Local Government and Public Service Reform Initiative

FISCO id
поінформовані рішення в публічних фінансах
informed decisions in public finance

The Bubble of Poor Governance:
Coping with social impacts of recession and demographic change in Ukraine

Background paper for a presentation at the CDLR/LGI international conference
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(Workshop D: Social Impacts of Recession and Demographic Change)

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Preface

This report was prepared by FISCO id LLC (www.fisco-id.com) with support from the LGI/OSI. It relies to a significant extent on the findings from earlier analysis conducted within consultancy contracts with UNICEF Ukraine for provision of on-going technical support in the area of Public Financial Management during May-December 2010 and LGI/OSI for monitoring of the impact of economic crisis on local governments in Ukraine during 2009-2010.

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

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Pre-crisis vulnerabilities in the policy-making process

By the time when crisis unfolded, Ukraine has accumulated a stock of inefficient institutions and policies which shaped its painful reaction to external shocks as well as the nature of its policy response. As noted in the background paper, the way countries across the globe reacted to the economic crisis was determined, to a critical extent, by their prior vulnerabilities and constraints in their initial conditions. For most of the European counties (advanced and emerging), such constraints were related primarily to the fiscal space available for mitigating fiscal measures, and the existing commitments related to exchange rate regimes and price stability [(1)]. However, as we show in this note, in Ukraine's case the key prior vulnerability was related to significant weaknesses in the policy-making process and public governance function as such. Because of these growing governance malfunctions, Ukraine arrived to meet the crisis with depleted capacity to design and implement effective policy action.

This note aims to deliver three major messages:

a) that the generation of policy response to the crisis in Ukraine was distorted by the fundamental failures in the policy-making process and governance structures;

b) that these dysfunctions in the policy-making process have emerged prior to the crisis; and

c) that extreme fiscal and political pressures created by the crisis have accentuated existing policy-making weaknesses, bringing country's strategic planning and governance capacity to a dangerously low level and creating entirely new set of social and economic risks.

This section outlines the key weaknesses in the policy-making process throughout Ukraine's multi-level governance system which accumulated before the crisis. These pre-crisis conditions are listed below and then briefly described in individual sub-sections:

- Inefficient regulation of country's participation in international trade and financial markets, resulting in dangerous imbalances
- Fragile national compact within the multi-level governance system
- Fragile social contract between the government and its taxpayers
- Corrosion in temporary civil mobilisation achieved in 2002-2004
- Rigid inefficient regulation of public services, resulting in dramatic deterioration in their quality and contributing to society's aging without living longer
- Growing imbalances in the pension system

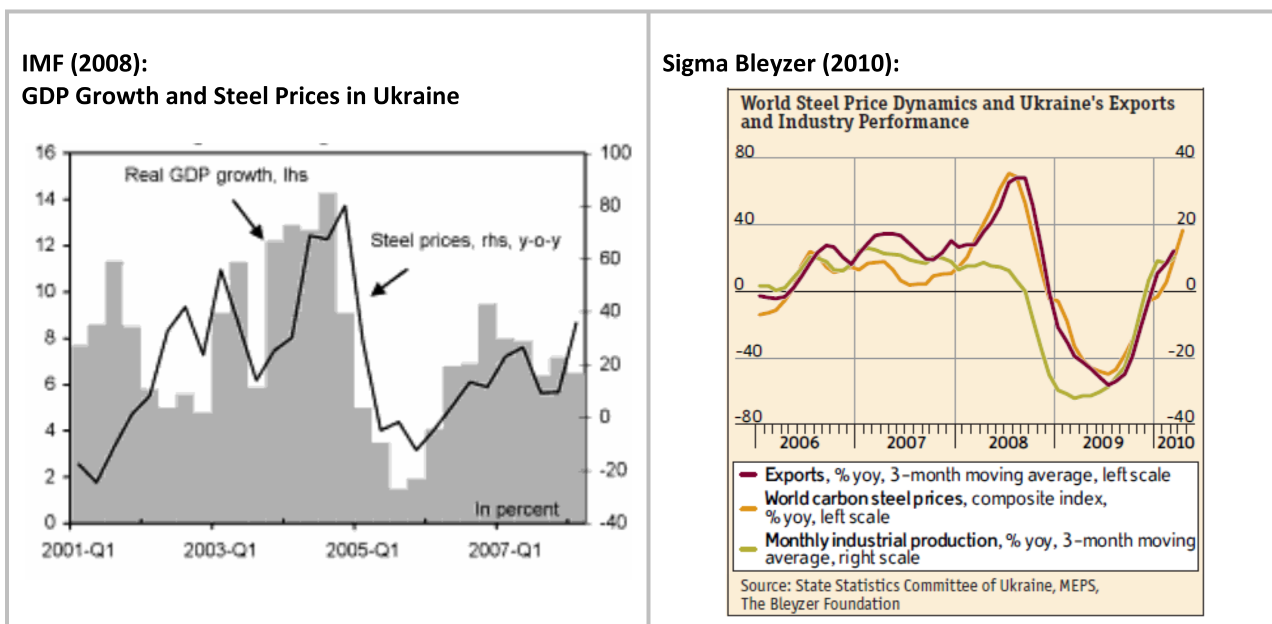
Inefficient regulation of country's participation in international trade and financial markets, resulting in dangerous imbalances

Handling of current account deficits before the crisis was biased towards external debt accumulation rather than attraction of FDI. At the same time, asset-related risks were aggravated by weak banking regulation. As many other countries, including developed countries, Ukraine was directly affected by the crisis given that: (a) its economy was infected by the property asset bubble and (b) 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 [(2), (3)].

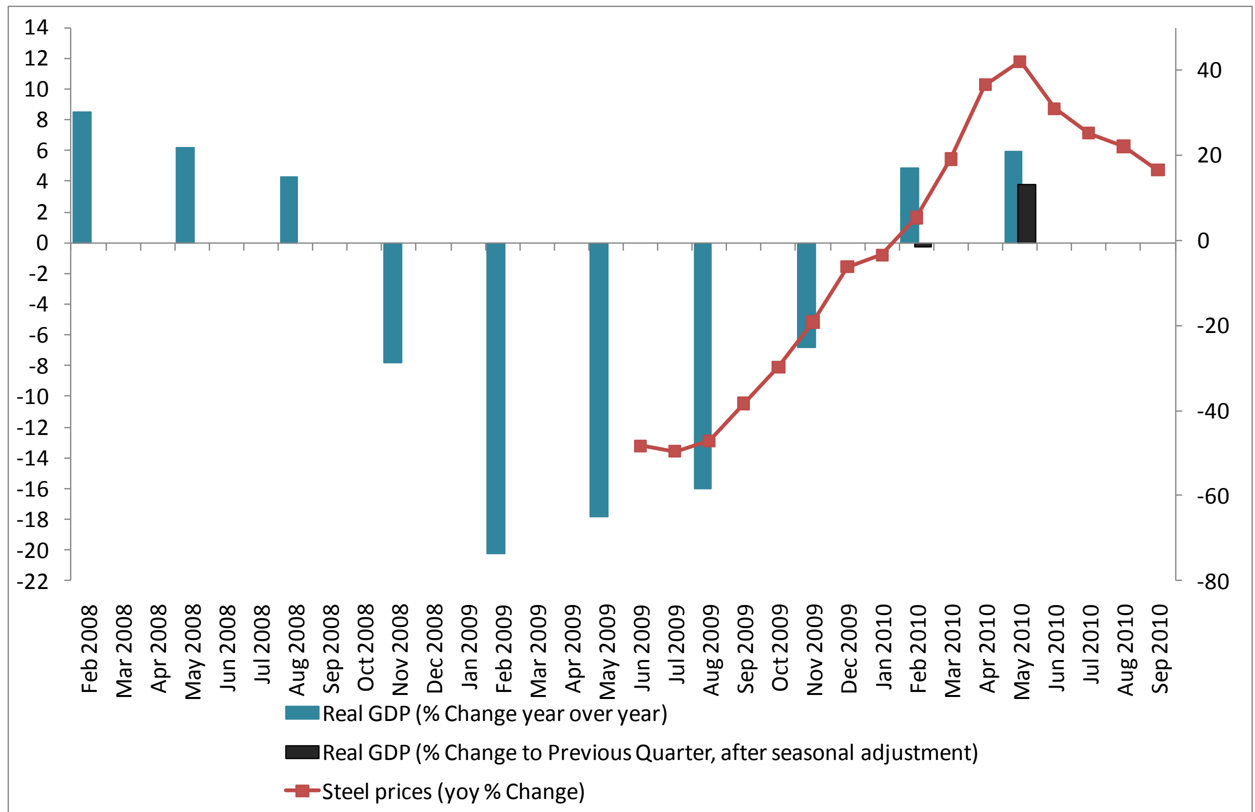
Relatively high dependence of Ukraine's economy on exports[i] resulted in unpredictability and volatility of the country's GDP during several years before the crisis. The most recent evidence-based analysis which accurately separated the impact of favourable terms of external trade on Ukraine's GDP performance from other factors based on data for 1999-2007 (conducted by IMF [(4)]) 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.

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



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

As global economy starts to recover, Ukraine's export is benefiting from rising steel prices, but domestically oriented sectors continue to contract and GDP is shrinking compared to previous quarters. Relatively high dependence of Ukraine's economy on exports 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 [(5)]. As a result, in the two first quarters of 2010 Ukraine's real GDP increased by 4.9% and 5.9% yoy respectively. Understanding exactly how much of this recent growth owes to improving steel prices and what was the contribution of government's stimulating policies 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 (or, rather, over the lack thereof). As further sections describe, 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. Respectively, exports remains highly undiversified (which helped it to expand in 2010, mirroring steel price dynamics), while domestically oriented sectors actually continue to contract (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)]. Moreover, although Ukraine's real GDP started to recover in 2010 in comparison to last year, in the first quarter it was still falling compared to previous quarter (after seasonal adjustment). In the second quarter of 2010 growth had somewhat accelerated, but compared to a very low base (both year-over-year and compared to previous quarter) (see Figure 2). Notably, these results take place at the background of almost a year of consecutive growth in global steel prices.

Fragile national compact within the multi-level governance system

Ukraine spent the last decade in an explosive stalemate of uncompleted intergovernmental reforms, launched in 2000. In particular, the reforms created a mismatch between financial and regulatory responsibilities at all tiers (6), leaving governments at all levels in a state of constant fiscal and institutional stress, motivating them to search for coping strategies which made the system even more opaque and unstable. At the same time, aleatory manner in which reforms were approved in 2000 implied that there was no underlying political consensus to fuel further movement: as a result, despite repetitive declarations, tangible changes in the system did not follow, perpetuating mistrust to nation-wide decentralisation reform initiatives and stimulating ad hoc distortive solutions, further mistrimming the system (7). Moreover, dialogue about options for finalising the transfer of responsibility to sub-national governments revealed weaknesses in the actual demand for decentralisation on behalf of the sub-national tiers: e.g. enthusiasm over the idea to introduce a property tax was often accompanied by suggestions of leaving the rate-setting power at the central level (to avoid political responsibility with local constituencies).

Fragile social contract between the government and its taxpayers

By 2006, observers agreed that tax burden on the economy in Ukraine was already significant and that public spending was already high, but extremely inefficient. Respectively, they recommended that any increases in budget revenues should be achieved through widening the tax base through measures such as better administration of VAT, streamlining of payroll taxation, and eliminating existing tax loopholes. These recommendations also demonstrated that improvement in public services could be achieved not by higher spending but through administration and governance reforms, as well as through introduction of long-term budgeting framework (4), (5).

Particular elements of high tax burden, corrupt tax administration, and lack of neutrality and equity in taxation are listed below:

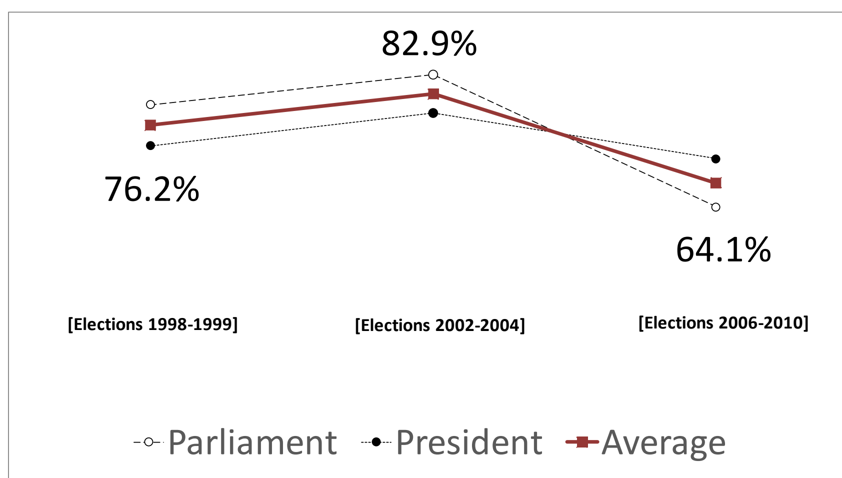
- Large and persistent sector-based tax exemptions and privileges (e.g. VAT exemptions in agriculture and pharmaceutical sector or EPT privileges);
- Continued tradition of free economic zones, which represent packages of tax exemptions which are extremely vulnerable to manipulation[ii];
- Fundamentally distorted system of VAT administration which allowed fraudulent agents to account the bulk of added value on accounts of missing traders, minimising tax liabilities within the country and claiming fictitious refunds of this tax through pseudo-export. This administrative failure resulted in mounting arrears on VAT refund to exporters, as well as in mounting market distortions because of constant in-direct cross-subsidisation of fraudulent and well-meaning exporters at the cost of other well-meaning exporters (6).
- Distorted system of simplified taxation, which allowed large enterprises to enjoy benefits of considerably smaller taxes designed to support small and new businesses;
- Major tax loophole represented by a privileged taxation regime of insurance companies[iii].

[ii] There is very little the government can do to restrain economic agents from outside the eligible territory to benefit from its exempt status unless this territory is protected by enforceable customs controls. Since 2005, Ukraine was on the path to gradual reduction of free economic zones, but the policy of granting free economic zone status has returned to the Government's agenda in 2010

Corrosion in temporary civil mobilisation achieved in 2002-2004

Civil participation is a separate topic which is outside of this paper. However, we find it important to note that weak public communications, lack of improvement in the quality of political institutions and political process (noted by most observers [7], [8]) contributed to visible disappointment of Ukraine's population in active civil participation and political activity. нижеFigure 3 shows that voter turnout has decreased substantially in the recent elections, after a historical record in 2002-2004.

Figure 3. Voter Turnout in Elections in Ukraine (1998-2010)



Source: Ukraine's Central Elections Committee (http://www.cvk.gov.ua/)

Rigid inefficient regulation of public services, resulting in dramatic deterioration in their quality and contributing to society's aging without living longer

Because of poor quality of healthcare and social protection, Ukraine's population is aging despite living shorter lives. Input based budgeting, which permeates the system, creates strong negative implications for technical and allocative efficiency in key sectors, where the quality of service delivery is deteriorating at dramatic rates, leading to rapidly deteriorating outcomes in healthcare and social protection and contributing to decreasing longevity at the background of decreasing birth rates.

In particular, policies (or, rather failures in the policy-making process) which started before the crisis and which explain persistently poor demographic outcomes include:

- **In Healthcare, continued strong reliance on "Semashko healthcare model" of centralised management and administration leads to systemic inability to deliver effective care and prevention of chronic and non-communicable diseases**. Research by World Bank illustrates how this inefficiency is one of the root causes of the dramatically underperforming outcomes in health sector in Ukraine, since that system was originally developed for episodic care for acute illness and is not properly oriented for a more proactive approach that involves multi-sectoral participation in prevention programs and meeting the needs of patients with chronic conditions [9].

[iii] According to Ukraine's current system, turnover of insurance companies is taxed at 3%, compared to 25% for regular business. This means that any company can deduct billions of profits as insurance of non-existent risks in a captive insurance company, which would pay a much lower tax on these amounts. Moreover, insurance companies can avoid even these tax liabilities by re-insuring non-existent risks in foreign offshores. This loophole allows Ukrainian companies to use the national taxation system as a legal national offshore and avoid very significant tax liabilities.

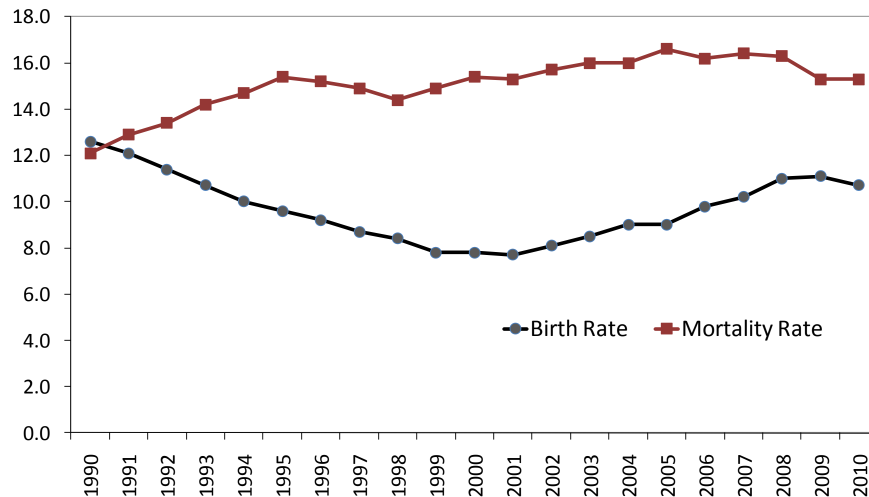
- **Ukraine's system of social assistance is ineffective because of poor targeting.** As was summarised by the World Bank in its post-crisis recommendations [10], "Ukraine has sizable system of public social assistance (around 2% of GDP is spent on annual basis) but its targeting to the poor can be improved. A number of income and asset tested programs are well targeted to the poor, including the program for extreme poor (the GMI), the child allowance program and the allowances for single parents. However, overall, poorly targeted subsidies and privileges take most of the social assistance resources and in general do not tend to reach the people that really need them. In 2009, the government adopted a new strategy to reduce the scope of privileges via shifting toward means-tested assistance benefits, but its implementation timetable is unclear. Moving forward, targeting accuracy needs to be enhanced, and administrative costs and delays in dispensing social assistance benefits reduced, by modernizing the local and central welfare offices. The bottom line: Ukraine can afford to protect its poor, if it targets its assistance more effectively".
- **Social services are funded in ways which encourage inefficient residential care.** Social services to vulnerable population groups are funded by a transfer from the central budget, which is calculated based on the number of clients registered in specific residential institutions. This stimulates local governments to continue funding traditional residential providers, since re-allocating resources to alternative services would decrease respective equalisation transfer to such local budget [7].
- **Funds for social services to vulnerable population groups are allocated with orientation on input (provider), which is a barrier to cost-efficiency.** At the moment, most expenditures on social service provision are administered via sub-national administrations based on the existing network of service-providers. This arrangement is fundamentally different from an alternative financing principle, when the state acts as a service purchaser representing best interest of the vulnerable client, assessing the client's needs, and commissioning required services on competitive basis. Such "purchaser-provider" financing model is strongly recommended to increase allocative and financial efficiency of service provision.
- **Responsibilities for policy development in social service provision are fragmented across several central ministries.** At the moment, responsibilities for social services to vulnerable population groups are divided between several agencies, which makes it difficult to produce co-ordinated policies.
- **Lack of long-term perspective in budgeting to account for demographic trends.** Ukraine is experiencing significant demographic changes, which will affect the nature of demand for social services, and require significant strategic re-allocation of funds within the budget envelope. In order to prepare for such changes, Ukraine needs to acquire specific methodologies of incorporating long-term demographic trends into its budgetary forecasting practices, and use this information to develop strategic macro-fiscal decisions and plans. However, although multi-year and long-term budgeting was declared as priorities, and although multi-year forecasts are formally calculated for all expenditure programmes, these excercises do not represent "a political consensus and commitment to choices of how to reconcile strategic goals with limited funding opportunities" which lies at the heart of strategic budgeting [9].

Key factors for population aging in Ukraine are: decreasing birth rates combined with growing mortality among adult population. Aging in Ukraine is fundamentally different from how (and why) it happens in most countries of Western and Central Europe. While in Europe aging is the result of increasing longevity at the background of largely stabilised fertility rates, in Ukraine low birth rates are accompanied by increasing mortality and falling life expectancy (see Figure 4 and Figure 5). In particular:

- Life expectancy at birth in Ukraine is one of the lowest in Europe;
- Ukraine is 17th in the world by mortality rate (16,4 per 1000);

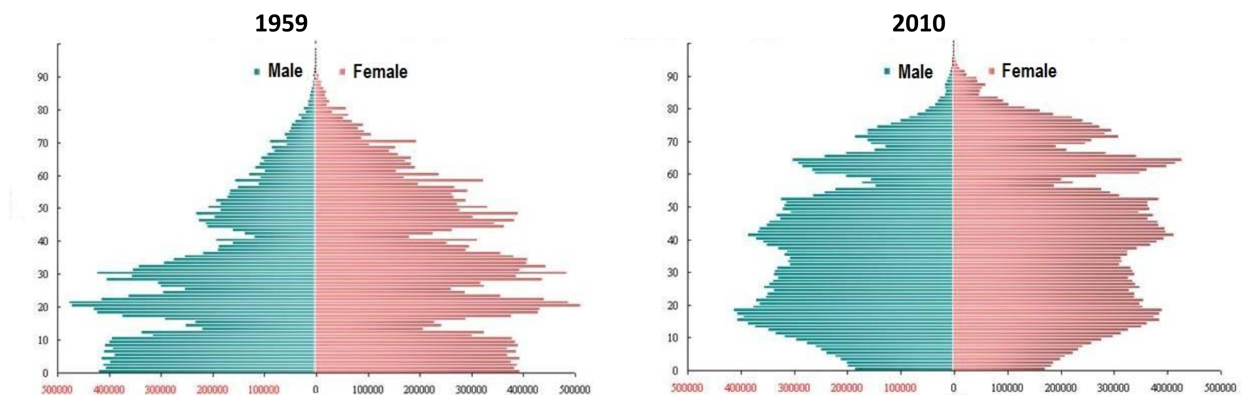
- Ukraine is 7th in the world by mortality related to cardio-vascular diseases (637 per 100 thousand);
- Given low birth rates (5th rate in the world in the ranking of lowest amount of children per one woman (1,22)), Ukraine is currently 3d in the world and 1st in the region by the rate of population decrease (in average, 0,76% per year). By 2025, the country's population is forecasted to shrink by 20%, which would be the second biggest absolute reduction in the region (15).

Figure 4. Overall Birth Rate and Mortality Rate in Ukraine in 1989-2006 (per 1000 population)



Source: Ukraine State Statistics Committee

Figure 5. Ukraine's Age Pyramid: 1959 and 2001



Source: Ukraine State Statistics Committee

Growing imbalances in the pension system

For the last decade, Ukraine's pension system had been experiencing an extreme fiscal stress, which would intensify as the population's average age would be increasing. In pre-crisis years, this stress has been mostly caused with the inability of the current pay-as-you-go (PAYG) system to ensure sustainable financing of growing pension expenditures. Figure 6, Figure 7, and Figure 8 illustrate how at the background of declining and aging population, demographic burden on labour force was forecasted to steadily increase until around 2060.

Figure 6. World Bank: Forecast of population decreases in the region between 2000-2025 (16)

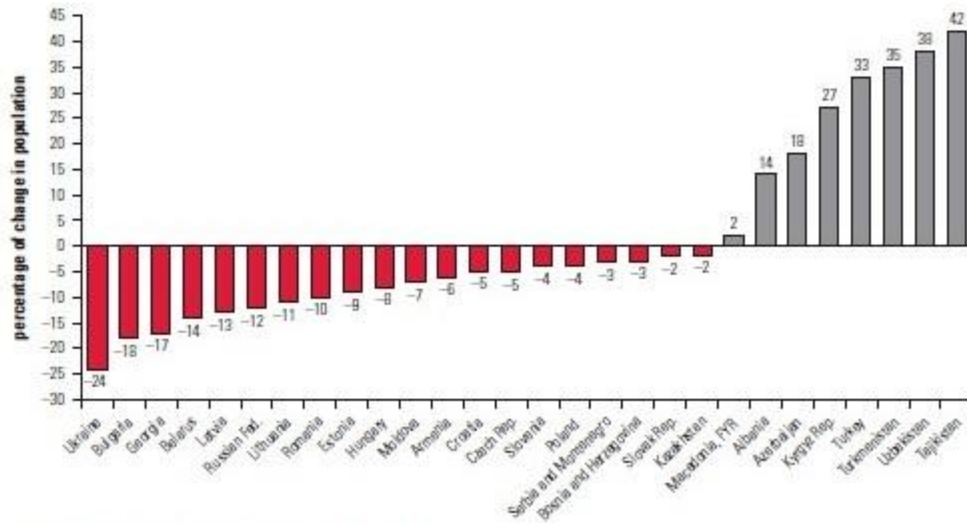


Figure 7. World Bank: Forecast of change in proportion of population aged 65+ by 2025 (16)

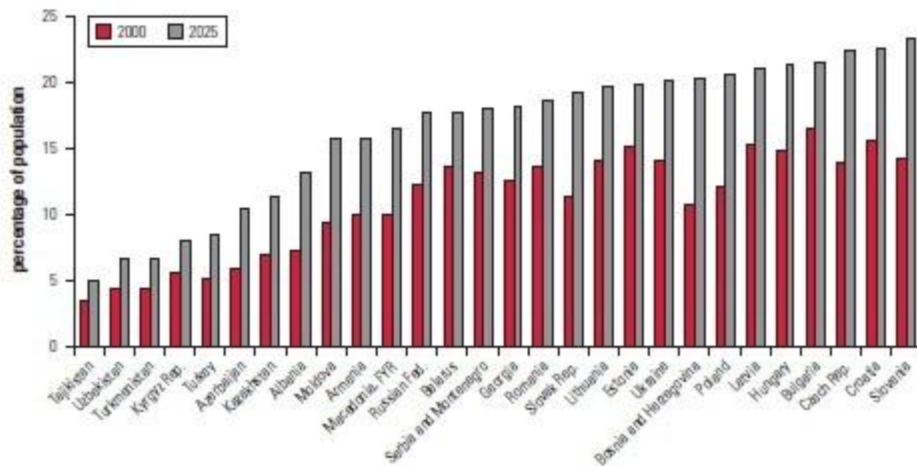
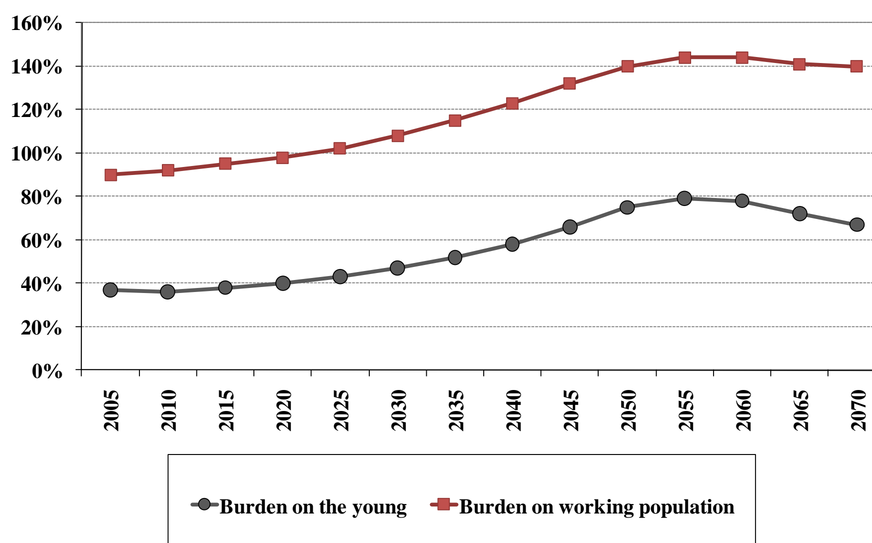


Figure 8. Forecasted change in the ratio of population aged 65+ to young (15-64) and working population in Ukraine [15]



But despite widely shared understanding that current pension insurance system is not sustainable, Ukraine was not able to move a step closer towards tangible reforms, because it required difficult changes in the taxation policy and unpopular decisions on pension age. In years before crisis, Ukraine created a legal platform and a wide consensus around the need to transfer to multi-pillar system which would include mandatory and voluntarily fully-funded state pension insurance. However, actual implementation of this reform remained unaccomplished and challenging task. One of the key challenges to introduction of the second pillar has been the need to mobilise considerable funds to support this mechanism without raising tax rates and jeopardising macroeconomic stability. Therefore the key challenge of the pension reform in Ukraine has been the need to coordionate it with tax reforms. In particular, such challenging reforms required [8]:

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

Dominoes of inefficient policies, in motion

Prior vulnerabilities in macroeconomic and fiscal policies outlined above determined a very deep magnitude with which global crisis has shaken Ukraine's economy. 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 1). 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 [11].

Table 1. 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.

However, the biggest pressure created by the crisis was on Ukraine's policy-making capacity, which turned out to be the economy's weakest link. Rapid and effective action through a complex government structure is a challenge to any country and was performed with varying success by even advanced economies. At the same time, as we try to illustrate in the following sections, Ukraine's case is distinctive by the amount of negative externalities created by the policy responses, that is by how especially pro-cyclical this response appeared to be in comparison to most other countries.

The key driver of change to restore public fiscal balance and ensure against unsustainable social policies in post-crisis period has been IMF, voicing unanimous opinion of other international development actors. It is notable that throughout the months of post-crisis fiscal shrinking and of coinciding rounds of elections (Presidential in January 2010 and local government in October 2010), Ukraine maintained negotiations with the IMF over renewal of stand-by financing, which culminated in an agreement reached in July 2010 [12] to allocate SDR10 billion (about USD 15.15 billion) loan to support Ukraine's economic adjustment and reform programme (making Ukraine one of the Fund's largest debtors). In this way, shortages of public funds coupled with electoral pressures opened a new window of opportunity for international players to voice opinions on reforms needed for Ukraine. Since the crisis hit public finance most painfully (not least given the irresponsible prior policies), the recommendations

were also concentrated on public financial management. Respectively, the IMF, and the donor community which subscribed to its recommendations, became the key driver of (potential) change in Ukraine's post-crisis reform agenda.

Most of the policy follow-ups after the crisis in Ukraine were visibly pro-cyclical and significantly exacerbated social impact. Some of these most important post-crisis decisions are listed below and then described in more detail in respective sub-sections. On some of these issues, initial measures were undertaken since July 2010 in response to IMF conditions to the agreed stand-by funding, but most of the agreed reform agenda is still to be undertaken (which is unlikely given the political pressures of upcoming local elections in October 2010).

- Cuts in primary expenditures combined with expansion of pensions;
- Funding growing deficits by accumulating pro-cyclical, quasi-fiscal debt:
  - Further VAT refund arrears;
  - Quasi-fiscal operations in the energy sector;
  - Funding current expenditures through mobilising advance tax payments for future periods;
  - Funding current expenditures through funds earmarked for other purposes;
- Continued rigidities in input-based vertical regulation of sector spending;
- Continued weakness of public communications;
- Failure of local price regulation for housing and utility services.

Cuts in primary expenditures combined with expansion of pensions

As most emerging economies [(1)], Ukraine resorted to pro-cyclical expenditure cuts. As illustrated by Figure 9, in real terms overall expenditures of Ukraine's consolidated budget decreased by almost 8% between August 2008 and August 2009 (overall annual expenditures for 2009 were almost 14% lower than in 2008). However, at the background of real shrinking in most programmes (especially investment-intensive capital expenditures across sectors), two consecutive governments in 2008-2010 steadily increased pensions, social benefits, and recurrent spending in social sectors at rates above inflation.

As the crisis unfolded, shrinking labour market and shrinking payroll tax revenues created obvious additional pressures on the Pension Fund balance, which depended almost exclusively on the pay-as-you-go funding, as explained earlier. But although the two consecutive governments acknowledged catastrophically growing size of the Pension Fund deficit [(13)], both were took a radically defensive standing about corrective measures, insisting on plans to raise enough revenues in order to preserve the current pension age and continue expanding nominal pensions [(14)]. Figure 9 and Figure 10 illustrate how, as a result, public spending on pensions quickly increased both in absolute terms and as a percentage of budget expenditures. By the middle of 2010, Ukraine's spending on Pension became one of the highest in the world (17% of GDP), while remaining based on an unsustainable and distorted funding mechanism.

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.

In particular, as part of the reform package agreed with the IMF, Ukraine committed to:

- Significantly reduce deficit transfer to Pension Fund by end of 2011 (not happened so far);
- 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. 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.

Figure 9. Real consolidated expenditures during comparable periods of 2007-2010 (Jan-Aug)

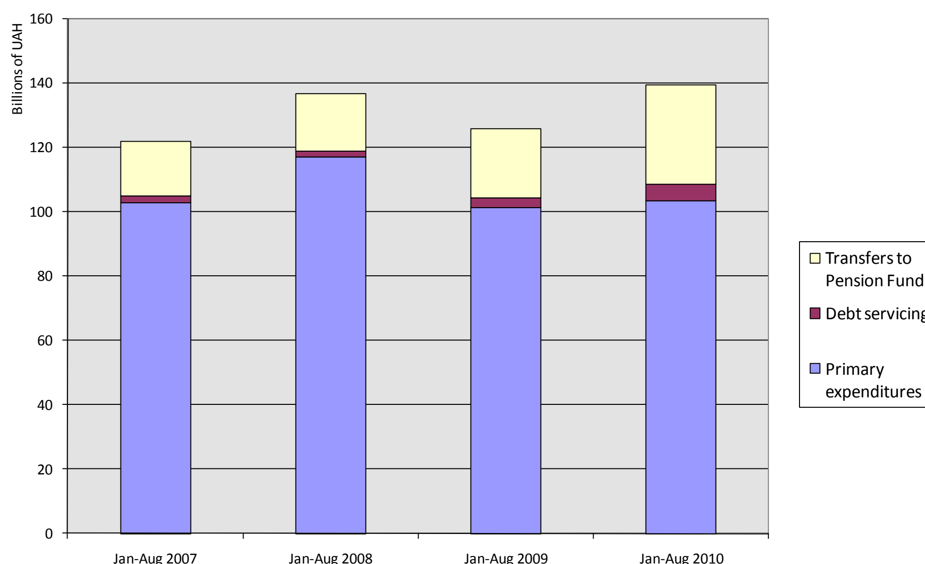
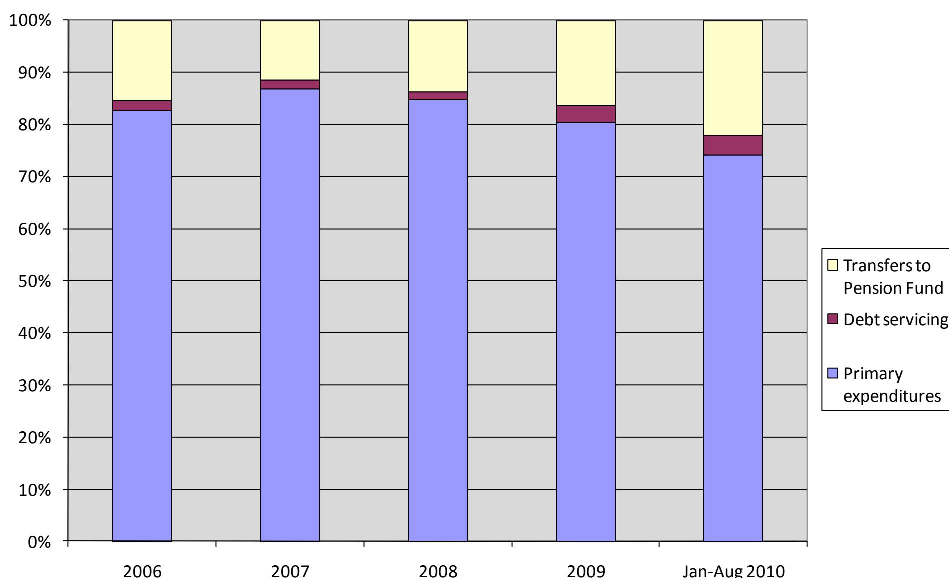


Figure 10. Composition of consolidated expenditures in 2006-2010



Funding growing deficits by accumulating pro-cyclical, quasi-fiscal debt

Shortage of funds made it even more obvious than before that Ukraine's traditional approach to increasing fiscal space for extra expenditures has been based on rather short-sighted and undemocratic political process. The two governments progressively relied on funding the inefficient expansion described above with hidden and unsolicited quasi-fiscal borrowing such as mounting VAT refund arrears, mandatory advanced tax payments, and wage arrears [(15)], as described below.

Further VAT refund arrears

As already discussed, 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 to reach an estimated UAH 45 billion [(16)]. Although the Government made multiple statements on its determination to address the crisis with VAT refund arrears, actual measures were mostly represented by administrative pressures on businesses coupled with transition to repaying VAT refund in T-bills instead of cash. In the reform package agreed with the IMF, Ukraine committed to ensuring the payment of all VAT refunds accruing in the remainder of the 2010 in full and on time and not accumulate any arrears during 2010. However, no information about progress or action on this priority was available in public access during August.

Quasi-fiscal operations in the energy sector

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

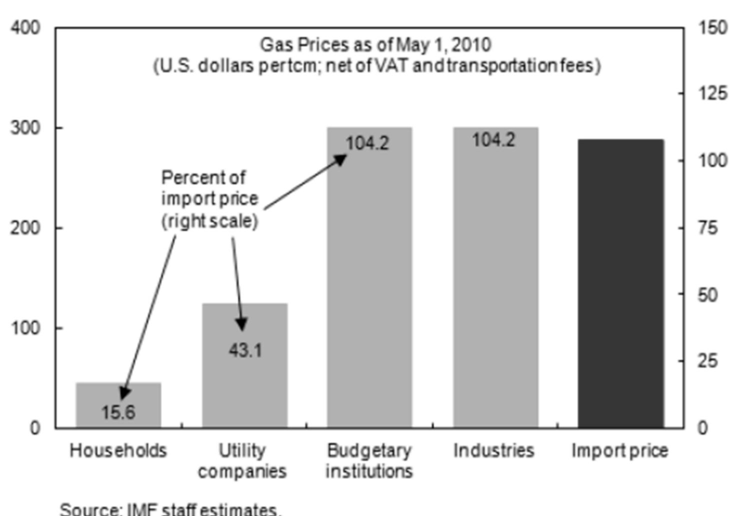
Ukraine's history of QFA in energy sector has followed a U-curve, improving around 2005-2006, but deteriorating to the point of macroeconomic emergency by the time of this report. In 2005, most donors declared that financial health of Ukraine's energy sector remained a significant problem but had markedly improved since independence. Initial quasi-fiscal activities in the sector were related to keeping energy tariffs below market rates and poor payment discipline, but these areas were quickly improving. In particular, payments collection has doubled over 2000-2004 and average energy tariffs have been increased [(17)]. The WB estimated that during 2001-2004, QFA in the energy sector in Ukraine fell from 8% of GDP to a "still-high 6%". However, revisions of gas supply agreements with Russia launched in 2006 created a new pricing mechanism on the energy market which proved to be detrimental for the financial balance of the Ukraine's Naftogaz – a state-owned company monopolistically responsible for extraction, transportation and processing of natural gas and oil. In 2006, the WB estimated that the impact of the new pricing structure on the consolidated quasi-fiscal deficit of the state-owned part of the gas sector would increase moderately during 2007 [(18)]. But as the pricing mechanism continued to evolve over the next years, the negative impact intensified.

In 2009, Naftogaz encountered palpable risks to its financial viability, absorbing state support equal to 2.5% of the country's GDP. In 2009, price differential between import of gas and its further sales to households and utility companies, coupled with low payment discipline, created a financial pressure on Naftogaz, putting its viability at risk and creating emergency pressures on the budget to provide

respective support (see Figure 11). According to IMF, during 2009 the Government transferred 2,5% of GDP in "recapitalization" bonds to Naftogaz, on top of additional borrowing by Naftogaz from other sources in the amount of USD 1.6 billion. IMF also estimated that if current policies do not change, its deficit could reach 1.5% of Ukraine's GDP in 2010 (19).

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

Figure 11. IMF Estimates: Gas Prices as of May 1, 2010



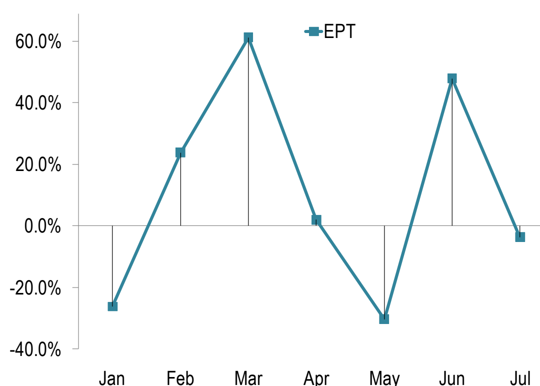
The mechanism of state support to Naftogaz creates extra fiscal inefficiencies. While any quasi-fiscal activities have impact on the budget as an extra spending liability, the deficit of Ukraine's state-owned energy sector creates an additional complication because of the way it is funded.

- **Current subsidization of Naftogaz benefits richer population much more than the poor.** First of all, the current mechanism of state support to Naftogaz includes a significant subsidy which covers the company's loss resulting from the difference between gas purchase price and the lower gas tariffs at which it charges municipal utilities. This subsidy is highly regressive: the households benefit from this state support in proportion to their consumption of energy, which grows together with incomes. In other words, the current subsidy benefits richer households much stronger than poorer ones. On the other hand, if the tariffs were increased, it would have been paid mostly by the middle and upper consumption expenditure groups, and mostly richer urban population, while the impact on poorer categories could be compensated with a much smaller social transfer in comparison with the current subsidization of the Naftogaz (20).
- **Current package of state support to Naftogaz is opaque and distortive for the economy.** Secondly, state support to the energy sector is exercised through a set of complex financial instruments in addition to the above mentioned direct subsidy to Naftogaz (such as budget support to state-owned banks against their privileged loans to Naftogaz, restructurisation of tax liabilities, etc). Most of these instruments lack transparency and distort respective markets.

Funding current expenditures through mobilising advance tax payments for future periods

Although Ukraine's GDP showed signs of recovery in the last year, by August 2010, all key taxes in Ukraine were collected significantly below period baselines, creating an about UAH 6 billion revenue shortage. Apart from indicating at imminent fiscal pressures, this result also pointed at symptoms of a principal breakdown in the state's relations with its taxpayers. Moreover, the only resilient tax, EPT, has been 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. However, as illustrated by Figure 12, 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 (which is widely supported by informal testimonies in the media).

Figure 12. Difference of monthly actual collections of EPT over period baselines in January-July 2010 (%)



Funding current expenditures through funds earmarked for other purposes

Throughout 2010, various types of evidence pointed at growing discretion with which central government handled expenditure allocation approved by the Parliament.

According to VR Budget Committee (27), the Government used accounting manipulations to use proceeds from earmarked funds, such as education user fees, to fund general current expenditures[iv]. An important source of such earmarked revenues withdrawn for funding current spending were proceeds from sales of CO_2 emission quotas to Japan.

By August, it became visible that dramatic underperfomance of key taxes was counterbalanced by receipts from non-tax sources were NBU transfers, CO_2 quota sales, rent payments for gas extraction, own revenues of budget institutions, and a variety of administrative fees and fines. As discussed earlier,

[iv] 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.

reliance on such sources was accompanied by redirection of funds to coverage of pension fund deficit, rather than investment and growth generation programmes.

Moreover, in July the Government used its newly introduced legislative provisions for higher flexibility in reallocating funds in order redirect funds in a highly biased way towards luxury running costs of central authorities (such a reconstruction of spa resorts) and increased protection of civil order [(21)].

Continued rigidities in input-based vertical regulation of sector spending

In line with the diagnosis of pre-crisis vulnerabilities described in the first part of this note, international development actors strongly draw Ukraine's attention at the importance of addressing current extreme rigidities in the input-based financing norms for decentralised service provision. In particular, the reform agenda agreed with the IMF included as its core goal on expenditure measures 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. In other words, the principal idea of this agenda is to promptly reform public spending to keep deficits under control while releasing regulatory rigidities and reallocating funds towards growth-enhancing programmes. However, none of these principles have been so far supported by the current bias towards consumption and lack of progress with any of the sector-wide regulatory reforms.

Continued weakness of public communications

In the recent years, the key theme in recommendations of most development actors to Ukraine in the area of public financial management was that while technical recommendations were relatively straightforward, they were difficult to implement in practice because of the lack of social consensus regarding desired development path for Ukraine. Therefore, the World Bank has refocused its programme of support to Ukraine towards "building trust in public institutions and building demand for better governance". Moreover, Public communications were at the heart of the WB's post-crisis recommendations to the Government [(22)]. Following the outburst of economic crisis, the WB has published its recommendations to the Government and actively participated in the public debates around the prospect for post-crisis fiscal consolidation. While these recommendations contained technical considerations, described further, the WB emphasised that "the main message of [WB's] recommendations is that reforms in Ukraine are possible if they are properly explained. Citizens will accept change, including cuts in pension benefits and higher tariffs, if they see this as part of a package that also closes tax loopholes, reduces bureaucratic red tape, improves transparency and delivers more effective public services" [(23)].

However, by the time of this report, the quality of Government's communication has not changed, even despite upcoming elections. In particular, the Government's presentation of the agreed stand-by arrangement with the IMF and future challenging reforms referred to a relatively narrow range of arguments outlined in the official press-statement, despite the obvious need to address public outcry regarding such plans as increased pension age.

Failure of local price regulation for housing and utility services

Weak regulation of local monopolistic providers of housing and utilities services has been increasingly problematic in Ukraine in recent years. Local monopolistic providers and intermediaries (such as communal energy companies and local utility administrators) have maintained much higher arrears to generating companies compared to arrears they themselves have accumulated from the consumers. E.g., while (by most recent data) consumers have paid 85% of their bill for gas to local companies, the latter have paid only 30% of their bill to the national "Naftogas" [(22)]. This was combined with constant

increases in tariffs approved by local councils, leading to allegations in collusions (through alleged kickbacks to local councils from accounts in locally controlled banks). In the face of crisis, the scale of this problem became even more palpable both socially and fiscally.

In the first year after the crisis unfolded, most of the local councils approved rapid unaccountable increases in user-charges for housing & utilities services (without changing the efficiency, transparency and accountability of the system of housing & utilities service provision, which implies that much of the new proceeds would be wasted) and introduction of loopholes for windfall rent-seeking in housing & utilites sector. (e.g. the increase in Kyiv – in June 2009 – was 50-85% [(23)]). Moreover, many providers approved new regulations which were dangerously close to explicit hijacking (e.g. a new requirement to approve installation of air conditioners by multiple authorities including local councils; with an urgent request to all current owners to provide appropriate documentation).

Both consecutive Governments – and later also international development organisations and in particular IMF – acknowledged that local price setting was not working and requires centralised regulation, launching a transfer of the authority for setting heating tariffs for communal utilities to a new independent regulator at the central level.

Questions for future

This note attempted to demonstrate that the fundamental vulnerability which defined Ukraine's ability to face global economic crisis was the country's deficit of policy-making capacity, accumulated during previous years. Not only has this weakness of the policy-making process, governance, politics and national compact contributed to extreme magnitude of crisis impact (by creating structural imbalances such as undiversified export structure, significant unfunded mandates on local budgets or growing deficit of the Pension Fund). On top of these unfortunate vulnerabilities, weak policy-making capacity meant that, faced by the real shock, the country found it difficult to generate a policy response which would match the challenge. Moreover, the nature of measures in taxation policy, expenditure regulation or intergovernmental fiscal relations was determined by short-term political context and appeared, therefore, strongly pro-cyclical. As a result, prior dysfunctions have escalated, creating entirely new risks (such as mounting quasi-fiscal deficit, extreme new tax pressures on businesses and new fragilities for previously agreed international commitments [(32)]).

This lack of strategic response seems to point that declared governance capacity in Ukraine was significantly overvalued prior to the crisis in terms of public trust, partnership between public and private sector, and international policy dialogue. As the crisis unfolds, dysfunctions in the policy process persist and escalate. The paper therefore raises a number of questions for the immediate future:

- While current fiscal deficits are handled with support from the international community, and in particular the IMF, the current deficit of governance capacity is also covered (with varying success) by the policy advice imposed via conditions attached to expanding public debt. One open question is how sustainable is such approach in the long-term – for both types of deficits – given the current lack of structural change either in macro-fiscal policies or in the policy-making process.
- Prospects and added value of *tilting* the multi-layer governance system any further to sub-national levels is questionable. In the absence of social consensus over needed change (identified by the World Bank) and in the absence of strong demand for public responsibility at sub-national levels, further decentralisation might be detrimental – as was supported by the recent episode with failing price regulations for utilities at the local level.

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