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

- Analysis of unexplained variation in annual plan figures quoted in the Treasury budget reports, which leads to improved official indicators of revenue performance and implies an annual deficit target at around 7.19% of GDP, rather than 5.14% of GDP agreed with IMF in July;
- Baseline revenue comparisons, which reveal that overall revenues in January-September 2010 were about 4% below schedule, with most taxes continuing to significantly underperform (the poorest performer being still VAT, which was 13.42% below period baseline);
- Overview of recent attempts to reduce VAT refund arrears in response to agreement with IMF;
- Comparisons of real expenditures to spending in same period of last year, which show that overall spending is growing given the increased social payments and transfers throughout the year, while investment-intensive programmes remain far below 2009 levels. Notably, the Government has restructured Pension fund arrears to coal mining and strategic enterprises;
- Overview of key policy initiatives, including a new indirect subsidy to Ukraine's Naftogas and plans to limit the coverage of Public Procurement Law by excluding procurement to Agricultural Fund and State Reserve.

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Acronyms and Abbreviations

CMU	Cabinet of Ministers of Ukraine
CPI	Consumer Price Index
EC	European Commission
EPT	Enterprise Profits Tax
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
MEFP	Memorandum of Economic and Financial Policies
NBU	National Bank of Ukraine
PFM	Public Financial Management
PIT	Personal Income Tax
PM	Prime Minister
SDR	Special Drawing Rights
UAH	Ukrainian Hryvnia
UNICEF	United Nations Children's Fund
USD	United States Dollar
VAT	Value Added Tax
VPM	Vice Prime Minister
VR	Verkhovna Rada
WB	World Bank

Budget results through September 2010

Consolidated budget deficit and financing

The latest available figure for deficit as % of GDP is for the 2nd Quarter 2010 (5.39%) (since GDP statistics is released later than budget execution data). Overall deficit of the consolidated budget in January-September 2010 reached UAH 47.5 billion (state budget deficit for the same period was at UAH 52.8 billion) (see Table 1 and Figure 1). Comparing these amounts to GDP is not yet possible since official statistics on GDP is normally released at much later date. Preliminary estimates of deficit as percentage of GDP quoted in official statements provide an uncertain picture. In early October, PM Azarov stated that budget deficit at the time was around 4.5% of GDP [(1)]. The latest available GDP statistics is for the 2nd Quarter of 2010, at which time consolidated public deficit was equal to 5.39% (see Table 1 and Figure 1).

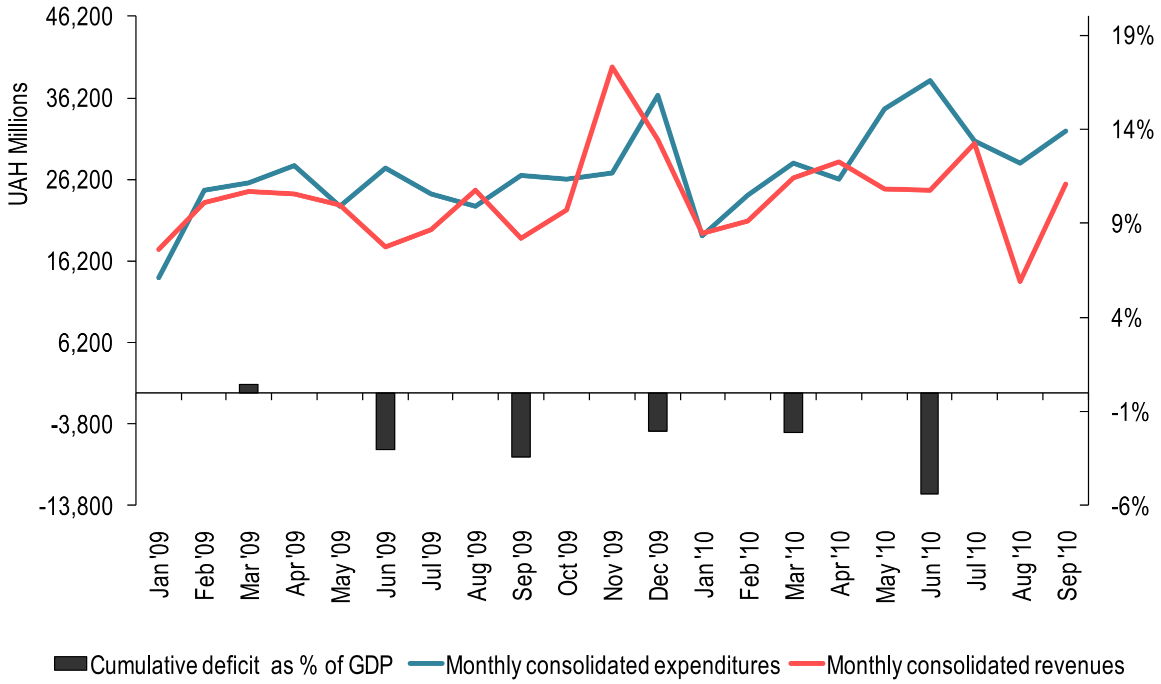
Table 1. Consolidated Budget Totals through September 2010

	Annual budget plan*	Actual budget totals	
	2010	2010	2009
Latest monthly comparisons		**Jan-Sep 2010**	**Jan-Sep 2009**
Expenditures	395,039,658,551	262,453,038,079	217,523,222,731
Revenues	317,147,692,323	215,301,631,711	195,010,985,205
Deficit	-77,891,966,228	-47,151,406,368	-22,512,237,526
% of GDP**	-7.19%	n/a	n/a
Latest quarterly comparisons		**Q2 2010**	**Q2 2009**
% of GDP		-5.39%	-3.04%

* Based on the latest Treasury Report

** Annual consolidated budget plan based on latest Treasury Report; GDP forecast based on IMF projection in Country Report No. 10/262

Figure 1. Consolidated Budget Totals through September 2010



Keeping annual consolidated deficit within 5.5% in 2010 is one of the core conditions agreed within the IMF stand-by support programme. General government balance, defined by the IMF as including central government, local governments and social funds, at a level below 5.5% of GDP for 2010, was one of the core benchmarks accepted by the Government as a condition to a SDR10 billion (about USD 15.15 billion) agreed with the IMF in July 2010 (within the Fiscal Policy reform agenda of the MEFP [(2)]). In particular, as a prior action for the stand-by agreement, the Government approved a supplementary budget which reduced annual target for general government deficit (not including Naftogaz) to 5.14% of GDP. Maintaining the deficit within this annual target is therefore critical for accessing further tranches of the loan.

In August-September 2010, revenue and expenditure execution were reported against changed numbers of annual plan, according to which projected annual deficit is actually 7.19% (rather than 5.14% voted in July). We have already discussed in earlier updates that official figures of annual plan execution for both revenues and expenditures, released by the State Treasury in its monthly reports, differ throughout individual months of the year [(3)]. In particular, it is notable that in August and September of 2010, Treasury Report have relied on annual plan figures where total consolidated revenue plan was decreased (by about 4%), total consolidated expenditure plan was increased (by about 3%), and as a result the projected deficit figure was expanded by 40% to 7.19% of the annual GDP forecast (see Table 2). These changes are difficult to explain, given that the Parliament has not considered any amendments to the annual Budget Law throughout this period (after the sequestration in July). However, lower figures of annual revenue plans obviously improve reported indicators of current revenue performance.

Table 2. Annual Budget Plans Quoted in the Monthly Budget Execution Reports by the State Treasury

	Annual Consolidated Budget Plan in Treasury Reports*			Deficit as % of GDP projection agreed with IMF in July**
	Revenues	Expenditures	Deficit (=Exp-Rev)	
May-10	311,448,852,068	348,931,167,589	37,482,315,521	3.46%
Jun-10	342,170,009,432	400,335,991,350	58,165,981,918	5.37%
Jul-10	329,446,571,489	385,115,398,315	55,668,826,826	5.14%
Aug-10	313,897,415,140	390,546,168,594	76,648,753,454	7.08%
Sep-10	317,147,692,323	395,039,658,551	77,891,966,228	7.19%
% change between Jul and Sep 2010	-3.73%	2.58%	39.92%	

* State Treasury Monthly Budget Execution Reports

** IMF projection in Country Report No. 10/262

Concerns over feasibility of maintaining deficit were raised by the Opposition. References to emerging problems with the budget balance were made by representatives of Opposition parties during October. In particular, ex-Minister of Finance V.Pynzenyk estimated that annual deficit result will reach 10% of GDP [(4)]. Similar concerns were voiced by representatives of BYUT at Shadow Cabinet meetings, estimating a revenue shortfall leading to extra annual deficit at UAH 20 billion or about 2% of GDP [(5)].

Consolidated budget receipts

Total revenues have recovered during September from a dramatic fall in August, but they are still about 4% lower than baseline projections for the period. Overall total revenues of consolidated budget (general and special funds combined) in January-September 2010 were about the same as last year (in real terms), but 3.87% behind current schedule, as shown in Table 3. The poorest performer is still VAT. Cumulative receipts from this tax since the beginning of year were 13.42% below baseline projections for the period, and 9.12% lower than in the same period of last year, in real terms. However, almost all other taxes (except from EPT) are also collected much slower than planned.

Table 3. Consolidated Revenue Execution in January-September 2010 (UAH Millions)

	Nominal actual revenues in Jan-Sep 2010	Comparisons to plan		Comparisons to baseline		Comparisons to same period of 2009	
		Annual plan (for Jan-Dec 2010)	Actual revenues as % of annual plan	Baseline projection (Jan-Sep 2010)	% Difference of actual over baseline	Nominal actual revenues in Jan-Sep 2009	% Change in real terms
Total Revenues	**215,301.63**	**317,147.69**	**67.89%**	**223,967.19**	**-3.87%**	**195,010.99**	**0.92%**
Value Added Tax	55,743.23	88,292.50	63.13%	64,380.22	-13.42%	56,027.47	-9.12%
Personal Income Tax	36,216.32	51,845.77	69.85%	37,609.41	-3.70%	32,255.93	2.74%
Enterprise Profit Tax	27,469.29	40,460.97	67.89%	26,976.70	1.83%	23,727.48	5.83%
Excise Taxes	20,456.76	30,378.87	67.34%	21,877.00	-6.49%	14,892.77	26.05%
Land Tax	7,063.70	10,085.83	70.04%	7,351.80	-3.92%	6,160.57	4.94%
Import Duty	5,828.78	8,290.00	70.31%	6,136.99	-5.02%	4,584.20	16.25%

Source: Treasury Budget Exectuion Report.

Accounting Chamber estimated that revenue of the general fund of the state budget in Jan-Sept 2010 were 4.8% below schedule and revealed that UAH 14.5 billion of raised taxes were collected in advance. On 29 October, Ukraine's Accounting Chamber issued a statement on its analysis of budget execution for 9 months, saying that the level of actual revenues and expenditures is low. In particular, revenues of the general fund of the state budget in January-September were 4.8% below period baseline[i], even though they included UAH 14.5 billion of taxes and duties collected in advance [(6)].

The recent months (August and September) were notable by the attempts of the Government to reduce the stock of accumulated VAT refund arrears to reach an indicative target of UAH 3 billion agreed with the IMF. A ceiling on VAT refund arrears for the remainder of 2010 was a specific commitment signed by the Government as a condition to a SDR10 billion (about USD 15.15 billion) agreed with the IMF in July 2010 (within the Fiscal Policy reform agenda of the MEFP [(2)]). Under the MEFP, the Government committed to "ensuring the payment of all VAT refunds accruing in the remainder of the year in full & on time and not accumulate any arrears during 2010" (with an operational ceiling at UAH 2 billion), which would be one of the prerequisites for release of further tranches of the loan. In particular, the stock of arrears, in the IMF definition, had to be reduced to UAH 3 billion by September and fully repaid by end of year.

The stock of VAT refund arrears which the Government committed to repaying in July MEFP was estimated by IMF at at least UAH 24.5 billion, of which UAH 16.4 billion were planned for restructuring in bonds. Examining VAT refund arrears is difficult because there is practically no official data on their stock, composition and changes, including amounts and nature of reported reductions. An additional challenge is lack of consistent definitions of VAT refund arrears data quoted by various sources. Some of the components of these data available in public domain are described in Table 4. It particular, it shows that in terms of co-operation with the IMF, existing stock of arrears by July 2010 was defined as at least UAH 24.5 billion. Of this amount, UAH 16.4 billion accumulated by the end of last year was indicated as those which would be restructured by VAT bonds.

The Government reports that it achieved agreed September targets on VAT refund arrears reduction, but there is no data in public access to analyse these figures. In early October 2010, the Government made several official statements reporting that it had reduced VAT refund arrears to UAH 3 billion and is determined to fully repay these by end of year. Interviews by key officials declare that part of the stock was repaid in cash, while other components were reduced by alternative measures whose nature is unclear from interviews (these includes "non-cash payment", "settlement against future periods" and "deeming as fictitious"). (see Table 4). As we discussed in our previous report [(3)], it is indeed likely that significant amounts of VAT were refunded in August, given that overall during this month cumulative amounts of VAT collected since the beginning of the year had decreased rather than increased (see Figure 2).

[i] Unlike figures quoted by the Accounting Chamber (which focus on the general fund of the State Budget), comparisons in this report are provided for the Consolidated Budget totals (general and special funds).

Figure 2. Value Added Tax Performance during 2010 (UAH Millions)

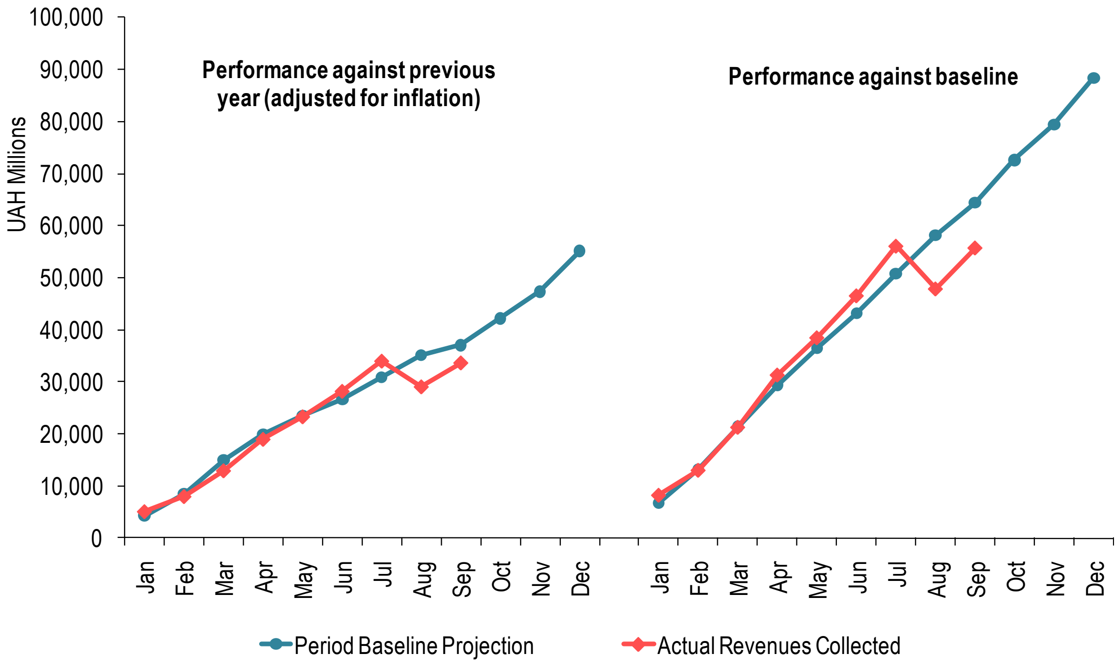


Table 4. Components of VAT refund arrears during 2009-2010, on which data was available in public sources

Types of VAT Refund Arrears	Disclaimer on data source	**UAH Billions**
Known components of VAT refund arrears during 2009-2010		
Stock of VAT refund arrears as of December 31, 2009 (IMF definition)*	MEFP	**16.4**
VAT refund arrears accumulated during 2010 by MEFP (July 2010) (IMF definition)*	MEFP	**8.5**
VAT refund arrears accumulated during 2010 since MEFP (after July 2010)		**?**
Stock of VAT refund arrears declared as remaining as of October 1, 2010	Statemenets by PM Azarov, Head of STA Papaika	**3**
Known components of VAT refund arrears reductions since July 2010		
VAT Bonds	Statement by Deputy Fin.Minister Yefimenko, quoted by Kommersant-Ukraine	**16.2**
Refunds in cash in August	No data available, but must have exceeded monthly VAT receipts (details in previous report)	**?**
Refunds in cash in September	Statement by Deputy Fin.Minister Yefimenko, quoted by Kommersant-Ukraine	**1.0**
Deemed ficticious	Statement by Deputy Fin.Minister Yefimenko, quoted by Kommersant-Ukraine	**2.0**
Refunds in "non-cash payment"	Statement by Deputy Fin.Minister Yefimenko, quoted by Kommersant-Ukraine	**3.8**
"Settled against future payments"	Statement by Deputy Fin.Minister Yefimenko, quoted by Kommersant-Ukraine	**11.5**

* In the MEFP, the stock of VAT refund arrears is defined as those claims that have not been settled (through a cash refund, netting out against obligations of taxpayers, payment with a government bond (VAT bond) or an official decision to reject the claim) within a specified time period after the VAT refund claim has been submitted to the STA. This time period is 60 days, allowing for verification of the validity and payment processing of claims. VAT refund claims that have been rejected by the STA but for which an appeal has been registered in courts are not considered to be in arrears.

Consolidated budget spending

Real cumulative expenditures remain higher than last year, given the increased social payments and transfers to Pension Fund throughout 2010. September was the third month is a raw which brought no change to the previously accumulated pattern of expenditure results. Budget expenditures over January-September 2010 remained at a considerably higher level compared to same period of last year (by 10.47% in real terms), mostly due to the growing transfers to cover Pension Fund deficit coupled with increasing public wages and social assistance payments, hiking in May and June. As illustrated in Table 5, real cumulative spending on Social Protection in the first seven months of 2010 remains 30% higher than in 2009. Because of the growth in public wages above inflation rate, expenditures in Healthcare and Education were also higher than last year (by 9.92% and 6.99%, respectively), with monthly expenditures on Education demonstrating a cyclical increase in September (see Figure 3).

Investment-intensive spenidng continues to be much lower than in 2009. Unlike current spending items, investment-intensive programmes were funded at consistently lower rates in 2010 compared to same period of last year. Over January-September 2010, real expenditures on Economic Activities, Housing and Utilities, and Environment decreased in real terms compared to same period of 2009 by 13.75%, 38.28%, and 6.26%, respectively. Figure 3 illustrates that monthly expenditures on Economic Activities had a cyclical pattern over the year, and were higher in June and July compared to earlier months. These monthly increases in Economic Activities programme were explained by higher spending on Agriculture and on Roads. But, as already mentioned, despite these monthly fluctuations, overall cumulative spending on these programmes remains lower than last year (in real terms).

Table 5. Consolidated Expenditure Execution in January-September 2010 (UAH Millions)

		Comparisons to plan		Comparisons to same period of 2009	
	Nominal actual expenditures in Jan-Sep 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-Sep 2009	% Change in real terms
Total Expenditures	**262,453.04**	**395,039.66**	**66.44%**	**217,523.22**	**10.47%**
Public Administration	28,250.04	48,025.69	58.82%	22,143.88	16.98%
Defence	7,306.31	12,348.71	59.17%	6,692.81	0.02%
Civil Order, Security & Judiciary	19,284.23	28,371.57	67.97%	17,514.87	0.86%
Economic Activities	28,058.21	47,052.53	59.63%	29,683.52	-13.75%
Environment Protection	1,523.24	6,832.54	22.29%	1,493.24	-6.26%
Housing and Utilities	3,251.44	7,780.94	41.79%	4,830.44	-38.28%
Healthcare	30,049.56	43,860.47	68.51%	25,014.44	9.92%
Culture and Sports	8,102.19	11,540.74	70.21%	5,471.59	35.69%
Education	55,622.04	80,692.60	68.93%	47,570.04	6.99%
Social Protection & Social Care	81,005.76	108,533.87	74.64%	57,108.41	30.00%

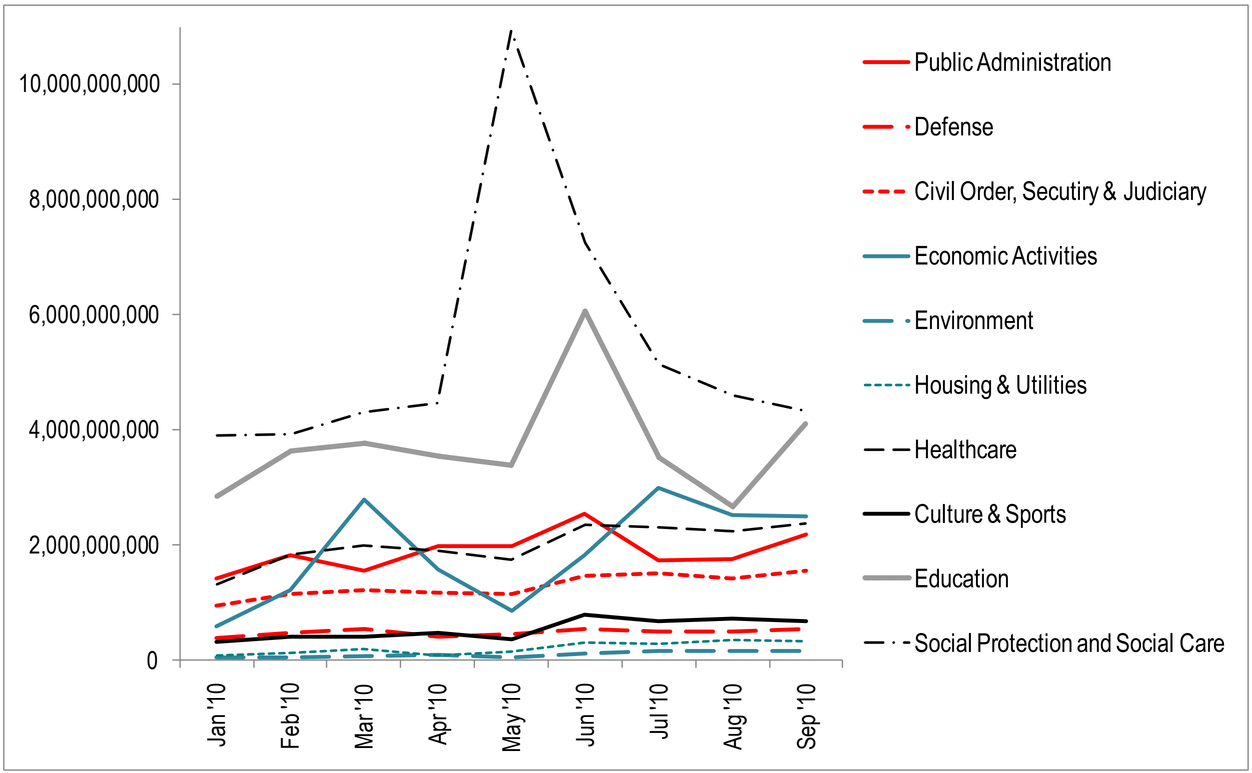
Source: Treasury Budget Exectuion Report.

The (poor) rate of performance of Environment and Housing&Utilities expenditures is explained, in part, by considerable increases of respective annual plan figures in the Treasury Reports for August and September. As noted in our previous report, similarly to revenues, the amounts of annual expenditure plans quoted in the monthly Treasury reports for individual functions was not stable throughout the year [3]. But while variations in these figures was not significant for most functions, two particular lines – annual plan for Environment Protection and for Housing and Utilities – were increased considerably: twofold between July and August for Environment (from UAH 3.4 billion to UAH 6.8 billion) and by a half for Housing and Utilities between August and September (from UAH 5.3 billion to UAH 7.8 billion) (see Table 6). As a result of this increase of quoted annual plan, the official rates of execution of the annual plan for Environment and for Housing and Utilities are the poorest across all functions (22.29% and 41.79%, respectively, as shown in Table 5). The reason and the implications of this statistical issue are still not clear.

Table 6. Annual Expenditure Plans Quoted in the Monthly Budget Execution Reports by the State Treasury

	Jun '10	Jul '10	Aug '10	Sep '10	% Change	
					Aug to Jul	Sept to Aug
Total	**400,335,991,350**	**385,115,398,315**	**390,546,168,594**	**395,039,658,551**	**1%**	**1%**
Public Administration	65,566,382,638	53,107,934,648	50,490,474,909	48,025,685,882	-5%	-5%
Defense	13,728,670,174	12,181,865,155	12,239,144,347	12,348,707,807	0%	1%
Civil Order, Secutiry & Judiciary	27,220,212,045	27,141,975,272	27,549,568,986	28,371,572,243	2%	3%
Economic Activities	41,455,150,546	43,107,892,676	45,017,460,083	47,052,534,173	4%	5%
Environment	3,240,318,729	3,379,176,909	6,770,980,346	6,832,535,918	**100%**	1%
Housing & Utilities	4,890,148,343	5,090,260,742	5,270,294,493	7,780,939,762	4%	**48%**
Healthcare	43,170,348,933	42,789,324,843	43,557,206,064	43,860,465,684	2%	1%
Culture & Sports	10,288,006,484	11,123,012,620	11,371,154,560	11,540,742,091	2%	1%
Education	79,317,855,291	79,265,875,503	79,843,749,503	80,692,602,026	1%	1%
Social Protection & Social Care	111,458,898,167	107,928,079,946	108,436,135,304	108,533,872,967	0%	0%

Figure 3. Monthly real expenditures on key functions in consolidated budget in January-September 2010 (UAH)



The Governments approves a Law which restructures pension arrears by coal miners and "strategic" enterprises. In October, President Yanukovych signed the recently approved Law of Ukraine which restructures (for 60 months) current arrears in payments and penalties to the Pension Fund accumulated by coal mining enterprises and enterprises classified as strategically important to the country's economy and security (7).

Key PFM-related policy initiatives

Pension Reform: status still unclear

No plans for Pension Reform released despite the missed deadline to submit related legislation in September 2010, agreed with the IMF. Throughout October, no draft policies or legislation were released with regard to the awaited Pension Reform. As discussed earlier [8], [3], considerable reformation of the Pension system was among explicit commitments taken by the Government within the Fiscal Policy reform agenda of the MEFP [2] agreed with the IMF, with key legislation to be submitted for Parliamentary consideration by end of September 2010.

Statements from top officials show that plans regarding increased pension age are uncertain. Official statements continue to introduce some of the plans on the substance of upcoming pension reforms. As we discussed in September, VPM Tyhipko shared plans to introduce a fully-funded pillar of the pension system in 2012 [3]. In October, PM Azarov stated that increases in pension age will not be on agenda until the fully-funded pension scheme is introduced and operational, and that it would only be considered for those retiring in 20-30 years [9]. At the same time, Minister of Finance Yaroshenko said at a press-conference in October that his ministry is currently working on assumption of a plan to balance the Pension Fund with its own revenue sources. The details of these plans are all unclear and are therefore not analysed in this report.

New indirect subsidy for Ukraine's Naftogas

Background

Reduction of quasi-fiscal deficits in the energy sector are central to Ukraine's recent agreement with the IMF because of the risks it exerts on the country's budget. As we discussed in a number of previous reports and papers [10], [8], a critical aspect of the IMF expectations as for a sustainable fiscal framework in Ukraine assumed a series of measures to improve financial viability and efficient regulation of the energy sector, and in particular, the finances of Ukraine's Naftogas. The reason for the central importance of these conditions within the signed MEFP [2] is in the risks which quasi-fiscal activities in the energy sector and resulting quasi-fiscal deficits create for the country's budget. These deficits have significantly increased since 2006, leading to a point of macroeconomic emergency noted by most key observers by 2010. In particular, since 2009, financial viability of Ukraine's Naftogaz – a state-owned company monopolistically responsible for extraction, transportation and processing of natural gas and oil – had dramatically deteriorated, absorbing (in 2009) state support equal to 2.5% of the country's GDP.

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.
- **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.

The MEFP signed with the IMF contained a range of measured aimed at streamlining Naftogas finances, decreasing the burden of its deficit exerted on the state budget, and improving transparency of energy sector governance and finance. Respectively, the MEFP included 9 specific conditions related to the energy sector finances, including a ceiling on cash deficit of the general Government and the Naftogas (along with approval of a respectively drafted Naftogas financial plan), a series of measures to help Naftogas in streamlining and increasing its revenues (such as increased gas prices for utility companies and households, elimination of price privileges, and support in collection of arrears), as well as a structural requirement to undertake additional measures to strengthen the transparency and governance of the gas sector, in accordance with the principles of the Brussels declaration (structural benchmark) (by December 2010).

Developments in October: Indirect extra subsidy to Naftogas via new share issue (UAH 7.4 Billion)

The Government allowed Naftogas to issue UAH 7.4 Billion of new shared which it would purchase in exchange of newly issued T-Bills. In October, the Government resorted to an earlier practiced method of indirect subsidisation of Naftogas via a buy-out of its additionally issued shares. On 12 October, it allowed Naftogas to issue new shares to increase its capital by UAH 7.4 Billion, which would be exchanged on Treasury bills, specifically newly issued for this purpose (11) (the same tool was used in December 2009, when Naftogas share capital was increased by UAH 5,8 Billion[ii]). This latest new share issue (of UAH 7.4 Billion) was a subsidy planned several months in advance, whose expected amounts were included into the Naftogas financial plan released in August 2010 (12).

The indirect nature of this new subsidy blurs the already opaque energy finance even further, creating new risks such as the possibility of monetisation of related debt by the NBU. As discussed above, this new indirect subsidy represents a two-fold new risk for the state budget. First, it reflects an increase in public debt to continue covering quasi-fiscal deficits in the energy sector. Secondly, the indirect nature in which this new subsidy was administered is itself problematic in a number of ways. In particular, the fact that it is funded with a new issue of Treasury bills opens possibilities for monetising this debt via stimulation of its buy-out by state-owned banks of the NBU, which was practiced in earlier years. Other possibilities suggested by the observers include buy-outs of the new T-bills by third parties with long term interest in acquiring ownership rights in Ukraine's energy system and with the view of utilising this debt as a respective leverage (13).

Developments in October: Plans to reintroduce a gas price subsidy for producers of nitrogen fertilisers

One of the IMF conditions for the energy sector signing within the MEFP, was "elimination of price privileges for sugar, chemical, fertilizer, and metallurgy industries and will maintain gas prices for industrial users consistent with import parity" (2). These price privileges were eliminated as a prior action for the agreement, and reflected in the Naftogas 2010 financial plan.

However, during October the Government pursued a new initiative to re-introduce a price subsidy on gas consumed by producers of nitrogen fertilisers. An instruction to prepare respective measures was given by the PM Azarov at a CMU meeting to four related ministries (14). This plan was presented by the Government as a policy of support to Ukraine's domestic agricultural producers, who would thereby enjoy cheaper fertilisers. In this way, the policy would directly contradict the commitment to keep gas prices consistent with import parity, agreed with the IMF.

[ii] The amount of actual increase of Naftogas share capital in December 2009 (UAH 5 776 191) was adjusted from the initial planned about of UAH 12 000 000, which was reflected in the legislation with the help of a separate CMU Resolution in October 2010 (22).

Developments in October: Introduction of distribution accounts for heating utilities

One of the IMF conditions for the energy sector signing within the MEFP was introduction of distribution accounts for heating utilities, aimed at supporting Naftogas's efforts to collect due payments from its consumers (2).. As we discussed in earlier reports, 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. 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. Measures discussed and agreed to address this problem included transfer the authority for setting heating tariffs for communal utilities to a new independent regulator (in progress) and introduction of distribution accounts for heating utilities, which would help to avoid possibilities of undue utilisation of energy payments collected from final consumers by local monopolistic intermediaries.

In October, a respective draft law (to introduce mandatory distribution accounts) was approved by the VR in the first reading. While MEFP explained that some legislation to effect this commitment was approved as a prior measure before the agreement with the IMF was signed, distribution accounts were still to be introduced. In October, the Government submitted and the VR approved in the first reading a draft law which would amend related previous legislation to require that all payments for consumed energy in the housing and utilities sector would be administered through special distribution accounts (15), (16) .

Planned amendments to Public Procurement Legislation

The latest approved Public Procurement Law (approved in June 2010) improved some of the procedures, but remained problematic. As we discussed in detail in previous reports, in June 2010 the VR approved a new Law of Ukraine "On State Procurement" (17). This law was approved after a considerable debate, including active participation of international development actors led by World Bank and the EU, given that several prior versions of the procurement legislation have not complied with the recommendations from the international community based on the Directives and international standards in the field of procurement regulation, as well as on experience of European countries. Our in-depth analysis of the approved law argued that while the new Law was significantly improved in comparison with the version voted in February to the dismay of international observers (by removing some of the biases in favour of domestic providers, improving definitions, requirements to confidentiality, and implementing some of the EC/WB recommendations towards complaints procedure and Appeal Agency), it remained highly problematic since it continued to discredit small procurement, kept many procedures cumbersome and lacked clarity of definitions.

Although one of the major requirements for procurement legislation is to ensure wide and comprehensive coverage, the Government considers narrowing this coverage by removing procurement to Agrarian Fund and State Reserve. One of the major critical comments on Ukraine's procurement legislation has traditionally been its fragmentation and lack of comprehensive coverage, which made it opaque and open for manipulation. We noted that while the June edition of the Law was improved, it left regulatory responsibilities fragmented across a number of central agencies and that its coverage of types of procurement was still not comprehensive. However, in October the Government shared that it planned to amend the current law even further, removing from its coverage those operations which relate to procurement to Agrarian Fund and State Reserve. It also revealed a plan to allow local administrations to engage in single-provider purchases at local level. These proposals seem to limit the coverage of the procurement law even further, representing a retrograde step.

2011 Budget

Aligning the 2011 Budget with new Tax Code: in time and in substance

The Government delays the submission of draft 2011 Budget, planning to base it on a new Tax Code to be approved in November. As discussed in the previous report, the Government is delaying the submission of the Draft Budget Law for 2011, with the view to synchronise this document with a new tax legislation to be implemented via a new Tax Code, which is still in the making. Both of these decisions are inconsistent with Ukraine's Budget Code, which requires the draft Budget to be submitted by 15 September, and be based on tax legislation introduced no later than 15 August of the pre-budget year (3). In October, PM Azarov empathised that the Government remains determined to base the 2011 Budget on a new Tax Code, which he believed would be approved during November (18).

Prime Minister and MinFin assure that 2011 Budget Deficit will be within the 3.5% GDP target agreed with the IMF, based on lower public wages and streamlined finances of the Pension Fund and Ukraine's Naftogaz. Statements on planned substance of the 2011 Budget promise that it would be based around commitments taken within the MEFP of co-operation with the IMF. Namely, the budget deficit would be reduced to 3-3.4% of GDP, based on: reduced rate of growth in public wages, pension reform (leading to lower pension fund deficit and reduced budget transfer to the pension fund), and balanced finance of the Naftogaz (implying no need for budget support) (18).

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