Child-Focused PFM Monitoring: Observations for January-April 2010

During April - December 2010, FISCO will be providing on-going technical support in the area of Public Financial Management to UNICEF Ukraine. This work aims to help UNICEF to facilitate more effective redistribution of resources to enhance children's wellbeing and protect their rights.

As part of this assignment, we will provide UNICEF with monthly updates on key developments in Ukraine's public finance. This note is the first monthly deliverable (for April 2010).

Given that fiscal events in April 2010 have roots in policy steps undertaken in earlier months, this first update takes an extended stock of the fiscal situation: it describes how current processes have started, what risks they represent for children, and what fiscal issues we will need to monitor during the year to support the work of UNICEF Ukraine.

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Acronyms and Abbreviations

BYT	Block of Yulia Timoshenko
CIS	Commonwealth of Independent States
CMU	Cabinet of Ministers of Ukraine
EU	European Union
GDP	Gross Domestic Product
HES	Household Expenditure Survey
IMF	International Monetary Fund
MoE	Ministry of Economy
MoF	Ministry of Finance
MoH	Ministry of Health
MoLSP	Ministry of Labour and Social Protection
MP	Member of Parliament
NBU	National Bank of Ukraine
PFM	Public Financial Management
PIT	Personal Income tax
PM	Prime Minister
SIF	Social Investment Fund
SSC	State Statistics Committee
STA	State Tax Administration
UAH	Ukrainian Hryvna
UNICEF	United Nations Children's Fund
USIF	Ukrainian Social Investment Fund
VAT	Value Added Tax
VR	Verkhovna Rada (The Parliament)
WB	World Bank

Major developments with possible implications for children

1. Key driving factors which influenced the fiscal situation

▪ Global economic downturn: fiscal impact and government's policy response

Vulnerabilities which existed before the crisis

Several factors made Ukraine especially vulnerable to global crisis, but many of these factors were created by inefficient pre-crisis macro-fiscal policies. As many other countries, including developed countries, Ukraine was directly affected by the crisis given that: (1) its economy was infected by the property asset bubble and (2) its economy has been highly dependent on exports, which made it vulnerable to economic performance of other countries. When the bubble burst, both domestic and external demand for Ukraine's goods and services rapidly contracted.

However, even before the crisis unfolded, the way Ukraine regulated its participation in international trade and financial markets created a number of imbalances, which increased its vulnerability. First, since 2006, when imports started to exceed exports, sending current account into deficit, Ukraine failed to attract enough foreign direct investment to cover the gap, and started to accumulate external debt instead (public and private). Secondly, weak regulations in the banking sector exacerbated its exposure to asset-related risks, especially given a considerable level of foreign participation in the sector. These circumstances – growing current account deficits and external debt obligations – became extremely problematic when global credit dried up[1].

Myopic policy responses

Despite this extreme vulnerability, Ukraine's reaction to crisis-related pressures has been extremely myopic – including through the first months of 2010. Shrinking economy presented the country with immediate fiscal challenges: the prospect of falling tax revenues, extra social protection obligations, and the need for the government to invest into specific additional measures to restore growth. At the same time, since the beginning of the crisis, the government has focused on measures which helped to mobilise funds in the short-run but which perpetuated the downturn rather then helped to counteract it (acting pro-cyclically, rather than counter-cyclically). Major such policies were launched and supported in 2008-2009. The new government, which took office in 2010, has criticised some of these policies, but so far reported few palpable steps to change or replace them.

The major failure of current policy trends is in wasted opportunities to use fiscal tools for restarting economic growth. While global community remains perplexed about ways out of the current crisis, one joint view is that fiscal policy remains the key tool for putting economies back on track. Moreover, for countries where fiscal expansion is not affordable, the key recommendation has been to encourage private sector-led recovery via an emergency reform programme to improve business climate. A key pillar of such reform should have been increased transparency of regulatory system and public finance, coupled with strategic government's investment into growth-generating programmes. However, fiscal measures implemented so far continue in an opposite direction, perpetuating the crisis-related risks.

The key aspects of the crisis-related policies, which continued in January-April 2010 and which remained pro-cyclical, are described below. As explained in the next paragraphs, most decisions in public finance management in the recent months were focused on maintaining – and expanding – current spending (salaries, utilities, social transfers etc), at the cost of transparency, macroeconomic stability and investment.

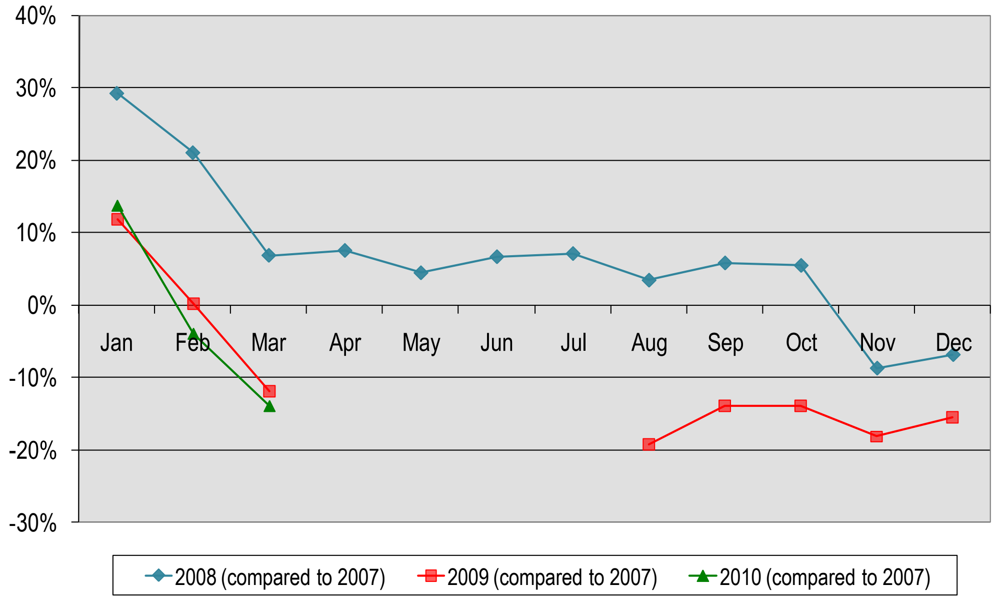
> **Shifting responsibility for current spending in most social programmes on local budgets**. Throughout 2009, the Government resorted to multiple, usually disguised, measures which increased unfunded expenditure mandates imposed by the national government on sub-national budgets. In Ukraine's PFM system, the bulk of social expenditures – including most expenditures in education, healthcare, social services to vulnerable categories of population, culture and sports – are administered from local budgets but regulated centrally and funded through a basket of "delegated revenues" (mostly, personal income tax (PIT) and equalisation transfers).

Despite shrinking budgets, the government keeps local budgets in a straight-jacket of input-based norms for public service provision. This excludes opportunities for communities to use the crisis as a chance to start providing services more efficiently (e.g. reorganise hospitals, consolidate schools, find alternative social service suppliers etc).

As of now, neither government has taken steps to relax expenditure norms and service standards which are unsustainable in current economic circumstances (but have to be funded by local budgets); in fact, as will be discussed further, these standards have been gradually increased. At the same time, the shrinking revenue available to local budgets to fund these programmes (as a result of falling PIT) has not been compensated by an increase of equalisation transfers from the central budget[i].

Figure 1 illustrates the extent of the PIT revenue contraction faced by the local budgets. It depicts the difference between monthly proceeds during 2008, 2009 and 2010 compared to same periods of 2007 (in real terms). The Figure 1 shows that real PIT revenues fell below the 2007 levels already by the end of 2008, and remained considerably lower than 2007 benchmarks since that time until now.

Figure 1. Change in real PIT collected to local budgets: monthly proceeds in 2008, 2009, and 2010 compared to same periods of 2007



Source: Ukraine's Treasury Budget Report.

Personal income tax, coupled with equalisation transfers, currently represents the bulk of funds available to fund key services for children. Until now, the central government managed to make sure that this (decreasing) pool is enough to pay for wages, utilities and supplies (by borrowing and making local budgets cut on investment). However, the central government will not be able to continue borrowing at this rate, and - if growth is not restored - PIT will continue to fall. Wages and supplies in key social sectors (healthcare, education, social care, culture, and sports) will be the next items for cuts.

[i] Apart from this major problem, additional fiscal pressure exerted on local budget by the central government included a variety of smaller initiatives which aimed to administratively increase proceeds from local and shared taxes. In particular, in 2009, the central government has introduced: (a) about 20-fold overall increase in road fines (half of which stays in local budgets, and would be increased to 100% under proposed new Budget Code), (b) proposals for considerable reforms in land tax[i] which is estimated to increase proceeds by 4 billion annually, (c) CMU Resolution (No 236, 05/03/2009) which "recommended" local governments to charge maximum rates of single tax on private entrepreneurs who work abroad.

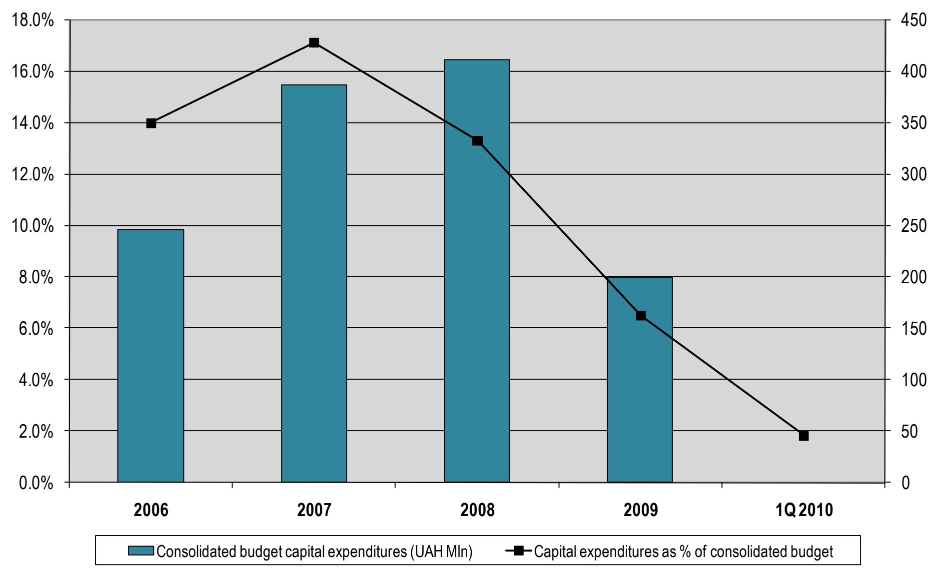
> **Funding current expenditures at the cost of collapsing capital spending**. Since the beginning of the crisis, composition of government spending steadily shifted away from capital spending towards current expenditures. As illustrated by Table 1 and Figure 2 below, by the end of I quarter of 2010, the share of capital expenditures in consolidated budget has fallen to 1,8% from 17,1% in 2007. In particular, capital expenditures have significantly decreased within the local budgets, who lost most traditional sources of funding for such programmes, including surplus general revenues and earmarked capital transfers.

Table 1. Capital expenditures within Ukraine's Consolidated Budget in 2006-1Q2010.

	2006	2007	2008	2009	1Q 2010
Total consolidated expenditures (UAH Mln)	1 753	2 261	3 092	3 073	717
Consolidated budget capital expenditures (UAH Mln)	245	387	412	200	13
Capital expenditures as % of consolidated budget	**14,0%**	**17,1%**	**13,3%**	**6,5%**	**1,8%**

Source: Ukraine's Treasury Bugdet Execution Report

Figure 2. Changes in Capital Spending during 2006-1Q2010.



Source: Ukraine's Treasury Budget Execution Report

> **Funding current expenditures at the cost of collapsing system of taxation of added value and defaulting on arrears to exporters**. Another item which the Government had explicitly and increasingly underfinanced in recent months, creating temporary fiscal space for current expenditures, has been VAT refund payments to exporters.

Ukraine's budget has been systemically defaulting on its VAT refund obligations to exporters thoughout the lifetime of Ukraine's VAT. The reason for this permanent problem is a fundamental distortion in the administration of this tax in Ukraine, which allows fraudulent taxpayers to collude in order to simultaneously avoid tax liabilities and receive refund of unpaid tax from the budget. As a result, the budget loses revenues from this tax and at the same time faces unaffordable amount of VAT refund claims (which contain claims from both, well-meaning exporters and colluding companies).

As the crisis unfolded, the amount of VAT refund arrears has skyrocketed, doubling during 2009 to reach an estimated UAH 45 billion[2]. In January, former PM Ms. Tymoshenko acknowledged that these obligations were unaffordable and would be given secondary priority in favour of social expenditures. The new Government's plans on the matter are not clear. However no systemic solution to the problem was announced so far. Moreover, the approved 2010 Budget has resurrected distortive approaches of earlier years when outstanding arrears were, post-factum, compulsively restructured into government's promissory notes. The 2010 Budget establishes that all arrears accumulated by 1 May 2010 will be "repaid" with newly issued Treasury notes, thus explicitly acknowledging technical default on these obligations with unclear prospect of repayment[3]. Apart from further damage to the growth-generating export industry, this approach permanently discredits the system of VAT, which is the most important current and potential revenue source in Ukraine's budget.

- **Funding current expenditures through mobilising advance tax payments for future periods**. During the first months of 2010, tax proceeds from enterprise profits tax and excise taxes have exceeded baselines and even pre-crisis levels, which were explained by some experts and sources in the STA as thanking to administrative measures to claim advance tax liabilities from taxpayers.[4]
- **Funding current expenditures through funds earmarked for other purposes**. According to VR Budget Committee[5], the Government used accounting manipulations to use proceeds from earmarked funds, such as education user fees, to fund general current expenditures[ii]. An important source of such earmarked revenues withdrawn for funding current spending were proceeds from sales of CO2 emission quotas to Japan.
- **Funding current expenditures from the Stabilisation Fund, and overall utilisation of the fund without clear rules and long-term strategy**. In October 2008, the Government created a Stabilisation Fund as a tool to redistribute state budget revenues (mostly surpluses from planned privatisation and additional borrowing) towards loans and co-financing to "long-term infrastructure development investment projects of national scale"[6]. Despite declared focus of the Stabilisation Fund, throughout 2008 and 2009 it was allocated in a highly opaque way and often to finance current expenditures in specific sectors selected without clear rules (e.g. mining). In one of the amendments to the 2009 Budget during that year, the VR had reduced the Fund's annual ceiling from UAH 20 million to UAH 8 million. In February 2010, this continuing problem was highlighted by the VR Budget Committee, which called for a changed policy in 2010[7]. However, the 2010 Budget was approved with an even higher ceiling for the Stabilisation Fund, without clarification of rules for its allocation. The text of the 2010 Budget does contain a list of areas and projects on which the fund should be spent. However, it is unclear why these expenditures are not included as regular expenditure lines and why the Budget delegates the right to establish rules and procedures for these particular expenditures, and for re-allocation of funds across them, to separate resolutions to be approved by the CMU. As a result, more than 9% of the Central Budget is currently allocated to a programme which remains highly unaccountable (see Table 2).

Table 2. Planned and Actual Expenditures of Ukraine's Stabilisation Fund (2009-2010).

		Total expenditures of Central Budget (UAH bln)	Stabilisation Fund within the Central Budget (UAH bln)	Stabilisation Fund as % of Total Central Budget
2009	Planned expenditures			
	Before VR reduced the Stabiliation Fund	274,16	19,96	7,28%
	After VR reduced the Stabilisation Fund	284,66	7,92	2,78%
	Actual expenditures	242,36	9,80 *	4,04%
2010	Planned expenditures	324,02	30,22	9,33%

** Actual expenditures of Stabilisation Fund are not reported as a separate line in Treasury Budget Execution reports; these expenditures are scattered around multiple programmes whose list is unclear. The number specified in the table is sourced from a statement of MoE, reported by Interfax-Ukraine (http://www.pmsbu.com.ua/novyni/29/1960/minekonomiki_u_2009_roci_byudetni_asignuvannya_sklali_9_8_mlrd_grn/).*

Source: Treasury Budget Execution Reports; Interfax Ukraine.

[ii] According to this source, the accounting trick was to excuse withdrawal of funds from earmarked sources by issuing Treasury loans to respective spending units (e.g. social funds or educational facilities), requesting their repayment during the budget year. The short-term loans are funded from temporary surpluses on the Unified Treasury account, while they are repaid from earmarked sources available to the debtors.

> **Lack of transparent policy on state support to international borrowing by commercial sector**. In 2009, the Government resurrected a retrograde practice of issuing state guarantees for international loans to individual companies selected without clearly visible rules. Considerable amount of such guarantees, mostly to private sector, was issued in early post-independence years, reaching about USD 1 billion or 11% of all external public debt by 2000[8]. Given the very opaque way in which the guarantees were issued, the tool became highly corrupted: the bulk of guaranteed loans were defaulted and transferred into public debt obligations to be funded from the state budget.

In 2000 this practice was banned. The ban was maintained as a specific article in the annual budget laws, but starting from 2002 it started to evolve, gradually expanding the list of exceptions and special cases, as illustrated in Table 3. Starting from 2007, the wording had changed away from banning guarantees towards specified allowed cases and setting their (growing) limits.

As the table shows, both 2009 and 2010 budgets only continued the trend. The 2009 budget introduced a possibility of guarantees on loans to unspecified "investment projects"; and most of the guarantees issued that year did rely on this exact possibility. However, the vagueness of the specification in the 2010 budget was unprecedented compared to all previous years (e.g. it allows guarantees for "loans to finance investment, innovative, infrastructural and other development projects which have strategic significance to Ukraine's development, including support to import-substituting and export-oriented sectors".) The ceiling for the guarantees is also significantly increased (by UAH 8 billion).

Table 3. Changes in Regulations of State Guarantees (Annual Budgets 2002-2010).

Year / Article of Annual Budget Law			Does the law prohibit guarantees (outside specified exceptions)?	Which loans are allowed?
2002	Article	11	Yes	Loans by international development organisations
2003	Article	13	Yes	Loans by international development organisations
2004	Article	18	Yes	Loans by international development organisations Loans to national infrastructural projects Loans to contruction of the road "Kyiv-Odessa" Loans to Ukrainian-Brazil project "Cyclon-4" Loans to construction of railbridge in Kyiv
2005	Article	17	Yes	Loans by international development organisations Loans to contruction of the road "Kyiv-Odessa" Loans to Ukrainian-Brazil project "Cyclon-4" Loans for financial leasing of domestic agricultural vehicles
2006	Article	15	Yes	Loans by international development organisations Loans to State Mortgage Instutition
2007	Article	14	**Unclear wording, but no prohibition**	Guarantees could be issues based on separate laws to be proposed by the CoM
2008	Article	13	**No**	Loans to State Roads Service (up to UAH 0.8 Billion) Loans to State Mortgage Institution (at UAH 1 Billion) Loans to coal mining enterprises (up to UAH 3,1 Billion) Loans to Naftogaz Ukraine (up to UAH 12 Billion)
2009	Article	14	**No**	Loans to State Roads Service Loans for construction of metro lines **Loans to investment projects** Loans related to preparation for Euro-2012 Overall amount up to UAH 37 Billion
2010	Article	13	**No**	Loans to state eneterprises (up to UAH 45 Billion), including - Loans to State Roads Service - Loans to National Agency for Euro-2012 - Loans to State Mortgage Institution (up to UAH 2 Billion) - "but also **loans to finance invesmtment, innovative, infrastructural and other development projects which have strategic significance to Ukraine's development, including support to import-substituting and export-oriented sectors"**.

Resulting impact on public finance

As a result of these policies, major crisis-related problems were aggravated further, as explained below.

- **Ukraine's macroeconomic fundamentals deteriorated more dramatically than in any other country in the region.** Ukraine's reaction to the crisis has been painful and prolonged. According to IMF estimates, Ukraine's real GDP decreased by 15,1% in 2009 – faster than any other country in the region (see Table 4). The fall was accompanied by rapid price inflation: as shown in the same table, Ukraine has demonstrated the fasted growth of consumer prices across all CIS countries (25,2% in 2008 and 15,9% in 2009), which is likely to continue in 2010. Moreover, according to IMF, these inflation indicators are also highest in the world, following only Venezuela[9].
- **The poorest households were hit the hardest.** Rapid inflation resulting from expansionary crisis-related policies represents a hidden tax on the poor (given that such households find it most difficult to finance increasing costs of goods and services). Apart from growing official unemployment, private sector had doubled wage arrears – which represents not only fiscal risks, but also, essentially, a cost of temporary unemployment to least mobile and most vulnerable labour. According to SSC, wage arrears amounted to UAH 1,7 Billion by end of March 2010 (see Figure 3).

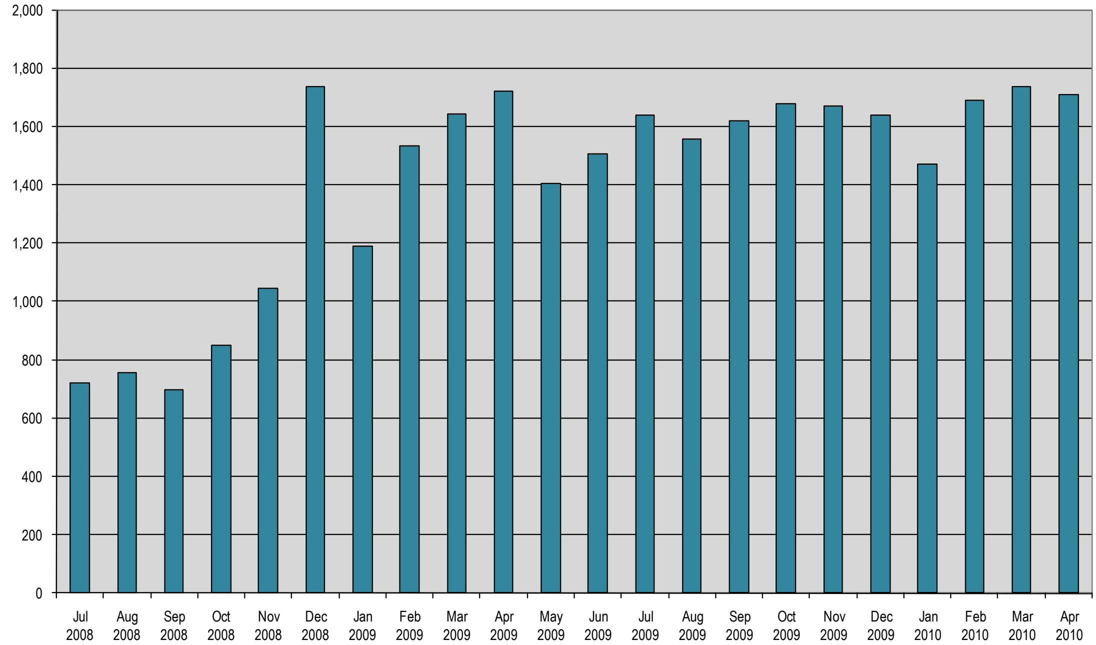
The nature of fiscal response to the crisis affected the economy in ways which were most painful to poor households – which, in Ukraine, tend to be families with children. This included second highest price inflation in the world, excessive economic slowdown, resulting in extra unemployment and wage arrears (affecting least mobile and poorest households).

Table 4. IMF projections on economic outlook of CIS countries in 2010-2011

	Real GDP				Consumer Prices (annual average movement)			
			Projections				Projections	
	2008	2009	2010	2011	2008	2009	2010	2011
CIS + Georgia, Ukraine and Mongolia	**5.5**	**-6.6**	**4**	**3.6**	**15.6**	**11.2**	**7.2**	**6.1**
Russia	5.6	-7.9	4	3.3	14.1	11.7	7	5.7
Ukraine	**2.1**	**-15.1**	**3.7**	**4.1**	**25.2**	**15.9**	**9.2**	**8.9**
Kazakhstan	3.2	1.2	2.4	4.2	17.1	7.3	7.3	6.6
Belarus	10	0.2	2.4	4.6	14.8	13	7.3	6.2
Azerbaijan	10.8	9.3	2.7	0.6	20.8	1.5	4.7	3.5
Turkmenistan	10.5	4.1	12	12.2	14.5	-2.7	5	5.4
Mongolia	8.9	-1.6	7.2	7.1	26.8	6.3	7.3	5.3
Low Income CIS	**8.6**	**4.7**	**4.5**	**3.9**	**15.8**	**6.2**	**6.8**	**6.3**
Uzbekistan	9	8.1	8	7	12.7	14.1	9.2	9.4
Georgia	2.3	-4	2	4	10	1.7	4.9	5
Armenia	6.8	-14.4	1.8	3	9	3.4	6.8	5.2
Tajikistan	7.9	3.4	4	5	20.4	6.5	7	8.3
Kyrgyz Republic	8.4	2.3	4.6	5.3	24.5	6.8	8.4	7.6
Moldova	7.8	-6.5	2.5	3.6	12.7	0	7.7	5.7

Source: World Economic Outlook: Rebalancing Growth. IMF, April 2010.

Figure 3. Changes in the stock of wage arrears in Ukraine, July 2008 – April 2010 (UAH Million, as of 1st day of month)



Source: Ukraine's State Statistics Committee

> **Mounting fiscal and quasi-fiscal deficit is creating economic and fiscal distortions which will be increasingly difficult to repair.** As discussed in the previous section, Government's crisis-related policies were strongly focused on short-term mobilisation of revenues at the cost of building up explicit and more disguised financial obligations. The size and nature of these obligations creates considerable risks to the economy, the budget, and to social safety of most vulnerable population groups.

- **Spending so far.** On the one hand, in the absence of structural reforms (to maintain the tax base) and without relaxing expenditure mandates, Ukraine's budget accumulated an explicit deficit which, in 2009 annual execution, was estimated by IMF at 11% of GDP (including off-budget funds) – three times higher than planned by the Government and six times higher than the previous year[10]. As also discussed in the previous section, much of this explicit deficit was covered by expanding public debt. However, a significant amount of expenditures so far were funded by revenues which were essentially borrowed against future obligations, representing a "quasi-fiscal" deficit. The biggest items of such disguised obligations are VAT refund arrears owned to exporters and other obligations resulted from manipulative tax accounting such as funding current spending with the help of advance tax payments.

- **Plans for next year.** How this policy will evolve during the rest of 2010 is an open and debated question. As of now, neither Government has launched palpable structural reforms which would allow to expect either a significant expansion of the tax base or efficiency gains in spending on major public sectors. At the same time, as the next section explains, both Governments have insisted on a political choice of raising state's participation in public service delivery and social protection, gradually increasing nominal social payments. This raised a conflict in views on sustainability of such approach between Ukrainian Government and the international development community, represented by the WB and the IMF – which evolved around the estimate of fiscal deficit in the 2010 Budget.

Short-term mobilisation of funds at the cost of building up explicit and hidden financial obligations creates a fundamental fiscal disbalance, which is unsustainable. Even though mounting financial commitments are owned to parties such as exporters, pensioners and international lenders, when the Government arrives to decision points for covering the gaps, resulting choices are likely to affect wider population and especially the poor (e.g. in case of continued inflationary financing of the budget deficit).

- **Immediate and long-term future: the Pension system.** Shrinking labour market and shrinking payroll tax revenues create obvious additional pressures on the Pension Fund balance, which depends almost exclusively on the pay-as-you-go funding. However, given that official statistics on the Pension Fund budget execution is not publicly available, throughout the crisis it has been subject to much controversy. Until elections, the previous Government implemented cosmetic measures to strengthen Pension Fund balance (such as legislation to improve payment discipline[11] and (unsuccessful) attempts to increase Pension Fund contributions from private entrepreneurs in April 2009 and to raise a discussion about minimum pension age in March 2009).

  After elections, both the new Government and the international observers turned their attention to the subject. The WB called Ukraine's Pension spending unsustainable (being one of the highest in the world, at 17% of GDP and based on a distorted funding mechanism), recommending to start immediate annual 6-month increases of pension age for women until it reaches 60 years and to radically reduce special privileged pensions. The new Government released dramatic statistics about Pension fund deficit (UAH 29.8 Billion), calling it catastrophic[12]. However, it took a radically defensive standing about corrective measures, insisting on plans to raise enough revenues in order to preserve the current pension age[13].

Political choice to expand social standards at the cost of pro-cyclical tax squeeze

Throughout 2009 – IQ 2010, notwithstanding certain disagreements regarding political ownership of social initiatives, both Governments consistently pursued attempts to increase social payments to population. As illustrated in Table 5, the Budgets of both years maintained a stable increase in the amount of wage and subsistence minimums (which have, since the end of 2008, essentially levelled off). Moreover, both Governments specifically emphasised the policy of continued increase in social payments despite growing economic difficulties and resulting confrontations around the subject with international finance organisations.

The increase in both minimums approved by VR in November 2009 led IMF to decline Ukraine the fourth tranche of the 2008 stand-by agreement[14]. IMF supported the policy of rising social payments in line with inflation (at around 10%), but noted that any further increase cannot be financed without resorting to inflation and or significant downsizing of the public sector workforce[15]. It estimated that the increase voted in November would cost an unsustainable extra 7% of GDP in 2010. Despite continued consultations in the following months (and some additional measures such as introduction of a concept for tax reform along the objectives agreed with IMF), the financing under the fourth tranche was not released[16].

After elections, the new Government consistently demonstrated determination to increase social payments above expected inflation targets, despite continued disagreement with international lenders. In early March, PM Azarov announced a plan to continue steadily increasing social payments[17], while IMF has restated its recommendation of a realistic budget with a deficit below 6% of GDP[18]. Development and approval of the 2010 Budget was accompanied by consultations with IMF, whose outcomes were not explicitly announced by the time of this report. As already mentioned (and detailed in the table), the approved Budget increased all social payments. The approved deficit is restrained to 5,33% GDP. According to most observers – and in line with statements by the Government – the Government hopes to balance the budget by new measures to mobilise revenues through an announced "de-shadowing agenda", discussed below. It stated that the approach has been agreed with IMF, with a view to replace the earlier stand-by agreement with an entirely new framework to ensure another two-year financing programme. However, the text of such agreement was not yet released, while IMF stated that "outstanding issues remain to be clarified, including fiscal consolidation"[19].

Increasing social payments at rate which exceeds the rate of inflation, under current economic circumstances, means that these extra payments would have to be funded through further inflation or through cutting the public sector workforce. So, even though most of the recent increases imply nominal increases to incomes of households with children, these benefits will be cancelled out by the likely macroeconomic consequences.

Table 5. Changes in nominal wage and subsistence level in 2006-2010.

	Nominal minimum wage (UAH)					% Increase over previous period				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Quarter I	350	400	515	605	869	5%	0%	12%	0%	17%
Quarter II	350	420	525	625	884	0%	5%	2%	3%	2%
Quarter III	375	440	525	630	888	7%	5%	0%	1%	0%
Oct-Nov	375	460	545	650	907	0%	5%	4%	3%	2%
Dec	400	460	605	744	922	7%	0%	11%	14%	2%
Increase throughout the year						19%	15%	28%	23%	20%

	Subsistence Level					% Increase over previous period				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Quarter I	453	492	592	626	825	5%	4%	11%	0%	18%
Quarter II	465	525	605	626	839	3%	7%	2%	0%	2%
Quarter III	465	525	607	626	843	0%	0%	0%	0%	0%
Oct	472	532	626	626	861	2%	1%	3%	0%	2%
Nov	472	532	626	701	861	0%	0%	0%	12%	0%
Dec	472	532	626	701	875	0%	0%	0%	0%	2%
Increase throughout the year						11%	12%	16%	12%	21%

	Min Wage - Subsistence Level (UAH)					Min Wage as % of Subsistence Level				
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
Quarter I	-103	-92	-77	-21	44	77%	81%	87%	97%	105%
Quarter II	-115	-105	-80	-1	45	75%	80%	87%	100%	105%
Quarter III	-90	-85	-82	4	45	81%	84%	86%	101%	105%
Dec	-72	-72	-21	43	47	85%	86%	97%	106%	105%

Source: annual State Budget Laws of Ukraine

Plans for compensatory revenue mobilisation announced so far include mostly administrative measures, not structural reforms which could extend tax base and recharge growth. Revenue-mobilisation initiatives announced so far included measures related to stronger administrative control over tax payment discipline (such as additional audits of big taxpayers, stronger income reporting requirements etc)[20]. Other planned measures include additional excise taxation of luxuries[21].

2. Individual reform initiatives (or lack thereof).

▪ Contradictory proposals in intergovernmental finance; status unclear.

> **Previous government attempted to reorganise intergovernmental finance in a reform declared as actively decentralising but raising significant concerns.** Throughout 2009, Tymoshenko Government pursued a reform to significantly amend the Ukraine's Budget Code along with other legislation (such as the Land Code, Law on Land Tax, and Law on Land Rent). Although the government positions proposed changes as "anti-crisis" measures, their content actually developed gradually over the recent years[22]. The reform was presented as strongly decentralising, based on such proposals as introduction of direct transfers of equalisation grants to all local budgets (including rural municipalities which are currently funded through rayons). However, less obvious aspects of proposals exposed it as rather retrograde and detrimental for local fiscal autonomy. One example of such contradictory aspects was to introduce an additional, parallel equalisation grant allocated through oblast budgets without clearly specified rules, which would expand opportunities for manual regulation of intergovernmental finance[23].

> **Proposed changes were incorporated in the previous Government's draft 2010 budget[24] and disappeared in the 2010 approved Budget, prepared by the new Government. However, the idea might resurface thanking to wide political support.**

Intergovernmental finance reform advocated by the previous Government – and not ruled out after elections – assumed introduction of a parallel equalisation grant which would not be formula based. This would significantly reduce decision-making autonomy of sub-national governments. At the same time, without such autonomy it will be nearly impossible to optimise provision of services for children by local authorities (including introduction of performance based healthcare and education and community-/family- based social services for vulnerable children).

Potential intergovernmental budget reform also assumes extreme decentralisation of delegated responsibilities, introducing direct transfer relations between the central budget and lowest budget levels (villages and settlements) and supports a territorial reform which would assume these units as the basic level of local self-government. One of the risks of such reform is insufficient capacity of such territorial units to effectively perform required delegated functions in healthcare, education and social care (with direct implications for children).

▪ Restatement of long-term economic and social development goals in new Government's programmatic documents

> **The State Programme of Economic and Social Development for 2010, attached to 2010 Budget broadly coincided with the previous Government's Action Programme[25].** The new programme has restated most strategic development objectives declared by earlier governments, expanding them with a series of concrete tax policy proposals (such as reduction of some tax rates) and economic policy proposals (such as privatisation of the Odessa Port Plant).

> **In February, the Government released a draft Strategy for Ukraine's Development "Ukraine-2020: a Strategy for National Modernisation".** Development of this document was specially commissioned by the MoE to State "Institute of Economy and Forecasting of the National Academy of Science of Ukraine". The document has a notably abstract and ambitious profile, elaborating on such priorities as "Removal of oligarchy from power", "Ensuring complete energy independence of the country" and "Creating the most modern system of Healthcare, Education and Science in Eastern Europe".

> **The new Government has set up a Committee on Economic Reform, chaired by President Yanukovych.** The new body was created in late February to direct consultations for developing poverty reduction reforms.

> **A new Poverty Reduction Strategy (2010-2015) is being developed by the MoLSP, which also co-ordinates development of regional poverty reduction strategies.[26]**

▪ Restatement of long-standing plans for tax reforms, with a new extra focus on revenue mobilisation to fund social spending

> **The last half-year witnessed continued change of mind with regard to tax policy reforms in the Government, with several reform strategies replacing each other.** The two recent Governments have consequently proposed alternative reform strategies. To a large extent all these strategies built upon similar long-standing agendas which have not been implemented so far, although they do contain significant differences. However, given the pace of change of declared strategic reform objectives, some of them raise concerns as being somewhat opportunistic.

First (in December 2009), PM Tymoshenko had cancelled the reform approved in 2007 by then-in-office Government of PM Yanukovytch, replacing it with a new Strategy for Tax System Reform to 2018[27]. Approval of this new Strategy was demanded by the IMF as a condition for the stand-by agreement – which explains some of its progressive objectives such as a shift from direct to indirect taxation (an idea which contradicts earlier declared scepticism of PM Tymoshenko towards value-added taxation, the major indirect taxation source). Other objectives of that strategy included introduction of a Single Social Tax[iii], introduction of a local Property Tax, and stronger autonomy of local budgets in regulating local tax rates and bases.

After elections, the new MoF announced a plan to develop a yet another new concept of tax reform. However, while the new concept is being developed, the MoF plans to release a new draft Tax Code already in May 2010 to approve it by the next year's Budget.

> **An ad-hoc attempt to introduce a property tax registered but failed in the VR.** While the governments consequently worked on developing tax policy reform strategies mentioned above, a separate proposal of a property tax was submitted to the VR by a BYT MP Mr. A. Pavlovskyi[iv] and voted (negatively) already after elections (in early March). The proposal suggested to introduce property tax as a central, rather than local tax (since the rates for this tax would have been set centrally)[28]. This contradicted most existing views on this tax, which agree that the tax is needed primarily for its potential to increase local budget revenue autonomy.

> **As already mentioned, the new Government has declared a plan to introduce specific additional measures for revenue mobilisation to fund its commitment to increase social payments.** However, the details of these plans are yet unknown.

One of the key obstacles to introduction of more efficient and innovative services for children at the local level is extremely low marginal revenue autonomy of local budgets. At the moment, local governments have to fund services for children based on rigidly defined central norms using revenues whose size they cannot regulate (a PIT with a centrally defined rate and formula-based equaliation transfers). Any additional or innovative service has to be funded by local taxes, which currently bring around 5% of local revenues. The only meaningful expansion of local revenues is possible through introduction of a property tax or local surcharges to PIT.

▪ Evolutionary developments in social policy and social protection.

> **Revision of legislation on privileges to families with many children.** Amended law became effective on 1 January 2010. It expands the range of existing privileges in: housing and communal services, transport, healthcare, education, labour regulation including pensions, as well as creates additional tax exemptions[29].

> **Proposals to revise administration of benefits to families with children.** A draft of related law was approved by the Government in early February. According to MoLSP, the new law would strengthen the targeting of benefits by clarifying rules for their provision.[30]

> **Debates about procedures for discharge of social benefits with implications to children.** In early February, the Government failed to pass through the VR a proposal to relax income-verification rules for provision of social benefits to low-income families (allowing families to continue receiving benefits in cases of minor delays in submission of income-verification documents). In Government's view, this amendment would have been especially important for families with many children who find it most difficult to comply with requirements of frequent reporting, given extra time pressures related to children-raising tasks.

[iii] Ukraine's payroll taxation is fragmented across four off-budget social insurance funds (Pension Fund, Unemployment Fund, Temporary Disability Insurance Fund and Work Injuries Insurance Funds), suffers from complex administration, and has relatively high average rate (estimated at 42%[iii]). This raises costs of compliance and discourages private investment. Since January 2009, Ukrainian government has debated a contradictory proposal to unify these taxes under a single social insurance tax. The point of disagreement was allocation of responsibility for administration of the combined funds to a newly created central agency. As a result, a respective law approved by the VR was vetoed by the President Yushchenko and failed to either override the veto or evolve to eliminate the conflict.

[iv] Current shadow Minister of Economy.

- > **First practical steps to introduce social housing.** Legal grounds for launching a Social Housing Fund existed since 2006[31], but lacked operational detail and practical implementation. At the end of February, first such steps were made by Kyiv city council, which introduced a legal clarification prohibiting privatisation of social housing and announced that the first 50 municipal flats will be soon allocated to the poorest residents[32]. Moreover, at the national level, the approved 2010 Budget allocated UAH 2 340 million for purchasing property to be converted into social housing[33]. NB: these innovations are additional to on-going state support to construction and purchasing of housing for selected privileged population categories (notably, military servicemen), which has been routinely funded throughout recent years[34].
- > **Continued donor-funded micro-projects to construct social infrastructure (schools, roads, etc) in Luganska, Donetska oblasts and AR Crimea with intermediation of USIF[35].** Ukrainian Social Investment Fund (USIF) was set up under a joint donor initiative led by the World Bank in 2001. Originally, it was designed as a "SIF of a new generation". The novelty was in the attempt to combine the usual SIF task of delivering quick and tangible benefits to the poorest communities with a more strategic ambition to assist the Government with a national reform in social protection and to build local capacity for service delivery at all levels. To achieve this, the SIF included an additional component to fund community-based micro-projects for development of innovative social services and a separate budget for policy development and capacity budget. By 2008, the WB recognised that despite its unusual structure, Ukraine's SIF was not capable to integrate itself into social policy and reform process and discontinued support to this work. The USIF continues to exist under KfW support, concentrating on a more typical SIF framework of funding social infrastructure micro-projects in rural communities.

In January-April 2010, the Government(s) continued introducing evolutionary modifications in areas related to child protection (including developments in administration of related social benefits, introduction of social housing, and development of juvenile justice system).

- > **Ministry of Justice released a new draft Concept of Juvenile Justice.[36]**
- > **Revised legislation on minimal wage guarantees, including a shift to hour rate of minimal wage.** Revised labour legislation effective from 1 January clarifies responsibilities in ensuring minimal wage payments, translating them on per hour basis. Despite some legal difficulties in actual implementation of these amendments, the new approach reflects potential range of working terms more accurately, especially given the frequently shrinking hours in times of crisis.

Evolutionary developments in healthcare reforms

- > **In January, Tymoshenko Government established Healthcare Reform Council, to work on reform agenda developed jointly with the WB.** The WB presented a reform roadmap along with proposals for several regional pilots, which were formally praised by the Government (PM, President and MoH leadership).
- > **In February, Tymoshenko Government approved a Concept for Healthcare Reform, including introduction of social health insurance and pilots in Dnipropetrovska and Vinnytska oblasts.[37]**
- > **In April, the new Healthcare Minister Mr. Mytnyk announced active support to the concept of state health insurance.** Mr Mytnyk explained that the MoH is preparing a draft law on state health insurance which will be shortly submitted to the VR.

Despite intensified attention to healthcare reform (including introduction of reform councils and concepts), strategic direction, practical detail and probability of actual implementation of such reforms is yet unclear. Most worryingly, the new Minister of Health announced support to introduction of social health insurance – a mechanism which would create an additional tax burden that would be wasted given the current systemic inefficiencies.

- ## Evolutionary developments in rural livelihoods policies.

  > **A new Concept of State Targeted Programme of Sustainable Rural Development to 2020 was approved in February.** The concept reflects a long-standing process to transform state support to rural population, replacing production-focused support to agricultural activities by a more comprehensive system of strengthening of rural livelihood, including social development, social services, public and business infrastructure etc.

Risks to children, including child poverty, are significantly more pronounced in Ukraine's rural areas. According to UNICEF Child Poverty Study, among all households with children, rural residents represent 32%, while among poor households with children (by national criteria), rural families represent 44% (based on 2006 HES). In Ukraine, rural poverty is not so much a problem of income as a problem of restrains and barriers to opportunities available in urban areas. The major reason for this is a bias of rural social and economic infrastructure towards agricultural production, instead of comprehensive rural development. Most previous governments recognised this problem at conceptual level, but practical steps in the direction are still rare.

- ## Notable cross-cutting initiatives

  > **Ukraine attempted to change its public procurement system in a way which dismayed international organisations, who essentially solicited revocation of the related new law.** The VR approved the new contradictory law on 11 February[38]. Following this, the WB and the EU representatives submitted a letter to President Yanukovych, asking him to veto the law based on a list of 34 concerns about its potential effect, including the appeal review mechanism, burdensome procedures and selective treatment of sectors, which might lead to corruption[39]. The veto followed in early March[40], along with a promise to quickly develop a new version of the Law, in line with international expectations[41].

In the long term, Ukraine's approach to public procurement will have decisive impact on how the Government will procure services in social sectors, and whether modern social commissioning and performance-based services will take root. The major obstacle for introducing social contracting so far – including "money follows the child" mechanism – has been lack of institutions for competitive selection of providers and poor accountability in service provision. Current debate about the future of the procurement system is setting strategic direction in this area.

2010 Budget Update

▪ Approved 2010 Budget Law

Background

The 2010 Budget Law designed by the new Government was approved on 27 April 2010, four months after the beginning of the year, given pre-election political turbulences. The law was approved four days after submission, without significant debates. It also followed intensive consultations between the Government and the IMF, which did not result in a signed agreement although both sides reported progress and plans for co-operation.

Key policy implications and concerns

As discussed in the previous section, the 2010 Budget raises concerns related to its feasibility, transparency and weakness of plans for structural reforms, and continues many of the practices initiated in previous years – including by the previous Government. The approved 2010 Budget is based on the assumption that new tax initiatives and loans will be sufficient to cover an increase in social payments which exceeds expected price inflation, keeping the deficit at 5,33% of GDP (below the 6% threshold suggested by the IMF). Expected ways of managing risks and potential shortages are highly opaque, as explain below. This continues the trend of decreasing transparency of public financial managing and exacerbates risks of economic distortions. At the same time, the document does not contain clear plans for structural reforms in key sectors, which would allow to expect efficiency savings.

> **Significant increases in transfers from National Bank without clear argumentation[42].** According to the Law "On National Bank of Ukraine", profit generation does not belong to the functional objectives of the National Bank[43]. Respectively, the Law instructs the National Bank to transfer any surplus revenues to the state budget. Every annual budget law contains an estimate of a transfer from the NBU to be expected in that year. The methodology for estimating revenues and expenditures of the NBU behind such estimated has remained unclear. At the same time, the two recent Budgets (2009 and 2010) have very significantly increased expected amounts of transfers (see Table 6).

Table 6. Estimated annual transfers of surplus revenues from the NBU to the state budget in annual Budget Laws in 2006-2010 (UAH Million)

	2006	2007	2008	2009	2010
Estimated annual transfers of surplus revenues from the National Bank to the State Budget	1,29	1,88	4,83	9,80	10,00

Source: Annual State Budget Laws of Ukraine, 2006-2010.

> **Further decrease in transparency of issuing guarantees to international loans.** This problem was discussed in detail in the previous section: the 2010 Budget contains a notoriously vague definition of possible loans and specifies that procedures for allocating loans will be defined in CMU Resolutions (opening doors for manipulations).

> **Restructuring of state debt to exporters against VAT refund arrears.** The previous section explained that significant VAT refund arrears essentially represent quasi-fiscal borrowing which was used to fund cash shortages in the shrinking budget. It also mentioned that the approved 2010 Budget has resurrected distortive approaches of earlier years when outstanding arrears were, post-factum, compulsively restructured into government's promissory notes. The 2010 Budget establishes that all arrears accumulated by 1 May 2010 will be "repaid" with newly issued Treasury notes, thus explicitly acknowledging technical default on these obligations with unclear prospect of repayment[44]. Apart from further damage to the growth-generating export industry, this approach permanently discredits the system of VAT, which is the most important current and potential revenue source in Ukraine's budget.

- **Explicit restatement of the requirement to local governments to fully respect input-based norms to staffing and ensure full and timely payment of wages and utilities[45].** As discussed earlier, maintaining rigid infrastructure-based norms for service provision in times of economic downturn exacerbates the mismatch between decentralised intergovernmental finance and centralised regulation of service provision.
- **Legitimisation of short-term Treasury loans to cover cash shortages.** The previous section described operations with the unified Treasury account exercised in the previous year to cover cash shortages. The 2010 Budget explicitly legalises the practice by establishing that local authorities can use short-term Treasury loans to cover cash shortages for the benefit of financing of wages and in cases of underperformance of the Personal Income Tax[46].
- **Legitimisation of short-term Treasury loans to the Pension fund to cover cash shortages.** In a similar way, the law allows the Treasury to cover cash shortages of the Pension fund – which further obscures the current financing arrangement[47].
- **Legitimisation of public borrowing above approved limits.** The Budget explicitly states that if revenues underperform, it allows the Government to fund protected expenditures by additional borrowing above the limits established in the annual law[48]. The previous Government resorted to such practice in the previous year, raising active criticism of the opposition. However, this same approach has been approved in the 2010 as legitimate.
- **Continued lack of transparency behind Stabilisation Fund expenditures, and its increased volume.** The previous section explained that the 2010 Budget has not clarified procedures for utilising proceeds earmarked under Stabilisation Fund, and yet increased the Fund to UAH 30 Billion or 9% of the Central Budget (three times compared to last year)[49].
- **Expenditure allocations and text provisions of the law do not contain visible plans for structural reforms in any of the key social sectors.** Although annual budgets are not primary vehicles to introduce such reforms, they provide indirect evidence on related plans in terms of relevant expenditure allocations. The 2010 Budget does not contain references to expected structural changes in amounts or procedures for sector funding; moreover, as already discussed, it reinforces input-based norms which currently define most sector policies.

The 2010 Budget continues funding to the current version of the "money follows the child" initiative, which discredits the idea of social commissioning. The current initiative to introduce "money follows the child" funding mechanism represents an additional targeted social transfer, which is divided without separation of purchaser-provider functions and competitive service commissioning, and therefore does not at all "follow the child". Application of the term to such transfer is misleading and creates long-term risks to introduction of proper social commissioning in Ukraine. The 2010 Budget continues to support this misleading approach by maintaining earmarked funding to the initiative.[50]

2010 Budget Expenditure Execution

- Overall level of consolidated public spending in Jan-Mar 2010 remained roughly at the level of last year (decreasing in real terms by 0,5% compared to same period of 2009).
- As discussed earlier, the Government's policy in key social sectors was to maintain current staffing norms and increase wages above inflation rate. Respectively, real spending in all these sectors either remained practically unchanged in real terms (in Education it decreased by only 0,3%) or slightly increased (by 3,9% in Healthcare and by 2,4% in Social Protection and Social Care). A more significant increase in Culture and Sports (16,8%) is due to expenditures related to preparation for Euro-2012, while regular wage-centered expenditure lines remained around 2009 levels.
- Biggest real reductions in January-March 2010 compared to last year occurred in expenditures on Economic Activities (-32,3% in real terms) and Housing & Utilities (-28% in real terms), which jointly accumulate most investment programmes. In particular, biggest cuts under "Economic Activities" were registered in expenditures on Railway Transport and Roads. This reinforces the observation about the policy of cutting on capital expenditures for the benefit of maintaining current spending.
- At the same time, in the first quarter of 2010, the Government significantly expanded spending on Defence (15,9% in real terms) and Public Administration (33,9% in real terms). The sharp increase of expenditures on Public Administration includes growing costs of debt servicing (both external and internal) and spending related to elections.
- Table 7 illustrates that all these expenditure trends were roughly in line with the temporary spending baselines used before the VR approved the 2010 Budget (around a half of amounts planned for half-year was released in most programmes during the first three months of 2010).

Table 7. Consolidated Budget execution in January-March 2010

		Comparisons to plan		Comparisons to same period of 2009		
	Nominal actual expenditures in Jan-Mar 2010	Temporary half-year plan (for Jan-Jun 2010)*	Actual expenditures as % of half-year plan	Nominal actual expenditures in Jan-Mar 2009	% Change in nominal terms	% Change in real terms
Total Expenditures	**71 733,9**	**139 942,3**	**51,3%**	**64 887,0**	**10,6%**	**-0,5%**
Public Administration	7 929,2	20 506,4	38,7%	5 335,0	48,6%	33,9%
Defence	2 345,0	4 590,6	51,1%	1 819,3	28,9%	15,9%
Civil Order, Security & Judiciary	5 524,7	11 327,9	48,8%	4 826,0	14,5%	3,0%
Economic Activities	7 624,3	14 685,5	51,9%	10 099,1	-24,5%	-32,3%
Environment Protection	286,2	732,6	39,1%	254,7	12,4%	1,4%
Housing and Utilities	669,6	1 251,2	53,5%	837,8	-20,1%	-28,1%
Healthcare	8 515,9	15 213,2	56,0%	7 365,0	15,6%	4,0%
Culture and Sports	1 899,3	3 694,4	51,4%	1 465,2	29,6%	16,7%
Education	16 905,2	32 517,1	52,0%	15 252,7	10,8%	-0,3%
Social Protection & Social Care	20 034,4	35 423,3	56,6%	17 632,2	13,6%	2,4%

** Given the delay in approval of the annual Budget Law, official mothly baselines ('rozpys') were not yet released at the time of the report. The table compares actuals to the temporary half-year plan used before the approval of the Budget Law in April.*

Source: Treasury Budget Exectuion Report.

2011 Budget Update

Background

The new Government has declared its fiscal plans for 2011 earlier than required by the Budget Code. Ukraine's Budget Code instructs every Government to inform the Parliament of the 'Key directions of fiscal policy' for the upcoming year by 1 June. This document – traditionally called "Budget Resoluton" – is submitted to the Parliament, which has to provide feedback by either approving or acknowledging the document. Ukraine's new Government announced its fiscal plans for 2011 at a much earlier date (on 19 April 2010) in a CMU Resolution containing a "Declaration of Goals and Tasks for the 2011 Budget (Budget Declaration)"[51]. Despite the early timing and the deliberate difference in the title (declaration rather than resolution), the content of the document strictly corresponds to all Budget Code requirements to the "key directions of fiscal policy"[v].

Key Messages

> **The Declaration consistently asserts an expansion in social payments to population, including payments at child birth.** The document promises to "systemically" increase all dimensions of nominal social standards such as: minimum wages, subsistence level, coverage of subsistence level by the minimum wage. It also specifically promises to increase the benefits linked to the fact of child birth.

> **The document is based on the assumption that the Government will raise enough funds through new tax initiatives to support expanded social standards and to keep new loans for investment purposes only.** The Declaration calls for a realistic budget with a deficit under 4,5%. This should be achieved thanking to bold steps in tax policy to extract revenues from the shadow and streamline tax administration, coupled with faster growth following measures to improve business environment.

> **Some of the announced tax policy initiatives represent long-standing reform projects, which, *if implemented*, should indeed help to broaden the tax base, decrease economic distortions and widen fiscal envelope.** Experts and international observers have consistently pointed that Ukraine's tax burden has been already rather high in the recent years, discouraging investment, and that raising more revenues would be possible only by broadening tax base and improving compliance[52]. Some of the initiatives described in the Declaration would represent important steps in this direction. Noteworthy examples are listed below.

- **Introduction of direct corporate tax for insurance companies.** The system of taxing insurance companies remains a legal national offshore which helps to avoid billions of tax liabilities, and whose mechanics is clear to all and is, these days, explained by media every week. 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 off-shores. A key step to resolve this problem is to introduce direct taxation of insurance profits.
- **Improved administration of VAT.** As explained in other sections, at the moment billions are leaked from the budget through avoiding VAT and claiming fictitious VAT refunds. Distorted system of VAT administration allows accounting 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. The 2011 Budget Declaration specifically addresses this problem by promising to streamline administration of VAT.

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[v] The content of the "Declaration" is structured precisely around eleven pillars requested by the Budget Code (information on: budget balance; size of public sector; public debt; intergovernmental finance; capital expenditures; relations with local budgets; expected legal changes; composition of key spending units; composition of protected expenditures; division of funds on general and earmarked; and minimum subsistence and wage levels.

- **Introduction of a single social insurance tax.** As also explained in other sections, Ukraine's payroll taxation is fragmented across four off-budget social insurance funds (Pension Fund, Unemployment Fund, Temporary Disability Insurance Fund and Work Injuries Insurance Funds), suffers from complex administration, and has relatively high average rate (estimated at 42%i). This raises costs of compliance and discourages private investment. The Declaration restates a promise to introduce a single social tax – an intention which was debated for several years but was not implemented so far because of disagreements regarding administration of the potential new tax.

> **The initiative to increase excise taxation is questionable.** The Declaration contains a plan to consistently increase the rates of excise taxes to match EU levels and to introduce a new tax on luxuries. Clearly, one of the objectives of this plan is to raise revenues for the budget. But excise taxation could be used by governments as a social policy tool, regulating consumptions of certain goods and services. Importantly for children, excise taxation can help to regulate consumption of addictive substances (alcohol and tobacco) which represent significant risks to children (by perpetuating risks of child abuse in addicted families and children's health risks because of exposure to addictive substances). However, in reality, effectiveness of excises as social policy tools is not as straightforward as it may seem, and depends on other strong factors. In particular, the impact of excises on consumption of alcohol and tobacco depends very strongly on the level of taxation in the neighbouring countries and on the strength of related trade barriers (formal and informal). In other words, despite high excises, the bulk of addictive substances can be smuggled to the country if no complementary measures are implemented to address the problem. Thus, raising excises without specific prior evidence-based policy evaluation may prove counterproductive: it can leave consumption of addictive substances unchanged but at the same time erode excise revenues.

> **The Declaration promises significant measures to boost investment and regenerate growth.** These measures include support to construction sector, investment into infrastructure, especially roads, reforms in housing and communal sector etc.

> **The Declaration refers to some concrete plans to improve transparency, such as introduction of open tenders in specific areas.** In particular, open tenders are expected in provision of funding for investment projects, state contracts for research and development, etc.

> **The Declaration promises to strengthen local tax autonomy, although this plan is not concrete.** The document states that in 2011 the Government will "assign new revenue sources to local budgets", "create incentives for local authorities to raise local revenues" and "increase the amount of revenue sources available for local investment". As already explained, stronger local revenue autonomy is a prerequisite of effective decentralisation, including more effective decentralised provision of services to children and introduction of new services. However, the wording of the Declaration is not sufficient to assume that new measures would indeed strengthen local taxation: that the new revenue sources would be appropriate, that local governments will be able to influence the rates of these taxes etc.

> **Some reforms are outlined for major social sectors, although most of them are evolutionary or marginal.**

- **Pensions.** The document promises steps to streamline the Pension system, including steps to unify approaches to pension assignments.
- **Healhcare.** Measures are promised to improve definitions of standards in healthcare services.
- **Education.** The document declares a programme of consolidation of small secondary schools, including introduction of transportation schemes for pupils.
- **Culture.** Measures are outlined to optimise expenditures in culture by reorganisation of existing institutions, clarifying user charge policies, staff employment norms etc.

Key Concerns

The aspects of the 2011 Budget Declaration which raise some concerns – including potential risks for children – are outlined below.

- **Above all, the probability of actual implementation of the declared initiatives is uncertain.** As with all Budget resolutions, the document is not compulsory and serves only as a broad direction of fiscal policy for the next year. If the Government does not incorporate these directions into the draft Budget for the next year, the Parliament can request modifications, but in reality there are no leverages to ensure that these promises are necessarily maintained.
- **The Declaration is biased towards deconcentrated version of decentralised spending in key sectors.** The document lists measures which assume further detalisation of central mandates for delegated spending such as "more scientific calculation of the norms of budget sufficiency" and introduction of detailed social standards into the equalisation formula. This represents a standing in the recent debate about whether current responsibilities of local governments should be treated as delegated or deconcentrated. The Declaration de facto assumes that these responsibilities will be deconcentrated, in that regulatory aspects of provision of these services will remain at the level of the central government.
- **Many proposals for changes in intergovernmental finance represent a retrograde tendency to earmark equalisation transfers across minor expenditure items, discrediting the idea of functional delegation of expenditure responsibilities.** Confirming the above statement, the Declaration proposes to change the formula by extending it to include specific additional variables to cover a more detailed range of decentralised programmes (e.g. "schools of aesthetic education").
- **Lack of clarity in proposals for local taxation: will actual changes really represent an improvement?** As already discussed, the nature of declared changed in local taxation is unclear.
- **The Declaration promises to reduce the share of protected expenditures, and yet actually extends it - and to items such as state intelligence and military housing.** Despite the stated intention to reduce the list of protected expenditures, the Declaration outlines items which will remain protected which corresponds exactly to the current list. Moreover, it goes on to promise protection to a significant list of additional items, which include: debt servicing, reforms and development in military force, state intelligence, preparation for Euro-2012 etc.
- **Continued provision of social privileges to profession-based population categories.**
- **No structural reforms outlined for any of the key social sectors.** The list of measures proposed for key sectors (healthcare, education, culture, social care) outlined above shows that there is currently no plan for a structural reform in any of these sectors, which would achieve fundamental changes in governance, financial management and administration of these sectors.

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