

Regional Development in Ukraine: War Bolsters Disparities Between Regional Economies

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Introduction

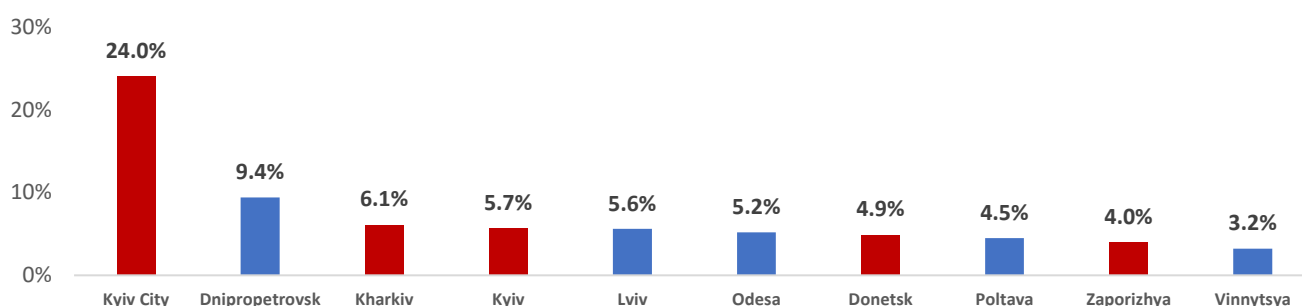
Since 1990s, Ukraine's economy has experienced a number of severe crises, caused by political and economic issues. In 2014, the Russian Federation annexed the Autonomous Republic of Crimea and also occupied selected districts of the Donetsk and Luhansk regions. The related military operations in the East Ukraine in 2014-2015 contributed to the economic decline when Ukraine's GDP fell twice in the US dollar equivalent, from circa \$190 to circa 90\$ billion¹. The war harmed Donetsk and Luhansk regions, two of the most industrially developed regions in the East Ukraine. Some of their districts were occupied by the Russian Federation. In 2013, the Donetsk and Luhansk regions provided respectively 10.8% and 3.6% of Ukraine's GDP. It is estimated that Ukraine lost 10% of GDP in 2014-2018 in those regions.² The war highlighted uneven development of Ukrainian regions.

In February 2022, the Russian Federation launched a full-scale invasion which has already caused a disastrous harm to a larger number of regions. The military operations touched vast territories in the north, east, and southern Ukraine. As of June 2022, almost 20% of Ukrainian territory has been occupied by Russia. It can be argued that the war will highlight the regional disparities again.

Overview of regional economies before the February 2022 invasion

In recent years, regional disparities remained on the economic landscape. Kyiv, the capital of Ukraine, concentrated almost a quarter of country's GDP (24% in 2020)³. Among other regional leaders there were the Dnipropetrovsk (9.4%), Kharkiv (6.1%), Kyiv (5.7%), Lviv (5.6%), Donetsk (4.9%) and Poltava (4.5%) regions. The picture mirrors the regional disparities inherited from the Soviet times when main heavy industry enterprises were located predominantly in the East Ukraine. The regional disparities are also proved by the gross regional product (GRP) per capita. Only a few regions demonstrate figures higher than the Ukraine's GDP per capita (\$3.8 thousand in 2020), including the City of Kyiv (\$12.7 thousand), Poltava region (\$5.1 thousand), Kyiv region (\$5.0 thousand), and Dnipropetrovsk region (\$4.7 thousand). The Donetsk region was also among the leaders with high GRP per capita before 2014.

Chart 1. Top-10 regions by contribution to Ukraine's GDP, 2020 (in red – affected by close military actions since February 2022)



Source: The State Statistical Service of Ukraine

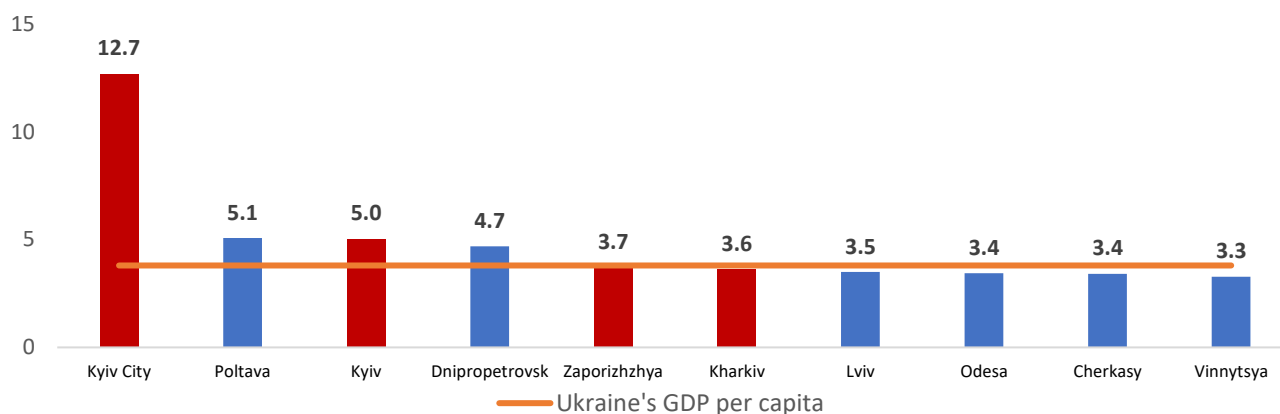
¹ World bank, <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=UA>.

² For more see <https://ces.org.ua/how-much-did-donetsk-and-luhansk-oblasts-lose-due-to-the-armed-conflict-with-russia/>.

³ The State Statistical Service of Ukraine.

Regional distribution of businesses emphasizes differences between regional economies. The City of Kyiv is home to a quarter (27.1% in 2020⁴) of Ukrainian enterprises. Kyiv also attracts business registration even for companies that have their production facilities in other cities, thus complicates economic assessments of other regions. Large numbers of enterprises are also registered in the Dnipropetrovsk (8.2%), Odesa (6.8%), Kharkiv (6.7%), Lviv (5.6%), and Kyiv (5.5%) regions. The distribution of leaders mirrors the list of the biggest Ukrainian cities. Nevertheless, the recent surveys demonstrate that big regional economies are not necessarily the most attractive places for doing business.

Chart 2. Top-10 regions by GRP per capita in \$, 2020 (in red – affected by close military actions since February 2022)



Source: The State Statistical Service of Ukraine

The Municipal Competitiveness Index (MCI), the USAID-funded research conducted in Ukraine in 2020-2021, assessed competitiveness of regional administrative centers⁵. The results can mirror the disparities of the respective regions. During two waves of survey, the MCI leaders among regional centers were Khmelnytskyi, Ternopil, Ivano-Frankivsk, Lviv, Vinnytsia, and Chernihiv. Most of them, except Chernihiv, are located in West and Central Ukraine that have not been hit by military land operations recently. At the same time, Chernihiv faced fights in February-March 2022, as it lays on the way from Ukraine-Russia border to Kyiv. Kramatorsk and Sievierodonetsk, temporary administrative centers of the Donetsk and Luhansk regions, gained medium MCI scores. Both of the cities are now on the main battlefield of the Russian invasion. Kherson, the only regional capital captured by Russia, received the lowest MCI score in 2019-2020. The city of Zaporizhia, also with low MCI score, is under Ukraine's control, but the region's territory is mostly occupied. Russian troops also occupied Mariupol and Melitopol that received high MCI score among top-45 Ukrainian municipalities by population.⁶ The full-scale war definitely can rewrite the landscape of economic attractiveness by regions.

Regional development policy before the war

Decentralization and regional policy became priority fields since the Ukraine-EU Association Agreement was signed in 2014. Ukraine's efforts have been acknowledged by the European Commission which recommended to grant Ukraine EU membership status in June 2022. The EC stated that Ukraine had "undertaken a successful decentralization reform, including fiscal decentralization" and "started to implement some key mechanisms for regional policy"⁷. Ukraine reformed the administrative-territorial organization (lower than regional level), introduced new self-governance system at the local level, and

⁴ The State Statistical Service of Ukraine.

⁵ MCI — is an analytical tool to evaluate business climate in municipalities. It was launched by the USAID Competitive Economy Program in Ukraine (CEP), in the partnership with Info Sapiens and the Institute for Economic Research and Policy Consulting (IER). See <http://www.ier.com.ua/en/mci>.

⁶ See <http://www.ier.com.ua/en/mci>.

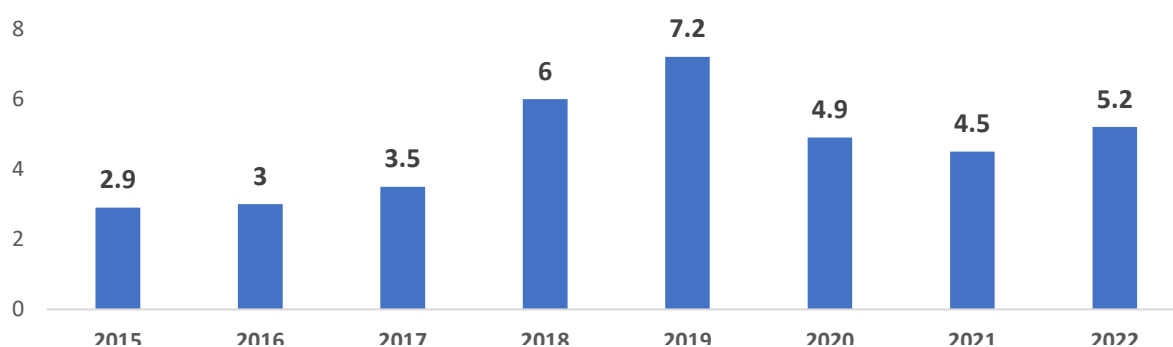
⁷ For more see <https://ec.europa.eu/neighbourhood-enlargement/system/files/2022-06/Ukraine%20Opinion%20and%20Annex.pdf>.

launched changes on the regional level. The reform process has been actively supported by numerous technical assistance projects funded by the EU, US, Canada, and other international donors.

The legal framework for new regional policy is based on the Law On Principles of State Regional Policy, adopted in 2015.⁸ Ministry of Communities and Territories Development of Ukraine (previously known as Ministry for Regional Development, Construction and Public Housing) is the central government body responsible for regional policy, including social and economic issues. Ukraine has also adopted the National Regional Development Strategy that aims to overcome regional economic disparities⁹. Besides, each region has own regional development strategy, developed based on the smart specialization approach that should emphasize regional strengths¹⁰. In many cases smart specialization on the regional level in Ukraine looks just a formal pattern embedded in regional strategies, but it is a big step to promote low-developed regions.

In 2012, Ukraine launched the State Regional Development Fund, an important instrument for regional economic policy. The Fund aims to finance investment programs and projects on the regional level. According to the Budgetary Code of Ukraine, the Fund should receive at least 1% of the projected budget revenues (1.5% from January 2023)¹¹. Nevertheless, the funding has never reached the required minimum, despite the importance of its goals.

Chart 3. Budget funding for the State Regional Development Fund by year, billion UAH



Source: The Laws on State Budget of Ukraine, 2015 - 2022

In 2021, the Fund had UAH 4.5 billion (more than \$160 million) or only 0.4% of budget revenues. Twelve regions in all geographic parts of Ukraine received additional funding because of their low GRP. As a result, most of the money (96.5%) were successfully disbursed for more than 300 projects in all regions. The Ukraine State Budget 2022 included more than UAH 5 billion for the Fund (circa \$190 million), but the war stopped capital expenditures for most projects.

War 2022 impact on regions

Since February 2022, the Russian military invasion directly affected regions located in the north, east and south part of Ukraine. In total, all regions affected by land military operations account for more than a half of Ukraine's GDP. As of June 2022, active fights and Russian occupation are immediately touching six regions (Donetsk, Luhansk, Kharkiv, Zaporizhia, Kherson and Mykolaiv) with 19.9% share in Ukraine's GDP (2020). The same regions also account for 19.5% of Ukrainian enterprises and 22.6% individual entrepreneurs. The cities of Kharkiv, Mykolaiv, and Zaporizhia are under full control of Ukraine, but still remain close to the fights. Kharkiv, the second largest city and a large industrial center, since mid-June is again under artillery shells. Therefore, restoration of business activity still looks premature near the battlefield.

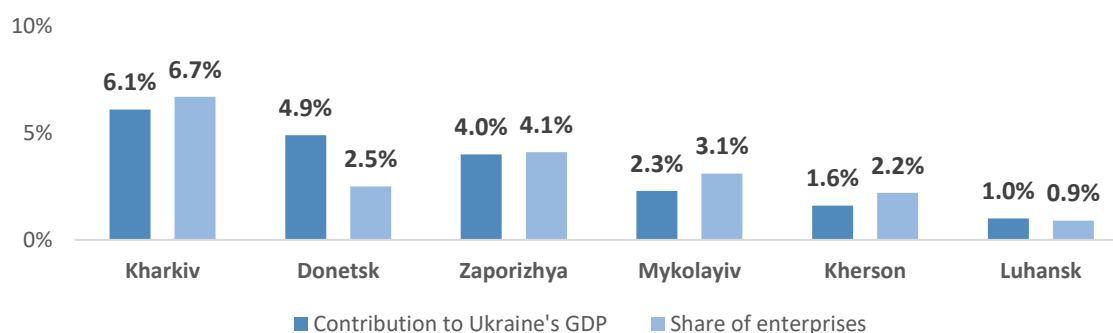
⁸ See <https://zakon.rada.gov.ua/laws/show/156-19#Text>.

⁹ See <https://zakon.rada.gov.ua/laws/show/695-2020-%D0%BF#Text>.

¹⁰ See <https://www.oecd.org/sti/inno/smartspecialisation.htm>.

¹¹ See <https://zakon.rada.gov.ua/laws/show/2456-17#Text>.

Chart 4. Share in Ukraine's GDP and number of enterprises of regions with active military operations as of June 2022



Source: The State Statistical Service of Ukraine

Despite the war is ongoing, there are already first assessments of economic losses by regions. As of end-April, the Kyiv School of Economics estimated that the direct damage to Ukraine infrastructure had reached \$88 billion. The largest losses are the costs of housing and enterprises assets damages. The main damage to houses and enterprises was recorded in Donetsk (40% of total value), Kharkiv (23%), Chernihiv (12%), Kyiv (8%), Luhansk (7%), and Mykolaiv (6%) regions¹². As of early June 2022, the direct damage to physical infrastructure made \$103.9 billion, and total economic losses reached \$564-600 billion¹³.

Business surveys provide additional information on war impact. The Institute for Economic Research and Policy Consulting (Kyiv, Ukraine) conducted the first wave of the Monthly Enterprises Survey 'Ukrainian business during the wartime'. As of April 2022, the Chernihiv region suffered the most from military actions, as 40% of surveyed enterprises reported stopping operation. The same indicator was high in Odesa region (32%), the City of Kyiv (22%), Sumy (17%) and Kyiv (10%) regions. At the same time, no respondents that stopped operations were found in the western regions. Moreover, enterprises from the West and Central Ukraine were more likely to operate at 100% higher production capacity. In particular, the shares were 56% for the Rivne region, 31% for the Zakarpattia region, 27% for the Vinnytsia region, and 22% for the Ternopil region. Besides, enterprises from western and central regions more often had a chance to increase their sales in comparison to the pre-war time¹⁴.

Support for regions after the start of the war

Key actions to support businesses during wartime combine general efforts on the national level, regional, and local levels. In particular, the government has introduced several tax incentives. First of all, broader application of the simplified tax system allowed large companies of selected sectors (with annual income less than circa \$340 million) to register temporarily as payers of the single tax (2% of income). Previously it was available for companies with annual income less than circa \$0.25 million (5% tax rate). Besides, payments of single tax are voluntary for most other users of the simplified tax system. Finally, there are tax exemptions (land and ecology tax) for companies located on territories touched by military operations or occupied¹⁵.

In March 2021, the government launched the free relocation program for companies seeking to move to safer regions in the West and Central Ukraine. Companies of strategic importance or producing essential goods have the highest priority for relocation. As of end-May, 601 enterprises participated in the program,

¹² For more see <https://kse.ua/about-the-school/news/direct-damage-caused-to-ukraine-s-infrastructure-during-the-war-has-reached-88-billion/>.

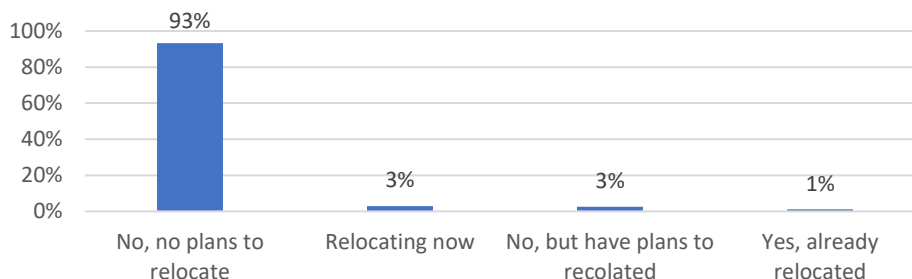
¹³ See <https://kse.ua/russia-will-pay/>.

¹⁴ For more see Oksana Kuziakiv, Yevhen Anhel, Anastasia Gulik, Iryna Fedets. Monthly Enterprises Survey. Issues 1 (May 2022), <http://www.ier.com.ua/en/institute/news?pid=6919>.

¹⁵ For more information on Ukraine's tax system see Tax Guide for Private Entrepreneurs in Ukraine, <https://www.contactukraine.com/taxation/private-entrepreneur-taxation>

already 390 enterprises restarted their production at new locations. Zakarpattia, Lviv, and Chernivtsi regions (all in West Ukraine) have become the most popular destinations¹⁶. Nevertheless, the numbers demonstrate that the program is not massively used. However, it is likely that many businesses could move on their own. The Monthly Enterprises Survey by IER demonstrates that as of end-April only 1% of enterprises had relocated, 3% were relocating at that time, and 3% had plans for relocation¹⁷.

Chart 5. Plans to relocate production facilities to safer regions of Ukraine (May 2022)



Source: Monthly Enterprises Survey by The Institute for Economic Research and Policy Consulting

Regional and local authorities in Lviv, Zakarpattia, Ivano-Frankivsk, Chernivtsi, Ternopil, Rivne, Khmelnytskyi, and Volyn regions have launched own initiatives to attract enterprises from other regions. Entrepreneurs are offered with consultations and support for relocation, including search of potential production sites and potential employees¹⁸. The Lviv region also introduced the Program for Business Support during wartime that offers financial support to local and relocated enterprises¹⁹.

Conclusions

For many years regional disparities have been visible on the economic landscape of Ukraine. Ukraine's economic power was traditionally concentrated in Kyiv, large cities, and selected industrial regions (mainly in the east). Decentralization and regional policy aimed to diminish the differences between the regions. Yet, the budget funding was not enough to decrease the development gap without massive private funding. The Russian invasion has created new challenges for regional policy. Almost 20% of Ukrainian territory has been occupied by Russia. Ukraine faced massive destruction of infrastructure in selected regions. Consequently, we are seeing that many Ukrainian businesses can "move" closer to the western border and contribute to competitiveness of western and central regions. The war can deepen the regional disparities.

¹⁶ See <https://www.me.gov.ua/News/Detail?lang=uk-UA&id=c6d9e305-b4b9-4aea-8ab9-3b426fbb6615&title=RelokatsiiaBiznesu-PereizdZavershiliPonad600-Pidprimstv-340-VidnoviliRobotu>

¹⁷ The survey sample represents predominantly manufacturing companies.

¹⁸ See <https://business.dii.gov.ua/en/cases/antikrizovi-risenna/programi-pidtrimki-sodo-timcasovogo-peremisenna-pidpriemstv-z-postrazdalih-regioniv>.

¹⁹ See <https://old.loda.gov.ua/news?id=66809>.

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