

5. STRENGTHENING CAPITAL BUDGETING IN UKRAINE

A. INTRODUCTION

5.1 A strategy for finding fiscal space for public investments is incomplete without improving the capital budgeting process. Public investment is an important potential contributor to economic growth and to the achievement of Ukraine's development objectives. But public capital spending in the country has increasingly supported subsidies to enterprises, rather than fixed capital investment. Moreover, capital spending is not efficiently targeted towards the expressed priorities (EU Action Plan). Significant efficiency gains (and best use of the fiscal space created) could be achieved by enhancing the processes of the planning, formulation, allocation, and supervision (including O&M) of capital expenditures.

5.2 In Ukraine, several components of the formal capital budgeting process are well structured and have some elements of good practice. For example, the line ministries and their programs are the unit of analysis for capital spending and select projects within their annual budget ceiling. Nevertheless, capital budgeting in Ukraine has also several weaknesses and is not well integrated into the overall budget process. This weakness is further compounded in investment programs funded by international donors, which are not fully integrated into the budget and implemented under a plethora of parallel systems of accounting, procurement and monitoring

5.3 The evaluation and screening of projects prior to selection is weak, the database of current assets or approved projects is inadequate, and the monitoring of project implementation is weak. This is partly due to a lack of coordination in functions between the Ministry of Economy (MoE) and the Ministry of Finance (MoF). In project planning, the major shortcomings are as follows: the absence of multi-year ceilings for both capital and recurrent spending; the absence of a central assets registry (including asset conditions) for planning maintenance and replacement spending; and the absence of strategic plans for line ministries. Capital project completion has also been a persistent problem and stems from the budgeting process, which favors the funding of new projects over ongoing projects. In addition, maintenance spending does not appear to be keeping pace with asset acquisition and maintenance requirements. There are also problems in the handling of capital budgeting at the sectoral ministries. The analytical capacity for project evaluation, internal controls, and project oversight in most ministries is poor.

5.4 Some key recommendations going forward include the following: (i) multi-year ceilings for total spending, line ministry spending (including capital and recurrent spending), and multi-year sector strategies/planning for all line ministries should be introduced; (ii) a database of current assets and their condition should be established for each line ministry; (iii) the MoF and MoE should more closely monitor capital project implementation during the year with line ministries, to assure that progress is being made and to identify and resolve any bottlenecks; (iv) the MoF and MoE should form a working group to review all aspects of capital budgeting from identification through completion and prepare a report on changes and improvements to the process; (v) the MoF should review current budget execution procedures for capital projects to review their adequacy and ensure that they are not contributing to the under-execution of capital spending; (vi) annual audits of internal control and internal audit processes in line ministries of capital project management should be conducted until performance improves; and (vii) donor assistance should be progressively integrated into government PFM systems requiring these

systems to be upgraded to conform with internationally accepted fiduciary standards while at the same time forcing donors to coordinate their assistance more effectively among each other and streamline their support with government priorities.

5.5 After reviewing the size of and trends in capital spending in Ukraine, this chapter considers some of the key elements of a robust capital asset management system and then uses this framework to provide an understanding of the current system in Ukraine. However, these issues are preceded by a discussion of the definitions that are required for a better understanding of the chapter.

B. DEFINING CAPITAL

5.6 **Governments around the world may define “capital” in different ways.** Capital spending is generally about physical assets with a useful life of more than one year. But it also includes capital improvements or the rehabilitation of physical assets that enhance or extend the useful life of the asset (as distinct from repair or maintenance, which assures that the asset is functional for its planned life). Capital spending is sometimes equated with investment or development spending, where expenditures have benefits extending years into the future. Under this definition, governments may include physical assets for government use (for example, office buildings), physical assets of a public good nature that also enhance private sector development (for example, roads, water systems), and intangibles (for example, education, research). It can be quite difficult to distinguish between investment and non-investment expenditures, and if investment spending receives favored treatment in the annual budgeting process, nearly all spending, whether recurrent or not, will end up being classified as investment. Every government establishes some arbitrary cut-off point to distinguish capital from current expenditures. For budgeting purposes, the relevant distinction is between capital and current (or operating) expenditures. Current expenditures are purchases of assets to be consumed within one year, regardless of expenditure size. Small expenditures (for example, less than US\$25,000) are current, regardless of useful life.

5.7 **Ukraine’s current Budget Law does not define capital in terms of monetary value.** The 1996 Budget Law did require the budget to be divided between operating and development expenses, and development expenses were in turn said to include: (i) financing of production and non-production capital investments; (ii) financing of restructuring in the national economy; and (iii) subventions and other spending in conjunction with expanded production. The 2001 Budget Code eliminates this distinction, but does require the use of economic classification, including separately identifying capital expenditures, and does specify that local government capital budgets are for (i) repayment of the principal of debts (Crimea), (ii) capital investment, and (iii) autonomies’ power authorities (Crimea).¹³¹

5.8 **Ukraine uses the IMF 1996 Government Finance Statistics as the basis for its budget classification system.** The 1996 GFS defines capital expenditure as follows: “Capital expenditure. Expenditure for acquisition of land, intangible assets, government stocks, and nonmilitary, nonfinancial assets, of more than a minimum value and to be used for more than one year in the process of production; also for capital grants. Capital expenditure is frequently separated (in some cases along with certain revenue) into a separate section or capital account of the budget or into an entirely separate budget for capital expenditure. That is, the capital budget. This separation may sometimes follow different criteria, however.” While allowing intangible assets and government stocks, it does not standardize “minimal value,” allowing countries to specify a value.

¹³¹ The Budget Code of Ukraine. 2001, Art. 71.

5.9 **In 2002, Ukraine changed its capital budgeting definitions to a “development” budget.** According to MoF staff, this has resulted in a mixing of recurrent and capital spending in the development budget. Regardless of this, budget data prior to 2002 have not been re-estimated using post-2002 criteria, which resulted in data comparability problems. Box 5.1 presents the current Treasury Chart of Accounts definitions for capital.

Box 5.1: Treasury Budget Classification

Capital Expenditures (Code 2000): design, estimation, reconstruction, restoration, innovation and repair of buildings
Basic Capital Acquisition (code 2100): capital goods with useful life over one year, and with a value over 1000 kopecks (UAH 10 or roughly \$US 2). Includes housing, furniture, equipment, automobiles and other transportation.
Code 2110 – equipment, for production and non-production, including transportation, computers, library books, cafeteria furniture, theatrical equipment, breeder cattle, plants for orchards or decorative use, non-military weapons
Code 2120 - capital construction acquisition
 Code 2121 - building or acquisition of new facilities
 Code 2122 - building/acquisition of administrative objects
 Code 2123 – other
 Codes 2121-2123 includes equipment or material for construction
Code 2130 – improvement repair. Classification entirely subject to discretion of manager and budget fund recipients. Includes subsystems such as sanitation, fire protection, etc.
 Code 2131 - expenditures for habitable housing
 Code 2132 – Administrative facility
 Code 2133 – other
Code 2140 reconstruction and restoration. Excludes expenditures for state-owned enterprises, which are to be under capital transfers (code 2410)
 Code 2141 housing reconstruction
 Code 2141 administrative reconstruction
 Code 2143 other reconstruction
 Code 2144 Cultural, historical reconstruction
Code 2200 - creation of government reserves
Code 2300 - acquisition of land and intangible assets, includes patents, royalty payments, computer software licenses, other rights of use.
Code 2400 - capital transfers. Grants and transfers, without obligation.
 Code 2410 capital transfers to enterprises, including higher education and scientific establishments
 Code 2420 - subnational transfers
 Code 2430 – transfers to public
 Code 2440 – capital transfers abroad
 Code 2450 – transfers to special funds

Source: Treasury Chart of Accounts, September 30, 2005, No. 181, Kiev.

5.10 **The important elements involved here are to have clear criteria and to use them consistently, and to ensure that the threshold value captures the type of capital spending that government and ministry management want to monitor.** For Ukraine, the low threshold value means that “capital” spending is misleading and captures many small items, from office supplies and office furniture to roads and schools. Ukraine should re-examine its capital definition and consider revising it, or at least regularly differentiating between physical capital (and within physical capital, between spending above UAH 50,000 and below) and capital transfers.

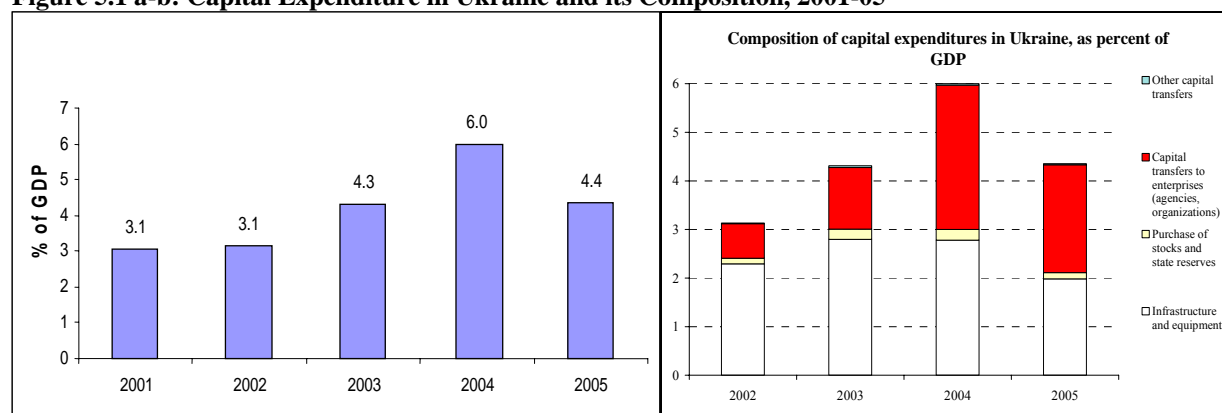
C. CAPITAL EXPENDITURE TRENDS IN UKRAINE

5.11 **In the mid to late 1990s, public investment in Ukraine was significantly reduced as part of the fiscal stabilization and transition to a market economy.** A 1997 World Bank Public Investment Review (PIR)¹³² reported: “Public investment in Ukraine is low and has fallen dramatically in recent years. ..., falling from 4.6 percent (KBV55 trillion) of official GDP in 1994 to 1.3 percent (KBV1 06 trillion) in 1996.”¹³³ Both central and local government public investment declined in the mid-1990s. Of this, central government capital investment declined from 3.3 percent of GDP in 1994 to 0.9 percent in 1996, and local government capital spending declined from 1.3 percent of GDP to 0.4 percent over the same period. The 1997 PIR concluded that capital spending had borne a disproportionate reduction compared to recurrent expenditures, though noting that much of the capital spending was not consistent with a market economy. From 1997 through 2000, capital spending fell even further, from 0.6 percent of GDP in 1997 to 0.4 percent in 2000. A 2002 World Bank Public Expenditure Review noted that: “with less than 1 percent of GDP spent by the government on capital investment and maintenance, it would appear that Ukraine threatens its future growth potential by depleting its existing capital stock.”¹³⁴

5.12 **Capital expenditures recovered between 2001 and 2004.** Total capital spending rose from 3.1 percent of GDP in 2001 to 6 percent in 2004, and settled at 4.3 percent for 2005 (see Figure 5.1a). Most of the increase in total capital spending between 2002 and 2004 was devoted to spending on the economic functions of government. Smaller increases were given to health, utilities, the environment, culture, defense, and general public services. Capital spending declined for education, justice, and social protection.

5.13 **However, within the post-2002 increases in total capital spending, most were in subsidies to enterprises, rather than fixed capital investment.** Transfers to enterprises had an almost fourfold rise between 2001 and 2005, from 0.66 percent of GDP to 2.22 percent. For 2004 and 2005, transfers to enterprises comprised more than half of total capital spending (see Figure 5.1b) and only around one-third of these transfers went to actual fixed investments (mainly the transfer sent to the State Roads Agency).

Figure 5.1 a-b: Capital Expenditure in Ukraine and its Composition, 2001-05



Sources: Ministry of Finance; State Treasury of Ukraine; Bank staff calculations.

¹³² “Ukraine Public Investment Review,” May 30, 1997. The World Bank. Report No. 16399-UA, p. 3.

¹³³ The definition of capital in use at that time under-estimated public capital investment by including asset rehabilitation expenses with maintenance (recurrent) expenses. However, at that time, investment included construction as well as expenditures on materials, equipment, social investments, and one-time expenditures on institution-building activities, which over-estimated capital spending.

¹³⁴ Ukraine Review of the Budget Process: A Public Expenditure and Institutional Review.” The World Bank, March 8, 2002. Report No. 23356-UA.

5.14 **Capital expenditures and fixed investments (within that category) fell in 2005.** Despite the need to avoid further deterioration in the country's public infrastructure, and the pressing need for new infrastructure in energy and basic services, investments fell significantly in 2005. Ukraine spends comparatively less on capital investment than other countries in the region (see Table 5.1).

Table 5.1: Public Capital Investments, Ukraine and Selected Countries

Public Capital Investments (fixed) as percent of GDP, 2004	
Kazakhstan	5.90
Hungary	5.50
Greece (1)	3.89
Poland	3.56
Romania (1)	3.50
Spain (1)	3.50
Armenia	3.40
Ukraine	2.76
Lithuania	1.8

(1) Data for 2003.

Sources: IMF Government Finance Statistics; OECD; Ministry of Finance-Ukraine.

D. ISSUES IN CAPITAL BUDGETING IN UKARINE

Project Planning

5.15 **The general process places emphasis on spending units as the primary point of integration for capital and recurrent spending, consistent with international good practice.**¹³⁵ Spending units also bear the primary responsibility for managing projects, assuring the completion and quality of workmanship, and subsequent maintenance and operation.

5.16 **For the overall budget process, there are some known elements missing that the government is actively seeking to correct.** For example, even though the budget guidelines are developed early in the process and approved by the Council of Ministers and the Rada, these are primarily economic projections and broad allocations between capital and recurrent spending for the budget year. They are not an overall fiscal policy position, with sector ceilings, over a multi-year horizon. As such, they tend to miss some of the strategic dimensions that the process could provide to public finances.

5.17 **Multi-year sector ceilings, covering capital and recurrent spending, are absent in Ukraine's budgeting framework.** International experience shows that multi-year spending ceilings are critical for providing a longer-term horizon for ministries and spending units to plan for capital and recurrent expenditures, which allows better planning and more productive spending. The picture is even worse for maintenance and operating costs, which lack any medium-term planning. Such planning is essential to enable the government to evaluate the affordability of new and existing capital assets.

5.18 **Similarly, there are no multi-year sector strategies developed within the expenditure ceilings which might provide more strategic direction to sectoral investments.** Sector strategies need to evaluate the different modes for delivering services and achieving sector objectives, each entailing a

¹³⁵ The Ministry of Finance has the overall responsibility for budget development, but, within the annual budget process, public investment project guidelines and approval are formally the responsibility of the Ministry of Economy. The general outline of the annual budget process is presented in Annex 5.1.

different mix of capital and labor. The mode of service delivery chosen will affect the capital investments needed.

5.19 The government is working on plans to require strategic planning for spending units. While valuable, these plans need to become an integral part of the budget process so as to inform spending decisions. Moreover, they need to be developed within the multi-year expenditure envelope provided by the overall fiscal policy. One of the most common shortcomings of strategic planning is undertaking it without any spending limits or realistic spending envelopes, making the plans unachievable or very abstract documents that cannot be used to guide management or finance decisions.

5.20 The MoE was built on the old State Planning Commission. It has frequently been reorganized, with each minister having his/her own vision of how it should be structured. The frequent reorganization has certainly played a part in inhibiting the development of the capital budget responsibilities that still remain with central organizations.

5.21 The Cabinet-approved “state targeted programs” arrangement contains too many programs and does not fit well with the program budget structure. An April 2004 law on state targeted programs established the new targeted programs framework. The MoE recently created a Targeted Programs Department to support the Cabinet of Ministers’ task of approving a list of targeted programs. There are currently 246 such programs, and many were adopted prior to the introduction of program budgeting and may not fit strategically within the sector or programs today. The MoE was attempting to reduce the list this year by 30 programs, with an ultimate goal of no more than 30 highly important programs linked to the government’s strategic priorities. Some of the programs that the MoE would like to discontinue are already in process, but the MoE analysis suggests that they are not economical or are no longer relevant and proposes canceling them. There are also projects on the list for which there is no financing, and the MoE proposes removing these from the list as well. Currently, targeted programs constitute less than 50 percent of total capital investment. Non-targeted programs are not directly addressed by the MoE capital investment processes, but would fall broadly under the MoE through the procurement process.

5.22 The MoE does have a database of capital projects covering central and local governments but does not have a complete inventory of capital assets and their condition. The existing database is not of completed projects but of proposed or ongoing projects, grouped by year of planned completion. The database is updated as an annual exercise, to enable the analysis and preparation of the list of approved projects. There are currently some 6,000-plus projects in the database. The specific procedures for preparing the project list change annually, but are viewed as transparent guidelines for spending units. The MoE reports that it is supposed to have a database of existing capital assets but that it does not at present. The MoE is also charged with monitoring the effectiveness and efficiency of capital investments, but it has not been able to undertake this task.

Project Evaluation

5.23 Project evaluation prior to selection is weak. The evaluation and screening of projects prior to submission to the MoE and MOF, and prior to final selection, do not follow a comprehensive economic evaluation. Project feasibility assessment and overall project evaluation is performed unevenly within the line ministries. Guidelines for evaluation are established on paper, but they are more “procedural” steps than requirement for comprehensive cost-benefit analysis and evaluation. This situation stems in part from weaknesses in the analytical capabilities in the sectoral ministries.

5.24 **Lack of precise project evaluation affects the efficiency of investments.** Because of the lack of analytical capabilities in the sectoral ministries, projects submitted to the MoF and MoE may not be the most productive investments needed. This situation affects the efficiency of public spending. Moreover, the process of evaluation seems to be divorced from the country's strategic plans (EU Action Plan) and growth expectations. Project evaluation (through cost-benefit analysis) is a critical ingredient for attaining a higher level of productive public investments (Box 5.2 presents a summary of key aspects of a proper cost-benefit analysis for capital expenditures).

Box 5.2: Cost Benefit Analysis -A Primer

Cost-benefit analysis assesses the costs and benefits of a project and reduces them to a common denominator. If benefits exceed costs—both expressed in terms of present value—then the project is acceptable; if not, the project is rejected. Benefits are defined relative to their effect on the fundamental objectives while costs are defined relative to their opportunity cost, which is the benefit forgone by not using these resources in the best alternative use. By doing so, cost-benefit analysis seeks to ensure that no alternative use of the resources consumed by the project would secure a better result from the perspective of a country's objectives. Thus, if X_t defines the benefit from the project in year t , C defines the cost today, r is the discount rate, and n the number of years that the project is expected to deliver benefits, then in very simple terms, a project is selected if: $\sum X_t / (1 + r)^t - C > 0$

Economic analysis is similar in form to financial analysis in that both assess the profit of an investment. The concept of a financial profit, however, is different from that of a social profit of economic analysis. The former identifies the money profit accruing to the project-operating entity whereas the latter measures the effect of the project on the fundamental economic and social objectives. These different concepts are reflected in the different items considered to be costs and benefits and in their valuation. Thus, a money payment made for wages is by definition a financial cost, but it will be an economic cost only to the extent that the use of labor in this project implies some sacrifice elsewhere in the economy with respect to output and other objectives. Conversely, if the project has an economic cost which does not involve a financial flow—for example, because of environmental costs—this does not constitute a financial cost. Economic costs and benefits are measured by "shadow prices" which may approximate market prices in well functioning market systems. However, imperfect markets—like those characterizing transition economies—typically reflect a divergence between them. The key requirements for social cost-benefit analysis are: (i) specification of the costs and benefits; (ii) valuation of costs and benefits; (iii) choice and formulation of constraints; (iv) treatment of risk and uncertainty; (v) choice of the rate of interest for discounting future costs and benefits; and (vi) choice of a decision rule for accepting or rejecting projects.

Source: Lyn Squire and Herman van der Tak, 1975, *Economic Analysis of Projects*, Baltimore and London—in the World Bank report "Russia: Towards Improving the Efficiency of Public Expenditures" (2001)

5.25 **There is also a lack of enforcement over project evaluation.** While a control of "procedural" steps is present in the system, the quality control over project evaluation is patchy within the Ministries of Economy and Finance. Moreover, since some projects are presented at the last minute in the budget process (with the support of Rada members), they lose the possibility of any conscientious evaluation.

Selection of Projects and Allocations

5.26 **As noted above, selection is not heavily based on project evaluation or other specific criteria.** A law is being drafted to allocate budget funds to projects that are 75 percent complete, to try to complete them. This is in response to the problem of skewed allocation of resources to new projects instead of the continued financing of ongoing projects. The following list shows how central budget funds were allocated to programs during 2001-03, together with their rate of completion:

- 51 percent of central budget funds for centralized capital investments were allocated to finance construction with a completion rate of less than 50 percent
- 21 percent of funds were allocated for the projects with a completion rate of 50-80 percent

- 28 percent of funds were allocated for the projects with the completion rate of more than 80 percent.

5.27 **The situation was slightly better in the case of local budgets.** In particular, during 2001-03, the structure of the local budget funds allocated to centralized fixed capital investments was the following:

- 33 percent of funds were allocated for the projects with a completion rate of less than 50 percent
- 12 percent of funds were allocated for the projects with a completion rate of 50-80 percent
- 55 percent of funds were allocated for the projects with a completion rate of more than 80 percent.

5.28 **The Rada's interest in capital budgets is high and often results in prioritizing new projects over the completion of ongoing projects.** According to MoE staff, the Rada Deputies pay close attention to the list of proposed capital projects and have extensive debates on the issues. Whereas limited funds could be allocated to completing ongoing projects, the extensive debates often result in emphasis being placed on new projects of greater interest to the Deputies. Deputies tend to favor such projects as the extension of natural gas lines to new villages, or schools and health clinics (with a view to having a school or clinic in every settlement, irrespective of economy or efficiency).

5.29 **The Rada's priorities do influence allocation.** In 2002, 93 percent of the projects proposed by the executive bodies were approved by the Parliament in the budget (though only 80 percent were actually funded by the MoF and MoE). For 2004, 98 percent of the projects proposed by the executive were approved by the Rada, and the Rada further increased the number of projects by 10 percent. (It should be noted that while not formally proposed by the executive, the new projects added by the Rada are subject to negotiation and the ultimate approval of the MoF and the government.) Rada increases were, in order of magnitude, for housing projects (25 percent increase), economic activity (22 percent), the environment (13 percent), and health care (11 percent).

E. ISSUES ON PROJECT EXECUTION, CAPITAL ASSET CONDITION, AND MAINTENANCE

Project Execution

5.30 **The 1997 PIR indicated that Ukraine had problems with project completion.** At that time, there were some 60,000 unfinished projects. A sample of 146 projects that received funding in 1996 for "production" and physical infrastructure found that half of the projects had implementation periods over 7 years and one-quarter had implementation periods over 10 years.

5.31 **There remain significant problems with project completion.** KRU, a centralized internal audit body, reviewed all construction projects financed by public funds for 2001-03, finding a 30 percent increase in uncompleted projects.

5.32 **Management and internal controls at the ministries are weak for project oversight, and central agency monitoring does not occur.** It appears that payments are being made for the completion of work without any assurance that the work is completed and is of acceptable quality. For individual types of projects, physical implementation rates varied from 100 percent for the construction and renovation of bridges to 7 percent for wastewater treatment facilities (see Table 5.2). The project's physical implementation rates do not match with financial execution. While 100 percent of bridge construction was completed, only 90 percent of funds were expended over this period (possibly cost

savings, or, if cash re-allocated, possibly arrears). For wastewater treatment, physical implementation was only 7 percent of the planned levels, but expenditures were at 76 percent of the budgeted levels.

Table 5.2: Capital Project Physical Completion and Financial Expenditure, 2001-03

Program	Unit of Measure	Physical Completion (%)	Expenditures (%)
Gasification of rural area	Km	48	71
Construction of gas pipelines	Km	50	74
Housing	thous. sq. m	72	75
Schools	Places	34	72
Hospitals	Places	20	83
Day care hospitals	Visits	26	85
Water pipes	Km	27	71
Wastewater Treatment plant	thous. cubic m per day	7	76
Underground	Km	66	98
Reconstruction and construction of administrative buildings	thous. sq. m	69	83
Repair and restoration works	Units	80	90
Construction and renovation of bridges	thous. running meters	100	90

Source: Audit Report, KRU, 2004.

5.33 **Regarding execution, procurement price targets are set using project normatives prior to tendering.** The normatives are developed by construction industry groups, covering labor and materials. The price target is a maximum price. There is no shortage of bidders for contracts, and the price is always at the maximum, suggesting that prices are in fact too high. The MoF would like a truly competitive bidding process, and they expect to get more value (e.g., for the same annual budget).

5.34 **Problems are also reported in financing capital spending.** In roads, for example, there are numerous change orders during construction which escalate the project cost. Moreover, there are seasonal construction patterns for roads, with work beginning in the spring. By autumn, roads have been completed, the Roads Agency provides a signature of completion, and there is a large spike in payments. Earmarked revenues for roads, on the other hand, are more evenly distributed throughout the year. For 2006 the problem may have been solved, with 100 percent of the revenues for roads being earmarked for the Roads Agency, up from 70 percent.

5.35 **The KRU report identified several sources of poor performance:**

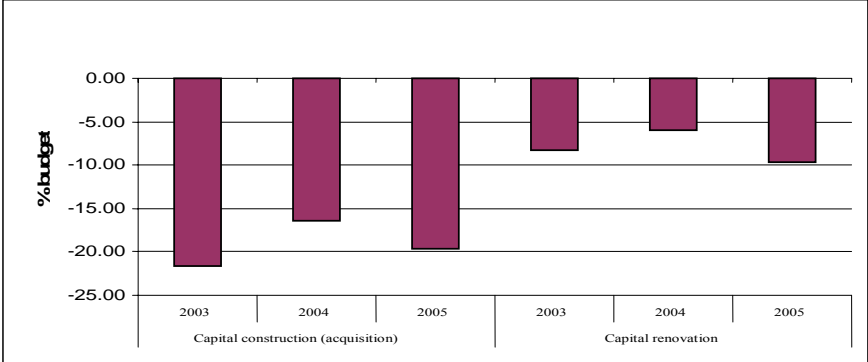
- In the course of the annual budgetary process the executive does not pay due attention to the completion of the previous capital investments projects at the time of launching new projects.
- Planning and analysis in budget preparation are weak, and are based on insufficient data and information on the project completion indicators, problematic projects, and current fixed assets. .
- There are costs increases owing to additional expenses incurred to avoid the deterioration of suspended projects, as well as to facilities not meeting client needs and requiring further expenses to correct existing problems.
- Insufficient control and oversight has resulted in some unlawful use of funds (5 percent of investments funds in 2003-04), of which less than 1 percent was attributed to scope of work or cost inflation).

While the KRU report was conducted before the interim Treasury system was operational in 2004, and a Treasury system might help with some of the mismatch between payments and project

implementation rates, the bulk of the responsibility for managing projects and certifying completion rests with budget users.

5.36 **Problems with capital implementation are further indicated by the under-execution of capital spending.** The MoF data for 2003-05 show significant under-execution of capital acquisition and renovation accounts (see Figure 5.2). Execution improved somewhat from 2003 to 2004, but deteriorated again in 2005 for both capital acquisition and renovation.

Figure 5.2: Capital Expenditure: Under-executed Accounts, 2003-05



Sources: Ministry of Finance; State Treasury of Ukraine; Bank staff calculations.

Capital Asset Condition and Maintenance

5.37 **Rather than examining only funding, it is important to examine other aspects of capital spending performance,** such as the condition of facilities and the adequacy of maintenance spending. These are important inputs and outputs of the capital budgeting process and they affect both decision-making and the efficiency of capital spending.

5.38 **At present Ukraine has no central or sector ministry registry of current assets and their physical condition.** The MoE does not have an inventory of existing assets and their condition. Individual sector ministries should have these inventories, but Bank staff were unable to obtain such information from Transport or through Economy. The only data available were from the MoF, and they included only data on the year that the asset entered service and depreciation (see Table 5.3). According to a 2005 ECORYS Transport Sector Review, the most recent data on the condition of the road network were collected in 1997.¹³⁶

Table 5.3: Residual Book Value as a Share of Initial Book Value of State Owned and Communal Owned Fixed Assets in Selected Sectors in 2003 (in %)

Sector	State Ownership	Municipal Ownership
Government services	72.9	49.3
Education	37.8	50.3
Health care and social assistance	50.7	46.1

Source: State Committee on Statistics of Ukraine.

5.39 **For three functions--government services, health, and education--the depreciation information suggests a mixed picture:** administrative facilities are relatively new, while education and health facilities are older.

¹³⁶ “Transport Sector Review Ukraine,” ECORYS. 2005.

- Administrative facilities at the central government level seem relatively new, with a high current book value, while municipal administrative facilities are older and may be in need of additional financing in the near future.
- For education facilities, little residual book value remains, suggesting older facilities that may need more significant investment in repairs and replacement. Centrally owned education facilities have a lower residual value than municipal education facilities, which suggests that the local governments have invested more recently in facilities, and the central government may require future investments in this area.
- Health facilities are at 50 percent of the residual book value, suggesting that they are roughly half-way through their useful life, and some investment may be required in the medium term.

5.40 **As depreciation and years of service are relatively crude measures, telling more about a facility's age than its current condition, they are not a satisfactory way to estimate maintenance costs or the need for various types of capital investment.** The absence of better data in this area raises serious questions: namely, whether more investment in a sector is justified, or whether the investment would be properly maintained and would serve its full useful life.

5.41 **Maintenance spending does not appear to be keeping pace with asset acquisition and maintenance.** Given the increases in fixed capital spending in recent years, as well as the fact that some facilities (health, education) are at a half-way point in their useful life, annual total maintenance spending should be increasing to accommodate new facilities and the repair of existing assets. However, total maintenance spending has been decreasing as a percent of GDP, from 0.33 percent in 2003 to 0.28 percent in 2005.

5.42 **Actual 2004 spending on maintenance was below the budgeted levels, with a budget execution rate of 87.6 percent for central government.** Local budgets showed better execution rates at 97.8 percent of budgeted amounts. It is not clear whether the under-spending was due to: (i) the weather or related conditions outside of agency control; (ii) the reallocation of maintenance funds for other purposes (by the spending ministries, MoF, Treasury); or (iii) the poor planning and management of maintenance projects.

5.43 **Estimates of maintenance costs by key spending units are based on technical norms and standards, some of which are developed by industry.** Maintenance norms for the repair of buildings are a part of state construction norms, which are developed by the State Committee on Construction and Architecture.¹³⁷ The State Committee on Housing and Community Services establishes maintenance norms for an adequate frequency of city road repairs. At least for transport, these norms have heavy industry involvement and may be too high.

F. SOUND CAPITAL BUDGETING AND ASSET MANAGEMENT: A FRAMEWORK TO IMPROVE THESE PROCESSES

5.44 **As noted in the introduction, good capital budgeting should be an integral component of a sound overall budgeting system.** While some important elements of the process are specific to capital spending, a robust public finance system and budget process are as important to sound capital management as the capital budgeting elements themselves (see Box 5.3).

¹³⁷ Order of the State Committee for Construction, Architecture and Housing Policy, "On approval of rules for determining the cost of construction" (DBN D.1.1-1-2000).

Box 5.3: Sound Overall Public Financial Management (PFM) Process

A country's budgetary process has three main objectives: (i) *aggregate fiscal discipline* - allowing budgets to be set consistent with a realistic macroeconomic framework and a sustainable fiscal program, and brought in on target; (ii) *allocative efficiency* - requiring that resource allocations reflect the policies and priorities of the government's program; and (iii) *technical efficiency* - requiring that resources are utilized efficiently and effectively towards the purpose for which they have been allocated. (Annex 5.3 sets out the features of effective PFM systems relative to these objectives) Additionally, five general principles of public finance have emerged over the years to guide developments in public expenditure systems.¹³⁸ These following principles are important preconditions for an effective PFM system: (i) *Comprehensiveness*: all revenue and expenditure, and all government agencies, are included in the budget, and all government agencies are integrated into the public expenditure management system; (ii) *Accuracy*: actual transactions and flows are recorded; (iii) *Regularity*: the budget covers a defined period of time (for example, one year); (iv) *Authoritativeness*: spending is carried out only as authorized by law. (v) *Transparency*: information on spending is publicly available, on a timely basis, in an understandable or common format. If elements of these principles are missing, the PFM system cannot serve as an effective tool for establishing and managing policies, holding agencies accountable for results, and, more generally, managing the public sector.

5.45 **Additionally, a sound overall public financial management system supports each element of the system, including capital spending.** Good multi-year planning supports overall fiscal balance, with more stable spending patterns for ministries and programs and for their capital planning and execution. Good budget execution and procurement enable the timely, within-budget completion of projects (assuming good program and project management). Financial Management Information Systems support the financial and program management needs of the Cabinet of Ministers, Ministries of Finance and Economy, spending ministries and program managers (all budget users).

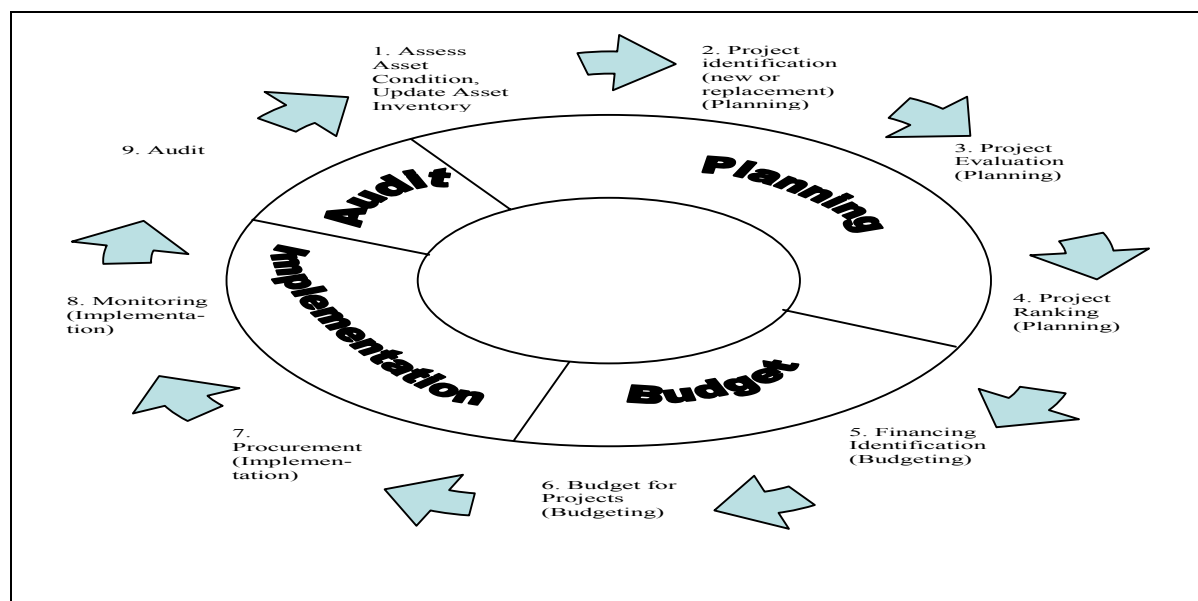
5.46 **As Ukraine moves to deepen its program budgeting process, it can be conceptually useful to think of the program operations as a *production function*.** That is, some mix of inputs is used to produce a good or service (intermediate or final) or achieve an objective. Inputs include total funding, staffing levels, equipment, and capital. Within total spending ceilings, ministries must decide what mix of programs best meets government objectives within their portfolio. And within programs, some decision must be taken on the best mix of inputs to meet program objectives. Capital planning and spending needs should be undertaken within this context. Capital spending is not an end in itself, but contributes towards a defined objective.

Capital Budgeting Process

5.47 **Within the overall budgeting process, robust capital budgeting elements need not be overly technical or sophisticated.** To help orient the reader, Figure 5.3 presents nine key steps in a capital budgeting cycle, covering four phases. These distinct phases are: planning, budgeting, and implementation, and audit. The latter one is not commonly included in capital budgeting discussions but it is an important step in assuring process and information integrity.

¹³⁸ Schick, Allen. 1999. *A Contemporary Approach to Public Expenditure Management*. World Bank Institute, 1999.

Figure 5.3: Capital Budgeting Cycle



5.48 **The planning phase is often considered the most important phase because of the long-lived nature of the assets.** Whether it is undertaking government-wide strategic capital planning, ministry planning, or program planning, the planning exercise needs to be kept within the overall expenditure ceilings or envelopes to help ensure more realism in the planning process, and in a multi-year framework, to take into account the inter-temporal nature of decisions. Capital planning is not divorced from strategic planning. Where strategic planning sets the goals and objectives for government, ministries, and programs, then capital planning fits in as part of the consideration of the mix of capital and recurrent spending that best meets those needs within the available resources. The planning phase should provide the type of investments and the size/number of investments (if not the specific investments) needed. The process should be guided with proper project identification and economic evaluation (typically using cost-benefit analysis).

5.49 **The budgeting phase entails selecting specific projects to include in the budget** and may entail trade-offs between specific investments, given the available resources and the government’s relative priorities. It includes identifying specific financing sources.

5.50 **Implementation is self-explanatory and entails government monitoring and oversight of the work for quality, timelines, etc.** The bulk of this work is in programs or ministries. Procurement is a critical step in the process, and care must be taken to ensure that costs do not rapidly escalate after contract signing, and that unit costs are within competitive ranges.

5.51 **Regarding the audit phase, the ex post audit of financial and physical records helps to ensure that weaknesses in the process are identified and can be corrected.** Table 5.4 provides more details on each step of the process shown in Figure 5.3.

Table 5.4: Robust Capital Budget Process Details

Phase	Step	Product	Feature	Responsible Agent
Planning	1. Update Inventory, Assess Asset Condition	Asset Inventory (including information on date facility entered service, annual maintenance and repair costs, current condition,	Condition assessment and maintenance cost history should enable better estimation of maintenance budget	Inventory Database centrally maintained by Central Agent (e.g., MoF Capital Budget Office, Ministry of Economy Capital Office, or Planning

Phase	Step	Product	Feature	Responsible Agent
		etc.)		Ministry) Asset Condition Assessment performed by sector ministry specialists, contracted to third-party
	2. Project Identification	Preliminary list of possible projects with cost estimates	Identify need for rehabilitation or replacement of existing facilities, as well as new facilities Should be tied to sector strategy, service objectives Valuable to prepare list within overall multi-year sector/ministry resource ceiling (capital and recurrent)	Sector ministries identify projects, cost estimates Central agent prepares guidelines, forms for use by sector ministries
	3. Project Evaluation	More detailed costing of projects For revenue producing projects, estimates of revenues Identification of possible financing sources	More detailed project evaluation should be done only for the top priority projects of ministry and government, projects likely to be funded Cost-benefit and rate of return analysis can be undertaken, but this can be very expensive and time consuming, and may not add value for many projects	Sector ministry, using expert panels or contracting with consulting engineers Central agent prepares standard guidelines, forms for use by sector ministries MoF Budget Department needs to be involved in revenue estimates, evaluating the quality of the cost estimates
	4. Project Ranking	CIP/PIP	Multi-year list of Approved Projects, ranked in priority Should be started afresh (zero-based) annually. No assumption that a project approved but unfunded last year is automatically included in subsequent plans or budgets	Central Agent maintains approved project database, prepares plan Ranking can be done using formal project ranking sheets, used by an inter-ministry review panel Including citizens in panel adds credibility A public hearing can also add credibility before final plan adoption Some governments submit CIP/PIP to legislature for review and approval before finalizing plan
Budgeting	5. Financing	Specific financing arrangements for proposals to be included in the budget	Options include general revenues, debt, user fees, concessions, public-private partnerships (which have to be properly evaluated to avoid future liabilities for the state). Must reconcile with debt limits decided in debt strategy	MoF Budget Department Capital Budget Office
	6. Budget	Include expenditures for projects in the budget, in sector/ministry	In addition to displaying the expenditures with the appropriate ministry and program, the budget might include an annex of those CIP/PIP proposals included in the budget for information	MoF Budget Department Capital Budget Office
Implementation	7. Procurement		Procurement plans should already have been developed for the projects to be included in the budget, including a schedule of cash requirements for budget execution Procurement should follow good practices as defined in Procurement Law	Responsible Ministry MoE Procurement Office may provide technical support, and certainly would set standards, provide general guidance
	8. Monitoring	Regular monitoring of physical and financial progress in completion	Financial progress can be monitored through Treasury payments Physical progress should be tied	Responsible Ministry Central Agent Treasury could require assessment of physical progress

Phase	Step	Product	Feature	Responsible Agent
			to a database of on-going projects	before making payment, and forward to capital database
Audit	9. Audit	Ex post assessment of financial records and physical completion	Ministry internal audit bodies, required under the budget code, should monitor accuracy of financial records and efficiency of operations KRU and the Accounting Chamber should periodically check on the effectiveness of internal audit and internal control processes	Budget User internal audit offices KRU Accounting Chamber

5.52 **Capital budgeting processes can be extremely time-consuming and expensive if they are not properly designed.** There is frequently a tendency to require elaborate studies and cost-benefit analyses for all proposed projects, regardless of importance, feasibility, likelihood of being adopted, etc. A better system would seek to use strategic planning and priority-setting to help screen ideas before the need for more detailed analysis. Much of the planning and budgeting process is a filtering process to arrive at an optimal set of investments with respect to the government objectives and available resources.

5.53 **A foundation of a robust capital budgeting process is a good inventory of existing capital assets.** Basic information needs to be readily available and up to date. The inventory should identify each asset, the ministry owning it, the program it supports, the date it entered service and its original construction cost, its annual maintenance and repair expense history, its current condition, its current replacement cost, and similar data. Current asset condition requires a simple but consistent framework for summarizing condition, and should be updated annually.

5.54 **Asset condition assessment is likely to be the most labor-intensive task in the capital budget process, but is essential in order to know whether the asset is in need of replacement.** The condition can be assessed by the owning agency/ministry, by a central agent (a central agent charged with the overall responsibility for capital budgeting or the budget generally, such as the Ministry of Economy's Capital Office, or the Ministry of Finance's Capital Budget Office), or through a contracted to a private firm or university.

Roles and Responsibilities

5.55 **The roles and responsibilities of the various actors in the budget process in Ukraine are clearly defined, but in practice some functions are not well coordinated between the MoF and the MoE.** Generally, the MoF has overall responsibility for budget preparation, including setting guidelines for the process,¹³⁹ reviewing all spending proposals for conformity with policy and other guidelines, deciding what to include in the budget,¹⁴⁰ and also defining what constitutes capital, recurrent, and other economic classification categories.¹⁴¹ The MoE is responsible for providing guidance to spending units on capital project preparation, collecting proposed projects, maintaining a database of current capital assets and new and ongoing proposals, preparing the list of priority investment projects for the Council of Ministers, and monitoring project implementation. The MoF, as noted above, is responsible for defining annual spending limits including capital and recurrent spending divisions within ministries, defining capital spending, and deciding which individual projects to include in the budget. During budget execution, the MoF manages cash (via the Treasury), including cash allocations for ministries.

¹³⁹ Article 35 (1), Ukraine 2001 Budget Code.

¹⁴⁰ Article 36 (1), Ukraine 2001 Budget Code.

¹⁴¹ Article 10 (1), Ukraine 2001 Budget Code.

5.56 **Individual spending units are responsible for developing project proposals and managing capital projects.** Generally, projects above UAH 15 million require the approval of the MoE and the Council of Ministers, and all projects require MoF approval for inclusion in the annual budget. The authority to approve capital spending is also clearly delineated. Larger projects require Cabinet of Ministers or Parliamentary approval, while smaller projects can be approved by spending units directly. Annex 5.2 presents the formal approval structure for capital projects.

G. DONOR FINANCED PROJECTS AND INVESTMENTS

5.57 **Donor funding is a potentially important source of financing for Ukraine, both for investment and for technical assistance to lay the institutional foundations of a well-functioning market economy.** Donor funding (through grants and loans) excluding non-guaranteed lending by bilateral and multilateral financial institutions to private entities amounts on average to USD 1.5 billion annually. Approximately USD 1 billion are in loans for investments and budget support, and USD 500 million in technical assistance and grants. Around two thirds of current lending is for capital investment, the key focus of this section. In the following years these amounts are likely to increase¹⁴², particularly through funding from the European Commission (EC), which may become a major donor in investments funding.

5.58 **While overall the effect of external development assistance has been positive in Ukraine, the cost of preparing and implementing projects is high and delays are widespread.** There is scope for significant efficiency improvements that would help achieve development objectives of projects better or faster, and reduce financial costs. There is also scope for exploiting more efficiently the synergies of the different forms of assistance provided by donors, and for greater emphasis on improving outcomes and results of external development assistance.

Issues in Donor Financed Investments and Projects

5.59 **Most investment projects are executed by recipient entities but under parallel structures not well integrated into regular government agencies.** Investments funded through loans and grants are typically managed and executed through Project Implementation Units (PIUs). Moreover, in some cases donors also make direct payments to contractors (based on requests by the project executing agency and the loan agreements).¹⁴³ PIUs are stand-alone units created within the recipient agencies to execute the projects. They are established with the objective of servicing the fiduciary requirements of donors (in areas such as financial management and procurement). However, research on development effectiveness increasingly argues against the use of parallel structures established outside of the regular, mainstream, organizational units in ministries and recipient agencies. Specifically, the emerging lessons of experience indicate that such structures do not necessarily facilitate execution, fail to build capacity in government

¹⁴² See Annex 5. 4 for details on most donors development assistance in Ukraine. Sources of external development assistance include international financial institutions (e.g., European Bank for Reconstruction and Development-EBRD, World Bank), other multilateral institutions (e.g., European Union-EU, United Nations-UN), and bilateral sources (e.g., Canada, Germany, Japan, Sweden, UK, USA). Forms of assistance include: (a) loans for investment projects and other specific activities; (b) budget support funding; and (c) technical assistance—generally own managed by the donors (d) in-kind assistance (such as equipment, training, scholarships). Development assistance is provided for a wide range of activities and sectors. For simplicity all international multilateral institutions and bilateral agencies are collectively referred to as “donors” in this report.

¹⁴³ Technical assistance grants are usually donor executed and in many cases may be provided to non-government recipients. The recommendations of this section apply primarily to investment funding, although some have more general validity.

agencies that would over time improve capital budgeting and execution processes as a whole, and can undermine government ownership.¹⁴⁴

5.60 Only a portion of development assistance operates within the country’s public financial management (PFM) system. Cash funding to the government and public sector entities is typically included in the annual budget and reported in budget execution reports.¹⁴⁵ But the execution of these activities, other than budget support loans, typically follow special procedures that are different from the country’s regular PFM system (e.g., treasury, payments, procurement, financial reporting, and auditing) In addition to potentially weakening internal control, ring fenced financial arrangements have contributed to implementation delays (see Box 5.3). Technical assistance and in-kind assistance to public entities are not reflected in the budget and budget execution reports, and operate fully outside the country’s PFM system.

Box 5.4: Issues with Special Arrangements for Financial Management in Donor-financed Investment Projects in Ukraine

“Ring-fenced” or special arrangements outside of the country’s public financial management (PFM) system have been instituted in many donor-financed investment projects implemented by recipient entities. These include aspects such as banking arrangements, payment procedures, procurement procedures, accounting and financial reporting, and auditing arrangements. Improvements in the country’s PFM system over the past few years, the most notable one being the installation of a comprehensive treasury payment and accounting system (which now covers the entire Government), provide a platform for increased use of the country’s PFM system. Yet, each project still has two different systems operating concurrently, based on the source of financing (i.e., there are separate systems for the government-financed and donor-financed portions of project expenditures). The dual system operates through all stages of the project financial management cycle – budgeting, payment authorization, funds flow and payments, accounting, reporting and auditing. This system is further complicated by various special procedures (e.g., tendering processes for Special Accounts, special authorizations by the Ministry of Finance for each payment, co-signature of the Ministry of Finance on each check) that have added complexities and delayed project implementation. An ad hoc reporting system with monthly reporting by project entities to the Ministry of Finance on project expenditures is used to obtain information for budget execution reporting. In several instances, the start-up of key project components is delayed due to the non-establishment of the special financial management systems. In some cases, these special arrangements diminish the internal control environment since regular checks and balances are substituted by ad hoc special controls.

5.61 Information on external development assistance flows is sketchy and incomplete. Consolidated information on total flows from external development assistance (commitments, inflows and expenditures) is not available. There is no single database that systematically captures and reports flows on all external development assistance.¹⁴⁶ As noted above, significant parts of external development assistance operates outside the country’s public financial management system, contributing to information problems. Information flows from donors on planned and actual flows are also weak.

¹⁴⁴ For the latter, the possible exception might be self-contained PIUs. That is, when the creation of a new implementing agency is due to a new activity not previously present in the country. In such case, greater institutionalization is expected at later stages (e.g., staff will continue to stay after project completion).

¹⁴⁵ That is, grants are included in revenues; loans are reflected under financing; expenditures from these sources (including related financing from the government’s own sources) are reflected as expenditure line items for the sector concerned; and financing for specific activities/projects (e.g., investment projects) and expenditures from such financing are reflected in the Special Fund.

¹⁴⁶ The Directorate for Coordination of International Technical Assistance (DCITA) of the Ministry of Economy maintains a database of technical assistance provided through grants. However, this does not cover all external development assistance, and is mainly restricted to donor commitments, and not inflows and utilization. It also includes only those projects/activities that are “registered” with the DITCA, a process that is not always systematically followed for all projects.

5.62 **The procedures of project approval in Ukraine are complicated and time consuming** (see Box 5.4). This not only substantially increases project preparation time, but makes it extremely difficult for the MoE and the MoF, and the implementing agencies to effectively plan budget expenditures under donor supported projects.

Box 5.5: An Unusually Complicated Pipeline of Project Processing and Approval in Ukraine

The project cycle, as currently designed, establishes a series of complex and repetitive reviews of project documentation for projects financed by international financial institutions (they are specified in Decree 1317 of 2001 amended in 2003).

Any loan documentation is subject to successive, duplicative, and often lengthy reviews by:

- (i) The Cabinet of Ministers: at the initiation stage, before, and after negotiations
- (ii) The President's office: before negotiations, when authorization to negotiate is issued, before signing when authorization to sign legal agreement is issued and after donor approval, and before submission to the Parliament.
- (iii) The Ministry of Foreign Affairs: according to the law "On international treaties", this Ministry has been given up to 6 months to review the signed legal documents for individual donor projects prior to their submission to the President's office, instead of mandating this review only for agreements affecting Ukraine's membership status with the Bank and other IFIs).
- (iv) Various ministries, including the ones that are not involved in project preparation and implementation, are required to give their "no objection" (visa) to documents reviewed. As a result, any ministry can delay or even veto further processing of the project.

5.63 **Donor financed projects and investments are not well integrated into the capital budgeting process.** Most donor financed projects are prepared and approved outside the budget process. Moreover, owing to some of the complexities above-described they are not included in the government's pipeline of capital budgeting. This situation may be reducing significantly the efficiency of these funds through under-execution, poor targeting of government priorities, overlapping of projects, and weak government ownership. Thus, execution delays are often even more acute in donor funded investments than in government capital spending (see Section 5.2). Moreover, a number of projects never move beyond the preparation stage and are cancelled after significant time and funds have been spent in preparing them. This has efficiency implications, including the higher costs of maintaining un-finished projects, costs of asset deterioration, costs of maintaining project management structures throughout a long implementation cycle, and the opportunity costs of staff time, counterpart funds, and the donor funds themselves.

5.64 **Despite recent efforts to improve donor coordination, there is still considerable overlap and a tendency for supply driven initiatives with only weak integration into the strategic priorities of the government.** The availability of funding from multiple sources is potentially a great asset, if these resources are effectively complemented (e.g., some donors offer technical assistance funding to specifically aid the preparation and implementation of investments funded by other donors). However, making the most of these complementarities requires donors to align their strategic planning cycles with each other, to determine respective roles and responsibilities, and to harmonize their internal rules and procedures. Moreover, both coordination and targeting need to be aligned with the country's development strategy. These principles have been endorsed by all major donors in the Paris Declaration on Aid Effectiveness of March 2005 (see Box 5.5). But the implementation of the Declaration on the ground remains a challenge.

Box 5.6: Donor Commitments in the Paris Declaration (Some Excerpts)

Donors have inter alia committed to:

- Base their overall support on the country's national development strategies, institutions and procedures.
- Draw conditions, wherever possible, from a partner's national development strategy.
- Link funding to a single framework of conditions and/or a manageable set of indicators derived from the national development strategy.
- Use country systems and procedures to the maximum extent possible, including on transparent partner government budget and accounting mechanisms. Where use of country systems is not feasible, donors have committed to establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures
- Avoid, to the maximum extent possible, creating dedicated structures for day-to-day management and implementation of aid-financed projects and programs.
- Align their analytic and financial support with partners' capacity development objectives and strategies.
- Implement, where feasible, common arrangements for planning, funding (e.g., joint funding arrangements), disbursement, monitoring, evaluation and reporting to government on donor activities and aid flows.
- Provide reliable indicative commitments of aid over a multi-year framework and disburse aid in a timely and predictable fashion according to agreed schedules;
- Provide timely, transparent, and comprehensive information on aid flows so as to enable partner authorities to present comprehensive budget reports to their legislatures and citizens.

5.65 Although some progress has been achieved, the use of country systems for donor finance investments is very limited. The recording of transactions in the budget is where most of the progress has been achieved, but coverage is not at 100 percent for all donor transactions. The reporting of execution has seen more limited progress, and therefore detailed reporting still relies on donor information. Almost no progress has been made in using core country systems, that is, the country's procurement systems for contracting and commitment of funds, the State Treasury for payment, the intergovernmental transfer system to finance local government projects, and the state auditing agency for control and auditing. It is clear, however, that progress on this issue depends both on the government's improvement of its PFM systems, and on donors working together and assisting the government to move forward in using improved country systems

Recommendations to Facilitate (and Improve Effectiveness of) Donor-financed Investments

5.66 Record (and report) all external development assistance flows to the public sector in the budget. This implies bringing up to 100 percent the recording of donor financed transactions in the annual budget and their execution details in government internal control reports. The budget is a central instrument for translating government policies and priorities into operational activities and programs, and to ensure efficient resource allocation. Recording donors' flows into the budget and keeping track of its execution in regular internal reports is a first step towards fully aligning donor-financed activities with national priorities and goals. Better recording also requires the following: (i) timely provision of information by donors on planned and actual flows; (ii) alignment of donor programming cycles with the country's budget cycle; and (iii) timely recording and reporting of information. . In the short-term, achieving 100 percent recording of donor executed assistance in the budget may not be realistic, but the principle of transparency should nonetheless apply.

5.67 Establish a comprehensive information system on external development assistance. A comprehensive information system that would facilitate better monitoring, management and reporting of all external development activities should be established. The unified database should capture information and report on aspects such as pledges/planned commitments, actual commitments, inflows (donor disbursements), amounts contracted, and utilization (spending), as well as progress of project

preparation and implementation. This should cover all forms of assistance (loans and grants, cash or in-kind, executed by national entities or by the donor agencies), and include information on government guarantees (e.g., on loans to state-owned enterprises). This system could also provide information to track and monitor pending decisions and actions during project preparation and implementation. To avoid duplication, this should be linked to and draw on information from the country's public financial management system.

5.68 Integrate the planning of donor financed investments (and assistance) to the core capital budgeting process (and to the overall budget process). Bringing donor-financed activities into the budget formulation and approval processes would ensure that these are better discussed with and disseminated to a broad range of stakeholders (including legislators and citizens), thereby securing better support and ownership. It would also assist in better planning and allocation of resources. But this shift requires the streamlining of current procedures of planning, processing, and approval of projects (see recommendation below).

5.69 Simplify processing and approval of donor financed investments. Efforts should be made to simplify, streamline and eliminate duplicative reviews of the project documentation for approval, for projects financed by donors (see Box 5.6 for some suggestions for consideration). An inter-ministerial working group could be established to work together with donors to develop changes to government procedures (and as appropriate, to those of donors), including longer-term legislative and institutional changes, and roles and responsibilities of different agencies. That simplification effort would need to be matched, on the donors' side, by helping to synchronize project preparation with the budget cycle.

Box 5.7: Synchronizing the Project Cycle with the Budget Process and Streamlining the Project Cycle: Suggestions for Ukraine

All activities related to project identification, preparation, and appraisal could be carried out in a way that is synchronized with the budget cycle envisaged in the Budget Code. For that purpose, a new procedure would need to specify objective processing benchmarks (i.e., completed pre-appraisal or appraisal stage in the project cycle) based on which the responsible line ministry will be able to submit to the Ministry of Finance specific project budgeting proposal for inclusion in the budget Resolution (no later than May 15) or draft State Budget (no later than August 15). That would allow the Ministry of Finance to reflect such projects in the projection of the Budget for the next fiscal year. In order to make this happen, it would be necessary to introduce a number of other changes that will make project preparation shorter, simpler and more predictable, and with less duplicative approvals; the following changes should be considered:

- (a) *Introducing of "one-stop-shop" authorization to negotiate and sign loan agreements:* this would help to eliminate multiple decisions and streamline loan processing procedures. For example, when there are no substantial changes between proposed and agreed loan provisions during negotiations, a single Presidential decision could be used to authorize the head of an official delegation to negotiate the proposed loan agreement, sign the agreed minutes of negotiations and follow-up letter confirming results of negotiations, as well as to sign the loan agreement upon approval by the donor agency.
- (b) *Setting a clear and reasonable timeframe for each of the steps in the project cycle:* currently, many steps of the project cycle are not defined in terms of time needed; and the ones that are actually defined are not consistent across the various legal acts.
- (c) *Revising of roles and responsibilities of all of ministries and agencies of government in the project cycle:* that is, the roles of the concerned sector ministry, Ministry of Economy, Ministry of Finance, directly related ministries and other non-related ministries) need to be clearly defined.
- (d) *Including the loans in all budget documents:* having this as part of the annual budget (through its documents) means that parliamentary approval is provided through the budget approval process itself, thus eliminating the need for separate ratification through stand-alone laws by Verkhovna Rada. This is actually provisioned in the Budget Code.

5.70 **Plan donor funding aligned with the country’s strategy and on multi-year basis.** Medium and longer term fiscal planning should similarly integrate resources from all sources—domestic sources and external development assistance. As national and sector medium-term fiscal/expenditure frameworks are further developed in Ukraine (as recommended in this report), planned external development assistance should be fully incorporated into such frameworks. On the donors’ side this should involve ample coordination to harmonize and complement aid efficiently on multi-year basis.

5.71 **Designate a single office to coordinate external development assistance activities.** An integrated institutional arrangement (i.e., a single unit within the Ministry of Economy or the Ministry of Finance to coordinate all external development assistance (grants and loans, investments and technical assistance, cash or in-kind assistance) would help in better management and monitoring.¹⁴⁷ This unit should take overall responsibility for formulating and implementing an aid management strategy to ensure that external development assistance is well aligned to country’s strategies and priorities; the activities of the proposed unit should include the following:

- Communicating country needs and priorities to donors, and assisting sector ministries to mobilize financing for their projects and programs.
- Ensuring donor coordination and utilizing complementarities within and across sectors (e.g., between technical assistance and investment financing across donors).
- Ensuring smooth and expeditious processing of donor-supported projects and activities.
- Serving as a focal point in the government for contacts with donors.
- Assisting sector ministries in working effectively with donor agencies.
- Ensuring availability of timely and complete information on external development assistance.
- Assessing utilization and effectiveness of external development assistance including results and outcomes.

5.72 **Continue improving PFM systems to allow donor funding, in the near future, to be channeled and executed fully through budgetary institutions and controls.** Progress on this issue lies heavily on the government’s efforts to tackle PFM weaknesses, such as procurement systems. In the meantime, the following suggestions could be considered jointly with donors:

- **Facilitate more direct involvement of staff and management of the beneficiary agencies in project preparation and implementation in order to improve ownership and implementation.** For example, project managers should be located within the concerned program unit of the ministry or implementing agency. The agencies’ regular financial management and other relevant units should be part of the project, and be phased-in with more responsibilities, as responsibilities of existing PIU are phased-out.
- **Donors could phase-in the use of the country’s (PFM) system, but supplemented, as needed, by additional arrangements in those areas where weaknesses in the country’s PFM system pose fiduciary risks.** Such additional measures could be progressively phased-out in sync with improvements in the country’s PFM and procurement systems. Box 5.7 provides an illustration of what the target model could be.

¹⁴⁷ The Ministry of Economy is currently responsible for overall coordination of international technical assistance and assistance from international financial institutions. Within the Ministry of Economy, different offices deal with issues relating to grants and loans: the Directorate for Coordination of International Technical Assistance (DCITA) of the Ministry of Economy deals with issues relating to international technical assistance (principally grant financing), and a separate unit deals with issues relating to physical investments and loans. An arrangement integrating these would appear more conducive to effective management and coordination. The Ministry of Finance manages external development assistance resource flows. Much of its focus currently appears to be on loans from international financial institutions; this should be extended to include other development assistance resources. Sector ministries should continue to have principal responsibility for formulation and implementation of projects and programs in their sectors.

Box 5.8: A Goal to be Pursued: Use of Country PFM Systems in Donor-financed Projects

- Total project expenditures would be budgeted and included in the annual budget.
- Donor disbursements would be made into the treasury (single treasury account).
- Regular budget execution procedures (commitments, warrants, and payments) would be followed for projects implemented by ministries and similar agencies.
- Payments would be made through the treasury system using the concerned sector ministry's or agency's treasury's regular payment verification and authorization procedures.
- Given weaknesses in the country's procurement system, special procurement arrangements or supplements to the country's procurement system will be needed for donor-financed projects/activities until improvements are made to the country's system.
- The treasury would account for project expenditures using the government's regular chart of accounts.
- The agency's regular financial reports would be the principal basis for financial reporting, with additional information provided with regard to any donor-specific requirements.
- Government's regular internal control systems and procedures would apply. Donor-financed projects would also be subject to internal audit by the KRU.
- Donor-financed projects would be subject to external audit by the country's supreme audit institution (the Accounting Chamber). While the capacity of the Accounting Chamber is being further developed, particularly in financial audits, this would be supplemented by external audit by an acceptable professional audit firm with agreed terms of reference.

G. CONCLUSIONS AND GENERAL RECOMMENDATIONS

5.73 **Some formal elements of the capital budgeting process are well structured and the process has some features of good practice.** For example, the line ministries and their programs are the unit of analysis for capital spending, and must select projects that are within their annual budget ceiling and are subject to financing availability.

5.74 **In project planning, the major shortcoming is the absence of multi-year ceilings, and strategies, for both capital and recurrent spending.** Multi-year ceilings help the government, the MoF and line ministries clearly see the future implications of spending decisions – particularly for capital spending. Currently, capital projects are prepared and selected by line ministries and the MoE without any multi-year ceilings. Another shortcoming in planning is the absence of strategic plans for line ministries, which present multi-year objectives for the Ministry and its programs. Strategic plans – undertaken within realistic resource constraints – aid the MoF, MoE, and line ministries in evaluating current spending within the Ministry, its effectiveness with respect to government and ministry objectives, and potential for reallocation across programs or within programs to increase marginal productivity. The following recommendations should be implemented:

- Introduce multi-year ceilings for total spending for line ministries (for capital and recurrent spending). The MoF should take the lead in this task.
- Introduce multi-year sector strategies/planning within resource ceilings for all line ministries. This is part of effectively implementing a MTEF. The MoF and the Cabinet of Ministers should take the lead in this issue.

5.75 **The planning process would also be improved if the MoE would create and maintain a database of existing capital assets and their condition.** Ideally, each line ministry would have access to such a database (managed by MoE) and would use it in capital planning. The World Bank project on public finance modernization could support this effort. The following is recommended:

- Establish a database of current assets and their condition. The MoE should set the standards, and possibly collect the data centrally for analysis and monitoring, but line Ministries would have the obligation of updating the information. The database can be used by line ministries to monitor their own progress and by the MoF/MoE for assessing the adequacy of maintenance spending and the longer run affordability of additions to the capital stock.

5.76 The recent addition of a Targeted Program process, with Cabinet of Ministers approval of a set of priority programs, is not well integrated into the budgeting process. It is not clear whether the Targeted Programs are true high-priority areas or are simply an accumulation of special projects. The projects seem to be selected by the Cabinet without reference to the available resources over a medium-term horizon, and may result in the selection of unrealistic projects that can never be funded. It is also not clear what role these programs play, as funds are not always allocated to these priorities. The following is recommended:

- Improve the timing and integration of the Targeted Programs process into the annual budget process. In the medium term, they should be phased out and replaced by an integrated multiyear investment program.

5.77 The government urgently needs to strengthen project evaluation capabilities in the Ministries of Economy and Finance, and in all sectoral ministries. Under the leadership of the MoE, the following recommendations should be considered and implemented:

- Assess the current analytical capabilities for project and program evaluation in line ministries.
- Set a concrete strategy and training program to strengthen those capabilities.
- Implement transparent and standard cost-benefit methodologies of evaluation.
- Apply consistently and selectively (and across all line ministries) an enhanced cost-benefit analysis as part of the formal process of capital budgeting.
- Strengthen the analytical capabilities to evaluate potential risks in Public Private Partnerships and privatization schemes in line ministries.
- Establish proper economic evaluation as a key element of the project submission process to the MoE and MoF (to be quality controlled).
- Enforce the use of economic project evaluation for capital expenditures in projects and programs submitted by sectoral ministries. This should be done by the MoE and the MoF in coordination.
- Monitor (and audit) the quality of the evaluation performed in line ministries (in coordination with KRU).

5.78 Capital project completion rates and the under-execution of project funding are persistent problems requiring further attention and monitoring. In the World Bank Public Finance Modernization Project under development, a close review of current budget execution procedures for capital projects is required to assure that these procedures are not contributing to under-execution. The following is recommended:

- Monitor jointly (between the MoF and the MoE) the progress made in capital projects during the year to ensure that work is progressing. Given the persistence of this problem, KRU should also annually audit a selection of capital projects, perhaps focusing on the poorest performing ministries, on the question of whether the ministry's internal control and audit processes are functioning for capital spending, and on the reasons for poor performance. Line ministries may require some support for capital project data collection and monitoring, and the World Bank public finance modernization program under preparation could be a useful vehicle for supporting this area.

5.79 **The current division of responsibility between the MoF and the MoE is not in itself a problem.** The MoE handles project preparation and evaluation from the standpoint of cost-benefit analysis and feasibility, as well as handling the identification of high priority areas for future investments. The MoF handles actual project financing, and the division of ceilings between capital and recurrent. This division is logical and can work, but it requires closer coordination between the MoF and the MoE. The following options are provided to strengthen that coordination:

- Establish a formal structure of collaboration between the MoE and the MoF, with the oversight of the Cabinet of Ministers within the overall public financial management structure.
- Coordinate functions on capital budgeting through the suggested working group. This working group should review all aspects from identification through completion.
- Prepare a report on changes and improvements to the process (this could include someone from the Cabinet of Ministers). This should be the first assignment for the working group.

5.80 **The management of donor-financed investments and projects needs revamping.** The analysis shows that efforts need to be made by the government and the donor community in Ukraine to facilitate and improve aid effectiveness in the country. Moving forward, the following broad options for reform should be considered (by both the government and the donor community):

- Bring up to 100 percent the recording of donor financed public sector transactions in the annual budget and their execution details in government internal control reports. In parallel, establish a comprehensive information reporting system of external assistance (including inflows and execution). In the short term, this does not apply to donor executed technical assistance, for which full integration into budget planning and reporting is not realistic, although the objective of maximum transparency should equally apply.
- Integrate donor financed investments (and assistance) to the core capital budgeting process (and to the overall budget process) by streamlining the complex procedures of project processing and approval in the government, and by synchronizing project preparation to the budget cycle.
- Plan donor funding aligned with the country's strategy and on a multi-year basis. This should be integrated with the multi-year planning recommended in this report for all public capital investments. On the donors' side this should involve further strengthening coordination to harmonize and complement aid efficiently.
- Continue improving PFM systems to allow donor funding, in the near future, to be channeled and executed fully through budgetary institutions and controls. In the meantime the following suggestion could be considered: (i) facilitate more direct involvement of staff and management of the beneficiary agencies in project preparation and implementation in order to improve ownership and implementation; (ii) donors could phase-in the use of the country's (PFM) system, but supplemented, as needed, by additional arrangements in those areas where weaknesses in the country's PFM system pose fiduciary risks.