Child-Focused PFM Monitoring: Observations for January-June 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 third monthly deliverable (for June 2010).

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Acronyms and Abbreviations

CabMin	Cabinet of Ministers
CMU	Cabinet of Ministers of Ukraine
EPT	Enterprise Profits Tax
GDP	Gross Domestic Product
IMF	International Monetary Fund
MOF	Ministry of Finance
MOLSP	Ministry of Labour and Social Policy
MP	Member of Parliament
NBU	National Bank of Ukraine
PFM	Public Financial Management
PIT	Personal Income Tax
PM	Prime Minister
PR	Public Relations
STA	State Tax Administration
UAH	Ukrainian Hryvnia
UNICEF	United Nations Children's Fund
USD	United States Dollar
VAT	Value Added Tax
VPM	Vice Prime Minister
WB	World Bank

Observations on the current state of PFM

External origins and continued risks of incipient GDP upturn

First months of 2010 confirmed a revival of Ukraine's GDP, but mainly due to rising steel prices in the course of global economic recovery. Relatively high dependence of Ukraine's economy on exports[1] was one of the factors which made it vulnerable to the 2008-2009 global downturn, but it also helped it to benefit from the recently recovering global demand. Rising global prices for metals, chemicals and machinery led to double-digit growth of production in related industries including extraction, coke products, cargo transportation, and wholesale trade[1]. As a result, in Q1 2010, Ukraine's real GDP increased by 4.9% yoy (based on revised official statistics) and was reported by PM Azarov to have further risen in March and April by 6,8% and 8,5% yoy respectively (as quoted by media)[2]. In the same month, the WB improved its forecast for Ukraine's GDP growth in 2010 from 2,5% to 3,5%[3].

Although Ukraine's economy started to recover, this is mainly due to growing global steel prices rather than domestic policies. On the contrary, current policies complicate doing business in Ukraine. This will make it more difficult for the economy to diversify away from current dependence on exports of steel and chemicals, and to achieve sustainable growth.

Accurate estimation of the role of external factors and domestic policies in recent GDP trends requires in-depth econometric analysis. It is tempting to say that Ukraine's GDP moves along with global steel prices. However, separating the impact of favourable terms of external trade on the GDP performance from other factors – including those related to Government's stimulating policies – is actually a demanding analytical task:

- In May 2008, IMF has produced a special paper to understand the high unpredictability and volatility of Ukraine's GDP and its dependence on steel prices[4]. It concluded (based on the data for 1999-2007) that a 10% decline in steel prices reduces annualised real GDP growth by 1,5%% in the quarter of impact, after which it dissipates within four quarters, leaving GDP a 0,5-0.75%% lower over the full year (See Figure 1). It also concluded that the only solution to this dependence is diversification, but such which should be driven by market forces, not distortive government's policies. Therefore, IMF recommended the government to focus on structural reforms and market liberalisation to promote diversification as strongly as possible.
- The Q1 2010 report by SigmaBleyzer notes that Ukraine's exports remains highly undiversified, which explains why it has recently expanded, mirroring steel price dynamics (Figure [x]). SigmaBleyzer notes that in the Q1 2010, sectors such as retail trade, passenger transportation, and construction continued to decline (by -3%, -5% and -21% yoy respectively)[5].
- Understanding exactly how much of the recently reported GDP growth owes to improving steel prices and what was the contribution of government's stimulating policies, therefore, would require a reproduction of proper econometric analysis, which is beyond this paper.

However, recent macroeconomic developments do raise a number of concerns over the impact of government's policies on economic growth:

- Domestically oriented sectors continue to contract, as described above;
- Although Ukraine's real GDP in 1Q 2010 grew 4,9% over the same period of last over the same period of last year, it actually contracted by 0,3% compared to the previous quarter (after seasonal adjustment)[2]. Notably, this contraction takes place at the background of almost a year of consecutive growth in global steel prices.

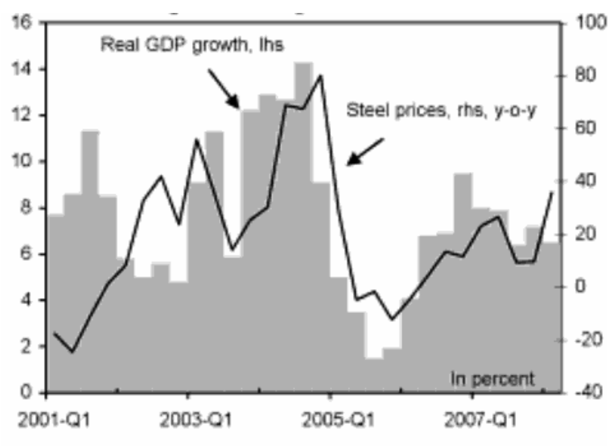
[1] The share of exports in Ukraine's GDP was 46,3% in 2009 and 50,5% in the 1st Quarter of 2010.

[2] Source: State Statistics Committee of Ukraine.

Figure 1. Illustrations of the impact of changes in global steel prices on Ukraine's economy in recent studies

IMF (2008):

GDP Growth and Steel Prices in Ukraine



Sigma Bleyzer (2010):

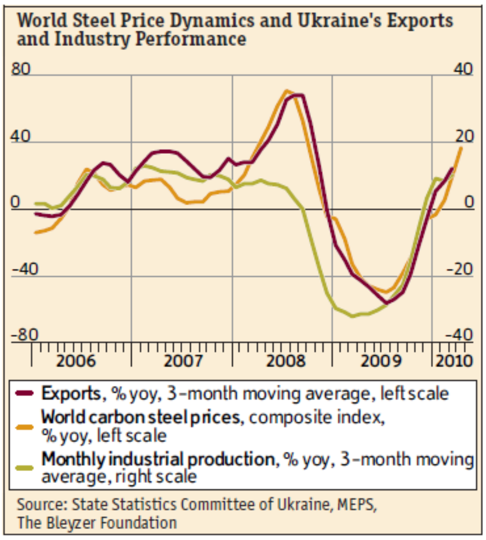
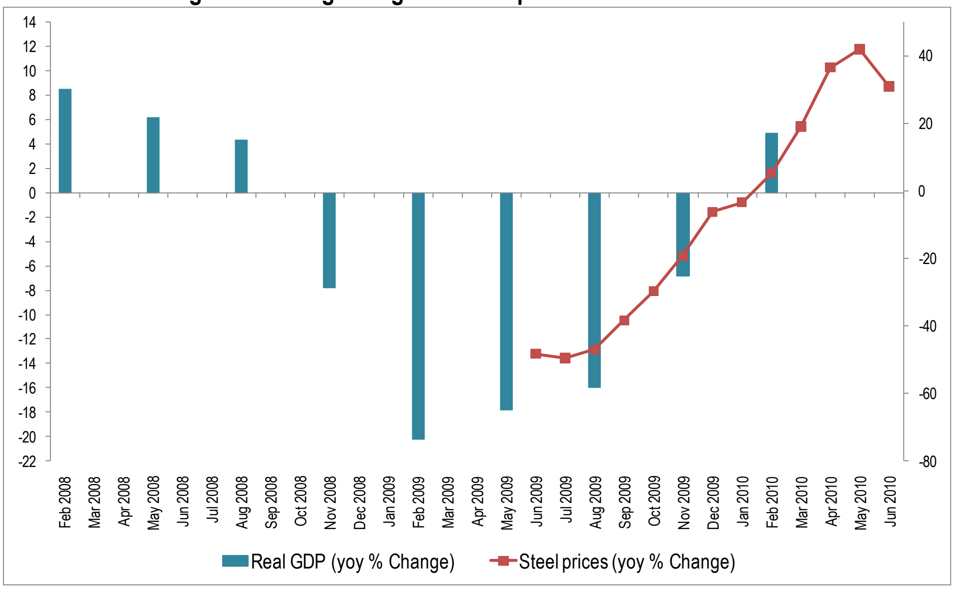


Figure 2. Changes in global steel prices and Ukraine's GDP



Source: Ukraine State Statistics Committee; http://www.worldsteelprices.com/
* Global composite carbon steel prices, USD/tonne

- Although forecasting of steel price dynamics is beyond this paper, we note that their growth has slowed down in May and reversed in June 2010, which seems to create further risks to Ukraine's future economic performance (See Figure 2). Moreover, earlier in 2010 global steel markets went through a considerable change due to a demise of a traditional system of pricing for iron ore, the industry's main component. Prior to 2010, benchmark prices for ore were established on an annual basis and set in long-term contracts through negotiations between three major ore-mining companies and steelmakers. However, following a new proactive position of China, this mechanism was changed towards spot-market pricing set in three-month contracts. This promises to increase fluctuations in ore prices, and, as a result, steel prices as well.[6]

Concerns over sustainability of recent recovery have grown after seasonally adjusted real GDP fell again in Q1 2010, and as trends in global steel prices started to stagger.

- As this report describes, current fiscal policies do not seem to promote market liberalisation and private business development, which would not promote diversification of growth but might be actually averting it.

Revenues behind plan

Consolidated revenues continue to decrease in real terms, despite growing economy, rising minimum wages and multiple administrative measures. Total consolidated revenues in January-May 2010 have decreased by 3.6% in real terms (Table 1). In particular, VAT – the budget's key revenue source (38% of all planned revenues) – continued to contract despite on-going accumulation of VAT refund arrears (described in more detail on page 10). Fast real contraction was registered in PIT (-2.62%). Moreover, Enterprise Profits Tax (EPT) grew at a very moderate 1.27% - much slower than in April (13.37%). Some analysts find this disturbing given that May figures should have reflected amounts of regular quarterly EPT payments for the 1st Quarter (implying continued practice of levying advance tax payments). Favourable year-to-year comparisons of excise receipts are explained with increases on excise duties on tobacco and alcohol in the last year.

Table 1. Consolidated Revenue Execution in January-May 2010.
(UAH Millions).

		Comparisons to plan		Comparisons to same period of 2009		
	Nominal actual revenues in Jan-May 2010	Annual plan (for Jan-Dec 2010)	Actual revenues as % of half-year plan	Nominal actual revenues in Jan-May 2009	% Change in nominal terms	% Change in real terms
Total Revenues	**120 449,69**	**311 448,85**	**38,67%**	**113 247,82**	**6,36%**	**-3,60%**
Value Added Tax	38 486,69	119 034,19	32,33%	35 165,93	9,44%	-0,81%
Personal Income Tax	18 505,76	33 725,76	54,87%	17 231,20	7,40%	-2,62%
Enterprise Profit Tax	14 763,03	40 739,35	36,24%	13 215,31	11,71%	1,27%
Excise Taxes	10 199,08	29 969,79	34,03%	6 835,86	49,20%	35,47%
Land Tax	3 737,14	6 422,06	58,19%	3 228,32	15,76%	4,91%
Import Duty	2 695,60	8 290,00	32,52%	2 381,94	13,17%	2,42%

Source: Treasury Budget Exectuion Report.

Collection of both local and central revenues seems to be considerably below schedule. Comparing Ukraine's budget totals to plan during the year is complicated by government's persistent policy of denying public access to the "budget rozpys" – the official monthly performance baseline for budget revenues and expenditures. Percentages of execution of annual plans are relatively poor indicators since they do not take into account various cyclical patterns such as tax collection schedules or seasonal fluctuations. Still, the following observations are nonetheless alarming:

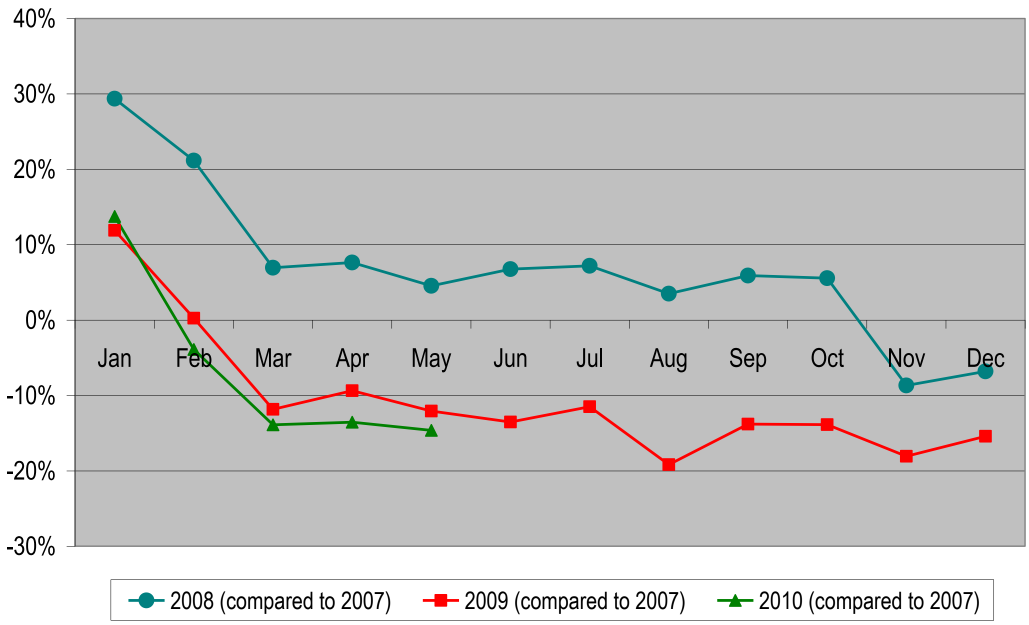
- Over January-May, actual consolidated revenues were less than 39% of annual plan;
- In the same period, the budget's key revenue – VAT – was collected at only 32% of annual target;
- Enterprise Profits Tax was raised at 36% of annual target, despite possibilities of advance collection;
- Personal Income Tax revenues brought 55% of annual target in the first five months, but this occurred at the background of a considerable nominal increase in public wages.
- Media sources quote unofficial figures of considerable under-execution of the unreleased rozpys baselines for sub-national contributions to the equalisation pool (shaped by the Personal Income Tax. Based on these reports, over January-May such contributions fell 25.2% short of respective period baseline (impairing performance of equalisation transfers as described further)[7].

Total consolidated revenues in January-May 2010 were 3,6% lower than in the same period of last year, in real terms, and only 38,67% of annual plan. Key taxes such as VAT and PIT are contracting. Poor revenue performance will make it difficult for the Government to balance the budget, which is likely to create risks to spending on children or macroeconomic complications such as inflation, or both.

- STA officials acknowledged to media extreme difficulties in revenue collection, as well as highly opaque nature of government's policy towards the choice of baselines for reporting. According to this source, during May the MOF has released to STA three entirely different collection plans[8].

Local budgets are strained given the fast contraction of PIT and slow transfer payments from central budget. The key source of local revenues – Personal Income Tax – continued to fall at increasing rate. By the end of May 2010, real decrease of PIT proceeds compared to same period of 2009 reached -2.62%, and the real decrease compared to the pre-crisis 2007 reached a record -15% (see Figure 3). As already mentioned, one consequence of this is an erosion of the equalisation transfer pool, with donor budgets contributing to the pool less than planned. Same media sources report that equalisation transfers themselves, as well as targeted subventions on social protection, have been below government's own period baselines during January-May (by 21,9% and 20.6%, respectively)[9].

Figure 3. Change in real PIT collected to local budgets:
monthly proceeds in 2008, 2009, and 2010 compared to same periods of 2007



At the same time, the Government has repeatedly asserted that Ukraine's public finance are improving beyond expectations. According to First Deputy Head of Presidential Administration Ms. Iryna Akimova, central budget revenues in January-May were actually 8,8% above the baseline plan for that period[10].

Over 43% of May's consolidated budget spent on pensions

In May, the Government funded a massive backlog payment of increments to pensions and social benefits due as a result of the increase in related obligations established in the 2010 Budget. As discussed in previous reports, the 2010 Budget approved in April established a series of increases to most types of social benefits and pensions. In May, the Government established that amounts of such increases due for the first months of 2010 (before the Budget was approved) would be funded in May (for January-February) and June (for April)[11]. As a result, in that one month the Government spent over UAH 18 Billion on Social Protection and Care, or two thirds of all previous expenditures on social protection in this year (Figure 4). Most of this amount (over UAH 17.1 Billion) was spent on *Social Protection of Pensioners* to fund the backlog of increments to pensions and the increased amounts of current pension obligations. Table 2 shows that this decision led to a 33% higher spending on social protection in January-May 2010 compared to same period of last year, in real terms. It also explains overall real growth in consolidated real expenditures compared to last year at 4% in real terms.

Figure 4. Monthly real expenditures on key functions in consolidated budget in January-May 2010 (UAH)

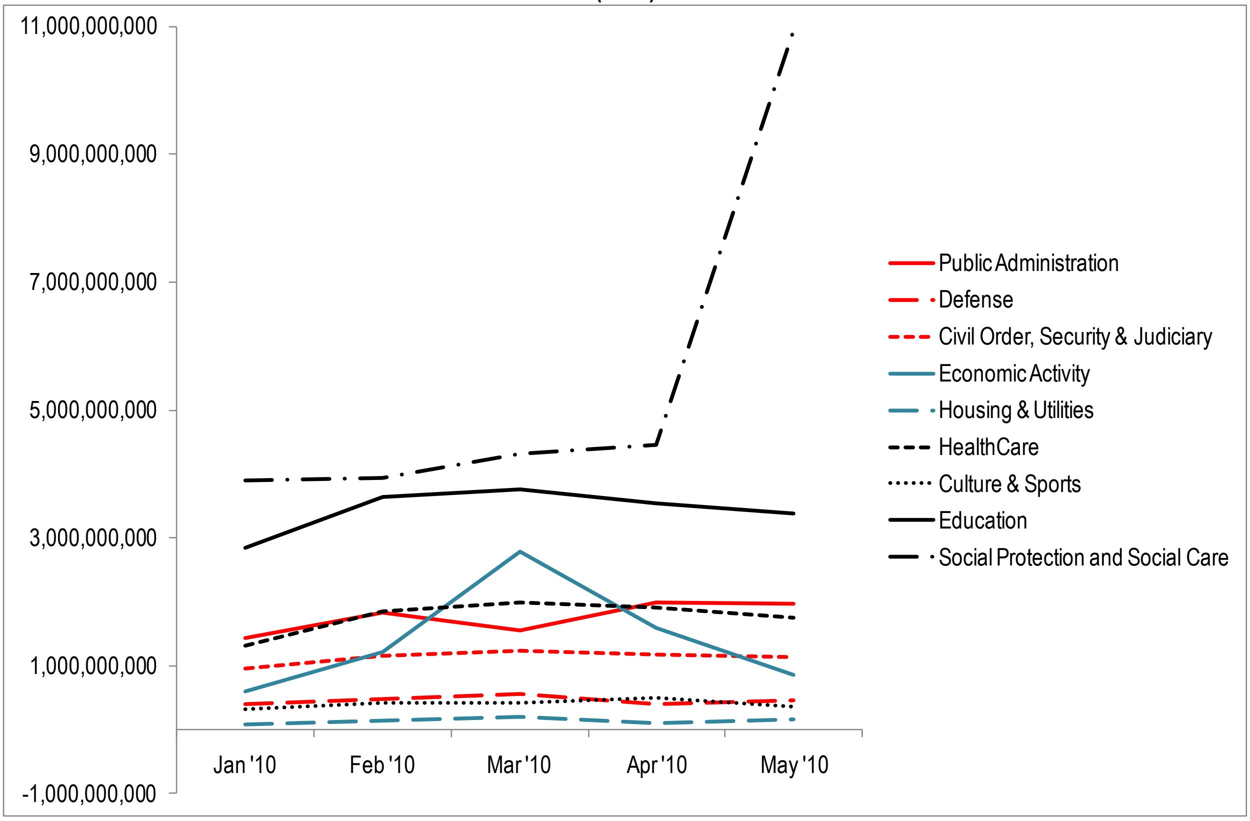


Table 2. Consolidated Expenditure Execution in January-May 2010. (UAH Millions)

		Comparisons to plan		Comparisons to same period of 2009		
	Nominal actual expenditures in Jan-May 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-May 2009	% Change in nominal terms	% Change in real terms
Total Expenditures	**132 801,20**	**348 931,17**	**38,06%**	**115 776,13**	**14,71%**	**4,07%**
Public Administration	14 514,97	65 327,72	22,22%	11 256,77	28,94%	17,27%
Defence	3 777,46	13 681,40	27,61%	3 313,37	14,01%	3,46%
Civil Order, Security & Judiciary	9 368,74	26 729,30	35,05%	8 689,54	7,82%	-2,15%
Economic Activities	11 672,44	34 587,13	33,75%	17 114,91	-31,80%	-38,31%
Environment Protection	529,09	2 753,93	19,21%	545,66	-3,04%	-11,76%
Housing and Utilities	1 093,60	2 609,97	41,90%	2 353,70	-53,54%	-57,69%
Healthcare	14 579,22	31 760,09	45,90%	13 069,94	11,55%	1,14%
Culture and Sports	3 313,05	8 047,31	41,17%	2 655,79	24,75%	13,24%
Education	28 400,29	63 031,99	45,06%	25 656,40	10,69%	0,32%
Social Protection & Social Care	45 552,36	100 402,32	45,37%	31 120,04	46,38%	32,87%

Source: Treasury Budget Exectuion Report.

The second fastest growing expenditures are on servicing of public debt. Since the beginning of this year, a growing amount of consolidated expenditures is allocated every month on public administration, which is attributable to the increasing expenditures on public debt servicing (Table 3). Over the first 5 months of 2010, public debt servicing constituted 3.8%, further expanding compared to previous years (notably, growing by 2.4%% compared to 2008).

Table 3. Public debt servicing as a share of budget totals over 2006-2010

	2006	2007	2008	2009	Jan-May 2010
Total consolidated expenditures (UAH Mln)	**17,528**	**22,605**	**30,922**	**30,731**	**13,280**
Consolidated Public Administration expenditures (UAH Mln)	1,989	2,427	3,084	3,317	1,451
Public debt servicing (UAH Mln)	*344*	*368*	*426*	*978*	*503*
Public debt servicing as % of consolidated budget	**2.0%**	**1.6%**	**1.4%**	**3.2%**	**3.8%**

Source: Ukraine's Treasury Bugdet Execution Report

Outside pensions and public debt servicing, the biggest increase in real spending compared to last year continues to be Euro-2012 and Defence. The two only other spending programmes to expand significantly in January-May 2010 compared to same period of last year were Sports (which was responsible for the impressive overall increase of 13.24% in Culture&Sports and whose share within this functional programme is increasing every month, including by 7%% in May at the expense of spending on Culture, with unchanged share of spending on Media) and Defence, which grew by 3.46%.

Spending in Healthcare and Education remains at around the same level as last year. Real expenditures in both sectors over January-May have grown slightly compared to the same period of 2009 (1,14% and 0,32% respectively), but their amounts have been decreasing over April and May.

Although increments to pensions and social benefits increase nominal household incomes in the short-term, their growth at rates above inflation and with falling revenues is unsustainable. Financing these increments absorbed 43% of May's consolidated budget, while Education, Healthcare, Culture and Social Services are maintained in same volumes and without reforms to increase spending efficiency. Moreover, at the background of increases in social standards, public wages go further into arrears.

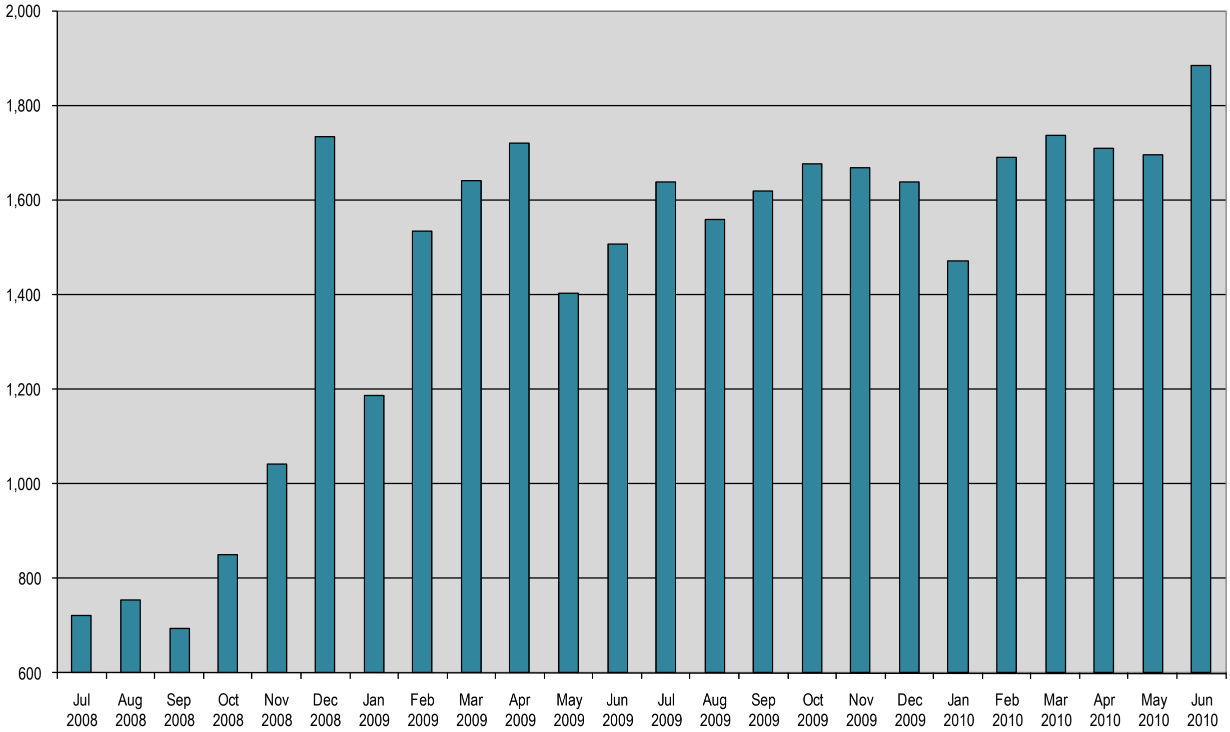
Programmes with traditionally larger capital investment components continue to shrink. Spending on Economic Activities, Housing & Utilities and Environmental Protection remains much lower in real terms than in the same period of 2009 (by 38%, 58% and 12% respectively). Moreover, as of 1 June 2010, the Government has not started to utilise its Stabilisation Fund programme (no expenditures under this line were reported by the Treasury). Respectively, capital expenditures in overall consolidated budget continued to fall, shrinking to 2% over January-May 2010 (compared to 6,5% in 2009 and 13,3% in 2008).

Wage arrears in public sector have grown to record levels

While private sector continues to repay wage arrears, public wage arrears are growing. During June, the official statistics and the Government acknowledged that while overall amount of wage arrears during April-May declined, this was due to repayments in private sector, while Central and Local budgets continued to accumulate more outstanding obligations to public servants[12]. While statistics on wage arrears by sectors is not readily available, media reported that, during April, public arrears in public sector grew by 22,7% reaching UAH 0.24 Billion by 1 May (moreover, according to these media reports the bulk of arrears was accumulated by central budget)[13] while additional arrears in public enterprises reached UAH 146 Million for communal enterprises and UAH 180 Million for state enterprises[14]. In June, overall amount of arrears has grown to record levels of UAH 1.88 Billion (Figure 4). Given the absence of official statistics, it is unclear what was the contribution of the public sector to that growth.

Government's statements on plans for reduction of arrears raise concerns. The Government claims to have plans to reduce overall wage arrears in the economy by UAH 1 Billion by end of year 2010, including total elimination of arrears in the public sector (for public enterprises the announced plan was to eliminate arrears by end of June 2010)[15]. According to press statements by PM Azarov, this should be achieved by reshuffling of managerial staff to remove officials who fail to ensure reduction of arrears[16]. PM Azarov also stated that reduction of public arrears should be expected as a result of increased wages and pensions, which would increase revenues of local budgets and the Pension Fund, creating fiscal space for repayment of arrears[17]. Such mechanism as it was quoted in the press statement is misleading since both extra payments and repaid arrears would have to be funded from one financial pool, without any expansion of the overall fiscal envelope.

Figure 5. Changes in the stock of wage arrears in Ukraine, July 2008 - June 2010 (UAH Million, as of 1st day of month)



Source: Ukraine's State Statistics Committee

VAT still refunded selectively, while past arrears compulsively restructured

VAT is Ukaine's key source of budget revenue (38% of total consolidated revenes in 2010 annual plan) and, at the same time, it suffers from systemic failures which deteriorated further during the crisis. As discussed in earlier reports, Ukraine's budget has been systemically defaulting on its VAT refund obligations to exporters throughout 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 2009-2010 to reach an estimated UAH 27,3 Billion by the end of May[18]. Both Governments acknowledged difficulties in timely repayment of VAT refunds, although no policy measures were taken so far to address its systemic malfunction. Most observers consider existing and growing VAT refund arrears to represent hidden fiscal deficit within the current budget which represents a fiscal risk and distorts the market.

During June, the Government started to implement its earlier resolution to restructure the current stock of accumulated VAT refund arrears. This policy, approved within the 2010 Budget in April, is to convert the stock of VAT refund arrears accumulated by 1 May 2010 into a new type of T-bills.

- **Although the option of restructuring is voluntary, in reality businesses have limited other choices.** The Government's Resolution which explains procedures for upcoming restructuring[19] leaves it as a free possibility for enterprises. However, in reality, earlier changes in tax legislation have essentially closed alternative options, e.g. by introducing a temporary ban on claiming unpaid VAT refund by including them into next period's tax credit and by limiting the period during which businesses can include their input VAT into the tax credit (to three months). Moreover, on 23 June the Government stated that arrears accumulated during 2009 would be repaid with the new T-bills exclusively[20].

- **New "VAT-bills" will be issued with profitability considerably below market.** The VAT-bills will be issued as 5-year Treasury securities with nominal annual yield of 5.5%. Most observers, including business community and international development organisations, assessed it as very low. Given cash shortages among exporters, the new securities will be likely traded on the secondary market with very considerable discounts (assessed at around 30%)[21], which will imply a considerable reduction of actual cash receipts by the businesses in return for the duly owned VAT refund liabilities. The Government acknowledges this as its deliberate policy[22].
- **Banks are likely to redirect their credit towards new T-Bills and away from other, market-driven, lending alternatives.** Relatively lower risks on government bonds compared to regular lending to non-state sector is likely to attract commercial banks to the new VAT-securities. This would crowd-out commercial loans in their portfolio and distort the market.

Although the Government has acknowledged the problem of fake VAT refund claims and no systemic solution is in place, some refunds are still released in significant volumes. Over January-May, actual VAT refunds were administered in a volume equal to 14% of VAT collection (Table 5). This share has decreased more than two times compared to last year as it became explicitly more difficult for exporters to claim their refunds, and yet it remains significant as some exporters still manage to receive the payments. Several Government statements explained that the refunds are paid and should be paid only to "normal"[23] and well-meaning enterprises, but without specifying what methodologies are used to identify such normality[24]. In the absence of transparency behind this approach, it continues to seem selective and distortive.

Table 4. VAT Refund as a Share of VAT proceeds over 2007-2010

Period	Share of VAT refund in total VAT proceeds
2007	**24%**
2008	**27%**
2009	**29%**
Jan-May 2010	**14%**

Lack of reforms in VAT administration continues to discredit the system of value added taxation, which is the budget's key revenue source. VAT refunds are administered selectively, and earlier arrears on these obligations are restructured on terms unfavorable for private sector.

Public debt is growing and a large part of it may be monetised by the NBU

So far, fiscal deficits have been funded by additional borrowing, whose repayment and servicing will exert additional pressure on expenditures in upcoming periods. The latest available statistics on deficit as a share of GDP is for the 1Q 2010 (given that GDP is reported on a quarterly basis). SigmaBleyzer estimated that it was equal to 7% GDP[25]. It also noted that during 1Q much of the deficit was covered by new domestic borrowing, in the absence of new foreign loans. Overall amount of Ukraine's public debt has tripled since 2007, even though it remains below the 60% GDP threshold specified in the country's Budget Code.

Much of the recent domestic borrowing was funded by the National Bank, and this practice is likely to continue. According to Sigma Bleyzer, NBU remained the key purchaser of the newly issued domestic debt securities throughout 1Q 2010. Representatives of the NBU stated that a combination of recently approved laws would oblige it to purchase up to UAH 30 Billion of Government T-bills if requested, and would most probably be funded though further monetary emission[26], [27]. The Government continues to deny the possibility of such emissionary funding of the budget deficit[28].

Since March, the Government has been negotiating with the IMF the possibility of extending its stand-by financing to cover the growing fiscal deficit. The current IMF standby agreement with Ukraine was approved in November 2008 for a USD 16,4 Billion support programme[29]. However, IMF discontinued releasing funds under this programme by declining its fourth tranche of about USD 3,7 Billion in December 2009 due to concerns over feasibility of expanding social payments approved by the Parliament[30]. After elections, the new Government continued to negotiate a restoration of access to IMF stand-by funding, albeit under a new agreement to cover a longer period and an extended amount of support. These consultations remained focused on continued policy of raising social payments at rate faster than inflation as well as on IMF's concerns over reliability of Government's revenue collection forecasts and lack of reforms in pension system and energy sector[31].

In June, IMF agreed, at staff-level, on a new stand-by programme, but it remains conditional on further reforms, so the prospect of actual release of funds is still bleak. IMF's negotiating mission was postponed several times but finally took place during 21 June – 2 July. The mission ended with a staff level decision to launch a new stand-by agreement of USD 14,9 Billion over 2,5 years, subject to approval of the IMF Management and the Executive Board[32]. However, these funds would again be conditioned by a list of significant reform measures such as budget balancing (such as maintaining 5,5% GDP fiscal deficit in 2010) and significant fiscal consolidation in further years, structural reforms in taxation and social security systems, restoration of healthy banking sector, including independence of the National Bank, and palpable reforms in the energy sector including improvement of financial position of NaftoGaz. In other words, the prospect of actual release of funds remains uncertain and, given the nature of Government's recent policies, - questionable.

A new agreement with IMF will result in actual release of funds only in case of considerable reforms in energy sector, pension system, and fiscal consolidation. In the absence of this loan, the budget is being funded by domestic borrowing, a significant part of it is purchased by the National Bank.

The Government's public communication on contingency plans for the case of failing to receive IMF funds is contradictory. Prior to the June mission the Government repeatedly stated that Ukraine critically needs to receive access to IMF funding to cover its fiscal deficit[33],[34]. However, further rhetorics has shifted towards statements of Ukraine's decreasing interest in direct financing of the budget with IMF loan (which would be used to support currency reserves instead) or even complete self-sufficiency of the 2010 Budget which, according to PM Azarov, could be implemented without additional foreign borrowing given the current fiscal performance which he assessed as more buoyant than was initially expected[35]. The Government also explained to domestic press that IMF became unwilling to release funds to cover budget deficit given Ukraine's current economic recovery, which requires the Fund to upgrade its approach to take account of the country's successful policies[36].

PFM policies in May-June

First reading of a new Tax Code

Verkhovna Rada approved in first reading a draft Tax Code, which was reported to differ dramatically from the liberal version discussed with the public and voted by the CMU. In the beginning of June, CMU led an active public communication to promote its newly developed Tax Code which promised to considerably liberalise the country's business environment. Advertised measures included tax vacations for small enterprises, decrease in rates of major taxes for newly established businesses, introduction of a property tax to increase local fiscal autonomy, introduction of tax on luxury etc[37],[38],[39],[40],[41],[42]. However, on 17 June, the Parliament considered and approved in first reading a draft Tax Code whose tax implied essentially opposite changes, which would considerably complicate doing business in Ukraine. This was followed by heated debates in the media claiming that the text voted by Parliament was different from the one approved by the CMU and publicised among key players[43],[44],[45],[46],[47].

The draft Tax Code approved in the first reading was heavily criticised for its draconian approach and multiple retrograde measures. International observers, business associations, experts, media and even representatives of the government have voiced multiple concerns over proposed reform. According to the joint line of criticism, voted draft Tax Code would not help to expand current tax base, bringing few opportunities to increase budget revenues, but that it would create new loopholes for corruption at both local and national scale. A particular point of concern is essential elimination of a simplified taxation regime for small businesses, which also happens to strongly contradict earlier declared policies. Another concern is the overall expansion of policing powers of tax authorities and reduction of its accountability.

The voted draft Tax Code contains a series of measures which would be truly innovative, albeit not all of them progressive. Some of the tax policy proposals which survived in the voted draft would considerably modify the current system; in particular:

- Taxation of interest on bank deposits;
- Introduction of direct profit taxation of insurance companies;
- Introduction of a unified social tax to replace existing fragmented system of payroll taxation;
- Introduction of local EPT surcharges.

Considerable debates around Tax Reform did not result in any actual change. A draft Tax Code voted in the VR in the first reading turned out to be a draconian document, dramatically different from the version agreed with the public. Proposals such as elimination of simplified taxation for small businesses caused a wide outrage and hundreds of requests for amendments, which make the future of the Tax Code uncertain.

The amount of proposed amendments that the Government will have to consider before the second reading makes the future of the current text highly uncertain. In line with the wide criticism, the Government received 1600 proposals for amendments which it would have to process before submitting the draft for the second parliamentary reading. This means that further drafts may differ very substantially from the current text and therefore the Government's plans for tax policy reforms are essentially impossible to analyse at this point.

The timing of future tax changes is equally uncertain. In principle, the amount of changes requested by all players may require considerable time before the next version of the Tax Code is complete. The text of the Tax Code also has to be verified for compliance with the new Budget Code which was approved in July (but was still waiting for Presidential signature at the moment of this report). Moreover, the version of the Budget Code acting at the time of this report contained a ban on approving tax changes after 15 August of the year prior to the budget period to be affected by such changes. Although this norm was already violated earlier in the year, it might, theoretically, still affect the speed of the potential second reading.

Alleged changes in tax amendments after they were approved by Parliament

Media believes that changes to Tax Legislation approved in May were modified by the President before he signed respective Law. On June 22, ICTV reported that before President Yanukovych signed the recently approved Law No 2275-17 with multiple tax scqueezing measures, he has introduced a large number of amendments into the already voted text. According to these media statements, this allowed the President to avoid placing a veto on a Law proposed by the Government of his own political party. The press report also claims that as a result of this, a significant amount of tax policy changes which were harmful for the business would not take effect[48]. Verifying this information requires detailed comparison of the current text of the Law with its earlier – allegedly different - version, which is beyond the scope of this report.

National regulation of local tariffs on housing & utility services

Weak regulation of local monopolistic providers of housing and utilities services has been increasingly problematic in recent years. Local providers and intermediaries of housing and utility services (such as water and sewage, heating and electricity) remain highly monopolistic, and tariffs on their services are established by local governments. This combination is highly vulnerable to corruption, since local authorities are tempted to increase tariffs beyond competitive levels if accountability mechanisms are insufficient. Indeed, in the recent years local tariffs have steadily increased while monopolistic service providers maintained higher arrears to their suppliers compared to arrears they themselves faced from their consumers. E.g. one report in June 2009 claimed that at the time consumers have paid 85% of their bill for gas to local energy companies, while the latter have paid only 30% of their bill to the national "NaftoGaz"[49]. This raised allegations in collusions between local councils and local providers, through alleged kickbacks to local councils from accounts in locally controlled banks. As the crisis unfolded, this problem became even more palpable both socially and fiscally.

The previous Government attempted to address the problem through centralising control over tariff regulation. In mid-June 2009, then-PM Tymoshenko proposed massive administrative attacks on potentially fraudulent providers and intermediaries. Her proposals included transferring all local payments for gas provision to special accounts in a state-owned bank (Oshchadbank), stronger control of the operations of local providers by the state tax administration, etc. PM Tymoshenko also proposed to centralise the right to establish housing and utilities tariffs but acknowledged that respective draft law could only be submitted after Presidential elections.

The Government is likely to introduce national regulation of prices on communal services (sewage, water and heating) to eliminate potential collusions between monopolistic local providers and local authorities. This is likely to increase value-for-money paid by households for such services and so improve their wellbeing.

In July 2010, the current Government approved in the second reading a Draft Law which introduces a national tariff regulator within the CabMin[50,51]. The Draft Law creates a specific Commission under the CMU to regulate pricing and quality of services in sewage, water supply, and heating provided at communal level by local monopolistic companies. The new commission would start work in July 2011. Local council would retain the right to establish tariffs on services of small communal enterprises.

New Procurement Law approved and signed

The final version of the Procurement Law addresses some of the earlier concerns, but detailed analysis is not available. Since February 2010, the Government was working to improve its approach to procurement after its initial draft law led to explicit disagreement with key international development orgnaisations. The new law approved in June, signed by the President and taking effect on 30 July 2010[52] addresses on of the concerns related to appeal review mechanism, delegating it to the Antimonopoly Committee and separate it from the policy development function, which would remain with the Ministry of Economy[53]. However, in how much the approved text is compatible with other international requirements and best practice requires additional analysis.

Other policy measures include introduction of a new Procurement Law and a new Budget Code, which both require additional analysis for substantial comment.

Amended Budget Code: analysis in process

Significant amendments to the Budget Code approved in early July require in-depth analysis before substantial comment. On 8 July 2010, Verkhovna Rada approved a new edition of Ukraine's Budget Code[54], but by the time of this report it was not yet signed by the President. Given the considerable scope of this document and its critical role in the country's PFM, our detailed comment on this development will be presented in further updates after more in-depth analysis.

Reform plans

Programme of Economic Reforms for 2010-2014

In early June, the Government revealed a Programme of Economic Reforms for 2010-2014 developed by its Economic Reform Committee[55]. The programme was published on the Government's official websites and extensively commented by key Government leaders. President Yanukovych explained that the Programme will aim to lead Ukraine into the top-twenty advanced economies in the world by 2021[56], and VPM Tigipko stated that the Programme will aim to give the economy a powerful impulse and ensure its steady growth[57].

The Reform Programme is set to ensure "prosperous society, competitive economy, and effective government" but its diagnostic part is much stronger than its operational proposals. As implied by its title, the Programme is a comprehensive document which covers all key areas of social and economic development: economic reforms, social policy reforms, regulatory reforms, and infrastructural reforms. For most of these large areas, the Programme provides in-depth and well-targeted diagnosis of key problems, some of which were never voiced at the level of programmatic documents before. Moreover, the document lists important related objectives, mostly in line with reform directions agreed with key international and domestic players (although some of them, such as social health insurance, could be debated). However, concrete tasks for each of the declared objectives are not always sufficiently precise (e.g. they may include tasks like "improvement of legislation"), sometimes too detailed compared to the strategic scale of declared objectives, and sometimes questionable and contradictory[3].

Although key donors supported the course of reforms, they noted lack ambition in critical areas: fiscal consolidation, inflation targeting, energy sector and pension system. IMF resident representative in Ukraine Mr. Max Alier voiced immediate concerns over proposed programme, which were later supported by the WB[58]. According to this view, the programme is a movement in the right direction, but its proposed steps would not be sufficient to ensure macro-fiscal stabilisation in Ukraine. In particular:

- A proposal to reduce fiscal deficit is not listed as a policy objective (but only as success indicator) and is planned as 1% reduction a year, which would not be sufficient to stop unsustainable increase in public borrowing;
- Inflation targets are also listed as success indicators rather than policy objective, and are equally modest (5-6% annually by 2014);
- Proposed measures for reforms in pension system and energy sector are not sufficient to remove current imbalances.

A released Programme of Economic Reforms for 2010-2014 contains important policy objectives including in most child-related areas, but lacks operational detail. IMF and WB reckon that the Programme is not sufficiently ambitious to repair current fiscal imbalances.

Respectively, donors acknowledged that current programme is an important platform for developing a more detailed action plan for ambitious and responsible policy changes.

For social sector, the MOLSP promises to develop a "roadmap of social reforms" to further operationalise Economic Reform Programme. The plan to develop such roadmap was shared by Minister of Labour and Social Policy Vasyl Nadraga[59].

Plans to start raising pension ages in 2012

A plan to increase pension age was one issue where Government followed up the agenda outlined in Economic Reform Programme with specific further PR. Throughout June, several Government communications including statements from the PM Azarov, MOLSP, and MPs from the Party of Regions[60],[61], announced plans to gradually increase pension age for women during 2012-2021 by 6 months a year to reach 60 and to introduce 65 minimum age for all citizens who would be younger than 35 by 2012. This change would be complemented by a parallel introduction of a fully funded pillar with introduction of mandatory individual pension accounts for all individuals younger than 35 by 2012[62].

No actual legislation drafted yet; concrete steps to be developed within a future "roadmap of social reforms" and are, therefore, uncertain. Minister of Labour and Social Policy Vasyl Nadraga explained that detailed timeline for proposed change is yet unknown and should be defined in the future roadmap[63]. Notably, this

[3] To provide only several examples for illustration, in the fiscal decentralisation area, the document gives a strategic and well-targeted diagnosis that one current obstacle to efficiency is defining expenditure responsibilities in terms of types of budget infrastructure to be funded by each tier of government (e.g. orphanages), rather than in terms of public functions (e.g. services to children without parental care). However, in the proposed solution section it goes directly contra to this idea by continuing to reshuffle lists of infrastructure items ascribed to each budget (e.g. including centres for professional rehabilitation of disabled – or, almost classically for Ukraine by now, expenditures on maintaining zoos – into delegated functions).

plan continues a series of earlier declared plans to modify Ukraine's pension system. A legislative platform for introduction of a fully funded pillar of the pension system was already created in previous years. However, actual introduction of mandatory pension accounts have remained a hostage to the need to find considerable financing for their launch combined with impossibility of further increase of the already significant tax burden, even in more affluent earlier years. Respectively, pension reform has been conditional to reforms in payroll taxation which would allow to extend the tax base. However, measures such as unification of payroll taxation currently fragmented between four structures, coordination of responsibilities between the Pension Fund and the STA, raising tax administration capacities of both agencies, and streamlining pension contributions of the simplified taxation system have all appeared politically and institutionally insurmountable, so far.

Announced plans to increase pension ages and introduce fully funded pension system pillar remain at the design stage. In earlier years, similar plans fell victim of the difficulties of necessary complementary reforms in the system of payroll taxation and of institutional changes within Ukraine's social insurance and tax collecting authorities. In the meantime, growing deficit of the Pension Fund represents one of the key risks to the country's fiscal stability.

Individual social policy measures considered

During June, the Government also made separate statements on considered individual social policy measures. Some of these measures overlap and expand the agendas outlined in the Economic Reform Programme for 2010-2014. All these changes are currently at the design stage.

- **Reforms of social privileges and benefits**, including:
    - **Monetisation of social privileges.** Streamlining existing privileges and transforming existing privileges into cash benefits is one of the objectives of the Economic Reform Programme and is in line of the reform agenda declared by most previous governments. In June, First Deputy Head of Presidential Administration Ms. Iryna Akimova explained that the MOLSP is currently designing a programme of unification and monetisation of privileges, which would also address other inefficiencies such as professional privileges which should not be funded from the budget[64].
    - **Introduction of indirect income verification for recipients of low income benefits.** This reform has been also considered for several years, with participation of major donors. One meae discussed by MoLSP in June is verification of expenditures along with income verification[65].
    - **Differentiation of amounts of social benefits based on income levels.** The current unified approach to all receipients would be revised to offer multiple income support levels depending on assessed needs[66].
- **Continued support voiced to introduction of social health insurance.** President Yanukovych stated his continued support to the idea of social health insurance in his annual Address to the Nation[67]. This idea was also featured in the respective part of the Economic Reform Programme for 2010-2014.
- **Continued work on juvenile justice reforms.** Ministry of Justice approved creation of a Working Group, which will officially take forward the work on an earlier developed reform concept[68]. Notably, during consultations at the point of creating the Working Group, representatives of consulted NGOs raised terminological concerns which spurred a heated debate over the nature of future reforms. Namely, the NGOs (and especially religious organisations) insisted on renaming the Concept to address "criminal justice for juveniles" rather than "juvenile justice", claiming that the latter is dangerously wide and could create conflicts of interest between the rights of children and rights of parents, as it sometimes happens in countries with more developed child protection systems[69]. Developers of the initial concept explained that these concerns are strongly overshooting since Ukraine's justice system still lacks basic elements of protection of children in direct conflict with law[70].

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