

Making Ukraine Stronger Post-Crisis

Overview and Policy Summary

- I. **The new President has an opportunity to put Ukraine back on track.** Reforms must be re-launched for sustained recovery and strong growth. This note explains why reforms are needed and lays out the main priorities for the first 100 days of the President's term.
- II. **The risks of inaction are significant.** Public finances are in crisis and the country remains highly vulnerable to investor sentiment because of large debt refinancing needs. The sources of pre-crisis growth are gone, while Ukraine has yet to adjust to paying market prices for Russian energy and to a slow export demand recovery. Only a clear reform signal will draw back investors and provide a sound basis for continued international support.
- III. **Three challenges stand out as high priority:**
- IV. ***Public finances must be stabilized.*** This can be done through fiscal reforms that reduce inefficiencies, streamline transfers and subsidies, and improve incentives for public investment.
- V. ***Private investment needs to be stimulated.*** Ukraine failed to upgrade technologically during the last decade and has remained stuck in an extensive, commodity driven growth path that has amplified volatility and limited productivity growth. This can be done if Ukraine deregulates its economy and fosters competition.
- VI. ***The financial sector has to be restructured.*** This requires a renewed effort to tackle the legacies of the past and strengthen regulation and transparency to regain trust.
- VII. **These three challenges are inter-related.** Without fiscal reform, macroeconomic stability and a sustained recovery will not be possible and investors will remain in waiting mood. Without private investment to fuel the recovery, fiscal consolidation will be more difficult, and banks will struggle to find decent new clients. Without a properly capitalized banking sector and regained trust among depositors, banks will not have the resources and the strength to support private business. Because of these inter-linkages, all three reform areas must be tackled simultaneously.
- VIII. **Reforms need to be prioritized.** Time is short and political capital limited. In practical terms, the following actions are recommended for the first few months:
- IX. ***Approve a prudent 2010 budget quickly.*** This would start fiscal consolidation without killing the recovery. The budget should be based on realistic macroeconomic and revenue parameters. The deficit needs to come down through spending cuts. The three main sources of fiscal savings that can be achieved quickly without hurting growth prospects are: (i) adjustments to the pension system, (ii) increases in energy and heating tariffs; and (iii) cutting VAT

exemptions and revoking tax minimization schemes (e.g., under Soviet era bilateral treaties with Cyprus). The budget should also raise thresholds for housing and utility subsidies, reallocate the resulting savings to targeted social assistance programs, and safeguard a basic level of infrastructure spending.

- X. ***Restore credibility of public finance management.*** This can be done by (i) enacting a public procurement law in line with international best practice (we provided our comments on the law passed by the VR in a joint letter with the EU on March 4); (ii) and dealing with VAT refund arrears. Public procurement accounts for 8% GDP (not including SOE spending). The present system is prone to abuse, and key source of waste of public resources. An adequate procurement law should be able to achieve fiscal savings and ensure proper governance, and thus send a strong signal to the international community about Ukraine's reforms commitment. A transparent and credible plan to reduce VAT refund arrears would enhance budget credibility and stimulate exports.
- XI. ***Launch a credible deregulation effort to promote business entry.*** As other countries have demonstrated, reforms to stimulate business entry can be introduced fast. Quick and powerful steps are (i) the reduction of activities subject to licensing by 30% and (ii) the elimination of outdated technical regulations in the context of harmonization with the EU (a real "guillotine", which this time goes all the way).
- XII. ***Clean up the banking sector and start key regulatory overhaul.*** NBU has the basic resolution tools to resolve insolvent banks quickly. These need to be used and capitalization plans enforced. Two sets of measures are especially urgent: (i) Basic information on the health of commercial banks should be made publically available and bank secrecy provisions revised to comply with international standards; (ii) NBU governance must be improved to reduce conflicts of interest and regain market credibility.
- XIII. ***Reforms should not stop at this prioritized list.*** They need to continue to tackle other fiscal and structural weaknesses, including in taxation, expenditure composition, financial sector, public administration, business climate, infrastructure, and public service delivery.

1. FISCAL REFORM TO SECURE STABILITY AND ENABLE A SUSTAINED RECOVERY

Key Issues and Challenges

1. In the context of constrained external financing, delayed spending adjustment, growing public debt, and significant infrastructure investment needs, fiscal reform has become the most urgent priority. The unreformed pension system and Ukraine's aging population threatens short term fiscal viability (with growing deficits that are becoming un-financeable) and long term sustainability (by 2055 there will be 1.43 pensioners for each contributor worker in the system). Domestic household utility tariffs (mainly for gas and heating) are well below cost recovery. In the absence of tariff increase, the quasi fiscal deficit generated just by domestic gas sales may reach up to 5.3 percent of GDP 2010 (transfers to cover Naftogaz operational deficit were above 2.5% of GDP in 2009). Moreover, local councils do not have the right incentives to set financially sound levels of heating tariffs and the existing collection mechanisms are weak.

2. To finance current transfers and underpriced utilities the budget has relied on growing deficits, high marginal rates on direct taxes (that encourage inefficient behavior in the economy), and reduced capital investments. Ukraine fiscal revenues reached 41% of GDP in 2009 (with tax revenue accounting for more than 36% of GDP). The tax burden is higher than the average for new EU member states and well-above that of other emerging economies. More than 60% of revenues rely on direct taxes of labor and capital. High marginal tax rates on payroll and income are the main cause of underreporting of wages and income in the country and thus of revenue losses and distortions to competition. Despite some improvements, revenue administration still generates significant compliance costs to the private sector. In 2009, the delays in VAT refunds reached alarming levels, exacerbating the already difficult situation of exporters and the real sector in general.

3. At the same time, Ukraine only spent an average of 2% of GDP (annually) on public fixed capital investments over the last 5 years compared to an average above 6% in other emerging economies. Ukraine's infrastructure is insufficient to support private sector growth in key areas such as transport, trade logistics, and energy, and the quality of public services is deteriorating.

4. In the short term, the lack of corrective fiscal action exacerbates macro risks because of the impact on market confidence. The lack of fiscal space for public investment hampers the recovery and opportunities for job creation. In the medium term, lack of fiscal reform could compromise debt sustainability and keep borrowing costs high. Moreover, the lack of public investments would increase the costs of doing business causing a protracted downturn.

5. The bottom line: the current fiscal model has proven unsustainable.

6. **Pension Reform:** The measures below are designed to help solve the short term imbalances of the system and gradually restoring sustainability whilst not affecting the poorest pensioners.

7. *Measures to be implemented in the first semester of 2010:*

- Reform special pensions and start by freezing the special and privileged pension benefits transferred from the Budget
- Cap pension payments for working pensioners whose pension is above subsistence minimum.
- Cap maximum pension in absolute terms instead of a multiple of 12 subsistence minimums.
- Start the convergence of special pensions to the general system formula.
- Postpone paying special pensions until the statutory retirement age.
- Increase gradually the averaging period for pensionable wages for some categories of special pension benefit recipients.
- Go back to the accrual rate of 1% for all pensioners, even if temporarily.
- Eliminate the 1% increase of pension benefit for service above 20/25 years for women/men

8. *Measures to be legislated in 2010 and implemented in 2011:*

- Increase retirement age only for women from 55 to 60, with an increase of 6 months per year beginning in 2010. This is a gradual approach that will take 10 years, but would not cause any drastic change at the beginning of the reform. (Savings are small in the short term but it is the single most important measure to bring sustainability to the system in the medium and long term)
- Introduce a stable indexation rule with price and wage indexation portions for all pension benefits to ensure pension payments stability.
- Gradually increase the averaging period for pensionable wages for some categories of special pension benefit recipients.

9. **Household Gas and Utility Tariffs:** The measures below are geared to increase cost recovery, depoliticize tariff setting arrangements, and strengthen the collection mechanism. These would help to the financial viability of energy companies whilst reducing reliance on fiscal transfers.

10. *Measures to be implemented in the first semester of 2010:*

- Increase gas and heating tariffs by at least 100 percent in 2010.
- Increase electricity tariffs to reflect the all recurrent costs and the investment component.
- Establish a special purpose account for centralized collections from heating enterprises.
- Establish a (provisional—during 2010) centralized regulator at national level to strengthen the mechanism of heating tariff setting.
- Improve targeting of safety nets to protect the vulnerable from the tariff increases, specifically: (i) Increase the threshold in the program for the extreme poor from the

current level to 50% of the subsistence minimum, which will automatically expand targeted funding to the poorer population; (ii) Increase the threshold in the program of housing and communal subsidies to 30%; (iii) Introduce a eligibility threshold for privileges programs at 2 or 3 subsistence minimums.

11. *Measures to be implemented in 2010-2011:*

- Establish a national (centralized) permanent regulator for heating tariffs with administrative and financial independence.
- Move towards a single gas price system (at the import level), eliminating the dual pricing system that generates arbitrage opportunities.
- Start privileges reform related to this sector (see section 5 for detailed measures).

12. **Tax Policy and Administration Reform:** The measures below are geared to broaden the base, reduce tax minimization schemes, improve the system to encourage private activity, and over time, as it becomes fiscally possible, reduce marginal rates on direct taxes.

13. *Measures to be implemented in the first semester of 2010:*

- Eliminate the remaining VAT exemptions and special treatments.
- Eliminate the preferential tax treaty with Cyprus (dating from Soviet times).
- Reform the simplified tax system (STS) to allow only truly small businesses (including by realigning the STS threshold to that of the VAT);
- Increase significantly fees and patents on gambling activities once these activities are reinstated.
- Introduce a local real estate tax, based on an appropriate fiscal cadastre.
- Reduce transfer pricing activities by legislating controls on these practices in industrial-financial groups (following OECD guidelines).
- Stop new VAT refund arrears and introduce a plan for eliminating arrears.
- Establish statutory limits of the number of days before a VAT refund is considered overdue (max. 60 days) and stop or control tightly voluntary registration below the VAT threshold; and establish risk based audits for VAT refunds.

Measures to be implemented in 2010-2011:

- Reduce gradually the enterprise profit tax (EPT) rate and payroll tax rates as soon as this is fiscally prudent and manageable (perhaps after 2012).
- Reform the EPT in the insurance sector to stop avoidance and evasion schemes.
- Unify rate and the administration of collection of social insurance payments.
- Introduce a strengthened large tax payers unit (with legislation mandating mandatory allocation of tax payers above the determined threshold).

14. **Public (Fixed) Capital Investments:** The recommendations below are geared to expand this expenditure category in the context of a prudent fiscal framework to support

the recovery of the real sector, reduce unemployment, reduce costs to exporters, and to crowd-in private investment.

15. *Measures to be implemented in the first semester of 2010 (see also section 6):*

- Revise the 2010 budget to increase infrastructure spending by at least 1 percent of GDP (using fiscal savings described in this note).
- Establish an umbrella framework and corresponding methodology for project and program evaluation (with cost benefit analysis) for all capital expenditures.

16. *Measures to be implemented in 2010-2011:*

- Legislate a criteria based capital transfer system for local governments (through the budget code).
- Budget a significant increase in fixed capital expenditures for the 2011 budget (beefing up investments in energy, transports, logistics, EURO 2012)

2. FINANCIAL SECTOR REFORM TO ENSURE STABILITY AND REIGNITE INTERMEDIATION TO THE REAL SECTOR

Key Issues and Challenges

17. The banking sector contributed to the overheating of the economy, was at the center of the macroeconomic pressures as the crisis unfolded, and is essential to the recovery. Mounting vulnerabilities in the banking sector, generated by lax credit analysis in the context of fast credit growth fueled by external borrowing, were accentuated by the crisis. They lead to a systemic liquidity and solvency crisis, including the leakage of deposits in late 2008 and early 2009. During the years leading to the crisis, regulation and supervision was unable to catch up with the growth of the sector, and thus currency and maturity risks increased coupled with a severe under-provisioning.

18. While progress has been achieved over the last year (e.g., setting up the process of recapitalization, providing the regulator with resolution tools), there are significant pressures and threats facing the system today. Volumes of unrecognized NPLs may rise, placing pressures on the capital adequacy of the system. While the recapitalization and resolution processes are moving, interference by vested interests slows the rehabilitation efforts reducing the value of time sensitive assets in problem banks.

19. There are also broader weaknesses that have not been addressed in the banking system and the overall financial sector. The banking sector needs consolidation to intermediate domestic savings more efficiently. Lack of transparency in relation to ultimate bank ownership reduces trust and hampers effective supervision of financial conglomerates exacerbating risks. Ukraine's savings level (as % of GDP) has been declining steadily since 2004. In the short term, banking sector reforms will send a powerful signal to international capital markets helping sustain debt roll over rates and reassure the domestic deposit base. Together with credible fiscal policy this is the main

tool to achieve a resumption of lending to the economy. Any use of NBU's balance sheet for directed lending operations should be strongly resisted. In the medium term, reforms should help to make the financial sector more resilient to shocks whilst being a reliable source of financing for a growing domestic economy.

20. The bottom line: the banking sector remains vulnerable.

21. *Reforms needed in the first semester of 2010*

- Ensure that capitalization plans in all banks are fulfilled.
- Restructure (including by introducing adequate governance controls) and/or resolve banks recapitalized by the state quickly and at least costs to the state. Resolve smaller banks using the set of tools provided by new legislation whilst strengthening the deposit guarantee fund to deal with problem bank resolution functions.
- Enact a legislative framework (through the banking law and the law on financial services) to enforce the disclosure of ultimate ownership of banks and non-bank financial institutions. The new legislation should significantly enhance the definition of beneficiary ownership (with a threshold of 5%) and include related legal entities, family and other associated persons at all levels.
- Appoint a technocrat to head the NBU and eliminate any commercial bank representation on the NBU Council

22. *Reforms needed in 2010-2011*

- If one or more of the nationalized banks has commercial viability, privatize it as soon as market conditions allow it.
- Enact legislation to make individual bank data transparent and publicly available in line with predominant international practice
- Legislate and implement (enforce) consolidated supervision of financial conglomerates.
- Revise capital requirement and provisioning rules to assure solvency and to avoid excessively pro-cyclical bank lending, respectively.
- Abolish the foreign exchange tax develop local currency funding.

3. STRUCTURAL REFORM TO ENABLE BUSINESS ENTRY AND EXPORT DIVERSIFICATION

Key Issues and Challenges

23. The costs of entry and operation in Ukraine are high and there are barriers to exit as well. Ukraine ranks in the 134th place in the world (among 183 countries) on the ease of starting a new business (DB survey), one of the worse in the region and among the worse compared to other emerging economies. Businesses have to comply with long list of permits (including construction permits), a protracted process of licensing, unnecessary mandatory certifications and other hurdles imposed by the outdated regulatory system. At the other end, to close a business, shareholders have to go through a long, cumbersome, and costly process of liquidation before they can dispose of the remaining assets to start a

different economic activity, which hinder economic reallocation processes. It takes almost 3 years to close a business in Ukraine.

24. Entry and operation costs are particularly burdensome for growing sectors that have export potential and have been more resilient to the crisis such food processing and light manufacturing. Technical Standards, sanitary and phyto-sanitary and food safety regulations are outdated and not aligned with the EU, which increases costs and damages Ukraine's export potential. A unified registry for land and real estate does not exist and property rights in land and real estate are poorly protected. The moratorium on agricultural land sales (in effect since 2001) has favored large and politically connected conglomerates that lease land at low prices in detriment of owners in rural areas (mainly poorer farmers). Businesses complain about the rule of law, excessive and unjustified inspections, and an overall unlevel playing field fostered by weak governance in regulatory agencies and public sector institutions (see also section 4).

25. Prior to the crisis, and in the context of high profits and low competition many of the issues raised above were simply accounted as an unavoidable "extra tax". Under current conditions and in the post crisis environment, with lower profits and slow growth, these weaknesses will keep new businesses and FDI away, harming growth and employment recovery.

26. Moreover, regulatory weaknesses have also severely restricted competition, innovation, and product diversification. The level of technology embedded in Ukrainian products is low relative to international competitors, who have recorded rapid improvements in the last decade. Key industrial enterprises remain in partial or full state ownership, with weak management capacity and chronic underinvestment. The recent crisis has highlighted Ukraine's lack of export diversification as a key vulnerability of the economy. While the Competition Law is roughly aligned with international practices its application has remained subject to political discretion. Legislation on State aid to the economy is fragmented and lacks comprehensive monitoring. The EU FTA negotiations could serve as an anchor to reform several of the issues raised above.

27. The bottom line: Regulatory weaknesses are slowing the recovery and will stifle growth.

28. *Policy priorities in the first 6 months of 2010.* The following recommendations are geared to jumpstart a credible reform program in this area.

- Reduce the groups of activities subject to licensing by 30% (this can be done quickly with political will since a large number of activities—more than 50%--should not be subject to licensing in the first place according to WBG analysis)
- Eliminate immediately outdated technical regulations and start adopting EU regulations (a meaningful "guillotine" effort is needed to reinvigorate this agenda)
- Eliminate mandatory certification for goods and services that do not require it in line with EU and good international practice.
- Credibly deal with VAT refund arrears (see Section 1 for specifics)

29. *Reforms needed in 2010-11.*

- Lift the ban on agricultural land sales and unify the registries of land and real estate under a single agency.
- Reform Sanitary and Phyto Sanitary requirements and introduce modern food safety regulation.
- Re-launch privatization through transparent, competitive auctions to attract FDI and achieve much-needed technological modernization of strategic industrial sectors
- Unify state aid legislation and strengthen political independence of the anti-monopoly committee
- Negotiate elimination of exemptions in the Ukraine-Russia and other bilateral CIS FTAs.

4. PUBLIC SECTOR REFORM TO IMPROVE GOVERNANCE AND REGAIN MARKET CONFIDENCE

Key Issues and Challenges

30. Ukraine scores extremely low on public sector governance and few improvements have been made in recent years. Red tape, burdensome regulation, allegations of corruption and abuse, and limited integration and accountability in public finance management are core challenges. Some progress has been observed in area of public financial management, particularly on the back of the budget code reform in 2001-2002. But the progress has been uneven. Critically, Ukraine lacks an acceptable public procurement framework. This greatly reduces spending efficiency, opens large scope for corruption, represents a stumbling block in international trade negotiations such as the deep FTA with the EU and distorts domestic competition. Moreover, Ukraine lacks a medium term budget framework that would enable better planning and alignment of public resources with medium term priorities. Transparency in the large SOE sector is also a critical pending task.

31. The process of fiscal decentralization initiated with the budget code reform in 2001 was never accompanied by administrative and political decentralization, the other two legs of the tripod of local governance. Consolidation of local governments is necessary because the size of the lowest tier of local government (i.e., the village level) is too small to discharge most public service functions effectively. The rayon and city level could be used as the core local government to consolidate core functions of local governments, although in some sectors (such as health) Oblasts would need to take the need is consolidating and re-organizing primary and secondary levels of health provision. Nevertheless, any changes need to be accompanied by appropriate levels of administrative decentralization in which central bodies may have a guiding role but do not micromanage functions through the line ministries.

32. Administrative reform is needed to make the state a true market enabler and basic service financier. Administrative reform would need to encompass reforms to the civil service, public sector employment, SOE management, and government agencies

operation. But this reform requires the highest political commitment and leadership. Moreover, the task of reforming the state needs to be commissioned to an independent body since public entities have no incentives to reform themselves. Finally, judicial reform is needed to strengthen the rule of law and reduce corruption in the court system.

33. The bottom line: Public sector governance needs to improve to regain the trust of the public and deliver public services more efficiently.

34. *Policy priorities in the first 6 months of 2010.*

- Enact legislation on public procurement in line with good international practice and harmonized with EU directives (we have provided our comments on the law recently passed by the VR in the joint letter with the EU Delegation on March 4).
- Take initial measures to rationalize the bureaucracy in the government. Do a functional assessment and start rationalizing unnecessary bureaucratic bodies and procedures.

35. *Reforms needed in 2010-11.*

- Introduce a MTEF framework through amendments to the Budget Code that would be fully integrated with the annual budget process.
- Adopt a strategy for administrative reform, rethinking the size, pay, political incentives, and functions of the state and all its units and agencies (it should include the civil service, public sector employment, SOE management, and all government agencies). Start drafting legislation (including using existing drafts for some specific areas such as the 2006 civil service draft law)
- Introduce a strategy for administrative decentralization. The key objectives should be to provide core functions and administrative responsible to a level of local government that has adequate size and capacity to manage them. This may not require territorial reform if the rayon and city level are used as the core local government.
- Improve SOE financial reporting and start public sector consolidated reporting.
- Establish an integrated public financial management system (across all PFM agencies).
- Adopt a credible strategy for judicial reform agreed with key stakeholders and start drafting legislation.

5. BASIC SOCIAL SERVICES AND SOCIAL ASSISTANCE REFORM

Key Issues and Challenges

36. Ukraine spends a large amount of its budget resources on health and education (mainly through local governments. However, for the large amount of resources the budget spends on services such as health and education, Ukrainians do not obtain good value.

Education

37. Ukraine spends more than 6% of GDP on public education (well above other middle income countries), but does so inefficiently. Input “norms” of the Ministry of Education and Science continue to govern staffing arrangements (supporting an excessive number of subjects in the curriculum), teaching hours, non-teaching staff ratios, and class sizes. As a consequence, student/pupil ratios are among the lowest in the world (at 9.4 for primary and secondary education), class sizes are small, the network of facilities remains too large, and the teaching load reaches only 85 percent of the OECD average. The country’s aging demographic profile aggravates the associated inefficiencies. Ukraine ranked below regional comparators (including Russia, Kazakhstan, Armenia, and the Baltic countries) in international achievement tests for 4th and 8th graders TIMSS (2007). Higher education is underperforming as well. The percentage of firms that see shortages of skilled labor as a critical constraint to growth has been growing and is higher than in most countries in the region. Public financing for tertiary education is allocated to universities and not to students, making the system irresponsive to demand.

The bottom line: Ukraine does not need to spend more, but it needs to spend better in the key social sectors.

38. *Reforms needed in 2010 and 2011.*

- Revise, reformulate (or eliminate) norms dictated by the Ministry of Education for budget formation at the facility level.
- Allow local governments more discretion on school optimization.
- Allow the natural (and painless) process of attrition to help with the rationalization process by not hiring of working pensioners and minimizing new hiring.
- Consider experimenting on a pilot basis with a voucher system for “budget financed” students in higher education (that is, for those students who receive tuition funding paid directly to universities from the budget), whereby the students would take funding with them to an institution of their choice. This would stimulate competition among universities for such students and improve the market relevance of their teaching.

Health

39. Health sector outcomes are poor in relation to the available fiscal resources. This highlights problems of inefficiency as well as inequities in spending and in access to health services. While maternal and child mortality rates improved in recent years, life expectancy remains below pre-transition levels at 67.1 years (and with a widening gap between male and female mortality, at 61.7 and 72.7 years, respectively). The mortality of males aged 25-39 and the incidence of tuberculosis and HIV has been worsening. Population aging will create additional challenges of morbidity and old age care in future years. Public spending in the health sector at just below 4 percent of GDP is moderate and in line with countries at the same level of per capita income. But out-of-pocket payments (OOP) are high and counting those total spending reaches between 6 and 7 percent of GDP. Close to 70 percent of the health budget is concentrated on hospitals and

specialized health facilities while primary health care and prevention are underfunded. As in the education sector, input norms of the Ministry of Health generate rigidities and discourage efficiency improvements, dictating the number of doctors, nurses, and other staff to be hired on the basis of fixed input parameters such as number of beds, unrelated to the actual number of patients. Thus, the system has a greater number of inputs per 100,000 inhabitants compared to EU averages, including more hospitals, beds, doctors, nurses, and non-medical staff. But it does not have better quality of health care.

40. The bottom line: Ukrainians could live longer and healthier lives if the health system is reformed and public resources are used more efficiently.

41. *Reforms needed in 2010 and 2011.*

- Revise and reformulate (or eliminate) the norms contained in Order 33 of the Ministry of Health for budget formation at the facility level. Turn norms that assure a minimum standard of quality (not related to financing rigidities or staffing) into criteria for the accreditation of health facilities.
- Give local governments the power to rationalize the network of health facilities under a national plan.
- Provide adequate incentives for shifting a larger proportion of doctors into primary care and for integrating the family medicine model more strongly into Ukraine's health system.
- Change the payment system for hospital to case-based, and for primary care centers to capitation-based payment.
- Change in the Legal Status of Hospitals to that of Non-Commercial Enterprises (NCEs), separate the purchaser (Oblast) from the hospital-providers, and grant managerial autonomy to hospital administrators.

Social Assistance

42. Ukraine has sizable system of public social assistance (around 2% of GDP is spent on annual basis) but its targeting to the poor can be improved. A number of income and asset tested programs are well targeted to the poor, including the program for extreme poor (the GMI), the child allowance program and the allowances for single parents. However, overall, poorly targeted subsidies and privileges take most of the social assistance resources and in general do not tend to reach the people that really need them. In 2009, the government adopted a new strategy to reduce the scope of privileges via shifting toward means-tested assistance benefits, but its implementation timetable is unclear. Moving forward, targeting accuracy needs to be enhanced, and administrative costs and delays in dispensing social assistance benefits reduced, by modernizing the local and central welfare offices.

43. The bottom line: Ukraine can afford to protect its poor, if it targets its assistance more effectively.

44. *Policy priorities for the first semester of 2010.*

- Increase the threshold in the program for the extreme poor from the current level to 50% of the subsistence minimum, which will automatically expand targeted funding for this program and to the poorer population.
- Increase the threshold in the program of housing and utility subsidies (HUS) to 30% in the revised 2010 budget. Plan for the 2011 budget to change the eligibility criteria for the HUS program so it is strongly correlated with the poverty or low-income status of the applicant. This could be achieved by applying the subsistence minimum threshold to verify the eligibility for HUS program.
- Introduce an eligibility threshold for housing and utility privileges programs at 2 or 3 subsistence minimums in the revised 2010 budget. For the 2011 budget improve the targeting efficiency of HU privileges by introducing an income test at the level of subsistence minimum or higher to set eligibility for HU privileges.

45. *Reforms needed in 2010 and 2011.*

- Improve the eligibility criteria for all means tested programs by using presumptive income to account for hard-to-verify incomes.
- Start a reform of the system of privileges shifting them toward means-tested assistance benefits.

6. PUBLIC INFRASTRUCTURE REFORM

Key Issues and Challenges

46. Ukraine's infrastructure is insufficient to support private sector growth and adequate (quality) services to the population. Moreover, the existing infrastructure is deteriorating rapidly due to the lack of maintenance spending and overall poor planning. Ukraine's spending on infrastructure is about 30% of what lower middle income countries spend in this area elsewhere in the world.

Transport, trade and logistics infrastructure

47. The roads system, which encompasses four key Pan-European corridors is insufficient to support trade growth (Ukraine's road network density is roughly one third of the Eastern Europe and Central Asia region average, and well below other emerging economies). Moreover, the fragile road network is deteriorating rapidly because of under spending in maintenance (countries with similar road networks spend at least 2 times more than Ukraine on maintenance). The railway system is deteriorating in terms of infrastructure and rolling stock. Cross subsidies from industrial users to passengers increase the cost of freight and reduce export competitiveness in some sectors such as steel. The railway's management structure and practices that are not aligned with market incentives. Costs in Ukrainian ports are higher than in comparable countries and operations are less reliable. The on-going preparations for the 2012 Euro Cup have once more highlighted the poor airport infrastructure of the country.

48. Weak trade logistics and storage infrastructure (together with other behind the border issues such as red tape in border agencies) and poor strategic planning across transport modes hamper exports and prevent Ukraine developing into a transit hub despite its strategic location. Ukraine ranks 102nd among 152 countries in the logistics performance index of the World Bank.

49. The bottom line: Ukraine has a huge opportunity to attract investment and improve productivity through better transport and logistics.

50. *Policy priorities in the first six months of 2010*

- Ensure higher investments in the roads sector and adequate financing for road maintenance in the 2010 budget (see Section 1, capital budget).

51. *Reforms needed in 2010 and 2011.*

- Address the cross subsidy from freight to passenger to ensure financial sustainability of the railway sector. Eliminate preferential price and barter arrangements for specific sectors.
- Separate economic functions and state management activities between railway and government.
- Replace legislation on concessions, road sector concessions and other legislation with single law regulating private sector participation (PPP) based on UNCITRAL and OECD principles, which also accounts prudently for fiscal risks.

Energy

52. Ukraine is a natural energy transmission hub but over the last decade has invested little in the gas and power sectors and has not been able to restructure its coal sector. Upstream investments in the gas sector have remained limited and private participation has been discouraged despite large potential and rising import costs. The gas transportation system has not been modernized, despite huge declared technical losses. Under pricing for domestic households and heating utilities has caused structural deficits in Naftogaz. The country has also invested little in power production and transmission, despite strong demand from neighboring countries. Incentives for private participation in the power sector are weak due to low tariffs and weak regulation. The coal sector remains un-restructured, plagued with inefficient SOEs, low quality steam coal (which represents roughly 80% of the coal production), and an ill-advised system of state centralized purchases and distribution. Infrastructure in the sector is crumbling and subsidies of 0.6 percent of GDP annually have failed to bring any improvement. Finally, Ukraine continues to be highly energy intensive (2.5 times more energy intensive than the average of OECD countries) due to a backlog of public and private investments, delayed by inadequate price incentives.

53. The district heating (DH) system in Ukraine has suffered from poor conditions for investment, declining efficiency and has become a burden for the state, local governments, and the gas sector. Fundamental reforms in the DH sector should be

accorded the highest priority. The primary problem stems from inadequate cost recovery, largely due to the politicization of tariffs setting (see Section 1).

54. The bottom line: The energy sector is currently a break on growth and a key source of corruption. With reform it can turn into a motor of investment led recovery.

55. *Policy priorities in the first six months of 2010*

- Raise household gas and heating tariffs to achieve revenue improvements up to 1.5% of GDP (see Section 1). Eliminate all preferential price arrangements for specific sectors.
- Increase prices for upstream domestic gas supply to stimulate private investment and increased production.
- Increase electricity prices to include all recurrent costs and an investment component.

56. *Reforms needed in 2010 and 2011.*

- In 2011 continue tariff increases.
- Improve corporate governance in the gas sector through increased financial transparency and the introduction of competition in line with EU Directives.
- Develop a transparent and competitive domestic production and exploration regime to attract foreign direct investment by early 2011.
- Liberalize pricing in the power sector.
- Recommence a transparent and accountable privatization of power generation and distribution assets
- Strengthen the national electricity regulatory commission's (NERC) capacity and independence.
- Initiate a national energy efficiency program to support economically rational energy use.
- Roll out a household heat and gas metering program.

57. **Start and deliver fast.** The agenda is daunting, but a credible start can create the necessary momentum.