Child-Focused PFM Monitoring: Observations for January-July 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:

- Budget execution statistics based on Treasury reports for January-June 2010; description of policy developments covers June and July 2010;
- Starting from this month: comparing budget execution with our own monthly revenue baseline projections (in the absence of publicly shared "rozpys");
- Focus on governance, political economy and drivers of change behind the PFM developments (with reference to media reports);
- Concerned with revenues falling behind plan and growing opaqueness of public finance;
- Special brief: analysis of the new Public Procurement Law
- Asking all peers and observers to criticise and debate at: www.fisco-id.com

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Acronyms and Abbreviations

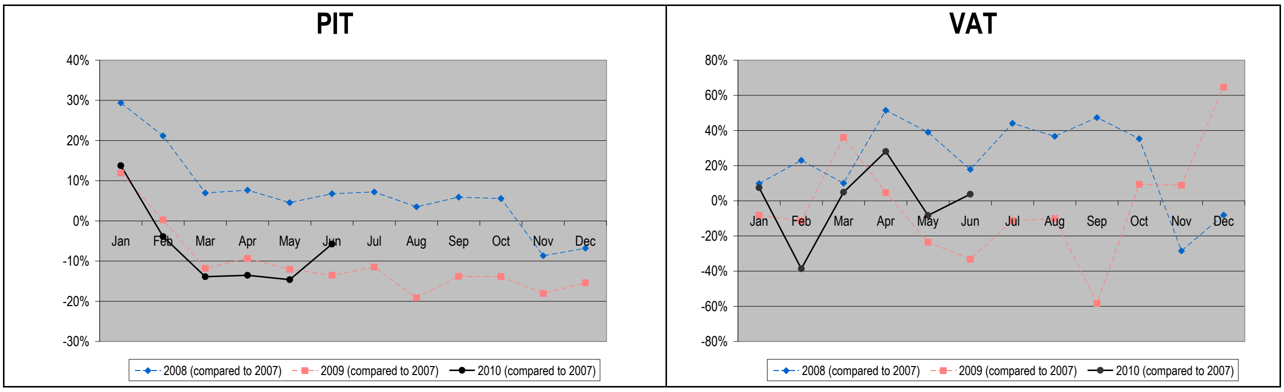
CMU	Cabinet of Ministers of Ukraine
EPT	Enterprise Profits Tax
GDP	Gross Domestic Product
JSC	Joint Stock Company
IMF	International Monetary Fund
MOF	Ministry of Finance
MOLSP	Ministry of Labour and Social Policy
MP	Member of Parliament
NBU	National Bank of Ukraine
NCRE	National Commission for Regulation of Energy
PFM	Public Financial Management
PIT	Personal Income Tax
PM	Prime Minister
PPL	Public Procurement Law
PR	Public Relations
SDR	Special Drawing Rights
STA	State Tax Administration
UAH	Ukrainian Hryvnia
UNICEF	United Nations Children's Fund
USD	United States Dollar
VAT	Value Added Tax
VPM	Vice Prime Minister
WB	World Bank

Observations on the current state of PFM

Revenues remain behind plan

Overall revenues for January-June 2010 remained at the level of 2009, thanking to larger collections of PIT and VAT in June. June has seen considerable hikes in collection of VAT and PIT, at the background of continued growth of Excises (Figure 1). The PIT was falling in previous months (in real terms), but as a result of larger collections in June, the cumulative real PIT proceeds for the first half of 2010 turned out almost the same as in the same period of last year (decreasing only by 0.51%). (Table 1). Respectively, overall cumulative revenues for January-June were also kept almost at the level of 2009 (increasing by 0.83% in real terms).

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



Despite increased collections of VAT and PIT in June, cumulative revenues over first half-year of 2010 were considerably below period baselines for most taxes and overall. Table1 compares consolidated revenues over January-June 2010 to monthly revenue baseline projections, calculated by our team in the absence of official budget "rozpys" (see Box 1). It shows that overall revenues were 6.87% below the half-year benchmark. Moreover, the Government is facing its most dramatic underrun with VAT receipts, which are 19.07% behind schedule, despite the growth of collections in June and despite the growing refund arrears. The PIT also remains 4.65% below plan despite the hike in June. Furthemore, excise revenues which grew considerably after increases in rates, are also behind schedule. The only revenue source which is collected at speed above historical levels is EPT, which is alarming, especially at the background of reported continued measures to seek EPT payments from enterprises in advance and above legislated amounts[1,2].

By the end of first half of 2010, most of the revenues were significantly below period projections, especially VAT and Privatisation Proceeds. Even Excises, whose rates have increased and whose collections are higher than last year, are still insufficient compared to what was planned for 2010. Such poor revenue performance creates risks to current fiscal envelope and, therefore, for its expenditures, including spending on children.

First half-year of 2010 revealed significant problems in raising revenues from privatisation. Approved 2010 Budget assumed that privatisation proceeds would bring UAH 10 billion throughout the year. Yet, by the end of June, Ukraine's State Property Fund reported that since the beginning of the year it managed to raise only UAH 280 million, as well as UAH 177 million in dividends (less than 2% of the annual plan)[3,4]. PM Azarov explained the slow progress with privatisation with Government's uncertainty about proper timing and approach to sales of state assets, claiming that these funds are not critical to cover the current budget gaps[5,6].

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

		Comparisons to annul plan		Comparisons to baseline projection for the peiod		Comparisons to actual execution in same period of 2009	
	Nominal actual revenues (Jan-Jun 2010)	Annual plan (Jan-Dec 2010)	Actual revenues as % of annual plan	Baseline projection (Jan-Jun 2010)	% Difference of actual over baseline	% Change in nominal terms	% Change in real terms
Total Revenues	**145 263,71**	**342 170,01**	**42,45%**	**155 987,54**	**-6,87%**	**10,75%**	**0,83%**
Value Added Tax	46 550,06	117 684,19	39,56%	57 519,01	-19,07%	16,31%	5,84%
Personal Income Tax	23 097,71	51 487,89	44,86%	24 224,58	-4,65%	9,08%	-0,51%
Enterprise Profit Tax	17 099,65	40 903,54	41,80%	16 197,25	5,57%	18,47%	7,72%
Excise Taxes	12 921,08	30 351,00	42,57%	13 635,69	-5,24%	48,11%	35,34%
Land Tax	4 521,97	9 970,96	45,35%	4 609,89	-1,91%	15,00%	4,82%
Import Duty	3 403,88	8 290,00	41,06%	3 403,49	0,01%	17,52%	7,00%

Source: Treasury Budget Exectuion Report.

Box 1. Comparing execution to plan in the absence of "budget rozpys": the concept of monthly revenue baseline projections

As discussed in previous reports, comparing Ukraine's budget totals to plan during the year is complicated by Government's persistent policy of denying public access to the "budget rozpys" – the official monthly performance baseline for budget revenues and expenditures. Even if/when the Government does reveal comparisons of actual execution to plan for the period, the overall rozpys for future months is still classified information, so the public cannot judge whether the rozpys totals were modified to improve execution reports. 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.

Media statements by the Treasury admitted that in January-June, central revenues were 7.7% behind plan for the period while local revenues were 10.6% behind plan for the period. However, the Treasury does not reveal its baselines for any other revenue components, including individual taxes.

For this and future reports, we will use our own monthly 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 (2007-2009).

Expenditure patterns unchanged

In June, expenditures in most social sectors considerably increased. Throughout June, the Government continued its policy of increasing nominal pensions, wages and social benefits. This included continuation of backlog payment of increments to pensions and social benefits due as a result of the increase in related obligations established in the 2010 Budget (according to earlier decisions, amounts of such increases due for the first months of 2010 (before the Budget was approved) would be funded in May (for January-February) and June (for April)[7]. Notably, additional increases in June included Education and Healthcare (Figure 2). Table 2 shows that, as a result, overall expenditure level in January-June 2010 was 8.96% higher in real terms compared to the same period of previous year.

At the same time, spending on all investment-intensive sectors remains significantly lower than last year. As in all previous months of 2010, expenditures on Economic Activities, Housing & Utilities, and Environment are significantly lower in real terms compared to the same period of 2009 (by 33.9%, 49.47%, and 11.91%, respectively, - as shown in Table 2).

Spending on most social sectors (Healthcare, Education, and, especially, Social Protection) increased in June, faster than in any previous month this year. However, this expansion is related to nominal growth in wages under un-reformed regulations, and at the cost of strategic investment programmes.

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

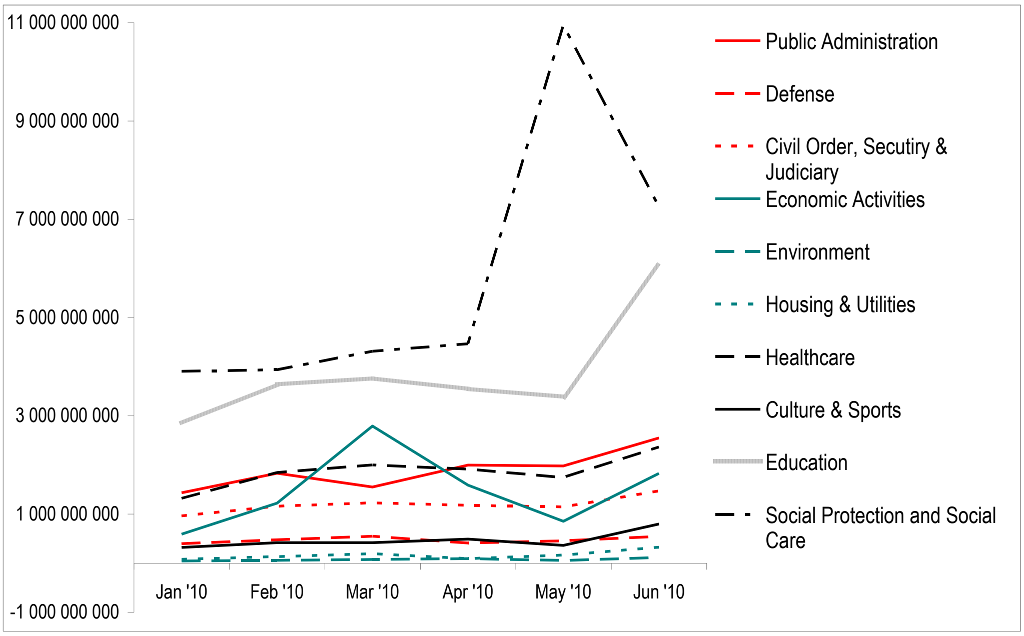


Table 2. Consolidated Expenditure Execution in January-June 2010. (UAH Millions)

		Comparisons to plan		Comparisons to same period of 2009		
	Nominal actual expenditures in Jan-Jun 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-Jun 2009	% Change in nominal terms	% Change in real terms
Total Expenditures	**171 154,97**	**400 335,99**	**42,75%**	**143 374,88**	**19,38%**	**8,96%**
Public Administration	18 710,66	65 566,38	28,54%	14 187,89	31,88%	20,64%
Defence	4 674,45	13 728,67	34,05%	4 123,16	13,37%	3,50%
Civil Order, Security & Judiciary	11 786,83	27 220,21	43,30%	10 849,76	8,64%	-0,80%
Economic Activities	14 678,86	41 455,15	35,41%	19 948,13	-26,41%	-33,09%
Environment Protection	720,72	3 240,32	22,24%	750,18	-3,93%	-11,91%
Housing and Utilities	1 623,01	4 890,15	33,19%	2 943,06	-44,85%	-49,47%
Healthcare	18 467,38	43 170,35	42,78%	16 066,28	14,94%	4,84%
Culture and Sports	4 623,80	10 288,01	44,94%	3 351,65	37,96%	26,05%
Education	38 374,80	79 317,86	48,38%	33 493,47	14,57%	4,62%
Social Protection & Social Care	57 494,45	111 458,90	51,58%	37 661,29	52,66%	39,32%

Source: Treasury Budget Exectuion Report.

Growing symptoms of quasi-fiscal deficit financing

Increasing expenditure commitments in social sector combined with problematic performance of major revenue sources, in the absence of significant borrowing opportunities, continue to result in hidden arrears on liabilities to private sector.

Wage arrears continue to grow. After a significant increase in May, wage arrears continued to slowly increase, reaching UAH 1.89 billion by 1 July 2010. The Government acknowledged the fact, but refused to explain its origins, calling the growing arrears "unfounded" and "surprising", given the economic recovery and explicit administrative pressures on regional authorities[8],[9].

No clear prospect for addressing VAT refund arrears. 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:

- **Actual stock of current arrears questioned by non-state observers.** While STA reported that VAT refund arrears decreased in June, reaching UAH 25-26 billion by 1 July[10], compared to UAH 27.3 billion by 1 June[11], these numbers were disputed by non-state observers. In particular, Ukraine's Federation of Employers estimates current arrears at UAH 30.4 billion (UAH 19.4 billion overdue), excluding around UAH 3-4 billion currently challenged in courts. The Federation claims that actual arrears are growing at UAH 2.4 billion a month in average[12]. These assessments were supported by an unofficial source in STA quoted by *Mirror Weekly*, who estimated current stock at UAH 34 billion or even higher[13].

- **Private sector increasingly concerned about administrative measures to collect VAT, including rejection of VAT declarations with refund claims.** June saw a surge in public statements on major difficulties faced by exporters because of the current situation with VAT refund arrears and alleging administrative pressures which STA exerts on private sector to deny refund obligations. This is, allegedly, achieved by refusing to accept tax declarations, delaying registration of declarations, and applying various measures such as intensified cross-checks to incline enterprises to contribute taxes in amounts established by STA internal plans. As a result, around 35 thousand declarations were rejected in May, and around 40 thousand – in June[14]. In the same month, the Ukraine's Federation of Employers submitted a letter to the President of Ukraine, explaining its view of the current situation as creating major risks for the country's economy, and asking for immediate resolution[15],[16].

- **VAT-bills will be issued with some delay and on smaller amount of claims than requested by exporters.** The Government's decision to restructure the current stock of accumulated VAT arrears is in the implementation stage, albeit with some delay (currently rescheduled to August-November). As discussed earlier, the policy, approved within the 2010 Budget in April, is to convert the stock of VAT refund arrears accumulated by 1 May 2010 into a new type of T-bills. During June, the Government processed the requests for restructuring it received from the VAT-payers with the view of eliminating potentially fraudulent claims. As a result, the original amount of claims (about UAH 17.7 billion submitted) was reduced to UAH 16.4 billion[17]. The Government repeatedly stated that VAT refund would become automatic starting from August, although it is not clear whether exporters would be routinely offered T-Bills instead of cash[18].

Government continues to spend at the cost of mandatory borrowing from exporters (via denying or restructuring its VAT refund obligations). Moreover, in trying to collect more VAT (which is the most important tax this year), the STA is reported to exert growing administrative pressures on businesses.

Central Government promising to bail out Kyiv's default on external municipal bonds. Kyiv's city administration revealed in June that the city's obligations on servicing and repaying earlier issued euro-bonds will peak in 2011-2012, requiring municipal authorities to allocate USD 450 million, which it finds potentially unaffordable. Ukraine's Ministry of Finance stated that it would totally support the city in ensuring timely repayment of the debts.[19]

Further distortions brewing: will mutual settlements be back to Ukraine's PFM?

VAT-bills create risks of re-emerging mutual-settlements in Ukraine's economy, which would be a significant threat to restructuring and growth. One of the significant downsides of converting Government's liabilities on VAT refund into VAT-bills under pressures of cash shortages is that it risks to re-create a dangerous circle of quasi-monetary fiscal transactions. To magnify this risks, in June, the media reported that Ukraine's chemical and metallurgical producers have postponed repayment of their depts to Ukraine's Naftogaz (amounting to UAH 5 billion of debt), hoping to repay them in future with VAT-bills instead of cash[20]. Such potential policy represents a typical case of a major mutual settlement, which is an extremely detrimental and unhealthy phenomenon for a country's public finance. Fiscal transactions in promissory notes, wechsels and barter suffer from a major problem with price valuation, as a result of which they are usually traded with significant discounts, create circles of mutual indeptedness between private businesses and public sector, and represent a significant threat to economic restructuring and growth[21].

Relocation of capital expenditure assignments towards running costs of central authorities without parliamentary approval

Earlier in the year, 2010 Budget Law already raised concerns over growing possibilities for the Government to re-allocate expenditures without Parliamentary approval. One of the provocative provisions in the 2010 Budget Law approved in April was Article 26, which allowed the CMU to re-allocate, "in exceptional cases", parliamentary-approved expenditures across lines of economic classification within individual programmes[22]. Same Article 26 also re-enforced CMU's right established by the Budget Code[1] (Article 23)[23],[24] to re-allocate parliamentary-approved expenditures between spending agents, although the Article had omitted the original formulation in the Budget Code which explains that such re-allocation is accepted only if the responsibilities/functions of one spending unit are legally transferred to another spending unit after approval of the Budget Law, which requires appropriate re-allocation of funds implying that transferred amounts would continue to be used on the same public functions, approved by Parliament.

In July, the Government resorted to this possibility, but in scale which exceeded any of the current legislative provision. As will be discussed in the next session, on July 17 the Parliament has sequestrated the current State Budget, cutting diverse range of expenditures by at least UAH 22,8 billion. However, while some expenditures were decreased, others were expanded. In particular, this amendment to the annual budget has created a brand new line under the Ministry of Finance called "State capital expenditures" in a size of UAH 2.4 billion. Two days after the Parliament approved this decision, on 19 July 2010, the CMU issued a Resolution No 597[25] which re-allocated UAH 647 million out of the UAH 2.4 billion approved for "State capital expenditures" under MoF to twenty other spending units, to be spent on programmes whose functions are entirely different from state capital expenditures. In other words, this transfer of allocation is hardly related to a transfer of respective responsibilities according to legislatively approved changes, as accepted by the Budget Code. Moreover, most of these programmes were exactly those which were sequestrated two days earlier (albeit the cuts were bigger than the compensation, and not all sequestrated lines were lucky to benefit from the Resolution No 597).

> *In July, the Cabinet of Ministers resorted to manual re-allocation of expenditures across spending units, without Parliamentary approval, and in violation of the currently effective Budget Code. This was done in a highly biased and opaque way, and on purposes related to running costs of central authorities and protection of civil order.*
>
> *This re-allocation of expenditures also essentially implied a partial re-consideration of the earlier expenditure cuts mandated by the IMF.*
>
> *Such policy of allocating public funds is not only harmful to overall transparency of PFM but is also a step-back from the idea of budgeting oriented at strategic results and policy objectives.*

The Government has re-allocated funds in a highly biased way, including luxury running costs of central authorities (such a reconstruction of spa resorts) and increased protection of civil order. The new set of allocations is described in Table 3.This breakdown is strikingly biased (e.g. for some reason it supports regional administration in only one of the oblast (Khmelnytska)), openly directed at extra funding to running costs of central authorities including luxury services such as improvement of specific spa facilities, and, most worryingly, includes several programmes of increased support to military capacities and protection of civil order.

[1] In our current understanding, this Article of the currently effective Budget Code was preserved in the new edition of the Budget Code approved on 8 July 2010 to become effective next year. However, some of the analysis published in the media claim otherwise (*Rada Improves the Budget Code*, Ukrainian News, 08 July 2010, http://www.fisco-id.com/?module=news&action=view&id=6389). More detailed analysis of this issue will be offered in our in-depth analysis of the new Budget Code to be conducted for future reports.

Table 3. Re-allocation of “State Capital Expenditures” across other spending units

Spending unit	Programme	UAH Thousand
State Capital Expenditures under MoF: overall amount allocated by Parliament*		**2,375,883**
State Capital Expenditures under MoF: funds re-allocated by CMU to other programmes (total)		**645,618**
Including:		
Verkhovna Rada		**53,521**
	Legislative activities of the VR	*53,085*
	Support services to activities of the VR	*436*
State Directorate of Affairs		**4,909**
	Support services to activities of the President of Ukraine, Presidential Administration, and other state authorities	*186*
	Financial support of spa facilities of the State Directorate of Affairs	*4,524*
	including design and construction of a building for a commandant service on the territory of the spa resort “Koncha Zaspa” and procurement of equipment for the needs of this building	*4,000*
	In-patient medical services to VR MPs and senior management of state authorities	*199*
State Judicial Administration		**11,681**
	Local commercial courts	*204*
	Appeal court of Ukraine and appeal courts	*454*
	Local courts	*1,761*
	Commercial appeal courts	*459*
	Administrative appeal courts	*3,030*
	Local administrative courts	*5,773*
Ministry of Internal Affairs		**2,008**
	Protection of civil liberties, society and state from illegal infringements; protection of civil order.	*1,968*
	Participation of internal military forces in protection of civil order, fighting criminals, and convoy of arrested and convicted during trials	*40*
Ministry of Defense		**936**
	Medical, rehabilitation and spa services to military servicemen	*736*
	Reforms and development of Ukraine's Military Force	*200*
	International peacekeeping operations	*0*
Ministry of Education and Science		**124,978**
	Textbooks for higher education and pre-school facilities	*90,000*
	Implementation of Europan Cherter of Regional Languages and Minorities	*692*
	Financial support to propaganda of Ukraine abroad	*1,286*
	Procurment of school buses for rural areas	*33,000*
Ministry of Labour & Social Policy	Procurement of cars for disabled and Chornobyl victims	**85,500**
Ministry of Industrial Policy	Life-support to KryvyiRig oxidized ores mining and processing plant	**1,874**
Ministry of Reg.Development & Construction	Housing to disabled veterans of II World War	**140,400**
Ministry of Family, Youth, and Sports	Support to Sports of Higher Achievements	**136**
Ministry of Finance	Training and re-traing services of the National University of the State Tax Administration	**14**
State Committee for Nationalities & Religions	Placement of Crimea Tatars and other nationalities deported from Ukraine	**5,682**
State Border Service	Construction and reconstruction of infrastructure of Ukraine's Border Service	**42**
Secretariate of the VR Human Rights Ombudsman	Parliamentary control over maintenance of constitutional rights and freedoms	**2,124**
Accounting Chamber	Management in the area of control over state budget execution	**2**
National Academy of Medical Sciences	Reconstruction of buildings (including child cardio centre) and procurement of equipment for the V.K. Gusak Institute of Emergency Surgery (Donetsk).	**4,800**

Foreign Intelligence Service	Intelligence in the area of state security and special protection of state representatives abroad	3
National Agency for Euro-2012	Organisational support to Euro-2012	**7,000**
National JSC "UkrAgroLeasing"	Expanding statutory fund of the JSC "UkrLeasing" to purchase equipment	**200,000**
Khmelnytska Oblast State Administration	Carrying out executive power in Khmelnytska Oblast	**10**

** Allocation according to 2010 Budget Law approved by the Parliament with amendments introduced by sequestration on 17 July 2010*

Source: CMU Resolution "On Certain Issues Related to Execution of the Law of Ukraine 'On State Budget of Ukraine for 2010'", No 597, of 19 July 2010.

IMF as a driver of change in fiscal policies

Stand-by agreement with IMF approved with first tranche available immediately

Prolonged negotiations over renewal of IMF stand-by financing for Ukraine culminated with an agreement reached at staff-level on 3 July[26] and approved by IMF Management and the Executive Board on 28 July[27] to allocate SDR10 billion (about USD 15.15 billion) loan to support Ukraine's economic adjustment and reform programme. Out of this amount, about USD 2 billion would be directed to the State Budget, with about one billion available immediately[28]. In response, the Government agreed to a series of reform objectives described below, with the first measures approved already during July. Release of further funds would be subject to continued consultations over Ukraine's future progress in implementing agreed reforms, scheduled for September/October – that is, before the upcoming elections[29].

IMF conditions and Ukraine's response-measures implemented in July

Overview

The new IMF stand-by financing is strictly conditioned to restoration of micro-fiscal stability, including consolidation of public finance and increasing robustness of monetary framework. This includes:

Priority area	Requirement as summarised by IMF[30]	Comment and summary of respective immediate policy measures in July
Consolidation of public finance (including Pension and Tax Reform):	"Restore confidence and fiscal sustainability by reducing the general government deficit to 3.5 percent of GDP in 2011 and 2.5 percent in 2012 and setting public debt firmly on a downward path below 35 percent by 2015".	While IMF conditions were very clear on the deficit target, expectations on Pension and Tax Reform were agreed as general guidelines[31]. Immediate actions on this priority in July were represented by sequestration of the budget; although the Government had not cut the debatable increases in social expenditures. The Government's plans for pension reform (including increased pension age) have not yet resulted in actual measures, although it ensured that the Pension Fund budget was approved. The tax policy initiatives currently remain counter-cyclical and distortive.

Reforms in energy sector:	"Initiate reforms to modernize the gas sector and eliminate Naftogaz's deficit starting from 2011, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. A new gas law adopted in early July will improve efficiency through unbundling production, transit, and distribution to end-users, and allowing new entrants and investment into the domestic gas sector;"	Immediate measures to start reforms in energy sector included: – the gas tariff increases (described below); – introduction of a national price regulation for public utility services (described in the previous report); – approval of the Naftogaz budget (details and reference) (to be analysed in the next report);
Rehabilitation of the banking system:	"Restore and safeguard banks' soundness through completion of recapitalization plans by end-2010 and strengthened supervision",	Detailed analysis of the banking system reforms in outside the scope of this report.
Flexible exchange rate regime and independent central bank:	"Develop a more robust monetary policy framework focused on domestic price stability under a flexible exchange rate regime to be implemented by a more independent National Bank of Ukraine."	As an immediate measure to this priority, Ukraine approved a new Law on NBU Activities[32], which expands its independence and strengthens its capability to ensure price stability within a flexible exchange rate regime[33],[34].

<u>Details on sequestration of the State Budget</u>

Change in budget totals fully coincided with IMF requirements. The key requirement of the resumed IMF programme was reduction of fiscal deficit 4,99% of GDP. On 17 July the Parliament approved an amendment to the annual Budget[35], which decreased its deficit by a respective UAH 3.65. This was achieved by cutting expenditures by UAH 17 billion and decreasing both forecasted revenues (by UAH 13.4 billion) and forecated privatisation proceeds (by UAH 3.65 million) (Table 4).

Most of the approved changes reflected actual deviations of current execution from annual budget plan approved in April (mostly crowding out of capital expenditures by running costs). Table 4 sheds light on the following aspects of these approved changes to the Budget:

- **The revenue cuts were made on current poorest performers – VAT and privatisation.** The biggest cut on the revenue side is VAT, whose forecast decreased by UAH 14.3 billion (including an increase in expected cash refunds by UAH 2.5 billion). The second essential decrease on the revenue side is privatisation, reduced by UAH 3.65 billion.
- **Revenues earmarked for capital investment shifted to the general fund.** All other changes on the revenue side have not affected overall budget envelope, but shifted revenues from special fund earmarked for particular expenditures (roads and military expenditures) towards the general fund (making these revenues more accessible for general use). Such shifted proceeds included parts of excises, imports taxes, proceeds from sales of arms, and domestic borrowing.
- **Some expenditures were actually increased.** As was already mentioned in previous section, while most expenditures were decreased, others were expanded – by at least UAH 4.8 billion (mostly central authorities).
- **The "sequestration" law created a buffer UAH 2.4 billion line for manual re-distribution by CMU.** As was also mentioned earlier, a major increasing programme was a totally new line – State capital expenditures under the Ministry of Finance, to which the amendment has allocated UAH 2.4 billion. We discussed that UAH 0.6 billion out of this amount was re-allocated back to many of the sequestrated agencies by a CMU Resolution two days later, in violation of the Budget Code.

- **The biggest cuts were in lines which have been poorly funded already.** The biggest decreased programmes were those whose financing has already been significantly behind schedule in the first half of the year. This included, primarily, Stabilisation Fund (whose expenditures were 16% of annual plan in January-June 2010), and a variety of capital investment expenditures under various spending units.
- **Cuts in transfers to Pension fund to be partially compensated by extra contributions from private entrepreneurs.** A UAH 3 billion cut in transfers to Pension fund was paralleled by a simultaneous approval (within the same law) of changes to the Pension legislation, introducing extra contribution to the Pension fund on top of the single tax for private entrepreneurs.
- **Unclear strategy on financing construction of roads.** The cut of expenditures on roads was paralleled by a statement in the Government's Explanatory Note to the proposed amendments that sequestration of the Budget would open a possibility for Ukraine to borrow additional UAH 3.7 billion from other international sources to finance construction of roads and preparation to Euro-2012.

Table 4. Amendments to 2010 Annual Budget in July (UAH billion)

	Total	General Fund	Special Fund	Comment
Total Revenues	**-13,4**	**-8,7**	**-4,7**	
EPT	-0,5		-0,5	
VAT	-14,3	-12,5	-1,8	
VAT on domestic goods	*-4,8*	*-4,3*	*-0,5*	
VAT refund (cash)	*2,5*	*2,5*		
VAT on imported goods	*-5,7*	*-5,7*		
Excise on domestic goods		1,0	-1,0	Taxes and fees from sales and imports of oil-products and vehicles originally earmarked for road maintenance
Excise on imported goods		0,7	-0,7	
Import Fee		0,2	-0,2	
Proceeds from Sales of Arms		2,0	-2,0	Originally eamarked for MoD expenditures
Overal Deficit (/Financing)	**-3,65**	**5,1**	**-8,75**	
Domestic Borrowing		5,1	-5,1	
Privatisation	-3,65		-3,65	
Total Expenditures	**-17,0**	**-3,6**	**-13,5**	
Expenditures increased*	4,8	4,3	0,5	
including:				
"State Capital Expenditures"	2,4	2,4		Re-allocated back to sequestrated lines on 19/017
Higher agricultural education	1,0	0,7	0,4	
State Property Fund	0,2	0,2		
Extra costs of local elections	1,0	1,0		
Other central authorities	0,2	0,1	0,1	
Expenditures decreased*	-22,8	-0,5	-20,4	
including:				
Stabilisation Fund	-8,8		-8,8	Not performing anyway (16% exection on Jan-Jun)
Transfer to Pension Fund	-3,0		-3,0	Paralleled by increased pension contributions requested from individual entrepreneurs
Road maintenance	-1,8		-1,8	New loans (UAH 3,7 billion) expected on roads and Euro-2012 if IMF grants the stand-by
Repayment of energy arrears by extracting plants	-0,9		-0,9	
Agency for Euro-2012	-3,1		-3,1	Part of these and other, smaller, sequestrated programmes was later compensated by manual re-allocation of funds by the CMU Resolution No 597 of 19/07/2010
Additional transfers to local budgets	-0,5		-0,5	
Central Ministries (Defence, Agriculture)	-3,6	-0,1	-1,6	
Medical Research	-1,1	-0,4	-0,7	

** Smallest identifiable amount*

Source: 2010 State Budget and amendments

Details on increase in gas tariffs and expanded compensatory benefits

On 13 July 2010, Ukraine's National Commission for Regulation of Energy approved retail price benchmarks for consumption of gas by population and two children's recreation facilities, increasing them by 50% starting from 1 August 2010[36],[37]. By some assessments, this change is likely to increase prices of services for water supply and heating by around 25%[38]. To compensate the increase to the poorest, the Government also expanded social benefits for consumption of housing and utility services by low income groups by decreasing respective income threshold (from now on, families would be eligible if their expenditures on utilities would exceed 15% of household income, and 10% in cases of disabled and pensioners[39].

Most of the changes introduced into Ukraine's PFM legislation in June-July was strongly requested by international lenders, especially IMF. At the same time, in terms of the mandated budget cuts, the Government did not amend the budget in a way which would tangibly change its current approach to spending. Most social programmes are preserved, and disguised steps are taken to expand current spending even further.

Developments with key PFM reforms

During July, the Government continued to pursue changes in the country's several fundamental legislative documents:

Tax Code: debates continue after controversial first reading

In the previous report, we discussed the details of Parliamentary consideration of a draft Tax Code, which was voted (on 17 June) in a draconian edition which appeared significantly different from earlier officially submitted Governmental draft. This episode was heavily criticised by most observers, generating hundreds of requests for amendments within the next weeks. During July, this process continued, with more stakeholders joining the key lines of protest (also described in the previous report). Notably, the new comments which emerged in July included:

- Statement by the WB with the view that Ukraine "should not hurry with approval of the current version of the Tax Code",[40]
- Statement by the President Yanukovych, saying that he would not want to sign the current edition of the Tax Code, [41]
- Statement of the Party of the Regions, saying that it does not support the current edition of the Tax Code,[42]
- Number of comments from private sector and civil society growing from hundreds to thousands.[43]

The Tax Code is still in the making, after the controversial parliamentary consideration last month. By now, all stakeholders – including the Party of Regions and the President – have distanced themselves from the draconian draft submitted by the Government for the First Reading in June.

The Government promised to facilitate debates on the matter, in particular by publishing the refined draft in the central newspaper "Uryadovyi Kurier" within the following weeks[44].

New Budget Code approved

On 8 July 2010, VR approved a new edition of Ukraine's Budget Code[45]. Given the scope and importance of this document for the country's PFM, its detailed analysis will be offered in future reports.

A new Law on Procurement came to effect

As mentioned in earlier reports, in June this year VR approved a new Law of Ukriane on Procurement[46]. In this report, we offer in-depth analysis of this document, provided in Annex 1.

Our argument in this Annex is that while the new Law was significantly improved in comparison with the version voted in February to the dismay of international observers, it remains highly problematic. In particular, the new PPL have eliminated some of the biases in favour of domestic providers, improved definitions, requirements to confidentiality, and implemented some of the EC/WB recommendations towards complaints procedure and Appeal Agency. At the same time, the Law remains discrediting in relation to small procurement, a lot of the procedures are too cumbersome (such as excessive publication requirements) and a lot of definitions are either vague or lacking. It is also notable that the Law leaves regulatory responsibilities fragmented across a number of central agencies and that its coverage of types of procurement is not comprehensive.

A new Law on Procurement has incorporated a lot of earlier recommendations by international observers. However, it still remains problematic. A detailed analysis is provided in Annex 1.

Analysis in the Annex 1 points out that while the new Law represents an improvement for the possibilities of social contracting in Ukraine, the above listed weaknesses will continue to represent obstacles for competitive procurement of social services, including for procurement of services from non-state providers.

Annex 1. A Brief Analysis of the Public Procurement Law

Background

For a long period time, the procedure for public procurement has been regulated by the Provisional Regulation on Public Procurement, adopted by the Government on March 20, 2008. On May 12, 2008 the Government submitted to the Parliament the draft Law on Public Procurement (PPL). The final version of the draft law, that had to be adopted in the second and final reading by the Verkhovna Rada, was prepared by the Parliamentary Committee on Economic Policy on 15 October 2009. The European Commission and World Bank provided the government and the parliament with extensive comments on this draft Law, based on the Directives and international standards in the field of procurement regulation, as well as on experience of European countries.

The EC and WB recommendations

In opinion of the EC and WB, the main problems with the draft law were connected to:

(1) the scope of regulation, since utilities and some other items were excluded from the application of the law;

(2) state regulation and control – the draft law did not provide for a clear separation of the powers of different state bodies entitled to regulate and exercise control over procurement;

(3) scope of powers of the Authorised Agency, which, according to the EC and WB, had to broadened to include definition of the policy, drafting and implementation of the relevant legislation, dissemination of good practices pertaining to public procurement, etc.;

(4) composition of the Appeals Agency (according to the draft Law, the Appeals Agency had to be composed of the representatives of a number of Ministries, "independent" experts) – the EC and WB stressed that the Appeals Agency had to be independent from the executive branch, any political interference with its activities, influence of contracting entities and economic operators;

(5) complaint review mechanisms, introduced by the draft Law, - in opinion of the experts those mechanisms were not in line with the Directives;

(6) excessive publication requirements and time limits, which seemed to be burdensome for all parties engaged in public procurement and, according to experts, had to be significantly simplified;

(7) narrow qualification criteria and lack of guidance on technical and financial capacity of the bidders, as well as lack of practicability of the award and evaluation procedure;

(8) absence of the regulation of "small" contracts, i.e. the contracts below the thresholds (UAH 100,000 for goods and services and UAH 300,000 for works); and

(9) application of domestic preference in bidding (a number of measures aiming to support domestic bidders were also introduced by the Government's Provisional Regulation on Public Procurement; the relevant provisions of the Regulation andd draft Law did not correspond with WTO practices).

In addition, the EC and the WB provided a fair number of recommendations pertaining to separate articles of draft law. In particular, they recommended:

- to include definitions of corrupt, fraudulent, collusive and coercive practices into the list of notions reflected in the Article 1 of the draft law;
- to change the provisions requiring not less than three bidders as a precondition of procurement;
- to define the term "economically advantageous proposal" more precisely;
- to restrict a number of entities empowered to control procurement process to authorized agency and single entity, such as the Accounting Chamber;

- to supplement the regulation of the Appeals Agency with some new provisions aiming to ensure its independence and professionalism of its staff;
- to ensure confidentiality during the procurement process until contract award;
- to review the complaints procedure, in particular by lifting limits concerning who may submit complaints, by permitting submission of anonymous complaints, by separation of powers of procuring entity, appeals agency and the court in terms of appeals consideration, and by defining standstill period for entering the contract;
- to restrict the validity period in the tender documents from 120 to 90 days;
- to clarify and review some of the procurement procedures (in particular, as concerns two stage procedure, restricted tendering).

Compliance of the final version of the PPL with the EC/WB Recommendations and European Standards/Good Practice

Initially (in February), the majority of the above recommendations were not taken into account by the Verkhovna Rada. On February 11, 2010, the parliament adopted the Law on Public Procurement in the second and final reading. The Head of Operations of the EU Delegation to Ukraine and the World Bank Regional Director for Moldova, Belarus and Ukraine recommended the President to veto the adopted law on the grounds that it did not comply with the international standards and good practice pertaining to public procurement. The President vetoed the law and returned it to the Parliament for reconsideration. The Verkhovna Rada adhered to a number of proposals of the head of state, and adopted a new version of the PPL law, that then was signed by the President.

The final version of the Law approved in June does reflect a number of EC/WB recommendations. In general, a number of recommendations of the World Bank and European Commission were reflected in the final version of the PPL. For example,

- domestic preference in bidding was cancelled,
- some definitions in Article 1 of the PPL were brought into correspondence with the recommendations of the EC/WB,
- the number of required bidders was limited to two,
- the representatives of the parliamentary committees, ministries, and independent experts were excluded from the Appeals Agency;
- confidentiality during a procurement process was ensured,
- the complaints procedure was reviewed and partly brought in correspondence with the EC/WB recommendations,
- validity period for tender documents was limited to 90 days as recommended, prequalification in restricted tendering was made mandatory.

However, a number of important provisions have not been changed, providing the grounds for critical assessment:

- **“Small” procurement (i.e. procurement below the established thresholds) is not regulated either by the PPL, or by any other law.** It should be mentioned in this regard that in a number of European states procurement laws define a list of certain principles with which “small” procurement must comply. The approach of the Ukrainian PPL provides the procuring entities with a wide margin of discretion on deciding on “small” procurement, which might have a negative impact on transparency, competitiveness and effectiveness of the use of public funds.
- **Same level of complexity regardless of contract value.** In most of the EU states, the following rule applies for public procurement: the smaller the value of a contract, the simpler the procedure for procurement. Therefore, under each type of procedures different levels of complexity are introduced,

depending on a contract value. Such an approach is also reflected in the Directive 2004/18/EC. In contrast, in Ukraine all the procedures for procurement exceeding the established threshold (100,000 for goods and services and 300,000 for works) have the same level of complexity, regardless of the contract value. This approach might be burdensome for those who are engaged in procurement process.

- **The publication requirements set forth in Article 10 are still excessive and should be simplified as has been recommended by the EC/WB.** Apparently, if a value of a contract does not exceed a certain threshold (which should be defined in the PPL), the legal requirements regarding publication should be less strict in comparison with respective requirements for procurements exceeding threshold.
- **Independence of the Appeals Agency should be strengthened even further.** Even though the regulation of the Appeals Agency (board of appeal at the Antimonopoly committee) was improved in comparison with the draft PPL, the relevant provisions of the PPL still require further amendments seeking to ensure its independence from both the head of the Antimonopoly Committee, other authorities and economic operators. In this connection it should be mentioned that Law does not define the term of office of the members of the Appeals Agency, the grounds for their discharge from the office, professional requirements to the members of the Agency and so forth. In contrast, in a fair number of European states the mode of operation of the Appeals Agencies are defined in seperate articles or even chapters of the PPLs.
- **Definitions are still weak.** There is no clear definition of corrupt, fraudulent, collusive and coercive practices in the Ukraine's PPL, and the definition of "affiliated persons" or "related parties", as suggested in Article 1 of the Law, is rather narrow. It is advisable to introduce the term "conflict of interest" in the Law, in order to prevent members of the tender committees, Appeals Agency from being directly or indirectly engaged into corrupt practices. The definition of works and services is still not harmonised with the Directives, which does not go in line with the previous recommendations of the EC/WB.
- **Coverage of types of procurement is not comprehensive.** Certain types of procurement, listed in Articles 2-3 and 2-4, are excluded from the regulation of the PPL, being subject to regulation by special laws (as concerns Article 2-3, for instance). It should be noted in this regard that WB/EC recommended to apply the provisions of the PPL to the procurement of the items listed in Article 2 until the time when the specific laws governing their procurement come into force.
- **Continued fragmentation of regulatory responsibilities.** Even though Article 7 of the PPL has been improved, it still stipulates that procurement are regulated and controlled by the Authorized Agency and "other bodies within the scope of their powers". Among these bodies are the State Treasury, the Accounting Chamber, the Main Control Department (the body of internal audit within the executive), the State Committee on Statistics, and even banks. In other words, the parliament did not take in account the relevant recommendations of the EC/WB suggesting that only authorized body and single entity (the Accounting Chamber) should be entitled to exercise control over procurement.
- **Weaknesses in procedures.** The list of procedures for procurement and their regulation, as envisaged in the PPL, does not fully comply with the Directive 2004/18/EC, in particular as concerns negotiated procedures (in Ukrainian Law – "single-source procurement"), restricted procedures (under Ukrainian PPL, restricted procedure is a secondary to the open procedure, while in a number of European states open and restricted tenders are the main procedures for procurement). Design contests are not regulated by Ukrainian PPL. The procedure of "price requesting", provided for by the Ukraine's PPL, is not defined in the Directive as a separate procedure; in most European countries the analogous procedure governs procurement below the established threshold.
- **Qualification criteria are too vague**. The qualification criteria listed in Article 16 of the Law, are general and should be specified and reformatted as recommended by the EC/WB. It is important to note that in many European states different criteria (such as financial, technical capacity, legal criteria etc.) are defined in separate articles of the PPL (or even in special act of the Government, for instance, in Poland) in order to narrow margin of discretion of the procuring entity in application of the relevant legal provisions.
- **The complaint review mechanism still lacks clarity.** The complaint review mechanisms (Article 18 of the PPL), though partly brought into correspondence with the EC/WB recommendations, are still not clear and should be defined more precisely. For instatance, standstill period, as well as the links between procuring entity, Appeals Agency and courts should be clarified; the complaints should be primarily reviewed by the procuring entities, rather than by Appeals Agency.

Possible Impact of the PPL on Social Services Provision

In general, the Law is expected to have a positive impact on social services provision, owing to:

- **more transparent and competitive procedures for procurement** (in comparison with the Provisional Regulation on Public Procurement), in particular as concerns restricted, two stage procedures and price requests;
- **broader definition of the "public funds"** in comparison with the Provisional Regulation;
- **limited list of items that cannot be procured under the PPL;**
- **providing for the possibility of centralised (coordinated) procurement** both at central, regional and local levels (Article 13 of the PPL).

However, many of the new PPL's aspects remain problematic for effective procurement of social services. In particular:

- Provisions of the Law that have been already analysed above and do not go in line with the EC/WB recommendations, may to certain extent reduce the positive impact of a new regulation on social services provision.
- It should be also noted that the Law does not amend the Law on Civic Associations, therefore a majority of the existing problems faced by NGOs as social services providers will remain unsolved. The requirement on bid security in amount of 1% (for works) and up to 5% (for goods and services) which can be introduced by a procuring entity under Article 24 of the PPL (though corresponds it to the EU directives), might be problematic to some NGOs providing social services, due to the lack of necessary funds for securing the bids.

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