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Moving Forward on Regional Development & Regional Policy

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Weights and Measures
Metric System

ABBREVIATIONS AND ACRONYMS

DATAR	Délégational'Aménagement du Territoire et al'Action Régionale
EGVA	Estimated Gross Value Added
EU	European Union
FDI	Foreign Direct Investment
FEZ	Free Enterprise Zones
GDP	Gross National Product
GVA	Gross Value Added
GVAP	Gross Value Added Per Capita
NGO	Non-Governmental Organization
NSRD	National Strategy for Regional Development
NUTS	Nomenclature of Territorial Units for Statistics (EU)
OECD	Organization for Economic Cooperation and Development
PDT	Priority Development Territories
SEZ	Special Economic Zones
SME	Small and Medium Enterprises
UEPLAC	Ukrainian-European Policy and Legal Advice Centre
ZBS-E	Research Center for Statistical and Economic Studies (Polish)

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TABLE OF CONTENTS

EXECUTIVE SUMMARY .... **v**

I. INTRODUCTION **1**

II. MEASURING THE ECONOMIC DEVELOPMENT OF THE REGIONS **5**

III. EXPLAINING REGIONAL DIFFERENCES **11**

IV. EVOLVING THINKING ON REGIONAL DEVELOPMENT POLICY AND UKRAINE'S REGIONAL DEVELOPMENT POLICIES TO DATE **15**

A. CONCEPTUAL FRAMEWORK & THE EVOLUTION OF REGIONAL POLICY 15
B. REGIONAL POLICY IN UKRAINE 20
C. THE FISCAL ALLOCATION OF RESOURCES TO SUPPORT REGIONAL DEVELPMENT 23

V. LESSONS FROM INTERNATIONAL EXPERIENCE **29**

A. FRANCE AND THE "CONTRACT-PLAN 29
B. ITALY AND THE DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES 31
C. THE ROLE OF REGIONAL DEVELOPMENT AGENCIES 33
D. FOREIGN DIRECT INVESTMENT & FREE ENTERPRISE ZONES 35
E. REGIONAL POLICY IN THE EU AND THE EXAMPLE OF POLAND 39

VI. CONCLUSIONS AND POLICY RECOMMENDATIONS **45**

ANNEX 1: Regional Inequalities Measured by GVA per capita in Constant and Current Prices **51**

ANNEX 2: Correlation Matrix for Explanatory Variables **52**

This policy note was prepared by Deborah L. Wetzel and draws on several background papers, including: Bartek Czyżewski, *Regional Income Inequalities in the Ukrainian Economy: Measurement and Analysis*; Roberta Benini, *Regional Policy in Ukraine: A Comparative Approach for a Strategy in the Transition, Theoretical, Institutional and Policy Aspects;* S. Romaniuk and O. Mrynska, *Analysis of Regional Discrepancies and Regional Policy un Ukraine*; Bogdan Danylyshyn, *Regional Profile: An Economic Analysis of Ukraine's Regions and Interregional Integration*; and Eyvgeny Fyshko, *Performance of Free Economic Zones and Introduction of Special Investment Regime in Priority Development Areas.*

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EXECUTIVE SUMMARY

The last decade in Ukraine has seen major economic upheaval. The forces shaping economic activity have changed drastically and moving toward a market-based economy has required fundamental changes in the use of resources. The ability of regions to respond to these drastic changes has varied and issues related to regional policy have come to the fore. It comes as no surprise that Ukraine has been grappling with regional development issues and has been working to put together the elements of a regional development policy. Ukraine as a country presents marked regional disparities in economic development – ranging from extensively industrialized centers, to agricultural zones, to the rural regions of the Carpathians. In addition, Ukraine also experiences regional differences in natural endowments, ethno-linguistic characteristics as well as cultural heritage. Managing such significant regional differences is made all the more difficult by the on-going changes occurring in the economy as a result of the transition. Even in well-established market economies, implementation of regional policy has proven difficult at best. In Ukraine, it poses substantial challenges. This note considers the evolving experience in Ukraine and looks at lessons from other countries in order to spur thinking about how best to move forward in the development of regional policy.

In the context of a transition economy, accurately measuring the changes that are underway is difficult. The statistical system itself is in transition and there are a wide range of activities that go unrecorded. The official statistics suggest that disparities among the regions have increased since the mid-1990s in Ukraine. The data suggest that many of the regions in the west that focus on heavy industry, plus Kyiv, continue to have the strongest economic performance. In contrast, regions in the far west of the country have the lowest per capita gross value added (GVA). The discussion of regional disparities often focuses on what measures need to be taken to overcome these differences in regional growth; however, experience across a wide range of countries suggests that these disparities may never be fully overcome. On top of this, there often may be significant disparities *within* regions, between cities and rural areas. The history of regional development in other countries has shown that it is important to balance carefully the goal of reducing disparities against the effort made to support dynamic economic growth.

Determining the factors that explain why one region does well and another does not is also difficult. The results of the statistical analysis are not surprising in that they show a strong relationship between existing capital stock and gross value added per capita – those regions which have had more investment tend to do better (and hence the larger GVA per capita in the eastern regions). Telecommunications and transport infrastructure also help to explain which regions have done better, as does FDI. However, almost 20 percent of GVA per capita was not explained by the classical factors suggesting that other things are at work. This unexplained component reflects the "productivity" with which a region uses its available resources – it may reflect greater efficiency in processes or intangible factors such as the degree of economic linkages and trust between individuals. Over time, approaches to regional policy have increasingly focused on creating a climate that is attractive for investors, but also in strengthening many of the factors that are thought to contribute to improved productivity.

After 30 years of experience, there have been significant shifts in how regional policy is practiced in most countries. This is in part a response to changing country circumstances, but it has also been generated by increasing globalization and all its implications (faster flow of information and technology, lower transport costs, increasing competitiveness). Whereas regional policy was once focused largely on top-down interventions in order to save specific sectors, it is now largely centered on helping regions to create an environment in which economic activity can prosper. There are many aspects to such an environment including, investment capacity, human resources, technology, institutions and social capital. Improvements in these areas build on each other and lead to synergies that can help to propel regions forward.

The experiences of particular countries and with particular issues also offer valuable lessons:

- In France, the experience over time suggests that "contract-plans" between the center and the region can be a useful device, but their effectiveness increases directly with the degree to which the region is responsible for the plan and the degree to which there is extensive consultation within the region on these issues. Monitoring and evaluation is also critical for their success.

- In Italy, the experience with regional policy demonstrates that pouring money into a depressed area (the Mezzagiorno) is not sufficient to address regional disparities. Italy's experience does show, however, the degree to which effective support for small and medium enterprises can transform areas that may have appeared in the past to have limited economic prospects. It highlights as well the extent to which regions influence their own development prospects.

- A number of countries have had experiences with regional development agencies (RDAs). There are wide variety of RDAs with great variation in objectives, structure and means of financing. At the same time, the experience with RDA's has also been mixed – some have worked well, some have not. A key factor in the effectiveness of RDAs is the extent to which their objectives are limited and focused. The appropriate mechanisms for financing an RDA depends on the objective, there are pluses and minuses to both public and private funding.

- There has also been a great deal of experience related to efforts to attract FDI and particularly free enterprise zones. Experience suggests that countries can often support regional development more effectively by making efforts to improve the overall climate for investment in the country. Rather than generating broad economic growth, such zones often lead to dualistic and distorted economic structures. They also provide a discretionary tool that can lead to reduced transparency and increased corruption.

- Poland's experience and the requirements of Accession to the EU also provide some important lessons and insights with respect to regional policy. Institutions to manage and coordinate regional policy are very important. Consideration needs to be given to the appropriate size of the territorial unit so that policies can be effectively implemented. There is a need for a national strategy that defines priority targets and sets guidelines for specific regional and sectoral programs. Mobilization of regional and local institutions and social institutions are an important element of creating effective partnerships at different levels.

This international experience is highly relevant for Ukraine as it moves forward in development of regional policy. However, before considering policy recommendations for the future, it is useful to consider some important lessons from the experience in Ukraine to date. A number of efforts to address regional development policy have been made in the past, but none have been successful so far. Some of the potential explanations for the lack of effectiveness are as follows:

- *Weak framework for setting objectives and priorities.* The proposed approaches to regional development in the early and mid-1990s were focused mostly on obtaining resources for particular initiatives rather than as a comprehensive approach to addressing regional development needs. Because they were ad hoc approaches coming from particular groups or regions, there was neither a full consensus nor support for moving forward.

- *No fiscal parameters.* Programs for regional development have typically been established without any consideration of working within a fiscal envelope. The programs have elaborated multiple objectives and usually multiple projects that were either unaffordable or unsustainable. At the same time, the preparation of these extensive programs also used up significant resources to no avail.

- *Ad hoc allocation of investment.* State investment policy has had a substantial influence on regional development and yet there is no transparent mechanism through which these investment resources are allocated. In addition, the budget process does not make the link between investments in the capital or development budget and the associated operations and maintenance costs that should be included in the current budget.

- *Reliance on heavy state intervention.* Past regional policies in Ukraine have typically focused on restoring old industries, promoting heavy investment, meeting social costs in ways that involve heavy state intervention. They have not typically taken a strategic perspective looking forward to the areas in which Ukraine will be competitive and creating an environment in order to support the creation of new industries and a service sector than can also be an important sources of growth in the future.

- *Top-down versus bottom-up.* While there are a wide number of efforts being developed at the regional level in order to support regional development, regional policy is often perceived as something that occurs from the top down. The central government provides resources for investment or special incentives and has great influence on what will happen in each region.

The current positive economic situation in Ukraine offers an opportunity to revisit and refine regional policy in Ukraine. In order to build a long-term base for regional development and to improve the effectiveness of policy in the short term, there are a number of steps to be taken:

Evaluate the appropriate roles of different actors in regional policy. There is a need to clarify who is responsible for what in the development and implementation of regional policy. Current practice in Ukraine has a wide range of actors undertaking many activities with very little clarity. The central government's role should focus on setting priority targets; (i) effective management of public spending; (ii) supporting the development of key national infrastructure; (iii) creating a positive investment climate across the country as a whole; and

(iv) addressing key distributional issues. There also needs to be improved coordination among sectoral ministries and other parts of the Government to evaluate the implications of specific sectoral policies (such as education policy, industrial policy and competition policy) and to make sure there is consistency across ministries and sectors. The regions themselves have a role to play in identifying potential sources of economic activity and growth, as well as strengthening the factors that have proven to be important to strong regional development (human resources, investment capacity, ability to absorb resources, institutions, governance and social capital). Through extensive consultation and development of regional, local and public-private partnerships, regions should develop a strategy for moving towards economic growth. It is important to push regions to develop their own solution as opposed to relying on the central government as the catalyst for change. Mechanisms for coordinating between the center and the regions are also necessary.

Strengthen the Concept of Regional Policy. The Concept of Regional Policy highlights a wide range of activities to be addressed and yet it lacks a coherent overall framework. In some parts it relies on the notion that continued support of heavy enterprises at the expense of other areas is a sound basis for future growth. This is based on the notion that these are the growth areas, but in fact, it is more a reflection of the status quo than of an effective plan for the future. In fact, regions with an environment that supports the development of SMEs and the service sector may have better prospects. The Concept might more clearly specify the broad targets of the Government's regional policy and the particular aspects of the central government's role. It should set out guidelines for the development of regional programs which focus on identifying areas of growth, support the development of horizontal linkages, create a positive environment for investment and how monitoring and evaluation will be undertaken. Development of the national strategy for regional development can help to focus on these issues.

Develop administrative structures over time, but don't tie regional development entirely to these structures. There is clearly a need over time to consider whether the current administrative structure is appropriately supportive of regional development. However, there is no need to lock in stone the boundaries of a territory that might effectively pursue development. Different aspects of regional development can occur in different boundaries. In some countries, certain development efforts might cover more than one region (Italy's northeast). It is also possible that micro regions can develop as a dynamic source of growth, as is the case in Wodj in Poland or in the small micro regions of Hungary.

Address issues related to disparities in basic services through equalization transfers and safety nets. Rather than creating special intervention mechanisms for meeting the needs of individuals in depressed or backwards areas, these needs should be addressed through the system of equalization transfers applied by the central government and oblasts and through the national safety net system. If appropriately designed, such an equalization mechanism not only helps to address the disparities between regions, but also the disparities within regions, such as between cities and rural areas. Such systems are meant to assure that a basic level of services is provided in an equivalent fashion across all regions.

Strengthen the financial accountability and then the ability of regions to raise revenues. Currently, regions have little financial accountability and no authority to raise revenues. To the extent that they are meant to show initiative in the design and implementation of regional programs, it will be necessary that their financial activities are clear and transparent, that all resources are fully part of the budget, and that it is possible to hold them accountable. While regional development can be organized around purely administrative and coordinating structures, the lack of a revenue source other than transfers from the central government, limits the capacity of the regions to pursue their own initiatives.

Create a transparent system of allocation for public investment that focuses on key national infrastructure. Public investment has played an important role in those regions that have demonstrated better performance. At the same time, it is clear that many of the poorer regions have received little investment. The basis for the allocation of investment of funds needs to be made transparent and objective. Transparent procurement can also improve the effectiveness of investment and create a better investment environment more generally. While public investment should focus on national infrastructure, there may be a need for specific transfer mechanisms to support investments at the regional level. While the "contract-plan" approach is one method of approaching this, it is important that: (i) the plans be generated by the region with extensive consultation; (ii) the overall amount allocated to such a transfer mechanism is clearly specified; and (iii) there are very clear criteria for the allocation of such resources.

Support efforts to improve the investment climate overall as opposed to pursuing investment in enclaves. The ability to attract investment, both local and external is essential for regional development. The most effective way to do this is to improve the environment for investment. This involves reducing the discretionary influence of government, enforcing rules and regulations in a systematic way, reducing the cost of doing business, and maintaining a stable economic and political environment. Ukraine relies on both Free Economic Zones and Priority Development Territories to promote increased investment. The evidence suggests, however, that in most of these areas investments have not occurred and in those where investment has taken place, much of the investment occurred before the Free Economic Zone was created. It is not clear that the economic activity induced by such zones is of a sufficient magnitude to offset the distortions, loss of fiscal resources and potential for corruption .

Pursue policies that help to develop small and medium enterprises. As the Italian example shows, small and medium enterprises can be a source of growth in areas that do not have a history of industrial development. In particular, small and medium enterprises can help to strengthen the service sector which is an important source of growth in economies that are growing rapidly. Both SMEs and services will be needed to help Ukraine sustain and diversify the growth that it has achieved in the past year. Policies that help to reduce the costs of doing business and create a level playing field between SMEs and larger existing companies are important tools. In addition, efforts to provide training, assistance in technology and innovation, and in entrepreneurship more generally may be important tools to help support the creation of SMEs. Special funds that help SMEs meet start up costs can also be useful tools.

Support Regional Development Agencies that have been created from the bottom up and not imposed from the top down. RDAs can be an important source of information, technology and guidance to those pursuing development within a region. Rather than impose a uniform structure of agencies from the top, it is likely to be more effective to support agencies that are developed through regional initiative. Such agencies are likely to be more focused on the specific needs of a given region and to have focused objectives.

Regions need to set out their own programs for creating an environment that will support growth and development. Probably the greatest lesson of the experience to date with regional development policy is that the regions themselves play an integral part in the effectiveness of their own development – they are more than just mere recipients of regional policy. Regions needs to work to build their human resources, strengthen their investment capacity, and build the institutions, governance and social capital that helps to support development. National policies can help to support this but it is largely up to the initiative of the regions.

These policy recommendations highlight a few steps that the Government might take to make regional policy more effective. While supporting regional development is a complex proposition, the World Bank stands ready to help support the Government in pursuing more effective policies. There are a number of ways in which the Bank is already supporting regional development, through efforts to improve the environment for private sector development and to mitigate the social costs of mine closures. Efforts to support public administration reform as well as improved budgetary processes and intergovernmental relations might also help to strengthen regional policy. Other possibilities include the provision of assistance in developing the national strategy for regional development, as well as assisting some regions on a pilot basis in the development of their own strategies.

I. INTRODUCTION

1. As Ukraine has moved forward in its transition, issues of regional policy have increasingly come to the fore. The President's Speech of 2000 highlighted regional development as an issue that would receive his personal attention. In the Government's Economic Program of 2000, regional policy was emphasized as a priority for the coming years. Both the central and lower levels of government alike have been discussing concepts and proposals for improving regional development.

2. It comes as no surprise that Ukraine has been grappling with regional development issues and has begun to try to put together the elements of a regional development policy. Ukraine as a country presents marked regional disparities in economic development – ranging from extensively industrialized centers, to agricultural zones, to the rural regions of the Carpathians. In addition, Ukraine also experiences regional differences in natural endowments, ethno-linguistic characteristics as well as cultural heritage. Managing such significant regional differences is made all the more difficult by the on-going changes occurring in the economy as a result of the transition. Even in well-established market economies, implementation of regional policy has proven difficult at best. In Ukraine it poses substantial challenges.

3. *"Regional development"* typically concerns itself with differences of growth patterns across different areas within a country. Such areas may be defined in different ways – by administrative jurisdiction or by types of economic activity. In the country context, issues of regional development typically arise in the form of questions concerning the dispersion of income among regions; differences in growth and unemployment, and the implications of such differences for the incidence of poverty, social indicators and social tensions more generally. Given the economic, social and political history of Ukraine, issues of regional development loom large as entire industries and locational choices for economic activity become unviable in the face of the transition to markets.

4. *Regional policy* (or regional development policy) aims to address the emergence of disparities in economic welfare, to improve resource allocation within countries and often to revitalize areas in distress. While the empirical evidence accumulated over the past decades shows that regional disparities do not necessarily affect the economic growth of a country and that the conditions by which such disparities become unsustainable vary greatly; it is clear that excessive regional disparities can lead to a range of negative outcomes that may call for a policy response.[1] These outcomes include:

- Creation of *regional bottlenecks* to the further expansion of the economy: including negative externalities, low human resource skills, poor firm performance and the consequent deterioration of existing or potential resources.

- *Depression of domestic demand* due to poor income creation and in turn associated with outflow of the population, the shrinking of local savings and reduction of tax collection in the region.

- *High costs for state social policy* resulting from high rates of unemployment, poverty and poorer social outcomes.

[1] See Benini (1996). Regional Development and Industrial Conversion Policy: Lessons from Western European Experience. World Bank. Processed.

- *Emergence of areas of political and social instability* that are potential sources of social tension and destabilization.

5. In addition, excessive concentration in more developed areas has also become less and less effective, with negative externalities and agglomeration effects leading to increasing shortcomings such as high costs, congestion and factor rigidities. In such a context, regional policy has been developed as a necessary approach to solving a wide range of systemic issues that cannot be resolved by isolated sectoral policies.[2]

6. The theoretical approaches and policy instruments of regional policy have evolved considerably over the past decades. In the 1950s and 1960s, regional policy in western, industrial countries was typically focused on addressing regional crises based on problems of particular industries, such as coal mining, steel, and shipbuilding. The approach used was essentially a "top-down," interventionist approach that aimed at addressing problems by direct intervention into the productive sphere with specific incentives and objectives for strengthening the enterprises. This approach was more (France) or less (Italy's south) effective, but success in any event was conditioned upon limited competition, so that governments were able to act in a sheltered national environment.

7. In the 1970s and 1980s, shifts in economic structure and new innovations (the emergence of electronics, communications and information) combined with the rise in international competition, called for a more flexible approach. The dynamics of growth based on spreading innovation implied that performance was increasingly related to the territory in which firms were located. The "top-down approach" was less relevant and gave way to a "horizontal approach" in which the conditions for better and more appropriate economic activity (infrastructure, services, etc.) became the main emphasis. Increasingly, internationalization and the interdependence of markets also served to undermine the "top-down" approaches based on direct intervention.

8. These approaches have evolved into two general approaches to regional development policy. "Active" policies aim at changing the structure of the economy and are generally employed when it is perceived that market forces will not be enough to address disparities. Active policies include such measures as: (i) raising productivity levels in backward regions by public investment in education and infrastructure; (ii) jump-starting the creation of economies of scale through employment and investment incentives for new businesses and strategic investment in productive assets; and (iii) the promotion of local development efforts aimed at small- and medium-sized enterprises.

9. "Passive" regional development policies aim to improve regional development by pursuing policies that help market forces to work more effectively, removing barriers to mobility of labor and capital, and addressing imperfections in the flow of information and technology across regions. Examples of passive policies might include: reforming labor, housing and financial markets, improving the environment for local and external investment; providing access to job retraining and information technology training. Most countries pursue a mix of active and passive policies.

10. The objective of this note is to assist the Ukrainian Government as it seeks to elaborate its regional development policies. The note aims to assess the current regional disparities in Ukraine, to identify the factors that influence these disparities and to consider Ukraine's

[2] See Benini , op cit. , p. 6.

experience to date in the implementation of regional policy. It also draws on the lessons of international experience in order to help the Government design a more effective approach to regional development. In the next section the paper provides an overview of the economic development of the regions. The subsequent section draws on the available data to identify the key factors that have influenced regional development. The paper then turns to how regional policy has been approached in the past and what lessons there are from the experiences in Europe and other transition countries. Finally, the paper concludes with policy recommendations and proposals.

II. MEASURING THE ECONOMIC DEVELOPMENT OF THE REGIONS

11. Ukraine has a population of about 50 million people and its total land area is about 604 thousand square kilometers. The administrative and territorial structure at the regional level includes the Autonomous Republic of Crimea, 24 oblasts and the cities-of-oblast-status (Kyiv and Sevastopol). Before assessing the economic development of the regions, it is important to consider the economic development of the country as a whole during the period under consideration (1990-2000). The liberalization of prices and the opening of the country's borders resulted in vast adjustments in the structure of aggregate demand. Mismatches of demand and supply for particular products led to changes in relative prices, which in turn affected the structure of produced output. The deep decline in output (see Figure 1) that occurred during the 1990s sets the context faced by most regions. The deepest annual decline in output was recorded in 1993 and 1994 – in the period of consolidating the nation and shaping the state. According to the official data, the huge decline in 1993 was dominated by the service sector and associated with a huge jump in inflation, especially service sector prices, in that year. In the subsequent years, relative prices of both industrial and agricultural outputs became relatively cheaper, whereas the relative prices of services increased. In constant prices, shares of industry and agriculture in Gross Value Added (GVA) were growing and the share of services shrank.

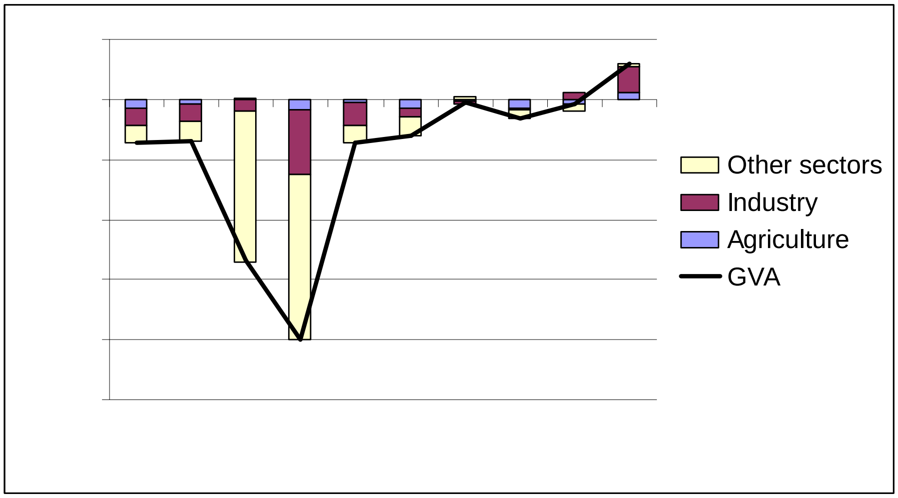
12. In most OECD countries, regional inequalities are measured by regional gross national product (GDP) per capita corrected for purchasing power parity. Work in other transition economies (Poland) indicates that in early stages of the transition, regional GDP per capita figures often do not meet System of National Account standards and have a number of biases, which suggest they should be treated with limited confidence.[3] In addition, for GDP at the regional level, there are issues related to apportioning the output produced by big multi-regional companies that is typically recorded in one area. There are also issues related to the pricing of output. In transition economies, where the share of the state property in economic activity is high, administrative prices (of energy and communal services) and differentiated taxation of products (excise tax for fuels, alcoholic beverages, tobacco are substantial source of budgetary revenue) need to be taken into account. At the same time, product subsidies and tax exemptions play a significant role in shaping profitability of some economic activities. Consequently, GDP net of indirect taxes and subsidies (GVA at basic prices) differs substantially from GDP at market prices. Thus, the relative position of regions, especially of those with the dominant economic activity subject to heavy state intervention or being a major tax source, depends on the price base. For assessing the ability of regions to generate income (as opposed to the income they receive as a result of Government policies) it is therefore

[3] See the background paper for a detailed discussion of the typical issues related to meeting System of National Account Standards in transition countries and how these effect the use of regional GDP per capita as an indicator.

preferable to use the GVA concept.[4] The discussion of regional inequalities that follows is thus based on measures of regional GVA.

[4] Another alternative for assessing regional performance is to rely on a "taxanomic indicator" which is a weighted average of a number of easily available social and economic indicators. However, these indicators, typically mix variables that result from economic development (like numbers of beds in hospitals) with variables driving or constraining regional development (regional investment, share of highly educated individuals, etc.) The normalization of such various indicators give greater weight to those variables with higher dispersion and therefore may overestimate regional disparities.

Figure 1: Contribution of agriculture, industry and services to economic growth, 1991-2000



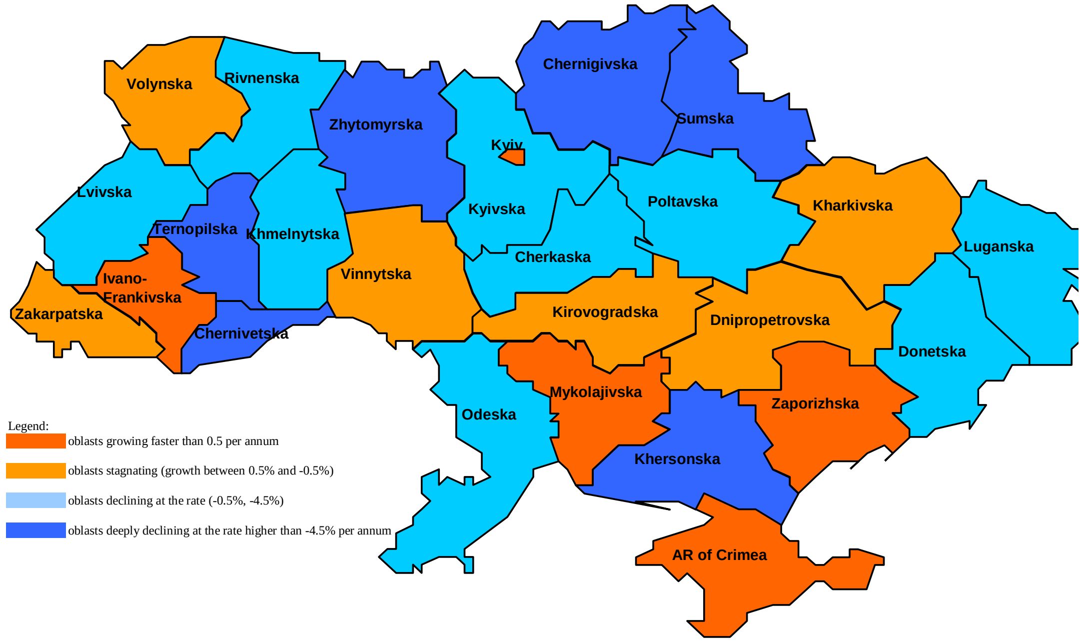
13. Before looking at regional inequalities, consider some basic information concerning the distribution of economic activities in Ukraine and patterns of economic growth in recent years. Economic activity across the regions varies considerably. Figure 2 shows the dominant economic activity of the regions in 1998. In Chernigivska, Kirovogradska, Ternopilska , Vinnytska and Volynska in the center and west of the country, agriculture is the dominant economic activity. The southeastern regions (Dnipropetrovska, Donestka, Luganska, Poltavska, Zaporizhska) and the northwest region of Rivnenska are dominated by heavy industry. The Autonomous Republic of Crimea, Kyiv and Odesa are dominated by services, whereas most remaining regions, mostly in the west and north of the country, are dominated by “other industries” or have no dominant economic activity.[5]

14. Economic growth between 1995 and 2000 does not seem to bear a close relationship to the dominant type of economic activity (Figure 3). The Autonomous Republic of Crimea, Ivano-Frankivska, Kyiv, Mykolajivska, and Zaporizhska are the only regions that have real growth above 0.5 percent per annum. Two of these regions with strong growth are dominated by services, two by other industries and one relies on heavy industry. Six regions with different geographical locations and different economic bases (Chernivska, Chernivetska, Khersonska, Sumska, Ternopilska, and Zhytomyrska) experienced declines of over 4.5 percent per annum. Other regions either stagnated or declined, but at a lesser rate than these six regions.

[5] Data is presented for 25 oblasts plus Kyiv. Separate data on Sevastopol is not available.

Figure 2: Dominant economic activity

Figure 3: Economic growth of regions in 1995-2000



15. The data on GVA per capita by region in both current and constant terms (see Annex 1) indicate that the magnitude of regional income disparities has increased over time. The Williamson coefficient, which measures the dispersion of GVA per capita across regions weighted by population, indicates that regional inequalities remained relatively flat through

1996 and then began to increase from 1997 onward (Table 1). The degree of regional inequality is somewhat greater than that typically found in developed countries, in which coefficients of variation are typically about 0.15. However, it is much less than is found in developing countries such as India and Brazil, which have coefficients of variation around 0.50.[6]

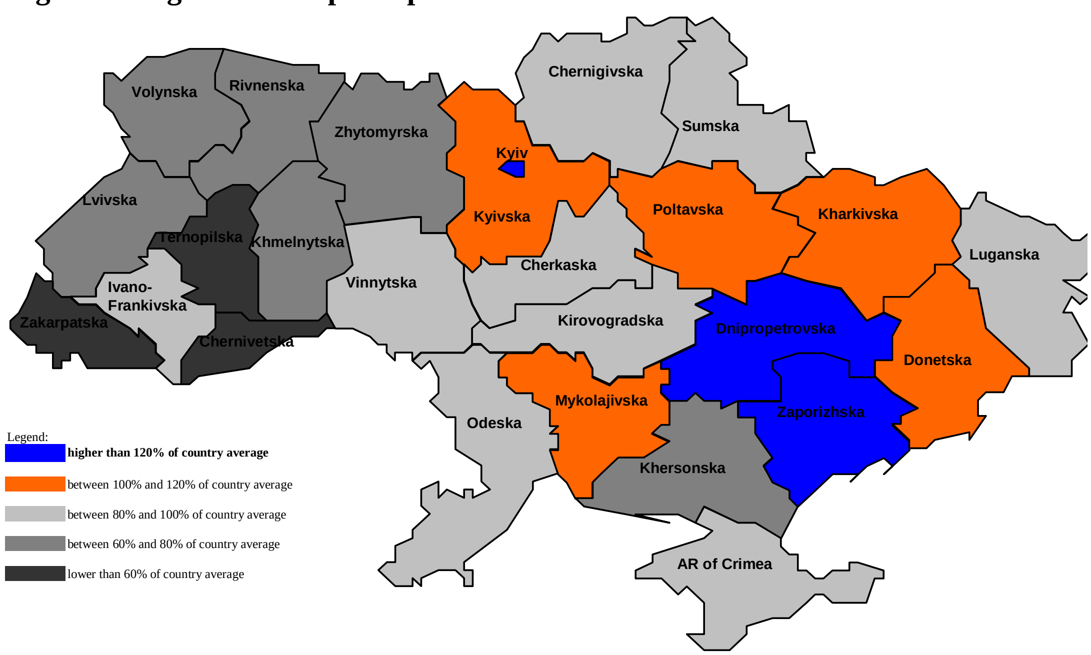
Table 1: Change in Regional Inequalities Over Time 1990-2000

	1990	1993	1994	1995	1996	1997	1998	1999	2000
Ukraine									
inequality in current prices	0.221			0.225	0.228	0.292	0.308	0.335	0.331
inequality in constant prices	0.199			0.190	n.a	n.a.	0.308	n.a.	0.330
rate of GVA growth per capita	-65% in the whole period				-6.0%	0%	-3%	-1%	6%
Poland (49 old voivodships)*									
inequality in current prices	0.370	0.231	0.266	0.266	0.302	0.306	0.352		
inequality in constant prices	0.388	0.248	0.287	0.281	0.318	0.314	0.352		
rate of GDP growth per capita	-11%	3.6%	5.0%	7.0%	5.9%	6.7%	4.8%		

Source: A.B.Czyzewski , Regional Inequalities in the Ukrainian Economy: Measurement and Analysis. Background paper. Data for Poland from A.B.Czyzewski "Comments on economic growth of Poland's regions 1986-1996", RECESS Bulletin 1/1999.

16. Experience suggests that the pattern of regional disparities is somewhat different in transition countries. Typically one would expect growth to reduce regional disparities. But Poland, for example, exhibited a pattern in which regional inequalities narrowed at first and then increased. In Poland, the deepest output decline occurred in 1990-91 and affected those regions with the highest GVA per capita. Regional income disparities in the period of output decline were thus narrower than before the economic transition. As economic growth returned it benefited the industrialized regions that had undergone deep restructuring and regional disparities tended to increase once again. In Ukraine, we see that the disparities

Figure 4. Regional GVA per capita



[6] See World Bank. 1998. Can Backwards Regions Catch Up with Advanced Ones? PREM Note No. 6. The World Bank. Washington, DC.

increased gradually in the first half of the decade, but in the latter part of the 1990s had a much more marked build up, and have become even larger as growth has turned positive.

17. By the year 2000, some 8 regions in the country had GVA per capita above average, whereas some 18 had GVA below the country average (Figure 4). Per capita GVA in Dnipropetrovksa, Kyiv and Zaporishska was over 120 percent of the country average. Donestka, Kharkivska, Kyiska, Mykolajivska and Poltavska had GVA per capita that were between 100 and 120 percent of the country's average. Nine regions had GVA per capita between 80 and 100 percent. With the exception of Ivano-Frankivsk, the regions in the west of the country had considerably lower GVAs per capita. Chernivestka, Ternopil and Zakarpatia all had GVA per capita of less than 60 percent of the country average.

18. This brief overview suggests that there are disparities across Ukraine's regions and that, at least according to official data, these are increasing over time. The coefficient of variation in GVA per capita increased from 0.22 in 1990 to 0.33 in 2000 (based on constant price data). This compares to about 0.15 in developed countries and 0.5 for developing countries. Most troubling is the increase in disparity that has occurred during the recent period of growth. For economic, social and political reasons it is important to understand the principal factors that are influencing the growth or decline of the regions, so that policy choices can be better informed. The next section turns to this topic.

III. EXPLAINING REGIONAL DIFFERENCES

19. While understanding the magnitude of regional disparities is quite important for shaping policy, evaluating the factors that contribute to good or bad regional performance is also needed in order to guide the development of appropriate regional policies. This section draws on econometrics to try to explain regional differences in GVA per capita. It first evaluates a classic growth model to evaluate regional differences and then tries to factor in elements that might help to contribute to a more complete picture of what determines regional results. The exercise provides a snapshot in time in order to provide some general indications. It does not include "leads" and "lags" that might be factored into a more dynamic approach, partly because of weak data and partly because of the magnitude of collapse in GVA per capita during the 1990s. Typically, econometric work assumes that the underlying structural parameters of an economy remain constant and it is highly likely that during this period such parameters were in flux. Nevertheless, such analysis can provide us with some useful insights.

20. The analysis starts with the classic model, which evaluates the primary endowments of a region -- capital and labor -- in contributing to GVA per capita in the region. As in the classic model, the unexplained component is assumed to represent "total factor productivity" or the efficiency with which factors of production are used either as a result of improved processes or technological change. Subsequent steps try to specify some items that might make the use of endowments more efficient and therefore lead to increased GVA per capita. These include items such as:

- the *structure of the regional economy*, including the share of agriculture, old industries, and services, and the degree of diversification;
- *foreign direct investment per capita* in the region as an indicator of openness and potential knowledge transfers from abroad;
- the *activities of local authorities in 1999*, (as measured by the Institute of Reforms index) as an indicator of the degree to which local authorities help or hinder development;
- *market infrastructure* as a measure of the extent to which economic activity is facilitated;
- *transport infrastructure* as a measure of potential transport bottlenecks; and
- *telecommunications infrastructure* as a measure of infrastructure to support businesses.

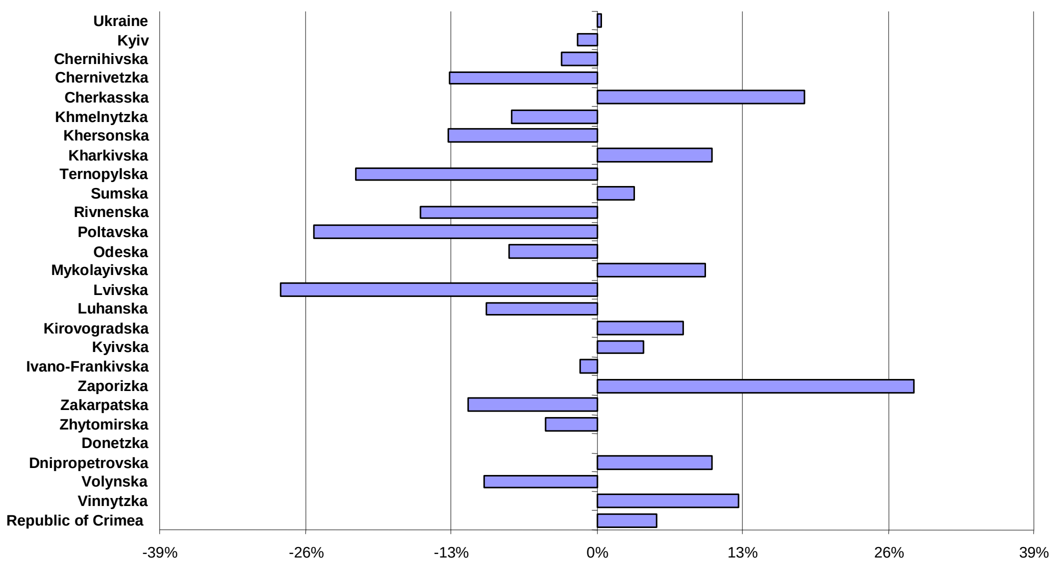
Annex 2 shows the complete list of tested variables and their correlations.

21. The results of the econometric work suggest that 80 percent of the differences in GVA per capita among regions are explained by differences in physical capital and labor endowments (see Table 2). The capital stock per capita appears to have the greatest influence on GVA per capita in the regions, with a one percent increase in investment stock per capita for 1995-2000 implying a 0.718 percent increase in regional GVA per capita. The obvious implication of this result is that poor regions are poor because the capital stock in the region is low, and rich regions do better because they have received more investment. Since the bulk

of investment has been allocated by the state it is important to consider how investment resources are allocated. This result also highlights the critical importance of investment to a region's performance and thus the importance of maintaining a positive climate for investment. Labor, as measured by per capita employment, also has an influence on regional per capita growth. For every percent increase in employment per capita, regional gross value added per capita increases by 0.253 percent. This suggests that promoting flexible and strengthened labor markets can also help to improve a region's performance and can contribute to reduced disparities.

22. In order to test the effect of each of the variables discussed above, they were first individually added to the classic model (Table 2). As an individual item, foreign direct investment has the largest impact, but at .022, the coefficient is significantly less than that of capital or labor. Telecommunications infrastructure seems to have a similar influence on regional GVA per capita (coefficient of .020), followed by the number of students per capita (coefficient of .014). When these items are grouped together in an unconstrained test, the investment stock remains most influential (coefficient of 0.564), then labor (0.277) followed by telecommunications infrastructure (0.078), foreign direct investment (0.015) and

Figure 5: Total Factor Productivity in % of GVAP 2000



transportation infrastructure (0.009). The other tested variables were not significant.

23. While the extended equation above explains about 82 percent of the variability amongst regions, there remains an unexplained component that, as mentioned above, is typically referred to as "total factor productivity". This unexplained component basically concerns a range of possible factors that influence the ability to use resources well – so, for example, even though two regions may have the same endowments of capital and labor and, say, a similar extent of FDI and telecommunications infrastructure, the outcomes in terms of performance may be better in one region than in another. Such differences may be attributed to differences in the efficiency with which resources are allocated, to technological differences or to a host of other factors that help to make production more effective (or ineffective). As seen in Figure 5, this unexplained component varies considerably by region. Those regions with positive total factor productivity (Cherkaska, Kharkivska, Vinnytska,

Zaporizhka), have performed much better than would be expected after controlling for capital and labor endowments and other elements of the extended equation discussed above. In contrast, some regions have not performed as well as their endowments would suggest and these can be seen on the left hand side of the figure (Khersonska, Lviviska, Poltavska, Rivnenska, and Ternopilska).

24. The results presented here must be considered with care because of the difficulties in effectively measuring variables and because of the significant changes that are still under way in Ukraine. Nevertheless, this type of analysis can provide a sense of the critical issues that relate to changes in regional gross value added and thus give some insights into the most effective tools for strengthening the performance of the regions. In this light, the most important determinants of regional performance appear to be the stock of investment and labor. The stock of capital has far the greatest influence on regional performance and underlines the importance of promoting a positive climate for investment. The increasing disparities over time may indeed be the result of too little investment. At the same time, an effective labor force plays a critical role, so supporting a flexible labor market with strengthened human capital is also an important tool for supporting regional development. Specific interventions to support the development of public goods such as transportation and telecommunication infrastructure can also help to assist regions. While items such as the structure of the regional economy and the activities of local government authorities do not appear to be significant, in most regions there is an unexplained residual that in some cases is positive and in others is negative. These unexplained factors suggest that there are elements to effective regional development that cannot be easily quantified and captured. The next section elaborates on some of these factors.

Table 2: Regression Results Explaining Regional GVA per capita in 2000.

Models explaining GVAP'00 p.c.	Investment Stock 1995-2000 p.c.	Employment/ Population '00	Students/ Population '00	Agr.share '98	FDI'00 pc USD	Market infra-structure '00	Transport infra-structure '00	Telecom infra-structure '00	Sum of para-meters	R^2
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*
Classic model	**0.718**	**0.253**							**0.971**	**0.788**
Classic model + all variables	0.718	0.253	0.000	0.019	0.000	0.000	0.000	0.000	0.990	0.797
Classic model + students	0.718	0.253	0.014						0.985	0.789
Classic model + FDI	0.718	0.253			0.022				0.993	0.792
Classic model + Market infrastructure	0.718	0.253				0.006			0.977	0.788
Classic+ transport infrastructure	0.718	0.253					0.002		0.973	0.788
Classic model + telecommunication infrastructure	0.718	0.253						0.020	0.991	0.794
Other parameters fixed	0.578	0.287	0.014	0.019	0.022	0.006	0.002	0.020	0.948	0.812
All significant unconstrained	**0.564**	**0.277**	**0.000**	**0.000**	**0.015**	**0.000**	**0.009**	**0.078**	**0.942**	**0.815**
All significant constrained	0.624	0.220	0.013	0.000	0.025	0.011	0.059	0.048	1.000	0.807

Source: authors' calculation.

IV. EVOLVING THINKING ON REGIONAL DEVELOPMENT POLICY AND UKRAINE'S REGIONAL DEVELOPMENT POLICIES TO DATE

25. Although the disparities among regions in Ukraine are not as severe as those found in other countries, the indication that these disparities seem to be increasing suggests that the policies for addressing regional development need to be revisited. However, defining "regional policy," particularly in a transition country, is not always straightforward. Traditionally, under central planning "regional policy" per se did not exist. Essentially, planning related to a geographic territory was the sum of sectoral or branch activities. Resource allocation evolved very differently than would be the case under a market allocation, leading to a segmented economic structure, severe rigidities and a reliance on heavy industry. Central planning was also based on a vertical organization between the state and productive forces and, as a result, few horizontal linkages between the enterprises developed. With the shift to a market-based economy, the approach to regional development needs to be reconsidered. This section will first consider the evolving concept and theoretical framework of regional development policy. It will then consider the Ukrainian policy approach to regional issues. Finally, it will consider how fiscal resources have been allocated to the regions since 1995 and the implications of these allocations.

A. CONCEPTUAL FRAMEWORK & THE EVOLUTION OF REGIONAL POLICY

26. The relatively straightforward measurement of regional development and regional disparities discussed above belies the complexities that are at the base of thinking about regional development policies. For many years a territory was considered simply a physical recipient of a range of policies and activities in its domain. More recently, it has become evident that the territory or region itself plays an important role in economic development by interacting with economic agents. This has significantly changed how regional development policy has been approached.

27. In the early years, regional policy was focused on the notion of an economic "space" as an abstract concept that refers to a complex system of relationships and dynamics and "territory" was used to indicate the concrete place where activities would occur. As thinking evolved, concepts such as "polarized space" (focused around different development poles) and "planning space," (related to territorial planning) emerged. Eventually, the notion of a "region" evolved, but with dual definitions: as a concrete territorial and administrative entity and as an economic space with inherent relations and dynamics that take place within a territory. This notion was complemented by that of "spatial development" or the developments that relate to urbanization, land use, rural development and the like, which go beyond particular regions, but may also apply within a given region.

28. In a coherent framework, there are important institutional and policy linkages between regional policies, strategies and spatial development (Figure 6). Central

government priorities and efforts in both regional policy and sectoral policy interact with regional strategies, and all of these in turn affect spatial development and planning.

29. The phenomenon of increased competition and of globalization led to further changes in the understanding of regions and their role. Regions began to obtain their own identity, not only as administrative entities, but as active players at a national and international level. Regions provided a framework for generating a new approach to development, partly based on their proximity to people and resources, but also based on a new thinking regarding spatial dynamics in which both material (capital investment and infrastructure) and intangible factors contribute to growth. The focus turned to a region's effectiveness, efficiency and productivity to ensure success, as embodied by the following characteristics:

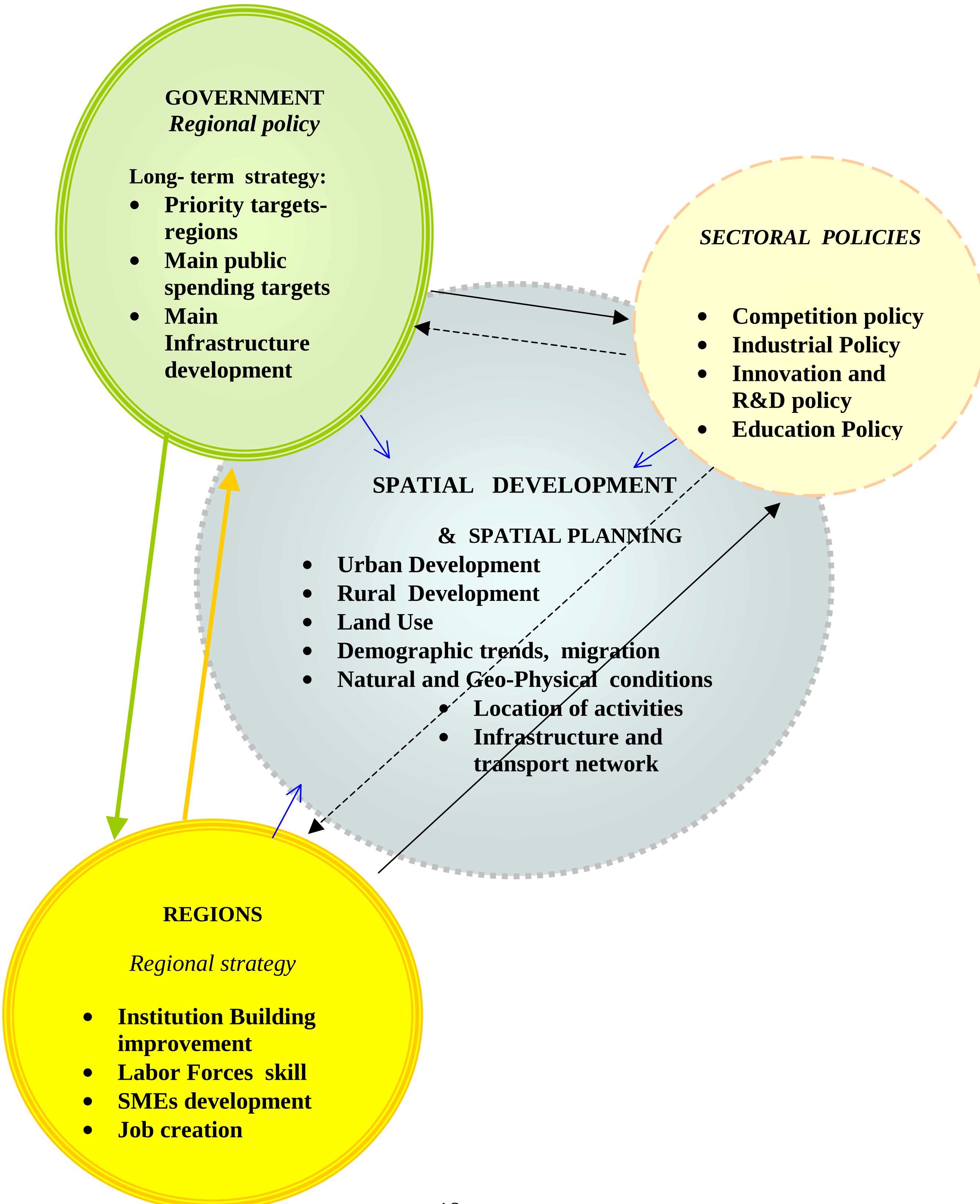
- *Human resources*: the quality, skill and mobility of labor forces, including the capacity to adapt to the mutations of technology and organisation.

- *Institutions*: not only their organization at different levels, central and local, but also their capacity, effectiveness and commitment. In other words, the fundamental role of institutions in the successful implementation of policies.

- *Intangible factors* such as "social capital," (which is a complex mix of consolidated knowledge and culture, innovation behavior, "entrepreneurial spirit", social rules, capacity to develop networks and trust) and co-operation among the social and economic actors

- The *historical heritage* and the *legacy* that influences to different degrees the present entrepreneurial culture: how the historic memory of the past determines, positively or negatively, the path that a society can take at present (the "path dependent" approach).

Figure 6: Institutional and Policy Linkages for Regional Policy and Spatial Development



30. In recent approaches, the mutual integration of these factors is seen to be at the origin of any process of development in the territory: thus the territory is not merely a recipient - where the different agents act in isolation from each other - but it becomes at the same time a *vehicle* and *factor* that influences economic development in the regions. This new understanding of the spatial dimension includes at the same time social, cultural and historic components, each interacting and influencing directly or indirectly the economic performance of a region (Figure 7). This suggests, as does the analysis in section III, that the economic performance of a region is not exclusively a function of capital and technical factors but is also influenced by non-economic factors, like institutions, culture, innovation behaviors and capability. On the basis of this approach, regional policy has been profoundly renovated, recognizing that the factors of growth are *"endogenous"* to the region, versus the traditional "*exogenous*" approach.

31. These changes in the conceptual framework have been paralleled by shifts in regional policy itself. Until the 1980s, regional policy was typically conceived as a centralized, top-down effort to strengthen key industries through special preferences and subsidies. However, this approach tended to foster both passive behavior and rent-seeking that contributed to increased inefficiency of public policy. The focus then shifted to an emphasis on improving the conditions in which businesses must operate. This "horizontal" approach emerged in which the role of public policy was to create a more favorable business environment, to reduce the barriers to firm operation and to strengthen the services that support an effective business climate. This approach has been reinforced by increasing globalization. However, this trend does not entirely exclude state support of specific sensitive structural problems that the market mechanism on its own would be unable to solve, such as severe issues of conversion; research, development and innovation; and small and medium enterprise (SME) support. But even in these cases, efforts are less and less focused on investment at the micro-level of the firm itself, but more on addressing broader problems and a range of measures for softening negative impacts.

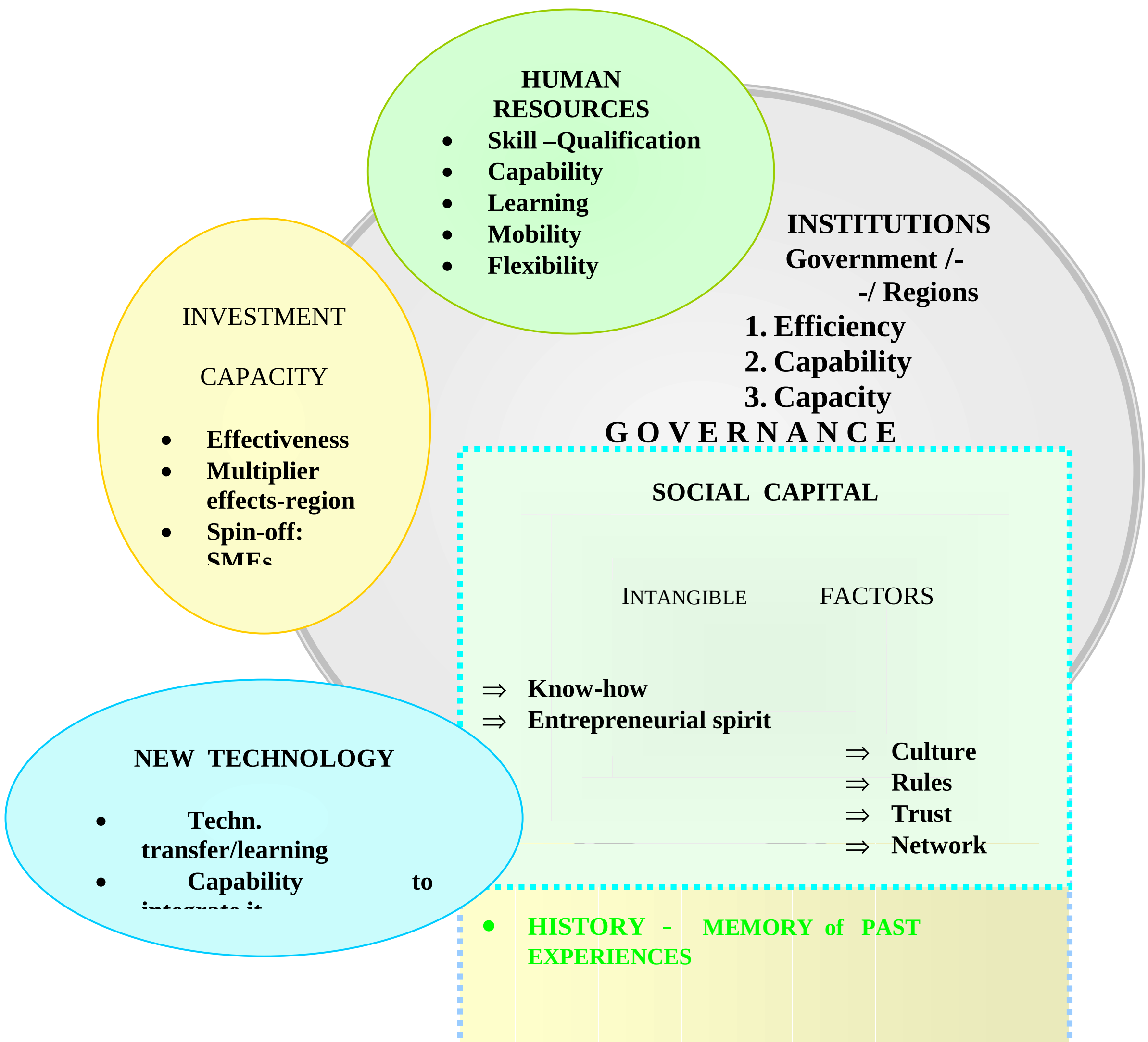
32. Along with the move to a more "horizontal approach," public spending to achieve regional policy objectives has been increasingly transferred to the regional or local authorities that are closer to the beneficiaries. Such incentives or services are often not delivered directly by regional or local administrations, but through the intermediary of an agency or other bodies, that have specialized or general responsibilities in managing such instruments in the territory. The instruments typically employed, include:

- *Financial incentives* either as direct grants or interest rate subsidies, or through reimbursable grants, guarantees and loans. Easier access to financing is becoming one of the major tools for helping firms to invest for expansion or consolidation. At the same time, grants, like subsidies, are increasingly shrinking.

- *Special funds* focused on specific objectives as small and medium enterprises, innovation, regional development, and restructuring. These funds seem to be the most useful because of their more targeted objectives and because they are usually linked to different kinds of conditionality that have to be fulfilled by the subjects to utilise such funds, in order to avoid ineffective utilisation or speculation;

- *Various types of services and assistance* depending on the fields and focus, such as marketing, technology and innovation information, and management.

Figure 7: A New Perspective on Spatial Development: the Constituent Parts at the Regional Level



33. This more recent approach to regional policy also suggests a new perspective on institutional roles. The direct involvement of the regional institutions often accompanied by other local bodies, like agencies, becomes a better way to improve both the identification of the objectives, the policy-making process, as well as the policy

implementation. This trend thus favors a more "bottom-up" process, that in many cases has been shown to be the most appropriate way to mobilize local resources, either human or financial, and consequently improve the policy effectiveness. Experience in Europe in the 1980s has suggested, however, that bottom-up processes may also require some strengthening of institutions and capacity building.

B. REGIONAL POLICY IN UKRAINE

34. Over time, concepts of regional policy have shifted to placing emphasis on the region as an active part of the development process as opposed to just a recipient of assistance. Rather than intervention from above, efforts focus not only on building capital and strengthening human resources, but on promoting the human resources, institutions and intangible factors, such as entrepreneurial spirit and culture, that help to both attract resources and assure that they are used effectively. Only recently has there been an attempt to articulate Ukrainian regional policy in a more systematic way. Since independence, efforts have largely been along the lines of the traditional, more top-down approach seen in the early years in Europe. This section briefly outlines the evolution of these policies.

35. Article 132 of the Ukrainian Constitution specifies that Ukraine's territorial structure is based on the principles of unity and the consistency of the state territory, on the combination of centralization and decentralization in exercising state power, and a balanced social and economic development of the regions taking account of historical, geographical and demographic features and the cultural traditions thereof. During the first years of independence, regional policy was a politically sensitive issue due to substantial regional differences and threats of secession. The focus at this time was on consolidating the newly independent Ukraine. A national conference in 1992 saw very different perspectives on the issues and led to a stalemate until recent years. During this period of time, state regional policy responded to specific situations on an ad hoc basis, but no clear strategy was ever laid out.

36. In the early 1990s, an attempt was made to develop an approach to regional development from the top down. A proposal was made among scientific circles to divide the country into extended economic regions along the lines of territorial economic complexes. Comprehensive programs were developed by the Government for five extended regions (Karpatskiy, Poliskiy, Podilskiy, Ukrainske Prychornomoria and Predniprovskiy) and programs were costed out at about UAH 60 billion of which UAH 24 billion was to be provided from the state budget. A special management unit at the government level was to be created to implement these programs. However, in the end, both the administrations at the oblast level and the Government itself rejected the programs.

37. In the mid-1990s, local bodies presented their own proposals to the Government requesting support for their own programs of medium- to long-term economic and social development. Nine of these programs were approved by the Government including programs for the Autonomous Republic of Crimea, Sevastopol, Greater Yalta, Kyivska, Donestka, Luhanksa and Khersonska oblasts, Lviv and Rakhivskiy Raion. Of these

programs only the latter two were targeted, all the others presented comprehensive solutions to regional and social economic problems. Implementation of these programs has not been strong. The central budget financed about 10-15 percent of the planned measures, so while some activities were begun, they are far from completed.

38. In his Year 2000 Message to the Supreme Rada of Ukraine, the President highlighted regional development as an issue that would receive his personal attention. He defined regional policy as a set of actions to "add an essential dynamism to regional socio-economic development by attracting the regions' potential resources to economic turnover on a fuller scale and by making greater use of the territorial division and cooperation through broader powers and higher responsibilities of local executive authorities and local self-governing authorities for handling the current and prospective problems of the territories." The President defined six key tasks:

- Introduction of mechanisms for encouraging the social and economic development of depressed territories.
- Delegation of an essential portion of managerial functions to the regions, with an emphasis on a detailed model of regional agencies.
- Introduction (from 2001) of a single minimum standard and workable mechanisms for the social protection of the population whatever the economic capacity of the regions.
- Implementation of comprehensive programs for productive employment in each region.
- Completion of administrative/territorial reform in 2003/2004.
- Introduction of a two-house Parliament for Ukraine.

39. At the same time work was being done to draft a Concept for State Regional Policy. This Concept was approved by the President on May 25th 2001. The Concept states as its principle goal "to create conditions for a dynamic, balanced socioeconomic development of Ukraine and its regions, to raise the living standards of the population, ensure compliance with social standards guaranteed by the state to each of its citizens, irrespective of place of residence, as well as to deepen the process of market reform on the basis of enhancing the effectiveness of administrative decisions and improving the work of bodies of state authority and bodies of local self government." It goes on later to cite several more specific objectives :

- Introduction of an in-depth review and evaluation of the internal natural, scientific and labor potential of each region and the design of comprehensive legal, organizational, economic and other mechanisms for its effective utilization.

- Implementation on an innovative basis of structural reform of the economy of the regions.

- Phased reduction of the level of territorial discrepancy of the region's economic development and the security of its citizens.

- Extensive development of entrepreneurship as the main factor of socio-economic development of the country and its regions.

- Stronger economic integration of the regions, taking advantage of territorial division and cooperation of labor, as one of the main factors enhancing the competitiveness of the state in international markets.

- Development of territorial communities and bodies of self government, of the ability to independently and responsibly cope with issues of socio-economic development and creation of effective mechanisms to ensure their active involvement in formulating and implementing state regional policy.

- Improvement of inter-budgetary relations, design of clearly defined criteria and effective mechanisms of providing state support for the development of the regions.

- Achievement of productive occupation of the population, stabilization and improvement of the countries demographic situation.

- Continued improvement of the system of environmental protection and utilization of natural resources as well as the mechanisms and instruments for the formulation and implementation of ecological policy.

- Establishment of international cooperation in regional policy, alignment of national legislation on these issues with the rules and standards of the European Union, and the development of trans-border cooperation as an effective method of strengthening inter-state relations and dealing with regional problems.

40. The Concept goes on to set out a whole range of areas in which actions need to be taken in order to achieve these objectives. Among the measures discussed are: improvements in state regional planning; creation of a centralized executive body for the allocation of investment resources in order to support regional development; creation of industrial-financial groups to develop trans-border and inter-regional economic ties; the creation of regional development agencies; development of special budgetary, tax, price, credit innovation and other mechanisms to support the depressed territories; formation of regional infrastructure to support the development of entrepreneurship; creation of a non-bank financial sector in the form of regional credit and guarantee institutions; support for the participation of local state administrations in the management of state enterprises; development of land markets; identification of territories attractive to investment and

development of special rules for these territories; and promotion of non-state pension insurance in the regions.

41. Two areas that receive particular attention in the Concept are the need for reform of inter-budgetary relations and for administrative reform. These topics receive more attention in the Concept than any others. On the inter-budgetary front, the emphasis is on improving equalization, better targeting of transfers, improved clarity of responsibilities, strengthening local revenue raising, encouraging the creation of local associations for dealing with local and regional development issues, bringing local authorities under the State Treasury and introducing mechanisms for encouraging the savings of the population in order to raise the investment potential of the regions.

42. With respect to administrative reform, the emphasis is on significantly raising the role and the responsibility of local state administrations, bodies of local self government and territorial communities. The Concept proposes that over time a part of the powers of the central bodies of the executive will be transferred to specialized state bodies, territorial units of the central bodies and to local state administrations and bodies of local self government. Regional state administrations will be granted additional authority in order to implement a socio-economic policy at the regional level and responsibilities for implementing the wide range of measures set out above.

43. Less attention is given to the overall institutional structures that are currently working on regional policy. The President's administration has had an important role in elaborating policy as has the Department of Regional Policy in the Ministry of Economy. Policies made by line ministries may also have important implications in the regions. Overall, there are many entities that have an influence on regional policy, but it is not clear that these efforts are always coherent and/or well coordinated and what institution is meant to pull all these efforts together.

44. While the Concept highlights the increasing importance of regional policy, it has not successfully set out a coherent, overall framework for addressing the issues underlying effective regional development. Rather, it sets out a long list of actions that might have some effect rather than a coordinated strategy that clearly sets prioritization and sequencing. It seems to reflect more of a vertical approach to regional development in which regions are acted upon, as opposed to being critical agents in their own development. However, one sees throughout Ukraine evidence on the regional level of efforts to promote improved results through efforts from the "bottom up". These include non-state sponsored development agencies, training centers and efforts at improving technology. The National Strategy for Regional Development, due to be discussed this summer, can usefully strengthen the Concept for regional development and build on activities that are under way at the regional level.

C. THE FISCAL ALLOCATION OF RESOURCES TO SUPPORT REGIONAL DEVELOPMENT

45. In addition to the development of proposals, policies and concepts over the years the Government has played a role in influencing regional development through the

allocation of resources. There are two principal types of flows that the Government controls. The first is the allocation of transfers, the second is the financing of capital investment at the regional level.

46. The principal transfers in the Ukrainian budget system are subsidies and subventions that are used to assist in the implementation of Government programs and typically to meet current expenditure needs (however, some may have been used to support capital projects). In the Ukrainian definition, transfers do not include the portion of taxes regional and local governments retain as part of shared tax arrangements. Until the 2001 budget, there was no objective, transparent system for allocating transfers, so patterns of allocation reflect to some degree the Government's support to regions in the implementation of their current programs. Table 3 shows for 1995-2000 the share in total actual regional revenues of these transfers, the share of each region in the yearly allocation of transfers and a ranking of regions in terms of which received the most (number 1) and which received the least (number 27) in transfers in a given year.

47. Some regions, (Vinnystka, Volynska, Zhytomirska, Zakarpatska, Kirovogradska and Ternopil) have consistently received a significant amount of transfers in the last five years. Others such as Odessa, Sevastopol and Zaporizska have consistently received less transfers as a share of their actual revenue. Some regions that received considerable transfers in 1995, no longer do so (Dnipropetrovska, Donestka and Kyiv). Still others face a highly variable situation in which transfers allocated can change radically from year to year (Kharkiv, Lviv, Poltavska, Sumska). The change in allocations over the past five years seems to reflect in part a shift in resources away from the more prosperous parts of the country towards those with less capability of raising the resources needed in order to maintain current services. The variation in regions across years, however, also seem to reflect the ad hoc nature of the approach to regional policy. Of course, in some case they may reflect responses to emergencies, such as the flooding that has occurred in recent years.

48. A second important source of support to the regions has been direct state expenditure to support capital investment. Over the years, the Government has by and large determined the capital stock by allocating resources across the country through the annual budget. There is no clear process or allocation mechanism for these funds, but budget data can give us some indication of what resources went where and how these changed over time. Unfortunately it cannot give us an indication of how well these resources were used. Table 4 shows the trends in state-financed capital expenditure from 1995-2000. Some regions are clearly leaders in receiving support for investment from the state budget. These include Dnipropetrovska, Donetska, Kyivska, Luhanska, and the city of Kyiv. Other regions seem to have continually lagged in support for investment, including Chernivetska, Khersonska, Khmelnyska, Poltavska, Sumska, and Zakarpatska). Others have received variable support over the years.

Table 3: Transfers as a Share of Actual Revenue of the Regions, 1995-2000

Regions	Transfers as % of total revenues						Share of region in total transfers						Regional ranking of amount received					
	1995	1996	1997	1998	1999	2000	1995	1996	1997	1998	1999	2000	1995	1996	1997	1998	1999	2000
Republic of Crimea	7.7	4.2	27.9	19.5	10.6	1.9	3.4	2.1	6.2	4.6	2.5	0.4	13	17	5	11	16/17/18	26
Vinnytzka	10.7	19.7	42.1	41.6	34.0	47.2	2.3	6.5	7.2	7.7	4.8	5.4	18	5	3	2	10	3/4
Volynska	35.0	33.0	52.5	50.5	49.8	52.6	5.0	5.7	5.2	5.9	4.9	4.1	9	9	8/9	6	7/8/9	14/15
Dnipropetrovska	15.0	6.0	12.8	0.1	5.3	3.7	10.8	4.6	7.4	0.1	1.8	1.0	1	11	2	23/24/25	22	24
Donetzka	8.0	7.7	1.4	0.1	9.8	7.5	6.7	7.7	0.8	0.1	4.6	2.9	3	3	23	23/24/25	11	19/20
Zhytomirska	36.7	31.5	55.3	54.1	46.8	56.4	9.4	10.4	9.3	10.6	7.3	5.6	2	1	1	1	3	2
Zakarpatska	38.8	32.9	59.0	49.6	50.3	49.1	5.7	6.7	6.6	6.7	7.7	4.5	5/6	4	4	3/4	2	11
Zaporizka	8.5	0.0	0.6	0.2	20.9	12.1	2.8	0.0	0.1	0.1	5.4	2.0	15	26/27	25	23/24/25	5	22
Ivano-Frankivska	7.9	3.8	26.6	23.1	23.5	52.5	1.7	1.0	3.5	3.9	3.8	5.3	22	22	14	13	13/14	5
Kyivska	16.7	5.8	28.8	10.2	15.9	30.6	5.1	2.3	5.2	2.8	5.1	4.7	8	15/16	8/9	17	6	7/8/9
Kirovogradska	31.2	25.0	43.0	44.9	42.9	48.9	5.7	6.2	4.8	5.5	4.9	4.0	5/6	7	11	8	7/8/9	16
Luhanska	14.4	10.7	13.3	15.4	9.4	28.9	5.3	5.5	3.4	4.3	2.3	4.7	7	10	15	12	20	7/8/9
Lvivska	0.6	6.3	13.4	10.0	9.3	41.4	0.3	2.9	3.2	2.9	2.5	8.0	27	14	18	16	16/17/18	1
Mykolayivska	13.0	5.2	19.4	13.4	16.3	30.7	2.7	1.3	2.9	2.6	2.2	2.9	16/17	20	19	18	21	19/20
Odeska	2.0	0.0	0.0	3.6	4.5	9.1	0.6	0.0	0.0	1.1	1.1	1.7	26	26/27	26/27	22	25	23
Poltavska	8.2	1.0	0.7	0.1	24.9	24.8	2.2	0.3	0.2	0.0	6.3	3.1	19	24	24	26/27	4	18
Rivnenska	12.3	8.9	30.8	33.5	15.3	55.3	1.8	1.7	3.3	4.8	2.4	4.4	21	18	16/17	10	19	12
Sumska	4.0	8.4	9.4	14.4	7.4	44.8	0.8	2.3	1.3	2.3	0.9	5.4	25	15/16	21	19	26	3/4
Ternopylska	21.9	32.5	51.3	51.9	49.9	60.2	3.0	6.4	5.3	5.8	4.9	4.6	14	6	7	7	7/8/9	10
Kharkivska	3.8	5.7	3.0	0.1	24.3	18.9	2.1	4.1	1.2	0.0	8.2	4.1	20	13	22	26/27	1	14/15
Khersonska	22.5	31.3	40.6	38.9	36.3	46.0	3.5	8.2	5.1	5.2	3.8	3.9	12	2	10	9	13/14	17
Khmelnytzka	17.8	20.1	39.2	38.4	29.3	49.9	3.6	5.9	5.6	6.7	3.9	4.7	11	8	6	3/4	12	7/8/9
Cherkasska	17.8	2.8	21.8	31.3	17.9	41.3	4.9	0.8	3.6	6.5	3.0	4.2	10	23	12/13	5	15	13
Chernivetzka	25.0	28.9	43.8	37.8	24.4	47.9	2.7	4.4	3.6	3.6	1.6	2.8	16/17	12	12/13	14/15	23	21
Chernihivska	4.8	4.8	25.3	27.1	13.2	50.6	0.9	1.2	3.3	3.6	1.5	5.0	24	21	16/17	14/15	24	6
Kyiv	8.3	0.1	0.0	1.5	4.7	0.1	6.0	0.1	0.0	1.3	2.5	0.1	4	25	26/27	20	16/17/18	27
Sevastopol	15.0	13.5	27.8	20.4	7.4	22.8	1.2	1.6	1.5	1.2	0.3	0.8	23	19	20	21	27	25
Ukraine	12.2	9.8	16.9	14.3	18.3	23.4	100	100	100	100	100	100						

Source: Ministry of Finance, Ministry of Economy, Trade and European Integration

Table 4: State-Financed Capital Expenditure in the Regions, 1995-2000

Regions	% of fixed capital investments financed by the State budget in total capital investments						Share of region in capital investments financed by the State budget, in%						Regional ranking of capital investments financed by the State budget					
	1995	1996	1997	1998	1999	2000	1995	1996	1997	1998	1999	2000	1995	1996	1997	1998	1999	2000
Republic of Crimea	39.9	27.6	12.6	10.9	7.9	4.8	4.2	3.5	3.4	2.6	4.1	2.5	8	9	10	9	7	11
Vinnytzka	17.8	13.1	7.6	6.4	4.4	4.7	1.9	1.6	1.9	1.3	0.8	1.0	18	18	16	18	20	23
Volynska	32.5	30.3	16.5	12.7	14.3	9.5	1.7	2.0	2.9	2.2	2.6	1.9	22	16	11	11	10	13
Dnipropetrovska	26.1	16.6	3.6	4.5	6.6	3.1	12.4	10.1	4.8	5.3	8.2	4.8	1	3	7	5	5	5
Donetzka	15.6	11.4	10.2	10.5	8.7	8.4	8.2	9.6	15.8	16.2	15.6	17.4	4	4	1	2	1	1
Zhytomirska	36.9	30.0	27.9	21.3	18.6	24.2	4.7	4.7	6.4	3.4	2.9	4.4	7	7	5	6	9	6
Zakarpatska	26.6	19.5	5.0	4.5	3.6	10.3	0.9	0.9	0.7	0.5	0.7	2.4	27	25	24	25	23	12
Zaporizka	19.7	7.5	0.8	2.0	5.6	2.0	3.8	2.3	0.5	1.6	4.5	1.8	9	13	26	15	6	17
Ivano-Frankivska	20.2	10.8	7.5	5.4	4.8	3.8	2.2	1.3	1.9	1.3	1.3	1.7	14	22	15	17	18	18
Kyivska	51.4	37.6	23.1	44.7	23.8	24.0	10.5	11.6	11.8	25.2	11.2	15.3	3	2	2	1	4	2
Kirovogradska	26.0	36.5	26.7	17.8	18.8	15.9	1.9	3.0	5.4	2.9	3.3	3.0	19	10	6	7	8	9
Luhanska	22.3	17.1	13.1	21.8	20.9	11.4	5.2	5.3	9.3	13.3	12.8	8.8	5	5	4	3	3	4
Lvivska	17.0	9.1	3.8	4.3	4.1	4.6	2.7	2.1	2.3	1.8	1.8	3.1	12	14	12	13	14	8
Mykolayivska	18.0	10.5	2.9	1.9	2.9	3.4	2.0	1.6	0.8	0.5	0.7	1.1	16	20	23	24	24	21
Odeska	17.9	13.4	4.7	4.3	3.3	4.8	3.2	2.7	2.2	2.2	1.9	4.1	11	11	14	10	13	7
Poltavska	10.6	5.4	1.5	1.3	0.8	1.1	2.1	1.8	1.3	1.2	0.7	1.1	15	17	19	19	21	22
Rivnenska	21.0	16.3	14.7	9.9	4.6	4.7	1.8	2.3	3.8	2.9	1.4	1.2	21	12	8	8	17	19
Sumska	23.0	9.5	5.3	3.1	1.5	1.1	2.0	1.5	1.7	0.8	0.6	0.4	17	21	18	21	25	27
Ternopylska	15.7	9.6	3.0	1.7	8.3	8.8	1.0	0.7	0.7	0.4	1.4	1.2	26	27	25	26	15	20
Kharkivska	27.8	14.3	3.1	2.0	3.7	2.0	4.8	4.2	2.3	1.4	2.3	1.8	6	8	13	16	11	16
Khersonska	22.9	13.9	3.1	3.8	1.9	12.7	1.7	1.2	0.5	0.6	0.2	1.9	23	24	27	23	27	15
Khmelnytzka	16.8	12.1	5.6	6.1	1.6	2.4	1.8	1.6	1.8	2.0	0.5	0.7	20	19	17	12	26	24
Cherkasska	24.7	16.3	6.4	4.3	6.0	13.1	2.6	2.1	1.3	0.7	1.4	2.7	13	15	20	22	16	10
Chernivetzka	26.3	24.0	11.2	10.2	11.9	5.1	1.1	1.2	1.2	0.9	1.0	0.4	25	23	21	20	19	25
Chernihivska	39.8	36.7	15.5	8.2	8.7	6.4	3.7	5.0	3.5	1.7	2.1	1.9	10	6	9	14	12	14
Kyiv	37.7	32.9	11.6	5.0	7.3	5.3	10.8	15.4	10.9	7.3	15.3	13.2	2	1	3	4	2	3
Sevastopol	50.2	26.0	19.3	3.9	14.0	5.0	1.1	0.7	0.9	0.3	0.7	0.4	24	26	22	27	22	26
Ukraine	24.8	18	8.3	8.4	7.5	6.2	100	100	100	100	100	100						

Source: Ministry of Economy, Trade and European Integration

49. Much of the state-financed capital investment goes to the regions whose dominant economic activity is heavy industry. Of course, Kyiv has also received resources because of its role as the capital city. Those that have lagged behind in support tend to be the regions that are dominated by “other industry” or have no dominant economic activity (see Figure 1 above). Given that investment in capital stock had a substantial influence on gross value added per capita (as seen in Section III) the continued investment in areas associated with heavy industry may serve to exacerbate the disparities in growth between these regions and regions that focus on other economic activities. The data suggest that the approach towards state investment is not fully consistent with the objectives of the Concept of Regional Policy and the Government may wish to revisit the objectives, and the processes for the allocation of state funds.

50. As economic growth resumes and the disparities between regions have increased, regional policy has taken on increasing importance in Ukraine. There has been no shortage of efforts at all levels to try to define ways to support more effective regional development, including the development of a Concept on Regional Development at the highest level. This concept makes good progress in identifying a number of important issues that are critical to regional development. At the same time, it does not go as far as it might to develop a coherent framework and to reduce the ad hoc nature of regional policy. It recognizes some important roles for the state in addressing inter-budgetary and administrative issues, but loses sight of other key roles of the state such as developing a long-term strategy, prioritizing public expenditure in a way that supports regional development goals, and in developing the major infrastructure and broad public goods that are necessary for the establishment of growth across the country.

51. Ukraine’s current positive economic situation provides a good base for moving forward in the development of regional policy and achieving the Government’s objectives. However, there are many lessons that can be learned both the experiences of other countries generally and the use of certain instruments proposed by the government in particular.

V. LESSONS FROM INTERNATIONAL EXPERIENCE

52. The Government's Concept highlights a range of different instruments that can be used as tools to help promote regional development. Many of these tools have been used in the past by other countries. The objective of this section is to draw on the lessons learned by other countries and the European Union, both generally as they apply to regional development more broadly, but also specifically as they relate to the specific tools. Such lessons can help shape current policy in Ukraine so that overall results may be more successful.

A. FRANCE AND THE "CONTRACT- PLAN"

53. France, among the European countries has always been an example of a centralized model, where the state plays the central role in the economy - with a powerful public sector[7] - and with the territory as the *"object*" of its planning activities. However, profound changes have been achieved in the last decades, since the 1980s, that have modified this hierarchical, centralized tradition. France initiated a long process towards a progressive system of decentralization, while maintaining a compromise: on one hand, keeping the necessary state control and regulation over the territory, and on the other hand, decentralizing in order to improve regional management and to respond to the political and economic pressures from below and from the increasing influence of the European Union. This compromise is reinforced by the "double administrative system" at regional level, with the maintenance of the Regional Prefect[8], as representative of the state in the region, at the same time as the Regional Council as elected body. It is also supported by the very formalized system of "Plan-Contract" (Contrat de Plan Etat-Regions) between the state and the regions.

54. The strong French state provided a considerable capacity to pursue long-term strategy in the territory, which mainly pursued two targets:

- *Infrastructure and transport* development - the strengths of French industrial competitiveness, both in terms of quality (high technology and effective service performance) and quantity (the attempt to spread them over the territory to counter-balance the centralisation of the Paris agglomeration); and

- *Urban development policy* including, the upgrading of large cities ("les métropoles d'équilibres") to balance the weight of the Paris agglomeration, as well as the support to medium and small cities

[7] Before a process of privatization of the state companies, in the 1980s, the public sector in France covered most of the large companies, "the national champions", that had a quasi dominant position in their branches such as: infrastructure, road and railway transport, chemical, pharmaceuticals and aerospace.

[8] The *Prefect* has been created at two levels: traditionally at the Department level and then at the regional level, when the first *"planning regions"* were created. So the representatives of the state in the territory cover two layers of the administrative structure, while the local one, the Commune, has only a local elected body.

in consideration of the importance of the rural areas in the whole territory.

55. Following the 1984 Decentralization Law, the state used the instrument of the State-Regions Contract-Plan to establish new formal relations with the regions. The Contract-Plan set regional priorities and targets, as well as setting out the financial aspects - the share of funds from the state and the region, and private and/or European Funds, when they existed. Over the past fifteen years, the role of this instrument has evolved by increasing the responsibilities assigned to the regions, both through the Regional Prefect and the Regional Council.

56. Four generations of Contract-Plans have taken place since 1984. Within the framework of the IX National Plan (1984-88): the focus was on infrastructure and the transport network (the latter represented close to 40% of total funds), with an additional focus on employment and speeding up the modernization of the economy. With the Xth Plan (1989-1993) there was a shift to long-term development and many regions started to prepare their own medium- and long-term economic plans. The state increased its contribution, confirming the importance attached to the regional efforts. A more active role was assigned to the Regional Prefect for the preparation of the Contracts-Plan and they are more and more the result of proposals from the region up to the Government, even if the state representative, the Prefect, played the determinant role.

57. With the XI Plan (1994-1999), the Contract-Plan was implemented but without the national plan, since in 1993 the government abandoned this instrument. In this period, there is a clear increase of “partnership” and involvement of the local communities in different initiatives: education, research and development, transport, competitiveness. A system of evaluation of the Contract-Plan was launched, to monitor their effectiveness and consistency: this step forward is very important for changing the behavior of the public administration to improve their capacity and competencies for the implementation of programs.

58. The last generation of the Contract-Plan, 2000-2006 (corresponding to the Structural Funds agenda) covers a longer period, seven years, and reflects a more long-term view of the targets and the effort to maximize the European contribution. With this generation, the state has attempted to define a more coherent and effective strategy including the regional targets. The regional Prefects have been in charge of defining “a strategy of the state in the region,” followed by wide consultation with the public, private and social partners, to enable the government to design a more tailored policy to take into consideration the real needs and priorities of the regions. The Contract-Plan foresee two components: one regional, with the focus on the improvement of public services, the other territorial, favoring local development and social cohesion. In this last phase of Contract-Plans, there is an unambiguous effort to strengthen the “coherence” between macro-economic targets, to define a more effective role of the state, and to fight regional gaps for more durable development in the regions.

59. While inequalities remain significant in France in terms of macroeconomic indicators, the evidence suggest that in the last fifteen years the gaps have begun to

narrow, though they have not yet been surmounted. Since the early 1990s, a qualitative shift has been under way in France, with an increasing focus on the "endogenous growth approach" and local productive systems (clusters) that had developed in other countries. As seen above, the focus of the Plan-Contracts has shifted away from top-down imposition of plans towards a much more "bottom-up" and participatory approach drawing on broad discussion and dissemination of plans, community input and greater focus on strengthening the capacity of regions to develop a sound environment for economic activity.

B. ITALY AND THE DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES

60. Italy has long been recognized for its profound regional disparities in particular with the heritage of the Southern regions (*Mezzogiorno*). However, since the 1970s, and in particular during the 1980s, this inherited *"dual structure,"* between an industrialized North and the depressed rural regions in the South, has changed. Between the industrialized Northwest and the rural south, the emergence of another area has provided a more diversified regional balance. The North-eastern regions have evolved based on a dense network of small and medium enterprises (SMEs) which are highly integrated and organized into clusters as *"Industrial Districts"*.

61. The following factors are among the main reasons for such differentiated regional performances:

- A *historically heavy heritage of the Southern regions*, before the creation of a unified country in the XIX century with a politically and economically stronger North and a large poor area in the South, under the secular domination of the conservative Bourbons. This historic, political balance, together with the conditions that led to the creation of the nation, engendered both a structurally feeble State and a difficult social and economic heritage for the Southern regions. The combination of these two elements had profound consequences that contributed to the perpetuation of these imbalances. To these structural historical weakness have been added inappropriate policy solutions towards catching up that have been put in place since the aftermath of World War II.

- *Italy has fewer centralized urban poles* at the national level (because of its history of strong small States) in contrast with other European countries (as France with Paris, or England with Greater London). The higher dispersion of "urban poles" has created the conditions for a more diffused system of regional capitals. This diffusion of medium-to-large cities has contributed to the development of both the regions that had strong industry-intensive development and those regions that did not enjoy great industrial concentrations (the North-east regions with medium cities).

- *The peculiarities of the North-east regions*, which were relatively behind in comparison with the North-west regions in the 1960s. They had more rural, handicraft and small company traditions. These local conditions represented the basis on which the small and medium companies started to grow. Some of them were sub-contractors to large companies with their headquarters located in the other North-west regions, but many others developed as locally-based systems around very specialised and narrow markets/products.

These different factors partially explain the regional disparities and the complexity of the social and institutional factors that confirm extremely diversified conditions existing in different parts of the country.

62. The role of SMEs has been important in developing alternatives to heavy industrialization, in Italy and elsewhere. The increasing diffusion of locally-based experiences in firm networks and with local productive systems or more advanced forms of clusters, as in the Italian industrial districts, allowed the emergence of new forms of spatial organization in which small firms are the most vigorous component. The SMEs, through their networking and integrating system, reach important economies of scale that usually only large companies are able to achieve. Their mutual relations depend on the region/area specifics and can be based on horizontal or vertical principles.

63. Different types of integration have evolved. There are the SMEs that create their own integrated system. In these cases, they often develop on the basis of long standing traditions of handicrafts, changing then into new, specialized production as has been the case in the Industrial Districts in Italy. In many examples, such clusters are located in traditionally rural areas, where more diffused urban structures with medium and small towns have been a positive factor for local networks and diffusion over the territory.

64. SME networks can also be organized on the basis of different types of integration, around one or a few major large companies or multinationals. In these cases, the SMEs are sub-contractors and have a very specialized focus on one product or part of the product. Small sub-contractor companies need to be able to respond quickly to the orders of large companies and the diffusion of the "just in time" system has pushed SMEs to improve their capacity to respond to the new productive systems and market pressure (flexibility and high quality). In most cases, such relations are developed in regions where important Foreign Direct Investment (FDI) has been attracted. The most successful cases have been in Ireland, Wales and Scotland in the U.K, Lorraine and Rhone-Alpes in France, and Baden-Wurttemberg in Germany.

65. SMEs also take an alternative approach in which the ability to compete is related to the identification of niche markets and through their very advanced specialization they can reach competitive advantage. In the meantime, they introduce innovation not only through the traditional vertical way of technology transfer (i.e. from R&D institutes to industry) but also through a cumulative process of "learning by doing" based on their local relations and proximity with the customers, thus introducing those changes to their products on the basis of market responses, taste or other indicators that they are able to detect in their close contacts with the market.

66. Another channel that facilitates the diffusion of innovation is "imitation". Firms that introduce new technology or innovating processes provide a good opportunity for the other firms in the cluster to reproduce or apply new technology and innovation, acquiring

in this way new know-how. This mechanism promotes the progressive diffusion of innovation in the territory. In all these different kinds of interactions, co-operation and competition coexist at the same time and they are the reason for the dynamic strengths of the cluster. The comparative advantages of remaining in the cluster, instead of the implicit or explicit competition, are much higher then the disadvantages that would exist if they operated individually.

67. In Italy, state and local institutions play an active role in creating a favorable environment for SMEs, reducing the barriers and bureaucratic procedures that hinder the development and the operations of the SMEs, in partnership with the other actors in the region. The *Industrial Districts*, initially more limited to few regions, like Emilia Romagna, a few in Tuscany, and some in the North-west (Lombardie), started then to spread to other regions like Veneto, Friuli, and more intensively in Tuscany. The regions in the center of the country did not develop these local systems to the same extent. The South has had a few isolated successful cases, but there are clearly barriers to the more diffused expansion of such local productive systems in regions that do not have a very conducive entrepreneurial environment and capable regional institutions.

C. THE ROLE OF REGIONAL DEVELOPMENT AGENCIES

68. The role of Regional Development Agencies is well recognized in all European countries as fundamental contributor to co-operation and partnership among local actors, either companies or social organizations. In most cases, such agencies serve as an intermediary between local/regional institutions and companies and sometimes help to manage specific incentives or instruments. In effect they are meant to act as catalysts to the development process. Because of their proximity with local economic or social players, regional development agencies often play a critical role in the implementation of policy measures and influence the policy-making process.

69. However, there is no unique type of Development Agency. There are numerous and heterogeneous types of organizations: either public or private legal entities, profit or non-profit organizations, specialized on few services, or covering a general set of tasks. Also relations with central and regional institutions may vary, depending on the specific tasks assigned to them. Their names also differ greatly among regions and countries, as well as their origins. For such a diverse set of cases, it is not possible to define a single standardized example, but two main types can be recognized.

70. First, those that result from a state strategy based on the need to have a powerful national and regional institution focused on wider tasks, either in terms of policy guidance and/or delivery of services both at central and local level. Usually these types of agencies exist in those countries that are characterized by a certain degree of centralization and/or are relatively small in size. In these cases, the agencies are public organizations and they can be totally or partially financed by the government or ministry (depending on which ministry is concerned). Most of these agencies are active partners in the Structural Funds programs and actions. These cases include:

- The Irish agencies, which consist of specialized public agencies like the Irish Development Agency, for FDI and attractiveness of foreign companies, promotion of the regions, and up-grading of labor; and Forbait for the indigenous companies and local development support, including also SMEs, market operations, transfer of technology. The agencies in Ireland vary also region by region, since they do not all cover the whole territory.

- The Scottish Enterprises Agency that operates through a network of Local Enterprises Companies, providing policy suggestion as well as operational matters like enterprise development, advice for FDI attraction, environmental problems and property development.

- The Welsh Development Agency that plays a great role for FDI attractiveness into the region, provides support services for local enterprises, and actively promotes the territory.

- The French Délégation a l'Aménagement du Territoire et a l'Action Régionale (DATAR) corresponds to a public agency as mentioned here. However, DATAR, is similar to this type of agency only for a part of its activity -- promoting foreign investments and supervising the Contract-Plan between the state and regions. Other tasks, like long-term policy advice and analysis for territorial planning were very centralized. Since decentralization and the increasing influence played by the regions, this role has weakened.

71. Second, there are those agencies that have local and regional origins and are a result of more bottom-up approach. They are in most of the cases private entities or regional, many as "association" or joint stock companies. Local/regional administrations, business organizations, trade unions, chambers of commerce, various NGOs are usually the shareholders. These agencies have very diverse approaches and profiles, but because of their direct linkages with the territory, are more focused on the specificities of their region.

72. Among the examples that correspond more to this kind of agencies are those in Italy, which has a very diversified range of agencies that provide general support to enterprises -- particularly SMEs -- or more specialized services, including acting as a financial intermediary between local banks and firms or managing special local funds for SMEs, or focused on particular aspects like innovation and technology transfer. The heterogeneity of the regions in Italy is a factor that has worked against the transfer of a single model from one region to another. However, the most successful agencies are located in the North and North-East of the country, in those regions where there are numerous "Industrial Districts", where the local productive systems have benefited from the actions of the Agencies for the diffusion of information, innovation and marketing. The regions in the South have very few active agencies and those that exist operate with difficulties and little effectiveness.

73. Spain, with its highly diversified regional conditions, has also developed a wide range of Agencies that play in some cases a very influential role in the policy making that

has been assigned to each region. The heterogeneity of these experiences, including also some countries that have not yet completely developed local agencies (like Portugal), show that much depends on the objectives assigned to them, the tasks that they have to fulfill in the territory, the historic relations that have developed with the local actors and their commitment together with their capacity building.

74. The financial bases on which regional agencies operate are diverse. When public funding is ensured, they have to respond also to the criteria for effectiveness in the implementation of the tasks assigned to them. However, most of the agencies do not have centralized public funds, but are either partially funded by local and regional administrations and/or private sources. In these latter cases, they have to raise their own resources in exchange for services. The double targets of being an entity that contributes to local development and being a body that needs to currently raise financing is not an easy task: contradictions between the two aims are not uncommon. These kinds of problems usually do not exist in the regions that are relatively well functioning and active, because of the wide opportunities that exist and also the capacity that the best agencies have to meet the demand for services in their region. The problems exist in the areas/regions that are depressed and where the agency has no capacity to promote initiatives. However, public funding for development agencies is shrinking (in Scotland the public funding for the agencies are under discussion for their possible partial reduction): more and more the agencies will be locally and regionally financed, applying the principle of proximity and involvement of local actors that take direct benefit from their services.

D. FOREIGN DIRECT INVESTMENT & FREE ENTERPRISE ZONES

75. Foreign Direct Investment (FDI) in many countries often plays an important role in transferring know how, improving management practices, diffusing technology and generally helping to strengthen the factors that support productivity gains. With increasing globalization, regions have become the focal point for FDI and policies for attracting investment have become pillars of many regional strategies. At the same time , the speed and mobility with which international resources move as a result of globalization also highlights the greater uncertainty of such investment and the efforts needed to remain a competitive investment destination.

76. From the perspective of the country receiving FDI, inward investments can ensure additional investment capacity, however, for a large country, the critical mass of needed investment cannot be met by foreign investment alone and strengthening of local capacities and strengthening of financing mechanisms to provide the needed capital, are usually necessary. Practice indicates that the multiplier effects of FDI are not automatic but depend on other conditions existing in the country or regions that may either be conducive to or impede the diffusion of FDI's effects into the economy. Typically the most significant contribution of FDI is technology transfer and transfer of know how, but this depends both on the quality of the investment and the absorption capacity and speed of local partners in adapting and learning from foreign investors. Inward investment can also contribute substantially to increased competition in the domestic economy. Indeed, the best multiplier effects from FDI are evident in those localities where there are clear

rules for competition and transparency so that domestic firms can identify the best strategy.

77. From the investor's perspective, a number of issues enter into the decision to invest or not. Two kinds of risk are typically taken into consideration: the country risk, determined by things such as the degree of political stability, legal rules and the enforcement of property rights, as well as the degree of criminality and security; and commercial risk, which is directly related to the to the sector branch of operation of the business and the conditions that affect the investment directly. The low cost of inputs is sometimes an important factor in the investor's decision, but more recently it has become clear that this also needs to be associated with things such as reduced transactions costs, a reliable legal framework, efficient and easy access to services and infrastructure and the capacity of local suppliers to respond to investors needs. These "quality of environment factors" are becoming increasingly important, and it is on these that the competitiveness of regions in attracting FDI is mostly focused. An additional factor that may influence an investor's decision is favorable fiscal treatment, such as special tax and tariff rates and other financial incentives that may reduce operating costs in the medium or long-term. Recent research, however, has suggested that these are becoming less important, since international investors typically have other, more effective mechanisms for managing costs.[9] The OECD found that in the early 1990s many states were substantially reducing the use of such incentives because they were not always effective in attracting capital and tended to lead to distortions, inequities and increased complexity.

78. The employment of special incentives, mainly related to tax breaks for corporate profits, free profits repatriation, substantial reductions in social charges for employment, abolition of tariff barriers, including imports duties, have been used in a number of countries in order to increase their ability to attract foreign direct investment. The primary reason to use free enterprise zones (also called special investment zones, priority development territories) is the creation of a "physical enclave" in the country in order to accelerate some process (foreign direct investment, financial flows, industrialization), to support increased exports, to facilitate the earning of foreign exchange, for restraining overall market liberalization, or for piloting a particular type of economic experiment. While these reasons cover a wide diversity of targets and conditions, in most of the countries that adopt such incentives, the long-term focus is development.

79. However, there are a number of fundamental problems with placing an emphasis on such mechanisms. The nature of special incentives in an enclave raises the problem of the linkages with the rest of the economy and the potential for increased duality and distortion. The questions of linkages is extremely important especially if the scope of the zone is large and aims to generate development. One issue is the extent to which intensive investment in an enterprise zone creates knock-on effects for other firms in the economy. Another issue is the extent to which the enterprise zone is really integrated with the domestic economy. If it is merely processing imports for re-export, it may have

[9] Sée Sofres (2000), Enquête sur la position du monde Européen des affaires a l'egard des règles internationales sur l'investissement. GD- Trade European Commission, Brussels. OECD (1990) Taxation and International Capital Flows. Paris, and OECD (1999) Foreign Direct Investment and Recovery in Southeast Asia; Centre for Cooperation with Non-Members.

a very limited impact on domestic development. There are also frequently issues with the transfer of technology to the rest of the economy and often anticipated benefits in upgrading skills do not materialize.

80. All the factors mentioned here underline the major concern that FEZs face: the problem of a "dual" economy – an enclave or enclaves linked to special incentives and arrangements and the rest of the economy, which does not have such benefits. It is due to the difficulty of creating and sustaining linkages that many FEZs have failed to reach the ambitious targets that national governments put forward.

81. The Cost and Benefits of FEZs can include the following:

- The cost for the creation of the FEZ material conditions are in most cases fairly high. Investments in infrastructure, facilities and more in general services (including premises) directly related to the enterprises needs are indispensable for creating the starting foundations for the FEZ's functioning. In the less successful cases that did not attract as much inward investment as expected, these initial investments overwhelm the investment capital return and related advantages that may have been expected, over the short to medium term, thus resulting in under-utilized assets.

- Reduced tax collection for the state or regional budgets may not always be covered by the expected benefits (export revenues, technology and skill transfer, additional investments etc.). Of course the size of lost fiscal revenue depends on the size of the tax base: in a poor and depressed area, the revenue collection would be anyway limited, taking also into account the possible sizeable shadow economy.

- FEZ's create room for discretionary treatment and lack of transparency. These in turn can lend themselves to an increase in corrupt activities in areas where normal rules do not apply and are not enforced.

- An increasing capacity for export as a result of an FEZ can contribute to a rise in foreign exchange revenues. It depends on the degree to which imports are needed as inputs to the export activities and also the extent to which export production is simply the result of assembling activity or the result of considerable processes (value-added) developed locally. The results of the net balance are often less bright than expected.

- The job-creation effects and the increase of the local demand are likely to occur if the size of the FEZ is large. Job-creation is often the main positive benefit that the FEZ may bring, especially in countries that suffer from unemployment.

82. A large number of countries have made use of FEZs . In the 1970s, there were ten countries that possessed such special zones. By the mid-1980s, some 46 countries had them. While some of these have been successful, such as China and Mauritius, success is typically associated with either historic background or overall conditions in the country. For example, China is a successful case but these zones are associated with the coastal regions where the British Empire set up trading arrangements in order to bring China's produce to the ports and they have a long memory of these arrangements.

Mauritius has had a successful FEZ, but its area covered the whole country, and therefore avoided the usual break of spatial and economic linkages between the FEZ and the rest of the country. In addition, Mauritius is politically stable, has an exceptional natural environment and maintains a strong government commitment to attracting foreign investors.

83. Although there have been some positive experiences with FEZs, the bulk of experience suggests that they are not the most effective instrument for addressing regional development. The following lessons can be taken from experience to date:

84. There is sometimes a naive belief that the FDI that may come to these special zones will solve structural problems in the country. In practice, the barriers to FDI attractiveness necessitate a more effective and sound reform and restructuring policy for the country as a whole, including improving market functioning, ensuring a stable and transparent legal framework and ensuring overall that the economic environment is one that promotes investment. It is misleading to expect that fiscal incentives will be able to solve a country's institutional and legal shortcomings.

85. The effectiveness of special fiscal incentives can be complicated by two main concerns: (i) it is not only the rate of fiscal burden itself that concerns the firms, but the political and policy stability that are behind the fiscal system in the country as a whole that can secure the investor's confidence; and (ii) the direct tax savings may conceal heavy transaction costs, due to the inefficiencies and deficiencies that exist in the local institutional and legal framework - in the country as a whole - thus affecting directly or indirectly also the FEZ (instead of the peculiar legal basis on which they usually operate). These two arguments suggest that the legitimacy of the FEZ lies more on the stability and quality of the host country as a whole, than on the isolated "guarantees" that are at the foundations of the FEZ, as an enclave (see Box 1).

86. In more conducive conditions, the ability to attract investment would not have only narrow sectoral targets, but wider scope for attracting quality investments, including investment in production and services that would contribute to the up-grading of the technology levels of the country. The capacity to induce multiplier effects depends on the conditions existing in the country. Fiscal incentives for FEZ may create a negative distortion in the allocation of investments, hindering the possible capital flow towards sectors and companies outside these "special regions" that could have better potential market perspectives.

87. Overall, the evidence suggests that FEZ's are not the appropriate response for addressing regional development issues. It is more effective to promote economic development by ensuring that the conditions are in place across the country for investment to earn good returns. Political and economic stability, clear rules of the game, enforcement of property rights, and transparency all contribute to such an environment. The benefits from special incentive regimes can easily be lost through reduced tax revenues, fragmentation in the economy and increased discretion and corruption. With increasing globalization, it is less appropriate to launch signals to international investors to come to limited territories within the country, than it is to improve the overall

conditions for investment attractiveness, thus showing a strong government commitment for going head with reforms in the country as a whole.

Box 1: Free Enterprise Zones and Priority Development Territories in Ukraine

The Government of Ukraine has authorized the establishment of 11 Special Economic Zones (SEZs) and 11 Priority Development Territories (PDTs). While there is a general law providing for the use of such zones, each zone is based on its own laws and the management arrangements may vary significantly. For example, the "Syvash" Zone in Crimea is run by a state company whose head is appointed by the President. The company performs the functions of the state body and those of a business entity. The special zone " Yavoriv", located in the Yavoriv raion in Lviv oblast, is governed by the Yavorivsky Raion Council and the Yavorivsky State Administration.

The functioning of SEZs and PDTs in Ukraine shows both positive developments and deficiencies. SEZs and PDTs have led to a revival of investment in some regions and have provided employment at higher than average salaries. Investments amounting to US$432 million have been attracted through the special zones, of which 50.3 percent was foreign investment. However, funds invested in special zones comprised only 17.9 percent of the direct foreign investments made in Ukraine in 2000. While more than 25 percent of the goods produced in the zone were exported, their share in the overall exports of Ukraine was only 1 percent.

The tax preferences (amounting to UAH 412 million) granted to the business entities in the special zones exceeded their flows to the budget, engendering a negative balance of UAH 117.3 million. Tax duties and arrears of these business entities consisted of UAH 35.6 million in arrears – UAH 26 to the State Budget and UAH 9.6 million to local budgets.

As a whole, the special zones have been unable to attract investment sufficient to meet the needs of economic restructuring. Some 98 percent of the total funds invested have gone into Donetska, Zakarpatyska and Lviv oblasts, while no activity has been observed in many PDTs and in 5 SEZs. In addition, investors have failed to meet in full the commitments they have made with the local self-government bodies.

Clearly some SEZs have generated some success by increasing investment and promoting employment, however, in the medium and long term regional development may be more effectively pursued by taking steps to improve the overall attractiveness of investment in Ukraine as a whole. This would include the development of a clear legal and regulatory environment for businesses, reducing the number of administrative obstacles and barriers for those wishing to start a business, as well as introducing transparent accounting and financial procedures. Supporting the development of the basic infrastructure required to enable the private sector is also critical. Overall, a sound policy environment will generate much more investment than medium-term fiscal incentives.

E. REGIONAL POLICY IN THE EU AND THE EXAMPLE OF POLAND

88. The role of European regional policy has had a substantial influence on individual countries with respect to both institutional decentralization and regional policy. The

compromises reached at every stage between "national policy" and "European policy" have not occurred smoothly. Member States' regional policy did not always comply with the European rules and the national institutional structures were not always appropriate for the management of the Structural Funds. Thus, many compromises, at different stages, have been found in many cases. There is an increasing trend of the European Commission to steer the Member States toward convergence in terms of a policy approach. This is also facilitated by the growing integration process underway among the European countries and by the stronger role that the European institutions will have in the future.

89. The most critical contributions from the European Union with respect to regional policy are as follows:

90. *The need for stronger institutional decentralization and the principle of subsidiarity.* The creation of regions as NUTS 2 in the European statistical nomenclature has been the core of the Structural Funds policy. Regions have the primary role of managing regional programs and promoting regional strategy. While the EU left the individual countries to develop their own specific institutional and legal system, as confirmed by the variety and degree of regionalization, the requirement of NUTS 2 entities has been a prerequisite that could not be avoided.

91. *Development of a strategic approach.* The necessity to work out an overall view of the structural problems of the country and define a National Strategy, on the basis of which to identify priority targets, is perhaps the most relevant contribution towards the improvement of the policy-making process. The main lesson is that regional problems have to be understood within a broader framework, taking into consideration all the factors in play – economic, but also social, financial, institutional - and to avoid treating each specific problem as isolated from the other components. This perspective suggests a more integrated approach among the different policies, sectoral and spatial. In the meantime, the long-term nature of regional imbalances requires an appropriate long-term strategy to coherently pursue the objective of reducing the gaps and improving regional economic performances.

92. *Support of a bottom-up approach involving local actors.* The principle of partnership has been considered one of the critical aspects with regard to successful policy implementation. Good co-operation among the different actors and in particular the active participation of social components, such as NGOs, entrepreneurial associations, local agencies, trade-unions, chambers of commerce, etc., have been identified as one of the key issues for creating better conditions for policy-making and implementation of targets, in particular for the objective of job-creation. Public – private partnership is suggested throughout, from the process of preparation of the national strategy to the implementation of the OP (Operational Programme) and measures. In the European Member States experience, lower results often correspond also to weak or low quality co-operation at the regional and local levels.

93. *Use of monitoring and evaluation (ex-ante, mid-term and ex-post) instruments to increase the effectiveness of policy implementation.* The monitoring and evaluation

techniques which have been, over time, improved and standardized by the Commission, have to cover both quantitative economic and financial indicators, as well as qualitative evaluation (in particular ex-post). These kinds of activities (achieved both in co-ordination between the member countries and the Commission, as well as only by the Commission, with the employment of external independent experts,) have an increasingly important role to play, in narrowing the inefficiency and lack of transparency in fund utilization, but also in identifying the possible causes of policy failures or inconsistencies among the different factors in play.

94. *Improving spending capacity.* The institutional capacity of the regions managing Structural Funds has been one of the preoccupations of the European Union. Inexperienced administration, lack of competency or capacity at regional levels often led to very critical situations, with failure to spend a large share of assigned funds. The lack of spending capacity is the result of both weak institutional capability, including low co-operation between private and public sectors, and non-comprehension of the scope and targets of regional measures and programs assigned to the funds.

95. *The additionality principle* is the other side of spending capacity. The recipient country/region is required to add its own contribution to that given by the Community. The criteria is not a simple "share of financing", but it is a spending component that should be "added" to projects, in principle, without which the EU program would not be implemented. This criteria is very difficult to measure but it aims at the creation of those "additional" capacities (additional to those projects already planned independently) that the region (and the state) would not able to fulfill alone. For the application of this principle the country needs to mobilize state or regional but also private resources. The involvement of private investors is increasingly a necessity not only for avoiding the development of a "culture of assistance," coming from the top (either the State or the Commission) but also for increasing the effectiveness of the projects as well as the need for balancing the limited public resources.

96. For the countries in transition, hoping to accede to the European Union (such as Poland), these lessons manifest themselves in the following requirements:

- Existence of an appropriate institutional organization able to manage and co-ordinate regional policy.
- The creation of new entities as NUTS 2 level able to become the main players in the territory for regional development strategy and management.
- Development of a national strategy for the whole country, defining the priorities targets as guideline for the specific regional and sectoral programs.
- Initiation of identification of future regional programs.
- Improvements in institution-building and capacity to manage European funds and spending capacity, both centrally and locally.

- Mobilization of regional and local institutions, social organizations and local people on the base of the partnership principle at different levels.

97. Poland is a good example of a country in transition that has managed to address the above requirements in a relatively short period of time. The Government has vested the responsibility for regional development in the medium term to the Ministry of Regional Development and Construction. This Ministry is supplemented by the Centre for Strategic Studies, which provides analysis and proposals for a long-term strategy. In addition, the Policy Agency for Regional Development has played a catalytic role in sustaining regional development programs and contributing to the policy debate about regionalization and decentralization. The rapid and impressive growth of locally-based regional agencies, which are organized into a network, has contributed actively to the support of local entrepreneurs, services to enterprises and participating in the elaboration of policy at the regional level.

98. Following a long debate about the identification of new territorial entities, 16 regions have been created corresponding to the NUTS 2 nomenclature. These new regions are close to the average size in Europe. They are responsible for defining regional strategy and economic development in their territories. They have some areas of shared responsibility with the Government in public safety, standards and conformity of laws. At present, the local component of their budgets remains very limited (less than 20 percent) and they rely on state transfers for the bulk of their resources.

99. The identification of a regional strategy for Poland is represented by the elaboration of the preliminary National Development Plan 2000-2002 made by the Regional Development Ministry and Construction in 1999. On the basis of this first step, the National Strategy for Regional Development 2000-2006 (NSRD) was elaborated in 2001. It defines targets, priorities and criteria for selecting areas as well as the principles of state financial support for the Voivodship Programmes. The NSRD identifies the direction and levels of spending for the State Budget, including also sectoral Ministries and other funds that have some linkages with the Regional Programmes.

100. The strategic long-term goals, put forward by the NSRD, that are the base for harmonizing the programming in Poland with the EU programming, are the following:

- Modernization of infrastructure for facilitating competitiveness of the regions and fighting isolation.

- Improving regional competitiveness by improving the quality of the labor market.

- Efficient administration at regional and local levels, together with a good strategy for the promotion of regions.

- Improve the attractiveness of the regions for foreign investors.

- Restructuring and diversification of regions affected by industrial decline (coal, steel, shipbuilding).

- SME development as a powerful instrument to promote the local economy.

- Address the problems of the regions lagging behind, launching revitalization policies and SME development.

- Encouraging the development of international co-operation among regions, facilitating also the creation of network among enterprises.

101. Through the development of the agencies cited above and the process of strategy development efforts area also being made to strengthen capacity and to mobilize local resources.

102. This section has highlighted a broad range of country experiences and examples with particular tools of regional development in order to highlight issues that are of relevance to Ukraine's efforts. With these in mind, the next section focuses on recommendations and proposals for moving forward with regional development in Ukraine.

VI. CONCLUSIONS AND POLICY RECOMMENDATIONS

103. The last decade in Ukraine has seen major economic upheaval. The forces shaping economic activity have changed drastically and moving toward a market-based economy has required fundamental changes in the use of resources. It is no wonder that the ability of some regions to respond to these drastic changes has varied and that regional policy issues have come to the fore. The return to growth in Ukraine creates a better environment than in the past for addressing regional development issues, however, even in the best of circumstances regional policy remains a very difficult and complex area. This note has considered the evolving experience in Ukraine and looked at lessons from other countries in order to spur thinking about how best to move forward in the development of regional policy.

104. In the context of a transition economy, accurately measuring the changes that are underway is difficult. The statistical system itself is in transition and there are a wide range of activities that go unrecorded. The official statistics suggest that disparities among the regions have increased since the mid-1990s in Ukraine. The data suggest that many of the regions in the west that focus on heavy industry, plus Kyiv, continue to have the strongest economic performance. In contrast, regions in the far west of the country have the lowest per capita GVA. The discussion of regional disparities often focuses on what measures need to be taken to overcome these differences in regional growth, however, experience across a wide range of countries suggests that these disparities may never be fully overcome. On top of this, there often may be significant disparities *within* regions, between cities and rural areas. Experience suggests that it is important to balance carefully the goal of reducing disparities against the effort made to support dynamic economic growth.

105. Determining the factors that explain why one region does well and another does not is also difficult. The results of the statistical analysis are not surprising in that they show a strong relationship between existing capital stock and gross value added per capita – those regions which have had more investment tend to do better. Telecommunications and transport infrastructure also help to explain which regions have done better, as does FDI. However, almost 20 percent of GVA per capita was not explained by the classical factors suggesting that other things are at work. This unexplained component reflects the "productivity" with which a region uses its available resources – it may reflect greater efficiency in processes or intangible factors such as the degree of economic linkages and trust between individuals. Over time, approaches to regional policy have increasingly focused on creating a climate that is attractive for investors, but also in strengthening many of the factors that are thought to contribute to improved productivity.

106. After 30 years experience, there have been significant shifts in how regional policy is practiced in most countries. This is in part a response to changing country circumstances, but it has also been generated by increasing globalization and all its implications (faster flow of information and technology, lower transport costs, increasing competitiveness). Whereas regional policy was once focused largely on top-down interventions in order to save specific sectors, it is now largely centered on helping

regions to create an environment in which economic activity can prosper. There are many aspects to such an environment including, investment capacity, human resources, technology, institutions and social capital (see Figure 6). Improvements in these areas build on each other and lead to synergies that can help to propel regions forward.

107. The experiences of particular countries and with particular issues also offer valuable lessons:

- In France, the experience over time suggests that "contract-plans" between the center and the region can be a useful device, but their effectiveness increases directly with the degree to which the region is responsible for the plan and the degree to which there is extensive consultation within the region on these issues. Monitoring and evaluation is also critical for their success.

- In Italy, the experience with regional policy demonstrates that pouring money into a depressed area (the Mezzagiorno) is not sufficient to address regional disparities. Italy's experience does show, however, the degree to which effective support for small and medium enterprises can transform areas that may have appeared in the past to have limited economic prospects. It highlights as well the extent to which regions influence their own development prospects.

- A number of countries have had experiences with regional development agencies (RDAs). There are a wide variety of RDAs with great variation in objectives, structure and means of financing. At the same time, the experience with RDA's has also been mixed – some have worked well, some have not. A key factor in the effectiveness of RDAs is the extent to which their objectives are limited and focused. The appropriate mechanisms for financing an RDA depends on the objective, there are pluses and minuses to both public and private funding.

- There has also been a great deal of experience related to efforts to attract FDI and particularly, free enterprise zones. Experience suggests that countries can often support regional development more effectively by making efforts to improve the overall climate for investment in the country. Rather than generating broad economic growth, such zones often lead to dualistic and distorted economic structures. They also provide a discretionary tool that can lead to reduced transparency and increased corruption.

- Poland's experience and the requirements of Accession to the EU also provide some important lessons and insights with respect to regional policy. Institutions to manage and coordinate regional policy are very important. Consideration needs to be given to the appropriate size of the territorial unit so that policies can be effectively implemented. There is a need for a national strategy that defines priority targets and sets guidelines for specific regional and sectoral programs. Mobilization of regional and local institutions and social institutions are an important element of creating effective partnerships at different levels.

108. This international experience is highly relevant for Ukraine as it moves forward in development of regional policy. However, before considering policy recommendations for the future it is useful to consider some important lessons from the experience in Ukraine to date. A number of efforts to address regional development policy have been made in the past, but none have been successful so far. Some of the potential explanations for the lack of effectiveness are as follows:

- *Weak framework for setting objectives and priorities.* The proposed approaches to regional development in the early and mid-1990s were focused mostly on obtaining resources for particular initiatives rather than as a comprehensive approach to addressing regional development needs. Because they were ad hoc approaches coming from particular groups or regions, there was neither a full consensus nor support for moving forward.

- *No fiscal parameters.* Programs for regional development have typically been established without any consideration of working within a fiscal envelope. The programs have elaborated multiple objectives and usually multiple projects, that were either unaffordable or unsustainable. At the same time, the preparation of these extensive programs also used up significant resources to no avail.

- *Ad hoc allocation of investment.* State investment policy has had a substantial influence on regional development and yet there is no transparent mechanism through which these investment resources are allocated. In addition, the budget process does not make the link between investments in the capital or development budget and the associated operations and maintenance costs that should be included in the current budget.

- *Reliance on substantial state intervention.* Past regional policies in Ukraine have typically focused on restoring old industries, promoting heavy investment, meeting social costs in ways that involve heavy state intervention. They have not typically taken a strategic perspective looking forward to the areas in which Ukraine will be competitive and create an environment in order to support the creation of small and medium enterprises and a service sector than can both be important sources of growth in the future.

- *Top-down versus bottom-up.* While there are a wide number of efforts being developed at the regional level in order to support regional development, regional policy is often perceived as something that occurs from the top down. The central government provides resources for investment or special incentives and has great influence on what will happen in each region.

109. The current positive economic situation in Ukraine offers an opportunity to revisit and refine regional policy in Ukraine. In order to build a long-term base for regional development and to improve the effectiveness of policy in the short term, there are a number of steps to be taken:

110. ***Evaluate the appropriate roles of different actors in regional policy.*** There is a need to clarify who is responsible for what in the development and implementation of regional policy. Current practice in Ukraine has a wide range of actors undertaking many activities with very little clarity. The central government's role should focus on: (i) setting priority targets; (ii) effective management of public spending; (iii) supporting the development of key national infrastructure; (iv) creating a positive investment climate across the country as a whole; and (v) addressing key distributional issues. There also needs to be improved coordination among sectoral ministries and other parts of the Government to evaluate the implications of specific sectoral policies(such as education policy, industrial policy and competition policy) and to make sure there is consistency across government. The regions themselves have a role to play in identifying potential sources of economic activity and growth, as well as strengthening the factors that have proven to be important to strong regional development (human resources, investment capacity, ability to absorb resources, institutions, governance and social capital). Through extensive consultation and development of regional, local and public-private partnerships, regions should develop a strategy for moving towards economic growth. It is important to push regions to develop their own solution as opposed to relying on the central government as the catalyst for change. Mechanisms for coordinating between the center and the regions also need to be improved.

111. ***Strengthen the Concept of Regional Policy.*** The Concept of Regional Policy highlights a wide range of activities to be addressed and yet it lacks a coherent overall framework. In parts it relies on the notion that continued support of heavy enterprises at the expense of other areas is a sound basis for future growth. This is based on the notion that these are the growth areas, but in fact it is more a reflection of the status quo than it is of an effective plan for the future. In fact, regions with an environment that supports the development of SMEs and the service sector may have better prospects. The Concept might more clearly specify the broad targets of the Government's regional policy and the particular aspects of the central government's role. It should set out guidelines for the development of regional programs which focus on identifying areas of growth, support the development of horizontal linkages, create a positive environment for investment and how monitoring and evaluation will be undertaken. Development of the National Strategy for Regional Development should focus on these issues.

112. ***Develop administrative structures over time, but don't tie regional development entirely to these structures.*** There is clearly a need over time to consider whether the current administrative structure is appropriately supportive of regional development. However, there is no need to lock in stone the boundaries of a territory that might effectively pursue development. Different aspects of regional development can occur in different boundaries. In some countries, certain development efforts might cover more than one region (Italy's northeast). It is also possible that micro regions can develop as a dynamic source of growth, as is the case in Wodj in Poland or in the small micro regions of Hungary.

113. ***Address issues related to disparities in basic services through equalization transfers and safety nets.*** Rather than creating special intervention mechanisms for meeting the needs of individuals in depressed or backwards areas, these needs should be

addressed through the system of equalization transfers applied by the central government and oblasts and through the national safety net system. If appropriately designed, such an equalization mechanism not only helps to address the disparities between regions, but also the disparities within regions, such as between cities and rural areas. Such systems are meant to assure that a basic level of services is provided in an equivalent fashion across all regions.

114. ***Strengthen the financial accountability and then the ability of regions to raise revenues.*** Currently regions have little financial accountability and no authority to raise revenues. To the extent that they are meant to show initiative in the design and implementation of regional programs, it will be necessary that their financial activities are clear and transparent, that all resources are fully part of the budget, and that it is possible to hold them accountable. While regional development can be organized around purely administrative and coordinating structures, the lack of a revenue source other than transfers from the central government, limits the capacity of the regions to pursue their own initiatives.

115. ***Create a transparent system of allocation for public investment that focuses on key national infrastructure.*** Public investment has played an important role in those regions that have demonstrated better performance. At the same time it is clear that many of the poorer regions have received little investment. The basis for the allocation of investment of funds needs to be made transparent and objective. Transparent procurement can also improve the effectiveness of investment and create a better investment environment more generally. While public investment should focus on national infrastructure, there may be a need for specific transfer mechanisms to support investments at the regional level. While the "contract-plan" approach is one method of approaching this, it is important that: (i) the plans be generated by the region with extensive consultation; (ii) the overall amount allocated to such a transfer mechanism is clearly specified; and (iii) there are very clear criteria for the allocation of such resources.

116. ***Support efforts to improve the investment climate overall as opposed to pursuing investment in enclaves.*** The ability to attract investment, both local and external, is essential for regional development. The most effective way to do this is to improve the environment for investment. This involves reducing the discretionary influence of government, enforcing rules and regulations in a systematic way, reducing the cost of doing business, and maintaining a stable economic and political environment. Ukraine relies on both Free Economic Zones and Priority Development Territories to promote increased investment. The evidence suggests, however, that in most of these areas investments have not occurred and in those where investment has taken place, much of the investment occurred before the Free Economic Zone was created. The economic activity induced by such zones is not of sufficient magnitude to offset the distortions, loss of fiscal resources and potential for corruption.

117. ***Pursue policies that help to develop small and medium enterprises.*** As the Italian example shows, small and medium enterprises can be a source of growth in areas that do not have a history of industrial development. In particular, small and medium enterprises can help to strengthen the service sector which is an important source of

growth in economies that are growing rapidly. Both SMEs and services will be needed to help Ukraine sustain and diversify the growth that it has achieved in the past year. Policies that help to reduce the costs of doing business and create a level playing field between SMEs and larger existing companies are important tools. In addition, efforts to provide training, assistance in technology and innovation and in entrepreneurship more generally may be important tools to help support the creation of SMEs. Special funds that help SMEs meet start up costs can also be useful tools.

118. ***Support Regional Development Agencies that have been created from the bottom up and not imposed from the top down.*** RDAs can be an important source of information, technology and guidance to those pursuing development within a region. Rather than impose a uniform structure from structure of agencies from the top, it is likely to be more effective to support agencies that are developed through regional initiative. Such agencies are likely to be more focused on the specific needs of a given region and to have focused objectives.

119. ***Regions need to set out their own programs for creating an environment that will support growth and development.*** Probably the greatest lesson of the experience to date with regional development policy is that the regions themselves play an integral part in the effectiveness of their own development – they are more than just mere recipients of regional policy. Regions need to work to build their human resources, strengthen their investment capacity, and build the institutions, governance and social capital that helps to support development. National policies can help to support this but it is largely up to the initiative of the regions.

120. These policy recommendations highlight a few steps that the government might take to make regional policy more effective. While supporting regional development is a complex proposition, the World Bank stands ready to help support the Government in pursuing more effective policies. There are a number of ways in which the Bank is already supporting regional development, though efforts to improve the environment for private sector development and to mitigate the social costs of mine closures. Efforts to support public administration reform as well as improved budgetary processes and intergovernmental relations might also help to strengthen regional policy. Other possibilities include the provision of assistance in developing the National Strategy for Regional Development, as well as assisting some regions on a pilot basis in the development of their own strategies.

Annex 1: Regional Inequalities Measured by GVA per capita in Constant and Current Prices 1990-2000

Oblast	GVA per capita in current prices, country level = 100			GVA per capita in constant prices, country level = 100			GVA per capita in constant prices, index			GVA per capita in constant prices, annual average rate of growth		
	1990	1995	2000	1990	1995	2000	1995/90	2000/95	2000/90	1995/90	2000/95	2000/90
AR Crimea	65.6	71.2	82.1	87.1	75.5	85.6	**0.304**	1.130	0.344	**-21.2**	2.5	-10.1
Vinytska	88.6	84.9	90.6	83.9	88.0	93.1	0.368	1.053	0.387	-18.1	1.0	-9.0
Volynska	85.6	68.5	73.0	62.8	71.6	75.3	0.400	1.048	0.419	-16.8	0.9	-8.3
Dnipropetrovska	120.9	124.9	133.3	121.0	119.7	126.1	0.347	1.049	0.364	-19.1	1.0	-9.6
Donetska	112.5	121.0	114.7	118.9	116.5	108.6	0.344	0.928	0.319	-19.2	-1.5	-10.8
Zhitomirska	91.4	90.4	74.6	90.7	94.7	76.8	0.366	0.807	0.296	-18.2	-4.2	-11.5
Zakarpatska	**57.1**	**55.4**	57.3	**61.3**	**59.3**	60.0	0.339	1.009	0.342	-19.4	0.2	-10.2
Zaporizhska	139.5	133.1	159.4	120.3	125.0	154.2	0.364	1.229	0.448	-18.3	4.2	-7.7
Ivano-Frankivska	77.7	74.1	84.5	77.9	76.2	86.7	0.343	1.133	0.389	-19.3	2.5	-9.0
Kyivska	115.3	117.3	113.9	118.9	120.8	116.1	0.356	0.958	0.341	-18.7	-0.9	-10.2
Kirovogradska	91.7	76.9	80.9	71.9	80.3	83.9	0.392	1.041	0.408	-17.1	0.8	-8.6
Luganska	83.1	90.7	83.3	92.2	89.7	79.8	0.341	0.886	0.302	-19.4	-2.4	-11.3
Lvivska	74.2	81.3	68.6	89.3	83.1	69.7	0.327	0.835	0.273	-20.1	-3.5	-12.2
Mykolaivska	102.4	95.2	101.8	93.2	95.9	103.3	0.361	1.072	0.387	-18.4	1.4	-9.1
Odeska	81.3	100.5	89.2	119.1	107.3	92.1	0.316	0.855	**0.270**	-20.6	-3.1	**-12.3**
Poltavska	129.9	125.5	110.5	122.3	125.6	107.6	0.360	0.853	0.307	-18.5	-3.1	-11.1
Rivnenska	102.2	86.4	70.4	79.2	86.4	70.6	0.383	0.814	0.311	-17.5	-4.0	-11.0
Sumska	108.6	101.8	87.1	96.5	102.8	85.7	0.374	0.830	0.310	-17.9	-3.7	-11.0
Ternopilska	89.7	71.7	55.9	63.8	74.0	57.4	**0.407**	0.773	0.314	**-16.5**	-5.0	-10.9
Kharkivska	92.2	104.3	112.6	110.0	105.6	114.3	0.337	1.078	0.363	-19.6	1.5	-9.6
Khersonska	84.0	77.7	66.0	81.3	82.0	68.1	0.354	0.828	0.293	-18.8	-3.7	-11.6
Khmelnitska	100.8	91.1	78.0	86.5	92.8	79.2	0.376	0.850	0.320	-17.8	-3.2	-10.8
Cherkaska	104.4	100.3	89.8	100.6	104.2	91.0	0.363	0.870	0.316	-18.3	-2.7	-10.9
Chernivetska	81.6	68.5	**52.2**	63.8	71.5	**53.7**	0.393	**0.748**	0.294	-17.0	**-5.6**	-11.5
Chernigivska	105.4	94.6	80.1	86.0	97.5	79.8	0.398	0.815	0.324	-16.8	-4.0	-10.7
city of Kiev	**148.9**	**144.3**	**194.4**	**130.0**	**131.2**	**203.5**	0.354	**1.545**	**0.547**	-18.8	**9.1**	**-5.9**
Ukraine	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**0.351**	**0.996**	**0.349**	**-18.9**	**-0.1**	**-10.0**
Maximum	148.9	144.3	194.4	130.0	131.2	203.5	0.407	1.545	0.547	-16.5	9.1	-5.9
Minimum	57.1	55.4	52.2	61.3	59.3	53.7	0.304	0.748	0.270	-21.2	-5.6	-12.3
Distance	91.8	88.8	142.2	68.8	71.9	149.8	0.1	0.8	0.3			
Max to min	2.6	2.6	3.7	2.1	2.2	3.8	1.3	2.1	2.0			
Coeff.of variability	0.218	0.234	0.340	0.220	0.201	0.336	0.070	0.180	0.174			
Williamson coeff.	0.221	0.225	0.331	0.199	0.190	0.330	0.024	0.178	0.063			

Source: A.B.Czyzewski , Regional Inequalities in the Ukrainian Economy: Measurement and Analysis. Background paper.

Annex 2: Correlation Matrix for Explanatory Variables

Matrix of correlation coefficients of variables likely to explain development level (GVAP'2000 per capita)

	GVAP'00 p.c. UAH	*Investment Stock 1995-2000 p.c.*	*Employment/population'00*	*Students/ popul'00*	*Agr.share' 98*	*"Old.ind". share'98*	*Serv.share'98*	*GVA.div (higher-better)*	*FDI'00 pc USD*	*99'Activity of local authorities (grade)*	*Market infratsructure'98*	*Transport infrastructure'98*	*Telecommunication infrastructure'98*	*Infrastructure development'98*
GVAP'00 p.c. UAH	1.000													
Investment Stock 1995-2000 p.c.	0.871	1.000												
Employment/population'00	0.658	0.538	1.000											
Students/popul'00	0.609	0.581	0.457	1.000										
Agr.share'98	0.729	0.708	0.531	0.848	1.000									
"Old.ind".share'98	-0.431	-0.436	-0.209	-0.009	-0.026	1.000								
Serv.share'98	0.011	-0.020	0.109	0.507	0.507	0.546	1.000							
GVA.div (higher-better)	-0.297	-0.201	-0.392	-0.432	-0.560	-0.445	-0.385	1.000						
FDI'00 pc USD	0.754	0.772	0.513	0.719	0.902	-0.005	0.509	-0.421	1.000					
99'Activity of local authorities (grade)	0.556	0.602	0.521	0.636	0.637	-0.236	0.255	-0.306	0.575	1.000				
Market infratsructure'00	0.484	0.505	0.449	0.442	0.436	-0.253	0.405	-0.162	0.516	0.679	1.000			
Transport infrastructure'00	0.350	0.321	0.439	0.291	0.266	-0.227	0.104	-0.422	0.202	0.664	0.666	1.000		
Telecommunication infrastructure'00	0.747	0.706	0.570	0.897	0.947	-0.079	0.495	-0.499	0.855	0.648	0.481	0.335	1.000	
Infrastructure development'00	0.709	0.687	0.614	0.763	0.783	-0.204	0.475	-0.450	0.749	0.808	0.847	0.703	0.848	1.000