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.