# Overview of Key Recommendations in Public Financial Management Area by International Donors in Ukraine

Prepared by FISCO id

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20 Septmber  2010

# Content

# Preface

This report was prepared by the FISCO id LLC (www.fisco-id.com) as a deliverable within a consultancy contract with UNICEF Ukraine for provision of on-going technical support in the area of Public Financial Management during May-December 2010. The authors of the report are Kateryna Maynzyuk, Yuriy Dzhygyr, and Denys Kovryzhenko.

The views expressed are those of the authors and do not necessarily reflect the policies or views of UNICEF.

We are very grateful to the representatives of International Development Organisations who have kindly agreed to meet with us, to share their views, or to help in collecting related materials for the benefit of this analysis:

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Olga Tymoshenko, SIDA, Ukraine;

Michael Martin, USAID, Ukraine;

Matthias Morgner, GTZ, Ukraine;

Sergiy Grytsenko, UNDP, Ukraine;

Ganna Yatsyuk, UNDP, Ukraine;

Olena Ursu, UNDP, Ukraine.

We are especially grateful to Natalia Astapova, Policy and Monitoring Officer at UNICEF Ukraine, for her patience and guidance during the preparation of this paper.

## Acronyms and Abbreviations

| | |
|---|---|
| AC | Accounting Chamber |
| CEE | Central Eastern Europe |
| CIS | Commonwealth of Independent States |
| CIDA | Canadian International Development Agency |
| CPS | Country Partnership Strategy |
| CRU | Control and Revision Unit |
| DCFTA | Deep and Comprehensive Free Trade Area |
| DFID | Department for International Development |
| DGWG | Donor-Government Working Group |
| DIALOGUE | Development Initiative for Advocating Local Governance in Ukraine |
| DPL | Development Policy Loan |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Commission |
| ENPI | European Neighbourhood Partnership Instrument |
| EPT | Enterprise Profit Tax |
| EU | European Union |
| FCO | British Foreign & Commonwealth Office |
| FRSSU | Facilitating Reforms in Social Services in Ukraine |
| GDP | Gross domestic product |
| GMI | guaranteed minimum income |
| GTZ | Deutsche Gesellschaft für Technische Zusammenarbeit |
| IMF | International Monetary Fund |
| IRF | International Renaissance Foundation |
| LARGIS | Local and Regional Government Institutional Strengthening |
| MFBF | Macro - Fiscal Budgeting Framework |
| MDG | Millennium Development Goals |
| MIC | Middle-Income Country |

| | |
|---|---|
| MoF | Ministry of Finance |
| MoH | Ministry of Health |
| MTEF | Medium term expenditure framework |
| NBU | National Bank of Ukraine |
| NGO | Non-governmental organization |
| NERC | National Electricity Regulatory Commission |
| OECD | Organisation for Economic Co-operation and Development |
| OOP | Out-of-Pocket Payments |
| PAYG | Pay as you go |
| PDSSR | Policy Dialogue for Social Services Reforms in Ukraine |
| PFM | Public Finance Management |
| PFR | Public Finance Review |
| PIU | Project Implementation Unit |
| PPL | Law on Public Procurement |
| QFA | Quasi-Fiscal Activities |
| SIDA | Swedish International Development Cooperation Agency |
| SIGMA | Support for Improvement in Governance and Management |
| SUFTAR | Sustainable Financing of Territorial and Administrative Reform |
| UK | United Kingdom |
| UN | United Nations |
| UNCIEF | United Nations Children's Fund |
| UNDP | United Nations Development Programme |
| USAID | United States Agency for International Development |
| VAT | Value added tax |
| VR | Verkhovna Rada |
| WB | World Bank |
| WFD | Westminster Foundation for Democracy |
| WTO | World Trade Organization |

# Background and approach

**UNICEF commissioned this overview to effectively engage in helping Ukraine spend public funds to achieve best results for children.** One of the key developments in the UNICEF approach in the CEE/CIS region during 2007-2010 has been increasing appreciation of the importance of public financial management for the effectiveness of its work on protection of children's rights in the region. In revising the country strategy in 2010, UNICEF Ukraine aims to incorporate the objective of helping Ukraine to spend public funds to achieve best results for children. This work has to be done in effective partnership with the Government, national non-state agents, and other development agencies. In order to fit effectively into the existing biology of PFM reforms in Ukraine, UNICEF commissioned this overview of the already existing recommendations developed by other donors.

**The overview is structured as analysis of key themes emerging among recommendations produced by key donors rather than a description of individual projects and programmes.** This overview was prepared based on (1) a desk-study of programmatic documents and project outputs of key international donors available in public access, and (2) interviews with representatives of key development agencies working on PFM in Ukraine. It outlines the history of PFM-related international assistance in Ukraine and describes major emerging themes in recommendations for reform.

**This review is limited to recommendations generated by donors and donor-funded projects, and does not cover the views of Ukraine's civil society or the Government itself.** According to the terms of reference, this review is limited to recommendations in PFM originated with support from international development organisations. Although these views are normally designed in partnership with national state and non-state agents, they do not represent an exhaustive range of opinions on PFM reforms needed for Ukraine. Additional sources of opinion include government's own position, national academia and civil society. These other views represent an important additional angle to the perspective of the donors.

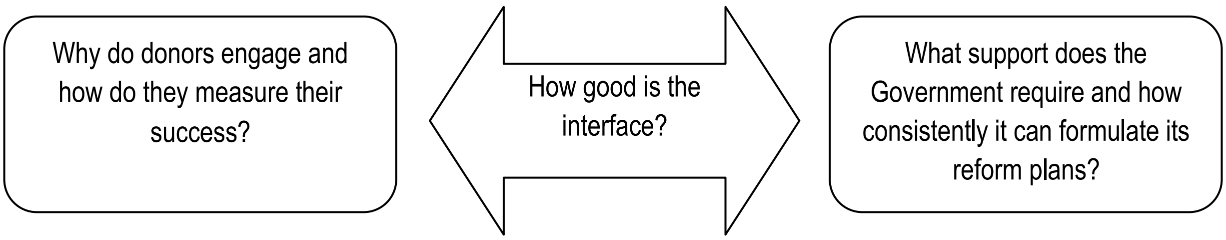
# Observations on aid architecture in Ukraine relevant to PFM

## *Key factors which shape PFM recommendations*

**The focus of the reform effort and the nature of the resulting recommendations produced with donor support reflect the following overall aspects of the underlying aid architecture** (illustrated in Figure 1)**:**

- The rationale of individual development actors for engaging in Ukraine, the scope of their instruments, and the nature of their evaluation benchmarks;
- The features of the decision-making process within the partner government, in particular – availability of a strategic development direction (overall and for PFM in particular), its quality, clarity, and thematic focus;
- The quality of coordination among donors, and the quality of reciprocal interface between the donors and the government structures.

**Figure 1. Features of aid architecture which shape the focus of donor-supported reform effort**



**In Ukraine, these aspects of aid architecture have evolved considerably in the recent years, stimulating a shift away from technocratic recommendations towards policy dialogue.** The kind of support that international development community has provided to Ukrainian government in the area of PFM (and in general) changed significantly, which affected both the kind of projects that were funded and the scope of recommendations they generated. In particular, the changes occurred in response to the following factors:

- **Ukraine's transition into the middle-income country category and resulting decrease in the fiscal importance of aid**. In 2006, Ukraine was reclassified into a (lower) Middle-Income Country (MIC), which was recognised by many donors as a circumstance requiring a revised development approach[1]. One aspect of MIC status is relatively low dependence of a country on international development flows and relatively higher significance of the country's own public finance in funding major reforms. As of 2010, aid as % of GDP in Ukraine is estimated at only 1.7%[2]. Respectively, over the last decade, international development agencies started to recognise key importance of the country's domestic PFM structures and institutional complexities as key factors to effective development.
- **Decreasing relevance of a fiduciary view on PFM.** On the other hand, many of the existing standard tools which were developed for analysis of PFM in countries who benefited from significant direct budget support by donors were not entirely relevant. Most of such tools were designed with the primary purpose of estimating "fiduciary risk" – that is, the risk that local PFM systems would not allow aid-recipient governments to effectively utilise development funds channelled to the domestic budget. Such fiduciary studies of course always serve a double-purpose, bringing information on the issues in the PFM systems which could also be of high value to the national governments. But very often – with varying expression – these assessments are still focused on issues which concern donors more than national governments. Moreover, when "fiduciary" elements of such studies are disguised, they could sometimes be even more detrimental since they make it difficult for recipient countries to use such studies well or use them at all. In particular, one big risk is that "fiduciary" anxieties often motivate donors to stimulate studies or analysis in parallel to incipient analytical efforts already developing in the recipient countries, and parallel systems (especially when they are unsolicited) are always the surest way to kill such authentic reforms at their birth.
- **Europeanisation agenda.** In the recent decade, one of the few sustainable drivers of change which consistently affected domestic policy-making has been the goal of EU approximation. Respectively, for some time at least, the donor community have considered the 2004 EU-Ukraine Action Plan[3] and the subsequent 2010 EU-Ukraine Association Agenda[4] as primary candidates to shape the coordinated aid effort. ENPI became the key expanding source of aid. These circumstances increased the importance of the more democratic development tools employed by the EU in the context of approximation (such as transfer of knowledge through training and twinning, influencing through political dialogue, structural support to regional development, etc.) as opposed to more technocratic approaches characteristic to institutional philosophies of such agencies as the World Bank (WB) or the IMF.
- **Lack of progress in strengthening political institutions in Ukraine.** As we will discuss repeatedly in this paper, throughout 2005-2010 Ukraine struggled inside a constitutional deadlock which reinforced the country's weak capacity to formulate consistent development goals. This absence of an agreed reform agenda made it difficult for most donors to engage into meaningful technocratic consultations, as well as to coordinate efforts.
- **2008-2009 global economic crisis, which brought PFM challenges to the fore.** Pre-crisis political inefficiency left Ukraine highly vulnerable to external shocks and made it one of the worst-affected countries. Shortages of public funds coupled with electoral pressures opened a new window of opportunity for international players to voice opinions on reforms needed for Ukraine. Since the crisis hit public finance most painfully (not least given the irresponsible prior policies), the recommendations were also concentrated on PFM.

- **A paradigmatic shift in International Development towards influencing institutions and governance.** Global development partnership increasingly recognises that effective protection of human rights, stronger democracy and support to economic growth are closely linked with institutional reforms. Gradual recognition of importance of good governance was matched by mounting statistical evidence which illustrates that institutional factors matter for social-economic development: e.g. better governance indicators are positively associated with improved investment and growth rates, government effectiveness, efficient bureaucracy and rule of law correlate with economic performance, adult literacy, and are negatively associated with infant mortality[5].

**Agendas and institutional philosophies among donors in Ukraine are very diverse, which makes it difficult to detect one coherent package of technical recommendations – generally or for PFM.** Development agents in Ukraine traditionally had different rationales for engaging, some of which have been wider than aid partnerships, as in the case of the EU. Moreover, there has been no transparent consensus on the purpose of aid in Ukraine and how to monitor its success (despite wide acceptance of Ukraine's Europeanisation goals, as well as the global MDG agenda). For example, as we will see in the next chapter, the EC has traditionally focused on EU-integration aspects of PFM reforms (such as approximation of key institutions, market liberalisation, public safety and social cohesion). These goals are complementary but conceptually different from the WB's mission to fight poverty through support to structural reforms or EBRD's focus on economic transition. Other agencies also working on poverty reduction had their specific focuses, e.g. protection of human rights in the case of UN agencies, in particular UNDP.

**However, despite institutional diversity, there is a recent convergence among donors regarding fundamental importance of governance and policy-making process.** Although development agents work on diverse PFM-related themes, apply diverse instruments and do not often coordinate effectively, their discoveries and recommendations – analysed in this paper – recently tend to focus on a more narrow range of fundamental problems which represent universal obstacles to donor's respective goals. These fundamental problems relate to the weakness of political institutions and governance structures, which make it difficult to set strategic objectives, assess and acknowledge public value, and deliver results in accountable and fiscally responsible way. In other words, while government's technocratic potential as such is relatively high, it has a very weak capacity to actually implement any emerging reform ideas into practice. As a result, recommendations of most donors on how to improve PFM increasingly focus on improvement of policy-making capacity rather than technical aspects of PFM as such. Donor-funded assessments and position papers in various PFM-related areas increasingly capture these resonating messages, which go beyond individual issue-based reforms.

> *"The role of institutions in economic growth and development is one of the most exciting frontier areas in economics research today."*
>
> *- K. Daron Acemoglu, MIT, 2006*

**The 2008-2009 economic crisis reinforced the similarities of broader governance concerns related to PFM, shared by most donors.** Rapid economic contraction of Ukraine's economy during 2008-2009 (a 15.1% real GDP reduction in 2009) resulted in a significant decrease of public revenues at the background of an already significant public debt, collapsing pension system, input-based regulation and substantial unfunded mandates on sub-national budgets in all social sectors. These circumstances created immediate fiscal pressures. But despite the fiscal emergency, electoral competition resulted in continuous expansion of social expenditures at rates above inflation, funded by distortive tax squeezes and accumulation of disguised public debt (including VAT refund and wage arrears). These developments emphasised the weakness of the policy-making process, irrelevance of technocratic argument, and, above all, lack of accountability behind public financial management, which lies at the heart of democratic state.

**Recent history of aid coordination in the area of PFM.** Historically, coordination of aid at the level of individual sectors has been more effective in Ukraine compared to overall strategic cooperation across donors and the government. One usual reason for this was availability of clearer strategies for reforms both within the Government and on the donor side.

- **High Level Donor-Government Working Group (DGWG), 2006-2008.** In 2006, development partners in Ukraine have subscribed to co-ordination under the High Level Donor-Government Working Group (DGWG), which contained several thematic sub-groups chaired by respective line ministries[6]. PFM issues were dispersed across several sub-groups, including: "Support to Institutional Reform and Governance" (Governance and Administrative Reform, Anti-Corruption) and "Support to Economic Reform" (Social and Economic Development, Regional Cooperation). However, despite wide donor support and publicity, this mechanism has not sustained the momentum and is not in active operation.
- **WB Public Finance Modernisation Project (2008-2013)**. A key sector-level coordination initiative for PFM in recent years centered around the WB Public Finance modernisation project which is linked to the WB investment loan contributing to improved information systems accross the PFM sector (including MOF, internal audit, Treasury, State Tax Administration and the State Customs service)[7]. Since the inception of this project, WB led an active dialogue with other donors regarding their PFM-related inputs. As the project progressed, this function was transferred to a special unit within the MoF, closely co-operation with the project's PIU.
- **MoF coordinatory initiatives with support from other donors**. The MoF donor coordination unit which took forward the agenda launched by the WB PF Modernisation project sought support from the donor community in enhancing its capacity to co-ordinate PFM-related aid flows. This request shaped a component of a new SIDA project which provides technical advice in PFM area to the MOF. Despite the very fruitful co-operation, this work was challenging because of recent uncertainties over the locus of the policy function within the current government, which makes it difficult for donors to identify entry points for their advice at the policy-development stage.

## *Scope and approach to PFM advice by key players*

The EU

**The EU approach is grounded in the priorities of the Association Agenda, with a special focus on political dialogue.** EU development cooperation with Ukraine is based on the European Neighbourhood Partnership Instrument (ENPI) which supports priorities outlined in the 2010 EU-Ukraine Association Agenda. A List of Priorities outlined in the Association Agenda in 2010 resonates closely with the ENPI Country Indicative Programme for 2011-2013. It contains ten priorities with pronounced PFM implications, outlined below. A priority which notably stands out as most detailed and extensive is *Political Dialogue*, which covers such fundamental conditions to effective PFM as political and public administration reforms.

**2010 EU-Ukraine Association Agenda Priorities related to PFM**

- Political Dialogue

  Strengthen the stability, independence and effectiveness of institutions guaranteeing democracy and the rule of law and in particular:

  1. promoting an inclusive constitutional reform process designed to further develop a constitutional system of effective checks and balances between state institutions, in the light of the relevant recommendations of the Venice Commission;
  2. work closely together in reforming and enhancing the capacity of the public administration system in Ukraine on the basis of an assessment by SIGMA, including an effective fight against corruption;

  Ensure the independence of the judiciary and the effectiveness of the courts and of the prosecution as well as of law enforcement agencies

  Ensure respect for human rights and fundamental freedoms by comprehensive cooperation on the protection of human rights and fundamental freedoms, covering both individual cases and issues concerning international law instruments on human rights.

*Promoting the implementation of international and regional human rights standards*

*Ensuring respect for the rights of persons belonging to minorities*

*Combating torture and inhuman and degrading treatment*

- Combating Corruption
- Co-operation on Justice, Freedom and Security issues
- Public procurement
- Energy co-operation (integration of energy markets and energy security)
- Public internal control and external audit and control
- Taxation (tax administration including IT support)
- Statistics
- Social co-operation (more efficient labour markets, including anti-discrimination of vulnerable groups in context of employment)
- Public Health (prevention and control of communicable diseases)

**ENPI Indicative Programme for 2011-2013**

**Priority Area 1: Good Governance and the Rule of Law**

Sub-priority 1: Justice, Freedom and Security

Sub-priority 2: Integrated Border Management

Sub-priority 3: Public Administration Reform and Public Financial Management

Sub-priority 4: Disarmament

**Priority Area 2: Facilitation of the entry into force of the EU-Ukraine Association Agreement (including a Deep and Comprehensive Free Trade Area)**

Sub-priority 1: Facilitation of the entry into force of the Association Agreement

Sub-priority 2: Facilitation of the establishment of a DCFTA

**Priority Area 3: Sustainable Development**

Sub-priority 1: Energy, Environment and Climate Change, Transport

Sub-priority 2: Regional and Rural development

## The World Bank

**The 2008-2011 CPS revised the Bank's approach to take into account institutional barriers to implementation of reforms.** The WB development partnership in Ukraine is based on Country Partnership Strategy (CPS) for 2008-2011[8]. As noted earlier, the 2008-2011 CPS was developed based on the observation that the impact of Bank's earlier work in Ukraine was modest and variable across themes and instruments. According to the previous strategy review, one of the reasons for this variable success was that clear specification of reform objectives was not enough to achieve results; apart from technical vision it is important to understand and remove the institutional barriers to their practical achievement. In particular, the WB noted importance of political economy constraints to practical implementation of reforms.

**The WB works on achieving better results in institutional development by investing into development of reform consensus and demand for change.** Respectively, the new operational framework in the 2008-2011 CPS established that on top of core programmes "where the Bank would support government reform efforts through the entire range of instruments at its disposal;" also "development programmes" and "advocacy programmes", which would help to develop a reform path and "create greater consensus and demand for change"[9].

**This new angle assumes increased analytical work, but the focus of the analysis is not so much on technocratic recommendations as on institutional barriers**. To achieve this, the new CPS proposed a new particular emphasis on non-lending interventions. "The purpose of this work will be to strengthen and broaden demand for good governance. Among the vehicles to support this objective will be the tailoring to Ukraine's context and dissemination of reports distilling international policy lessons."

## The IMF

**IMF policy leverage in the last decades has been variable.** The IMF defines its main job as "monitoring of the world's economies, lending to members in economic difficulty, and providing technical assistance"[10]. Respectively, its cooperation with Ukraine followed the pattern of the country's economic performance in the period since it joined the Fund (in 1992). Intensive lending policies of the 1990s were gradually revised towards a precautionary standby facility, approved in March 2004. Given Ukraine's robust growth observed at that time, the focus of the revised co-operation arrangement shifted to technical assistance in the area of debt management, fiscal forecasting and transparency. However, as we discuss on many instances in this text, the 2008-2009 economic crisis urged Ukraine to repeatedly request renewed lending, opening a new window of opportunity for intensive policy dialogue around attached conditionalities.

> *"Regardless of the type of program that Ukraine may wish to have with the IMF, the government should try to get specific commitments from the IMF on expanded technical assistance. In fact, implementation capacity is a major constraint to successfully implement reforms in Ukraine. This capacity can be increased with expanded technical assistance. The major areas of technical assistance such as fiscal policy, monetary policy and statistics continue to be of great relevance for Ukraine".*
>
> *- The Bleyzer Foundation, 2002* [11]

**The IMF has been a source of authoritative technical assistance in PFM throughout last decades, even when financial assistance was less significant and influencing leverages were weaker**. Ukraine has been constantly receiving technical support from IMF in the area of macro-fiscal policy-making via training programmes to government officials at the IMF Institute in Washington, D.C. and at the Joint Vienna Institute in Austria, and in the form of expert advice on reforms such as improvement of macroeconomic statistics and observance of international financial standards and codes. Technical and diagnostic reports of IMF regular missions to Ukraine have retained a reputation of trusted and objective analysis of the country's macro-fiscal situation. Already in 2002, observers such as The Bleyzer Foundation, noted that IMF technical assistance proved to be the most valuable contribution to domestic reforms[11].

**Post-crisis negotiations on renewed lending package opened a new phase of dialogue around needed PFM reforms.** In 2008, in reaction to the crisis-related fiscal tightening, Ukraine requested a renewal of financial co-operation with the IMF, which opened intensive negotiations over the content of the economic reform package which would be supported by the potential loan. The size of the requested funding in these recent years has been considerably higher than any previous lending operation of the IMF in the country: agreement approved in November 2008 equalled about USD 16.4 billion, and the re-negotiated agreement in July 2010 equalled about USD 15.15 billion, compared to much smaller amounts in earlier years (see Table 1). Throughout negotiations over both of these agreements, with two consecutive governments over 2008-2010, IMF has communicated a strong vision for the needed reform package, which focused on sustainability of macro-fiscal policies, reforms in the gas sector and the banking system.  These recommendations will be reviewed in detail further in this paper.

**Table 1. History of Ukraine's Credit Agreements with IMF over 1994-2010 (based on the overview on Ukraine's Ministry of Foreign Affairs[12])**

| Period | Types of Lending Agreements | Lending Agreements (not always fully disbursed) |
|---|---|---|
| **1994-1995** | STF (Systemic Transformation Facility) | 763 mln USD |
| **1995-1998** | Three annual stand-by programmes | 1 935 mln USD |
| **1998-2002** | EFF-Extended Fund Facility | 2 600 mln USD |
| **2002-2008** | Non-lending support | - |
| **2008** | Two-year stand-by agreement | 16 400 mln USD |
| **2010** | Revised cooperation agreement | 15 150 mln USD |

# Major themes in recommendations for change

## *Cross-cutting PFM-related concerns*

Governance, anti-corruption, political dialogue, and public communications

**Technical analysis of PFM in recent years increasingly focused on institutional barriers to change.** Although broad-based institutional development and good governance have always been on the agenda of most development agencies working on PFM, in the recent years recommendations related to institutional development came to the fore as central, and also as most challenging. Recommendations to improve PFM-related institutions and policy-making processes are featured in the programmatic documents of key donors, as well as in the analytical outputs produced with the donor support.

### *EU SIGMA Assessment (2006-2007)*

**2006-2007 EU-OECD SIGMA assessment is the most systemic existing analysis of Ukraine's PFM given that it is designed as pre-integration, rather than fiduciary, tool.** Starting from 2006, EU gradually expanded its support to Ukraine's participation in the SIGMA initiative, the EU's most advanced instrument for assessment of government systems and PFM system in particular, which was designed to evaluate public administration of accession candidates. Given Ukraine's non-candidate status, SIGMA's analysis of Ukraine's systems has combined a political dimension with the capacity-building and development in the area of public administration. The first assessment was conducted in 2006[13] (and updated in 2007)[14]

> *"Governance in Ukraine continues, broadly speaking, to operate according to inherited modes of organisation, practice and thinking. […] During the last 15 years, established ways of thinking and doing business – stable "institutions" in the sociological sense – have formed; and these, more so than formal institutions, are resistant to change. They cannot be modified by change in the legal system alone. […]"*
>
> *– SIGMA Governance Assessment, 2006*

with support from DFID and SIDA, and since 2008 EU started to fund Ukraine's co-operation with SIGMA experts as part of the ENPI.

**The 2006 report remains the broadest available analysis, covering most PFM aspects.** Initial SIGMA assessment (2006-2007) covered a broad range of PFM issues, including public expenditure management, public procurement, public internal financial control and external audit. Thanking to its systemic approach, the assessment also included broader areas such as policy making system, legal and constitutional framework, and human resource management. However, it was still incomplete, leaving aside such areas as local self-government and regulation. Further analysis conducted under 2008-2011 ENPI coverage have so far focused on internal and external financial control systems.

> *"Ukraine is largely investing this creative impetus in internal fights for division of power, instead of on crucial reforms aiming at developing substantive policies and improving the system of governance."*
>
> *– 2007 SIGMA Assessment Update*

**2006-2007 SIGMA assessment concluded that no PFM reforms were possible without clarification of fundamental confusion in the political system and without restoring of state's ability to mobilise social support to change.** While the 2006-2007 report contained lists of recommendations by individual PFM areas (some of which are covered in relevant sections below), its overall conclusion was focused on overall fundamental weakness in the country's political system, which lacked clear divison of responsibilities and respect to the rule of law. The 2006 report stated that "The implementation of the specific recommendations proposed in this report should await this clarification, since most of them can improve the policy system only if the fundamental power issues are resolved first."[15] The 2007 update concluded that these political barriers have become more pronounced: "The State is becoming weaker and, consequently, it will be more difficult to mobilize people and to generate social support for essential reforms. So, without overcoming the current political problems – in which constitutional reform and political culture play a highly relevant role – only some minor improvements are possible in the areas covered by Sigma's 2006 assessment.".

### *WB Public Finance Review (2006-2008)*

**The PFR (2006-2008) is the backbone of the WB's technical opinion on Ukraine's PFM and the most detailed evidence-based analysis of the subject in the field so far.** During 2006-2008 the World Bank undertook a Public Finance Review for Ukraine, which remains the most comprehensive and detailed evidence-based technical analysis of the country's PFM so far, although parts of it were taken forward in further analytical products by the WB. The review had two phases: the first - looking at micro-fiscal tensions (with analysis of taxation, general budgeting issues, pension reform and capital budgeting) and the second – looking at decentralised public spending on healthcare and education, as well as local capital budgeting.

**Most reform recommendations advocated by the report assumed a more strategic policy-process, broader-based taxation, and better governance of key spending programmes.** The report listed key reforms to make the government smaller and more efficient and showed how they could be funded by fiscal savings from streamlined social security and pension systems, coupled with broadening of the tax base and improving tax compliance. It also pointed at specific changes that would improve financing of healthcare and education (described further in this paper). However, the report also illustrated that most of these reforms depended on making politically difficult trade-offs between recurrent and investment spending, on significant changes in tax compliance, on allocating responsibilities more clearly across levels of government (to match financial allocations), and on removing fundamental governance malfunctions in administration of healthcare and education, which create extreme inefficiencies in delivery of these services, including such problem as massive out-of-pocket financing of these sectors.

### *WB Country Partnership Strategy (2008-2011) and Crisis-Related Recommendations*

**WB CPS identifies Governance and Anti-Corruption as a cross-cutting theme for all activities.** As already discussed, WB considers lack of progress in institutional reforms to be the core obstacles to Ukraine's development. The CPS stated that based on the most recent evaluation, that "Ukraine's unexpectedly strong economic performance may not be sustained without a deepening of structural reforms and improvements in public and private sector governance."[16] Respectively, the CPS identifies Governance and Anti-Corruption as key cross-cutting themes for all issue-based activities supported by the WB in Ukraine.

> *"A key problem for Ukraine is the lack o f trust in public sector institutions, and the resulting low expectations trap: the public expects little from the state, but is in turn not willing to make much of an effort to advocate for improvements either."*
>
> *– WB CPS 2008-2001*

**A specific focus in better governance which the WB has stressed since 2008 was public communications and building trust in the state.** As already discussed, analysis behind WB CPS revision in 2008 revealed that variable results in practical implementation of clearly stated technical recommendations for reforms were explained with the lack of social consensus regarding desired development path for Ukraine. As a result, the CPS's vision of desirable support to reforms implied "building trust in public institutions and building demand for better governance".

**Public communications were at the heart of the WB's post-crisis recommendations to the Government[17].** Following the outburst of economic crisis, the WB has published its recommendations to the Government and actively participated in the public debates around the prospect for post-crisis fiscal consolidation. While these recommendations contained technical considerations, described further, the WB emphasised that "*the main message of [WB's] recommendations is that reforms in Ukraine are possible if they are properly explained. Citizens will accept change, including cuts in pension benefits and higher tariffs, if they see this as part of a package that also closes tax loopholes, reduces bureaucratic red tape, improves transparency and delivers more effective public services*"[18].

### *Post-crisis consensus on the risks of unaccountable growth in quasi-fiscal budget deficit*

**Pre-crisis recommendations noted that a way to better services was not in levying more taxes but in eliminating tax loopholes, spending more efficiently, and budgeting for long-term.** Already in previous technical papers, donors have shown that tax burden on the economy in Ukraine was already significant and that public spending was already high, but extremely inefficient. Respectively, they recommended that any increases in budget revenues should be achieved through widening the tax base through measures such as better administration of VAT, streamlining of payroll taxation, and eliminating existing tax loopholes. These recommendations also demonstrated that improvement in public services could be achieved not by higher spending but through administration and governance reforms, as well as through introduction of long-term budgeting framework.

**However, Ukraine's Government responded to the crisis by increasing inefficient expenditures through further tax squeeze, which showed that no institutions were in place to take on board technical recommendations.** As discussed earlier, economic crisis created significant fiscal pressures on Ukraine's budget. Shortage of funds made it even more obvious than before that Ukraine's traditional approach to increasing fiscal space for extra expenditures has been based on extremely myopic, confused and undemocratic political process. In particular, the key measures taken by two consequent governments during the crisis period (2008-2010) included progressive increase in nominal pensions, social benefits, and recurrent spending in social sectors without steps to release administrative inefficiencies and unfunded vertical mandates on local budgets. At the same time, the two governments progressively relied on funding this inefficient expansion with hidden and unsolicited quasi-fiscal borrowing such as VAT refund arrears, mandatory advanced tax payments, and wage arrears[19].

## Macro-fiscal stability

### *Growing attention to weaknesses in macro-fiscal framework*

**Robust economic growth in 2000-2007 allowed Ukraine to maintain a stable macro-fiscal framework.** During 2000-2007 Ukraine achieved a substantial progress in macro-economic stabilisation and, e.g. according to WB CPS, "tended to perform well on macroeconomic results, even if crucial policy milestones were delayed". In these years, Ukraine's GDP grew at an average of 7,5%, and inflation remained moderate. Respectively, during these years, budget revenues expanded in line with GDP, easing borrowing requirements, and helping to reduce the debt-to-GDP ratio to less than 15%.

**Even during years of growth, donors pointed at a number of weaknesses in Ukraine's macro-fiscal policy framework, which would represent risks in less favourable years.** Already during those affluent periods, domestic and international observers noted the underlying economic growth was achieved primarily as a result of favourable terms of international trade which helped Ukraine to expand its exports of metals and chemicals. This meant that although Ukrainian economy was growing, it was highly vulnerable to the possibility of external economic shocks. Another unsustainable factor noted by observers was significantly undervalued currency, which was supported by the NBU's de facto peg of Ukrainian Hryvnia to the US Dollar. On the fiscal side, the government spent the years of economic growth increasing the share of public consumption (which grew to 44% of GDP) without increasing public investment (which remained at 2% of GDP)[20], and key reforms with macro-fiscal implications – such as Pension Reform and taxation reforms – were not implemented. Moreover, structural sector-reforms in key spending programmes such as healthcare, education, and social protection – have stalled, which made growing public expenditures increasingly inefficient[21]. Consequently, in its 2008-2011 CPS, the WB had chosen macro-fiscal stability as one of the two cross-cutting objectives for all activities in country.

> *"A massive turn-around in the savings-investment balance observed around 2004 has raised concerns that Ukraine may be pursuing unsustainable macroeconomic policies and needs a combination of fiscal tightening and greater exchange rate flexibility to allow external balance to be restored. Pre-election promises of further increases in public sector wages and transfers underline the concern that Ukraine may be over-heating."*
>
> *- WB CSP 2008-2011*

**Some of the negative consequences of inefficient macro-fiscal policy-making started to show several years before the global crisis.** Given these intrinsic vulnerabilities, the macro-fiscal pressures have started to accumulate long before the global economic crisis, as was noted in the WB PFR in 2006. It showed that economic growth in Ukraine started to decelerate starting from 2004 (from 12,1 in 2004 to 2,5% in 2005), and that macro-fiscal framework was increasingly at risk. It illustrated that failures to reform taxation to ease the burden on businesses while improving compliance started to discourage private sector, and that growing public consumption is starting to create risks of inflation and growing interest rates, which would erode household wealth.

**The crisis has reinforced earlier technical recommendations and created a financial leverage to drive these reforms in a form of conditions to IMF stand-by loans.** As the crisis unfolded, growing macro-fiscal concerns materialised into growing public arrears on financial liabilities (such as wages and VAT refund arrears), soaring public debt, rapid contraction of the private sector, and extreme inflation rates which were highest in the world, following only Venezuela[22]. At the same time, emerged cash shortages have shifted the locus of policy-driving technical opinion on PFM priorities back to the conditionalities attached to the IMF stand-by funds, which were again urgently required. During 2009-2010, the IMF led the dialogue with the Ukrainian government on key macro-fiscal reforms as a prerequisite for releasing its stand-by loan. However, the essence of the technical recommendations within these conditions coincided with the earlier consensus on weaknesses in the macroeconomic and fiscal policies, and were supported by the key donors. These reform agendas are briefly presented below.

### *Broadening the Tax Base and Improving Compliance without Increasing the Tax Burden*

**The only way for Ukraine to expand its fiscal space without damaging macroeconomy is to widen the tax base and improve tax compliance.** The 2006 WB PFR[23] illustrated that any extra fiscal space that Ukraine would need to mobilise (e.g. in order to fund structural reforms) would need to be built by expanding the scope of assets or income streams which are subject to taxation (the tax base), rather than increasing the tax rates. It showed that the tax burden on the private sector was already very considerable, and that further increases in the tax rates would slow down economic growth. On the other hand, the government should expect that additional public funds would be required to finance structural reforms in key social sectors and in case if external economic shocks would change the positive dynamics of budget revenues (as it happened by 2008). The only way to collect such extra revenues without damaging macro-economic implications would be to eliminate current exemptions and loopholes which allow significant amounts of assets and incomes to remain outside taxation system.

**The WB PFR listed the following potential sources of how Ukraine's tax base should be expanded:**

- Elimination of sector-based **tax exemptions and privileges** (e.g. VAT exemptions in agriculture and pharmaceutical sector or EPT privileges ).
- **Reparation of the simplified taxation system**, in order to eliminate opportunities for large enterprises to enjoy the benefit of considerably smaller taxes designed in support to small and new businesses (e.g. by rationalising eligibility criteria).
- Improvement of compliance with the VAT liabilities by resolving the problem of **VAT refund fraud**. Current distorted system of VAT administration allows fraudulent agents to account the bulk of added value on accounts of missing traders, minimising tax liabilities within the country and claiming fictitious refunds of this tax through pseudo-export.
- **Elimination of free economic zones,** which represent packages of tax exemptions which are extremely vulnerable to manipulation. There is very little the government can do to restrain economic agents from outside the eligible territory to benefit from its exempt status unless this territory is protected by

> *VAT exemptions granted to pharmaceutical products may appear reasonable on the surface (with people buying cheaper /tax free medicines) but anecdotal evidence suggests that this exemption is used by pharmaceutical companies and their distributors as an implicit price mark-up instrument. Thus, the distributional impact of this tax expenditure may be quite inequitable, contrary to the original intent.*
>
> *- WB PFR 2006*

enforceable customs controls. At the time of the PFR, Ukraine was on the path to gradual reduction of free economic zones which started in the beginning of 2005. The PFR acknowledged this positive trend and raised this issue as a reminder of the importance of finalisation of related reforms. It is notable that the policy of granting free economic zone status has returned to the Government's agenda in 2010[24].

**A major tax loophole not listed by the PFR but noted by another WB project is privileged taxation of profits of insurance companies.** One other major tax loophole which should be eliminated to widen the current tax base, not mentioned by the PFR but attacked by another WB-funded project is current regime of taxing profits of insurance companies. During 2003-2004, the WB project to Support to Advisory Board to Inter-Ministerial Council for Financial Sector Policy Development produced its recommendations on reforms in taxation of financial services, which paid a significant attention on the insurance taxation problems. It noted that according to Ukraine's current system, turnover of insurance companies is taxed at 3%, compared to 25% for regular business. This means that any company can deduct billions of profits as insurance of non-existent risks in a captive insurance company, which would pay a much lower tax on these amounts. Moreover, insurance companies can avoid even these tax liabilities by re-insuring non-existent risks in foreign offshores. This loophole allows Ukrainian companies to use the national taxation system as a legal national offshore and avoid very significant tax liabilities.

### *Pension Reform*

**The 2006 WB PFR provided evidence-based illustration of macroeconomic unsustainability of the Ukraine's current pension system.** The PFR illustrated that Ukraine's pension system is experiencing an extreme fiscal stress, which would intensify as the population's average age would be increasing. This stress is caused with the inability of the current pay-as-you-go (PAYG) system to ensure sustainable financing of growing pension expenditures.

**The key challenge of the pension reform in Ukraine is the need to coordinate it with tax reforms.** Analysis in the PFR acknowledged that during the previous years Ukraine created a legal platform and a wide consensus around the need to transfer to multi-pillar system which would include mandatory and voluntarily fully-funded state pension insurance. However, it noted that actual implementation of this reform remained unaccomplished and challenging task.

> *"The main driver behind the high growth of current (and total) expenditures is a rapid increase in pensions. The current level of pension expenditures is one of the highest in the world, and is draining resources from other programs and uses. (...) Pension payments grew from 9.2 percent of GDP in 2003 to 15.3 percent of GDP by 2005, while in parallel the pension system balance went from a small surplus in 2003 to a 3 percent deficit in 2005."*
>
> *– WB PFR 2006*

One of the key challenges to introduction of the second pillar is the need to mobilise considerable funds to support this mechanism without raising tax rates and jeopardising macroeconomic stability (as discussed in earlier section). Therefore, PFR explained that the only path to continuation of this reform lied through the widening of tax base and especially through reforms in payroll taxation, including:

- Unification and rationalisation of the payroll taxation rates, and streamlining administrative responsibilities for payroll taxes, which are currently fragmented across four diverse structures, redirecting them to the Pension Fund.
- Introduction of a clear coordination mechanism between the Pension Fund and the State Tax Administration, which should act jointly to minimise possibilities for tax manipulation and minimisation;
- Strengthening the analytical capacity of the Pension Fund to address manipulations in social insurance payments;
- Reforms in the simplified taxation system, which currently allows to minimise social insurance payments.
- Increase female retirement age from 55 to 60 years by 2017, with an increase of 6 months per year.
- Lengthen the required contribution period for eligibility for a full minimum pension to 30 and 35 years for women and men, respectively
- Suspend the increase in pension benefits up to subsistence minimum if pensioner continues to work.
- Replace minimum pension with means tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level.
- Introduce a regular contribution rate for those taxed under the simplified tax system.

### *Macroeconomic unaffordability of growing public spending on current consumption*

**Already in 2006, the WB was concerned about growing share of consumption expenditures in the government's budget.** The 2006 WB PFR looked specifically on the problem of Ukraine's growing public spending on consumption expenditures. It noted that "the concept of fiscal space is another way of looking at the fact that resources are always limited, and thus, for any sustainable fiscal program, resources and plans for allocation must add up. When a government puts more public resources into recurrent spending (e.g., wages, pensions, subsidies), it takes up more of the "fiscal space" that could be granted to its reform program and to growth-enhancing public investments in human and physical capital. In the absence of excess fiscal space, increases in investment and aggregate spending increase fiscal deficits and lead to higher debt and accelerated inflation. But ignoring key productive investment needs would keep growth rates at low levels."

**The PFR recommended significant strengthening of institutional capacity to ensure fiscal discipline and strategic budgeting.** Statistical modelling for several scenarios of Ukraine's development already in 2006, presented in the WB PFR, demonstrated that although implementing recommended reforms could help Ukraine to increase its fiscal space, using these savings strategically would require a considerable change in budgeting approaches. In particular, fiscal authorities would need to develop better capacities to maintain fiscal discipline, ensuring that funds are spent within affordable limits, and according to strategic, rather than short-term, policy priorities.

**2006 WB PFR warned Ukraine against unsustainable increases in public borrowing.** Analysis of public debt sustainability for Ukraine provided in the PFR in 2006 illustrated that despite significant improvement in the debt management practices and in the debt-to-GDP ratio, Ukraine did not have much room to increase its borrowing given its contingent liabilities which were significant already at the time of that report.

Quasi-fiscal activities in the energy sector as macroeconomic and social risk

**Rationales of donor engagement in the energy sector has traditionally been highly variable.** Historically, the rationales of donor engagement in the energy sector has been even more variable than in other development domains. For example, the EU maintained its co-operation with Ukraine under the joint objectives of energy market integration and energy security. On the other hand, the WB pursued reforms in the energy sector primarily as part of its support to enhancing Ukraine's economic competitiveness through higher energy efficiency, and better delivery of key services to population. Along the same lines, EBRD had supported investment into restructuring and modernisation of Ukraine's energy system at national and sub-national levels.

**However, a joint concern of key donors throughout post-independence period has been the tradition of Quasi-Fiscal Activities in the energy sector, typical for post-soviet countries.** As most Former Soviet Union countries, Ukraine has developed a practice of forcing publicly-owned energy companies to operate at a loss (usually by keeping regulated tariffs below full cost recovery and tolerating arrears in payments) and covering resulting corporate deficits by public funds. Because of this need to cover emerging losses in the energy sector from the budget, this practice is known as Government's "Quasi-Fiscal Activities" (QFA).

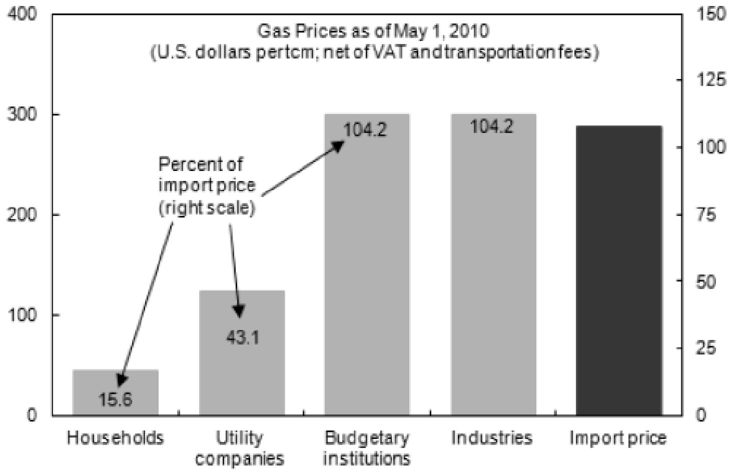
**Ukraine's history of QFA in energy sector has followed a U-curve, improving around 2005-2006, but deteriorating to the point of macroeconomic emergency by the time of this report.** In 2005, most donors declared that financial health of Ukraine's energy sector remained a significant problem but had markedly improved since independence. Initial quasi-fiscal activities in the sector were related to keeping energy tariffs below market rates and poor payment discipline, but these areas were quickly improving. In particular, payments collection has doubled over 2000-2004 and average energy tariffs have been increased[25]. The WB estimated that during 2001-2004, QFA in the energy sector in Ukraine fell from 8% of GDP to a "still-high 6%". However, revisions of gas supply agreements with Russia launched in 2006 created a new pricing mechanism on the energy market which proved to be detrimental for the financial balance of the Ukraine's Naftogaz – a state-owned company monopolistically responsible for extraction, transportation and processing of natural gas and oil. In 2006, the WB estimated that the impact of the new pricing structure on the consolidated quasi-fiscal deficit of the state-owned part of the gas sector would increase moderately during 2007[26]. But as the pricing mechanism continued to evolve over the next years, the negative impact intensified.

*"Fiscal management to date has been conservative, but political instability has led to election promises that if fulfilled could be fiscally costly. Fiscal expansion would risk overheating the economy, with further rises in inflation, growing external imbalances and the potential risk of a hard landing."*

*– WB CSP 2008-2011*

**In 2009, Naftogaz encountered palpable risks to its financial viability, absorbing state support equal to 2.5% of the country's GDP**. In 2009, price differential between import of gas and its further sales to households and utility companies, coupled with low payment discipline, created a financial pressure on Naftogaz, putting its viability at risk and creating emergency pressures on the budget to provide respective support (see Figure 2). According to IMF, during 2009 the Government transferred 2,5% of GDP in "recapitalization" bonds to Naftogaz, on top of additional borrowing by Naftogaz from other sources in the amount of USD 1.6 billion. IMF also estimated that if current policies do not change, its deficit could reach 1.5% of Ukraine's GDP in 2010[27].

**Figure 2. IMF Estimates: Gas Prices as of May 1, 2010**[28]




Source: IMF staff estimates.

**By 2010, most donors commenting on the state of Ukraine's public finance in the context of the recent economic crisis noted that restoration of the financial balance of Naftogaz became a major macro-fiscal concern:**

- **The WB CSP 2008-2011** noted that the future DPL 11 would support, among other priorities, restructuring of energy debts, reduction of quasi-fiscal deficits in the energy sector, and enactment of a law making the national energy regulator independent;
- **The EBRD country strategy approved in 2007** establishes among its focus areas reforms in the gas sector, including restructuring and corporatising Naftogaz, strengthening its transparency and governance, as well as raising domestic gas prices to cost recovery levels[29].
- **The EU-Ukraine Association Agenda priorities for 2010** included a list of measures including: work towards Ukraine's rapid accession to the Energy Community Treaty, strengthening capacity and independence of the national energy regulator (NERC), reforms in tariff and gas pricing, including payment discipline, bringing Ukraine's market in natural gas in line with relevant EC norms, full implementation of commitments in modernization of the gas transit network, and acceleration of work toward integration of Ukraine's power system into central European electricity network[30].

> *Continuing to modernize the gas sector and to restore the financial viability of the state-owned gas company, Naftogaz, are crucial to creating a viable and competitive sector that does not drain scarce budgetary resources.*
>
> *– IMF, 2010*

- **The IMF 2010 Stand-By Arrangement** includes among major reform objectives to be supported by this loan the reformation of the Ukraine's energy sector to restore financial viability of the Naftogaz. One of the conditions is elimination of the Naftogaz deficit starting in 2011, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. This includes: gradually bringing domestic gas prices to import-parity; strengthening social safety nets to limit the impact of the large gas price increases on the poorest segments of the population, strengthening payment discipline and liberalization of the gas sector and unbundling of Naftogaz.

**The mechanism of state support to Naftogaz creates extra fiscal inefficiencies.** While any quasi-fiscal activities have impact on the budget as an extra spending liability, the deficit of Ukraine's state-owned energy sector creates an additional complication because of the way it is funded.

- **Current subsidization of Naftogaz benefits richer population much more than the poor.** First of all, the current mechanism of state support to Naftogaz includes a significant subsidy which covers the company's loss resulting from the difference between gas purchase price and the lower gas tariffs at which it charges municipal utilities. This subsidy is highly regressive: the households benefit from this state support in proportion to their consumption of energy, which grows together with incomes. In other words, the current subsidy benefits richer households much stronger than poorer ones. On the other hand, if the tariffs were increased, it would have been paid mostly by the middle and upper consumption expenditure groups, and mostly richer urban population, while the impact on poorer categories could be compensated with a much smaller social transfer in comparison with the current subsidization of the Naftogaz[31].
- **Current package of state support to Naftogaz is opaque and distortive for the economy.** Secondly, state support to the energy sector is exercised through a set of complex financial instruments in addition to the above mentioned direct subsidy to Naftogaz (such as budget support to state-owned banks against their privileged loans to Naftogaz, restructurisation of tax liabilities, etc). Most of these instruments lack transparency and distort respective markets.

## *Public Services Delivery*

### General concerns: the Holy Grail of policy-based budgeting

**The key theme in international recommendations to Ukraine's public expenditure reforms resonates with the standard development agenda for this area, which focuses on multi-year policy-based budgeting.** International development organisations recommend most developing countries, including those in CEE/CIS, to reform their PFM systems along a standardised policy budgeting framework, with a strong emphasis on MFBF, MTEF and a set of programme-budgeting techniques. The key function of this toolkit is to transform PFM to make it more realistic, strategic and efficient. Respectively, it includes, for most aid-recipient countries including Ukraine, eight broad recommendations borrowed from the OECD own PFM experience[32]:

- Achieving budget savings through more robust central controls or by providing greater flexibility to managers and organisations in reallocating funds within budget line items to reflect changing conditions and priorities;
- Restructuring budgets to include expenditures for all government activities, global budgetary targets, hard budget constraints, and program allocations to facilitate results monitoring and evaluation;
- A multiyear budget linked to a realistic fiscal policy and revenue estimates;
- Regular use of performance information in monitoring against targets to facilitate accountability and manage performance;
- Shifting from cost accounting toward accrual accounting;
- Shifting from compliance auditing toward performance auditing;
- Computerized information systems providing timely financial and related information to all parties in the budget process;
- Greater use of devolved budget management and market-based mechanisms, such as user and capital charges, market testing, outsourcing, and performance agreements.

**Given Ukraine's low dependence on aid and weakness of its own political institutions, initial standardised policy-based budgeting recommendations have not performed well in Ukraine.** Most assessments of the progress of PFM reforms in developing and transition countries openly admit that one of the key drivers for accepting this reform agenda for recipient countries was often the attached possibility of access to aid funds[33]. However, as already discussed, international development assistance is relatively insignificant to Ukraine in financial terms, representing about 1,7% of its GDP in 2010[34] - as is typical for middle-income countries. Moreover, Ukraine was recognised by key donors as an illustrative example of numerous institutional and contextual limitations to applying standardised recommendations for policy-budgeting reforms in complex government systems. The central idea of policy-based budgeting - a committed political consensus[35] (at the level of national development programmes or sector reform strategies) - proved very difficult to achieve in Ukrainian context given considerable problems in distribution of responsibilities across agencies, sectors, and levels of government, as well as weak tradition of responsible and accountable public administration.

> *Neither policy budgeting, nor any of its individual tools, have strict, universally accepted definitions or methodologies: they represent a system of broad principles which help to link policies to budgets. (…) What matters in policy budgeting is the essential idea of a political consensus and commitment to choices of how to reconcile strategic goals with limited funding opportunities.*
>
> *– N. Petkova, 2009* [32]

**One of the biggest obstacles to policy-based budgeting in Ukraine is lack of clear and accountable division of responsibilities for policy making and delivery across levels of government.** All major sectors of basic public service provision in Ukraine include significant participation of sub-national levels of government. In particular, the bulk of spending programmes in healthcare, education and social services to vulnerable population groups is administered via sub-national budgets. According to the WB PFR, local spending on education accounted to 64.1 % of total consolidated education expenditures in 2006, and local budget on healthcare in that year was 79.3%. Moreover, housing and communal services are funded almost fully from local budgets. Local spending is also critical to other sectors, such as transportation. At the same time, despite significant reforms in intergovernmental relations in the last decade, this reform remains incomplete, which creates fiscal pressures on all government tiers, perpetuates political risks, and makes it impossible to exercise coherent and realistic policies in any of the decentralised expenditure sectors. In particular:

- **Political and administrative relations between levels of government remain ambiguous**, ineffective and create conflicts of interest, especially at regional and sub-regional levels.
- **There is a sharp mismatch between fiscal and administrative responsibilities in all social sectors, imposing considerable unfunded mandates.** Local governments have very low discretion in allocating funds and administering respective programmes. Administrative decision-making (including facility-level budgeting) is subject to a rigid vertical structure of input norms, dictated by central line ministries. These norms are contained in ministerial guidelines dictating the amounts of staffing and other resources based on existing infrastructure inputs, but also in constitutional prohibition of closing facilities in healthcare and education. These norms are also the key principle behind budgeting at the facility level and negotiating these budgets with local governments. One consequence is imposition on local governments of vertically protected recurrent spending, including half of the total public wages. Some decisions on local approaches to service provision are also stimulated by incentives built in the transfer formula as described earlier.
- This input based budgeting, which permeates the system, creates **strong negative implications for technical and allocative efficiency in key sectors,** where the quality of service delivery is deteriorating at dramatic rates.

**Donor recommendations on sector-based reform focus increasingly on the need to streamline intergovernmental fiscal relations.** In the recent years, donors have increasingly recognised these specific challenges and significantly expanded the focus of their sector-based technical analysis to include relevant aspects of intergovernmental fiscal relations, policy-making process, and institutional development. As explained by further sections, while many development organisations tend to focus on sectors and reform aspects which are more relevant to their respective country strategies and institutional philosophies, their outputs increasingly capture general concern related to fiscal decentralisation.

- **DFID, Facilitating Reforms in Social Services in Ukraine project (FRSSU) (2004-2008),** (Institutional origin/focus: poverty reduction and provision of basic services to vulnerable population groups). The project worked at the central, regional and local level to understand and remove barriers to efficient provision of services to vulnerable population groups. It concluded that one of the key challenges to reform was inefficient policy-making process, including inefficient allocation of financial and administrative relations across levels of government. Excessive centralisation of policy function at the national level makes it impossible to deliver services through social commissioning and target them effectively to the needs of the clients. The project recommended to work on strategic reforms in the ways responsibilities are divided between tiers of government through informal policy dialogue and gradual transfer of knowledge on the basis of the Europeanisation agenda.
- **EU, Developing Integrated Social Services for Exposed Children and Families Project (2006-2007),** (Institutional origin/focus: protection of human rights). Although the project worked on a specific localised pilot of a new service for children and families, it concluded that successful implementation of the integrated services for vulnerable groups and introduction of other alternative services was restrained by weaknesses in the overall decentralisation arrangement in Ukraine. In particular, it illustrated that sustainable financing for new services could not be secured through a mistakenly popular idea of introducing respective variables into the current intergovernmental transfer formula, which merely redistributes existing limited pool of funds. It also showed that wider opportunities for alternative services were possible only through delegation of wider policy autonomy to sub-national governments, making it possible for them to engage into purchaser-provider models of social service procurement.
- **WB Public Finance Review, Phase II: Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy (2007-2008)[36],** (Institutional origin/focus: effective delivery of basic services to population). This analytical report consolidated significant statistical evidence to illustrate that although sub-national budgets in Ukraine play a large role in allocating public expenditures, they are tightly restrained in their ability to determine spending structure and allocate expenditures within sectors. This mismatch between financial and administrative responsibilities creates major obstacles to efficient spending. Moreover, the report noted that local government have very small incentives and possibilities to raise their own revenues or to borrow, which makes them excessively dependent on central transfers.
- **Joint WB-EC Initiative on the Development of Human Capital for Economic Growth, Competitiveness and Innovation in Ukraine (2008),** (Institutional origin/focus: labour market integration, economic competitiveness). One of the thematic papers produced by this initiative looked specifically into financial management for better results in education and training in Ukraine[37]. This paper reinforced the importance of: (i) the linking of policy, planning and budgeting together with improved capacity for planning at each level directed towards achieving measurable and realistic results; (ii) decentralisation of responsibility to allow greater ownership of and accountability for results; (iii) a funding scheme that responds to needs rather than adhering to traditional norms and encourages a flexibility of approach in achieving results.
- **USAID Development Initiative for Advocating Local Governance in Ukraine project (DIALOGUE).** This project reflects the evolution of USAID's approach to working on decentralisation reforms which started in the 1990s around technocratic advice and developed into more partnership based influencing work. The DIALOGUE project works with Association of Ukraine's Cities to strengthen the dialogue between local and national governments for developing sustainable agreement on fiscal decentralisation in Ukraine.

Recommendations for selected functional sectors

**This section focuses on recommendations specific to individual sectors.** It was discussed in detail in previous sections that all decentralised spending programmes in Ukraine face a number of common constraints related to weaknesses in governance (public administration, human resource management, information management, policy-making process etc) as well as inefficient intergovernmental fiscal relations. This section summarises some of the particular issues which donor have identified as requiring improvement across individual expenditure sectors.

### *Social Protection and Social Care*

**Major problems and recommendations:**

- **Ukraine's system of social assistance is ineffective because of poor targeting.** As was summarised by the WB in its post-crisis recommendations[38], "Ukraine has sizable system of public social assistance (around 2% of GDP is spent on annual basis) but its targeting to the poor can be improved. A number of income and asset tested programs are well targeted to the poor, including the program for extreme poor (the GMI), the child allowance program and the allowances for single parents. However, overall, poorly targeted subsidies and privileges take most of the social assistance resources and in general do not tend to reach the people that really need them. In 2009, the government adopted a new strategy to reduce the scope of privileges via shifting toward means-tested assistance benefits, but its implementation timetable is unclear. Moving forward, targeting accuracy needs to be enhanced, and administrative costs and delays in dispensing social assistance benefits reduced, by modernizing the local and central welfare offices. The bottom line: Ukraine can afford to protect its poor, if it targets its assistance more effectively". Recommendations along the same lines were voiced earlier (in 2008) by the analysis funded by the German Federal Ministry of Economics and Technology which recommended urgent reforms to target social assistance on households in sever poverty through a mixed system based on a combination of self-selection and proxy means testing[39].
- **Financial incentives to residential provision of social services.** Social services to vulnerable population groups are funded by a transfer from the central budget, which is calculated based on the number of clients registered in specific residential institutions. This stimulates local governments to continue funding traditional residential providers, since re-allocating resources to alternative services would decrease respective equalisation transfer to such local budget (DFID FRSSU and PDSSR projects).
- **Input (provider)-oriented allocation of funds for social services.** At the moment, most expenditures on social service provision are administered via sub-national administrations based on the existing network of service-providers. This arrangement is fundamentally different from an alternative financing principle, when the state acts as a service purchaser representing best interest of the vulnerable client, assessing the client's needs, and commissioning required services on competitive basis. Such "purchaser-provider" financing model is strongly recommended to increase allocative and financial efficiency of service provision. (DFID FRSSU and PDSSR projects)
- **Fragmentation of responsibilities for policy development in social service provision across several central ministries.** At the moment, responsibilities for social services to vulnerable population groups are divided between several agencies, which makes it difficult to produce co-ordinated policies. (DFID FRSSU and PDSSR projects)
- **Lack of long-term perspective in budgeting to account for demographic trends.** Ukraine is experiencing significant demographic changes, which will affect the nature of demand for social services, and require significant strategic re-allocation of funds within the budget envelope. In order to prepare for such changes, Ukraine needs to acquire specific methodologies of incorporating long-term demographic trends into its budgetary forecasting practices, and use this information to develop strategic macro-fiscal decisions and plans. (DFID FRSSU and PDSSR projects)

## Healthcare

**Major problems and recommendations:**

- **Inefficiencies in health financing in Ukraine reflect systemic inability of the Semashko-type healthcare management to deliver effective care and prevention of chronic and non-communicable diseases.** WB research illustrates that inefficient system of healthcare financing is one of the root causes of the dramatically underperforming outcomes in health sector in Ukraine. The second phase of the Public Finance Review in 2006[40], and the subsequent health-specific study in 2009[41], show that current financing arrangement reflects a healthcare management approach rooted in a "Semashko healthcare model" of centralised healthcare and administration. As stated in the latter study, "this system originally developed for episodic care for acute illness is not properly oriented for a more proactive approach that involves multi-sectoral participation in prevention programs and meeting the needs of patients with chronic conditions. Furthermore, the structure and financing of the current system leads to the exacerbation of inequalities." This research also shows that "while a focus on primary care and multi-sectoral targeted cost effective interventions (...) is essential to prevent and control non-communicable diseases; this would be difficult and less effective in the absence of substantial reform in the health system."

- **WB research provides ample objective evidence showing that poor health outcomes in Ukraine result from inefficient, rather than insufficient, spending.** The WB PFR illustrates that the amount of public funds which Ukraine spends on healthcare is rather generous. Healthcare expenditures represented 3.7% of GDP in 2006 which was comparable with new EU members and above average compared with countries of the same per capita income; moreover, when these expenditures were combined with out-of-pocket financing, overall healthcare budget reached 6-7% of GDP. However, given the extremely poor and deteriorating healthcare outcomes, it was clear that the system was not delivering good value for money.

> *The fiscal savings resulting from greater efficiency in spending are potentially large and could be re-allocated within the health sector towards quality enhancing expenditures and investments. A simple estimation suggests that reducing the number of hospital beds (and with them the number of physicians and nurses) to the EU-10 or EU levels would yield savings of 0.25 and 0.34 percent of GDP (per annum), respectively.*
>
> *- WB PFR 2006*

- **Efficiency of Healthcare Spending is constrained by outdated centrally imposed input-based spending norms and lack of flexibility at the level of local governments.** The WB PFR showed that while local governments are responsible for administration of the bulk of healthcare expenditures (about 80% in 2006), they have very low discretion about how to spend these funds and therefore have very limited opportunities to optimise the network of facilities or otherwise improve service delivery. The vertical constraints include sector-based norms imposed by the MoH, but also other spending regulations such as protection of spending on wages and utilities.

- **Donors are deeply concerned with high out-of-pocket spending in Healthcare and the inequalities which they create.** WB notes that high and increasing incidence of informal payments for healthcare services represents a significant barrier to access to healthcare services, especially to the poor. Moreover, current structure of public expenditures on healthcare only exacerbates inequalities created by OOP, since most of these expenditures (about 70% in 2006) are allocated to specialised facilities utilised more intensively by richer segments of the population.

- **Input (provider)-oriented allocation of funds.** As with social services, healthcare spending suffers from lack of separation between the roles of purchaser and provider, which does not allow local governments to link allocated funds to performance indicators at the level of facilities. The WB recommends that these reforms should be taken forward by: changing payment system for hospitals to case based and for primary care centres to capitation-based, changing the legal status of hospitals to non-commercial enterprises, separating oblasts as purchasers from hospital providers, and granting managerial autonomy to hospital administrators[42].

**Lines of debate and controversial themes:**

- **Does Ukraine need social health insurance?** Proposals of a social health insurance system have been considered by various stakeholders including several consequent governments in Ukraine. From the viewpoint of PFM, the most detailed and evidence-based analysis of such possibility for Ukraine is provided by the WB research. As already noted, the key message of the 2006 PFR for healthcare finance was that this system did not need to spend more but spend better. This implied that raising additional funds through introduction of social health insurance would not resolve current systemic inefficiencies, but would create additional tax burden on the economy which would be detrimental.

### *Education*

**Major problems and recommendations:**

- **Ukraine's public spending on Education is very significant but highly inefficient.** The WB PFR demonstrated that in the Education sector, even more strikingly than in Health, public spending was at 6.3% of GDP in 2006, exceeding all countries in the region and with similar per capita income, and yet allocated in highly inefficient way. This research acknowledged that comparing inputs to outcomes is not so easy in education as in healthcare, especially given that Ukraine had only recently started to participate in internationally comparable standardized tests of student performance, but such comparisons could be still made given Ukraine's growing inability to provide skilled labour to businesses.
- **Inefficiencies in public spending on Education are also related to rigid input-based and centrally imposed spending norms and lack of flexibility at local level.** The WB PFR illustrated that education finance in Ukraine showed alarming inefficiencies such as dramatically falling student/teacher ratios, low teaching hours per teacher, inefficient ratio of non-teaching staff to teachers, which is all driven by centrally imposed norms. As with other decentralised programmes, these norms are imposed by the central government, despite the fact that the bulk of expenditures is allocated through local budgets which do not have sufficient flexibility for optimisation of expenditures. The same concerns and recommendation were voiced by the WB in its post-crisis recommendations in 2009[43].

## *Transparency and accountability of PFM*

### Public procurement

**Public procurement has been one of the central concerns of key donors in recent years.** In recent years, key donors maintained active dialogue with Ukraine's government regarding its procurement legislation and repetitive attempts to reform it. The key concerns shared by donors were consistently featured in their PFM analysis, including the EU SIGMA report (2006-2007)[44] and more recent detailed comments provided by the EC and the WB to the Government during debates around adopting a new Law on Public Procurement (PPL)[45] (to replace earlier Provisional Regulation on Public Procurement, in operation since March 2008). The final version of the draft law approved in June 2010 was analysed by FISCO in the July issue of the Child-Focused PFM monitoring for UNICEF Ukraine[46] (we are not aware of other analysis so far).

**The major problems and recommendations for change raised by donors included:**

- **Problems in division of functions and responsibilities.** Throughout recent changes in the procurement legislation, donors noted general considerable confusion of roles and mandates across authorities involved in the system, as well as specific distortions and negative incentives that such division was creating.
- **Effective policy-making function for the state.** Policy-making and regulatory functions should be clearly allocated and preferably exercised by a government agency, rather than a non-public organisation. In 2006-2007, EU SIGMA experts were concerned that these functions were not clearly spelled out and were concentrated within a non-public body (the Tender Chamber). In the 2010 debate around the new PPL, the EU and the WB were proposing to allocate the policy-making functions to the Authorised Agency.
- **Independence of procurement process from political risks and conflicts of interest.** In 2006-2007, the EU SIGMA analysis saw biggest risks of political impact on procurement in direct involvement of Members of Parliament in execution and implementation of procurement policies (via participation in the Special Control Commission under the Accounting Chamber and of the Supervisory Commission of the Tender Chamber). During 2010 debate, the major focus of concern in terms of conflicts of interest shifted towards independence of the Appeals Agency. In the draft PPL proposed in February 2010, such Agency was composed of representatives of central Ministries and parliamentary committees, making the Agency insufficiently independent from the executive authority and political influences, which was criticised by the EU and the WB. The final PPL approved in June addressed this concern by excluding parliamentary and ministerial members from the Appeals Agency, and transferring the function of regulating the agency to Anti-Monopoly committee. Although this arrangement was recognised as sufficient improvement, concerns remain to ensure independence of the Appeals Agency from both the head of the Antimonopoly Committee, other authorities and economic operators. In this connection it should be mentioned that Law does not define the term of office of the members of the Appeals Agency, the grounds for their discharge from the office, professional requirements to the members of the Agency and so forth. In contrast, in a fair number of European states the mode of operation of the Appeals Agencies are defined in separate articles or even chapters of the PPLs.
- **Clarity, comprehensiveness and administrative efficiency.** Although considerable improvements were made in the latest approved PPL, this law still covers the various types of procurement selectively, lacks clarity in definitions, and establishes administrative requirements which are still burdensome and excessive.
- **Preferential treatment of domestic suppliers.** Ukraine has committed, under its WTO obligations, to treat domestic industries on equal terms with foreign competitors in provision of access to public contracts. Procurement legislation which existed prior to WTO accession contained numerous preferences to domestic suppliers, especially in agricultural sector, which was criticised by the EU already at that time (within the EU SIGMA analysis). Within the 2010 list of priorities of the EU-Ukraine Association agenda, reforms in public procurement remain under the objective of trade integration and liberalisation. During the PPL debates in February 2010, donors have identified continued biases in favour of domestic bidders.
- **Continued barriers to competitive procurement of social services.** Our own analysis shows that despite significant improvement in the recent PPL (such as broader definition of “public funds” and introduction of the possibility of coordinated procurement at all levels of government), some aspects of the current procurement legislation remains problematic for effective commissioning of social services, especially by alternative non-state providers. First, weaknesses of the Law described above and its aspects which do not go in line with the EC/WB recommendations, may to certain extent reduce the positive impact of a new regulation on social services provision. But on top of these general concerns, we note that the newly approved Law did not amend the Law on Civic Associations, therefore a majority of the existing problems faced by NGOs as social services providers will remain unsolved. The requirement on bid security in amount of 1% (for works) and up to 5% (for goods and services) which can be introduced by a procuring entity under Article 24 of the PPL (though corresponds it to the EU directives), might be problematic to some NGOs providing social services, due to the lack of necessary funds for securing the bids.

## Public financial management and internal control

**Improved financial management and internal control have been central to recent co-operation with SIGMA experts and WB PFM modernization project.** The two core donor activities which drew international and domestic energies towards reforms in the PFM in the recent years have been WB Public Finance Modernization project (2008-2013), and the EU SIGMA cooperation, which focused specifically on expert advice in financial management and control after initial broader governance assessments in 2006-2007. The WB PFM project works on strengthening Ukraine's institutional capacity and operational effectiveness in managing public funds by helping the Government to develop an integrated PFM system and improve project management methodologies. This project includes analytical components on several policy aspects including internal financial controls, which were in development at the moment of this report. The EU SIGMA experts have recently finalised a draft report with their most recent analysis of the current issues in the area and presented it to the Government, but the content of this report is not publicised while it remains at the draft stage[47].

**While information from these recent studies is pending, earlier major threads of recommendations are listed below:**

- Upgrading institutional capacities for multi-year and results-oriented budgeting (such as appropriate organisational structures in the Ministry of Finance, State Treasury reform, approval of sector ceilings early in the year to frame the next budget's preparation by spending units, etc);
- Comprehensive review of existing special funds and full disclosure of all quasi-fiscal activities;
- The need for more effective allocation of functions and responsibilities across central agencies (especially MoF and CRU) for processes, decision-making, capacity-building and reform initiatives;
- Development of sound procedures and practices for accounting of public funds in line with international standards;
- Improving of budgeting procedures in individual line ministries.

## External audit

**Since Ukraine's system of external financial oversight is in development, donors work on both: enhancing capacities of individual stakeholders (primarily Accounting Chamber) and improving the system itself.** Some of the key donors – including EU, WB, and SIDA – are supporting improvements in operational capacities of key Ukrainian counterparts engaged in external financial control, the key of which is Ukraine's Supreme Audit Institution – the Accounting Chamber (AC). Instead of looking into the details of such technical recommendations, this section lists major concerns which international observers share about how the system of external control is organised and what barriers make it inefficient. Donor agencies which helped to consolidate these insights include: the UK FCO-funded project to strengthen parliamentary financial oversight in Ukraine (coordinated by the Westminster Foundation for Democracy (WFD), the USAID Parliamentary Development Project for Ukraine - II[48], GTZ.

- **Weaknesses in policy-making process and absence of tradition of using oversight function to improve results.** Ukraine is biased towards a system of "control", rather than "oversight" – which, as a term, remains an alien concept to most officials. Control function is rarely perceived as a policy instrument; rather, it is seen in a post-way as the task to control execution of legislation by the government, not helping to make things better.
- **Systemic failures in the overall PFM system described in other sections represent barriers to effective external financial oversight.** Post-soviet constitutional tradition with a significant menu of declared rights without realistic sources of funding, supported with obsolete structure of vertical sector regulation with rigid spending norms detached from budgeting sources makes it nearly impossible for Ukrainian Government to fund all promises in full and leads to constant de jure violation of legislation on the

financial side. This circumstance represents a significant obstacle to meaningful, policy-oriented financial oversight by any agency. As already discussed, overall system of PFM is not results-oriented, which hinders opportunities for parliamentary analysis of spending efficiency (including introduction of value for money approaches and methodologies in the AC).

- **Continued disagreement about the outlook of Ukraine's political system and the role of the Parliament.** Ukraine is at the frontline of defining its political system. This search includes constant disagreement on the role of the Parliament and its relations with the Government. This includes continued conflict about control instruments, including Accounting Chamber (whose role, rights and powers are not firmly defined).
- **Lack of strategic vision of the financial oversight system.** Although there is significant demand for better understanding and better technical approaches in analysing public finance within the government and general public, the Parliament (including professional staff) does not have a vision and skills about a comprehensive system of financial oversight, including how to utilise the AC effectively. Several concepts were developed and discussed at conferences, but there is yet no joint vision.
- **Lack of vision over the role of external oversight of public revenues.** While Ukraine's Parliament traditionally has a strong and motivated committee on taxation, it lacks a political vision about parliamentary oversight role in the revenue side (and how does the AC fit into this process).
- **Underdeveloped system of oversight of sub-national spending.** The system of intergovernmental fiscal relations still in the making. The biggest unresolved issue in this area is lack of agreement on the nature or delegated spending: as already discussed, the bulk of social programmes in Ukraine are funded from the local budgets; but they are financed from the central sources which are allocated among territories based on rough demographic indicators (assuming that local governments would use their local knowledge to use them in the best way), while in reality local governments are rigidly constrained by vertical norms in how they must spend these funds. One key factor in further development of this system is how the central government could oversee its delegated spending. At the moment, there is no source of external audit for these funds (given that equalisation transfers are part of local budgets which are not subject to AC control).
- **Weaknesses in organisation of the Financial Oversight Function in the Parliament.** At the moment, financial oversight function is fragmented among VR committees. This complicates cooperation in the financial oversight process, often takes political participation to extreme (without committees being able to reach decisions), and delegates technical matters in policy analysis to officials without sufficient knowledge and skills. Furthermore, there is no single committee responsible for overseeing activities of public funds in general since off-budget funds fall under the remit of a separate committee. Many sector-committees are very narrow-focused; they see financial oversight as checking on "their line" in the proposed budget, negotiating for more (and this is how they use AC materials).
- **Weaknesses in co-operation between the Parliament and the Accounting Chamber (AC).** Much progress was made in this area in recent years and there is a strong demand for co-operation and scope for productive partnership on both sides. In recent years, Ukraine developed clear procedures for engaging the AC into parliamentary work (participation in the committees, hearings etc). However, parliamentary committees often find that recommendations generated by the AC are not practical, are not clearly spelled out and well-communicated.
- **Continued debate about the role and powers of the Accounting Chamber.** Despite constant debate there is yet no consensus about the AC's role, disagreement continues regarding the details of respective legislation (both effective and proposed as drafts), and Constitutionality of the AC role and powers itself have been under inquiry. There are still significant limitations to AC's independent status (despite legal declaration of the opposite): influencing channels are still in place from the VR (ability to dismiss the Chair for minor violations; ability to overburden the AC with ad-hoc requests from politicians) and the Government (salaries administered through the MOF, even though approved as a separate budget line). Donors note

that legislation on AC lacks power or practical implementation of AC recommendations (their role is to inform rather than to change things), lacks clarity about depth of access to information for the AC.

- **Weaknesses in information management and communications.** While a lot of information is available to key stakeholders (including access of AC to information for oversight purposes; and including access of opposition to all resulting materials), a lot of weaknesses remain. In particular, there is no vision about public communications in any of the agencies. Besides, public and non-state actors lack access to public financial data and to the majority of products produced by the external oversight authorities.

## *Local and Regional Development*

### Administrative and Territorial Structure

**One specific barrier to streamlining intergovernmental fiscal relations and local development is inefficient administrative and territorial structure.** Most donors working on decentralisation aspects of PFM in Ukraine note inefficiencies in the administrative and territorial setup in Ukraine. At the moment, the amount of units at the lowest level of government is too large (over 12,000), they are too diverse and, in average, too small (average population around 1,400) to effectively administer basic sector functions. Since 2005, there have been repeated attempts to reform this system.

**Views on ways to address this barrier differ across international and domestic stakeholders.** One type of proposals is to create a new level of local self-government through community amalgamation and a territorial re-cut (these ideas were explored by several donor-funded projects including GTZ-funded Reform of the national administration for the support of decentralization project[49]). An alternative vision of reform – supported, among others, by the 2008 WB PFR (Phase II)[50] and DFID Sustainable Financing of Territorial and Administrative Reform project (SUFTAR)[51] - is to transfer current rayons into a proper self-government tier by clearly establishing its access to locally elected and locally accountable executives. The latter approach considers rayons to be more cost-effective candidates to perform the functions of lowest level of government, while creating a new sub-rayon layers would represent political and economic risks (given that it would be difficult to quickly upgrade administrative capacity of amalgamated communities enough to overcome current issues of administrative weakness and inefficient economy of scale for major sector functions).

### Regional and local development, sub-national capital investment

**Most donor projects working on regional and local development produce opinions on improvements required in overall fiscal decentralization framework.** Since independence, attempts to promote regional development in Ukraine have been interlinked with reforms to build the very institutional platform for design and implementation of regional policy. Regional policy (defined as support to effective development of potential across territories) is intimately linked to, and dependent on, the nature of rules for relations between the levels of government and the country's territorial organisation. In particular, these rules prescribe which instruments could be realistically devised for regional policy implementation. Given that legal framework for intergovernmental relations in Ukraine is still in the making, most concepts for a regional development strategy contained certain proposals on political, administrative and fiscal decentralisation needed for each of these strategies to work. However, most of these proposals broadly resonated with decentralisation reform agenda outlined earlier in this report (clearer division of responsibilities across levels of government, stronger local revenue autonomy, financially responsible delegation of mandates to lower government tiers).

**Donors concerned with regional development helped to produce recommendations on improved financial instruments for capital investment at sub-national level.** The World Bank noted in the 2008 PFR, that Ukraine's system of capital budgeting both at national and at sub-national level was opaque and inefficient. In particular, the report noted that existing capital transfers to local budgets (which were and remain the main source of capital expenditures at the local level) were not transparent and lacked consistent and stable criteria for allocation[52]. This creates uncertainties and makes it difficult for sub-national governments to develop long term investment plans. The report recommended reforms to introduce planning, evaluation and selection processes based on clear and stable criteria which would allow to allocate capital transfers more strategically across the regions. Other donors working on the same agenda (and specifically on developing criteria and capacities for transparent allocation of capital grants and helping local and regional governments to design and implement development strategies) included: DFID Local and Regional Government Institutional Strengthening project (LARGIS) (Phase I and II)[53], CIDA Regional Governance and Development project (2005-2010)[54], CIDA Community Economic Development in Ukraine project (2004-2008)[55], CIDA Improving Regional Economic Development Planning project (2009-2015)[56], CIDA Support for Economic Growth and Development in Local Municipalities project (2009-2015)[57].

Local Budgeting

**A significant portion of donor recommendations focus specifically on improvements in budgeting methodologies at the local level.** An important element of efficient intergovernmental fiscal relations is local capacity for strategic and realistic budgeting within the resources available to local communities. Many donors in Ukraine have focused specifically on improving these capacities through replicable pilots across Ukraine. While some of these projects produce opinions in support of nation-wide reforms, their key technical focus is on local budgeting methodologies of public financial management (sometimes as part of broader local economic development or community development agenda). These projects include: SDC Support for Decentralisation in Ukraine project[58], USAID Municipal Finance Strengthening Initiative project[59], UNDP Community-Based Approach to Local Development project[60], UNDP Municipal Governance and Sustainable Development Programme[61], International Renaissance Foundation (IRF) micro-projects aimed at strengthening civil society impact on local policy-making including local budgeting[62].

## Concluding thoughts

**Based on the information we have collected in this review, we would like to emphasise the following key features of the current donor opinion on PFM in Ukraine:**

- **Despite institutional diversity among donors, they gradually converge to recommendations related to fundamental weaknesses in governance and policy-making**. Although development agents work on diverse PFM-related themes, apply diverse instruments and do not often coordinate effectively, their discoveries and recommendations – analysed in this paper – recently tend to focus on a narrow range of fundamental problems which represent universal obstacles to donor's respective goals. These fundamental problems relate to the weakness of political institutions and governance structures, which make it difficult to set strategic objectives, assess and acknowledge public value, and deliver results in accountable and fiscally responsible way.
- **Donors are increasingly prepared to move away from technocratic recommendations to supporting Government's implementation capacity and building consensus about reforms.** Donors increasingly agree that the Government's technocratic potential in PFM is relatively high, but it has a very weak capacity to actually implement any emerging reform ideas into practice. As a result, recommendations of most donors on how to improve PFM increasingly focus on improvement of policy-making capacity rather than technical aspects of PFM as such.
- **The 2008-2009 economic crisis reinforced the similarities of broader governance concerns related to PFM, shared by most donors.** Despite urgent fiscal pressures on the budget resulting from economic contraction, electoral competition resulted in continuous expansion of social expenditures at rates above

inflation, funded by distortive tax squeezes and accumulation of disguised public debt (including VAT refund and wage arrears). These developments emphasised the weakness of the policy-making process, irrelevance of technocratic argument, and, above all, lack of accountability behind public financial management, which lies at the heart of a democratic state.

- **Urgent changes are required to restore macro-fiscal framework by expanding the tax base and removing quasi-fiscal deficits in the pension system and energy sector.** The economic crisis coupled with political developments over the recent years reinforced earlier concerns about weak interface between macroeconomic and fiscal policies in Ukraine, which create dangerous imbalances. The only way for Ukraine to expand its fiscal space without damaging macroeconomy is to widen the tax base and improve tax compliance, given that the tax burden on the private sector is already high. On the other hand, the Government needs to implement urgent reforms to release extreme fiscal stress faced by the Pension system and to address growing imbalances in the energy sector resulting from its indirect and inefficient subsidisation from the budget and low payment discipline.

- **One of the biggest obstacles to policy-based budgeting in Ukraine is lack of clear and accountable division of responsibilities for policy making and delivery across levels of government.** All major sectors of basic public service provision in Ukraine include significant participation of sub-national levels of government. At the same time, despite significant reforms in intergovernmental relations in the last decade, this reform remains incomplete, which creates fiscal pressures on all government tiers, perpetuates political risks, and makes it impossible to exercise coherent and realistic policies in any of the decentralised expenditure sectors.

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