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

This report is a monthly PFM update for UNICEF Ukraine. It is part of on-going technical support which FISCO is providing to UNICEF in the area of public finance during 2010, to facilitate more effective redistribution of resources to enhance children's wellbeing and protect their rights.

Key features:

- Baseline revenue comparisons which reveal underperformance of most taxes. The only resilient tax, EPT, is collected at patterns which seem to indicate that extra amounts are raised by ad hoc administrative efforts. Alignment of consolidated revenue results with period baselines is explained by extraordinary collections from non-tax sources.
- Comparisons of real expenditures to spending in same period of last year, which show that overall spending is growing given the increased social payments and transfers throughout the year, while investment-intensive programmes remain far below 2009 levels;
- Detailed description of reform agenda agreed with the IMF within the Memorandum of Economic and Financial Policies (MEFP) and analysis of progress so far. Key principles of changes in fiscal policy defined in the stand-by arrangement have not yet materialised into action. On the revenue side, the commitment to widen the tax base to decrease tax burden on the economy while maintaining prudent deficits is compromised by ad hoc administrative measures to raise extra revenues. On expenditure side, a commitment to promptly reform public spending to keep deficits under control while releasing regulatory rigidities and reallocating funds towards growth-enhancing programmes is not supported by current bias towards consumption and lack of progress with any of the sector-wide regulatory reforms.
- Analysis of public communication and debates around IMF stand-by agreement, which shows that public awareness of reform agenda is limited to a narrow range of arguments and would benefit from a more strategic PR.

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Acronyms and Abbreviations

CMU	Cabinet of Ministers of Ukraine
CPI	Consumer Price Index
EC	European Commission
EITI	Extractive Industries Transparency Initiative
EPT	Enterprise Profits Tax
GDP	Gross Domestic Product
ILO	International Labour Organization
IMF	International Monetary Fund
MOF	Ministry of Finance
MEFP	Memorandum of Economic and Financial Policies
NBU	National Bank of Ukraine
PAYG	Pay As You Go
PFM	Public Financial Management
PIT	Personal Income Tax
PM	Prime Minister
PPI	Producer Price Index
SDR	Special Drawing Rights
UAH	Ukrainian Hryvnia
UK	United Kingdom
UNICEF	United Nations Children's Fund
US	United States
USD	United States Dollar
VAT	Value Added Tax
VPM	Vice Prime Minister

Budget results through July 2010

Consolidated budget receipts

Although overall consolidated receipts in January-July were in line with period baselines, most taxes dramatically underperformed, creating an about UAH 6 billion revenue shortage. In January-July 2010, consolidated budget revenues (general and special fund combined) were slightly above baseline projections for that period (by 0.16% as illustrated in Table 1). However, this result was achieved at the background of significant underperformance of the key taxes and is mostly explained by extraordinarily high collections of non-tax revenues. Figure 1 shows that all major taxes apart from the EPT were collected in amounts significantly below period baselines. In particular, VAT – currently the most fiscally important tax for Ukraine – remains almost 7% behind schedule, even though its collection grew more than 10% in real terms compared to last year. Similarly, PIT was 4% behind the baseline, and Excise Taxes underperformed by almost 11%, even though the government collected them at increased rates and respectively in considerably larger amounts than in 2009 (Excise receipts were almost 13% higher than last year in real terms). Collectively, the five major underperforming taxes (VAT, PIT, Excises, Import Duties and Land Tax) created an unexpected revenue shortage of about UAH 6 billion.

The only resilient tax, EPT, is collected at patterns which seem to indicate that extra amounts are raised by ad hoc administrative efforts. The only tax which is collected in amounts which exceed period baseline (by almost 6%) has been EPT. Figure 1 shows that this overperformance was not uniform throughout the year: on the contrary, the government collected extraordinary amounts of EPT in March and in June (at the end of each quarter), but fell short of EPT receipts in other months. This is alarming. Theoretically, the quarterly cycle of EPT collection should not affect the pattern of overperformance represented by the % difference over period baselines: the period baseline projects are specifically calculated to take into account specific cyclical patterns of each tax. In other words, if EPT were overperforming because of factors such as economic growth or overall improvement in administrative procedures, changes in monthly percentage of overexecution should have been distributed evenly across all months. The fact that EPT was collected above its historical seasonal baselines specifically in the months when the tax is officially due seems to indicate that in these specific months the government exerted, ad hoc, extra administrative effort to collect this tax.

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

		Comparisons to plan		Comparisons to baseline*		Comparisons to same period of 2009	
	Nominal actual revenues in Jan-Jul 2010	Annual plan (for Jan-Dec 2010)	Actual revenues as % of annual plan	Baseline projection (Jan-Jul 2010)	% Difference of actual over baseline	Nominal actual revenues in Jan-Jul 2009	% Change in real terms
Total Revenues	**175,877.41**	**329,446.57**	**53.39%**	**175,597.46**	**0.16%**	**151,147.60**	**6.36%**
Value Added Tax	56,083.33	104,735.19	53.55%	60,210.90	-6.86%	46,463.78	10.29%
Personal Income Tax	27,528.05	51,542.36	53.41%	28,717.44	-4.14%	25,008.82	0.80%
Enterprise Profit Tax	18,867.63	40,454.23	46.64%	17,853.97	5.68%	16,270.91	5.77%
Excise Taxes	15,582.38	30,366.00	51.32%	16,197.78	-3.80%	10,482.56	36.40%
Land Tax	5,367.05	10,014.27	53.59%	5,526.00	-2.88%	4,682.50	4.92%
Import Duty	4,243.37	8,290.00	51.19%	4,754.53	-10.75%	3,444.30	12.71%

Source: Treasury Budget Exectuion Report.

** Revenue baseline projections, which allocate approved annual plan into monthly benchmarks, based on the real monthly revenue patterns and monthly inflation patterns over the last three years (calculated by FISCO id)*

Alignment of consolidated revenue results with period baselines is explained by extraordinary collections from non-tax sources. To reinforce, despite about one UAH billion of EPT revenues collected above period baseline over January-July 2010, all other major taxes remained about UAH 6 billion below schedule. The fact that overall consolidated revenues were no smaller than period projection was explained by extraordinarily high collections from non-tax sources. Identifying precise origin of such unusually good non-tax collections is beyond this report, since collection patterns of non-tax sources do not lend themselves to baseline projections based on historical trends and require additional analysis of factors which influence their monthly behaviour. We should also note that a certain share of these non-tax proceeds belongs to the budget's special fund, which, theoretically, diminishes their fungibility.

The biggest receipts from non-tax sources were NBU transfers, CO2 quota sales, rent payments for gas extraction, own revenues of budget institutions, and a variety of administrative fees and fines. Table 2 describes the major sources of non-tax revenues whose proceeds were very close or significantly above annual budget already by the end of July. It shows that the biggest such item thus far was the transfer of surplus revenues from the NBU, which was already utilised despite the record high annual plan[i]. An unexpected extra billion of non-tax revenues is explained by proceeds from Ukraine's sales of CO2 emission quotas. Already at the annual benchmark are rent payments for domestic gas extraction. Notably, annual projections were already significantly exceeded for own revenues of budget institutions, as well as for a series of smaller sources representing a variety of administrative payments such as road fines, executive fees, and, especially, penalties (administrative and regulatory).

Table 2. Best performing non-tax revenue sources in January-July 2010 (major items)

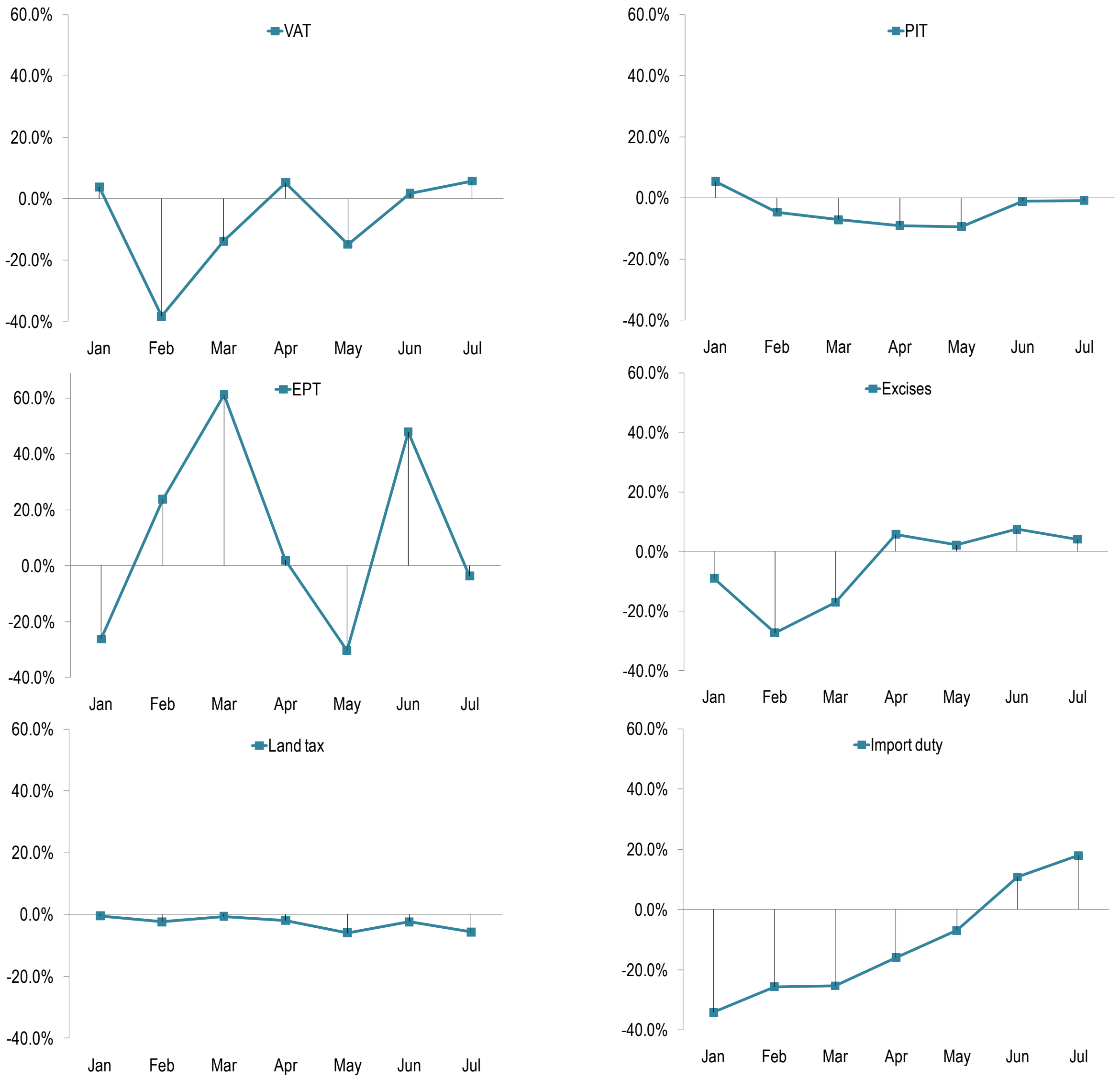
	Annual Plan for 2010 (UAH mln)	Actual Receipts over Jan-Jul 2010 (UAH mln)	Difference of Actual Receipts in Jan-Jul over Annual Plan (UAH mln)	Actual Receipts in Jan-Jul 2010 as % of Annual Plan
Tranfers of surplus revenues from NBU	10,000	9,895	-105	99%
Other non-tax revenues	1,836	2,240	404	122%
Other own revenues of budget institutions	1,544	2,206	662	143%
Proceeds from sales of CO2 emission quotas	150	1,538	1,388	1025%
Rent payment for domestic gas extraction	1,546	1,482	-64	96%
Road fines	397	550	153	139%
Administrative penalties	20	263	244	1330%
Payments to Ukraines Fund for Social Protection of Disabled	168	168	1	100%
Execution Fee	110	117	7	106%
Penalties for violation of regulations in trade sector	4	115	112	3257%
Payments for temporary placement of budget funds	114	114	0	100%
Stamp Duty on issuance of new passports	15	101	86	665%

Source: Treasury Budget Execution Report

Compared to 2010, all revenues are growing in real terms, but this comparison is low-based and, in case of VAT, distorted by refund arrears. Compared to the same period of last year, revenues in January – July 2010 grew in real terms for all taxes and for overall consolidated receipts. As shown in Table 1, overall cumulative receipts grew 6,36% in real terms compared to 2009. The biggest real increase was registered in Excise Taxes, whose rates were considerably increased. VAT also remains above last year's benchmarks, although this comparison is relatively low-based (given the GDP's improved growth rates during 2010) and is coupled with continued problems with VAT refund arrears.

[i] According to the Law "On National Bank of Ukraine", profit generation does not belong to the functional objectives of the National Bank[i]. 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 (to UAH 9,8 billion and UAH 10 billion respectively).

Figure 1. Difference of monthly actual collections of key taxes over period baselines in January-July 2010 (%)



In the absence of official revenue baselines, public assessment of fiscal results grows increasingly sceptical and anxious. As explained in technical footnotes and in the detailed section in last monthly update [(1)], comparisons of revenue collections to period baselines in this text operate with period projections calculated by FISCO id, given that official revenue baselines – the "budget rozpys" – has been persistently restricted from public access[ii]. This secrecy over official period baselines was widely lamented by the media with regard to July fiscal results. In particular, *Dzerkalo Tyzhnya* shared that despite Government's reports of revenue buoyancy (allegedly of the July revenues being 3% behind schedule) the paper's sources in STA witness much lower performance. The paper assessed that actual underperformance of tax revenues in January-July would amount to around 35%, if actual collections would be decreased by VAT refund claims due for payment (which would be different from our methodology which is based on official VAT collection results, without additional assumptions about outstanding arrears) [(2)].

[iiii] In the absence of rozpys, 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.

Consolidated budget spending

Real cumulative expenditures remain higher than last year, given the increased social payments and transfers to Pension Fund throughout 2010. Budget expenditures over January-July 2010 remained at a considerably higher level compared to same period of last year (by 10.31% in real terms), mostly due to the growing transfers to cover Pension Fund deficit coupled with increasing public wages and social assistance payments, hiking in May and June. As illustrated in Table 3, real cumulative spending on Social Protection in the first seven months of 2010 remains 36.77% higher than in 2009. Because of the growth in public wages above inflation rate, expenditures in Healthcare and Education were also higher than last year (by 6.93% and 5.47%, respectively).

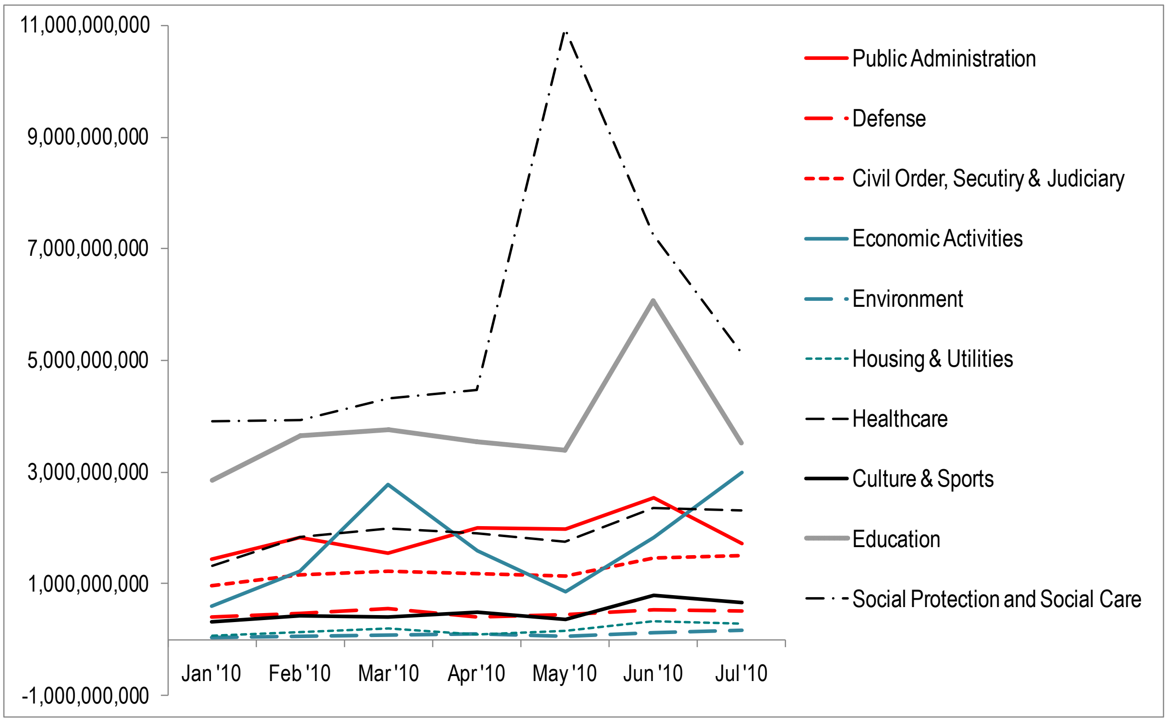
Investment-intensive spenidng continues to be much lower than in 2009, despite monthly increases in expenditures on Agriculture and Roads. Unlike current spending items, investment-intensive programmes were funded at consistently lower rates in 2010 compared to same period of last year. Over January-July 2010, real expenditures on Economic Activities, Housing and Utilities, and Environment decreased in real terms compared to same period of 2009 by 22.22%, 46.00%, and 7.14%, respectively. Figure 2 illustrates that monthly expenditures on Economic Activities had a cyclical pattern over the year, and were higher in June and July compared to earlier months. These monthly increases in Economic Activities programme were explained by higher spending on Agriculture and on Roads. But, as already mentioned, despite these monthly fluctuations, overall cumulative spending on these programmes remains lower than last year (in real terms).

Table 3. Consolidated Expenditure Execution in January-June 2010 (UAH Millions)

		Comparisons to plan		Comparisons to same period of 2009	
	Nominal actual expenditures in Jan-Jul 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-Jul 2009	% Change in real terms
Total Expenditures	**202,088.43**	**385,115.40**	**52.47%**	**167,854.18**	**10.31%**
Public Administration	21,552.39	53,107.93	40.58%	16,662.03	18.74%
Defence	5,513.68	12,181.87	45.26%	4,928.65	2.55%
Civil Order, Security & Judiciary	14,274.10	27,141.98	52.59%	13,146.55	-0.42%
Economic Activities	19,586.69	43,107.89	45.44%	23,009.65	-22.22%
Environment Protection	978.67	3,379.18	28.96%	971.17	-7.14%
Housing and Utilities	2,103.66	5,090.26	41.33%	3,584.61	-46.00%
Healthcare	22,275.70	42,789.32	52.06%	19,082.11	6.93%
Culture and Sports	5,728.30	11,123.01	51.50%	3,972.27	32.30%
Education	44,143.93	79,265.88	55.69%	38,342.51	5.47%
Social Protection & Social Care	65,931.31	107,928.08	61.09%	44,154.64	36.77%

Source: Treasury Budget Exectuion Report.

Figure 2. Monthly real expenditures on key functions in consolidated budget in January-July 2010 (UAH)



IMF-driven changes in fiscal policy

Background details on the Stand-By Arrangement

As noted in the previous monthly update (1), prolonged negotiations over renewal of IMF stand-by financing for Ukraine culminated with an agreement reached at staff-level on 3 July (3) and approved by IMF Management and the Executive Board on 28 July (4) to allocate SDR10 billion (about USD 15.15 billion) loan to support Ukraine's economic adjustment and reform programme. In response, the Government agreed to a series of reform objectives, including a list of "prior actions" which were implemented in July, before the agreement was approved.

After initial brief press releases in July, the IMF has released (on the 6 August) the actual package of reports and agreements accompanying the stand-by arrangement, including a Letter of Intent signed by Ukraine's PM M. Azarov, Finance Minister F. Yaroshenko, and NBU Governor V. Stelmakh, and a Memorandum of Economic and Financial Policies (MEFP) summarising Ukraine's commitments to reform (5). These documents have revealed much more detailed information on the agreed reforms compared to what was available at the time of the previous monthly update, and is the basis of analysis in this section.

Key facts:

Accessable amount:	SDR 10 bln (approximately USD 15 bln)
Length:	29 months
Phasing:	SDR 1.25 bln available upon Board's approval of the arrangement. The nine subsequent tranches will equal SDR 8.75 billion and are contingent upon completion of quarterly reviews, starting from November 2010

The nature of priorities in fiscal policy area agreed within the MEFP (discussed in detail in next section) are fully in line with earlier reform recommendations by other international development actors (6) and represent long-standing reform objectives, dictated by Ukraine's challenging fiscal situation, long-term demographic pressures, and assumed demand for transformed nature of the state's role in PFM, strengthening its capacity to support economic growth and efficiently provide services to the public. Most of these reform objectives were outlined in earlier technical papers and Government's own programmatic documents, but were not implemented for a series of (mostly institutional or political) reasons. Recent determination to proceed with these reforms is visibly and admittedly related to the conditions attached to stand-by financing, which therefore positions IMF as driver of welcomed political consolidation and change, even where resulting response is not entirely straightforward and immediate.

Public communication and debates

Government's presentation of the agreed stand-by arrangement and future reforms referred to a relatively narrow range of arguments outlined in the official press-statement. On 10 August the Government issued a press statement with an official view on the reasons and objectives for the renewed co-operation with the IMF, as well as on the related reform plans [(7)]. In this statement, the Government acknowledged that it plans at least two challenging reforms: increasing gas prices for population and restructuring the pension system by increasing pension age for women by 5 years through 2020 and by increasing by 10 years the qualification period for receiving full pension benefits. It provided the following explanations about why such measures are unavoidable:

Gas price increases -	Pension age increases -
▪ To ensure economic independence of Ukraine; ▪ To stabilise financial situation; ▪ To decrease the size of the public debt (accumulated by the previous Government); ▪ To stop the destruction of the country's energy sector and housing & utilities sector.	▪ To borrow from countries where pension age is higher than in Ukraine (UK, US, Japan); ▪ To decrease the Pension Fund deficit, which – according to estimates by experts – may otherwise grow from UAH 17 bln in 2009 to UAH 29 bln this year. Such deficit is a risk to economy given that the economy suffered from both external shocks and from populist assessment of crisis by the previous Government. ▪ To correct the current critical ratio of pensioners to working population (13,5 mln / 14 mln, respectively).

As additional benefits of future reforms, the press statement listed:

- The possibility to break down the social "one-size-fits-all" approach and to increase social fairness (by increasing the qualification period for receiving full pension benefits).
- Access to IMF funds will allow to ensure stability of hryvnya, to attract investors, to rebuild trust from international community, which would ultimately increase living standards of Ukraine's people.

The Government also assured that pension age changes would be gradual, and that the impact of gas price increases on law income households would be compensated by extended social protection packages.

The list of arguments in the official press-statement was consistently promoted by the follow-up media communications by key government officials [(8), (9), (10)].

Critical feedback to reform plans which was voiced through key printed and on-line media was very active and is briefly summarised below:

Table 4. Summary of key concerns over IMF stand-by arrangement voiced by key stakeholders

Stakeholder	Concerns
Organisations supported by public funds	
Federation of Trade Unions of Ukraine[iii]	▪ Increasing pension age for women will increase unemployment since it would leave around 2 million of women employed and make respective vacancies unavailable to younger people. ▪ Recommendations on pension reforms represent an attempt to intervene into Ukraine's internal policies. [11]
National Academy of Sciences of Ukraine	
Institute of World Economy and International Relations	▪ IMF conditions would ruin Ukraine's investment strategy, since they require to re-allocate funds towards supporting NBU and stable currency and away from investment into national economy and into development of high-tech [12].
Institute of Demography and Social Research	▪ A lot of women of older age are in poor state of health. If they continue to work, they would qualify for pensions based on their disabilities [13].
Opposition	
BYUT	▪ IMF loans are allocated to consumption, which is not strategic [13].
Nasha Ukraina	▪ Subscribing to IMF conditions contradicts electoral promises of the current Government [13].
Civil Society	
Institute of Transformation of Ukraine	▪ Despite signing the agreement, the Government had not changed the nature of its economic policies. Therefore, access to one tranche of new programme had only postponed problems rather than resolved them. Respectively, significant fiscal problems should be expected later this autumn around October-November [14].

Agreed measures in fiscal policy and progress so far

<u>Overall approach</u>

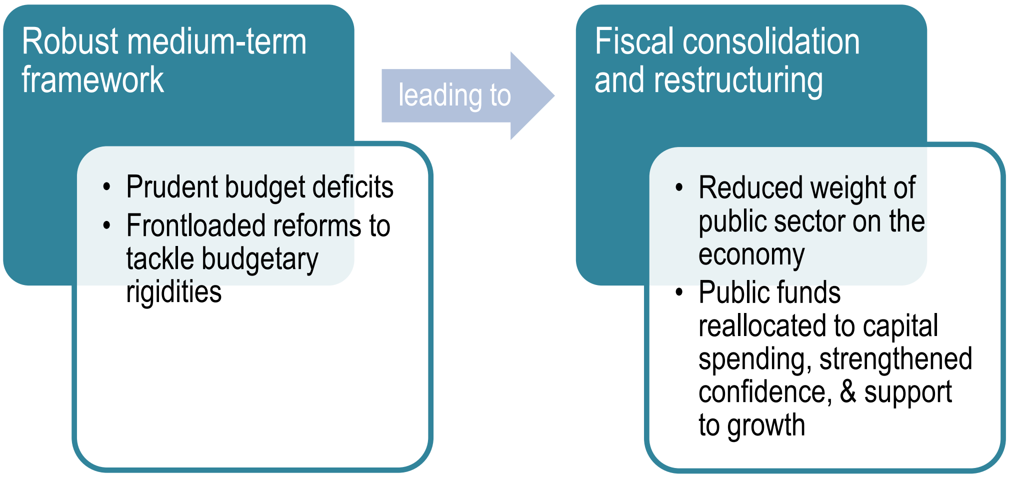
This section outlines the Fiscal Policy reform agenda of the MEFP [5]. As was just mentioned, the MEFP has a detailed reform agenda, including a specific section on fiscal policy measures[iv]. Further in this text we focus on these fiscal policy commitments, outlining the key objectives and benchmarks, as well as some of the response measures implemented – or not implemented – so far. It is important to note that we are using the IMF-driven reform agenda as a convenient structure for analysing progress in structural PFM changes, and do not claim to provide a comprehensive analysis of Ukraine's progress against these commitments.

[iii] Federation of Trade Unions of Ukraine is not formally a tax-funded organisation. However, analysis provided by the media claims that the main source of funding of this organisation originates from off-budget social payroll funds (which are tax-funded). http://www.day.kiev.ua/161108/

[iv] Other priority areas of the MEFP (which we do not analyse) include: monetary and exchange rate policy, and financial sector policies.

Key agreed goals and objectives: The Fiscal Policy section of the MEFP states that "the government's objective is to bring public finances back to a sustainable position". In particular, this would require a "robust medium term framework" (based on prudent deficits and frontloaded reforms to tackle budgetary rigidities) leading to significant consolidation and reallocation of public funds to transform the public sector from the current burden and barrier to growth into an efficient and supportive investor and regulator (as we illustrate in Figure 3).

Figure 3. Key objectives of fiscal policy reforms outlined in MEFP



Key agreed progress benchmarks and monitoring schedule: Figure 4 outlines specific success indicators for reforms during 2010-2015 to which the Government had signed up within the MEFP. It describes a path of determined fiscal consolidation (with gradual reduction of the public deficit combined with expenditure-saving and reducing tax burden on businesses), transformed debt management policy, and major reduction of quasi-fiscal activities in the energy sector (including restoration of fiscal balance of the Ukraine's Naftogaz). Ukraine's progress against agreed benchmarks would be monitored by the IMF through quarterly reviews.

Figure 4. Key fiscal policy conditions under the agreed IMF stand-by arrangement, by years

Revenue measures

Revised standby arrangement was based on the overall agreed principle of the need to reform the tax policy and administration practices to widen the tax base and eliminate tax loopholes, so that the government continues to raise sufficient revenues to ensure prudent deficit targets while gradually decreasing tax burden on the economy. However, the only two specific benchmarks outlined as conditionalities were: the ceiling on VAT refund arrears and the requirement to eliminate surcharges on purchases/sales of foreign currency. All additional revenue measures outlined in the MEFP were listed by the Ukrainian government as its (agreed) vision of how to bring about wider tax policy goals outlined above. As explained in the table below, whether these measures will prove helpful to this end (including whether they would ensure estimated increases in revenue collection to maintain agreed deficit target) is an open question.

During August, the Government continued to work on designing a new Tax Code, although this work was mostly performed internally and was not yet officially presented [15]. At the same time, throughout this period, media continued to very actively comment on this process, referring to a range of contradictory and mutually exclusive informal evidence, which makes it impossible to shape a consistent story. One possible explanation to such a contradictory profile of the Tax Code design process is that the document is being developed by several parallel policy groups within the Government – which, in turn, is claimed by some media sources [16], [17] and rejected by others [18]. The key themes of debate relate to the following potential changes: introduction of a tax on property [19], luxuries [17], and interest income [20]; reformation of the insurance profits [21]; and – most controversially – modification of simplified taxation of small businesses.

The details of possible changes with regard to simplified taxation are not yet public and presented in similarly contradictory manner by various sources. One option which was officially mentioned (by the VPM Kolesnikov) revealed a strikingly radical approach which would completely eliminate any simplified taxation for small businesses and start-ups [22]. However, other sources in the media refer to a wide range of alternative options, including increases in rates, pension insurance surcharges, reduction of eligibility threshold and narrowing down the range of eligible types of small businesses [20].

	Condition type	Timeframe	Measure	Comment
	-	2010 (achieved)	Increased excise tax rates and increased surcharges on radio frequency for cell phones	Increases in excise rates and in radio frequency surcharges have contributed to considerable growth of respective revenues in the recent periods.
	-	2010 (achieved)	Limit on the carry-over of 2009 losses	Allowing business to carry forward some of their losses to future tax periods is important for ensuring even and neutral distribution of tax burden across all kinds of legitimate economic activities. However, this opportunity means a certain revenue loss for the budget. Government may choose different degrees of flexibility towards loss carry-forwards in terms of this trade-off between fiscal gains and economic efficiency. However, resulting policy choices should be transparent and consistent [23]. Ad hoc, and ex-post, decision to limit the opportunity to carry forward already incurred losses is likely to distort business incentives and injure long-term economic growth.

	-	Effective January 1, 2011	Reducing the threshold turnover for qualifying for the Simplified Taxation System to UAH 300,000 for physical persons	Reparation of the existing system of simplified business taxation has been among key PFM recommendations to Ukraine in the recent years, since the current system lends itself to easy manipulation with very large business enjoying a system initially designed for start-ups and small enterprises. Reduced threshold is an important step in that direction. As described above, reforming simplified taxation is one of the key components of the current work on design of a new Tax Code. However, as we also mentioned earlier, some of the debated proposals – including the one officially mentioned by the Government – reveal a very radical approach to such reform, which goes much further than reduction of the threshold discussed with the IMF and suggests full elimination of simplified taxation regimes for small businesses.
	Structural benchmark	By December 31, 2010.	Elimination of surcharges on purchases/sales of foreign currency for the purposes of mandatory state pension insurance	There is no economic argument (beyond a need for a quick-fix fiscal squeeze) to tax currency trade and earmark such revenues to pension insurance. The Government suspended this surcharge prior to signing the stand-by agreement and committed to permanently eliminate it by the end of the current year.
	-	2010 onwards	Improve tax administration with the objective of strengthening compliance, reducing fraud, and closing taxation loopholes by widening the authority of the tax inspection and improving monitoring of tax returns on the basis of enhanced documentation.	Improved tax administration and payment discipline is a key prerequisite for Ukraine to increase its fiscal envelope without increasing tax burden on businesses. However, MEFP does not outline exact measures of how it would be achieved. Recent observations on various ad hoc administrative measures applied by the Government to increase revenues in response to fiscal pressures raise concerns about whether measures outlined in MEFP such as stronger authority for tax inspection would be applied to increase transparency and neutrality in taxation, rather than perpetuate existing distortions.
	Indicative target	2010 onwards	Ensuring the payment of all VAT refunds accruing in the remainder of the year in full & on time and not accumulate any arrears during 2010	No information about progress or action on this priority was available in public access during August.

Expenditure measures

As already discussed, the standby agreement – and the MEFP – assume that expenditure policy would be based on the broad principle of prompt reformation of public spending with the view to: keep deficits under control, release current regulatory rigidities which inhibit spending efficiency; reallocate public funds towards investment-intensive growth-enhancing priorities; and structurally reform public administration to make public sector smaller and more efficient. The only specific conditions in the MEFP were to reduce planned expenditures for 2010 to limit the deficit (which was achieved prior to approval of the loan and described in our previous monthly update) and a comprehensive public sector reform, a plan for which should be in place by March 2011. However, as illustrated below, the Government also subscribed to a series of additional measures to make its spending more efficient.

	Condition type	Timeframe	Measure	Comment
☒	Prior Action	2010 (partially achieved)	Sequestration of expenditures for 2010	(described in detail in the July update [1])
⌛		2010 onwards	Keeping spending in control in further periods	Too early to comment
?		By end of 2010	Repayment of all loans to Agrarian Fund	Commenting on this measure would require access to data beyond what is currently in public access
?		2010	Including all spending on Euro-2012 into the budget	Commenting on this measure would require access to data beyond what is currently in public access
?		2010	Balancing local budgets, the Unemployment Insurance Fund, the Disability Insurance Fund and the Accident Fund	Too early to comment. We also suspect that commenting on the balances of the listed off-budget funds would require access to data beyond what is currently in public access
⌛		in 2011	Refrain from increases in public sector wages above what is mandated by the inflation indexation mechanism for civil servant wages.	Too early to comment
?	Structural benchmark	By March 31, 2011.	A comprehensive public administration reform to reduce public sector	Too early to comment

Pension Reforms

As repeatedly discussed in this and previous reports [6], Ukraine's pension system is experiencing extreme fiscal stress, which would intensify as the population's average age would be increasing. This stress is caused with the inability of the current pay-as-you-go (PAYG) system to ensure sustainable financing of growing pension expenditures. Several consecutive Governments recognised the need for a pension reform but actual implementation of any changes remained impossible for a number of political and institutional reasons.

During the negotiations over renovation of the IMF stand-by financing, the urgency of resolving this problem intensified as the Government continued to increase the deficit funding transfer to the Pension fund. But at the same time the negotiations opened a new window of opportunity to exert political will for change given that the ultimate conditions behind the loan were formulated as a very clear requirement to reduce structural imbalances in the long-term funding of the Pension System (described below).

	Condition type	Timeframe	Measure	Comment
❄		2011	Significant reduction of deficit transfer to Pension Fund	Too early to comment
☒		2010 (achieved)	Requiring both legal persons and physical entities participating in the Simplified Taxation System to pay contributions to the pension fund corresponding to the minimum wage surcharges.	
❄	Structural benchmark	Law submitted by end-Sept 2010 and enacted by end-Dec 2010	Increase the minimum required insurance period from 5 to 15 years; Gradually increase the pension age for women from 55 to 60 years, by adding 6 months every year starting in 2010, aiming to equalize the pension age for all workers; Increase by 10 years the qualification period for receiving full pension benefits. This measure will motivate workers to stay in the work force, improving the balance of the Pension Fund by UAH 2.0 billion in 2011.	These commitments have raised heated public debates, as described in the earlier section. The Government confirmed its recognition of the need to reform the Pension System in the official statements, despite the outcry (7). At the same time, despite the very short timing for the agreed reform, the agreed legislation was not yet submitted or released in a draft form.
❄		by end-December 2010	Changes to the base for calculating the additional 1 percent pension benefits accrued for each year of service above 20/25 for women/men. This base for the long service pension benefit will be the basic working pension.	

Restoration of Naftogaz financial balance

As we discussed in detail in another recent paper [6], Ukraine's quasi-fiscal activities in the energy sector and resulting quasi-fiscal deficits have significantly increased since 2006, leading to a point of macroeconomic emergency noted by most key observers by the time of this report. In particular, since 2009, financial viability of Ukraine's Naftogaz – a state-owned company monopolistically responsible for extraction, transportation and processing of natural gas and oil – had dramatically deteriorated, absorbing (in 2009) state support equal to 2.5% of the country's GDP. As a result, a critical aspect of the IMF expectations as for a sustainable fiscal framework assumed a series of measures to improve financial viability and efficient regulation of the energy sector.

The Table below summarises these conditions. Prior actions implemented before the agreement (including increases of gas prices for households) were discussed in the previous update. Detailed analysis of continued Government's action with regard to Naftogaz financial position will be provided in future reports.

	Condition type	Timeframe	Measure
?	Quantitative &Continuous Performance Criteria		Ceiling on cash deficit of the general government and Naftogaz
☒		2010 (achieved)	Naftogaz financial plan adopted
☒			Eliminated price privileges for sugar, chemical, fertilizer, and metallurgy industries and will maintain gas prices for industrial users consistent with import parity
☒	Prior action	Effective from August 1 2010	Increased final gas prices for utility companies and all households by 50 % (accompanying by additional compensatory subsidies to low-income households)
⌛		April 2011 onwards	Further price increase of 50 % for households and utilities will be effected in April 2011. Semi-annual increases of gas prices paid by households and utility companies will continue until domestic price levels reach import parity. Thereafter, all gas prices will be adjusted as needed to reflect market prices.
⌛	Prior action	Operational no later than end-2010.	Transfer the authority for setting heating tariffs for communal utilities to a new independent regulator has been adopted
⌛	Structural benchmark	By September 30, 2010	Support Naftogaz's efforts to collect payment arrears. In particular, by end- September, we will pass legislation to revoke the Law "On Temporary Ban to Levy Penalties on Ukraine's Citizens For Overdue Payments of Utility Bills" so that any arrears on utility payments accumulated after October 1, 2010 are subject to penalties
☒			Introduce the distribution accounts for heating utilities
?	Structural benchmark	By December 31, 2010	Undertake additional measures to strengthen the transparency and governance of the gas sector, in accordance with the principles of the Brussels declaration (structural benchmark). In this context, (i) a gas sector law has been adopted ensuring compliance with EC Directive 2003/55/EC; and (ii) progress has been made towards joining EITI and the European Energy Community.

Deficit, Financing and Debt Accumulation

As already discuss, steady reduction of deficit levels and more efficient debt management have been at the core of the agreed conditions to the loan. The Table below summarises these quantitative requirements.

	Condition type	Timeframe	Measure
	Quantitative performance criterion		Ceiling on the cash deficit of the general government
	Quantitative performance criterion		Non-accumulation of external debt payments arrears by the general government
	Quantitative performance criterion	2010	Keep state guarantees on new debt below UAH 15 bln

2011 Budget: macroeconomic forecast

In August, the Government approved official macroeconomic forecast which would be used in preparation of the next year's annual budget law (summarised in Table 5) [24]. This year, approval of the official macroeconomic forecast is somewhat unusual compared to previous history:

- The NBU will restrain from developing its alternative exchange rate forecast, and the 2011 Budget would be drafted based on the forecast by the CMU (developed by the MOF);
- The forecast was developed at the background of continued policy discussions with the IMF over the renewed financial co-operation, and therefore reflects co-ordinated views on the economy's development prospects. Respectively, most of the macroeconomic indicators in the government's forecast are close to the IMF projections outlined in the report accompanying the agreed stand-by loan. Such co-ordination was acknowledged by the representatives of the Ukraine's MOE who noted that approved macroeconomic forecast had taken into account IMF's expert advice, resulting, among other things, in reduced optimism in most figures [25].

Table 5. Government's Forecast of Macroeconomic Indicators for 2011

Macroeconomic Indicator	2011 Forecast
GDP (nominal and growth to last year)	UAH 1253 billion / 104.5%
Prices	
Consumer price index (CPI) change	108.9%
Producer price index (PPI) change	111.3%
Corporate profit	UAH 218.3 billion
Payroll fund	UAH 390.8 billion
Average monthly wage	
Nominal	UAH 2587
Real change to last year	104%
Labour markets	
Labour productivity (growth to last year)	104.1%
Employed population aged 15-70	20.6-20.4 million people
Unemployment (ILO methodology)	7.6-8.1%
International Trade	
Trade Balance	- USD 2490 million
Exports (nominal and growth to last year)	USD 72908 million / 110.3%
Imports (nominal and growth to last year)	USD 75387 million / 111.4%

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