

1 Assessment and recommendations

Overview

The parameters of this OECD publication were defined in 2020 and the data collection process was concluded prior to the Russian Federation's large-scale aggression against Ukraine on 24 February 2022. However, in order to ensure the work remains as relevant as possible given the context of the war, the OECD, the Government of Ukraine and the European Union (EU) agreed to expand the scope of the collaboration by including a focus on the role of effective multi-level governance for post-war reconstruction and recovery. The main findings and recommendations on these topics are summarised below, encapsulating the report's Part I, "Supporting post-war recovery with place-based regional development" (chapters 2-5), and Part II, "Making the most of decentralisation for post-war recovery (chapters 6-8).

In 2014, the Government of Ukraine embarked on an ambitious overhaul of its multi-level governance structures. The territorial organisation of public authorities was modified, resulting in the creation of 1 469 amalgamated municipalities from over 10 000 communities in 2014. At the same time, Ukraine enacted a decentralisation reform, giving these municipalities new responsibilities and additional financial resources. In 2015, Ukraine also established a legislative framework for its State Regional Policy, and implemented successive State Strategies for Regional Development that sought to boost competitiveness and territorial cohesion. Public funding for regional development increased significantly.

Despite these advances, prior to February 2022, there was still work to be done to better achieve the government's regional development and decentralisation objectives. On the regional development side, this included streamlining planning requirements for subnational governments and regional development funding mechanisms, as well as providing more systematic capacity building support to municipalities. In addition, space remained to strengthen stakeholder engagement in all stages of the regional and local development planning life-cycle. Furthermore, Ukraine's national co-ordination bodies needed to be reactivated in order to improve policy coherence and to act as a channel for national/subnational exchange, which in turn supports the successful implementation of State Regional Policy. On the decentralisation side, necessary actions included addressing tensions among different levels of government arising from overlapping mandates, and strengthening municipal capacity to meet administrative, financial and investment-related challenges.

Russia's large-scale aggression against Ukraine, with its profound territorial impact, has severely undermined progress made since 2014. It will likely accentuate pre-existing multi-level governance challenges and further exacerbate territorial disparities as some regions, such as Donetsk, Kharkiv, Kherson, Kyiv, Luhansk, Mykolayiv, Sumy and Zaporizhzhia have been particularly hard hit. At the same time, the vital role played by local officials, civil servants and non-governmental actors during wartime foreshadows the critical contribution that they can make to post-war reconstruction and recovery.

In light of this, Part I of this report first considers how adopting a place-based approach—taking into account territorially-differentiated needs and capacities, and the role that subnational authorities and non-governmental actors play in shaping development outcomes—can support post-war recovery and reconstruction at the subnational level. Second, it takes stock of regional economic and well-being trends

in Ukraine before February 2022, to inform the design of regional development policies needed during the recovery phase—notably to address territorial disparities. Third, it considers the strengths and weaknesses in Ukraine’s strategic planning frameworks that are relevant to developing and implementing post-war reconstruction and recovery initiatives at the subnational level. Finally, it assesses the various public funding mechanisms used for regional and local development, and draws lessons from them in order to inform the design of funding tools that can support post-war recovery at the subnational level.

Part II of this report first addresses advances in Ukraine’s decentralisation reform process since 2014, including improvements in local public service quality and administrative capacity, as well as ongoing challenges, such as the differentiated ability of municipalities to meet their responsibilities. Second, it includes a qualitative and quantitative assessment of the impact of amalgamation on municipal performance. Finally, it identifies a number of success factors that are key to improving municipal performance and outlines how performance measurement at the subnational level in Ukraine can be improved. This can help the government as it advances with finalising and implementing a national recovery plan.

Towards a place-based approach for effective post-war recovery

Prior to February 2022, Ukraine had made significant progress in addressing challenges to regional well-being, including a reduction in poverty from 52% to 23% nationally (as measured by the share of the population living below the nationally defined subsistence income level) with some variation across territories (CabMin, 2021^[1]). However, a series of shocks, beginning with the 2008 global financial crisis, followed in 2014 by the Russian Federation’s seizure of Crimea and its intervention in support of rebel separatists in the east of the country, and finally the COVID-19 pandemic in 2020-2021 put pressure on Ukraine’s ability to generate economic growth, strengthen territorial cohesion and increase citizen well-being. These successive crises, and now the vast destruction wrought by the war, highlight the importance of strengthening Ukraine’s capacities to manage shocks and subsequent recovery, including the capacities of subnational authorities.

Disaster management and the role of subnational governments

Ukraine is proving itself in terms of response capacity in the face of Russia’s war. Immediately after the full-scale invasion began on 24 February 2022, Ukraine declared martial law and facilitated the creation of *oblast*, *rayon* and municipal military administrations. This included introducing legislation to clarify powers and responsibilities of subnational governments under martial law, such as giving subnational governments additional powers to transfer funds from local budgets to the armed forces and to inspect buildings and other infrastructure damaged by the war. Additionally, with the easing of criteria for civilians to become members of the territorial defence forces, 110 000 civilians had joined territorial defence units by early April 2022 (Romanova, 2022^[2]).

Despite the fact that the war is ongoing, Ukraine is already thinking about reconstruction and recovery, particularly in the areas liberated by the Ukrainian army. Given the territorially differentiated impact of the war on Ukraine’s regions and cities, as the government finalises and implements a recovery plan, attention will need to be focused on ensuring that the plan meets the specific needs of subnational governments and builds on existing capacities. Maintaining the dialogue it has launched with a wide range of stakeholders from the public and private sectors, civil society, academia, the international donor community and international experts to develop and advise the government on a national recovery plan will be critical as it considers and refines its short-, medium- and long-term priorities and goals.

Multi-level governance for effective disaster management and recovery can be strained

Ukraine's regions and municipalities are facing different levels of destruction and different types of immediate and long-term challenges as a result of the war. Thus, ensuring a degree of flexibility or adaptability in the multi-level governance arrangements supporting recovery will be important. This includes the level of government at which decisions are made and implemented, the co-ordination and communication mechanisms used, and a clear attribution of responsibilities. The extent to which a more centralised or decentralised approach to disaster management and recovery can be adopted in different regions will depend, at least in part, on the extent to which subnational governance structures are still functioning.

Effective disaster management and recovery depends on well-co-ordinated action and actors working together—be they public, private or third sector (civil society)—and at all levels of territorial governance. However, prior to February 2022, different national co-ordination bodies were either not fully operational or lacked the systematic participation of local authorities to support communication and exchange among and across levels of government. If national level co-ordination bodies, such as the Inter-departmental Co-ordination Commission for Regional Development, were more operational they could help the National Council for Recovery of Ukraine, an advisory body under the President of Ukraine, to ensure that recovery initiatives meet local needs and that reconstruction efforts are not fragmented. It could also help track progress on reconstruction initiatives and facilitate dialogue across and among levels of government. With additional financial and technical support, Ukraine's regional development agencies could also function as platforms to co-ordinate regional recovery efforts.

Ensuring that responsibilities are clearly attributed among different levels of government can also facilitate disaster management. Such clarity has been elusive in Ukraine's multi-level governance arrangements so far, and the recovery offers an opportunity to address this weakness. Many municipalities surveyed by the OECD in 2021 reported that responsibilities among levels of government were least clear in three areas that will be reconstruction priorities: public transport, roads, and energy/utility facilities (OECD, 2021^[3]). The lack of clarity can hamper post-war reconstruction if different levels of government are unclear on who decides, who builds, and who maintains in the short, medium and long terms.

Applying a place-based approach to support post-war recovery in Ukraine

In April 2022, the government established the National Council for the Reconstruction of Ukraine, which is responsible for devising a national recovery plan. As Ukraine advances with this plan, it will be important not only to consider the damage inflicted by the war, but also how Ukraine's socio-economic development trends and governance challenges prior to the war could be addressed. Pre-existing territorial factors, such as historic regional differences in Gross Domestic Product (GDP), competitiveness, the size and skills of the labour force, and territorial differences in citizen well-being could affect the long-term success of the plan—unless they are also addressed in the recovery process. Post-war reconstruction and recovery can be used to improve on the past by introducing ambitious economic, social and governance reforms.

At the same time, policy makers should be aware that the public goodwill that often marks the first years of reconstruction and recovery is often short-lived. After a devastating conflict, people will want to regain the standard of living that they were used to as soon as possible and not wait for more ambitious reforms to generate tangible results. As such, the government will have to make sure that in the short term the delivery of basic services is restored, housing is provided and local economies are kick-started. This can sustain trust in government and donors, and generate a willingness to support more ambitious reforms. Leveraging local expertise is exceptionally important for a place-based approach to disaster management, as it can help channel resources where they can have the most impact. For example, Ukraine's different tiers of subnational government can support the development of an open-source national inventory of territorial needs, design and implement reconstruction projects, and track progress of local recovery efforts. Moreover, current legislation could be amended to enable greater involvement of non-governmental actors

(e.g. businesses, academia and citizens) in the design, implementation and monitoring of measures to support the reconstruction of their regions or municipalities.

Finally, the government, as well as international partners, should be prepared to mitigate the pre-existing risks associated with vested interests and corruption. These tend to be exacerbated in post-disaster contexts due to a combination of 1) an expected vast inflow of recovery funds; 2) pressure on authorities to allocate resources swiftly; and 3) strained absorption capacity in national and subnational institutions. Investing in community-based accountability processes as well as transparency and oversight mechanisms that can be established relatively rapidly would be important in the short term. For example, public expenditure tracking, citizen monitoring of public service delivery and citizen advisory boards are used in many countries. Digital platforms enabling governmental and non-governmental actors to track funds and projects are one option to support this.

Building on regional development successes

To support recovery efforts, it will be important for Ukraine to continue building on the regional development planning and funding frameworks developed since 2015. One essential step for regional development after the war will be updating the existing seven-year State Strategy for Regional Development (SSRD) (2021-2027), as well as regional and municipal development planning documents, while ensuring that strategic documents link to a final national recovery plan. At the same time, Ukraine should also consider streamlining the planning requirements for subnational governments in order to facilitate decisive recovery action. With the gradual rollout of the regional development reforms and decentralisation beginning in 2014, the number of territorial development strategies and plans that subnational governments were required to develop proliferated. This risks overlap among different planning documents, potentially resulting in a duplication of efforts, and may lead to a fragmented use of resources, particularly when the objectives of different strategies and plans are not well aligned.

Attention will need to be paid to ensuring that public spending on reconstruction and recovery at the regional level is optimised. Between 2015 and 2019, a total of 110 grants and subventions¹ linked to regional and local development were implemented by a wide array of institutions (U-LEAD, forthcoming^[4]). This hampered the effectiveness of public spending, risked a duplication of efforts and increased the potential for misuse of public funds. These challenges were compounded by the absence of a formal body to co-ordinate regional development funding, a lacuna that should be addressed when designing and implementing the recovery and reconstruction funds at the national and subnational levels. Based on this experience, consideration could be given to establishing only a limited number of dedicated recovery funds and subventions and formally mandating a national-level body responsible for co-ordinating recovery funding.

Box 1.1. Key OECD recommendations for reinforcing a place-based approach to post-war recovery

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 enable reconstruction initiatives to meet territorially-differentiated needs and strengthen resilience, Ukraine is advised to:

- Ensure that recovery implementation and funding mechanisms reflect national priorities and specific regional and local needs and assets. This can be achieved by involving representatives of subnational governments in the definition of both immediate recovery support schemes and more long-term development strategies.
- Assess the extent to which existing regional development funding, implementation and co-ordination mechanisms can be leveraged and improved to support post-war reconstruction, for example by:
 - Building on the experience and skills in providing citizens with a wide array of public services and managing public investment funding that municipalities have gained since the 2014 start of the regional development and decentralisation reform process.
 - Mobilising existing co-ordination bodies—or establishing new ones—at the *oblast* level and in larger cities to allow public institutions, as well as non-governmental actors, to share information, co-ordinate activities and mobilise diversified resources.
- Build the capacity of weaker municipalities to develop and implement local reconstruction projects, monitor their results, and absorb recovery funding.
- Develop a robust municipal performance measurement framework, which can identify weaker municipalities in need of additional capacity building support. Such a framework could include socio-demographic, fiscal, operational and political system indicators applicable to all 1 469 municipalities.
- Promote and facilitate the involvement of non-governmental actors in the development, implementation and monitoring of recovery initiatives in the short term, and ensure increased public participation in decision-making processes after the initial reconstruction period.
- Establish mechanisms that allow for the transparent use of recovery funding by subnational governments and strengthen anti-corruption efforts, for example by:
 - Supporting municipalities on issues related to local public procurement and transparent decision making.
 - Strengthening mechanisms to control and oversee the spending of recovery funds.
 - Establishing a national-level body responsible for co-ordinating recovery funding.
 - Setting up digital platforms that enable governmental and non-governmental actors to track funds and projects.
- Invest in community-based accountability processes (e.g. public expenditure tracking and monitoring of public service delivery).

Setting the scene: A volatile context for regional development

The Russian Federation's large-scale aggression against Ukraine in 2022 has severely affected existing demographic, economic and well-being trends. Moreover, with no end in sight, it is difficult to predict what

the specific baseline of many development indicators will be in the war's aftermath. Despite this uncertainty, the data and analysis reflected in this report—conducted in large part in 2021—offer insights for policy makers in a recovery setting. Experience from different countries and regions that have implemented post-disaster recovery strategies shows that reconstruction efforts need to meet immediate needs while attempting to improve underlying governance, socio-demographic and economic conditions.

An analysis of demographic, economic and well-being trends at the national and subnational levels in Ukraine, as well as obstacles to regional development were compared with four benchmarks: i) former Soviet countries; ii) neighbouring countries; iii) the OECD average; and iv) the EU average. The results were mixed in terms of improved performance. In most dimensions—e.g. demographics, the economy and well-being—there were areas of significant improvement. For example, between 2015 and 2020, there was greater political stability, a strong increase in GDP per capita, and an impressive drop in poverty rates. At the same time, the contributions of most *oblasts* to aggregate Gross Value Added (GVA) did not change much between 2010 and 2019: there were generally low employment rates for the country as a whole, and there was a significant population decline in all *oblasts* except Kyiv City and Kyiv *Oblast*. On most other available metrics, territorial inequalities have become more entrenched or worsened.

The demographic dimension

By the end of 2021, almost all regions suffered from decreasing population, which was driven by a range of factors including external and internal emigration, low fertility, as well as ageing. The exceptions to the trend were Kyiv City, Kyiv *Oblast* and, to a much more limited extent, Zakarpattia. In addition, all regions, except Ternopil, were confronted with a shrinking labour force—even Kyiv City and Kyiv *Oblast* saw labour-force declines—mainly reflecting population ageing. This has significant implications for the cost of, and demand for, public services, not to mention productivity and economic development. Between 2011 and 2020, Kyiv City, Luhansk *Oblast* and Zaporizhzhia *Oblast* reported the country's strongest declines in the share of working-age persons in the total population (6.6, 4.4 and 3.8 percentage points, respectively) (CabMin, 2021^[1]). With 5.8 million people having fled the country by July 2022, and millions more internally displaced, Russia's war against Ukraine has dramatically increased the scale of Ukraine's demographic challenge and the strain it puts on productivity and economic development (UNHRC, 2022^[5]).

The economic dimension

Between 2014 and 2020, Ukraine suffered major political and economic shocks that hampered growth. These include the 2014 Euromaidan revolution, Russia's annexation of Crimea, the conflict in the Donbas region and the COVID-19 pandemic. Ukraine's proximity to the European market and the signing of various trade and co-operation agreements with 46 countries since 2014, however, opened a window to more international economic integration, with exports as an economic driver. Between 2014 and 2019, the volume of exports to the EU-26 increased by 43% in current USD terms (OECD, 2021^[6]).

Regional productivity was affected by a number of factors prior to the war, which in turn could aggravate regional inequalities and affect subnational capacity for regional development and public service delivery, as well as recovery. Among these factors is limited labour-force participation, particularly among women and youth. To address this issue, Ukraine could enact tailored labour-market policies that are designed and implemented in a way that takes into account local barriers to increased female and youth participation in the labour force while building on territorial industrial structures and assets. Wage differentials among Ukraine's regions were also relatively large—ranging from an average monthly wage of UAH 17 086 in Kyiv City (the highest) to UAH 9 166 in Chernivtsi *Oblast* (the lowest) in 2020 (CabMin, 2021^[1]). This is larger than wage differentials in many OECD member countries. Before the war, low wages were a key driver of outward migration.

The well-being dimension

Prior to the war, Ukraine's regions had markedly improved in terms of poverty. This was driven in part by real wage growth. Between 2015 and 2019, the share of the population living below the nationally defined subsistence income level fell by over half, from 52% to 23%. Lviv *Oblast* reported the largest reduction (47 percentage points) (CabMin, 2021^[1]). Russia's invasion is likely to severely undermine the significant progress in poverty reduction that Ukraine's regions achieved between 2015 and 2019.

Internet access in Ukraine increased significantly over the past 20 years but remains below the OECD average (86%). In 2020, 84% of households in Kyiv City had internet access, the highest level in the country, followed by Dnipropetrovsk *Oblast* (79%). By contrast, only 49% of citizens had access to broadband services in Rivne *Oblast*, the region with the lowest level of internet access prior to the war (CabMin, 2021^[1]). Ensuring continued digital connectivity and even expanding coverage is key to recovery efforts as it will support economic activity, enable citizens to stay abreast of relevant recovery initiatives, and facilitate access to different public e-services.

The COVID-19 crisis highlighted the need to address territorial disparities in Ukraine's healthcare system. In 2020, the number of hospital beds and doctors per 10 000 inhabitants varied significantly across regions, with some performing better than the OECD average (e.g. Chernivtsi, Ivano-Frankivsk and Ternopil). In 2020, Chernihiv *Oblast* reported the highest number of hospital beds per 10 000 inhabitants (80.4). Meanwhile, Zakarpattia had the lowest number—55.4 beds per 10 000 inhabitants, which was more than the majority of OECD member countries (Ministry of Health, 2020^[7]). While territorial variation in access to healthcare is common in OECD countries, it can have important implications for a region's preparedness to deal with public health or disasters requiring medical attention, such as war. In a post-war context, Ukraine will not only have to invest in rehabilitating the damaged physical healthcare infrastructure, but also ensure access to mental health and psycho-social support, as mental disorders are prevalent in post-war settings.

Ukraine's regional and municipal development frameworks

Since 2015, Ukraine has established an elaborate legislative and policy framework for regional and local development and built up policy and service delivery implementation capacity at all levels of government. This was accomplished through the 2014 reform of local self-government and territorial organisation of power, the approval of a legislative framework for the country's State Regional Policy, the design and implementation of successive State Strategies for Regional Development (SSRD) and the creation of regional development agencies. Although these reforms had contributed to numerous advances, a number of key challenges remained at the outbreak of the war, primarily with respect to strategic planning frameworks, the multi-level governance mechanisms and planning instruments available to support these frameworks, and the need for additional information and expertise to advance regional development goals and implement programming in an effective manner.

The proliferation in the number of strategic frameworks for regional development, in addition to various national and subnational planning documents, can lead to uncertainty with respect to the goals of the State Regional Policy, fragmentation in policy implementation and sub-optimal use of scarce public services. Successfully operating a large number of plans to guide regional development requires effective national-level co-ordination of regional development efforts. This has been lacking and hampers the implementation of the country's State Regional Policy across sectors and among levels of government. The limited functionality of existing horizontal and vertical co-ordination mechanisms compounds the co-ordination problem, as these are necessary to increase policy coherence and effectiveness, and to generate trust-based partnerships among levels of government and with stakeholders.

Strategic planning, although vital, is only half of the equation. Implementation is just as important. Mechanisms for implementing the country's regional development policy and corresponding strategies, particularly at the *oblast* level, were embryonic at the outset of the war. At present, urgent attention needs to be paid to implementation issues if Ukraine is to meet its regional reconstruction and recovery objectives. The regional development agencies could be strong partners in helping articulate and implement regional and local development strategies throughout the recovery process and beyond. Non-governmental actors are also important contributors to strategy and policy implementation. Unfortunately, the structure of the SSRD limits their participation in its implementation. Civil society organisations, the private sector and academia can play a strong role in implementing, monitoring and evaluating strategies and their programming by providing local insight into development needs, priorities and results. Given the experience all levels of government are gaining by working with non-governmental groups to support the war effort, it would be valuable to carry this knowledge forward and apply it to post-war recovery activity as well.

Despite the advances stemming from decentralisation reform, many of Ukraine's 1 469 municipalities were still building the necessary technical expertise to effectively contribute to the implementation of the country's State Regional Policy on the eve of Russia's war against Ukraine. When a national recovery is adopted, this need for greater technical capacity will likely be even more urgent. Among the municipal capacity constraints that still needed to be addressed before the war were developing realistic strategic plans, effectively involving stakeholders (e.g. private sector, civil society, academia) in strategy development and implementation, and identifying targets and indicators to support performance measurement (monitoring and evaluation).

Prior to the war, most municipalities surveyed by the OECD reported that decentralisation reforms had a generally positive impact on municipal performance, particularly with respect to development planning, monitoring and evaluation. For example, 59% of the surveyed municipalities indicated that the reforms had improved their ability to design local development strategies (OECD, 2021^[3]). The reforms have offered mixed results in stakeholder participation, however. For example, most municipalities considered that the decentralisation reforms had not increased the participation of businesses in municipal decision making. At the same time, municipalities reported that the reforms had a relatively positive impact on the participation of individual citizens in municipal decision making related to strategy design, though less so in identifying investment needs (OECD, 2021^[3]). Legislation to clarify the tools and mechanisms through which stakeholders can participate in municipal decision making could help address these issues. This is particularly relevant for the post-war reconstruction and recovery phase. The immense cost of the reconstruction requires the involvement of non-governmental actors, who can contribute by identifying immediate needs and providing support to vulnerable populations, particularly in remote areas, as well as by contributing to the design, delivery and monitoring of recovery initiatives.

All levels of government need to enhance their capacity to produce, analyse and disseminate information on regional and local development performance. The government is aware of the data challenges it faces, particularly with respect to micro-level data on regional and local development. Prior to the war, a number of initiatives were launched to address this issue. These included a survey by the Ministry for Communities and Territories Development (MinRegion) that was sent to municipalities to gather suggestions on topics to include in a new system of local statistics; the Hromada Performance Monitoring Platform; and a move to develop a municipal performance management system together with USAID's DOBRE project. The findings associated with this project highlight the scarcity of information available to municipalities to assess their performance, particularly among municipalities that have recently amalgamated.

Addressing the very limited availability of territorially-disaggregated data may require continued capacity building among national and subnational governments to produce, analyse and share reliable data. In particular, it is important to substantially expand the list of well-being indicators for which local-level data are produced, moving well beyond the indicators presented on the Hromada Performance Monitoring Platform. Moreover, the government, aided by international partners, will need to support the capacity of

subnational governments and local non-governmental actors alike to provide up-to-date information on immediate and longer-term reconstruction and recovery needs.

Reinforcing the role of the State Statistics Service of Ukraine (SSSU) to support subnational data gathering could help all levels of government improve performance. As the central executive body responsible for statistics, it could play a key role in ensuring that the territorially disaggregated data needed for recovery are collected centrally and are presented on an easily accessible platform. This is essential for supporting evidence-based decision making on recovery and reconstruction, and tracking progress on meeting local needs. However, this requires revamping the SSSU's online portals, which do not meet the standards of modern statistical and geographic data reporting, limiting the ability of users to identify and use data for decision-making purposes.

Furthermore, there is no formal co-ordination mechanism to facilitate regular and systematic exchange between the SSSU and other government institutions to support the generation, analysis and dissemination of development statistics. One way to address this last issue is via an inter-agency statistics commission that could spearhead the creation of a publicly accessible platform for monitoring territorial recovery.

Box 1.2. Key OECD recommendations for reinforcing Ukraine's regional and municipal development frameworks

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 refine the strategic planning framework and support the implementation of the State Regional Policy at all levels of government, Ukraine is advised to:

- Strike a balance between development planning and implementation, and promoting horizontal and vertical policy coherence. The enactment of a national planning law that defines the short-, medium- and long-term planning documents needing to be developed, and who should be responsible for their design, implementation and monitoring, can help achieve this.

To strengthen the horizontal and vertical co-ordination of regional development, Ukraine is advised to:

- Provide MinRegion with more tools to ensure its contribution to policy development in sectors with a regional-/local-level incidence, for example by giving it a role in the review of draft policy proposals on issues such as transport and subnational economic development.
- Improve the functioning of existing horizontal and vertical co-ordination mechanisms. This could be accomplished, for example, by streamlining the Inter-Departmental Co-ordination Commission for Regional Development's broad set of responsibilities to ensure its meetings focus on key regional development issues and by creating (technical) working groups within the commission.
- Clarify the mandate and improve the capacity of regional development agencies to execute their tasks and responsibilities, for example, by setting up peer-to-peer learning trajectories to facilitate the exchange of good practices between Ukrainian regional development agencies and their peers from OECD member countries.

To strengthen the ability of municipalities to foster territorial development and contribute to the implementation of the State Strategy for Regional Development, Ukraine is advised to:

- Develop initiatives to increase the participation of non-governmental actors throughout the regional development planning cycle (e.g. making economic development funds for municipalities conditional on private sector involvement). The Working Groups established by the government for the National Recovery Council in which representatives from different sectors participate could serve as an example.

To strengthen effective data management for regional development policy, Ukraine is advised to:

- Increase the availability of up-to-date territorially-disaggregated information on a wide range of topics (e.g. economic, social, demographic). In particular, it is important to significantly expand the list of well-being indicators for which territorially-disaggregated data are produced, moving well beyond the indicators currently presented on publicly accessible platforms.
- Invest in the generation, analysis and dissemination of information on citizen experience with public services at the national, regional and local levels.
- Strengthen the role that the SSSU plays in gathering, analysing and disseminating data across ministries and among levels of government. The Cabinet of Ministers may be well positioned to support such efforts as it has been co-ordinating the activities of the SSSU since 2019. Alternatively, inter-agency commissions could be created—for instance for regional development—that are charged with defining sectoral data needs, establishing standards to generate and present statistics, and ensuring that current databases are up-to-date and new ones are developed.

Public funding for regional development in Ukraine

Beginning in 2015 and up until February 2022, subnational development funding increased significantly in Ukraine, highlighting the importance that the government placed on regional and local development. Between 2015 and 2019, central government budget allocations to regional and local development increased from 1.9 to 6.9% of the total national budget, i.e. from slightly over UAH 11 billion to almost UAH 76 billion (U-LEAD, forthcoming^[4]). This marked increase reflected the creation of several subventions to fund subnational investment projects. Yet despite the increased funding, subnational government capacity to invest in regional development was limited by four principal challenges that could further entrench regional disparities: i) the structures underlying the allocation of the Personal Income Tax (PIT) to municipalities; ii) fragmentation in Ukraine's fiscal framework for regional development and a heavy focus on funding the maintenance of "hard" infrastructure; iii) a reliance on competitive funding and co-funding that hampers the ability of poorer municipalities to meet their investment needs; and iv) a divergence in the capacity of larger and smaller municipalities to fund investment projects through own-source revenue.

The impact of fiscal equalisation and PIT allocation on regional inequalities

Ukraine's approach to the distribution of PIT strongly affects the ability of subnational governments to fund basic service delivery and to undertake strategic investments. Ultimately, the current approach risks aggravating territorial disparities and undermining political accountability.

Currently, Ukraine allocates PIT revenues to the municipality where the employer is legally registered, rather than to the employee's place of residence. Thus, private companies play a large role in the distribution of PIT funds. Furthermore, large municipalities, where multi-office companies are registered, may benefit from PIT revenues at the expense of smaller municipalities, where workers actually work or reside. As companies can change the place where they are registered, the system renders PIT a potential bargaining chip, giving companies negotiating power over municipalities that do not want to risk losing revenue from PIT funds. Ukraine is encouraged to consider PIT reform based on place of residence. Such a shift has the potential to boost financial resources for many municipalities, helping them deliver better public services and undertake additional investment. It would also strengthen local political accountability. An ex-ante study, however, would be strongly advised in order to determine how the reform would affect the fiscal health of the national, regional and municipal governments. In addition, the size of the horizontal fiscal equalisation system necessary to offset, at least in part, territorial disparities in PIT revenues should also be assessed. Municipalities surveyed by the OECD consider changes to the PIT allocation system an urgent area of fiscal reform (OECD, 2021^[3]).

Grants and subventions for regional development in Ukraine

In 2019, the government's financial support for regional and local development was almost four times greater than in 2015 (in real terms) (U-LEAD, forthcoming^[4]). The creation of different intergovernmental grants and subventions contributed to this increase, but there were factors limiting the effectiveness of these funds. These included a fragmented and relatively unstable fiscal framework, an emphasis on funding "hard" regional and local infrastructure, and the tendency to use funds for small-scale local projects. Recalling the impact of these challenges and actively trying to avoid them when designing mechanisms to fund Ukraine's post-war reconstruction and recovery at the subnational level could be valuable for policy makers as they move forward with their planning.

Between 2015 and 2019, the share of subnational funding became more fragmented in terms of the number of grants and subventions available for regional and local development, and in terms of grant administration. The number of available grants—110 in total—led to increased administrative costs associated with managing development funding. Moreover, the administration of those funds was

fragmented across 20 different government entities. This fragmentation represented a co-ordination challenge that could potentially compromise spending efficiency, the quality of implementation and the effectiveness of the different intergovernmental transfers.

One way to address the fragmentation challenge is to reallocate a larger share of regional and local budget grants and subventions to a single fund, such as the State Fund for Regional Development (SFRD) managed by MinRegion. This would help ensure that overarching government objectives in the regional and local development sphere are met. It should be reinforced by a mandate for MinRegion to co-ordinate the different regional and local development funds, even when they are implemented by other ministries. Yet certain challenges would have to be overcome. First, adjusting the SFRD distribution formula could help improve regional convergence, e.g. by linking the formula to the population and GDP per capita of *rayons* instead of *oblasts*. However, if Ukraine decides to implement PIT reform based on place of residence—which may affect GDP per capita of *rayons*—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. Second, shortfalls in the level of funds attributed to the SFRD would need to be avoided. As of 2022, it was mandated to receive 1.5% of planned General Budget fund revenues (up from the original 1%). In practice, the funding level fluctuated between 0.43% and 0.79% between 2015 and 2021 (Verkhovna Rada, 2015^[8]; Verkhovna Rada, 2020^[9]).

Many of Ukraine's largest subnational subventions, including the SFRD, were awarded competitively and required municipalities to meet co-funding criteria. Given vast differences in the fiscal capacity of municipalities, such criteria risk undermining the ability of poorer municipalities to obtain the funding needed to fulfil their investment needs. Approximately one in three municipalities surveyed by the OECD in 2021 reported that their financial situation was the key impediment to obtaining SFRD funding (OECD, 2021^[3]). To address this challenge, ideally municipalities with the weakest fiscal capacity could be exempt from providing co-funding, barring this, they should be eligible for a significantly reduced co-funding requirement. This is particularly relevant in the post-war reconstruction and recovery phase, as the fiscal capacity of many subnational governments has been severely weakened.

The effectiveness of regional development funding has also been hampered by a heavy concentration of small projects with relatively low economic impact, risking non-strategic use of resources. Between 2015 and 2018, 63% of SFRD-funded initiatives targeted single municipalities, while less than 10% of projects had a more regional-level focus (U-LEAD, 2018^[10]). To increase the strategic use of the SFRD and achieve economies of scale, prioritising projects with a cross-jurisdictional focus would be important. This also applies to mechanisms to fund subnational reconstruction and recovery projects. Determining the right territorial scale of subnational recovery initiatives requires a solid assessment of the particular needs of municipalities across the country and where these coincide or diverge. To the extent possible, this needs to be combined with feasibility studies and robust cost-benefit analysis to make sure that recovery funds are spent effectively and efficiently.

Finally, intergovernmental spending on regional development has mostly focused on “hard” infrastructure. Over the 2015-2019 period, spending on this type of infrastructure accounted for close to two-thirds of all regional development spending (U-LEAD, 2018^[10]). While investment in hard assets (e.g. reconstruction of roads, schools, hospitals, electricity grids) should be the priority during the reconstruction and recovery period, complementary investments in human capital as well as support for small and medium-sized enterprises will be essential. 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 public investment capacity

Between 2015 and 2020, direct investment by subnational governments increased in real terms by 26%. However, the share of subnational direct investment as a percentage of total public direct investment dropped by 21 percentage points (IMF, 2022^[11]; World Bank, 2021^[12]). Moreover, local authorities in particular witnessed a decline in investment. For example, between 2016 and 2018, the share of investment as a percentage of total spending by amalgamated municipalities fell sharply, from 33% to 19% (SKL International, 2019^[13]). To boost the investment capacity of smaller municipalities, there are several options to consider. For example, a block grant could be provided to fund projects linked to both regional and local development plans. Another possibility is to expand municipal power to set the tax base and rates for own-source taxes, possibly within a nationally determined range in order to avoid too much variation among municipalities, and an excessive tax burden on citizens. This would improve municipal fiscal capacity, provide more flexibility to fund initiative that meet local needs, and could boost accountability to citizens. Building up the skills of subnational government staff, particularly with respect to investment management, would also prove beneficial, especially in light of funding and financing that will be available for post-war recovery.

Under certain conditions and strict control mechanisms, public-private partnerships (PPPs) can be a mechanism to diversify funding for regional and local development projects, particularly when a government is faced with budgetary and funding constraints. However, PPPs are subject to the same fiscal or willingness-to-pay constraints as traditional public projects. In both cases, strong institutional capacity at all levels of government is required for effective project delivery. Moreover, PPPs involve significant risk, including regulatory capture, conflict of interest and corruption, and long-term constraints on government fiscal capacity. PPPs should not be used to overcome budget constraints. Rather, they should be used only when they can produce greater value for money than would be provided by the delivery of public services or investment through traditional means.

Efforts to build the capacity of subnational governments to manage public investment for regional development—including for post-war territorial recovery—need to include measures to mitigate the misuse of funds. This is particularly important given a 2019 audit by the Accounting Chamber of Ukraine that revealed significant outstanding systemic issues, including misuse of budget funds and violation of legislation in the field of planning and budgeting, as well as a significant number of unfinished construction projects. 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 and channelling international aid to support this.

Box 1.3. Key OECD recommendations for reinforcing public funding for regional development in Ukraine

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, it is advised to:

- Modify legislation to allocate the Personal Income Tax (PIT) based on place of residence, thereby increasing its potential to provide municipalities with financial resources commensurate with the demand for public services and investment in their territory.
- Conduct an ex-ante study to determine how the different proposals to reform the PIT allocation system under consideration by parliament 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.

To help Ukraine capture the benefits of its intergovernmental transfers for regional development, it is advised to:

- Streamline the number of grants and subventions for regional development, without reducing their value, to increase spending efficiency, avoid overlap and strengthen the quality of implementation. One way to achieve this is by reallocating a higher share of regional and local budget grants and subventions to a single fund managed by MinRegion.
- Balance investment in “hard” (e.g. roads, bridges, railways) and “soft” infrastructure (e.g. innovation, research and development) as a means to promote balanced regional development. This could be accomplished by, for example, ensuring that funds and subventions with a cross-sectoral focus, such as the SFRD, promote and facilitate investment in areas such as innovation and skills, as well as physical infrastructure.
- Level the playing field so that municipalities 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 municipalities that are wealthier or have greater technical capacities. This could be achieved by, for example:
 - 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.

To help strengthen the ability of municipalities to fund local development and investment, 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, and monitoring and evaluating investment projects.

To improve the legal and efficient use of regional development funding, 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.

To increase the responsible use of public-private partnerships (PPPs) as a means to finance regional and local development, 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. Guidance should also seek to ensure that subnational governments are well-informed regarding alternatives to PPPs, and the potential benefits and risks of these.
- Develop and disseminate training material for municipalities on assessing the value-added and risks of PPPs, managing such partnerships, as well as establish a transparent system to track the use of public funds and determine their effectiveness.

Advances in Ukraine's decentralisation process since 2014

Six years into the reform process, in 2021, many municipalities reported improvements in the quality of local public services (such as administrative services and education), as well as a consolidation of their administrative capacity. These advances, which were achieved despite the absence of a constitutional amendment to institutionalise the territorial-administrative structure that had been modified through regular legislation, are highly relevant in the context of the current war. They have provided municipalities with expertise and tools to meet the exigencies of the war, and positioned them to more effectively support place-based reconstruction and recovery in the medium to long term.

Decentralisation created new responsibilities and resources to municipalities

Ukraine's decentralisation reforms sought to reinforce democratic governance by adjusting subnational political power; reinforcing public service delivery at the local level; simplifying the territorial-administrative structure; and clarifying the responsibilities attributed to each level of government. Initially intended to be introduced through a constitutional amendment and then reinforced through adjustments in legislation, the fact that, on different occasions, the government was not able to obtain the votes necessary to pass a constitutional amendment led it to rely strictly on legislative and regulatory changes to carry out its initiative.

There were several key elements underscoring the reform process. First, the municipal amalgamation process reduced the number of local councils from more than 10 000 in 2015 to 1 469 by 2020. Second, local democracy and accountability were bolstered by simplified electoral voting and registration laws, and a move to institutionalise *starostas*—local community officials responsible for representing the interests of residents. Third, administrative decentralisation transferred responsibilities to municipalities in key service areas, including administrative services, education, healthcare, waste, water and sanitation and housing, leading to improvements in service quality, as reported by the municipalities. Fourth, fiscal decentralisation led to greater municipal budget capacity and more room for autonomous fiscal decision making, as municipal reliance on intergovernmental transfers decreased in favour of revenues from shared and local taxes. This was the result of various government financial incentives to spur municipal mergers, including increased revenues from PIT, as well as access to regional and local development funding through the SFRD and the Local Infrastructure Subvention.

Despite these successes, at the start of the war, municipalities still faced a number of territorial-administrative challenges, often linked to the country's multi-level governance arrangements and the way in which the decentralisation process was implemented. These shortcomings include legislative discrepancies in the assignment of responsibilities among levels of government, a lack of municipal oversight, a need for better vertical and horizontal co-ordination, and a need to build municipal capacity in a number of areas (e.g. planning, human resources, fiscal and investment management). Furthermore, municipal economic development remains limited and there is room to further reinforce local democracy and accountability.

Addressing tensions between the rayon and municipal levels of government

The absence of a constitutional reform meant that, as the decentralisation reform process advanced, inconsistencies increased between the Constitution of Ukraine and various pieces of legislation on the respective functions of municipalities and *rayon* state administrations. In addition, the different legislative and regulatory reforms that guided the transfer of tasks and responsibilities to amalgamated municipalities resulted in a lack of clarity about the division of tasks and responsibilities across levels of government in different sectors (e.g. public transport and roads). The government should look to harmonise the legislative framework in order to provide clarity on the responsibilities of different levels of government and ensure an effective and efficient allocation of recovery funding.

There are also concerns about the absence of clear guidance on whether *oblasts* and/or *rayons* are responsible for overseeing the legality of municipal decisions and activities. This can be problematic given the vast increase in administrative and service delivery responsibilities of amalgamated municipalities and the relative inexperience of some municipal governments in executing their acquired mandates. This calls for redefining the role of *rayon* state administrations as territorial actors, particularly in light of their highly reduced administrative and service delivery responsibilities. The latest attempt to address both issues came in 2021, when the government drafted a constitutional amendment proposing the creation of a prefecture-like system to replace the *oblast* and *rayon* state administrations (Office of the President of Ukraine, 2021^[14]). According to this proposal, prefects would be responsible for overseeing the legality of municipal decisions and have the power to temporarily suspend legislation deemed inconsistent with Ukrainian law. This latest attempt to resolve the challenges related to oversight over municipal decisions was not adopted before Russia's large-scale invasion on 24 February 2022. As long as martial law is in place, no constitutional amendments can be made.

While there has been agreement among many national and subnational government representatives that updating the role of *oblast* and *rayon* levels and clarifying the mechanisms for oversight over municipalities is important, there has been ample debate about how to balance the powers of each level of government. Any future reform should ensure that increasing oversight over municipal decisions does not impinge on local democracy or stifle municipal decision making.

Revisiting co-ordination mechanisms for municipal governance

Limitations in the country's vertical and horizontal co-ordination mechanisms risk hindering the effective implementation of the decentralisation reforms, as well as national reconstruction and recovery initiatives. Municipalities often fail to fully understand the rapidly evolving legal framework that supports decentralisation. At the same time, while successive governments have invested in the creation of different multi-level co-ordination bodies, as well as *ad hoc* consultation of local leaders, municipalities often struggle to communicate their needs and challenges to higher levels of government.

These challenges could be overcome by reinforcing the participation of municipalities in the Inter-Departmental Co-ordination Commission for Regional Development (ICC) and the Congress of Local and Regional Authorities. In the case of the ICC, which is tasked with the design, implementation and

monitoring of Ukraine's regional development policy at the municipal level, among other responsibilities, this could be achieved by providing a representative cross-section of municipalities with a permanent seat in the Commission's meetings (Verkhovna Rada, 2015^[15]). In the case of the Congress, which was set up to represent and advance the interests of regional and local authorities, this could be achieved by ensuring that two chambers are established, as envisioned when the Congress was created: one for municipalities and another for regions. Actions such as these would be particularly valuable during the reconstruction and recovery process given that municipalities will likely play a major role in defining and/or implementing reconstruction projects, making effective co-ordination even more important than ever.

Strengthening municipal capacity to meet administrative, financial and investment-related challenges

The differentiated process and timeline by which municipalities received their responsibilities through the amalgamation process accentuated existing differences in municipal capacity in planning, administration, finance and investment. Ensuring that municipal capacity continues to be built will help reinforce the benefits accumulated throughout the decentralisation process. It will also enable municipalities to contribute to post-war recovery efforts.

Municipal strategic planning capacity will be essential in a post-war period to ensure that recovery initiatives match local needs and realistic with respect to local capacities. Just prior to the war, research indicated that experience in strategic planning was not uniform among municipalities. For example, about half of the municipalities surveyed by the OECD did not have an officially approved strategy, which limited their ability to guide local development efforts. Additional capacity gaps associated with strategic planning include monitoring and involving non-government actors in all phases of the strategic planning life-cycle.

In order to advance post-war recovery processes and further meet decentralisation objectives, building civil servant capacity in strategic planning, economic development, financial management and donor relations is of the essence. This requires improving the training framework for civil servants, as there are indications that local civil servants are not staying up-to-date on training, which may reflect dissatisfaction or disinterest in the training that is being provided. Reinforcing the capacity of municipal civil servants would become even more urgent if the government were to reduce the number of civil servants, for example due to budgetary constraints or to increase efficiency. In parallel, the government should promote peer-to-peer exchanges by the different local government associations to help municipalities learn from good practices. Facilitating peer-to-peer exchange with local governments in the EU could also support EU accession. In addition, the government should prioritise updating the 2001 Law "On Service in Local Self-government", introducing mechanisms for professional development and merit-based recruitment. It should also seek to reduce the gap in the remuneration of national and local civil servants, which hampers the ability of municipalities to attract and retain skilled staff.

Prior to the war, municipalities were already facing fiscal pressures. Many local governments felt that the increase of administrative and service delivery responsibilities had not been met with a sufficient increase in municipal revenues, which raised the risk of mandates being underfunded. Moreover, there has been a relatively inequitable distribution over time of fiscal incentives for amalgamation. For example, municipalities that merged voluntarily received a 60% share of the locally-levied PIT (Verkhovna Rada, 2021^[16]). Municipalities that did not amalgamate voluntarily were not eligible for these tax revenues until they were mandatorily merged in 2020. Furthermore, they could not access funds from different regional and local development grants and subventions. Thus, they have had less time to generate own-source revenues and spend resources according to local needs. Russia's war against Ukraine has only increased fiscal pressures, as municipalities have assumed wartime responsibilities and expenditures. In the first months of the war, municipalities saw large drops in local budget revenues. Increased deficits limit local government's ability to contribute to financing targeted recovery activities.

Public investment capacity among municipalities was also limited prior to the war. Capital expenses as a percentage of total spending by amalgamated municipalities declined from 31% to 15% between 2016 and 2020 (CabMin, 2021^[17]). Possible reasons for this include the gradual increase in the minimum wage of civil servants, and a steady decline of revenue that individual amalgamated municipalities received from funds created to encourage amalgamation. Evidence also indicates that in 2021 many municipalities did not believe that decentralisation reforms had improved their ability to identify and refine investment needs in partnership with non-government actors. This can limit their ability to establish investment priorities that meet the needs of different stakeholders (OECD, 2021^[3]).

Decentralisation had an uneven effect on local service quality. While most municipalities indicated that reforms had helped improve local service delivery in areas such as education, and social care, the opposite was true for water and sanitation management, as well as housing. Rebuilding and further improving public service delivery after the war may depend on stronger inter-municipal co-operation.

Inter-municipal co-operation arrangements have gradually increased among local authorities. Between 2014 and 2020, 769 inter-municipal co-operative agreements were established, the majority in 2018 and 2019 (MinRegion, 2022^[18]). However, there appears to be ample room for improvement. In 2021, municipalities reported that the decentralisation process had had little noticeable effect on co-operation among peers. This appears to be due to a lack of understanding of the advantages of such arrangements and limited capacity to establish them. Overall, improving knowledge and awareness of the advantages of inter-municipal co-operation and facilitating these arrangements could be an advantage in the post-war recovery period. It could help boost local service delivery in terms of quality and/or mix, and relieve financial pressure on municipalities. This could be achieved, for instance, by providing municipalities with additional support materials and advice on how to set up and manage inter-municipal co-operation.

Box 1.4. Key OECD recommendations for strengthening institutional capacity at the subnational level in Ukraine

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 improve the oversight of amalgamated municipalities, Ukraine is advised to:

- Reinforce municipal oversight, for example by adopting a constitutional amendment that replaces *oblast* and *rayon* state administrations with a system of prefects at the *oblast* level, as discussed at length in parliament, in order to provide local administrative supervision and facilitate the co-ordination of national-level priorities at the local level.

To strike a better balance in territorial reform and ensure the conditions for successful decentralisation, Ukraine is advised to:

- Harmonise the legislative framework to remove duplication and provide clarity on the allocation of responsibilities in sectors where it is lacking (e.g. public transport and roads).

To further strengthen vertical and horizontal co-ordination mechanisms, Ukraine is advised to:

- Strengthen the Congress of Local and Regional Authorities by creating a separate municipal chamber, and ensuring a transparent and equitable process that enables municipalities to participate on a rotating basis.
- Reinforce the Inter-Departmental Co-ordination Commission for Regional Development by granting municipalities a permanent seat in its official sessions.

To consolidate subnational strategic planning capacity, Ukraine is advised to:

- Develop and implement training modules on areas of local administrative performance where municipalities are lagging (e.g. citizen engagement, performance monitoring).
- Support national and international peer-to-peer exchanges between municipalities on issues of local administrative performance to foster the sharing of good practices and innovative ways of working.

To strengthen subnational human resource capacity, Ukraine is advised to:

- Develop and periodically update a subnational strategy for human resource management, including an expanded list of standardised training programmes with improved mechanisms for quality control of teaching content.
- Amend the Law “On Service in local self-government” to require local civil servants to be politically neutral and ensure open and merit-based recruitment, and performance management, while also setting out effective mechanisms for professional development.

To improve subnational fiscal and investment capacity, Ukraine is advised to:

- Ensure that poorer municipalities and those with limited technical and financial capacities can compete on an equal footing with their stronger (in terms of technical capacity and funding) peers for regional development funding by linking, for instance, co-funding requirements to the fiscal capacity of municipalities.

To increase the uptake of inter-municipal co-operation arrangements, Ukraine is advised to:

- Provide municipalities with additional support materials on inter-municipal co-operation (e.g. on relevant legislation, good practices, draft co-operation agreements, etc.).
- Develop guidance for municipalities on how to set up and manage inter-municipal co-operation, particularly in sectors where uptake has been weaker in the past.

Amalgamation and its impact on municipal performance

Understanding the impact of the decentralisation reforms on municipal performance in Ukraine prior to Russia's large-scale invasion can provide insight into municipal success factors that can underpin local development outcomes post-war. It also helps reveal why improvements in municipal performance have not been uniform across the country. Such information can help regions with weaker performance 'catch-up' to their more successful peers and identify how 'leading' municipalities could continue to strengthen their performance.

In this regard, the OECD assessment of municipal performance focuses on different performance areas including administrative and human capacity, service delivery, local democracy and co-ordination. These areas were examined using a qualitative municipal self-assessment, with information obtained through a questionnaire sent to all 1 469 municipalities in 2021. There was a total response rate of 741 municipalities in 119 *rayons* and 24 *oblasts*, as well as Kyiv City, yielding a highly representative sample. In addition, a quantitative Data Envelopment Analysis (DEA) of relative efficiency in public service delivery was used. The DEA built on the data available from the Hromada Performance Monitoring Portal to identify how much local taxpayers receive in return for their tax contributions. The results of these two analyses lay the foundation for the OECD's assessment of success factors in municipal performance in Ukraine. It is important to note that the conditions under which the information for these analyses was gathered have changed dramatically since Russia's war against Ukraine.

Before February 2022, municipalities generally perceived a large increase in their ability to carry out administrative, planning and investment tasks, as well as an increase in public service quality and improved relationship with higher levels of government. This applied, in particular, to rural and settlement municipalities, which also began to see improvement in democratic governance, for example through increased citizen participation in municipal planning. At the same time, the way in which the decentralisation reforms were implemented has widened capacity gaps among different types of municipalities (rural, settlement and urban). Understanding capacity gaps and development needs can help national and subnational officials, as well as development partners tailor technical and financial support during the recovery period. The following sections outline factors contributing to successful municipal performance that were identified by the OECD, while also highlighting capacity gaps across rural, settlement and urban municipalities.

Municipal success is linked to population size and time to build institutional capacity

According to OECD analysis, municipal performance is contingent on two factors in particular: size (i.e. population) and the number of years a municipality has had to build institutional capacity. The DEA identified that more populous municipalities tend to be more efficient in terms of providing and maintaining physical municipal infrastructure. The assessment also identified that municipalities with fewer than 10 500 inhabitants tended to be in the bottom 5% of the efficiency index. This may seem intuitive. Yet there is no one-size-fits-all solution in terms of optimising cost efficiency or scale. It depends on the country, the subnational institutional and financial context, and the services being delivered.

The time that municipalities have had to build institutional capacity is a particularly crucial element. Many of Ukraine's urban municipalities that were formerly categorised as cities of *oblast* significance were

delivering an extensive set of responsibilities before the decentralisation reforms were launched in 2014. These municipalities, which obtained relatively high efficiency scores in the DEA, have had more time to build and consolidate institutional capacities (e.g. administrative, strategic, fiscal and financial management, service delivery) than many others. At the opposite end of the spectrum are some smaller and less capacitated municipalities that received their responsibilities in 2020 when they were administratively amalgamated. These findings, which are based on pre-February 2022 data, indicate that it is inherently unfair at this stage of the decentralisation process to compare or expect the same performance from the different types of municipalities. Thus, time must be recognised as a success factor, as it is a key ingredient in building institutional capacity.

Sufficient fiscal capacity is a prerequisite for successful municipal performance

Fiscal capacity, and in particular the ability to raise own-source revenues, is another important element behind municipal success. The DEA found that capacity to raise own-source revenue was a key factor in municipal performance. In most *oblasts*, the more efficient municipalities were those that received at least 15% of their revenues from local taxes, highlighting the importance of a minimum level of local financial autonomy. Creating the conditions for greater fiscal autonomy of municipalities should be a priority, as an increase in own-source revenue can generate a stronger sense of ownership over local budgets, leading to improved public accountability. In this regard, rural and settlement municipalities appear to have made the most improvements since 2014. For example, in 2021, 87% of rural municipalities reported an increase in own-source revenue compared to 62% of urban municipalities (OECD, 2021^[3]).

In addition, sufficient fiscal capacity is fundamental to avoiding un- or underfunded mandates. This will be particularly important in the recovery period, given the significant costs associated with rehabilitating or rebuilding municipal infrastructure. Achieving sufficient fiscal capacity will require fiscal reforms, including a potential shift away from earmarked grants to general or block grants. Moreover, in order to ensure that municipalities with relatively limited fiscal capacity do not miss out on recovery funding, national and regional governments should keep track of which municipalities are applying for funds, while remaining vigilant regarding those that are not, in order to determine whether this is due to a lack of need or a lack of capacity to apply for funding. This should be coupled with the establishment of transparent monitoring and accountability frameworks that show how recovery funds are spent.

Increased public investment capacity contributes to municipal success

Enhanced public investment capacity, in terms of accessing local development funds and of effective investment management, also appears to contribute to municipal success. Making sure that all municipalities have a fair chance to access regional development funds is a factor to consider. For example, only 50% of municipalities that, prior to 2021, had applied for regional development funds from Ukraine's State Fund for Regional Development reported having received any funds (OECD, 2021^[3]). This suggests that a significant number of municipalities are not tapping into an important source of funding for local investment projects, thus limiting their ability to develop. It also runs the risk of deepening territorial inequalities.

Various factors may contribute to this situation, ranging from an inability of less affluent municipalities to meet co-financing requirements, to a lack of municipal capacity to develop and submit project proposals of sufficient quality. With regard to the latter issue, there are significant differences in the self-reported capacity of rural, settlement and urban municipalities to carry out investment-related tasks. About 87% of urban municipalities reported sufficient human resource capacity to identify investment needs and develop project proposals, compared to only 66% of rural municipalities (OECD, 2021^[3]).

Building expertise to manage investment planning and ensure more equitable access to investment funding and financing should be priorities in the recovery period. Both will help municipalities meet

territorially-differentiated reconstruction needs and support greater territorial cohesion and resilience in the longer term. In addition, the enormous volume of investment that will be required to support reconstruction and recovery at the local level accentuates the need for effective public engagement in municipal decision making.

Strategic planning capacity is essential for guiding municipal development

Municipal performance and development are also supported by strategic planning capacity. The OECD assessment identified large variations in the strategic planning capacities of municipalities. For example, while 80% of urban municipalities reported sufficient capacity to design development strategies, only 67% of rural municipalities felt the same way. This difference was similar when considering monitoring and evaluation capacities (OECD, 2021^[3]). These perceived capacity gaps may be explained by the fact that, until 2022, legislation did not mandate municipalities to develop a local development strategy (Verkhovna Rada, 2015^[15]).

Gaps in municipal planning capacities can undermine development efforts. The challenge to build or rebuild physical infrastructure and ensure service delivery during the war and forthcoming recovery period highlights the need for strong strategic planning capacities—from diagnosis and objective setting, to action identification, implementation, and monitoring and evaluation. Limited capacity in these areas can affect municipal ability to develop and implement local reconstruction projects, absorb recovery funding and monitor results.

Inter-municipal co-operation can advance municipal success

Inter-municipal co-operation appears to also boost local performance, as it can contribute to municipal scale (beyond what the amalgamation process accomplished), help manage service delivery and administrative costs, and potentially expand the service delivery mix. In general, municipalities reporting that they had an inter-municipal co-operation agreement in place (56%) tended to be more likely to report having the necessary capacity to fulfil their entire remit versus those that did not have such agreements (29%). Typological differences are at play, with 56% of rural municipalities reporting that the decentralisation reforms had had a positive effect on co-operation with other municipalities, compared to 48% of settlement municipalities and 38% of urban municipalities (OECD, 2021^[3]). The post-war recovery process could benefit from good co-operation among municipalities in order to support public service delivery in municipalities where public infrastructure (e.g. hospitals, schools, etc.) has been damaged or destroyed, and/or where human and financial resources are very limited.

Box 1.5. Key OECD recommendations for the continued progress of the decentralisation reforms, in the context of reconstruction and recovery

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 build up a more professionalised municipal civil service, Ukraine is advised to:

- Establish a reconstruction and recovery training strategy for municipalities that can be adapted to different territorial contexts and needs. The strategy should prioritise capacity building in areas that are particularly relevant for the post-war recovery period, such as strategic planning, project appraisal, procurement, implementation, transparency and stakeholder engagement (including with donors).

To strengthen local accountability and public engagement, Ukraine is advised to:

- Reinforce legislation making public consultation a systematic component of development and investment planning at the subnational level. However, the government should be careful not to overwhelm municipalities with requirements to organise public engagement processes, as this might stifle municipal decision making and lead to ‘consultation fatigue’.

To improve the quality of municipal service delivery, Ukraine is advised to:

- In the context of the highly territorially-differentiated impact of the war on municipal service delivery capacity, adopt and/or facilitate flexible and shared public service delivery models, such as co-operation, collaboration, co-production, collocation and flexible service provision.
- Increase outreach to and capacity building of municipal leaders on the value of inter-municipal co-operation and developing financial and functional incentives:
 - Financial incentives could include providing a higher tax-share for delivering joint services and awarding additional points in the selection process of competitive regional and local development grants to project proposals developed by two or more municipalities.
 - Functional incentives could include establishing a condition of population size for the delivery of different services (e.g. utilities and healthcare), thereby encouraging co-operation between smaller municipalities.

Municipal performance measurement

Russia’s war in Ukraine is bringing to the fore the pivotal role municipalities play in providing public services and supporting the well-being of their communities in times of crisis. Since 24 February 2022, municipalities have had to meet new challenges, such as providing housing, supporting territorial defence and organising the allocation of humanitarian assistance. The centrality of municipalities in public efforts to strengthen local economics and communities, and boost citizens’ well-being is likely to be consolidated further in the post-war recovery period. Effective action on the part of national and local policy makers will require a solid understanding of the relative performance of municipalities on a large range of indicators, far beyond what is currently available. This implies, for example, generating and disseminating data on the quality of and/or access to a range of public services (e.g. education, healthcare, basic utilities, etc.).

A more robust performance measurement framework can support post-war recovery

In order for the government and international partners to tailor reconstruction initiatives and funds to local needs and build longer-term resilience, a robust local performance measurement framework based on clear objectives, measurable targets, and appropriate indicators would be valuable. This was much needed before February 2022, and it will become even more critical in the years to come, particularly since 67% of surveyed municipalities indicated that in 2021 they were not yet executing all of their responsibilities effectively. A solid performance measurement framework can help municipalities make informed decisions on how to prioritise reconstruction initiatives, rebuild local economies, redress territorial inequalities and improve the well-being of local communities. It can also help the national government determine the next steps in the decentralisation process, as it contemplates how to best support place-based reconstruction and recovery. Such a framework will undoubtedly aid in the EU accession process, as well.

In addition, improved municipal performance measurement will hinge on developing a comprehensive monitoring and evaluation framework that permits comparability across local governments and can reveal where capacity gaps exist. Such a framework would need to capture outputs and outcomes in order to identify the extent to which i) different municipalities deliver on their objectives and responsibilities in an efficient and effective manner; and ii) formal and informal mechanisms, practices, rules and arrangements contribute to or hinder municipal performance.

In the forthcoming reconstruction and recovery period, municipal efficiency should continue to be evaluated in order to ensure that local development initiatives are not resulting in cost overruns or an inefficient allocation of public resources. The metrics supporting this include revenues, expenditures and debt data, as well as measures of built or rebuilt social infrastructure facilities in a given territory. Much information is already available through the Ministry of Finance's Open Budget Portal, for instance. However, these datasets need to be complemented with regularly updated population statistics to enable in-depth, cross-municipal comparison.

Municipal effectiveness is often evaluated in terms of the quality, equity and accessibility of public services in a specific territory. Measurements can include the number of cubic metres of drinking water supplied by a municipality or the proportion of households covered by drinking water supply, for example. Citizen satisfaction data is a good complement to operational metrics, and is frequently faster and less expensive to gather.

Developing a performance measurement framework for municipalities requires continued investment in the production, analysis and tools to share reliable data, and expanding the indicator set beyond what is currently available. A comprehensive set of municipal performance and development indicators should be developed for all municipalities—for which data are collected annually and shared through a publicly accessible digital platform. The information obtained could reinforce evidence-based decision making, for example on legislation and regulatory reforms affecting municipalities, Budget Code amendments, and on service delivery and citizen well-being. In addition to a dedicated local performance measurement framework, international benchmarks and indicators, such as the OECD Infrastructure Governance Indicators, could serve as a useful basis for developing tools to monitor municipal performance over time, particularly as Ukraine's regions and municipalities rebuild damaged or destroyed public infrastructure.

Box 1.6. Key OECD recommendations for strengthening municipal performance measurement in Ukraine

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 support evidence-based decision making for improved municipal development outcomes, Ukraine is advised to:

- Develop a set of municipal performance and development indicators (e.g. socio-demographic, fiscal, operational, political system) applicable to all 1 469 municipalities, that capture:
 - Outputs establishing to what extent formal or informal mechanisms, practices, rules and structures exist to help facilitate municipal performance.
 - Outcomes determining to what extent different municipalities are able to deliver on their objectives and responsibilities efficiently and effectively.
- Link the available statistics (on municipal revenues, expenditures and debt) to up-to-date data on the population of each municipality in order to facilitate in-depth cross-municipal comparisons.
- Ensure that data on municipal performance and development are widely accessible and regularly updated.
- Invest in the generation, analysis and dissemination of information on citizen satisfaction with public service delivery.

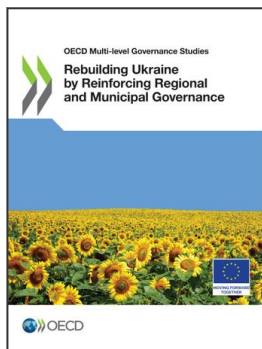
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Note

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^[16]).



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