



# UKRAINE

## TECHNICAL ASSISTANCE REPORT—PUBLIC INVESTMENT MANAGEMENT ASSESSMENT

December 2019

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## **Ukraine**

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# **Public Investment Management Assessment**

Brian Olden, Miguel Alves, Yugo Koshima, Ulrike Rwida, and Eivind Tandberg



**Technical Report**

**June 2016**

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## GLOSSARY

CoA	Chart of Accounts
COM	Cabinet of Ministers
EBRD	European Bank for Reconstruction and Development
GFSM	Government Finance Statistics Manual
IFIs	International Financial Institutions
IMF	International Monetary Fund
LIA	Law on Investment Activities
LIDCs	Low Income Developing Countries
LMs	Line Ministries
LMSP	Law on Management of State Property of 2006
MoE	Ministry of Economic Development and Trade
MoF	Ministry of Finance
MTBF	Medium-term Budget Framework
NCCIR	National Commission for State Regulation on Communication and Information
NES	New Energy Strategies
NKREKP	National Commission of State Regulation on Energy and Utilities
PIM	Public Investment Management
PIMA	Public Investment Management Assessment
PIP	Public Investment Program
PPP	Public-Private Partnerships
SPF	State property Fund
SOE	State-owned Enterprise
SSP	State Support Procedure
TA	Technical Assistance
TSA	Treasury Single Account
UZ	Ukraine Railways
VR	Verkhovna Rada
WB	World Bank

## PREFACE

A technical assistance mission from the IMF's Fiscal Affairs Department (FAD) visited Kiev, Ukraine during the period April 7–21, 2016 to conduct a Public Investment Management Assessment and advise the government on improving public investment management (PIM) practices. The mission was led by Brian Olden and comprised Miguel Alves, Yugo Koshima (all FAD), Ulrike Rwida, and Eivind Tandberg (both FAD experts). The mission was funded by the Global Affairs Canada.

The mission met with Mr. Danylyuk, Minister of Finance; Mr. Omelyan, Minister of Infrastructure; Mr. Synyutka, Governor of the Lviv Region; Mr. Sadovyy, Mayor of Lviv; Mr. Chuprynenko, Deputy Minister of the Ministry for Regional Development, Construction and Municipal Economy; Mr. Kachur, Deputy Minister of Finance; Mr. Nefyodov, Deputy Minister for Economic Development and Trade; Mr. Lozytsky, Budget Director; Mr. Panteleyev, Deputy Head of the Kyiv City State Administration and their senior staff.

The mission also met with the Budget Committee of the Verkhovna Rada, separately with Mr. Serhiy Kiral, Deputy Committee Head of the Verkhovna Rada Industrial Policy and SME Committee, the State Audit Service of Ukraine, the Accounting Chamber of Ukraine and the State Road Agency of Ukraine. Discussions with the European Commission, World Bank, and the US Treasury Advisor Mr. Whitman also took place.

The mission would like to thank the authorities for their cooperation during the mission and express its gratitude for the courtesy extended from all these officials and institutions throughout the stay. It is especially grateful to Mr. Ihor Shpak from the IMF resident representative office for his excellent organization and contribution to the mission, as always. The mission would also like to express its appreciation to Ms. Valentina Kukhtik, Ms. Zenida Shulga, and Ms. Oksana Burakovska for their excellent interpretations services.

## EXECUTIVE SUMMARY

**Ukraine's public capital stock has been on a declining path over the last 20 years.** Having started the period at a relatively high level (99 percent of GDP in 1996), it now ranks amongst the lowest of its comparator countries (56 percent in 2013). Evidence as to the reasons for the deterioration point to significant and persistent weaknesses in the institutional framework surrounding public investment management, inefficient allocation of resources to productive public investment and high levels of perceived corruption. Ukraine currently has an efficiency gap of around 32 percent, which ranks it below average amongst emerging market countries and other comparators. Persistent under-investment, the currently high stock of debt, and ongoing institutional weaknesses, coupled with effects of the conflict in the East could see this gap continuing to grow, absent concerted efforts to reverse recent trends.

**Since 2008, public investment spending has been extremely low, averaging only 1.5 percent of GDP.** This can be explained, to some extent, by the absence of fiscal space, but the main reason lies in the practice of explicitly protecting current expenditures through legislation, at the expense of investment expenditures. Consequently, investment is regarded as a residual item, especially in times of economic stress.

**Government policy on fiscal decentralization, articulated in the government's 2014 coalition agreement, has the potential to significantly impact on the allocation of public investment.** Since 2005, the share of investment allocated to local government has increased from 46 percent to 70 percent with the majority of this shift occurring in 2015. This move to increased decentralization will require a re-assessment of how public investment is managed at both central and local level, with the center reluctant to cede control over investment allocation decisions, and the local level struggling to develop its investment management capacity. SOEs both at central and local level also have a large share of investment, and their monitoring frameworks remain underdeveloped including the area of fiscal risk management.

**The institutional framework is weak in all areas.** Seven out of 15 institutions are ranked low in terms of their strength, while a further eight are ranked as medium. No institution is ranked as strong. However, it is in terms of effectiveness of the institutions that the Ukrainian PIM system really falls short. Twelve institutions are ranked as ineffective while a further two are moderately effective, with only one institution scoring a high rank in this category.

**While the picture looks bleak, some recent initiatives may bring about significant improvements.** For example, recent proposals to better coordinate inter-governmental fiscal relations; improve the legislative and oversight frameworks for PPPs; introduce a multi-annual budget process and introduce comprehensive project appraisal and selection processes should result in marked improvements, provided the reforms are fully implemented.

**The many institutional gaps will require prioritization of efforts to introduce reforms.**

Specific areas in need of urgent action include:

- At the planning stage: (i) national and sectoral planning strategies, which do not prioritize or cost investment proposals nor take account of fiscal constraints; (ii) fragmentation of systems of resource allocation for local government investments where, in some cases, decisions are largely ad hoc; and (iii) the confusion caused by the myriad of legislation surrounding PPPs, including concession contracts, added to the lack of capacity to manage fiscal risks.
- At the allocation stage: (i) the inefficiency and lack of certainty caused by the absence of a multi-annual budget framework and in particular the lack of a stable medium-term funding framework for public investments; (ii) the absence of a precise definition of capital spending with many recurrent costs being included in development budget spending; and (iii) the weaknesses in project appraisal and selection processes, which while improving, are only being applied to a small subset of projects.
- At the implementation stage: (i) the uncertainty surrounding availability of funding for capital spending, due to protection of current spending and weak cash management arrangements; (ii) the weaknesses of monitoring systems, including ex post external audit with audit largely focused on financial compliance; and (iii) inadequate project management frameworks for domestically financed projects, which are not focused on achievement of project objectives.

**To address these weaknesses, the recommendations in the report prioritize improvement in three key areas:**

**1. *Improving planning and prioritization***

- Establish a common, concise set of fully costed and prioritized capital investment plans to be included in national and sectoral strategies.
- Consolidate and make more transparent the allocation methodology and process for approval of capital transfers to local governments and merge the Regional Development and Socio-economic Development funds, while delegating the selection of projects to be financed from these funds to the local level.
- Consolidate and strengthen the legal and institutional framework for PPPs, focusing on the management of fiscal risks arising from those arrangements.

**2. *Improving resource allocation for public investments***

- Establish a medium-term investment project pipeline process and combine this within a comprehensive medium-term budget framework that facilitates and takes account of multi-annual commitments.
- Provide a clearly defined capital budget in budget documents using international classification standards and have this formally approved by parliament, as part of the budget approval process.



- Strengthen the newly established project appraisal and selection approach and extend this to all major state investments, including projects with external financing.

**3. *Developing comprehensive and efficient project implementation systems***

- Ensure effective oversight of public investments through centralized monitoring and systematic ex post financial and performance audits.
- Prohibit reallocation from capital to other expenditure and specify carryover rules common to the general and special fund appropriations within quantitative limits and with MoF approval.
- Implement previous FAD recommendations to strengthen cash management arrangements.

**Reversing the cumulative decline in the public capital stock will require urgent action.**

Some of the recommendations in this report are already being considered as part of an overall public financial management reform plan. The action plan in this assessment seeks to leverage these reforms and prioritize implementation of the recommendations, focusing on the most urgent actions within realistic timeframes, while taking account of capacity constraints.

**Table 0.A summarizes the assessment.** The assessment of institutional strength is based on the questionnaire presented in the IMF Board Paper “Making Public Investment More Efficient.” Each institution was assessed across two dimensions: institutional strength (i.e., whether the institution was nominally in place) and effectiveness. The following color code was used:

	High	Medium	Low
Institutional strength			
	High	Medium	Low
Effectiveness			

**Table 0.A. Ukraine: Summary Assessment**

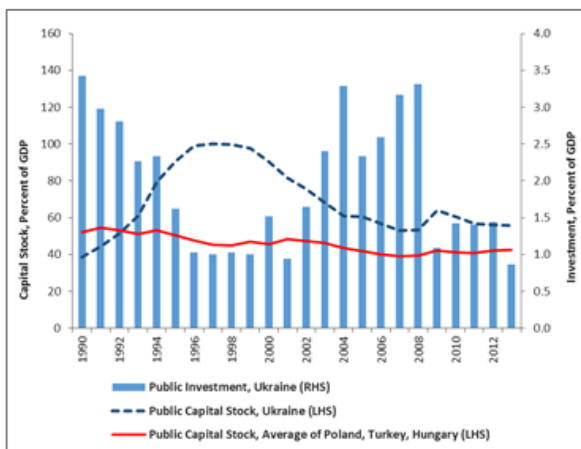
Phase / Institution		Institutional Strength	Effectiveness	Rec.	
<b>A. Planning</b>	1	<b>Fiscal rules</b>	A debt ceiling is included in the budget code but the ceiling has been breached and there are no escape clauses.	The debt ceiling was breached in 2015, although the ongoing voluntary debt restructuring is likely to bring the debt stock back under the ceiling.	
	2	<b>National and sectoral planning</b>	National plans do not prioritize or cost capital investments or specify their output targets, while some but not all sector plans do so.	Sector plans do not take into account financial constraints imposed by the annual budget and only a fraction of proposed projects are actually funded.	1
	3	<b>Central-local coordination</b>	A strong legal framework for local borrowing exists, including limits on how much local government can spend on servicing the debt.	There is no strategic discussion between national and LGs on capital programs, and limited transparency on transfers to LGs.	2
	4	<b>Public-private partnerships</b>	The scrutiny and selection of PPP projects in not transparent and value-for-money analysis is not always required.	The government is ill-equipped to manage fiscal risks arising from PPP arrangements.	2, 3
	5	<b>Regulation of infra. Companies</b>	Domestic competition exists in some but not all infrastructure markets, the regulator is not fully independent.	The institutions controlling SOEs' investments are overlapping and unclear, and the oversight functions are limited.	
<b>B. Allocation</b>	6	<b>Multi-year budgeting</b>	A comprehensive multi-year budget framework currently does not exist	Plans to introduce multi-year budgeting for the 2018 budget remain vague.	1, 4
	7	<b>Budget comprehensiveness</b>	Most government capital spending is undertaken through the budget and externally financed projects are disclosed. PPPs are not disclosed.	PPPs are currently limited. Failure to disclose does not pose a challenge for budget comprehensiveness.	3, 5
	8	<b>Budget unity</b>	A single budget is prepared but no disclosure of operating costs for investments. The budget classification specifies consumption and development costs, not capital spending.	Failure to specify capital spending and the absence of information on operational cost implications are serious obstacles to effective oversight.	5
	9	<b>Project appraisal</b>	Few investment projects have been subject to systematic appraisal, but new appraisal procedures were introduced for the 2016 budget.	New project appraisal methodology has been applied to a limited set of projects, and its effectiveness remains unproven.	6
	10	<b>Project selection</b>	Few investment projects are systematically reviewed, but new selection procedures were introduced in the 2016 budget. There is no systematized project pipeline.	New project selection methodology is incomplete and has been applied to few projects. Its effectiveness will depend on introduction of medium-term budgeting.	6
<b>C. Implementation</b>	11	<b>Protection of investment</b>	Outlays appropriated on an annual basis, the MOF can reallocate from capital to other expenditure, and carryover applies only to special fund appropriations.	Total variation from the original budget for capital expenditure to actual outturn is small, but allocation to each project in the original budget is not credible.	5
	12	<b>Availability of funding</b>	Cash forecasts are not amended as the year progresses, making it difficult to ensure that sufficient funds are available as projects are adjusted.	Current expenditures are protected, and as a result, disbursements for capital programs are rationed.	8, 9
	13	<b>Transparency of execution</b>	New procurement law provides potential for improvements. There is no centralized project monitoring mechanism and no systematic ex post audit.	Efficacy of the new procurement law remains unproven. Plans for strengthened centralized project monitoring and ex post audit are vague.	7
	14	<b>Project management</b>	There is no standard for project management. Externally financed projects are managed as required by the funder.	Management and monitoring relates to budget adherence, with very little consideration to meet project objectives.	7
	15	<b>Assets accounting</b>	Financial statements exclude the stock positions and depreciation of nonfinancial assets.	Asset surveys are conducted regularly only for a minor subset of the general government nonfinancial assets.	

# I. TRENDS IN PUBLIC INVESTMENT

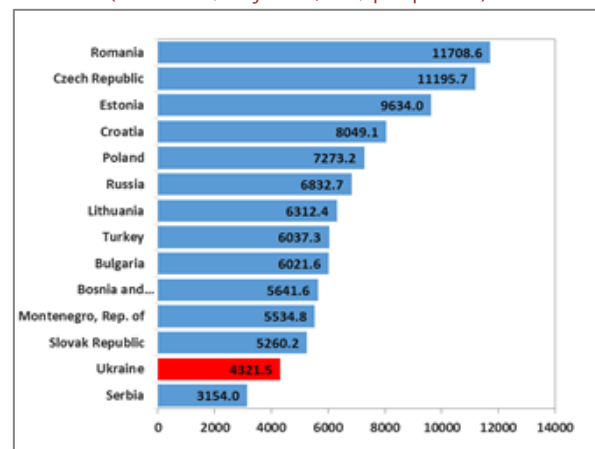
## A. Trends in Total Public Investment and Capital Stock

1. The level of public investment has been insufficient to maintain public infrastructure for most of the last 20 years. Ukraine’s public capital stock relative to GDP was higher than in some peer countries in 1995, but has been on a declining trend since then (Figure 1.A), reflecting the inability of the government to replace depreciating public fixed assets. This trend can also be observed in other former Soviet Union countries, which suggests that the economic decline after the dismemberment of the USSR, which reduced the resources for investment, may have been a significant contributing factor. Ukraine’s public capital stock per capita is currently one of the lowest among peer countries (Figure 1.B). The significant damage to public infrastructure, resulting from the conflict in the East, will also continue to dampen growth of the public capital stock in the near future.

**Figure 1.A. Public Investment and Capital Stock**  
(2005 PPP\$-adjusted, percent of GDP)



**Figure 1.B. Public Capital Stock per Capita, Comparison with Peers, 2013**  
(2005 PPP\$-adjusted, US\$ per person)

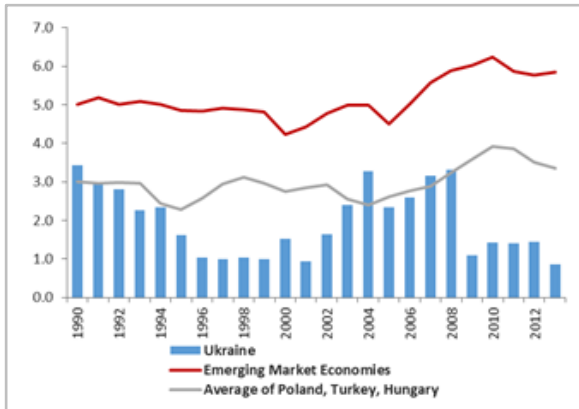


Sources: WEO and staff estimates based on official data

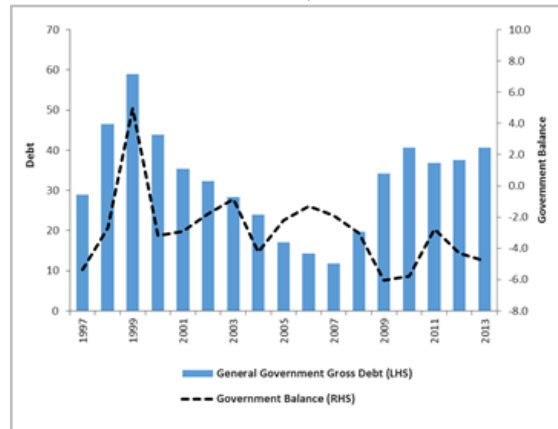
## 2. Existing budget rigidities are a constraint on efforts to increase investment levels.

Levels of public investment in Ukraine have been significantly lower than those of emerging market economies, since before independence (Figure 1.C). After a period of higher investment between 2002 and 2007, a combination of limited fiscal space resulting from the financial crisis (Figure 1.D), and high levels of current spending (Figure 1.E), many of which are protected in the Budget Code of Ukraine (Article 55), brought investment levels back to under 1.5 percent of GDP, even taking account of the period of investment in infrastructure for the Euro 2012 Football Championship co-hosted by Ukraine. The explicit “protection” of wages, social benefit and other current expenditures in the Budget Code means that it is extremely difficult to protect investment spending, particularly in times of economic downturn, as investment spending is typically the adjusting component when there are revenue shortfalls.

**Figure 1.C. Public Investment, Comparison with Peers**  
(2005 PPP-adjusted, percent of GDP)

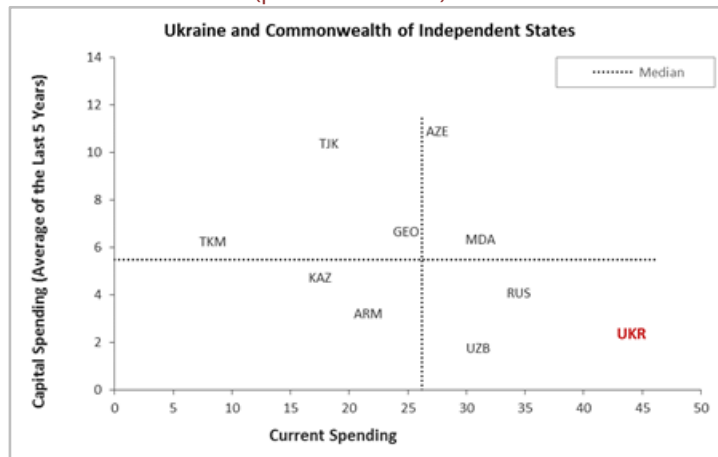


**Figure 1.D. General Government Debt and Deficit**  
(percent of GDP)



Sources: WEO and staff estimates based on official data.

**Figure 1.E. Current and Capital Spending, Comparison with Peers, 2014**  
(percent of GDP)



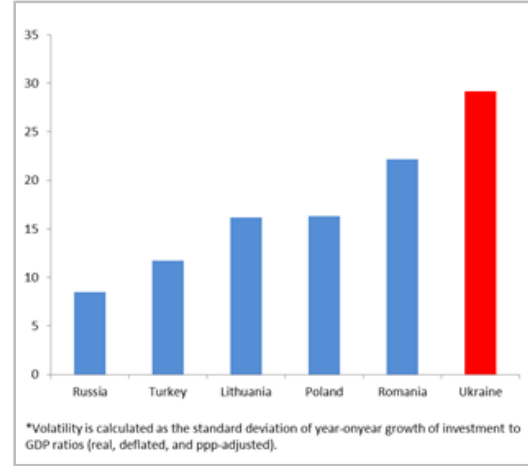
Sources: WEO and staff estimates based on official data.

**3. Public investment is also highly volatile.** Over the last decade, the execution rate for general government investment in fixed assets ranged between 53 and 87 percent of the revised budget (Figure 1.F). Budget allocations for public investment are often significantly revised during the year, contributing to uncertainty in investment spending. Ukraine's public investment in recent years has been the most volatile among peer countries (Figure 1.G). These factors are likely contributors to the high inefficiency of public investment at different institutional levels.

**Figure 1.F. Execution of Public Investment Spending (in billion UAH)**



**Figure 1.G. Comparison of Investment Volatility\* (2010–13)**



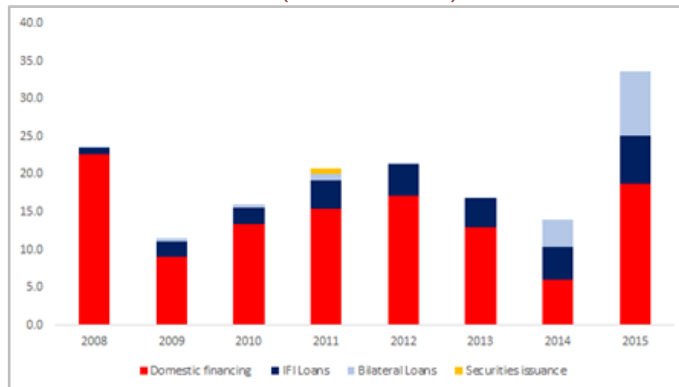
Sources: Staff estimates based on official data.

## B. Composition of Public Investment

### Sources of Funding

4. **Currently, around half of general government investment is financed through external sources, a proportion that is substantially larger than in the past.** This recent trend is mostly explained by the bilateral loans provided to support the infrastructure recovery component of Ukraine’s reform program (Figure 1.H). Before that, external financing of public investment represented on average 25 percent of total financing, and was primarily provided by international financial institutions (IFI)—loans from the World Bank, EBRD, and EIB, the lion’s share of which were directed to the road and energy sectors. The small share of this stable source of financing is one of the explanations for the volatility of investment spending, described above. With the exception of local government borrowing (relatively small), all external financing for investment is provided on concessional terms.

**Figure 1.H. Execution of Public Investment Spending (in billion UAH)**



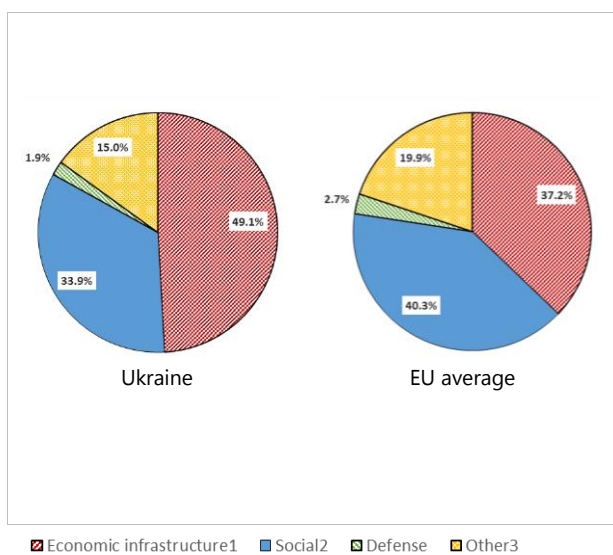
Sources: Staff estimates based on official data.

## Sectoral Decomposition

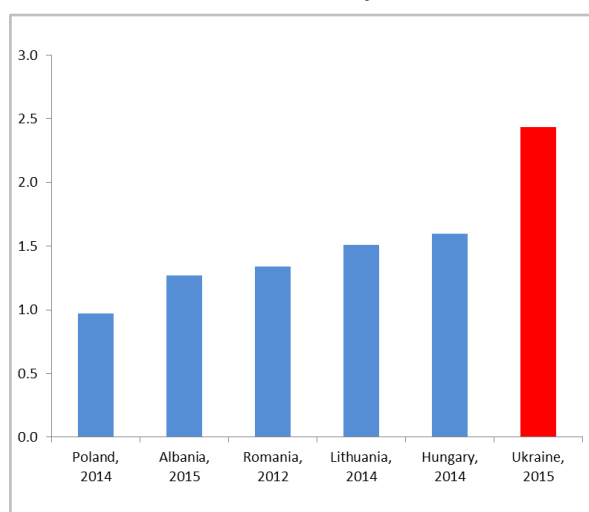
**5. The functional allocation of public investment in Ukraine has historically differed from the average witnessed in the European Union (EU).** Between 2009 and 2013, the share of capital investment in economic infrastructure, was substantially higher than in EU countries (Figure 1.I). This is mostly related to the investment in roads by the Ukrainian State Road Agency (Ukravtodor) (financed with external loans, guaranteed by the State) to address the significant gap in road infrastructure (see Section II.A). At the same time, capital spending in the social sectors, most notably education, is lower than in EU countries (34 compared to 40 percent).

**6. Recent political instability has led to higher volatility in the functional allocation of investment spending.** Investment spending in non-defense functions has in recent years been more volatile than in peer countries (Figure 1.J), reflecting political instability and implementation of sectoral reforms and public expenditure rationalization measures, in the context of the financial assistance programs with the IMF and the EU. The increases in the share of spending on public order and safety (from an average of 5.1 over 2009–13 to 10.6 over 2014–15) and social services (from 33.9 to 41.3) were at the expense of investment in infrastructure (which decreased from 49.1 to 36.4). Following the escalation of the conflict in the East, the share of investment in defense has been gradually increasing.

**Figure 1.I. Public Investment by Function**  
(Average 2009–13, Percent of total public investment)



**Figure 1.J. Volatility<sup>4</sup> in Functional Allocation of Non-Defense Public Investment**  
(most recent year)



Sources: WEO and staff estimates based on official data

1/ Economic infrastructure is approximated by economic affairs and includes public investment for transportation infrastructure, among other components.

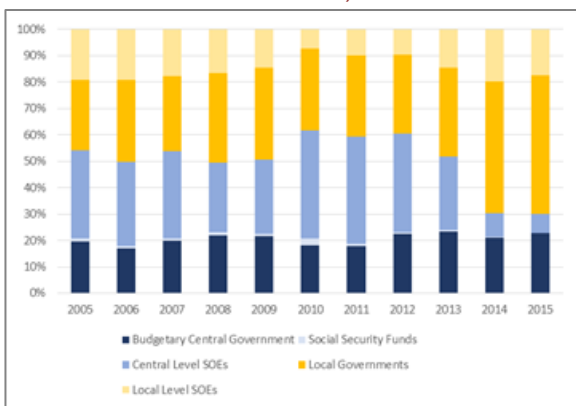
2/ Social comprises public investment in education, health, housing, social protection, and recreation and culture.

3/ Other includes public investment for general public services, safety and public order, and environment.

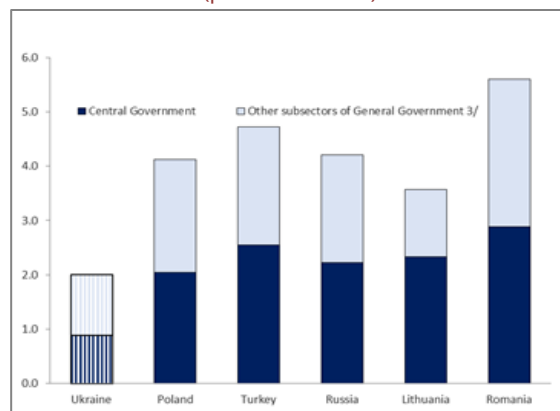
4/ Measured as the average absolute year-on-year percentage change in the distribution of government investment spending between the nine COFOG nondefense functions of government.

**7. The share of investment being carried out at the local level has increased in recent years, although account must also be taken of the low absolute level of public investment across general government.** Until 2013, central and local levels contributed roughly<sup>1</sup> equally for public sector investment in fixed assets (Figure 1.K), which is comparable to the composition in peer countries (Figure 1.L). In 2014–15, the share of local level investment rose to around 70 percent, which is mostly explained by the reallocation of central government expenditure from investment to defense. In the aftermath of Euromaidan (early 2014), the public demand for devolution of powers brought decentralization issues to the top of the reform agenda. As a result, decentralization legislation was passed in late 2014, which also played a role—particularly in 2015—in the higher share of local level investment.

**Figure 1.K. Public Investment by Subsector** <sup>1/</sup>  
(percent of total public sector investment in fixed assets)



**Figure 1.L. General Government Investment Spending by Level of Government, 2013** <sup>2/</sup>  
(percent of GDP)



Sources: Staff estimates based on official data.

1/ In the absence of direct data on SOE investment, capital transfers to SOEs were used as a proxy.

2/ Data for countries other than Ukraine were taken from OECD if available, then Eurostat, and finally GFS (in that priority order). The shares of central and subnational investment as a percent of general government investment were then applied to the nominal public investment numbers from WEO to calculate the numbers used in the figure.

3/ Other subsectors of general government include state governments, local governments, and social security funds.

## II. EFFICIENCY AND IMPACT OF PUBLIC INVESTMENT

### A. Efficiency of Public Investment

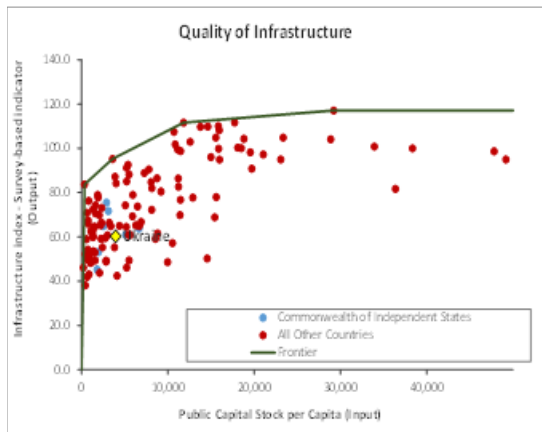
**8. Investment levels have fallen sharply in recent years, and analysis indicates that the efficiency of public investment is below average as compared to emerging markets, CIS countries and the world (Figure 2.A).** The efficiency gap in Ukraine, based on a quality indicator, is about 32 percent, whereas the average efficiency gap for emerging market countries is about 22 percent and 28 percent for CIS countries (Figure 2.B). A recent IMF Board paper<sup>2</sup>

<sup>1</sup> Slightly higher central level shares (amounting to 60 percent) occurred only in the period of infrastructure investment associated with Euro 2012.

<sup>2</sup> IMF Policy Paper: *Making Public Investment More Efficient*, June 2015.

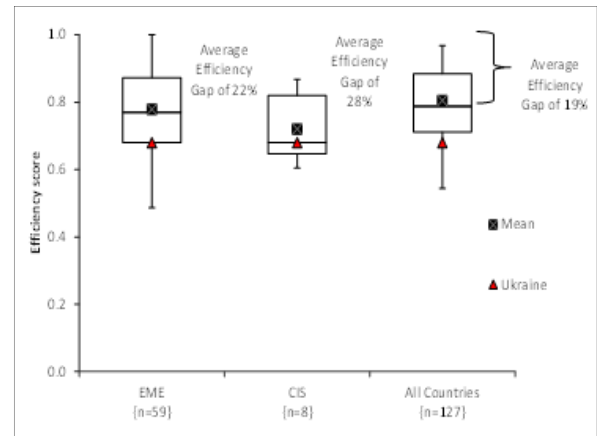
demonstrated that public investment efficiency is highly dependent on the strength of institutions in a wide sense, i.e., processes, legal framework, and institutional capacity, many of which appear to be deficient in Ukraine. As is the case in emerging market countries and emerging European countries in particular, substantial improvements in institutions are possible in Ukraine as will be discussed in Section III.

**Figure 2.A. Efficiency Frontier, Quality of Infrastructure Indicators (2008–14)**



Source: Staff estimates.

**Figure 2.B. Efficiency Gap, Quality of Infrastructure Indicators (2008–14)**

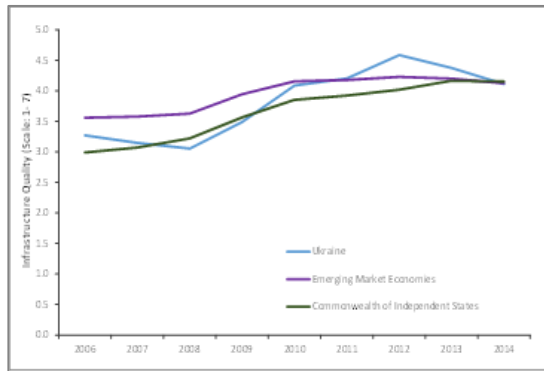


**9. The perceived quality of infrastructure has also been trending downwards in recent years (Figure 2.C).** This can, at least partially, be attributed to the reduction in investment spending since the beginning of the current crisis (2008: 3.3 percent of GDP - 2013: 0.9 percent of GDP in 2005 PPP adjusted terms). Despite the downturn, Ukraine performs better than average on a number of physical indicators of infrastructure access, including public education, electricity production and public health infrastructure.<sup>3</sup> Access to treated water is at a similar level to comparator countries. However, road infrastructure at 3.7 kilometers per capita is far below the average of Poland, Turkey and Hungary (12 kilometers per capita), Emerging and Developing Europe (8) and even emerging markets in general (6.2) (Figure 2.D), reflecting years of underinvestment.

<sup>3</sup> The IMF Fiscal Affairs Department TA Report on “Expenditure Review and Rationalization”; Olden et. al, October 2015, demonstrates that, while the physical indicators used to measure education (secondary teachers per 1,000 students) and health (beds per 1,000 persons) infrastructure access demonstrate show heavy investment in the past, changes in demographics and changing structural needs in both sectors have led to considerable levels of inefficiency. These includes sub-optimization of the school network which has largely remained constant since the Soviet era and an over-sized hospital sector, coupled with inadequate primary care facilities and an imbalance between doctors working in hospitals and general practitioners.

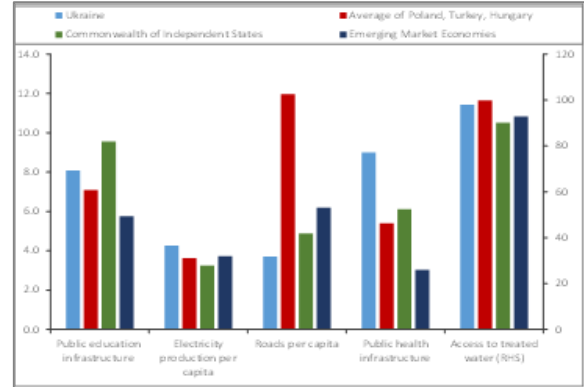


**Figure 2.C. Perceived Infrastructure Quality (2006–13)**



Source: World Economic Forum and staff estimates.

**Figure 2.D. Measures of Infrastructure Access (2014)**

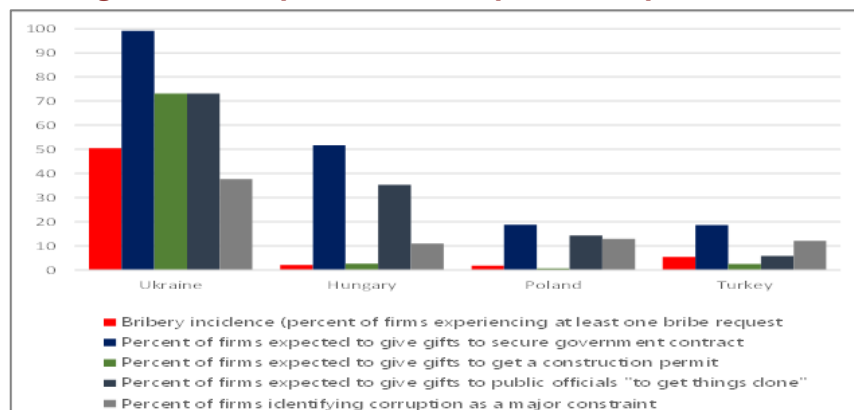


Source: World Bank and staff estimates.

\* Public education infrastructure is measured as secondary teachers per 1,000 persons; Electricity production per capita as thousands of kWh per person; Roads per capita as km per 1,000 persons; and Public health infrastructure as hospital beds per 1,000 persons.

**10. Corruption levels in Ukraine are perceived to be extremely high, which contributes to lower investment rates.** Ukraine scores poorly on all of the major indicators against comparator regional countries, including Hungary, Poland, and Turkey. Particularly striking is the percentage of firms that expect to pay bribes in order to win government contracts (99 percent), although other indicators such as "gifts" required to secure construction permits (73 percent) and get things done (also 73 percent) are also far in excess of comparator countries (Figure 2.E). The low level of participation by private partners and especially foreign investors in investment opportunities such as Public Private Partnerships (PPPs)—see Chapter III—can, to some degree, be directly attributable, to the perceptions that the costs and risks of doing business in Ukraine are too high in this environment. The level of perceived corruption can also reduce efficiency through increasing costs as more efficient firms are discouraged from entering the market for public investment contracts.

**Figure 2.E. Comparison of Corruption Perception (2014)**



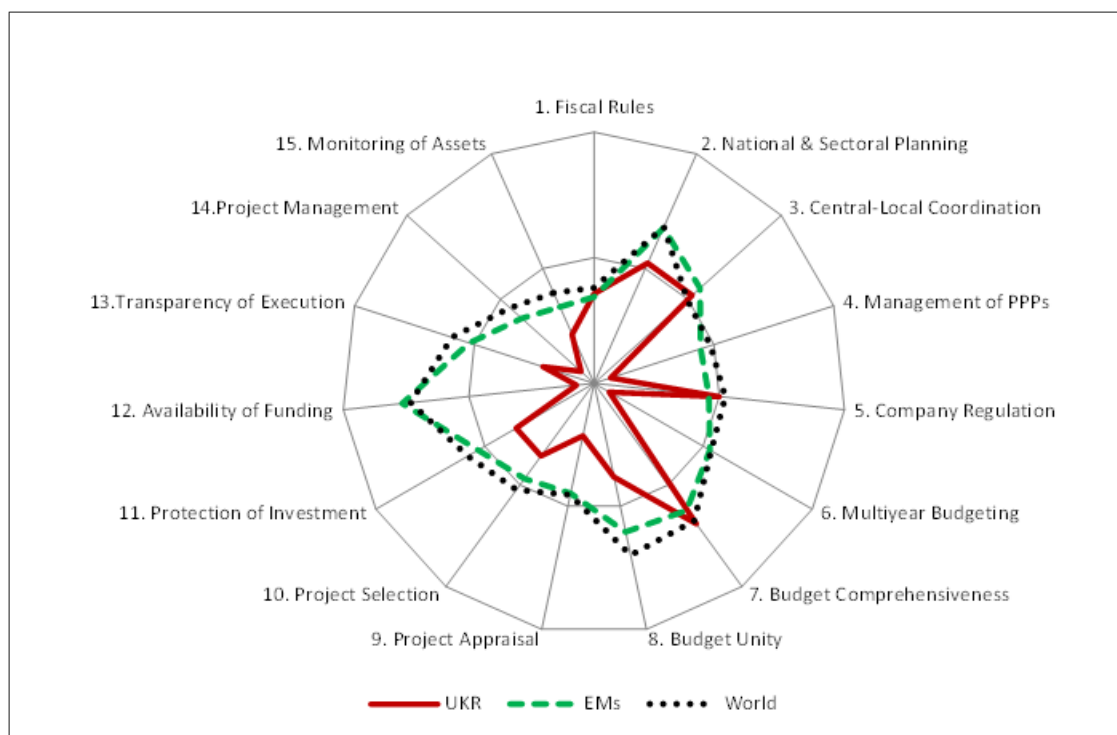
Source: World Bank, Enterprise Surveys, the World Bank Group.

### III. PUBLIC INVESTMENT MANAGEMENT INSTITUTIONS

#### A. Overall Assessment

**11. Ukraine’s institutions for managing public investments are weak at all stages of the process, but some recent initiatives may bring about significant improvements.** Figure 3.A compares Ukraine’s ratings with the average scores of emerging market economies and advanced economies. As can be seen, with the exception of company regulation and budget comprehensiveness, Ukraine scores badly in almost all areas as compared to emerging markets and the world. On average, formal institutions in the planning (1–5), allocation (6–10), and implementation (11–15) phases score low with particular weaknesses in management of PPPs, multi-year budgeting and project management. However, there are serious weaknesses across the board. The weaknesses in formal institutions are also reflected in the low effectiveness scores. Recent initiatives to reform some of the institutions surrounding public investment, such as: efforts to better coordinate inter-governmental fiscal relations; improve the legislative and oversight frameworks for PPPs; introduce a multi-annual budget process and introduce comprehensive project appraisal and selection processes (at least for some investment) are to be welcomed, but have not progressed sufficiently to materially affect many of the assessed scores for this assessment.

**Figure 3.A. Public Investment Management Institutions**



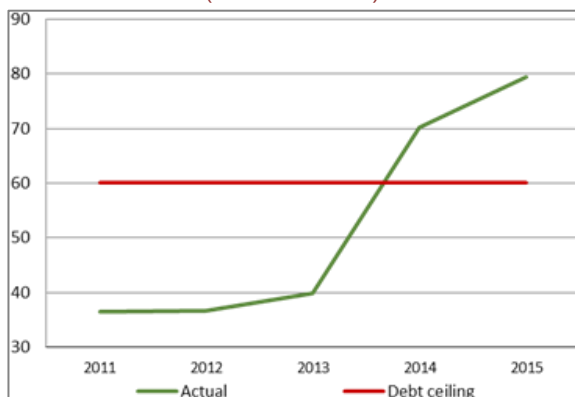
## B. Investment Planning

Fiscal rules (Strength—**Medium**; Effectiveness—**Low**)

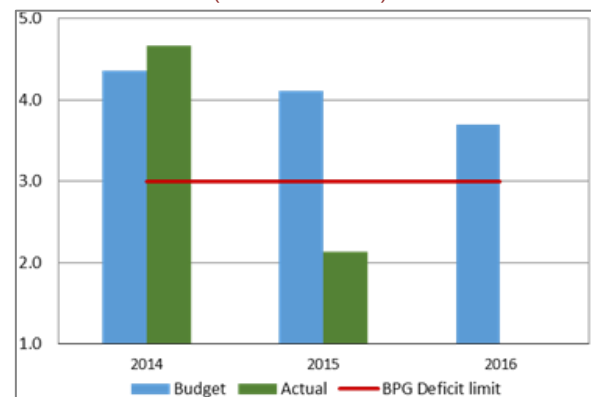
**12. Existing fiscal rules do not protect capital expenditure and enforcement mechanisms are weak.** The Budget Code includes a debt ceiling on budgetary central government set at 60 percent of GDP and covering domestic and external debt and loan guarantees. Amendments to the Budget Code in 2014 also required the government to submit a corrective plan to the Verkhovna Rada (VR) if the limit was breached, but the amendments did not provide for an automatic correction mechanism. The VR may authorize a temporary deviation, but there are no escape clauses. Externally financed capital expenditure is included within the debt ceiling and there is no floor on the level of capital expenditure. The debt ceiling was breached in 2014 (Figure 3.B). However, the ongoing process of debt restructuring would put external debt on a downward path and likely serve to bring the debt stock back under the ceiling.

**13. The forecasted deficit in the State Budget Law frequently exceeds the annual deficit target specified in the Budget Policy Guidelines (Figure 3.C).** No justification for the increase is provided in the budget documents, and there is no attempt to identify whether the fiscal position will comply with the debt rule.

**Figure 3.B. Budgetary Central Government Debt**  
(Percent of GDP)



**Figure 3.C Budgetary Central Government Deficit**  
(Percent of GDP)



Source: IMF staff estimates.

## **National and Sectoral Planning (Strength—Medium; Effectiveness—Low)**

**14. National strategic plans do not prioritize capital investment projects.** The “Sustainable Development Strategy of Ukraine 2020” (Ukraine 2020)<sup>4</sup> adopted by Presidential Decree in 2015 and published on the VR website is the sole strategic document at a national level, but it provides only broad policy direction and does not include plans for capital investments or policy measures.<sup>5</sup>

**15. Some but not all sectoral strategies include prioritized capital investments with costing information.** Sectoral strategies are classified into those for broad policy direction and for specific objectives and tasks. The former (e.g., the New Energy Strategies for 2035 of the Ministry of Energy) focuses on long-term policy visions and targets and does not specify priority of policy measures or projects. The latter includes a variety of documents, such as the State Target Program (STP), other “program” documents, and Action Plans, and they are adopted as Cabinet or Ministerial Orders and published on the VR website. The STP (e.g., State Target Economic Development Program for Public Roads)<sup>6</sup> is regulated by the Law on State Target Program (2004) and includes a list of prioritized investment projects with expected project costs and output targets. However, there is no regulation on the other documents, some of which do not specify priority of investment projects (e.g., Action Plan on Natural Gas Market).<sup>7</sup>

**16. The existing strategic planning process is largely dysfunctional, consisting of a myriad of programs that often overlap and pay little heed of the resourcing constraints posed by the budget.** Currently, 30 STPs exist and a further 27 are likely to be submitted to the Cabinet by the end of 2016. Consequently, these sectoral strategies take on the appearance of wish lists, with only a fraction of the proposed projects (e.g., around 5 to 10 percent in case of the public roads program) being actually funded.

## **Central-Local Coordination (Institutional strength—Medium; Effectiveness—Low)**

**17. Limits on local government borrowings are stated in the Budget Code.** These are set at 200 percent of the forecasted local development revenues for the following two years, except for the City of Kiev, where the debt limit is 400 percent. Article 74 of the Budget Code defines the scope and terms for local borrowing and the issuing of local guarantees, which requires the approval of the MoF. The state is not liable for local government debt and Article 74 further

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<sup>4</sup> Ukraine 2020 (<http://zakon3.rada.gov.ua/laws/show/5/2015>) consists of descriptions of 60 reform programs, their broad explanations, and quantitative targets for 25 high level economic and policy indicators, such as increasing GDP per capita by USD 16,000 and entering into top 50 in a ranking of Corruption Perception Index.

<sup>5</sup> The COM annually adopts a plan for implementation of Ukraine 2020, but implementing measures in 2015 focus on development of other strategic documents and do not specify priority capital investment projects or cost proposed measures.

<sup>6</sup> <http://zakon3.rada.gov.ua/laws/show/696-2013-%D0%BF>

<sup>7</sup> <http://zakon5.rada.gov.ua/laws/show/z1458-15>

limits the amount that can be spent on debt servicing in any year to 10 percent of the local general fund. Debt for local government is 1 percent of total general government debt (local government investment increased from 56.3 percent<sup>8</sup> of general government investment in 2005 to 69.6 percent in 2015).

**18. Capital spending plans of local governments are submitted to national governments on a project by project basis for projects funded through external sources and by the state.** This is in accordance with Article 24–1 of the Budget Code for state funded projects from the Regional Development Fund. For the Subvention for Amalgamated Territories, an intergovernmental committee, which is chaired by the Minister of Regional Development, approves the projects, after consultation with the relevant Oblast State Administration. The 2016 State Budget Law gives the COM authority, in consultation with the VR to allocate funds for projects in the Subvention for Socio-Economic Development in some regions (see Annex I for a description of the different funding options available for local government investment projects). There are no clear criteria to select the regions and the projects within these regions. Article 74 of the Budget Code requires national government approval for local government borrowing from IFIs and for issuing guarantees. The discussions between national and local government at the project level dilutes any strategic discussion on medium-term capital plans at the program level, which can be attributed to the lack of a multi-year budget planning framework.

**19. Capital transfers to local government are managed by individual line ministries and have differing criteria for allocation.** The Ministry of Regional Development manages the Regional Development Fund (UAH 3 billion in 2016, 0.15 percent of GDP) and the Subvention for Amalgamated Territories (UAH 1 billion, 0.05 percent of GDP), whilst the MoF manages the Subvention for Socio-Economic Development (UAH 1.94 billion, 0.1 percent of GDP) and the Ministry of Economic Development manages the program to support national and regional development projects (UAH 485 million). Combined, these four transfers equating to UAH 6.43 billion in 2016 constitute 1 percent of the main budget or 0.35 percent of GDP. Local capital spending, financed from own revenue, is insignificant due to low own revenue raising capacity and existing budget rigidities that leave little room for locally financed capital spending.<sup>9</sup> Funding certainty at the local level is limited.

**Public-Private Partnerships (Institutional strength—Low; Effectiveness—Low)**

**20. There is no PPP strategy or set of criteria for entering into PPP arrangements currently in place.** The previous government adopted a “Concept for PPP Development

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<sup>8</sup> Staff estimates based on official data.

<sup>9</sup> See: IMF Fiscal Affairs Department TA Report on “Fiscal Decentralization,” Hughes et al. 2015.

2013-18”<sup>10</sup> that includes a rationale for PPPs and defines priority areas for such arrangements, but this document is not considered in the investment decisions of the current government.

**21. Government units can procure PPPs using a range of often overlapping legislation.**

Currently, four different laws,<sup>11</sup> articulating different procedures, can be applied to public investment projects that include private sector actors. The 2010 PPP law has a number of deficiencies,<sup>12</sup> but it contains many of the elements that would be considered good international practice in regulating the use of PPP-style public investments, such as requirements for mandatory value for money analysis, appraisal procedures, competitive tendering, risk assessment, or risk allocation, and funding mechanisms.

**22. Currently, most projects that include participation of the private sector require no explicit funding from the government budget, as they take the form of concession contracts.** They are procured according to the concession laws, which include much less onerous requirements (e.g., no requirement for value-for-money analysis or oversight by the PPP unit in the Ministry of Economy). Consequently, these concession arrangements are favored by contracting agencies. Since the 2010 PPP Law was passed, only two very small projects have been procured under its provisions.

**23. The MoE and the State Property Fund (SPF) have central registries of PPP/Concession arrangements, but neither records the projects’ explicit or contingent liabilities.** Both registries record the date and duration of the contract and identify its parties, object and purpose, and state property used under the concession. Financial information is limited to total cost and funding (MoE) and the concession fees paid by the concessionaire (SPF).

**24. The government is ill-equipped to manage fiscal risks that may arise from PPPs and Concessions.** The MoF plays a very limited role in the PPP/Concession approval procedures (its approval is only required for explicit government funding, through direct payments or loan guarantees).<sup>13</sup> The absence of multi-year budgeting and commitment controls, together with the

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<sup>10</sup> See <http://zakon1.rada.gov.ua/laws/show/739-2013-%D1%80>

<sup>11</sup> The “General Concession Law” (1999), the “Law on Concessions in Construction and Operation of Motorways” (1999), the “Law on Leasing and Concession of Municipal Assets in Heating, Water Supply and Sanitation (2010), and the “Law on Public-Private Partnerships (2010).

<sup>12</sup> The most important limitations of the PPP law are related to: (i) limited role of the MOF in the PPP gateway process; (ii) lack of protection of the private partner (e.g. no access to arbitration, access to government guarantees only after the agreement is finalized, or impossibility of multi-year commitments by the public partner); (iii) lack of step-in rights in the event of contract breach by the PPP contractor; and (iv) no systematic approach to deal with unsolicited proposals.

<sup>13</sup> These exclude important fiscal risks of a more implicit nature (i.e. not directly stipulated in the contractual arrangement), such as those described in the manual of the IMF/WB PPP Fiscal Risk Assessment Model (<http://www.imf.org/external/np/fad/publicinvestment/pdf/PFRAMmanual.pdf>)

absence of full lifetime costing and analysis of individual PPP arrangement, also limits the MoE's and the MoF's ability to identify the fiscal impact of individual PPP arrangements, over the medium and longer-term. These weaknesses could be mitigated through introduction of a limit on the accumulation of associated liabilities, but the government has no plans to do so.

**Regulation of Infrastructure (Strength—Medium; Effectiveness—Low)**

**25. Infrastructure services are dominated by SOEs, although there has been progress in liberalization of some markets.** In the energy sector, domestic competition exists in wholesale gas provision, in which Naftgaz's share is limited to 30 percent. However, Naftgaz has a monopoly on gas import, transportation, storage, and retail, although the legal protection of its gas import monopoly was eliminated in 2012. The 2014 Law on Principles of Operation of Electricity Market liberalizes the wholesale electricity market in line with the EU-Ukraine Memorandum of Understanding on Energy Cooperation, but progress has stalled due to the recent energy crisis. In the railway sector, Ukraine Railways (UZ) has a monopoly on passenger services and infrastructure management and a 70 percent share of freight services. The liberalization of the telecom market is more advanced than other markets with domestic competition in the mobile market while in the fixed-line market, the Ukrtelecom privatization was completed in 2011.

**26. The government is accelerating the liberalization of infrastructure services.** The draft New Energy Strategies (NES)<sup>14</sup> envisages opening gas and electricity markets to new distributors and providers by 2018, following the requirements of the third EU Legislative Energy Package.<sup>15</sup> The government has been developing legislation, including the Law on Natural Gas Market adopted in 2015 and the draft Law on Electricity Market currently in the VR, to unbundle generation, transportation, wholesale and distribution of energies. The government is also prioritizing reform of the railroad company (UZ), which was converted into a joint stock company with a new governance structure in 2015, and new management is currently being appointed.

**27. Regulators setting prices of infrastructure services are not fully independent.** Electricity, gas, and heat prices are set by the National Commission of State Regulation on Energy and Utilities (NKREKP). In accordance with the existing IMF supported program, reform of the energy tariff policy is progressing. Gas and heat prices were scheduled to be increased to the level of full cost recovery by 2017 but a cabinet resolution at end-April 2016 adopted a

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<sup>14</sup> The NES will is a long-term strategic plan until 2030 and replace the pre-crisis Energy Strategies 2035 adopted by the Cabinet in 2013. The NES is designed to meet the requirements under the EU-Ukraine MOU on Energy Cooperation and its draft specifies ambitious policy targets to be achieved by 2030, such as increasing non-SOE share in heat production to 70 percent, reducing energy intensity by 60 percent from the level of 2013, and reducing CO2 emission by 20 percent from the level of 2010. However, the roadmap in the draft NES focuses on production and implementation of other laws, regulations, and standards.

<sup>15</sup> <https://ec.europa.eu/energy/en/topics/markets-and-consumers/market-legislation>.

resolution to bring gas tariffs to full cost recovery one year ahead of schedule. However, the NKREKP acts as both price setter and industry regulator licensing and supervising operations of energy companies. Combining the regulatory and price-setting functions includes significant conflicts of interest,<sup>16</sup> undermining its independence from regulated energy companies. Similar issues also exist in the railway and markets where railway fare increases require authorization by the Ministry of Infrastructure and local governments. Article 9 of the Law on Railway Transportation adopted in 1996 allows fares of regional commuter services to be set at a level below cost recovery. The losses will be compensated by fares of other services as well as budget subsidies.

**28. Tight control over financial and investment plans of SOEs is exercised, but overlapping and opaque institutional responsibilities weaken their effectiveness.** Financial and investment plans include: (i) multiannual financial projections; and (ii) details of project costs and funding sources. Publication of financial or investment plans of individual SOEs is not mandatory and some ministries (e.g., Ministry of Infrastructure) publish them while others (e.g., Ministry of Energy) do not. There is no published consolidated report on investment plans, although the MoE published a consolidated report on financial indicators of the largest 100 SOEs. The overlapping roles of five separate institutions (the Cabinet, MoF, MoE, sector regulators, and shareholding line ministries/local governments/SPF) creates redundancy and sews confusion in the approval processes surrounding financial and investment plans. Furthermore, oversight of financial and investment plans is largely vested in shareholding line ministries and local governments, whose primary focus is on achievement of sectoral policy targets. As a result, limited oversight or management of economic efficiency or of SOEs' investment activities exists, except for the State Support Procedure mentioned below. The oversight of fiscal risks emanating from SOEs is being addressed through the creation of a fiscal risks unit in the MoF, established in 2015 with initial responsibility to identify and analyze fiscal risks from the SOE sector.

**29. A State Support Procedure (SSP), introduced in 2011, sought to strengthen the institutions for oversight of SOE investment programs, but its effectiveness is limited.** The amendments to the Law on Investment Activity (LIA)<sup>17</sup> in 2011 subjects state support for investment projects to an assessment of economic efficiency by the MoE. Article 12 (1) of the LIA, includes four funding sources such as financing and co-financing of projects from the State or local budgets, State or local guarantees on financing of projects, and subsidy to financing costs of projects. Capital transfers to or guarantees on projects of SOEs, local governments, and private-sector companies are conditioned on being listed in the State Register of Investment

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<sup>16</sup> For example, conflicts between establishing industry policy objectives (e.g. increasing gas-supply capacity to avoid energy crisis and funding new pipelines through profits of gas companies) and criteria on tariff-setting (e.g., the criteria requiring tariff-increases which would reduce gas companies' income).

<sup>17</sup> <http://zakon3.rada.gov.ua/laws/show/1560-12>.



Projects after passing the assessment of economic efficiency. Although the SSP has strengthened the MoE's oversight powers, the effectiveness is limited for the following reasons:

- The process is redundant and adds little value – Out of 45 projects (aggregate project costs; 61 billion UAH) currently listed in the State Register, 30 projects are those of local governments or community owned companies counting only for 0.2 percent of the aggregate project costs. The projects are typically assessed by local governments according to their own procedures and again by the MoE, using its limited resources to duplicate the assessment of small projects of local governments and their companies; and
- Lack of comprehensiveness of coverage – The SSP targets new “revenue-generating” projects proposed after 2012, although it is not clear under the LIA which projects are subject to the SSP. As a result, SOEs’ projects for capital repairs or restructuring or those to meet regulatory requirements are not captured by the SSP. Currently, only six SOE projects are included in the State Register and no project has been added since 2015.

Annex II examines in more detail some of the issues surrounding regulation of assets that need to be addressed.

## C. Investment Allocation

### Multi-year Budgeting (Institutional strength—Low; Effectiveness—Low)

**30. There is currently no comprehensive multi-annual budget framework.** Article 21 of the Ukraine Budget Code provides for public investments to be incorporated within a multi-year budget framework, but in reality this has not been implemented. The government did approve a multi-annual budget forecast in 2012 but this initiative was abandoned after a year and the approved estimates bore little relation to the eventual approved annual budget. The MoF does circulate expenditure ceilings for the current year and indicative ceilings for two subsequent years to the spending units (May) prior to their preparation of budget proposals, but the actual approved budgets differ substantially from the ceilings, making it largely a cosmetic exercise. In addition, the annual budget ceiling bears little relation to outer year expenditure estimates from previous years. The absence of a definition as to what constitutes public investments further complicates any proposals to impose aggregate limits on capital investment (see Budget Unity below).

**31. Starting with the 2016 budget, a list of major public investments is included as an annex to the Budget and includes an estimate of the remaining lifetime costs of the project.** However, this relates only to those projects defined as public investments under the Budget code and does not include other capital projects which constitute more than 90 percent of capital expenditure. The costs are also not broken down by year.

**32. All appropriations lapse at the end of each budget year and as a result spending units cannot enter into multi-annual contractual commitments.** This leads to increased risks of funding not being made available to complete budget financed projects in subsequent years.

The government has agreed under its approved PFM action plan to introduce a medium-term budget framework in time for the preparation of the 2018 budget. However, work has yet to start in earnest.

**Budget Comprehensiveness (Institutional strength—Medium; Effectiveness—High)**

**33. General government capital spending is overwhelmingly undertaken through the budget and reported in general government financial statements.** The final state budget for 2015 included 44.472 million UAH for “development” spending.<sup>18</sup> The budget documents do not provide an economic classification breakdown, so there is no formally approved capital budget. The MoF develops quarterly budget implementation schedules (ROSPIS) based on the economic classification. At the end of 2015 the total allocation for capital spending during the year amounted to approximately 43 billion UAH, of which approximately 35 billion UAH were executed. The development budget includes central government capital spending, as well as capital grants to subnational governments, but does not capture local government capital expenditure financed by other sources. However, budget execution reports and the consolidated financial statement comprises both central and local government capital spending.

**34. Government borrowing for investment is disclosed in budget documents International borrowing for projects is expected to amount to 15 billion UAH for 2016.**

This is recorded as revenue to the special fund, and the investment spending is included under relevant budget heads.

**35. SOEs carry out substantial investment, of which a large share is financed by capital grants from the budget or by loans with state guarantees.** Government guarantees for direct loans to SOEs amounted to 12.8 billion UAH in 2015, whereas capital grants from the budget (to SOEs and private entities) amounted to 11.0 billion UAH. This means that most of the SOE investment in 2015, which is estimated to be approximately 20 billion UAH, was covered by state guarantees or financed by capital grants.

**36. PPP arrangements are not disclosed in budget documents.** Two small district heating projects have been established under the PPP law. The authorities worked to establish two larger PPP projects in 2015, one road project and one seaport, but none of these have materialized so far. There are a number of concession agreements in place where publicly owned land is used for commercial purposes against a fee. The income from the concession fees is transparently disclosed in the budget.

**37. Although there are shortcomings in budget comprehensiveness, this is not critical for efficient management of public investments.** The information about foreign-funded

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<sup>18</sup> According to MoF order No.11 of 14.01.2011, development spending comprises capital spending (budget code 3000) as well as research and development for implementation of state and regional programs (parts of 2281), materials, equipment, construction, repair and special purpose activities with national value (parts of 2260) and subsidies and transfers to organizations involved for their research and development (parts of 2610).

projects is quite comprehensive, and integrated with sector budgets. Since PPPs are limited, the failure to disclose these in the budget document does not pose urgent challenges for the quality of overall public investment management. The failure to identify and approve a specified capital budget is of greater concern, and this is covered under Budget Unity below.

**Budget Unity (Institutional strength—Medium; Effectiveness—Low)**

**38. The capital and current budget is prepared by the MoF and presented in a single budget document, based on a program classification.** The MoE plays a key role in many areas of fiscal management, including in the selection process for public investment projects, but does not take part in consolidated budget preparation. The budget classification is largely on a program basis, but some of the programs are organizational units.

**39. The budget document does not provide any appropriations for or information about recurrent costs associated with investment projects.** The recently established mechanism for preparation and selection of state investment projects require that project proposals include recurrent cost information, but this information is not yet used for budget preparation.

**40. The budget classification distinguishes between consumption costs and development expenditures instead of current and capital spending, and is not consistent with GFSM 2001/2014.** According to MoF order No.11 of 14.01.2011, development spending comprises capital spending as well as research and development for implementation of state and regional programs, spending for some activities with national value and subsidies and transfers to organizations for their research and development. The MoF prepared ROSPIS are based on the economic classification. However, the details of the mapping from the classification in the budget documents to the ROSPIS are not available in any public document. The absence of a clearly defined capital budget is a significant weakness, in terms of budget transparency.

**Project Appraisal (Institutional strength—Low; Effectiveness—Low)**

**41. Most capital projects currently in the budget have not been subject to standardized cost/benefit analysis, but the recently established public investment project mechanism provides a framework for conducting such analysis in the future.** In 2015, the Ministry of Economy established a mechanism for identification, preparation, appraisal and selection of public investment projects for the 2016 budget.<sup>19</sup> Projects are reviewed by a committee comprising nine ministers and nine parliamentarians. For the 2016 budget, 36 projects were prepared and submitted for assessment in accordance with this new mechanism. Ten projects were selected for implementation within a 1 billion UAH envelope set aside for 2016.<sup>20</sup> Eight

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<sup>19</sup> Cabinet resolution No. 571 of 22.07.2015 establishes an inter-agency committee for public investment projects and detailed procedures for preparation, appraisal and assessment of these projects.

<sup>20</sup> In the appendix to the budget one of the 10 projects is divided into three sub-projects, giving a total of 12 projects to be financed.

projects were positively reviewed but considered suitable for financing from other sources. Eighteen projects were returned for further development and elaboration.

**42. To date, only a small fraction of government capital projects are covered by the new mechanism.** The total allocation for these projects in 2016 of 1 billion UAH must be compared to expected total general government capital spending during the year of 30–40 billion UAH.<sup>21</sup> However, the mechanism does cover a large share of new central government investment projects. A significant part of development spending is allocated to military and security purposes without any identification of individual projects.

**43. The new public investment project mechanism provides a standard methodology for project appraisal in line with international good practice.** Cabinet resolution No. 571 provides detailed guidelines on how to develop project identification and project preparation documents. It covers specification of objectives and targets, quantification of costs and benefits, analysis of financial and economic viability, preparation of risk assessment and project implementation plans, and provides for independent examination of project proposals by the Ministry of Economy according to pre-determined criteria. If this mechanism is effectively implemented and gradually applied to a larger set of project proposals, this can become a very important tool to ensure the quality of investment project appraisals.

**Table 3.A. Ukraine: Structure of Project Document According to Cabinet Resolution No. 571**

Objective and brief description	Power sources
Main purposes and results	Economic efficiency
Responsible entity	Economic impact
Purpose of new facilities	Social impact
Project rationale and zero-option	Environmental impact
Strategic framework	Annual project revenues
Alternative analysis	Annual operational costs
Total project cost	Domestic and foreign currency costs
Project implementation plan	Project consistent with legal framework
Funding sources	Permits required for the project

**44. Investment projects before 2016 were not subject to systematic appraisal, and there is no mechanism for consideration of risks related to these projects.** The vast majority of public investment projects have so far been financed and implemented without any systematic centralized scrutiny. The new public investment mechanism does require systematic appraisal, including a specification of risks related to investment projects, and identification of risk mitigation measures. This should form the basis for a more stringent risk assessment and

<sup>21</sup> Since capital spending is not specified in budget documents we do not have a precise estimate for 2016.

management framework in future projects. However, the mechanism has limited coverage so far and its effectiveness remains to be proven.

**Project Selection (Institutional strength—Medium; Effectiveness—Low)**

**45. Some major project appraisals are now subject to central review prior to the decision to include them in the budget.** As mentioned above, the new public investment project mechanism specifies the process for Ministry of Economy review of project appraisals. Although the volume of spending on these projects in 2016 is low compared to the overall capital budget, they do constitute a significant share of new investment projects outside the military and security sectors, and include several large and strategically important projects. Annex III contains an overview of projects that have been reviewed and accepted under this process.

**46. The new public investment process specifies some criteria for project selection, but these are quite general and provide limited guidance for prioritization decisions.** The projects are examined by the MoE prior to submission to the inter-agency committee. Article 12 in the section “Procedures” of Cabinet resolution No. 571 provides some criteria: compliance with state requirements, expected impact (environmental, social and economic), impact on state budget figures, reasonableness of costs and implementation plan and availability of adequate resources. They are quite high-level and process-oriented, and are more helpful for ensuring the quality of project documentation than for the final prioritization and decision process. The criteria that had most impact on project selection for 2016 was to prioritize completion of ongoing projects.

**47. The MoE examination of investment projects focuses on ensuring that the formal criteria for project development and appraisal are complied with, whereas the actual selection is based on ad hoc prioritization in the inter-agency committee.** The MoE plays a similar role in reviewing other types of investment projects, including local government projects to be funded by foreign loans and SOEs or private sector projects seeking some state financial support. Annex IV provides an outline of how a more stringent project selection mechanism can be constructed.

**48. The selection of investment projects is directly linked to the annual budget process, and there is currently no pipeline of projects for subsequent inclusion into the budget.** The 10 projects that were approved through the new public investment process were immediately included in the budget. The new mechanism will over time allow for the development of a project pipeline, where projects can be systematically tracked from the initiation stage through project development until they are ready for decisions and possible financing. The effectiveness of such a mechanism will depend critically on the integration with the budget process and the introduction of medium-term budget planning. In the absence of a well-functioning MTBF, an investment project pipeline will add limited value.

**49. Selection of a project for one budget year does not guarantee funding in future budgets.** The decision on investment project funding for 2016 includes an indication of similar funding levels for these projects in 2017 and 2018. The projects selected for the 1 billion UAH set aside in the 2016 budget, are estimated to require an additional 7 billion UAH to be completed. They must be resubmitted each year to have a chance of securing additional funding. The MoE is currently reviewing public investment project proposals for the 2017 budget. They have received 46 project proposals, of which six are continuations of projects funded in 2016. Thirty-four of the proposals have been returned for further elaboration and possible resubmission before the final deadline of April 15, 2016.

## **D. Investment Implementation**

### **Protection of Investment (Strength—Medium; Effectiveness—Medium)**

**50. Capital investments are appropriated on an annual basis.** In accordance with Article 38(4–1) of the 2015 amendments to the Budget Code, the 2016 budget documents present non-binding information on total projects costs and expenditure for the budget year of 10 “public investments” (see project appraisal above), but do not show medium-term expenditure on a year-by-year basis. Budget documents include no information on other domestically financed capital projects. The State Budget Law authorizes the total amount of loans for externally financed projects on a project-by-project basis and these are automatically carried over. However, co-financing and grant-financed projects are authorized through annual appropriations, as are domestically financed projects. Multi-annual commitments are strictly prohibited for all projects except those financed through external loans and even in this instance budget co-financing is appropriated annually (see Multi-Annual budgeting above).

**51. The MoF can approve in-year reallocation from capital to other expenditure.** Under Article 23 of the Budget Code, reallocation of any appropriations requires the MoF’s approval on the request of a key spending unit.<sup>22</sup> Amendments to the State Budget Law are necessary for reallocation between general and special fund appropriations or to change authorization of loans from donors. There is no prohibition of specific types of reallocation and no quantitative limit on the amount. Reallocation of externally financed expenditures is restricted, as they are generally included in special fund appropriations or their funding is authorized on a project-by-project basis. However, there is no restriction on reallocation of capital expenditure by the MoF of domestically financed projects to other expenditure.

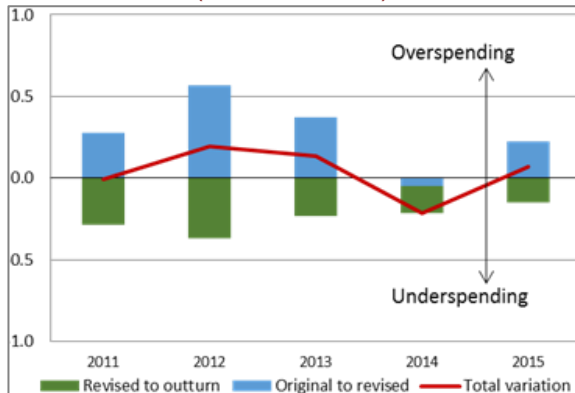
**52. Under-execution of capital expenditure appropriations is limited in aggregate but its allocation to each project in the budget is not credible.** Variations between the originally voted budget to actual outturns is small for both expenditures on acquisition of fixed assets and

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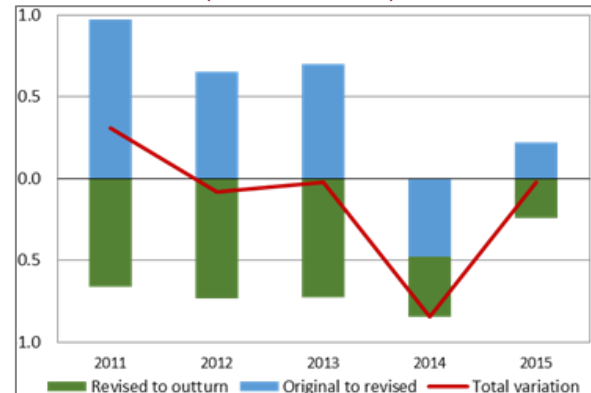
<sup>22</sup> In addition, reallocation between different programs of key spending units and increases in development expenditure require Cabinet approval and the consent of the VR Budget Committee. Amendments to the State Budget Law are required for reallocation between different key spending units except for transfer of functions or services.

capital transfers, except for 2014, at the beginning of the crisis (Figures 3.D and 3.E). However, there is a persistent tendency for revised budgets to increase capital expenditure appropriations through reallocation and supplementary budgets and for these revisions to be subsequently under-executed. This probably reflects the fact that increases in budget allocations for capital projects are approved too late in the year to allow for the expenditures to be executed.

**Figure 3.D Budget Performance (Acquisition of Fixed Asset)**  
(Percent of GDP)



**Figure 3.E Budget Performance (Capital Transfer)**  
(Percent of GDP)



Source: IMF staff estimates.

#### Availability of Funding (Institutional strength—**Low**; Effectiveness—**Low**)

**53. Monthly financial plans of spending units are produced at the beginning of the year, as required under Article 23 of the Budget Code, but they are not updated over the course of the year.** Cash forecasting is focused on short-term cash needs. The State Treasury Service produces a weekly forecast of cash balances for the following month used in planning budget execution but there is little by way of systematic planning and assessment of evolving cash needs over the course of the budget year.

**54. Investment spending is treated as a residual in the budget in terms of release of funds.** Protected items in the budget,<sup>23</sup> which are almost entirely made up of current spending and transfers to households and local governments, get paid as a priority. Until 2015, local governments were required to deposit their own revenues in accounts in the Treasury Single Account which meant that frequently funds were not released on time by the State Treasury, if liquidity conditions at the central government level were tight, but they are now permitted to open accounts in commercial banks. While this offers local government increased flexibility in management of their own expenditures, it has also increased their exposure to the banking system.<sup>24</sup>

<sup>23</sup> Article 55 of the Ukraine Budget Code.

<sup>24</sup> Discussions with the authorities revealed that it is possible that some local governments may have suffered losses as a result of depositing funds in banks that have subsequently failed.

**55. Spending units hold foreign exchange accounts for projects financed by IFIs in commercial bank accounts, outside of the Treasury Single Account.** While this weakens the ability of the State Treasury Service to manage liquidity effectively at the consolidated level, any changes to the current procedures would require significant upgrades in cash planning and management capacity to ensure timely release of funds to finance investment project related expenditures.

**Transparency of Execution (Institutional strength—Low; Effectiveness—Low)**

**56. The procurement process for capital projects has been non-transparent and there have been many exceptions to competitive tendering.** According to government statements, annual procurement amounts to about 300 billion UAH, and as much as 40 percent of the funds might have been misused.<sup>25</sup>

**57. A new procurement law became effective April 1, 2016.** The new law will simplify procedures and reduce the number of exceptions, improve public access to and the transparency of procurement process and bring Ukraine's legislation closer to European practices. The government is also rolling out a new E-procurement system (Prozoro). This system is mandatory for central government entities' procurements above 200 thousand UAH for goods and 1.5 million UAH for services from April 1, 2016, and will be mandatory for all government entities including local governments from August 1, 2016. The law and the E-procurement system are developed in accordance with good international practices, and provide a potential for significant improvements in this area. To realize this potential, effective monitoring of compliance and consistent action against breaches and irregularities will be key.

**58. There is no centralized mechanism for monitoring of major capital projects during implementation.** Individual line ministries may have systems in place for this purpose, but there is no centralized repository for project implementation information, and no systemic mechanism to take action if projects are delayed or go off track. The MoE is currently developing a monitoring process, and plan to begin implementing this from mid-2016. Until this is in place, the possibility for centralized monitoring is limited to following financial reporting on budget execution.

**59. There is no systematic ex post internal or external audit of capital projects.** The State Financial Inspection has performed ex post internal audit of at least one capital project (in 2011), and plans three new assessments of completed investment projects in 2016. The Accounting Chamber have carried out ex post audit of some investment projects, but these are not documented in separate reports and are focused on compliance with provisions of the annual budget. The annual report of the Accounting Chamber does not contain information about specific audit findings.

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<sup>25</sup> Prime Minister Yatseniuk in Reuters, April 10, 2014.



## **Project Management (Institutional strength—Low; effectiveness—Low)**

**60. There is no consolidated and consistent system for monitoring and managing projects.** Projects financed by IFIs are monitored and managed in terms of the requirements set out by each institution. State funded projects are managed on an ad hoc basis and monitoring is largely based on compliance and adherence to the budget. This is done by various agencies, including the State Financial Inspection (internal audit) and the Accounting Chamber (external audit), in the project implementation cycle.

**61. There are no guidelines for project adjustments that are applied consistently across government.** Where project adjustments are made for a specific category of capital expenditure, Article 33 of the 2016 State Budget Law requires that the spending units report these to the VR on a quarterly basis. Project monitoring is largely based on budget compliance and project adjustments, if made, are based on adherence to the budget, as opposed to the needs of the project. The absence of multi-annual commitments for budget financed projects contributes to the failure of project managers to assess the need for adjustments to ensure that the projects objectives are being met.

**62. Ex post review and evaluation of investment projects are limited to the projects financed by IFIs.** The State Financial Inspection and the Accounting Chamber purport to carry out some ex post assessments but in the case of the Accounting Chamber these are almost entirely focused on compliance with budget appropriations. The State Financial Inspection intends to carry out ex post audits of three projects in 2016<sup>26</sup> and has carried out similar audits in the past but these typically do not involve a full review and evaluation of the project and these reports are rarely published. However, the Ministry of Economic Development is developing a new monitoring framework for state investment projects. The monitoring framework is expected to include the requirement to complete ex post reviews and evaluations of projects, once construction is completed.

## **Assets Accounting (Institutional strength—Low; Effectiveness—Low)**

**63. Key spending units conduct annual surveys of nonfinancial assets, but these represent only a small share of total nonfinancial assets owned by the government.** The surveys form the basis for revaluation of nonfinancial assets, which are disclosed in the balance sheet submitted to the State Treasury Service, on an annual basis.<sup>27</sup> Government nonfinancial assets that are not formally held by those units, are managed by the State Property Fund who, despite keeping a registry of those assets, does not update their value on a regular basis.

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<sup>26</sup> Projects related to Hydro-electrical Power Generation, Power Transmission and High Speed inter-city trains (Ukrainian Railways) completed in preparation for the 2012 European Football Championships.

<sup>27</sup> As part of the annual reports submitted to the State Treasury Service, key spending units' report, using a specific form, on their stocks of fixed assets and inventories. Accumulated depreciation is disclosed as well as stock values at "original revalued cost" (equivalent to fair value, excluding depreciation) and "book (residual) value" (equivalent to fair value).

**64. No information on the stock of assets or depreciation is included in the final consolidated financial statements of the government.** The latest version of the national public accounting standards, approved in 2010, adopt a number of accrual IPSAS, but accounting of general government units continues to be carried out using a cash basis. As a result, the two transaction statements of the Annual Financial Report of the State Treasury Service—Statement of Government Operations and Cash Flow Statement—are two presentational variants of the same cash data, with no disclosure of depreciation. The third financial statement of the report—the consolidated balance sheet—includes only financial assets and liabilities.

## IV. RECOMMENDATIONS

**65.** Based on the assessment provided in Section III, the following recommendations are suggested:

**Issue 1:** Most of the national and sectoral strategic plans do not prioritize capital investments, and investment plans specified in some sectoral plans do not take into account the budget constraints.

**Recommendation 1:** Establish a common format of fully costed and prioritized capital investment plans to be included in national and sectoral strategies and require the MoF to provide opinions on their affordability by amending the laws and regulations on the economic and social development programs.

**Issue 2:** Capital transfers to local government are fragmented, even though the objectives are the same.

**Recommendation 2:** Consolidate the allocation methodology and process for approval of capital transfers to local government and merge the Regional Development and Socio-Economic Development funds should be merged. Given the equity considerations in allocating funding and the limited capacity at national government, the allocations to local government should be formula based. To strengthen spending effectiveness, local governments should report to national government on outputs and outcomes, against the formula based allocations.

**Issue 3:** The legal and institutional framework surrounding PPPs is fragmented, over complicated, and ill-equipped to ensure that fiscal risks emanating from PPPs and concessions are adequately identified, disclosed and mitigated.

**Recommendation 3:** Consolidate and strengthen the legal and institutional framework for PPPs, focusing on the management of fiscal risks arising from those arrangements. Specifically:

- Develop and adopt a single PPP law that is comprehensive in scope (and applicable to concessions) and coverage to provide sound principles for fiscal risk management and a stable and attractive environment for private investors.

- Assign the MoF an explicit role as gatekeeper of public finances in all stages of PPP/concession projects (see Annex V).
- Incorporate PPPs and concessions in the overall budget process and medium-term planning exercise and include information on the lifetime costs of outstanding PPPs in the budget documentation.

**Issue 4:** There is currently no pipeline of approved projects that can be considered for funding as it is made available.

**Recommendation 4:** Establish a medium-term investment project pipeline process and combine this within a comprehensive medium-term budget framework that facilitates and takes account multi-annual commitments for investment projects. As the project appraisal and selection process is strengthened and extended, it should form the basis for systematic monitoring of a portfolio of investment projects, from the initiation stage, through approval and implementation.<sup>28</sup> The development and management of the portfolio should be closely coordinated with and integrated into the medium-term budget framework, which is planned to become operational from 2018. The Budget Code should also be amended to permit approval of multi-annual commitments for capital projects.

**Issue 5:** Capital spending is not clearly defined and presented separately in budget documentation.

**Recommendation 5:** Provide a clearly defined capital budget in budget documents and have this formally approved by parliament. The MoF already prepares a budget release plan according to an economic classification and should provide a similar specification in the budget documents. This should replace the current development budget concept as the basis for parliamentary budget approval. The development budget breakdown could still be included as an information item, if this is deemed to be important.

**Issue 6:** Project appraisal and selection processes remain relatively weak and recent improvements have only covered a small sub-set of capital projects.

**Recommendation 6:** Strengthen the newly established project appraisal and selection approach and extend this to all major state investments, including projects with external financing. Cabinet resolution 571 provides a good basis for systematic appraisal of projects, but the framework for selection of projects should be further developed. Over time, most major state investment projects should be subject to this procedure. It should also include projects that are funded by external sources, to ensure consistent prioritization. This will require working with development partners to streamline and coordinate relevant processes. The centralized process should focus on large and strategically important projects, whereas appraisal of and decisions regarding

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<sup>28</sup> See: <http://www.treasury.govt.nz/statesector/investmentmanagement/do/index.htm#monitored-projects> for an example of a modern public investment monitoring framework.

smaller projects should be left to the responsible ministries or local governments. The threshold for which projects are reviewed in the central process should be defined in the regulation.

**Issue 7:** Existing external and internal audit oversight is weak and focused on compliance with financial limits. Audit findings are also not published as a matter of course.

**Recommendation 7:** Ensure effective oversight of public investments through centralized monitoring and systematic ex post audit. A portfolio approach to public investment projects will allow for more effective oversight. Systematic reporting about project development and implementation will provide the basis for active risk management, including necessary project and portfolio adjustments. The State Financial Inspection Service should help ensure the quality and integrity of the monitoring process through its internal audit activities. This should be combined with stringent requirements for external ex post audit of all major investment projects and subsequent publication of the audit findings.

**Issue 8:** There are no limitations to budget reallocation from capital to other expenditure and no carryover is allowed for projects funded by the general fund appropriations, while there is no limitation to carryover of the special fund appropriations.

**Recommendation 8:** Amend the Budget Code to prohibit reallocation from capital to other expenditure and specify carryover rules common to the general and special fund appropriations within quantitative limits and with MoF approval.

**Issue 9:** Cash forecasts are short term and cash requirements are not integrated in debt management strategies leading to significant uncertainty surrounding availability of funding for investments.

**Recommendation 9:** Implement previous FAD recommendations<sup>29</sup> to:

- Strengthen cash management capacity,
- Eliminate foreign currency accounts of spending units,
- Review the practice of maintaining large balances in foreign currency accounts in the National Bank of Ukraine to finance future debt redemptions; and
- Integrate debt management strategies with cash management strategies.

Table 4.A provides an action plan to guide implementation of the recommendations.

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<sup>29</sup> See: IMF Fiscal Affairs Department TA Report on “Public Financial Management Overview,” Olden et al. 2014.

**Table 4.A. Ukraine: Detailed Recommendations and Action Plan**

Recommendation	Investment Stage (Institution)	Specific Activities	2016	2017	2018 and beyond-	Responsible Institutions
<b>I. Limited Planning and Prioritization</b>						
<b>1. Enhance the effectiveness of National and Sectoral Plans</b>	Planning (2)	1.1 Develop and adopt a new Planning Law and associated regulations, establishing a more integrated and coordinated planning process	Draft by Nov. 2016	Regulations approved by Jun 2017		MOE
	Planning (2) Allocation (6)	1.2 Require all sectoral strategies to include fully costed and prioritized capital investment plans, according to an harmonized template	Stock-take all sectoral strategies by Sep. 2016	New template issued by Jun 2017	New sectoral strategies approved by June 2018	MOE, MOF
<b>2. Streamline the process for allocating funds for local government investment</b>	Planning (3)	2.1 Merge regional Development Fund and Socio-Economic Development Fund	Allocations combined in 2017 budget			MOF, MORD
	Planning (3)	2.2 Develop a transparent formula-based system for all capital transfers to local authorities	New allocation formula, approved by end-2016	Funds allocated according to the new formula in 2018 budget		MOF, MOE, MORD
	Planning (2,3)	2.3 Develop a reporting system for local authorities, that links outputs and outcomes to the formula-based allocations		Performance management framework developed by Oct. 2017	New system implemented in 2018 budget execution	MOE, MOF, MORD
<b>3. Consolidate and strengthen the legal and institutional framework for PPPs</b>	Planning (4)	3.1 Develop and adopt a single, comprehensive PPP law, providing sound principles for fiscal risk management and a stable and attractive environment for private investors.	Draft by Oct. 2016			MOE, MOF
	Planning (4)	3.2 Assign the MOF an explicit role as gatekeeper of public finances in all stages of PPP/Concession projects		Implement gatekeeping procedures and assign responsibilities		MOE, MOF
	Planning (4) Allocation (7)	3.3 Incorporate PPPs and Concessions in the overall budget cycle, and disclose related information in budget documentation		2018 budget preparation		MOF

II. Inadequate Budget Practices						
<b>4. Prioritize the multi-year budgeting of investment expenditure</b>	Allocation (6)	4.1 Establish a medium-term investment project pipeline process, with annual projections of full project costs	Procedures defined and guidelines updated, by Jun-2016; Multi-year commitment for capital spending authorized in Budget Code	Include multi-annual commitments for capital projects in 2017 budget law.		MOE, MOF
	Allocation (6)	4.2 Integrate multi-year investment budgeting into the overall MTBF		2018 budget preparation		MOF
<b>5. Clarify presentation of capital Budget</b>	Allocation (8) Implementation (11)	5.1 Include a table on expenditure by economic classification, broken down between current and capital budgets in the budget documents to be approved by VR	2017 budget preparation			MOF
<b>6. Strengthen investment projects' appraisal and prioritization</b>	Allocation (9, 10)	6.1 Extend the new project appraisal and selection procedures to all major projects involving capital formation, and establish mandatory scrutiny of budget affordability by MOF staff		Procedures extended to all major domestically financed projects in 2017 selection process	Procedures extended to projects with external financing in 2018 selection process	MOE, MOF
	Allocation (10)	6.2 Clarify criteria for project selection and develop a centralized project selection platform where all selection decisions are transparently disclosed	Transparent scoring and selection methodology developed and guidelines updated, by end-2016		Project selection platform used in 2018 selection process	MOE, MOF, MORD
	Allocation (10)	6.3 Set a project cost threshold, below which selection can be performed by line ministries or local authorities	Threshold defined in updated guidelines, by end-2016			MOE, MOF, MORD

### III. Weak Implementation Processes

<b>7. Establish centralized monitoring and auditing of investment projects</b>	Implementation (13, 14)	7.1 Establish systematic reporting system with information on project development, implementation, and risk assessment	MOE monitoring framework in place from July 2016			MOE, MOF
	Implementation (13)	7.2 Mandatory ex post financial and performance audit of all projects involving significant fixed capital formation	Specific ex post audits included in audit program for 2017	Ex post audits published as separate reports, starting Jan 2017		Accounting Chamber
<b>8. Protect investment spending during budget implementation</b>	Implementation (11)	8.1 Amend the Budget Code to (i) prohibit reallocation from capital to other expenditure, and (ii) allow carryover of unused appropriations for capital expenditure	Budget Code amended and regulations adapted by Sep 2016	New rules enforced in 2017 budget execution		MOF
<b>9. Strengthen management and forecasting of funds available for investment</b>	Implementation (12)	9.1 Integrate all foreign currency accounts of spending units into the TSA.	Integration of accounts into TSA, by end-2016			MOF
	Implementation (12)	9.2 Integrate debt and cash management strategies and forecasting techniques	MOF responsible for central government cash planning, by Oct. 2016	MOF responsible for managing central government cash position, by Jun 2017		MOF, State Treasury Service

## Annex I. Fiscal Support for Decentralization

Fiscal decentralization is based on the premise that public spending becomes more efficient as decentralized governments are more responsive to citizens needs and therefore strengthens accountability. The increased accountability is supported when local governments have adequate levels of discretion in raising their own revenue. In 2014, the Tax Code of Ukraine was amended to allow local government to collect multiple taxes, including land and property taxes, tourism taxes, fees for certain business activities, parking fees and a tourism tax.

The authority and certainty to raise revenue locally enables local government to finance capital investment programs through borrowing. The limits to local government borrowings are stated in the Budget Code of Ukraine which is 200 percent of the forecasted local development revenues for the following two years and 400 percent for the City of Kiev. Article 74 of the Budget Code further limits the amount that can be spent on debt servicing in any year to 10 percent of the local general fund.

Amendments to the Budget Code in 2014 created a new system of financial equalization. In terms of Article 64 of the Budget Code, local government receives 60 percent of the personal income tax, 5 percent of the excise tax on the sale of excisable goods, 100 percent of the single tax, 100 percent of the property tax, 100 percent of the land payment, 100 percent of the corporate income tax for municipal property enterprises, 100 percent of the fee for the provision of administrative services and 25 percent of the environmental tax. The City of Kiev receives 40 percent of the personal income tax, but also receives 10 percent of the corporate income tax.

Investment programs of local government are supplemented by 3 transfers; the Regional Development Fund, the Subvention for Social and Economic Development and the Subvention for Infrastructure in Amalgamated Communities. The 2016 budget also contains an allocation for national and regional investment projects managed by the Ministry of Economic Development. Of all transfers to local government, the evaluation process for the Regional Development Fund is the most comprehensive.

### *Regional Development Fund*

Regional development is one of the priority programs in the Ukraine 2020 strategy. To support this, the Budget Code was amended in 2014; creating a Regional Development Fund which is not less than 1 percent of the revenues in the state general fund. The Regional Development Fund is allocated 3 billion UAH in 2016, despite the projected 559.7 billion UAH general fund revenue.

The Regional Development Fund is allocated on a formula basis to each regional authority, where 80 percent of the allocation is based on population size and 20 percent is based on GDP per capita in the region is less than 75 percent of average national GDP per capita. Within this limit, local authorities are allocated funding on a project basis after evaluation by the Ministry of



Regional Economic Development. The projects funded through the Regional Development Fund require 10 percent co-funding contribution from the local authority.

Article 24 of the Budget Code requires the Oblast Councils to submit regional project proposals that can be funded through the Regional Development Fund by May 1 each year. The Ministry of Regional Development is required to complete its evaluation of these proposals by August 1 each year and submit it to the Cabinet of Ministers for approval and inclusion in the budget the following year. Despite this requirement, the Ministry of Regional Development have not finalized projects to be funded in 2016.

#### *Subvention for Amalgamated Territorial Communities*

The adoption of the law on Voluntary Amalgamation of Territorial Communities in 2015 allowed for the creation of 159 new communities. In general, these communities do not have a revenue base large enough to undertake investment programs. To support infrastructure investment programs in these communities, the 2016 budget allocated 1 billion UAH through a formula which includes the size of the rural area and rural population.

Local authorities are required to report on progress on a monthly basis, within 5 days after the end of the month, to the Ministry of Regional Development.

#### *Subvention for Socio-Economic Development*

Managed by the MoF, 1.94 billion UAH is allocated in 2016 for socio-economic development in some regions. Article 30 of the State Budget Law requires the Cabinet of Ministers, in consultation with the VR to allocate funds to projects. Allocations are project based (official state that allocations are per facility) with no transparent criteria.

The final decision on local government projects funded through the state budget does not lie with the local authority. This weakens accountability as local councils cannot be held responsible for decisions taken at national or oblast level and undermines the decentralization objectives set out in the Ukraine 2020 strategy.

## Annex II. Selected Issues in Legislation on Regulation of Infrastructure Companies

Regulations surrounding SOE provision of infrastructure services are inadequate. This annex gives an overview of the current legal framework, analysis of its issues, and recommendations to improve the legislation.

### *SOEs' Financial Performance Monitoring*

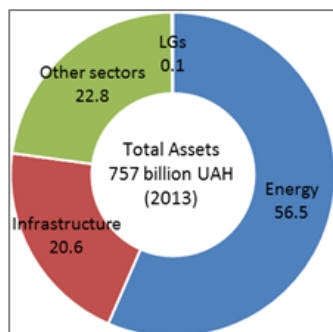
**Key Legislation:** The Law on Management of State Property (LMSP, 2006); Cabinet Resolution on Control over Functions of State Property Management (832–2007); Presidential Decree on Ministry of Economic Development and Trade (634–2011); MoE Order on Guidelines for Efficiency Criteria on Management of State Property (253–2013); MOE Order on Performance of State Enterprises (1307–2012); MoE Order on Guidelines for Transparency of Entities in the Public Sector (116–2015); Cabinet Resolution on List of State Property of Strategic Importance (83–2015); Cabinet Resolution on List of Entities in the Public Sector to Be Restructured (1227–2015); Cabinet Resolution on the Ministry of Finance (375–2014); Presidential Decree on National Commission for State Regulation on Energy and Utilities (2014–715); Law on State Property Fund (SPF Law, 2012).

**Main Issue:** The legislation creates overlapping institutions while at the same time creating gaps in SOEs' performance monitoring. Box 1 describes the institutional responsibilities for oversight of SOEs' financial performance under the current legislation. Of particular concern are the following:

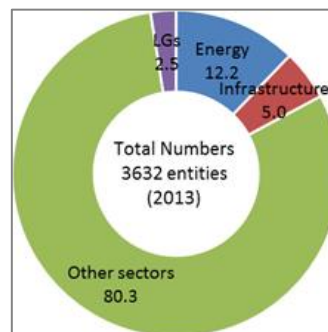
- The requirement for the MoE to approve SOEs' financial plans that require the COM approval (Presidential Decree 634–2011), which duplicates the oversight undertaken by shareholding ministries and local governments; and
- The MoE's oversight burden (Cabinet Resolution 832–2007), is overwhelming given its lack of resources (in 2013 there were around 3,632 entities (of which around 1,338 were estimated to be viable. Of these 623 entities in energy and infrastructure sectors counted for 77.1 percent of the total aggregate assets (Figures A3. 1 and A3.2).

To address the lack of resources and to focus on the largest SOEs, the MoE is currently concentrating on monitoring the performance of the largest 100 SOEs (MoE Order 116–2015), but methodologies have not been issued yet and no amendments have been made to the existing legislation. The MoE is tasked with drafting lists of SOEs to be restructured (Cabinet Resolution 1227–2015) and those of strategic importance (Cabinet Resolution 83–2015), but the selection criteria are not defined in the legislation.

**Figure A3.1 Sectoral Share in SOEs' Total Assets (Percent)**



**Figure A3.2 Sectoral Share in Number of SOEs (Percent)**



Source: IMF staff estimates.

The MoF is tasked with identifying and analyzing and proposing mitigation measures for fiscal risks arising from SOEs (Cabinet Resolution 375–2014), but the legislation is yet to (i) specify and require necessary information flow to the MoF from the SOEs and relevant line ministries, (ii) require the publication of fiscal risk statements with defined contents, and (iii) set out methodologies for fiscal risks monitoring and management.

#### **Box A.1. Institutions for Control over SOEs' Financial and Investment Plans**

- Cabinet – Article 5(20) of the LMSP requires the Cabinet to approve financial plans of SOEs that are monopolies or have estimated net profit of more than 50 million UAH.
- Shareholding line ministries and local governments – Articles 6(6) and (7) of the LMSP require shareholding line ministries and local governments to approve SOEs' financial and investment plans for three to five years and monitor their financial performance. Article 6(14-1) of the LMPS also requires them to appoint and instruct their representatives who vote at SOEs' general meetings where important financial and investment decisions may be approved.
- Ministry of Economy – The Cabinet Resolution 832-2007 made under the LMSP requires the MOE to evaluate line ministries and local governments in respect of "the effectiveness of the management of state property."
- Ministry of Finance – Cabinet Resolution 375-2014 requires the MOF to "control fiscal risks associated with activities of entities in the public sector" and coordinate domestic long-term and external borrowing of SOEs.
- Sector regulators – Some sector laws require the regulators to oversee performance of regulated companies including SOEs. For example, Presidential Decree 715-2014 requires the NKREKP to exercise control over "targeted use of funds" and "performance of natural monopolies" in an energy sector through the review of the financial and investment plans.
- State Property Fund – Article 5(3) of the Law on SPF requires the SPF to analyze and monitor "financial and economic indicators of economic companies under its jurisdiction," which are mostly SOEs going through privatization or insolvency processes or regarded as dormant.

Addressing these issues will require amendments to the LMSP and its regulations to replace the MoE's existing responsibilities for the direct approval of financial plans and for "the oversight of the oversight" with those for monitoring of largest 100 SOEs and specify the new methodologies. It will also require amendments to the existing MoF Order to specify information flow to the MoF, define the contents of fiscal risk statements, require the publication, and set out methodologies for assessment and management of fiscal risks arising from SOEs.

### *Oversight of SOEs' Capital Investments*

**Key Legislation:** The Law on Investment Activities (LIA, 1991); Cabinet Resolution on Evaluation Criteria on Economic Efficiency of Project Proposals (684-2012); MOE Order on Methodological Recommendations on Development of Investment Projects with State Support (1279-2012); Cabinet Resolution on State Examination of Investment Projects (701-2011); Cabinet Resolution on Methodology for State Examination of Investment Projects (243-2013); Cabinet Resolution on Selection of Project Proposals with State Support (835-2013).

**Main Issue:** The lack of a clear definition of “investment” creates redundancy in, and limits coverage of, the State Support Procedure (SSP) which serves to weaken its effectiveness. In particular, the legal framework includes the following issues:

- iv. “Investment activity” encompasses investments by local governments (Article 2(2) of the LIA), but this definition requires capital transfer to and guarantees on local governments to follow the SSP duplicating the project appraisal already undertaken by the local governments;
- ii. “Investment” is required to “result in creating profit (income) or achieve social effect” (Article 1 of the LIA), but this definition requires the SSP to target revenue-generating projects, raises a dispute about its meaning, and narrows the coverage of the SSP;
- iii. “Public investment” includes not only state support but also projects of spending units (Article 2(2) of the LIA), but this creates an overlap with the public investment process under Article 32(4) of the Budget Code;
- iv. There are two sets of project evaluation criteria (Cabinet Resolution 684-2012 and 701-2011) – one focuses on profitability of projects and the other include broader criteria – but it is unclear which project should follow each process and the bifurcated criteria risk arbitrary application; and
- v. The LIA requires monitoring of project implementation selected through the SSP (Article 12-1(6)), but no monitoring methodology or process is specified.

Addressing these issues will require amendments to the LIA to (i) establish a clear definition of “investment” required to follow the SSP based on the unambiguous criteria, such as an amount of project costs; and (ii) avoid duplication of project appraisal of spending units’ and local governments’ projects. It will also require amendments and issuance of new regulations under the LIA to (i) unify the bifurcated evaluation criteria; and (ii) specify the methodology and process for monitoring of project evaluation.

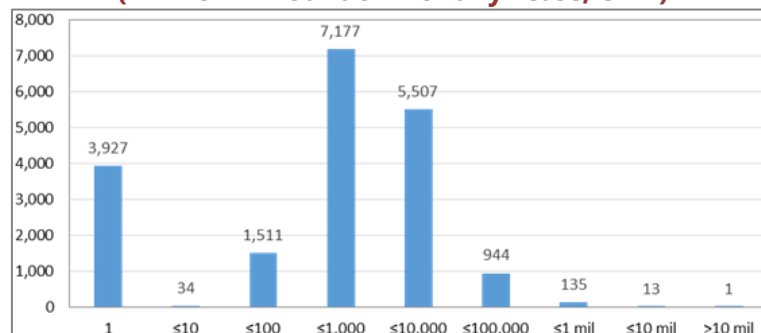
### *Lease of State Property*

**Key Legislation:** The Law on Lease of State and Municipal Property (Lease Law, 1992); Cabinet Resolution on Methodology for Evaluation of Lease (629-1995).

**Main Issue:** The lease terms and pricing criteria under the legislation prevent the government from setting appropriate prices for the use of infrastructure. Currently, there are 19,260 leased properties recorded in the Register of Operating Lease maintained by the SPF. Most of leased properties relate to buildings and lands, but several infrastructures, such as energy and manufacturing plants and port and mining facilities, are leased as “integral property complexes.” Around 4,000 properties, mostly non-residential buildings, are leased at 1 UAH per month (Figure 3). The lessor is the SPF and lessees include SOEs, local governments, private sector companies, and individuals. Lease revenue is limited to 0.2 percent (1.2 billion UAH) of the total revenue of the State Budget in 2015. The seemingly inadequate economic value assigned to these lease arrangements is caused partly by the following issues in the legal framework:

- i. Lease prices appear to include provisions allowing the lessee to reduce fees and rents to take account of depreciation of assets (Article 33 of the Lease Law). It is difficult to see how such reduction can be justified on economic grounds given that the lessee does not own the asset and this provision imposes significant costs on the budget;
- ii. The term of the lease is set at five years or more, unless the tenant agrees to a shorter term (Article 17(1) of the Lease Law), and an adjustment to lease prices is permitted only when both parties agree on it or there is an exceptional circumstance (Article 21 of the Lease Law). These provisions essentially require the government not to change lease prices over the long term, irrespective of economic conditions;
- iii. A lease can be terminated without consent of the party only by the court decision or on other limited grounds (Article 26 of the Lease Law). This provision makes it difficult for the government to evict a tenant violating lease terms;
- iv. A lease price is required to be based on an “index” (Article 10(1) of the Lease Law) and the Cabinet Resolution (629–1995) requires independent evaluation of property when making or renewing a lease, but there is no clear principle or criteria guiding how to set the lease price; and
- v. There is no model lease contract available under the Lease Law.

**Figure A3.3. Number of Lease Contrasts of State and Municipal Property  
(X-Axis – Amount of Monthly Lease, UAH)**



Source: IMF staff estimates.

## Annex III. Selection of Public Investment Projects

In most countries, the potential for productive public investment exceeds available resources by a large margin. Many countries have put in place mechanisms for development and analysis of public investment projects.<sup>1</sup> These mechanisms aim to ensure that projects that reach the selection stage are well-designed, well-documented and have positive benefit/cost ratios. However, given resource constraints, it is necessary to have more stringent criteria for selecting the projects that are finally approved for financing and implementation. In the absence of such criteria, there is a clear risk that too many investment projects are approved and that these will suffer from under-funding and extended implementation periods (as is the case in Ukraine). This will have significant negative impacts on the effectiveness of the projects in achieving the stated objectives.

Many governments have defined criteria for public investment project selection, but in fairly general terms. These can include consistency with national and sector development strategies, readiness for implementation, positive social impacts, positive economic impacts, availability of concessional financing, etc. It is often difficult to use generally formulated criteria as the basis for saying yes or no to specific projects. There will often be many more projects that meet the criteria than available funding.

A more stringent approach is to assign weights and scores to the different criteria, and to base project selection on the total weighted scores for each project. The approach is similar to what is used during many tender processes. This approach will not eliminate the role of subjective judgment, but it will help ensure the consistency and transparency of the selection process. It can also provide concrete feedback to project developers about which goals the projects must contribute to and how these contributions must be documented in project documents. The simplest version of such a scheme would be to base the selection on projects' quantifiable benefits and costs (net present values), but most government will want to pursue a more complex set of goals, including goals that cannot be readily quantified and priced. Table 1 provides an example of how an assessment framework for public investment projects could be formulated.

**Table A.1. Criteria for Assessing Public Investment Projects**

<b>Indicator</b>	<b>Points</b>	<b>Questions and guidelines for assigning scores</b>
National development strategy	10	How well does the project contribute to national goals?
Sector development strategy	20	How well does the project contribute to sector goals?
Benefit/cost ratio	40	B/C 2,0: 40; B/C 1,5: 20; B/C 1,0: 0, (proportional scoring)
Implementation risks	20	Insignificant risk gets score 20, others relative
Concessional financing	10	Scores for reduced cost consistent with benefit/cost ratio

<sup>1</sup> See "Making Public Investment More Efficient," IMF, 2015, for examples of investment planning mechanisms in several countries, including Uganda, Brazil, Korea, UK and Norway.

In this example, a project that has a moderate impact on achieving national development goals (5), high impact on sector goals (15), benefit/cost ratio at least 2,0 (40), quite high implementation risks (5) and no concessional financing (0) would get a total score of 65. This would be compared to the score for other projects in determining which projects should be approved for financing.

## Annex IV. Projects Accepted According to Cabinet Resolution 571

Name of project	V. Project start and end	VI. Total project costs	VII. Financed before 2015	VIII. Funding 2015	IX. Project completion end 2015	X. Investment 2016	XI. Projected investment	
							2017	2018
Reconstruction of X-ray radiology department Institute Otolaryngology	2012-2016	167 167,80	137 193,50		82,10 %	29 974,30		
Rehabilitation and adaptation Institute of Neurosurgery	2011-2017	150 144,90	70 831,30		47,20 %	45 000,00	34 313,60	
Medical-diagnostic complex of National Children's Hospital" Okhmatdyt " Ministry of Health / National Cancer Institute (3 sub-projects)	2011-2018	3 347 057,80	390 477,60	500 000,00	26,60 %	395 000,00	380 000,40	490 000,39
Restoration and adaptation Mariinsky Palace on ul.Grushevskogo, 5a, Kiev	2005-2018	1 478 162,50	60 431,80		-	115 000,00	198 291,00	127 654,61
Creating a cultural arts and museum complex "Art Arsenal"	2005-2020	4 179 351,00	402 442,00		26,60 %	95 000,00	100 000,00	100 000,00
Reconstruction of roads in Lviv region	2016-2018	1 751 468,00			9,60 %	25 000,00	0	0
Closing storage SDRW "third phase of Chernobyl." Adjustment	2012-2016	10 407,22	5 019,40		48,20 %	5 387,81	250 000,00	250 000,00
Conservation SDRW storage №29 "Buriakivka"	2016	2 359,96	110		4,70 %	2 249,96		
Reconstruction of waterworks protection arrays Dnieper reservoirs	2016-2030	1 289 034,00			-	55 310,00	37 395,00	32 345,00
<b>Total</b>		<b>9 501 338</b>	<b>905 682</b>	<b>600 000</b>		<b>1 000 000,00</b>	<b>1 000 000,00</b>	<b>1 000 000,00</b>



## Annex V. Gatekeeping Role for the MoF in PPP Design and Implementation

	Line Ministry / Contracting agency	MOF Investment Unit (IU) and other Units/Agencies	
Project preparation	Phase 1 PLANNING	Prepare initial pre-feasibility study and undertake VfM and public sector comparator analysis	<ul style="list-style-type: none"> <li>MOED: ensure alignment of project's scope with National Strategic Plans and advise contracting agencies in the preparation of pre-feasibility studies and VfM analysis.</li> <li>MOF-IU: assess pre-feasibility study and the public sector comparator analysis, assess VfM.</li> <li>MOF Finance Division: evaluates budgetary affordability of project and ensure consistency with overall fiscal goals and priorities, reviews impact on the macroeconomic scenario and global sustainability.</li> <li>MOF-IU: reports to the Finance Minister; advise to turn down project if found to offer insufficient VfM or to be unaffordable.</li> </ul>
		GATEWAY 1: Finance Minister to approve/reject initial project	
	Phase 2 FEASIBILITY	Prepare feasibility study and update VfM	<ul style="list-style-type: none"> <li>MOED: advise contracting agencies in the preparation of the feasibility studies.</li> <li>MOF-IU: assess feasibility study and the public sector comparator analysis, assess VfM.</li> </ul>
		GATEWAY 2: Finance Minister to approve/reject "go ahead" project	
	Phase 3 DESIGN AND PREPARATION OF TENDER	Prepare tender documents	<ul style="list-style-type: none"> <li>MOED: advise contracting agencies in the preparation of the tender documents.</li> <li>MOF-IU: review tender documents for consistency with the financial project specifications that were agreed in the previous phase; report to the Finance Minister.</li> </ul>
		GATEWAY 3: Finance Minister to approve/reject issuance of tender documents	
	Phase 4 BIDDING AND CONTRACT SIGNING	Receive tender bids and select bidder(s).	<ul style="list-style-type: none"> <li>MOED: review tender bids and advise contracting agency in the selection of the bidder.</li> <li>MOF-IU: ascertain VfM of the pre-selected bid, and report to the Finance Minister; advise to reject the pre-selected bid if found to offer insufficient VfM or to be unaffordable.</li> </ul>
		GATEWAY 4: Finance Minister to approve/reject selected bid	
		Present final version of PPP contract.	<ul style="list-style-type: none"> <li>MOED: advise contracting agency in contract negotiations with preferred bidder</li> <li>MOF-IU: review consistency with bidding conditions, and report to the Finance Minister; advise to reject final version of contract if found to offer insufficient VfM or unaffordable.</li> </ul>
		GATEWAY 5: Finance Minister to award/reject contract	
PPP contract signed			
Project implementation	Phase 5 CONSTRUCTION AND OPERATION	Supervise and monitor contract on regular basis.	<ul style="list-style-type: none"> <li>MOED: monitor construction of physical infrastructure and service delivery.</li> <li>MOF-IU: monitor financial soundness of PPP.</li> </ul>
		If needed, propose to renegotiate the terms of the initial contract.	<ul style="list-style-type: none"> <li>MOED: advise contracting agency, in renegotiating the terms of the initial contract.</li> <li>MOF-IU: review VfM of renegotiated draft contract, and report to the Finance Minister; advise to reject draft renegotiated contract if found to offer insufficient VfM or unaffordable.</li> </ul>
	GATEWAY 6: Finance Minister to approve/reject renegotiated contract		