5 Public funding for regional development in Ukraine

This chapter explores the framework surrounding regional and local development funding in Ukraine. It assesses the different mechanisms used by the national, regional and municipal governments to fund regional development. First, the chapter describes how basic fiscal indicators related to subnational investment have changed over the past few years. Second, it examines how the distribution of Personal Income Tax could be modified to reduce territorial inequalities and to strengthen service delivery. Third, it takes a close look at the wide variety of intergovernmental grants and subventions that have been established to fund regional and local development. It takes a particularly close look at how certain practices, such as co-funding requirements, could affect regional convergence efforts. Finally, the chapter addresses the capacity of local governments to manage investment, as well as the use of public-private partnerships.

Preface: Building on Ukraine's regional development funding mechanisms to support recovery from the war

This chapter assesses the different mechanisms that are used by the national, regional and municipal governments to fund regional and local development. In particular, it analyses the wide array of intergovernmental grants and subventions[1] for regional development, and the way in which certain characteristics of these funds risk limiting regional convergence efforts. The chapter also addresses the capacity-related challenges facing local governments to effectively manage investment.

Considerations for funding Ukraine's national recovery plan at the subnational level

The data and analysis presented in this chapter are relevant for designing and implementing subnational level mechanisms to fund Ukraine's post-war reconstruction and recovery. The discussion of regional and local development funding is central to advising policy makers on how to set up mechanisms to fund the implementation of local reconstruction and recovery projects. At the same time, it is important to acknowledge that the conditions under which the reconstruction and recovery funds need to operate will differ from those designed for regional development. For example, in the recovery context there is a need to achieve swift results, especially in response to humanitarian needs and rebuilding critical infrastructure (e.g. roads, schools, hospitals, housing) (see Chapter 2). In addition, the combined domestic and international financing that will be available for reconstruction will likely be higher than the regional development funds allocated prior to the war. This will put additional pressure on the capacity of governments at all levels—which, as highlighted in this chapter, are already strained—to effectively allocate funding to meet local needs, as well as to ensure that funds are managed transparently and efficiently.

Similarly, the discussion of the strengths and challenges faced by municipalities when managing regional development investments presented in this chapter can inform the design of interventions aimed at boosting their capacity to manage recovery funds. More generally, by detailing the significant advances Ukraine has made since 2014 in funding regional development, this chapter highlights the steps that domestic and international policy makers can take to establish mechanisms to fund subnational recovery and reconstruction. The following paragraphs present key findings from this chapter.

The government should avoid fragmentation of subnational recovery funding

In testament to the importance that Ukraine assigned to regional development policy, between 2015 and 2019, the national government's budget allocation for regional and local development rose significantly, from slightly over UAH 11 billion to almost UAH 76 billion (U-LEAD, forthcoming[1]). The significant increase in regional development funding since 2015 has enabled the implementation of many projects, ranging from improving economic development and energy efficiency to upgrading local water supply, sewage, and roads. It also provided subnational governments with invaluable experience and skills in managing investment funding, which the government can build on to ensure efficient investment for subnational recovery and reconstruction.

Ukraine's framework for funding regional development, however, has been quite fragmented. Between 2015 and 2019, a total of 110 grants and subventions linked to regional and local development were implemented by a wide range of institutions. This risks increasing costs related to the administration of funding, as well as overlap among different funds in terms of objectives and target groups. Given the fragmentation of regional development funding and the wide array of national-level institutions involved in managing the different funds, the absence of a formal body to co-ordinate regional development funding risks undermining the coherence of regional development spending.

As Ukraine advances in establishing mechanisms to fund subnational reconstruction and recovery, creating a limited number of dedicated funds and subventions to ensure that overarching government objectives are met would be important to limit fragmentation. In addition, to ensure a coherent approach to funding post-war recovery efforts, the government should consider the formation of a centre-of-government body responsible for co-ordinating recovery funding. It will be important to ensure representation of subnational governments that adequately reflects their territorially-differentiated needs and absorption capacities. This body could be linked to the National Council for Recovery.

Investment in local "hard" infrastructure should be complemented by investment in skills

Over the past few years, intergovernmental expenditure on regional development has predominantly focused on "hard" infrastructure, such as roads, bridges, hospitals, factories. Between 2015 and 2019, spending on "hard" infrastructure accounted for 59% of all spending on regional development (U-LEAD, forthcoming[1]). Most investment targeted the construction and maintenance of roads.

Despite these significant investments, however, the vast destruction caused by Russia's war against Ukraine has drastically increased the need for investment in "hard" infrastructure. By August 2022, damage to Ukraine's buildings and infrastructure as a result of the invasion was estimated at over USD 108 billion, and will likely rise further. Up to 129 000 residential buildings, over 900 healthcare institutions, 23 000 kilometres of roads and 2 200 education institutions have been destroyed or damaged as a result of the war (KSE, 2021[2]).

Investment in hard assets (e.g. reconstruction of roads, schools, hospitals, electricity grids) should be the priority during the reconstruction and recovery period. At the same time, however, complementary investments in human capital, as well as support for small and medium-sized enterprises (SMEs) will be essential. OECD analysis highlights that, generally, investing in "hard" infrastructure alone has little impact on regional growth unless it is associated with "soft" investments (e.g. human capital, innovation) (OECD, 2009[3]; OECD, 2020[4]). Indeed, this was also flagged, albeit prior to the war, as a priority by municipalities in an OECD survey (Figure 5.8). Striking the right balance between investment in "hard" and "soft" infrastructure is particularly important in the context of Ukraine's post-conflict recovery, as many skilled workers have fled the country. This means that the upskilling of internally displaced people may be necessary to facilitate their economic integration into their host communities.

Subnational recovery funding needs to be at the right territorial scale

Prior to the invasion, regional development funding was heavily concentrated in small projects with relatively low economic impact. For instance, between 2015 and 2019, the majority of the initiatives funded through the flagship State Fund for Regional Development (SFRD) only targeted a specific community (63%), and just 8% of projects had a more regional-level focus (Figure 5.10). The dominance of projects that target local-level improvements creates the risk that resources will be used in a less-than-strategic way, as many small projects may tackle similar issues that could have benefited from inter-municipal or inter-regional intervention.

As Ukraine moves forward in designing mechanisms to fund subnational recovery projects, the government should prioritise projects that have a cross-jurisdictional focus in order to achieve economies of scale and increase the resilience of local communities to future natural or manmade shocks. The government could also consider setting up different funding 'windows' for initiatives that either have a local, district or regional focus. Determining the right territorial scale of subnational recovery initiatives requires a solid assessment of the particular needs of municipalities across the country and where such needs coincide or diverge. To the extent possible, this needs to be combined with feasibility studies and robust cost-benefit analysis so recovery funds are spent effectively and efficiently. In cases when the government may be unable to conduct full-scale cost-benefit analyses due to their complexity, policy makers should ensure that possible investment projects are still ranked following a more basic assessment of their expected cost and impact.

The allocation and spending of local recovery funds should be transparent and accountability mechanisms should be in place

The government should ensure that decision-making processes regarding the allocation and execution of recovery funding are transparent and that the involved actors at all levels of government are held accountable. This is particularly important as audit reports published prior to 2022 mention the strong political influence over the distribution of Socio-Economic Subvention funds, which have been used for political campaigning in local constituencies. Ukraine is advised to set up mechanisms to oversee the effective, efficient and transparent use of recovery funding, thereby reducing the risk of regional development funds being awarded based on electoral considerations.

Assessments made by the State Audit Service regarding the legal and efficient use of local resources, which were published prior to Russia's large-scale invasion of Ukraine on 24 February 2022, revealed important violations and shortcomings in the field of public procurement (CabMin, 2021[5]). As such, the government and international partners are advised to support municipalities on issues related to local public procurement and transparent decision making, for example, by providing targeted training or by developing easy-to-use procurement guidelines. Efforts to this effect would be in line with the OECD *Recommendation of the Council on Public Procurement*, which calls upon countries to develop the necessary public procurement expertise in their workforce so as to be able to continually deliver value for money efficiently and effectively (OECD, 2015[6]). The government and international partners could build on the public procurement training programmes that the European Union-funded U-LEAD programme has provided to different municipalities. It could also leverage the online training course on electronic calls for proposals in the education sector that this donor initiative developed together with the Ministry of Digital Transformation of Ukraine (U-LEAD, 2022[7]). This should be coupled with measures such as mandating internal auditing by municipalities. Doing so requires, among other elements, providing municipalities with financial and capacity building support to conduct reliable and effective internal audits, and learn from audit results.

Increased expertise of municipalities to manage investment can support recovery efforts

As it advances with its National Recovery Strategy, Ukraine, supported by international partners, should pay close attention to the capacity of subnational government to absorb and process recovery funding. Ukraine can build on the expertise gained by many municipal governments since 2015 in managing funds from different regional development subventions. This includes experiences in identifying local needs, developing project proposals, and implementing investment projects. According to OECD survey results, 76% of surveyed municipalities reported that they had the human resources to develop investment proposals (Figure 5.13). However, there are signs that the quality of project proposals developed by municipalities remains very low (U-LEAD, 2022[7]; OECD, 2021[8]). To address this challenge, Ukraine is encouraged to set up peer-to-peer learning trajectories, for example with European municipalities, to facilitate the exchange of approaches and good practices on the preparation, implementation, and monitoring and evaluation of investment projects.

Close attention also needs to be paid to the question of how to oversee the effective, efficient and transparent use of national and international recovery funding by subnational governments. According to OECD survey results, 87% of surveyed municipalities indicated that they had the necessary human resources to implement transparent procurement processes with appropriate control systems.

Larger cities should explore public-private partnerships and alternatives to support the subnational recovery

Despite the potential of public-private partnerships (PPPs) to generate resources for investment projects, their use by Ukrainian municipalities is limited (Box 5.11). According to OECD survey results, only 10% of surveyed municipalities reported that they were engaging with the private sector through PPPs. Public distrust in co-operation between the public and private sector, as well as regulatory uncertainty are cited as the main obstacles to setting up PPPs (Figure 5.15).

When determining whether to promote PPPs as a mechanism to support recovery efforts, the government should recall that, generally speaking, only larger cities have the fiscal and institutional capacities needed to implement such partnerships. It should also consider improving outreach to larger municipalities and the private sector about the potential of PPPs, their regulatory framework, while emphasising the multiple risks involved in setting up this type of collaboration. Fiscal risks relating to the use of PPPs are critical to consider. This is particularly the case given the detrimental impact of Russia’s war on Ukraine’s subnational fiscal and human resource capacities. In general, PPPs risk being used to overcome public financial management controls, which can have negative long-term fiscal repercussions for subnational governments. In fact, PPPs should only be undertaken where they are affordable and produce greater value for money than would be provided by the delivery of public services or investment through traditional means, and never to overcome budget constraints.

Introduction

Since 2015, Ukraine has witnessed a marked increase in regional and local development funding—a testament to the importance that the government assigns to regional and local development policy. Between 2015 and 2019, the central government budget allocations to regional and local development increased from slightly over UAH 11 billion (or 1.9% of the total national budget) to almost UAH 76 billion (6.9% of the total national budget) (U-LEAD, forthcoming[1]). This marked increase is due to the implementation of key elements of the regional development and decentralisation reforms since 2014 (see Chapter 4), including the creation of several subventions to fund subnational investment projects. These subventions are, however, not the only source of funding for regional and local development. Others include loans from national and international financing institutions, financial support provided by foreign governments and donor organisations, as well as public-private partnerships (PPPs). Furthermore, Ukraine's fiscal equalisation system, which aims to help subnational governments deliver comparable levels of public services, should also be considered when designing regional and local development policy, its funding and financing. While not specifically designed to boost regional development, the equalisation system has a profound impact on subnational government capacity to finance investment.

Despite the increase in funding, Ukraine's capacity to invest in its regional development agenda has been met by four principal challenges. First, the mechanism through which the Personal Income Tax (PIT) is allocated across municipalities—60% of PIT funds go to municipalities, 15% to *oblasts* and 25% to the national government—appears to negatively affect PIT revenues of many smaller municipalities. Under current legislation, a company must allocate its employees' PIT to the municipality where the company is registered. As a result, employees in large companies with offices and staff in different parts of the country pay income tax in the municipality in which the company is legally registered, which might not correspond to the place where (most of) their employees actually do their work or indeed live. Second, Ukraine's regional development funding framework is relatively fragmented and heavily focused on funding the maintenance of "hard" infrastructure. Investing in "hard" infrastructure alone has little impact on regional growth unless it is associated with investment in areas such as human development and innovation (OECD, 2009[3]; OECD, 2020[4]). Prior to the war, this focus undermined the effectiveness of regional development policy as a means to boost regional competitiveness and growth. Third, the co-funding criteria of several of the country's major regional development funds hamper the ability of poorer municipalities to compete for funding to fulfil their investment needs. Together, these elements risk undermining the objectives of Ukraine's regional development policy (e.g. building regional cohesion and stimulating competitiveness) by entrenching regional disparities.

To capitalise on the increased funding for regional and local development, Ukraine needs to adjust the distribution mechanism of PIT and address the fragmentation of intergovernmental subventions for regional and local governments. In addition, the design of intergovernmental grants and subventions should better reflect territorially-differentiated investment needs and fiscal capacities. It also requires strengthening oversight mechanisms and the capacity of local governments to manage investments. These actions would help align Ukraine's regional and local investment frameworks with the OECD's *Recommendation of the Council on Effective Public Investment across Levels of Government* to which it adhered in 2018 (OECD, 2014[9]).

This chapter first looks at how Ukraine's basic fiscal indicators related to subnational revenues and expenditures, particularly related to investment, have changed over the past years. Subsequently, it deals with Ukraine's fiscal equalisation mechanism and explores how one of its core elements, the distribution of PIT, could be redesigned to strengthen service delivery and public accountability. It then reviews the wide variety of intergovernmental transfers used to fund regional and local development. Finally, this chapter takes a critical look at how local government fiscal and human resource capacity to manage investment has changed during the municipal amalgamation process, and discusses the use of PPPs.

Box 5.1. Recommendations for increasing the effectiveness of Ukraine's funding for regional and local development

The following recommendations should be considered in a timeframe that is appropriate to the current context of war and post-war reconstruction and recovery.

To help Ukraine optimise the effects of the equalisation system on regional convergence and growth, the government is advised to:

- Modify legislation to base personal income tax (PIT) allocation on place of residence, thereby maximising its potential to provide municipalities with financial resources commensurate with the demand for public services and investment in their territory, while also strengthening local political accountability.
- Improve data processing systems related to a citizen's place of residence to allow the government, instead of employers, to allocate PIT to subnational governments.
- Conduct an ex-ante study to determine how the different proposals to reform the PIT allocation system would affect the fiscal health of the national, regional and municipal governments, as well as the size of the horizontal fiscal equalisation system necessary to offset, at least in part, territorial disparities in PIT revenues.
- Set up a national/subnational government task force to identify policy interventions that would improve the efficiency and effectiveness of the PIT allocation reform, based on the findings of the ex-ante study.

To improve the effectiveness of Ukraine's grants and subventions for regional development, the government is advised to:

- Streamline the number of grants and subventions for regional development, but not reduce their value, in order to increase spending efficiency, avoid overlap and strengthen the quality of implementation. This could be done, for example, by:
    - Reallocating a higher share of regional and local budget grants and subventions to a single fund (e.g. the SFRD) managed by MinRegion.
- Reinforce the capacity of the Inter-Departmental Co-ordination Committee for Regional Development (ICC) to effectively co-ordinate regional development policy and funding, for example by:
    - Ensuring that, if sub-committees are established within the ICC, one or more support the design, implementation and monitoring of Ukraine's regional development funding mechanisms.
- Balance investment in "hard" and "soft" infrastructure as a means to promote balanced regional development, for example by:
    - Ensuring that funds and subventions with a cross-sectoral focus, such as the SFRD, facilitate investment in areas such as innovation and skills, as well as "hard" infrastructure.
- Adjust the SFRD distribution formula to improve regional convergence, for example by:
    - Linking the formula to the population and GDP per capita of *rayons* instead of *oblasts* or increasing the share of SFRD funds allocated to those territories that have a relatively low GDP.
- Ensure that poorer municipalities, those with limited technical and financial capacities, as well as those most affected by Russia's war against Ukraine, can compete for regional development

funding against their wealthier peers and/or those with greater technical capacities by, for example:
    - Providing municipalities with more clarity on eligibility criteria.
    - Boosting their technical skills to develop competitive proposals.
    - Linking co-funding requirements to the fiscal capacity of municipalities.
    - Setting up a complementary general block grant that provides all *oblasts* and municipalities with a minimum level of funding to implement their respective regional and local development strategies. This must be coupled with robust oversight mechanisms to ensure that investment projects meet clear local and/or cross-jurisdictional needs.
    - Modifying the SFRD regulations to promote funding of multi-year projects that have a cross-jurisdictional focus.

To help strengthen the ability of regional and municipal governments to fund regional development and finance investment in the medium and long term, Ukraine is advised to:

- Develop and implement methodologies that municipalities can use to identify investment needs, given the scarcity of territorially-disaggregated data, and to effectively engage with governmental and non-governmental actors.
- In collaboration with international development partners, provide training and advice to municipalities, particularly those with more limited capacities, in areas such as stakeholder engagement, as well as monitoring and evaluating investment projects.

To improve the legal and efficient use of regional development funding in the short to medium term, Ukraine is advised to:

- Mandate internal auditing by all municipal governments. This requires, among other elements, providing municipalities with financial and capacity building support to conduct reliable and effective internal audits, and learn from audit results.
- Ensure effective communication between the municipalities, the State Audit Service, and the ministries that manage regional development funds to identify common challenges and bottlenecks in financial management and procurement, and propose tailored actions to address them.

To increase the responsible use of public-private partnerships as a means to fund and finance regional and local development in the short and medium term, Ukraine is advised to:

- Improve outreach to larger municipalities and the private sector about the potential of PPPs, the regulatory framework and, in particular, the multiple risks involved in setting up and managing a public-private collaboration. This could also include national government guidance regarding alternatives to PPPs that present value for money, and their potential benefits and risks.
- Develop and disseminate training material for municipalities on assessing the value-added of PPPs, managing such partnerships, as well as establish a transparent system to track the use of public funds and determine their effectiveness.

Sources of regional development funding in Ukraine

Since 2015, Ukraine has made significant progress in its approach to planning for regional development at the national, regional and local levels. Regional and local development initiatives are funded through multiple sources, including intergovernmental transfers, shared taxes, such as PIT, as well as own-source taxes of subnational governments. Furthermore, both national and subnational governments receive donor support to finance regional and local development projects, and under certain conditions some subnational governments can borrow from national and international credit markets.

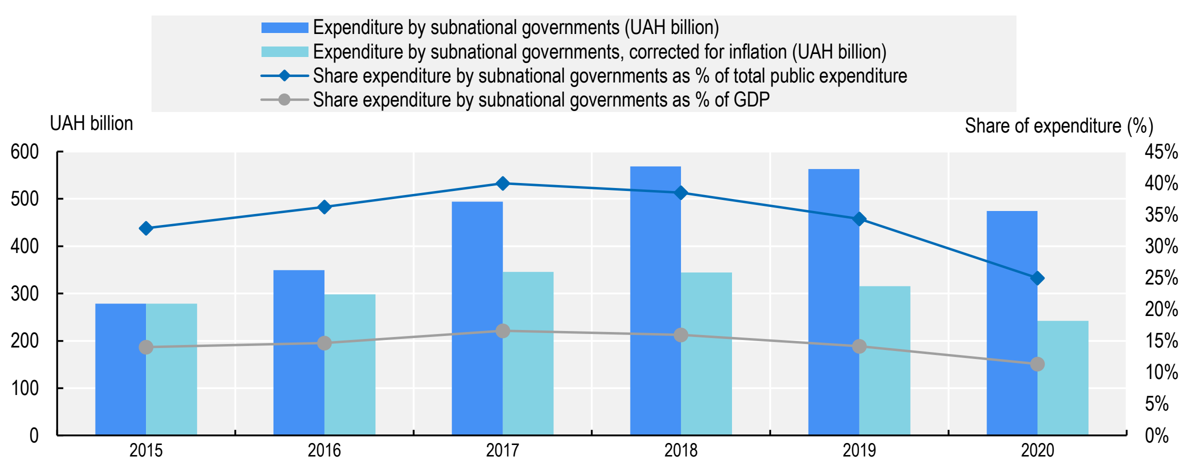
Ukraine's performance on selected fiscal indicators since 2015

An assessment of Ukraine's performance on a series of fiscal indicators related to subnational revenues and expenditures since 2015 points to challenges in the ability of *oblasts*, *rayons* and municipalities to fund and finance investment. It also shows a continued dependency of subnational governments on transfers by the central government and revenues from PIT.

Share of subnational expenditure as part of all public expenditure has remained stable

Between 2015 and 2019—prior to the COVID-19 pandemic—Ukraine reported an increase in subnational expenditure (i.e. *oblasts*, *rayons* and municipalities combined) in nominal and real terms (Figure 5.1). Over this five-year period, the share of subnational expenditure as a percentage of total public expenditure fluctuated between 33% and 40%, similar to the European Union (EU-28) average (34% in 2019), but below that of the OECD (40%) (OECD, 2022[10]). It was also similar to that of Poland (34%) whose population and three-tiered subnational government structure is relatively comparable to that of Ukraine (OECD, 2022[10]).

Figure 5.1. Subnational expenditure, 2015-2020

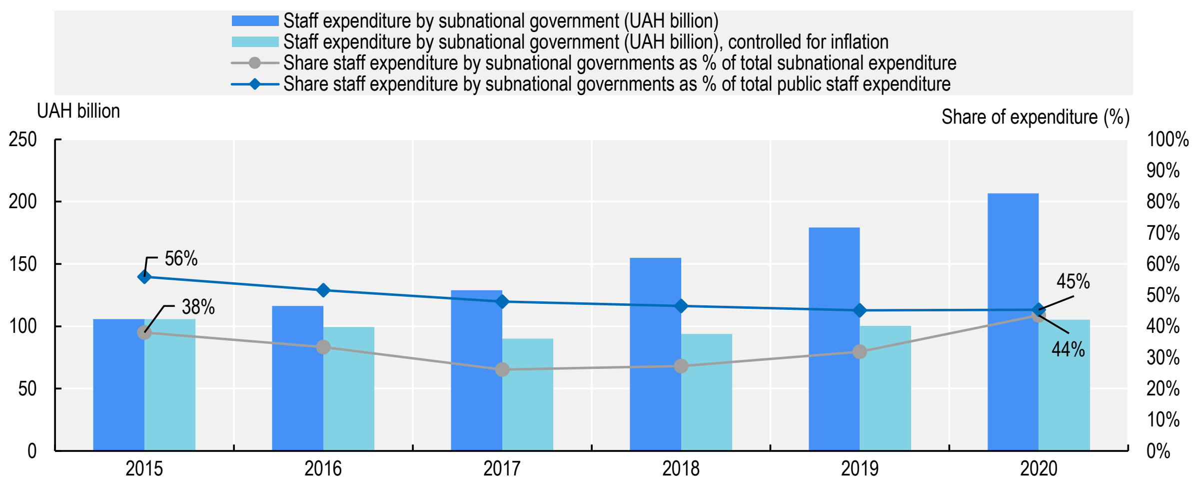


Source: Author's elaboration, with data from (IMF, 2022[11]; World Bank, 2022[12]; World Bank, 2021[13]).

In 2020, however, the spending share by subnational governments dropped sharply to only 25% (OECD, 2022[10]; IMF, 2022[11]), reflecting in large part the decision of the government to reduce the size of several funds open to subnational governments in order to create the COVID 'Stabilisation Fund'. This fund was used, in part, to make additional payments to medical workers and assistance to the elderly, and to help subnational governments cope with the pandemic. Another factor contributing to this decrease were changes in the mechanisms for funding social protection and healthcare. Since 2019, a significant part of expenditures in both areas are funded directly from the national budget. In 2019, Ukraine's subnational expenditure as a percent of gross domestic product (GDP) was 14%, similar to that of Italy and Poland (OECD, 2022[10]). The large drop in subnational expenditure between 2019 and 2020 meant that between 2015 and 2020, subnational expenditure actually declined in real terms (-13%).

Ukraine's subnational governments continue to be important public employers, albeit less so than in 2015. Whereas in 2015, the share of subnational staff expenditure of all public staff expenditure was about 56%, by 2019 this decreased to 45%, and was stable in 2020 (Figure 5.2). This is below the 2019 averages of the EU-28 (51%), the OECD (62%) and Poland (53%) (OECD, 2022[10]). The reduction between 2015 and 2020 can be explained by the fact that in this six-year period, staff expenditure by the national government increased more rapidly (298%) than that of subnational governments (194%). Moreover, this period coincides with the rollout of the municipal amalgamation process. In real terms, subnational expenditure on staff costs remained relatively stable between 2015 and 2020.

Figure 5.2. Staff expenditure by subnational governments, 2015-2020



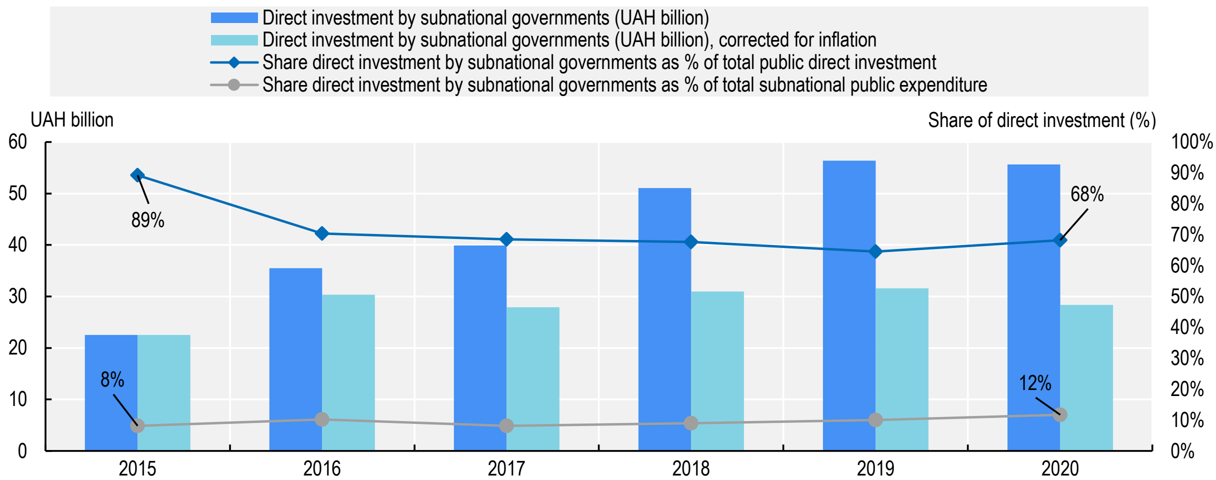
Source: Author's elaboration, with data from (IMF, 2022[11]; World Bank, 2021[13]).

Between 2015 and 2020, the share of subnational staff expenditure as part of all subnational public expenditure fluctuated between 26% and 44%, peaking in 2020 (IMF, 2022[11]). The marked increase between 2019 and 2020—from 32% to 44%—reflects the sharp drop in the overall expenditure by subnational governments and an increase in nominal staff costs. In 2019, the share of subnational staff expenditure as part of all subnational public expenditure was similar to the EU-28 average (both 32%) yet less than that of the OECD (35%) and Poland (38%) (OECD, 2022[10]).

Share of subnational investment as part of total subnational expenditure increased slightly

Between 2015 and 2020, direct investment by subnational governments increased both in nominal and in real terms (147% and 26%, respectively) (Figure 5.3). Meanwhile, the share of subnational direct investment as a percentage of total public direct investment dropped 21 percentage points. Despite dropping from 89% in 2015 to 68% in 2020, the share of subnational investment in total public direct investment remained well above the 2019 EU-28 (54%) and OECD (56%) averages, as well as that of Poland (49%). It was similar to that of Colombia (69%), Germany (68%), Japan (70%) and Switzerland (68%) (OECD, 2022[10]). As such, Ukraine's subnational governments continue to play a pivotal role in public investment. Between 2015 and 2020, the share of direct investment by Ukraine's subnational governments of all subnational expenditure increased slightly, from 8% to 12%.

Figure 5.3. Direct investment by subnational governments, 2015-2020



Source: Author's elaboration, with data from (IMF, 2022[11]; World Bank, 2021[13]).

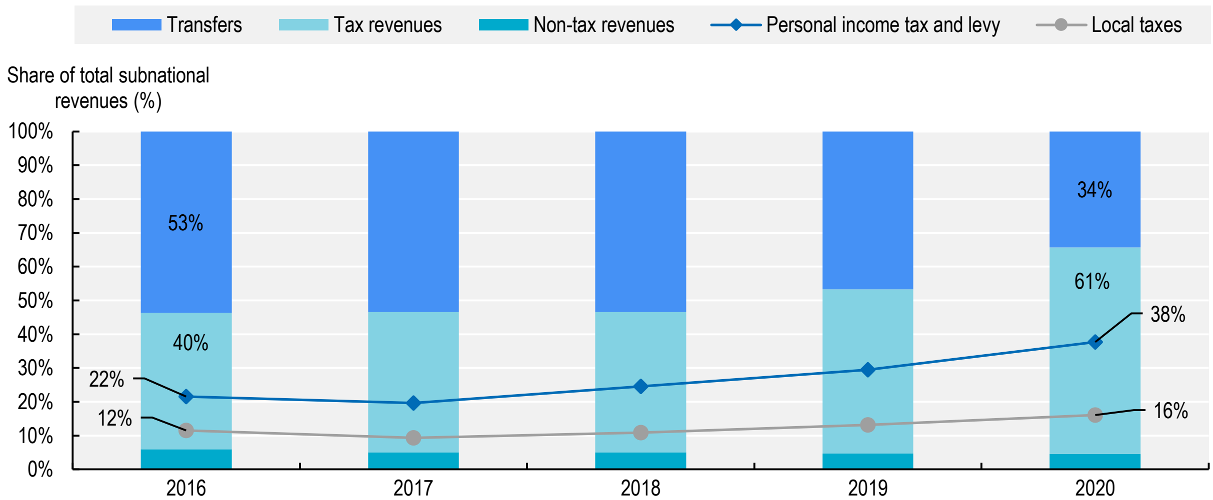
These fiscal indicators should be interpreted with caution as *oblasts* and *rayons* are composed of both deconcentrated and decentralised entities. This means that parts of their budgets, although categorised as "local government sector" in national accounts, should be classified as "central government sector". For example, *oblast* executive committees are not elected. They represent the central government and report to a presidentially appointed *oblast* governor. Conversely, *oblast* and *rayon* councils have relatively few powers. As a result, the data presented above tends to overestimate the weight of the subnational sector.

Central government transfers remain a major source of subnational revenue

Between 2016 and 2020, subnational revenues increased significantly in nominal terms: from UAH 366 billion in 2016 to UAH 471 billion in 2020. However, when controlling for inflation, subnational revenues actually declined by 23% over this five-year period (CabMin, 2021[5]; World Bank, 2021[13]). Over these same years, subnational tax revenues as a share of total public tax revenues increased from 22% to 25%. While this is lower than the 2019 OECD average of 31%, it is slightly above that of the EU-28 (23%) and of Poland (20%) (OECD, 2022[10]; IMF, 2022[11]). This change was, however, accompanied by a reduction in the share of subnational revenue as part of all public revenue: from 40% in 2016 to 28% in 2020. Over the five-year period, revenue of the national government increased by 182% compared to 128% for subnational governments.

Between 2016 and 2020, the share of central government transfers as part of all subnational revenues dropped significantly, from 53% to 34% (Figure 5.4). This is less than the OECD and EU-28 averages of 38% and 45% respectively (IMF, 2022[11]; OECD, 2022[10]). It is also well below that of Poland (60%) (OECD, 2022[10]). A large portion of this reduction came between 2019 and 2020 (from 46% to 34%) (CabMin, 2021[5]; OECD, 2022[10]). This can be attributed to the government's decision to cut the size of several funds, including the SFRD, in order to create the COVID Stabilisation Fund, as well as the aforementioned changes to the mechanisms for funding healthcare and social services. As central government transfers are often earmarked, this limits the scope for subnational governments to adapt spending to local investment needs. Generally speaking, lowering subnational government dependence on earmarked intergovernmental transfers increases their relative fiscal autonomy.

Figure 5.4. Change in the composition of subnational revenue, 2016-2020

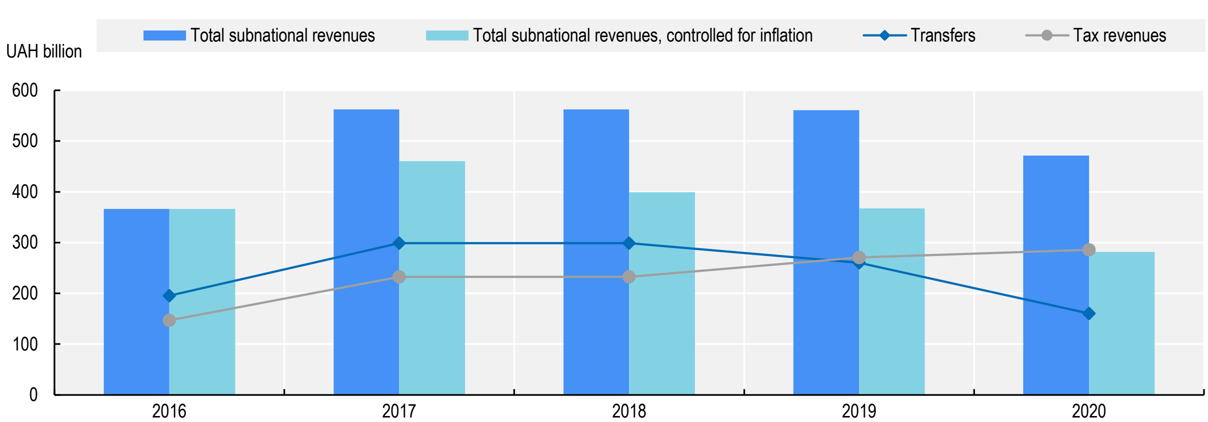


Note: Transfers include, among other elements, grants and subventions from the national budget. Income from capital transactions, revenues from the European Union, foreign governments, international organisations and donor institutions, as well as revenues from Budget Trust Funds are excluded from this list as, during the 2016-2020 period, on average, they each represented less than 1% of all subnational revenues. Grants from local budgets to other local budgets and subventions from local budgets to other local budgets are not incorporated in this chart.
Source: Author's elaboration with data provided by the Cabinet of Ministers of Ukraine (2021[5]).

Own-source taxes continue to represent a minor part of subnational government revenues

Between 2016 and 2019, the share of tax revenues—including own-source and shared taxes—as part of all subnational revenues, increased gradually, from 40% to 48% (Figure 5.4). In 2020, however, it jumped to 61% (CabMin, 2021[5]; OECD, 2022[10]). This is not the result of a change in the mandate of subnational governments to raise local taxes or an increase in the percentage of shared taxes that they are allowed to keep. Rather, it reflects a gradual increase of tax revenues, as well as a marked decrease in the amount of state transfers between 2019 and 2020 as a result of the creation of the COVID Stabilisation Fund (Figure 5.5.). Moreover, it reflects changes to the funding of certain costs related to social services and healthcare.

Figure 5.5. Subnational revenues from taxes and transfers, 2016-2020



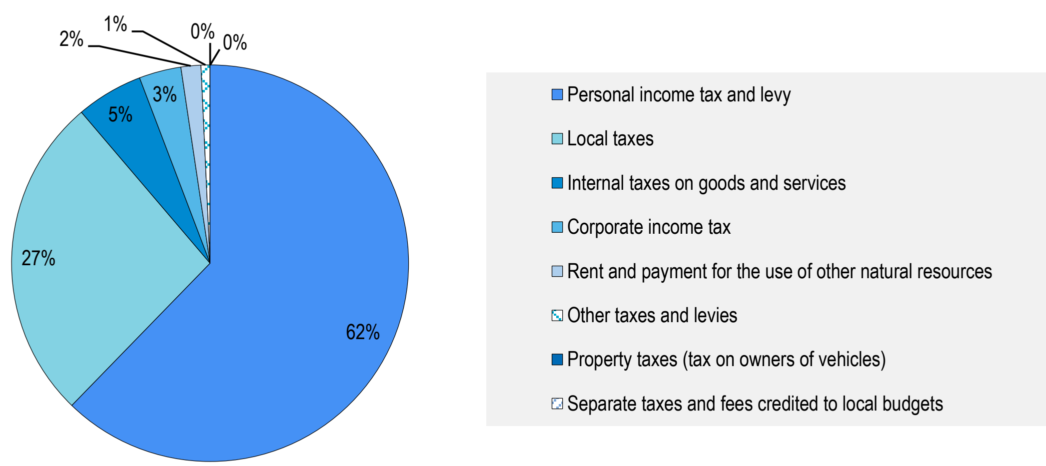
Note: Official transfers include, among other elements, grants and subventions from the national budget, as well as grants and subventions from local budgets. Total subnational revenues, include intergovernmental transfers from the state budget.
Source: Author's elaboration with data provided by the Cabinet of Ministers of Ukraine (2021[5]).

The revenues generated through the PIT as part of all subnational revenues, which are shared among levels of government, increased by 16 percentage points between 2016 and 2020. In 2020, 38% of all subnational revenues came from PIT (Figure 5.4) (CabMin, 2021[5]; OECD, 2022[10]).

As explained in more detailed later this chapter, PIT and Corporate Income Tax (CIT) are the main elements of the country's fiscal equalisation system, with the former generating the highest level of resources. Currently, *oblasts* receive a 15% share of PIT, municipalities receive 60%, and 25% goes to the national government[2]. An exception is Kyiv City, which receives 40% of PIT, meaning that 60% of PIT that is generated in Kyiv City flows into the national budget. This makes the criteria for PIT allocation a crucial element in determining subnational fiscal capacity, and thereby their ability to invest in regional and local development initiatives (OECD, 2018[14]; Verkhovna Rada, 2022[15]). CIT, on the other hand, is shared only between *oblasts* and the national government. In 2020, 2% of subnational revenues came from CIT.

As previously mentioned, tax revenues represent a significant share of total subnational revenues, the majority of which comes from shared taxes and a relatively small part from local taxes (i.e. property tax, tourist tax, single tax and certain user charges and fees). Between 2016 and 2020, the share of local taxes as part of all subnational revenues remained relatively stable, fluctuating between 12% in 2016 and 16% in 2020 (CabMin, 2021[5]; OECD, 2022[10]). In 2020, local taxes represented 27% of revenues received by subnational bodies from taxes and fees, including those redistributed by the central government (Figure 5.6). This is two percentage points less than in 2016 (29%). This reflects limited legislative changes to expand the ability of subnational authorities to raise taxes.

Figure 5.6. Breakdown of subnational taxes and fees, 2020



Note: Breakdown of taxes according to information provided by the Cabinet of Ministers. The "Local taxes" category includes property tax (other than tax on owners of vehicles), tourist tax, single tax and certain user charges and fees.
Source: Author's elaboration with data from the (CabMin, 2021[5]).

The share of subnational expenditure on education and economic development as part of total subnational expenditure has increased

Between 2016 and 2020, there were important changes in the expenditure patterns of subnational governments. In particular, the share of subnational government expenditure on education increased from 27% to 42%, on economic development from 10% to 20% and on general public services from 5% to 10% (Table 5.1). In fact, the subnational expenditure on these three functional areas increased significantly both in nominal and real terms. Conversely, the share of subnational expenditure on social protection as part of total subnational expenditure significantly decreased, from 30% in 2016 to 5% in 2020. This is attributed, in part, to the fact that in recent years certain payments to families with children were funded through the national budget, instead of local budgets (U-LEAD, 2021[16]). Moreover, between 2019 and 2020, the share of subnational expenditure on healthcare as part of total subnational expenditure also decreased as the funding of certain costs was centralised (U-LEAD, 2022[7]).

Table 5.1. Distribution of subnational government expenses by function, 2016-2020

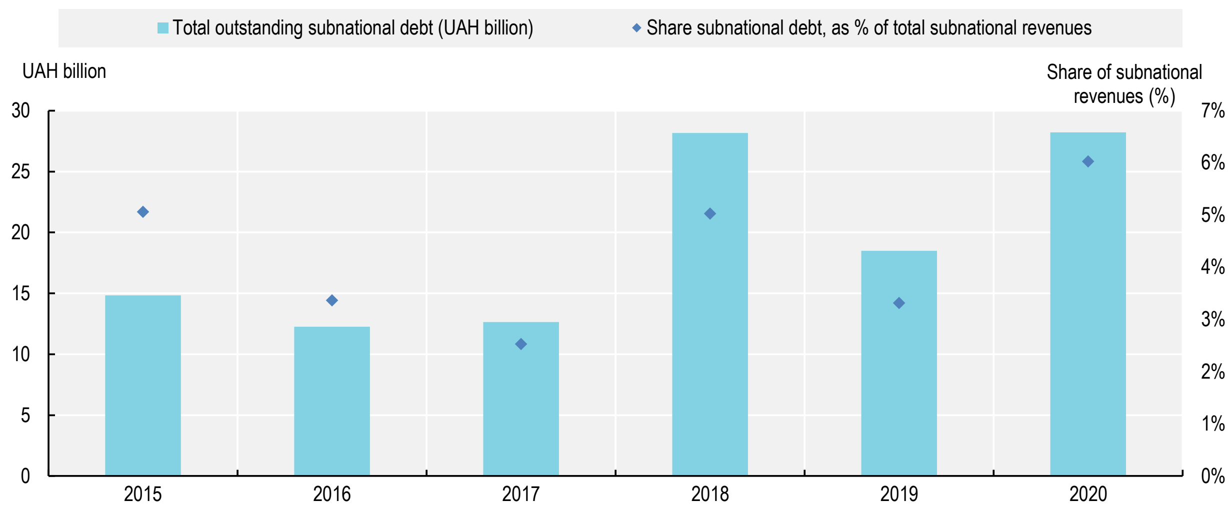
Functional area	2016		2020		
	UAH billion	Share of total expenditure	UAH billion	UAH billion (adjusted for inflation)	Share of total expenditure
General public services	19	5%	48	29	10%
Defense	0	0%	0	0	0%
Public order, & safety	0	0%	2	1	0%
Economic affairs	35	10%	94	56	20%
Environment protection	1	0%	2	1	1%
Housing & community amenities	18	5%	32	19	7%
Health	63	18%	51	30	11%
Recreation, culture, & religion	12	3%	22	13	5%
Education	95	27%	199	119	42%
Social protection	106	30%	24	14	5%
Total	**349**	**100%**	**475**	**283**	**100%**

Source: Author's elaboration with data from (IMF, 2022[11]).

Subnational debt almost doubled in five years, but remains relatively low

Between 2015 and 2020, subnational debt almost doubled in nominal terms, from UAH 14.8 billion to UAH 28.2 billion. However, as a share of total subnational revenue, Ukraine reported only a minor increase; from 5% in 2015 to 6% in 2020 (Figure 5.7). Moreover, when controlling for inflation, in 2020, subnational debt was about the same as in 2015. Furthermore, subnational debt continues to represent only a very small part of all public debt, fluctuating between 0.6% and 1.4% between 2015 and 2020. This is well below the 2019 EU-28 (14.5%) and OECD (22%) averages. It is also well below the share of subnational debt as part of all public debt in Poland (8.9%) (OECD, 2022[10]). Compared to OECD member countries, only Greece (0.5%) has lower subnational debt as a share of all public debt. This trend can be explained by the fact that in recent years no significant changes have been made to the legislative and regulatory framework related to borrowing by subnational governments. As such, in effect only the councils of *oblasts* and major cities can borrow.

Figure 5.7. Subnational debt, 2015-2020



Source: Author's elaboration with data from (IMF, 2022[11]; World Bank, 2021[13]).

The data provided above highlight several key issues and challenges with respect to funding and financing regional development, which will be explored in the following sections. These include the PIT allocation system, the variety of intergovernmental subventions and grants used to fund regional and local development projects, and the investment capacity of local governments after the amalgamation reforms.

The impact of fiscal equalisation and PIT allocation on regional inequalities

Although not specifically conceived as an instrument to support regional development funding, Ukraine's fiscal equalisation mechanism, through the distribution of PIT, has a strong effect on the ability of subnational governments to fund basic service delivery, as well as to make strategic investments. As such, it is essential to understand how the fiscal equalisation mechanism works and to what extent certain aspects of it may hamper the impact of Ukraine's regional development policy. For example, the PIT allocation mechanism allows multi-office companies to credit the PIT of their employees to the municipality in which the companies are registered—often larger municipalities—and not necessarily where their employees live or work. This undermines the capacity of smaller municipalities to fund service delivery and finance investment, requiring substantial horizontal equalisation to offset at least a portion of the fiscal disparities across municipalities.

Limited evidence on the impact of the equalisation system on territorial convergence

Fiscal equalisation—the transfer of financial resources to and among subnational governments (Box 5.2)—can allow subnational governments to provide their residents with similar levels of public services at comparable levels of taxation by levelling fiscal capacities among different subnational governments (OECD/KIPF, 2016[17]; OECD, 2021[18]). Equalising transfers are usually non-earmarked, as in the case of Ukraine, which increases the relative fiscal autonomy of jurisdictions that would otherwise have fewer resources.

Box 5.2. Fiscal equalisation

Fiscal equalisation can be necessary to reduce regional disparities, in particular regional differences in fiscal capacity and expenditure needs of subnational governments. It is particularly necessary in the context of a decentralisation process. Without proper corrective mechanisms, decentralisation can result in increased inequalities among subnational governments, depending on their geographic location, socio-economic features, capacity constraints and fiscal potential. By redistributing funds from wealthier governments to those that face higher per capita costs or lower per capita revenue capacities, fiscal equalisation systems promote the principles of solidarity and territorial cohesion.

The dual functions of fiscal equalisation—to promote equality while enabling autonomy—give rise to a key challenge for policymakers: designing a system that allows differentiated public goods to be provided according to regional and local needs, while enabling comparable levels of public services to be delivered among subnational governments. In addressing this challenge, it is important to bear in mind the economic objectives that underpin equalisation, such as facilitating regional convergence and bolstering growth or mitigating the economic losses associated with interregional disparities that could arise from in-country migration.

Different modalities of fiscal equalisation

Generally speaking, three types of fiscal equalisation can be identified: revenue, cost, and gap-filling.

- **Revenue equalisation** seeks to reduce differences in the fiscal capacities (per capita) of subnational governments. Germany and Canada are examples of countries with a revenue equalisation system. Revenue equalisation may give subnational governments an incentive to increase tax rates (i.e. thresholds) in order to reduce the tax base and to obtain higher equalisation grants. Setting tax rate ceilings and floors may reduce such strategic behaviour by subnational governments.
- **Cost equalisation** aims to compensate subnational governments with higher per capita costs relative to other local authorities, so that they do not face an undue burden in delivering a baseline level of public services. The equalisation systems of several OECD member states (e.g. Estonia, Lithuania and Norway) integrate both cost and revenue equalising components. Cost equalisation that relies on actual spending may give subnational governments an incentive to inflate their budgets and lead to increased equalisation payments. In addition, cost equalisation payments that seek to compensate small municipalities that have relatively high costs for operating a school or hospital could prevent them from investing in measures to reduce service delivery costs, for example through amalgamation or inter-municipal co-operation.
- **Gap-filling equalisation** seeks to bridge the gap between per capita costs and revenues for each subnational government, rather than consider either side of the ledger in isolation. Several OECD member states, including Australia, Italy and Japan, are generally recognised to have gap-filling equalisation systems.

Most equalisation systems combine elements of these three modalities of fiscal equalisation. Equalisation may take place vertically, from higher levels of government to financially weaker lower levels of government, or horizontally, across the same level of government from wealthier jurisdictions to poorer ones.

The difficulty lies in designing a system that can combine solidarity and equity principles with economic efficiency. In addition, policy makers should ensure that the equalisation system provides subnational governments with incentives to develop their economic and fiscal base, and to take measures to improve the quality and cost-efficiency of local service delivery.

Source: Author's elaboration, based on: (OECD/KIPF, 2016[17]; Dougherty and Forman, 2021[19]; OECD, 2007[20]; OECD, forthcoming[21]).

While there is evidence that fiscal decentralisation facilitates regional convergence, there is some debate over whether fiscal equalisation might actually hinder long-term development incentives in an attempt to correct short-run disparities in fiscal capacity (Bartolini, Stossberg and Blöchliger, 2016[22]). In this regard, it is important to note that fiscal equalisation policies generally do not aim to reduce income inequalities or stimulate territorially balanced economic growth, which are objectives generally associated with regional development policy (OECD, forthcoming[21]).

Data on Canadian provinces show that equalisation payments contribute to increases in unproductive expenditure, slowing convergence (Hailemariam and Dzhumashev, 2018[23]). Conversely, a study on German municipalities found that increasing equalisation rates can lead to less distortionary taxation choices by local governments, which could be conducive to growth and productivity (Holm-Hadulla, 2020[24]). Moreover, OECD analysis shows that there is no significant correlation between fiscal equalisation and regional income equality (OECD, forthcoming[21]).

At the same time, fiscal equalisation and regional development policies can be complementary. Even when the objectives and target groups of fiscal equalisation and regional development policy may be different, the outcomes of both tools are closely related. For example, “regional development policies that succeed in reducing regional income disparities may lessen the need for generous fiscal equalisation schemes” (OECD, forthcoming[21]). However, both tools should not be conflated. Equalisation should be the main purpose of equalisation transfers, just as regional development funds should be used to boost regional development. Combining too many objectives in a single grant or transfer programme may give way to an overly complex system that fails to achieve its multiple objectives.

Ukraine’s recent modifications to the equalisation system make it fairer

Ukraine’s 2014 amendments to its Budget Code introduced an equalisation mechanism for subnational government revenues rather than expenditures, basing it on two taxes: the Personal Income Tax (PIT) and Corporate Income Tax (CIT), with the former generating the highest level of resources. The system, which takes revenue performance into consideration when calculating the equalisation grants, is designed to improve horizontal equality between local governments, while avoiding incentives for municipalities to undermine their own tax capacity (Box 5.3) (OECD, 2018[14]). Before a 2020 amendment to the Budget Code was passed, the system was imbalanced, benefiting those subnational governments with the fewest service delivery responsibilities.

Box 5.3. Ukraine's equalisation systems: base and reverse grants

Ukraine has two horizontal equalisation mechanisms, one for *oblasts* and one for municipalities. They are based on the following:

1. The population of the subnational government (*oblasts* or municipalities);
2. Received shared tax revenues: PIT and CIT in the case of *oblasts,* and PIT in the case of municipalities;
3. Tax capacity index of each *oblast* and municipality. This is the ratio between the tax capacity per person of a local budget and the average tax capacity per person of the budgets of the same level of subnational government (e.g. municipalities or *oblasts*).

The tax capacity index determines which subnational governments will receive a basic grant, which ones will pay the reverse grant and which ones will be unaffected by the mechanism.

Oblasts and municipalities with a tax capacity index of less than 0.9—measured against the national average—receive a basic grant amounting to up to 80% of the difference between their tax capacity and the 0.9 threshold. However, if their tax capacity index is more than 1.1, then 50% of their revenue surplus (i.e. 50% of the PIT revenues that exceeds the 1.1 threshold) is deducted and transferred back into the State budget through a reverse grant. Subnational governments with revenues between 90% and 110% of the country's average are not subject to compensation or deduction.

As a result, equalising transfers neither allow poorer subnational governments to overtake one another in terms of fiscal capacity, nor wealthier ones to fall below one another in terms of fiscal capacity. Furthermore, by intentionally keeping equalisation below 100%, it seeks to stimulate the development of own-source revenues. Local revenues from sources other than PIT and CIT are not subject to equalisation.

Use of the equalisation system as an incentive for voluntary amalgamations

As an incentive for voluntary amalgamations during the reform period, only "towns of *rayon* significance", villages and rural settlements that merged could retain their share of PIT (OECD, 2018[14]). This left non-amalgamated municipalities without access to important public resources necessary for carrying out administrative tasks or for funding service delivery, possibly exacerbating territorial disparities.

Source: Author's elaboration, based on (OECD, 2018[14]).

Until 2021, the equalisation baseline of *rayons*, cities of *oblast* significance and amalgamated municipalities was calculated together. This lowered the equalisation baseline for cities of *oblast* significance, while raising it for *rayons* and amalgamated communities. As such, for the 2016-2018 period, cities of *oblast* significance paid the most into the PIT system through reverse grants and received the least in return through base grants (SKL International, 2019[25]). Conversely, *rayons*, which have limited service provision responsibilities, paid the least into the system, but got the most out of it. During the same period, the convergence effect of the equalisation system[3] was highest for *rayons* and significantly lower for cities of *oblast* significance and amalgamated municipalities (SKL International, 2019[25]). As part of a 2020 amendment to the Budget Code, *rayons* no longer receive a share of the PIT fund. This modification makes the PIT distribution more commensurate with the assignment of responsibilities among levels of subnational government.

The current PIT allocation system undermines efforts to reduce territorial disparities

The PIT is a cornerstone of subnational government ability to fund regional and local development projects and boost local well-being. However, the way the PIT distribution mechanism is set up, and in particular the role companies have in allocating the tax, runs the risk of contributing to territorial disparities.

Private companies play an outsized role in the distribution of PIT funds

Ukraine's practice of allocating PIT to the municipality where the employer is legally registered rather than place of residence has three important ramifications. First, large companies with offices located throughout the country credit the PIT payments of their staff to the local government in which the company is legally registered. These payments might not correspond with the place where (most of) their employees work. This facilitates the tax administration of large companies as it enables them to credit the PIT to just one local government. This benefits larger municipalities where large companies are often registered, at the expense of smaller, frequently rural, communities. In turn, this increases the need for equalisation and requires that the base/reverse grant system be larger than necessary (Box 5.3). Third, it creates the conditions for companies to use PIT as a bargaining chip with local authorities, as companies can change their place of registration (and thus where the PIT payments are allocated). This gives them significant negotiating power (e.g. for favourable operating conditions) over local authorities, who do not wish to risk losing PIT funds (KSE, 2021[26]).

The current PIT allocation system may undermine democratic control

The current link between PIT allocation and place of employment (or more accurately place of company registration) risks undermining local democratic control. In principle, the more a municipality's revenues and expenses are determined by democratically elected councils, the more likely it is that they will make planning and budgeting decisions that contribute to meeting residents' needs and demands. Basing PIT allocation on place of residence—often the place where demand for and use of services such as public transport, education, healthcare, etc. is greatest—could strengthen democratic control. However, the positive effect that changing PIT allocation to place of residence can have on democratic control is dependent on the size of the equalisation mechanisms. Having a relatively large equalisation system in which many municipalities either receive a basic grant or pay the reverse grant could weaken the direct link between taxpayers and local leaders. Currently, however, Ukrainian municipalities where large multi-office companies are registered may spend the PIT contributions of people who do not live or work in their locality, who do not vote for them and to whom they are not politically accountable.

Possible profound implications of alternative PIT allocation systems

In early 2021, the Office of the President of Ukraine issued a decree giving the Cabinet of Ministers three months to submit draft legislation that would credit part of the PIT to local budgets, according to the registered place of residence of taxpayers. In response, over a dozen different amendments have been presented and were being reviewed when Russia launched its large-scale invasion of Ukraine on 24 February 2022.

Some of these proposals called for PIT to be shared with local governments based on where people work; while others proposed that PIT distribution should be based on place of residence or on a hybrid system that is linked to both place of work and of residence (Levitas, 2021[27]). A closer look at how some European countries such as Croatia and Romania manage the distribution of the PIT provides an indication of the pros and cons associated with the different models proposed. These include how complex the models are to establish, the incentives that they may provide to subnational governments to stimulate economic development, and the need for a strong equalisation system to offset any territorial disparities in PIT revenues (Table 5.2).

Table 5.2. Advantages and disadvantages of the alternatives to Ukraine's PIT allocation system

Description and examples	Advantage	Disadvantage
National PIT collection. Some countries such as the Slovak Republic earmark a set share of the national PIT yield for local governments and then allocate these funds to them through a formula based mainly on population size.	- Relative simplicity of the model. No specific information on employee's place of work is required. - Any year-on-year change in the amount of the PIT funds collected nationally will affect all local governments equally. This pairs the volume of the PIT disbursements with any changes in the overall economy.	- As the allocation of PIT funds is not linked to the PIT generated in each territory, local governments do not have a clear fiscal incentive to boost local employment.
PIT disbursement based on place of residence. Countries such as Belgium, Croatia, Italy and Sweden link PIT disbursement to the place where workers live. In Croatia, municipalities and cities are allowed to establish a PIT surcharge.	- This system connects the financial interests of subnational governments' electorates with the performance of subnational governments, thereby serving as an incentive for subnational governments to boost their economies. - Giving subnational governments influence over the local PIT rate can serve as a tool to strengthen political accountability. This positive effect could, however, be undermined by the need for a large equalisation system.	- A strong equalisation system is required, otherwise unproductive communities and those with a high share of informal employment will not receive many PIT funds. - This model may create incentives for municipalities to attract high-salary workers, risking gentrification effects. - The model does not give municipalities direct incentives to increase local employment. - The institutions involved in gathering and distributing the funds require up-to-date granular data on citizens' place of residence, and establish effective mechanisms to exchange information.
PIT disbursement based on place of work. In such a system, like the one used in Romania, PIT allocation is based on the place where people actually work, instead of where their employers are registered. The national government is responsible for PIT allocation.	- This system is potentially politically attractive due to the relative simplicity of the reform, compared to the other alternatives.	- Kyiv City and cities with large urban centres would be 'overfunded' at the expense of surrounding municipalities where urban workers live. - To offset this effect, the equalisation system (e.g. base and reserve grants) may have to be larger than for some of the alternative models.
Hybrid PIT distribution system. In such a system—an option currently being discussed in the Verkhovna Rada—PIT distribution would be partially based on the place of residence and place of work.	- This system has the potential to compensate local governments for the costs they incur when providing services, such as public transportation, to people who work but do not live in their jurisdictions and vice versa.	- This system requires up-to-date information on both people's place of residence and work, making it complex to manage.

Source: Author's elaboration, based on (Levitas, 2021[27]; Hrvatski sabor, 2017[28]; Hrvatski sabor, 2020[29]; Miličević, Bubaš and Majić, 2019[30]; Verkhovna Rada, 2021[31]; OECD, 2018[14]).

Changing PIT allocation involves identifying potential 'winners' and 'losers' and taking corrective policy decisions

The government should consider opting for a PIT reform based on place of residence as it appears to have the highest potential for providing municipalities with financial resources that are commensurate with the demand for public services and investment, while also strengthening local political accountability. However, an ex-ante study would be required to determine how the reform would affect the fiscal health of the different subnational governments, as well as that of the State. A 2021 report estimates that changing PIT allocation to the taxpayer's place of residence will increase PIT revenues of poorer rural municipalities by 50% to 70% (U-LEAD, 2021[32]). Careful consideration should be given to the question of how to compensate Kyiv City, which potentially stands to lose the most when allocating PIT based on place of residence. Ukraine should also consider giving larger municipalities some leeway to set a surcharge, as they too stand to lose if PIT allocation is based on place of residence, following the example of Croatia (Table 5.2). The ex-ante impact study should also be used to assess the effect that linking PIT allocation to place of residence would have on municipal disparities in PIT revenues, which influences the size of horizontal fiscal equalisation system.

Any reform of the PIT allocation mechanism should ensure that the government, instead of employers, allocates PIT to *oblasts* and municipalities. This requires investing in better information and data processing systems. Developing and operating such systems entails close collaboration among the State Treasury Service, the Ministry of Finance (MinFin) and the Ministry of Digital Transformation. In February 2022, an online service to change one's place of residence was set up, which could be an important stepping stone for changes to the PIT allocation mechanism, as it enables the government to have up-to-date information on where people live. This is particularly relevant given the high number of internally displaced people in Ukraine.

The government could also consider creating a task force in which representatives from all affected parties (i.e. municipalities, *oblasts* and Kyiv City), as well as state level institutions participate to discuss the findings of the ex-ante study, and to identify policy interventions that would improve the efficiency and effectiveness of the PIT allocation reform. It is, furthermore, imperative to closely monitor the roll out of the eventual reform to assess its impact on the fiscal capacity of subnational government. In particular, this will help determine how the reform affects the investment capacity of municipalities, as well as identify any negative externalities that require further intervention.

As a key source of non-earmarked revenue for municipalities, *oblasts* and Kyiv City, PIT is pivotal to their ability to fund regional and local development projects and boost local well-being. As such, improving the fairness of the PIT allocation mechanism needs to be part and parcel of any effort to strengthen Ukraine's regional development funding system.

Regional development funds in Ukraine

In 2019, the Government of Ukraine's financial support for regional and local development was approximately seven times greater than in 2015 (U-LEAD, forthcoming[1]). The creation of different intergovernmental grants and subventions helped contribute to this increase. However, the effectiveness of these funds is undermined by a series of challenges such as a fragmented and relatively unstable fiscal framework, an emphasis on funding "hard" regional and local infrastructure, and the prevalence of small-scale local projects. This affects the ability of national and subnational governments to boost regional competitiveness and growth. Most importantly, the current set-up of many of the grants and subventions for regional and local development may aggravate, rather than reduce, regional disparities.

The proliferation of regional and local development funds leads to fragmented decision making

Subventions and grants with a regional or local development dimension in Ukraine have been in plentiful supply. Between 2015 and 2019, a total of 110 grants and subventions linked to regional and local development—with a total budgetary allocation of UAH 209 billion—were implemented. Over this period, the share of subnational funding as a percentage of public spending grew from 2.1% in 2015 to 6.5% in 2019. It also became more fragmented, with the number of annual grants and subventions substantially rising between 2015 and 2019 (U-LEAD, forthcoming[1])[4]. This makes the administration of funding more costly and could lead to overlap. It could also make it harder for subnational governments to understand relevant regulations and whether or not they are eligible to apply for public funds.

The 110 grants and subventions were implemented by 20 different entities, including the Ministry of Communities and Territories Development (MinRegion), MinFin, 11 line ministries and three *oblast* state administrations. Less than 25% of budgetary allocations for regional and local development funds were the responsibility of MinRegion, undermining its role in supporting regional development across the whole of government, and fragmenting decision making (U-LEAD, forthcoming[1]). Only three of the nine largest regional and local development grants and subventions—amounting to more than UAH 5 billion during the 2015-2019 period—were managed by MinRegion (Table 5.3).

Table 5.3. Largest regional and local development grants in Ukraine between 2015 and 2019

Name of grant	Volume over 2015-2019 period (UAH)	Years implemented	Managing institution	Competitive/non-competitive	Sectoral / geographical focus
Subvention for State Highways	56 624 815 507	2015-2019	Ukravtodor	Non-competitive	Sectoral
Subvention for Local Public Roads	26 207 118 000	2018-2019	Ukravtodor	Non-competitive	Sectoral
Socio-Economic Subvention	17 724 516 171	2015-2019	MinFin	Competitive	Cross-sectoral
SFRD	17 446 036 426	2015-2019	MinRegion	Competitive	Cross-sectoral
Highway Improvements (Lviv-Uman and Byla Tserkva-Kherson)	8 685 483 727	2017-2019	Ukravtodor	Non-competitive	Sectoral and geographic
Local Infrastructure Subvention	6 301 027 665	2016-2019	MinRegion	Non-competitive	Sectoral
Rural Healthcare Subvention	6 000 000 000	2017-2019	MinRegion	Competitive	Sectoral

Note: This chart only includes grants worth over UAH five billion between 2015 and 2019. Two other initiatives where spending was over UAH five billion included "Financial Support of Agricultural Producers" and "State Support of Livestock Breeding, Storage and Processing of Agricultural Products, Aquaculture (fish farming)". However they were excluded from the OECD analysis on account of their sectoral focus.
Source: Author's elaboration with data retrieved from U-LEAD (forthcoming[1]).

The proliferation of grants and subventions presents a co-ordination challenge that could potentially undermine spending efficiency, the quality of implementation, and the effectiveness of the different intergovernmental transfers. This is particularly difficult given the problems associated with the Inter-Departmental Co-ordination Committee for Regional Development (ICC) and the Congress for Local and Regional Authorities described in Chapter 4.

To address this challenge, the government should consider reallocating a higher share of regional and local budget grants and subventions to a single fund (e.g. the SFRD) managed by MinRegion. This would help ensure that overarching government objectives in the regional and local development sphere are met. MinRegion should also reinforce its efforts to effectively co-ordinate the different regional and local development funds, even when such funds are implemented by other ministries.

If it is deemed politically unfeasible to merge funds, it would be even more urgent to operationalise the ICC as a body that effectively co-ordinates regional development policy and funding. Ukraine should consider creating a sub-committee within the ICC whose objective could include co-ordinating the design, implementation and monitoring of Ukraine's regional development funding mechanisms. This sub-committee could be tasked with monitoring possible overlap in the thematic and geographic focus of different grants. It could also propose monitoring frameworks to assess how effectively different funding mechanisms support the achievement of the government's main regional development policy objectives. Moreover, it could function as a forum to discuss policy and legislative solutions to challenges related to issues such as the ability of subnational governments to provide co-funding, and their human resource capacity to manage investment processes. Finland's Advisory Committee on Local Government Finances and Administration offers some insights to consider. While it focuses primarily on local government finances, the scope of its functions, its composition and the frequency of its meetings could be relevant if Ukraine decides to create a regional development funding sub-committee within the ICC (Box 5.4).

Box 5.4. Finland's Advisory Committee on Local Government Finances and Administration

The Local Government Act provides for the establishment of an "Advisory Committee on Local Government Finances and Administration". The Committee is a fundamental actor in the negotiation procedure between the national government and municipalities. Its key function is to provide a forum where the following topics, among others, can be discussed:

- Development plans and proposed legislation related to local government finances and administration.
- Proposals concerning local government finances and administration.
- The division of costs between the national and local governments.
- Other significant matters concerning local government finances and administration.

The Committee includes representatives from the Ministry of Finance, as well as from the Ministry of Education and Culture, the Ministry of Social Affairs and Health and the Association of Finnish Local and Regional Authorities. The Advisory Committee, which meets between 10 and 15 times per year, may set up different technical chambers to facilitate discussion.

Source: Author's elaboration, based on (Association of Finnish Local and Regional Authorities, 2021[33]; Ministry of Finance of Finland, 2022[34]).

Possible overlap among subnational funding mechanisms may lead to an inefficient use of funds

As a result of the proliferation of funds for regional and local development, there is significant thematic overlap in the scope of subventions (Table 5.4). This may create uncertainty among subnational governments regarding which institutions are responsible for a specific topic and lead to a duplication in reporting efforts. Good examples of this are the SFRD and the Subvention for the Implementation of Measures for Socio-Economic Development of Certain Territories" (Annex Box 5.A.3) (CabMin, 2015[35]; CabMin, 2012[36]). Between 2015 and 2019, the two subventions were almost identical in size and targeted many of the same investment objectives (e.g. improving energy efficiency, water supply, sewage, or heating networks in local communities, as well as purchases of public transport infrastructure) (Verkhovna Rada, 2014[37]). Despite these similarities, the two funds are managed independently of one another: the SFRD by MinRegion and Socio-Economic Subvention by MinFin.

Table 5.4. Examples of potential overlap in the focus areas of the main funds for regional and local development

Area of potential overlap	Sources of funding and managing institution
Purchase of medical equipment	- Subvention for the Implementation of Measures for Socio-Economic Development of Certain Territories (MinFin) - Subvention for the Implementation of Measures Aimed at the Development of the Healthcare System in Rural Areas (MinRegion)
Investment in infrastructure for local roads, energy efficiency initiatives, water supply and sewage	- SFRD (MinRegion) - Subvention from the State Budget to Local Budgets for the Formation of Infrastructure of Local Hromadas (MinRegion)

Investment in infrastructure for local roads	- Subvention from the State Budget to Local Budgets for the Construction, Reconstruction, Repair and Maintenance of Highways in General Use of Local Importance, Streets and Roads of Communal Importance in Settlements (Ukravtodor) - Subvention from the State Budget to Local Budgets for the Formation of Infrastructure of Local Hromadas (MinRegion)

Source: Author's elaboration, based on (CabMin, 2012[36]), (CabMin, 2017[38]), (CabMin, 2015[35]), (CabMin, 2016[39]).

The possible overlap among the different funds does not in and of itself portend an inefficient use of resources. It can, however, pose the risk that some government initiatives aimed at supporting the regional and local levels duplicate each other, possibly resulting in an inefficient use of scarce public resources. This may be particularly true of the overlap between thematically similar budget funds that are being administered in separate government departments, such as the SFRD and the Socio-Economic Subvention (CabMin, 2015[35]; CabMin, 2012[36]).

In this regard, the government should consider combining thematically overlapping subventions and funds into consolidated ones with multiple budget lines. This would facilitate centre-of-government co-ordination and ensure that the institutions directly involved co-ordinate the grant and subvention design, implementation, and monitoring and evaluation mechanisms. In addition, if a sub-committee for regional development funding is created, this co-ordination body could be tasked with identifying possible overlap in proposed funding mechanisms and ensuring that corrective action is taken.

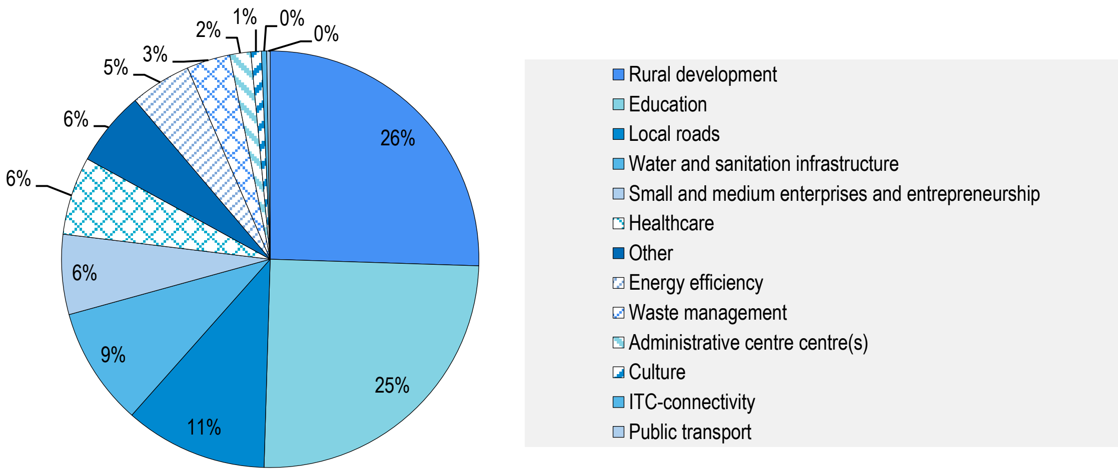
Regional development spending focuses heavily on "hard" infrastructure

Intergovernmental spending on regional development has predominantly focused on "hard" infrastructure Even though there is clear merit in investing in, for example, the construction or maintenance of roads, OECD analysis highlights that this alone has little impact on regional growth unless it is associated with "soft" investments (e.g. human capital development, innovation, research and development, SMEs, etc.) (OECD, 2009[3]; OECD, 2020[4]). A crucial challenge for policy makers is how to strike an adequate balance between both types of investment.

The government's emphasis on "hard" infrastructure is illustrated by the fact that the two largest subventions during the 2015-2019 period were implemented by Ukravtodor, the State Agency for Motor Roads (Table 5.3). Combined, these two funds amounted to nearly UAH 83 billion (CabMin, 2017[40]). In fact, spending on "hard" infrastructure accounted for 59% of all spending on regional development (U-LEAD, forthcoming[1]). Moreover, the European Investment Bank (EIB) and the Ukrainian government signed, in late 2020, loans totalling EUR 640 million, some of which will be used to finance projects at the municipal level to rehabilitate social infrastructure (e.g. hospitals, schools, kindergartens, post offices), improve public utility services and repair damaged administrative buildings, and other key social infrastructure (European Investment Bank, 2020[41]).

The dominant focus of these funds on "hard" infrastructure contrasts with the top investment priorities expressed by municipalities (Figure 5.8). A plurality of municipalities surveyed by the OECD in 2021 reported rural development (26%) and education (25%) to be their main investment priorities. Eleven percent of respondents considered local roads as a main investment need. This was followed by water and sanitation infrastructure (9%), healthcare, and small and medium-sized enterprises (SMEs) (both 6%) (OECD, 2021[42]).

Figure 5.8. Top municipal investment priorities



Note: Question: What is your municipality's top investment priority? Please select only one option. Full response options: Education; Healthcare; Culture; Local roads; Public transport; Rural development; Administrative centre centre(s); ITC-connectivity (e.g. access to broadband, digitalisation); Waste management; Water and sanitation infrastructure; Energy efficiency; Small and medium enterprises and entrepreneurship; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

The COVID-19 crisis provoked a renewed focus on the relevance of investing in research, skills and innovation. For example, hospitals rely on "soft" investment for developing new treatments. Going forward, the government should strike a more complementary balance between "hard" and "soft" infrastructure spending. Funds that have a cross-sectoral focus, such as the SFRD, could be better used to boost investment in areas such as innovation and skills.

The SFRD as the flagship regional development funding mechanism

The SFRD (Box 5.5) is the government's key funding mechanism to stimulate regional competitiveness, facilitate subnational cohesion, and fund the State Strategy for Regional Development (SSRD) and the *oblast* (regional) development strategies. The SSRD, is a competitive, grant-based fund, managed by MinRegion. Until late 2021, the SSRD was legally mandated to receive 1% of all planned revenues from the General State Budget Fund of Ukraine. In 2022, this was increased to 1.5%. Due to its size and cross-sectoral focus, the SFRD is a crucial source of funding that *oblasts* and municipalities can use for regional and local development projects in areas as varied as healthcare, public transport and culture. The effectiveness of the SFRD, however, is undermined by a series of challenges including the stability of its funding, project selection procedures, the type of projects that are funded, as well as the capacity of local governments to develop quality project proposals. Several of these obstacles are not unique to the SFRD but are also characteristic of other subventions that disadvantage poorer municipalities and risk exacerbating regional inequalities.

Box 5.5. Basic structure of the State Fund for Regional Development

State Fund for Regional Development (SFRD) funds are allocated to regional development programmes and projects that correspond to the priorities and tasks outlined in the SSRD, as well as regional development strategies. The grant is open to *oblast* state administrations, regional development agencies and local governments (notably amalgamated municipalities). A pre-requisite for receiving funding is being able to co-fund at least 10% of the total project cost through local budgets.

Allocation of funds between *oblasts* and Kyiv City

Beginning in 2022, the SFRD should be composed of at least 1.5% of the revenues from the General Fund of the State Budget. Previously this was 1%. The SFRD funds are disbursed to each *oblast state administration* and Kyiv City according to the following formula:

- The distribution of 80% of attributable funds is based on *oblast* population (as a percentage of the national population).
- The remaining 20% is based on the gross regional product per capita (for regions where this indicator is less than 75% of the national average).

Selection procedures for project proposals

The selection procedure for projects seeking funds from SFRD has two stages. First, candidates submit proposals to a regional-level commission, which is led by *oblast state administrations* and can include a range of other stakeholders, such as municipalities, regional branches of associations of local governments and relevant research institutions. Second, the commission reviews the proposals according to criteria set by MinRegion, and then draws up a shortlist of projects to receive funding. In the second stage, the shortlist is reviewed by a national-level commission, which makes the final decision. The commission must be comprised of at least 50% of the members of parliament (MPs) that sit on the Verkhovna Rada Budget Committee, as well as MinRegion representatives.

Source: Author's elaboration, based on (CabMin, 2015[35]; OECD, 2018[14]; MinRegion, 2021[43]).

Adjusting the SFRD distribution formula could improve regional convergence

Several changes could be made to the SFRD allocation formula to support regional convergence efforts. For instance, the allocation formula currently takes into account differences in population and GDP per capita at the *oblast* level. This allows the fund to cater to regionally differentiated needs and assets. However, as there are significant economic and socio-demographic disparities within *oblasts,* the government could consider linking the formula to the population and GDP per capita of *rayons* instead of *oblasts*. This would allow the government to allocate SFRD funding with more precision, which would benefit less-affluent municipalities that often struggle, in comparison to wealthier cities for instance, to fund investment projects through private sources (e.g. loans from international financial institutions). This change could also be justified by the fact that the majority of SFRD-funded projects are limited in geographic scope, 63% focusing on just one community. In recent years, less than 10% of SFRD projects had a regional focus, the rest focused on individual *rayons*. To enable such a modification of the allocation formula, the State Statistics Service of Ukraine (SSSU) and MinRegion could build on the *rayon*-level data that is already being gathered. However, if Ukraine decides to implement the PIT reform based on place of residence as discussed earlier—which may affect *rayon* GDP per capita—the government should consider reviewing the manner in which GDP per capita of *rayons* is calculated, in order to ensure that it adequately reflects local economic activity.

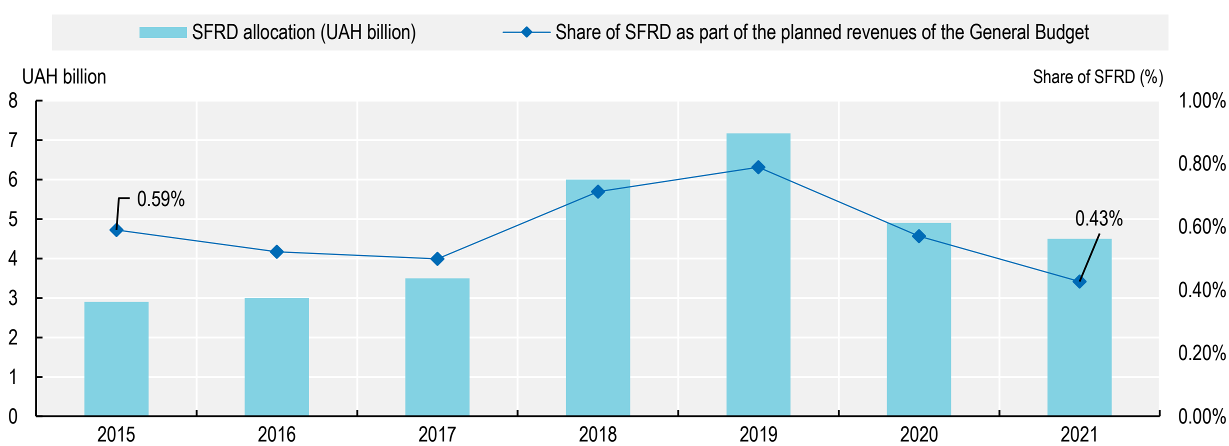
Additional indicators could be used to better identify territories that are in the greatest need of SFRD funds. For example, the government could take into account regional GINI coefficients, regional human development indexes or assess the capacity of regions to mobilise investment funding through sources other than the SFRD. However, such measures would make the allocation formula more complex. To facilitate this shift, the government would need to invest in the generation and dissemination of territorially disaggregated data, including on non-financial indicators.

Other options have been proposed to increase the amount of SFRD funding that reaches less affluent subnational governments. One possibility is to significantly increase the share of SFRD funding allocated on the basis of GDP per capita (U-LEAD, 2022[7]). This would directly benefit the relatively poor regions, but does not necessarily address the underlying issue of subregional disparities.

SFRD funding remains below the legally mandated level

A second concern is related to the volume of the SFRD. Between 2015 and 2021, the percentage of funds allocated to the SFRD fluctuated between 0.43% and 0.79%, remaining well below the then legally mandated level of 1% of planned General Budget fund revenues (Figure 5.9). This is despite the fact that, between 2016 and 2019, the EU provided budget support worth EUR 38 million to the government to support its regional development policy, which contributed to the volume of the SFRD (Box 5.6). It is important to note, however, that the budget support was not intended to exclusively fund the SFRD. Moreover, the execution rate of the SFRD fell between 2015 and 2019 (U-LEAD, forthcoming[1]).

Figure 5.9. SFRD funding, 2015 and 2021



Source: Author's elaboration data from (Verkhovna Rada, 2015[44]; Verkhovna Rada, 2016[45]; Verkhovna Rada, 2017[46]; Verkhovna Rada, 2018[47]; Verkhovna Rada, 2018[48]; Verkhovna Rada, 2020[49]).

Box 5.6. The European Union budget support programme for regional development

Between 2016 and 2019, the EU sought to contribute to Ukraine's social, economic, and territorial cohesion, increasing the well-being of its citizens through the Sector Reform Contract (SRC) "Support to Ukraine's Regional Policy". As part of this agreement, EUR 50 million was committed as budget support to bolster the social, economic, and territorial cohesion of Ukraine, and enhance the well-being of citizens throughout the country.

The budget support programme provided Ukraine with a framework and funds to experiment with new ways of funding regional and local development policy. Of the EUR 50 million, only EUR 38 million was disbursed as various key targets of the SRC were not met. This amounted to about 9% of the total budget allocations for the SFRD in the same period.

The 2020 evaluation of the SRC found that "concerns remain about the sustainability and mainstreaming of improvements across the system". It also indicated that a lack of capacity and unclear responsibilities at the local level are major hurdles to the success of regional development policy. This is exemplified by the overreliance on many small-scale infrastructure projects with low economic impact.

The SRC evaluation report concluded that the "establishment of the policy, legislative and institutional framework for regional policy, though fundamental, is not in itself sufficient to bring about the social and economic changes required to raise regional parity and promote regional economic and social development". Based on the findings of the 2020 evaluation report, among other elements, the EU decided not to renew the budget support for regional development but rather to invest in supporting local capacity to develop and implement local regional development plans and initiatives.

Source: Author's elaboration, based on (Ecorys, 2021[50]) (U-LEAD, 2018[51]).

Changes to the Budget Code defined the share of SFRD funds for national and regional investment and development initiatives

In early 2022, Ukraine amended the Budget Code to strengthen the SSRD's effectiveness. The amendments specified that SFRD funds should be used to implement investment programmes and regional development projects that are aligned with SSRD priorities, as well as those of the regional development strategies. Specifically, 30% of SFRD funds should be used to fund programmes and regional development projects that contribute to the SSRD. The remaining 70% should be used to fund programmes and regional development that ensure the implementation of the regional development strategies. These changes can strengthen the relationship between the SFRD and the different national and regional development planning documents. This is a particularly salient point as historically the link between the SFRD funded projects and the different regional development planning instruments has not been optimal. To illustrate this point, between 2015 and 2017 the objectives of the development projects funded through the SFRD contributed to achieving only 17% of objectives of the regional development strategies (MinRegion, 2019[52]). Earmarking a specific percentage of the SFRD for the implementation of regional development plans could help overcome this challenge. It would have to be paired, however, with efforts to improve financial planning at the national and subnational levels to make sure that the allocation of funds matches the thematic scope of the different development strategies.

The 2022 changes to the Budget Code did not include clear provisions to ensure that the legally mandated funding and the actual funding align. In other words, despite the change in the law, the actual funds assigned to the SFRD may continue to be (well) below the official threshold of 1.5% of all planned revenues from the General Budget Fund of Ukraine. In the absence of such regulations, the government is advised to consider several complementary actions. First, the ICC—including any (technical) working group related to regional development funding that it may establish—is advised to hold an annual meeting to review the parts of the draft State Budget that are related to regional development and issue recommendations for modifications in case less than 1.5% of the General Fund of the State Budget is proposed to be allocated to the SFRD. Second, the Verkhovna Rada's Committee on State Building, Local Governance, Regional and Urban Development is advised to use its participation in the process of developing and reviewing the State Budget of Ukraine to emphasise the legal commitment of allocating 1.5% of the General Fund of the State Budget to the SFRD.

The 2022 changes to the Budget Code also do not address a series of other fundamental problems with the SFRD, such as those related to its co-funding requirements. Furthermore, unlike legislative changes proposed by MinRegion in 2020, the 2022 changes to the Budget Code only earmark a specific percentage of the SFRD for the implementation of the SSRD and the regional development strategies, but not the local development plans.

A 2020 proposal to amend the Budget Code, developed by MinRegion sought to gradually increase the volume of the SFRD for the relevant budget period in 2023 to 3% of the planned revenues from the General Budget Fund of Ukraine (Box 5.7). If approved, the law would also have fixed the share of funding that could be used to implement the SSRD, the regional development strategies and the municipal development strategies. Thus, it would not only have strengthened the position of the fund as the main (cross-sectoral) funding instrument for regional development, it would also have enabled municipal development strategies to guide local investments more effectively.

Box 5.7. Draft Law No. 4200 "On Changes to the Budget Code of Ukraine"

The draft law proposed changes to the Budget Code of Ukraine and aimed to amend the article of the law that legislates the use of the SFRD. If approved, the SFRD would receive no less than 3% of the total projected revenue of the General fund of the draft State Budget of Ukraine.

The existing regional disbursement criteria would be complemented by the following formula link to the different regional development planning instruments:

- 50% of the funds are allocated to implementing programmes and projects under the auspices of the State Strategy for Regional Development (SSRD).
- 30% of the funds are allocated to implement the tasks defined by regional development strategies.
- 20% of the funds are allocated to implement municipal development strategies.

As is currently the case, regional development programmes and projects that are undertaken at the local level would be required to secure co-funding from local budgets at a minimum threshold of 10%.

If adopted, the draft law would also have reduced parliamentarians' participation in the project selection commission. If approved, members of the Verkhovna Rada would be able to represent up to 50% of the commission's members. Currently they make up at least 50%. At the same time, the law would not alter the requirement that at least 10% of allocated funding to a region be channelled towards investment programmes and projects that promote the development of local sports infrastructure.

Source: Author's elaboration, based on CabMin (2020[53]).

Parliamentarians play a major role in the selection procedures for competitive funding mechanisms

One issue that needs to be critically reviewed is the very active role of parliamentarians in the Verkhovna Rada in selecting projects for the SFRD and the Socio-Economic Subvention.

Despite the SFRD and the Socio-Economic Subvention being formally managed by MinRegion and MinFin respectively, legislation stipulates that at least 50% of the membership of the commission for project selection for each fund should be parliamentarians that sit on the Verkhovna Rada Budget Committee. This gives them significant power over the allocation of the funds (CabMin, 2012[36]). Representatives from the ministries that manage each of the funds form a minority in the respective selection committees. Without the adequate transparency and accountability mechanisms in place, this risks allocating project funding on the basis of electoral considerations. Different audit reports mention the political influence over the distribution of Socio-Economic Subvention funds, which have been used for political campaigning in local constituencies (National Institute for Strategic Studies, 2020[54]). This not only results in a loss of valuable resources, it also erodes trust in public institutions and elected officials, as well as policies associated with regional and local development.

Municipalities consider the issue of bias in the selection process to be the most important obstacle to obtaining funding through the different funding mechanisms for regional development (Box 5.8) (2021[42]). This signals a significant lack of confidence in the fairness of the project selection process.

Box 5.8. Main obstacles to obtaining funding, according to the municipalities

As part of the OECD online survey, municipalities were asked what they consider the main challenges to receiving funding through: i) the SFRD and ii) other funding mechanisms for regional development. For both questions—one related to the SFRD alone, the other to additional mechanisms for funding regional development—a plurality of the 741 surveyed municipalities reported that “bias in the selection process” of their proposals is the most important obstacle (22% and 24% or respondents respectively).

Approximately one in every three municipalities reported that factors related to their financial situation—either because of a lack of financial means to provide the necessary co-funding, or the costs associated with the design of the proposal—constitute the key impediment to obtaining funding through the different funding mechanisms. With regard to the SFRD, 18% consider that changing the priorities of the SFRD are the biggest obstacle. This hints at a perceived lack of clarity about the extent to which the SFRD can provide funding to meet local investment priorities. The identification of investment priorities is generally not seen as an obstacle. Only 1% of municipalities reported that this is the biggest challenge to obtaining funds through the SFRD.

Note: Annex Figure 5.B.2 and Annex Figure 5.B.3 present a more detailed breakdown of what municipalities consider the top challenge to receiving funding through the SFRD and other funding mechanisms. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author’s elaboration, based on the OECD online survey.

Any modification of the SFRD—or any other competitive funding mechanism—requires a reevaluation of the involvement of parliament in the allocation of funds. In particular, the government should consider providing the executive branch with a stronger say in the review and selection of project proposals. Meanwhile, parliamentarians should double down on their mandate to hold the different ministries involved in regional and local development accountable for their performance in implementing legislation that is relevant to regional and local development. This could mean, for instance, ensuring that the legally established percentage of funds from the revenues of the general budget fund is actually distributed to the

SFRD. To strengthen the transparency of this process, observer status could be awarded to representatives of the different associations of local governments, civil society organisations and/or international institutions with expertise in the field of local government funding and development. The collaboration between the United National Development Programme (UNDP) and the Mexican government could serve as an example. The Federal Government of Mexico invited UNDP to support the development and implementation of its Sovereign Sustainable Development Goals Bond, which seeks to expand the country's investor base by accessing international funds committed to sustainable economic development. Besides being able to review the development of the bond framework, UNDP can comment on the bond impact report, to strengthen its transparency (UNDP, 2020[55]).

The role of oblasts in initial project selection needs to be further scrutinised

Oblasts occupy a key position between the national government and municipalities in terms of initial project selection and disbursal of SFRD funds, as well as other competitive funding mechanisms. Depending on the specific subvention, the role that *oblasts* could play according to current legislation runs the risk of undermining their effectiveness, as well as transparency.

The government should consider amending the legislation for funding mechanisms by including clear criteria and a systematic consultation of municipalities. This is particularly relevant for the Socio-Economic Subvention and Subvention for Developing Healthcare in Rural Areas (Annex Box 5.A.1). For both subventions, *oblast* state administrations submit preliminary proposals to a national-level commission suggesting which local projects should receive funding (CabMin, 2017[38]; CabMin, 2012[36]). The legislation foresees no role for municipalities in shaping these proposals. Moreover, the subventions lack criteria that could outline a basis on which projects should be awarded, such as development gaps in local communities (CabMin, 2012[36]) (CabMin, 2017[38]). This raises the risk that initial project funding decisions could be made based on inaccurate or incomplete information, or lobbying of *oblast* state administrations by municipalities.

A second concern related to the participation of *oblast* state administrations in the regional development subventions is the lack of transparency about how they evaluate and score project proposals. This applies to the SFRD in particular. Municipalities can submit proposals to a regional-level commission, which is led by *oblast* state administrations. The commission reviews the proposals according to criteria set by MinRegion, and then draws up a shortlist of projects to receive funding. Afterwards, the shortlist is reviewed by a national-level commission, which makes the final decision. To improve the transparency of this process and increase the quality of proposals going forward, the regional commission's evaluation of project proposals should be shared with municipalities—a point that is not included in the SFRD legislation.

There are also concerns about whether municipalities are receiving their allocated funding from *oblasts*. For example, in the case of the SFRD, the distribution of funds is only mentioned in relation to *oblasts* and not to municipalities (CabMin, 2015[35]). The legislation thereby implies that the municipal share of SFRD funds is meant to be transferred to them by *oblasts*. OECD interviews with local stakeholders indicated that there have been instances where *oblasts* did not distribute funds in a timely manner, or even at all (OECD, 2021[8]). This factor might partially account for the low SFRD execution rates between 2015-2019, which have fluctuated between 63% and 89% (U-LEAD, forthcoming[1]).

Certain eligibility criteria risk putting poorer municipalities at a disadvantage

Many of the largest subnational subventions in Ukraine are awarded competitively and require municipalities to meet co-funding criteria. Given the vast differences in the fiscal capacity of municipalities, such criteria risk undermining the ability of poorer municipalities to obtain the funding necessary to fulfil their investment needs. This can further entrench territorial disparities.

To obtain funding through the Socio-Economic Subvention municipalities need to ensure that infrastructure maintenance can be paid from local budgets (CabMin, 2012[36]). In other instances, local governments need to co-fund at least 10% of the total project through local budgets. This applies to the SFRD and the Subvention for Developing Healthcare in Rural Areas (CabMin, 2015[56]; CabMin, 2017[40]). If municipalities are unable to meet the co-funding requirements, *oblasts* can provide funding if they consider the project to be sufficiently important (OECD, 2021[8]). However, it is unclear what criteria need to be met for *oblasts* to support municipal co-funding efforts. There is therefore a risk of arbitrary decision making.

In principle, making co-funding a prerequisite for funding can be useful. It can help leverage resources and increase local government ownership of development projects. At the same time, co-funding requirements risk entrenching the gap between wealthy and poor municipalities as they place an uneven strain on local budgets. Many Ukrainian municipalities consider the lack of financial means to provide co-funding the main obstacle to obtaining funding (Annex Figure 5.B.2; Annex Figure 5.B.3). In addition, more than 10% of surveyed municipalities indicated that the costs associated with the design of proposals for the SFRD and other funding mechanisms represent the main impediment to obtaining development funds.

The criteria for competitive subnational subventions can also reduce the pool of municipalities that are eligible to receive funding. The SFRD is an example of this. Its selection committee assesses projects according to five criteria: 1) contribution to the development of municipalities/overcoming a specific development challenge; 2) expected impact of the proposed project; 3) innovativeness of the proposal; 4) share of co-funding from local budget and; 5) the extent to which the proposed project includes social, economic and environmental components (MinRegion, 2019[57]). The innovation criterion risks putting municipalities with weaker administrative capacity at a disadvantage, given that they are likely to have limited in-house capacity with which to design proposals for innovative projects. By strengthening outreach to municipalities and prioritising their capacity building, the government could provide municipalities with more clarity on the eligibility criteria and the application procedures of competitive subventions, as well as their capacity to develop competitive proposals.

Different practical actions could be taken to address these issues, such as linking co-funding requirements to the fiscal capacity of municipalities. For example, those municipalities with the least fiscal capacity could be exempt from providing co-funding altogether. The data on the financial situation of the municipalities presented on the Open Budget Portal of MinFin could support this effort. The government would, however, need to make sure that the adjusted regulations include provisions to prevent municipalities from undermining their own tax capacity. Another solution would be to strengthen Ukraine's revenue equalisation mechanism to ensure that all municipalities have the possibility to cover the co-funding requirements.

In the medium or long term, the government could also consider creating a complementary general grant that provides all *oblasts* and municipalities with a minimum level of funding to implement their respective regional and local development strategies. Such a grant would complement the own-source revenues that municipalities can provide, as well as any funds they obtain from non-governmental actors. It would not only provide subnational authorities with more predictable and stable funding to implement investment projects linked to their regional and local development strategies, it would also increase their ability to spend funds to meet their particular investment needs—within the framework of the officially approved regional and local development plans. In order to ensure the effective use of the grant, the government is advised to establish clear guidelines for how the funds can be used. For example, the guidelines could indicate that projects would have to be developed and implemented by more than one municipality and address clearly-established cross-jurisdictional investment needs. Moreover, robust oversight mechanisms would have to be in place to ensure that the funding that subnational governments receive as part of the general grant is implemented in compliance with official guidelines. In addition, policy makers would have to ensure that such a grant does not disincentivise municipalities from identifying alternative sources of funding for local development initiatives.

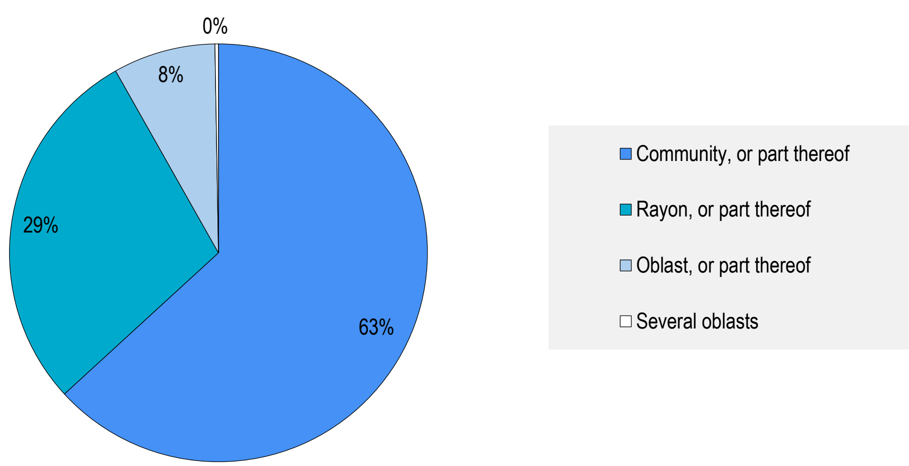
Unless policy interventions such as these are taken, poorer municipalities and those with limited technical capacity to develop competitive project proposals may continue to miss out on funding opportunities, possibly exacerbating regional disparities.

Prevalence of local and small-scale projects risks fragmenting investment

Additional challenges to the effectiveness of the projects funded through the SFRD are related to their territorial scope and timespan. Despite important improvements between 2015 and 2018, the timespan of projects is relatively short, possibly limiting the impact and sustainability of the development initiatives.

While in 2015, 99.8% of all projects lasted only one year, in 2018 this decreased to 76.5%. During the same period, the share of projects lasting either two or three years increased to 18% and 6%, respectively (Figure 5.10). The average geographical focus of the projects did not change much, however. The majority of the initiatives were targeting a specific community (63%). Less than 30% focused on a *rayon*, and only 8% of projects focused on the *oblast* level. Moreover, between 2015 and 2018, only five projects had a distinct interregional focus (0.3%) (U-LEAD, 2018[58]). An example of a community project is the construction of a sports and recreation complex in Dubrovytsia, Rivne *Oblast* (Rivne Regional State Administration, 2020[59]). An example of a project with a wider geographical focus is the reconstruction of the Lviv Regional Clinical Perinatal Centre (Verkhovna Rada, 2019[60]).

Figure 5.10. Geographic focus of SFRD projects between 2015 and 2018



Source: Author's elaboration with data from (U-LEAD, 2018[58]).

The predominance of short-lived projects that target improvements at the community level could lead to a suboptimal use of resources, as many small projects might tackle similar issues that could benefit from inter-municipal or inter-regional intervention.

In an attempt to increase the strategic use of SFRD funding, in 2021, CabMin passed a resolution establishing that only projects worth UAH 10 million or more could be funded through the SFRD (MinRegion, 2021[61]). Beyond this measure, the government should consider amending the fund's regulations to encourage the funding of multi-year projects that have a cross-jurisdictional focus. For example, additional points could be awarded to initiatives that are developed by multiple subnational governments and propose a solution for a particular district- or region-wide development challenge. An alternative could involve organising different funding 'windows' for initiatives that either have a local, inter-municipal or regional focus.

The SFRD heavily funds the maintenance of "hard" infrastructure

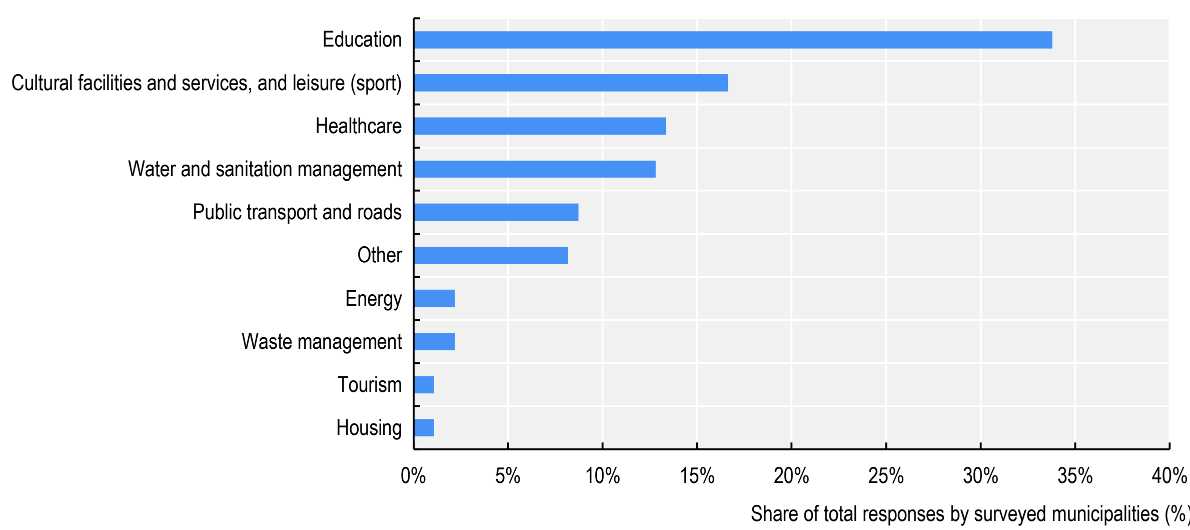
The predominance of investment in "hard" infrastructure discussed earlier also applies to the SFRD. During the 2015-2019 period, most projects funded through the SFRD targeted secondary education (including the construction of education facilities), followed by utilities supply (gas, heat, and electricity), road transport infrastructure and water supply. The thematic areas that were least targeted included promoting entrepreneurship and agricultural and non-agricultural businesses in rural areas (U-LEAD, 2018[58]).

Two factors can explain the SFRD's overreliance on "hard" infrastructure projects. First, municipal authorities tend to believe that the regional development policy framework is geared towards satisfying existing "hard" infrastructure needs (Ecorys, 2021[50]). Second, investments in tangible, "hard" infrastructure projects are often prioritised by local leaders who see them as tools to bolster public support for their administrations (National Institute for Strategic Studies, 2020[54]).

Taking into account the various national government initiatives that specifically target the maintenance and upgrading of "hard" infrastructure, the government could consider adjusting the SFRD guidelines to strike a better balance between investments in "hard" and "soft" infrastructure. The latter refers to investments in innovation, SME development, local competitiveness and human capacity (e.g. skills training or retraining). Spending on "soft" infrastructure often takes time to generate results. In addition, the results of investment in, for example, SME development are often not as tangible as, for instance, the construction of roads, bridges or schools. It is not uncommon that the latter are prioritised by local leaders seeking to bolster their public approval ratings. For example, *oblast* state administrations and municipalities could be required to present project proposals that contemplate spending a minimum percentage of funds on such issues. Such a quota for investment in "soft" infrastructure could replace the existing one for sports.

Indeed, at least 10% of funding through the SFRD must be channelled into investment programmes and projects that promote the development of local sports infrastructure. Albeit small, a sector-specific quota limits the capacity for municipalities to design and fund projects that meet their specific needs, and reduces autonomy in decision-making and development prioritisation. This quota might contribute to the marked differences in the investment priorities of municipalities and the sectoral focus of SFRD-funded projects (Figure 5.11). According to municipalities, more than 18% of the projects that received SFRD funds are related to "cultural facilities and services, and leisure (sports)".

Figure 5.11. Sectoral focus of SFRD-funded projects, as reported by municipalities



Note: Often projects related to education and healthcare involve significant spending on the construction of schools, kindergartens and health clinics. These can be characterised as “hard” infrastructure investments. Question: In which of the following areas was the project (projects) implemented that received funding through the State Regional Development Fund implemented? You can choose several options. Response options: Waste management; Water and sanitation management; Housing; Healthcare; Public transport and roads; Education; Cultural facilities and services, and leisure (sport); Tourism; Energy; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author’s elaboration, based on the OECD online survey.

The prevalence of projects related to culture and sports makes sense when looking at the quota used in the SFRD allocation system and the thematic focus of the SSRD. In addition, investment in sports can have a direct contribution to regional and local economic activity (European Commission, 2016[62]). However, it does not reflect the self-identified investment needs of municipalities. As shown in Figure 5.8, culture was prioritised by just 1% of respondents. The government should consider removing the quota for sports infrastructure. Another option would be to replace it by one that better matches municipal investment needs, prioritises economic development, and/or balances “hard” and “soft” infrastructure investment.

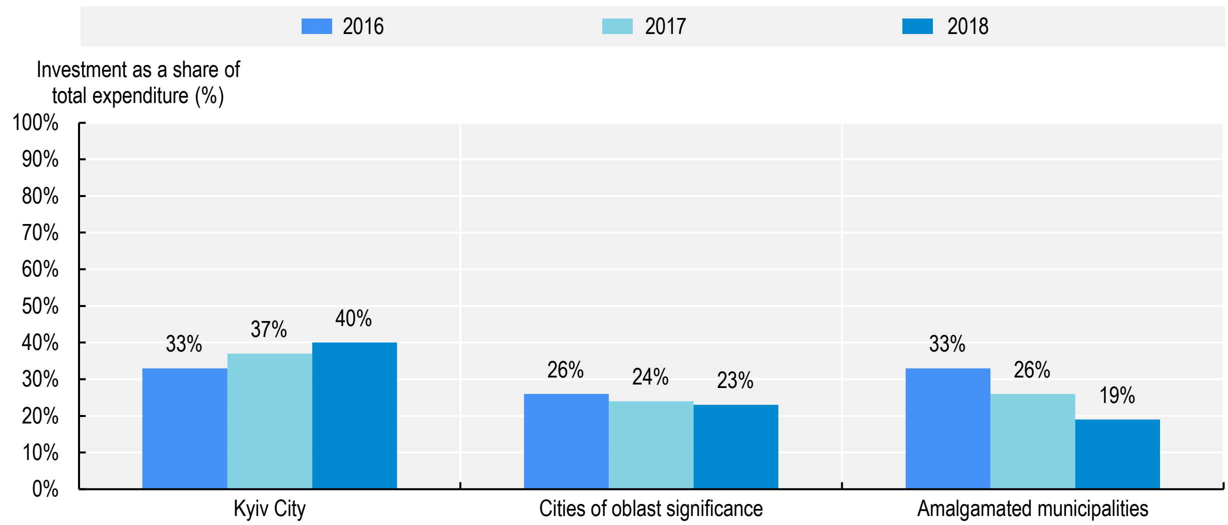
Subnational investment capacity

Even though the share of all investment by *oblasts, rayons* and amalgamated municipalities combined as a percentage of total public direct investment declined by 21% between 2015 and 2020, it still represents 68% of all public investment, which is well above the OECD average (56%) (OECD, 2022[10]; IMF, 2022[11]). In the same period, the share of direct investment by Ukraine’s subnational governments as part of all subnational expenditure, remained relatively stable, fluctuating between 8% and 12% (IMF, 2022[11]). There is evidence, however, of divergence in the investment capacity of different subnational governments (e.g. Kyiv City versus amalgamated municipalities) and in local skills to effectively manage investment processes. Furthermore, several mechanisms that subnational governments can use to increase investment, such as borrowing and public-private partnerships, could be better exploited.

The investment capacities of different subnational governments have gradually diverged

Between 2016 and 2018, Kyiv City’s share of investment spending as part of its total expenditures rose from 33% to 40% (SKL International, 2019[25]). This was accompanied by an increase in investment per capita[5] (Figure 5.12). In the same period, however, the share of investment spending as part of the total expenditures of “cities of *oblast* significance” and amalgamated municipalities fell. “Cities of *oblast* significance” witnessed a decrease of 3 percentage points (from 26% to 23%), while their per capita investment spending stayed the same. The share of investment as part of total spending by amalgamated municipalities decreased more drastically, from 33% to 19% (SKL International, 2019[25]). One possible explanation is related to the size of the Local Infrastructure Subvention (Annex Box 5.A.2). This fund was created in 2016 to encourage municipal mergers, which meant that only amalgamated municipalities were eligible to receive funds. The increase in the number of amalgamated municipalities between 2016 and 2020 appears to have been greater than the increase in available funds over the same period, reducing the available funds per municipality (SKL International, 2019[25]). The Local Infrastructure Subvention was eliminated in 2020 due to COVID-19 budget cuts.

Figure 5.12. Investment as part of total expenditures of selected subnational governments, 2016-2018



Note: Data in this figure varies from the subnational investment data collected by the IMF. This can be explained by the fact that although the IMF looks at total investment made by all subnational governments combined (including *oblasts,* Kyiv City, *rayons* and municipalities) the SKL study focuses specifically on Kyiv City, *"*cities of *oblast* significance" and amalgamated municipalities. Also, in the SKL study expenditures exclude social welfare transfers as local governments have little control over the allocation of these funds.
Source: Author's elaboration with data from (SKL International, 2019[25]).

To boost the investment capacity of smaller municipalities, the government could consider several aforementioned policy interventions. For example, they could be provided with a block grant to fund investment linked to their local development plans. This would likely be welcomed at the local level, as 58% of surveyed municipalities indicated that reinstating the Local Infrastructure Subvention is among the most urgent subnational finance and investment reform areas (Annex Figure 5.B.1). The government could also consider expanding the municipal power to set the tax base and rates for own-source taxes, possibly within a nationally determined range to avoid too much variation among municipalities, and an excessive tax burden on citizens. This would not only improve their fiscal capacity and give them more flexibility to address local needs, it could also bolster public accountability. Over 40% of all municipalities that responded to the OECD online survey indicated that increasing their powers to set the base or rate of local taxes is a particularly urgent area of reform (Annex Figure 5.B.1).

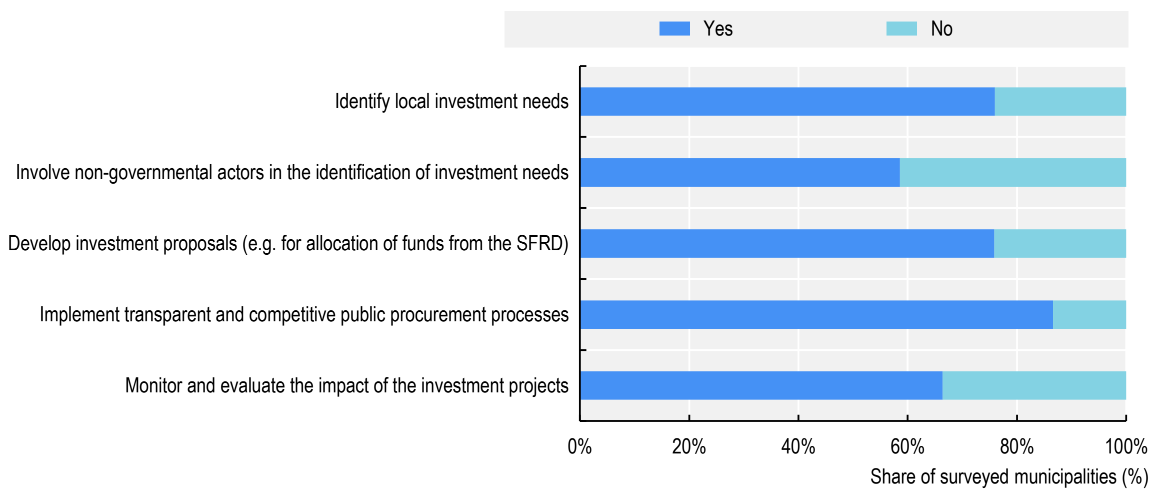
A closer look at the investment capacity of "cities of *oblast* significance" showed that the decrease in investment capacity went hand-in-hand with an increase in their spending on wages and other operational costs (SKL International, 2019[25]). As commented before, this may be in part due to the minimum wage increase that reduced the revenue that subnational governments were free to spend. While it is widely considered that many municipalities are facing challenges in attracting and maintaining skilled staff, in part because of low wages, any measure aimed at improving the financial remuneration for public officials may reduce the scope for investment. Thus, urgent efforts to attract and maintain skilled staff would therefore have to be accompanied by an increase in revenue generation.

Building skills is crucial to improve the effectiveness of local investment

Ensuring sufficient and qualified human resources at the subnational level is key to effectively carrying out public investment tasks, improving public service delivery and supporting local economic development. There is evidence that the decentralisation reforms have had a relatively positive impact on municipalities' local investment capacity. At the same time, however, skills need to improve across a range of topics, including developing frameworks to monitor investment projects, as well as engaging with non-governmental actors throughout the life-cycle of investment projects.

Analysis from the OECD's online survey (Figure 5.13) shows that while a sizeable majority (74%) of surveyed municipalities reported having sufficient human resources to identify local investment needs, 24% indicated that they lack such expertise. This could negatively affect the ability of those municipalities to develop quality investment projects that match local development needs and capacities, thus jeopardising the effectiveness of their investment. In addition, 24% of municipalities reported that they lacked the human resources to develop investment proposals. As many regional and local development subventions in Ukraine are competitive, this may imply that municipalities could miss out on funding opportunities. This particularly applies to those municipalities that were administratively amalgamated in 2020 and have received less capacity building support than their peers (OECD, 2021[8]).

Figure 5.13. Availability of human resources to effectively carry out public investment tasks



Note: Question: Indicate whether you believe that your municipal government has the human resources (including expertise) to effectively carry out the following public investment tasks: Identify local investment needs; Involve the private sector, civil society or academia in the identification of investment needs; Develop investment proposals (e.g. for allocation of funds from the SFRD); Implement transparent and competitive public procurement processes with appropriate internal control systems; Conduct periodic M&E exercises to determine the impact of the investment projects. Response options per task: Yes, No. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

Regarding monitoring and evaluation, 34% of surveyed municipalities reported that they lack the human resource capacity (including expertise) to conduct periodic monitoring and evaluation exercises that could determine the impact of the investment projects. This suggests that certain municipalities may not have developed important mechanisms for accountability and learning. Ensuring effective monitoring capacity can enable municipalities to keep tabs on the implementation of investments, make mid-course adjustments when necessary and communicate the results of their investments to relevant stakeholders. Ex-post evaluation can help determine whether intended outcomes were achieved and inform the development of future investment proposals.

Engaging with non-governmental actors is a key challenge for municipalities

With regard to involving the private sector, civil society or academia in the identification of investment needs, it is notable that 41% of municipalities reported that they lack the human resources (including expertise) to do so. As set forth in the OECD's *Recommendation of the Council on Effective Public*

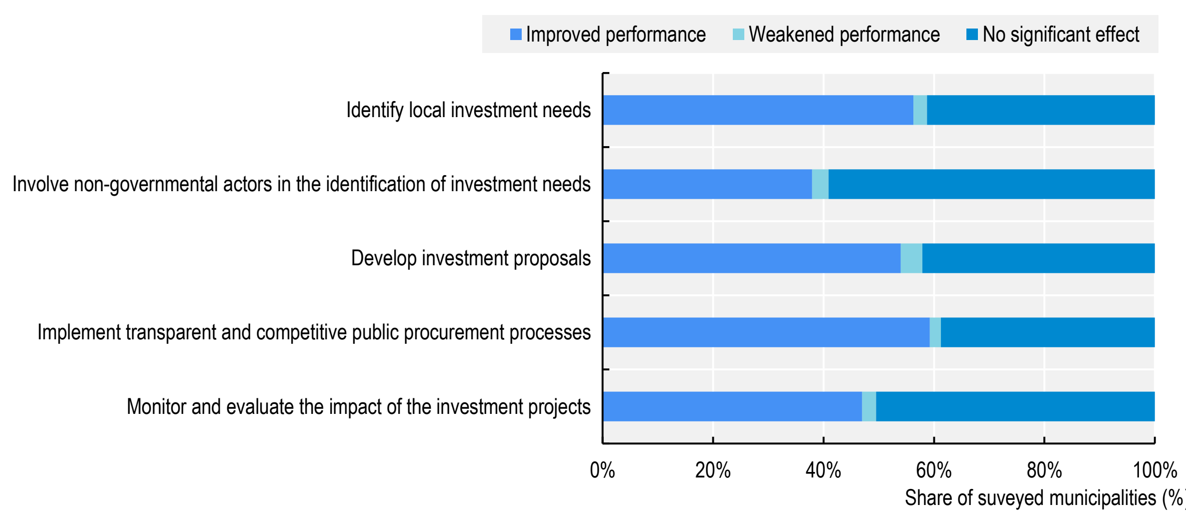
Investment Across Levels of Government[6], engaging with private sector and civil society stakeholders when designing and implementing public investment strategies is fundamental for enhancing the social and economic value of investment and ensuring accountability (OECD, 2014[9]).

All levels of government should involve stakeholders at an early stage of the investment cycle, starting with identifying investment needs and designing an investment strategy. At later stages, a balanced group of stakeholders should be involved in monitoring and evaluation. Information on public investment plans, expenditures, and results should be exposed to some level of public scrutiny to promote transparency and accountability. In addition, municipalities need to have the capacity to balance the incorporation of stakeholders' views and their contributions to the investment process, taking steps to prevent a disproportionate influence by special interest groups.

The decentralisation reform process has improved municipal performance in some aspects of investment planning

Many municipalities find that the decentralisation reform has had a predominantly positive effect on their investment planning capacity. A majority of municipalities (57%) reported that the decentralisation reform process (including amalgamation) improved their ability to identify local investment needs. Furthermore, 59% reported that it had improved their capacity to implement transparent and competitive procurement processes with appropriate internal control systems (Figure 5.14). In addition, 54% of municipalities indicated that the decentralisation reforms had improved their capacity to develop investment proposals for competitive grants, such as the SFRD. At the same time, over 40% of municipalities indicated that the reforms either had no significant effect on or had weakened their performance in other public investment-related areas. This includes involving non-governmental actors in identifying investment needs, where 62% reported that capacity had either decreased or remained unchanged; and the ability to conduct periodic monitoring and evaluation exercises to determine the impact of the investment projects, where 53% reported a decrease or no change

Figure 5.14. Impact of the decentralisation reform on municipal performance related to public investment



Note: Question: What effect have the decentralisation reforms and amalgamation process had on the performance of your municipal government in the following fields related to public investment? Identify local investment needs; Involve the private sector, civil society or academia in the identification of investment needs; Develop investment proposals (e.g. for allocation of funds from the SFRD); Implement transparent and competitive public procurement processes with appropriate internal control systems; Conduct periodic monitoring and evaluation exercises to determine the impact of the investment projects. Response options: Improved performance; Weakened performance; No significant effect. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

National-level institutions that manage subventions for regional and local development should ensure that municipalities receive sufficient training and advice to better execute their tasks and responsibilities throughout the investment cycle. These efforts can be supported by the different local government associations. Methodologies should be developed and shared on how to identify regional and local development and investment needs given the scarcity of territorially-disaggregated data, and how to effectively engage with governmental and non-governmental actors.

The government should also use its international donor co-ordination mechanisms to identify which municipalities and municipal staff have already received capacity building support for investment planning in the past and which topics have been covered in the training initiatives. This information could generate a database that would allow ministries to identify capacity building needs. In case the turnover of local civil servants is very high, the training database might become outdated quickly. An alternative could be to develop a register that presents the skills and capacity building support received by (local) civil servants. However, such a registry would be more complex to manage and keep up-to-date.

A training database could also serve as a critical input for the selection of municipalities to be targeted in future (international) development projects. The Territorial Portal (*Portal Territorial*) developed by the National Planning Department of Colombia could provide an example (Box 5.9). In Ukraine, such a portal would greatly contribute to the accessibility of relevant training material.

Box 5.9. Colombia's Territorial Portal

The Territorial portal of Colombia was created by the National Planning Department to support municipalities in their efforts to improve municipal planning, administration and service delivery. It features an interactive map that provides information on the municipalities that have received training by governmental and non-governmental actors. The portal also functions as a one-stop-shop for:

- Information on municipal planning and budgeting regulations and procedures.
- E-learning packages on topics such as: public investment, spatial planning, financial management, design of local development plans, and monitoring and evaluation. These packages include manuals, training videos, recommendations, examples of good practices, etc.
- Excel and PowerPoint formats related to the abovementioned topics that can be adjusted by the local governments.
- Contact information of territorial advisors located in different parts of the country.
- Information on relevant national government policies implemented at the local level.

Source: Author's elaboration, based on (Departamento Nacional de Planeación, 2021[63]).

Misuse of investment funds may reduce trust in regional and local development policies

The capacity of subnational governments to use regional and local development funds according to official regulations is another area of concern. The misuse of public funds, a failure to follow procurement guidelines and a lack of transparency in investment spending could undermine the effective and efficient use of scarce resources. It could also reduce trust in government and in regional and local development policies.

An audit conducted by the Accounting Chamber of Ukraine revealed significant outstanding issues related to the implementation of the SFRD, including misuse of budget funds, violation of legislation in the field of planning and budgeting and a significant number of unfinished construction projects (CabMin, 2021[5]). These issues are not solely applicable to the SFRD but appear to be systemic. For instance, a State Audit

Service assessment of the legal and efficient use of communal resources totalling UAH 872 billion during 2018-2020 and the first five months of 2021, revealed violations and shortcomings totalling UAH 141 billion. In addition, a procurement monitoring exercise that looked at UAH 119.7 billion of local expenditures, identified violations of procurement legislation related to almost 80% of the reviewed costs (CabMin, 2021[5]).

The capacity of the government to conduct a more thorough assessment of the adequate use of funds by subnational governments has been significantly curtailed. In recent years, the staff of the State Audit Office was reduced from 14 000 auditors to 3 000, and departments in charge of auditing in *rayons* and cities were closed. In light of these developments, the State Audit Office has advocated for an increase in the territorial presence of auditors and allocation of additional funds (CabMin, 2021[5]). To improve the legal and efficient use of financial resources by subnational governments, the government is advised to prioritise boosting the capacity of municipal authorities to conduct internal audits. Conducting internal audits should be an obligation set by regulations for all municipal governments. This would have to be coupled with financial and capacity building provided by the national government to allow municipalities to equip themselves with a specific team or external support (consultants) and set up an adequate information system (OECD, 2018[14]).

Simultaneously, the government should ensure effective communication between the municipalities and the State Audit Service to identify common challenges and bottlenecks in the field of financial management and procurement. This will allow the State Audit Service to provide MinFin and MinRegion, as well as other relevant ministries, with data regarding the type of funds that are most often misused, as well as the budgeting or procurement regulations that tend to be violated. This would facilitate decision making regarding budget modifications, procurement regulations and the training of local governments in the fields of procurement and investment management. Actions such as these would help align Ukraine with the eleventh principle of the OECD's *Recommendation of the Council on Effective Public Investment across Levels of Government*, i.e. "promote transparency and strategic use of public procurement at all levels of government" (OECD, 2014[9]).

Subnational debt represents a small part of all public debt

Given the fiscal constraints that many subnational governments face, debt financing can be an attractive way to help them carry out the necessary investment projects. However, guardrails need to be in place to ensure that those subnational governments that are allowed to borrow—all except for settlement and rural municipalities—do not assume excessive risks, especially given the capacity challenges many municipalities face.

Between 2019 and 2020, local debt increased by 38.6%, reaching UAH 25 billion (Accounting Chamber of Ukraine, 2021[64]). This increase can be explained, in part, by the devaluation of the hryvnia. In fact, when controlling for inflation, in 2020, subnational debt was about the same as in 2015. Moreover, subnational debt continued to represent only a very small part of all public debt (approximately 1%) (IMF, 2022[11]).

Between 2019 and 2020, local domestic debt increased by 41.7%, to UAH 20.8 billion. This increase was primarily caused by the issuing of bank loans to different city councils (e.g. Odessa and Zaporizhzhia), which used the funds to finance various projects including the reconstruction of municipal utilities and housing projects. Another important factor behind the increase is the issuing of new securities by several cities to finance the reconstruction of social and cultural facilities, transport infrastructure and roads.

Prior to Russia's large-scale aggression against Ukraine, it was expected that the gradual economic recovery from the COVID-19 pandemic would support a rebound in the 2021-2022 tax revenue of Ukrainian cities, enabling them to service their growing debt (Fitch Ratings, 2021[65]). In order to improve the capacity of municipalities to finance local development projects, the right to borrow could be extended to mid-sized municipalities that meet certain fiscal criteria, subject to prior approval by MinFin.

In addition, the government should consider establishing a working group on local debt (management) that includes central government entities such as MinFin and MinRegion, as well as representatives from local government associations. This group could help identify to what extent the current borrowing framework favours public investment in the context of post-war reconstruction and recovery, without jeopardising economic stability and sound fiscal management. Long-term measures to be assessed in such a working group include developing a credit market for subnational borrowing (i.e. creating a more diversified local debt market). One particular area of attention could be the creation of a municipal bond agency to lower the costs of financing investment projects (Box 5.10), thereby making borrowing more accessible to more municipalities.

Box 5.10. Finland's Municipality Finance Public Limited Company

In many countries, helping smaller municipalities gain access to capital markets to finance investment is a key challenge. As their investment projects are often small and municipalities do not pool their resources, they do not obtain very competitive lending conditions from commercial banks. OECD member countries such as Denmark and Finland have dedicated financial agencies that specialise in municipal lending. As these local government financing agencies provide better conditions, municipalities rarely opt for commercial loans.

In 1989, Finland created the Municipality Finance Public Limited Company (MuniFin), which is a credit institution that is specialised in financing the local government sector and government-subsidised social housing production. MuniFin pools municipal risk and provides loans to Finnish municipalities drawing on resources from financial markets. MuniFin is jointly owned by:

- Municipalities, joint municipal authorities and companies owned by municipalities (53%).
- A local public sector pension fund (31%).
- The national government (16%).

Its funding is guaranteed by a separate institution—Municipal Guarantee Fund—which has access to the entire tax base of the Finnish population. Finnish municipalities, all of which are all members of the Municipal Guarantee Fund, have unlimited right to levy PIT, which provides sufficient collateral for MuniFin funding. Around 80% of municipal debt is financed through MuniFin.

Source: Author's elaboration, based on (OECD, 2021[66]; MuniFin, 2021[67]; OECD, 2021[68]; André and García, 2014[69]).

The government should also consider using the wealth of information on subnational debt presented on the Open Budget Portal and the Register of Local Loans and Local Guarantees to build a public monitoring dashboard to detect the municipalities at risk. This would improve transparency and facilitate decision making on corrective measures. MinFin and MinRegion should also explore the option of providing training to municipal administrators on debt management. Finally, it is important to recognise that, when asked what they consider the most urgent areas of financial reform, only 3% of municipalities mentioned legal adjustments to facilitate borrowing (Annex Figure 5.B.1). As such, any reforms to facilitate local borrowing should be considered complementary to, for example, adjusting the PIT allocation system or increasing the ability of local governments to raise own-source revenue.

Public distrust and lack of know-how hamper the potential of public-private partnerships

Under certain conditions and strict control mechanisms, public-private partnerships (PPPs) can be a mechanism for diversifying funding for regional and local development projects, particularly when a government is faced with funding constraints. However, PPPs are subject to the same fiscal or willingnessto-pay constraints as public projects. In both cases, a strong institutional capacity is required for the effective delivery of projects.

PPPs are complex and sometimes risky arrangements that require capacity to design, negotiate and implement. This capacity is not always available, particularly at the subnational level. Despite widespread excitement about the potential of PPPs for generating additional resources for investment projects, there continue to be relatively few Ukrainian municipalities that have embarked on such partnerships (Box 5.11).

Box 5.11. Public-Private Partnerships in Ukraine

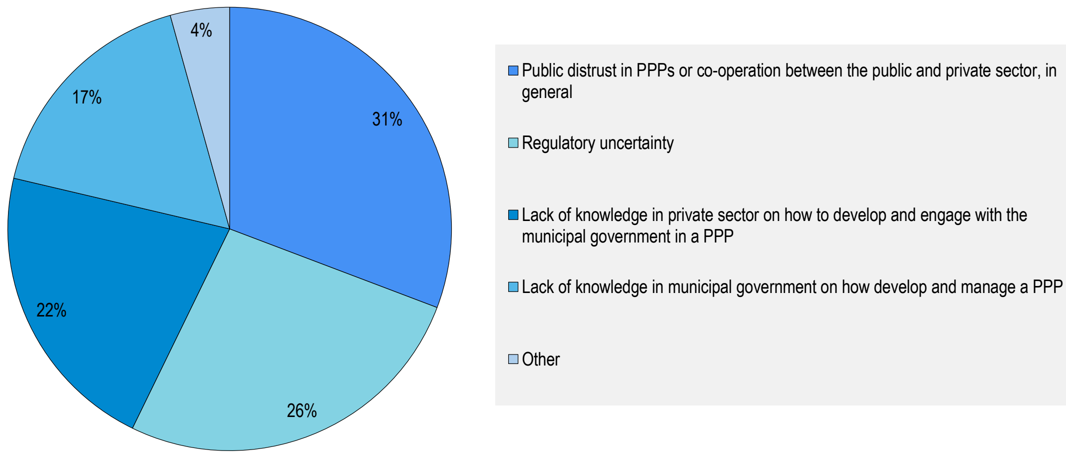
The first Law "on Public-Private Partnerships" was passed in 2010 and considerable hope was placed on it as a tool to attract investment. However, it did not live up to expectations for a variety of reasons. To improve the legal framework, a new PPP Law entered into force in 2016 introducing amendments to "Some Laws of Ukraine to Eliminate Regulatory Barriers for Development of Public-Private Partnership and to Stimulate Investments in Ukraine". The PPP Law better defined the scope of a PPP project.

In 2019, a new Law on Concessions was passed to resolve inconsistencies between the laws regulating concessions and PPS, and to increase private investment, particularly in the field of infrastructure. In addition, in 2018, the State Agency on Support to Public-Private Partnership was established, which provides training to national and local authorities in the field of PPP. More specifically, it offers assistance in the preparation of necessary documentation and supports PPP contract management processes. There are concerns, however, that it mainly focuses on major national level PPPs and does not have the requisite human resources to support the establishment and management of partnerships at the subnational level.

Source: (OECD, 2018[14]) (OECD, 2021[8]) (CabMin, 2021[5]).

According to the results of the OECD online survey, only a fraction of municipalities (10%) reported that they are engaging with the private sector in PPPs. Sixteen percent indicated that they are not sure if they do, and the remaining 74% of municipalities reported that they are not part of any PPP (OECD, 2021[42]). Of those municipalities that have a PPP, a number of them (30%) mentioned that the partnership targets waste management, followed by education (27%) and water and sanitation management (25%). Municipalities are reluctant to set up PPPs for a variety of reasons. For example, 31% of municipalities consider that the lack of public trust in public-private collaboration is the greatest obstacle to setting up a PPP (Figure 5.15). This may be related to the public's perception that corruption is widespread. Furthermore, 26% of municipalities consider that regulatory uncertainty is the biggest obstacle to setting up PPPs. This is followed by a perceived lack of knowledge on the part of the private sector (22%) or the municipality (17%) on how to develop and manage a PPP.

Figure 5.15. Greatest obstacle to the successful co-operation with private sector organisations through PPPs



Note: Question: What do you think is the greatest obstacle to the successful co-operation between your municipality and private sector organisations through PPPs? Response options: Public distrust in PPPs or co-operation between the public and private sector, in general; Regulatory uncertainty; Lack of knowledge in private sector on how to develop and engage with the municipal government in a PPP; Lack of knowledge in municipal government on how develop and manage a PPP; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

The government could consider improving outreach to municipalities and the private sector—for example via local business or regional chambers—about the potential of PPPs, and its regulatory framework, as well as emphasise the multiple risks involved in establishing and managing such partnerships. This should be coupled with the development of training material for municipalities on how to assess the value added of PPPs, manage partnerships, and establish a transparent system to track the use of public funds and determine its effectiveness. The latter is of singular importance as it could increase public trust in collaboration between the public and private sectors. Related to this, the *OECD Principles for Public Governance of Public-Private Partnerships* stress the importance of having a clear and transparent regulatory framework that is duly enforced and which all parties involved can trust (OECD, 2012[70]). Such a framework needs to foster competition, while helping governments minimise the risk of conflicts of interest, regulatory capture and corruption.

Ukraine's State Agency on Support to Public-Private Partnership could also assess the experience of the PPP Centre in the Philippines (Box 5.12). For example, it could promote the dissemination of the practical experience that larger cities, in particular, have gained in managing PPPs. Municipalities tend to approach larger cities, though on an *ad hoc* basis, for insights and recommendations on how to set up a PPP (OECD, 2021[8]). The State Agency on Support to Public-Private Partnership could share succesful practices, but also those where the national or subnational authorities involved were unable to adequately manage the financial risks involved.

Box 5.12. The PPP Centre in the Philippines

The 1991 Local Government Code of the Philippines devolved the provision of local infrastructure to local governments, stipulating the institutional mechanisms for formulating and implementing local plans. The PPP Centre was created to assist local governments in preparing projects, clarifying procedures, and evaluating PPP projects, as well as providing training.

The Centre launched a PPP strategy for local governments including the preparation and dissemination of a PPP manual. It also helped prepare action plans and strategies for the implementation of PPP projects at local levels. In addition, local governments have access to the Local Government Unit Guarantee Corporation, which offers guarantees for municipal bonds as a private risk guarantor for PPP projects.

Source: Adapted from (OECD, 2021[71]).

Municipalities should use PPPs with great caution, as across the OECD there are many recent examples of PPP failures or misuse. The *OECD Principles for Public Governance of Public-Private Partnerships* outline that when deciding whether or not to use a PPP, governments should "carefully investigate which investment method is likely to yield most "value for money" and consider "key risk factors and characteristics of specific projects" (OECD, 2012[70]). Moreover, benefits, costs and risks of PPPs need to be considered against other project funding and financing models (OECD, 2019[72]; OECD, 2022[73]).

Value for money should be the primary objective in PPP design. Value for money refers to what a national or subnational government "judges to be an optimal combination of quantity, quality, features and price (i.e. cost)", calculated over the complete life-cycle of a project (OECD, 2021[74]). A PPP project generally yields higher value for money compared to traditional procurement or government in-house production when it provides better features, higher quality or lower whole-of-life cost. Higher value for money is mainly obtained through risk transfer, competition and the use of private sector management skills and innovation (OECD, 2021[74]).

Fiscal risks related to the use of PPPs by subnational governments are especially critical to consider. In some cases, PPPs risk being improperly used to circumvent public financial management controls, which can create long-term fiscal risks for national and subnational governments (World Bank Group et al., 2017[75]). A desire to bypass fiscal constraints should not be considered a valid reason to opt for a PPP over traditional public procurement (IADB, 2018[76]). It can also pose a threat to sound project preparation and value for money, while creating an "affordability illusion" (Eurostat, 2016[77]). The latter particularly holds true when national and/or subnational governments lack a long-term perspective on public finances, which may mean that PPPs look affordable due to their delayed budget impact while, at the same time, long-term payment obligations are overlooked (World Bank, 2020[78]). Risks specific to subnational governments relate to institutional capacity and fiscal and regulatory frameworks (OECD, 2022[73]). Substantial institutional expertise is required for subnational governments to successfully harness PPP projects. This includes the capacity to properly assess the potential benefits, costs and risks of a PPP, and to manage the subsequent development, approval, procurement, award and contract management elements, while ensuring transparency (OECD, 2018[79]). This implies that PPPs should be used primarily by larger cities and regional jurisdictions that are more likely to have the fiscal and institutional capacities needed to manage them, under certain conditions, and framed by strict control mechanisms. In addition, PPPs should not be "off-budget" (i.e. when costs and revenues are not included in subnational budgets) nor should they be adopted only to attract finance, as other mechanisms may be available (e.g. bond issuance and loans from multi-lateral development banks).

Subnational governments should consider PPPs if gains from these factors outweigh the costs of private finance and risks associated with such partnerships, such as the ones mentioned above, and offer significant value for money (OECD, 2021[80]). Moreover, they should primarily be directed towards large-scale projects in priority infrastructure sectors.

In general, PPPs are not appropriate for small projects, which, despite their appeal to local governments, do not necessarily represent value for money. Moreover, small PPP projects do not necessarily portend small liabilities, underscoring the need to also consider the full extent of contingent liabilities created through guarantees to PPP projects (OECD, 2022[73]). In addition, small PPPs are not always commercially viable. To overcome this challenge, some countries have introduced provisions for bundling PPPs across sectors or jurisdictions to encourage economies of scale or attract operators (Box 5.13).

Box 5.13. Example of bundling subnational public-private partnerships

A practice highlighted by PPP practitioners is the bundling of smaller projects into larger ones in order to improve scale and viability thus making them more attractive to larger players in infrastructure, and enabling better financing options, including PPPs. In some cases, governments in multiple jurisdictions are involved. An example of bundling is the programme designed by the Pennsylvania Department of Transportation that aggregated the construction and maintenance of a few hundred small bridges into a single PPP project under its old bridges rehabilitation programme. This helped manage the limited viability of individual PPP projects given that the average cost of the individual bridges was as low as approximately USD 2 million.

Source: Author's elaboration, based on (OECD, 2021[71]).

In Wales, the Mutual Investment Model (MIM) is an example of how to set up a PPP to support subnational investment. In a MIMs, the Welsh government pays a fee to the private partner to cover the cost of the project's construction, maintenance and financing. In return, the Welsh government becomes a direct investor in the project, able to take an equity stake of up to 20% in the holding company established to deliver the project and to appoint a director to the holding company's board. At the end of the contract, the asset is transferred into public ownership (OECD, 2020[4]).

Though not technically a PPP, Ukraine could draw inspiration from the Scottish Futures Trust (SFT). This initiative provides an interesting example for strengthening local governments' capacity and expertise in the fields of investment financing and implementation. The SFT works with Scottish local authorities to reinforce capacity by transferring knowledge and carrying out independent expert reviews at various stages of investment projects. In particular, the SFT's "Hub" programmes seek to improve the planning, procurement and delivery of smaller public infrastructure projects that support community services across Scotland. It operates through joint venture arrangements between local public sector organisations and the private sector in each territory. Their objective is to increase efficiency and reduce the cost of building community infrastructure.

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Notes

[1] The Budget Code of Ukraine defines subventions as inter-governmental transfers of funds to be used for specific purposes through procedures defined by the authority that decides to provide the subvention (Verkhovna Rada, 2021[81]).

[2] Exceptionally, during the winter of 2021-2022, municipalities received 64% of PIT to ensure that they could cover utility covers (Verkhovna Rada, 2022[15]).

[3] The convergence effect was measured as the total revenue of the poorest cohort of each level of subnational government, as a share of the total revenue of the wealthiest cohort of the same level.

[4] These figures exclude grants and subventions for which no funding was allocated in a given year.

[5] When calculating the per capita investment spending as a share of total expenditure, social welfare transfers, over which subnational governments have little control, were excluded.

[6] In 2018, Ukraine adhered to the OECD's *Recommendation of the Council on Effective Public Investment across Levels of Government* (OECD, 2014[9]).

Annex 5.A. Regional and local development subventions

Annex Box 5.A.1. Subvention for the Implementation of Measures aimed at the Development of the Healthcare System in Rural Areas

The Subvention for the Implementation of Measures Aimed at the Development of the Healthcare System in Rural Areas (“Rural Healthcare Subvention”) is a competitive, regional and local development grant that is managed by MinRegion. Launched in 2017, its annual spending has fluctuated, from a high of UAH four billion in 2017 to a low of UAH one billion in 2018-2019. The rural healthcare subvention is the only large grant (over UAH five billion) that is aimed solely at developing healthcare at the subnational level, although healthcare also falls within the Socio-economic Subvention’s cross-sectoral remit.

Funds from the Rural Healthcare Subvention are allocated for the development of the healthcare system in rural areas. This includes action such as including: 1) construction or modernisation of public health facilities; 2) purchases of medical equipment; 3) development of telecommunications infrastructure (including broadband and IT systems for electronic healthcare and telemedicine); and 4) housing and vehicles for medical workers. The grant is open to *oblast* state administrations, which submit proposals in consultation with municipalities. Projects are selected by a commission chaired by MinRegion and that includes representatives from the Ministry of Health. The commission selects projects based on their compliance with the priorities of state health policies and the specifications of the grant.

Key pre-conditions for receiving the grant include: a) that the realisation of proposed projects should take no longer than four years; b) that the needs of persons with disabilities and other low-mobility groups should be taken into account in the proposal; and c) that projects are subject to co-financing of at least 10% from local budgets (except for purchases of official vehicles for public health workers in rural areas). After projects have been selected by the commission, MinRegion distributes the funds to *oblast* state administrations, which in turn distribute them to municipalities.

Source: Author’s elaboration, based on (CabMin, 2017[38]).

Annex Box 5.A.2. Local Infrastructure Subvention

The Subvention from the State Budget to Local Budgets for the Formation of Infrastructure of Local Hromadas (Local Infrastructure Subvention) was a non-competitive, regional and local development fund managed by the MinRegion. It was launched in 2016 and annual spending rose steadily in subsequent years, from under UAH one billion in 2016 to over UAH two billion in 2019, before the fund was scrapped in 2020 due to COVID-19 budget cuts. It is the only major grant (over UAH five billion during the 2015-2019 period) to date in Ukraine that has exclusively targeted the municipal level of government.

The Local Infrastructure Subvention was intended to fund projects contributing to the formation and development of communal property infrastructure, specifically: 1) establishing and modernising administrative service centres; 2) building or upgrading streets, roads, bridges; 3) building or modernising water supply and sewage facilities; 4) purchasing vehicles for transporting educational institutions; 5) purchasing special purpose vehicles for fire, rescue and medical institutions; 6) refitting buildings with energy efficient technologies; and 7) modern community management technologies.

The Local Infrastructure Subvention was non-competitive, however, only amalgamated municipalities were eligible. To apply for the fund, municipalities had to first submit project applications to *oblast* state administrations, who would issue an opinion on the compliance of the proposals with the grant's objectives. Following this, a MinRegion commission would review the proposals for compliance with requirements. They would either approve it or provide comments to be addressed by municipalities before resubmission. Funding allocations were made according to a formula that took into account both the population and territory of individual municipalities. After a list of proposals had been approved, the funds would be paid out directly by MinRegion to the municipalities.

Source: Author's elaboration, based on (CabMin, 2016[39]; U-LEAD, forthcoming[1]).

Annex Box 5.A.3. Socio-Economic Subvention

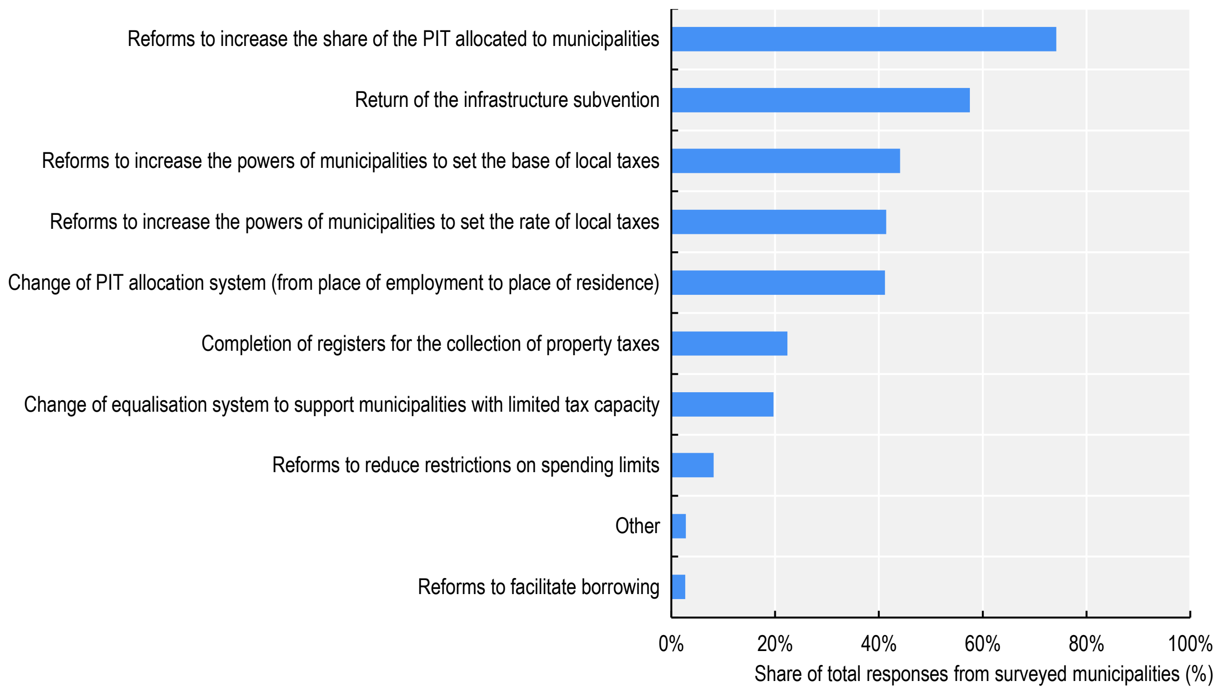
The Subvention for the Implementation of Measures for Socio-economic Development of Certain Territories (socio-economic subvention) is a competitive, regional and local development grant managed by MinFin. It was launched in 2012 and annual spending in subsequent years has fluctuated significantly, from a low of UAH 700 million in 2015 to a high of UAH 6.2 billion in 2017. Overall, between 2015-2019 spending on the socio-economic subvention was broadly comparable to spending on the State Fund for Regional Development (UAH 17.7 billion compared with UAH 17.4 billion respectively).

The socio-economic subvention is allocated for the implementation of measures designed to promote socio-economic development at the subnational level in Ukraine. The grant is open to *oblast* state administrations, which submit proposals in consultation with municipalities. Projects are selected by a commission consisting of members of parliament (MPs) of the Verkhovna Rada Budget Committee, as well as representatives from MinFin. By law, at least 50% of the commission's membership must be comprised of Budget Committee MPs.

Source: Author's elaboration, based on (CabMin, 2012[36]).

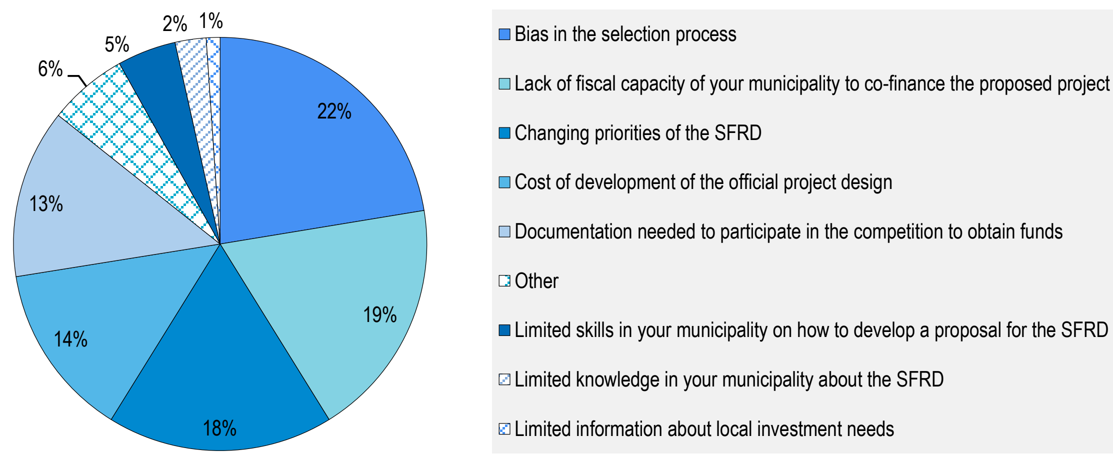
Annex 5.B. Results from the OECD survey

Annex Figure 5.B.1. Urgent areas of reform in the field of subnational finance and investment



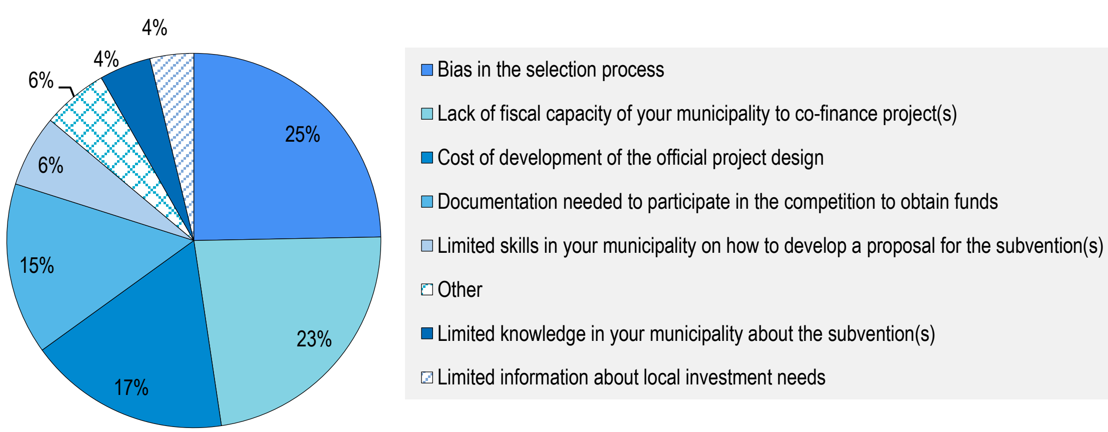
Note: Question: Which of the following areas of reform related to subnational finance and investment do you consider most urgent? You can select more than one option. Response options: Reforms/revisions to facilitate borrowing; Reforms/revisions to reduce restrictions on spending limits; Reforms/revisions to the equalisation system to increase support to those municipalities that have a limited tax capacity; Completion of registers for the collection of property taxes; Reform to change the PIT allocation mechanism from the place of employment to the place of residence; Tax reforms/revisions to increase the powers of municipalities to set the tax rate of local taxes; Tax reforms/revisions to increase the powers of municipalities to set the tax base of local taxes; Return of the infrastructure subvention; Reforms to increase the share of the PIT allocated to municipalities; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

Annex Figure 5.B.2. Main challenge to receiving funding through the SFRD

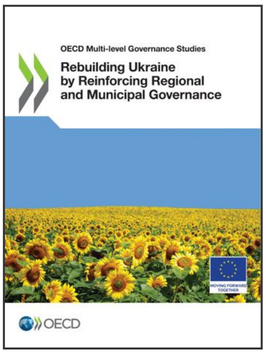


Note: Question: What do you think is the main challenge or obstacle to receiving funding through the State Fund for Regional Development? Please select only one option. Response options: Limited knowledge in your municipal government about the SFRD; Changing priorities of the SFRD; Limited skills in your municipal government on how to develop a proposal for the SFRD; Cost of development of the official project design; Documentation needed to participate in the competition to obtain funds; Limited information about local investment needs; Lack of fiscal capacity of your municipality to co-finance the proposed project; Bias in the selection process; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

Annex Figure 5.B.3. Main challenge to receiving funding through subventions from sources other than the SFRD



Note: Question: What do you think is the main challenge or obstacle to receiving funding through subventions from sources other than the State Fund for Regional Development? Please select only one option. Response options: Bias in the selection process; Lack of fiscal capacity of your municipality to co-finance project(s); Cost of development of the official project design; Documentation needed to participate in the competition to obtain funds; Limited skills in your municipality on how to develop a proposal for the subvention(s); Limited knowledge in your municipality about the subvention(s); Limited information about local investment needs; Other. The questionnaire was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.



From:
Rebuilding Ukraine by Reinforcing Regional and Municipal Governance

Access the complete publication at:
https://doi.org/10.1787/63a6b479-en

Please cite this chapter as:

OECD (2022), "Public funding for regional development in Ukraine", in *Rebuilding Ukraine by Reinforcing Regional and Municipal Governance*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/3c575d1a-en