

3. FINDING EXPENDITURE SAVINGS BY IMPROVING ALLOCATIONS

A. INTRODUCTION

3.1 Public spending in Ukraine is high and has been increasing. The consumption orientation of the budget is crowding-out public and private investment. The allocation efficiency of public spending is also questionable, both in terms of its consumption orientation and because it is financing a variety of inefficient subsidies and untargeted programs. Public expenditures in Ukraine grew steadily since 2001, reaching 44 percent of GDP in 2005 (4.6 percent of GDP higher than in 2004) (see Table 3.1). This is a record level for Ukraine and one of the highest in the region. This trend has been driven by hikes in recurrent spending. Pension payments grew from 9.2 percent of GDP in 2003 to 15.3 percent of GDP by 2005, while in parallel the pension system balance went from a small surplus in 2003 to a 3 percent deficit in 2005. Although not an outlier for the region, Ukraine's public wage bill registered a record high for Ukraine in 2005 at 8 percent of GDP (from 7.4 percent of GDP in 2004). The public wage bill has been pushed by minimum wage hikes, and is likely to make up 8.4 of GDP in 2006 owing to further planned step-wise increases this year. On the other hand, capital expenditures, as listed in the budget, have remained low and decreased significantly in 2005 (from 6 percent of GDP in 2004 to 4.3 percent of GDP in 2005). However, just above half of those expenditures are comprised of the category called "capital transfers to enterprises." Under this category, close to 65 percent are subsidies to SOEs, or transfers to spending units of the government (i.e., Ministry of Agriculture, Ministry of Energy) that in turn run subsidy programs with these resources.

Table 3.1: Hike in Public Expenditure in Ukraine, 2003-05 (as Percent of GDP)

	2003	2004	2005
Total expenditures	36.8	39.4	44.0
Current expenditures	32.5	33.4	39.7
<i>Pension payment</i>	9.2	11.4	15.3
<i>Public wage bill</i>	7.6	7.4	8.0
Capital expenditures	4.3	6.0	4.3
<i>Capital investments (fixed)</i>	2.8	2.8	2.0

Source: Ministry of Finance and State Treasury of Ukraine; Bank staff calculation (and estimation for 2005)

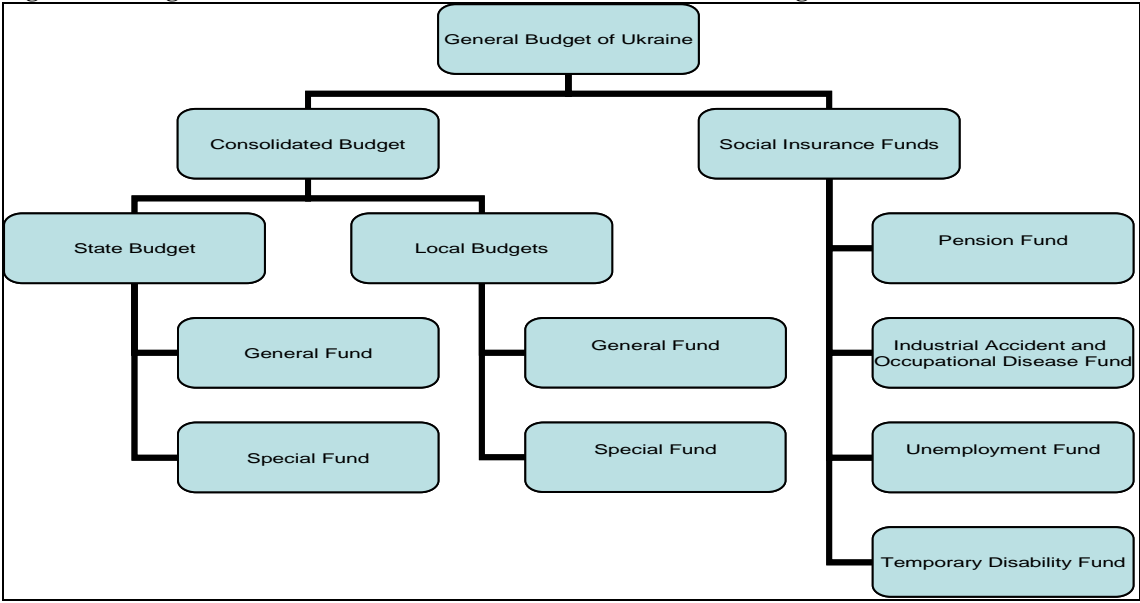
3.2 This chapter provides a review of the trends and composition of public expenditures in Ukraine, highlighting potential expenditure savings that could be achieved by rationalizing, phasing out or cutting specific untargeted programs and inefficient subsidies. The objective of identifying potential expenditure savings is that they can be sources of fiscal space that later can be re-allocated to more efficient spending (e.g., productive public investments) and can be used to finance the government reform agenda. The chapter is organized as follows. Section B starts by outlining the organizational structure of Ukraine's budget and the relative expenditure trends of its parts. Among other things, this provides a basis for understanding the rest of the chapter. Section C provides an analysis of public spending using the economic classification of the budget. It highlights issues of allocation and it points out potential expenditure savings that could be achieved from curtailing inefficient subsidies. Pension expenditures are briefly overviewed, as the bulk of that discussion is taken up in Chapter 4. Section D provides an analysis of public spending using the functional classification of the budget. It provides an overview of the core sector programs, and focuses in more detail on social assistance programs (especially social and occupational "privileges"), agriculture and the energy sector. This section also highlights issues of allocation and it points out potential expenditure savings that could be achieved from curtailing inefficient

subsidies, phasing out some untargeted programs, and improving others. Section E provides a summary of recommendations to improve public spending and Section F provides a summary of the discussion and concluding thoughts.

B. ORGANIZATIONAL STRUCTURE OF THE GENERAL GOVERNMENT BUDGET IN UKRAINE

3.3 This section provides a brief overview of the particular and unique characteristics of the budget structure in Ukraine and its main expenditure trends. In Ukraine, the General Government Budget (as broadly defined internationally) comprises two main components (see Figure 3.1): the Consolidated Budget (as defined by Ukrainian legislation); and four off-budget Social Insurance Funds, of which the Pension Fund is the largest. The Consolidated Budget is further divided between the state budget (that is, the central budget) and the local budgets. Both the state budget and the local budgets are additionally subdivided between a General Fund and a Special Fund.

Figure 3.1: Organizational Structure of the General Government Budget of Ukraine



Note: It is important to clarify that Ukraine’s legislation does not have a “General Government Budget” but two separate branches: the “Consolidated Budget” and the off-budget Social Insurance Funds. For the purpose of this analysis (and to enable international comparisons) we consolidate both branches under the broad definition of General Government Budget.

State and Local Budgets

3.4 **The share of local budgets in total spending has been declining.** During 2002-05 local budget expenditures grew as a ratio of GDP, but at a slower pace than other components of the General Government Budget (i.e., the state budget and social fund expenditures). As a result, the share of sub-national spending in total spending fell from 34.2 percent in 2002 to 29.8 percent in 2005. Local budget expenditures play an important role in various budget programs, especially in education and health (see Table 3.2).

Table 3.2: Local Budget Expenditures, 2002-05

	2002	2003	2004	2005
Local budget expenditures, percent of total expenditures	34.2	32	30.2	29.8
Local budget spending in education, percent of total spending on education	57.8	61.7	60.7	60.9
Local budget spending on health, percent of total spending on health	79	75.8	71.7	77.4

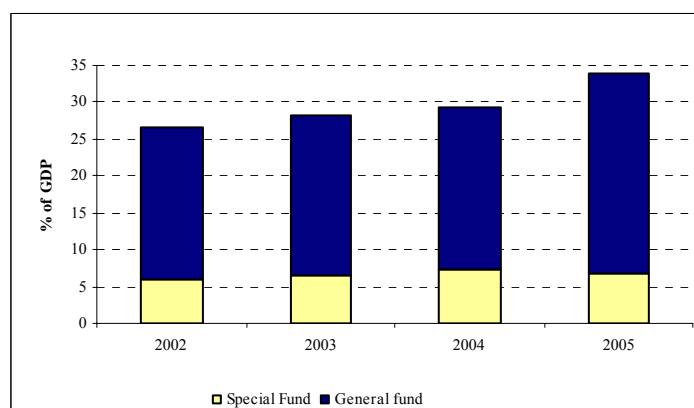
Source: Ministry of Finance and State Treasury of Ukraine; Bank staff calculations (estimations for 2005)

3.5 **Among a variety of issues, the problem of unfunded mandates at the local level persists.** The share of financed delegated expenditures for local budgets fell from 81 percent of total local expenditures in 2002 to 72 percent by 2005, but the scope of responsibilities was not reduced accordingly. This is especially acute in relation to social privileges, which are discussed later in this chapter. While this first programmatic PFR for Ukraine does not analyze expenditures in detail at the local level, such an exercise is planned for the next PFR. In particular, this exercise should focus on education, health, social assistance, and housing and community services, all in the context of the intergovernmental fiscal framework of Ukraine and the role of state and local institutions in program implementation.

The Special Fund

3.6 The creation of the special fund was an important step in the direction of budget consolidation.

The main rationale behind this reform (established in the 2001 budget code) was to pull together a variety of off-budget funds and revenues, and bring them into the Consolidated Budget. Before the introduction of the Special Fund, sector ministries were frequently against the integration of off-budget funds, arguing that without those dedicated funds they would be unable to fulfill their investment programs. As a consequence, the establishment of the special fund stipulated that the expenditures within this fund are to be financed by specially earmarked revenue sources.⁷⁶ Overall, this consolidation brought more transparency to the budget (for example, the Special Fund has been fully integrated into the Single Treasury Account of the Treasury of Ukraine).

Figure 3.2: General Fund versus Special Fund Expenditures, 2002-05

Source: Ministry of Finance and State Treasury of Ukraine.

3.7 **The relative size of the Special Fund has been declining slightly.** The share of Special Fund expenditures in total expenditures fell from 22.8 percent in 2002 to 20.1 percent in 2005. This was essentially due to the fact that general budget expenditures grew faster than special fund expenditures. As

⁷⁶ Special budget fund expenditures are financed by earmarked revenue sources defined by the legislation. In 2005 over 70 percent of special fund revenues consisted of the following: (i) user fees for public services (39.2 percent), (ii) excise charges for domestically produced and imported oil products and vehicles (8 percent), (iii) extra charges to the tariff for electricity and heating (6.3 percent), (iv) duties on foreign exchange buying-selling operations (7.7 percent), and (v) receipts from sales of capital assets.

a share of GDP, Special Fund expenditures increased from 6.1 percent in 2002 to 7.2 percent in 2004, but fell to 6.4 percent GDP in 2005 (see Figure 3.2).

3.8 The Special Fund is particularly linked to financing of capital expenditures. Capital expenditures accounted for 43 percent of total special fund expenditures in 2005, being responsible for 67 percent of total capital spending. The Special Fund is a key source of resources for transport expenditures, which made up 17.4 percent of total special fund expenditures in 2005 (92.1 percent of total transport spending is financed through the special fund).

3.9 However, investments within the Special Fund are relatively under-executed. Executed expenditures from the Special Fund accounted for only 85 percent of the allocated amounts, while the figure for general fund expenditures is a much higher 97 percent. The difference is even higher for capital expenditures. The executed amount of capital expenditures from the Special Fund was only 80 percent of the funds allocated, as compared with 95 percent from the General Fund.

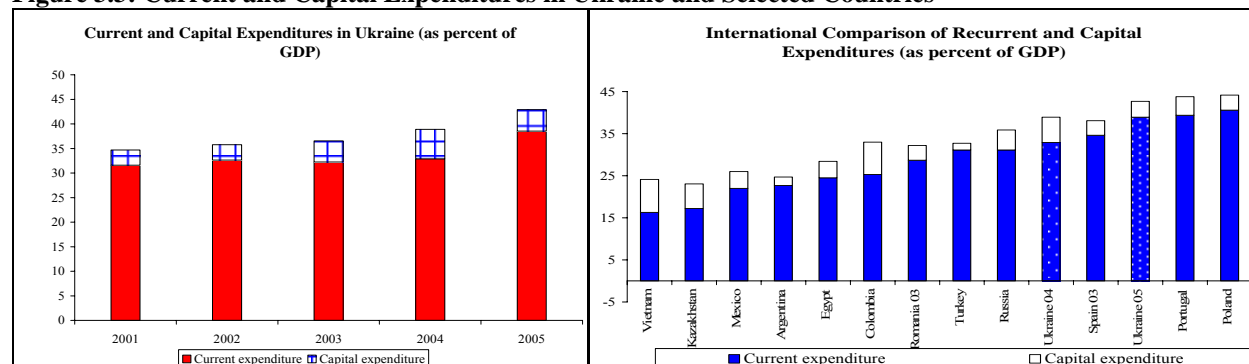
3.10 As the budget process improves, preserving the division between the General and Special Funds should lose its rationale; and consequently, further consolidation should be placed on the budget reform agenda. But since the Special Fund likely continues to serve a de facto role, by (somewhat) protecting resources for capital expenditures, particularly at the local level, the issue requires close and systemic scrutiny. Thus, consolidation should go hand in hand with a strengthening of the capital budgeting process (including capital transfers to local governments).

C. ALLOCATION OF BUDGET EXPENDITURES: ECONOMIC CLASSIFICATION

Current Expenditures

3.11 Current spending increased sharply in 2005. From 2001 to 2004 current expenditures in Ukraine represented a relatively stable share of GDP (see Figure 3.3). Their hike in 2005 (by 4 percentage points of GDP) boosted total expenditures to their highest level in the past five years. By international comparison, Ukraine's current (and total) public spending is higher than in countries with the same level of GDP, and at the same level as (or higher than) most EU accession countries. Moreover, Ukraine spends relatively less on interest payments than do most countries in the comparator sample. The sharp increase in recurrent (and total) public expenditures in 2005 was driven by increases in public wages, pension expenditures, and subsidies. All of these categories show sharp increases from 2004 to 2005.

Figure 3.3: Current and Capital Expenditures in Ukraine and Selected Countries

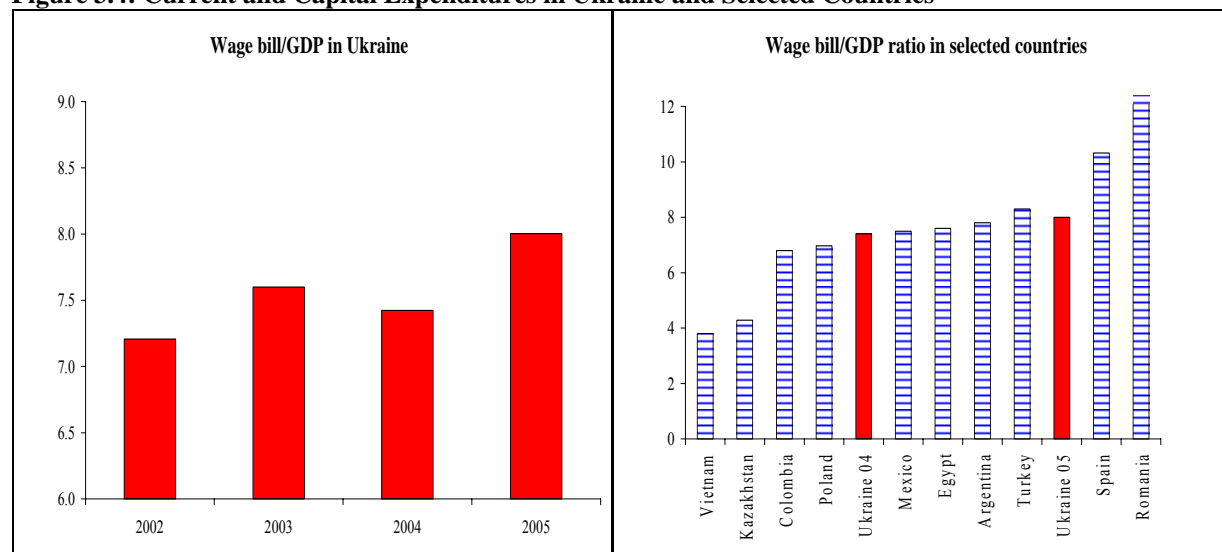


Source: IMF, OECD, WB, Ministry of Finance; State Treasury of Ukraine; Bank Staff calculations.

The Hike in the Public Wage Bill

3.12 **The wage bill registered a record high for Ukraine in 2005, reaching 8 percent of GDP.** Increases in the minimum wage had a drastic effect on the public wage bill during 2005. The wage bill to GDP ratio may increase further to 8.4 percent of GDP in 2006, owing largely to the minimum wage increases and the decompression process in the wage structure (see Figure 3.4).

Figure 3.4: Current and Capital Expenditures in Ukraine and Selected Countries



Sources: IMF, OECD, WB regional fiscal dataset, Ministry of Finance; State Treasury of Ukraine.

3.13 **The size of the wage bill needs to be carefully monitored to contain its further expansion.** The growth in wage expenditures, in the absence of sector reforms leading to the improved productivity of public workers, and in an environment of economic slowdown, entails a risk of crowding out government operational and capital expenditures. Controlling the wage bill does not mean reduced wages for public workers. In fact, public wages may need to grow to be more competitive with the wages of other sectors of the economy. However, this implies that reforms need to be undertaken to achieve a streamlined and more productive public administration.

3.14 **In order to maintain sustainable levels in the wage bill and yet pay competitive wages and increase productivity, the government needs to improve the efficiency of public sector programs and employment.** Beyond social sector reforms which are needed in order to increase salaries of teachers and medical professionals, efforts are needed to improve the system of public administration. This will require a sustained effort that goes beyond drafting and approving legislation, and would focus on actually streamlining and implementing improvements in administration, public services and public employment.⁷⁷ As the institutional systems and business processes are rationalized, and in parallel with a decompression of the wage scale so that highly qualified staff in the public sector receive a competitive salary (and are thus more likely to be retained), considerable attention should be given to developing personnel skills through effective in-service training systems.

⁷⁷ In this report and in most international usage “civil servants” refers to members of the formal state civil service, while public employees include civil servants and other public workers of the Consolidated Budget of Ukraine (for example, public sector teachers, doctors, non-professional staff).

3.15 Transparency in the pay system is important for creating incentives for civil servants and increasing efficiency. In past years, the basic salary made up only 30 percent of the total pay, while the rest (70 percent) was comprised of various pay increments and bonuses that are dependent on subjective and/or ad hoc factors.⁷⁸ In March 2006, new regulation was approved to streamline the pay system in the country. Owing this regulation, the portion of the base salary in total remuneration has increased significantly to around 60 percent.⁷⁹ Nevertheless, this report still cautions against having ad hoc remunerations in the system, particularly because non-cash benefits (which are often not costed-out) may provide more incentives for entering public service than official cash remuneration.⁸⁰ Despite important improvements (such as the legislation commented on above), broad-based ownership for civil service reform needs to be reached by all levels of government. Experience and practical concerns suggest that if civil service reform is to be successful, it should be championed at the highest levels of government.

3.16 An increase in pay progression should be one of the central considerations in the continued effort to improve the pay system in Ukraine. The pay structure in the civil service is very compressed. The range of pay between the lowest and the highest ranks in the civil service (the decompression factor) is only about 3 (for base pay).⁸¹ In most OECD countries the decompression factor is in the range of 5 to 10, with an average of 7. When Ukraine's relatively low average salary levels are combined with the opportunities for rent seeking that come with higher grade positions, incentives for corruption become an acute issue. A significant increase in pay progression in Ukraine should be linked with cashing out most benefits and increasing the share of basic pay in the total remuneration. This would increase incentives for increased productivity. This can be financed through the restructuring of public sector employment consistent with operational efficiency. To achieve this goal the government needs to revise and streamline institutional procedures and develop a new, analytically underpinned, remuneration system.

Pensions

3.17 The main driver behind the high growth of current (and total) expenditures is a rapid increase in pensions. The current level of pension expenditures is one of the highest in the world (see Figure 3.5), and is draining resources from other programs and uses. Along with the increasing need to cover the Pension Fund deficit (1.1 and 3.8 percent of GDP in 2004 and 2005, respectively), regular budget transfers to the Pension Fund grew to cover the gaps in resources generated by the expansionary spending policy in pension-related programs.⁸² Chapter 4 of this report provides a set of recommendations to improve the fiscal stance of the pension system and to generate sufficient savings for the successful implementation of the Government Pension Reform Strategy.

⁷⁸ These factors include: the attitudes of superiors, the availability of vacancies (extra vacancies are obtained for topping up salaries since budget allocations are based, in part, on norms per position), and cash reserves for bonuses.

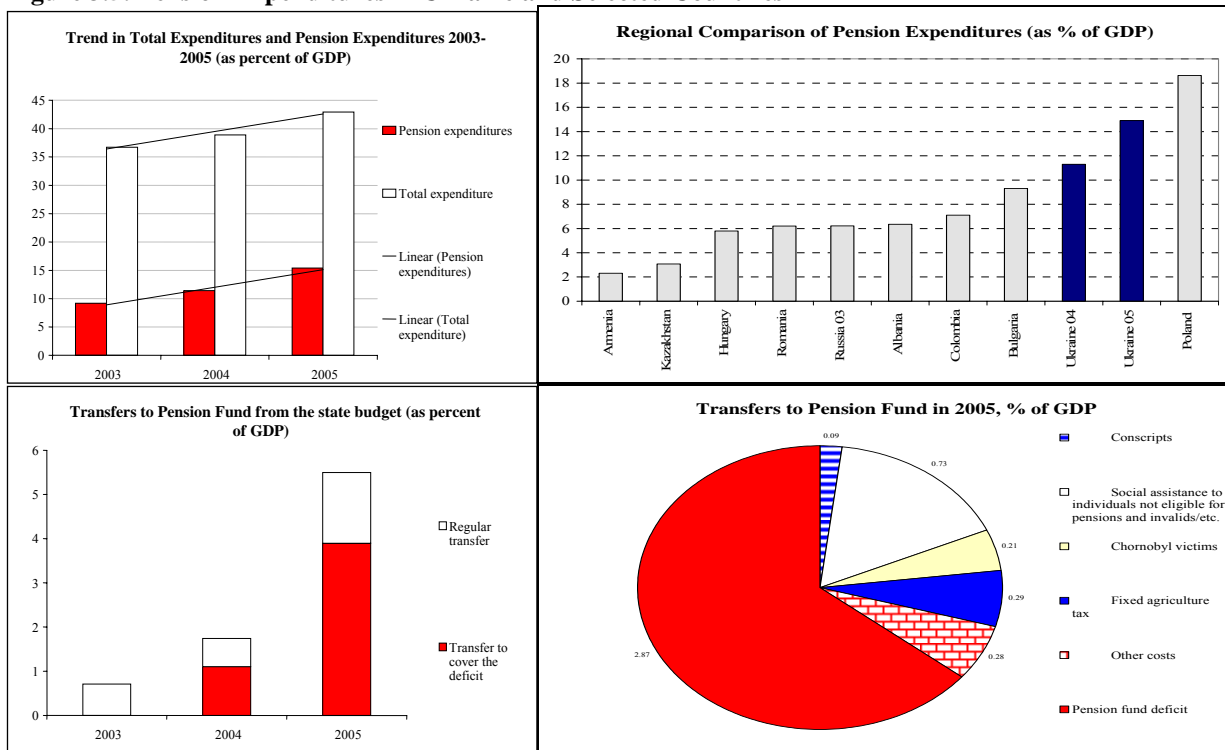
⁷⁹ This is just a rough estimation and more analysis is needed in the near future to determine the effect of the legislation more accurately.

⁸⁰ One example is the issue of assets in return for public service. For example, many civil servants are promised apartments if they serve for either a specified or an unspecified period of time. Apart from the lack of transparency of such arrangements, they create compromising situations for those involved.

⁸¹ The new Government Resolution of March 9, 2006 essentially preserves the same pay progression.

⁸² For example, this is to cover the gap created by the social insurance collection program in the agriculture sector. Agricultural producers pay the fixed agricultural tax (FAT), which substitutes for various taxes, including contributions to the social insurance funds. Before 2005, agricultural producers did not contribute to the Pension Fund and the Pension Fund losses were to be fully compensated from the budget. In 2005, agricultural producers started to pay 20 percent of the regular rate. The rate remains the same for 2006 and will gradually be increased to 40 percent in 2007 and to 100 percent of regular contributions in 2010 (the same rate as that for non-farm employees).

Figure 3.5: Pension Expenditures in Ukraine and Selected Countries



Sources: IMF, OECD, WB regional fiscal dataset, Pension Fund of Ukraine.

Utility Subsidies and Housing Allowances

3.18 Success in poverty reduction helps to contain expenditures on utility subsidies and housing allowances. As incomes have increased and poverty has fallen, subsidy expenditures for utilities have decreased as fewer households have sought assistance. This is a natural benefit of targeted social assistance programs; the energy price safety net is provided only to households whose utility expenditures are 20 percent or more of income, as evaluated through the program's administration. Nevertheless, the total program is still transferring about 1.4 percent of GDP in subsidies to vulnerable households, out of which about 0.8 percent are subsidies to the population for utilities.

3.19 With the rise in energy prices, and expected further increases (particularly on gas), the program on utility subsidies for households will increase its expenditures. In order to avoid an inefficient hike in subsidies, reforms such as better targeting to poorer population are urgent and necessary. These reforms also involve the integration of appropriate incentives in energy efficient use throughout the system.

3.20 Further increases aimed at cost-recovery tariffs across housing and communal services are recommended as a basis for efficiency in the choices of energy users, incentives to encourage service operators to invest in maintenance and new capital, and the overall preservation and operations of the system. In the light of natural gas price increases and the existing large quasi-fiscal transfer already represented by energy-related tariff structures, the National Energy Regulatory Commission has announced a 25 percent electricity tariff increase effective May 1, 2006. Further increases are expected throughout the next few years. This is a welcome step in the direction of cost-recovery and the efficiency of the system.

3.21 **At the same time, moving tariffs toward cost-recovery will have a poverty impact, and the budget will need to factor in the financing requirements for targeted safety net programs.** The payoffs for improved targeting and more efficient program administration will rise along with the costs of energy inputs. Research should be undertaken to estimate the potential poverty impact of energy price increases based on Ukraine's Household Budget Survey data. This has already been done for other countries in the region, such as Moldova, and is a particular area in which World Bank assistance may be useful. Initial estimates from consultants to the Ministry of Labor and Social Protection (MoLSP)⁸³ indicate that a doubling of all utilities prices in 2006 would require UAH 8.6 billion to be spent on subsidies to the population for utilities, out of which UAH 2.5 billion would have to be allocated for targeted housing allowances. However, the same consultants indicated that if the government were to substitute privileges with a targeted housing subsidy for all groups of the population, the doubling of all utilities prices in 2006 would require only UAH 3.3 billion.⁸⁴ Also, as is shown in the recent World Bank Poverty Study for Ukraine, utility subsidies, because of their urban/non-poor biases,⁸⁵ are the most expensive means of reducing poverty, followed by pensions. According to these estimates, achieving a 1 percentage point reduction in poverty through utility subsidies would cost about 0.8 percent of GDP, whereas only 0.3 percent of GDP would be required to achieve the same reduction through poverty-targeted social assistance.

Capital Expenditures

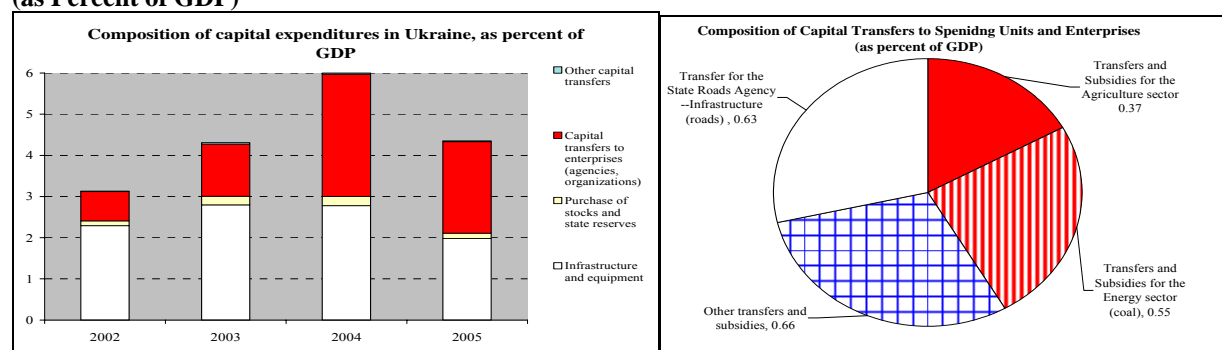
3.22 **Capital expenditures in Ukraine are small and are falling, and an estimated one-third of these expenditures are actually recurrent subsidies.** Despite an increase in total public spending, capital expenditures fell significantly in 2005 (see Figure 3.6). Total capital expenditures, as listed in the budget, represent 4.3 percent of GDP (they fell significantly from 6 percent in 2004). However, just over half of those expenditures (2.2 percent of GDP) are comprised of the category called "capital transfers to enterprises." Under this category, close to 65 percent are subsidies to SOEs, or transfers to spending units of the government (i.e., Ministry of Agriculture, Ministry of Energy) to support programs that in turn provide subsidies to various sectors. In addition, a large portion of these capital expenditures are significantly under-executed. All of these issues add up to the conclusion that public investments are given low priority by policy-makers. Yet every government program in memory has talked about the importance of investments (both public and private) to fostering growth in Ukraine. The remainder of this section focuses on the trends in and composition of capital expenditures in Ukraine. Chapter 5 is focused on examining the processes of planning, formulation, and allocation of capital expenditures, and provides recommendations for improving them.

⁸³ This information was provided by the Center for Social Development in March of 2006.

⁸⁴ Estimates are provided by a team of local experts based on simulations using the HHEIS data.

⁸⁵ The urban bias in utility subsidies is a consequence of the eligibility criterion that combines the utility cost as reported in the bills and reported or estimated income subject to major underestimation. In this way, households in areas with fewer utility services are less likely to qualify for the subsidy because of the lack of objective evidence about the cost of energy. Since 29 percent of the population uses solid fuel, mostly in rural areas, and since they have the highest poverty incidence, utility subsidies tend to exclude the poor. An analysis based on a proxy-means testing (PMT) simulation conducted by the Bank suggests that savings may be found, along with gains in poverty reduction, if utility subsidies were limited to households with a per capita equivalent income below the poverty line, based on PMT criteria, and excluded households comprised solely of working-age adults.

Figure 3.6: Composition of Capital Expenditures in 2002-2005 and Composition of Capital Transfers in 2005 (as Percent of GDP)

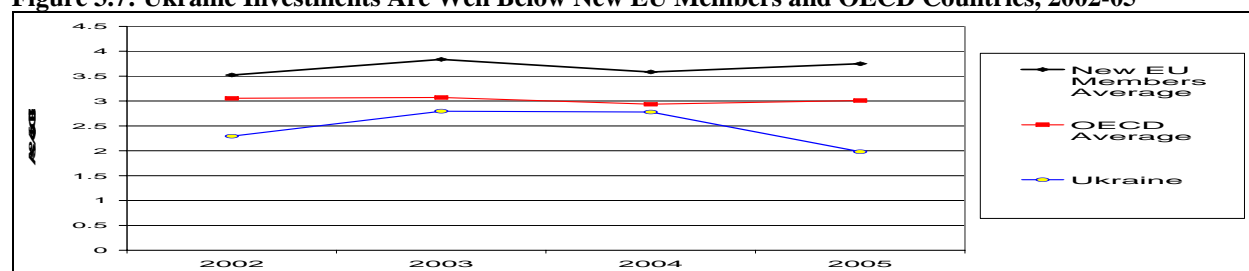


Source: WB staff estimates based on Ministry of Finance and State Treasury of Ukraine data.

3.23 Subsidies hidden as capital expenditures crowd out expenditures for infrastructure and equipment. More than half of the capital budget is spent on transfers to enterprises. Their share in total capital expenditures increased from 22.8 percent in 2002 to 51 percent in 2005, with the major swing between 2003 and 2004 (see Figure 3.6). Less than one-third of this category (capital transfers to enterprises) in 2005 is composed of actual investments, which go mainly to the State Roads Agency. In addition to the misclassification of some of these expenditures, most of them appear to have little justification relative to other resource-constrained programs in the budget. Moreover, they take up fiscal space that could be given to public growth-enhancing investments and/or tax rate cuts. Bank staff efforts to better understand these expenditures were stymied by a basic lack of information. This is an area in which comprehensive close scrutiny by the government would be useful, as significant costs savings may be found at little development cost to Ukraine.⁸⁶

3.24 The actual level of public investments (in infrastructure / fixed capital) in Ukraine is small by international standards. Given the structure of the economy (almost one-quarter of Ukraine's exports are capital-intensive goods) and the large but deteriorating capital stock, capital spending in Ukraine should be expected to be higher than its current level. Ukraine lags behind EU member states and OECD countries in the level of public investments made over the past four years (see Figure 3.7).

Figure 3.7: Ukraine Investments Are Well Below New EU Members and OECD Countries, 2002-05



Source: OECD, Eurostat, State Treasury of Ukraine; Bank staff calculations.

3.25 In addition to being low, the budget provisions for infrastructure and equipment have persistently been under-executed. While the scope of under-execution was being reduced during 2003-05, it still large considering the small size of the budget devoted to this spending category (see the detailed discussion in Chapter 5).

⁸⁶ Indeed, poorly designed subsidy programs create distortions that may actually reduce production in the sectors subsidized, let alone reducing net welfare overall in light of forgone better opportunity use of those funds.

3.26 **The so-called development budget (investment program) for 2006, as in past years, shows a lack of clarity in Ukraine’s strategy regarding growth-enhancing investments.** The 2006 budget not only stipulates an overall decline in capital spending (to below 4 percent of GDP), it also exhibits a more acute bias toward capital transfers, which account for 58 percent of total allocated capital expenditures. One-third of the total increase in the development budget is represented by the increase in food reserves for the agriculture fund, the subsidies in interest rates for coal extraction loans, the subsidized loans for agriculture and the state guarantees for bonds to be issued for the state mortgage institution. Strategic and financially consistent planning in the energy sector in particular is becoming increasingly important, but has yet to emerge.

3.27 **Procurement reform remains a lagging area of institutional change, and recent changes to the Procurement Law put the accountability and efficiency of the system in high jeopardy.** Box 3.1 outlines the recent regression and highlights key steps to address the problem over the short run. The forthcoming Country Procurement Assessment Report prepared by the World Bank in coordination with the Government looks at this in much more detail, and outlines in much more detail both short-term and long-term problems and solutions for improving the procurement system.

Box 3.1: Public Procurement Reform in Ukraine is Off Track

Prior to the latest amendments the MoE Public Procurement Department had the internationally accepted functions appropriate to a government Authorized Agency (AA) in countries with a decentralized public procurement system. These functions included issuing by-laws, providing methodological guidance and support to procuring entities, approving non-competitive procedures, publishing public procurement bulletins, and complaints resolution. After the December 2005 Amendment, the functions of the Public Procurement Department have been diluted and assigned, in descending order of authority, to the Tender Chamber (an NGO), the Special Control Commission (SCC) under the Accounting Chamber, the Accounting Chamber, Parliament, the Anti-Monopoly Committee (AMC), and central executive bodies. The AMC has nominally become the AA, however its role in the complaints mechanism and authorization of non-competitive procedures has been reduced to recording of results. TC appears to be the de facto AA and most of its functions are those of an executive body and certainly are not consistent with that of an NGO. The TC has the right to authorize restricted tendering and single source procurement, issue opinions on complaints, propose improvements to public procurement legislation, and provide methodological guidance. The TC is a non-profit association of NGOs whose goals are to promote the public procurement system and improve its transparency and efficiency. However, there appears to be a close relationship of the TC management with a number of consulting companies in public procurement, including a single company which owns the website that was defined by the TC as the only acceptable one for placing mandatory procurement announcements on the Internet.

The distribution of public procurement functions creates a conflict of interest between the responsibilities of the TC and any commercial interests its members may have, while the responsibility of the Accounting Chamber as the supreme audit institution is not consistent with its involvement in the execution of a process – this essentially means that there is no external audit for the procurement function. Also, the application of the law to state-owned enterprises (state share of more than 50 percent) is inconsistent with the objective that they operate in line with normal commercial practice. The recommendations to resolve the situation with public procurement in Ukraine are the following:

- Revoke or substantially rework the December 2005 Amendment of the Public Procurement Law
- Reconsider the role of the Tender Chamber in public procurement
- Establish an Authorized Agency, which should be independent and accorded the responsibilities and rights normally placed with such a body
- Prevent further development of a monopolized and privatized market for procurement services.

D. ALLOCATION OF BUDGET EXPENDITURES: FUNCTIONAL CLASSIFICATION

Context

3.28 Table 3.2 presents general government expenditures in Ukraine by functional classification for the period 2002-05. This section starts with an overview of trends and issues concerning the major categories of social expenditures (social protection and assistance,⁸⁷ health, education and social privileges), and then discusses the trends and issues with respect to public spending on economic activities (agriculture and energy). The section concludes with a brief analysis of the size and patterns of public expenditures aimed at the improvement of the business climate. Table 3.3 shows the recent expenditure trends for the broad functional classifications in the general budget.

Table 3.3: General Government Expenditures by Function, as Percent of GDP, 2002-05

	2002	2003	2004	2005
General public services	3.8	3.7	3.6	3.7
Defense	1.6	2	1.8	1.5
Public order and safety	2.2	2.2	2.3	2.5
Economic services	3.2	4.6	5.4	4.6
Environment protection	0.3	0.3	0.3	0.3
Housing & community services	0.6	0.7	0.8	0.9
Health affairs and services	3.3	3.6	3.5	3.7
Recreational, cultural, religious affairs	0.6	0.8	0.8	0.8
Education affairs and services	5.4	5.6	5.3	6.4
Social protection and social assistance	14.6	13.2	15.6	19.6
Total expenditure	35.6	36.7	39.4	44.0

Sources: Ministry of Finance and State Treasury of Ukraine; Bank staff calculations (and estimations for 2005).

Social Protection and Social Assistance Expenditures

3.29 **From a functional perspective, the increases in public expenditures between 2003 and 2005 have been dominated by the social sectors.** Throughout the period in question, social expenditures (that is, expenditures on health, education, culture, social privileges, social protection and social assistance) represent the bulk of total expenditures, and have been increasing steadily. The highest increase was registered in 2005, which took spending in social sectors to a record high for the country, and to the highest levels in the region.

3.30 **Social assistance transfers comprise a small and relatively stable share of total social protection expenditures; however, moderate savings could be found by better targeting.** Social assistance transfers are represented mainly by scholarships, family transfers (child benefits), poverty targeted transfers, and unemployment benefits. In 2001, changes in legislation introduced some income-testing criteria for eligibility into these programs. These programs have a relatively low coverage of the population, and two programs—poverty-targeted transfers and family benefits—show a significant focus on low-income populations. Further savings could be achieved by limiting social assistance to social pensioners and families with many children to those whose actual income is below the poverty line on the basis of proxy means testing (PMT) criteria.

Social and Occupational Privileges

3.31 **Expenditure privileges are the rights of certain individuals to receive services and goods at discounted prices.** The rate of the discount ranges from 50 to 100 percent. For example, those with disabilities as the result of war are eligible for free utilities (including gas, electricity, and hot and cold water), regardless of the size of their homes or the number of people living there. Chernobyl victims, on

⁸⁷ With the exception of pension expenditures, which are covered in Chapter 4.

the other hand, are eligible for a 50 percent discount. Telephone bills are discounted by 50 percent for several categories of retirees (for example, those retired from the military services, the fire-fighting services, the police, and other groups). The parents of deceased service personnel are eligible for a 50 percent discount for intercity travel by train, air, ship or bus (but not for intra-city travel), whereas several other categories of people are eligible for a discount of 100 percent for intra-city travel by streetcars, buses, trolley buses, metro systems, ferries, and commuter trains -- or if they live in rural areas, by intra-oblast buses.

3.32 **It is estimated that actual public expenditures for privileges are equivalent to approximately 1.6 percent of Ukraine’s GDP.** But the total cost of these privileges, if they were fulfilled according to the law, is difficult to estimate. The consolidated 2006 budget provides nearly UAH 7.8 billion (US\$ 1.55 billion equivalent).⁸⁸ However, these are only the estimated costs explicitly financed through the budget. When entitled privileged persons execute a privilege (such as to get on a bus and not pay), any associated cost not explicitly covered by the budget becomes an implicit tax on the service provider. As the methods used to finance privileges are imperfect, with errors of overpayment and underpayment, the total cost of the privilege system in Ukraine is not actually known. Table 3.4 provides a breakdown of the budget allocations in 2006 for expenditure privileges, as well as an estimated value per recipient as explicitly financed.

3.33 **There are 13 types of privileges for three categories of the population** (see Table 3.4). The largest expenditure item is “Housing and Utility Services,” costing close to UAH 3.5 billion or 44.3 percent of the total budget for privileges, followed by “Free and Discounted Purchase of Food Products” (UAH 1.4 billion or 18.5 percent of the budget) and “Sanatorium Treatment” (UAH 1.25 billion or 15.9 percent of the budget). These three largest items absorb 78.7 percent of the total privilege budgets. In 2006, additional privileges for individuals born around the Second World War were approved (i.e., privileges for the “children of the war”). The funding of these privileges could raise the spending on this category in 2007.

Table 3.4: Type of Privileges and Budget Allocation for 2006 (in millions of UAH)

Privileges by type of services	Special Merit Based	Social Characteristics Based	Occupation Based	Total
Housing and utility services	-	2,907.3	565.3	3,472.6
Communication services, installation of telephone and security and alarm system	-	179.2	1.5	180.7
Public transport and baggage handling	21.9	549.7	181.8	753.4
Prescription medicines	192.4	70.4	-	262.8
Dental treatment and prosthesis	-	174.6	-	174.6
Sanatorium treatment	5.7	1,112.3	128.2	1,246.2
Cars to drivers with disabilities	-	84.4	-	84.4
Dwelling repairs	-	13.1	-	13.1
Preferential/subsidized credits and loans	14.7	-	15.0	29.7
Free/discounted purchase of food products	1,445.4	-	-	1,445.4
Compensations for special categories of individuals	115.4	-	2.6	118.0
Other	-	-	52.0	52.0
Total	1,795.5	5,091.0	946.4	7,832.9

Source: “Analysis of Special Privileges in Ukraine”, background paper prepared by Anna Nechai.

⁸⁸ The cost estimate (UAH 7.8 billion) is based on the consolidated budget for 2006. An estimated GDP for 2006 of UAH 480 billion UAH has been used for the calculation.

3.34 **Approximately one-quarter of the Ukrainian population enjoys some kind of privilege.** Annex 3.1 summarizes the categories of privileged populations in Ukraine. The 58 different categories of privileged populations outlined in the Annex may be grouped into three major types: (i) those with special merits (e.g., accomplishment/recognition gained in conjunction with major historical and political events; approximately 760,000); (ii) those with certain social characteristics (approximately 10,500,000); and (iii) those with certain occupations (approximately 900,000).

3.35 **In 2005, the Ministry of Labor and Social Policy (MoLSP) established a unified registry of privileged individuals.**⁸⁹ This was a major step forward and reflected the government's serious intent to reform the system of privileges. However, this unified registry is still incomplete because it covers only the second category of privileged populations (social characteristics based). The special merit based and occupation based categories are not entered in the unified registry. Their numbers can only be roughly estimated by cross-checking the registry of different service providers, not all of whom keep complete and audited records of the use of privileges.

3.36 **Privileges are de facto administered by service providers.** Privileges in the Ukrainian context are not direct cash subsidies to individuals and households. To exercise a privilege, an individual must first be certified by a government entity defined by a legal instrument that provides for a specific type of privilege. For example, a retired military serviceperson with disabilities must obtain a special certificate of eligibility for certain privileges. A teacher living and teaching in a rural area must obtain a certificate of her/his status from the local education department.

3.37 **Once the certificate is obtained, the eligible individual must register with the service providers.** For example, the widow of a deceased victim of the Chernobyl accident is eligible for a 50 percent discount in rent, hot/cold water, natural gas, electricity, garbage collection, wastewater disposal and telephone service. She will have to register with each of the service providers separately – there is no one-stop shop. Service providers, upon her registration, start billing her at a discounted price.

3.38 **Service providers, not the population with the privileges, receive the public funds.** In terms of the flow of funds, explicitly financed privileges take the form of advance payments to the service providers from the government. These service providers receive payments from either the central government or local governments, depending on the type of privilege. The amount is determined largely on the basis of the historical figures, namely, the actual amount of exercised privileges during the previous year.

3.39 **As a result, the service providers may be either under-compensated or over-compensated by public funds.** In the case of under-compensation, the service provider may attempt to recover the loss by raising tariffs and/or reducing the quality of services. Since many of the tariffs are fixed by regulation, such as those for utility providers, a reduced quality of services is often the default financing mechanism, typically through reducing maintenance costs and/or not making needed physical investments. In either case, the non-privileged users of the services and taxpayers are paying for the services received by privileged individuals. In the case of over-compensation, public funds end up as de facto subsidies to the service providers.

3.40 **Mechanisms to see if service providers are under-compensated or over-compensated are either nonexistent, or do not function well.** In cases where service providers are overcompensated, it is natural that their tracking may be weak or nonexistent (see Box 3.2). Furthermore, auditing systems are generally weak in Ukraine, and therefore it is difficult to ascertain whether the service providers are correctly declaring the cost of honoring privileges.

⁸⁹ Unified State Automated Register of Individuals Eligible for Privileges Based on Social Characteristics.

Box 3.2. An Example of Cost Tracking

A pilot study was carried out by a private transport provider in one of Ukraine's largest cities. This firm was interested in monitoring the use of services by passengers with privileges. They installed electronic card readers in their vehicles, and provided card passes to the passengers with privileges. The study showed that the actual cost of honoring privileges was only 54 percent of the funds which this firm had received from public sources to cover the cost of privileges. Naturally, the experiment was discontinued.

3.41 The privilege system's built-in cost control mechanisms are weak. Service providers have practically no incentives to control the cost of privileges because they have guarantees for loss-recovery (either through public funds or increased tariffs) and they often do not receive strict audits. From the point of view of privileged persons, incentives to ration the use of privileges are practically non-existent, particularly when the discount rate is 100 percent.

3.42 The legal foundation for privileges is complex and makes reforming the system challenging. The legal framework for privileges consists of over 60 instruments (see Annex 3.1). There are 43 laws, two presidential decrees and 16 decrees of the Cabinet of Ministers that have entitled people to privileges, as well as decrees and normative acts issued by the Cabinet of Ministers and local authorities. Many of these legislative acts were established under the Soviet Union. However, after its independence in August 1991, Ukraine introduced 26 legislative acts and expanded the provision of privileges. This extremely complex legal framework grants various types of privileges to 58 different categories of persons.

3.43 According to the interpretation of the Constitutional Court of Ukraine, Article 22 of the Constitution prevents any reduction of the existing rights on the adoption of new social legislation.⁹⁰ Unless this decision is adjusted, the reform of special merit-based privileges appears practically impossible. Means-testing, for example, apparently cannot be introduced for privileges under this category without violating the article. The Constitutional Court also made a judgment that limiting occupation-based privileges only to the "minimum subsistence" level (UAH 365 for 2003 and UAH 386.7 for 2004) -- a measure established with respect to the 2003 and 2004 state budgets -- was unconstitutional.⁹¹ For 2005 and 2006, the government replaced the minimum subsistence level based limitations with a salary cap, but this measure is also under threat of being declared unconstitutional. The fact that some privileges are essentially unfulfilled entitlements (e.g., invalids on a perpetual waiting list for a free car) appears not to have been considered on a constitutional basis. Privileges based on social characteristics are based on either laws or decrees of the President and/or the Cabinet of Ministers. It is constitutionally possible to eliminate these privileges, but political considerations make such reform unpopular in the absence of consultation and explanation, especially about who is actually paying the bills for the privilege recipients.

3.44 Confusion exists among privileges, employment benefits, social protection and loss/damage compensation. Existing sets of legislations and registries create confusion because they do not differentiate the purposes of providing privileges. It is possible that, owing to this confusion, debates over the system of privileges have been unnecessarily politically and emotionally charged. Moving forward, it

⁹⁰ Article 22 declares: "Human and citizens' rights and freedoms affirmed by this Constitution are not exhaustive; Constitutional rights and freedoms are guaranteed and shall not be abolished; and the content and scope of existing rights and freedoms shall not be diminished in the adoption of new laws or in the amendment of laws that are in force."

See <http://www.rada.gov.ua/const/conengl.htm>.

⁹¹ The 2003 and 2004 laws of the state budget established that privileges for selected categories of personnel would be provided: (i) within the budgetary allocations to their institutions; and (ii) only up to the gap between their income and the minimum subsistence level.

would be better if they were based on rational examination of the following: (i) the societal merits of providing certain benefits to certain group of the population, (ii) the form of benefit provision that would be most adequate, and (iii) whether the costs justify the perceived benefits on a welfare basis, given that all privileged recipients have to be financed by other service users, service providers and/or taxpayers.

3.45 Conceptually, the Ukrainian system of privileges consists of four different types of target populations. *The first group* includes those who have earned a distinguished status by having made positive contributions to the society in the past. About half of the categories under “Special Merit” and some under “Social Characteristics” (see Annex 3.1), namely, Heroes of Ukraine, Heroes of the Soviet Union and Heroes of the Socialist Labor, War/Military Veterans, and Labor Veterans would belong to this type. *The second group* includes those who have certain types of occupation that are considered to make positive contributions to the society at present. This group includes most of the categories under “Occupational Characteristics.” Privileges for this group should be considered as employment benefits and provided within the context of employment contracts. This needs careful consideration in the context of overall public employment pay reform, as judges, for example, receive several privileges but may not receive salaries consistent with their responsibilities and purview. *The third group* includes those who are exposed and vulnerable to negative shocks (poverty, illness, etc.) at present and require protection. These include some categories under “Special Merit” and “Social Characteristics,” including those with disabilities regardless of the cause, orphans, families with many children and certain types of pensioners/retirees. Consequently, privileges for this type of population have strong characteristics of social protection. Finally, *the fourth group* consists of those who sustained damage or losses in the past. Some are under “Special Merit” (those with disabilities as a result of war, Chernobyl victims Category I) and others are under “Social Characteristics” (for example, Chernobyl victims Category II, pardoned people and their survivors, widow(ers) of military veterans, spouses of service persons missing in action and their children, and parents of deceased service persons). Privileges for this type of population should be regarded as loss/damage compensation.

3.46 Past attempts to address this problem have not been successful or sustainable. But over the years progress has been made in understanding the problem and proposing some aspects of a solution. Looking ahead there are opportunities for success through a comprehensive and stepwise process of measures, including consultation with the public as various actions are taken. Assuming that the decisions of the Constitutional Court would not be reconsidered, the following strategy might present a workable solution:

(a) **The grandfathering of existing privileges could be secured.** With Article 22 of the Constitution, and with political pressures, it would be difficult to eliminate or reduce the benefits provided to the existing privileged population. Consequently, any reform effort in the future could be based on the principle that the benefits to the existing population with privileges would not be subject to future reform in most cases. At the same time, there should be a clear commitment not to introduce new, un-targeted privileges outside the social assistance framework.

(b) **There should be a clear separation of the purpose of providing the privileged benefits at the outset, and then the legal framework and record-keeping systems should be reorganized accordingly, to establish clear eligibility criteria.** As part of this task, the *Single Automated Register of Individuals Eligible for Privileges* should be made comprehensive and operational. As discussed above, the current system of privileges (the legal framework and registries) does not provide a framework for debating the societal merit of providing special benefits to selected groups, or the form that these benefits should take. At minimum, work-related benefits should be provided only within the framework of employment contracts. And those benefits with strong social protection characteristics should be provided and administered within the legal and administrative framework of social protection, with clear eligibility criteria.

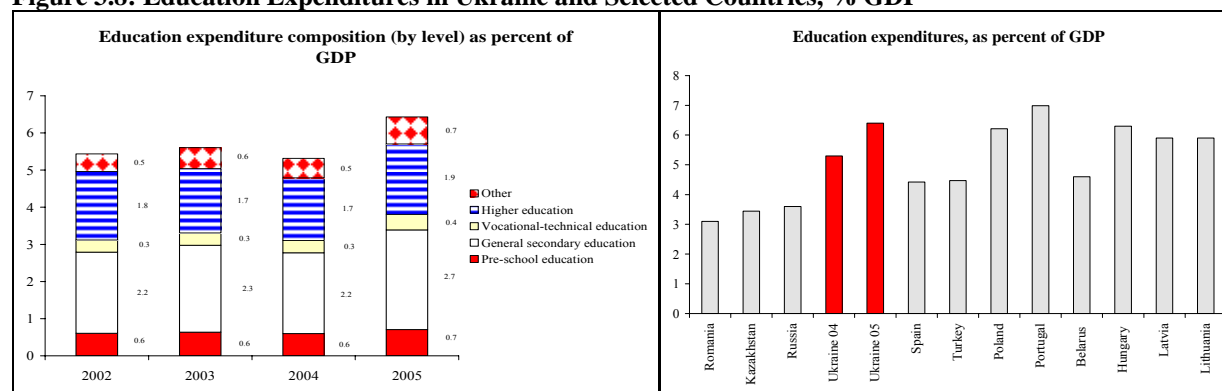
(c) **The flow of funds should be shifted from “government to service providers” to “government to beneficiaries,” while avoiding the provision of in-kind compensations.** As discussed above, the current flow of funds provides little or no incentives for expenditure rationalization. Shifting the flow of funds to the beneficiaries, possibly with a ceiling on the total combined benefit amount, is likely to result in a more efficient spending of public resources.

(d) **If the shifting of the flow of funds is too difficult to accomplish in the short term, a system could be adopted in which service providers were compensated only on the basis of the service actually provided; the system would be evaluated by periodic sample-based audits.** As discussed above, service providers may be over-compensated or under-compensated. For metered services (such as gas, electricity, and water), determining the amount of compensation to the service provider should be straightforward. For transport services and sanatorium use, the government could provide beneficiaries with vouchers of a certain cash value, and the service provider could be compensated on the basis of the vouchers surrendered. In any case, it would be important to audit service providers to ensure that compensation is aligned with costs.

Education Expenditures

3.47 **Education expenditures increased to 6.4 percent of GDP in 2005, after recovering from relatively low levels during the period of economic contraction.** As is seen in Figure 3.8, the level of educational spending in Ukraine is the highest in the selected sample of countries (except for Portugal) and is similar to that in Poland, Latvia and Lithuania. These figures exclude side-payments (in cash and/or in kind) by parents to teachers and education institutions. Thus, the overall expenditures as a ratio of GDP are higher

Figure 3.8: Education Expenditures in Ukraine and Selected Countries, % GDP



Sources: IMF, OECD, WB regional fiscal dataset, Ministry of Finance and State Treasury of Ukraine.

3.48 **The increase in educational current expenditures was not accompanied by increases in their capital component.** The large and increasing share of the budget spent on wages and utility expenditures leaves little room for other education-enhancing inputs such as textbooks and other goods and services. Recurrent spending represents about 90 percent of total education expenditures from the state budget and an even higher share of local budget expenditures (the shares vary by local government). Allocations for instructional materials and teacher training, which are essential to ensure quality of learning, are severely limited. Moreover, investments in the maintenance and repair of educational facilities are desperately needed, and the share of capital outlays in total education spending is low and declining.

3.49 **Ukraine shows signs of inefficient operations in the provision of education.** The average student/teacher ratio is close to 11, one of the lowest levels in Eastern Europe. On top of that, the non-teaching to teaching staff ratio is high at 2 for pre-schools and general education schools. Together, these

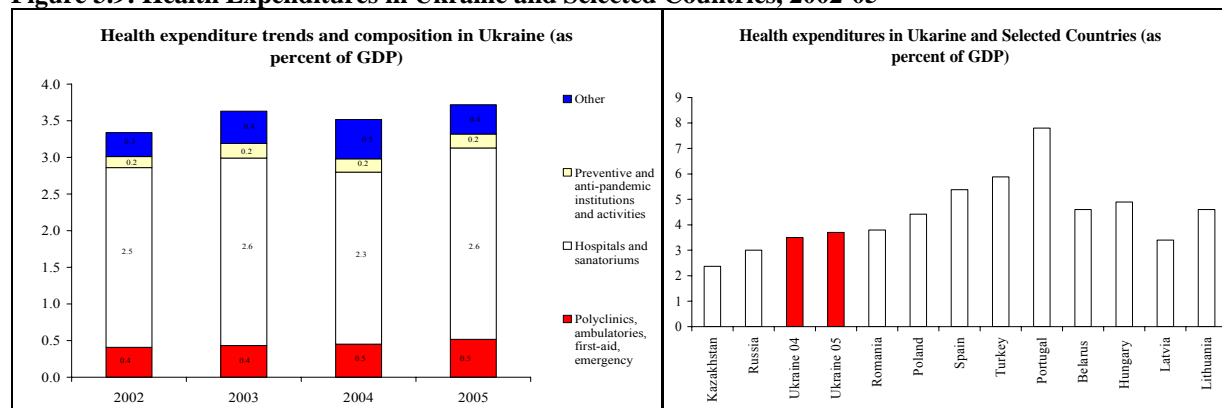
employment ratios are a clear sign of inefficiency. When this information is combined with the average salary of teachers, which is 83 percent of the official average salary in the economy at a point in Ukraine's history when human capital development is absolutely crucial, it becomes clear that employment and pay changes need to be part of Ukraine's education reform program. Extremely low student/teacher ratios, low levels of the utilization of educational facilities, and overall overstaffing are obstacles to efficient spending in this area. One of Ukraine's comparative advantages is its highly and broadly educated population. The development and implementation of an education reform program within a realistic priority allocation of financial resources appears to be a crucial area for the enhancing of Ukraine's human capital competitiveness.

3.50 Some of the inefficiencies seem to arise from dysfunctional links among financing, administration, and regulation in the education sector. Fiscal decentralization has brought about several positive changes. However, this reform is incomplete, and there are several obstacles that impede the realization of its benefits.⁹² In the education sector, owing to the Ministry's guidelines on norms and staffing needs, and to the large network of facilities, local governments have rigid budgets that are mostly hijacked by recurrent spending on wages, salaries, and heating. This perpetuates the inefficiency. The second phase of the PFR is intended to focus on this issue and related issues in more detail.

Health Expenditures

3.51 Public health expenditures as a share of GDP are moderate by international standards. Public financing for the health sector has increased marginally since 2002 and reached 3.7 percent of GDP in 2005 (see Figure 3.9). Private spending (formal and informal out-of-pocket expenditure) is high; estimates suggest that it may be as high as formal expenditures.⁹³ Thus, total health expenditure at least in the range of 5-6 percent of GDP, and is thus comparable to other countries of the same income level in the region. The relatively high share of out-of-pocket expenditures, however, suggests the existence of financial barriers in accessing health care, especially for lower income groups.

Figure 3.9: Health Expenditures in Ukraine and Selected Countries, 2002-05



Sources: IMF, OECD, WB regional fiscal dataset, Ministry of Finance and State Treasury of Ukraine.

3.52 Inefficiencies in the provision of health are acute. Ukraine inherited an extensive hospital infrastructure and staffing system. Most of the limited resources are being spent on staff salaries and utilities (on average, between 80-90 percent). This leaves little room for needed supplies, adequate

⁹² In particular, the fiscal and administrative aspects of the intergovernmental fiscal framework and sector regulations do not provide the right incentives for raising official revenue collection at the local level for performing the same tasks (namely, producing the same outputs) with fewer resources (in terms of staffing and network).

⁹³ These include informal payments to professional health staff, self-provision of supplies and medicines and in some cases equipment, and the excess opportunity cost of under-utilized real-estate and other assets.

equipment, maintenance, and repairs to deteriorated infrastructure. The Ukrainian health care system is hospital centered, which consumes over 70 percent of public health spending. The number of hospital beds per 100 000 population is 716; this is 30 percent over the EU-10 average. The average length of stay (ALOS) in Ukrainian hospitals is 12.3 days (one of the highest in the region) compared with 7.5 for the EU-10 in 2003. This suggests considerable overcapacity in the hospital sector and significant efficiency gains to be made from preventive medicine and the adoption of modern ambulatory care based treatment modes. It is worth noting that the value of real estate, especially in city centers, and other freed up resources stemming from downsizing and improving health facilities could be indirectly used to finance the reform and improved delivery of health services.

3.53 Incentives in the current health financing system are not yet geared towards efficiency. The public health financing system is fragmented, combining funding on different levels of local government with vertical programs between local and national budgets and national institutions funded by the state budget. Providers are mostly paid by norm-based line-item budgets, which do not motivate cost-saving measures or improvements in service delivery.

3.54 In recent years the equalization formula in the intergovernmental fiscal system has been backsliding, with the reconsideration of input-based norms. In the 2000 budget, a first stage intergovernmental reform was introduced that integrated objective criteria for financial allocation based on local incomes and demographics. However, starting in 2004, health expenditure allocations again began to be dispensed on the basis of input, as opposed to output-based norms (for example, number of hospitals, number of hospital beds). The second phase PFR will therefore focus in more detail on this and related issues.

Agriculture Expenditures

3.55 Expenditures on agriculture have been increasing as a share of total spending and as a percent of GDP. In 2005, fiscal support to agriculture, including tax expenditures, reached 2.5 percent of GDP, as compared to 1.8 percent in 2002. The share of expenditures on agriculture in total spending increased from 6.7 percent to 8.6 percent during this period and accounted for almost a quarter of all budget spending on economic activities in 2005. The 2006 budget allocates about 2.3 percent of GDP to agriculture. Actual support to agriculture is even higher if non-fiscal support measures are taken into account.⁹⁴

3.56 International comparisons suggest that Ukraine's fiscal support to agriculture is high. The share of agricultural expenditures (including tax expenditures) in GDP (adjusted by the size of agriculture) in Ukraine is above most middle-income countries and even higher than in some high income countries such as Australia (see Table 3.5). An interesting benchmark in this area is Brazil. This country increased its agricultural exports from US\$6 billion in 1993 to US\$17 billion in 2003, mainly by exporting more agri-food of high quality at competitive prices, but with low support and subsidies from the government.⁹⁵

⁹⁴ In addition to explicit budget measures, agriculture is supported by, at least, the following: (i) import tariffs; (ii) sugar quota, (iii) support of grain prices through pledge and intervention purchases, (iv) benefits from the low interest rate for machinery leased from UkrAgroLeasing, and (v) agreements with supply companies to provide fuel and fertilizers at lower than market prices. The annual value of these subsidies is estimated to have been at least UAH 1 billion on average during 2000-05 and around UAH 2 billion in 2005 alone.

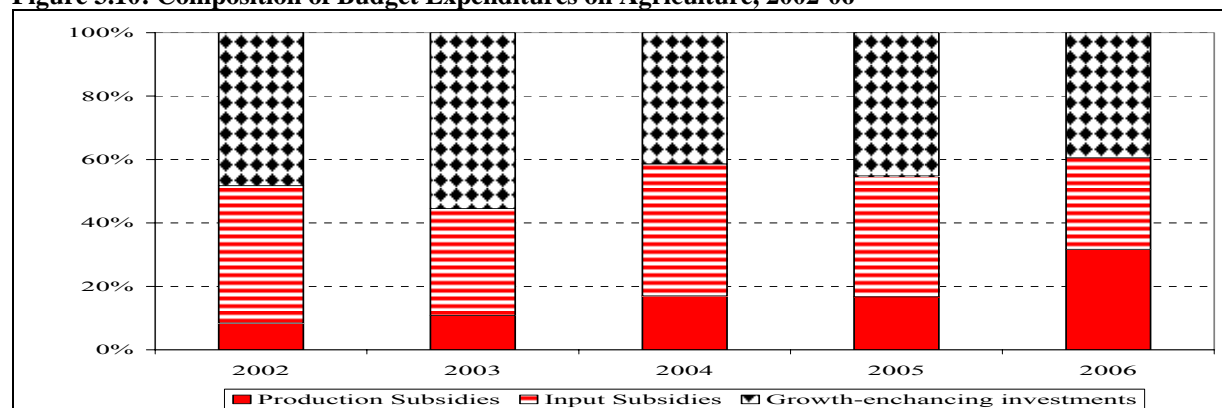
⁹⁵ According to Tangermann, *OECD Work on Agricultural Policies in Brazil, China, India and South Africa*, in the Presentation at the Rural Week of the World Bank, 2006, the gross agricultural output in Brazil almost doubled between 1989 and 2003, while the farm support level during 2000-03 was a low 3 percent of the farm gross income and 0.7 percent of GDP.

Table 3.5: International Comparison of Expenditures in Agriculture

Countries	Agriculture Sector Value added to GDP	Public expenditures for agriculture (including tax expenditures) a percent of GDP	Public expenditures for agriculture as percent of GDP- Adjusted for the size of agriculture in the country
	A	C	C/A
Ukraine (total fiscal expenditures, including VAT expenditures)	11.60%	2.10%	0.18
Higher-income countries			
Australia	3.00%	0.31%	0.1
Canada	2.30%	0.51%	0.22
EU	2.30%	0.65%	0.28
USA	1.60%	0.73%	0.46
Middle-income countries			
Turkey	13.00%	2.00%	0.15
Mexico	4.00%	0.70%	0.18
Venezuela	5.00%	0.50%	0.12
China	15.00%	1.20%	0.08
Brazil	9.30%	0.70%	0.08

Sources: OECD (2004), World Bank (2005) and Tangermann (2006).

3.57 During the period 2000-05, fiscal support to agriculture was increasingly dominated by subsidies, including plain budget subsidies and tax expenditures -- the latter concentrated particularly in the VAT system (see Chapter 2).⁹⁶ In 2005, total agricultural subsidies increased to 1.7 percent of GDP from 0.7 percent in 2000. Subsidies financed from both VAT and budget expenditures supported inputs and production, especially for livestock production and meat and milk processing. The share of subsidies in total budget spending on agriculture was 55 percent in 2005 and is expected to increase to 60 percent in 2006 (see Figure 3.10). Input subsidies were used to lower the costs of selected inputs (for example, fertilizers, machinery and credit) and of farm labor, through the financing of Pension Fund compensations as a result of the Fixed Agricultural Tax (FAT).⁹⁷

Figure 3.10: Composition of Budget Expenditures on Agriculture, 2002-06

Source: WB staff calculations on Ministry of Finance and Ministry of Agriculture data.

3.58 Despite the significant public expenditures received, the Ukrainian agricultural sector performs below its potential. In 2005, the output of the large agricultural enterprises was only 30 percent of the level in 1990, despite the fact that they operate on around 70 percent of total agricultural land. The agricultural production level is extremely dependent on weather conditions because of the lack

⁹⁶ Chapter 2 (section E) provides a detailed discussion of the inefficiencies and inequities generated by VAT expenditures for the agriculture sector in Ukraine.

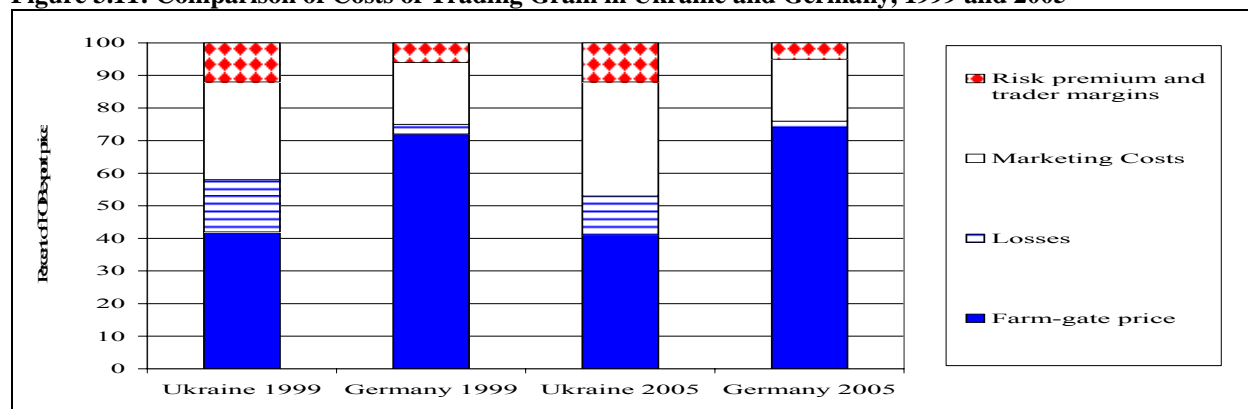
⁹⁷ See Chapter 2 for a discussion of the Fixed Agricultural Tax.

of modern farm production technologies and poor farm management. Crop yields and livestock productivity remain low, and around 50 percent of large agricultural enterprises are loss-making. Indeed, 15 years into the transition, Ukrainian agriculture still faces numerous structural challenges.

3.59 Subsidies have had little impact on agricultural efficiency. Most subsidies have suffered from unequal in-year allocations, and lack of transparency in the eligibility criteria and the selection processes. The efficiency of both budget allocations and VAT expenditures continues to be judged by the government through observed changes in nominal output or input use, while the level of attention to changes in agricultural productivity and farm incomes, as a result of specific government programs, remains low. In the end, most subsidies are encouraging the higher production of targeted products or increasing the use of subsidized inputs, but they are not necessarily supporting the investments that are urgently needed to increase farm competitiveness.

3.60 Public spending on agriculture takes place in an environment in which subsidies and regulations offset each other. As described in the joint study by the World Bank and OECD, taking various administrative and trade distortions into consideration, total market price support was negative in Ukraine - farm-gate prices are typically depressed below reference border prices.⁹⁸ As a result, the significant public transfers from the budget to the farms merely compensate farmers for these low prices, which are significantly the result of government policies. Border policies and behind the border policies are the key factors depressing agricultural prices and squeezing farm profitability. Policy measures at the border, such as the export taxes on oilseeds and live cattle, directly reduce farm-gate prices. In addition, ad hoc domestic market interventions, such as controls on prices and margins for grain, meat and other products, restrict inter-oblast movements of agricultural commodities, raise marketing costs, reduce competition, increase transaction costs, and discourage private investment. Investment and entrepreneurial incentives, combined with support services, land reform and a further opening of input and output markets, are the factors which can most effectively lead to sustainable productivity and output increases.

Figure 3.11: Comparison of Costs of Trading Grain in Ukraine and Germany, 1999 and 2005



Source: WB staff calculations on Ministry of Finance and Ministry of Agriculture data.

3.61 The program of interest rate subsidization through the budget should be phased out. During 2002-04, the budget for this program was relatively moderate, on average UAH 120 million, but it increased to UAH 350 million in 2005. Under the 2006 budget, UAH 260 million (or 0.06 percent of GDP) will be allocated for this program. The program should be replaced by a set of measures to reduce the risks of crediting agriculture, to improve the agricultural collateral base, and to increase the capacities

⁹⁸ World Bank and OECD, "Achieving Ukraine's Agricultural Potential: Stimulating Agricultural Growth and Improving Rural Life, OECD and the ESCCD", Europe and Central Asia Region, the World Bank, 2004.

of farmers, through training and consultancy, to increase access to credit from commercial banks on commercial terms.

3.62 The programs intended to ease farmers' access to agricultural machinery failed to accelerate the technical modernization of the agricultural sector. Over the years, the government has allocated substantial budget resources to programs aimed at increasing the supply of domestic machinery and reducing the costs of this machinery to farmers through a state financial leasing company which is itself subsidized (UkrAgroLeasing),⁹⁹ since is partially compensated for machinery costs from the budget, and since it has been given exclusive rights to seize all farm equipment for which credits were defaulted and state guarantees called.¹⁰⁰ Two of these agricultural machinery programs alone cost the budget almost 0.1 percent of GDP (UAH 1.4 billion) during 2002-05 and accounted for 18 percent of total input subsidies. Despite the greater supply of domestically manufactured agricultural machinery and equipment, farmers continue to purchase foreign machinery because of its better price-quality characteristics (e.g., more efficient fuel usage). Financial leasing through UkrAgroLeasing has not functioned well, and arrears for purchases of foreign machinery have mounted, reflecting the essential failure of the program.

3.63 To capture agriculture's full growth potential, the government faces three key policy challenges. First, it needs to create the conditions for an investment enabling environment in agriculture. Second, it needs to shift away from market-distorting measures that undermine the long-run competitiveness of the sector and focus its fiscal resources on resolving the structural constraints faced by agriculture and rural areas. And third, it should improve the quality of growth-enhancing support programs to meet the evolving needs of private agriculture and the food processing sector.

3.64 Currently, the share of growth-enhancing investments in total budget expenditures is small and is not performing well owing to lack of attention. The share of growth-enhancing investments in total budget spending on agriculture increased somewhat in 2005 from the low level in 2004, but it did not recover to the levels of 2003-04. The 2006 budget stipulates a reduction in the share of growth-enhancing investments. At the same time, their impact (especially for investments in agricultural education and training, research and development, crop selection and livestock breeding, and the public food safety and quality system) was very moderate, reflecting weaknesses in the way in which these potentially important support programs were being financed, managed and implemented.

3.65 Policymakers in Ukraine should focus on improving the effectiveness and also the nature of public spending on agriculture rather than on increasing its level. There is a strong justification for public spending to overcome policy and institutional challenges and to stimulate agricultural growth. Cross-country evidence suggests that public expenditures on growth-enhancing programs such as agricultural research and development, extension services, education, rural infrastructure, food safety, and rural development – are among the most important drivers of agricultural growth and competitiveness. Moreover, supporting agriculture through growth-enhancing investments is fully compliant with the WTO.¹⁰¹

3.66 Thus, the government's support to agriculture should shift away from the current fiscal subsidies and towards competitiveness-enhancing programs. As subsidies are phased out, the fiscal savings can be reinvested in the provision of investment support and public goods in order to ease the sector's structural problems and enhance rural development. In doing this, the budget could save up to 1

⁹⁹ For example, UkrAgroLeasing was given exclusive rights to seize and lease all agricultural equipment purchased in the 1990s with a state guarantee on which 90 percent of the borrowers defaulted and on which the state guarantee was called.

¹⁰⁰ A more effective approach would have been for the Ministry of Finance to hold a tender or auction for the right to cease and resell, or lease, these machines.

¹⁰¹ These types of investments fit within the so-called "Green Box," and do not figure into distortion support calculations.

percent of GDP, even while increasing its support to such growth-enhancing investments as R&D, disease control, and WTO readiness programs.

The Energy Sector

3.67 Budget expenditures on the energy sector have declined but still remain substantial. After the continuing increase both in nominal terms and as a share of GDP during 2002-04, expenditures on the energy sector fell in 2005 by 0.4 percentage points (a 14 percent decline) to less than 1 percent of GDP.

3.68 Very little is spent on research and development in the sector. Over a long period, explicit budget expenditures for the energy sector were mainly concentrated in the coal industry, whose share in total budget expenditures for the energy sector was as high as 98 percent (in 2002). Starting from 2003, the construction of power plants became another competing priority for state support, taking 15 percent of total budget outlays for the energy sector in 2005. About 1 percent of the energy sector budget outlays have been allocated for R&D.

3.69 Budget expenditures for the sector have been dominated by subsidies to the coal industry. Over the years, the overwhelming bulk of these subsidies has gone to three categories: (i) restructuring or mine closures and the associated mitigation of the social and environmental impacts of these closures (on average, about a quarter of the total during 2002-05); (ii) production support or partial coverage of the gap between prices and production costs (on average, 30 percent in total during 2002-05); and (iii) technical re-equipment or broadly defined “investments” (on average, about 40 percent in total during 2002-05).

3.70 The government should clarify the fact that the subsidy scheme is temporary and will be phased out as the coal sector is allowed to make a transition to a pricing structure that reflects the true economic value of the coal it produces. The current system of allocating subsidies to cover losses arises from the difference between the regulated price for coal and production costs. This creates a perverse incentive to incur (or at least to declare) greater losses in the expectation of receiving a larger subsidy in compensation. At minimum, this deters efficient investments (such as investments to reduce energy input costs), while the lack of a contractual agreement between the subsidy recipients and the provider exemplifies the absence of accountability for the use of funds and its poor results-orientation. In addition, maintaining low prices for steam coal hinders the adjustment of power tariffs. The price for steam coal does not reflect the actual value of the coal. The primary reason for this is to avoid putting pressure on power tariffs, which are highly sensitive to the cost of the fuel used to produce the power.

3.71 Moreover, the coal subsidies need to be re-evaluated in the context of the prices of alternative energy sources. As prices of other sources of energy such as gas go up, coal production acquires a price advantage and producers will increase their profitability. Consequently, the subsidies to this sub-sector should be phased-out rapidly. With this trend in energy prices there is no remaining rationale for budget support to this sector. Moreover, SOEs and companies with partial State ownership in this sector should be subject to higher standards of management, transparency, and financial discipline.

3.72 The protracted process of mine closures adds to the final costs of closure and contributes to social tension. The overall mine closure process in recent years has been almost at a standstill, although privatization of viable mines has accelerated. There continues to be significant financing from the budget which is absorbed by recurring costs at the mines under the slow closure process (the wages of the workers engaged in the closure process which account for about one-third of the recurrent costs,

electricity costs, etc.) and by components that have little or nothing to do with the mine closure process per se, such as the provision of free household coal to former workers.¹⁰²

3.73 Investment subsidies do not contribute effectively to efficient coal production. The bulk of the subsidies for technical re-equipment (investment) is allocated for relatively routine repair and replacement, and dispersed among a large number of recipients. Investment subsidies, if they are to be preserved, should be linked to capital budgets, submitted by the mining companies and approved by the government. This would increase the prospects for funds to be allocated to the investments with the highest returns.

3.74 Quasi-fiscal activities (QFA) in the energy sector have declined but are still large and are driven primarily by price-based cross-subsidies. The implicit costs of QFA in the energy sector fell from 7.4 percent of GDP in 2001 to 4.3 percent in 2005, mainly because of improvements in payment discipline and the eradication of the barter trade. Mis-pricing, however, especially in the gas sector, remains the main contributing factor. QFA because of mis-pricing in the gas sector, increased from 2 percent of GDP in 2002 to 2.8 percent in 2005. This is the most conservative estimate, using an average price of independent gas traders in Ukraine as a benchmark. The calculations, where the regional market price is taken as the benchmark, yield to significantly higher estimates and much stronger growth, from 4.4 percent of GDP in 2002 to 8.3 percent in 2005.¹⁰³

3.75 Looking ahead, unless energy prices are allowed to move along with input costs as the natural gas price rises, QFA will rise with it. At an import price of US\$95 per 1,000 cubic meters of natural gas, it has been estimated that Naftagaz alone will incur losses as high as US\$1.5 billion per year. QFA frequently finds its way back to future budgets, representing contingent liabilities. This occurs through the accumulation of the tax arrears of energy providers, through the reduced value of state-owned energy companies at their time of privatization, through debt incurrence taken on by the state (often a pre-requisite for privatization when the debts are larger than the value of the rest of the enterprises), or through supplier debts to other countries taken on by the state. All of these types of contingent liabilities have resulted in budget allocations or debt incurrence by Ukraine in the past (for example, the US\$1.4 billion worth of bonds that Ukraine issued to Russia as payment for the energy arrears of Naftogaz, or the leasing of Sevastopol ports to Russia, which was a deal struck with implicit debt repayment built into the annual rent calculations). The implementation of a comprehensive energy sector reform will necessarily incur budget liabilities in the future (such as budget participation in the debt restructuring settlements needed to complete power sector privatization). It is safe to say that the longer this comprehensive reform is delayed, the larger these liabilities will be when they are finally addressed. As noted above, the steps being taken and planned in 2006 to raise energy tariffs are needed, and more attention will be needed in the years to come to assure that implicit cross subsidization and/or under-priced energy-based services are curtailed.

3.76 To ease the fiscal burden of support to the energy sector, the government should undertake a comprehensive reform of the sector aimed at improving its governance, increasing its transparency and reducing its vulnerability. Box 3.3 summarizes some key recommendations from that body of work.¹⁰⁴

¹⁰² For example, more than a quarter of total mine closure subsidies in Donetsk Oblast in 2005 were subsidies for household coal. See *Ukraine: Coal Sector Update*, World Bank, April 2005.

¹⁰³ More details can be found in Poltavets, "Subsidies and Quasi-fiscal Activities in the Energy Sector of Ukraine," Background paper for the PER, 2006.

¹⁰⁴ Detailed discussion and recommendations of energy sector reform can be found at www.worldbank.org.ua

Box 3.3: Roadmap for Energy Sector Reform – Summary Recommendations

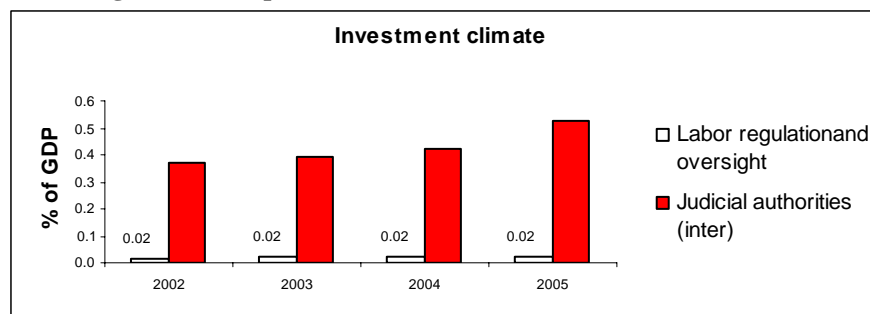
- Maintain hard budget constraints on energy producers, intermediate energy suppliers and consumers to encourage them to improve efficiency, modernize capital, and reduce energy dependency.
- Eliminate cross-subsidization of energy tariffs and bring them to full cost recovery, including needed investment costs.
- Implement the *Law on Debt Restructuring of the Energy Sector* and adopt a strategic plan for further restructuring, ownership transformation and private sector participation in the energy sector.
- Improve corporate governance and foster the commercialization of majority state-owned energy companies based on transparent performance targets contracted with the corporate management and supervised by independent boards.
- Foster competition in coal and electricity supply through further market opening and gradual liberalization of the wholesale electricity trade.
- Strengthen the financial and administrative independence of the energy regulator (NERC) and gradually introduce the main regulatory principles governing the EU gas and electricity markets.

Source: World Bank 2005, Taking the Next Steps in Energy Sector Reform.

Investment Climate Expenditures

3.77 **Expenditures in the areas related to the investment climate are growing, but they remain small.** These expenditures are related to the creation of fair conditions for the functioning of various product and factor markets – their absence represents binding constraints to Ukraine’s growth and movement toward EU harmonization. They are important if Ukraine is to experience the benefits of WTO accession, and they are especially important for transition economies where some of the markets are non-existent or at an embryonic stage. To give some examples, expenditures on labor regulations and oversight represented a very small and stagnant share of GDP (0.02 percent) during 2002-05. Spending on the judicial authorities increased from 0.4 to 0.5 percent of GDP during the same period (see Figure 3.12). The strengthening of the judicial systems is one of the most important investments the state can make to improve the investment climate. Annex 3.2 provides more details about the judicial budget, issues in this area, and the proposed expenditure and investment program for the future.

Figure 3.12: Expenditures on the Investment Climate, % GDP



Source: WB staff calculations on Ministry of Finance and State Treasury of Ukraine data.

3.78 **In addition to being small in size, some important programs that support the creation of market institutions are not financed at all in practice.** For example, programs such as “Increasing Transparency and Accountability of Public Sector and Strengthening Property Rights” received only 1.6 percent of the amount that it was allocated in the 2005 budget. Another example is the severe under-execution of various programs aimed at developing financial markets at the national and sub-national levels (national depository development – 5.2 percent of the allocated amounts); municipal credit market

development – 5.7 percent; establishment of the information and analytical system of financial bodies – 14.7 percent). The government spends large amounts of public resources on various subsidization programs (namely, subsidized interest rates), justifying this by the underdevelopment of well-functioning credit markets. To break this vicious circle, more resources should be devoted to market-promoting programs while, at the same time, market and incentive distorting programs are phased out.

3.79 **Part of the explanation for the low level of the allocation of investment programs to enhance the investment climate may actually represent decisions made by the Cabinet of Ministers and/or the Ministry of Finance regarding design flaws in some of these programs.** It takes time to redesign such programs, to build consensus, and to issue decisions to correct perceived problems.¹⁰⁵ These programs should conform to the government’s development policy program of improving the investment climate through the creation and the effective functioning of market-supporting institutions. Another explanation may be that program administrators are not able to implement programs according to the path originally envisaged (or the path presented at budget formation time in order to attract financial allocations). In either case, progress can be made by more carefully integrating the growth program represented by government development policy programs (such as the Development Policy Program supported by the World Bank) into the budget formulation process and consulting extensively with the Verkhovna Rada about both the allocations needed and the design of programs that those allocations are meant to support.

E. SUMMARY OF RECOMMENDATIONS

3.80 The following options for reform and recommendation should be considered:

- (a) **The public wage bill growth should be contained while the wage scale is decompressed.** *The public wage bill* should be kept below 8 percent of GDP - the 2005 level. A decompression of civil service wages is necessary, but, to avoid an increase in wage spending and align worker incentives with program objectives, this policy should be coupled with the rationalization of positions in the civil service system (this would also allow more competitive salaries per position). To achieve these goals the government needs to revise and streamline institutional procedures and develop a new analytically underpinned remuneration system. Transparency in the pay system is important for creating positive incentives for, and improving the efficiency of, civil servants.
- (b) **A comprehensive and systemic reform of the systems of social assistance and social privileges is recommended.** In its current design, these systems are non-transparent, costly and convoluted. They are ultimately an inefficient method of achieving the goals they appear to be pursuing. Up to 1 percent of GDP could be saved (without hurting needy recipients) through three related sets of measures: (i) phase out spa/sanatorium and telephone benefits; (ii) tighten the eligibility requirements for utilities subsidies, housing allowances, and other smaller social assistance programs and replace them with programs using proxy means testing (PMT)); (iii) target properly Chernobyl benefits, which are currently too often abused. Moreover, the introduction of new privileges outside the existing social assistance system should be avoided.

¹⁰⁵ The allocation for the development of the National Depository of Ukraine (NDU) is a good example here. Ukraine already has an effective depository owned by securities market participants. The idea for the NDU to take over this business is not consistent with the government’s development program. To address this problem, efforts are currently ongoing to support a merger of these institutions, with the state share reduced at least to a minority blocking share. While this debate and reform is under way, it would not make sense to spend significant levels of allocated state funds on further NDU development.

- (c) **The government should undertake a thorough review of subsidies in the energy sector (including those masked as capital transfers to enterprises).** *Cutting subsidies* is essential to bring more efficiency to the budget. Subsidies in the energy sector have perpetuated inefficient energy use. The government should enforce financial discipline on the energy companies (including energy SOEs to avoid transfers to cover losses) while phasing-out under-pricing and cross-subsidization. This should be done in tandem with completing the coal sector restructuring and quickly phasing out coal subsidies. Moreover, the coal subsidies need to be re-evaluated in the context of prices of alternative energy sources. As prices of other sources of energy (e.g., gas) go up, coal production acquires a price advantage and producers will increase profitability, which also slashes any remaining rationale for budget support to this sector. Roughly 0.6 percent of GDP in expenditure savings could be achieved by implementing coal sector reform while phasing out inefficient subsidies (and transfers to cover losses) to this sector.
- (d) **Other subsidies in the category of “capital transfers” should also be curtailed, including those related to the continual re-capitalizing of state-owned financial institutions.** Up to 0.6 percent of GDP in savings could be achieved by eliminating the most inefficient subsidies in this area and other smaller sectors supported by the budget (excluding agriculture).
- (e) **Government support to agriculture is necessary but needs to be shifted from the current inefficient fiscal subsidies to competitiveness-enhancing programs, compliant with WTO requirements.** Just by implementing the government proposal for the new VAT system for agriculture up to 1 percent of GDP could be saved in tax expenditures (the total savings would range from 0 to 1 percent of GDP depending on a variety of factors).¹⁰⁶ Also, in the short term, up to 0.4 percent of GDP in expenditure savings could be achieved by cutting the most inefficient production subsidies (such as financing for livestock production, horticulture, wine grapes, and support to private farms) and the most inefficient input subsidies (including the funding for leasing through the UkrAgroLeasing)¹⁰⁷
- (f) **The government should make greater investments to support investment climate-supporting institutions (within the government).** A portion of the savings from the elimination of market-distortive subsidization programs should be directed for these purposes.
- (g) **Total expenditures in health and education are at somewhat reasonable levels compared internationally, however, attention should be given to make spending within the sectors more efficient.** In particular, fiscal space is needed to allow for capital investments in these sectors. The second phase of the Public Finance Review will examine these issues in detail from the sectoral perspective and within the framework of the intergovernmental fiscal and administrative relations in Ukraine.
- (h) **Further budget consolidation should be put on the agenda.** Preserving the division of the Consolidated Budget in its General and Special Funds no longer has a clear rationale. This budget reform should be preceded by the strengthening of capital budgeting (including capital budgeting and capital transfers to local governments). Further budget consolidation would increase budget management efficiency and might well help to improve the implementation of public investment programs.

¹⁰⁶ These factors include the cost and input structure of farmers and their patterns of consumption after the reform.

¹⁰⁷ A comprehensive discussion of these subsidies is presented in the background paper “Improving the Agricultural Fiscal Policy in Ukraine” prepared for this report.

F. CONCLUSION

3.81 **The analysis in this chapter shows that in Ukraine’s public spending there is the scope and the need for better allocation efficiency, for better use of allocated funds, and for a reduction in the overall size of public spending (to below 39 percent of GDP in the medium term).** Significant expenditure savings can be achieved by rationalizing and phasing out inefficient and poorly targeted programs. Moreover, part of the savings obtained may be used to finance the government’s reform agenda and to increase the low level of capital investments (prioritizing reallocation to productive investments). This amount includes the savings that could be achieved on the pension system, which are examined in the next chapter of this report.