



Ukrainian regions: economic development and its true costs

Position paper

Executive summary

The current political crisis has provoked heated debates on the role of industrial regions for Ukraine's economic development and on claims that were made for a special autonomous status in order to become more financially and economically independent from the centre.

In this paper we expressly do not touch the issue of inter-linkages existing within the economy and consequently do not attempt to speculate on economic effects of a possible economic disintegration scenario along regional lines.

We argue that four Ukrainian regions - Dnipropetrovs'ka, Donetsk'a, Kharkivs'ka and Luhans'ka¹:

- a) significantly contribute to Ukrainian economy, but this contribution is not a gift, but is an exchange, resulting in higher wages and profits.
- b) significantly contribute to the revenues of Consolidated Budget but at the same time all of them (except for Kharkivs'ka oblast) are net recipients from the budget.

Our general conclusion is that proper analysis of the 4 SE-regions economic performance and subsequent policy recommendations should take into account the total social costs of economic activities and industrial development.

Introduction

Current debates on the role of industrial regions for Ukraine's economic development and various claims for a special autonomous status are not something new. In fact these issues has been already raised but under different circumstances regarding the status of Crimea and in discussions preceding the adoption of the new Budget Code.

The main argument voiced by the leaders of industrial regions (Dnipropetrovs'ka, Donetsk'a, Kharkivs'ka and Luhans'ka regions) is "industrial regions are feeding the

¹ In the text we shall denote this group of regions – 4 SE-regions.

country and are not getting what these regions deserve in exchange for their contribution to the economic development". In other words, some unjust free riding of other regions is assumed.

This paper attempts to assess the economic significance of Dnipropetrovs'ka, Donets'ka, Kharkivs'ka and Luhans'ka oblasts as well as some key features of the economic development of these regions.

Impressive figures of economic development should not be overestimated because one can find behind them a lot of really burning problems. In other words there is a striking difference between industrial development as such and a wide array of different economic, social, ecological and other problems. These problems present serious constraints for economic development and raise concerns about ability of the local authorities to cope with them independently.

In other words total costs are to be taken into account while defining the real economic contribution.

1 4SE-regions: economic performance

The 4SE-regions play important role in Ukrainian economy. In 2001-2002 these four oblasts produced a bit more than one-third of total value added thus contributing significantly to the economic performance of the country (See Table 1).

Table 1
Regional contributions to total growth and value added in Ukraine

	Value added, % of total		Value added, % growth yoy		Contributions to total growth, % of total	
	2001	2002	2001	2002	2001	2002
Ukraine	100	100	13.6	5.8	100	100
Dnipropetrovs'ka	8.9	8.8	12.8	3.3	8.2	4.9
Donets'ka	12.5	12.4	11.8	2.8	10.6	5.9
Luhans'ka	4.1	4.2	18.9	6.1	5.6	4.3
Kharkivs'ka	5.7	5.8	17.9	5.9	7.3	5.8
Kyiv city	17.0	17.2	21.4	6.4	26.2	18.7

Source: Derzhkomstat

The economy of these oblasts is dominated by manufacturing and extractive industry. It is especially true for Luhans'ka oblast where more than two thirds of output is concentrated in industry. Thanks to rich natural resources, these oblasts hold half of all Ukrainian extractive industry and almost one third of Ukrainian manufacturing, which is highly resource-intensive. If taking year 2003 as a base for estimating the oblasts' contributions to total industrial growth in the country, then in 2003-2004 the Donets'ka oblast alone has contributed approximately one quarter to total industrial growth. Donets'ka, Luhans'ka and Kharkivs'ka oblasts together

has accounted for nearly 36% of total industrial growth in Ukraine during the last two years.

One of the leading export industries - iron and steel industry - is concentrated predominantly in the four south-eastern oblasts (Donets'ka, Luhans'ka, Zaporizhs'ka and Dnipropetrovs'ka). The geographical structure of the core ferrous metal areas is explained by the allocation of mineral resources in the Donbas-Dnieper Bend. One half of steel works are located in Donbas-Donets Coal Basin, the rest are in the lower Dnieper River region.

These regions (except Luhans'ka) account for a relatively high share of FDI in Ukraine, although the total amount of FDI into Ukraine and, thus, into these oblasts has remained very low. According to recent data Dnipropetrovs'ka oblast has received 8.2% of total investments and possessed the 2nd place among all oblasts, Donets'ka got 6.1% (5th place), Kharkivs'ka – 5.1% (6th); Luhans'ka – 1.0% (10th).

The economic performance of the 4SE oblasts results in higher wages – in terms of average wage Donets'ka, Dnipropetrovs'ka, Luhans'ka oblasts occupy 2nd, 3rd and 5th places respectively, while wages in Kharkivs'ka oblast are a bit lower than average in Ukraine (8th place).

2 4SE-regions: total costs of economic performance

Besides the tremendous industrial potential the regions currently face some substantial problems.

On the one hand, the region has in comparison to the rest of Ukraine rather high wages. However, wage arrears are in Donets'ka, Luhans'ka and Dnipropetrovs'ka oblasts not uncommon - these oblasts hold first three places in the list of Ukrainian oblasts. However, big share of these wage arrears was accumulated before 2004. The last feature is also typical for Kharkivs'ka oblast.

Different household surveys show that the households total expenditures and total revenues in Kharkivs'ka, Donets'ka, and especially Luhans'ka oblast are below the average in Ukraine. In other words industrial development currently does not translate into higher household income!

Consumption of gas by industry in Donets'ka and Luhans'ka oblasts amounts to 21% (about 7.4 billion cubic meters) of all gas consumed by the industry in Ukraine, while debts for consumed gas concentrated in Donets'ka and Luhans'ka oblasts amount to 28% (UAH 833 m) of overall Ukrainian indebtedness.

Donets'ka and Luhans'ka oblasts produce 68% of total coal production in Ukraine. However, costs of production are above their price levels. The coal industry in the region received billions of hryvnia in financial aid from the central budget, while remaining severely indebted (see Table 2.1).

The indebtedness of utilities is rather high, as Donetskoblenergo, Luhanskoblenergo and Ukrenergovuhillja are to receive about 40% (UAH 4.1 bn) of overall Ukrainian debts by consumers for electricity consumed.

Table 2.1**Accounts payable and receivable of coal enterprises in Donetsk and Luhansk oblasts, UAH bn**

	Accounts payable	Accounts receivable
Donetsk coal enterprises	4.57	1.17
Luhansk coal enterprises	3.81	1.31
Total	8.38	2.48

Source: Derzhkomstat

The Eastern regions of Ukraine show also poor results in utilities development. Payment collection for utilities services in Donetsk oblast is the second worst in Ukraine (as of August 2004). Only 7 regions do not pay for utilities in full, of which 3 are regions under consideration (Donetsk, Luhansk, Kharkiv).

Total debt of the Eastern region population for utilities services accounts for 55% of total debts of Ukrainians, whilst the share of population that live there is 32%. Accumulated debt of population for utilities services is the highest in Donetsk oblast.

Donetsk and Luhansk oblasts together account for almost half of Ukraine's atmospheric pollution, with density of pollution per square km being up to 7 times more than Ukrainian average. In the eastern region are the most polluting industries located (Table 2.2.). While consuming less than 1/5 of total fresh water consumption, these regions accounts for almost 1/3 of pollution of Ukrainian surface water basins (s. table 2.2)

Table 2.2**Regions and pollutions**

Atmosphere emissions volume	Emissions to atmosphere (in terms of density per km ²),	Growth rate of emissions
<i>Ukraine. 6097.5 th. tons</i>	<i>Ukraine average 10.1 tons</i>	<i>Ukraine average 99.9%</i>
Donetsk – 1782.2 th. tons (29.2%);	Donetsk – 67.3 t;	Donetsk – 99.4%;
Dnipropetrovsk – 995.9 th. tons (16.3%);	Dnipropetrovsk – 31.2 t;	Dnipropetrovsk – 94.8%;
Kharkiv – 286.8 th. tons (4.7%);	Kharkiv – 9.1 t;	Kharkiv – 104.0%;
Luhansk – 580.0 th. tons (9.5%);	Luhansk – 21.7 t;	Luhansk – 106.3%;
Zaporizhzhya – 344.1 th. tons (5.6%)	Zaporizhzhya – 12.7 t	Zaporizhzhya – 102.9%

Source: Derzhkomstat

Clearly, such extremely serious ecological conditions take their toll in terms of poor health and high mortality of population of these (and neighbouring) regions.

The high indebtedness and poor ecological situation clearly demonstrate that not all costs of industrial production are internalized and restructuring remains a main challenge. So small wonder, that according to the UN Human Development Index (HDI), only Kharkivs'ka oblast is in the first half of the list, holding 6th place among all Ukrainian regions. At the same time, Dnipropetrovs'ka, Donetsk'ka and Luhans'ka oblasts are lagging behind.

The "fiscal profile" of the regions in question deserves special attention. These regions are the largest contributors to the revenues of Consolidated budget after city of Kiev – Donetsk'ka, Dnipropetrovs'ka, Kharkivs'ka, and Luhans'ka account for 10%, 7%, 7%, and 4% respectively. At the same time our calculations show that these regions except Kharkivs'ka oblast are net recipients of budget funds, although the amount of net transfer varies (Appendix, Table 1). However, if we take into account privatization proceeds as revenues, the situation improves only partially. In this case, Dnipropetrovs'ka and Kharkivs'ka oblast are expected to become net donors of the Consolidated budget.

The whole group is a net recipient of the budget funds, partially due to high amounts of state aid directed to these regions. Donetsk'ka, Luhans'ka and Dnipropetrovs'ka oblasts are the main recipients of sector-related aid, financed by Central budget. In 2002 above mentioned oblasts received UAH 2.2 bn from the Central Budget in the form of subsidies to coal mining. In 2004 subsidies to coal industry increased up to UAH 3.1 bn.

Traditionally these regions have been getting various tax privileges granted by central government. The Cities of Donetsk and Kharkiv and numerous towns in Donetsk'ka and Luhans'ka oblasts have benefited from special investment regimes. According to Ministry of Economy data, in September 2004 free economic zone (FEZ) "Donetsk" and numerous territories of priority development (TPDs) in Donetsk'ka oblasts received 83% of total tax privileges granted to all FEZs and TPDs in Ukraine. In 2003 enterprises located in FEZs and TPDs (throughout Ukraine) received UAH 1891 m in form of tax exemptions and paid only UAH 794 m to budget.

3 Conclusions

While contribution of 4SE-regions to GDP is significant, its real size is likely overestimated as industrial production is based on subsidized inputs (especially cheap coal) and a low payment discipline for utilities and energy. Other production costs remain externalized, and household income of population are in comparison to other regions in Ukraine disproportionately low.

While the economic importance of the 4SE-regions for Ukraine should not be underestimated, their economic contribution is not a free gift to the other regions and rewarded higher wages and profits. So, strictly in economic sense we find not support for "feeding the country" thesis.

Industrial profile of the 4SE-regions was formed under planned economy and requires serious restructuring and technical modernization. The regions themselves cannot solve these tasks on their own, and, of course, the economic effects of this restructuring for the country in general (for example, migration flows from 4SE-

regions) must be taken into the account. Besides, international experience shows that in the long run a regional development predominantly based on coalmining and metallurgical industry is not sustainable. At the moment these regions have not attracted significant enough volumes of FDI comparing to their needs, and the structure of FDI proves that there are very few potentially attractive fields for foreign investments.

At the same time the 4SE-regions contribution is accompanied with number of problems. As it was mentioned earlier high level of wages comparing to the rest of Ukraine coexists with wage arrears as well as debts for utility, environmental pollution, etc. In economic sense these and other problems reduce somewhat the "economic value" of 4SE-regions industrial development.

These regions contribute significantly to the state budget. But at the same time these regions receive significant tax privileges and transfers from the state budget as well. This transfer towards the East, however, is in the interest of the whole nation if spent properly on meeting the social cost of production in the East. Meeting these costs (reducing pollution etc) is a national-wide task, not just a local Donbass problem.

Human development data analysis suggests that industrial production in the regions often goes at the expense of the quality of life, and the further economic progress has rather tough economic, ecological, social and human development limits.

Summing up we can say that widely quoted indicators of economic and industrial development of the 4SE-regions as well as its contribution to the State budget do not reflect total social costs of production. And without proper accounting of these costs as well understanding the role of economic inter-linkages it is impossible to get the real picture of the current economic situation as well as realistically assess the medium and long-term prospects.

These and other issues have already clearly demonstrated that Ukraine needs a well-thought and coherent regional policy, that is well-defined strategies and current targets and proper instruments to achieve the goals in the most efficient way. This policy should be aimed in strategic perspective at the shift from equalization to efficiency and economy-wide growth. At the same time the equalization efforts should be concentrated on the reduction of discrepancies in regional fiscal capacities rather than levels of regional economic performance.

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Appendix

Table 1.
Distribution of consolidated revenues and expenditures by oblast in 2004

	<i>A. Total revenues to consolidated budget</i>		<i>B. Local expenditures w/o intergovernmental transfers</i>		<i>C. Total expenditures</i>	<i>A-C Revenues net of expenditures</i>	<i>Revenues net of expenditures (privatization as revenues)</i>
<i>Oblast budgets</i>	<i>UAH bn</i>	<i>% of consolidated revenues</i>	<i>UAH bn</i>	<i>% of consolidated expenditures</i>	<i>UAH bn</i>	<i>UAH bn</i>	<i>UAH bn</i>
Crimea	3.74	4%	1.88	2%	4.04	(0.30)	0.14
Vinnnytska	1.88	2%	1.23	1%	3.24	(1.36)	(0.98)
Volynska	1.09	1%	0.88	1%	2.15	(1.07)	(0.85)
Dnipropetrovska	6.37	7%	2.69	3%	6.94	(0.57)	0.39
Donetska	8.66	10%	3.59	4%	10.96	(2.31)	(1.04)
Zhytomyrska	1.55	2%	1.00	1%	2.81	(1.26)	(0.96)
Zakarpatska	1.35	2%	0.88	1%	2.10	(0.75)	(0.52)
Zaporizska	3.88	4%	1.46	1%	3.57	0.31	0.83
Ivano-Frankivska	1.63	2%	1.00	1%	2.45	(0.82)	(0.54)
Kyivska	2.76	3%	1.51	1%	5.83	(3.07)	(2.61)
Kirovogradska	1.39	2%	0.82	1%	2.24	(0.85)	(0.61)
Luhanska	3.69	4%	1.81	2%	5.73	(2.04)	(1.48)
Lvivska	3.69	4%	1.85	2%	4.86	(1.18)	(0.58)
Mykolaivska	1.91	2%	0.94	1%	2.26	(0.35)	(0.06)
Odesska	3.70	4%	1.93	2%	5.27	(1.57)	(1.03)
Poltavska	4.21	5%	1.21	1%	3.14	1.07	1.47
Rivnenska	1.55	2%	0.92	1%	2.80	(1.25)	(1.00)
Sumska	2.14	2%	0.91	1%	2.35	(0.21)	0.08
Ternopilska	0.94	1%	0.79	1%	2.10	(1.15)	(0.95)
Kharkivska	6.15	7%	2.39	2%	5.85	0.30	1.04
Khersonska	1.14	1%	0.81	1%	2.05	(0.91)	(0.68)
Khmelnitska	1.61	2%	1.01	1%	2.86	(1.24)	(0.95)
Cherkasska	1.61	2%	1.03	1%	2.70	(1.09)	(0.80)
Chernivetska	0.82	1%	0.64	1%	1.61	(0.79)	(0.63)
Chernihivska	1.95	2%	0.92	1%	2.37	(0.42)	(0.15)
Kyiv	19.63	22%	4.28	4%	8.41	11.22	12.44
Sevasopil	0.71	1%	0.35	0%	0.75	(0.05)	0.04
Ukraine	89.72	100%	38.74	38%	101.45	(11.73)	-