

**Ukraine: Report on the Observance of Standards and Codes—
Fiscal Transparency Module**

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UKRAINE

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

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March 26, 2004

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in Ukraine in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information. The IMF *Manual on Fiscal Transparency* (<http://www.imf.org/external/np/fad/trans/manual/>) should be consulted for further explanation of the terms and concepts discussed in this report.

Ukraine has improved key aspects of fiscal transparency substantially since the completion of an initial ROSC in 1999. The Budget Code has established a solid legal framework for budget management. The treasury system now provides a mechanism for timely, reliable, and comprehensive reporting on the fiscal position and debt of central government—and will cover regional government from 2004. State procurement has been modernized and transparency greatly improved through use of the internet. Though much remains to be done, progress has also been made, particularly in the electricity sector, in applying economic pricing and addressing the poor payment collection and enterprise tax arrears that have contributed to high quasi-fiscal costs. These, and other achievements noted in the report, combined with its considerably improved growth and fiscal performance, provide a sound basis for further improvements in transparency.

The staff have made a number of recommendations on priorities for consolidating progress and toward addressing a number of long-standing transparency and fiscal management issues. The budget process can be further strengthened by building a more consistent general government policy framework, developing a more accountable medium-term budget, and considering fiscal risks more explicitly and systematically. Interagency barriers that have proved costly in terms of the integration of government functions need to be reduced. The most important structural issue that needs sustained further effort is that of the relative lack of knowledge and control over the public enterprise sector. The many activities of a fiscal nature carried out by that sector continue to impede the establishment of sound long-term fiscal policies. The authorities are beginning to address these problems, but there is a need to place more emphasis on improving coordination of management responsibilities and establishing a clear reporting and accountability regime (including with respect to quasi-fiscal activity). Oversight mechanisms, particularly that of the Accounting Chamber, need to be strengthened and brought into line with international practice.

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ABBREVIATIONS AND ACRONYMS

CFAA	Country Financial Accountability Assessment (World Bank)
COM	Cabinet of Ministers
CPAR	Country Procurement Assessment Report (World Bank)
CSD	Civil Service Department
EBF	Extrabudgetary Funds
EBRD	European Bank of Reconstruction and Development
EU	European Union
GFS	Government Finance Statistics
KRU	Main Control and Auditing Department of Ukraine
MOE	Ministry of Economy and European Integration
MOF	Ministry of Finance
NAFTOGAS	Gas and Oil Company of Ukraine
NBU	National Bank of Ukraine
NERC	National Commission for the Regulation of Electric Energy
PF	Pension Fund
QFA	Quasi-fiscal Activity
ROSC	Reports on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standard
SIF	Social Insurance Fund
SPF	State Property Fund
SSC	State Statistics Committee
STA	State Tax Administration
STU	State Treasury of Ukraine
TSA	Treasury Single Account
WTO	World Trade Organization
VAT	Value-Added Tax

List of Websites

National Bank of Ukraine	http://www.bank.gov.ua/
Parliament of Ukraine	http://www.rada.gov.ua/
President of Ukraine	http://www.president.gov.ua/
Cabinet of Ministers	http://www.kmu.gov.ua/control/
State Property Fund	http://www.spfu.gov.ua
Ministry of Finance	http://www.minfin.gov.ua
Ministry of Economy and European Integration	http://www.me.gov.ua/
Parliament's Budget Committee	http://budget.rada.gov.ua/
Ministry of Fuel and Energy	http://mpe.energy.gov.ua/minenergo/control/index
Customs Service	http://www.customs.gov.ua/ukr/index.php?lng_ =
State Tax Administration	http://www.sta.gov.ua/
Prosecutor's Office	http://www.gpu.gov.ua/
State Control and Revision Department	http://www.dkrs.gov.ua/www/wwwdkrs.nsf
Accounting Chamber	http://www.ac-rada.gov.ua/main.asp
Association of Ukraine's Cities	http://www.auc.org.ua/
Pension Reform in Ukraine	http://www.pension.kiev.ua/
International Centre for Policy Studies	http://www.icps.kiev.ua/
State Statistics Committee	http://www.ukrstat.gov.ua
National Commission for the Regulation of Electric Energy	http://www.nerc.gov.ua

I. INTRODUCTION¹

1. This draft report provides an assessment of fiscal transparency practices in Ukraine against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of discussions with the authorities and their responses to the fiscal transparency questionnaire, and drawing on other available information. The second part is an IMF staff commentary. Assessments and recommendations against the code are summarized in Appendix I.

2. This ROSC replaces the ROSC (*Experimental Module on Fiscal Transparency for Ukraine*) completed and published in September 1999. In nearly all respects, transparency has improved—in some cases significantly—from that recorded earlier. The fiscal environment has also changed markedly for the better, and this development will permit a new phase of reform. In line with the need to focus on further reforms and general development of the assessment methodology since 1999, the discussion of issues is more extensive than in the earlier experimental modules.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

Definition of government activities

3. **General government is defined consistently with Government Finance Statistics (GFS) principles, but is not fully considered in the budget process.** 1.1.1 The units of general government and their relationship with the budget are listed in Box 1. Except for the pension fund, the social insurance fund for temporary disability, the national labor accident and occupational disability insurance fund, and the national compulsory unemployment social insurance fund (collectively described hereafter as extrabudgetary funds (EBFs)), all receipts and spending are included in the budgets of the relevant jurisdiction. Draft budgets of these latter funds are presented to the Verkhovna Rada (parliament—hereafter, the Rada) at the same time as the budget, but are not, in practice, subject to parliamentary review or discussion during the budget approval process. Spending units of general government are not allowed to set up EBFs under the budget code of Ukraine, of June 2001 (the Budget Code) (Article 13 (8))—reflecting a strengthening of definition of government operations since the

¹ Discussions on fiscal transparency were held in Kiev during Oct. 6-17, 2003. The staff team, comprised Messrs. Davis (Head), Allan, Moissinac (all FAD), and Ramachandran (member of the FAD panel of experts); and Mr. Shpak of the resident representative's office. The Senior Resident Representative, Mr. Figliouli and staff provided support throughout. The mission met with officials from the Ministry of Finance (MOF); Ministry of Economy and European Integration (MOE); Ministry of Fuel and Energy; Ministry of Labor and Social Affairs; State Treasury of Ukraine (STU); State Tax Administration (STA); State Customs Administration; State Property Fund (SPF); the gas and oil company of Ukraine (NAFTOGAS); National Commission for the Regulation of Electric Energy (NERC); National Bank of Ukraine (NBU); the Rada Budget Committee; the Rada Social Affairs Committee; the Accounting Chamber; the Main Control and Auditing Department of Ukraine (3KRU); the Civil Service Department; the Kiev Municipal Finance Department; the Association of Ukraine's Cities; and the International Center of Policy Studies. The mission liaised with the resident World Bank representatives.

² Two kinds of special fund can be distinguished: (i) those using earmarked tax revenue for specific purposes (10.2 percent of total central government revenue—2.1 percent of GDP); and (ii) own revenue funds of entities providing services for fees (13.5 percent of total central government revenue—2.8 percent of GDP). Insufficient information is

(continued...)

1999 ROSC. For the units covered by the state(central government) budget (1-10 in Box 1), expenditures are made both from the general fund, which covers most ministry expenditures, and special (earmarked) funds set up for specific purposes.² Regional and local budgets are separately approved by their respective rada, based on transfers approved in the state budget. A preliminary cash flow table covering the general government sector is however presented as part of the state budget, based on MOF forecasts (see paragraph 22).

Box 1. General Government in Ukraine	
(In percent of GDP)	
General government in Ukraine comprises the following :	2002
Central Government Units Covered by the State Budget of Ukraine	13.9
General Public Services, covering:	
1. Parliament, president's office, judiciary,	1.8
Sixteen ministries, 19 committees in the following functions:	
2. Defense	1.6
3. Public order and safety affairs	2.1
4. Education affairs and services	2.3
5. Health affairs and services	0.7
6. Social security and welfare affairs (excluding transfer to EBFs)	1.1
7. Housing and community services	0.0
8. Recreational, cultural, religious affairs	0.2
9. Energy, agriculture, and industry	2.0
10. Other (excluding interest payment and intergovernmental transfers)	0.7
Central Government Units with Individual Budgets	11.1
11. Pension Fund	9.1
12. Social Insurance Fund for Temporary Disability	0.9
13. National Labor Accident and Occupational Disability Insurance Fund	0.5
14. National Compulsory Unemployment Social Insurance Fund	0.6
Regional and Local Government	11.2
15. Republican Budget of Crimea Republic, 24 oblast (province) budgets, budgets of Kyiv and Sevastopol cities (excluding transfers to the state budget).	2.6
16. 488 rayon (district) budgets and 174 municipal budgets	8.6

1.1.1

4. Relationships between government and nonfinancial public enterprises and public financial institutions are being clarified, but significant gaps remain. As noted above general government is well defined. Although off-budget funds are prohibited, ministries have some authority to create enterprises to carry out certain government functions (hereafter referred to as ministry enterprises), although the extent of such activity is not

1.1.4

provided in either case to determine the rationale for separating such funds from the general revenue fund. It was envisaged, at the time these funds were set up as part of the Treasury Single Account (TSA), that they would be subject to further review, and that at least some would be fully integrated with the budget. Little progress appears to have been made in this direction.

reported to the public.³ These activities are integral parts of general government, and their legal status and fiscal significance should be clearly reported. State- and local-owned enterprises continue to perform some services of a social nature that are not covered by budget subsidies—that is, they are quasi-fiscal. Management responsibilities for such activities should be defined more clearly; and, ideally, their quantitative impact should be reported alongside the general government budget. The significance of quasi-fiscal activities (QFA) are discussed in more detail below in relation to the energy sector (see Box 4 below).

Government relations with nonfinancial corporations and the private sector

1.1.5

2.1.4

5. Government holdings of fully owned corporations and equity are extensive and coordination of state property management needs further consolidation. Article 116 of the Constitution, of June 28 1996, establishes the authority of the COM to administer state property on the basis of prevailing legislation. Responsibilities for the management of state property are currently shared among government bodies on the basis of the Economic Code (law No. 436-IV, January 16, 2003) and the COM decree No. 8-92, December 15, 1992, On the management of the state-owned property.⁴ While the management of equity holdings and state property undergoing privatization has been consolidated in the SPF,⁵ other state property including state enterprises is under the control of individual ministries and other state executive bodies such as the State Affairs Department. Communal assets, including enterprises, under communal ownership are managed by individual communities (see Box 2). Ministries and other state executive bodies have powers to approve the status of state enterprises, reorganize (and liquidate) state property, appoint directors of state enterprises, in accordance with procedures and methods developed by the MOE. Monitoring of state enterprise activity has recently been improved. Starting in 2002, the MOE has been given the authority to monitor the financial performance of most state enterprises⁶ supervised by state executive bodies (Decree of the President No. 216, March 5, 2002, On the Measures for Denshadowing the Economy).⁷ The SPF has become responsible for the management of all equity holdings and real estate assets of the central government—with the exception of Naftogas and the *Bread of Ukraine* joint-stock company—in addition to all state property undergoing privatization. The legal framework requires extensive further development. To this end, draft laws modelled on European standards have been developed with the participation of the SPF, namely draft laws On the Management of State-Owned Property, On Joint-Stock Companies, and On State Property Rights.⁸

³ Ministry enterprises are developed on the general basis of the Economic Code (law No. 436-IV, January 16, 2003) and COM decree, No. 8-92, December 15, 1992, On the Management of State-Owned Property.

⁴ Another important decision is COM resolution No 1703, October 28, 1998, On the concept of separation of responsibilities between central and local authorities regarding the management of state property.

⁵ The SPF is an executive authority body controlled and administered by the Rada. The Rada annually considers and approves the SPF's report on the execution of the state privatization program. The chairman of the SPF is appointed and dismissed by the President upon agreement with the Rada. The SPF activities are determined and coordinated by the COM. The SPF is subject to audits by the Accounting Chamber, the Main Control and Auditing Department of Ukraine (KRU), as well as controls by the General Prosecutor's Office.

⁶ Ministry enterprises are not registered with the MOE; all enterprises, however, are registered with the State Commission on Statistics.

⁷ This reform was taken to strengthen review and control of state enterprises' finances, investment decisions, and transfers.

⁸ This is part of a broader reform program to improve the effectiveness of the management of state equity holdings. Priorities identified in the COM program are to improve the registering of equity holdings; to provide better

(continued...)

6. Arrangements regulating profit transfers from state enterprises to the budget have been tightened, but further clarification of dividend policy and practice is needed. 1.1.4
In the past, several COM resolutions required state enterprises to transfer a share of their profits to the budget, but this could not be enforced mainly because of a lack of control on state enterprises.⁹ Profit transfers of 15 percent were introduced in 2003 and enforcement has been improved as result of strengthened monitoring (see paragraph 5). This approach at least ensures some transfer of revenues to the budget, though incentives to underreport their profits remain.

7. Basic disclosure of privatization transactions does take place, but the legal framework needs further elaboration to help ensure a transparent bidding and selection process. 1.1.5
Privatization processes are governed by the law On the State Privatization Program, No. 1723-III, May 18, 2000.¹⁰ Annual state privatization programs, listing enterprises and valuation estimates, are approved by parliament on a yearly basis in conjunction with the budget law.¹¹ Privatization programs with three-year horizons are also prepared and approved by the Rada on a rolling basis. The execution of these programs is the responsibility of the SPF. A draft law on the SPF, with the goal of clarifying its role with respect to privatization and the management of state property, has been under consideration for some time (see paragraph 5). Privatization proposals are scrutinized by the Control Committee for Privatization of the Rada. Since 2001, efforts to ensure transparency have focused on creating a competitive environment, the use of standard procedures, and the independent valuation of assets. In particular, the appointment of an independent tender commission, or external privatization advisors, has been systematized. Moreover, a Privatization Advisory Group has been created under the sponsorship of the World Bank to provide an external ex-post evaluation of the privatization process and advise on best international practice. While efforts to ensure an open privatization process have been sustained in recent years, transparency has been lacking in a number of cases and some privatization tenders have been insufficiently advertised. Perceptions of corruption and unfair selection of bidders, despite assurances of competitive tenders, have also emerged. Significant privatizations take place at the subnational level (yielding some 0.1 to 0.2 percent of GDP per year), but these privatizations do not have a formal legal basis.¹²

protection against emission of stocks diluting state holdings; to enhance the monitoring of activities of joint-stock companies; to enhance the effectiveness and accountability of officials responsible for the management of equity holdings.

⁹ Until 2003, most state enterprises transferred to the budget only a fraction of the targeted amounts.

¹⁰ There have also been legal attempts at preventing asset stripping. An asset stripping law On Introducing the Moratorium on the Enforced Delineation of Property, No. 2864-III, November 29, 2001, has had limited effectiveness so far. Discussions with the SPF indicated that the only effective recourse is the prosecution of chief executives of state enterprises, and chairmen of joint-stock companies, under the criminal code.

¹¹ Privatization receipts are reflected in full in the budget on a gross basis.

¹² The absence of an accepted legal basis for communal property creates difficulties for enacting a law on privatization of such property. The constitutional court has given an interpretation that the privatization of communal property should be governed by the state privatization law..

Box 2. Responsibilities for the Management of Public Assets¹³

Oversight of different elements of state and local-owned property are allocated among the following centers of responsibility: 1.1.5

Line ministries and other state executive bodies:¹⁴

- 2,980 state enterprises
- 50 unitary enterprises¹⁵
- ministry enterprises (number not reported)
- holding companies other than state or joint-stock companies, including in the coal and transportation sectors
- other productive assets identified in the COM decree On the management of state property

State Property Fund:

- equity holdings in 1,403 joint-stock companies;
- equity holdings in 150 to 200 joint-venture companies with foreign participation;
- 100 state enterprises undergoing privatization and their assets;
- 30,000 contracts leasing state property, including 200 enterprises;
- real estate owned by the central government.

Cabinet of Ministers (COM):

- Naftogas and *Bread of Ukraine* joint-stock company.

Regional and local self-governments:

- Regional and local government property, including a majority of local communal service enterprises (e.g., pharmacies, housing, heating, sewage, transport).

8. Government regulation of the nonfinancial private sector is complex and subject to frequent change, but steps are being taken to make regulatory processes more open. 1.1.5

The private sector in Ukraine is regulated by a wide range of laws¹⁶ that have many inconsistencies and ambiguities and frequently change, and a regime of inspections that has long been recognized as a costly disincentive to entrepreneurial activity. Steps are being taken to rationalize the system. More transparent regulatory frameworks are being developed for key sectors: communications, energy, and nonbank financial institutions. Further work has to be done on telecommunications regulation. The regulatory framework for energy should improve with the expected enactment of legislation ensuring the independence of the National Commission for the Regulation of Electric Energy. The regulatory process has been streamlined in various ways. Rules for granting business licenses have been unified—law On Licensing for Determined Business Activities, No. 1775-III, June 1, 2000, has set national

¹³ Estimates as of end-2002.

¹⁴ In that regard, one important state executive body is the State Affairs Department which manages about 600 state enterprises and holdings under the control of constitutional bodies such as the Presidential Administration.

¹⁵ These are enterprises of vital state interest (for social or national security reasons), and thereby exempt from certain aspects of corporate law and assured of state orders.

¹⁶ The basic laws currently governing business activities include; the law On Enterprises, No. 887-XII, March 27, 1991, to expire in 2004; the law On Entrepreneurship, No. 698-XII, February 7, 1991, to expire in 2004; the law On Economic Partnerships in Ukraine, No. 1576-XII, September 19, 1991; the Presidential Decree On the Simplified Regime of Taxation, Accounting, and Reporting for Small Business Entities, No 727/98, July 3, 1998; and many sectoral state and local laws and by-laws.

procedures for licensing. However, inconsistencies between this law and the law On Natural Monopolies, No. 1682-III, April 20, 2004, have been a problem. Steps have been taken to reduce the number of inspections, and recent surveys show a slowly declining number of inspection visits. “One-stop registration shops” for setting up new businesses, established on a pilot basis, have reportedly succeeded in reducing the time and bureaucratic hassle of business registration.¹⁷ Reforms in this area should be greatly strengthened when two recently enacted laws, the Economic Code and the Civil Code, come into force.¹⁸

Government relations with the central bank and public financial sector

9. The National Bank of Ukraine (NBU) has substantial operational independence. The operational independence of the NBU is established by the law On the National Bank of Ukraine, No. 679-XIV, May 20, 1999. The NBU has considerably scaled down its fiscal role.¹⁹ In late 2002, the NBU started to provide long-term refinancing for liquidity support to commercial banks if they extended commensurate long-term credits to economic sectors identified by the government. However, this activity has been limited and is expected to be cancelled in early 2004.²⁰ The NBU has provided some support to state-owned banks—including a free-interest deposit to be repaid within three years—though mainly to help with problems associated with past government interference.²¹ The law On the National Bank of Ukraine of 1999 prohibits the provision of direct credit to government (Article 54). The authorities advise that profit transfers to the government do not exceed the post-audit profit of the NBU, as required by the central bank law. There has, however, been some contention about the timing of payments. The government is obliged to keep the budgetary accounts, and EBFs with the NBU. No interest is paid on government deposits and no charges are levied for NBU services to government.²² This arrangement lacks transparency, as it does not show the true cost of banking services provided to the government nor allow an appropriate definition of NBU profits. 1.1.4

10. Public financial institutions no longer assume any explicit fiscal functions, but they 1.1.4

¹⁷ One-stop shops currently exists in four cities. Legislation to systematize one-stop registration shop is currently being considered by parliament. See “An Analysis of Regulatory Barriers to Business Development in Ukraine,” Sean O’Connell, World Bank (2003).

¹⁸ The Economic Code (law No. 436-IV, January 16, 2003) aims at consolidating previous legislation in a single code and restricting state intervention to clearly defined areas. These areas include: licensing; application of state orders for procurement; certification and standardization; price and tariff regulation; and subventions, compensation, and grants. The law should come into force from January 2004, but some problems of consistency with the Civil Code (law No. 435-IV, January 16, 2003—also coming into force from January 2004) have emerged, and implementation may be delayed. This should be followed by other important regulatory reforms. The Anti-Monopoly Committee is working toward improving the competitive environment and a more level playing field for private and public companies. A law on state support, based on the principles of the European Union (EU) “state aid” law, has been drafted with the aim of providing a stronger legal framework for competitiveness policy to be implemented by the committee.

¹⁹ Prior to 1996, the NBU directly financed the government deficit and provided some loans at below market rate (as recorded in the 1999 fiscal ROSC). These activities have been discontinued.

²⁰ The legal framework allows for central bank long-term refinancing despite the quasi-fiscal implications. The NBU and government have explicitly stated that the use of long-term refinancing would be arrested, but these statements should be included in budget documents to become more accountable.

²¹ In addition, the delay in the resolution of Bank Ukraina’s insolvency in 2001 also showed forbearance on the part of the NBU vis-à-vis banks engaged in politically motivated lending.

²² The NBU also acts as the government agent and depositary for domestic government securities.

remain a significant source of fiscal risk due to poor lending practices. There are three state-owned financial institutions: the Savings Bank;²³ the state export-import bank; and the joint-stock insurance company for emergency medical aid. The government's relationship with state-owned banks has, in some respects, been improved both through clearer policies and some strengthening of the legal framework. Directed lending by state-owned banks, supported by government guarantees, is no longer carried out. The government has been compensating banks for nonperforming loans made on its behalf in the past with treasury bills and cash payments approved in the state budget. The operational independence of state-owned financial institutions has been established by law and, accordingly, the COM has stopped issuing resolutions creating new functions for state-owned banks.²⁴ However, some state-owned banks were involved, until recently, in lending on a noncommercial basis. The NBU decisively intervened in its role of banking supervisor to stop these practices, but potential risks for the state budget will remain until governance and managerial weaknesses are fully resolved. The law On Banks and Banking, No. 2121-III, December 7, 2000, requires that the supervisory councils of state-owned banks are nominated equally by the parliament and the president.

Fiscal management relations among the branches of government

11. The fiscal roles of the executive, legislative and judicial branches are clearly defined in law, but some aspects are evolving. The 1996 Constitution of Ukraine (Articles 95-98) specifies the following general requirements: that budgets are determined by law; that budgets and budget execution reports must be made public; that the government must submit the draft law on the budget to the Rada by no later than September 15 of each year; and that the accounts be audited by the Chamber of Accounts (external auditor) on behalf of the Rada. The enactment of the comprehensive budget code in 2001 and amendments to the code in 2003 (discussed in more detail below) constitute a major improvement in defining budget procedures and the respective roles of the executive and legislative branches of government—and a significant advance in transparency relative to the 1999 ROSC. Under the budget code and constitutionally, the Rada has considerable powers to amend the government budget. While these powers in the past have contributed to unrealistic budgets, the dialogue between the government and the Rada is being developed constructively and recent budgets have been set with greater appreciation of underlying policies and short-term fiscal risks (see also paragraph 51 below). One key change in that regard was the code's requirement that the Rada's budget committee independently evaluate draft laws with a budgetary impact before their consideration in the Rada (Art. 27).²⁵

1.1.2

Fiscal management relations among different levels of government

12. The budget code defines the responsibilities of different levels of government and establishes a stable basis for intergovernmental fiscal relations. The code defines both the

1.1.2

²³ The government guarantees household deposits in the Savings Bank.

²⁴ For instance, COM Resolution No. 1729 issued in 1998 gave the state export-import bank the authority to extend credit to priority sectors.

²⁵ Such draft laws must also be approved well in advance of the budget submission to be effective during that budget year. This provision of the code, however, has been poorly enforced so far.

expenditure responsibilities of the different levels of government and the revenues to be allocated to subnational levels. Expenditure responsibilities delegated by the central government are distinguished from local responsibilities and so are their sources of financing.²⁶ The definition of responsibilities has helped address the question of “unfunded mandates” (whereby subnational governments were assigned responsibilities that were not matched by resources) that had been growing increasingly problematic under the previous regime.²⁷ These changes represent a very significant improvement over the situation observed in the 1999 ROSC. Transfers between the state and regional governments are based on clear, objective criteria known to all participants. The system has helped establish more realistic budget planning at oblast, oblast city, and rayon (district) level, and has increased local government budget powers and accountability. The central government ceased to interfere with the composition of local budgets with the introduction of the new transfer system. The system also helped improve the targeting of budget expenditure by shifting from input-based budget norms (e.g, maintenance costs of existing infrastructures) to needs-based norms (e.g., student population).

13. Further clarification of responsibilities and transfer mechanisms is desirable, particularly with respect to towns and localities. The complexity of formulae currently used for computing transfers undermines their transparency and creates scope for manipulation. Another serious limitation has been the growing cost of local responsibilities, especially in relation to the housing and communal service sector (municipally-owned), which has often crowded out the financing of delegated responsibilities. A number of issues remain to be resolved with regard to the development of a stable and objective basis for allocation of funds to towns and localities within rayons. The basis of capital grants to regions also requires further elaboration and clarification.²⁸

1.1.2

14. Mechanisms for dialogue and review between central and subnational governments require strengthening. Official consultations are organized by the MOF to advise oblast officials of policy changes. Although the interests of local authorities are given some focus and authority through organizations such as the Association of Cities of Ukraine, these groups are not consulted in a sufficiently timely way to allow the views of local authorities to be clearly presented during the Rada’s deliberations on the budget. Changes in tax policy are made centrally, but opportunities for the local governments to discuss and review proposed changes are limited.²⁹ While avenues do exist for representation of local interests and these matters are discussed in the Budget Committee and other relevant committees of the Rada, there may be scope for establishing an independent body to provide objective analysis and advice on intergovernmental fiscal relations. A further issue in this regard is the absence of detail in treasury reports on execution of central government transfers to local government by

1.1.2

²⁶ For instance, the code (Art. 71) ensures that local governments’ capital income, privatization receipts, and borrowing²⁶ are used to finance local-level investment within local development budgets.

²⁷ For instance, responsibility for, and financing of, social allowances and housing subsidies, which in the past had given rise to chronic local government arrears, were shifted to the national level.

²⁸ The 2004 draft budget includes special capital grants for a number of regions, involving continuation of the practice of bilateral negotiations in the determination of equalization transfers. Work is underway to establish a formula-based model for allocation of capital grants.

²⁹ There are a few revenue-yielding local taxes currently in Ukraine and local budgets rely heavily on the sharing of central taxes (mainly the personal income tax). Consultation should not impede tax reform, which is necessarily initiated centrally, but clear discussions on the impact of tax changes on local budgets, especially equalizing transfers should help local decision-making.

region. Such data are available within the STU and their timely publication would be of great value to local authority associations, as well as to external analysts.

The legal and administrative framework for budget management

15. The budget code provides a comprehensive framework for management of budget funds. 1.2.1 The budget code provides clear and comprehensive definitions of basic budget procedures at all levels of government (see paragraph 33, Section C), the roles of executive agencies and the legislature, and intergovernmental relations. In particular, the code clearly defines the role of the MOF and the STU and its enactment has substantially strengthened these organizations relative to the situation described in the 1999 ROSC. As indicated in Box 3, the code has provided a basis for a number of other key reforms, which have been strengthened by the recent amendments. The revised Articles 38 (5-(2)(3)), in particular, represent important steps toward ensuring that the possible budget impact of all legislation must be considered in the context of the budget law. The code clearly mandates many elements of fiscal transparency, promotes the establishment of a medium-term (three-year) budget planning horizon, and strengthens intergovernmental finance (see paragraph 13 above). Important areas of transparency that are not yet addressed sufficiently in the budget code are those of overall management of budget and EBFs, and comprehensive coverage of fiscal activity over the medium and long term.

16. The legal framework for managing public debt is sound, and further strengthening of the long-term policy framework is now underway. 1.2.1 The budget code provides a sound basis for basic elements of public debt management, as indicated in Box 3. It prescribes against the general use of borrowed funds for current expenditure, though it leaves room for exception,³⁰ and annual budget laws systematically protect payments of debt servicing and redemption in cases of financing shortfalls. Importantly, the authority to borrow is delegated to the Minister of Finance and the borrowing authority of subnational levels of government is defined. Article 18 requires debt ceilings to be established in the annual budget law and sets an overall ceilings for state debt at 60 percent of GDP. The monitoring of loan guarantees has been significantly strengthened and reports cover both government debt and guarantees. Annual budget laws have prohibited against the granting of new guarantees other than for loans from international financial institutions. Debt policy has also been guided by a COM-approved concept paper on public debt management, which gives priority to reducing the share of foreign debt in total public debt. The framework does not, however, comprehensively address issues related to development and execution of debt policy over the long term, covering composition, risk management, and sustainability. Further definition of the relative roles of agencies involved in management of debt and guarantees is also 3.1.1 required. The government is working with the Rada to establish such a framework, although there are a number of differing views on the roles of the agencies involved. Coordination among the key agencies, the State Debt Management Department of the MOF, the STU, and the NBU needs improvement, particularly in integrating cash and debt management and in developing the domestic debt market. The likely increased involvement in the international markets lends further importance to addressing these coordination problems as soon as possible.

³⁰ The code allows for exceptions if there is a need to “maintain the general economic balance”.

Box 3. The Budget Code and Key Fiscal Management Objectives		
Fiscal Management Objective	Main Impact	Reference
Improved definition of fiscal management roles	Prescribes conditions for rejecting the draft budget law at the stage of presentation by the COM.	Art. 39(2)*
	Provides for the approval of some of the major underlying assumptions of the state budget, including the planned minimum wage and subsistence levels, the general amount of revenue, expenditure, and deficit (or surplus), and amounts of intergovernmental transfers as well as any other provisions needed for formulating subnational budgets, during the second reading of the state budget.	Art. 43(2)* Art. 43(3)*
	Defines the circumstances under which in-year changes can be introduced in the Annual Budget Law.	Art. 52 (1)*
	Mandates the Budget Committee of the Rada to provide an assessment of draft laws influencing budget revenue or expenditure	Art. 27 (1)(2)
Transparency of inter-governmental transfers	Mandates the inclusion of estimates and formulae of inter-governmental transfers into the budget policy guidelines.	Art. 33(4)*
	Prescribes the presentation of additional information with the draft state budget law, to explicitly state the bases of inter-governmental transfers.	Art. 38(1)(1)(d)* Art. 38(1)(1)(e)* Art. 38(5.1)*
	Defines the types of intergovernmental transfers and formulae used for the computation of equalization transfers to oblasts, cities, and rayons.	Art. 96-108
Assurances of prudent budgetary practices.	Prescribes restrictions on the use of deficit budgets and restricts use of budget surpluses to repayment of debt. .	Art. 14(1)* Art. 4(2)*
	Mandates the publication of draft laws affecting the fiscal stance of government well in time for inclusion in the annual budget law.	Art. 27(3)
	Prescribes procedures for sequestration of spending from the General Fund.	Article 54
Promotes medium-term and program-oriented budgeting.	Prescribes the inclusion in the draft budget of forecasts of economic and social development and the estimated amount of the consolidated budget revenues, expenditures and financing for next three budget periods.	Art. 38(1-1g)
	Provides for a program-based expenditure classification.	Art. 10(1)(4)
Mandates transparency of public expenditure	Provides for the reporting of state budget outcomes on a monthly, quarterly, and yearly basis.	Art. 58(4)
	States the principles of the budget system.	Art. 7
	Mandates the timely publication of budget outcomes and the public presentation of budget outcomes by the authorities of different levels of government.	Art. 28*
	Estimates of minimum salary and subsistence levels are required to be indicated in the budget policy guidelines and presented with the draft budget law to the Rada.	Art. 33(11)* Art. 38(5.2)* Art. 38(5.3)*
	Prescribes the authority to provide guarantees, and the scope and evaluation of guarantees.	Art. 17
	Prescribes the inclusion of a list of tax and other exemptions, including an estimate of lost budget revenues attributed to these exemptions, along with the draft budget law.	Art. 38(3)
Establishes basic debt management framework.	Prescribes against using borrowed funds for incurring current expenditures, but leaves room for circumvention.	Art. 15
	Prescribes borrowing authority of subnational levels of government.	Art. 16
	Prescribes debt ceilings	Art. 18

* Signifies amendments to the budget code in July 2003.

17. Mechanisms for the coordination and management of budgetary and extrabudgetary activities are improving, but a number of issues remain. A recent reorganization of the Budget Department has consolidated budget management under a single department. This change represents a significant improvement of budget coordination relative to the situation in 1999.³¹ Several weaknesses in overall fiscal coordination remain, however. Most importantly, the EBFs are not included in the budget presentation in an analytical format nor subject to the same level of scrutiny as other parts of general government; moreover, the medium- and long-term fiscal impact of these funds is not adequately addressed in the overall fiscal management process (see paragraph 34 below). Another area where transparency of operations can be improved is in the treatment of earmarked (special) funds in the budget. Effective delegation of authority over such a significant portion of general government resources needs to be clearly justified and the level of scrutiny over the use of such funds should be equivalent to that of the general fund.

1.1.3

Legal and administrative framework for tax policy and administration

18. Tax laws and administrative procedures have been consolidated and clarified, though further improvement in transparency is needed. All state and local taxes and customs tariffs are established by the law On the Taxation System of Ukraine and separate laws and presidential decrees.³² Administrative procedures are defined by the collection law On Procedure of the Repayment of Liabilities of Taxpayers to Budget and State Special-Purpose Funds, No. 2181-III, December 20, 2000 and the Customs Code, No. 1970-XII, December 12, 1991.³³ Reforms of the enterprise profit tax and the personal income tax in 2002-03³⁴ have improved the definition of the tax base, for instance by fine-tuning the taxation of insurance and leasing activities, and provided a legal basis for addressing problems of transfer pricing. The authorities indicate that the new Customs Code, enacted on January 2004, is in line with World Trade Organization (WTO) standards. The code introduces modern customs procedures that are simpler and lessen compliance costs. Importantly, the code defines customs valuation methods in the law for the first time.

1.2.2

19. The transparency of tax policy is compromised by problems in the interpretation of tax law, frequent changes in tax structure, and a range of tax preferences. Several tax laws continue to leave scope for interpretation, due to gaps, ambiguities, and deficiencies in accounting rules. This has created the need for numerous regulations and interpretations by

1.2.2

³¹ Previously, responsibilities were divided between a main budget department and several sectoral financing departments that dealt directly with line ministries and agencies.

³² Including VAT No. 168/97 of April 3, 1997; a set of laws regulating excise taxation (e.g., law On Excise Rates for Tobacco Products, No. 30/96, February 6, 1996, law On Excise Rates for Alcohol Beverages, No. 178/96, May 7, 1996, or law On Excise Rates and Import Duties for Vehicles, No. 216/96-BP, May 24, 1996; law On Customs Tariffs of Ukraine, No. 2371-III, April 5, 2001, and law On Uniform Customs Tariff of Ukraine, No 2097-XII, February 5, 1992; a set of laws regulating export taxes (e.g., law On Export Duties on Waste and Ferrous Metal Scraps, No 216-IV, October 10, 2002, law On Export Duties for Seeds and Oil Crops, No 1033-XIV, September 10, 1999, or law On Export Duties for Live Stock and Leather Raw Materials, No 180/96, May 7, 1996); President's Decree On the Simplified Regime of Taxation, Accounting, and Reporting for Small Business Entities, No. 727/98, July 3, 1998.

³³ These laws establish tax payment procedures, penalties for non-compliance including for customs duties, and appeals procedures.

³⁴ Laws On Taxation of the Profit and Enterprises, No. 334/94-VR, Dec. 28, 1994), and On Tax on the Incomes of Natural Persons, No. 889-IV, May 22, 2003).

the MOF, STA, the Rada Financial and Banking Committee, and the State Committee on Regulatory Policy and Entrepreneurship, that are not always consistent and do not have a well defined legal status. The understanding of tax laws is further complicated by frequent legal changes. For instance, annual budget laws often introduce temporary tax changes, such as the suspension of specific tax preferences or changes in accounting rules. Tax preferences have to be granted through the law.³⁵ Their large number, and the lack of clarity of objectives and targeting (many preferences deal with indirect taxes) complicate and distort the tax system. In particular, free economic zones and priority development zones have been established, and now cover about ten percent of Ukraine's territory. The annual review of these zones in 2002 together with quarterly reports of their operations in 2003, have found a lack of effectiveness and growing revenue costs. Tax evasion and governance problems are also known, which can be attributed partly to poor oversight and some degree of discretion in the selection of investment projects. In response to those problems, the authorities are committed to halt the granting of new tax incentives within all free economic and priority development zones in the 2004 budget law.³⁶

20. Taxpayers' legal rights are well defined, but have been undermined by administrative practices that weaken voluntary compliance. The collection law passed in 2001 strengthened taxpayers rights by establishing principles of self-assessment and voluntary compliance, and replacing intrusive collection methods by modern enforcement tools. In disputed cases, the burden of proof has effectively shifted from the taxpayer to the STA. Starting in 2000, the practice of offsetting budgetary payments with tax liabilities was discontinued with few exceptions.³⁷ These improvements are supported by the initiation of administrative reforms at the STA and customs administration. The STA is to be reformed in the context of long-term modernization program sponsored by the World Bank (through 2013). Customs administrative reforms will be framed by the forthcoming adoptions of a new law On the Disciplinary Status of Customs Officials, in the context of the implementation of the new Customs Code. Problems in tax administration remain, as illustrated by the retention of some value-added tax (VAT) refund claims beyond the legal period (including amounts that have been validated), without any compensation for taxpayers.³⁸ The STA attributes this problem to delays in legal resolution of VAT refunds as well as the desire to meet revenue targets. Other administrative problems include frequent tax amnesties, with the latest in 2001, and forbearance of tax arrears for certain enterprises mainly in the energy sector. Poor compliance continues to be encouraged by relying partly on cash offsets to settle these arrears.³⁹

1.2.2

21. Lines of authority between the MOF and the STA need further clarification. Both the STA and the customs administration are directly responsible to the president and the chairman of each has ministerial status in the COM—although formally not members of the

1.1.3

³⁵ As required by the law On the System of Taxation, No. 1251-XII, June 25, 1991.

³⁶ As argued in footnote 22 with reference to NBU policies, such explicit policy statements are a welcome move toward transparency—but their implementation should be made clearly accountable through the annual budget process.

³⁷ Annual budget laws since 1999 prohibit against the noncash settlement of budgetary obligations. This ban has been effectively enforced starting in 2000. A few exceptions have been made, including for specific payments of the Ministry of Defense and foreign amortization to Russia. Such noncash settlements undermine transparency because they should, in principle, be excluded from the fiscal accounts.

³⁸ The outstanding stock of VAT refund arrears at end-August 2003 was equivalent to 1.2 percent of GDP.

³⁹ Using one-day banking loans.

COM. The MOF thus has more difficulties in coordinating revenue administration than is usual in other economies. Consultations are held on revenue targets in the budget and on new legislation, such as tax reform measures. However, in practice, information exchanges and policy coordination are limited because the MOF lacks a clear line of authority over tax issues. Lack of coordination has contributed to the adoption of rigid and overly disaggregated revenue targets and recent problems in the administration of VAT refunds.

Public servants' code of behaviour and anti-corruption activity

22. Public servants are subject to a code of behavior, but the laws require modernization. Civil servants are bound by the rules set out in the Civil Service Law, No. 3723-XII, December 16, 1993 and Order No. 58, October 23, 2000 of the Main Department of Public Service of Ukraine (thereafter Civil Service Department or CSD), on general rules of civil servants' behavior. Other categories of public servants, such as teachers, doctors, etc., are governed by their separate laws. The Civil Service Law provides a basic framework for the management and operation of the civil service including a code of conduct, but it has many weaknesses because of its enactment at an early stage of reform. The current framework needs to be adapted to European standards—and steps are being taken toward this end. 1.2.3

23. Measures to combat corruption require strengthening. The low level of remuneration, and lack of well established civil service structures at the time of establishing the Civil Service Law also gave opportunities and incentives for corrupt activities. The President's Decree, No. 599, April 14, 2000, On the Strategy for Reforming the Public Service in Ukraine, includes provision for establishment of more effective mechanisms to counter corruption, including mandatory rotation of selected civil service personnel. The proposed law on the "Control of Income and Expenditure of Civil Servants" (submitted by COM to Rada on the 18th of July 2003) will further address anti-corruption measures. COM reviews the annual anti-corruption reports of the CSD and approves the anti-corruption measures for the following year. The CSD published quarterly reports on anti-corruption measures through the media and on their website. Substantial institutional progress at the NBU, MOF, STU and in the oversight of the budget process by the Rada have made a significant contribution to reducing such activity. A remaining source of opportunities for corruption in managing public finances, however, is the lack of clear definition of managerial responsibilities and weak oversight of public financial assets. 1.2.3

B. Public Availability of Information

Coverage and quality of budget documents

24. The budget documents⁴⁰ cover central government fiscal activities, including information on the EBFs, and provide summary data on general government. The annual budget law is required under Article 38 (1) to be supported by a range of fiscal data and information on the economic and fiscal situation. Consistent with these requirements, extensive information is provided by the government to the Rada, a substantial improvement 2.1.1

⁴⁰ See paragraphs 39-40, and 48 below for discussion of final accounts and within-year budget execution reports.

over the situation prior to enactment of the code in 2001.⁴¹ Fiscal data primarily relate to state budget appropriations, and both detailed estimates of spending, revenue, financing, and economic and fiscal analysis, are comprehensive and broadly satisfactory (see paragraph 0 below). The format used for these data is broadly consistent with GFS requirements.⁴² Financial flow data on the four EBFs are provided in Volume II of the budget documents. Article 38 (2) requires also that the draft State Budget Law presented to the Rada each year should include estimates of the consolidated budget of Ukraine as supporting material. The State Budget Law gives details of state revenue and expenditure (by spending unit and functional or program classification), including transfers to local governments, and its financing (including gross privatization receipts, shown separately).⁴³ Estimates of total revenue, and its distribution between the state and local budgets, are also presented. Volume II, The *Consolidated Balance of Financial Resources* table presents cash flow projections for the general government as a whole, including the revenues, gross borrowing and payments on debt, projected expenditures of state and local budgets as well as of the EBFs, and overall cash balances for the budget year, the revised outturn for the current year, and actual result for the preceding year. However, this cash flow table does not include a consolidated general government fiscal balance in the GFS format.

2.1.5

25. Defense expenditures are reported in the budget. The authorities advise that Defense transactions are budgeted, accounted for, and are considered by the Budget Committee of the Rada in the same way as other agencies. Under Article 31 of the Budget Code, only national security and other “secret expenditures” are exempted from detailed disclosure, but are subject to scrutiny by the Budget Committee and other relevant committees of the Rada and are supervised by the MOF and the Accounting Chamber, under procedures established by the Rada. Some reports on use of funds may be reviewed by the Rada at a secret sitting.

2.1.1

Past and forecast fiscal data in the budget

26. The budget document discloses the main fiscal aggregates for two years prior to the budget year and three years beyond the budget year. The Explanatory Notes volume, gives a summary overview of the main state and local budget aggregates (excluding EBFs). The summary table shows revenue, expenditures, balance, and financing for actual spending two years prior to the budget, revised outturn for the current year, and forecasts for the budget and three succeeding years.

2.1.2

⁴¹ The budget documents presented to the Rada consist primarily of two volumes. Volume I includes the covering budget policy statement of the COM, detailed estimates of general fund expenditure to be appropriated, revenues, borrowing, investment by main spending unit, transfers to local government, a statement of consistency with the budget policy approved by the Rada and forecast of indicators of the consolidated general government budget. Volume II, the Explanatory Notes volume, provides a series of notes on key fiscal policy issues, and tables and other analysis on these topics; these include the following: a list of tax exemptions and estimated costs; the SPF annex; the list of enterprises whose shares are subject to sale; privatization; budgets of the special funds; budgets of the EBFs; and, the table *Consolidated Balance of Financial Resources*.

⁴² Budget accounting has been improved in recent years, including by reclassifying privatization receipts as budget financing.

⁴³ Local budget spending and deficits are not known at the time of presentation of the state budget, because their budgets can only be approved after local government transfers are approved by the Rada. The MOF prepares projections of the local government fiscal position for preparation of the consolidated table.

Budget treatment of offbudget fiscal activity

- 27. Government guarantees are discussed in the budget documents, but contingent liabilities are not covered comprehensively.** Limits are required on the issuance of central government debt (or state debt) and guaranteed debt in the annual budget law (Article 18 of the Budget Code). The code also requires that the budget documents include a summary of central government debt and guaranteed debt showing the debt structure and obligations through to retirement, as well as a list of investments that are to be guaranteed (Articles 38 (5,6)). This information is provided in the Explanatory Notes volume of the budget documents. A full listing of all outstanding guaranteed debt has not been provided on a systematic basis.⁴⁴ Other forms of contingent liability (such as indemnities, or risks that may arise from private/public partnerships or privatization) are not explicitly covered in the law and no information is provided. 2.1.3
- 28. Estimates of most tax expenditures are presented in the budget documents, as required by the budget code (Article 38).** The Explanatory Notes volume of the budget includes an inventory of tax expenditures with individual cost estimates. The basis for these estimates are tax returns received by the STA.⁴⁵ Estimates are provided for the two years preceding the budget and a forecast for the budget year. The reliability of these estimates has improved progressively since their introduction with the 2002 budget.⁴⁶ Good progress has been made in separating tax expenditures from core tax features. The cost estimates of VAT exemptions have been adjusted to reflect the tax credit mechanism. The inventory of tax expenditures provided with the 2004 budget appears to rely on the general structure of European tax legislation as a baseline. The identification of tax expenditure does not yet give a clear definition of the tax baseline (including justification for incorporation of commonly used exemptions), and the calculation methodology is not documented. Moreover, estimates do not cover exemptions from taxes not collected by STA, namely import duties and social security contributions, nor reflect the revenue cost of tax incentives embedded in simplified taxes (for small business activities and agriculture). 2.1.3
- 29. QFAs are still fairly extensive; neither qualitative nor quantitative reports are included in the budget documents, though some QFAs are monitored closely outside the budget process.** The authorities recognize the existence of QFAs in the energy sector, the housing and communal services sector, and in state-owned banks. State-owned enterprises in other economic sectors also provide social services without budgetary compensation, though to a lesser extent than in the past.⁴⁷ Some of these activities are monitored and reported to the public outside the budget context. As discussed in Box 4, the National Commission for the Regulation of Electric Energy (NERC) tracks the main sources of QFA in the electricity sector, namely payment compliance, differences between tariffs and production costs, and excessive losses. It publishes information on tariffs and cash collection ratios on a monthly basis; and price setting is transparent and based on a cost plus model available to the public. The MOE is developing a similar methodology for tracking implicit price subsidies for the main housing and communal services, but only information on collection performance and 2.1.3

⁴⁴ The MOF recently carried out an inventory of outstanding loan guarantees granted by the central government. Some detailed information was subsequently made available to the public.

⁴⁵ The 2004 budget documents indicate that the revenue cost of tax exemptions remains significant, but has declined from 3.7 percent of GDP in 2002 to 2.6 percent of GDP in 2003.

⁴⁶ Early inventories presented VAT refunds, loss carry-forwards, and depreciation deductions as tax expenditures.

⁴⁷ For instance, metallurgical companies maintain significant housing stocks without budgetary compensation.

tariff levels is currently published. There is no systematic monitoring of QFAs in other sectors.⁴⁸ No consolidated review of the extent of QFAs is undertaken, nor is a statement on such activities published with the budget documents.

Publication of data on debt and financial assets

30. Information on gross public debt is published in a timely way. The State Debt Management Department of the MOF publishes monthly data on central government debt and guaranteed debt. Reports are placed on the website about 25 days after month-end. External debt and guaranteed debt are classified by categories of creditors; domestic debt information distinguishes between treasury bills, classified by maturities, other state securities, and outstanding NBU loans. Debt data is reported by the STU to the MOF on gross terms and is reliable. Within-year NBU domestic debt records often indicate higher debt figures than those of the MOF, but this is explained by differences in the timing of reporting and minor differences in government coverage, and these differences are reconciled at year-end. Past, debt swaps have been disclosed to the public. There is no central registry of subnational debt. Subnational governments are required to submit information on their outstanding debt (as well as data on actual and expected revenues and expenditures) for authorization to be given to borrow at maturities exceeding one year (COM resolution On Approval of the Order of Local Borrowings, No. 207, February 24, 2003). There is no systematic monitoring of state enterprise debt.

2.1.4

31. Consolidated reporting of state financial and nonfinancial assets is limited to annual statistical data. The MOE receives quarterly financial reports from most state enterprises including estimates of their assets and liabilities. Decentralized management of state enterprises, as described in section A, has failed to establish comprehensive and consistent reporting standards. Moreover, enterprise accounts are not within the mandate of the COM. The SPF maintains a register of all assets under its management with valuation estimates. These estimates use book values that are often outdated.⁴⁹ No information on state property is currently reported on a regular basis to parliament, although some partial information is publicly available. The State Committee for Securities and Stock Exchange publishes government holdings in individual joint-stock companies. The State Statistics Committee (SSC) publishes statistical data on various aspects of all enterprises by ownership status, including estimates of net worth. There is only limited assurance of the reliability of such aggregate data. Enterprise reports are based on accounting standards approved by the MOF.⁵⁰

2.1.4

⁴⁸ In the coal sector, the government monitors accounts payable and receivable of state-owned mines. Price increases for unfinished coal products (by about 9 percent) and the collection of accounts receivable brought a small reduction in the stock of accounts payable, but the stock at end-October 2003 was still at more than 4 percent of GDP.

⁴⁹ Book values of equity holdings are updated only when joint-stock companies engage in new privatization, or stock operations.

⁵⁰ Law of Ukraine on accounting and financial reporting in Ukraine, No. 996-XIV, of July 16 1999.

Box 4. Transparency of Energy Sector Policies ¹

The regulated and still largely state-owned energy sector, comprising electricity, gas, and coal, has remained the primary source of quasi-fiscal activities (QFAs) in the Ukrainian economy. There have been some significant improvements. The electricity sector was restructured in 2000—a single wholesale market was created and a system of distribution accounts was introduced in order to ensure payment discipline within the sector. However, transparency of the energy sector's relations with the budget requires further strengthening.

Progress has been made in reducing the breadth of energy QFAs since 1999:

- **Payment compliance improved considerably.** In the electricity sector, cash collection ratios (payments to the wholesale market) have reportedly increased from less than 10 percent in 1999 to 91 percent in the first nine months of 2003. This was permitted by the restructuring of the electricity sector, the prohibition of barter transactions starting from mid-2000, and the privatization of several distributors in 2001. In the gas sector, cash collection ratios (Naftogas gas collections) increased from 18 percent in 1999 to 88.6 percent in the first nine months of 2003. This reflected stricter disconnection policies and the decline in noncash settlements.
- **Electricity tariffs are regulated on the basis of short-term production costs.** NERC utilizes a cost-plus model to determine electricity tariffs, taking account of the cost of electricity transmission and the depreciation of existing capital. Excessive commercial losses are not covered by tariffs but are being addressed by encouraging reform. NERC allows suppliers of electricity to have temporary tariff surcharges, that partly cover excessive losses, if they simultaneously take remedial measures, including additional investment.

Energy QFAs remain extensive, implying economic losses leading to forgone profits, decapitalization, and arrears. The World Bank has estimated the economic cost of each type of QFA.² The cost of QFAs in the gas sector was estimated at 2.5 percent of GDP in 2002. This estimate reflects below cost-recovery gas tariffs (2.2 percent of GDP) and nonpayments (0.3 percent of GDP), but does not capture excessive commercial losses. The extent of underpricing was estimated using the assumption that the true economic value of the gas consumed should be the price of Russian gas imports.³ Under this assumption, Naftogas forgoes large potential profits in price subsidies and the resulting price distortion severely discourages investment in domestic gas production. Nonpayment problems are concentrated in sectors also involved in conducting QFAs—such as heating and power generation. Economic losses resulting from QFAs in the electricity sector were estimated at 1.8 percent of GDP in 2002, on account of underpricing (0.5 percent of GDP), nonpayment (0.6 percent of GDP), and excessive losses (0.7 percent of GDP). This assumes that the cost-recovery price exceeds the wholesale electricity price by 10 percent, because of long-term investment needs unaccounted for in the tariff structure. For both gas and electricity, tariffs have been increasingly differentiated between households and the corporate sector, reflecting the absence of price adjustment for the former since 1999. As a result, cross-subsidies in each sector amounted to about 0.5 percent of GDP in 2002.

Regulation of the gas and coal sectors is not sufficiently transparent. Good standards of transparency have been achieved in the electricity sector, including clear pricing criteria and a reasonable degree of regulatory independence. The regulation of the gas complex is hampered by a rigid pricing structure, the lack of reliable operational and financial information, and the weak accountability of its governing body. Reform has been slow. NERC has recently become responsible for determining gas tariffs for industrial consumers, in addition to households and the budget sector. Naftogas has been subject to successive stages of an external audit since 1999. The audit has not been conclusive as of yet, because of major qualifications including on the estimation of gas reserves, the value of fixed assets, and the audit coverage. The next stage aims at auditing the consolidated 2002 accounts for about 32 enterprises affiliated to Naftogas—about 90 percent of Naftogas' cash flow. The timely completion of this audit should enable disclose and review Naftogas' cost of operation. The coal sector has been poorly supervised by the government, with indications of large payment arrears, below-cost coal prices, and misuse of budget subsidies. Below-cost coal prices have been the result of both government policy⁴ and the monopsony power of large coal dealers, or downstream industrial consumers—magnified by the financial distress of coal mines. The World Bank has recommended a strengthening of the responsibility of mine operators with effective enforcement by the state; to disallow the sale of coal below cost; and to crackdown on remaining barter trade and predatory practices.

¹ The QFA estimates presented in this box were provided by the World Bank and were not confirmed by the Ukrainian authorities.

² These estimates try to capture economic distortions. Accordingly, an assumption is made about the would-be market-determined energy tariff (i.e. the marginal cost of providing energy in the domestic market). The results are highly sensitive to this assumption. Actual financing needs will, of course, differ from these estimates, because underpricing relative to international prices does not create an immediate demand for financing. Estimates recently published by the IMF, which are substantially lower (1.5 percent of GDP for gas and 0.9 percent of GDP for electricity), calculate only such financing needs based on the accumulation of tax and payment arrears.

³ Because about 70 percent of the gas consumed in Ukraine is supplied through imports and transit gas.

⁴ In line with Presidential decree, On the restructuring of the coal sector, No. 116, July 2 1996, coal prices are administered only for households and the electricity sector. In principle, the state budget provides fully for the cost of these subsidies.

Commitment to the publication of fiscal information

2.2.1
2.2.2

32. Formal commitments for regular publication of fiscal data have been made and advance release calendars are announced. As noted above, the budget code requires publication and dissemination of annual budget and accounts data and monthly budget execution reports. These are observed in a timely way. The 2003 data ROSC records that an advance release calendar is disseminated on the statistics website (<http://www.ukrstat.gov.ua>). The data ROSC also records that fiscal data largely meet Special Data Dissemination Standard (SDDS) timeliness and periodicity standards.

C. Open Budget Preparation, Execution, and Reporting

Openness and clarity of the budget preparation and approval process

The annual budget process is open and the presentation is broadly consistent with international standards. The budget preparation, approval, and execution processes are clearly prescribed in the budget code for all levels of government. The main steps in budget preparation are described in Box 5, and, apart from the final stage of approval, these are followed. Budget and accounts classification are in line with GFS 1986 standards, and administrative, economic, and functional classifications are used. A program classification is also being applied in the context of developing results-oriented budgeting (see paragraph 37 below). EBFs are presented as annexes using their own classifications, which are consistent with GFS at an aggregate level.

3.2.1

The macroeconomic framework and policy basis for the budget

33. Fiscal policy goals are set around the balance of the central government, excluding extrabudgetary funds; although information is provided on general government balances in the budget document. The policy focus of the state budget law is on the deficit of the state budget, excluding EBFs.⁵¹ Equal, or more, emphasis is placed on limiting state government debt, with ceilings established on the stock of domestic and foreign debt. The deficit, as defined in the law, is with minor adjustments consistent with GFS concepts; policy targets have a consistent analytical basis, and are legally binding and effectively monitored. However, in terms of policy transparency, the process is limited by its narrow coverage. EBFs are presented with the budget for information and monitored quarterly. Aggregate data on cash balances and revenues of subnational governments are included in the budget documentation. The state budget does not present indicative estimates of expenditure and budget balances of local governments. Nevertheless, monthly revenue and expenditure reports covering the local government sector and the combined central and local

3.2.3
3.2.4

⁵¹ Separate balances and financing sources are established for the general and special funds—and primary emphasis is given to the general fund balance.

government sector are published during the fiscal year. Given the significant size of the state EBFs and subnational government (see Box 1), the budget documents should place more emphasis on the fiscal position of the consolidated general government.

Box 5. The Budget Preparation Process		
Due dates	Activities	Legal basis
The fiscal year is set on a calendar-year basis by the constitution. The MOF has primary responsibility for preparing the budget for the executive branch, but the MOE coordinates the preparation of all proposals on public investments. The main steps in the process are as follows:		
March/April	Preliminary macroeconomic forecast by MOE, NBU, and MOF in consultation, and estimate of revenue by MOF	Administrative
April/May	Expenditure limits set for key spending units.	Administrative
May 29	Budget policy guidelines sent to Rada	Art. 33(2)
June 1	Commencement of hearings on budget policy in the Rada	Art. 33(1)
Early June	Expenditure guidelines and request for expenditure estimates issued by the MOF.	Art 34(1)
End-June)	Estimates of recurrent and capital needs prepared by key spending units* (and their subordinate units) in accordance with schedule set by MOF.	Art 35(1)
August 15	Other laws that affect budget revenues or expenditures must be enacted before August 15 of the year that precedes the planned year.**	Art 27(3)
Mid-August	Consolidated state budget prepared by MOF and submitted to government.	Administrative
September 15	Revised budget approved by government and submitted to Rada. Within five days after government approval, the Minister of Finance presents the budget to a plenary session of the Rada, accompanied by a report from the Budget Committee on compliance with the budget code and the policy guidelines—noncompliance could result in resubmission.	Constitution Art 37(2)(2)
October 1 or 6	Rada: first reading, no later than October 1 (or October 6 if a second submission by government required).	Art. 40
November 3 or 8	Rada: second reading no later than November 3 (or 8).	Art. 42
November 25	Rada: third reading no later than November 25. Should the budget law not be adopted, monthly state budget expenditures will be restricted to 1/12 of the monthly amount applied under the previous year's budget.	Art. 44(1)
December 1***	Rada: adoption of the State Budget Law.	Art. 44(5)
December	Regional and local authorities: approval of budgets taking into account transfers and other provisions approved by the Rada	Art.77
<p>* Ministries, agencies, and committees receiving primary budget authority. The number of these agencies has been reduced by more than half since 1999. Lower-level units within the key spending units receive suballocations from the key unit.</p> <p>** The budget code prescribes that laws that do not meet this requirement should not come into force until the beginning of the year after the budget.</p> <p>***This timing has not been met on several occasions.</p>		

34. Budget forecasts and underlying assumptions are clearly presented, but coordination and consistency of forecasting could be strengthened. The budget is based on macroeconomic forecasts prepared by the MOE in consultation with other line ministries. Although the MOF is consulted, the MOE has been reasonably independent in making forecasts. These forecasts are presented in detail in the annual draft law On the Program for

the Social and Economic Development of Ukraine, which is submitted to parliament together with the draft budget law. The main economic forecasts of the budget are made publicly available in advance of the budget deliberation. The budget resolution provides a preliminary summary forecast, and the COM discloses the main economic indicators to be incorporated about a month before the budget submission deadline.⁵² Economic forecasts are formulated in a consistent framework, using a wide range of sectoral and macroeconomic data. With few exceptions, forecasts have been fairly reliable and, given uncertainties inherent to the transition process, appropriately conservative.⁵³ The macroeconomic forecasts made for the budget are generally not consistent with those of the NBU in presenting the monetary policy guidelines, which are submitted to the Rada at about the same time as the budget. There is no formal requirement to explain differences in assumptions to the Rada. Budget revenue forecasts are made by the MOF in consultation with STA and Customs.

35. A statement on medium-term fiscal policy objectives is included in the budget document, but does not provide a solid basis for future fiscal policy. A quantified fiscal framework covering three years after the budget year is presented. For the 2004 budget, it was approved as a COM resolution (No. 1427, September 9, 2003) and for the first time covered the combined local and central governments. The analytical framework includes deficit and debt indicators—reflecting the government’s plans for revenue and expenditure reforms. The framework does not yet represent a fully accountable statement of government policies for the medium term and does not constrain future budgets.⁵⁴ Rather, expenditure estimates reflect a general intention to redirect expenditure toward social sectors without being underpinned by well defined medium-term strategies. Fiscal sustainability issues are not examined fully: no account is taken of future unfunded liabilities created by the pension system and other social insurance policies; and there is no quantified analysis of risks to debt sustainability such as the impact of large exchange rate fluctuations or the assumption of public enterprise debt.

3.1.1

Fiscal rules

36. The budget code clearly defines a number of fiscal rules. Central government borrowing should not exceed 60 percent of GDP. The right to borrow⁵⁵ is limited to cities,

3.1.2

⁵² The COM resolution No. 621 of 4/26/2003 On the Development of Forecast and Program Documents for Social and Economic Development and on the Drafting of the State Budget, establishes a clear schedule for the submission of inputs by government agencies and the COM approval of the draft law On the Program for Social and Economic Development and the Draft State Budget.

⁵³ Since 1999, the GDP outturn has generally been in line or has exceeded the original budget forecast, except in 2002. In that year, nominal GDP fell short of the budget estimate by about 8 percent mainly reflecting an unexpectedly fast drop in inflation. For the 2003 and 2004 budgets, the government has used two medium-term economic scenarios, with the rationale that rapid economic growth would hinge on the implementation of structural reforms presented in its economic program. The 2003 and 2004 budgets were prepared using the more conservative scenario.

⁵⁴ In developed administrations, such a framework should be able to accommodate a change in government—allowing changes in policy to be made while retaining a discipline of accountability. Accountability is achieved by clear definition of the policy and cost basis of continuing government policy and a disciplined process for adding new policy commitments to the government program. It will be the prerogative of a new government to change policies, but the framework should require that they explain precisely the nature of these changes.

⁵⁵ All subnational governments are allowed to borrow domestically at very short-term maturities for liquidity management. The budget code regulates any borrowing that would not be unwound by the end of the fiscal year.

towns, and the Republic of Crimea (Article 72 of the Budget Code). Borrowing is allowed only to finance capital spending, with some additional safeguards: (1) only cities with populations exceeding 800,000 habitants are allowed to borrow externally; (2) total debt service should not exceed 10 percent of the expenditure of the general fund of the respective budget.⁵⁶ A separate COM resolution No. 207, February 24, 2003, requires the certification of the creditworthiness by a recognized rating agency for any subnational government willing to borrow. Subnational governments designated as oblasts, rayons, and local settlements are prohibited from borrowing. The MOF enforces these rules mainly by verifying compliance before authorizing borrowing. Moreover, any breach to these rules may be sanctioned as a budgetary “offense” in accordance with the budget code (chapters 18). In those circumstances, the code provides for suspending budget transfers and, in some cases, budget decisions of subnational governments. Prosecution may also be initiated against public officials.

3.1.3
3.1.4

Medium-term and results-oriented budgeting

37. Medium-term, program-oriented budgeting is being initiated, but procedures are not yet in place; estimates of new initiatives and ongoing costs of government policies are not clearly distinguished in the budget documents. As required in the Budget Code, steps are being taken to establish a medium-term framework. Regulations are being prepared to establish this process formally at the level of the key spending units. At present, however, these regulations are not fully in place, although spending units are now required to maintain forward estimates. New proposals are discussed separately from ongoing activities in budget preparation, but the budget documents do not clearly distinguish ongoing costs of activities from new spending proposals introduced in each year’s budget.

38. The objectives and expected results from government activities are defined only in general terms. A substantial number of programs have been introduced under the initiative described above, but the budget documents, at present, state objectives and performance targets only in broad terms. Reporting focuses on financial compliance, with no systematic performance reporting yet in place.

3.2.2
3.4.3

Fiscal risk analysis

39. The sensitivity of budget estimates to changes in economic variables is not assessed and fiscal risks are only briefly discussed with the budget. Some risks, such as contingencies for guarantees, are considered in the budget process, and a budget allocation is made to cover such risks. Although different scenarios are presented as part of the budget presentation, no systematic review of all types of risk is provided. The budget document does not include simulations using different economic assumptions.⁵⁷ In the past crisis-management environment, budget sequestration became the primary tool to address the many weaknesses arising from unrealistic budgeting. More transparent examination of fiscal risks

3.1.5

⁵⁶ To be assessed on the basis of fiscal data of the previous year.

⁵⁷ As well as risks arising from changes in macroeconomic conditions, other risks warranting some discussion in the budget could include the loss of market access, larger-than-expected revenue shortfalls as a result of tax reforms, or the cost of energy tariff increases.

in the budget document should permit more carefully tailored responses—and further strengthen the realism of budget estimates.

Accounting and fiscal reporting

40. The accounting system is capable of producing accurate in-year reports on central government budget outturn, but does not cover all EBFs. 3.3.1 The consolidation of the central government treasury system from 1999 to cover all budgetary institutions has established effective and timely reporting on cash transactions by the central government. Reporting is based on adequate revenue and expenditure classifications. Expenditure reports are compiled using both a functional and economic classification.⁵⁸ Summary monthly reports provided by the STU are posted on the MOF website (<http://www.minfin.gov.ua/minfin/index.jsp>) around 20 days after month-end. In addition to centralized treasury reporting, individual spending units maintain their own accounts on accrual principles. While the two systems of reporting are not yet fully integrated, these reports are consolidated by the STU on a quarterly basis. Accounts payable and bills due for payment are recorded as part of the commitments management facility of the treasury system. These data have been used in the past as a basis for payments arrears reporting.⁵⁹

41. The treasury system covers most of central government and is being extended. 3.3.1 All budget entities are currently covered, and the system is being extended to other elements of central government and oblasts. The cash balances of three EBFs pertaining to social benefits have now been amalgamated into the TSA and are maintained as sub-accounts by the STU. The balances of these EBFs are included in the STU's reports. At present, the STU does not exercise any budgetary control over the individual transactions of these EBFs. There are plans to extend the budgetary control exercised by the STU to these EBFs by 2004. The Pension Fund remains outside the purview of the STU; the Law On Mandatory State Pension Insurance, No. 1058-IV, July 9, 2003 allows the Pension Fund (PF) to bank with commercial banks. Eleven oblasts are now included in the treasury reporting system and it is planned that the treasury cover all subnational governments by January 1, 2004.⁶⁰ Treasury coverage of oblast operations has improved the timeliness and reliability of oblast government reporting (currently reported by oblasts to the STU) and has permitted rationalization of some overlapping allocation of funds by central and oblast governments.

Clarity of control of budget execution

42. The MOF, STU and NBU should establish clear roles and coordination mechanisms for cash and debt management. 3.3.1 The STU prepares rolling three-month forecasts of cash

⁵⁸ Data according to the economic classification is however available with a two month lag, one month more than the functional classification.

⁵⁹ At present, with realistic budgets, payments arrears is not a significant issue. Differences between commitments recorded by the STU and the monthly rospis (annual and monthly spending plans produced by the MOF to authorize spending) are sometimes referred to as arrears, but these arise more from inflexibilities in the rospis system than from genuine arrears in payment.

⁶⁰ The inclusion of subnational governments and EBFs into the treasury system has placed some strains on treasury resource, and some initial problems have been experienced in some regions. However, the response to the extension appears to be broadly favorable.

flows, based on the rospis and updates of actual cash flow data. This information will be enhanced when the coverage of the treasury system is extended. The cash forecasts are circulated to the MOF and NBU to assist with debt management and coordination of monetary and fiscal policy, but effectiveness of coordination among the agencies needs to be strengthened in this regard.⁶¹ The use and flexibility of the rospis should also be re-examined in the context of the improved fiscal management environment.

43. Basic internal control procedures are in place, but are not well coordinated.

3.3.3

Spending units and the STU have well established rules and regulations that provide a platform for developing modern internal controls. Government receipts now flow entirely to the TSA (see discussion above). STU controls payments and has established registration of commitments and effectively monitors all stages of payment. These functions of the STU are being extended to cover local governments and EBFs. In addition to the concurrent internal controls exercised through the STU, the Main Control and Auditing Department of Ukraine (KRU) is an inspection service reporting directly to the president, the Rada, and the COM, with powers covering all budgetary institutions (including line ministries, central and local executive authority bodies, local self-government entities), as well as state-owned enterprises and any entities that receive resources from the general or special funds of the budget (irrespective of their ownership, organizational, legal, or accountability structure). Many of the continuing functions are derived from the former central planning system, but are being adapted to meet modern fiscal management needs. In addition, the majority of ministries and central executive authority bodies have their own internal control units, but these need further development to enable them to fulfill their management support function. The system of coordinating all of the internal control and audit functions of government needs considerable further development.

44. Sustained emphasis on modern management-oriented systems and coordination among internal control agencies is needed.

3.3.3

Both STU and KRU are substantially compliance oriented. KRU in particular has placed most emphasis on inspection of misappropriation of funds. However, the effectiveness of STU controls has greatly reduced the need for such an emphasis. Accordingly, the legal basis⁶² for the functioning of KRU is being revised. The revised legal framework will clarify the relationships between KRU and other executive arms of the government and parliament. The new law will provide the authority to conduct preventive audits of systems and procedures.⁶³ KRU is moving towards adoption of international auditing standards. Their activities are now governed by auditing standards adopted in 2002⁶⁴. The KRU staff have received a considerable amount of training in new approaches to internal control and now devote around 10 percent of total resources to value-for-money audit. This approach complements the STU and ministry internal audit systems well—but will take time to implement.

45. Open procurement rules and practices are being put in place, though some weaknesses exist.

3.3.2

A World Bank assessment of procurement practice indicated that the

⁶¹ Currently there are some sizeable unplanned government cash surpluses.

⁶² Law of Ukraine On the State Control and Revision Service in Ukraine, No. 2939-XII, January 26, 1993.

⁶³ The draft law would strengthen the focus of audits on effectiveness and would give KRU powers to audit the management of state-owned and communal property and take legal action on behalf of the state in these matters.

⁶⁴ Order of the Main Auditing Department of Ukraine of August 9, 2003 No.168, On the Approval of Standards of State Financial Control Over the Use of Budget Resources, State-Owned and Communal Property.

introduction of the public procurement law in 2000⁶⁵ has established a sound basis for open, competitive procurement of goods and services by budgetary institutions. The new law provides the framework for decentralized procurement systems, transparent and appropriate procurement methods, effective advertisement process, improved anti-corruption measures, and a regulated appeal process. The World Bank assessment, however, also noted a number of weaknesses. Prominent among these are the ad hoc authority vested in the COM to suspend provisions of the Public Procurement Law, preferences towards domestic firms, considerable leeway to extend contracts without competition, excessive pre-qualification requirements, and absence of standard bidding documents.

46. Further improvement in the procurement framework is planned. The Public Procurement Department of the MOE is developing a strategy paper to implement the CPAR recommendations. This strategy paper will be submitted to COM by end-December. The paper addresses issues regarding the institutional development of the Public Procurement Department. Some amendments have already been made to the Public Procurement Law (in Jan. 2003) to abolish the preferences towards purchases from domestic firms and to restrict the application of direct purchase procedures. The Public Procurement Department is also developing standard bidding documents. An accreditation procedure for procurement officials has been instituted which will be obligatory from mid-2004. Three times a month information about opened tenders, results of tenders, and procurement regulations are posted on the website of the Public Procurement Department (www.me.gov.ua). Budgetary institutions develop procurement plans for the following year, in accordance with their proposed budgets. These procurement plans are consolidated and published in a procurement bulletin which is also posted on the website. The commitment registration exercised by treasury, internal audits by KRU, and external audit by the Accounting Chamber give assurances about the implementation of the Public Procurement Law.

3.3.2

47. The pay structure of the public service is not transparent and the employment procedures should be made more objective.⁶⁶ A recent review of the civil service system indicated that the remuneration system for civil servants is complex, nontransparent, insufficiently related to outputs, and discretionary in terms of payments of bonuses. The Civil Services Department (CSD) is developing a three- to five-year strategy to meet the requirements of accession to the EU. The strategy addresses shortcomings mentioned in the review. The government has introduced a resolution replacing the present performance appraisal system, of attestation once in three years, with a comprehensive annual system.⁶⁷

3.3.2

⁶⁵ Law On Procurement of Goods, Works, and Services for Public Funds, No. 1490-III, July 2000. (see *Ukraine: Country Procurement Assessment Report (CPAR)*, World Bank, November 2001.

⁶⁶ The Civil Service includes only the administrative staff of state power bodies and key spending units. There are around 32,700 civil servants in these units, 110,000 in their regional branches, and 77,400 in local governments. The CSD has a staff complement of around 100 to administer the civil service and has the capability to train new entrants and to provide in-service training for around 40,000 civil servants each year.

⁶⁷ COM Resolution No. 1922, of December. 28, 2000, On the Approval of the Provision on the Certification of Civil Servants.

Independence and accountability of tax administration

48. The State Tax Administration (STA) reports directly to the President, and is weakly accountable to the government. 3.3.4 The STA role and powers are defined in the law On the State Tax Administration, No. 509-XII, December 4, 1990 and in the Presidential Decree No. 886/2000, On Approval of the Charter of the State Tax Administration of Ukraine, of July 13, 2000. The STA is responsible directly to the President who appoints its chairman. The COM and the Rada have limited powers to assess tax administration practices, including STA observance of tax laws. Both KRU and the Accounting Chamber can audit administrative expenditures of the STA, but revenue collection functions are subject only to internal STA audit. The Prosecutor's Office can investigate the operations of STA. The limited external oversight of STA and Customs (see paragraph 55 below) contributes to the negative perception of problems (such as VAT refunds) and most likely reduces the pressure for remedial action.

Reporting and review within year, and submission of final accounts

49. The legislature examines budget progress quarterly, but does not undertake a full mid-year review. 3.4.1 Article 60 of the budget code requires a quarterly report on the execution of the state budget to the Rada and the Accounting Chamber, and, as noted, budget reports are produced monthly by STU. These reports provide important information on progress to parliament and the public. The Budget Committee of the Rada, follows these reports closely. Some Civil Society Organizations, such as the International Center for Policy Studies and the Institute of Financial Policy, also pay close attention to monthly and quarterly budget reports. A formal review by the legislature is not mandated by the law.

50. The final accounts are presented to the Rada and audited within six months after the end of the fiscal year. 3.4.2 Article 61 of the budget code requires submission to the Rada of the final accounts⁶⁸ for the budget year by May 1 of the following year, and this is observed in the presentation of the *State Budget Execution Statement*, which is prepared by STU. The cash accounts presented by the STU include the EBFs except for the Pension Fund. With the coverage of local government transactions by the treasury system in 2004, the treasury will be able to present consolidated cash accounts for most of general government. Local government annual accounts reports are submitted to their rada by the local state administration or the rada's executive body, within two months after the end of the fiscal year. The scope of audit conducted by the Accounting Chamber is limited to observations of compliance and the Budget Committee of the Rada does not examine the final accounts in depth.

⁶⁸ The state government final accounts includes a balance sheet; an income and expenditure account; a cash account; statement of public debt by type of debt and debt holder; a statement of guarantees provided by the government; and information on the execution of local budgets.

D. Assurances of Integrity

Integrity of data processes

51. **A basis for reliable estimates for the state general fund has been established, but strengthening is required in some areas.**⁶⁹ The more explicit discussion between the government and the Rada of central government assumptions for revenue, and the favorable policy environment, have improved the reliability of budget estimates—a great improvement over the situation recorded in the 1999 ROSC. The 2003 state budget, in particular, has established a sound benchmark for realism compared to earlier budgets. The general fund of the budget has been executed broadly as planned so far in 2003.⁷⁰ On the other hand, budget estimates of the special funds continue to be largely inaccurate, reflecting its limited oversight. Earmarked revenue is consistently underestimated (in the range of ½–1¼ percent of GDP in 2001-02); the ability of special funds to accumulate unspent cash balances is not reflected; and foreign-financed projects loans are generally overstated. As a result, the budget estimate of the fiscal balance is not fully reliable. As regards state extrabudgetary funds, revenue and expenditure outturns deviate significantly from the original budget estimates, although the budget assumption that these funds achieve fiscal balance is usually achieved in fact.

4.1.1

52. **The variance between budgeted and actual outturn of the main fiscal aggregates is disclosed and explained to the Rada.** The report on budget execution presented to the Rada includes a comparison of budget outcomes with the original budget estimates for revenue and expenditure programs. During the year, monthly budget execution reports show actual revenue and expenditure as a proportion of the budget estimate for the year. Within-year revenue and expenditure plans are not published with the result that there is no solid basis to assess budget execution before the end of the fiscal year.

4.1.1

53. **Statements of accounting policy are not included in the budget and final accounts documents, but are clearly stated for administrative purposes.** Neither the budget documents nor the *State Budget Execution Statement* contain statements of accounting basis or accounting policies. However, policies are clearly explained within the administration.⁷¹ Treasury accounting is largely on a cash basis, but some elements of accrual data (such as balance sheet presentation, debt data, and limited data on financial assets) are also included

4.1.2

⁶⁹ The situation is unclear for subnational budgets because consolidated data on their original budgets is not available.

⁷⁰ Nonearmarked revenue and privatization receipts have performed in line with the budget targets. Following revisions to finance unexpected wage increases, expenditure programs of the general fund have been executed according to plan. This contrasts sharply with the execution of earlier budgets, characterized by chronic shortfalls in nonearmarked revenue (in the range of ½-1 percent of GDP in 2001-02), privatization receipts (in the range of 1¼-2½ percent of GDP in 2001-02), and the subsequent need for ad-hoc expenditure sequestration or additional financing.

⁷¹ Articles 56(1) and 56(3) of the budget code authorize the STU to prescribe accounting rules for all key spending units. The STU has prescribed uniform accounting rules which are used to record and account for cash transactions of spending units processed through the treasury. These rules also apply to the registration of budget distribution and commitments in the treasury. The treasury has also prescribed an accrual based chart of accounts for spending units [treasury instruction 114 of 2002]. These two sets of instructions are the basis for the accounting policies of the general government sector.

in statements. A presidential decree,⁷² as recently modified, requires that the treasury move to an accrual basis of accounting by 2007, but, at present, accounting standards are not fully compliant with International Public Sector Accounting Standards (IPSAS).

54. The processes of accounts reconciliation and fiscal reporting are effective. The STU and its regional branches directly draw down the TSA account in the NBU, to make payments to suppliers of spending units. As a result, the reconciliation between NBU and STU for cash flows out of the TSA is automatic. Government receipts are electronically deposited into the TSA and the underlying documents also simultaneously transferred (electronically) to the treasury—with again no need to further reconcile receipts with the NBU. The treasury system and STU regulations give assurance of effective checking of spending against budget appropriation and apportionment, as well as reconciliation between treasury ledger accounts and the TSA. The treasury periodically reconciles its accounts with those of the spending units and the STA. Debt flows are reconciled between STU and the MOF in the same manner as the receipt and expenditure flows of spending units.

4.1.3

Independent oversight

55. External audit is independent of the executive branch, but has a restricted mandate.

4.2.1

This position has not materially strengthened since the 1999 ROSC. The Accounting Chamber is established as an independent body under the Rada by the constitution (Article 98). It was set up in 1996 and operates under the Law of Ukraine, On Accounting Chamber, of July 1996, as amended. Its audit activities cover expenditure execution by all budgetary agencies and extrabudgetary and earmarked funds and overall execution of the state budget and creation and repayment of public debt. It does not cover public enterprises or revenue administration. Audit is largely limited to the examination of propriety and regularity of expenditure. Aspects of the law and the independence of the Accounting Chamber have been challenged in the constitutional court by the President. The challenge was upheld by the constitutional court and as a consequence the 1996 law was amended to limit immunity for the Head and senior staff of the Accounting Chamber, to limit its authority to examine and possess documents, and to carry out audit on state revenues the SPF, or state-owned enterprises.⁷³ Accounting Chamber activities are made available to the public through its annual report and its findings are regularly disseminated through the media and the internet (<http://www.ac-rada.gov.ua/common.asp>).

56. Strengthening of audit capacity is required. The Accounting Chamber performs regular audits of the expenditures of key spending units of the central government. The audits cover 30-35 percent of the spending units every year—all are covered over an audit cycle of three years. The audit is conducted in accordance with an audit program which is circulated to all spending units by November of the previous year. The capacity of the Accounting Chamber to conduct specialized audits such as value-for-money audits is limited. The Accounting Chamber has a staff of 200 within 10 departments each of which deals with a group of functions of the government. It does not have regional units. These resources are

4.2.1

⁷² Presidential Decree No. 1251, December 25, 2001, On the Strengthening of the Financial Discipline and Preventing Infringements in the Budgetary Sphere.

⁷³ The Accounting Chamber may, however, undertake analytical reviews of the activities of revenue collection agencies, SPF and other government organizations. These analytical reviews are not legally binding, but are publicly available through the press and on their website.

small in comparison to the mandate of the Accounting Chamber. Moreover, the budget for training staff is limited.

57. The legislature discusses external audit reports, but systematic review is limited.

4.2.1

The budget code (Article 62) requires that the Accounting Chamber audit the final accounts within two weeks of their submission to the Rada. The audit of government accounts by the Accounting Chamber is an on-going exercise as it receives quarterly accounts from the government and publishes quarterly reviews of these accounts. Given the relatively limited scope of audit and the concurrent review, the two-week time limit is not a constraint. However, the quality and depth of audit should be substantially enhanced. Follow-up of Accounting Chamber findings is largely left to the executive—through the COM and relevant agencies of government, such as KRU. A more extensive audit, and in depth review of government finances, would be needed to attain satisfactory international standards of external oversight.

58. External scrutiny of macroeconomic models and assumptions is actively

4.2.2

encouraged. MOE uses an economic model that has been developed jointly with the NBU and a number of external think tanks and technical assistance providers. MOE organizes quarterly macro-forecasting seminars open to government agencies, the NBU, and external think tanks and institutes to discuss and compare economic forecasts, including assumptions. Following each of these meetings, MOE publishes a report that compares forecasts submitted by seminar participants including MOE's and calculates the average forecast (consensus forecast). Occasionally, MOE also organizes special meetings on modeling and other technical issues, open to the same group of participants. MOE methods and assumptions can also be examined by the Accounting Chamber and the Rada Budget Committee in their review of the draft state budget, after its submission to parliament. Both can resort to outside experts in this endeavor.

59. The national statistics office is given legislative assurance of independence.

4.2.3

Technical independence of the SSC of Ukraine is guaranteed by law, as discussed in the 2003 Data ROSC. Consistent with this legal framework, the MOF takes lead responsibilities for collecting, processing, and disseminating government finance statistics. These responsibilities are clearly specified in the budget code and in a formal agreement between the MOF, STU, and the SSC (see 2003 Data ROSC (0.1.1)).

III. IMF STAFF COMMENTARY

60. **Since the 1999 ROSC, Ukraine has made significant progress in improving key aspects of fiscal transparency.** The budget code has established a solid legal framework for budget management. The treasury system now provides a mechanism for timely, reliable, and comprehensive reporting on the fiscal position and debt of central government—and, from 2004, of general government. State procurement has been modernized and transparency greatly improved through use of the internet. Though much remains to be done, progress has also been made, particularly in the electricity sector, in applying economic pricing and addressing the poor payment collection and enterprise tax arrears that have been contributing causes of high quasi-fiscal costs. These and the other achievements described above, combined with its considerably improved growth and fiscal performance, place Ukraine in a sound position to further improve transparency and establish sound and sustainable fiscal policies.

61. **The new environment carries considerable challenges that will require different strategies from those of the past.** A number of long-standing transparency and fiscal management issues are still to be fully addressed. The focused development of the treasury system and tax administration through strong independent agencies has had merit in the transition environment. However, there have been some costs in terms of the poor integration of the government functions. Some of the interagency barriers that are prevalent in the administration need to be broken down in order to realize the full benefits of reform to date. The description of practice in the preceding section suggests a number of ways in which the greatly improved information now available can be used more effectively, and with further gains in transparency. The relative lack of knowledge and control over the public enterprise sector—and, the many activities of a fiscal nature carried out by that sector—continue to impede the establishment of sound long-term fiscal policies. A beginning has certainly been made on these problems, but a sustained effort will be required to fully establish a modern institutional framework.

62. **Equal priority should be given to consolidation of recent improvements and maintaining momentum for strategic restructuring in the medium to long term.** *With respect to consolidation, many improvements can be made in the relatively short term with significant transparency gains.* Two aspects should be given particular emphasis: (a) deepening and widening of analysis in the budget documents to provide a more comprehensive basis for discussion and monitoring of the budget; and (b) clarifying responsibilities and improving coordination among fiscal management agencies. *Longer-term strategic reform requires more fundamental change, but this does not reduce the urgency of early initiation of measures and the need for full political support.* The key areas that need to be emphasized are: (c) broad reform of the public sector; (d) deepening of energy sector reforms; and (e) build up of oversight institutions. All areas of reform require that sustained attention be paid to clarifying roles and improving coordination among the agencies of government

A more comprehensive budget presentation

63. The aim should be to move toward a clear analytical presentation of general government, with a sharp distinction between government and commercial activity. Such an approach is consistent with developments already underway; it will enhance budget realism and consistency, give better information to the Rada, the public, and the financial markets, and build support for government programs. Three elements should be particularly emphasized: (i) broadening the state budget presentation to feature special funds, EBFs, and subnational government more prominently in the analysis; (ii) deepening the analysis presented in the Explanatory Notes; and, (iii) developing the methodology for management of fiscal policy over the medium and long term.

65. The state budget presentation should provide a more comprehensive picture of general government. The sound approach now taken to the general fund of the budget should be extended to include all of the elements of general government:

- Special funds should be reviewed and some elements considered for inclusion in the general fund. Surplus balances of such funds should be considered more explicitly in the budget analysis and debate. 1.1.3
- The framework for examining the overall deficit or surplus should explicitly include EBFs and subnational government projections—presenting an analytical (GFS-consistent) table with accompanying explanatory notes as a central element of the budget presentation, rather than the present *Consolidated Balance of Financial Resources* table. 3.2.4
- Macroeconomic and fiscal forecasting should incorporate all elements of general government in the methodology and the present approach, including consensus forecasting, further developed to establish consistent forecasting and clear explanations of differences among groups. 3.1.3

66. The Explanatory Notes should be further systematized in line with best international practice. The present Explanatory Notes (Volume II), of the budget documents, provides a good coverage of key issues for budget discussion. It could be further enhanced, by developing the following annexes in line with best practice in advanced countries:

- **A fiscal risk annex.** This would systematically look at all factors that could give rise to changes in the fiscal position and would aim to provide assurance of the reliability of fiscal projections as well. The annex should include: sensitivity analysis to examine risks from changes in macroeconomic assumptions; an assessment of risks from all contingent liabilities; risks that may arise from QFA (see below); an analysis of budgetary controls and the reliability of budget estimates; and, other contingencies that may have an impact on the budget forecast for the current year and medium term. 3.1.5
- **A review of QFA in the public sector.** Such analysis is not common in advanced countries, where best practice is to eliminate these kinds of activity by clear arms-length arrangements, explicit budget subsidies, or privatization. In light of the significance of this issue in Ukraine, it would be appropriate to establish a regular annual review of such 3.1.3

activity in the budget documents.⁷⁴

- **A tax expenditure budget.** The tax expenditure presentation in the budget has established a good basis for a report that could meet best practice standards. This presentation could be further clarified by explicitly defining the baseline used for each tax (including a justification for including commonly used exemptions), and describing the estimation methodology. 3.1.3
- **A comprehensive fiscal sustainability budget annex** showing long-term debt and pension fund forecasts and discussing policy implications. A great deal of data and analysis of pension liabilities over the long term is already available 3.1.1

67. An accountable medium-term budget framework should be developed. The government has taken important steps toward establishing a medium-term budget framework, but regulations are not yet in place to ensure that the benefits of a forward estimates system are fully realized. Key elements to ensure accountability are as follows: 3.1.3

- Ministries and agencies must maintain estimates of their spending, including agreed estimates for the years following the budget year (forward estimates); these latter become a firm basis for negotiating the budget with the MOF in those following years. 3.1.3
- Existing policy estimates (a baseline of the continuing costs of government programs) should be maintained and new policies clearly distinguished from ongoing activity in ministry programs 3.1.4
- Aggregate forward estimates should be derived from those data, and changes to the aggregate ongoing costs of government programs should be clearly explained in terms of changes to underlying costs or the introduction of new policies in the budget presentation. 3.1.4

Clarifying responsibilities and coordination

68. Definitions of government and agency responsibilities need clarification and key interagency issues should to be addressed. Lack of clarity in distinguishing government and commercial activity is a significant problem in relations with public enterprises. Within government, the role of different agencies needs better delineation to further sharpen the focus of fiscal policy. In the key areas of tax policy, and cash and debt management, there is a need to strengthen the overall coordinating role of the MOF, and to resolve any issues arising in the coordination of fiscal and monetary management.

⁷⁴ The work carried out by NERC in the electricity, and to some extent, in the gas sectors, provides a good working example of the information that could be included. A first step, therefore, would be to initiate such a report by introducing a brief summary of NERC's estimates of quasi-fiscal operations in the electricity and gas sectors (see also further discussion of public enterprises and energy sector below).

69. A rigorous definition of general government activity should be used to demarcate lines of responsibility. Some issues arise in this regard with respect to own-revenue earmarked funds (see paragraph 3 above) and ministerial enterprises (paragraph 4 above). In the former case, there is a need to examine whether certain elements could be better handled by contracting out arrangements, or incorporation as part of the general fund. In the latter, clear principles of accountability should be established. In this context:

1.1.1
1.1.3

- Where receipts for services are retained by a unit within central government, the associated expenditures should be accounted for and controlled in the same way as other spending. 1.1.3
- The concept of ministerial enterprises should be clearly explained and a registry maintained, with regular reports included in the budget documents. Creation of such enterprises should be justified with reference to alternative ways of achieving the service objective: either by carrying out the service as a normal part of general government, or by contracting out to the private sector. 1.1.1
1.1.4

70. Consultation on the implementation of the intergovernmental budgetary system should be strengthened and open to independent analysis. The budget code introduced clear principles for intergovernmental relations, but implementation has relied on complex transfer formulae and has involved only limited participation from subnational governments. Consideration should be given to the following measures: 1.1.2

- Establishing an independent body responsible for assessing and providing technical analysis and advice on the implementation of intergovernmental budget rules. In particular, this body should be empowered to review the computation of intergovernmental transfers and their use in local government budgets. Its relationship with the government and parliament should be clearly defined, to ensure that its findings are properly discussed and acted upon.
- Opening transfer computation to discussion by all the parties involved. All of the parameters used in transfer formulas (with justification for any change), as well as the resulting transfer amounts for each subnational government, should be published.
- Simplifying existing formulae and developing more objective criteria for the allocation of capital grants.
- Extending the broad rule-based approach to lower tiers of government.
- Avoiding new unfunded mandates, by matching any new delegation of expenditure responsibility to lower government tiers with budgetary transfers and refraining from granting tax expenditures eroding local governments' own revenues.

71. The MOF should be made clearly responsible for coordinating all fiscal management units, notably STA and STU. Such a broad management role will enhance flexibility of response to changing circumstances, without impeding the necessary independence of STA, STU, and Customs in implementing their respective administrative functions and legal responsibilities. Key issues on which the MOF should take the lead include: tax issues involving several fiscal agencies (e.g., VAT refunds); efforts to achieve more stability in tax laws and their implementation—involving both tax policy and tax administration issues; and coordination of cash and debt management—involving the MOF, STU, and NBU. 1.1.3

Public enterprise reforms

72. The purpose, scope, and management of the public enterprise sector needs to be clearly defined. The size of the public enterprise sector and its disaggregated policy oversight, present a substantial barrier to reform. Both management of the enterprises (including policy on dividends) that remain in the public sector, and the government's privatization program, require consistent and comprehensive data on the size and performance of the sector. Emphasis should be placed on improving coordination of management responsibilities and establishing a clear reporting and accountability regime (including with respect to QFA). The following transparency goals should be integrated with ongoing programs of reform: 1.1.4

- **Establish a coordinated system for reporting** on the full range of state- and local-owned enterprises and advising the government on management and dividends policy, including long term goals for privatization and corporatization. 1.1.4
- **Upgrade accounting practices** for public enterprises to a level consistent with international standards. 1.1.4
- **Systematically identify and report on arrangements leading to QFAs.** Enterprise reporting should be provide details on the cost of activities undertaken for social purposes under government direction. 1.1.4
2.1.3
- **Establish a clear dividends policy.** Over time, there should be a shift towards transfers that are based on audited accounts and that reflect the financial situation of each enterprise. 1.1.4
- **Introduce systematic reviews of public ownership** of assets with a view to establishing clear policy directions on corporatization, privatization, liquidation, or inclusion in the budget. 1.1.4
- **Develop a consistent methodology** for valuing and reporting on public financial assets, with a view to monitoring public sector investment and establishing a government balance sheet statement (including all public enterprises, that would be maintained by the STU). 2.1.4

Energy sector reforms

2.1.3

73. Energy sector QFAs should be disclosed more fully and strategies for their gradual reduction open to public debate. QFAs in the electricity sector are monitored satisfactorily and information on sources of such activities is publicly available. The information for assessing the gas and coal sectors has remained poor, preventing a full-fledged assessment of the tariff policy in those sectors. There are also significant QFAs in the housing and commercial service sector. In this context, good transparency practice suggests:

- **Energy sector QFAs should be systematically reported.** Similar principles to those used for electricity should be applied to the gas and coal sectors. Both elements should be summarized in the proposed quasi-fiscal annex to the budget and taken into account in fiscal policies.
- **The monitoring of QFAs in the housing and communal service sectors should be strengthened,** and local governments made responsible for financing price subsidies.
- **Public discussion of strategies for phasing out QFAs should be encouraged.** Such debate should give the opportunity to explain the costs of large QFAs, and the possible recourse to budget subsidies to compensate low-income groups for their elimination.

74. Barriers to efficient and transparent regulation should be removed. Regulation of energy prices continues to be hampered by political constraints on tariff adjustments for households and some other rigidities. Regulation is also hampered by the lack of credibility of reporting in the gas and coal sectors, on account of a limited comprehensiveness and a poor certification process—audits conducted in the gas sector so far have been inconclusive because of their limited scope. Improvement in transparency should include steps to: give NERC greater effective autonomy for the regulation of tariffs; and, enhance the comprehensiveness and reliability of operational and financial reporting of the gas complex by producing external non-qualified audits of the Naftogas annual accounts in a timely way. Measures should also be taken to strengthen accountability in the state-owned coal sector, especially with respect to pricing decisions.

2.1.3

Oversight institutions and anti-corruption activity

75. A sustained program for strengthening and deepening the functioning of oversight institutions is required. International best practice is that a strong independent external auditor is supported by effective internal control and audit mechanisms. Once satisfactory administrative and accounting controls have been established, as is the case in Ukraine, the main emphasis of internal audit and control should be to improve the effectiveness of line ministry management. Control in Ukraine is moving from a heavy emphasis on internal inspection to a more modern approach. The following elements should be emphasized:

- **Support should be given to effective management control within line ministries** by developing specialized internal audit skills pertaining to the mandates of these ministries.
- **Effectiveness and systems audit should become the major focus of KRU inspections.** Its mandate should be formally extended in these respects. KRU should increasingly play a significant role in providing assurances on the effectiveness of other internal oversight institutions in the line ministries and the STA. It should be responsible for standard setting,

quality assurance, oversight and training.

- **The Accounting Chamber mandate should be extended** to cover revenue functions and state-owned enterprises, as is standard practice in other supreme audit institutions in other countries.

Appendix I. A Summary Assessment of Practices

Code Reference	Summary Assessment	Comment
Overall summary	<p>Ukraine has improved key aspects of fiscal transparency substantially since the completion of an initial ROSC in 1999. The Budget Code has established a solid legal framework for budget management. The treasury system now provides a mechanism for timely, reliable, and comprehensive reporting on the fiscal position and debt of central government—and will cover regional government from 2004. State procurement has been modernized and transparency greatly improved through use of the internet. Though much remains to be done, progress has also been made, particularly in the electricity sector, in applying economic pricing and addressing the poor payment collection and enterprise tax arrears that have contributed to high quasi-fiscal costs. These, and other achievements noted in the report, combined with its considerably improved growth and fiscal performance, provide a sound basis for further improvements in transparency.</p> <p>The staff have made a number of recommendations on priorities for consolidating progress and toward addressing a number of long-standing transparency and fiscal management issues. The budget process can be further strengthened by building a more consistent general government policy framework, developing a more accountable medium-term budget, and considering fiscal risks more explicitly and systematically. Interagency barriers that have proved costly in terms of the integration of government functions need to be reduced. The most important structural issue that needs sustained further effort is that of the relative lack of knowledge and control over the public enterprise sector. The many activities of a fiscal nature carried out by that sector continue to impede the establishment of sound long-term fiscal policies. The authorities are beginning to address these problems, but there is a need to place more emphasis on improving coordination of management responsibilities and establishing a clear reporting and accountability regime (including with respect to quasi-fiscal activity). Oversight mechanisms, particularly that of the Accounting Chamber, need to be strengthened and brought into line with international practice.</p>	
Clarity of roles and responsibilities		
1.1.1	General government is defined consistently with Government Finance Statistics (GFS) principles, but is not fully considered in the budget process.	General government should be more central to fiscal policy.
1.1.2	The fiscal roles of the executive, legislative and judicial branches are clearly defined in law, but some aspects are evolving.	
	The budget code defines the responsibilities of different levels of government and establishes a stable basis for intergovernmental fiscal relations.	A significant improvement since 1999
	Further clarification of responsibilities and transfer mechanisms is	Consultation should be enhanced

Code Reference	Summary Assessment	Comment
	desirable, particularly with respect to towns and localities.	in the implementation of the system; and the formula-based approach should be extended to lower tiers of government
	Mechanisms for dialogue and review between central and subnational governments require strengthening.	
	Consultation on the implementation of the intergovernmental budgetary system should be strengthened and open to independent analysis.	
1.1.3	Mechanisms for the coordination and management of budgetary and extrabudgetary activities are improving, but a number of issues remain.	Reliance on special budgetary funds should be minimized over time. The MOF should have a clear line of authority over tax matters.
	Lines of authority between the MOF and the STA need further clarification.	
	A rigorous definition of general government activity should be used to demarcate lines of responsibility.	
	The MOF should be made clearly responsible for coordinating all fiscal management units, notably STA and STU.	
1.1.4	Relationships between government and nonfinancial public enterprises and public financial institutions are being clarified, but significant gaps remain.	A medium-term priority should be to establish clear responsibilities and a coordinated system of reporting on public enterprises.
	Arrangements regulating profit transfers from state enterprises to the budget have been tightened, but further clarification of dividend policy and practice is needed.	Dividends policy should be clarified. Regulation of the energy sector should be enhanced on the same basis as electricity sector reforms.
	The National Bank of Ukraine (NBU) has substantial operational independence.	Some improvement from 1999, but continuing consolidation required
	Public financial institutions no longer assume any explicit fiscal functions, but they remain a significant source of fiscal risk due to poor lending practices..	
	The purpose, scope, and management of the public enterprise sector needs to be clearly defined.	
1.1.5	Government holdings of fully owned corporations and equity are extensive, and coordination of state property management needs further	As for 1.1.4

Code Reference	Summary Assessment	Comment
	consolidation.	
	Basic disclosure of privatization transactions does take place, but the legal framework needs further elaboration to help ensure a transparent bidding and selection process.	Continuing work needed
	Government regulation of the nonfinancial private sector is complex and subject to frequent change, but steps are being taken to make regulatory processes more open.	
1.2.1	The budget code provides a comprehensive framework for management of budget funds.	Very significant improvement since 1999
	The legal framework for managing public debt is sound, and further strengthening of the long-term policy framework is now underway.	
1.2.2	Tax laws and administrative procedures have been consolidated and clarified, though further improvement in transparency is needed.	Continuing attention is needed on tax exemptions (2.1.3) and
	The transparency of tax policy is compromised by problems in the interpretation of tax law, frequent changes in tax structure, and a range of tax preferences.	improving coordination (as per 1.1.3) on tax matters
	Taxpayers' legal rights are well defined, but have been undermined by administrative practices that weaken voluntary compliance.	
1.2.3	Public servants are subject to a code of behavior, but the laws require modernization.	Stronger oversight mechanisms are required (4.2.1)
	Measures to combat corruption require strengthening.	
Public Availability of Information		
2.1.1/2.1.5	The budget documents cover central government fiscal activities, including information on the EBFs, and provide summary data on general government.	Solid achievements have been recorded in developing budget documentation since 1999. At comparatively low cost, the
2.1.2	Defense expenditures are reported in the budget.	quality of analysis could be
2.1.3	The budget document discloses the main fiscal aggregates for two years prior to the budget year and three years beyond the budget year.	substantially further improved by focusing more on general
	Government guarantees are discussed in the budget documents, but contingent liabilities are not covered comprehensively.	government and establishing clear
	Estimates of most tax expenditures are presented in the budget	formal analytical annexes on

Code Reference	Summary Assessment	Comment
	documents, as required by the budget code (Article 38).	fiscal risks, costs of public sector QFAs, and fiscal sustainability.
	QFAs are still fairly extensive; neither qualitative nor quantitative reports are included in the budget documents, though some QFAs are monitored closely outside the budget process.	
	Energy sector QFAs should be disclosed more fully and strategies for their gradual reduction open to public debate.	
	Barriers to efficient and transparent regulation should be removed.	
2.1.4	Government holdings of fully owned corporations and equity are extensive and coordination of state property management needs further consolidation.	As for 1.1.4 and 1.1.5 above
	Information on gross public debt is published in a timely way.	A major improvement since 1999
	Consolidated reporting of state financial and nonfinancial assets is limited to annual statistical data.	As per 1.1.4, 1.1.5, and 2.1.4.
2.1.5	Government holdings of fully owned corporations and equity are extensive and coordination of state property management needs further consolidation.	
Open Budget Preparation, Execution, and Reporting		
3.1.1	A statement on medium-term fiscal policy objectives is included in the budget document, but does not provide a solid basis for future fiscal policy.	An improvement since 1999, which can be further strengthened as per comment on 2.1.1-3 above.
3.1.2	The budget code clearly defines a number of fiscal rules.	Special attention should be given to future unfunded liabilities of the pension system
3.1.3	Budget forecasts and underlying assumptions are clearly presented, but coordination and consistency of forecasting could be strengthened.	
3.1.4	Medium-term, program-oriented budgeting is being initiated, but procedures are not yet in place; estimates of new initiatives and ongoing costs of government policies are not clearly distinguished in the budget documents.	This aspect needs sustained attention over the medium-term
3.1.5	The sensitivity of budget estimates to changes in economic variables is not assessed and fiscal risks are only briefly discussed with the budget.	An important area for short-term improvement
3.2.1	The annual budget process is open and the presentation is broadly	

Code Reference	Summary Assessment	Comment
	consistent with international standards.	
3.2.2	The objectives and expected results from government activities are defined only in general terms.	As per 3.1.4
3.2.3	Fiscal policy goals are set around the balance of the central government, excluding extrabudgetary funds; although information is provided on general government balances in the budget document.	As per 2.1.1 and 3.1.1 above
3.3.1	The accounting system is capable of producing accurate in-year reports on central government budget outturn, but does not cover all EBFs.	Treasury reporting is a significant achievement and is being further strengthened
	The treasury system covers most of central government and is being extended.	
	The MOF, STU and NBU should establish clear roles and coordination mechanisms for cash and debt management.	An area for short- to medium-term improvement.
3.3.2	Open procurement rules and practices are being put in place, though some weaknesses exist.	An improvement since 1999, with further work underway
	Further improvement in the procurement framework is planned.	
	The pay structure of the public service is not transparent and the employment procedures should be made more objective.	An important issue to be addressed over the medium-term
3.3.3	Basic internal control procedures are in place, but are not well coordinated.	A very important area for strengthening over the medium to long term.
	Sustained emphasis on modern management-oriented systems and coordination among internal control agencies is needed.	
3.3.4	The State Tax Administration (STA) reports directly to the President, and is weakly accountable to the government.	As per 1.2.2
3.4.1	The legislature examines budget progress quarterly, but does not undertake a full mid-year review.	Timeliness and reliability of within and end-year reporting are sound, but follow-up needs to be improved (as per 4.2.1)
3.4.2	The final accounts are presented to the Rada and audited within six months after the end of the fiscal year.	As per 3.1.4 and 3.2.2
3.4.3	The objectives and expected results from government activities are defined only in general terms.	
Assurances of Integrity		
4.1.1	A basis for reliable estimates for the state general fund has been	A substantial improvement over

Code Reference	Summary Assessment	Comment
	established, but strengthening is required in some areas.	1999
4.1.2	The variance between budgeted and actual outturn of the main fiscal aggregates is disclosed and explained to the Rada. Statements of accounting policy are not included in the budget and final accounts documents, but are clearly stated for administrative purposes.	The treasury system is an area of continuing improvement.
4.1.3	The processes of accounts reconciliation and fiscal reporting are effective.	
4.2.1	External audit is independent of the executive branch, but has a restricted mandate. Strengthening of audit capacity is required.	Strengthening oversight and follow-up mandate and capacity is a very high priority for the medium to long term—which requires immediate support.
4.2.2	The legislature discusses external audit reports, but systematic review is limited. External scrutiny of macroeconomic models and assumptions is actively encouraged.	A robust feature of the system, which is being actively promoted
4.2.3	The national statistics office is given legislative assurance of independence.	