

Assessment and recommendations

Overview

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

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

Regional development trends in Ukraine

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

Fractures in Ukraine's economy have widened since 2014

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

growth, consistent delays in implementing structural reforms to improve the business environment, and weaknesses in the integrity and efficiency of public institutions.

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

Urban agglomerations are driving aggregate growth in Ukraine

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

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

Interregional disparities have increased and reflect regional specialisation

Territorial inequalities are high by OECD standards – in terms of gross domestic product (GDP) per capita, disposable household income per capita and living conditions. Ukraine inherited substantial regional imbalances from the Soviet era, which were exacerbated during the transition recession in the 1990s. Interregional disparities have continued to rise since the turn of the century, with a marked increase since the Donbas conflict erupted in 2014. The rapid economic development of the Kyiv agglomeration is a major factor behind rising territorial disparities: Kyiv city and the surrounding *oblast* (region) accounted for almost 60% of national GDP growth in 2004-14. Kyiv will continue to play

a leading role, and the possibility of greater interregional disparities should not be excluded.

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

Labour market inefficiencies constrain regional growth

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

Citizen engagement and electoral participation are low

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

Recommendations to strengthen Ukraine's regional development policies

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

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

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

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

Advances in territorial and multi-level governance reform since 2014

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

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

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

Ensuring an enabling environment for decentralisation reform

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

Striking a new territorial balance: Unified territorial communities and rayon

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

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

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

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

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

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

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

decentralisation reform have been successfully established in countries as diverse as Denmark, Japan and New Zealand.

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

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

Reinforcing advances in the amalgamation process

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

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

Embedding advances in regional development, 2014-17

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

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

Key recommendations for maintaining momentum in Ukraine's decentralisation process

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

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

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

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

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

- Establishing a high-level inter-ministerial council or commission specifically for decentralisation to boost inter-ministerial co-ordination capacity and better support an integrated reform process across sectors.
- Launching a cross-sector, multi-level dialogue body dedicated to decentralisation reform (strategy, policy, programming, etc.) to strengthen dialogue and co-operation among different levels of government, build synergies, and boost trust in reform.
- Introducing an explicit decentralisation policy to establish a consistent course of action for decentralisation stakeholders, using it also to guide institutional actors with respect to decentralisation activities and managing challenges that arise.
- Clearly assigning responsibilities and functions to different levels of government to help build efficiency in service provision and policy making, and to support greater accountability of government, by:
 - Identifying and distinguishing clearly responsibilities in sector-, service- and development-related tasks (e.g. transport, education, infrastructure, economic development), and operational functions (e.g. strategic planning, financing, regulating, implementing, monitoring).
 - Ensuring that ascribed responsibilities are legally supported.
 - Including and maintaining minimum services standards to be met, and strengthening monitoring and evaluation practices.

To continue promoting regional development, the OECD recommends:

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

Moving beyond amalgamation with fiscal decentralisation and enhanced local management

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

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

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

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

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

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

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

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

The 2014-15 fiscal decentralisation reforms have introduced changes

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

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

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

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

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

Fiscal decentralisation should be better “conceptualised” and monitored

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

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

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

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

The system of inter-governmental grants needs further improvement

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

Despite early positive results, there are some concerns with this new system, particularly the low amount of the basic grant (1.3% of all subnational revenue in 2016), the reduced basket of taxes taken into consideration, the exclusion of Kyiv from the equalisation mechanism and the risks associated with an equalisation system based only on horizontal mechanisms. This “Robin Hood” system may be efficient in terms of “solidarity” (redistribution of tax resources from the “richest” to the “poorest” subnational governments) but not necessarily in terms of equity (fairness) across subnational governments, especially if

the basket of tax sources for redistribution includes own-source taxes in the future. It may also have some counterproductive effects on local and regional development and be economically inefficient. If this trend is confirmed, adjustments would be needed in the medium term to combine solidarity, equity and economic efficiency principles. The impact of the equalisation system on these three aspects should be closely monitored to correct potential adverse effects.

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

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

The subnational tax system needs to continue to advance

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

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

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

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

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

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

More effective public investment would further support regional development

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

First, capital transfers, in particular the State Fund for Regional Development, should be more stable and more properly used for effective public investment. The project selection process should be more neutral and less sector-oriented. At the regional level, the criteria for fund allocation could be linked to state-region contracts and regional development

plans. At the local level, technical assistance and capacity building should be provided to help the UTCs design and implement projects for territorial development and infrastructure.

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

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

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

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

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

Advancing further in building subnational government human capacities

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

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

Key recommendations for improving fiscal and human capacities

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

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

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

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

To improve the subnational tax system, the OECD recommends:

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

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

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

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

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

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

financial support for technical assistance, etc.).

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

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

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

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

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

Decentralisation in Ukraine's transport sector: A case study

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

Transport infrastructure suffers from chronic underinvestment

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

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

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

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

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

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

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

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

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

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

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

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

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

Further promotion of inter-municipal co-operation (IMC) on public transport provision is also needed. Out of the 133 ongoing IMC projects listed on the website of the Ministry of Regional Development, 3 relate to transport service projects and 16 are road repair and maintenance projects. The government could also consider expanding IMC agreements

between the UTCs and non-amalgamated communities. Such agreements can act as a precursor to amalgamation, by helping to better integrate isolated populations with neighbouring localities.

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

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

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

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

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

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

Poor road safety and a high number of road traffic accidents also leads to reduced mobility in urban areas, creating strong incentives for private car use. Better enforcement of vehicle and emissions standards can help to encourage more non-polluting modes of transport, such as walking and cycling. Establishing strong environmental standards for

public transport could help to reduce air pollution and further increase efficiency in transport networks. It could also help to reduce inefficient competition between unlicensed private operators and official public transport routes.

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

Mobility data can revolutionise public transport provision in Ukraine

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

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

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

Improving logistics performance and port-city relations

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

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

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

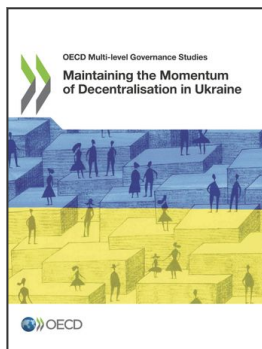
Key recommendations for decentralisation in the transport sector

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

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

environmental standards, by:

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



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