ANNEX 1

of the Commission Implementing Decision on the Annual Action Programme 2013 in favour of Ukraine

Action Fiche for the Sector Policy Support Programme Support to Ukraine's Regional Policy

1. IDENTIFICATION

Title/Number	Sector Policy Support Programme - Support to Ukraine's Regional Policy CRIS number: ENPI/2013/024-517		
Total cost	Total amount of EU budget contribution : EUR 55,000,000, of which: EUR 50,000,000 for budget support EUR 5,000,000 for complementary support		
Budget support			
Aid method / Method of implementation	Direct (centralised) management Sector Reform Contract		
Type of aid code	A02 – Sector Budget Support	Markers	BSAR
DAC-code	43040	Sector	Rural/Regional development
Complementary support			
Aid method / Method of implementation	Direct centralised management – grants – call for proposal procurement of services		
DAC-code	43040	Sector	Rural/Regional development

2. RATIONALE AND COUNTRY CONTEXT

2.1. Summary of the action and its objectives

Regional and local development will be supported with a Sector Budget Support to Ukraine's Regional Policy. The budget support will provide Ukraine with additional financial resources to implement the State Regional Development Strategy 2020 which is currently under elaboration and expected to be finalized and adopted by the Government before the end of 2013. The draft strategy defines three strategic objectives:

1. Improving competitiveness of regions;

2. Territorial social and economic integration;
3. Effective State Governance of Regional Development.

2.2. Country context

2.2.1. Main challenges towards poverty reduction/inclusive and sustainable growth

From 2000 to 2007, Ukraine's economic performance was strong and poverty decreased substantially, but the economic crisis hit Ukraine hard in late 2008. After experiencing one of the sharpest downturns in the region in 2009, real GDP growth reached 4.2% in 2010 and 5.2% in 2011, helped by export-oriented industries, particularly steel, but increasingly also by domestic demand. In 2012, however, Ukraine's economy was affected by a negative global environment as well as by a weak investment climate, and real GDP growth slowed to only 0.2% year on year (y/y). In the absence of a strong global economic recovery leading to higher external demand, real growth in 2013 is expected to remain sluggish between – 1 and - 2.5%.

Ukraine scored 76th out of 187 in the 2011 Human Development Index (HDI), in the group of High Human Development. Inequality remains a major problem in Ukraine. Ukraine's per-capita income is about USD 3,600, or 10% of the EU level.

2.2.2. Fundamental values

Ukraine presents a mixed picture of developments on deep and sustainable democracy. Recent positive developments in the areas of legal reform and freedom of association have been overshadowed by selective justice, slow progress in critical reforms, a high level of corruption and the conduct of the parliamentary elections showing deterioration from previously set standards.

However, despite backsliding in several areas, Ukraine remains broadly committed to the protection and promotion of common fundamental values of democracy, human rights and the rule of law. The citizens of Ukraine have continuously shown their attachment to a democratic and pluralistic society, and the Ukrainian authorities should step up their efforts to strengthen democracy and pluralism.

The overall country's adherence to fundamental values is further reviewed as part of the enclosed risk assessment framework.

2.3. Eligibility for budget support

2.3.1. Public policy

The current Ukrainian system of regional development can be characterized as rather fragmented and ineffective. A top-down approach with too many inconsistent and uncoordinated policies and strategies elaborated and not always ever implemented still prevails.[1]

---

[1] To be noted that the government of Ukraine does not claim to have a well defined sector policy. The updated State Regional Development Strategy as of 16.11.2011 formulates: "low efficiency of state management of regional development which is caused by: underestimation of regional policy as an integral part of socio-economic policy, unsatisfactory regulatory framework of state regional policy (....); unsystematic, fragmented use of certain legislative instruments to promote regional development; lack of a unified system of strategic

In 2005, the *State Regional Development Strategy until 2015* was approved as the main strategic document for regional development[2]. The strategy was slightly updated on 16 November 2011. This strategy links legislation supporting and regulating regional policy, including a law on "*Stimulation of Regional Development*". It establishes as its overall objective the creation of an enabling environment for regions to become more competitive and to realize sustainable growth. However, the strategy lacks a clear operational programme for its implementation and is not directly linked to the budget. All Ukrainian regions have adopted regional strategies, but as is the case at the national level, linkages between budgetary allocations and concrete regional development actions are generally weak.

The Ukrainian Government has expressed a strong interest in approximating its policy to EU Regional Policy. In various political declarations and decisions, President Yanukovych has instructed the Government to develop a programme to reform the "management system for regional development".

One of the mandatory elements of this reform, the State Regional Development Fund, was established on 12 January 2012 with the Law № 4318-VI Amendment of the law to the Budget code of Ukraine and some other legal acts of Ukraine. A draft Law on Fundamentals of State Regional Policy, elaborated with the support of EU technical assistance, is under consideration by the Government of Ukraine. The State Regional Development Strategy until 2015, already approved in 2005, was updated on 16.11.2011. A new State Regional Development Strategy until 2020 is currently under development and will be supplemented with a Plan of Implementation. The initial deadline for approval of the strategy, set on 31 December 2012, was extended to December 2013.[3]

Within the policy dialogue with the EU Delegation, the Ministry of Economic Development and Trade elaborated a roadmap for developing the strategy. A draft State Regional Development Strategy until 2020 was submitted in June 2012. Furthermore, the Minister informed the EU Delegation to Ukraine in an official letter in June 2013 that the Ministry plans to submit the State Regional Development Programme 2020 to the Cabinet of Ministers of Ukraine at the end of August 2013 for approval. The draft strategy defines three strategic objectives, namely: improving competitiveness of regions; territorial social and economic integration; effective state governance of regional development. The Ministry at various occasions expressed its commitment to improve the draft strategy in close cooperation with Ukrainian stakeholders as well as with the EU Delegation and EU technical assistance.

Therefore, it can be concluded that a well-defined sector policy is in the process of being developed. The main conceptual documents currently in place, a concept of State Regional Policy (2001) and the State Regional Development Strategy until 2015 (2006), define objectives to a certain degree but lack implementation mechanisms. However, in 2012 and 2013, clear progress has been made in the overall Regional Development framework, i.e. the

---

planning and coordination mechanism of the strategic priorities of States and regions; imperfect administrative-territorial structure (…)". In the 2012 Annual Address to the Parliament, the President criticizes the current Regional Policy system as "critically non effective" as most of the strategic documents of the regions have a "solely declarative character".

[2] The strategy will expire before the sector policy support programme will commence.

[3] The reason for this request was that the Ministry intended to make use of Technical Assistance under the EU financed programme "Support to Ukraine's Regional Development Programme", launched in January 2013. The new deadline is mentioned in the National Annual Action Plan 2013 of the Economic Reform Programme of the President.

launch of the State Regional Development Fund and the drafting of the previously mentioned strategy to 2020.

However, some additional efforts must be implemented to consolidate the policy and meet the eligibility criterion for budget support. The following conditions shall apply:

- New State Regional Development Strategy until 2020 adopted in 2013, including an improved performance assessment mechanism with annual targets;
- Defined Regional Development framework through the adoption of the Law on Fundamentals of State Regional Policy or amendments to regional development legislation;
- Effective coordination mechanism in place, including a structured consultation procedure with regional development stakeholders (national and regional level, including civil society);
- Full transparency and oversight of the budget for regional development, including State Regional Development Fund and subventions.

Sector Budget

There is neither an overall Medium Term Fiscal Framework (MTFF) nor a Medium Term Expenditure Framework (MTEF) for the regional and local development sector. Funds are allocated through the annual state budget. There are two main sources of funding for Regional Development, the *State Regional Development Fund* and *subventions related to Regional Development*.

The *State Regional Development Fund* provides the equivalent of 1% of the revenues of the general annual budget to Regional Development. 70% of the resources of the Fund shall be distributed among regions in proportion to their size of their population. The remaining 30% of resources shall be distributed among regions with a GDP less than 75% of Ukrainian average, also according to their size of population.

A main advantage of the fund is that a clear mechanism for distribution of funds to the regions has been established. Further, regions are in the position to initiate projects and propose them for financing to the central state. However, the Fund is limited in its scope of activities, as only construction (works) projects are eligible actions. In 2012, the fund spent UAH 1.6 Billion, mainly on small social and engineering infrastructure (such as repairing and construction of schools, hospitals and other objects of social infrastructure as well as gasification of rural areas and repairing/constructing of sewage systems).

The amount foreseen in the state budget for the State Regional Development Fund in 2013 is 27.4 % of the amount stipulated in the law on Budget Code. Instead of an equivalent 1% of the revenues of the general part of the budget (approximately UAH 3.6 billion) only UAH 0.987 billion were actually allocated.[4]

The financial control of the funds is implemented at the level of Oblast State Administration (regional government) and at the level of specific projects. As all projects are targeted at construction/repairing of certain infrastructure, the financial and performance control are implemented according to construction works procedures approved in the Ukrainian legislation. The State Regional Development Fund is subject to audit by the Accounting

[4] In 2012 the fund allocated 40% of the amount fixed in the budget code (1.14 billion UAH instead of 2.9 billion UAH).

Chamber of Ukraine that issues audit reports on an annual basis; audits for 2012 are not yet available.

In addition to the fund, the general budget continues to fund regional development activities through subventions. The system is rather complex and opaque, without clear links to the State Strategy. The Ministry of Economic Development and Trade has expressed the intention to integrate all existing budget lines devoted to regional policy into the State Regional Development Fund. Such a decision would allow a better matching between financial resources and strategic documents.

In 2013 the Government introduced a new mechanism of loan guarantees for financing both sectoral (top-down) and local (at the level of urban municipalities) development projects. The President of Ukraine (in June 2013) informed that it will generate projects worth approximately UAH 50 billion (EUR 4.74 billion). The mechanism allows for partial and full reimbursement of interest as well as partial and full reimbursement of loans.

Institutional Capacity

The main beneficiary of this Sector Policy Support Programme (SPSP), the Ministry of Economic Development and Trade, has demonstrated a good commitment to the reforms to be undertaken, a vision of future steps, and good co-operation with the EU Delegation and EU-funded assistance.

However, additional efforts have to be taken to raise institutional capacity of other stakeholders, i.e. on the regional and local level. Regional and, especially, local administrations face an extremely narrow income base and lack powers to expand it. As a result, they have been heavily dependant on transfers from the central level and ended up distributing delegated expenditures in the framework of annual budgets rather than pursuing comprehensive and forward-looking policies in the delegated spheres. The division of responsibilities and the allocation of powers between the different levels of the Ukrainian State Administration do not follow the principle of subsidiarity and are frequently unclear. Legislation is not fully harmonized with the European Charter of Local Self Government signed by Ukraine in 1996, in the framework of the Council of Europe.

Performance Monitoring

The current system of monitoring and evaluation of the State Regional Development Strategy is not sufficient to draw a performance assessment framework. With introduction of new types of development interventions (in addition to construction), further development is necessary. The Government intends to update the monitoring and evaluation framework in the context of elaboration of a new State Regional Development Strategy until 2020.

A list of all projects which received funding out of the State Regional Development Fund from the 2012 budget is publicly accessible; other means of monitoring and evaluation of the financed projects have so far not been published.

2.3.2. Macroeconomic policy

Ukraine's economy was affected by a negative global environment in 2012 as well as by a weak investment climate. Following growth at 4.2% of GDP in 2010 and 5.2% of GDP in 2011, real GDP growth slowed to only 0.2% y/y in 2012. Ukraine's GDP real growth was negative at -1.3% y/y in first quarter of 2013, implying that economic contraction continued without any major improvement in key economic sectors.

Ukrainian industry, which is heavily dependent on exports, suffered from restrained private investment, very weak foreign demand in the metals and machinery markets, from Russia's introduction of a car utilization fee and from disruptions in domestic railcar production. As a result, industrial output declined by 1.8% y/y in real terms in 2012, causing a slowdown in the construction (-14% y/y) and cargo transportation (-7.6% y/y) sectors. Agricultural output fell below the 2011 record-high levels (-4.5% y/y). Among the key sectors, only retail trade turnover showed positive growth of 14% y/y last year (in line with 2011), manifesting still strong domestic consumption demand supported by government social spending ahead of the October 2012 elections. In 1Q2013, industrial output dropped by 5% y/y in real terms, showing no signs of recovery across the board (except in the food processing sector), and the reported growth in the retail trade sector (+13% y/y) hid a one-off surge in sales of imported cars ahead of the introduction of higher import duties which took effect in mid-April.

The economic developments in first quarter of 2013 confirm that Ukraine's prospects continue to be affected negatively by external headwinds and uneven policy implementation. Private consumption is expected to weaken in 2013 on tighter spending policy of the government, and investment activity will remain low. In April 2013, the IMF downgraded its GDP growth forecast for Ukraine to 0% y/y for 2013 and 2.8% y/y for 2014 from its previous projection of 3.5% for both years. World Bank worsened its forecast of Ukraine's GDP real growth to 1% y/y (from 3.5%) for 2013 and to 3% (from 4%) for 2014. EBRD for the second time this year downgraded the forecast for the development of the Ukrainian economy, expecting it to decline by 0.5% y/y in 2013 and grow by 2.4% y/y in 2014. Meanwhile, the Ukrainian government continues to underpin its planning by extremely optimistic economic projections, including for GDP growth, which is officially forecast to accelerate by 3.4% y/y in real terms in 2013 and by 3% y/y in 2014.

Low food prices (53% of the official consumer basket) brought inflation to its lowest level in a decade. Headline inflation reached -0.2% at year end, after 9.1% and 4.6% in December 2010 and 2011 respectively. In first quarter of 2013, consumer prices continued declining as the Consumer Price Index (CPI index) was reported at -0.5% y/y. The key reason for this was strong domestic production of key food staples. Besides, the government further delayed increases in administratively regulated utilities tariffs (11.4% of the official consumption basket). The central bank was pursuing very tight monetary policies, which suppressed investment and economic growth. In 2013, the CPI dynamics will be largely dependent on the volumes of the agricultural harvest, any decision to implement utility tariff hikes, and foreign exchange policies (which might lead to the depreciation of the hryvnia). The official government forecast for the end-of-year CPI is 5% end-of-period. The low inflation rates observed for the past year have both positive and negative aspects. On the one hand, they support household real income and purchasing power. However, a prolonged period of zero inflation may discourage growth in domestically oriented sectors.

Ukraine's fiscal deficit (including the Naftogaz state oil and gas company) exceeded the IMF projection of 5.3% GDP and increased to an estimated 6% GDP (of which Naftogaz' deficit was 1.7% GDP) in 2012, up from 4.2% GDP in 2011 (of which Naftogaz' deficit was 1.5% GDP), mainly as a result of the authorities' refusal to increase gas tariffs for households and utilities to cost-recovery levels, but also because of increased government spending before the October 2012 elections. Neither the 2013 central budget deficit target of 3.2% GDP, nor the

2014 central budget deficit target of 3% GDP appear realistic, as both are based on optimistic real GDP growth estimates (see above). For 2013, the highest risks lie in the estimated collections of VAT on local products, due to expected slowdowns in domestic consumer demand and corporate income tax, stemming from weak corporate profits, sizable advances already paid and a reduction in the corporate income tax rate already in 2013. IMF experts insist on cutting tax benefits and privileges as an immediate remedy to help the government avoid a massive shortfall in revenue collection. Also, should the government continue to delay adjustments to gas and utility tariffs, Naftogaz Ukrainy's "structural deficit" will likely exceed the 0.8-1% GDP both in 2013 and 2014.

Ukraine's current account deficit increased to USD 14.4 billion in 2012, or 8.3% GDP, compared to 5.5% of GDP in 2011. Weak external demand combined with strong consumer and investment imports were the key factors behind the increase in last year's C/A deficit, while the energy import bill (the key reason for C/A deterioration in 2010-2011) declined by 8% y/y in 2012 (to USD 27 billion) as Ukraine cut gas import volumes to 33 bcm from 40 bcm in 2011, fully offsetting a 36% increase in the average gas price. A social spending hike ahead of the October 2012 parliamentary elections and state infrastructure projects related to the Euro2012 football championship caused non-energy imports to increase by 12% y/y, keeping overall merchandise import growth positive at +5.3% y/y. At the same time, exports increased by a mere 0.5% y/y in 2012 as strong grain and vegetable oil sales only partially offset weaknesses in metallurgy and machine building The share of food & agriculture exports increased to 26% in 2012, from 18% in 2011. The first quarter of 2013 C/A dynamics suggests that the full-year C/A deficit will remain high, with a slight improvement over the 2012 record (around 7.6% GDP in 2013 versus 8.4% of GDP in 2012) as the prospects for a global economic recovery remain slim.

The international reserves of the National Bank of Ukraine (NBU) stood at USD 24.5 billion as of end 2012, down 23% y/y or USD 7.3 billion compared to end 2011. This represented the equivalent of 2.8 months of imports, below the 3.0 month safety threshold and the lowest level since 2002. Since the start of 2013, the National Bank has continued to support the hryvnia via F/X market sale interventions which signals that pressures on the currency remain high.

The public debt volumes in 2011-2012 have remained constant: after a marked rise following the 2008-09 crisis, public debt has been at around 36-40% GDP in 2011-2012. In the first quarter of 2013 , Ukraine's public debt increased by 3.9% (+ USD 2.9 billion) to USD 67.4 billion and reached 38% of the 2012 GDP. In 2013, Ukraine has taken advantage of the favourable conditions in external capital markets and placed more bonds than previously expected (USD 1.25 billion 10-year Eurobond at 7.5% yield in April and a USD 1 billion Eurobond placement at 7.625% in February), most likely letting the debt-to-GDP ratio rise above 40% GDP in 2013, despite the very high public F/X debt repayments (peaking at USD 10.5 billion in 2013). Overall, the Ukrainian government appears sufficiently financed to cover its F/X debt service, allowing Ukraine to "muddle through" without IMF financing.

In November 2008, the IMF board approved a USD 16.5 billion or Special Drawing Rights (SDR) 11 billion Stand-By Arrangement (SBA). However this SBA was interrupted in November 2009 due to slow progress in a number of agreed structural reform priorities. By that time, Ukraine had drawn some USD 10.6 billion under the programme. A new 29-month USD 15.2 billion SBA was approved in July 2010. Following the successful conclusion of the first review under the current SBA, Ukraine received the first tranche of USD 1.89 billion.

The second review – originally scheduled for conclusion at end-March 2011– is yet to be completed. Ukraine received no disbursements under the IMF standby arrangement in 2012 (which lapsed in December 2012) and no new cooperation programme has been agreed up until the present moment, as authorities have not reached agreement with the Fund on gas prices, the budget parameters and the issue of exchange rate flexibility. No progress is likely until the yearend on the IMF front.

To summarise, Ukraine's macroeconomic performance worsened in 2012 and economic decline continued in the first quarter of 2013. Further ahead, the internal (related to the increasing fiscal deficit) and external vulnerabilities are significant, especially the growing fragility of the local foreign exchange (F/X) market (due to the fixed exchange rate policy, high public borrowing needs in the F/X, and the ongoing re-pricing of the emerging market assets on the back of growing expectations on reversal of the US monetary policies). As a result, they may endanger the 'muddling-through' approach of the Ukrainian authorities in the short-term and therefore need to be monitored closely.

2.3.3. Public financial management

The Public Expenditure and Financial Accountability (PEFA) Assessment 2011 for Ukraine (update of the 2006 PEFA Assessment) was published in July 2012. Ukraine scored 2.67 out of 4, above the worldwide average of 2.53. This indicates that the country has established fundamental Public Finance Management (PFM) systems but there is still considerable scope for improvement. Ukraine performs well on execution control as well as on accounting and reporting, however is lagging behind on credibility of the budget, policy based budgeting, external scrutiny and audit. Public procurement has been a difficult area with setbacks since 2011 further reducing competition and oversight of state purchases.

Overall, progress in PFM has been fragmented and not based on a comprehensive reform strategy. A Concept Note to develop PFM, formally approved by the Cabinet of Ministers in September 2012 was considered a "good start" by the EU, but the need for a real and consistent Strategy was also underlined. A draft Action Plan on PFM presented in October 2012, which responded only in a limited way to requirements, was withdrawn by the Cabinet of Ministers in January 2013. An Inter-Ministerial Working Group started working on a "Global Strategy for the Reform/Improvement of Public Finance Management" which is expected to take into account comments from the EU Delegation and SIGMA received at various stages in the process, and to be approved by September 2013.

The latest report by the Accounting Chamber of Ukraine was published in December 2012 for 2011. It concluded that the major part of budget law infringements, cases of mismanagement and inefficient spending of budget funds were of a systemic nature. In particular, there was no decrease in the rate of offences in the public procurement sphere.

Corruption continues to be an important problem in Ukraine. According to Transparency International's Corruption Perceptions Index (CPI), corruption in Ukraine was perceived to be higher in 2012 than it was in 2011. The CPI index published for Ukraine in December 2012 was 26 while it was 27 in December 2011 (fewer points mean higher corruption perception).

In summary, whereas fundamental PFM systems are in place, there is still considerable scope for improvement in several areas. Actions taken with regard to PFM in 2012 were more of a political than of a practical nature and corresponded in a limited way to what is needed. There is an urgent need to adopt a comprehensive PFM strategy document and action plan in 2013.

2.3.4. Budget transparency and oversight of the budget

The six indicators measuring Comprehensiveness and Transparency in the PEFA exercise have basically remained the same from 2006 to 2011 (2xA; 1xB+; 1xB and 2xD+). Public access to key fiscal information scores a B in the 2011 PEFA report (as in 2006). Ukraine's OBI score for 2011 is 54 out of 100, which is a little higher than the average score of 43 for all the 100 countries surveyed. Ukraine's score indicates that the government provides the public with only some information on the national government's budget and financial activities during the course of the budget year. This makes it challenging for citizens to hold the government accountable for its management of public money.

The most recent World Bank – EU report from 2011 on the effectiveness of state budget management confirmed that Ukraine provides the public with a significant amount of information. However, this information is not well-structured and transparent. For example, the comprehensiveness of end-year reports could be increased by an analytical explanation of key budget indicators. For the moment, budgetary information is more of statistical nature.

An important negative development in 2012 was that, contrary to the requirements of the Budget Code, the budget proposal for 2013 was not published in September for consultation prior to adoption at the end of the year. It is expected that in 2013 the draft budget will be published in line with the law.

2.4. Lessons learnt

Specific regional and local development projects financed in the past have had, by nature, only a limited capacity to disseminate experiences and best practices to all regions and municipalities of the country. There is, therefore, a need to implement a systematic step-by-step approach related to deepening the capacities in all regions and for all local authorities.

The prevailing regional development planning methodology in Ukraine does not establish a link between limited resources and development needs. Very often Regional Development strategies and regional programs are elaborated based on academic expertise "ex cathedra", without involvement of stakeholders and concrete implementation plans and budgets. A systematic approach is needed which would promote a dialogue between stakeholders in order to elaborate realistic development strategies, link the identification of problems to policies and budgets and involve civil society in all steps of the planning cycle[5]

In spite of the general observation that institutional and absorption capacities in the regions are low, there are at the local level good practices and experiences in understanding main mechanisms for development of specific areas. These lessons have to be taken into account.

2.5. Complementary actions

The European Commission signed in 2009 a Memorandum of Understanding for the Establishment of a Dialogue on Regional Policy and Development of Regional Cooperation with the Ukrainian government. The EU has supported Ukrainian authorities in the past years

[5] The EU Technical Assistance Support to Ukraine's Regional Development Policy is tasked to assist the regions with elaborating of the new Regional Development Strategies and Regional Operational Programs that would correspond with the State Regional Development Strategy until 2020 and be based on EU best practice methodologies of regional development strategic planning and programming.

through different types of projects, using bottom-up as well as top down approaches. The EU has already financed a long term technical assistance project "Support to Sustainable Regional Development" with EUR 6 million in order to develop an EU-compatible approach and a financial instrument for regional development. This project triggered the establishment of State Regional Development Fund in 2012 and also supported the draft law on Fundamentals of State Regional Policy.

A follow-up programme "Support to Ukraine's Regional Development Policy" (Annual Action Programme 2011) was launched in January 2013. The programme will provide support to a large number of local and regional authorities in order to improve their institutional and administrative capacities. This includes a process of learning by doing to link strategic priorities to budgets available and concrete regional development actions. The programme has a budget of EUR 31 million and is a response to the Pilot Regional Development Programme under the Eastern Partnership.

The EU also supports and finances development programmes in the area of local rural development, based on a participatory/community-based approach. There is a large experience in decentralised cooperation; several projects are financed through programmes such, as Cross Border Cooperation programmes, the Non-State Actors and Local Authorities programmes, Cooperation in Urban Development and Dialogue (CIUDAD), etc. Generally speaking, those EU programmes follow bottom-up approaches and promote the concept and principles of self-government or autonomy of local authorities.

The overwhelming majority of donors active in regional development finances projects targeted at municipal development (e.g. USAID, CIDA[6], SIDA[7], the Swiss Agency for Development and Cooperation, GIZ[8] Ukraine Office), mostly reaching out to a maximum of one or two pilot regions. These projects would greatly benefit from a systematic approach to regional development in Ukraine.

2.6. Risk management framework

The risk assessment framework is included as an annex to this action fiche. The specific assumptions and risks relevant to regional policy are highlighted below.

Assumptions:

Ukrainian authorities (at national and local level) will remain committed for delivering improved regional development policies. Promotion of regional and local development and of an administrative-territorial reform will remain a national priority and the Government ensures a stable institutional environment for its implementation.

National/Regional/Local stakeholders are open for full cooperation within the programme. Local and regional authorities will be granted with greater financial autonomy, as well as greater financial visibility and capacity in the mid-term.

Ukrainian authorities are committed to address corruption and conflicts of interest, also at regional and local level.

[6] Canadian International Development Agency
[7] Swedish International Development Cooperation Agency
[8] Deutsche Gesellschaft für Internationale Zusammenarbeit

Risks:

The Government or Parliament will not approve any major reform on the Regional Development. Risk mitigation: constant policy dialogue with involvement of all stakeholders to create a consensus on actions.

Public finance management (PFM) remains weak without a clear reform strategy. There is a risk of corruption linked to the disbursement of the State Regional Development Fund. Risk mitigation: establish sound monitoring and evaluation system. Ensure full transparency of the whole budget-making process.

The authorities will apply unfair selection procedures and/or favour certain regions in a non-objective way. Risk mitigation: involve EU technical assistance and Ukrainian civil society into the developing, improving and assessing of disbursement rules of the fund. Ensure full transparency of the whole budget making process.

The continuation of the economic crisis provokes weaknesses in providing a transparent and comprehensive financial framework for the regions and the municipalities in the short and medium term. Risk mitigation: continuous dialogue with the authorities and strengthening of coordination processes should lead to a better assumption of financial responsibilities within state authorities toward regions and cities.

The State Regional Development Strategy 2020 will not be timely adopted and/or provide the basis for a credible strategy. Risk mitigation: High level commitment to timely approval and close monitoring of strategy building.

3. DETAILED DESCRIPTION OF THE BUDGET SUPPORT CONTRACT

3.1. Objectives

The overall objective of this contract is to support the social, economic and territorial cohesion of Ukraine, wellbeing throughout the country.

The budget support will contribute to the implementation of the State Regional Development Strategy 2020, following its three strategic objectives.

Purpose (specific objective)[9]:

1. Improving competitiveness of regions;
2. Territorial socio-economic integration;
3. Effective State Governance of Regional Development.

Regional Development is per se a crosscutting, multi-sectoral policy. Putting in place policies and framework for Regional Development will help tackle issues of governance, an improved monitoring and evaluation framework the fight against corruption and conflicts of interest across all sectors. The programme will lead to an increased involvement of civil society into the regional and local planning process. Through the provision of financing for regional and

[9] The purpose might need to be adapted in accordance with the objectives defined in the approved version of the State Regional Development strategy until 2020.

local development actions, various crosscutting issues are likely to be tackled, including environmental sustainability, gender equality, and good governance.

3.2. Expected results

Regional and local development will be supported with a budget support to regional policy. The expected results will depend on the State Regional Development Strategy until 2020 which is currently under elaboration and expected to be finalized in July 2013.

According to the Ministry of Economic Development and Trade, for the implementation of the first strategic objective it is planned to develop a set of measures aimed at solving the problems of urban territories; better use the potential of rural territories; increase the possibilities to innovate; supporting the development of a competitive business environment; diversify energy sources and increase energy efficiency; develop cross-border cooperation.

The implementation of the second strategic objective will be aimed at preventing the deepening of disparities that impede the development of regions; support to territories with low access to education, training, health, transport and communication, housing and culture; improvement of environmental protection.

For the implementation of the third strategic objective, measures aimed at improving the system of strategic planning of regional development at national and regional levels; improving the quality of governance of regional development; strengthening inter-sectoral coordination in formulation and implementation of regional policy; institutional support for regional development will be targeted.

Taking into account the objectives defined in the draft State Regional Development Strategy 2020, the SPSP is expected to be linked to the following results[10]:

Component 1: Improving the competitiveness of regions

- Successful realization of projects as defined in the operational programme/action plan for the realization of the State Regional Development strategy.

Component 2: Territorial socio-economic integration

- Stable, pre-defined budget provided for the development of regions;
- Reduction of regional disparities.

Component 3: Effective State Governance in Regional Development

- Operational programmes for the implementation of national and all regional strategies established, linking actions to the budget available with well-prepared project pipeline;
- Improved capacity of central, regional and local authorities to elaborate, implement, monitor and evaluate regional development strategies and operational programmes including a pipeline of projects**;**
- Decentralisation of governance, increased fiscal autonomy of regional and local authorities;
- Procedures of the State Regional Development Fund approximates EU best practices of Financing of Regional Development;

[10] The expected results might need to be adapted in accordance with the results defined in the approved version of the State Regional Development strategy until 2020.

- Improved communication and coordination between stakeholders at all territorial levels;
- An effective monitoring and evaluation system implemented, providing regularly information about the effectiveness of the policy.

3.3. Rationale for the amounts allocated for budget support

Given the relatively large size of the Ukrainian economy the macroeconomic impact of budget support is limited. The EU national aid programme in the current financial perspective is equivalent to about EUR 150 million per year or 0.1% of GDP (or 0.3% of government revenue). Annual disbursements of budget support have varied substantially within this overall ceiling and are expected to reach about 0.05% of GDP in 2013, provided that budget support payments restart."

The total amount allocated to sustainable development under the National Indicative Programme (NIP) is EUR 211,500,000 - 258,527,000 of which 21.27% to 26.00% is to be delivered under the present budget support programme.

This amount is based on:

- The commitment of Ukraine, defined in the budget code, to allocate an equivalent of 1% of the revenues of general part of the budget to the State Regional Development Fund (approximately UAH 3.6 billion) in line with strategic objectives as defined in the State Regional Development strategy 2020.
- The commitment of Ukraine to supplement the strategy with a result oriented monitoring mechanism and an action plan defining annually measurable targets.

3.4. Main activities

Main activities by the EU in the framework of the programme will include:

- transfer of EUR 50 million over the fiscal years 2015-2018;
- continued political and policy dialogue with the Government with a particular focus on regional development policies;
- a continued effort to reinforce Government's capacities in the area of PFM in the context of existing complementary support programmes;
- regular monitoring of budget support eligibility criteria:
    - monitoring of achievement of the sector's priority objectives will be undertaken on the basis of annual progress reports and other EU or development partners' reviews, supported by regular briefings for and discussions in the relevant sector working group;
    - monitoring of macro-economic developments will be performed in the context of the IMF missions and other relevant assessments;
    - monitoring of PFM eligibility will be done on the basis of the reviews of the government's PFM reform strategy and associated assessments or ad-hoc analysis;
    - monitoring of budget transparency will be undertaken through verifying public availability of appropriate documentation.

3.4.1. Budget Support

The proposed sector budget support programme is being prepared jointly with the Ministry for Economic Development and Trade, which is currently developing a new State Regional Development strategy. The Ministry has declared its full support to align the strategy with requirements of this sector budget support.

3.4.2. Complementary support

A technical assistance (TA), complementary to the TA component financed under the Annual Action Programme 2011, will focus on the active monitoring of the implementation of this new policy, formulating recommendations to the Ukrainian authorities, visiting and evaluating on the field the actions undertaken by the authorities. The capacity of the relevant Ukrainian authorities to steer and implement the above-mentioned reform areas targeted by this SPSP will be constantly evaluated. This active technical assistance monitoring will support and facilitate the Ukrainian authorities in ensuring the effective and transparent implementation of this SPSP by ensuring high quality and coherence of the implementation measures and maintaining an efficient programming, management, control, and evaluation system. Further, on request of the Ukrainian government, Twinning programmes may be financed to support the approximation to EU Regional Policy and practices.

3.5. Donor coordination

The Donor co-ordination is formally ensured by the Government. Although the Government had set up the Government-donor co-ordination structure in 2006 and updated it several times since then, the Government-led donor coordination focuses on general coordination in the form of Government-donor meetings once or twice a year.

The Government has not established the mechanism of regular donor coordination in the area of regional and local Development with a structured approach. In the absence of a government led approach to donor coordination, donors have mainly coordinated themselves through informal meetings and working groups.

3.6. Stakeholders

Regional development is a multi-dimensional issue covering a number of policy areas. Stakeholders are:

- *Central Government:* Ministry of Economic Development and Trade (lead ministry), Ministry of Regional Development, Construction, Housing and Municipal Economy, Cabinet of Ministers, Ministry of Finance, Presidential Administration, etc.

- *Local and regional authorities* at Oblast, rayon and municipal level, associations of local and regional authorities

- *Other national & local stakeholders:* Institutes, business and other associations, NGOs, education institutions, etc.

- *Donors and international organisations:* USAID, GIZ, WB, UNDP, CIDA, Swiss cooperation, EU, EBRD, etc.

3.7. Conclusion on the balance between risks (2.6.) and expected benefits/results (3.2.)

The perspective of budget support in combination with a TA under the "Support to Ukraine's Regional Policy programme" and the ongoing elaboration of the State Regional Development strategy 2020 provides a unique momentum and strong incentives to approximate EU regional policy. It has already encouraged the government to take concrete steps to reform the current regional policy system. In 2012, the government launched the State Regional Development Fund which established a clear and transparent mechanism of distribution of state budget to the regions.

However, as the State Regional Development Strategy 2020 is currently under development and a first consolidated draft is expected only for 1 July 2013, the programme is under high risk. The risk has been mitigated by seeking high level commitment from Ukraine to develop an effective regional policy. The strategy building process is closely monitored.

4. IMPLEMENTATION ISSUES

4.1. Financing agreement

In order to implement this action, it is foreseen to conclude a financing agreement with the partner country, referred to in Article 184(2)(b) of the Financial Regulation.

4.2. Indicative operational implementation period

The indicative operational implementation period of this action, during which the activities described in sections 3.4. and 4.4. will be carried out, is 48 months, subject to modifications to be agreed by the responsible authorising officer in the relevant agreements.

4.3. Criteria and indicative schedule of disbursement of budget support

The general conditions for disbursement of all tranches are as follows: Satisfactory progress in the implementation of Regional Policy and continued credibility and relevance thereof; implementation of a credible stability-oriented macroeconomic policy; satisfactory progress in the implementation of the PFM reform programme; and satisfactory progress with regard to the public availability of timely, comprehensive and sound budgetary information.

Specific conditions and broad areas for indicators that may be used for variable tranches will be defined once the new State Regional Development strategy will be approved. The indicators are expected to measure progress in three areas:

- **Competitiveness of regions;**
- **Territorial socio-economic integration;**
- **Effective State Governance in Regional Development.**

Disbursements of all tranches will depend on meeting general conditions related to:

- Sector policy: satisfactory progress in the alignment of Ukrainian legal and regulatory framework in the area of regional development.
- Macroeconomic: maintenance of a credible and relevant stability-oriented macroeconomic policy or progress made towards restoring key balances.
- PFM: satisfactory progress in the implementation of its programme to improve public financial management.
- Budget Transparency: satisfactory progress with regard to the public availability of accessible, timely, comprehensive, and sound budgetary information.
- Performance monitoring of specific conditions and disbursement criteria of the variable tranches will be detailed in the Technical and Administrative Provisions to the Financing Agreement.

The disbursements will therefore depend on the degree of compliance with the general and specific conditions stipulated in the Financing Agreement. Amount of the variable tranches will be decreased in case of partial compliance or non-compliance, in proportion of the weight specified in the Financing Agreement for each condition. Assessment on the degree of compliance with the general and specific conditions will be performed by the EU Delegation (with possible external support, if there is a need). In the event of failure to fulfil a condition or achieve a quantitative target of indicator due to forces majeures it will be possible for the given condition or indicator to be neutralised as a determinant of the variable instalment.

The indicative schedule of disbursements is summarised in the table below (all figures in EUR millions) based on fiscal year of the partner country.

Implementation period of 48 months is equal to 4 years: Funds will be disbursed in 2015, 2016, 2017 and 2018.

Country fiscal year	2015				2016				2017				2018				
Tranche Type	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Total
Base tranche		12.5															
Variable tranche						12.5				12.5				12.5			50
Total		12.5				12.5				12.5				12.5			50

4.4. Details on complementary support

4.4.1. Procurement (direct centralised management)

Subject in generic terms, if possible	Type (works, supplies, services)	Indicative number of contracts	Indicative trimester of launch of the procedure
Technical assistance to implement the activities listed in 3.4. (includes communication and visibility).	Services	1	First trimester of 2015
Technical assistance for assessment of performance indicators	Services	1	Third trimester of 2015
Evaluation	Services	1	Third trimester of 2016

4.4.2. Grants: call for proposal /Twinning on Regional Development (direct centralised management)

(a) Objectives of the grants, fields of intervention, priorities of the year and expected results

To increase the capacity of governmental and regional authorities to develop and implement effective Regional Development policies

Eligible Actions: Twinning with EU Member states, Grants to public bodies

(b) Eligibility conditions

Potential applicants are public administrations from EU Member States or mandated bodies,

(c) Essential selection and award criteria

The essential selection criteria are financial and operational capacity of the applicant.

The essential award criteria are relevance of the proposed action to the objectives of the call; design, effectiveness, feasibility, sustainability and cost-effectiveness of the action.

(d) Maximum rate of co-financing

The maximum possible rate of co-financing for grants under this call is 100% in accordance with Articles 192 of the Financial Regulation if full funding is essential for the action to be carried out. The essentiality of full funding will be justified by the responsible authorising officer in the award decision, in respect of the principles of equal treatment and sound financial management.

(e) Indicative trimester to launch the call

Third trimester 2015

(f) Use of lump sums/flat rates/unit rates

Twinning contracts include a system of unit costs, defined in the Twinning Manual, for the reimbursement of the public sector expertise provided by the selected Member States administrations. This system of unit rates exceeds the amount of EUR 60,000 per beneficiary of a Twinning contract.

4.5. Scope of geographical eligibility for procurement

Subject to the following, the geographical eligibility in terms of place of establishment for participating in procurement procedures and in terms of origin of supplies and materials purchased as established in the basic act shall apply.

The responsible authorising officer may extend the geographical eligibility in accordance with Article 21(7) of the basic act on the basis of the unavailability of products and services in the markets of the countries concerned, for reasons of extreme urgency, or if the eligibility rules would make the realisation of this action impossible or exceedingly difficult

4.6. Indicative budget

Module	**Amount in EUR thousands**	**Third party contribution (indicative, where known)**
3.3. – Budget support - Sector Reform Contract	50,000.00	N.A.
4.4.2. – Call for proposals (Twinning)	1,000.00	N.A.
4.4.3. – Procurement (direct centralised)	3,400.00	N.A.
4.8. – Evaluation	600,000	N.A.
4.9. – Communication and visibility	Included in the Procurement	N.A.
Contingencies	N.A.	N.A.
Totals	55,000.00	N.A.

4.7. Performance monitoring

In general, the concept of performance-based monitoring as a critical component to the implementation of projects, programmes and strategies is broadly understood in Ukraine, although not effectively implemented. With respect to planned SPSP, it is important that at least three levels for monitoring are implemented to ensure effective operation of government programmes, including regional development. With respect to regional development, these levels include:

- Strategic/policy level: At this level, the State Regional Development Strategy and Regional Development Strategies (of regions) should be the subject of monitoring and evaluation. Aggregate information and indicators should be collected and analysed in particular as regards outcomes.
- Implementation/operational level: At this level the implementation instruments for the strategies (thematic programmes, state target programmes, agreements for regional development, etc.) should be the subject of monitoring.
- Working level: At this level the specific measures and projects should be monitored. Progress in the implementation of related activities and actions should be assessed taking into account respective work plans. Specific indicators and interim results (outputs) should be developed to verify progress.

The Ministry of Economic Development and Trade has requested EU support to improve the effectiveness of the current performance monitoring system. The ongoing EU technical assistance project "Support to Ukraine's Regional Development Policy" will support the Ukrainian government to elaborate and implement a more effective system.

Performance monitoring will be exerted by a Joint Monitoring Group to be led by the Ministry of Economic Development and Trade. The Joint Monitoring Group will rely on official information provided by Ukraine and verify as appropriate. The Joint Monitoring Group will meet at least twice a year at technical level. High level meeting of the Joint Monitoring Group should take place at least once a year, including in the beginning and at completion of the programme. Additional mid-term meeting at high-level could be convened in case of the need to introduce changes in the policy objectives. The Joint Monitoring Group may include technical subgroups to follow-up specialised issues (e.g. specific industrial sectors, or specific areas of activities, such as the market surveillance, etc). The establishment, composition and schedule of activities of technical sub-groups will be decided by the main Joint Monitoring Group.

4.8. Evaluation

The programme will be subject to regular monitoring by the Joint Monitoring group. A specific mid-term evaluation will be organised to, inter alia, review the validity of the monitoring system.

Evaluation of the results achieved will be reviewed and decided by the European Commission. In carrying out such review, the Commission will, as appropriate, use the technical advice of external consultants recruited by the Commission to verify technical reports and data transmitted by the government of Ukraine. Programme evaluations, whenever necessary, will also be decided and funded by the EU out of the technical assistance component of the programme. Part of the technical assistance component may be used to enhance the local capacities for auditing the programme.

The complementary measures (technical assistance) component may be subject to evaluation/audit following European Commission's standard procedures. Evaluation of the results achieved may be entrusted to independent consultants as well as external audits. Mid-term and final evaluation of the project implementation may be commissioned by the European Commission to assess project performance, achievements and impact.

4.9. Communication and visibility

The programme will follow the orientations of the "Communication and Visibility Manual for EU External Actions" (e.g. press release at the signature of the FA, visibility for reports and studies, etc) available at http://ec.europa.eu/europeaid/work/visibility/index_en.htm.

Proper communication and visibility of the action will be achieved via regular joint communication events on the occasion of the achievement of the disbursement criteria as well as in connection with the results of technical assistance projects in the areas targeted by the SPSP. The budget foreseen for complementary measures may be used for funding activities aiming at increasing the visibility of the programme.