subnational budgeting is being modernised as well. Local governments are now fully responsible for their budget planning, rather than having local earnings and expenditures planned by the Ministry of Finance (Kantor, 2015). The principle of budgetary autonomy was expanded, and deadlines for approval of local budgets have been clearly defined, irrespective of approval of the state budget. Finally, Ukraine is transitioning to multi-year budgeting and a medium-term expenditure framework, which offers the potential of greater predictability with respect to financing. This has been done at the subnational level in several OECD countries, including Belgium (Flanders), with its six-year strategic planning system and innovative digital reporting system. Subnational multi-annual budgeting will be trialled in 2018-20 (Ministry of Finance) in order to better develop medium- and long-term investment projects. The introduction of results-oriented budgeting is also foreseen.

The impact of fiscal decentralisation reform and challenges ahead

Though still in their early stages of implementation, the 2014-15 reforms have started to reap positive results. This process, however, has taken place in a differentiated way, which could rapidly become an issue for the success of decentralisation. Moreover, despite some real progress in terms of fiscal decentralisation, i.e. increased fiscal autonomy in some areas, the reform still tends to promote a subnational financing model based on grants and subsidies more than own revenues. Transfers from the state budget are vital to financing devolved responsibilities, and they have steadily increased over recent years to become the main source of revenue for subnational governments. Paradoxically, this means that fiscal reform, which was meant to favour decentralisation, has led to greater dependence on the central government.

Fiscal decentralisation should be sustained and further deepened

Fiscal decentralisation is helping transform the governance system, but it may be at risk

Because of the difficulties in advancing decentralisation through political and administrative reforms as explored in Chapter 2, fiscal decentralisation has been used as a tool for transformation. It is inducing profound changes in the distribution of powers.

Fiscal decentralisation has paved the way for a new balance of powers among subnational governments. As already underlined, budgets of cities of *oblast* significance and the UTCs have increased substantially. *Oblast* administration revenues have shrunk while those of the *rayon* administrations have not shown any significant change for the moment (Levitas and Dkijik, 2017; World Bank, 2017a). Changes in the tax system and grant allocation have shifted subnational organisation and responsibilities.

This pragmatic method has produced some good results, allowing the “critically needed momentum to be maintained” (Levitas and Dkijik 2017). But it may also produce some undesired outcomes that will be difficult to correct in the future. The reduction in *oblast* administration budgets (and thus of their responsibilities) could contradict the decentralisation reform objective of creating full self-government entities at the regional and intermediate levels. This approach can also lead to some “improvisation and frustration” (Levitas and Dkijik, 2017). This may also generate instability and uncertainty among subnational governments, but for the central government as well, and especially for the population and business community, which is directly impacted by these permanent changes.

Fiscal decentralisation now needs to be better conceptualised in a strategic framework. The government could prepare, in association with representative associations of subnational governments at all levels and other key stakeholders, a fiscal decentralisation strategy, in particular concerning the allocation of powers and responsibilities.

On this basis, a road map and implementation plan for fiscal decentralisation should be prepared and discussed in a multi-stakeholder dialogue. A specific permanent “fiscal decentralisation committee” could be established involving key ministers, subnational government associations, business and citizens’ associations, universities, etc. (see below). At the central level, there should be also an inter-ministerial committee on fiscal issues more generally, to ensure consistency of reforms and regulations concerning subnational government finance.

The implementation plan should identify the necessary steps for the successful execution of fiscal decentralisation in terms of adjustments to make or new measures to take. It should also include tools and indicators to monitor the progress of the action plan and regularly assess the outcomes of the reform.

Subnational governments need more stable and autonomous revenue sources

Despite recent fiscal decentralisation measures, Ukrainian subnational governments are still strongly dependent on the state budget and state decisions for their revenues and expenditures. They have no control over more than 70% of their revenue, as it is comprised of grants and shared taxes. The remaining 30% can be considered own-source revenue (i.e. own-source taxes, fees, rents, property income, etc.), providing them with little flexibility. There is a wide gap between own-source revenues and operation and investment spending needs. This results in large fiscal imbalances. It is, therefore, still necessary to increase the share of own-source revenue in subnational revenues, including own-source taxes and non-tax revenues.

Subnational fiscal power should be reinforced through more flexibility in managing grants, and greater access to external funding. Subnational governments should enjoy more freedom in deciding how to allocate grants, without strict guidelines, norms and control from the central government, even if these are earmarked to specific sectors. The distribution of state transfers needs greater stability and transparency. To support subnational investment for local and regional development, access to borrowing should be facilitated with loosened borrowing rules and the strengthening and diversification of the credit market.

Spending responsibilities should be clearer

Delegated expenditure (i.e. in healthcare, education, social protection) amounts to almost 80% of subnational expenditure. Lack of flexibility in spending these funds leaves subnational governments with little spending autonomy. Many local authorities lack the resources to support their exclusive competences, in particular those necessary for the economic and social development of their territories. The weight of current expenditures on local budgets makes it highly difficult to generate self-financing capacity for investment.

Moving forward it will be necessary for Ukraine to (re-)evaluate the assignment of responsibilities across levels of government in order to ease the burden imposed by some functions on subnational governments and to enlarge their spending autonomy. A review of competences and functions among central, regional, intermediary and local levels should be undertaken to clarify the breakdown of responsibilities and to assess the relevance of delegating some functions to subnational governments. Decentralising does not necessarily mean transferring all functions from the centre to the lower levels of government. It means assigning the adequate function to the adequate level according to the principle of subsidiarity.

In Ukraine, numerous tasks are being transferred to the UTCs without a clear understanding of the impact in terms of charges and constraints. Apart from the fact that many small and/or under capacitated communities are ill-equipped to take on new responsibilities, the transfer of several functions to the local level is not always appropriate. This is particularly the case when it does not follow the subsidiarity principle, when it entails diseconomies of scale or when it involves significant current expenditure on behalf of the central government (e.g. paying teachers or doctors, managing hospitals or distributing benefits). This can be counterproductive to decentralisation reform if local governments are not able to effectively carry out the responsibilities entrusted to them by the reform.

On the basis of a comprehensive diagnostic of the distribution of responsibilities and functions across levels of government, Ukraine may want to consider “recentralising” some specific functions, leaving those which are “locally relevant” and best managed by subnational governments at the local level. In the education sector, for example, some heavy current charges could be transferred back to higher levels of government while education investment functions and the associated costs (i.e. maintenance and repairs) as well as some operating expenditure (i.e. energy, extra-curricular activities, administrative services, canteens, pupils transport, non-teaching personnel, etc.) could be maintained at the local level. The idea is not to recentralise the entire sector, but rather to recentralise some functions (potentially more costly ones). In the social sector, the distribution of social benefits could be reassigned to the central level, since income distributional issues and assistance to vulnerable populations are traditionally the domain of the central government (Bogdan et al., 2017).

This reflection should be conducted for all sectors that the government intends to decentralise (and especially education, health and social welfare), in close co-ordination with ongoing reforms. For example, profound changes are foreseen in the health sector which would have a significant change on subnational governments' health responsibilities.

Assigning the right competences and the right functions among the different subnational levels is another challenge. There is no one model for breaking down responsibilities across subnational governments in the OECD. However, a general scheme based on OECD country experience, as outlined in Annex 2B could inspire Ukraine, as work still remains to be done with respect to assigning spending responsibilities and revenues.

Local communities are confronted with significant fiscal challenges

The future of non-amalgamated communities is also worrying in terms of resources. While fiscal incentives were used to encourage amalgamations, unless some action is taken to accelerate and consolidate the amalgamation process, this could create a large imbalance between the non-amalgamated communities and the UTCs.

The unified territorial communities: New budgetary entities with increased spending responsibilities and resources

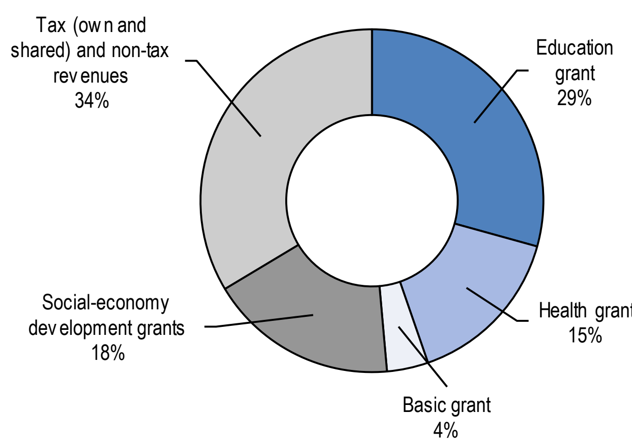
The heterogeneity of the UTCs in terms of size, capacity and financial resources also raises concern. Many UTCs are still too small and are unlikely able to cope with their new responsibilities. Specific actions targeted at the UTCs are needed to face these challenges. Increasing the size of many UTCs to reach a minimum threshold for medium- to long-term sustainability will be important. Co-operation between the UTCs to deliver services and build new infrastructure should be also encouraged as a means to accomplish this. Furthermore, developing a special human resources plan that involves significant support in terms of training and capacity building in fiscal matters would also be of value.

The incentive mechanism to promote mergers is an increase in financial capacity and fiscal autonomy attributed only to the UTCs. Thanks to the fiscal decentralisation reform, the UTCs are autonomous budgetary entities the direct inter-budgetary relations with the state budget, and can now negotiate their budget directly with the *oblast* (regional) government. With more fiscal capacity, however, comes more (transferred) responsibility, including the management of schools and nurseries; primary healthcare; culture, leisure and sports; social aid; and providing administrative services. The UTCs have received resources to cover these, including state funds, shared taxes and own-source taxes, putting them on par with cities of *oblast* significance.

The UTCs have been able to increase both central government transfers and own-source revenues. On the tax side, the UTCs receive 60% of the PIT collected on their territory, 100% of the CPT from local public enterprises, 25% of the ecological tax, 100% of the retail excise tax and 100% of the four main local taxes (i.e. property tax, single tax, parking fee, tourist tax). On the grants side, they receive direct inter-budgetary transfers from the state budget, including an equalisation grant (basic grant) and subventions, and sectoral grants (e.g. for education, health and social protection). They also receive a grant for having merged. Furthermore, they can access capital transfers funds, including privileged access to funds from the State Fund for Regional Development, a subsidy for social and economic territorial development, and dedicated funds for their development projects (subsidy for infrastructure development in the UTCs). Finally, they can benefit from non-tax revenue (previously reserved for cities), in particular payments for administrative services, user charges, revenues from the sale and leasing of assets, etc.

In 2016, grants represented 66% of the UTCs' revenues. Taxes (shared and local) and non-tax revenues accounted for 34% of their revenues (Figure 3.23). Grant funding is 7 points higher for the UTCs than for all subnational governments, highlighting a higher dependence of the UTCs on the central government. This dependence can be even higher: grants represented more than 75% of UTC revenues for 45% of the UTCs, and more than 90% for 7% of the UTCs. By contrast, these UTCs received very few tax revenues (World Bank, 2017a).

Figure 3.23. **Revenue structure for unified territorial communities, 2016**



Source: Adapted from World Bank (2017a), "Ukraine: Public finance review", http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review.

Some government sources estimate that the General Fund of the UTCs (including transfers from the state budget) increased almost seven-fold between 2015 and 2016. In reality, if one eliminates the transfers, they increased by more than three times. In 2017, of the 366 active UTCs, the own-source revenues of local budgets more than doubled, totalling UAH 3.2 million in 2017.

The UTCs are using this increase in own-source revenue to address gaps in social and other infrastructure (e.g. schools, heating, roads, health/dental clinics). In 2016, capital expenditures made by the UTCs reached UAH 52.5 billion, compared with UAH 32.1 billion in 2015 (Ministry of Finance). In 2016, investment expenditure represented 30% of total expenditure – the highest rate for all categories of subnational governments (Levitas and Dkijik, 2017). There is anecdotal evidence that they are also successful in promoting greater economic development and growth. Other positive results associated with the reform is the perception that this new funding structure can improve tax compliance, as mayors have a vested interest in ensuring that taxes are paid, improving the climate for business and innovation, and helping fight corruption.

However, some issues have emerged. First, numerous UTCs are still too small (although no threshold has been defined). Among the 665 UTCs registered in October 2017, covering 28% of the national territory and 13.4% of population, 35% have fewer than 5 000 inhabitants, while the average is 8 565. There are, on average, 4.7 communities amalgamated in one UTC (Ministry of Regional Development, October 2017). Small UTCs are unlikely to achieve economies of scale in service delivery. This could undermine efforts to rationalise education, health and social healthcare networks and facilities (World Bank, 2017a).

Although they have received transfers and tax revenue, the transfer of former *rayon*-owned assets has yet to be completed and personnel have yet to be reassigned. As a result, the UTCs have to transfer funds from the state budget to their former *rayon* to pay for services the *rayon* is still providing (World Bank, 2017a).

The UTCs do not all have the same financial capacity. A 2017 study undertaken for the Ministry of Regional Development showed that UTCs with a low number of residents had limited capability to provide all of the required services to their residents, and limited capacity for sustainable development. By contrast, those UTCs with a larger number of residents had higher indicators of earned revenues per individual community resident.[12]

The UTCs also face a lack of technical capacity to manage new responsibilities and funding. In the social sector, providing social care is a completely new function, for which they are unprepared. According to a 2017 Work Bank report, many UTCs have handed this responsibility back to the *rayon* together with the associated funds. The emergence of the UTCs as direct beneficiaries of sectoral subventions thanks to the decentralisation process has resulted in an increase of the total number recipients of sectoral grants. This represents progress, as they now receive direct funding to carry out their tasks. However, it has also deepened the fragmentation of budget resources, which was already high, increasing duplication and risks of inefficiency in the use of resources. This raises the more general issue of the relevance of decentralising health and education to the lower level of government, and underscores the need to review the overall budgeting process, in particular how grants are transferred from the state to local budgets.

A new problem arose in 2017 concerning unspent funds at the local level. These are being accumulated in treasury and bank accounts, instead of being used for maintenance or infrastructure development. Prior to the 2015 reform, unspent funds had to be returned to the state budget. Now, they can be kept and put in treasury accounts or banks accounts. This measure constitutes progress for subnational governments, as they can now keep their funds, accumulating savings for future large projects, and strengthening financial strategies and planning. The practice, however, is now criticised by the government, which is concerned about the increase in unspent funds. According to the Ministry of Regional Development, unliquidated local budget balance funds in treasury and bank accounts are constantly growing. As of January 2017, they amounted to UAH 49 billion, compared to UAH 31 billion the previous year – an increase of 35% in real terms. Significant investment needs are not being covered while subnational governments still claim additional funds. This may, however, reflect the difficulty subnational governments face in designing and implementing projects, due to capacity gaps and/or lack of territorial strategic planning. It is recommended conducting and in-depth survey (possibly by the inter-municipal associations) to understand the reason for such an accumulation.

Improving fiscal dialogue between central and subnational governments

The dialogue between central and subnational governments, in particular through their associations, could be reinforced. At the central government level, there are no formal (or informal) mechanisms of systematic and permanent consultation and co-ordination with subnational governments. A positive step was taken in December 2015 with the creation of the Parliamentary Office of Local Self-Government, which provides information and advisory assistance to representatives of local self-government bodies, and helps to resolve organisational issues regarding their co-operation with parliament.

As far as financial issues are concerned, the influence of subnational governments on the central government is modest, except for some large cities. The government has its reform agenda and takes decisions unilaterally, which translates into limited predictability in terms of changes to the institutional framework. Although the law requires the state to make the draft state budget available to local governments for the purpose of consultation, the vast majority of financial decisions are taken solely by the central government with no reference to other tiers of government (Standard & Poors, 2013). Representative associations of subnational governments are not consulted on the calculations of annual grants or tax-sharing arrangements, contrary to practices in a number of OECD and European countries.

Fiscal decentralisation reform needs to establish, or reinforce, co-ordination mechanisms in fiscal matters across levels of government. Ukraine could set up a permanent state-local government fiscal co-ordination committee which would meet regularly each year. This committee should have a permanent secretariat and a budget to ensure its effectiveness and sustainability. To ensure credibility with government institutions, it should be placed under the prime minister and chaired in a bipartite way, i.e. by a representative of the Ministry of Finance/Regional Development and a representative of an association of subnational governments.

Box 3.10. Select OECD experiences with multi-level dialogue and co-ordination

OECD experience shows that countries with well-developed co-ordination arrangements have a comparative advantage for the introduction and implementation of future reforms (OECD, 2013a).

Co-ordination is well-developed in Australia, Germany, Italy and Spain, where dedicated permanent policy exchanges, forums or “conferences” have been set up at the central and/or regional levels. Co-ordination mechanisms are also widespread in Nordic countries, where co-ordination is ensured through regular formal meetings held between representatives from central and local governments. Subnational government associations are consulted on legislative changes and participate in the dialogue and negotiations with the central government. They can be also associated upstream in drafting legislation that concerns them through precise consultation procedures, but also via multiple informal interactions and exchanges of information, built on mutual trust. There is a genuine “culture of negotiation”, based on transparency and respect for all stakeholders, aimed at consensus-building.

In France the government introduced a “Conference of Territories” (*Conférence des territoires*) and reactivated the Observatory on Local Finance and Public Services in July 2017. The first body, chaired by the prime minister, is composed of members of the government, representatives of local and regional authorities, the parliament and the existing territorial co-ordination bodies. The aim is to ensure that subnational governments are involved upstream in decisions that affect them, to build a “trust pact” between levels of government, and to establish a new mode of functioning and distribution of roles between the state and the subnational governments. The second instrument is a bipartite body aimed a favouring information, dialogue and negotiation concerning new measures that impact local government finances.

Sources: OECD (2017e), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, http://dx.doi.org/10.1787/9789264272866-en.; OECD (2013a), *Investing Together: Working Effectively across Levels of Government*, http://dx.doi.org/10.1787/9789264197022-en.

Box 3.11. **Recommendations for sustaining and further deepening fiscal decentralisation: General principles**

- Better conceptualising fiscal decentralisation in a shared strategic fiscal framework, implemented according to a clear road map that includes monitoring tools and indicators.
- Setting up a permanent sub-commission dedicated to fiscal decentralisation issues. This could be part of the decentralisation committee or council recommended earlier.
- Acting on the side of revenues, in particular by increasing own-source revenues, but also on the expenditure side by undertaking a review of competences and functions to clarify the breakdown of responsibilities across levels of government and to assess the relevance of further delegating or recentralising some tasks.
- Avoid creating a “two-speed system” between dynamic unified territorial communities and the other local communities which continue to resist amalgamation; increase UTC fiscal capacities.
- Improve fiscal dialogue between central and subnational governments through appropriate co-ordination mechanisms, including a permanent state-local government fiscal co-ordination committee.

The system of inter-governmental grants needs further improvement

Preliminary look at the impact of the new equalisation system

It is difficult at this early stage to assess the performance of the new horizontal equalisation system, as it has been in place only since 2015. Such an exercise should be undertaken over a longer period of time. In addition, it should be assessed in conjunction with the equalisation components of other grants, for example in education, social protection and health, once their allocation mechanisms are determined and stabilised. What can be said, however, is that the regional variation in per capita revenues (taking into consideration *oblasts* and all their subordinate jurisdictions) was very low pre- and post-2015 reforms, except for the city of Kyiv. This indicates that the equalisation system was, and still is, effective in equalising subnational government revenues. Significant per capita tax revenue disparities are offset by variations in per capita budget subsidies (World Bank, 2017a).

However, a deeper analysis is necessary. Contrary to appearances, there is a significant change before and after the reform, underlined by a 2016 study by PwC. There is a clear correlation at the regional level between the amount of the net equalisation grant (the difference between basic and reverse subsidies) and regional GDP, which was not the case with the previous equalisation mechanism. That means that the wealthiest regions in terms of GDP transfer the largest amounts to the state budget, while the poorest receive the most. Other positive results are the increased transparency and simplicity of the new system.

Nevertheless, some issues need to be raised. First, the basic grant remains modest, representing 1.3% of subnational revenue in 2016. Second, the basket of taxes taken into consideration for horizontal equalisation is limited to the PIT and the CPT. This basket could be enlarged to include other shared taxes (e.g. excise taxes) or even some local taxes. Third, the exclusion of Kyiv from the equalisation mechanism is questionable, as the city receives a large portion of the shared PIT and CPT (38%), while accounting for only about 7% of the population. Fourth, the new horizontal equalisation system is essentially a "Robin Hood" system based on the redistribution of tax resources across subnational governments from the "richest" to the "poorest" and seems efficient in terms of "solidarity". But it should be closely monitored for its incentive effects in the medium term, especially if the basket of taxes is enlarged to include own-source taxes. Additional time will be needed to identify side effects, any counterproductive effects or fiscal incentives, especially on local and regional development. If it is too focused on horizontal solidarity, a compensation system such as this one can favour "inequity" or "unfairness" and be economically inefficient in the end. It can undermine subnational government efforts to increase their own tax bases and boost regional growth (OECD, 2013b). The experience of several OECD countries in this respect is illustrative. Several OECD countries tend to combine vertical transfers (from the central government to financially weak subnational governments) and horizontal transfers (from wealthy jurisdictions to the poorer ones), as well as arrangements based on revenue equalisation (to reduce differences in tax-raising capacity) or charges equalisation (to reduce differences in the cost of providing public services). In Ukraine, some adjustments could be needed in the future to find a trade-off between solidarity, equity and economic efficiency principles. Implementation of the new allocation mechanisms for sectoral funds will have an impact on territorial disparities. They may include vertical equalisation instruments, based on population needs (i.e. "charges").

The reform of education and health grants should be completed and ensure sufficient and stable revenues

The new system of grants has improved the financing of delegated functions, in particular in education and healthcare: there are more funds and they are better allocated. The flexibility measure concerning education and healthcare grants allows subnational governments to keep unspent funds for the following year in their budgets. In addition to encouraging the rationalisation of funds, it supports investment in local infrastructure.

However, some issues remain and new issues have emerged, becoming more and more sensitive as responsibilities are progressively transferred and taken over by local governments. Underfunded mandates remain. Despite a significant increase in grants, central government transfers are still insufficient to cover all of the delegated functions prescribed by law and to be secured with sufficient revenues (OECD interviews). Thus, subnational governments use other subsidies and own-source revenues to fund delegated functions. This leaves little room for maneuver to cope with the transfer of additional responsibilities and to finance exclusive responsibilities. According to Kantor (2015), 20% of public services are still underfunded. In particular, funding for education and health delegated expenditure is insufficient (e.g. vocational schools as the Vocational Education Grant, created in 2015, was abolished in 2016). Specific funding for capital investment is insufficiently considered in funding allocations.

Furthermore, instability in funding and a risk of inconsistencies between the new expenditure obligations of local governments and the revenue sources assigned to them persist. The reform was intended to promote stability and predictability of financing but it has not done so. Fund allocation rules have been changed every year since 2015, which generates great uncertainty. Until 2016 local budgets had to cover the financing needs of schools and polyclinics, and hospitals predominantly via central budget transfers, including maintenance, repairs and utilities (energy and water bills). In 2017, subnational budgets had to take on a significant part of expenditures for schools and medical institutions, as central government transfers were earmarked exclusively for teacher remuneration and hospital costs, without including utilities and maintenance costs. Local governments are using their local revenues to finance these operating expenditures at the expense of investment, which had to be cut.

The "principles" of grant allocation were determined by the reform based on the switch from an input-driven approach to a demand-driven one – which is more focused on users' needs. These measures, however, have yet to be implemented. The allocation formulas remain the same as those used for 15 years, with some difference: rather than being part of a gap-filling calculation as in the previous equalisation grant, they are "stand-alone formulas" allocating education or medical subventions. This means that the current allocation mechanisms are still based on input indicators and historical data, not output indicators, population needs or performance indicators. Further political commitment and work are needed to address these challenges. The revision of grant allocation mechanisms according to a demand-driven approach should be accelerated in order to encourage an efficient use of resources, ensure the equalisation of resources across subnational governments to improve territorial equity, and increase transparency. This will require developing a list of services and standards in each sector, entailing the commitment of the various ministries responsible for developing new capacities, procedures and data-collection mechanisms. The international donor community could support this, as it is doing in the case of the education sector.

Ukraine needs a comprehensive assessment of the quality of public services

Healthcare, education and social systems still lack a comprehensive assessment of service quality. There are few to no criteria for evaluating the quality of public services in Ukraine and there is no a single methodology for calculating the cost of providing them. This makes it difficult to determine whether local budget revenues will match spending needs or whether local governments use their funds efficiently. Measures should be put in place to gather information about the actual effect policies have on the quality of such services. This information is essential in making the service more respondent to the needs of the population, thereby generating a more efficient use of resources (OECD, 2014a).

Box 3.12. Recommendations for improving the system of intergovernmental grants

To improve the system of intergovernmental grants, the OECD recommends:

- Closely monitoring the impact of the new equalisation system on solidarity, equity and economic efficiency to be able to correct potential adverse effects. Envision some adjustments, for example an enlarged tax basket, the inclusion of Kyiv, an increase of the basic grant.
- Designing and implementing new allocation mechanisms of sectoral grants according to a demand-driven approach, based on output indicators and quality standards.
- Supporting line ministries to increase their capacities, procedures and data-collection mechanisms to manage their new responsibility as fund managers.
- Developing a comprehensive assessment of the quality of local public services.
- Guaranteeing the level, stability and predictability of funds to adequately finance delegated functions and avoid underfunded mandates and inconsistencies from one year to another.
- Integrate capital funding in sectoral grants.

The tax reform needs to move to a new stage

Overall, the tax reform has modified the distribution of national tax receipts across and within levels of government. It has also introduced new local taxes and increased the power subnational governments have over tax rates and bases. The impact on subnational tax revenue taken globally is not evident, however, as subnational tax revenue decreased in 2015 in relation to GDP, public tax revenue and total subnational revenue.

Tax-sharing arrangements

The personal income tax needs adaptation

The PIT reform is a positive measure: its redistribution is better balanced across subnational governments. In particular, it has been a major, and effective, incentive for amalgamations. In addition, the reduction of the PIT weight in subnational tax revenues was welcome, because it reduced the reliance of subnational government budgets on one unique tax and on a revenue source which is very cyclically sensitive.

However, the PIT reform raises several concerns. First, the suppression of the PIT for non-amalgamated local communities is understandable, as it formed part of the incentive mechanism for mergers. However, this deprivation of resources can become problematic for non-amalgamated communities, raising the question of their sustainability.[13] Second, the current PIT collection system is criticised, even if it can be justified. The PIT is collected where people work (i.e. payable at the place of company registration) instead of where they live. As a result, there is a disconnect between the place where local services are consumed and the place receiving the benefits of PIT revenues. Most of the PIT paid by the residents of a given municipality may benefit another municipality, that where the company is registered, generally a neighboring city, but also often Kyiv. This situation leads smaller communities to often indirectly "subsidise" larger cities, while they lack resources to finance their own services and infrastructure.

The justification for the system is mainly technical. Today, there is no universal declaration of income by individual taxpayers, rendering residence-based taxation challenging. Therefore, the PIT is collected at the source – where the companies are registered and PIT administration is the task of employers and the tax administration, with no taxpayer intervention. In the medium to long term and in the perspective of a wider national tax administration reform (including the introduction of mandatory PIT filing by taxpayers), it could be envisioned to change the system of PIT collection to the place of residence instead of the place of work.

Excise tax should be stabilised as a tax targeted at subnational government

Finally, the introduction of the retail excise tax on alcoholic beverages, tobacco, petroleum and gas into subnational budgets represents a positive change. Excise taxes are quite common in the OECD, generally as a surcharge of national tax, but even as a local tax. In fact, there are easily linked to local services or infrastructure such as the tax on petroleum products (redirected to supporting roads) or the taxation of alcoholic beverages and tobacco (used to support healthcare services).

One major issue since the reform has been the change to the retail tax on petroleum. Originally abolished as a local tax because of management problems, as of 2018 it will be used to finance a new Road Fund. It will receive 50% of the proceeds of the excise tax on petroleum products in 2018, 75% in 2019 and 100% in 2020. Sixty per cent of the Road Fund will be channeled to construction, reconstruction, repair and maintenance of roads of general use; 35% will be spent for local roads; and 5% for road safety.

Developing own-source tax revenues

Despite recent progress, the revenue structure remains unbalanced, as own revenues are still under-developed, especially own-source taxes. Ukraine could undertake a comprehensive analysis of its local tax system to identify the main options for reform and a road map for their implementation. The objective would be to develop a mix of own-source taxes. A basket of taxes applied to different taxable basis can provide subnational governments with more flexibility to cope with economic, social or political changes. There are several general principles or guidelines of good subnational taxation that could inspire Ukraine in this reflection. First, it upholds the link between taxes paid and public services received (the "benefit principle" or "pay for what you get"). Property values are, to a great extent, influenced by the actions of local government (quality of infrastructure and services, etc.), so it makes sense that the beneficiaries of rising property values (a rent) should be taxed on some of that benefit. Secondly, local governments need to rely on taxes that are relatively non-mobile and non-redistributive (to avoid base erosion via the movement of firms and households). And finally, local taxes should be designed so that the local tax burden cannot easily be "exported" to other jurisdictions (e.g. via very heavy reliance on sales taxes).

One major obstacle in this process is the difficulty in creating new local taxes (e.g. local business tax on non-wage income tax, business licences imposed on businesses for the services and infrastructure provided by subnational governments, waste collection tax, cleaning tax, street lighting tax), as it increases the pressure on local taxpayers. Fortunately, there are other alternatives. The first is to transfer some national taxes to local governments, by providing them some margin on the rates and/or the base. A review of the Ukrainian overall tax system should take this into consideration. Such transfers should be made in relation to the transfer of new responsibilities and functions, according to the "benefit principle". There are different possibilities in this area and Ukraine could look at international experience to see which taxes could best fit local Ukrainian characteristics.

A second approach is to optimise existing local taxes (bases and rates), in particular the property tax, in its three components: the transport tax, the real estate tax other than land and the land tax. The 2014-15 reform of the property tax, mainly the land tax and the introduction of the real estate tax in 2015, is a large step forward for Ukraine, but there is still a long way to go. The property tax represents a relatively small share of subnational revenue. The low ratio for Ukraine is the result of a narrow tax base, numerous exemptions, and the limitations of the current cadastre and real estate property register, despite recent improvements.

Optimising the transport tax

In 2016, the transport tax generated very few resources for Ukrainian local governments in comparison to OECD countries, where it is generally a significant source of revenue for subnational governments. This tax, called the "motor vehicle tax", "road tax" or vehicle registration tax", paid by owners of a vehicle, has a strong link with local infrastructure provided by subnational governments, in particular road construction and maintenance. If the tax is used to finance roads and other transport needs, it can match payment for the service to the benefit from the service. It has many other advantages: a potentially large tax base; a relatively fair tax, especially if tax is based on the value of the vehicle and there are alternatives to owning a car; a non-exportable base; a simple tax that is relatively easy to pay and collect; a relatively balanced distribution across subnational governments; and a tax that is compliant with environment goals as it can counteract the negative externalities associated with local traffic congestion and air pollution (PwC, 2016).

Boosting the real estate tax

The new real estate tax applied to property other than land is still a minor source of revenue, explained by a very limited tax base and under-utilisation by subnational governments. The thresholds for taxation are very high (tax is not charged for properties under a certain area), exempting a large number of (smaller) properties. The tax rate is not linked to the size of the property, constituting another limitation. Industrial and commercial properties are also excluded, further limiting the property tax. There is a long list of exemptions, determined by the Tax Code but which can be extended by local governments. The local level, however, tends to make little use of its taxing power. Tax rates set by subnational governments are often below what is permitted by the law, making them quite low overall. Meanwhile, gaps between nominal rates and effective rates can be significant. In 2016,[14] the rate was 0.5% in L'viv, Rivne and Kropiwnicki; 1% in Kyiv, Chernihiv, Cherkasy, Ternopil, Khmelnytskyi, Chernivtsi, Lutsk, Uzhgorod, Kherson and Mykolaiv; and 2% in Kharkiv, Dnipro, Zaporizhia, Odesa, Sumy, Zhytomyr, Vinnytsia and Ivano-Frankivsk.

Finally, property registration is incomplete, despite the 2004 Law "on State Registration of Proprietary Rights to Real Property and their Encumbrances" that went into effect in 2013. The law aims at creating a single and more integrated, consistent and efficient system of state registration of real estate rights, covering both lands and buildings (Registration Law). The law introduced certificates to confirm right to ownership of real property (instead of previous state acts) and it is now possible to register through administrative service centres. Currently, only about 20% of taxable properties are on the tax rolls. The other properties are not taxed at all (World Bank, 2017a).

Improving the land cadastre, valuation methods and land market

The absence of an efficient and reliable unified cadastre remains a significant issue, despite several important advances. Implementation of the 2011 Law of Ukraine on State Land Cadastre (Land Cadastre Law) got underway in 2013, bringing some important changes to the availability and quality of cadastre data. The data will include boundaries of administrative territorial units and land plots, cadastre numbers and purpose designation of land plots, limitations in use of lands and servitude, normative monetary value of lands, etc. These data are now available on the official website of the State Agency of Land Resources to facilitate the access of individuals and companies to available land plots. However, the process is still ongoing.

The other issue is the absence of an explicit land market, which makes evaluation particularly difficult. The difficulty in this area is related, more broadly, to the unfinished land reform and moratorium on the sales of agricultural land enacted in 1992 and extended in 2005, 2008 and 2012, prohibiting the sale, purchase and transfer of private agricultural land. The result is an undervaluation of agricultural land and imperfect land valuation – both of which have an impact on tax collection. In addition, because of the lack of data about sale prices for land, the evaluation method used to calculate land taxes and land lease payments, the so-called "normative monetary evaluation of land", is based on numerous normative documents rather than on market data (USAID, 2016).

Box 3.13. Recommendations for improving the subnational tax system

- Improve tax-sharing arrangements:
  - Change the system of personal income tax collection to the place of residence instead of place of work.
  - The excise tax should be stabilised as a tax targeted at subnational government.
- Increase revenues from own-source taxes:
  - Undertake a comprehensive review of Ukrainian's own-source tax system to identify the main options for reform and create a balanced "basket of local taxes": creating new taxes, new transfers of national taxes, optimisation of existing local taxes (e.g. transport tax and the real estate tax other than land).
  - Reform the tax on real estate other than land in order to enlarge its base. Several options can be envisioned: abolition or lowering of areas' thresholds; reduction of the cases of exemption; integration of industrial and commercial buildings into the tax base as well as of state-owned lands and property, as both categories also benefit from local public services and infrastructures; bundling various fees into the property tax to raise additional revenues related to local services (e.g. street lighting, cleaning of public spaces, waste collection) and setting up a minimum tax rate to avoid under-taxation.
  - Accelerate the reform to build a modern unified cadastre and property register to better define land and property rights, facilitate transactions, help to resolve land/property disputes and improve tax/rent yields. In particular, a significant effort should be made to complete the registration of lands and properties to enlarge the tax base while reducing inequalities in this area.
  - Improve the valuation methods of lands and real estate properties based on market value, taking into consideration various criteria.
  - Encourage reluctant local governments to fully use their taxing power, in particular by rewarding local government tax effort, as some can be reluctant to exercise this power for political reasons (unpopularity).

Delivering better local public services through more transparent and efficient management tools

Reforming the sector of municipal enterprises for more transparency and effectiveness

The municipal enterprise sector is poorly known and assessed, and has low profitability. This raises several questions regarding transparency and accountability, and their difficulties in terms of funding. Ukraine could undertake a thorough analysis of the "municipal economy" in order to stake stock of municipal companies (including joint stock companies) and the challenges they face, in particular with respect to decentralisation. This would constitute the starting point for reforming the sector in order to improve its funding, profitability, the quality of services provided and overall accountability. Reform in this sector should go hand-in-hand with an overhaul of public service tariffs. Municipal companies should also become a tool for better public investment at the subnational level. If well managed and profitable they can provide significant dividends to their shareholders.

Ukraine could look at international experiences in this field, in particular in Europe where there are about 25 000 local public companies, with particular prevalence in Austria, France, Germany, Italy, Poland and Spain. Local public companies are common and typically used to manage municipal services in sectors such as water and sewage, energy, waste collection and treatment, local public transport, social services, healthcare, but also urban planning and development, etc. Local public companies are very often active in basic infrastructure services where market failures or high transaction costs are present (OECD, 2017b).

Supporting further inter-municipal co-operation for the delivery of public services

At its introduction, Law No. 1508-VII of 17 June 2014 on Co-operation of Territorial Communities, supporting inter-municipal co-operation (IMC), did not generate a high level of co-operative agreements for this form of service delivery, but the situation seems to be evolving positively (Chapter 2). The government should reinforce its support to inter-municipal co-operation, for example by encouraging the creation of joint co-operation bodies, which are permitted by law. Additional regulations could be prepared to favour the establishment of such entities based on private or public law, with clear responsibilities and associated funding. In fact, more formal structures would ensure more financial stability and sustainability, allowing IMC bodies to plan over a longer period of time.

Optimising revenues generated by the delivery of local public services

Today revenues generated by local public service delivery are quite small, with tariffs kept low for social and political reasons. Despite an increase observed over the last years, Ukraine still has among the lowest tariffs in several sectors (e.g. the water sector) compared to other countries in the region (DANUBIS, 2015). As is the case elsewhere, tariffs in Ukraine do not cover operational costs. In addition, the system of privileges allocated to low-income households and to other categories of users further reduces revenues generated by the provision of public services. Numerous sectors are underfunded in Ukraine, in particular housing, municipal utilities and urban public transport. Therefore, services must be subsidised by the national budget, which is insufficient and unpredictable.

The existing legal and regulatory framework for tariff setting is multi-layered and complex. Many of the documents that define rules for calculating utility-specific norms are outdated or inadequate for application to real practice (Shugart and Babak, 2012). The creation of the National Commission for State Regulation of Energy and Public Utilities has not yet led to a clarification of roles or to a simplification.

The decentralisation of tariff setting in the heating and water sectors launched in March 2017 by a resolution taken by the National Commission for State Regulation of Energy and Public Utilities could improve the funding of utility services, but it is too early to draw conclusions. The resolution expanded the powers of communities to set tariffs of heat-energy production, transport and supply, as well as in the area of water supply and sanitation. In both sectors, local authorities will be responsible for approving operating licenses (for 74% of licenses in the heating sector and 67% in the water sector). However, this reform should be accompanied by a significant programme of capacity-building in order to disseminate modern management, and monitoring tools and practices within local governments.

The system of privileges should be also revised beyond their implications for tariff regulation. There is a tendency to shift central government obligations on social protection, transport, housing and municipal utility privileges to local governments while the state budget does not compensate these with the corresponding funds. Beyond the issue of "fair compensation", the reform should aim at providing subnational governments with more powers to apply differentiated user charges and tariffs according to local characteristics, not social needs defined by the national level.

Developing revenues generated by the use and improvement of public domain

Complete the demarcation of local public domain and strengthen the role of subnational government in land management

To develop income from assets, it is necessary first to properly and thoroughly identify these assets and second to have the right to use them. In Ukraine, the issue of municipal land ownership and use is becoming more and more sensitive, in particular in the context of increased decentralisation. Registration of the boundaries of towns, villages and other settlements is still incomplete. According to the Land Governance Monitoring (implemented in 2015 by the World Bank), only 50 communities out of 29 772 had formally registered their boundaries as of end 2015. This undermines the legitimacy of decisions taken by local governments concerning the assignation of land plots. This also lays the ground for land conflicts in several regions. In addition, the low level of municipal land registration in the cadastre tends to encourage non-transparent activities, to reduce economic development and investment, and to diminish potential local revenues. This also weakens the rights of the tenants and land users, making lease relations non-transparent and the local authorities unaccountable for the decisions taken (USAID, 2016). This problem is part of a wider unresolved debate on the land reform.

This issue of property and land-use rights has also become one of the biggest sources of pressure between the UTCs and state administrations – be it at the central, *oblast* or *rayon* level. In fact, the UTCs should have received property and land-use rights for the entire territory formed by the amalgamation of the communities (i.e. land within the individual administrative boundaries, and the land in between them), including the revenues they generate. This has not been the case because of the lack of a legal basis for a transfer of rights by *oblast* or *rayon* administrations, or for a claim to rights by the UTCs. The result is unclear property rights, fragmented land management in the UTCs, and limitations on own-source revenue and decision-making capacity by local authorities.

Several reforms are ongoing in this area to accelerate the definition of boundaries and decentralise land management to subnational governments, but they are facing a lot of resistance. For example, the 2014 draft Law No. 1159 on "Some Measures to Strengthen Territorial Community Role in Land Management" which aimed at reducing the monopolistic power of the State Agency of Land Resources by decentralising land management to independent local councils, was finally abandoned. A new draft Law No. 4355 "on Introducing Amendments to Certain Ukrainian Legislation Concerning Increasing the Local Government Authority in Land Management and Strengthening the

State Control Over the Use and Protection of Lands" was first approved by the parliament in April 2016 but its adoption is still pending. It proposes:

- transfering to local councils the authority to manage state-owned and municipally owned lands located beyond the boundaries of populated areas as the type of the delegated authority (except for the lands of the Ministry of Defence, natural reserve and environmental preservation lands, or other lands of high importance for the state)
- establishing a mechanisms for the UTCs to transfer state-owned lands located beyond the boundaries of populated areas to communal ownership
- providing local governments with the power to exercise oversight over the use and protection of lands.

It appears urgent to complete the registration of boundaries of towns, villages and settlements. A clarification of the responsibilities of central and subnational governments concerning land management is also necessary in order to promote efficiency, reduce corruption and increase revenue from land. In this perspective, Ukraine could envision increasing the role of local governments in land management and accelerate, to this end, the adoption of the draft Law No. 4355 on the Decentralisation of Land Management. As far as the UTCs are concerned, a new draft Law No. 7118 was approved by the Cabinet of Ministers and registered to the parliament in September 2017, which grants them the right to manage state-owned lands that are located within and beyond the boundaries of populated areas, and transferring the ownership of these lands to them.

Develop land value capture instruments

Ukraine could consider developing further land value capture instruments, in particular the system of "shared participation in infrastructure development", already well developed in Kyiv. Such a betterment levy paid by land, building and housing developers (and also from homeowners) is particularly suited to local financing needs and establishes a direct link between an increase in property value resulting from public works and services improvements (e.g. road paving, sidewalk, street lighting, etc.) and an increase in local revenues paid by the beneficiaries of such works and improvements. In addition, betterment levies provide funds which are reinvested almost immediately.

To develop further these instruments, Ukraine could also draw inspiration from international practice in land-based financing instruments. Colombian cities are Latin America's leaders in this area, but there are also interesting arrangements in North America, Europe and New Zealand (Box 3.14).

Box 3.14. Land-based financing instruments: Focus on several international practices

Several Colombian cities are leaders in land-based financing instruments. Inspired by the Constitution, which stipulates that one of the state's duties is to capture the added value generated by public actions, Colombia created two interesting revenue-raising mechanisms aimed at financing urban development by capturing the capital gains from property and land generated by public infrastructure projects. The *Contribución de valorización* (1921) is a betterment levy (also called a special assessment). The *Participación en Plusvalías* (1997) aims at recovering part of the increased land values resulting from the change in land-use regulations (e.g. changing zones, change in the designation of the type of land, change in density regulations, etc.). These instruments are primarily used by large cities, such as Bogota, Barranquilla, Bucaramanga and Cali.

Some of most common fiscal instruments to manage land development in OECD and non-OECD countries are: brownfield redevelopment incentives, historic rehabilitation tax credits, transfer of development rights, use-value tax assessments, development impact fees and betterment levies (OECD, 2017d). Examples of land value capture tools in the OECD include "development charges" in Canada and the United States or tax increment financing districts in the United Kingdom. In New Zealand, councils require development rights or development contributions from developers as part of granting consent for development so that developers bear the costs of new infrastructure (i.e. roads, water and wastewater infrastructure, and community facilities). They account for about 2% of revenues.

Sources: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, http://dx.doi.org/10.1787/9789264279049-en; OECD (2017d), *The Governance of Land Use in OECD Countries: Policy Analysis and Recommendations*, http://dx.doi.org/10.1787/9789264268609-en; OECD (2016a), *Making the Most of Public Investment in Colombia: Working Effectively across Levels of Government*, http://dx.doi.org/10.1787/9789264265288-en.

Box 3.15. Recommendations for delivering better local public services

To deliver better local public services through more transparent and efficient management tools, the OECD recommends:

- Taking stock of the situation of the "municipal economy" and municipal companies, considering the challenges faced with decentralisation, and designing a reform for more transparency, accountability and effectiveness.
- Reinforcing further inter-municipal co-operation to make it a common and efficient tool for delivering public services through increased incentives, the promotion of "joint co-operation bodies" and the development of inter-municipal co-operation in metropolitan areas with dedicated funding.
- Optimising revenues generated by the delivery of public services to better cover the costs of services, decentralising tariff setting accompanied by a capacity-building programme at the local level to carry this out in a modern and efficient manner; and revising the system of privileges.
- Developing revenues generated by the use and improvement of the public domain:
    - completing the demarcation of local boundaries over the national territory
    - strengthening the role of subnational governments in land management by accelerating the adoption of draft Law No. 4355; adopt draft Law No. 7118 concerning land management in the unified territorial communities.
- Further developing land value capture instruments.

More effective public investment across levels of government for regional development in Ukraine

The governance gaps of public investment are one of the major bottlenecks for efficient public investment in Ukraine. The quality of investment strategy, planning and co-ordination, the project selection procedures, the project's implementation, evaluation and audit, are particularly weak.

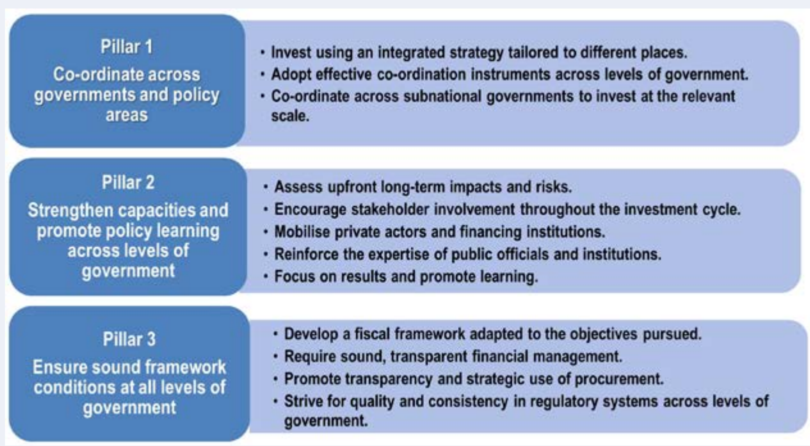
The strong involvement of subnational governments in public investment confirms that investment in Ukraine is a shared responsibility across levels of government. But it also confirms the complexity of its governance. In Ukraine, more than in many other countries, managing inter-dependencies is crucial for strengthening the efficiency and effectiveness of public investment. There is a need for effective co-ordination among levels of government in order to help identify investment opportunities and bottlenecks, manage joint policy competencies, ensure adequate resources and sufficient capacity to undertake investment, resolve conflicts, or create trust (OECD, 2014a). OECD member countries have acknowledged the importance of better governance for public investment by adopting the *Recommendation of the Council on Effective Public Investment across Levels of Government* in March 2014 (OECD, 2014b) (Box 3.16).

Box 3.16. Recommendation of the Council on Effective Public Investment across Levels of Government

The OECD Council Recommendation groups 12 principles into 3 pillars representing systematic challenges for efficiently managing public investment: co-ordination challenges, subnational capacity challenges and challenges in framework conditions.

An implementation toolkit has been developed to provide basic guidance and help policy makers at all levels of government implement these principles in practice, providing concrete examples and best practices for countries at any stage of decentralisation.

Figure 3.24. **OECD Recommendation of the Council on Effective Public Investment across Levels of Government**



Sources: OECD (2014b), *Recommendation of the Council on Effective Public Investment across Levels of Government*, www.oecd.org/regional/regional-policy/Principles-Public-Investment.pdf; OECD (2015b), *Implementation Toolkit of the Recommendation on Effective Public Investment Across Levels of Government*, www.oecd.org/effective-public-investment-toolkit.

The OECD Recommendation could help Ukraine to address systemic challenges for public investment in the context of the ongoing decentralisation reform. In Ukraine, all areas covered by the Recommendation are instrumental to ensure effective public investment across levels of government for regional development: clear responsibilities and political power, in particular adequate assignment of responsibilities at different levels of government for investment; stable, sufficient and sustainable financial resources, including autonomous revenues; appropriate human resources and local management capacity; efficient strategic development planning at local and regional levels for public investment; effective horizontal and vertical co-ordination among the various levels of government, but also between the private and public sectors; identification of investment priorities and appropriate estimations of costs and risk assessments; adequate system of evaluation, selection and monitoring of projects; preparation of financial plans, etc.

In particular, co-ordination mechanisms and sound framework conditions are fundamental for subnational governments when investing in a multi-level governance context. The following part will focus on some principles of the OECD Recommendation:

- How to ensure that capital transfers, in particular the SFRD, are used properly for effective public investment?

- What other financial instruments can be mobilised to support investment? The borrowing framework and PPP schemes will be analysed.
- How to promote transparency and strategic use of public procurement at the subnational level?
- How to develop a sound and transparent financial management at all levels of government?

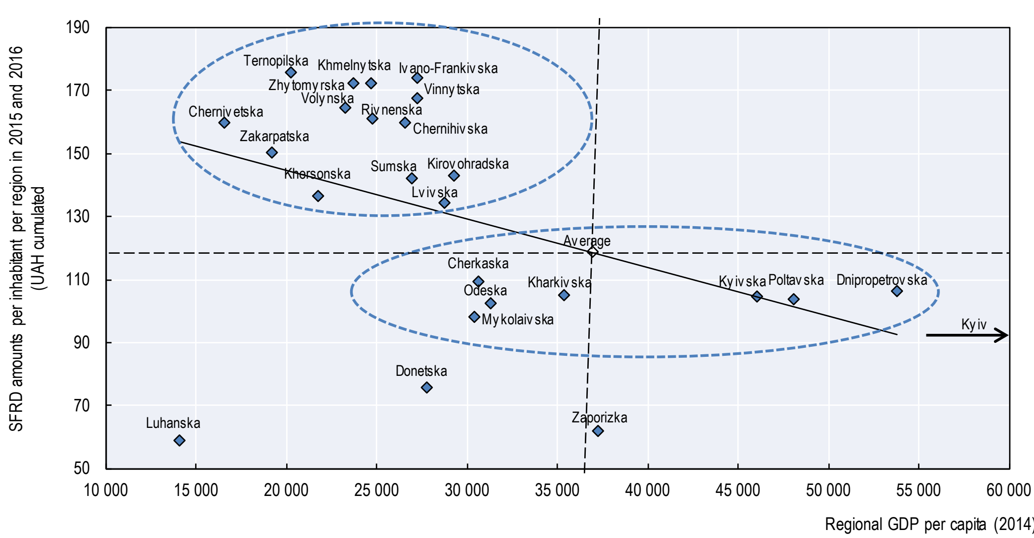
More effective capital transfers for subnational investment

In 2015, the SFRD financed 728 projects (UAH 2.37 billion) out of 1 267 submitted projects. In 2016, the SFRD amounted to UAH 2.69 billion, financing 810 projects. In total, the SFRD amounted to UAH 119 per inhabitant on average in Ukraine in 2015-16 (cumulated).

The amounts allocated per region show significant regional variations, which is quite normal, as the fund is supposed to support regional development, in particular for lagging regions. If we compare the SFRD allocation per region in 2015 and 2016 and the regional GDP per capita, there is a negative correlation. This means that the SFRD funds have been allocated to the least favoured regions of Ukraine. There is, however, a strong discontinuity. Two groups are clearly identifiable: that of regions below the cut-off at 75% of average per capita GDP (i.e. around UAH 27 700) and that of regions for which the GDP is over this threshold but without correlation between their wealth and the amount of subsidy they received. There are, however, some outliers: Kyiv, which received UAH 101 per inhabitant while its regional GDP per capita amounted to UAH 124 163 in 2014; and the three Eastern regions of Donesk, Zaporizka and Luhansk. Overall, the SFRD has served its purpose, i.e. “extending regional development funds to all regions, while concentrating resources in the places of greatest need” (Figure 3.25).

Despite the 2017 modification shifting the 70/30 split to a 80/20 split (with a cut-off at 75% of average per capita GDP), there is still significant discontinuity in the distribution, i.e. regions just above and just below the threshold have been treated very differently.

Figure 3.25. **Correlation between regional GDP per capita and SFRD allocations per inhabitant, 2015 and 2016**



Note: No data available for the Autonomous Region of Crimea and Sevastopol.
Source: Based on data from the State Treasury (SFRD executed budgets) and the Ukrainian Bureau of Statistics.

Overall, the fund could be better integrated with other inter-governmental grants to ensure that the overall pattern of transfers corresponds to priorities in terms of reduction of interregional inequalities and use similar sets of territorial and socio-economic criteria. This approach would also help reduce the risk that the uncoordinated actions of different ministries result in central government transfers that reinforce interregional disparities.

In addition, the SFRD only covers development and capital expenditures – funds cannot be used for other categories of expenditure (e.g. educational and consulting services that can help prepare and execute investment projects). Nor does it cover maintenance and repair expenditures. A debate surrounding the definition of investments that can be financed with the SFRD has emerged. A broad definition of investments could fill the financial gap in terms of general purpose local investments, but it could also undermine the purpose for which the SRRD was created: financing regional development plans. This restriction could be loosened when expenditures are closely linked to the investment project. Article 103.1 of the Budget Code on subsidies to construction, reconstruction, repair and maintenance of local roads of municipal property is a step in that direction, but there is a need for a more global solution to support subnational investments.

Finally, establishing new funds for regional and local development projects is a very positive step towards ensuring more effective regional development. These projects answer real and concrete needs for basic equipment and infrastructure, such as the reconstruction of first aid stations, refurbishment of hospitals, replacement of windows in schools and kindergartens, road surface maintenance, etc. The implementation of these new instruments has, however, faced several challenges. Projects are very fragmented and, although they are useful for the communities, they do not contribute to the implementation of the State Strategy for Regional Development or regional strategies. They do not generate added economic value and do not contribute to regional development. They also reflect the low capacity of local governments in terms of preparing development projects, stressing the need of technical assistance and training to support local staff during project preparation and implementation.

Developing access to external funding for investment

Developing subnational borrowing should be a major component of fiscal decentralisation in Ukraine, providing more financial autonomy to subnational governments. The current restrictions on municipal borrowing are questionable from an economic point of view, in particular for investment. Borrowing is an essential means to increase subnational financial capacity to invest in municipal infrastructure and create an environment conducive to inclusive economic growth at the regional and local levels.

A working group could be established that includes central government entities (Ministry of Finance, State Treasury, Central Bank of Ukraine, Ministry of Regional Development, etc.), subnational government association representatives, commercial banks, international financial institutions and the donor community, rating agencies, etc. to reflect on a new borrowing framework for subnational governments, with a set of fiscal rules that contributes both to favour investment in infrastructure and to ensure economic stability and sound fiscal management. Among the measures which could be assessed are reviewing prior authorisation of the Ministry of Finance; enlarging the subnational borrowers' categories (the regions in the future, the UTCs, medium-sized cities); developing a credit market for subnational borrowing (i.e. creating a more diversified local debt market); and changing the fiscal ratios thresholds.

Transparency and reporting requirements are essential to monitor and control municipal debt levels. Implementing a central evaluation system for municipal public debt management is a best international practice. In Ukraine, this monitoring exists through the registry for local public debt management provided by the Budget Code. This registry should be made public in order to promote transparency and monitoring and detect the municipalities that are at risk so corrective measures can be implemented in a timely manner, as is the case in several OECD countries such as Mexico (*registro publico único* and warning system called *Sistema de alertas*), Norway (ROBEK, Register for Governmental Approval of Financial Obligations), Portugal or Korea (OECD, 2017b).

Cautiously developing the use of public-private partnerships at subnational level in Ukraine

Public-private partnerships (PPPs) can attract much-needed investment, especially in large cities that have capacity to manage a complex financing tool. The use of PPPs is incipient Ukraine. The first Law "on Public-Private Partnerships" was passed in 2010 and considerable hope had been placed on it as a way to attract investment, though it did not live up to expectations for a variety of reasons ranging from the formulation of the law itself to a lack of government and sector capacity (Arzinger, 2015).

To improve the legal framework, a new PPP Law entered into force in May 2016 introducing amendments to "Some Laws of Ukraine to Eliminate Regulatory Barriers for Development of Public-Private Partnership and to Stimulate Investments in Ukraine" (Law of Ukraine No. 817-VIII). The PPP Law better defines the scope of a PPP project. The areas for the application of PPPs were widened to include housing, energy-saving technology and social services. In addition, in order to increase certainty and protect investors, the law provides new rights and security and establishes a clearer institutional framework and governance structure for PPPs through a dedicated PPP Unit in the Ministry of Economic Development and Trade.

The law is still too recent to had a significant impact on subnational PPPs. In general, if Ukraine is to develop PPPs at the subnational level, some points to remember are:

- PPPs present particular risks in the context of high levels of corruption, such as are observed in Ukraine. It is still necessary to improve the public procurement framework, and to take into consideration subnational specificities in this area (see below).
- The use of PPPs in specific sectors also depends on the progress of economy-wide reforms, e.g. tariffs policies in the housing and utilities sphere. The state will have to take on some kind of guarantor's role even in PPPs concluded with regions or cities.
- Developing subnational PPPs requires considerable capacity building. Regional or local officials must be capable of: identifying strategic opportunities at the local level; planning complex technical, legal and financial projects; co-ordinating numerous actors with different cultures and knowledge and over long periods of time; building local support for PPP projects; monitoring and evaluating projects and liabilities; reporting and auditing, etc.
- PPPs are useful to finance large-scale or complex infrastructure projects, but cannot substitute for public investment efforts, in particular to address needs in remote and lagging regions. PPPs can only be a useful, but partial, response to investment needs as, by definition, private actors are looking for bankable projects which might or might not be the case in the poorest regions. In most

OECD countries, PPPs account for less than 10%, or even 5%, of overall infrastructure investment (Burger and Hawkesworth, 2013; OECD, 2016a).

Despite these risks and limitations, developing subnational PPPs remains an option for Ukraine to address its large infrastructure investment needs. Several recommendations can be made to maximise the likelihood of success of subnational PPPs:

- Ukraine should proceed with caution in rolling out subnational 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 low and well understood – basic infrastructure, for example. In the same way, PPP projects should be restricted to regions and big cities. PPP projects are technically, legally and financially complex, and imply a high-level of resources and expertise that is not available outside large subnational governments. Subnational governments should have enough creditworthiness to support the financing of PPPs.
- The PPP Unit created under the Ministry of Economic Development and Trade should be mandated to help subnational governments in dealing with PPPs. To this end, the PPP Unit should be strengthened and trained to subnational specifics. Several PPP units at international levels have developed their activities in this perspective (Box 3.17).
- All national, regional and municipal PPP projects – including those in the planning phase – should be made as transparent as possible, including for tender procedures. A comprehensive central registry of PPP projects involving central and subnational governments and public satellites (e.g. municipal companies) should be maintained and publicly accessible on the Internet. It would allow a monitoring of PPPs based on reliable and comparable data; more transparency on the different PPP arrangements; and exchange of methodologies, expertise and good practices across territories. The PPP Unit could develop and maintain this database. Today, there are no accurate data on the number of PPPs and concessions underway in Ukraine. International practices could be useful (Box 3.17).
- The government could launch a dedicated PPP training programme to build and reinforce municipal sector capacity to effectively engage with the private sector in PPPs. Training programmes for regional and local officials could include topics such as project finance, appraisal methodologies, risk assessment and other subjects relevant to PPPs. The PPP Unit could be involved in this process.
- An important step forward would be the standardisation of PPP subnational projects, an approach taken by several countries (Box 3.17).
- The government could provide financial resources to subnational governments to access technical support dedicated to PPP projects, such as in the Philippines through the Project Development and Monitoring Facility funds.
- A legal framework adapted to local projects should be established to regulate, secure, facilitate and stimulate PPPs at metropolitan levels.

Improving the public procurement framework

In Ukraine, public procurement remains one of the most challenging areas in general, and for its subnational governments in particular. Due to non-transparent and uncompetitive procedures, state and local budgets are losing a significant share of their resources which otherwise could be directed to important activities requiring investments (EBRD, 2014).

An efficient and transparent public procurement system is needed to strengthen integrity, enhance accountability and thus support decentralisation.

In 2014, a new Law "on State Procurement" was adopted that was expected to cut the channels of corruption. However, the law does not yet appear to have yielded the anticipated results. A 2014 report of the Ministry of Economic Development and Trade indicated that while funds of local budgets represented around 29% of public procurement in 2015, the Treasury issued 225 warnings on identified violations of the procurement requirements towards local budgets' funds; the Antimonopoly Committee of Ukraine received 1 342 complaints of violations of the legislation on public procurement (44% more than in 2014), out of which 494 complaints were satisfied. It is expected that the introduction of "ProZorro", the electronic public procurement system, will help reduce corruption at the local level. The Law "on Public Procurement", adopted in 2016, approved the full transition of public procurement to the new electronic platform, requiring that all public procurements be carried out through electronic means.

These changes represent substantial progress with respect to openness, transparency and procedural fairness. Institutions such as the Council of Europe, the European Union and the World Bank have welcomed the new legislation, which brings greater alignment with good international practices in public procurement (OECD, 2016b). They should be continued and a focus on the specificities of subnational procurement could be further given to better assess the challenges and needs of the subnational public sector. Ukraine could pay more attention to the provision of guidance to subnational governments for procurement. The government could also encourage and support subnational governments willing to collaborate (through purchasing alliances, framework agreements, central purchasing bodies). It is also essential to professionalise procurement through training programmes and recognition of procurement officials as a specific profession. In fact, the experience in EU countries shows that corruption – estimated to cost EUR 120 billion per year according to the European Commission – is not primarily linked to fraud but more to incompetence. In the EU, 55% of public procurement spending occurs subnationally – and many subnational governments lack the capabilities to conduct procurement in terms of knowledge and specialised staff. As a result, 41% of quantifiable errors for absorption of EU funds in 2006-09 were associated with procurement and the vast majority of problems are errors, not fraud (OECD, 2015b).

Box 3.17. Selected examples of tools supporting the development of public-private partnership projects at subnational level

- Establishing dedicated public-private partnership (PPP) units. In line with the OECD on *Principles for Public Governance of Public-Private Partnerships*, dedicated PPP units exist in most OECD countries. France and the United Kingdom have enlarged the scope of their PPP units to include subnational projects.
- Developing databases of subnational PPPs. Such registries have been developed in several countries. In Colombia, the National Planning Department has set up and manages a database to register PPP projects. In the Philippines, the PPP unit has developed a comprehensive database.[1] In the United Kingdom, HM Treasury has compiled a database of signed Private Finance Initiative (PFI) projects by over 100 different procuring authorities, covering over 20 sectors.[2] In India, the state of Gujarat, which developed the first ever PPP legal framework in India in 1999, has developed a database of PPP projects.[3] In Canada, the Canadian Council for PPPs provides information on PPPs and maintains a Canadian PPP Project Database called *P3 SPECTRUM*.[4]
- Standardising subnational PPP projects. Colombia has carried out this work in order to reinforce expertise in the preparation of projects among subnational governments. The United Kingdom has also developed standardised contract documents and standardised guidelines for PFIs to help to attenuate some of the risks presented by the complexity of PPP contracts and the administrative capacity constraints of the public sector, especially at the local level. This has led to relatively uniform PFI contracts in England and likely reinforced a minimum level of local capacity (OECD, 2016a).
- Providing financial subsidies to finance technical assistance. In the Philippines, the Project Development and Monitoring Facility funds are administered by the PPP Center and may be utilised to finance consultancy services for the preparation of project pre-feasibility and feasibility studies; project structuring; preparation of bid documents and draft contracts; transaction advisory; assistance in the tendering process, including bid evaluation and the award of the PPP contract.

Notes: 1. https://ppp.gov.ph/?page_id=26068. 2. https://www.gov.uk/government/publications/private-finance-initiative-and-private-finance-2-projects-2016-summary-data. 3. www.gidb.org/ppp-ppp-project-database. 4. www.p3spectrum.ca.

Sources: OECD (2014a), *OECD Territorial Reviews: Ukraine 2013*, http://dx.doi.org/10.1787/9789264204836-en; OECD (2016a), *Making the Most of Public Investment in Colombia: Working Effectively across Levels of Government*, http://dx.doi.org/10.1787/9789264265288-en; OECD (2016b), *OECD Investment Policy Reviews: Ukraine 2016*, http://dx.doi.org/10.1787/9789264257368-en; OECD (2012), *Recommendation of the Council on Principles for Public Governance of Public-Private Partnerships*, www.oecd.org/gov/budgeting/PPPnoSG.pdf.

Towards a renewed fiscal responsibility framework

In the context of the decentralisation agenda, a significant amount remains to be done in Ukraine with respect to fiscal discipline, despite the progress achieved so far. Looking at all dimensions of fiscal health and the responsibility framework is beyond the scope of this report. The following developments point out some issues that were identified as crucial during the study process.

Improving municipal budgeting rules to avoid unfunded and underfunded mandates

The Ukrainian government should ensure that decentralised responsibilities are financed with sufficient resources to avoid structural deficits. In fact, any fiscal rule will be ineffective if there is a structural problem of unfunded mandates. Structural mismatch between subnational spending obligations and the allocation of revenues is a common source of subnational government deficits and debts, with the risk of fiscal distress and insolvent (OECD/KIPF, 2016).

The presence of underfunded mandates in Ukraine is real. It is also increasing with the delegation of new functions and the lack of regulatory and funding stability, including in the case of grants but also for tax revenues (e.g. abolition of the excise tax on petroleum). Compounding this situation is the tendency to shift the financial burden of privileges relating to housing and municipal utility services, guaranteed by the state, to local budgets (Association of Ukrainian Cities). This leaves subnational governments with the difficult choice of whether and how to continue services: by cutting them or reducing their quality. This also results in little or no leeway for investment, leading to a downgrading of local assets and higher costs to upgrade them when repairs are absolutely needed.

Some OECD countries have introduced reforms to mitigate or even reverse the use of unfunded or underfunded mandates and regulations in systems, such as in Denmark. This type of regulation could be introduced in Ukraine, setting the basic principle that there is no transfer of charges without the adequate transfer of funding and that the compensation should be consistent over time.

Establishing audit mechanisms adapted to the decentralisation context

As far as budgetary and financial supervision and control are concerned, they are essential in a context of increased fiscal decentralisation and greater autonomy. Financial audits are necessary to assess the quality of financial reporting and the reliability and accuracy of financial information and management. However, this control should be done in accordance with the principle of local autonomy, in particular laid down in Article 8 of the European Charter of Local Self-Government on “administrative supervision of local authorities’ activities”.[15]

Financial audits can be done externally, internally or both. Internal audit tools should be better developed. Currently, only *oblasts*, *rayon* and large cities are able to implement such internal procedures of fiscal audit. Internal audits should be an obligation set by regulation for all subnational governments and supported financially by the central government. Such financial support would allow subnational governments to equip themselves with a specific team or external support (consultants, inter-municipal expert team) and an adequate information system, also reducing the technology gap at the local level. With respect to external audits, state financial supervision and the control system over subnational governments should be adapted to the new decentralisation context. The budgetary control should be done *a posteriori*. In the perspective of the creation of the prefect function, it could be carried out by this new “body”. However, it should be done in accordance with the principle of local autonomy and in liaison with an external audit institution. In Ukraine, such an institution exists through the Accounting Chamber of Ukraine (ACU), but it does not have the mandate to audit subnational governments

(Box 3.19). The Ukrainian authorities should consider an extension of the remit of their supreme audit institution to subnational governments, and in the longer term to develop an ACU network of regional or interregional chambers such as in France or Italy. Such a process of independent financial process covering the entire public sector could improve the quality of public finance accounts as a whole. In the case of Ukraine, it is recommended to apply both internal and external approaches.

Box 3.18. Avoiding unfunded mandates at the local level: The Danish example

In Denmark, there are two long-established basic principles on unfunded mandates. These principles guide decisions about how much the central government should contribute to the local government system when devolving new tasks to subnational authorities or when additional costs arise from a change in national legislation.

The Expanded Total Balance Principle (*Det Udvidede Totalbalanceprincip*, DUT principle), requires the central government to compensate local authorities with extra grants whenever new national legislation has an impact on local expenditure. Conversely, resources must be refunded where new national legislation has the opposite effect.

The Budget Guarantee Scheme compensates local authorities for additional expenditure resulting from external factors which are outside of local government control. Some areas are particularly sensitive to changes in market or social conditions, such as social security benefits, cash assistance for the unemployed, early retirement pensions, integration of refugees or immigrants, etc.

These principles, adopted by agreements between the Danish central and local governments, are intended to safeguard an equitable relationship between them and establish effective budget co-ordination.

Sources: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, http://dx.doi.org/10.1787/9789264279049-en based on CoR (2001), *Regional and Local Government in the European Union: Responsibilities and Resources*, https://publications.europa.eu/en/publication-detail/-/publication/d681ca99-788f-49d9-bb04-40b74a9acc06/language-en.

Reinforce democratic oversight and accountability

The oversight role of regional and local councils on budgetary issues is critical to promoting fiscal transparency and accountability. It should be developed in particular by reinforcing the capacity of councillors in the budget process, which is often low. This is particularly the case in the UTCs. Each member of regional, *rayon*, city and local councils should be trained on fiscal financial management techniques and ethics when taking office, to understand how the budget process works and how, as a councillor, s/he may have a role for effective budget scrutiny. Permanent specialised councillors on financial issues could be nominated.

Box 3.19. The role of the Accounting Chamber in subnational government fiscal auditing in Ukraine and OECD countries

Established in 1996 with a constitutional status, the Accounting Chamber of Ukraine (ACU) is the country's supreme audit institution. The organisation and activities of the ACU are regulated by the Constitution, the Law on the Accounting Chamber of Ukraine, the Budget Code and other secondary legislations. The ACU is only subordinated and accountable to the parliament. It operates independently of any other state authority.

Historically it has focused on the control of expenditures of the central budget, reporting its audit in public reports. In 2014/15, the scope of its control was extended to the revenue side of the central budget. It also provides public advice on the budget law submitted by the government to parliament and issues reports on budget execution. In addition, the ACU audits the preservation and use of state property.

The new Law on the Accounting Chamber of Ukraine adopted in July 2015 has strengthened the independence of the ACU in a range of areas. For example, it requires the ACU to publish all its reports and decisions, and the ACU has an option to apply to the Budget Committee for consideration of proposals on ACU funding in the state budget in cases of disagreement with the government. Other changes have been introduced which will align the ACU with a modern supreme audit institution (World Bank, 2015).

However, local finances are still not included in its mandate, which is not the case of several OECD countries where the supreme audit institution can audit both state and local government budgets, on the expenditure and revenue side. This is the case in France (*Cour des Comptes*), Germany, Italy (*Corte dei Conti*), Poland (NIK) and Portugal, for example. Some national supreme audit chambers have a network of regional chambers, as the *Chambres régionales des comptes* in France. In France, the Decentralisation Law of 1982 created the regional chambers of audit. These public bodies are responsible for an *ex post* auditing of subnational governments' accounts, and must also review the management of local governments and related entities.

Sources: World Bank (2015), *Ukraine: Public Financial Management Performance Report*, https://openknowledge.worldbank.org/handle/10986/11898?locale-attribute=en; Accounting Chamber of Ukraine, www.ac-rada.gov.ua/control/main/en/index; OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, http://dx.doi.org/10.1787/9789264279049-en.

Beyond regional and local councils, increasing citizen and civil society participation to the financial management of the city and their role of oversight is instrumental for the success of the decentralisation process as acknowledged by the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power, involving further citizens and the civil society. Fiscal decentralisation challenges are to ensure that citizens understand the issues and how the changes will take place and how they can contribute and take benefit. Not only must fiscal reforms be communicated and explained to citizens, their social acceptance must be underpinned by awareness, and citizens must buy into and participate in the creation of reforms well before they are implemented. There is a need for an inclusive and participative approach to develop citizens' willingness to pay taxes. To this end, efforts to educate taxpayers would be welcome, with a view to attenuating the hostility resulting from taxpayers' misunderstanding of the logic behind the taxation process (OECD, 2017b). More citizen participation provides effective control over the way budgets are spent. It may also develop trust in government and reduce corruption.

Today, there is low citizen engagement in many local jurisdictions of Ukraine as the current system does not promote the accountability of local budgets to local residents, although there are cities, such as Zhytomyr, that are beginning to implement participatory budgeting. Citizens and civil society should be involved further in the budgeting process and financial oversight. This involves more transparency and public access to the budget process as well as setting up specific tools to support the involvement of citizens and civil society. There are different ways to develop social accountability in financial issues:

- Making budget information more easily accessible and understandable to the public (a “budget for citizens”) and developing capacity-building meetings with the population and associations in order to develop their financial skills and understanding.
- Developing citizens’ monitoring committees on fiscal issues.
- Publishing a yearly (or half-yearly report) on budget execution in a friendly format, accessible by the public.
- Favouring participatory budgeting experiences through which citizens can express their demands in terms of allocation of budget. They can become active participants in community problem-solving and influence the provision of local services. Participatory budgeting can also improve the efficiency of the budget by better targeting it to citizens’ needs. There are already some interesting experiences in Ukraine, such as in Zhytomyr, Bergdiansk or Chernihiv, which could be promoted and shared among municipalities.

Box 3.20. Recommendations for improving the multi-level governance of public investment

To improve the governance of public investment across levels of government for regional development in Ukraine, the OECD recommends:

- adhering to the OECD *Recommendation of the Council for Effective Public Investment across Levels of Government*
- reviewing how the SFRD and funds for territorial development and infrastructure are distributed to better support regional development and decentralisation
- consider developing state-region contracts for regional development
- developing subnational borrowing by loosening borrowing rules and developing a more diversified local debt market (loans and bonds)
- developing cautiously subnational PPPs for regions and large cities with adequate capacities and with special support
- promoting transparent and strategic use of public procurement, especially at subnational level, through specific guidelines and strengthening human resources
- improving the budgetary and fiscal rules framework:
  - introducing a budgeting rule forbidding unfunded or underfunded mandates
  - making internal audit compulsory and developing tools and financial support to help local governments to this end
  - improving external audit by extending the remit of the Accounting Chamber of Ukraine to subnational governments.

Improving quality and access to data on subnational finance and assets

There is no adequate indicator system for monitoring, evaluation and control of subnational government finance and assets. Both macro and micro data are insufficient, and not properly provided and disseminated. The lack of access to systematic and comprehensive data limits the scope of the analysis and overall assessment of the fiscal decentralisation reform and also underscores the need for transparency in inter-budgetary relations.

The clear allocation of roles and co-ordination between institutions is lacking

Monitoring the responsibility for collecting, processing and disseminating statistics is not clear, despite a clear allocation of roles on paper. According to the Budget Code, the Ministry of Finance regulates the accounting and reporting methodology on budget execution. The State Treasury Service is responsible for summing up, drawing up and budget execution reporting and assures the reliability of this information. Budget reports (monthly, quarterly and annual) on consolidated state and local budget execution on revenue, expenditure, lending/borrowing and financing provide information on budget execution which is available on the official website of the State Treasury Service.[16] The Ministry of Finance is responsible for the dissemination of fiscal information. The information exchange between the Ministry of Finance and the State Treasury Service is regulated by a specific order of 2009. The Ministry of Finance also has information exchange agreements with the State Statistics Service (www.ukrstat.gov.ua) and the National Bank of Ukraine as well as with other data-producing institutions (IMF, 2017). Despite this system, it is still very difficult to have access to data and co-ordination between the different institutions seems to be lacking. Providers of data do not seem to be willing to disseminate the appropriate data, preferring to shift responsibility back and forth between them.

Lack of appropriate data on subnational government finance and local assets

While there has been significant progress in budget classification, particularly since 2011, data are not fully harmonised according to international standards. This explains some differences between IMF data and data provided by the State Treasury Service. For example, consolidated data applied to the state and local government, but do not include social security. Local tax revenues include fees which normally should be excluded. Local debt does not include commercial debts and arrears.

While information on budget execution is public and shall be published, it is not possible to access data for any breakdown by level of subnational government or by source of revenue and destination of expenditure (at *oblast* level for all subnational governments and then by category: *oblasts*, districts, cities, communities). At any rate, the OECD Secretariat was unable, despite repeated requests over a period of months, to obtain this information from the different authorities (Ministry of Finance, State Treasury). This lack of macro data at a disaggregated level is a major obstacle for analysing subnational finance and progress of fiscal decentralisation reform in a detailed manner. Data are also lacking on an historical basis (series), which makes comparisons over time difficult.

In addition, it is not possible to access micro-data of individual subnational governments' budgets. To obtain information for a specific local budget, one has to approach the respective local financial authority or a local office of the Treasury Service (Council of Europe, 2015). At the local level, although the law requires all local governments to publish their budgets and budget performance reports, this requirement is not always followed (Standard & Poors, 2013).

Such data are instrumental in the context of decentralisation and the need to bring more transparency, consultation and accountability towards citizens and civil society in Ukraine.

The same difficulty applies to subnational government financial and non-financial assets. An inventory of financial (municipal companies and company shares, financial investments, savings, cash deposits, loans and other liabilities, etc.) and physical assets (facilities and equipment, natural assets such as water, land and forest) owned by subnational governments is missing in Ukraine while the Constitution and the Law on Local Self-Government stipulate that local self-government units have the right to use their assets to settle the important issues of local life. There is no comprehensive data on these different assets in Ukraine where it is a particularly complex issue because of the huge transfer of state properties to regional and local governments since independence. In fact, before 1991, subnational assets in Ukraine were very small in volume and did not play a significant role in economic and social development. After independence, local property formation began with the delineation between state and local property, the transfer of properties to the different levels of government. In parallel, a process of privatisation of local property was undertaken. While this process of delineation and transfer is not terminated, in particular concerning land, better knowledge of subnational assets is urgently needed.

Such asset inventories are lacking in many OECD and non-OECD countries. But they are critical for improving assets management and for designing performant fiscal management frameworks. Such a diagnostic allows an assessment of the potential for making better use of these financial and non-financial assets and increasing revenues they may generate (taxes, fees, rents, dividends, land value capture instruments, sales, etc.).

Dissemination of data could be improved

There is still major progress to make in Ukraine in the dissemination of appropriate information in an appropriate manner. Very often existing data are disseminated in an inadequate format as a list of excel sheets, which limits the ability to extract and analyse data over a time series. This could be overcome with a database format.

However, there are a number of laws related to the dissemination (and protection) of public finance data, including the "Law on Information" of 1992, the "Law on Access to the Public Information" of 2011, the "Law on State Statistics and the "Law on Open Use of Public Funds" of February 2015. The latter requires, in particular, that all central and subnational government bodies, including municipal and state-owned companies, disclose their budgets and transactions on an online portal. To implement the law, a test portal has been set up. In November 2016, the Cabinet of Ministers approved the Procedure for Maintaining the Unified State web-portal of open data (http://data.gov.ua). Another initiative has been launched with the support of SlovakAid under the auspices of the project "Transparent, Financially Healthy and Competitive Local Governments in Ukraine", implemented by the Institute for Economic and Social Reforms (INEKO, Slovak Republic), in partnership with the International Center for Policy Studies (ICPS, Ukraine). The project provides budget data and comparative analysis for the 24 oblasts and 24 regional capital cities (http://budgets.icps.com.ua). These initiatives are a very positive step towards more transparency and efficiency. However, only 50% of governmental bodies and 20% of state and municipal companies had published their information by the end of 2016 (IRF, 2016).

There are some good practices among countries which have developed portals or observatories on local finance macro and micro data with the aim to increase the dissemination of information, transparency, accountability and citizen engagement thanks to verified, comparable and harmonised sets of indicators. One can cite Austria (*Transparenz Portal*), Chile (SINIM),[17] the Czech Republic (MONITOR),[18] France (*Observatoire des finances et de la gestion publiques locales*), Portugal (*Portal de transparência municipal*)[19] and South Africa (Municipal Money).

Box 3.21. Recommendations for improving quality and access to data on subnational finance and assets

To improve quality and access to data on subnational finance and assets, the OECD recommends:

- continuing to harmonise Ukrainian data to international standards and improving data availability by category/level of subnational government for every budget item, including debt and over time
- developing an easy-to-use database with government statistics (revenue, expenditure, lending/borrowing and financing) covering all levels of government over a long period of time, accessible on line
- establishing a web portal with micro-data with individual accounts
- undertaking a comprehensive, clear and updated inventory of local assets and developing monitoring tools for them.

Subnational government human capacities

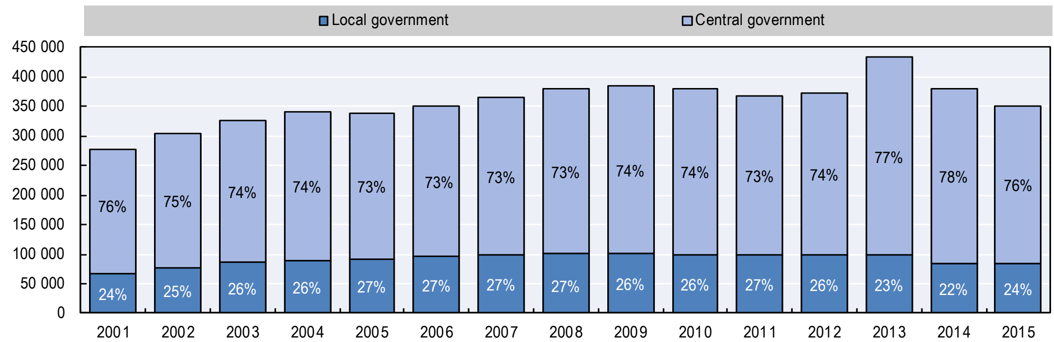
Having adequate human resources at subnational level is one of the primary conditions for the success of decentralisation reform. In fact, it is not efficient to assign the provision of a service at the local level without the necessary capacity. Bardhan (2002) argues that lower levels of government 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 (OECD, 2014a). At the same time, the lack of human capacities at subnational level cannot be used as a pretext for not decentralising or for limiting local autonomy. Capacity development often comes from learning by doing and sharing the results.

The lack of human capital and capacity in Ukraine

One of the most critical challenges facing decentralisation reforms in Ukraine is the lack of human capital and capacity to effectively administer the duties of governance at the local level (USAID, 2014).

In January 2015, there were 84 500 officials in local governments and 268 000 in central government. Included in local government officials are those who work in councils and executive committees; not included are civil servants working for the state territorial administration (regions and districts) as well as education and healthcare workers. Overall, the number of civil servants decreased in 2015, but the drop was higher at the central government level than at the local level. As a result, although the share of local government officials in total civil servants has decreased over the last years, it has increased compared to 2014 to reach 24% (Figure 3.26). Seventy-seven per cent of local government officials are women, a high ratio that is also found at the central government level (76%). The majority of local government officials (48%) are in towns, villages and rural settlements while 45% work in cities. Officials of districts and regional councils and Kyiv and Sevastopol councils represent only 7% of the local public workforce.

Figure 3.26. **Number of civil servants at the central and local government levels, 1 January 2016**



Sources: OECD elaboration based on National Agency of Ukraine on Civil Service (2015), "Civil service in figures 2015"; State Office of Statistics of Ukraine (2017a), Statistical Bulletin on "The number of civil servants and officials of local government on December 31, 2015 year".

The breakdown by region of the number of inhabitants per local government official and per central government official shows significant differences between local and central governments as well as within local and central government sectors. The (unweighted) average rate for the local government is 141 inhabitants per official while it is 426 inhabitants for the central government (without Kyiv city, Donetska and Luhanska *oblasts*, which have extreme values). Within the local sector, the number of inhabitants per local government official ranges from 116 (Chernihivska) to 178 (Dnipropetrovska).

The regulatory framework for local government staff is obsolete

According to Kantor (2015), the 2001 Law on Service in Local Self-Government Bodies has several drawbacks, number one being the lack of control mechanism of its application. In theory, the selection and appointment of officials are based on an open competition, but in practice the procedure is complicated and lengthy and therefore bypassed. In 2015, only 35% of local staff were recruited according to open competition while 57% were appointed with other procedures, the remaining coming from internship or staff reserve. In some regions the proportion of staff recruited through competition is even significantly lower (less than 25% in five regions in 2015). Promotions through unjustified managerial decisions and from political pressure are not uncommon as well as cases of corruption and abuse of power in the process of recruitment (Kantor, 2015). These uncompetitive conditions of recruitment combined with low salaries and a lack of prestige explain why the number of applicants is limited and that the local government sector struggles with attracting people. The level of staff turnover has been quite high – around 10% in the last couple of years (Kantor, 2015). This situation also explains why the proportion of management staff is disproportionate compared to specialists/technicians: 44% vs. 56% in subnational government, much more than in the central government sector where managers account for 26% and specialists/technicians 74% (State Office of Statistics of Ukraine, 2017a).

Beyond these drawbacks, one of the fundamental issues concerning the Law on Service in Local Self-Government Bodies is its *raison d'être*. The fact that officials of local self-governments are not subject to the Civil Service Law has been criticised, considering that local self-government officials should be included as civil servants (Parrado, 2014). The difference of regulatory framework is all the more problematic as the Law on Civil Service has now been profoundly amended in order to comply with European standards of good public administration (Box 3.22).

Box 3.22. The new Civil Service Law in Ukraine and its impact on local governments

Central and subnational government civil servants are not regulated by the same legal framework. The status of local government civil servants is regulated by the Law on Service in Local Self-Government Bodies of 2001 (employees are called "officials"), while that of the central government is regulated by the Law on Civil Service (employees are called "civil servants").

In principle, both laws are close and the Law on Service in Local Self-Government Bodies is intended to take into account specific characteristics of the local government sector. It regulates legal, financial and social conditions of the employees (not elected people) of local governments (procedure of appointment, staff categories, salary and retirement conditions). It also stipulates the scope of authority of local officials and their legal protection. According to the law, local councils and their executive bodies are responsible for determining the number of local officials, and thus have some autonomy to manage their staff.

However, the Law on Civil Service was amended in May 2016 as part the Strategy for Public Administration Reform and Strategy for Civil Service Reform, while the law concerning local self-government bodies has not yet been modified.

In fact, at the central level, profound changes have been introduced to set up a modern and transparent civil service in Ukraine, in particular to create a professional civil service in the state administration. It improves the status of civil servants (introduction of three categories instead of seven and salary scales), strengthens the individual responsibility of civil servants and provides for more transparency. Appointments will be based on an open competition with oversight by a special Senior Civil Service Commission as far as top managers are concerned, composed among others of representatives of the civil society. Civil servants will be prevented from lobbying the interests of political parties. High-level civil servants are forbidden to combine civil service and mandate in a local council. A new position of "state secretary" has been introduced to manage ministerial administration, who will be a civil servant chosen through a contest instead of a political figure. Thus, there will be a difference between political and administrative positions. In addition, top officials will no longer enjoy unlimited terms in office but will be appointed for a five-year term and can serve no more than two consecutive terms. Salaries will be more stable and resistant to handling as bonuses will only make up 30% of the salary (instead of 70-80% previously).

The law is being implemented. In 2016, 30 subordinated regulations were adopted, in particular those related to the Senior Civil Service Commission, the procedure for competitive selection for civil service positions, the standard qualification required for the new civil servant categories and to the remuneration scheme. Currently, one urgent issue is to harmonise the Law on Service in Local Self-Government Bodies with the Law on Civil Service. To this end, draft Law No. 2489 was presented to the parliament in April 2015 and should integrate a major part of these new provisions but, as of September 2017, adoption was still pending.

Source: National Council of Reform (n.d.), "Reforms Progress Monitoring: 2016", National Council of Reform, Kyiv, Ukraine, http://reforms.in.ua/en/news/reforms-progress-monitoring-2016-past-2-years-ukraine-has-made-greater-progress-implementing

It is expected that the Law on Service in Local Self-Government Bodies will be also revised to be synchronised with the Law on Civil Service and integrate these fundamental principles, in particular the clear distinction between political and administrative functions in order to help depoliticise the civil service at the local level. According to the National Agency on Civil Service, 53% of local government officials are such dual “jobholders”. Draft Law No. 2489 on Service in Local Government Bodies was introduced by the government in 2015 and adopted in first reading in the parliament. The final adoption is still pending.

The aim of the proposed law is to establish a new legal and institutional framework for service in the local self-government bodies which guarantees the separation between political and professional activities without interference. The draft law aims at enhancing the “prestige of service” in local government, defines the status of local officials and ensures equal access to local civil service based on merit and not on arbitrary and partisan appointments.

Impact of the decentralisation process on subnational staff

It is expected that the decentralisation reform will reduce the number of central government civil servants by about 30% as numerous functions will be transferred to subnational levels. Local governments will not be able to assume such responsibilities with their current staff.

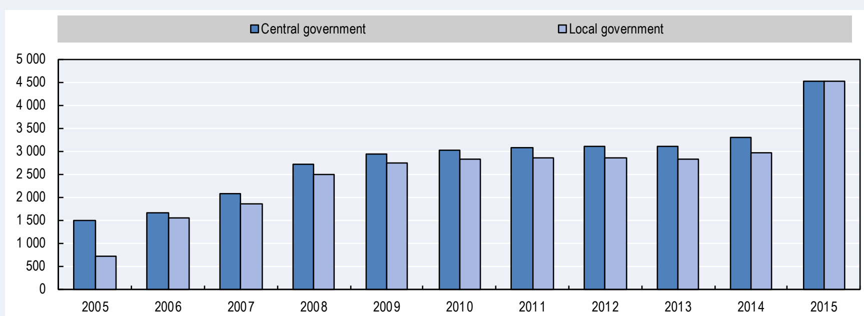
Quantitative and qualitative impacts

On a quantitative side, subnational governments will have to recruit new staff. Transfers of staff from the state territorial administrations (*rayon* in particular) will probably take place. Several *rayon* have progressively fewer and fewer responsibilities, which are being transferred to the UTCs. These transfers of staff pose specific challenges because they imply changes in terms of status and remuneration as well as geographical movements. This can constitute a major obstacle. Recruitment of human resources is another issue. As already underlined, the local government sector has difficulties attracting and retaining highly skilled people because of low salaries (despite catching up over recent years) (Box 3.23), difficult working conditions in remote areas and limited career opportunities in some areas. The shortage of staff can be problematic in some regions. Moreover, many subnational governments, especially the UTCs, do not have human resources departments able to organise recruitment contests, run panels, etc. Another obstacle is to find candidates with adequate capacities to manage the competences which are transferred or to exercise specialised functions, such as local budgeting or strategic planning.

Box 3.23. Wages in central and local governments: Higher and more harmonised

Salaries in Ukraine's central government sector have always been higher than salaries in the local governments. However, there was a significant catching-up effect in 2005 between central and local government average salaries. The average pay for civil servants in the central government was more than twice the average salary of local government officials. In 2006, the difference was only 8% and it remained quite stable during the period. In 2015, there was a significant revalorisation for both the central and local governments. The gap between both sectors is now very modest. As a comparison, in 2015 the average monthly nominal wages of a full-time employee amounted to UAH 4 195, three times above the level of the minimum wage while it amounted average UAH 3 480 in 2014.

Figure 3.27. **Average pay of civil servants in central and local governments, Ukraine**



Sources: OECD elaboration based on National Agency of Ukraine on Civil Service (2015), "Civil service in figures 2015"; State Office of Statistics of Ukraine (2017a), Urkstat (2015), "The Number of Civil Servants and Officials of Local Government on 31 December, 2015", *Statistical Bulletin,* Ukrastat, Kyiv, Ukraine, http://www.ukrstat.gov.ua/.

On a more qualitative side, although the level of human capital is quite high in Ukraine compared to other low-income countries, it can be challenging at subnational level. The level of education of civil servants is higher in central government than in local government: in 2015, 92% of civil servants in central government had completed a higher education vs. 74.5% in local government. Moreover, local government capacity varies a lot by the nature of the territorial-administrative units in question. In *oblasts* and cities of regional significance, the capacity of government officials is quite adequate. The capacity on the *rayon* and *hromada* level, however, is currently very low. Many towns, villages and settlements, in particular those which are depopulated, even lack executive bodies, which can perform governmental functions. They have no fiscal responsibility as they do not manage their budget, which is embedded in the upper-level budget (USAID, 2014).

This is a critical issue as far as the UTCs are concerned. Many do not have the minimal human capital and technical capacity to implement self-governance. In UTCs formed with villages and settlements, the lack of human capacity is significant, much more than in the UTCs formed around a town or a city of *rayon* significance, which can count on human resources.

Improving skills in subnational governments

As a result of the decentralisation reform and the reallocation of responsibilities, there is a particularly massive need for improving skills at community level, especially in the UTCs. As stressed by a recent survey of the Council of Europe, a substantial effort for capacity-building work should be undertaken in areas such as management of the new responsibilities, regulation and procedures, budgeting and accounting, management of property assets, strategic planning, formulation of local development policies, public procurement, engaging citizens, etc. (Box 3.24).

Box 3.24. The educational needs of members of local government bodies in unified territorial communities

A study carried out by the Kyiv International Institute of Sociology in February-March 2017 at the request of the Council of Europe Program “Decentralization and Territorial Consolidation in Ukraine” in co-operation with Council of Europe experts and in collaboration with the Ministry of Regional Development and the National Agency of Ukraine on Civil Service, provides interesting key findings. People interviewed were heads, deputy heads, members of local councils, secretaries, employees of executive bodies and village headmen from 159 communities.

Among the expanded responsibilities, the most difficult areas for respondents in terms of skills, qualifications and organisation of service are healthcare and education facilities management, land plot and property registration, and the allocation of housing subsidies. Respondents were also asked to evaluate to what extent spheres need an improvement in competence. Most often, unified territorial community heads, deputy heads and local council members mentioned financial and tax legislation and public procurement, then financial management, planning and use of budget funds, local development and infrastructure development, strategic planning, and communication with citizens.

The absolute majority of heads, deputy heads and local council members think that all kinds of instruments/events are effective for professional development. By far, exchanges of experience with colleagues from other territorial communities rank first (69% of respondents), followed by participation in exchanges of experience with foreign colleagues (24%), consultation with experts (24%), study visits (20%), studying best practices (15%), participation in seminars and training (14%). Online training ranks last.

Nearly all UTC heads and their deputies had participated in educational events at least once in the past year. However, when asked about regular educational activity (at least every two months), 47% of heads and 36% of deputy heads said that they studied regularly. In the case of council members, the indicator of educational activity is considerably lower; only 43% participated in at least one educational event, including only 6% who studied regularly. The vast majority of those who have participated in any educational events (85%) think that these events are rather or very beneficial.

Seventy-one per cent of respondents among chief UTCs’ officials were satisfied with the level of access to educational events offered in their territorial community. The majority of UTCs’ heads, deputy heads and local council members trust all kinds of institutions in the context of education. The relatively least trustworthy for them are non-governmental organisations while the most trustworthy are international organisations (technical assistance projects), the Association of Ukrainian Cities, regional training centres (retraining and advanced training of employees of state agencies, local governments, state enterprises, institutions and organisations), the National Academy of Public Administration and its regional institutes, individual consultants and the Ukrainian Association of Village and Town Councils and the National Agency for Civil Service of Ukraine and its territorial bodies.

Source: Council of Europe (2017), "Survey of training needs of local self-government officials in amalgamated territorial communities: Results of sociological research", https://rm.coe.int/report-survey-training-needs-of-amalgamated-communities-representative/168072b8ec.

Mechanisms are in place to support subnational capacity building, but they need to be substantially strengthened (OECD, 2014a) to meet the challenges brought by the decentralisation process and to adapt the Ukrainian training system to European standards.

The national training system is co-ordinated by the National Agency of Ukraine on Civil Service, set up in 2011 by presidential decree with the mission to ensure the modernisation and further development of the civil service and the service in local self-government bodies (Vyacheslav, 2012) as well as by the National Academy of Public Administration under the President of Ukraine (NAPA). Funding is provided by the state budget, but also partly by local budgets. In 2014 around 8 000 local civil servants participated in training in state-owned institutions (Kantor, 2015).

Created in 1995, NAPA is an essential element of the training system for public servants. It is the main higher educational establishment in the system of training, in-service training and advanced training of civil servants and local self-government officials in Ukraine. NAPA has established four regional institutes in Dnipropetrovsk, Lviv, Odesa and Kharkiv as well as an Institute of Public Administration and Local Self-Governance which is a scientific and methodological institution which accounts for the challenges of formation and implementation of comprehensive practice-oriented system of training of civil servants and local government officials. Among its missions is the development of professional competences of civil servants and local self-government officials. NAPA has developed a draft Concept of Reform and Development of the Academy for 2016-2020 but the current concept is for the moment very general and does not seem to take into proper account the challenges resulting from decentralisation. A national strategy for reforming the training system in relation to subnational governments' current and future development challenges seems to be missing, and more largely a national strategy for human resources management at subnational level. NAPA should work to train staff in the local authorities (Lviv OECD seminar).

In this regard, the experience of the French National Local Civil Service Centre (*Centre National de la Fonction Publique Territoriale*, CNFPT) is instructive. It is now a worldwide best practice in terms of implementing an efficient single vocational training system for local government workers to cope with the needs brought by successive decentralisation reforms. Today, the CNFPT is very deconcentrated, based on a network of 29 regional "delegations", their antennae in each department, 18 poles of competences and 5 institutes, allowing proximity with decision makers as well as with trainees. Among the five institutes is the National Institute of Local Government Studies, based in Strasbourg, which is responsible for the initial and continuing training of senior local government managers. The regional network is the pillar of the CNFPT's functioning and effectiveness. The CNFPT participates in the Observatory of Public Employment and has also developed a directory of local civil service professions based on the National Employment Agency (ANPE) directory, which lists 231 jobs divided into 35 professional groups reflecting the diversity and efficiency of local public services. This *Répertoire des métiers* became a job management and employee training tool for local governments.

Other countries such as Chile, Colombia, Greece, Italy, Lithuania and Spain have also set up dedicated public schools of government, programmes or academies for municipal and regional training, whose experience can be helpful for Ukraine.

Among other main actors, we find regional training centres, associations of local government (Association of Ukrainian Cities and the Ukrainian Association of Village and Town Councils), the Ministry of Regional Development, non-governmental organisations, individual consultants, and international organisations through dedicated programmes and technical assistance such as the Council of Europe's Programme on "Decentralisation and Territorial Consolidation in Ukraine"[20] and the "U-LEAD with Europe" initiative "Local Empowerment, Accountability and Development Programme". Managed by GIZ, this programme aims at setting up, in co-operation with the Ministry for Regional Development, local government development centres in all *oblasts* of Ukraine. Launched in April 2017, local government development centres are non-profit entities to build the capacity and enhance the management and leadership skills of local government authorities. They provide direct support to local government bodies, primarily those of amalgamated communities.

Box 3.25. Recommendations for improving human resource capacity

To support decentralisation with improved human resource capacity, the OECD recommends:

- Designing a subnational strategy for human resources management.
- Significantly stepping up support for training regional and local officials:
  - Enlarge the National Academy of Public Administration's mission to develop training programmes targeted at subnational governments.
  - Support the establishment of the national consultation platform on reforming the training system for local authorities.
  - Request and technically support subnational governments to build an annual training plan. This should be accompanied by dedicated funding from the central government, with significant allocations at least for the coming years.
  - Establish specific training actions for senior managers in local government.
- Set up an observatory of local employment, remuneration and competences.
- Reinforce the human resources management function (HRM) in subnational governments with HRM professionals. In smaller local authorities this could be accomplished through inter-municipal co-operation (i.e. a municipal association and shared back offices).
- Favour mobility across levels of government (central and subnational governments) and within subnational governments and create incentives to attract qualified professionals and students to subnational governments.

Notes

1. The Tax and Budget Codes represent the main the legal bases for regulating intergovernmental fiscal relations and managing subnational government budgets (Annex 3.B).
2. Subnational government functions are broadly described in Article 143 of the Constitution, and detailed in a series of laws, including "on Local Self-Government in Ukraine" (Chapter 3, Articles 27-41) and "on the capital of Ukraine – Hero City of Kyiv", as well as in the Budget Code and in sectoral legislation (e.g. the Land Code, the Forest Code and the Water Code).
3. According to Ukrainian Statistical Committee, in 2016 there were 11 438 municipal companies, compared to 16 700 in 2006.
4. On average in 22 *oblast* capital cities.
5. In 2015 the PIT represented around 11% of central government tax revenue.

6. The CPT also includes the tax on profits of municipal enterprises and several taxes on the profit of companies with foreign investment, foreign legal entities, insurance entities, banking organisations, etc.

7. These are derived from receipts from capital transactions (proceeds from property privatisation, sale and lease of land), from transactions with assets from own revenues of budgetary entities and from municipal enterprises' dividends.

8. These include: registration of legal entities and individual entrepreneurs, registration of real estate property rights, registration of place of residence, construction permits, cadastre information, preparation and issuance of national ID cards and passports for travelling abroad, etc.

9. Source: presentation to the Council of Donors on the Decentralisation Reform, July 2017.

10. If the Ministry of Finance does not provide objections within a month, a local government can proceed with a loan (Article 74).

11. This limitation dates to 2011 when it was felt that Ukrainian commercial banks were unwilling to lend to municipalities, or lend responsibility to municipalities. Thus the state felt it prudent to "pave the way" with lending by International Financial Institutions in order to build the capacity of municipalities in managing commercial borrowing (EBRD, 2014).

12. This analysis is based on the first 159 UTCs, which formed in 2015; 27 indicators were processed to determine the financial capacity of the amalgamated territorial communities, classified into 4 demographic groups (less than 5 000 inhabitants, 5 000-10 000, 10 000-15 000 and more than 15 000 inhabitants).

13. It appears, however, that PIT receipts represented a very small to non-existent portion of revenues in the case of small rural communities due to the collection system.

14. In 2016 when the maximum tax rate was still 3%, i.e. before the reduction to 1.5% because of the minimal wage reform.

15. Signed by Ukraine in 1996 and in force since 1998.

16. www.treasury.gov.ua/main/uk/doccatalog/list?currDir=146477.

17. www.sinim.gov.cl.

18. http://monitor.statnipokladna.cz/en/2017.

19. https://www.portalmunicipal.pt.

20. www.slg-coe.org.ua.

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Annex 3.A. Financial dimension within the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power

The Concept Framework provided for the establishment of appropriate material, financial and organisational conditions as well as adequate human resources for the implementation by local self-governments of their own and delegated responsibilities.

In that perspective, the Concept Framework established several principles to be followed:

- Providing local governments with the resources necessary for the exercise of statutory responsibilities.
- Calculating intergovernmental transfers on the basis of unified standards for the provision of public services.
- Allocating transfers from the state budget directly to every local budget.
- Determining the financial basis for the implementation of local governments' own powers in terms of taxes and fees related to the territory of the respective administrative-territorial unit.
- Consolidation by local budgets of part of the proceeds from the payment of income tax of newly created legal entities, within five years from the date of investing in the legal person.
- Giving local governments the right to regulate the rates of local taxes and fees.
- Preventing other bodies of local self-government and executive bodies to provide tax benefits that reduce own revenues of local budgets. Such fiscal privileges may only be established by the local self-government body, whose budget includes such local taxes and fees.
- Providing local governments with access to credit resources for their investment projects. Borrowing procedures of approval and local guarantees should be simplified. These procedures should be balanced with state control methods aimed at preventing bankruptcy of municipal property rights.
- Increasing the transparency and efficiency in the use of budget funds by introducing a programme-target method for all local budgets.
- Determining the material basis of local self-government, including land owned by the territorial communities of villages and settlements, towns/cities and commonly owned assets by territorial communities of villages and settlements, towns/cities, *rayon* and *oblasts* as well as determining the proper tax base.
- Providing the territorial communities with the right to dispose land resources within their territories, to pool their assets and resources within the framework of inter-community co-operation to implement joint programmes, and to provide public services in a more efficient manner to the population of the adjacent territorial communities.

Source: Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power.

Annex 3.B. Key regulations impacting intergovernmental fiscal relations

Besides the Constitution and the Law on Self-governments, the main regulations governing the financing of subnational governments in Ukraine are the Tax Code and the Budget Code. These regulations stipulate all stages of the budget process, monitoring and audit, the structure and functioning of the fiscal information system, accounting rules, as well as local budgets' reporting system and the availability of fiscal data (Council of Europe, 2015).

The first Ukrainian Budget Code was adopted in 2001, and 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. It was reformed in 2010 to improve the transparency and predictability of inter-budgetary relations, which entered into force 1 January 2011. Several changes were introduced, including:

- the reassignment of tasks (removal of primary healthcare functions from lower level communities, introduction of more detailed lists of social tasks for the *rayon* level – *rayon* and cities of *oblast*/republican significance)
- the provision of a list of resources taken into consideration for the calculation of the tax potential index
- tax-sharing arrangements between the central and subnational governments.

The Tax Code was also modified in 2010, reducing the number of local taxes from 15 to 5 (tax on immovable property other than land, unified tax, license for special entrepreneurial activities, parking tax and tourist tax). New reforms of the Tax and Budget Codes were introduced in 2014, and came into force in 2015.

Table 3.B.1. **Key regulations impacting intergovernmental fiscal relations**

Title	Date of enactment and reform	Function
Constitution	1996	Defines the basic functions of local self-governments, the central government, its executive bodies and their responsibilities.
Law of Local Self-government	1997	Provides the basis for functioning of local government finance.
Law on Local State Administrations	1999	Outlines the duties of central government bodies at *oblast* and *rayon* levels.
Budget Code of Ukraine	2001, with significant amendments in 2010/11 and 2014/15	Regulates relationships in the process of preparation, consideration, approval, and execution of budgets and reviewing reports on budget execution, as well as controlling the execution of the state budget of Ukraine and local budgets. It also determines the structure of tax allocations across levels of government and the system of inter-governmental transfers.
Tax Code	2001, with significant amendments in 2010/11 and 2014/15	Divides all taxes collected into national taxes and local taxes and fees.
State Budget Law	Annual	Defines intergovernmental transfers. The state budget annual Law of 2001 refined the division of responsibilities between the central and local governments.

Source: adapted from OECD (2003), "Multi-year investment planning for the city of Lutsk", https://www.oecd.org/countries/ukraine/35177698.pdf.

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Annex 3.C. Subnational government responsibilities

Subnational government responsibilities are described in broad terms in Article 143 of the Constitution. They are detailed in the Law "on Local Self-Government in Ukraine" (Chapter 3, Articles 27-41), "on the Capital of Ukraine – Hero City of Kyiv", in the Budget Code, and in sectoral legislation including the Land Code, the Forest Code and the Water Code.

In terms of functions, subnational governments are in charge of the following key assignments:

- ensuring integrated social/economic and cultural development of the territory of the community
- planning
- adopting the local budget, accounting and financial management
- municipal property management
- creation of municipal enterprises
- licensing and registration
- regulation of land relations.

Subnational governments must meet the needs of the population in the areas of housing, transport, trade and communal services, social protection, health, education, culture and sports, and environmental protection.

In practical terms, subnational governments provide the majority of their services in the sectors of education, public health, housing and public utilities. They are in charge of: running schools and hospitals; providing social protection, including social benefits; constructing and maintaining local roads and housing; providing municipal utilities (water and sanitation, waste collection, heating, etc.); and local transportation, as well as developing cultural and leisure facilities and activities.

Table 3.C.1. **Breakdown of spending responsibilities between the state and subnational budgets**

	State budget	Subnational budgets
Public administration	Legislative and executive branches, president of Ukraine, holding elections and national referendums.	Maintenance of local government bodies.
Education	Specialised state-owned schools and extracurricular activities (designated by the Cabinet of Ministers), vocational, higher and postgraduate education.	Preschool, general primary and secondary (including specialised educational institutions), extracurricular activities.
Healthcare	Specialised hospitals and polyclinics, military hospitals, national sanatoria, sanitary and epidemiological stations.	Outpatient clinics, polyclinics, hospitals, maternity homes, primary medical care centres, first and emergency aid stations.
Social protection and social security	State programmes of social aid, payment of pensions to military servicemen, state support to public organisations, compensation for deficit of the Pension Fund of Ukraine.	Support of children and low-income individuals.
Culture and arts	National and state libraries, nature reserves, national museums and exhibitions, national theatres and philharmonics, support of cinematography, TV, radio broadcasting, the press, state archives.	Local libraries, museums, exhibitions, theatres, clubs, philharmonics of local significance, zoos.
Physical culture and sports	State programmes in the area of physical culture and sports, maintenance of central sports schools for sport excellence, national centres for physical culture and sports.	Sport schools for children and youth, centres for physical culture and sports, maintenance of sports facilities.
Economic activity	Economic development, development of transport, road infrastructure, postal service, telecommunications and information technology, conservation of architectural monuments, building of national monuments.	Construction, reconstruction, repair and maintenance of local roads.
Other expenditures	Basic and applied research, and information links of state significance, international activity, judiciary, national defence, law enforcement, national security, creation and replenishment of state stocks and reserves, state debt servicing.	Local programmes for development of housing and municipal utilities. Municipal improvements in localities.

Source: Presentation by the Council of Europe.

Annex 3.D. Shared taxes and own-source taxes before and after the 2014/15 reform

Table 3.D.1. **Shared taxes and own-source taxes before and after the 2014/2015 reform**

	Before the 2014/15 reform	After the 2014/15 reform
Regions (*oblasts*), Autonomous Republic of Crimea	25% of personal income tax (PIT) 100% of the corporate profit tax (CPT) from local public enterprises 10% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas)	15% of the PIT 10% of the CPT 100% of the CPT from local public enterprises 55% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for the extraction of minerals
Kyiv	50% of the PIT 100% of the CPT from local public enterprises 35% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas) 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	40% of the PIT 10% of the CPT 100% of the CPT from local public enterprises 80% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for extraction of minerals 100% of the excise tax on retail sales of excisable goods 4 local taxes*
Sevastopol	100% of the PIT 100% of the CPT from local public enterprises 35% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas) 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	100% of the PIT 100% of the CPT from local public enterprises 80% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for extraction of minerals 100% of the excise tax on retail sales of excisable goods 4 local taxes*
Districts (*rayon*)	50% of the PIT 100% of the CPT from local public enterprises	60% of the PIT 100% of the CPT from local public enterprises
Cities of regional importance	75% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	60% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 local taxes*
New amalgamated communities		60% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 main local taxes*
Other local communities (cities of *rayon* importance, towns, villages and rural settlements)	25% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 local taxes*

Note: Before the 2014/15 reform, the five local taxes were: the tax on real estate other than land, the single/unified tax, the license for special entrepreneurial activities, the parking tax and the tourist tax. Since the reform, there are four local taxes: the property tax (land tax/rent, tax on real estate tax other than land, transport tax), the single tax, the parking fee and the tourist tax.
Source: OECD elaboration based on diverse sources

Chapter 4.
Decentralisation in Ukraine's Transport Sector: A case study

This chapter explores the prospects for decentralisation in Ukraine's transport sector. It provides an overview of the state and importance of transport infrastructure in Ukraine's economy, and of the governance structures supporting it. Urban public transport systems are discussed, particularly with respect to financial and managerial capacity, regulations and standards, and how better mobility data and new technologies can support a more innovative approach to public transport provision in Ukraine. The chapter also highlights the importance of improved logistics performance and strengthened co-operation between ports and port-cities. It concludes with a series of recommendations to carry forward progress in decentralisation within the sector.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Introduction

Transport networks are interwoven in the fabric of the economy. When designed effectively, they can be a motor for productivity, integration in global value chains and improved quality of life for citizens. The transport sector plays a fundamental role in Ukraine's development trajectory and ability to achieve growth, reduce inequalities and create jobs. At the same time, there is growing awareness of the negative externalities that transport may generate: congestion, pollution, and bottlenecks in trade and mobility created by outdated and inefficient infrastructure.

As mentioned in Chapter 1, urban agglomerations are driving Ukraine's growth. Kyiv, as well as some cities in Central and Western Ukraine, are experiencing population surges that will require infrastructure and adjustments to transport services to accommodate new arrivals. Meanwhile, smaller villages and remote areas will need to contend with changes in demand resulting from an ageing and declining population. To meet these opposing challenges, international experience can help Ukraine in designing and implementing transport policies that yield economic, environmental and social benefits for the entire population.

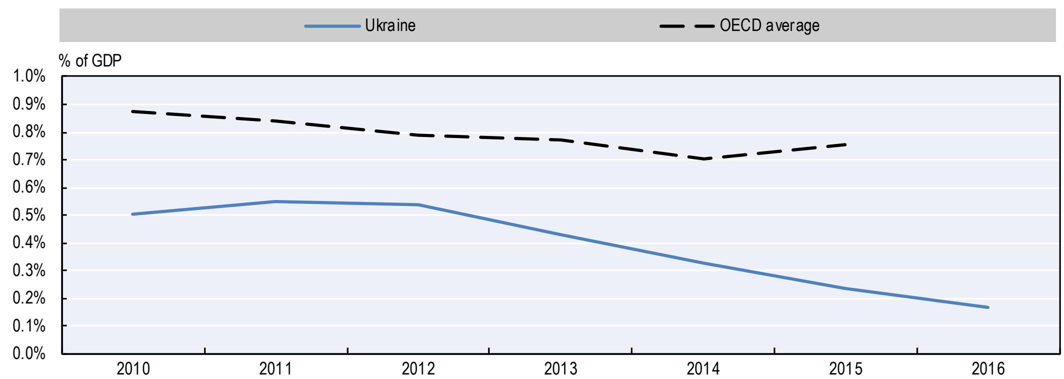
As part of its decentralisation agenda, Ukraine has included sector decentralisation as a second stage of the process. While the focus of most discussion to date has been on decentralisation in the education, health and social sectors, decentralisation of the transport sector is also being discussed. This chapter presents key challenges faced by the sector, along with good practice case studies and a series of policy solutions to support decentralised development in Ukraine's transport sector. The analysis was conducted through a combination of interviews during fact-finding missions to Ukraine and secondary sources.

The state of transport infrastructure in Ukraine

The transport sector plays a crucial role in Ukraine's economy. In 2016, transport and storage accounted for 6.8% of gross value added and 6.1% of the employed population (compared with 4.4% and 4.9% in OECD member countries in 2014[1]). Ukraine's economy is highly transport-intensive: it took almost 6 tonne-kilometres of freight to produce USD 1 of GDP in 2005, more than ten times the EU average (World Bank, 2010). This is the result of a heavy reliance on the production and export of commodities such as metals, iron ore and grain.

Chronic underinvestment in Ukraine's transport sector has led to insufficient modernisation of legacy infrastructure inherited from the Soviet Union, high wear and tear, and increasing gaps between transport infrastructure supply and demand (Foundation for Effective Governance, 2011). Investment in fixed assets in the transport industry (excluding pipeline transport) declined to 0.2% of GDP in 2016 (Figure 4.1). Preparations for the Euro-2012 UEFA football championship (co-hosted by Ukraine and Poland) boosted infrastructure spending in 2011-12: for instance, the Ukrainian railway monopoly invested in new rolling stock and introduced a faster railway service between Kyiv, Lviv and Kharkiv. With the exception of 2012, however, Ukraine's investment in inland infrastructure as a share of GDP has lagged below the OECD average in recent years. The annexation of Crimea in early 2014 and the ensuing conflict in the eastern regions of Donetsk and Luhansk had a significant impact on the sector, with the loss of a number of strategic transport assets (roads, railways, sea ports and airport infrastructure) and important markets. Investment in transport infrastructure was further hampered by fiscal constraints resulting from a significant increase in military expenditures and social programmes to assist internally displaced persons (IDPs).

Figure 4.1. **Transport investment in Ukraine and OECD countries***



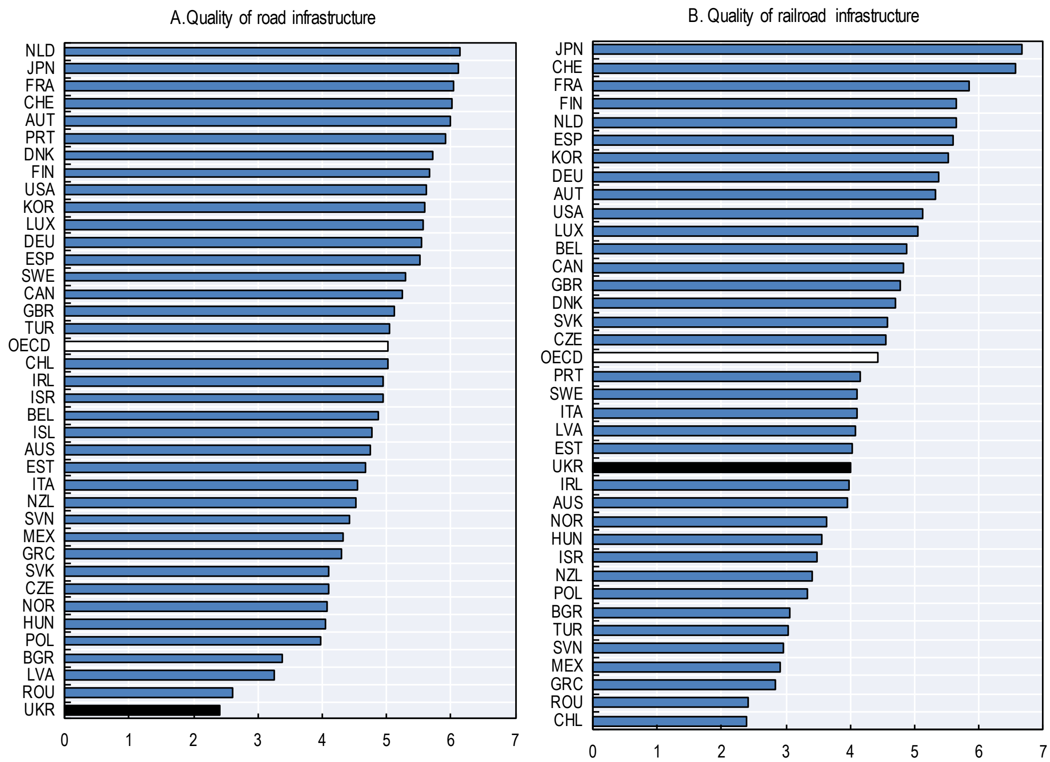
* The share of GDP needed for investment in transport infrastructure depends on a number of factors, such as the quality and age of existing infrastructure, maturity of the transport system, geography of the country, and transport-intensity of its productive sector. Caution is therefore required when comparing investment data between countries.
Source: State Statistics Service of Ukraine (2015), "Transport and communication in Ukraine"; OECD (2017a), Infrastructure investment (indicator), https://data.oecd.org/transport/infrastructure-investment.htm (accessed 30 January 2018).

Underinvestment in transport infrastructure across Ukraine's regions and cities can be a constraint on future economic growth. Meanwhile, upgrading the transport infrastructure could help to bridge the connectivity gap between urban and rural territories. OECD research highlights that the impact of infrastructure investment depends on how well it is managed and co-ordinated with other aspects of regional development policy, such as education and workforce training (OECD, 2016b). The literature on the impact of infrastructure investment on economic performance suggests that the government should prioritise subsectors where infrastructure is the poorest (i.e. in Ukraine, the road sector), as returns on infrastructure investment are higher where current endowments are lower (UNECE, 2016).

Ukraine's road density (277 km of roads per 1 000 km^2) is low compared to most OECD countries (OECD average: 1 516 km/1 000 km^2). The Executive Opinion Survey conducted for the World Economic Forum's *Global Competitiveness Report* reveals that road infrastructure is perceived as the most problematic area: Ukraine ranks 134th out of 138 countries on the perceived quality of its roads, with a score of 2.4 out of 7 (World Economic Forum, 2016).[2] The perceived quality of road infrastructure is lower than in all OECD countries. In contrast, the railway network is the second most extensive in Europe (excluding the Russian Federation). Railway density (37.2 km^2) is higher than in many large OECD countries, including Turkey and the United States. As a result, the perceived quality of railway infrastructure (4 out of 7) is higher than that of many OECD countries, suggesting that railways are more reliable than roads (Figure 4.2).

Since the early 2000s, road traffic (both freight and passenger) has risen rapidly along with the number of motor vehicles. However, road development and repair have lagged behind traffic growth – 50% of the roads do not meet national roughness standards, and 40% do not meet national road strength standards. As a consequence, the average speed

Figure 4.2. **Quality of road and railroad infrastructure***



* *The Global Competitiveness Report*'s Executive Opinion Survey asks business executives to evaluate, on a scale from 1 to 7, one particular aspect of their operating environment (in this case the quality – extensiveness and condition – of road and railroad infrastructure).
Source: World Economic Forum (2016), *The Global Competitiveness Report 2016-2017*, https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1.

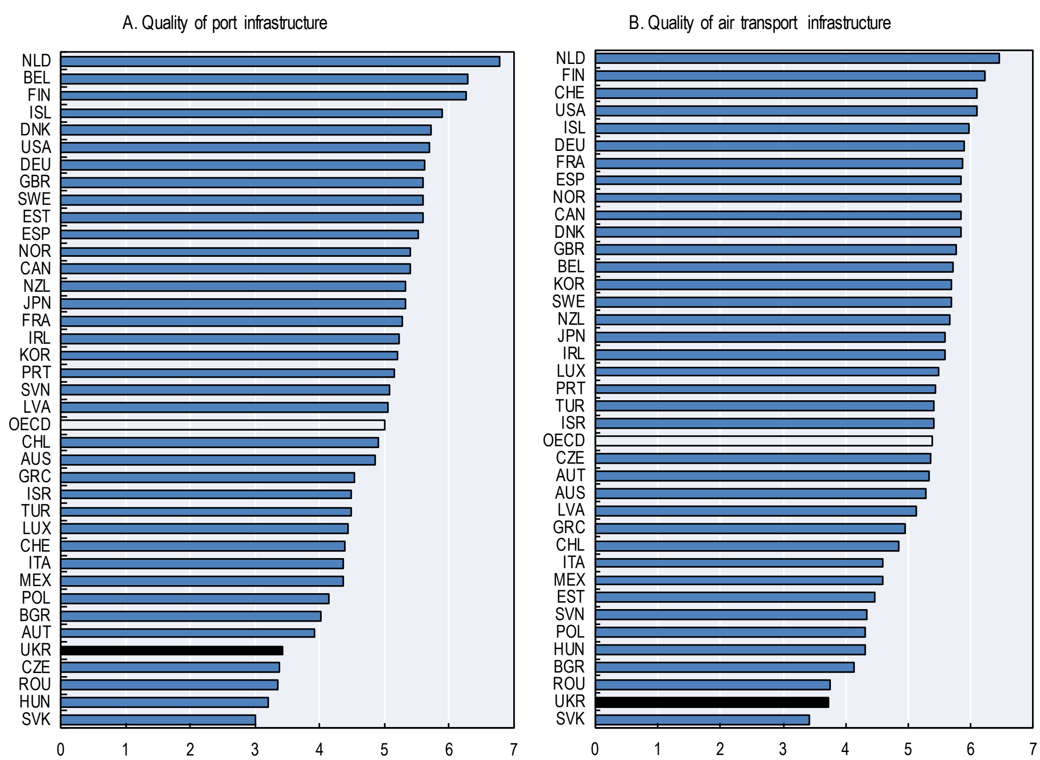
on highways is one-third to one-half of what it is in Western Europe (Ukraine Transport Policy Note, 2016). The poor quality of roads also contributes to car accidents and fatalities: in 2013, the fatality rate per 100 000 inhabitants reached 11.3, well above the OECD average of 6.8.[3] The quality of roads and the density of support infrastructure (such as gas stations) differ significantly across regions: road infrastructure indicators (Table 4.A.1 in Annex 4.A) and a regional executive opinion survey suggest that the best roads are found in Kyiv and Kyiv *oblast*, Poltava and Kharkiv. By contrast, agricultural regions, mainly in Western and Central Ukraine, have some of the country's worst roads. Among regions hosting large urban agglomerations, the road network is particularly poor in Dnipropetrovsk and Lviv *oblasts*. On the positive side, survey data from the third annual Ukrainian Municipal Survey suggest some improvement in the perceived quality of roads in Ukraine's largest cities between 2015 and 2017.

The railway system is the backbone of long-distance freight transport, accounting for 58% of freight turnover all over Ukraine in 2015.[4] The railway system is crucial for the transport of Ukraine's exports such as grain and steel to the Black Sea ports, and for the supply of intermediate products (coal, coke, iron ore and fertilisers) to industrial facilities and farms. As a result, Ukrainian railroads have high freight traffic intensity but lower traffic speed than in Western Europe. Ukraine's railway infrastructure requires considerable modernisation. Single tracks in many parts of the network mean that passenger trains and freight shipments are using the same railways, decreasing considerably the average speed of passenger trains. The average age of locomotives and passenger cars owned by the national railway company (Ukrzaliznytsia) is above 40 years (Ukraine Transport Policy Note, 2016; Foundation for Effective Governance, 2011).

The Global Competitiveness Report also assesses the perceived quality of sea port and air transport infrastructure. The perceived quality of port infrastructure (3.1 out of 7) and air transport infrastructure (3.7 out of 7) is somewhat better than the perceived quality of road infrastructure, but still below the levels in nearly all OECD countries (Figure 4.3).

An overwhelming majority (80%) of the infrastructure in Ukraine’s 13 sea ports[5] is either obsolete or in a depreciated state. For instance, 11% of berths are not functional. Ukraine has a fairly limited number of deep water facilities and restricted depths at approach channels; this sets technical limitations on many modern large ships (Ukraine Transport Policy Note, 2016). Increased grain exports put pressures on limited port capacity, pointing to the need to build new grain silos and adapt existing storage capacities. The lack of multimodal logistics infrastructure and the underdevelopment of container facilities raise the cost of container shipments. Overall, this highlights the need to modernise Ukraine’s port infrastructure, including strategic state assets such as berths, aquatic areas and moorage walls.

Figure 4.3. **Quality of sea port and air transport infrastructure***



* *The Global Competitiveness Report*’s Executive Opinion Survey asks business executives to evaluate, on a scale from 1 to 7, one particular aspect of their operating environment (in this case the quality – extensiveness and condition – of sea port and air transport infrastructure).

Source: World Economic Forum (2016), *The Global Competitiveness Report 2016-2017*, https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1.

Air passenger traffic is dominated by international routes: in 2016, international passengers accounted for 90% of total air passengers in Ukraine. The domestic share of passenger traffic is thus rather low for a country of Ukraine's size,[6] but this can be explained by relatively low income per capita, obsolete infrastructure in many regional airports and the well-developed internal railway network, which provides a high degree of connectivity between major urban centres. The two airports in the Kyiv agglomeration (Boryspil and Kyiv's Zhuliany Airport) accounted for 75.6% of all air passengers in 2016. After a strong contraction in 2014-15, the aviation industry demonstrated a positive dynamic in 2016, with the number of air passengers (5.7 million) exceeding the level of 2013 (5.2 million).

However, underinvestment in state-owned infrastructure hampers the development of air transport. In terms of infrastructure, there is a stark contrast between airports whose airfield (light strip, taxiway strip, ramp, etc.) benefited from state investments as part of the budget for the Euro-2012 UEFA football championship and those that did not. The first group includes all state-owned airports (Kyiv's Boryspil and Lviv's Halytskyi) as well as Kharkiv Airport, which is an example of a successful public-private partnership (PPP) in transport infrastructure to finance the construction of a new passenger terminal. Most other airports are under municipal (sometimes *oblast*) ownership and have obsolete infrastructure (outdated and worn out air strips). Dnipro, the only major airport with declining air passenger numbers in 2016, has experienced repeated flight interruptions owing to security problems related to the light strip. In most cases, local authorities as owners of airport infrastructure lack the necessary funding to invest in airfield repair and modernisation, and therefore lobby the central government to obtain the necessary funds. The State Programme for Airport Development until 2023, adopted in February 2016, would substantially reform airport management.[7] All airfields would be transferred to a newly created state-owned enterprise with an enhanced capacity to attract funding (for instance, from international financial institutions) and therefore to invest in airfield modernisation (Cabinet of Ministers of Ukraine, 2016).

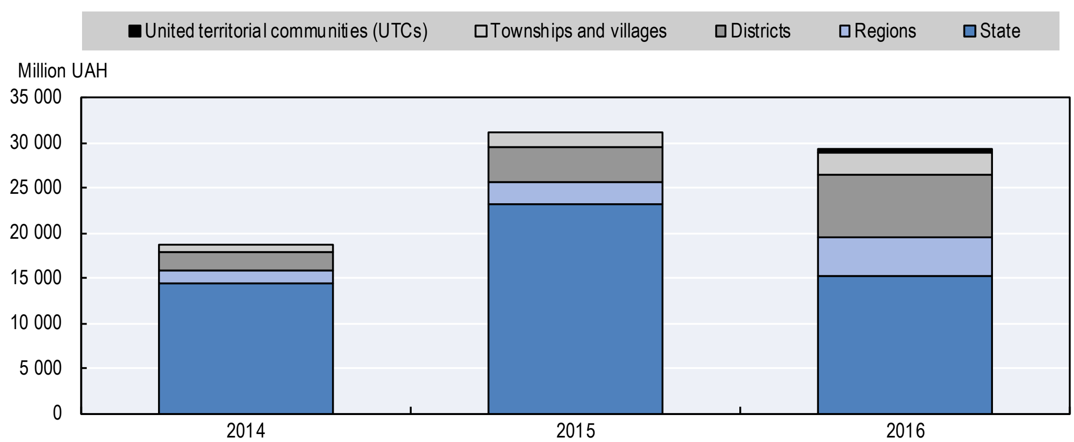
Strengthening governance and co-ordination in the transport sector

When implemented correctly, decentralisation can be an effective policy tool to strengthen governance, transparency and accountability at local levels. An analysis of the governance and institutional design of Ukraine's transport sector reveals that a number of the essential preconditions for decentralisation are missing.[8] For instance, governance structures are overly centralised, with significant fragmentation in the allocation of responsibilities across entities. There is a need to strengthen subnational fiscal autonomy to invest in transport infrastructure, better align responsibilities with revenues, and build managerial and operational capacities at local levels. Effective mechanisms for co-ordination are also lacking, leading to difficulties in managing joint responsibilities across levels of government, between neighbouring jurisdictions and amongst entities with differing responsibilities in transport. A new transport strategy was developed with the aim of addressing some of these issues; the government should now turn its attention towards implementation.

Centralised governance and fragmented responsibilities impede transport sector development

In spite of recent advances in the decentralisation reform, the governance of Ukraine's transport sector remains highly centralised at state and regional levels. Figure 4.4 depicts the evolution of budget expenditures in the transport sector, divided across different levels of government. Total transport sector funding amounted to UAH 29.2 billion (EUR 882 million) in 2016, or 3.5% of the overall Ukrainian budget. This represents a marked decrease from 2015, when transport accounted for 4.6% of budget expenditures. Notably, the share of the central administration in total transport spending has fallen substantially, from 74% in 2015 to 52% in 2016. Much of this decline was absorbed by regional (*oblast*) administrations (including Kyiv city) and cities of regional subordination, whose combined share in transport expenditures rose from 20% in 2015 to 37% in 2016. The remaining funds were spent by district (*rayon*) administrations (0.5%), cities of district subordination (1.8%), townships (1.5%), villages (5.3%) and unified territorial communities (UTCs) (1.3%) (Ministry of Finance, 2017). The contribution of the UTCs to transport expenditure can be expected to increase steadily over time, as further progress is achieved in municipal amalgamations, fiscal decentralisation and greater allocation of responsibilities to local levels.

Figure 4.4. **Budget expenditures in Ukraine's transport sector**

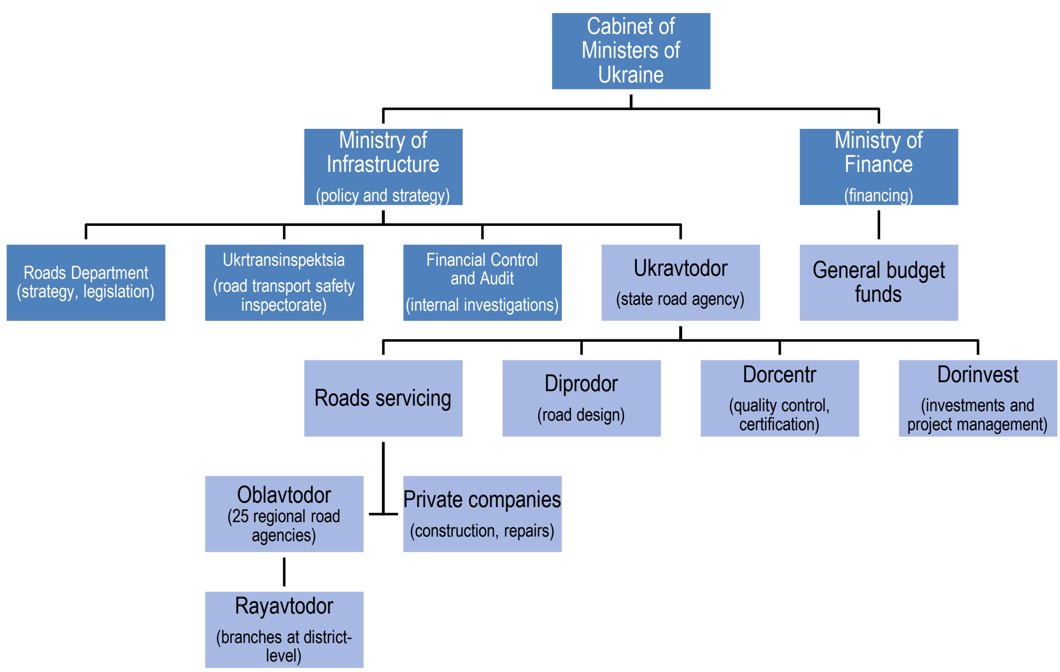


Notes: "Regions" includes regional (*oblast*) administrations and Kyiv city administration. "Districts" includes cities of regional subordination and district (*rayon*) administrations. "Townships and villages" includes cities of district subordination, townships and villages. The data predominantly reflect spending on roads, which accounted for 92% of budget expenditures on transport in 2014 and 2015, and 86% in 2016.
Source: Ministry of Finance of Ukraine (2017), "Budget of Ukraine – 2016", https://www.minfin.gov.ua/uploads/redactor/files/Budget%20of%20Ukraine%202016.pdf (accessed 13 February 2018).

Road infrastructure is a critical priority for the government, accounting for 86% of total budget expenditures on transport in 2016. It is worth noting that approximately 69% of paved roads in Ukraine are classified as local roads, yet subnational administrations accounted for just 40% of spending on roads. This reflects the limited capacity of local authorities to ensure local road operations and maintenance (Figure 4.A.1 in Annex 4.A shows significant variation in transport expenditure across regions). In the framework of the road decentralisation, the maintenance and operations of most state roads will be transferred to the regional level in 2018, and the state road agency Ukravtodor will focus on motorways of national significance (around 50 000 km out of 170 000 km of state roads). A new national road fund is being set up (partly financed by a fuel excise tax) to finance road maintenance and repairs: 35% of the fund will accrue to the regions. The reform aims to bring the road management system closer to EU standards and improve the funding of road operations and maintenance (Ukraine Transport Policy Note, 2016).

Transport and road networks are shaped by the spatial distribution of population and socio-economic activities such as jobs, education, healthcare, retail and services. Transport policy in turn influences outcomes across a broad range of policy domains, including economic growth, environmental outcomes, housing, land use, spatial planning, social equity, trade and regional development. As such, new laws and regulations relating to transport infrastructure and mobility should be developed in consultation with the relevant line ministries (e.g. Ministries of Economic Development and Trade, Finance, Ecology and Natural Resources, Infrastructure, and Regional Development). This can lead to a more balanced approach to decentralisation across sectors; improved policy coherence; and reduced chances for duplication, waste and loss of accountability. Figure 4.5 illustrates the institutional structure of road transport authorities in Ukraine. The management of the extensive network of state roads is currently centralised under Ukravtodor and its 25 regional branches. At present, there are no inter-ministerial working groups or official mechanisms for cross-ministerial co-ordination on transport policy in place.

Figure 4.5. **Institutional mapping of road transport authorities in Ukraine**

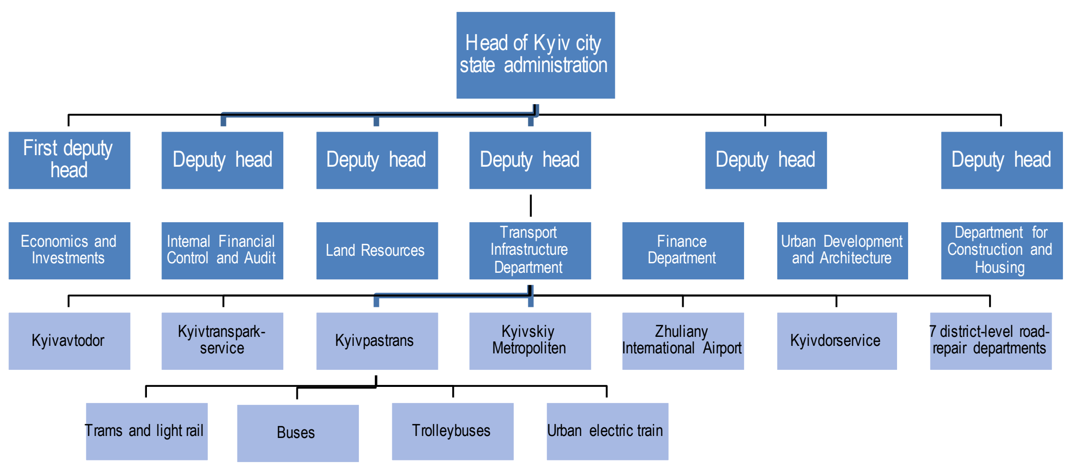


Source: Ministry of Infrastructure (2015).

The scale of urban public transport often extends beyond the administrative boundaries of cities, creating significant obstacles to the co-ordination of transport policy across municipalities. A top-down approach to the development of transport plans prevents local governments from developing dynamic responses to spatial expansion and changing mobility patterns in urban areas. In this respect, the ongoing decentralisation reform and voluntary municipal amalgamations are helping to build scale and capacity at the local level, allowing for the provision of higher quality and more affordable public services. Fiscal decentralisation is providing a strong stimulus for urban transport infrastructure and services, by allowing autonomous and empowered local administrations to generate sustainable sources of income and improve the efficiency of public expenditures. For instance, there have been reports of UTCs undertaking repair and maintenance of local roads at one-fifth the cost quoted by the state and regional road agencies (OECD interviews, 2017).

In large metropolitan areas such as Kyiv, effective planning of public transport services is hampered by inadequate co-ordination between the central government, *oblast* and city administrations, subsidiary organisations, and neighbouring municipalities. Figure 4.6 illustrates the main institutional structures responsible for urban public transport provision in Kyiv city. Within the city administration, there is limited co-ordination on transport policy between departments responsible for areas such as transport infrastructure, construction and housing, urban development, land use and spatial planning. Additionally, there are few to no incentives in place to encourage co-operation and collaboration across administrations. Formal mechanisms for co-ordination between the Kyiv *oblast* administration, the Kyiv city administration and municipal companies (such as Kyivpastrans, which operates most of Kyiv's public transport services, and Kyivskiy Metropoliten, which operates the Kyiv metro system) are non-existent or limited at best.

Figure 4.6. **Institutional mapping of Kyiv city state administration and municipal transport companies**



Source: Kyiv City State Administration (2018a), "Structure" (in Ukrainian), https://kyivcity.gov.ua/content/26_struktura.html (accessed 31 January 2018); Kyiv City State Administration (2018b), "Subordinated enterprises" (in Ukrainian), https://kyivcity.gov.ua/files/2017/12/22/Pidporyadkovani-DTI-KMDA-pidpryiemstva.pdf (accessed 31 January 2018).

A renewed focus on implementing the transport strategy is needed

The Ukraine Transport Strategy 2030 was released by the Ministry of Infrastructure in January 2017. The strategy was designed with financial support from the EU, within the framework of a project supporting Ukraine's implementation of the EU Association Agreement. It reflects certain core underlying principles of effective transport policy – in particular, the need to align transport policy priorities with the country's broader economic, social and environmental objectives, rather than focusing exclusively on infrastructure development. For instance, low-income areas of urban agglomerations often have poor access to public transport networks. Limiting the integration of low-income segments of the population with local labour markets is counterproductive and only serves to exacerbate inequalities. The strategy also reflects the need to support the development of less carbon and space-intensive modes of transport, such as walking, cycling, trains and buses. Priority is given to maintenance and upgrading of existing infrastructure, before undertaking new and potentially costly construction projects. Striking an effective balance between infrastructure maintenance and new construction investment is essential – the overall cost of preserving a poorly maintained road can be anywhere from three to seven times more than the cost of preserving a properly maintained one (OECD/ECLAC, 2012).

The transport strategy also reflects the need for Ukraine to adopt a multi-modal approach, focusing on building the capacity of various transport modes to improve connectivity, mobility and accessibility. For example, transport interchange locations on the periphery of Kyiv are under increasing pressure to cope with large volumes of passengers transferring between different modes of transport. With significant future population growth forecast in the towns and villages surrounding Kyiv, this problem is only expected to get worse. Improving the integration between different transport modes should help to improve mobility and alleviate congestion. Moreover, Ukraine’s public transport systems require significant modernisation of the infrastructure, governance and administration in order to meet the rapidly evolving needs of the population. Demand management measures such as congestion charges and investment in alternative modes of transport can also help to improve fiscal sustainability and reduce the need for additional expenditures on infrastructure and new rolling stock.

Moving forward, effective implementation of the transport strategy will be essential. Transport strategies can be useful tools to structure and co-ordinate interventions relating to the sector. It is vital to develop realistic targets and milestones, ensuring that transport master plans are fiscally constrained and therefore likely to be fully funded. For instance, the transport strategy estimates annual road investment needs to be about UAH 35-40 billion (EUR 1.1-1.2 billion), which is significantly higher than the current level of spending on roads (UAH 25 billion in 2016). Enhancing subnational fiscal autonomy and leveraging new sources of funding such as road user charges can help to bridge the financing gap. Ukraine should also develop mechanisms for co-ordination of transport policy across regions, particularly with regard to improving logistics performance and interregional connectivity.

Strong co-ordination mechanisms are essential to support the transition to a decentralised transport sector

Improving connectivity and the performance of Ukraine’s transport sector requires a strong institutional framework and clear mechanisms for the design and implementation of transport policies at national and subnational levels. Well-defined national policy frameworks can help to improve local transport planning and strengthen local capacities to invest in urban mobility.

Given the complexity of existing institutional structures, urban transport development in metropolitan areas requires effective co-ordination within administrations (across departments) and across different levels of government. City administrations could work more closely with municipal companies and private transport operators to establish an integrated public transport system that enhances mobility and connectivity for all citizens and is based on sustainable and environmentally friendly technologies. In the Kyiv agglomeration, co-ordination with the municipalities surrounding Kyiv city is essential, as many of their residents make frequent trips to the city to access employment and services. Land-use planning and housing developments in these areas can have significant implications for infrastructure and transport needs within Kyiv city. The lack of co-ordination reflects the need for a holistic approach with a strong mandate and clear instructions on how to align activities around urban transport development.

Better co-operation and co-ordination can help to manage some of the problems arising from the unclear attribution of responsibilities across levels of government. For example, the legal environment does not clarify how responsibilities for financing and undertaking road maintenance should be allocated at local levels. As a result, the blurred nature of responsibilities between the UTCs and district (*rayon*) administrations hinders the development of strategic long-term investments in roads and transport infrastructure.

Inter-municipal co-operation (IMC) on public transport provision remains in its infancy in Ukraine. IMC is particularly important in rural areas, where high levels of territorial fragmentation continue to generate excessive co-ordination costs. Municipal amalgamations can act as a strong force to encourage horizontal co-operation on transport development. In places where amalgamation is not politically feasible, co-operation is somewhat less forthcoming, particularly between the UTCs and non-amalgamated communities (OECD interviews). The Ministry of Regional Development's website lists a total of 133 ongoing IMC projects.[9] Three of these relate to transport service projects and 16 are road repair and maintenance projects. To better support municipalities in transport provision, the government should consider expanding IMC agreements between the UTCs and non-amalgamated communities. IMC is an effective policy tool to develop mobility solutions across administrative boundaries, and can even act as a precursor to amalgamation by helping to better integrate isolated populations with neighbouring localities. Box 4.1 outlines some examples from Poland's experience in developing IMC for public transport provision.

Box 4.1. Inter-municipal co-operation in public transport: The Polish experience

Upper Silesia

The decentralisation reforms introduced in Poland's transport sector in the 1990s created significant problems for Upper Silesia, an old mining and industrial region with large commuting flows between residential towns and places of work. As no state or regional budget financing was provided, municipalities had to make a financial contribution to the Public Transport Municipal Association of Upper Silesian Industrial District, calculated as a fixed percentage of their total income. There was widespread disagreement on the size of the percentage contribution, as smaller communes were unable to afford more than half of the proposed level, and ultimately threatened to leave the union. In the late 1990s and early 2000s, the quality of public transport deteriorated significantly because responsibilities had been transferred to the association. As a result public transport was no longer politically important for mayors.

A new model was introduced in 2007, with contributions calculated based on the individual deficit of a given bus line. A municipality's contribution is now calculated based on the number of passengers (from representative passenger counting) multiplied by an average income per passenger (uniform across the network) minus real costs. The deficit is split between the municipalities, based on the number of vehicle-kilometres within the territory of the commune. While the new model is far from perfect, it has created more of a customer service-oriented system.

Gdynia

The city of Gdynia established its own public transport authority (ZKM Gdynia) in 1992. ZKM Gdynia developed a unified transportation network by setting up contracts with several surrounding communes, including inter- and intra-communal bus lines. Each contract states the required frequencies and quality levels, is tendered to an operator separately, and is settled with the partner commune separately. While associations were a popular mechanism for inter-municipal co-operation (IMC) in the 1990s, the contract model became widespread in Poland in the 2000s. The network provides passengers with the option to buy a single ticket for the entire network, and to get unified information on public transport in the area.

Lessons from Poland's experience with inter-municipal co-operation in public transport

- Unions and agreements are both effective tools to achieve IMC. The law should allow local authorities to freely create unions and agreements adapted to their needs.
- IMC in public transport is significantly more complicated than for the management of roads, and typically requires contracts to be signed rather than civil law agreements.
- Creating a union should not imply that local authorities are absolved

of their political responsibilities.

- A union has two types of customers: its members, who require a tailor-made offer, and end-users, who require a mass offer. The union should try to serve both customers as best it can.
- Integration of ticketing does not necessarily imply full integration of management.

Source: Wolański, M. (2017), "Inter-municipal co-operation as a tool to foster road infrastructure development and efficient public transport service delivery".

Modernising urban public transport systems

Ukraine has one of the highest urbanisation rates in Europe, with 70% of the population living in urban areas. Demographic trends such as ageing, rural decline, interregional migration and population growth in urban and peri-urban areas are reshaping the demand for transport services. Across the country, legacy public transport systems inherited from Soviet times are in a dilapidated state, and after years of underinvestment, public transport services struggle to cater to complex and evolving travel demand patterns.

With a population of 2.9 million and a surface area of 835 km^2, Kyiv is the seventh largest city in Europe. Its population has been on an upward trend for the past 15 years, and rates of private car ownership and use have risen in tandem. To combat air pollution, congestion and other negative side effects associated with population growth and increasing car ownership, Kyiv needs to develop a fast, cost-effective, sustainable and multi-modal mobility system for all citizens, including those that live in low-income areas with fewer connections to transport services and employment opportunities.

Kyiv's public transport network is dense compared with other European cities, with 94% of the population living within 400 metres of a transit stop (Oh and Nunez, 2016). The underground metro system is old but very efficient, moving 45% of passengers (or 1.4 million passengers per day) in 2017. Buses are the second most popular means of public transportation, accounting for 28% of passenger transport (849 300 passengers per day). The trolleybus system is relatively modern and transported 15% of passengers in 2017. The remaining passengers were transported by tram (11%) and the city's electric train (0.6%) (Kyiv Department of Statistics, 2018).

In Kyiv, as in many other parts of Ukraine, a lack of resources for maintenance and investment in transport infrastructure leads to poor quality service and limited enforcement of traffic regulations; environmental standards constrain mobility; and strong market power of incumbent operators creates barriers to entry and deters competition.

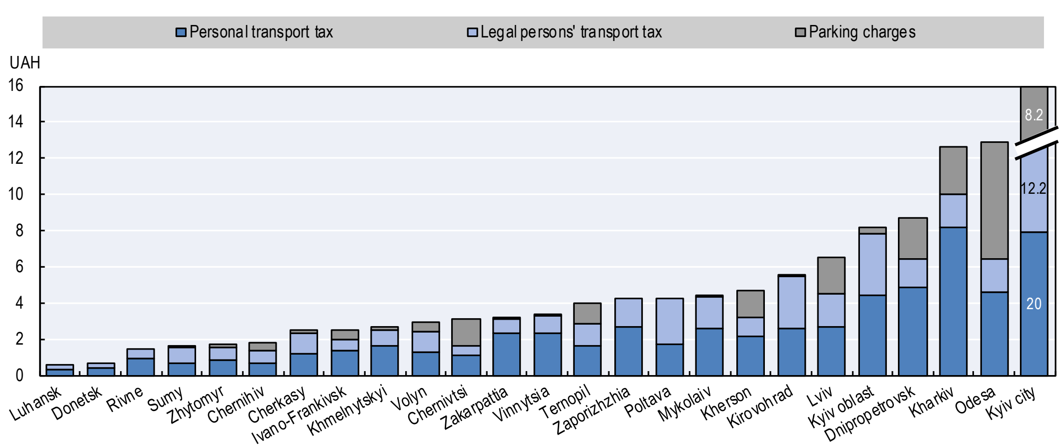
Ukraine needs to strengthen financial and managerial capacity at local levels

Local governments lack the financial capacity to invest adequately in the maintenance and renewal of urban public transport infrastructure. Low density in rural areas is a particularly challenging issue, leading to weak physical and operational integration of transport networks. A number of UTCs reported difficulties in organising efficient school bus routes across a group of newly amalgamated communities. This issue is compounded by the limited operational and managerial capacity at local levels. Traditionally, transport policy and spatial planning were not undertaken by municipal authorities in Ukraine, and were only partially undertaken by regional administrations (OECD interviews, 2017).

Ensuring that local administrations have sufficient funding and adequate capacities to manage local roads, particularly in small towns and rural areas, should be a central part of the road decentralisation agenda. Ukraine's road investment needs are estimated at UAH 35-40 billion (EUR 1-1.15 billion) per annum, and the State Road Fund will cover approximately one-third of financing needs in the short term (Ministry of Infrastructure, 2017). To bridge the financing gap, the government should consider developing toll roads and leveraging road user charges, parking fees and speed enforcement charges. Figure 4.7 demonstrates significant variation across regions in transport tax revenues. Overall, per capita revenues from transport-related taxes and charges are extremely low, ranging from UAH 0.6 (EUR 0.02) in Luhansk to UAH 40.43 (EUR 1.23) in Kyiv city in 2016. The extent to which regions leverage personal transport tax, legal persons' transport tax and parking charges as sources of financing also varies substantially across regions. In large urban agglomerations, taxes and charges should reflect the costs of negative externalities, such as congestion and pollution. Establishing additional off-street parking capacity can also help to alleviate congestion in high-density traffic zones.

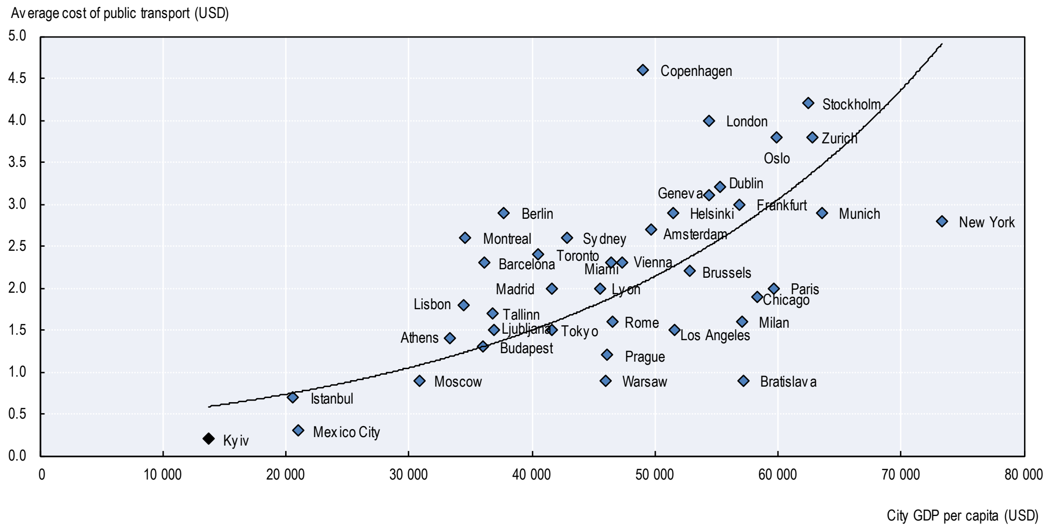
Public transport in Ukraine is highly affordable when compared with cities in OECD member countries, after accounting for relative differences in incomes. Figure 4.8 shows a positive correlation between public transport fares and GDP per capita in cities around the world. In spite of reforms to ticketing and fares introduced in 2014-15, prices in Kyiv remain relatively low. Low public transport fares (in USD terms) can partly be attributed to the sharp depreciation of the hryvnia that began in 2014 as a result of the Donbas conflict, and the fact that ticket prices have not increased by a commensurate amount. However, it is worth noting that about 50% of passengers are eligible for generous fare discounts and exemptions; as such, public transport affordability is even greater than the level illustrated in the graph. Current fares are UAH 5 (EUR 0.15) for the Kyiv metro; UAH 4-7 (EUR 0.12-0.21) for Kyivpastrans buses, trolleybuses and the city electric train; and UAH 5-7 (EUR 0.15-0.21) for private minibus (*marshrutka*) services.

Figure 4.7. **Per capita local revenues from transport-related taxes and charges, 2016**



Source: Ministry of Finance (2017), "Budget of Ukraine – 2016", https://www.minfin.gov.ua/uploads/redactor/files/Budget%20of%20Ukraine%202016.pdf (accessed 13 February 2018).

Figure 4.8. **Comparison of public transport fares and city GDP per capita**



Notes: The average cost of public transport (bus, tram, metro) in 2015 is based on the price of a single ticket for a journey of approximately ten kilometres or at least ten stops. City GDP per capita data are for 2013, or 2012 when 2013 data were not available. With the exception of Istanbul, Kyiv and Moscow, city GDP per capita data are from OECD (2018), which uses the functional urban area (FUA) methodology to compare indicators across cities.

Sources: Statista (2018), "Average cost for public transport (bus, tram or metro) in selected cities around the world in 2015 (in U.S. dollars)", https://www.statista.com/statistics/275438/public-transport-cost-cities (accessed 7 February 2018); OECD (2018), "Metropolitan areas", *OECD Regional Statistics* (database), http://dx.doi.org/10.1787/data-00531-en (accessed 8 February 2018); State Statistics Service of Ukraine (2018), "Gross regional product (2004-2015)", https://ukrstat.org/en/operativ/operativ2008/vvp/vrp/vrp2015_e.zip (accessed 8 February 2018).

While low fares are often desirable from the point of view of citizens, they should be appropriately balanced with fare discounts and exemptions in order to ensure the sustainability financing of public transport services. As a result, city administrations spend a significant portion of their budgets on public transport. Over the past five years, the Kyiv city administration spent about 6% of its total budget on operating subsidies. High subsidies are inefficient policy tools and result in less available funds for other areas, such as maintenance, inspections, upgrading of infrastructure and replacement of rolling stock.

The introduction of zonal fare systems setting public transport costs based on the distance travelled can help to put public transport financing on a more sustainable footing. Currently, discounts are not available for trips using multiple modes of transportation, and greater fare integration is recommended. Regular testing through stated and revealed preference surveys can help to better understand the views of citizens and the impact of fare increases on demand for public transport, commuting patterns and equity. Care should be taken when increasing public transport fares, in order to mitigate the impact on low-income populations and avoid creating incentives for increased private car usage.

Transport creates access, which provides economic benefits to other sectors of society such as real estate, corporations, etc. This value is often never returned to the transport sector, which remains responsible for incurring the costs of infrastructure and service provision without any return beyond farebox revenues. This is one domain where Ukraine has the opportunity to leapfrog and reorganise the financing channels that support transport.

Value capture taxes can help cities to raise revenues to finance the construction and maintenance of transportation infrastructure. The base for a development-based land value capture tax is calculated from the increase in property values arising from the development of public transportation infrastructure. However, it can only be applied when the increase in property value can be unambiguously attributed to the new infrastructure development. Land value capture schemes require strong institutional capacities in local governments, and have been successfully implemented in a number of large cities, including Delhi; Hong Kong, China; London; New York City; São Paulo; and Tokyo (GCEC, 2016). Implementing taxes on additional valuations of real estate due to improved access, and establishing corporate contributions in exchange for the benefit of improved accessibility for their employees, has a direct impact on the productivity and competitiveness of cities and urban areas. Box 4.2 outlines the French experience in introducing a value capture mechanism for local firms.

Better enforcement of parking rules, traffic regulations and environmental standards can improve mobility

Buses, trolleybuses and trams operating in congested urban areas suffer from low operating speeds due to a lack of priority and segregation from congested street sections. Poor enforcement of parking controls and traffic regulations often results in further bottlenecks caused by parked vehicles (Oh and Nunez, 2016).

Box 4.2. Value capture mechanisms in France: The *Versement Transport*

In France the "*Versement Transport*" (VT) is a local tax levied on firms with more than 11 employees. The VT represents a percentage rate of the payroll, which is determined at the discretion of the local authorities with a ceiling imposed by law. For the Île-de-France region, the percentage rate has been capped at 2.95% in Paris, and stands at 2.12%, 2.01% and 1.6% in other parts of the region. In the other regions of France the rate is capped at 1.95% for touristic towns with 100 000 inhabitants or more, and 1.05% for touristic towns and villages with 10 000 to 100 000 inhabitants. This has been a very effective source of funding to modernise public transport networks. In 2014, the VT generated EUR 3.6 billion in revenues, accounting for 65% of the budget of the transport authority of Île-de-France and nearly 40% of the total public transport financing for France. In addition, employers reimburse 50% of the cost of a transit pass, providing extra incentives for employees to use public transport. This scheme has been applied in the Île-de-France region since the 1980s, but since 2009, it has been compulsory for all urban areas with public transport services and extended to bike rental services.

Source: URSSAF (n.d.), "Le versement transport et le versement transport additionnel", https://www.urssaf.fr/portail/home/employeur/calculer-les-cotisations/les-taux-de-cotisations/le-versement-transport-et-le-ver.html; Île de France mobilités (2018), *Les recettes de fonctionnement*, https://www.iledefrance-mobilites.fr/les-recettes-de-fonctionnement/.

Public transport often competes with privately owned minibus services (*marshrutka*), which offer high levels of connectivity and convenience. This results in inefficient service duplication, with fewer revenues for local administrations to recover the costs of public transport provision. Unlicensed *marshrutka* operators often operate minibus services without formal permission from city administrations. Vehicles tend to be outdated, as private operators face little pressure to invest in new vehicles and use existing vehicles for as long as possible in order to maximise profits. Another practice commonly observed is that licensed bus drivers operating routes that originate in neighbouring municipalities will violate regulations by picking up passengers within the city boundaries – reflecting the lack of co-ordination across jurisdictions on public transport provision. This is compounded by the limited capacity in city administrations to undertake inspections, impose appropriate sanctions, and encourage operators to conform to performance standards and regulations. Inspection teams are often understaffed, and do not have adequate supervision and enforcement powers. Non-compliance with standards and regulations is tolerated by the city administrations, police and the National Inspectorate for Public Transport, which is responsible for the regulation of transport operators (Oh and Nunez, 2016).

Road safety is another hurdle to improved mobility, particularly in urban areas. Official statistics reported 3 410 fatalities in road traffic accidents across Ukraine in 2016, or 80 deaths per million inhabitants, compared with an average of 51 road deaths per million inhabitants in the EU (ETSC, 2018). This situation creates strong incentives for private car use, leading to increased congestion and air pollution in dense urban areas. Due to low levels of disposable income and car ownership, walking nonetheless remains highly common as a means of travel, particularly for localised trips in residential suburban areas to access education, social and medical services. The government could do more to encourage non-polluting modes of transport, by better enforcing vehicle and emissions standards and improving the infrastructure for walking and cycling.

Establishing strong environmental and emissions standards for public transport would require the retirement of some outdated vehicles (in particular the *marshrutkii*, many of which are at or below Euro II emissions standards). This could help to reduce emissions and air pollution, not only through the implementation of better performance standards, but also through further optimisation and greater efficiency in public transport networks. It could also reduce inefficient competition with official public transport routes. These actions should be accompanied with measures to minimise the losses incurred by employees of *marshrutka* services, through retraining schemes or programmes to facilitate access to new employment opportunities.

Strong market power of incumbent operators deters competition

The rights to operate public transport services (e.g. bus routes) are typically held by municipal enterprises. In Kyiv, the city administration identifies a route that requires a bus service and opens up a competitive tendering process to prospective operators. In spite of the formal regulatory processes and structures in place, incumbent providers are the only applicants for 90% of tenders for existing routes (Oh and Nunez, 2016). This reflects the high risk and lack of a competitive environment for new entrants.

The government should work to stimulate a competitive environment for the provision of transport services, by allowing for city administrations to franchise routes and attract private operators that adhere to standards and regulations. The experience of Lublin, Poland, can be instructive in this regard. The city was struggling with unfair competition between private companies and municipal buses. To improve efficiency and financial sustainability, the local government announced a tender and employed the small private operators as sub-contractors of the municipal transport company. In the United Kingdom, the city of Oxford dealt with high levels of competition between bus operators by establishing stringent quality requirements for buses to enter the city. Another option is to give exclusive rights to one operator and charge a fee for giving the operator a monopoly on the provision of local public transport services. The Lithuanian experience of setting minimum fees for minibuses and taxi companies could also be a useful model for Ukraine.

A logistics observatory based on detailed mobility data can strengthen project evaluation

Incorporating commuter flows and travel cost data into sophisticated transport models would allow for more detailed analysis of transport flows and help to monitor the impact of any changes implemented in public transport systems. Changes in mobility patterns can have profound impacts on the financial position of public transport networks. In London, a decline in passenger numbers caused by greater numbers of people working from home or using ride-hailing apps has contributed significantly to the burgeoning operational deficit of Transport for London. Scheduled to reach GBP 968 million in 2018-19, the deficit has led Transport for London to defer critical infrastructure upgrades on the Northern and Jubilee lines of the London Underground (Financial Times, 2018). Revisions to public transport networks should be integrated with strategic land-use planning, housing and other relevant place-based policies. Detailed data on commuter flows are essential for this, and currently lacking in Ukraine.

Further social research and consultations with local populations and relevant stakeholders are needed to take account of their views when making changes to public transport networks. In particular, it is important to ensure that citizens' needs are taken into account, that new routes enjoy high levels of use and that low-income segments of the population are not disadvantaged by new developments.

Local administrations should undertake detailed cost-benefit analysis and feasibility studies before investing in new infrastructure, public transport or mass transit routes. The analysis would allow for more informed policy making and a strong, evidence-based business case for prioritising potential investments in local public transport.

New technologies can help to generate innovative mobility solutions

The advent of smart technologies, big data and mobile information platforms is revolutionising the provision of transport services across the globe. In recent years, the efficiency of transport has been bolstered by advances in computer-assisted scheduling, routing and dispatching, as well as the growing use of mobile applications that make services more accessible to users. With high passenger and vehicle densities, urban areas are a fertile ground for the development of innovative mobility solutions such as car-sharing and ride-sharing services. However, these developments are not unique to urban areas, and a number of schemes have been found to work well in rural areas too.

Increasingly, OECD countries are making use of big data to improve public transport planning, traffic operations and safety. The growing availability of near real-time data can help to better understand and model commuter behaviour; optimise collective transport services; and adapt routes, stops and schedules to user demand. Private operators are also analysing transport data to assess the potential for new and profitable services. In Ukraine, public transport authorities could leverage mobility-related data to identify periods of low demand, areas that are poorly served by public transport or specific segments of the population (e.g. elderly, handicapped) in need of specialised mobility solutions. Strong data literacy and sufficient capacities to exploit new streams of data are necessary for local administrations to take full advantage of the opportunities offered by new technologies (OECD, 2016a).

There is growing recognition that demand-responsive transport (DRT), which provides flexible transportation (typically bus services) in response to customer demand, has strong potential to improve the provision of public transport services in rural areas. DRT can either be provided as a flexible door-to-door service within a given area, or as a bus service operating along fixed, pre-defined routes. A number of funding models for DRT schemes exist, including full funding by local transit authorities, partial funding and selection of operators through a competitive tendering process, independent private operators, and community-operated non-profit enterprises. While DRT may entail higher unit (per person) costs, evidence suggests that DRT users are prepared to pay slightly more than the fares for standard bus services. The design of DRT schemes (e.g. routes, location of stops, frequency of services, etc.) should be developed in close consultation with users, and it is essential to select vehicles in line with the density of demand (OECD/ITF, 2015).

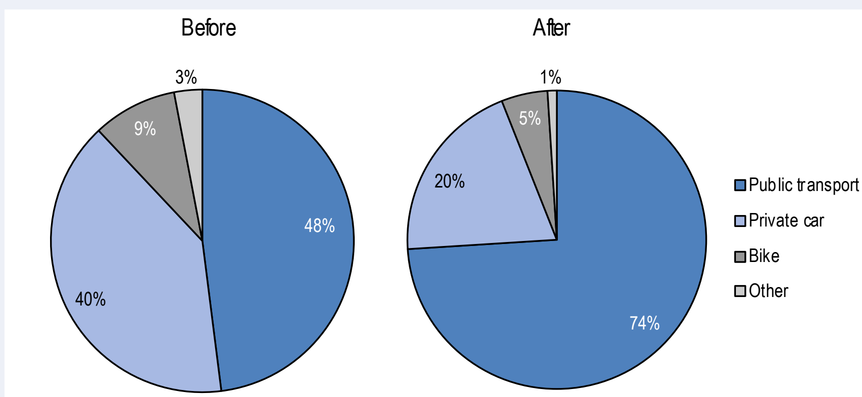
Car-sharing and ride-sharing programmes are becoming increasingly widespread across the globe. While some schemes are led by local governments, a number of large-scale vehicle manufacturers and car rental companies have established services of their own in response to declining incentives for private car ownership. In some cases, municipalities have launched services in collaboration with private companies. AutoLib, an electric car-sharing service that originated in Paris, had nearly 4 000 vehicles in its fleet and 109 400 active subscriptions in 2016. Autolib is operated by the firm Bolloré, and owned by Autolib' Velib' Métropole, an inter-municipal structure grouping 103 communes in the Paris agglomeration (Autolib' Metropole, 2017). Another well-known programme is car2go, a subsidiary of Daimler AG providing car-sharing services with 2.5 million registered members and a fleet of 14 000 vehicles in 26 cities across Europe, the United States and the People's Republic of China. Ride-sharing and ride-hailing applications such as BlaBlaCar, DiDi Chuxing, Lyft and Uber have also proliferated.

The trend to remodel transport into a user-centred service has been boosted by the spread of smartphones and GPS navigation devices, which allow for the integration of public and private transport systems by combining live data on user demand, traffic conditions and delays in public transport networks. Box 4.3 outlines the Finnish experience in developing Whim, a mobile phone application to improve mobility in Helsinki region.

Box 4.3. Mobility as a service and the Whim app, Finland

Mobility as a Service (MaaS) Global is a start-up based in Finland that improves mobility by providing multi-modal transport services to residents of the Helsinki region. Through its mobile application Whim, MaaS combines public and private means of transport and presents a variety of alternatives to the user, allowing for comparisons to be made based on speed, comfort and price. Whim integrates conventional means of transport such as trains, buses and taxis with new and innovative transport options, such as bicycle-sharing schemes, on-demand buses and car-sharing. The application helps to alleviate congestion in Helsinki by efficiently combining existing mass-transit schemes with privately operated services in a single platform, leading to better mobility and reduced incentives for private car use.

Figure 4.9. **Impact of Whim in the first two years of implementation**



Source: The Economist (2016), "Transport as a service – It starts with a single app", https://www.economist.com/news/international/21707952-combining-old-and-new-ways-getting-around-will-transform-transportand-cities-too-it.

Managing shrinking cities, ageing and declining rural populations will be a key challenge for Ukraine in the years ahead. In some cases, the development of online or mobile solutions (e.g. telemedicine, e-learning) can help to sustain service provision in remote areas and reduce the reliance on public transport. However, as local tax revenues dwindle and the cost per person of service provision rises, local governments will be faced with the need to close or downsize schools, hospitals, public transport and other facilities. While this may alleviate some of the pressure on public finances in the short term, it also results in longer travel times and reduced mobility for residents trying to access basic services. To compensate for reductions in the scale of service provision, cost savings can be channelled into strategic investments to improve the quality of transport services, leading to more efficient, reliable and affordable transport solutions – particularly for populations in rural and low-density areas. Successful interventions to improve passenger comfort and convenience have included reducing seat density, using smaller vehicles and improving service reliability (e.g. by making transport timetables and live traffic information available through mobile applications). Not-for-profit community bus services are another example of an effective mobility solution for rural areas. Community bus services often rely on local volunteers, and can be funded by a combination of ticket fares, municipal budgets and contributions from local businesses (OECD, 2016a).

New technologies can also help Ukraine to improve logistics performance (see next section for further details). For instance, the development of autonomous vehicles has significant potential to disrupt the road freight industry in the coming years, by displacing workers. In Europe, labour currently accounts for 35-45% of road freight operating costs. However, regulatory harmonisation between neighbouring countries is necessary to ensure that trucks can pass freely across borders. The availability of big data on border crossings and transit flows can help to analyse traffic flows and provide accurate estimates of travel time and reliability. These factors are essential to encourage investment in new efficiency-enhancing technologies from manufacturers and road users (OECD/ITF, 2017).

Improving logistics performance and port-city relations

Logistics services are the backbone of international trade. Improving the capacity to transport goods efficiently and connect consumers and manufacturers with international markets can yield important productivity gains and lead to greater sophistication of exports. Sea ports are an essential component of integrated multi-modal logistics systems, and their effective functioning is necessary to ensure Ukraine's participation in cross-border supply chains. This section evaluates logistics performance in Ukraine, and outlines strategies for local administrations to strengthen the governance of sea ports and increase the economic benefits from port activities.

Boosting the performance of logistics systems

Ukraine could significantly strengthen the performance of its logistics systems. Logistics is particularly relevant for export-oriented economies, where high trade and transportation costs can have a negative impact on competitiveness. The World Bank's Logistics Performance Index ranks 160 countries on the efficiency of international supply chains, measuring six key areas on a scale of 1 to 5: efficiency of customs and border management clearance, quality of trade and transport infrastructure, ease of arranging international shipments, quality of logistics services, ability to track and trace consignments, and timeliness of deliveries. Figure 4.10 compares Ukraine's performance across these six areas with Germany (the top performer) and selected benchmark economies. Although there is room for improvement across all six categories, performance is the weakest in the areas of customs efficiency and quality of trade and transport infrastructure.

Figure 4.10. **Logistics Performance Index: Ukraine and selected benchmark countries, 2016**

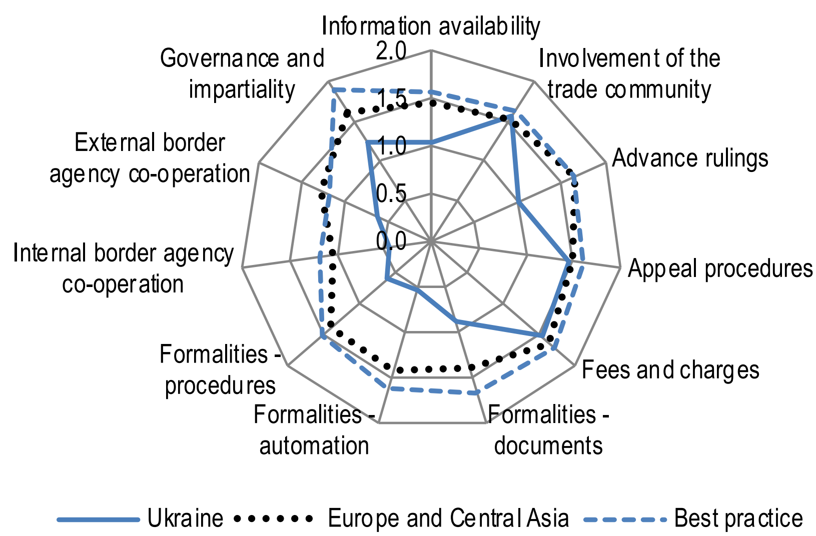
Source: World Bank (2016), Logistics Performance Index (LPI) dataset, https://lpi.worldbank.org (accessed 22 January 2018).

High transport and trade costs are reflected in a number of other key indicators. The World Bank's Doing Business 2018 assessment ranked Ukraine 119th out of 190 economies in the Trading across Borders dimension, which measures the time and cost of logistical procedures associated with exporting and importing goods (World Bank, 2018). The OECD Trade Facilitation Indicators compare and benchmark 163 countries over the full spectrum of border procedures, helping to identify important areas in need of reform and prioritise policy actions. Ukraine performs significantly below the best practice level and the average for the Europe and Central Asia region across nearly all 11 categories (Figure 4.11). Involvement of the trade community – which measures the extent to which public consultations with traders take place – is the best performing category, and the only area where Ukraine scores above the average for Europe and Central Asia. The weakest performance is observed in the areas of border formalities (automation, documentation and procedures), and co-operation between internal border agencies. The area of governance and impartiality also shows substantial room for improvement. Reducing transport costs would help to lower the prices of tradable goods, improve export competitiveness and support the diversification of Ukraine's economy.

Strengthening co-operation between ports and port-cities

Commercial seaports remain under state ownership and are administered by the State Seaport Administration. The 2013 Law on Seaports reformed port governance by separating port commercial activities from the ownership of strategic infrastructure and administrative functions, and by opening the door to private stevedoring companies. However, while the Ministry of Infrastructure plans to attract private investment to strategic port infrastructure through concession mechanisms, no port concession agreements have been signed, largely due to an inadequate legislative framework.[10] Port directors have insufficient management flexibility: for instance, even the smallest capital investment must be approved by the Cabinet of Ministers. Moreover, there is insufficient co-ordination between the seaport administration and local administrations of seaport cities. This issue is becoming more prominent as the ongoing decentralisation reform enhances the responsibilities of city administrations.

Figure 4.11. **OECD Trade Facilitation Indicators, 2017**



Source: OECD (2017b), Trade Facilitation Indicators dataset, www.oecd.org/trade/facilitation/indicators.htm (accessed 22 January 2018).

Well-run, competitive ports produce local economic benefits for port cities. However, there is a port-city mismatch because the negative impacts associated with ports are disproportionately concentrated in port cities, while the economic benefits of ports largely spill over to other regions, as they act as gateways for trade with entire countries. In Ukraine as elsewhere, port-cities face the challenge of getting more local value-added out of their ports. OECD research suggests that various local public policy instruments can be effective in increasing the economic benefits from port activities while minimising the negative impacts (Box 4.4). In Ukraine, field research suggests that increased co-operation of the State Seaport Administration with local city administrations is required to deal with the negative externalities of port activities (such as rapid deterioration of road infrastructure or environmental and health impacts from grain dust).

Box 4.4. Highlights from the OECD study on port-cities

A port cannot be a driver of urban economic growth if it is not competitive. Port competitiveness can be improved by increasing maritime connectivity, the effectiveness of port operations and hinterland connections. These factors are crucial to integrate the port system into multimodal transportation networks, so as to improve market access, fluidity of trade and integration in an industrial network. Direct rail access to the quays, smooth interconnections with the railway network outside the port and canals linking berths with inland waterways both contribute to hinterland connectivity and raise the competitiveness of alternatives to truck transport. Ports cannot sustain their operations if they lack local support: support from the local administration and population is an integral part of the port competitiveness agenda. Successful port authorities therefore pay attention to informing and educating local stakeholders: their actions may include international exhibitions, seaport days and direct business trips, school visits and the creation of a seaport education centre, etc.

Ports and port-cities should co-operate to reduce the negative impacts of port activity on urban populations. These impacts are mostly related to the environment (air and maritime pollution), land use and traffic congestion. Air pollution and noise usually have adverse consequences on the health of port-city dwellers. Sulphur dioxides (SO_2), nitrogen oxides (NO_x), as well as particulate matter (PM_{10}) present high negative externalities in terms of the health of urban dwellers. Shipping emissions can present a large share of the total emissions in port-cities: for instance, port activities account for half of SO_2 emissions in Hong Kong, China and Los Angeles. Encouraging sustainable modal splits to non-truck means of transport can help reduce negative externalities (congestion and air pollution) from truck transport. Pollution from shipping activities can be limited through regulations (e.g. setting strict limits on SO_2 emissions from ships in populated coastal areas) and by enhancing monitoring systems, for example by creating port emission inventories. Such efforts at quantification are essential, as they provide a baseline against which subsequent progress and performance can be measured. Last but not least, ports can invest in cleaner, low-emission technology to drive their own operations. This usually implies a shift away from diesel engines. For example, the port of Busan, Korea, has switched from fuel-driven rubber-tired gantry cranes to electricity-driven ones in its cargo-handling operations.

Three main models exist for cities to reap additional benefits from their ports: maritime service clusters, industrial development and port-related waterfront development. Maritime service clusters try to attract high value-added services related to the maritime industry, such as maritime finance, consulting, engineering and legal services. In Ukraine, such maritime services can be found in the urban agglomeration around Odesa. Additionally, port cities may attract value-added logistical services related to port activities, such as trans-loading and cargo transformation activities (processing, packing, consolidation, etc.). Another promising path for port-cities is industrial ecology, i.e. systematic management of material and energy flows, using waste from one process as an input for another process. Ports can have substantial influence and incite local industries to develop industrial ecology projects, supporting the dual objectives of efficient waste management and local economic development. Port-related waterfront development provides a third policy option to increase local economic value from ports. It implies transforming former industrial port sites into places for leisure, consumption and tourism, such as port maritime heritage sites or cruise ship passenger terminals and marinas. In Ukraine, Odesa has actively engaged in waterfront development, for instance with the Istanbul park and the reconstruction of the Potemkin Stairs in the city's main waterfront.

Source: OECD (2014), *The Competitiveness of Global Port-Cities*, http://dx.doi.org/10.1787/9789264205277-en.

Conclusions and recommendations

While significant progress has been made in advancing the decentralisation reform in Ukraine, carrying this forward in the transport sector will require better co-ordination across different policy domains, across levels of government and across jurisdictional boundaries. This can help to improve policy coherence, boost investment in transport infrastructure, and lead to greater mobility – particularly in metropolitan areas. The Ukraine Transport Strategy 2030 provides a solid basis for reform, and the government should now turn its attention towards implementation, ensuring that local transport plans are adequately funded and based on realistic targets and milestones.

Developing decentralised governance arrangements in the transport sector will require stronger financial, operational and managerial capacities at local levels. Greater autonomy can enable local authorities to better enforce parking rules, traffic regulations and environmental standards, leading to greener and more sustainable public transport networks. The government could also take steps to reduce the influence of incumbent operators, and develop a more competitive environment for the provision of public transport services. Leveraging new technologies, such as big data, demand-responsive transport, car-sharing and ride-sharing schemes can also help to generate innovative mobility solutions.

Finally, a renewed focus on improving the performance of logistics systems is needed to lower transport costs and improve export competitiveness. Strengthening the co-operation between ports and port-cities is necessary to minimise the negative externalities incurred by cities as a result of port traffic and infrastructure, and to ensure that port-cities are able to share in the economic benefits of port activities.

Box 4.5. Recommendations to advance decentralisation reform in Ukraine's transport sector

To further support decentralisation in Ukraine's transport sector, the OECD recommends:

- **Strengthening cross-ministerial co-ordination on transport policy,** by developing new laws and regulations in close consultation with relevant line ministries (e.g. Ministries of Economic Development and Trade, Finance, Ecology and Natural Resources, Infrastructure and Regional Development).
- **Fostering horizontal co-operation across jurisdictional boundaries,** where the scale of urban public transport extends beyond the administrative boundaries of cities.
  - Encouraging further use of inter-municipal co-operation (IMC) as a tool to develop mobility solutions across administrative boundaries, by expanding IMC agreements between unified territorial communities and non-amalgamated communities.
  - Developing transport networks and mobility solutions in metropolitan areas in line with functional urban areas.
- **Encouraging vertical co-ordination across levels of government, and with municipal transport companies and private operators**, to improve the planning, operations and management of public transport services.
  - Clarifying the attribution of responsibilities relating to transport across levels of government, with clear delineation of responsibilities for financing, operations, management and maintenance.
- **Implementing the Ukraine Transport Strategy 2030,** ensuring that local transport plans are adequately funded and based on realistic targets and milestones.
- **Boosting financial and managerial capacities for transport at local levels**, by:
  - Increasing the collection of transport-related taxes, developing road tolling systems and leveraging road user charges, parking fees and speed enforcement charges.
  - Reducing overly generous subsidies by improving the balance between low public transport fares and the allocation of fare discounts and exemptions.
  - Introducing zonal fare systems, setting public transport costs based on the distance travelled.
  - Improving fare integration, with single tickets applying across multiple modes of transportation.
  - Conducting regular assessments of mobility systems through stated and revealed preference surveys.
  - Leveraging new sources of revenue, such as value capture taxes, to finance the construction and maintenance of transport infrastructure.

- **Strengthening enforcement of parking rules, traffic regulations and environmental standards**, by:
  - Encouraging operators to conform to performance standards and regulations, by undertaking regular inspections and imposing sanctions when appropriate.
  - Ensuring inspection teams are appropriately staffed and have adequate supervision and enforcement powers.
  - Ensuring better enforcement of vehicle and emissions standards by city administrations, the police and the National Inspectorate for Public Transport.
  - Improving the infrastructure for walking and cycling.
  - **Stimulating a competitive environment for the provision of transport services,** by allowing city administrations to franchise routes and attract private operators that adhere to standards and regulations.
- **Establishing a logistics observatory,** based on detailed commuter flow and travel cost data. The logistics observatory can help to inform:
  - Social research and evaluations of mobility provided by transport networks.
  - Cost-benefit analysis and feasibility studies for new infrastructure investment projects.
- **Leveraging new technologies, such as big data, demand-responsive transport (DRT), car-sharing and ride-sharing schemes**, in order to generate innovative mobility solutions. This implies:
  - Strengthening data literacy and capacities to exploit new streams of data in local administrations.
  - Using mobility-related data to identify periods of low demand, areas that are poorly served by public transport or specific segments of the population (e.g. elderly, handicapped) in need of specialised mobility solutions.
  - Developing adequate funding models for DRT and designing schemes (e.g. routes, location of stops, frequency of services, etc.) in close consultation with users.
  - Improving mobility by combining existing mass-transit schemes with privately operated services in a single platform.
  - Managing population decline through strategic investments to improve the quality and efficiency of public transportation services.
- **Boosting the performance of logistics systems**, by:
  - Focusing on much-needed improvements to customs efficiency and the quality of trade and transport infrastructure.
  - Harmonising regulations with neighbouring countries and providing accurate estimates of travel time and reliability, which can help to encourage investments in efficiency-enhancing logistics technologies.
  - **Strengthening co-operation between ports and port-cities,** to minimise the negative externalities incurred by

cities as a result of port traffic and infrastructure, and ensure that port-cities are able to share in the economic benefits of port activities.

Notes

1. Calculations based on OECD.Stat.
2. According to the World Economic Forum's *Global Competitiveness Report*, 1 is extremely poor – among the worst in the world; 7 is extremely good – among the best in the world.
3. *Source: ITF IRTAD Road Safety Database*, www.itf-oecd.org/irtad-road-safety-database.
4. Based on data from the State Statistics Service of Ukraine, including pipeline transport.
5. Excluding five sea ports operating in the Autonomous Republic of Crimea.
6. In France, the closest OECD country to Ukraine in terms of territory, internal flights accounted for 25% of air passengers in 2016.
7. For a detailed discussion of the airport reform, see Pavlenko (n.d.).
8. For more details, see Box 2.2 in Chapter 2.
9. For a detailed list of ongoing IMC projects, see: www.minregion.gov.ua/wp-content/uploads/2017/04/reestr-11.01.2018.pdf.
10. A new concession law is being drafted with support from the European Bank for Reconstruction and Development to replace the outdated 2001 concession law.

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Annex 4.A. Additional figures and tables

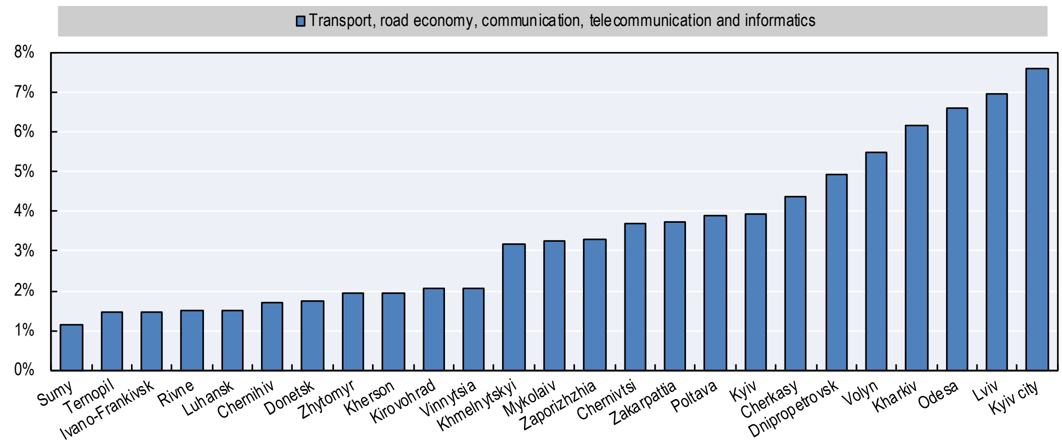
Table 4.A.1. **Road infrastructure by region: Quality and density indicators**

Region	Perceived quality of roads, 2013*	Density of all-purpose paved roads, 2015	Average road wear over five years, 2006-10
Ukraine	**2.4**	**275**	**47**
Rivne	4.17	252	45
Donetsk	4.06	302	42
Kyiv	3.99	306	55
AR Crimea	3.85	245	20
Kharkiv	3.78	299	35
Vinnytsya	3.72	339	34
Dnipropetrovsk	3.59	287	44
Zaporizhia	3.54	251	72
Odesa	3.44	242	26
Volyn	3.35	288	49
Zakarpattya	3.3	261	51
Zhytomyr	3.28	280	30
Poltava	3.25	308	64
Kherson	3.22	174	39
Khmelnytskiy	3.22	346	51
Mykolayiv	3.18	195	51
Chernihiv	3.08	227	74
Cherkasy	3	284	39
Lviv	2.98	376	42
Ternopyl	2.98	361	74
Luhansk	2.89	219	49
Ivano-Frankivsk	2.82	296	46
Kirovohrad	2.79	252	47
Chernivtsi	2.76	355	55
Sumy	2.69	282	51

* Perceived quality of roads on a scale from 1 (lowest) to 7 (highest) based on business executive survey in each region. For methodology and details see Foundation for Effective Governance (2013).

Sources: State Statistics Service of Ukraine (2015), “Transport and communications in Ukraine”; Foundation for Effective Governance (2011a), “Quality of roads indicator”, www.feg.org.ua/en/reports (accessed 10 April 2017); Foundation for Effective Governance (2011b), “The current state of transportation infrastructure impedes economic growth”, www.feg.org.ua/docs/sostoyanie_en.pdf.

Figure 4.A.1. **Share of transport and communications in total regional expenditure**



Source: Ministry of Finance of Ukraine (2017), “Budget of Ukraine – 2016”, in Ukrainian, https://www.minfin.gov.ua/uploads/redactor/files/Budget%20of%20Ukraine%202016.pdf (accessed 13 February 2018).

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