

EXECUTIVE SUMMARY

1. Recent economic and fiscal trends in Ukraine, combined with the financing requirements of the reform agenda, have brought fiscal pressures to the fore. Ukraine's economy grew by more than 50 percent between 1999 and 2004, but growth decelerated from 12.1 percent in 2004 to 2.6 percent in 2005. Contributing to this slowdown were less favorable terms of trade dynamics (in particular for metal prices)¹ and a substantial deceleration in investment demand (partly as a result of uncertainty about government policies and cutbacks in public investment). Despite the recovery of the economy in the first semester of 2006 (5 percent growth y/y), the short term outlook is still threatened by potential further increases in energy prices in 2007.² At the same time, increasing public spending threatens to crowd out the private sector. Driven by hikes in pensions and public sector wages, public spending soared from 39.4 to 44 percent of GDP in 2005, placing significant pressure on public finances. This high public spending and its consumption orientation risks generating inflationary impulses and higher interest rates, and eroding household wealth. Ukraine also has a high tax burden which discourages the private sector.

2. The current fiscal pressures accentuate the challenges the government faces to meet the country's economic development aspirations. The implementation of the government's reform program of pursuing the EU Action Plan, introducing the second funded pillar in the pension system, reducing payroll taxes, modernizing public sector institutions and improving the investment climate needs to be financed. Moreover, the government needs significant productive investment in infrastructure and human capital to reach a level of development consistent with its EU aspirations. But given that the tax burden is already high, financing reforms through increasing the tax burden is not a desirable option. In addition, Ukraine's authorities have been rightly cautious about increasing public debt. While Ukraine has a moderate debt to GDP ratio (18.7 percent) it should issue new debt prudently given its large stock of implicit and explicit contingent liabilities (estimated at 41.1 percent of GDP in 2005).³

3. **Thus the government needs to create sufficient fiscal space to finance its reform program and productive investments, and this must be carried out within a consistent macroeconomic framework.** Ukraine is on the cusp of major opportunities and challenges. The vision of an enhanced EU orientation has created considerable expectations among both the population and investors about the country's growth prospects. Investors are beginning to recognize the country's potential in terms of its resources, industry, well-educated population, and strategic geographic location. Achieving this potential will require reform efforts to be further strengthened and accelerated in the context of prudent fiscal and monetary policies. Fiscal space for priority spending needs to be created within the existing (or a reduced) fiscal envelope. Table 1 highlights the scope of this challenge by comparing Ukraine's key macro and fiscal indicators to those of the EU-8 countries⁴.

¹ Additionally, China has gained some market share to Ukrainian metal exports.

² Estimates of the impact of recent natural gas import price increase (from US\$50 to US\$95 per 1,000 cubic meters) indicate a negative effect of 2 percent of GDP on growth, which could potentially add 0.7 percent of GDP to the fiscal deficit (see World Bank 2006 note on the Impact of Energy Prices in Ukraine, available at www.worldbank.org.ua).

³ See section on debt sustainability in this Executive Summary (and Chapter 6) for a breakdown of these contingent liabilities and for important clarifications about their nature.

⁴ EU-8 countries are the new Central European and Baltic members of the European Union—The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.

Table 1: Selected Macro-Fiscal Indicators for Ukraine and EU-8 Averages, 2000-05

	2000	2001	2002	2003	2004	2005	EU-8 average for 2000-2004
GDP growth, %	5.9	9.2	5.2	9.6	12.1	2.6	5.2
Nominal Exchange Rate (UAH/USD), aop	5.4	5.3	5.3	5.3	5.3	5.1	-
CPI, % change	28.2	12.0	0.8	5.2	9.0	13.6	5.3
Terms of trade (2000=100)	100.0	98.3	98.0	99.3	104.6	112.9	
Gross capital formation, % GDP	19.7	21.8	20.2	20.6	21.1	21.8	25.0
Public and publicly guaranteed debt, % GDP	45.3	36.5	33.5	29.0	24.8	18.7	29.8
Total revenues, as % of GDP	33.3	33.2	35.7	35.9	35.0	41.3	39.1
Indirect Taxes	8.6	8.7	9.9	8.8	8.6	12.3	8.6
VAT	5.6	5.1	6.0	4.7	4.3	8.1	7.8
Direct Taxes	19.6	19.2	20.4	21.8	20.6	22.7	13.5
Payroll taxes	6.8	7.2	7.9	7.9	8.4	9.3	12.8
Non-Tax Revenues	5.1	5.3	5.4	5.3	5.8	6.3	
Total expenditure, as % GDP	34.7	35.1	35.5	36.8	39.4	44.0	42.5
Pension payments, % of GDP	7.5	7.6	9.0	9.2	11.4	15.3	
Public wage bill, % of GDP				7.6	7.4	8.0	10.4
Capital expenditures, % GDP				4.3	6.0	4.3	
Capital investments (fixed), % GDP				2.8	2.8	2.0	3.1
Primary deficit, % of GDP	0.9	0.0	1.4	0.1	-2.5	-2.0	-1.1
Fiscal balance, % of GDP	-1.4	-1.9	0.2	-0.9	-4.4	-2.7	-3.1

Sources: MoF; State Statistics Committee; State Treasury of Ukraine; Eurostat; Bank staff calculations (and estimations for 2005).

4. Ukraine's level of public fixed capital/investments over the past few years lags behind that of the new EU member states (see Table 1). While the bulk of investment should come from the private sector, the government has a key role to play in facilitating private investment and in providing basic infrastructure that the private sector needs to rely upon. The needs are especially pronounced in the energy sector, transport, basic infrastructure for services (water, sanitation, housing and community services), and environmental clean-up. The upgrading of the capital stock has been very limited in the last 15 years and infrastructure quality has been deteriorating. The government also needs to invest in human capital in order to enhance the technical sophistication of its labor force and to achieve higher levels of productivity. Initial rough estimates developed by World Bank staff suggest that the public investments needed may easily top US\$100 billion over the next 10 years (see Table 2). Against this background, public capital expenditures are too low at 4.3 percent of GDP in 2005, particularly as an estimated one-third of these expenditures are subsidies to public and private sector enterprises.

Table 2: Capital Investments for EU Aspirations over the Next 10 Years, 2006-15

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

Source: Bank staff estimates.

5. These fiscal tensions imply that trade-offs have to be made (see Box 1). Facing these tensions, and dealing with them effectively, is a crucial element of the program's success.

Box 1: The Trade-offs in Creating and Allocating Fiscal Space

The concept of fiscal space is another way of looking at the fact that resources are always limited, and thus, for any sustainable fiscal program, resources and plans for allocation must add up. When a government puts more public resources into recurrent spending (e.g., wages, pensions, subsidies), it takes up more of the “fiscal space” that could be granted to its reform program and to growth-enhancing public investments in human and physical capital. In the absence of excess fiscal space, increases in investment and aggregate spending increase fiscal deficits and lead to higher debt and accelerated inflation. But ignoring key productive investment needs would keep growth rates at low levels.

Broadly, there are several dimensions (sources) through which fiscal space can be created: tax policy and administration (by improving collection performance and compliance, and broadening the tax base); reallocation and rationalization of expenditures (by shifting resources from less to more efficient uses, making ongoing spending programs more efficient, and cutting or phasing out inefficient programs); expansion of government spending financed by debt accumulation, privatization proceeds and donor funding(aid); and through other various sources of non-tax revenues. In cases where there are simply not enough resources to meet priority public needs (and even where there are), private sector participation in public goods provision can provide an efficient alternative, if properly evaluated, structured, and regulated. In all instances, creating and allocating fiscal space has to be achieved in the context of an overall prudent macro-fiscal and social program. Moreover, these processes are country specific, and thus they are intrinsically linked to each country’s characteristics, needs, capabilities, and specific reform program.

6. This report concentrates on four key sources of Ukraine’s fiscal space and provides a macro-framework to ensure consistency: (i) tax policy and administration, (ii) overall public expenditures, (iii) pensions reform, and (iv) the capital budgeting process.⁵

(i) Broadening the Tax Base and Improving Compliance without Increasing the Tax Burden

7. Over the past few years Ukraine has made considerable progress in tax policy and administration. In particular, it has halted the growth of tax arrears, ended the practice of issuing tax amnesties, eliminated tax exemptions (although some remain, particularly in agriculture), simplified the system for the corporate income tax (CIT) and personal income tax (PIT), and designed a modernization strategy for tax administration.

8. Going forward, revenue policy should aim at reducing the high marginal rates (particularly on payroll taxes), but coupled (or preceded) by policies geared toward the objectives of broadening the base, improving compliance, and enhancing revenue authorities’ administrative capabilities. This would avoid significant revenue losses (due to rate reduction), allowing a gradual and smooth reduction of the tax burden in the country. This report focuses on key selected areas in tax policy and administration. The aim is not to review tax policy and administration comprehensively but to highlight key challenges and opportunities for reform.

9. *VAT policy:* Despite important progress in VAT policy (e.g., curtailing a variety of VAT exemptions), there is an important reform agenda ahead. The poor past performance of the VAT and the burden of refund arrears on business have brought up discussions about replacing it with a turnover tax. At the same time, a rate reduction on the VAT is being considered (the current rate is 20 percent). Moreover, the VAT has some problematic issues in the agriculture and energy sectors. The “double VAT pass-through” on gas imports, where the VAT only starts to be charged at a third stage in the VAT chain, continues to be a problem. It represents a large subsidy, it may be generating revenue losses since

⁵ This part of the report also contains an analysis of the planning and management of donor-financed investments, proposing alternatives for better integrating them into the core budget process.

two stages of collection are bypassed (making the job of revenue authorities more difficult), and it may be subject to abuse when refunds are claimed (as the control of having to pay VAT at earlier stages of the chain is not present). The VAT in agriculture is costly and inefficient for the budget as a result of a combination of factors, including the following: a zero rate for milk and meat producers; the retention of VAT collected by agricultural taxpayers; the right of purchasers of agricultural products to claim VAT credit for their purchases; and the fact that meat and milk processing factories charge VAT but not remit it to the budget. Moreover, the VAT system in agriculture is inefficient because its tax expenditures support specific commodities and producers (such as milk and meat products and producers and the livestock sub-sector) at the expense of other commodities and producers. Moreover, evidence shows that a small number of larger (and wealthier producers) are mostly the ones that reap the benefits of this special system. In this context, the following recommendations should be considered:

- Maintain the VAT rate at the current level. The ground is not yet ready for reducing the VAT rate in Ukraine. The current rate of 20 percent is not high when compared regionally, and a reduction could cause serious losses to the budget at a time when fiscal pressures are building.
- Strengthen VAT policy and administration rather than replacing the VAT as a basis for a potential reduction of VAT rates in the future when the tax base is broader and more stable. A turnover tax is not a solution as it is highly distorting (as the market shifts to less efficient production modes to reduce turnover at every production stage) and it brings about a cascading effect of taxation. Moreover, its potential gains from easier administration are dubious since evasion is harder to identify, and its distributional effects are uncertain.
- Consider the elimination of the “double VAT pass-through” on gas imports in the context of an improved energy policy.
- Introduce the VAT system for agriculture proposed by the government in 2005, which cuts out several inefficiencies, reduces losses to the budget, and is more in line with EU practice.

10. *VAT administration:* The VAT has experienced difficulties as a revenue raiser, with declining collection efficiency during the period 1998-2004. Despite the sharp increase in collections in 2005, problematic issues persist in the overall performance and administration of this tax, such as delays in refunds to exporters⁶ and evasion throughout the system. But these are merely symptoms of underlying administrative weaknesses in core tasks of tax administration, such as screening registrants, reducing high compliance costs, improving monitoring and audit strategies, and developing an efficient system of penalties. In this context, the following actions are recommended:

- Enhance the registration processes by screening applicants (to avoid potential evaders). Moreover, voluntary registration of tax payers below the threshold should not be allowed as it complicates administration.
- Reduce compliance costs (including reducing the time spent by firms in the required compliance procedures for the VAT and other core taxes, and simplifying the tax forms).
- Build a comprehensive monitoring system (beyond risk assessment of exporters and refund controls) based on analytical capabilities and using fraud and collection benchmarks such as “VAT collection gaps” by sectors of the economy, by industry, and by region. In doing so, avoid the higher compliance costs associated with excessive, expensive and ineffective cross-controls.

⁶ The level of VAT refund arrears was at UAH 3.3 billion (0.8 percent of GDP) as of August 2005. This increased level was partly due to the new refund claims generated by enterprises in FEZs (claiming refunds for the first time in 2005) and by SOEs that did hold refund claims towards the end of 2004, but pushed them forward for collection in 2005. Toward the end of 2005, refund arrears dropped to 642 million. In 2006, this amount has been reduced to 586 million as of May 1.

- Undertake better-informed (that is, targeted on the basis of analytical information gained from monitoring) and coordinated (with other revenue collection agencies) audits.
- Move to a more effective system of penalties with fewer criminal prosecutions and more administrative penalties.
- Avoid the renewed build-up of VAT refund arrears and reduce further the stock of outstanding refund arrears.

11. *Payroll taxes:* The high marginal tax burden caused by payroll taxes (social insurance contributions) and their narrow base are issues of concern for both the business community and the government in Ukraine.⁷ This situation has been exacerbated by two factors: the inefficient and burdensome system of collection through the four different agencies (insurance funds); and the behavioral distortions caused by the Simplified Tax System (STS) for firms and individuals that migrate to this system in order to significantly lower their tax burden. Currently, the pension system is under stress. The increases in pension expenditures have generated a serious deficit in the system, and the implementation of the pension system's second pillar planned for 2008 by the government depends critically on balancing the deficit and generating enough resources afterward to achieve long-term sustainability. At the same time, lowering the high marginal tax burden of payroll taxes in Ukraine is important and needed, but any rate reduction needs to be preceded by the following reforms geared to broadening the tax base and improving compliance:

- Strengthening the revenue authorities' administrative capabilities.
- Implementing the pension system's second pillar to create a clearer link between payments and benefits. This should include implementing the parametric changes in the first pillar (see pensions section).
- Reforming significantly the STS, which is currently eroding the base of payroll taxes.⁸

12. *Payroll tax administration:* Ukraine has a rather complex system of four separate social insurance programs that collect payroll taxes. Each program has its own tax rates, its own independent administration and operation, and its own regulation. Currently, each insurance fund administers its own separate collection machinery. These collection systems are largely independent of one another and this occurs despite a broadly common base and method of collection (namely, employer withholding taxes directly on gross wage incomes). The separated administration of these programs is inefficient and wasteful of public resources, and creates high compliance costs for taxpayers. The following recommendations should be considered to achieve higher collection efficiency and lower compliance costs:

- Accelerate the process of unifying the common administrative functions (registration, data warehousing, reporting, collection, control, enforcement) of the four social insurance funds under the Pension Fund (PF). This process will render important benefits in reducing compliance and administrative costs. In the medium term the government should aim at full unification, which would imply a single unified tax rate and a single collection agency.

⁷ Currently, the employer contribution rate alone is close to 37 percent, which covers contributions to the four funds (see Table 2.5). Payroll taxes (or social insurance contributions as they are sometimes referred) are made on wage withholding, and do not include the personal income tax (PIT).

⁸ The next section deals specifically with the inefficiencies and problems caused by the STS, and lays out the options available for its reform.

- Improve coordination with the State Tax Administration (STA). The PF (representing all insurance funds) and the STA should establish a formal coordinated compliance program to reduce evasion, involving a formal structure of coordination and joint task teams.
- Strengthen analytical capabilities in the PF in order to improve monitoring and fraud detection.

13. *The Simplified Tax System (STS)*: There are well-known compliance, administrative, and efficiency arguments for having a special system for small taxpayers, and there is evidence, albeit mixed, that the STS has encouraged Small and Medium Enterprises (SMEs) registration and entry. However, the current system design has led to substantial abuses, inefficiencies, and base erosion of the regular tax system in the following ways: (i) it creates incentives for legal and illegal migration from the regular tax system, which generates revenue losses for the budget in all major taxes (payroll taxes, the PIT, the VAT, and, more marginally, the CIT); (ii) it distorts taxpayer behavior in inefficient ways for the economy, potentially lowering productivity in the economy (e.g., firms fragment their operations into smaller firms to meet the threshold, losing economies of scale; and production and sales are kept below thresholds hampering output growth); and (iii) it introduces substantial horizontal (and vertical) inequalities to the system (e.g., an individual working as a “consultant” under the STS may pay significantly lower taxes than an individual with the same type of job description at a firm and the same level of income under the regular income tax system). The STS should be kept but the following recommendations should be considered to bring efficiency and equity to the tax system:

- Ensure that only “truly” small businesses are accepted into the STS by lowering the upper threshold for legal entities (currently at UAH 1 million) to the VAT entry threshold (UAH 300,000)—which is also important for the VAT.
- Modify the upper threshold for physical persons, which is currently 50 times the average annual salary (at UAH 500,000), by reducing it to no more than 2 or 3 times the average annual salary (UAH 20,000 – UAH 30,000).
- Rationalize the eligibility criteria in terms of employee limits (currently, the threshold for applying is 50 employees, while a level of 15 is more consistent with the type of small business that simplified systems are designed to facilitate).⁹
- Limit the type of activities of individuals accepted by the STS, particularly excluding professionals and “consultants,” who currently represent the bulk of tax avoiders in the simplified system and who should be able to comply with the regular tax system.
- Implement a clear mechanism for “graduation” from the STS system. Effort is needed to improve enforcement (and “graduation” if it applies) in the STS. This could be undertaken in coordination with local governments (in order to reduce administrative costs).

14. *Tax expenditures*: Tax expenditures have been generating distortions across a variety of sectors in Ukraine’s economy, but they are highly concentrated in the agriculture sector.¹⁰ Tax expenditures can be found across most major revenue sources, including the VAT, the CIT, the land tax and a variety of excise taxes. However, the government of Ukraine has gradually but steadily curtailed tax expenditures. At the beginning of 2005, a significant reduction of tax expenditures was achieved through the curtailment of exemptions in the free economic zones (FEZs) and various VAT tax expenditures. Although the share of tax expenditures as a percent of GDP was significantly reduced from 7.6 percent

⁹In addition, this report supports the International Monetary Fund’s (IMF) recommendation that calls for the exclusion from the STS of any business that directly or indirectly controls other businesses, and/or that it is controlled by another business entity, or by a person that controls another business.

¹⁰ Tax expenditures refer to exemptions, privileges, holidays and other loopholes that confer a subsidy on the beneficiary and a cost on the budget (through foregone revenues). For a complete definition see Chapter 2.

in 2002 to an estimated 3.2 percent in 2005, tax expenditures remain sizable, and transparency in their reporting creates concern. Moreover, the newly appointed administration is considering re-introducing the FEZs, which would represent a step backward in this area. The following recommendations should be considered:

- Do not re-introduce tax privileges in the Free Economic Zones. Structure all investment incentives in full compliance with WTO regulations.
- Continue curtailing VAT and other tax expenditures. Some good candidates for elimination are those in agriculture, pharmaceutical products, publishing, and car manufacturing. (up to 1.5 percent of GDP could be saved). In this regard, the agriculture VAT regime proposed by the government in December 2005 should be implemented for the 2007 budget.
- Discuss tax privileges in the budget process as an expenditure item. This would require a prior analysis and public dissemination of the results to enable policymakers to make informed decisions.
- Assure transparency of tax expenditures in all budget documents.

(ii) Finding Expenditure Savings in the Budget

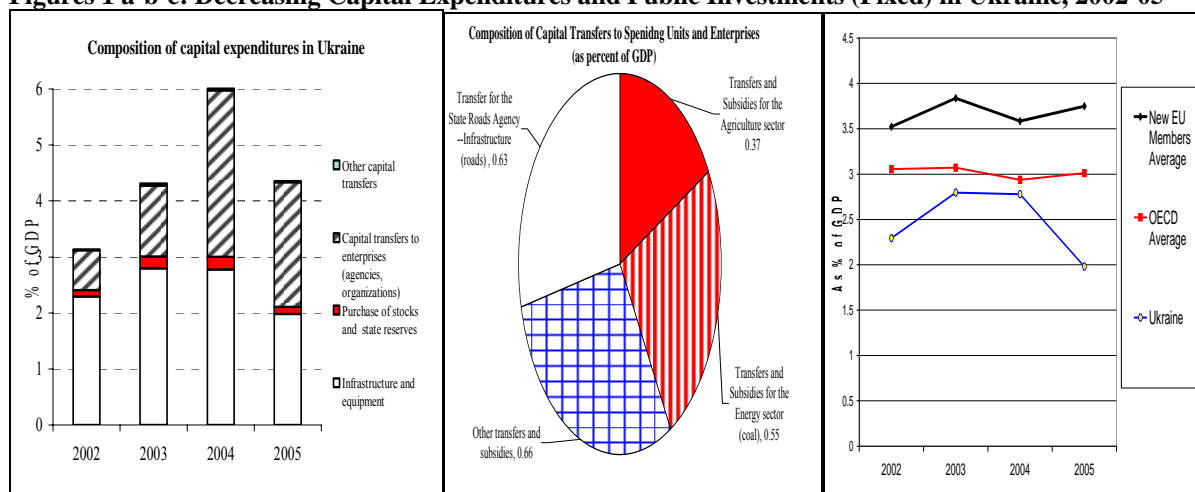
15. Public spending in Ukraine is high and has been increasing. Moreover, it is crowding-out private investment; its consumption orientation means that urgently needed public investments are delayed. The allocative efficiency of public spending is questionable in terms of its consumption (and current transfers) orientation, the efficiency of program implementation, and the plethora of subsidies in both current and capital expenditures. Public expenditures in Ukraine have grown steadily since 2001, reaching 44 percent of GDP in 2005 (4.6 percent higher than in 2004) driven by hikes in recurrent spending. Pension payments grew from 9.2 percent of GDP in 2003 to 15.3 percent by 2005, while in parallel the pension system balance went from a small surplus in 2003 to a 3 percent deficit in 2005. Although the country is 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 7.3 percent in 2004). The level has been raised by minimum wage hikes, and is likely to make up 8.4 of GDP in 2006, owing to further planned step-wise increases.

16. But capital expenditures have remained low and decreased significantly in 2005. Moreover, the reported size of capital spending is inflated by misclassified subsidies which crowd-out expenditures for infrastructure and equipment. Total capital expenditures, as listed in the budget, represent 4.3 percent of GDP down 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) that in turn run subsidy programs with these resources (see Figure 1 a-b-c).¹¹ This situation has left investments in infrastructure at just above 2 percent of GDP, which is well below new EU member states. Furthermore, public investments in Ukraine are systematically under-executed. In 2005, the category "capital construction" was under-executed by 20 percent on an already small budget allocation. The analysis of capital expenditures shows that low priority has been placed on this critical area of government spending. The 2006 budget reflects a marginal increase in capital expenditures, but a drilling down on the composition of that increase shows that it is composed of increased subsidies, as well as a state guarantee on the bonds of the State Mortgage Institution. In

¹¹ Only close to 35 percent of "capital transfers" are actual investments in infrastructure, mostly resources transferred to the State Road Agency (30 percent). There are, in addition, some small investments within these transfers across spending units..

particular, the subsidies include increases in the food reserves of the Agriculture Fund and other subsidies for the coal and agriculture sectors.

Figures 1 a-b-c: Decreasing Capital Expenditures and Public Investments (Fixed) in Ukraine, 2002-05



Sources: MoF; State Statistics Committee; Eurostat; OECD.

17. **There is the scope and the need for more efficient allocation of funds across spending categories, for better use of allocated funds within these categories, 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 allocations to productive investments). The following selected issues and recommendations should be considered:

18. *The rapid growth in the public wage bill should be checked.* A short term target would be to stabilize it below the 8 percent of GDP reached in 2005.¹² A decompression of civil service wages is necessary, but, to avoid a further 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 allow more competitive salaries per position. Despite important improvements regarding the streamlining of the pay system (passed in legislation in March 2006), multi-position appointments and bonuses are still used to make jobs attractive and to reward behaviors, while base salaries per position do not correlate strongly with qualifications and responsibilities.¹³ To achieve the goals stated above, 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 improving the efficiency of civil servants.

19. *The system of social protection and social privileges* is costly, convoluted, and non-transparent, and is ultimately an inefficient way of achieving the goals it aims to pursue (i.e., redistribution and poverty targeting). Moreover, these systems need to create savings to be able to cope with potential increases in the energy/housing subsidy payments connected with rising energy prices and housing and

¹² This ratio does not consider wages paid to professors in higher education institutions, as the government moved these salaries from the wages category to the R&D category in 2005 (code 1170). The minimum wage is the key determinant of the public wage bill. This recommendation is consistent with aiming for nominal increases in the minimum wage not in excess and perhaps slightly below the rate of inflation.

¹³ Rough estimations suggest that prior to March 2006 the basic salary made up only 30 percent of the total pay. In March 2006, new regulation was approved to streamline the pay system in the country. Owing to this regulation, the portion of the base salary in total remuneration may increase significantly to roughly 60 percent.

communal service tariffs. The government should consider phasing-out untargeted programs such as occupational benefits, spa/sanatoriums, and telephone benefits and should certainly avoid the introduction of any new privileges in addition to existing social assistance programs going forward. At the same time, it should better target the social assistance programs by tightening the eligibility requirements for utilities subsidies and housing allowances using proxy means testing (PMT). **Up to 1 percent of GDP could be saved by this reform without hurting poorer recipients.**

20. *Subsidies* are crowding out potential productive spending and are damaging Ukraine's economy. For example, subsidies to the energy sector and related quasi-fiscal activities (e.g., underpricing of energy) have worsened the financial position of energy companies and their ability to attract investments. Moreover, these subsidies and quasi-fiscal activities have sustained inefficient energy use and vulnerability to energy price shocks in the economy. The government should enforce financial discipline on SOE in the energy sector (including companies in which the State is a shareholder) while phasing out underpricing and cross-subsidization. This should be done in tandem with completing coal sector restructuring and quickly phasing out coal subsidies. As prices of other sources of energy (e.g., gas) go up, coal production acquires a price advantage and producers will increase profitability, which eliminates the rationale for budget support to this sector. Another example of sector subsidies that should be reduced is the repeated re-capitalizing of state-owned financial institutions. Progress has been made with regard to the Savings Bank's restructuring process; this should be continued. **Up to 1.2 percent of GDP in savings could be achieved by eliminating the most inefficient subsidies in energy and other sectors** (excluding agriculture, which is discussed below).

21. *The government's support to agriculture* is expensive and inefficient, and creates inequalities. International comparisons suggest that Ukraine's fiscal support to agriculture is high (even above the level of some OECD countries). In 2005, fiscal support to agriculture, including tax expenditures, reached 2.5 percent of GDP (1.5 percent higher than in 2000), and it is increasingly dominated by subsidies.¹⁴ But the evidence suggests that subsidies have had little impact on agricultural productivity. For example, subsidies intended to ease farmers' access to agricultural machinery failed to accelerate the technical modernization of the agricultural sector. Most subsidies simply encourage the higher production of targeted products or the increased use of subsidized inputs, and are not focused on improving sustainable efficiency improvements in the sector. Finally, evidence also suggests that subsidies (particularly tax expenditures in the sector) create inequities, as they mostly benefit large producers.

22. Thus, support to agriculture should be shifted from the current inefficient fiscal subsidies to productive investments and competitiveness-enhancing programs such as R&D, extension programs, rural development, disease control, and WTO readiness programs. In parallel, public support to the sector should be improved and geared to market facilitation (land reform, cadastre and registry), and WTO's "Green Box" programs, in partnership with the private sector. Moreover, the changes should be accompanied by the avoidance of market-distorting measures, such as price controls and restrictions on the inter-oblast movements of agricultural commodities. If these actions were taken, significant progress could be made in rural growth and poverty alleviation. **Up to 0.4 percent of GDP in savings could be achieved by eliminating the most inefficient subsidies in this sector. This is in addition to the up 1 percent of GDP in expenditures savings that could be achieved by implementing the government's proposed agricultural VAT reform.**¹⁵

¹⁴ Actual support to agriculture is even higher (by at least 0.5 percent of GDP) if non-budget public support measures are taken into account, such as the sugar quota, the support of grain prices through pledge and intervention purchases, and the reduced interest rates for machinery leased from UkrAgroLeasing, among other measures.

¹⁵ The savings on tax expenditures in agriculture may range from 0 to 1 percent of GDP depending on the cost and input structure of farmers and their patterns of consumption after the reform.

23. *Further budget consolidation* is needed. The creation of the Special Fund (which groups several off-budget categories together and brings them into the budget) was a positive step four years ago. Attention should now be given to further budget consolidation, since preserving the division between the General and Special Funds does not have a clear rationale in a properly functioning budget system. But since the Special Fund protects (to some extent) the resources for some critical public investments in infrastructure, budget consolidation in this area should be preceded by the strengthening of capital budgeting (including capital budgeting and capital transfers to local governments). Higher flexibility and transparency in allocation and better budget management could be achieved with their consolidation. In addition, the government should consider the integration of the Social Insurance Funds into the consolidated budget over the medium term.

(iii) Getting Pension Reform Back on Track

24. The pay-as-you-go (PAYG) pension system in Ukraine encompasses a variety of problems that threaten its fiscal sustainability. These problems range from difficulties with designed features of the system to threats posed by a rapidly aging population (by 2055 there will be 1 worker in Ukraine for every 1.42 pensioners). In 2003, the government enacted legislation with the objective of preserving and enhancing the system by adding to it a second fully funded mandatory pillar and a third voluntarily funded pillar. While the core legislation was approved, the envisioned multi-pillar system has not been implemented due to the fact that its institutional and administrative underpinnings are not yet ready and the system remains under fiscal stress. The minimum pension increase introduced prior to the 2004 presidential elections drove pension expenditures up from 9.2 percent of GDP in 2003 to 11.4 percent in 2004 and a record 15.3 percent in 2005 - the highest level in the region (with deficits of 1 and 3 percent of GDP in 2004 and 2005, respectively).

25. The measures introduced in 2005 to reduce pension expenditures and the measures planned by the government's strategy, while tilting the system's balance in a positive direction, are not sufficient to accommodate a smooth introduction of the second pillar, to implement rate reductions in contributions, and to bring long-term fiscal sustainability to the system. The indexation rule changes¹⁶ and other additional measures reduced pension expenditures from an expected 17 percent of GDP to 15.3 percent in 2005. Moreover, estimates indicate that pension expenditures would drop to around 14 percent of GDP in 2006 owing to these measures. In addition, the government launched its "Strategy for the Pension System Development" which encompasses additional measures to improve the system's finances.¹⁷ The estimation of the overall fiscal impact of the measures envisaged by this strategy shows a moderate positive effect of around 0.42 percent of GDP annually (on average). This takes account of the negative effect of the planned indexation of all pension benefits to 20 percent of nominal wage growth. Without this change, the government's strategy would achieve somewhat higher savings.

¹⁶ According to changes in the indexation rule, instead of an increase in the minimum pension benefits being made at the beginning of the year, the minimum pensions would gradually reach the minimum subsistence level by December 2006. Additional measures included the abolishment of the rule that allowed 1 percent of minimum pension increment for each additional year of service above 20/25 years for women and men, respectively; and the abolishment of the rule that allowed increases in supplementary payments to special categories of pensioners based on the increase in the minimum pension.

¹⁷ The Government's Strategy measures include the following: (i) an increase in the retirement age for women to 60 at the rate of 6 months per year, but starting only in 2010; (ii) the introduction of the indexation of all pension benefits in payment status by 20 percent of the nominal wage growth; and (iii) the suspension of the increase in pension benefits up to the subsistence minimum for working pensioners, retaining payment of only the formula part of the benefit. The introduction of the indexation of all pension benefits in payment status by 20 percent of the nominal wage growth would increase expenditures

26. In order to move the system onto a long-term path of fiscal sustainability while fulfilling the government's agenda of reducing the high marginal burden of payroll taxes and introducing the second pillar in 2008, this report recommends the following additional savings measures:

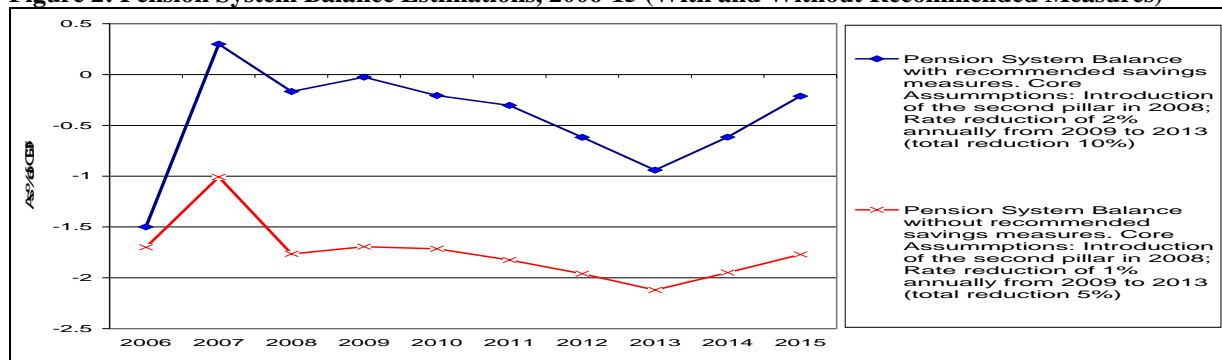
- Increase the retirement age for women from 55 to 60 years, with an increase of 6 months per year, starting in 2007. This measure would save an average of 0.32 percent of GDP annually, starting from 0.1 percent in 2007 and increasing to 0.7 percent by 2015. As life expectancy continues to grow, the retirement ages for men and women would need to be further increased.
- While continuing to pro-rate pensions for those with less than the minimum required contribution period for the full minimum pension, lengthen the minimum period for a full pension to 30 and 35 years for women and men, respectively. This measure would save an average of 0.17 percent of GDP annually, starting from 0.1 percent in 2008 and increasing to 0.2 percent by 2015.
- Suspend the increase in pension benefits up to the subsistence minimum if the pensioner continues to work. This measure would save an average of 0.54 percent of GDP annually, starting from 0.5 percent in 2007 and decreasing to 0.4 percent by 2015.
- Replace the minimum pension with means-tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level.¹⁸ Only low income pensioners whose household income is below the notional amount of the "subsistence minimum" should receive the automatic increase. This measure would save an average of 0.33 percent of GDP annually, starting from 0.5 percent in 2007 and decreasing to 0.4 percent by 2015.
- Introduce a regular contribution rate for those taxed under the STS. This measure would save 0.1 percent of GDP annually from 2007 to 2015.¹⁹
- Maintain over the medium term the current indexation rule (as applied for 2006).

27. The recommended measures would affect poorer pensioners least (since targeting is involved) and would generate more than three times the savings of the measures envisaged under the government's Strategy. The expected savings for the system would be, on average, 1.4 percent of GDP annually from 2007 to 2015 (starting from 1.1 percent of GDP in 2007 and increasing to 1.7 percent in 2015). These savings would outgrow revenues passed on to the funded second pillar, allowing a fiscally smoother transition. The savings would also allow more fiscal space for rate reductions in payroll taxes, which is a crucial and appropriate policy in the government's reform agenda (see Figure 2). Moreover, the rising "dependency ratio" (the product of an aging population and the early retirement age provisions) will continue to cause strains on Ukraine's pension system over the long term. The reforms proposed here are thus critical to maintaining sustainability in the system for current and future retirees, and they actually follow the path taken by new EU members that inherited similar problems.

¹⁸ The increase in the minimum pension currently occurs automatically up to the level of the "subsistence minimum." The subsistence minimum is a notional amount set by the government each year in the annual budget. This link between the "subsistence minimum" and pension insurance blurs the distinction between social insurance and poverty targeted social assistance, confuses the pension dialogue, and leads to wasteful transfers which poorly target poverty.

¹⁹ This estimation is based only on the wage income reported by employees and individuals under the current STS regulation.

Figure 2: Pension System Balance Estimations, 2006-15 (With and Without Recommended Measures)



(1) A full set of measures and assumptions for the pension and macro-scenarios considered can be found in Chapter 4.

Source: Based on a projection of the Ukrainian Pension Model- developed in collaboration by the Government of Ukraine, the National Academy of Sciences of Ukraine, and the World Bank.

(iv) Strengthening the Capital Budgeting Processes

28. Capital spending in Ukraine is not efficiently targeted towards the expressed priorities (e.g., the EU Action Plan). A strengthened capital budgeting process would help policymakers redirect capital expenditure toward productive investments. Moreover, an improved capital budgeting process will be critical to ensure that resources freed up by reform measures proposed elsewhere in this report are used efficiently. While there are some formal capital budgeting processes that are well structured (for example, the line ministries and their programs are the unit of analysis for capital spending and select projects that are within their annual budget ceiling), significant efficiency gains could still be achieved.

29. *Coordination and integration of overall budget.* Capital budgeting in Ukraine is not well integrated into the overall budget process. The following recommendations should be considered:

- Establish a formal structure of collaboration between the Ministries of Finance and Economy to review all aspects of capital budgeting, from identification and evaluation through completion and monitoring.
- Prepare a report to the Cabinet of Ministers on changes in and improvements to the process, including specific steps that would strengthen the integration of capital budgeting into the core budget process.

30. *Project planning and evaluation:* In this area the major shortcomings are the following: (i) the absence of multi-year ceilings for both capital and recurrent spending; (ii) the absence of a central assets registry, including asset conditions, for planning maintenance and replacement spending; (iii) the absence of strategic plans for line ministries; and (iv) the weakness in the economic evaluation of projects. This is partly due to a lack of coordination in functions between the Ministry of Economy (MoE) and the Ministry of Finance (MoF) and the analytical weaknesses of sectoral ministries for planning and evaluation. The following recommendations should be implemented:

- Establish multi-year ceilings for total spending and for line ministry spending (including capital and recurrent spending).
- Introduce multi-year sector strategies/planning for all line ministries.
- Establish a central database of current assets with links to all line ministries.
- Strengthen project evaluation capabilities in the Ministries of Economy and Finance.

- Apply consistently (and selectively) cost-benefit analysis as part of the formal process of capital budgeting.
- Enforce the use of economic project evaluation (using cost-benefit analysis) in the sectoral ministries as part of their project submission to the MoE and MoF.

31. *Project implementation, execution, and monitoring (including O&M):* Capital project completion has been a persistent problem. Poor completion rates stem from a budgeting process which favors funding new projects over ongoing projects. This behavior is observed in both the government and the Rada. In addition, maintenance spending is not keeping pace with asset acquisition and maintenance requirements. The following recommendations should be implemented:

- Strengthen coordination between the MoE and MoF to closely monitor capital project implementation during the year with line ministries. This would help assure that progress is being made and would help identify and resolve bottlenecks as they arise.
- Review the current budget execution procedures for capital projects to assess their adequacy and ensure that they are not contributing to the under-execution of capital spending.
- Improve the monitoring and assessment of adequacy of operations and maintenance. The MoE and MoF in coordination (and together with line ministries) should monitor information and feed it back into the assets database (which, as recommended above, needs to be created).

32. *Capital budgeting in sectoral ministries:* There are also problems with the handling of capital budgeting in the sectoral ministries. The analytical capacity to perform project evaluation is poor in most ministries. Moreover, management and internal controls in the ministries are weak in terms of project oversight; this is coupled with a lack of central agency monitoring. Poor accountability and oversight also contribute to low completion rates. The ineffectiveness discussed here, combined with the low level of capital spending has led some spending units to advance new financing techniques such as Public-Private Partnerships (PPPs). But with weak targeting and screening, and weak analytical capabilities, additional financing is likely to be ineffective (and contingent liabilities may arise for the state), particularly if structural enhancements to capital budgets are not implemented at the level of the spending units (sectoral ministries and agencies). The following recommendations should be implemented:

- Strengthen project economic feasibility assessment and project evaluation in all line ministries. The Ministry of Economy should take the lead in this process.
- Set common (and high) standards for project evaluation for line ministries. This also implies the implementation of transparent and standard methodologies of evaluation (based on cost-benefit analysis).
- Strengthen analytical capabilities to evaluate potential risks in all types of Public Private Partnerships and privatization schemes. This is critical as flawed designs and evaluation may generate liabilities of different kinds for the state in the future.

33. *Donor financed investments and projects:* Donors contribute significant resources to fund capital investments in Ukraine (total support is estimated at US\$ 1.5 billion, of which two thirds are loans for investment or budget support and one third is technical assistance and grants) and donor funding may rise significantly going forward. Yet, current systems for planning, approving and executing donor funded projects are complex and reduce the effectiveness of this assistance. This stems from a variety of sources, including the following: (i) donor-financed investments, even when executed by the recipient, are not well integrated into the budget process; (ii) the use of parallel administrative structures to prepare and implement donor funded investments raises transactions costs, fails to build

capacity in counterpart agencies, and may reduce government ownership; (iii) the procedures of project approval in Ukraine are complicated and time consuming causing delays and preventing the government to reliably plan and budget donor assistance; (iv) complex existing procedures for implementation (e.g., release-of-funding requests within the Ukrainian government) slow disbursements and delay project completion; and (v) supply driven initiatives and remaining weaknesses in donor coordination undermine strategic coherence and government ownership. Moving forward the following broad options for reform should be considered:

- 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 the country's own 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, and supplement them, as needed, by additional arrangements in those areas where weaknesses in the country's PFM system pose fiduciary risks.

Creating and Allocating Fiscal Space within a Consistent Macro Framework

34. The creation and the allocation of fiscal space should be carried out in the context of a consistent macroeconomic framework. Thus, this report presents an adding-up exercise based on the recommended sources and uses of fiscal space, using two sets of macro-fiscal projections. These projections exhibit the ways in which different policy packages would be likely to affect economic outcomes. These projections also highlight the inter-temporal dynamics that take place between investments and macro-fiscal variables.

35. The first macro-fiscal scenario, called here the "base case" scenario, tracks the expected path of the economy under a moderately fast and well-implemented reform package, including improved recurrent and capital spending, better revenue policy and administration, and improved public finance management. This scenario assumes the implementation of a portion (not all) of this report's recommendations. The scenario shows that policies and specific savings measures to create fiscal space allow for higher public (and private) productive investments, and also allow for the introduction of the critical reforms planned by the government (e.g., the reduction of payroll taxes by a total of 10 percent from 2009 to 2013, along with the introduction of the second pillar in 2008), while maintaining moderate fiscal and external deficits, an average GDP growth of 5 percent, and allowing inflation to decelerate over the projection period (2006-15).

36. The base case leaves considerable room for an upside should all the recommendations made in this report be implemented and should the external environment remain favorable. The rationale behind showcasing a moderate base case scenario (and a lower more conservative one as depicted below) is that it is much better to plan conservatively and efficiently, and benefit from a windfall, than to expect a windfall and find that available fiscal resources impose considerably higher constraints than had been envisaged.

37. A second macro-fiscal scenario, called the “conservative case,” assumes a policy status quo that is relatively slow and uneven, but with some continued progress in reforms (e.g., a reduction in payroll tax rates of 5 percent from 2009 to 2013), and slightly less favorable external conditions (reflecting Ukraine’s increased vulnerability to these conditions in this scenario). The projections of this scenario show that it allows for considerably less public investment (i.e., almost at the current level). It also involves higher fiscal deficits, persistent inflation dynamics, and moderate domestic investments and FDI (which in turn implies somewhat lower current account deficits than in the base case). Together, this is projected to yield an economic growth in the 2.5-3 percent range over the medium term. The macro projections of both scenarios are presented in Table 3.

Table 3: Projection of Macro Scenarios

	Base-Case			Conservative-Case		
	2006	av 2007-10	av 2011-15	2006	av 2007-10	av 2011-15
Real GDP, % growth	4.5	5.0	4.6	3.0	3.0	2.5
GDP per capita, USD			4244			3318
Consumption, % growth	7.3	3.1	3.7	5.9	1.5	1.7
Investment, % growth	8.5	9.7	5.1	3.8	4.1	2.8
<i>private investment, % growth</i>	8.4	6.9	5.2	2.7	4.0	2.8
Real wage, % growth	9.0	7.0	6.2	5.0	4.3	3.5
GDP deflator, % growth	12.3	8.6	5.4	13.8	10.8	9.0
Current Account Balance, % GDP	-2.2	-4.3	-3.9	-2.3	-3.5	-1.9
Gross National Savings, % GDP	17.5	17.3	18.9	17.2	16.6	18.1
Budget Revenues, % GDP	41.0	39.0	35.8	40.9	39.4	38.6
<i>tax revenues, % GDP</i>	35.3	34.0	31.9	35.1	33.4	32.9
<i>direct taxes, % GDP</i>	22.9	21.5	18.7	22.9	21.8	22.2
<i>indirect taxes, % GDP</i>	12.4	12.5	13.2	12.3	11.5	10.6
<i>non-tax revenues, % GDP</i>	5.7	5.0	3.9	5.8	6.0	5.7
Budget Expenditures, % GDP	44.1	42.4	38.5	44.3	43.8	42.2
<i>public consumption, % GDP</i>	15.6	15.4	14.7	15.6	15.7	15.2
<i>public investments, % GDP</i>	2.1	3.7	4.3	2.0	2.2	2.2
<i>capital transfers, % GDP</i>	2.2	1.7	1.3	2.3	2.2	2.2
<i>current transfers, % GDP</i>	20.8	18.5	15.5	20.8	19.9	18.1
<i>subsidies, % GDP</i>	2.5	1.9	1.4	2.5	2.2	2.0
Fiscal Balance, % GDP	-3.1	-3.3	-2.7	-3.4	-4.4	-3.6
Direct Public Debt, % GDP	14.5	17.2	21.9	15.0	20.5	25.5

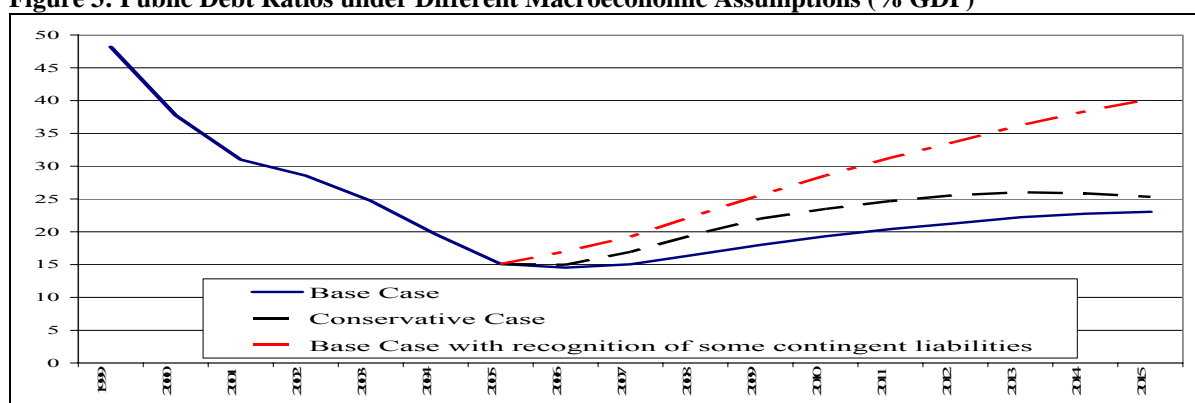
Source: Bank staff estimations.

38. A debt sustainability analysis embedded in this fiscal space exercise reveals that under the base case, the increase in public debt is limited, whereas the conservative case involves significantly higher debt financing. Figure 3 shows the path of public debt under the two scenarios. In the base case, direct public debt increases moderately to an average of 17.2 percent for the period 2007-10, and 21.9 for the period 2011-2015, whereas the conservative case implies a higher increase in direct public debt up to an average of 25.5 for the period 2011-2015.²⁰

²⁰ As of 2005 direct public debt was 15.1 percent of GDP; additionally, publicly guaranteed debt was 3.6 percent of GDP.

39. While these are still relatively moderate debt ratios, Ukraine should be cautious about new debt issuance, especially in view of its relatively large stock of explicit and implicit contingent liabilities. A rough estimate of the stock of contingent liabilities amounts to 41.1 percent of GDP in 2005. This estimate includes 29.2 percent of GDP corresponding to the so-called “lost savings of the Former Soviet Union Savings Bank.” **However, these calculations deserve two important clarifications: first, the “lost savings” are an implicit contingent liability²¹ not likely to become explicit debt all at once, but rather, if at all, throughout a long and structured process; second, so far, the fiscal authorities of Ukraine have been able to address this issue (i.e., lost savings) prudently minimizing any impact on the budget and the economy.** Assuming conservatively that only 30 percent of the contingent liabilities become explicit liabilities and 50 percent of the guaranteed debt is called evenly over 10 years and that no additional contingent liabilities are contracted, Figure 3 shows the path of public debt under the base case rising to around 40 percent of GDP by 2015.

Figure 3: Public Debt Ratios under Different Macroeconomic Assumptions (% GDP)



Source: World Bank estimations

Summary of Recommendations

40. The fiscal analysis presented in this report shows that there is scope in Ukraine for a better, more efficient, and smaller government. To achieve this Ukraine should change the consumption (and current transfers) orientation of its budget, which is hampering future growth, and move towards a more productive and efficient spending, and overall toward a pro-growth fiscal policy. The broad goals on the expenditure side of the budget should be to have higher productive spending on infrastructure, and more efficient (not higher) social spending on improving human capital, while reducing the overall size of public spending. The fiscal space for this can be found by phasing-out the most inefficient subsidies and poorly targeted social assistance programs in the budget. In addition, significant fiscal savings can be obtained from parametric changes in the pensions system, as recommended in detail in this report. On the revenue side, the broad medium-term objective should be to lower the average tax burden through lower rates on indirect taxes, particularly on payroll taxes (also called social insurance contributions). But, as stressed in this report, this policy should be preceded by specific reforms geared to broaden the base and to improve compliance.

²¹ Based on the interpretation of the Budget Code of Ukraine this would not be considered a liability or a commitment based on a guarantee (Part 2, article 8). For this reason, and considering the background of this issue, the “lost savings” are considered in this analysis as an “implicit contingent liability”. Also, this implicit contingent liability is linked to the State and not to the current state company called “Savings Bank”

41. This report highlights the urgent need for setting budget policy in a strengthened medium-term framework that would allow better planning and continuity, and less wasteful spending. The tables below summarize the options for reform outlined throughout this first installment of the Public Finance Review, including broad suggestions on sequencing them and the positive impacts that can be expected if reforms are fully implemented (more detailed recommendations can be found in the respective chapters of this report). Moving forward, the stage is set for a second phase PFR which will examine in detail issues of local government finance and the efficiency of health and education public spending.

Area	Options for Reform and Recommendations	Suggested Sequencing	Expected Impact
Tax Policy	Overhaul the simplified tax system (STS)-reducing the opportunities to hide taxable income. Only “real” small business should be allowed in the STS. Most physical persons should pay regular taxes. Set a maximum threshold for firms at UAH 300,000, so it matches the VAT entry threshold and reduce maximum threshold of individual to the level of 2-3 annual average wage salaries. Also rationalize the eligibility criteria, leaving out of the STS all categories of professional and consultants.	Prepare the amendments during 2006-07 and implement in 2008.	<ul style="list-style-type: none"> • Base broadening would take place for the VAT, PIT, payroll taxes, and more marginally for the CIT. • Increased compliance rates.
	Eliminate the double pass-through for VAT on gas.	Effectively implemented by 2008.	<ul style="list-style-type: none"> • Reduction of the burden on revenue authorities • Reduction of leakages of revenue that may be taking place at later stages of collection.
	Implement the government’s proposed amendment to reform the VAT in agriculture, which in parallel would curtail the VAT tax expenditures.	Implement for the 2007 budget.	<ul style="list-style-type: none"> • Up to 1 % of GDP of potential savings. • Lessening of distortions in the sector.
	Reduce payroll tax rate <u>only after</u> implementation of the second pillar in the pension system, unification of the insurance funds (under the PF), and the reforms suggested for the STS. Strive for a single rate in payroll taxes.	Phase-in rate reductions in 2008-9 (if second pillar is introduced in 2008)	<ul style="list-style-type: none"> • Lower marginal tax burden on payroll taxes. • If done as recommended it may increase compliance rates.
Tax Adm.	Strengthen tax administration by: enhancing the registration processes (with screening of potential evaders); reducing compliance costs; building a comprehensive monitoring system; performing better, well informed, and coordinated audit strategies; and moving to a more effective system of penalties (fewer criminal prosecutions and more administrative penalties)	Enhance data and IT capabilities of the single window of registration (2007). Establish revenue intelligence units to monitor compliance (in STA).	<ul style="list-style-type: none"> • Higher compliance rates. • More efficient use of revenue authorities’ resources. • More targeted audits (less hassle to compliant taxpayers) • Expansion in audit coverage.
	Accelerate the process of unification of common administrative functions (registration, data warehousing, reporting, collection, control, enforcement) of the four social insurance funds under the Pension Fund. In the medium to long-run the government should aim at full unification, which would imply a single unified tax rate and a single collection agency with all functions incorporated.	Start process in 2006	<ul style="list-style-type: none"> • Higher collection efficiency through lower administrative and compliance costs
	Enhance coordination in collection, monitoring, and auditing among STA, SCA, and PF, with participation of MoF. Establish a coordinated compliance program.	Set a formal framework for this coordination during 2006.	<ul style="list-style-type: none"> • Higher compliance rates. • More efficient use of revenue authorities’ resources.

Area	Options for Reform and Recommendations	Suggested Sequencing	Expected Impact
Public wage bill	Keep the public wage bill below 8% of GDP (2005 level). De-compression of the civil service wages is necessary but coupled with rationalization of personnel. Revise and streamline institutional procedures, and develop a new analytically underpinned remuneration system.	Start the evaluation of civil service remuneration and reform in 2007-8.	<ul style="list-style-type: none"> • Expenditure neutral • More transparency in civil service pay. • Rationalization of positions. • More competitive salaries per position.
Pensions	Increase female retirement age from 55 to 60 years by 2017, with an increase of 6 months per year.	Starting in 2007.	Would save an average of 0.32 % of GDP annually, starting from 0.1% in 2007 and increasing to 0.7 % by 2015
	Lengthen the required contribution period for eligibility for a full minimum pension to 30 and 35 years for women and men, respectively	Starting in 2007.	Would save an average of 0.17 % of GDP annually, starting from 0.1% in 2008 and increasing to 0.2 % by 2015
	Suspend the increase in pension benefits up to subsistence minimum if pensioner continues to work.	Starting in 2007.	Would save an average of 0.49 % of GDP annually, starting from 0.5% in 2008 and increasing to 0.4 % by 2015
	Replace minimum pension with means tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level.	Starting in 2007.	Would save an average of 0.33 % of GDP annually, starting from 0.4% in 2007 and increasing to 0.3 % by 2015
	Introduce a regular contribution rate for those taxed under the simplified tax system (STS)	Starting in 2007.	Would save 0.1 % of GDP annually from 2007 to 2015.
Privileges and social assistance programs	Reform systematically the privileges system. Phase-out poorly targeted programs such as occupational benefits, spa/sanatoriums, and telephone benefits. Target better social assistance programs (using proxy means testing). Tighten eligibility for utilities subsidies and housing allowances.	Implement in 2007-8	<ul style="list-style-type: none"> • More transparency and efficiency in the system, with fewer abuses. • Up to 1% of GDP saved by phasing out only the most inefficient programs and through better targeting.
Subsidies (through transfers to SOE and government agencies)	Phase out subsidies to non-viable enterprises in the coal sector. Gradually reduce agriculture subsidies (commitments under WTO). Phase out the practice of re-capitalization and provision of guarantees to state-owned financial Institutions (e.g., State Mortgage Institution). Improve financial position of energy enterprises by phasing-out the under-pricing and cross-subsidies in energy. Enforce financial discipline.	Start phasing out subsidies with the 2007-8 budget.	<ul style="list-style-type: none"> • Up to 1.2 % of GDP in savings by phasing the most inefficient programs in energy and other areas. • Reduction in Quasi-Fiscal Activities (currently at 4.3% of GDP)
Agriculture	Shift government support to agriculture from the current inefficient fiscal subsidies to competitiveness-enhancing programs (WTO compliant). Avoid price controls, restrictions on inter-oblast movements of agricultural commodities, and other inefficient measures that hamper proper market functioning and hamper farmer profitability.	Start in the 2007-8 budget	<ul style="list-style-type: none"> • Expenditure savings up to 0.4% of GDP-by cutting the most inefficient subsidies • Improved efficiency and productivity in the sector.
Budget process	Consolidate the budget further by integrating general and special funds. In addition, consider the integration of the Social Insurance Funds into the consolidated budget.	Discuss amendments in 2007. Integration in 2008.	<ul style="list-style-type: none"> • Higher flexibility in budgetary allocations. • Better budget management. • Higher transparency in the allocation of capital budgeting.

Area	Responsible Agent	Options for Reform and Recommendations	Suggested Sequencing	Expected Impact
Capital Budgeting	MoF/Cabinet of Ministers	Introduce multi-year ceilings for total spending (capital and recurrent). Introduce multi-year sector strategies/planning within resource ceilings in all line ministries and agencies	2007-8	Better fiscal planning. Improvement in selection criteria and priorities.
	MoE	Establish a database of current assets and their condition for each line ministry.	Start in 2006-7	Better monitoring. The database can be used by line ministries to monitor progress and by MoF/MoE for monitoring and assessing the adequacy of operations and maintenance spending and longer run affordability.
	MoE, MoF, and all line ministries.	Strengthen project evaluation capabilities in the MoF and the MoE, and all sectoral ministries. Apply consistently cost-benefit analysis as part of the formal process of capital budgeting. Enforce the use of economic project evaluation (using cost benefit analysis) at the sectoral ministries as part of their project submission to MoE and MoF. Set common (and high) standards for project evaluation for line ministries. Implement transparent and standard methodologies of evaluation. Strengthen analytical capabilities to evaluate potential risks in PPPs and privatization schemes to avoid the financial risk they may carry.	Start in 2006	Improved quality of projects selected. Higher level of productive investments.
	MoE/MoF	Monitor closely capital project implementation with line ministries to assure progress is being made and to identify and resolve any bottlenecks.	Start in 2006 with full implementation by 2007	Higher levels of execution Improved assessment of operations and maintenance needs.
	MoE/MoF/ Cabinet of Ministries	Establish a formal structure of collaboration between MoE and MoF, with the oversight of the Cabinet of Minister (within the PFM context). Coordinate functions on capital budgeting through a formal working group. The recommended working group should review all aspects from identification through completion. Improve the timing and integration of the Targeted Programs process better into the annual budget process.	Formation of the group in 2006. Start function in 2007	More coherence throughout the process of capital budgeting. Priorities and objectives will be discussed more transparently.
	MoF/Treasury	Revise current budget execution procedures for capital projects to check adequacy and execution.	Start in 2007	Improved project execution Improved assessment of operations and maintenance needs.
	KRU	Perform annual audits of internal control in line ministries to assure that they support capital project management and completion, particularly for high risk ministries.	Start in 2006	

Area	Responsible Agent	Options for Reform and Recommendations	Suggested Sequencing	Expected Impact
Donor financed investments and projects	MoF and MoE	Continue improving PFM systems to allow donor funding to be channeled and controlled through them (in this regard, procurement continues to be an obstacle and should be strengthened in line with best international practices)	Start in 2006	Improved PFM system upon which domestic and international resources can flow efficiently and with accountability.
	MoF, MoE, and the donor community	Examine transition options to move closer to the use of country systems. International experience provides some options that could be examined, including eliminating parallel accounts of disbursement and execution controls, financing projects with domestic resources to later be reimbursed by donors with certain checks and balances, and financing projects already approved in the capital budget applying certain procurement and audit agreements; phasing in use of PFM systems by supplementing them with additional arrangements where specific fiduciary risks are identified	Start in 2006	Improved aid effectiveness, reduced under-execution of projects, increased government ownership.
	MoF, MoE, and the donor community	Integrate donor financed project into the budget process by streamlining procedures of project processing and approval within the government. Plan donor funding aligned with the country's strategy, and on multi-year basis. This planning should also be integrated into the multi-year framework recommended in this report for all public capital investments. On the donors' side this should involve ample coordination to harmonize and complement aid.	Start in 2007	Improved aid effectiveness, harmonized investment strategy, higher productive investments
	MoF and MoE	Bring up to 100 percent the recording of donor financed and recipient executed transactions in the annual budget and their execution details in government internal control reports	Start in 2007	Improved transparency, improved coordination, improved accountability on public investments.