

1. WHY IS FISCAL SPACE NEEDED IN UKRAINE?

A. RECENT MACRO-FISCAL DEVELOPMENTS AND SOURCES OF TENSIONS

1.1 **Ukraine's economic performance has been strong since 2000 and poverty has declined sharply.** GDP growth totaled more than 50 percent for the period 1999 through 2004. This, combined with significant improvement in the country's fiscal position, led to a dramatic lowering of the debt-to-GDP ratio (from 61 percent of GDP in 1999 to 26 percent in 2004). The mix of a favorable exchange rate in the years following the 1998 financial crisis, the strengthening terms of trade (fueled by growth in world commodity prices), and financial discipline in the post-1999 environment, encouraged enterprise restructuring and increased capacity utilization, particularly in the traditional industrial sectors (metals, chemicals, and agro-processing). These factors went hand in hand with strong export growth and a current account surplus which reached a record high of 10.5 percent of GDP in 2004. International reserves have accumulated to a value of more than 3.5 months of imports. Real demand for money has grown rapidly, encouraged by financial discipline, increased confidence in the UAH and growing incomes. These factors have also helped facilitate rapid financial sector growth (bank assets have grown from 19 to over 50 percent of GDP since 1999), while inflation has remained at marginally tolerable levels.

1.2 **The economy grew by more than 50 percent between 1999 and 2004, but growth has slowed.** Growth rates fell from 12.1 percent in 2004 to 2.6 percent in 2005 (see Table 1.1). From around mid-2003 through 2004 the terms of trade moved strongly in Ukraine's favor, leading to the 2004 growth and current account surge. But with volatile international prices for metals in 2005 (Ukraine's main exports), and higher energy prices in 2006 the country's terms of trade have been less favorable. The value added of metals production, oil refined products, agriculture, and construction slowed throughout 2005. A gradual real appreciation of the UAH also played a role in the decline of exports in 2005. Investment demand fell in 2005 due to political instability combined with a cutback in official public investment, contributing to the downward trend. In 2005, the current account surplus declined to 3.1 percent of GDP and will move into deficit in 2006 with a substantial growth in imports. The annualized growth rate for the first semester of 2006 recovered (to 5 percent y/y GDP growth) but the outlook remains subject to the risk of further increases in energy prices in 2007 remains.

1.3 **While growth has slowed, the economy has begun to diversify.** This could set the stage for an improved quality and sustainability of growth over the medium term. Positive signals of such a trend towards diversification include the following: a heightened investor interest and a surge in FDI; sale by financial industrial groups of subsidiaries and banks; continued growth (particularly in the first half of 2006) of services, manufacturing of machinery and equipment, and non-traditional sectors such as retail and transportation); and continued entry of new SMEs. These early signs of diversification are a highly positive development that could, in the future, help to reduce the economy's vulnerability to energy prices and to international prices of metals (and other commodities exported by Ukraine).

Table 1.1: Macroeconomic Trends in Ukraine (2000-05) and EU-8 Averages, 2000-05

	2000	2001	2002	2003	2004	EU-8 average for 2000-2004	
GDP growth, %	5.9	9.2	5.2	9.6	12.1	2.6	5.2
Nominal Exchange Rate (UAH/USD), aop	5.4	5.3	5.3	5.3	5.3	5.1	-
CPI, % change	28.2	12.0	0.8	5.2	9.0	13.6	5.3
Terms of trade (2000=100)	100.0	98.3	98.0	99.3	104.6	112.9	
Gross capital formation, % GDP	19.7	21.8	20.2	20.6	21.1	21.8	25.0
Public and publicly guaranteed debt, % GDP	45.3	36.5	33.5	29.0	24.8	18.7	29.8
Total revenues, as % of GDP	33.3	33.2	35.7	35.9	35.0	41.3	39.1
Primary deficit, % of GDP	0.9	0.0	1.4	0.1	-2.5	-2.0	-1.1
Fiscal balance, % of GDP	-1.4	-1.9	0.2	-0.9	-4.4	-2.7	-3.1

Sources: MoF; NBU; State Treasury of Ukraine; Bank staff estimations.

1.4 Monetary policy conditions, combined with fiscal looseness after the 2004 election, have not facilitated the announced goal of single digit (consumer) inflation. Inflationary pressures have been building over the past two years and continue to represent significant tension. The consumption orientation of the budget in 2005, for example, has contributed to demand-push inflationary impulses. Inflationary pressures deriving from speculative capital inflows also took place during 2005, and in response, the NBU allowed a one-off shift of the de facto peg by 2.7 percent (from UAH/USD 5.19 to 5.05). More recently, a substantial increase in the price of imported natural gas has added to inflationary pressures.

1.5 Higher gas prices are expected to have a negative impact on growth and on the fiscal stance. Net energy imports represent around 16 percent of GDP. While this is high, the energy intensity of use in Ukraine is remarkable — 22 times more than in Germany on a GDP basis, and 3.6 times higher than in Germany on a purchasing power parity basis. This high energy intensity makes Ukraine especially vulnerable to both oil and gas price increases. Estimates of the impact of the recent increase in natural gas import prices (from US\$50 to US\$95 per 1,000 cubic meters) suggest a potential reduction of GDP of 2 percent in 2006 with a knock-on increase of 0.7 percent of GDP in the fiscal deficit.²²

1.6 Ukraine has a relatively low debt-to-GDP ratio (at 18.7 percent) but carries a significant stock of contingent liabilities that could become explicit debt. Ukraine has been successful in lowering the debt-to-GDP ratio after the late 1990s crisis (the ratio was 61 percent of GDP in 1999), and successive governments have since remained cautious about significant levels of new borrowing. The President recently expressed his desire not to see an increase in the ratio of public debt to GDP over the coming years. Yet a rough estimate of the stock of contingent liabilities amounted to 41.1 percent of GDP in 2005, which, combined with investment needs consistent with Ukraine's growth plans, suggests that explicit debt levels may grow. This further emphasizes the need to create fiscal space for growth within the budget.

1.7 Public spending in Ukraine is high and is increasing. Public expenditures in Ukraine grew steadily since 2001, reaching 44 percent of GDP in 2005 (4.6 percent of GDP higher than in 2004), a record level for Ukraine and one of the highest levels in the region. This trend has been driven by hikes in recurrent spending (capital spending has actually been falling), which have arisen mostly from the fulfillment of pre-Presidential election commitments to raise pensions and minimum wages (first by an act of the Cabinet of Ministers, and then by both candidates, and finally by Parliament). Pension payments grew from 9.2 percent of GDP in 2003 to 15.3 percent in 2005; in parallel, the pension system balance moved from a small surplus in 2003 to a deficit of 3 percent in 2005. The wage bill, while not high by regional standards, registered a record high for Ukraine in 2005 reaching 8 percent of GDP (see Table 1.2). The driver has been significant increases in the minimum wage (which affects significantly

²² See the World Bank Note (2006) on "The Impact of Higher Natural Gas and Oil Prices in Ukraine," available on www.worldbank.org.ua.

the public wage bill), and further increases planned for 2006 may yield a total public wage bill of 8.4 percent of GDP for the year. As both public sector wages and pension benefits are heavily determined by minimum levels (that is, both the wage and pension scales are very compressed), the overall pay and transfer system of Ukraine erodes work and growth incentives at the individual level – and this hurts productivity.

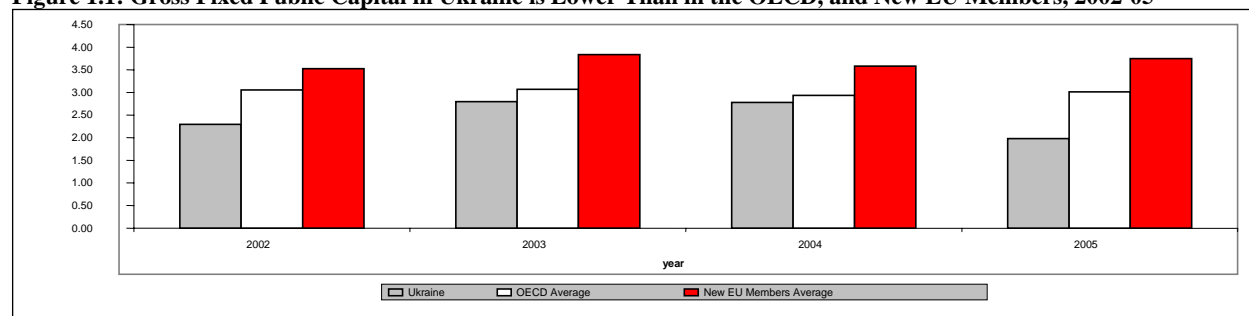
Table 1.2: Revenues and Expenditures in Ukraine, 2000-05 (as % of GDP)

	2000	2001	2002	2003	2004	2005
Total Revenues	33.3	33.2	35.7	35.9	35.0	41.3
Tax revenues	28.2	27.9	30.3	30.6	29.2	35.0
<i>Indirect Taxes</i>	8.6	8.7	9.9	8.8	8.6	12.3
<i>Direct Taxes</i>	19.6	19.2	20.4	21.8	20.6	22.7
Non-Tax Revenues	5.1	5.3	5.4	5.3	5.8	6.3
Total Expenditures	34.7	35.1	35.5	36.8	39.4	44.0
Pension payments	7.5	7.6	9.0	9.2	11.4	15.3
Public wage bill				7.6	7.4	8.0
Capital expenditures				4.3	6.0	4.3
Capital investments (fixed)				2.8	2.8	2.0
Primary deficit	0.9	0.0	1.4	0.1	-2.5	-2.0
Fiscal balance	-1.4	-1.9	0.2	-0.9	-4.4	-2.7

Sources: MoF; State Treasury of Ukraine; Bank staff calculations.

1.8 The consumption orientation of public spending in Ukraine is crowding-out investments (both private and public); this will constrain future growth. Capital expenditures have remained low and decreased significantly in 2005. Moreover, the reported size of capital spending is inflated by misclassified subsidies which crowd-out expenditures for infrastructure and equipment. Total capital expenditures, as listed in the budget, represent 4.3 percent of GDP (they fell significantly from 6 percent of GDP in 2004).²³ However, just above half of those expenditures (2.2 percent of GDP) are comprised by the so called “capital transfers to enterprises”. Close to 65 percent of transfers under this category are either direct subsidies to SOEs or transfers to spending units of the government that in turn use them to run subsidy programs. As a consequence, Ukraine is investing less public fixed capital than the new EU members (see Figure 1.1). Moreover, the excess capacity that allowed Ukraine to grow in recent years has largely been utilized, while the country’s infrastructure continues to deteriorate. In this context, and while keeping in mind that the lion’s share of investment will need to be provided by the private sector, the deficiencies of the capital budget and public spending on investment represent key constraints for medium-term and long-term growth.

Figure 1.1: Gross Fixed Public Capital in Ukraine is Lower Than in the OECD, and New EU Members, 2002-05

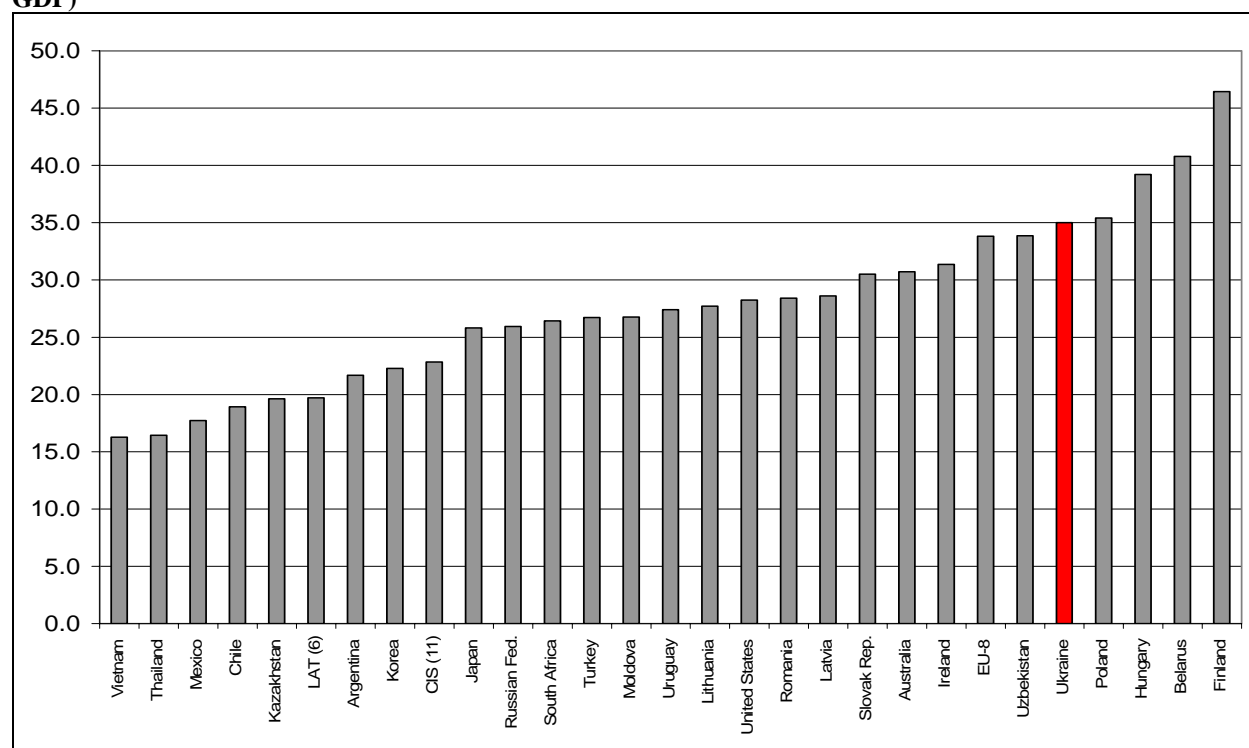


Sources: MoF; State Statistics Committee; Eurostat; OECD; Bank staff calculations.

²³ One of the reasons for the decline in public investment in 2005 was the new government’s reaction to the capital budget approved by the previous administration, which was viewed as the fulfillment of a pre-election political formula. It was largely scrapped in amendments to the 2005 budget. The 2006 budget process, however, also did not lead to a reformed capital budget process and was also kept relatively small.

1.9 **Ukraine has a relatively high tax burden which discourages private investment.** In 2005, Ukraine's tax burden stood at 35 percent (or 41.3 percent considering non-tax revenues, most of which are in fact different forms of fees on production and economic transactions). This is average burden is high for an emerging economy (see Figure 1.2). Payroll taxes in particular are characterized by high statutory rates that on average reach 42 percent (most of the rate -- around 37.5 percent -- is the employer's share). The high marginal burden on payroll taxes is coupled with a sizable shadow economy consisting largely of underreporting of income. This is somewhat different from countries at similar level of income in other regions, which often experience the bulk of their shadow activity through unregistered businesses.

Figure 1.2: Ukraine Has a High Tax Burden: An International Comparison 2004-05 (Tax Revenues over GDP)



Note: Data for Ukraine are for 2005 (all other countries for 2004).

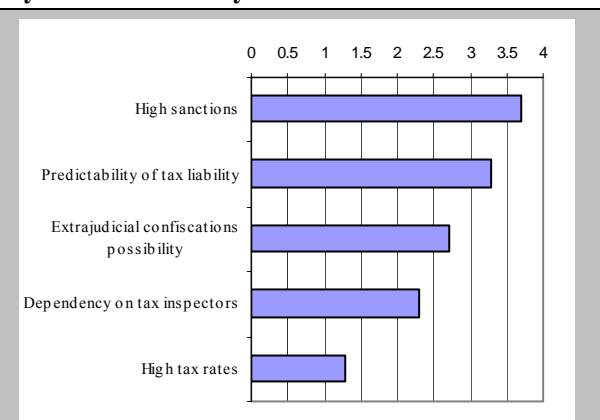
Sources: IMF GFS; World Bank (LDB); Eurostat; OECD; Bank Staff calculations.

1.10 **Reforms in taxation have taken place, but much remains to be done in the areas of both policy and administration.** Through the elimination of mutual offsets, tax amnesties, budget arrears, bankruptcy proceedings and administrative pressures on enterprises (especially SOEs), the government has been able to improve financial discipline and halt the growth of tax arrears. In addition, through piecemeal legislative changes and annual budget laws, a large number of tax exemptions have been abolished (although some remain, particularly in agriculture). Moreover, reforms to the CIT and PIT have introduced simple flat rates (i.e., 13 percent for the PIT and 25 percent for the CIT). In response, the CIT has performed well, while a decline in PIT collections (as a share of GDP) has been observed. The PIT's performance (below expectations) may partly be explained by the fact that other parts of the tax system have not yet been reformed, keeping incentives for accurate income reporting almost unchanged (for instance, payroll taxes – which remain very high - have almost the same base as the PIT). In addition, improved tax administration and coordination between revenue agencies are needed. Finally, there has been a shift toward dependency on collections from the VAT on imports, as well as persistent problems with VAT administration (e.g., regarding fraud and refund arrears). These factors, combined with the

high marginal burden of the payroll tax system and the base erosion generated by the simplified tax system (STS), present significant challenges. Figure 1.3 shows the major problematic issues regarding the tax system as indicated by private businesses.

1.11 **Given that the tax burden on the economy is already high, the creation of fiscal space through increasing taxes is not an option.** Collections went up significantly in 2005 (mainly driven by the VAT) owing to a variety of factors. These include legislative changes that curtailed tax exemptions at the beginning of 2005, the fact that the VAT on oil imports from Russia began to be collected by Ukraine (Russia was charging an export VAT but stopped this practice for 2005),²⁴ changes in leadership and personnel in key areas of the STA and Customs, and an anti-corruption program related to Customs (“Contraband Stop”) initiated early in 2005. Yet these are largely one time effects; and 2005 collections are likely to be a high base for measuring future increases. Instead, and consistent with the government’s desire to reduce tax rates, policy should aim at reducing the high marginal rates (particularly on payroll taxes), but coupled with broadening the base and improving compliance to avoid significant revenue losses, thus, allowing a gradual and smooth reduction of the average tax burden. Once tax reform has matured, it will be important to lock the changes into a new tax code, particularly in light of recent enterprise surveys which show that businesses worry particularly about inconsistent and uncertain tax rules (see figure 1.3).

Figure 1.3: Most Problematic Issues in the Tax System as Viewed by Private Businesses



Note: The scale above ranks the most problematic issues in the tax system from 0 to 4 (4 being the most problematic)
 Source: Cost of Doing Business Survey, World Bank, 2004.

1.12 **Despite these fiscal pressures and the recent growth slowdown, Ukraine is potentially on the cusp of major steps forward.** The country’s strong commitment to accelerated reforms in the context of its EU accession aspirations has brought considerable growth expectations. Moreover, it has made Ukraine a focus of attention for investors that recognize the country’s potential in terms of its natural resources, its industry, its well-educated population, and its strategic geographic location. Indeed, Ukraine has a good mix of economic resources to further advance its economy – the challenge ahead is to capitalize on these factors through accelerated reforms and greater economic diversification. Ukraine’s major financial industrial groups have begun to improve their transparency and business practices.²⁵ This promises better opportunities for market entry and domestic competition, complemented by more private investment, both foreign and domestic. It is critical for Ukraine’s future development prospects that these positive trends continue.

²⁴ Roughly 89 percent of Ukraine’s oil imports come from Russia (Bank estimate based on 2002 WITS figures). Assuming this is the current share of oil imports to Ukraine from that country, and applying the VAT rate to imports for 2005, VAT revenues on these imports would reach just above UAH 4.4 billion. This represents around 13 percent of the net VAT collection for 2005. Of course, this is not the amount of revenue gained, since VAT was being charged at later stages before 2005 (without a VAT credit). However, the loss may still be significant, as the first stage of VAT collection (the most effective) was forgone.

²⁵ See “Big Business: Institutional Role and Interrelation with Government and Society,” Center for Economic Development, April 2006, and forthcoming on www.worldbank.org.ua.

B. FUNDING NEEDS AND PRESSURES ARISING FROM THE GOVERNMENT'S REFORM AGENDA

1.13 **Reaching Ukraine's EU Aspirations and growth expectations will require significant resources.** The government has been actively engaged in discussing and planning a comprehensive reform package, while the hike in recurrent spending has left little fiscal space to cover the costs. The reform areas listed below are just part of the overall reform agenda, but they highlight the fiscal pressures on the budget, and all of them have been highlighted recently by the government as priorities:

- (a) Making investment consistent with the EU Action Plan (e.g., energy and basic infrastructure)
- (b) Introducing the second funded pillar in the pension system and providing for the long-run sustainability of the system
- (c) Reducing payroll tax rates
- (d) Implementing public sector reforms (e.g., judicial reform, financial management reform, civil service reform, public salary decompression, etc.)
- (e) Providing investments that will improve education and health services (and specific reforms in these areas).

Box 1.1 provides specific examples of those EU Action Plan objectives for Ukraine for which planning and financial sources will be needed to support the reform.

Box 1.1: Ukraine's EU Action Plan Objectives (Paraphrased excerpts)	
Strategic Planning	Introduce strategic planning at the national and regional levels in Ukraine, and elaborate a draft state strategy for regional development up to 2015.
Fiscal Management	Reinforce fiscal sustainability, including by implementing tax reforms and streamlining expenditure programs. Improve transparency of public finance management, including by development and restructuring of the system of public financial control and audit.
Social Services & Social Assistance	Take measures to address imbalances in the pension system. Develop sustainable systems for education, health and other social services with access for all.
Institutions for Consumer and Business Services	Ensure the effective implementation of independent and well-trained supervisory authorities to monitor regulatory frameworks in accordance with internationally recognized standards. Adopt regulations concerning licensing, interconnection, numbering and generally accessible telecommunications services. Carry out judicial and legal reform, strengthening the administrative capacity.
Infrastructure	Identify and commit sources of financing and adopt financing strategies for transport infrastructure development, while implementing an action plan for improving road safety. Pursue gradual convergence towards the principles of the EU internal electricity and gas markets. Develop infrastructure for the diversification of oil and gas supplies.
Environment	Enhance/adopt national programs and plans for key environment sub-sectors.
Public-Private Partnership	Address issues of infrastructure financing, including through the use of public-private partnerships. Implement a privatization program, including large-scale privatization (with transparency). Encourage the restructuring of the state-owned port sector (separating operational and commercial functions). Further explore the possibilities for the financial and legal restructuring of the gas transit business.

1.14 **While the bulk of investments should come from the private sector, the needs are high and there is a role for the state.**²⁶ Investments in productive infrastructure and human capital are key ingredients for economic growth and for capitalizing on the mix of resources the country already has as it moves towards an EU standard of living. However, as is mentioned earlier and discussed in greater detail throughout this report, the government has not been spending effectively in these areas. As basic infrastructure has deteriorated, the need for public investment has increased. Strategic infrastructure in the energy sector (especially in areas where the private sector is unlikely to invest in the short run, such as district heating) needs to be upgraded to ameliorate Ukraine’s high vulnerability to energy prices (and to improve energy efficiency). Investments are also urgently needed in transport, housing and community services (e.g., water, sanitation, heating) and environmental cleanup. In addition to purely physical investments, investments are needed in human capital in order to enhance the technical sophistication of Ukraine’s labor force (in both the public and the private sector) and thereby achieve the higher levels of productivity consistent with Ukraine’s wealth aspirations.

1.15 **Institution building is needed to support a market economy.** The movement toward a more modern way of business can herald the enactment of the needed corporate governance legislation, the improvement of the regulatory systems, a reduction in distortions and quasi-fiscal activity in the economy (e.g., energy tariff cross-subsidization, tax exemptions, nonpayment), and a better rule of law. But along with these changes, and in order to benefit from them, Ukraine needs to continue building complementary market supporting institutions, such as independent, accountable and effective regulatory agencies, a competent and transparent judicial system, and a better working system for state enterprise management.

1.16 **In light of the EU Action Plan and Ukraine’s growth prospects, Table 1.3 summarizes some estimates of key investment needs over the next 10 years.** These figures are merely a rough estimate of the potential public investment needed in view of the EU Action Plan and the concomitant growth expectations and should be viewed as preliminary at this point. Feedback from the government on their estimates will be integrated into a future version of this report. The Bank’s team expects to revise and update the estimates jointly with the government through the process of discussion and dissemination of this report.

Table 1.3: Capital Investments for EU Aspirations Over the Next 10 Years, 2006-15

Sector	Amount (Billions of USD)
Energy	30
Transport	5
Housing and Communal Services	14
Agriculture and Land Reform	9
Health, Education, Social Protection	6.5
Environmental Protection	15
Market Supporting Institutions	4
Other	16.5
Total	100

Source: World Bank estimates in consultation with the Government of Ukraine.

C. UNDERSTANDING THE FISCAL SPACE ARGUMENT FOR UKRAINE

What Does “Fiscal Space” Mean?

1.17 **The concept of fiscal space is another way of looking at the fact that resources are always limited, and thus, for any sustainable fiscal program, resources and plans for allocation must add**

²⁶ The government has a special role in addressing market shortcomings in investment and providing public goods. For example, a trucking company that wants to ship goods to Europe or Russia will hardly take it upon itself to fix the roads along those routes. Rather, the company will make choices subject to the quality of roads, the availability of complementary transport services, and the institutional quality of customs and border processes. Similarly, parents on their own will not be able to establish a modern education environment for their children, nor quality health care.

up. When a government puts more public resources into recurrent spending (e.g., wages, pensions, subsidies), it takes up more of the fiscal space that could be granted to other expenditures, such as investments for enhancing infrastructure and human capital.

1.18 **There are several dimensions (sources) through which fiscal space can be obtained.** Fiscal space can be obtained through tax policy and administration by broadening the tax base, improving compliance, and using other policy instruments to raise higher revenues. Fiscal space can be obtained through the reallocation of expenditures (that is, through shifting resources from less efficient to more efficient uses), included by the phasing out or cutting of spending that is inefficient. It can be obtained through borrowing (government debt), or just through more efficient use of donor support. Privatization proceeds also have the potential to create fiscal space, since they are a source of finance (representing the conversion of a non-liquid asset to a liquid asset of the government, and sometimes complemented by the elimination of the recurrent and capital expenditures needed to run these enterprises).²⁷

1.19 **Fiscal space also has an important inter-temporal component.** Essentially, the effective use of resources today which leads to increased productivity in the economy generates a larger base of resources (human and physical capital, and incomes) for tomorrow's economic choices (wealth can be saved and invested, or consumed). When significant investments are required, as in Ukraine today, decisions are needed as to whether to reduce current or future consumption to pay for them. Public consumption today can be increased (at the cost of future public and private consumption) through borrowing or through the sale of assets (such as oil and gas reserves). But in this case the economy can quickly come up against two broad tensions: debt sustainability and macroeconomic pressures. Thus, policies geared to create fiscal space also create fiscal solvency for the future by allowing more productive and growth enhancing public spending and by reducing distortions that hamper growth.

1.20 **Fiscal space is country-specific.** The policy choices available for finding fiscal space depend on the country's unique fiscal framework, including its characteristics, constraints, and policy agenda. Thus, while some countries may need to raise more revenues to finance their expenditure envelope, others may want to reduce the tax burden. While some countries may be able to acquire more debt cheaply, others may be above their debt limits or may be able to raise funds only at high overall costs to the economy. And while some countries may want to reallocate expenditure from one area to another while maintaining the same level of expenditure, others may want merely to phase out or cut programs, thus reducing the overall size of the government.

How Can Fiscal Space Be Created and Allocated in Ukraine's Budget?

1.21 **Improved fiscal policy and public finance management will create fiscal space.** Fiscal space for a rate reduction in payroll taxes can be achieved by improving collection efficiency through broadening the base and through achieving better compliance, without increasing the tax burden in the system. Chapter 2 deals with concrete issues in selected areas of tax policy and administration and provides concrete recommendations for achieving these broad objectives. The fiscal space for the pressing need to upgrade and build new infrastructure could be achieved through a rationalization of several expenditure programs. This process would involve the phasing out and the reallocation of resources from inefficient programs to productive investments. Fiscal space for social programs can be found by better implementing them within current expenditure allocations and/or by raising allocations when efficiency has clearly improved. An overview of the expenditures in the budget, and options for achieving expenditure savings, are provided in Chapter 3. Fiscal space for the sound introduction of the second funded pillar into the pension system can be achieved through a combination of savings measures

²⁷ On the other hand, should large injections of capital be needed to prepare enterprises for privatization and/or to mitigate the social consequences of privatization, those expenditures should be factored into the fiscal framework.

(parametric changes) in the PAYG system. Chapter 4 examines the current issues in the pension system and calculates the fiscal impact of planned reforms (by the government) and additional recommended reforms (in this report) that should achieve the necessary savings to bring long-run sustainability to the system. It should also be noted that the savings in the pension system (achieved through the parametric changes suggested in Chapter 4) would be large enough to reduce the deficit of that system currently covered by the budget; this would further free up resources for productive investments and social expenditures once efficiency has improved.

1.22 As noted above, fiscal space for human capital investments could be achieved through more efficient use of resources within the health and education sectors. To achieve higher efficiency in these sectors, it is necessary to revisit their intergovernmental fiscal and administrative relations. These relations are fundamental for financing and regulating the operations of the bulk of these services in Ukraine, but several features of these relations need to be restructured if resource allocation efficiency is to be enhanced. This important issue will be a key focus of the second phase of the Programmatic Public Finance Review in Ukraine.

1.23 In parallel with gaining more fiscal space for public investment, capital budgeting needs to be improved, or scarce resources will be wasted. A better capital budgeting process would, on its own, create fiscal space, as better planning, evaluation, and allocation would channel resources to more productive investments (and away from economically poor choices). Moreover, this process would permit better use of the fiscal space created in other areas of the budget. Chapter 5 provides concrete recommendations for an improved capital budget process. Another related issue is the reform of the financing, implementation, and management of investments financed by donors. Strengthening these processes, and better integrating them into the core budget process, would allow for a more efficient use of these funds. Moreover, efforts by the government and the donor community in Ukraine toward harmonization would need to be scaled up as donor support may increase over the coming years.

1.24 As noted in Box 1.1 above, the EU Action Plan also envisages the use of public-private partnerships (PPPs) (in different formats and to different degrees) to finance capital spending. This could be an important factor in creating fiscal space in Ukraine. However, in order to utilize PPPs effectively, the government would need to strengthen the analytical and technical capabilities of its spending units so that they could make a proper evaluation of the fiscal implication of these financing schemes. The design aspects of PPPs can be crucial to their success; legal and regulatory issues almost always arise, and some PPPs imply significant contingent liabilities which the authorities would need to factor into their medium-term thinking.²⁸ Finally, improvements in debt management can reduce borrowing and debt service costs, can reduce macroeconomic risks in the economy, and can even help facilitate financial intermediation by the private sector. This is addressed in Chapter 6 in the context of the macroeconomic framework and debt sustainability analysis.

Fiscal Space within a Macro-fiscal Framework

1.25 The policy choices for obtaining and allocating fiscal space are unavoidably linked to the macro-fiscal framework of the country. Thus, creating and allocating fiscal space is in effect an adding-up exercise based on an underlying macroeconomic framework that provides key parametric inputs (i.e., inflation, growth, and the exchange rate, among others) and an inter-temporal dynamic. As every policy program needs to be financed, realistic, and typically conservative, economic projections are required. As projections are about the future, there should not be just one projection but rather a distribution (or a range) of possible outcomes. Chapter 6 of this report performs this adding up exercise through two

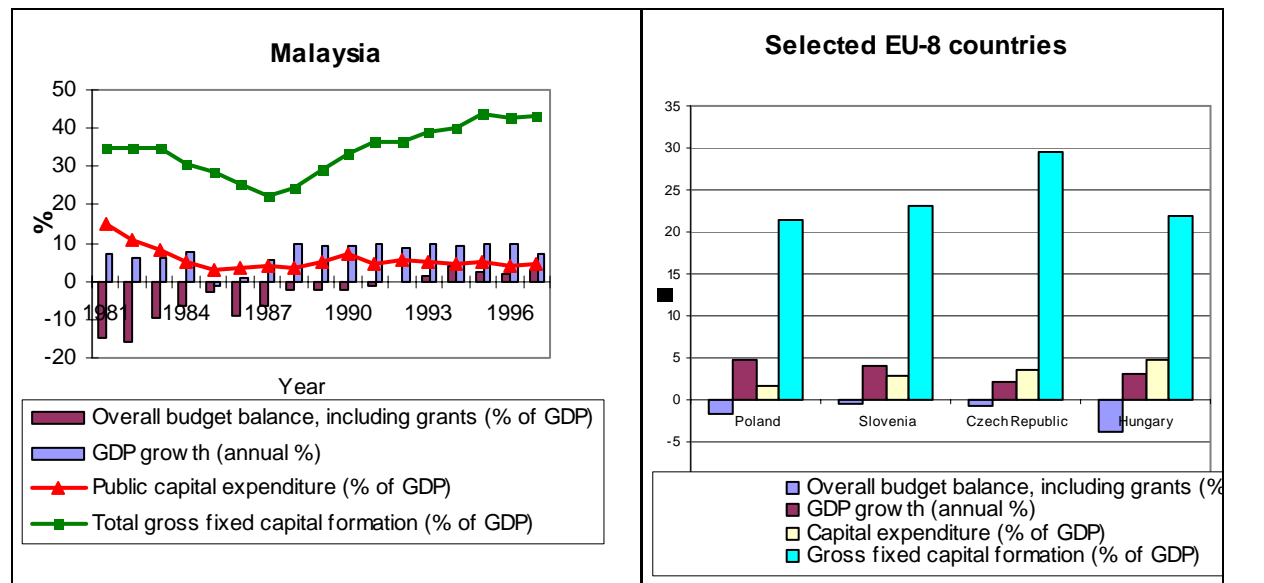
²⁸ See Annex 1.1 for a discussion on PPPs and other countries' experience with this issue.

macroeconomic scenarios. These scenarios present a consistent macro-framework and projections within an expected distribution of outcomes for Ukraine. Moreover, they integrate the choice between creating and not creating fiscal space, offer choices of meeting or partly meeting the reform agenda, and consider two different levels of public and private investment for the next 10 years. Related to this exercise, but not explicitly modeled in this report, is an underlying risk/return relationship. Among consistent macroeconomic programs, some fiscal strategies will be characterized by high risks / high returns, and others by lower risks / lower returns.²⁹ This is discussed in more detail in Box 1.2.

Box 1.2: Risks and Returns of Fiscal Strategies

All else being equal, and assuming that countries have the foresight, capacity, rigor, and discipline to implement well structured public investment programs (i.e., channeled to productive investments), a program which finances relatively larger public capital investments by running relatively larger fiscal deficits could be considered high risk / high return. Some of the Asian Tigers followed this path. On the other hand, if the same objective could be achieved by letting the private sector fulfill the investment needs (assuming that the government creates the proper conditions to that effect), this would be an ideally lower risk / higher return strategy. The Central European countries tended to follow this path owing to the fact that they were already on an EU accession track, which attracted a high level of private investment. If public infrastructure clearly represents a binding constraint to growth, recurrent expenditure reductions cannot be found, and the strategy is thus to maintain a low deficit through relatively low capital expenditures: this would be considered a low risk / low return strategy. A number of countries have followed this path, largely because of financing constraints, an inability to sufficiently rationalize expenditures, and the absence of the prerequisites for good public investment programs. In reality, there are more choices than those outlined here, and the choices are ultimately more complex. These characterizations are designed to help provide an understanding of the underlying tensions.

In considering its options, Ukraine should take guidance from the experience of other countries. Countries that went through significant periods of economic growth have successfully harnessed some combination of public and private provision of public goods and services, and investments in infrastructure. The Asian Tiger economies (Malaysia, Singapore, Thailand, South Korea) tended to lean toward public investment (averaging between 5 and 10 percent of GDP, especially during the early years of the growth surge). The figure below depicts the high levels of investment (both public and private) in Malaysia in the years leading up to the 1998 financial crisis. This can be compared to the EU-8 countries which followed a more conservative path from the perspective of public investment, benefiting significantly from their EU accession processes and proximity to European investors.



Source: WDI, World Bank.

1.26 Two important dynamics arise from the fiscal space adding up exercise: the “debt tension” and the “macro tension.” In simple terms, expenditures greater than revenues (i.e., deficits) can be

²⁹ There are many programs that are characterized by high risks, low returns; ideally, one would search for the program characterized by lower risks and higher returns.

financed through debt issuance.³⁰ As debt levels rise, debt service in future years can represent a significant drag on the budget and the economy. There is a level of debt which is simply unsustainable, and the closer the economy comes to that level, the worse terms it will experience for new borrowings (higher interest rates and shorter maturities). This is referred throughout the report as the “debt tension.” While the public debt stock is less than 20 percent of GDP in Ukraine, and thus the country could afford prudent debt increases, the government also needs to weight-in the fact that it has acquired (and inherited) over the years a large stock of contingent liabilities (e.g., the so called “lost savings” in the former USSR Savings Bank, 100 percent guaranteed deposits in state banks, and even pensions if not properly addressed by reforms). Thus, debt accumulation could take place with surprising rapidity.³¹ In addition, public borrowing reduces the foreign and domestic savings available for private sector borrowing, in effect crowding-out private sector investment. This is fine if public expenditures are more productive than private expenditures, which is often the case with the provision of truly scarce public goods, but will hurt growth and national wealth if this is not the case.

1.27 More immediately, the macro tension can come into play if fiscal expansion at the cost of future consumption begins to overheat today’s economy. This can lead to inflation, increased risks in the economy, and higher borrowing costs for both public and private spending. In considering the macroeconomic program, governments must take into account the impact (stimulus) that deficit spending will have on economic activity (e.g., will it crowd out or help facilitate the private sector?). Critical to this is the type of expenditure that drives the deficit (that is, consumption or productive investments, the latter typically being more beneficial for future growth). At the same time, larger deficits may raise red flags about the ability of the government to manage the country’s finances and contain inflation, which in turn may deteriorate borrowing terms. In short, there are a number of inter-linkages to consider here, and clearly Ukraine has some careful choices to make. We display some of these dynamics specifically in relation to Ukraine in the macro-frameworks developed in Chapter 6.

D. CONCLUSION

1.28 Given the macroeconomic constraints that Ukraine faces, the level of investment needs consistent with its growth and welfare aspirations, the costs associated with planned and needed reforms, and the room for improvement in the structure and implementation of the consolidated budget, Ukraine’s policy-makers face important choices and trade-offs, which will affect Ukraine’s development outcomes significantly. The chapters in this report examine and provide selected sources of fiscal space throughout the budget in order to manage fiscal pressure, strengthen the capital budgeting processes and make the best use of donor financing. This is done within a consistent macro-fiscal framework.

³⁰ There are, of course, other ways to finance deficits including privatization revenues and donors’ aid.

³¹ And, as Chapter 7 shows, this is especially the case should macroeconomic tensions negatively feed back into the debt tension, and vice-versa.