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BUDGET REVIEW OF UKRAINE

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BUDGET REVIEW OF UKRAINE

PREFACE

This review of the budget process of Ukraine was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In 2004 the Working Party established the Network of Senior Budget Officials of Central, Eastern and South-Eastern European (CESEE) countries. Budget reviews serve as a basis for examination of a country's budget institutions by the network in its annual meetings and enable participants to discuss the budget procedures of a country in depth.

A team of the OECD Secretariat consisting of Dr. Dirk Kraan (lead), Ms. Lisa von Trapp, and Ms. Valentina Kostyleva, supported by Mr. Jan van Tuinen (Dutch Ministry of Finance) and Mr. Matthias Morgner (GIZ, German International Co-operation), made a mission to Kiev from 11 to 15 October 2010 to prepare the review. During the mission the team met with Mr. Vladimir Lositsky, Head of the Budget Department, Natalia Tovsta, Deputy Head of the Budget Department, Liudmilla Litvinenko, Deputy Head of Department of the Treasury, and other officials of the Ministry of Finance, Ms. Svitlana Danylenko, Director of the Department of Economics and Financing of the Ministry of Education and Science and other officials of the Ministry of Education and Science, and Nataliya Shchepotyeva, Director of Department of the Financial Inspection.

The OECD team also met with Mr. Andriy Vatulev, Head of the Secretariat of the Budget Committee of Parliament, Ms. Svitlana Feshuk, Deputy Head of the Secretariat of the Budget Committee of Parliament and other officials of the Budget Committee staff, Mr. Oleksandr Yaremenko, Deputy Head of the Accounting Chamber of Ukraine, Mr. Taras Prytula Director International Co-operation of the Accounting Chamber and other officials of the Chamber, Mr. Yuri Hanushak, Director of the Association of cities of Ukraine, and Ms. Klavdia Pavluk of the Institute of Economics and Forecasting. Additional information was provided by Andriy Bega of the Main Department for Civil Service, the State Statistics Committee, and the State Property Fund.

The OECD team is grateful to all these officials and experts for the information they provided and for their willingness to explain the procedures and practices of budgeting in Ukraine. The OECD team appreciated in particular the open and frank discussions with the Ukrainian interlocutors.

The team would like to thank in particular Ms. Valentina Doletska, Deputy Head of the Budget Department, for the excellent organisation of the meetings, her help with the collection of document and her extraordinary hospitality during the team's stay in Kiev.

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CHAPTER 1

INTRODUCTION

1.1 Contents of the review

1. The main purpose of an OECD budget review is to provide information about the current institutional features of a country's budget process, which can serve as a basis of discussion in a meeting of delegates from countries in similar conditions. Such discussions may be useful to other countries in that they can learn from the country under review and for the country under review because it can receive suggestions from other countries for overcoming problems it is facing (peer review). The OECD Secretariat usually adds its own policy suggestions to the reviews, but in general it strives for restraint in this respect in order to allow maximal room for exchange of views among peers. In countries of the most eastern part of Europe, restraint seems the more appropriate because these countries are already overloaded with policy advice on budget reform from international organisations and foreign donor countries. In general this review follows this approach of focus on description and restraint on recommendations, but with one nuance.

2. The OECD Secretariat has noticed that the emphasis of the advice from other international organisations and donor countries to Eastern European governments often focuses on what is thought to be particularly important for transition countries. However, such advice sometimes does not take into account the features of budget institutions actually prevailing in OECD countries. Most OECD budget reviews are of course concerned with OECD countries and serve as peer reviews for Member States of the OECD. However, since 2004 the OECD Secretariat also conducts budget reviews outside the OECD area, particularly in central and Eastern Europe and in Asia. The general approach of non-member countries reviews is that similar problems should be analysed in a similar way, regardless whether a country is an OECD country or not. Within certain limits, principles of effective and efficient public finance management are equally applicable to OECD and non-OECD transition countries. A difference in economic context may necessitate different budgetary policies, but generally does not justify a different approach to the reform of budgetary institutions. The current review follows the usual OECD approach, comparing the budgetary institutions of Ukraine with those actually prevailing in OECD countries. In some areas, such as medium term expenditure frameworks, base line estimates, governance of State owned enterprise, steering of executive agencies, internal financial control and internal audit, this may lead to conclusions that differ from those of other international organisations or donor countries. Since it may be important for Ukraine to be informed about these differences, the current review is less reserved in making recommendations in these areas than in other areas.

3. Under the before mentioned proviso, the review follows the usual set-up of an OECD budget review. In the rest of this chapter, some general legal, political and economic characteristics of Ukraine will be mentioned and recent institutional reforms will be surveyed. Chapter 2 is devoted to the budget formulation process with separate attention for the budget structure and classification, the annual budget preparation cycle, medium term planning, long term fiscal sustainability, the organisation of the Ministry of Finance and the funding of local government. Chapter 3 addresses the parliamentary budget process with special attention for the Budget Committee, the annual parliamentary budget cycle and the

impact of Parliament. Chapter 4 focuses on budget execution with special attention for the annual executive process, cash management and budgetary discipline. Chapter 5 looks at the supply side of the budget process: the ministries and agencies that provide for public administration and service delivery at the level of central government, as well as local governments that provide for administration and service delivery at the level of local government. It also addresses public procurement, public employment and the civil service. Furthermore it surveys the public enterprise sector. Chapter 6 looks at accounting and audit, with special attention for financial reporting, internal audit and external audit.

1.2 General characteristics

Legal framework

4. Ukraine gained independence in 1991. The constitution of 1996 established Ukraine as an independent republic. The Constitution provides for a unicameral parliament of 450 members elected for a five-year term, a directly elected President and an independent judiciary. The members of Parliament are elected from party lists on the basis of proportional representation with a threshold of (currently) 3 percent of the popular vote to gain parliamentary seats. The government is formed by the President and the Cabinet of Ministers. Currently there are 16 ministers, including the Prime Minister. The Prime minister is nominated by the President with the approval of the parliament and resignates upon dismissal by the President (art. 103 sub 9 of the Constitution). The ministers are nominated by the President on the proposal of the Prime Minister (art. 102 sub 10 of the Constitution) and resignate if the Prime Minister resignates. The Cabinet needs the confidence of the Parliament and is obliged to resign if it loses confidence (art. 115 of the Constitution). The Cabinet is also responsible to the President. This arrangement characterises the government form of Ukraine as a semi-presidential system. In such a system it is possible in principle that the President has to work with a cabinet composed of parties that have not supported his/her own election, as has happened in 2006-2007 and for short period after the Presidential elections of 2010.

5. The Constitution enshrines judicial independence (art. 126). There are courts of first instance and appeal courts. The courts of last instance are the Supreme Court and high courts for some forms of administrative jurisdiction. Next to the regular court system there is a Constitutional Court that decides on the constitutionality of laws and by-laws. The Constitutional Court is composed of 18 members, six of which are appointed by the President, six by the Parliament and six by the Congress of judges (art. 148 of the Constitution).

6. The main laws regulating the budget process are:

- the Constitution of Ukraine (of 1996)
- the Budget Code of Ukraine (of 2010)
- the Law on the Accounting Chamber (of 1996)
- the annual Law on the State Budget of Ukraine

The revenue side of the budget is further determined by:

- The Tax Code (of 2010)

Other relevant laws are:

- the Law on the Cabinet of Ministers (of 2010)
- the Law on Local Self Government (of 1997)

- the Law on Local State Administrations (of 1999)
- the Law on the Civil Service of 1993
- the Law on Public Procurement (of 2010)

Geography and demography¹

7. The land area of Ukraine is 603.700 square kilometres, the second largest country of Europe after the Russian Federation.

8. The population is 45.9 million (January 2010). Ethnic Ukrainians make up 76.5 percent of the population, the next largest ethnic group being Russians (13.5 percent). The population is declining rapidly due to one of lowest fertility rates in Europe (1.27 birth per woman) and substantial emigration (0.3 per 1000 in 2008). The population declined from 51.7 million in 1989 to 45.9 in 2010, a loss of 11.2 percent in two decades. Life expectancy at birth is low: 68.0 years (estimation 2008) with a large discrepancy between males (62.2 years) and females (74.2 years). Although estimates vary, approximately two to three million Ukrainian citizens are currently working abroad, most of them illegally, in construction, service, housekeeping and agriculture, around half this number in the Russia.

9. GDP per head is 2,569 USD, higher only than Georgia and Moldova among European countries. In 2009 35 percent of Ukraine's population could be defined as poor (on the basis of the World Bank's threshold of income less than a dollar per day). Poverty is concentrated in rural areas, particularly in the Western and Southern parts of the country. Poverty rates are substantially lower in urban areas and in the industrialized East of the country.

Gross Domestic Product²

10. Ukraine experienced a sharp economic contraction in the 1990s following independence. As a result, by 2000 real wages plunged to less than 40 percent of their 1992 level. Positive economic growth resumed in 2000. In 2001-2008 growth of GDP averaged 7.5 percent year on year, among the highest in Europe. Strong foreign and domestic investment together with improvements in the external terms of trade, due to high steel prices (steel being a main export product of Ukraine), sustained double digit growth in domestic demand. However, with a pre-crisis fixed exchange rate, buoyant international liquidity led to the built up of foreign commercial debt causing high inflation (over 30 percent in 2008) and a widening deficit on the current account (17 percentage points over the period 2004-2008).

11. The global economic and financial crisis hit Ukraine particularly hard. By the fourth quarter of 2008, capital inflows came to an abrupt stop, the terms of trade reversed as steel prices dropped, and exports markets shut down. The crisis also accentuated the vulnerabilities of the banking sector, leading to a systemic liquidity and solvency crisis. GDP contracted by 15 percent in 2009, with investments falling by 46 percent year on year. Since October 2008, after the abandonment of the fixed exchange rate, the national currency (hryvnya, UAH) has lost about 40 percent of its value against the US dollar.

12. Ukraine's economy resumed growth in 2010 on the back of moderate improvements in external demand. Real GDP grew by 3.7 percent in 2010. The balance of payments pressures have eased and the

¹ Sources: Economist Intelligence Unit (2010) and State Committee for Statistics of Ukraine (2001). (http://en.wikipedia.org/wiki/Demographics_of_Ukraine).

² Sources: Economist Intelligence Unit (2008, 2010a, 2010b, 2011), World Bank (2010), IMF (2008, 2010, 2011).

current account has been almost balanced in 2010 thanks to growing export demand and higher prices of core exports (steel, agricultural products). At the same time, improved roll-over rates on external commercial debt supported new inflows on the capital account. Deposits in the banking system have been increasing from the lows of 2009. Consumer price inflation decelerated to single digits since 2010.

13. Table 1 summarises the GDP development since 2005 in comparison to the EU, split in the “old” (pre-2004) member states and the “new” (central and Eastern European) new member states.

Table 1. Growth of real GDP
Percent change on previous year

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011* | 2012* |
|----------------------|------|------|------|------|------|-------|------|-------|-------|
| EU 15 (older) | 2.3 | 1.8 | 3.0 | 2.8 | 0.2 | -4.3 | 1.8 | 1.6 | 1.9 |
| EU 10/12 (accession) | 6.0 | 5.4 | 6.2 | 5.8 | 4.3 | -3.0 | 1.8 | 2.9 | 3.2 |
| Ukraine | 12.1 | 2.7 | 7.3 | 7.9 | 2.1 | -15.1 | 3.7 | 4.5 | 4.9 |

* Forecasts

Sources: IMF (2008, 2011)

Sectoral structure³

14. Ukraine has a major ferrous metal industry, producing cast iron, steel and pipes. Ukraine is one of the largest steel producers in the World. Another important branch is the country’s chemical industry which includes the production of mineral fertilisers. Manufactured goods include metallurgical equipment, diesel locomotives, tractors and automobiles. The country possesses a massive high-tech industrial base, including much of the former USSR’s electronics, arms industry and space programme. Most of the latter are state owned. Ukraine is a major producer of grain, sugar, meat and milk products. It is the largest producer of sunflower oil in the world. Because Ukraine possesses 30 percent of the world’s richest black soil, its agricultural industry has a huge potential. However, farmland is for a large part not privatised, hampering access to international investments and best farming technology. The agricultural industry is already highly profitable with 40-60 percent profits, but according to analysts its outputs could still rise up to fourfold.

15. Ukraine encourages foreign trade. The EU is the largest trading partner, with 27.1 percent of exports and 33.7 percent of imports in 2008. Trade with the EU has seen double digit growth in recent years. The Russian Federation is Ukraine’s second trading partner, with 21.1 percent of exports and 28 percent of imports in 2009. Steel exports account for 46 percent of the country’s overall exports. Ukraine is among the top 10 arm exporters in the world. The output of Ukrainian defence plants grew annually with more than 50 percent in recent years with largest growth reported by aircraft builders and ship builders.

16. Ukraine imports 90 percent of its oil and most of its natural gas. Russia ranks as Ukraine’s principal supplier of oil and Russian firms now own and/or operate the majority of Ukraine’s refining capacity. Natural gas imports come from Russia, which delivers its own gas, as well as gas from Turkmenistan. Ukraine is transporting Russian gas to the EU through its well developed gas pipelines system, being Europe’s vitally important connection to the Russian gas supply.

³ Sources: Economist Intelligence Unit (2008, 2011).

17. Ukraine is independent in its electricity supply, moreover exporting it to Russia and other countries in Eastern Europe. This is achieved through a wide use of nuclear power and hydro-electricity. The current energy strategy intends gradual decreasing of gas- and oil-based generation in favour of nuclear power, as well as energy saving measures reducing industrial gas consumption. Reform of the still opaque energy sector is a major objective of the IMF and World Bank programmes with Ukraine (see below). Ukraine is a partner country in the EU INOGATE (Interstate Oil and Gas Transport to Europe) programme, which has four key objectives: enhancing energy security, convergence of member state energy markets on the basis of EU internal energy market principles, supporting sustainable energy development and attracting investment for energy projects of common and regional interest.

18. Table 2 summarises the current sectoral structure of the domestic economy.

Table 2. Sectoral structure of the domestic economy

| Sector | Contribution to GDP (per cent; 2010) | Employment (per cent of total domestic employment; 2009) |
|---------------|---|---|
| Agriculture | 9.8. | 15.8. |
| Industry | 32.3 | 18.5 |
| Services* | 57.9 | 65.7 |

* Services include: construction, transport and communication, trade, health and social services, communal and other consumer services, education, culture, art and science, finance and public administration.

Source: CIA World Fact Book

Political developments

19. On 1 December 1991 an All-Ukrainian referendum endorsed with 90 percent of the popular vote the independence of Ukraine and the presidential form of government. Simultaneously Leonid Kravchuk was elected as the first President of the new Ukrainian State. He was one of the three participants of the Belovezhski agreements, which led to the dissolution of the Soviet Union ceased and the establishment of the Commonwealth of Independent States (CIS). In July 1994 Leonid Kuchma was elected as his successor in pre-term presidential elections. He was re-elected in 1999 and stayed in office for 10 years. During his term in office the new Constitution was adopted. In December 2004 Viktor Yushchenko was elected as President of Ukraine..

20. The parliamentary elections of March 2006 were based on a new electoral law that substituted a mixed system according to which half of the 450 seats were elected from single seat constituencies and one half from party lists with proportional representation (used in the parliamentary elections of 1998 and 2002). The new electoral law lowered the threshold for parties to be eligible to enter parliament from 4% to 3%, making it increasingly difficult for any one party to gain a majority of seats. The election of March 2006 produced inconclusive results. None of the three main parties (Our Ukraine supporting Mr. Yushchenko, Party of the Regions led by Mr. Yanukovich and Yulia Tymoshenko, Block led by Ms. Tymoshenko) in the new parliament won sufficient seats to govern on its own. Next to the three main parties only the Socialist Party of Ukraine and the Communist Party of Ukraine secured seats. For months coalition talks dragged on. By late June 2006 an "orange coalition" was formed between Our Ukraine and the Yulia Tymoshenko Block with support of the Socialist Party of Ukraine. However this coalition unravelled after a few months. In August 2006 Mr. Yanukovich became Prime Minister.

21. As part of the “orange revolution”, the Ukrainian constitution was changed to shift powers from the presidency to the Parliament. Among other things, as far as the appointment of minister was concerned, the President retained only the right to appoint the ministers of Foreign Affairs and Defence, with the approval of parliament. Other ministers were appointed by the Prime Minister. This constitutional revision came into effect in 2006 when Mr. Yanukovich formed the government. As a result Mr. Yushchenko had to deal with a powerful Prime Minister who had control over many important portfolio’s.

22. After more and more parliamentarians defected to the ruling coalition, bringing a two third majority into sight (which would allow the parliament to overturn presidential veto’s), Mr. Yushchenko decided to dissolve Parliament. The decree was immediately labelled unconstitutional by the ruling coalition which appealed to the Constitutional Court. Against a backdrop of mutual recriminations and before the Court could reach a verdict, negotiations between Mr. Yushchenko, Mr. Yanukovich and Mr. Moroz produced an agreement in May 2007 on the legal base for an early election in September.

23. In the new parliament five political parties or blocs surpassed the 3% threshold to win a seat in parliament. The Party of Regions emerged as the overall winner with 175 seats in its control, followed by the Yulia Tymoshenko Bloc with 156 seats. The Socialist Party did not reach the electoral threshold and a new party, the Lytvyn block, led by former parliamentary speaker Mr. Volodymyr Lytvyn, entered the Parliament with 20 seats. The Communist Party of Ukraine obtained 27 seats. However, the formation of a coalition between the Yulia Tymoshenko Bloc and Our Ukraine allowed them to obtain a narrow majority of just one vote and Yulia Tymoshenko was elected prime-minister on 18 December 2007. Ms. Tymoshenko was then ousted as Prime Minister on March 3, 2010 following a parliamentary vote of no confidence and the breaking up of the coalition that had appointed her.

24. The Presidential elections of January/February 2010 were won by Mr. Yanukovich. The major priorities of President Yanukovich were: establishment of Ukraine as a democratic state, with respect for the rule law, the rights of people and freedom of speech; administrative reform, fighting corruption and the shade economy; building a strong national economy with a high level of employment; increase of salaries and pensions; stability of the price level and currency exchange rate; introduction of European standards of social security, health care, education, housing and quality of life to develop the human potential of Ukraine; reform of the armed forces of Ukraine to build a professional defence force; assurance of the principles of openness and good-neighbourly relations in the external policy, non-aligned status of Ukraine; European integration of Ukraine; strategic partnership with Russia, the USA and the EU. After this election, the Party of the Regions succeeded in organising a parliamentary majority consisting of the Party of Regions, the Communist Party, the Lytvyn block, and some others which voted in a government led by Mr. Mykola Azarov.

25. The difficult relations between President and Cabinet that have complicated the governance of Ukraine almost since independence have now come to a end and have restored a certain stability in the political process.

International relations⁴

26. Ukraine has acceded to the World Trade Organisation in 2008 after a long process to enact the required legislation. Although EU membership is at best a distant prospect, a deepening of economic

⁴ This section is largely based on Economist Intelligence Unit (2008, 2011).

relations with the EU is still expected. Work is under way on a new “enhanced agreement” with the EU, including a deep free trade deal, to replace the existing Partnership and Co-operation Agreement. Ratification of any enhanced agreement with the EU could take several years, although the free-trade deal would come into force sooner.

27. Relations with between Russia and Ukraine have improved markedly. In June 2010 the Parliament passed a law barring the country’s membership of military blocks, in effect ruling out NATO membership. In April the President agreed to extend the lease of the Russian Black Sea Fleet on facilities in Crimea for a further 25 years from 2017, in exchange for a reduction in the price of Russian gas imports. The agreement will ease previous bilateral tensions related to energy supplies.

1.3 Foreign aid⁵

28. Ukraine’s economy has grown rapidly from 2000 to 2008 (more than 7 percent annually). Strong growth was supported by high steel prices (steel exports amounting to 15 percent of GDP) and lingering Russian subsidies on gas supply (gas imports amounting to 6 percent of GDP). Large capital inflows left banks and corporations reliant on short term external borrowing. Household and corporate balance sheets weakened with increased borrowing from banks in foreign currency encouraged by low interest rates and a rigid monetary policy aimed at stabilising the exchange rate. In 2008 the fiscal position deteriorated sharply. Windfall revenues were spent largely on higher wages and social transfers, propelling them some 220 percent higher over 2004-2008. Over the first months of 2008 credit growth amounted to 70 percent, consumer price inflation to 30 percent, wage growth to 30-40 percent. In Ukraine the global financial crisis set in relatively early, namely in mid-2008. On the export side the price of steel declined with 65 percent shortly after July. On the import side Russia signalled its intention to phase out remaining gas subsidies. In the context of the deepening global financial turmoil Ukraine was shut out of the international capital markets. Major strains were showing up in the banking system, causing among other things the sixth largest bank to be put under State receivership. After the National Bank of Ukraine had spent 4 billion USD (US dollar) to sustain the exchange rate, it was forced to let the UAH float. In this context the authorities asked the IMF for a two-year stand-by agreement in an amount of 16.5 billion USD in support of its policy plan as laid down in the Memorandum of Economic and Financial Policies (MEFP).

29. The MEFP envisaged to restore financial and macro-economic stability. Measures were specified regarding (1) appropriate liquidity support and expansion of deposit guarantees, (2) a stronger bank resolution framework, including availability of public funds for re-capitalisation, and (3) a stronger framework for resolution of household and enterprise sector debts. In addition the MEFP aimed to facilitate adjustment to potentially large external shocks and allow gradual reduction of inflation. Measures included: (1) a flexible exchange rate policy, (2) transition to inflation targeting in monetary policy, (3) resetting incomes policy in line with targeted inflation, (4) maintaining a prudent fiscal policy, and (5) bringing energy prices more in line with costs. The programme was set up to respond with flexibility to economic developments. Recovery of steel prices and resumption of capital inflows would be met with higher reserve accumulation and adjustments to monetary policy (to safeguard inflation targets). Downside risks such as a longer loss of access to capital markets would be cushioned by the flexible exchange rate and additional measures.

30. In response to the request, the IMF agreed a two-year arrangement under credit tranche terms. Fund financing would contribute to covering Ukraine’s balance of payments needs. Following initial

⁵ Sources: IMF (2008, 2010, 2011).

reserve losses, associated with tactical interventions aimed at facilitating an orderly adjustment of the exchange rate, the financing would be utilised to build Ukraine's gross international reserves back to a level that would be sufficient to cover at least 75 percent of short-term debt obligations.

31. The new government that took office in March 2010 was confronted with the aftermath of the global financial crisis. It quickly moved to formulate a five year economic reform plan to tackle long-standing structural weaknesses and requested in July, some months before the expiration of the stand-by agreement of 2008, support from the IMF in the form of a new stand-by agreement spanning the period to the next parliamentary elections scheduled for the fall of 2012, amounting to 14.9 billion USD. The authorities saw a new stand-by agreement as providing a strong signal that sound macro-economic policies and financing are in place to support adjustment and reforms to ensure that Ukraine will be in a position to deal with risks in the event external conditions worsen. The new stand-by agreement was expected to catalyse financing from markets and governments to cover Ukraine's still sizeable external financing needs.

32. The five year economic reform plan of the new government aims to (1) restore confidence and fiscal stability by reducing the general government deficit to 2.5 percent of GDP in 2012 and setting public debt on a downward path below 35 percent of GDP by 2015, (2) initiate reforms to modernise the gas sector and phase out the deficit of Naftogaz, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities, making use of the new gas law adopted in July, (3) restore and safeguard banks' soundness through completion of recapitalisation plans by end 2010 and strengthened supervision, and (4) develop a more robust monetary framework focused on domestic price stability with greater exchange rate flexibility under a more independent National Bank of Ukraine.

33. As far as fiscal policy is concerned, discussions with the IMF on the new stand-by agreements focused on bringing public finances down on a sustainable path without hampering the nascent economic recovery. It was agreed that the combined general government deficit and the deficit of the State owned gas company Naftogaz, would not exceed 6.5 percent in 2010. Because without policy change the combined deficit would approach 9 percent of GDP, reflecting revenue shortfalls, higher wages and pensions and Euro soccer tournament investment needs, the authorities had prepared a supplementary budget for 2010 that would bring this target within reach. Given the half-year effect of measures and the fragility of the economy more was not considered feasible in 2010. However, the authorities agreed to reduce to decrease the deficit to 3.5 percent of GDP in 2011 and 2.5 percent of GDP in 2012, while Naftogaz's deficit would be eliminated in 2011. For that purpose the authorities agreed to adopt the following structural measures: (1) structural pension reform to be initiated in 2011, (2) fiscal reforms, as envisaged in the recently adopted Tax Code and Budget Code, including improved tax collection, a medium term perspective for budget preparation and stronger requirements for assessing the impact of new initiatives, (3) public administration reforms to be implemented by March 2011, including bringing a larger part of user fees collected by public enterprises on budget, strengthening the oversight and control of the delivery of administrative services to the public and improving cost efficiency, and (4) additional energy sector reforms, including an additional increase of gas prices with 50 percent in April 2011, semi-annual price increases thereafter and an automatic price adjustment mechanism to follow import prices, once import parity is reached.

34. The IMF has agreed the package. The package includes 2 billion USD for budget support in 2010, which was requested in view of the shallowness of domestic capital markets and the need to enhance confidence in international capital markets.

35. In the first review under the stand-by agreement of 2010 (February 2011), the IMF concluded that all end September fiscal performance criteria were met, although the lifting of the ban on penalties for overdue utility bill payments with delay. The issuance of bank recapitalisation funds were within programme ceilings. Monetary targets were also met although the agreement on phasing out of restrictions on the foreign exchange market with delay.

36. The World Bank provides support for Ukraine on the basis of its Country Partnership Strategy (CPS). It covers fiscal years 2008-2011 and has the objectives of: (1) improving competitiveness, (2) reforming public finances and the public sector and (3) improving service delivery. In the context of the economic downturn of 2009, the CPS progress review focused its policy priorities to support fiscal, business climate and banking sector reforms for the remainder of the CPS. The CPS envisages a lending range of 2 to 6 billion USD over the four-year CPS period.

37. The World Bank concluded a series of Development Policy Loans in late 2008 and will initiate a new series focusing on structural reforms. The first of the new series is tentatively sized at 500 million USD. The Bank will continue with a policy lending series on banking sector reform. A first operation was disbursed in 2009 (400 million USD) and a second is being prepared (350 million USD). Both policy lending operations are subject to agreement with the authorities on key structural reforms to be supported.

38. The World Bank continues to be active on project financing. As of December 2011, among the projects in the public sector are a Public Finance Modernisation Project (50 million USD), a State Tax Service Modernisation Project (40 million USD) and Statistical Modernisation Project (32 million USD). In addition the Bank supports a large number of projects in the sphere of land registration (195 million USD), energy (366 million USD), infrastructure and pipelines (104 million USD), export promotion (304.5 million USD), social support (99.4 million USD) and energy efficiency (200 million USD).

39. Ukraine joined the European Bank for Reconstruction and Development (EBRD) in 1992 and since then the EBRD has been active in supporting Ukraine's transformation to a market economy. The previous Bank's country strategy for Ukraine, approved in 2007 and effective until recently, outlined four main areas of operational focus: (1) promoting higher efficiency, competitiveness and corporate governance standards in the local private sector and assisting direct foreign investment, (2) promoting the development of the domestic capital markets and providing continued support to micro, small and medium sized private enterprises through dedicated long-term credit lines with partner banks, (3) promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy, and (4) improving efficiency and reliability of key infrastructure, power generation, transmission and distribution and of the oil and gas transport systems of Ukraine. A new strategy for Ukraine has been approved by the EBRD Board on April 13, 2011. It promotes the diversification of production capacities, enhancing the country competitiveness, the development of local capital markets, energy sector reforms as well as improving corporate management and transparency.

40. As of November 2011, the EBRD's portfolio in Ukraine accounted for about 296 projects with the total amount of funding 6.7 billion EUR. The Bank's exposure in Ukraine is the second largest after Russia, accounting of 1/8th of the Bank's overall portfolio. Financial sector and industry are the two largest sectors of operations in Ukraine, accounting for 4/5th of the total operating assets. Operations in the infrastructure and energy sectors are also significant. Among other programmes, the EBRD launched a new Business Advisory Services programme aimed at efficiency enhancement of the local small business. The programme implies involving local business advisors.

41 The European Union is another major international donor for Ukraine. For the period from 2007 to 2013 technical and financial assistance is principally provided under the new European Neighbourhood and Partnership Instrument (ENPI). This instrument is established to develop an increasingly close relationship, gradual economic integration and deeper political cooperation, including on foreign and security policy, between the EU and Ukraine. The total budget of the ENPI for the seven year period (from 2007 to 2013) amounts to 2,7 billion Euros. The main tools used to provide technical assistance in the framework of the ENPI are Twinning⁶, TAIEX⁷, and SIGMA⁸. Moreover, within the framework of the ENPI, the European Commission and the Government of Ukraine signed on 2 March 2011 the Memorandum of Understanding on the National Indicative Programme (NIP) for Ukraine for 2011-2013. The overall budget of EU assistance to Ukraine under the NIP is 470 million Euros. The Programme focuses on good governance and the rule of law, on the preparations for the entry into force of the Agreement on a Deep and Comprehensive Free Trade Area (DCFTA)⁹, and on Sustainable Development, including energy, environment, transport and regional development. Specific programmes of support under these priority areas are at present being developed.

42 Next to the IMF, the World Bank, the EBRD and the EU, European country donors active in Ukraine, particularly Germany (GIZ), the Netherlands, Sweden (SIDA) and the USA (USAID). All of these country donors have programmes in the sphere of financial management. GIZ focuses on assistance in the sphere of budget classification, financial impact assessment of legislation, internal and external audit and the medium term expenditure framework. The Netherlands has set up a training facility for financial officials. Sida focuses on modernisation of the budget process in the Ministry of Finance, line ministries and other Central Public Authorities, particularly development of the medium term expenditure framework and performance based budgeting. USAID focuses among other things on intergovernmental financial relations. The EU as focused on the development of internal public financial control. All country donor organisation report lack of commitment of the Ukrainian authorities and slow progress on separate projects. In view of the substantial overlap of the efforts of international financial institutions and country donors this should not cause surprise. There is a serious problem of donor co-ordination in Ukraine. Two factors are at work in this respect. On the one hand it is the task of the Ukrainian government to clearly articulate its requests for advice to specific donors. On the other hand some of the donors are driven by intra-organisational incentives to spend regardless the needs expressed by the Ukrainian partners. Both factors in combination lead to a considerable waste of efforts and resources that needs to be addressed urgently. It is not enough that donors sit around a table and decide who does what. What is required is a turn-around of mentality. Aid should only be provided for concrete projects at the explicit request of the

⁶ Twinning is a technical assistance tool which implies that State institutions of European Union countries deliver technical assistance to Ukrainian public institutions in order to share best practices and to help adopting and implementing reforms and legislation consistent with the EU policy.

⁷ TAIEX (Technical Assistance and Information Exchange), is an instrument of the Directorate-General Enlargement of the European Commission. TAIEX helps countries with regard to the taking over, application and enforcement of EU legislation.

⁸ SIGMA, a joint initiative of the EU and the OECD, supports Ukraine in its efforts to improve governance and management by: assessing reform progress and identifying priorities for reform against baselines set by good European practice and existing EU legislation; supporting institution-building and setting up legal frameworks and procedures to meet European standards and good practice; facilitating assistance from the EU and other donors by helping to design projects preconditions and implement action plans.

⁹ The DCFTA is designed to deepen Ukraine's access to the European market and to encourage further European investment in Ukraine.

Ukrainian authorities and budgets should only be made available after agreement about such requests has been reached. Intra-organisational incentives to spend predetermined budgets should be removed.

1.4 Fiscal policy¹⁰

43 After spending hikes in 2004 related to the Presidential election of 2005 leading to a deficit of more than 4 percent in that year, subsequent cabinets have succeeded to reduce the deficit to a more sustainable level. However, the global financial crisis has hit Ukraine particularly hard, reducing tax revenues and inducing a general government deficit (exclusive of the Naftogaz deficit and bank recapitalisation cost) of more than 6 percent of GDP in 2009. In addition Naftogaz saw itself confronted with large increases in the import price of Russian gas, unilaterally imposed by the Russian Federation. The support for Naftogaz in 2009 amounted to 2.5 percent of GDP. Bank recapitalisation costs amounting to 2.6 percent of GDP in 2009.

44 The budget of 2010 aimed at a deficit of 5.3 percent exclusive of Naftogaz support and bank recapitalisation costs. When this target slipped, the government proposed and Parliament approved a revision of the 2010 budget in July 2010, lowering the general government deficit to 5.5 percent and the Naftogaz deficit to 1 percent of GDP. Measures included: an increase in tax and pension fund revenue (increase in several excise rates, limited loss deduction from 2009 and raised social insurance rates), spending cuts (mostly subsidies, and administrative appropriations for several government bodies), an increase in Naftogaz's revenue and better control over its spending (increased final gas prices for utility companies and households, elimination of gas price privileges for industrial sectors, automated drafting system for utility companies payments to improve compliance, measures to save costs and rationalise spending for Naftogaz's operations), mitigation of the impact of rising gas prices and increased taxes on the most vulnerable by extension of existing social assistance programmes, and improvement of the tax administration and spending monitoring.

45 The revised target was roughly met, mostly due to good revenue performance in the final quarter of 2010 supported by additional non-tax revenue (5.1 percent of GDP). The Naftogaz deficit was overshoot (1.4 percent instead of 1.0 percent of GDP), but the total deficit remained within the 6.5 limit agreed with the IMF.

46 The stock of Value Added Tax (VAT) arrears is nearly phased out. Arrears peaked at UAH 25 billion (2.3 percent of GDP) in mid 2010 and then declined through issuance of VAT bonds (1.5 percent of GDP) and cash payments. The end September 2010 indicative ceiling agreed with the IMF was met. In view of administrative delays in processing claims and budgetary constraints, the authorities have requested a modification of the December 2010 indicative target to allow for a small amount of arrears (0.1 percent of GDP). They are committed to eliminating all arrears in 2011 and will introduce a more systematic process for refunds in 2011.

47 Fiscal policy in 2011 remains strongly determined by the IMF stand-by agreement. The 2011 general government budget submitted to Parliament targets a deficit of 3.1 percent of GDP. As revenues are projected to decline by about 1.7 percent of GDP, mainly on account of lower non-tax revenue, especially lower profit transfers of the National Bank of Ukraine, the authorities are determined to achieve the adjustment through spending consolidation, while protecting capital and social protection outlays. Measures include (1) reduction in the public wage bill (freezing real wages, curtailing

¹⁰ Sources: Economist Intelligence Unit (2008, 2010a, 2010b, 2011), IMF (2008, 2010, 2011).

employment, reducing bonuses), (2) reduction in subsidies and discretionary spending on goods and services, and (3) consolidation of pension spending by limiting increases and enacting pension reform. The budget 2011 increases capital spending to about 3 percent of GDP. The authorities consider this necessary to meet project commitments for the Euro-2012 soccer tournament and for basic infrastructure upgrades which were compressed in recent years. They also view selected infrastructure projects to be delivered by private companies and state enterprises as critical and plan to facilitate these through state loan guarantees. To control overall public sector indebtedness, state guarantees will be limited to UAH 15 billion (1.2 percent of GDP), the same level as in 2010.

48. On the revenue side, apart from the decline of non-tax revenues, the new Tax Code is broadly revenue neutral (see box 1) and no other tax policy changes are envisaged in the near term, leading to tax revenues remaining broadly unchanged as a share of GDP. In addition, some specific operations not reflected in the general budget deficit are expected to add to public debt in 2011. The government plans to issue guarantees of 1.2 percent of GDP. The budget also provides for the recapitalisation of banks, limited to the unused amount carried over from 2010.

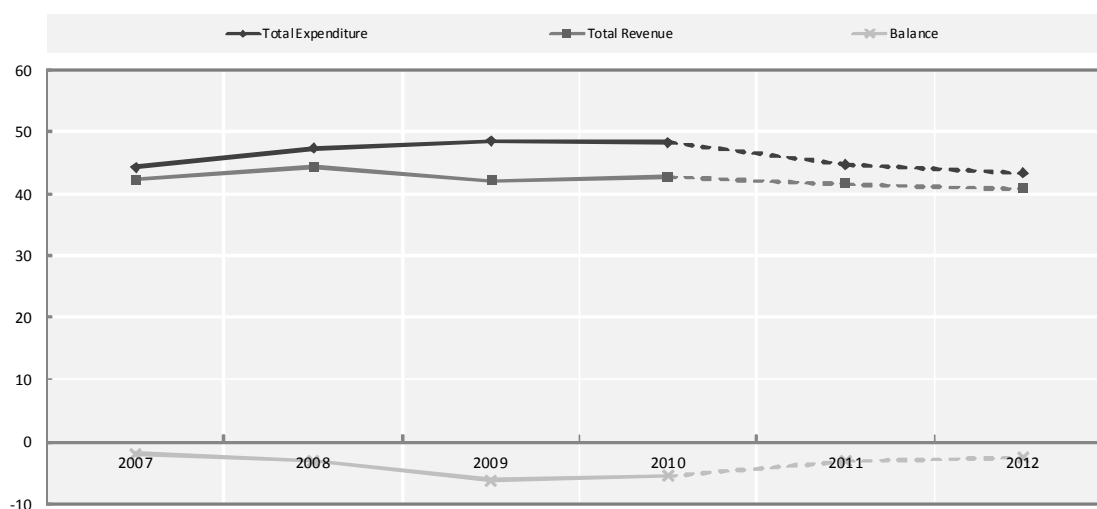
Box 1
The new Tax Code

The new Tax Code adopted in early December after considerable public opposition, aims to reform the complex tax legislation, reduce the tax burden over time and strengthen administration. The Tax Code consolidates most existing legislation, but launches significant changes. The authorities have sought to create incentives for small business owners thus stimulating growth and job creation. On balance the code's impact is estimated as fiscal neutral in 2011, though with downside risks given potential implementation challenges. The main changes introduced in the Code are:

- Elimination of many small taxes (reducing revenue with some 0.2 percent of GDP in 2011)
- Tax rate cuts. The corporate tax rate will be cut from 25 percent by two percentage points each year through 2013, to 19 percent, and then reduced to 16 percent starting from 2014. The Value Added Tax (VAT) rate will be reduced by 3 percentage point starting from 2014, to 17 percent. These measures will reduce revenues by about 0.2 percent of GDP in 2011.
- New taxes and increases in existing rates. The Code introduces a property tax for large homes, increases the personal income tax on large incomes from 15 to 17 percent, and increases a number of excise and other tax rates, generating about 0.4 percent of GDP in revenues in 2011.
- Tax holidays and exemptions. The Code introduces new tax holidays for small enterprises (up to January 1, 2016) and for specific industries (hotels, shipbuilding and aerospace industry, electrical power industry, machine building industry for agribusiness and light industry, up to January 1, 2021) and a three-year VAT exemption for several sectors that are subject to significant VAT refund fraud. While the overall revenue impact of these measures is likely to be small, they bring distortions, add to existing exemptions and break the VAT chain.
- Changes to the calculation of the corporate profit base and amendments to tax reduction rules. These measures aim at closing a number of loopholes in the existing legislation.

49 Figure 1 shows the development of expenditures and revenues of general government since 2007 as well as the resulting deficit. The deficit excludes the Naftagaz deficit and bank recapitalisation transfers.

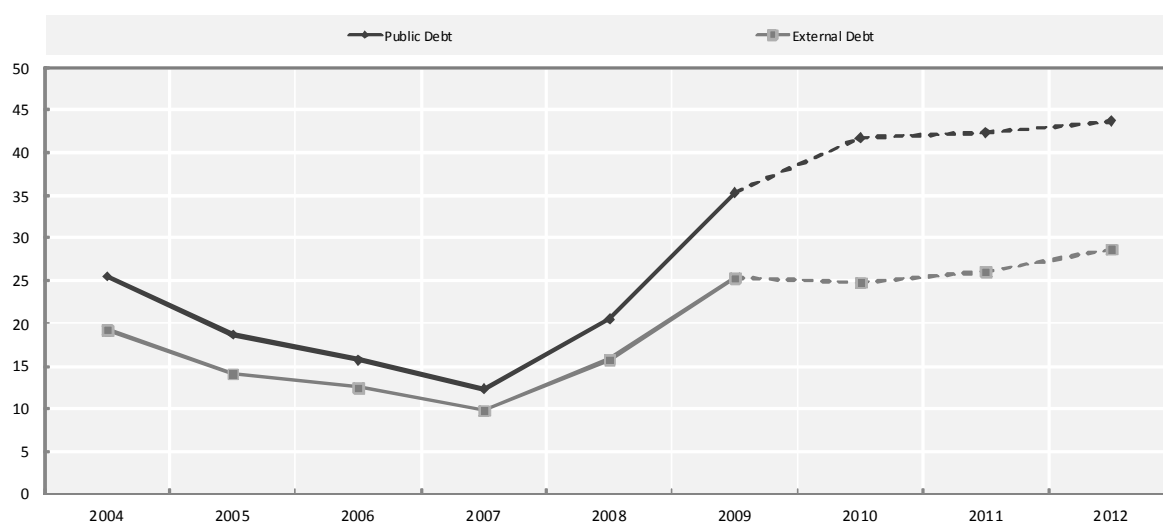
Figure 1. Expenditures, revenues and balance of general government
Per cent of GDP



Source: IMF 2008, 2011

50. Due to strong growth and low deficits, public debt has been falling rapidly in Ukraine in the period from 2000 to 2008, reaching the bottom level of 12.3 percent of GDP in 2007. After that a sharp upward turn occurred due to the global financial crisis. Even if GDP growth resumes as currently expected, public debt will not start to fall again before 2013. Given the limited capacity of domestic capital markets, a substantial part of debt (more than half) is held by foreign creditors, which explains the concern to maintain the confidence of international capital markets and the need for IMF support. Figure 2 shows the development of public debt in Ukraine.

Figure 2. General government public debt
Per cent of GDP



Source: IMF (2008, 2011).

1.5 Institutional policy in the recent past

*The new Budget Code*¹¹

51. In Ukraine reform of fiscal institutions started around 2000. The cabinet that took office in 2000 ensured for the first time that enterprises paid their taxes in cash and eliminated a long-standing recourse to mutual offsets. These measures raised receipts significantly and increased transparency. Subsequent cabinets largely preserved these reforms and introduced others. Methodological changes introduced in 2002 brought revenue planning more in line with IMF standards, by including privatisation as financing rather than revenue. Other reforms included a shift in intergovernmental budget relations. Introduced in 2002, this brought greater financial independence to local government by ensuring that transfers go directly to sub-national budgets on the basis of objective criteria, irrespective of the financial situation at the local level.

52. In 2007 the Cabinet of Ministers adopted a public finance reform strategy, which in its final version was supported by a major financial contribution of the World Bank (see par. 38 above). Major components of the strategy are:

- Introduction of a Financial Management Information System along with the required legislative and organisational adjustments;
- Modernisation of accounting including integration of charts of accounts, and harmonisation with budget classification;
- Further improvements in debt management;
- Improvements in monitoring and evaluation of institutional reforms;
- Improved revenue forecasting;
- Introduction of modern internal financial control techniques.

53. World Bank financing has mostly focused on the Financial Management Information System. Bank support for other components is relatively limited. Country donors have been asked either to deepen support in other areas or to fund activities that fall outside the boundaries of the existing strategy (see par. 41 above).

54. In 2007 a Decree on a Concept of Local Finance Reform was signed by the Prime Minister. It sets out an ambitious agenda for reform of the funding of local government by introduction of tax sharing arrangements and equalisation grants. The reform was intended to proceed in two phases. The revision of the Budget Code was intended as the legal vehicle for the first phase of the reform.

55. A major revision of the Budget Code was approved by the Rada in 2009, but subsequently rejected by President Yushenko in early 2010. After some amendments were made the Rada and President Yanukovich¹² approved the new Budget Code later in 2010.

¹¹ Sources: Economist Intelligence Unit (2010a), OECD Sigma (2010)

¹² Mr. Yanukovich succeeded Mr. Yushenko in February 2010; see par. 24.

56. Important features of the new Code include:

1. Introduction of medium-term budget planning, including:
 - Submission of the draft medium-term forecast of the State budget to the Rada together with the submission of the draft budget law, and Cabinet of Ministers' approval of an updated forecast within one month after publication of the State Budget Law.
 - The draft medium-term forecast covers two years following the budget year. The forecast is put up under the responsibility of the Ministry of Finance (for the State budget), respectively the local financial authorities (for local budgets).
2. Introduction of programme budgeting and a budget classification according to programmes.
3. Improvement of the procedures of the examination and adoption of the State Budget of Ukraine.
4. Improvement of debt management.
5. Improvement of budget management through new procedural rules and adjustment of the budget calendar, allowing more time for budget preparation by line ministries and other Central Public Authorities.
6. Modernization of accounting in the public sector.
7. Implementation of the European model of public internal financial control.
8. Enhancement of the financial autonomy of local government by:
 - Expansion of the revenue base of local budgets by re-allocation of certain revenue sources from the State budget to local government's budgets, and by enlarging the number of local revenue sources which are not taken into account when determining intergovernmental transfers;
 - Allocation of responsibilities between State and local governments on the basis of the principle of subsidiarity;
 - The promotion of investment areas.

Innovation projects

57. In 2010 the Ministry of Finance of Ukraine has launched a programme aimed at the modernization of public finances. The programme is called "Reloading of the system of public finances of Ukraine". The aims of the programme are to provide for more stability in fiscal planning, to shift from micromanagement to strategic management, to modernize budget regulation based on the updated Budget Code and the Tax Code, to promote and protect investment in infrastructure and to develop mutually profitable relations with the IMF on the basis of restored credibility of fiscal planning. It is hoped that the implementation of the programme will improve the climate for foreign investment in Ukraine.

58. The programme encompasses fifteen projects that are to be implemented in two stages.

59. In the first stage, among other things, the Budget Code and the Tax Code were implemented and by-laws and regulations were developed to implement these Codes, including regulations concerning the handling of the State debt. In the second stage, projects such as "Virtual University", establishment of a "Center for independent assessment and certification of employees' competences" and "Transparent

budget” were launched. Currently eleven of fifteen projects of the programme “Reloading of the system of public finances of Ukraine” have been implemented.

60. “Virtual University” is a training facility for civil servants that applies modern technologies of electronic (remote) learning. It facilitates the acquisition of new knowledge and its practical application alongside with professional activity. It is based on the involvement of highly qualified practitioners of the Ministry of Finance of Ukraine and other ministries, agencies and organizations in the training process. It allows trainees access to various sources of information (on-line libraries, data bases, bases of knowledge, etc.).

61. The major goal of the programme is to provide training at an academic level for civil servants who are working in the areas covered by the Budget Code and the Tax Code. The target group of the programme consists of around 20,000 civil servants working in the area of budgeting and 20,000 civil servants working in the area of tax implementation.

62. The project “Transparent budget” aims to make available to the public more information about budget preparation and execution. This will allow the public to carry out independent monitoring of the budget process and thus contribute to the fight against corruption. It is expected that this will also raise the sense of responsibility of public authorities for the efficient handling of public resources.

Privatisation¹³

63. After independence the State had privatised on a grand scale. By 1999 more than 80 percent of all enterprises (accounting for over 60 percent of GDP) had been privatised but in many cases, controlling shares of so-called privatised enterprises remained in government hands, perpetuating the role of former communist directors and precluding significant productivity gains. Privatisation efforts intensified in 2003-2004 in the run up to the Presidential elections of 2004. As a result in 2004 privatisation earnings totaling UAH 9.6 billion (USD 1.8 billion) exceeded the sales recorded cumulatively over the preceding five years. However, this led to a certain debate in subsequent years about the procedures that were followed and to renegotiations of previous contracts.

64. The appointment in August 2006 of the cabinet headed by Mr. Yanukovych brought a stop to the reprivatisation debate. As to new planned privatisations in the coal sector, the government failed to produce the necessary legislation. After returning to power in late 2007 Ms. Tymoshenko put a renewed focus on privatisation, including reprivatisation. In 2008 her government put up a privatisation list including the fixed line telecommunications monopoly Urktelecom, chemical plants and six regional power distributors. The cabinet of Mr. Azarov, after taking office in 2010, appears to push on with privatisation, but with a more pragmatic approach. In 2010 only UAH 1.9 billion (240 million USD) was realised of the total revenue target of UAH 6.4 billion (820 million USD). However the government will overshoot the 2011 target of UAH 10 billion (1,270 million USD), after it has sold in March 2011 the State’s 93 percent share in Urktelecom to Austrian-based Epic Financial Consulting for UAH 10.6 billion (USD 1,340 million). The revenue from the sale of state enterprises for 11 months 2011 comprised UAH 11.01 bn. The forecasted indicators for the state budget 2012 in terms of revenues from the state property privatisation are defined at the level of UAH 10 bn and are estimated based on the tasks defined by the Economic Reforms Programme for the years 2010-2014 “Rich society, competitive economy,

¹³ Source: Economist Intelligence Unit (2008).

efficient state”, which presupposes the optimisation of the public economy sector and completion of privatisation as a broad scale social and economical project by the year 2014.

Pension reform¹⁴

65. Ukraine’s pay-as-you-go pension legislation has structural weaknesses. Pension expenditures increased from around 9 percent of GDP in 2003 to well above 18 percent in 2009, one of the highest levels in the world. At the same time the Pension Fund revenues have not increased at the same pace, and increasing transfers from the central government (having reached 7 percent of GDP in 2009) are needed to balance the accounts. These developments were the result of an ageing population and trend increase in the dependency ratio, low retirement age and minimum contribution periods, generous benefits, favourable treatment of working pensioners, early retirement provisions, extensive special pension regimes, and compliance problems at the revenue side. The government had decided to prioritise pension reform, partly in connection with the IMF stand-by agreement.

66. In December 2010, the government developed the draft law referring to the pension scheme reform, by which in the medium term perspective a series of measures are suggested aimed at the balancing of the pay-as-you-go pension insurance scheme as well as the parameters for the functioning of the II level pension system, i.e. mandatory defined contribution pension scheme. The law is expected to improve the pension provision, to mitigate the aging population effect on the Pension Fund budget, to clarify the conditions for pension contributions, and to help to resolve a number of other social issues.

Gas sector reform¹⁵

67. Gas sector reform is a high priority under the government’s new economic plan (see par. 32). Ukraine is one of the least energy-efficient countries in the world and highly dependent on imported gas, mainly from Russia. Below-market domestic prices and low payment compliance have weakened the finances of the State owned Naftogaz company’s finances, generating the need for substantial budgetary financial support. Investment in exploration, extraction and transportation is insufficient, domestic production is well below potential and gas transit through Ukraine is at risk due to deteriorating gas networks.

68. The reforms undertaken and to be pursued under the new economic plan include:

- Gradually bringing domestic gas prices to import-parity. Fifty percent domestic gas price increases for households and utility companies were implemented in August 2010. Further gas price increases are planned for April 2011 (20%) and July 2011 (20%). Central heating prices are planned to rise by 26% in April and October 2011. Industrial prices are already at market levels, and preferential tariffs for various industries have been eliminated.
- Strengthening social safety nets. To limit the impact of the large gas price increases on the poorest segments of the population, the government has increased transfers (affecting around 5 percent of households) using established support programmes.
- Strengthening payment discipline, among other things by automatic drafting of utility payments to Naftogaz.

¹⁴ Sources: Economist Intelligence Unit (2010a, 2011. IMF 2011)

¹⁵ Source: IMF (2011)

- Liberalisation of the gas sector by a gradual restructuring of Naftogaz, including by adopting separate cost centres for gas imports, gas production and gas transit.
- Modernising the gas transit infrastructure with the help of a loan from the World Bank, the EBRD and the European Investment Bank (see par. 38 and 39).

CHAPTER 2

BUDGET FORMULATION

2.1 National Budget

Structure of the National Budget

69. The National Budget of Ukraine is composed of the State budget and the local budgets. The State budget is the budget of the central government including all grants and transfers to the local level. Local budgets include the budgets of the Autonomous Republic of Crimea and of the cities of Kyiv and Sevastopol, the budgets of oblasts, rayons and cities and the budgets of city districts, villages, rural settlements, and towns. The National Budget can be seen as the consolidated budget of Ukraine. It is used for analysis and forecasts of economic and social development of the country.

70. The Insurance Funds are excluded from the National Budget. They are the Mandatory Insurance Fund for Unemployment, the Social Insurance Fund for Temporary Disability, the Social Insurance Fund for Occupational Accidents and the Pension Fund. The Insurance Funds are managed on a parity basis by the State and representatives of the trade unions. The budgets of these funds are approved by their boards, except for the Pension Fund, which is approved by the Cabinet of Ministers.

71. The budget reserve fund exists to cover incidental expenditures, e. g. related to the natural disasters clean-up operations and humanitarian aid provision. The size of the budget reserve fund shall not exceed one per cent of the respective budget's general fund expenditures. In 2010, the state budget reserve fund was approved in the amount of UAH 1.5 bn(USD 190 ml). The decision on the appropriation of funds from the budget reserve fund is taken respectively by the Cabinet of Ministers of Ukraine, the Council of Ministers of the Autonomous Republic of Crimea, local state authorities and executive authorities of the respective local councils (p. 24 of the Budget Code of Ukraine), with the Cabinet of Ministers of Ukraine (the Council of Ministers of the Autonomous Republic of Crimea, local state authorities and executive governments of the respective local councils) being accountable on a monthly basis before the Verkhovna Rada of Ukraine(the Verkhovna Rada of the Autonomous Republic of Crimea) in respect of the application of the funds of the respective budget's reserve fund. The state budget reserve fund shall refer to the expenditures of the State budget of Ukraine for the respective year approved by the Verkhovna Rada of Ukraine.

Budget classification of the State budget

72. The State budget of Ukraine is adopted for one calendar year and consists of two parts: an extensive textual part and annexed budget tables. The textual part, structured by articles as any other law, contains a detailed description of the tables' figures. It also contains a set of general rules (principles of budgeting, budget reallocation rules, etc.), which are transferred from year to year in the same formulation. The 2010 Budget Code has taken over most of these provisions, which allowed a substantial reduction of the volume of the textual part of the 2011 budget (the textual part of the 2010 budget

amounted to 69 pages, that of the 2011 budget to 17 pages). As the textual part refers to the figures in the annexed tables, any changes in these figures lead to changes in the textual part of the law in respective articles¹⁶.

73. The appropriations of the State budget are presented in the tables annexed to the budget law. In 2011 there are nine annexes to the state budget law which all have the same legal status and are approved by parliament as part of the law:

Annex 1: Revenues of the State budget of Ukraine;

Annex 2: Financing of the State budget of Ukraine;

Annex 3: Expenditures of the State budget of Ukraine;

Annex 4: Reimbursement of credits to the state budget and its distribution by programmes;

Annex 5: Distribution of expenditures on health programmes by local governments;

Annex 6: Equalisation grants to local governments;

Annex 7: Subsidies, subventions and other grants from the State budget to local governments:

Annex 8: The list of bodies assigned to control the execution of payments to the budget;

Annex 9: Expenditures on the courts of all jurisdictions

74. Annex 3, the most employed annex as it contains information on budget expenditures, classifies the appropriations by institutions (Ministries and other Central Public Authorities), budget holders, programmes (including activities under programmes), with some detail on economic groups (labour costs, utility and energy services, gross investments), according to the format of Table 3. The columns of labour costs and utilities and energy services not necessarily count up to amount of current expenditures since there may be other current expenditures (subsidies, other procurement than from utilities and energy services, etc.). However, the requirement to specify labour costs and utilities and energy services, makes them into line items with binding ceilings. Additional spending on these line items is only possible through reallocation.

Table 3. Format of the line item structure of the State budget of Ukraine

| Special Fund | | | | General Fund | | | |
|--|------------------|-------------------------------|----------------------|-------------------------|------------------|-------------------------------|-----------------------|
| Investment expenditures | <u>of which:</u> | | Current expenditures | Investment expenditures | <u>of which:</u> | | Current expenditures: |
| | Labour costs | Utilities and energy services | | | Labour costs | Utilities and energy services | |
| Total | | | Total | | | Total | |
| Title under the programme classification | | | | | | | |
| Code of functional classification | | | | | | | |
| Code of programme classification | | | | | | | |

¹⁶ That is the reason why the Verkhovna Rada amends articles together with the lines in the budget tables.

75. The State budget of Ukraine is split into general and special funds. The general fund includes all budget revenues that are not earmarked to specific purposes and all expenditures funded from these revenues. The special funds cover budget revenues earmarked for a specific purpose and expenditures for that purpose.

76. The appropriations for grants to local government as well as interest on debt are contained in other annexes (6 and 7).

77. All line items are also classified for informative purposes in an economic and functional classification. The code of the functional classification is applied to the programme level, the code of the economic classification to the line item level. The economic, institutional and functional classifications are separately adopted by a Resolution of the Ministry of Finance. This Resolution is annually amended in light of the adopted state budget (and its programme classification). The economic and functional classifications remain in practice unchanged from year to year, while the institutional classification alters depending on the distribution of budget programmes among line ministries.

78. An example of the first three columns of the line item format presented in table 3 for the Ministry of Foreign Affairs is provided in Table 4.

Table 4. The programme classification of the Ministry of Foreign Affairs

| Code of programme classification | Code of functional classification | Title under the programme classification expenditure |
|----------------------------------|-----------------------------------|---|
| 1400000 | | Ministry of Foreign Affairs |
| 1401000 | | Apparatus of the Ministry of Foreign Affairs |
| 1401010 | 0113 | Management of the State Policy in the area of Foreign Affairs |
| 1401020 | 0113 | Ukraine's contributions to the budgets of UN bodies and specialized agencies of the UN and other international organizations |
| 1401030 | 0113 | Operation of Foreign diplomatic missions of Ukraine |
| 1401040 | 0113 | Ownership for the needs of overseas diplomatic missions of Ukraine |
| 1401050 | 0113 | Implementation by the Ministry of Foreign Affairs of its authority to conduct foreign policy of Ukraine abroad, organization of and control over the overseas diplomatic missions of Ukraine. |
| 140106 | 0113 | Expenditure related to Ukraine's chairmanship of the Committee of Ministers of the Council of Europe |
| 1401080 | 0113 | Ensuring the stay of foreign delegations coming to Ukraine with official visits |
| 1401100 | 0950 | Trainings and development of skills in area of international relations |
| 1401110 | 0113 | Financial support for promoting a positive image of Ukraine at the international level |
| 1401120 | 0950 | Training of diplomatic officers belonging to categories 5-7 of the civil service |
| 1401130 | 0113 | Production of identity documents for travelling abroad |
| 1401150 | 0829 | Measures to support relations with Ukrainians residing abroad |

79. All budget programmes have codes. The code contains information referring to the responsible ministry or other Central Public Authority (CPA), its budget holder, the programme and the activities under the programme. The programme code is presented in table 5.

Table 5. The budget programme code

| Budget programme code (seven digits) | | | |
|---|--|---|---------------------------------------|
| xxx | x | xx | x |
| Main line ministry or other CPA (code of the institutional classification of budget expenditures) | Budget holder of the main line ministry or other CPA responsible for the budget programme implementation | Budget programmes, implemented by the budget holder | Activities under the budget programme |

80. The programme classification has been introduced in Ukraine in 2002. Its implementation was approved in a Resolution of the Cabinet of Ministers of 14 September 2002 (No. 538). Until recently, the number of budget programmes¹⁷ in the classification of Annex 3 varied from year to year and amounted to 900-950 programmes (including activities under programmes) per year¹⁸. Since 2011 the number of budget programmes has been reduced¹⁹ and there are 580 programmes in the draft budget Law of Ukraine for the year 2012. Therefore, the number of “line items” is not very large. It is noteworthy that the number of programmes can increase within the budget year (by supplementary budget laws).

81. Each budget programme has its own *passport*, a document that defines the objectives and areas of use of programme funds, persons in charge, effective indicators, and other characteristics of the programme. It guides the programme implementation during the budget year and contains performance indicators necessary for performance evaluation. The *passports* are signed by both responsible line ministry and the Ministry of Finance. As the State budget, the *passports* are valid for a one year period.

82. The programme passports are compiled by line ministries in co-ordination with the Ministry of Finance right after the state budget is approved on the basis of the information provided in the budget requests. Responsible line ministries report on a quarterly basis and at the end of the year on the programme performance results as targeted in the passports.

¹⁷ A budget programme is a range of measures aimed at achieving a common objective, tasks, and the expected result, identified and implemented by a spending unit according to its respective functions (Art. 2 of the 2010 Budget Code).

¹⁸ The number of budget programmes has been increasing since 2002 and has reached 1000 by 2007. Starting from 2007 the Government took efforts to decrease their number and in the 2008 budget there were 923 programmes, in the 2009 budget 991 and in the 2010 budget 919. These numbers do not take into account appropriations for interest and grants to local governments that are appropriated in other annexes of the State budget.

¹⁹ See the Strategy for optimisation of the budget programmes’ number adopted by the Government Resolution #292-p dated 6 April, 2011.

Budget and priority programmes

83. Budget programmes in Ukraine are partly based on priority programmes (also called “target programmes” or “earmarked programmes”). The priority programmes are approved by the Cabinet of Ministers for the medium or long terms (for 5-10 years) and anchor State priorities. However they do not authorise expenditures. Priority programmes cover broader areas than budget programmes. Hence, the number of priority programmes is less than that of budget programmes (for example in the area of education and science, in 2009 there were 18 priority programmes and 50 budget programmes). Budget programmes develop certain areas of priority programmes and make their financing possible in the upcoming budget year. Therefore a priority programme not elaborated by a budget programme does not receive funding and remains on hold. While budget programmes are co-ordinated by the Ministry of Finance, priority programmes are under the responsibility of the Ministry of Economic Development and Trade.

84. In 2010, there were about 280 priority programmes with different status (effective, discontinued, on hold, etc.) in Ukraine. At present the Government makes efforts to review them in order to eliminate overlapping and discontinued programmes and analyse the needs.

Programme classification in OECD countries

85. OECD countries usually have a single budget classification which serves as the basis for budget negotiations within the government and for authorisation by Parliament. Frequently occurring features are:

- a limited number of line items (not more than 500);
- within each line ministry, there is a single line item for current operational expenditure of the core ministries and for each agency under the ministry (compensation of employment plus procurement);
- breakdown by expenditure groups or programmes (apart from current operational expenditure);
- multi-annual estimates on the basis of current policy should be provided in the same classification.

86. A stylised form of such a classification is shown in Table 6.

Table 6. Stylised budget classification

| | Budget year (b) | b + 1 | b + 2 | b + 3 | b + 4 |
|---|--------------------|-------|-------|-------|-------|
| Ministry I | | | | | |
| Current operational expenditure core ministry | | | | | |
| Current operational expenditure agency 1 | | | | | |
| Current operational expenditure agency 2 | | | | | |
| Etc. | | | | | |
| Programme A | | | | | |
| Sub-programme A1 | | | | | |
| Sub-programme A2 | | | | | |
| Programme B | | | | | |
| Etc. | | | | | |
| Ministry II | | | | | |
| Current operational expenditure core ministry | | | | | |
| Current operational expenditure agency 1 | | | | | |
| Current operational expenditure agency 2 | | | | | |
| Etc. | | | | | |
| Programme A | | | | | |
| Sub-programme A1 | | | | | |
| Sub-programme A2 | | | | | |
| Programme B | | | | | |
| Etc. | | | | | |
| Ministry III | | | | | |
| Etc. | | | | | |

Cash base of appropriations

87. Ukraine uses cash-based appropriations. According to OECD experience, this is a suitable appropriation standard. Accrual budgeting leads to many practical and technical problems and reduces the transparency and comprehensibility of the budget, not least for the politicians who have to decide on it. The EU follows an intermediate approach by requiring stabilisation programmes to be on ESA 95 basis. This requires to present most of expenditures on commitment basis, but with ample room for exceptions in the sphere of revenues and transfers, and with investments on production rather than consumption basis.

2.2 The annual budget formulation sequence***Budget calendar***

88. Table 7 summarizes the calendar for the annual budget preparation process.

Table 7. Budget preparation calendar

| | |
|-----------------|--|
| By 15 March | The National Bank of Ukraine submits to the Verkhovna Rada of Ukraine and the Cabinet of Ministers of Ukraine projected monetary indicators for the forthcoming year |
| by 20 March | The Ministry of Finance of Ukraine prepares a draft Budget Declaration for the forthcoming budget year and submits it for consideration of the Cabinet of Ministers of Ukraine. Line ministries and other CPAs submit to the State Budget Department of the Ministry of Finance data (estimates) on structural changes occurred in line ministries and other CPAs (and their budget holders) since the previous year and make preliminary requests for additional expenditures needed in the upcoming budget year due to new policy/legislation. |
| by 1 April | The Cabinet of Ministers considers and approves the Budget Declaration and submits it to the Verkhovna Rada of Ukraine within a three day period. |
| May-August | The Ministry of Finance fixes expenditure ceilings (for current expenditures and capital expenditures included in priority programmes) for the upcoming budget year as well as expenditure benchmarks for two out-years for ministries and other CPAs and brings them to the attention of line ministries. |
| | Line ministries and other CPAs submit budget requests (electronically) where they breakdown expenditures by and within the programmes, and, if needed, demand and motivate additional sources. |
| | The State Budget Department receives and analyses the budget requests and holds conciliatory meetings with the line ministries and other CPAs regarding the parameters of the state budget for the coming budget year. |
| | The Local Budgets Department of the Ministry of Finance calculates and makes known to the local governments sub-national revenue forecasts, amounts of inter-budgetary transfers and indicators used for defining the transfers. |
| | The Ministry of Finance prepares a forecast of the consolidated budget of Ukraine on key of revenue, expenditure, financing and debt parameters for a period of three years following the budget year for the approval of the Cabinet of Ministers (draft Resolution) |
| September | The Ministry of Finance submits the draft Budget Law to the Cabinet for consideration |
| by 15 September | The Cabinet of Ministers of Ukraine approves the Budget bill and submits it along with relevant materials to the Verkhovna Rada of Ukraine and the President of Ukraine. |

Source: Budget Code of Ukraine

89. The sequence, deadlines and participants of the budget preparation process are elaborated in details in a document ("Action Plan") adopted annually by the Ministry of Finance. The plan assigns responsibilities and tasks to the divisions of the Ministry of Finance or to relevant state bodies regarding the draft budget. The Action Plan is approved by an internal decree of the Ministry of Finance. For example, the action plan for the 2011 state budget and preliminary forecasts for the 2012-2014 consolidated budget of Ukraine includes the following preparation stages:

- Devising goals/objectives for the Budget Declaration and preparing preliminary indicators for the 2011 budget;
- Fixing ceilings, collecting budget requests from line ministries and other CPAs for the 2011 State budget and preparing parameters for 2012-2014 consolidated budget (for Cabinet's approval and adoption of a Cabinet's resolution);
- Preparing and submitting the 2011 budget bill to the Verkhovna Rada of Ukraine.

Budget declaration

90. The annual budget formulation process starts in January-February with the preparation of a Budget Declaration for the forthcoming year (see box 2). The declaration contains the major outlines of budgetary policy for the upcoming budget. The Ministry of Finance drafts and submits the Declaration to the Cabinet of Ministers by 20 March. Line ministries can comment the draft Declaration and make suggestions. According to the Budget Code, the Cabinet of Ministers, approves the Budget Declaration not later than 1 April and submits it to the Verkhovna Rada of Ukraine within a three day period (art. 33.3).²⁰ Subsequently, the Rada considers the major outlines of the budgetary policy for the upcoming budget and adopts a Resolution on the Budget Declaration (see chapter 2). The draft budget law of Ukraine for the next year must be developed while taking into account the requirements of the Budget Code and the major lines of the budgetary policy for the next budget as adopted or acknowledged in the Resolution of the Rada.

Box 2.

Budget Declaration for the forthcoming budget year

The Budget Goals and Objectives Declaration (Budget Declaration) for the upcoming budget year is based on economic and social development projects and programmes, and contains the following provisions:

- 1) basic projections of macro indicators of economic and social development of Ukraine, including nominal and real GDP, consumer price and producer price indexes, official exchange rate of Hryvnia on average for the year, and by the end of the year, unemployment rate;
- 2) major objectives of the budget policy, in particular deficit and debt ceilings of the state budget, share of the projected annual GDP distributed via the consolidated budget of Ukraine, minimum wage, cost of living;
- 3) priority tax policy objectives;
- 4) implementation of the priority state programmes;
- 5) interrelationship of the State budget with local budgets, including justification of the share of local budgets in the consolidated budget of Ukraine;
- 6) other issues required to prepare the Budget bill.

Macroeconomic forecasting

91. In Ukraine, the Ministry of Economic Development and Trade plays a key role in preparing and co-ordinating of macroeconomic forecasts underling the budget. Forecasting procedures are established in the Decree of the Cabinet of Ministers on Drawing Forecast and Programme Documents of Economic and Social Development of 26 April 2003 (No.621), which has been recently amended in light of the new Budget Code of Ukraine. The amendments introduced strategic plans²¹ and modified terminology and time frames.

²⁰ Prior to 2010 amendments to the Budget Code, the Declaration had been adopted too late in the budget formulation schedule, so it could not be taken into account during budget preparation. From 2010 the Declaration has to be approved early enough to provide guidelines on policy priorities.

²¹ Strategic plans include the "Development strategy for Ukraine" for ten years, the "State strategy for regional development", and State strategies for specific regions.

92. The Macroeconomic Forecasting Department of the Ministry of Finance is in charge of medium term budgetary forecasting, making use of the macro-economic forecasts of the Ministry of Economic Development and Trade. It also performs analyses of the impact of macroeconomic developments on the budget and of the impact of fiscal policy on the economy. Finally, the Department is responsible for updating its forecasts in the course of the budget formulation and execution, for the preparation of the annual budget execution report and for disseminating public finance statistics. The co-ordination procedures between both ministries are established by Decree No. 621 mentioned above, but officials of both ministries saw the task division not entirely in the same way and in practice there may be some overlap.

93. The Macroeconomic Forecasting Department has a staff of 22 and is organised in five sub-units:

- macroeconomics (5 staff);
- statistics (5 staff);
- modelling (5 staff);
- medium-term forecasting (5 staff);
- budget execution (2 staff).

94. Macroeconomic forecasting for the forthcoming budget year starts in March. The Ministry of Economic Development and Trade together with the National Bank and other relevant State bodies prepares preliminary macroeconomic forecasts of economic and social developments for the forthcoming budget year²² (by 1 April 2010 for the 2011 budget). Since 2003, the Ministry of Economic Development and Trade has also prepared preliminary macroeconomic forecasts of economic and social development for the three years following the budget year.

95. The Ministry of Economic Development and Trade takes into consideration opinions of independent institutions while preparing forecasts, for instance the assumptions of the Forecasting Institute of the Academy of Science of Ukraine and of Consensus Economics²³. The Forecasts of Consensus Economics are posted on the web- site of the Ministry of Economic Development and Trade.

96. While the Ministry of Economic Development and trade prepares its preliminary macroeconomic estimations, the responsible units of the Ministry of Finance submit to the Revenue Department preliminary revenue forecasts for the State and local budgets for the coming budget year and two out-years²⁴ (by 1 March 2010). The forecasts incorporate expected changes in tax policy. The responsible units also submit an assessment of expected revenue performance in the current year.

97. The Revenue Department of the Ministry of Finance (25 staff) is organised in four divisions:

- Aggregating Unit (7staff);
- Excise Taxes and other payments Unit ;
- Income tax and VAT Unit;

²² In practice, it is a one page document listing key parameters.

²³ Established in London in 1989, Consensus Economics prepares monthly compilations of country economic forecasts and topical analyses (see www.consensus-economics.com/about.htm).

²⁴ Forecast for two out years are the current requirement of the new Budget Code; the 2001 Budget Code was requiring three out-years.

- Natural resources fees and local level taxes Unit

98. Each of these divisions prepares a calculation of tax and fee revenue using the preliminary macroeconomic estimations of the Macroeconomic Forecasting Department of the Ministry of Finance²⁵, the prevailing tax legislation and the data from other relevant ministries or agencies.

99. The divisions of the Revenue Department and other responsible divisions of the Ministry of Finance prepare and submit to the Macroeconomic Forecasting Department and the State Budget Department of the Ministry of Finance (by 15 April for the 2011 budget) the following estimations for the upcoming budget year and two out-years:

- Revenue forecast of the State and local budgets (in 2010 for 2011 and 2012-2014²⁶);
- Debt interest payments and repayments from the budget (in 2010 for 2011 and 2012-2014);
- Loans' reimbursements back to the budget (in 2010 for 2011 and 2012-2014);
- Forecasts of deficit financing and interest.

100. First calculations are available in April and are subject to further adjustments as new macroeconomic forecasts from the Ministry of Economic Development and Trade come in. The Ministry of Economic Development and Trade updates its macroeconomic assumptions up to three times within the period from March to August. By 1 September the final revenue forecast is submitted to the State Budget Department. The calculations are usually quite accurate. Supposing that the economy is stable and macroeconomic forecast are not modified substantially, the calculation error may amount to 5 percent of total real revenue at most.

101. If necessary, the Ministry of Economic Development and Trade can further update its macroeconomic estimations for the upcoming budget year and two out-years after submission of the budget to the Rada. This can for instance occur in the period between the first and the second readings of the budget bill Rada, as well as during the budget execution. If macroeconomic situation changes substantially during the budget year, the macroeconomic estimations for the budget year are adjusted by a resolution of the Cabinet of Ministers of Ukraine. In practice, such adjustments occur every three months. If it has impact on the revenues and expenditures, the budget law is subsequently amended (art. 52 of the Budget Code).

Preliminary requests

102. In March-April the Ministry of Finance asks line ministries to provide data on structural changes and requests for additional expenditures in the upcoming budget year. The data concern in particular:

²⁵ It is interesting to mention, that within the Ministry of Finance, the Revenue Department receives macroeconomic forecasts from the Macroeconomic Forecasting Department. The Revenue Department may comment or make suggestions to these macroeconomic forecasts, if needed, and accept the forecasts to be used in calculations. If the Revenue Department disagrees to the macroeconomic estimations, it has to address the Macroeconomic Forecasting Department, which in its turn addresses to the Ministry of Economic Development and Trade with a reasoned request to reconsider and change the macroeconomic forecasts. This fact supports the argument that the Ministry of Economic Development and Trade is essentially the only producer of macroeconomic estimations in Ukraine.

²⁶ In 2010 budget formulation the old rule requiring not two, but tree out-years forecast, was applied. Therefore, the forecast was covering three out years, and not two.

- changes in budget programmes; inclusion/exclusion of a budget programme, merging or splitting of programmes, transferring a programme to a different budget holder due to legislation changes;
- changes in the parameters that determine programme totals (for instance increase/decrease in numbers of unemployed, pensioners or other entitlement beneficiaries);
- calculations regarding the need for capital expenditures for the coming budget year;
- sectoral expenditure calculations;
- staff number alterations.

Setting of ceilings, submitting requests and drafting the State budget

103. On the basis of the data on structural changes and preliminary requests of line ministries and other CPAs, the Ministry of Finance fixes expenditure ceilings for current expenditures and for capital expenditures which are covered by priority programmes, which will further determine the development of budget formulation process. The ceilings cover the upcoming budget year. In addition the Ministry sets expenditure benchmarks for the two out-years. The ceilings and benchmarks are set in the budget circular which is sent out to the line ministries and other CPAs. The budget circular contains guidelines for formulating requests and various forms to be filled in. The Ministry of Finance also establishes a time schedule for further conciliation meetings with the line ministries. The Ministry of Finance also communicates to the line ministries and other CPAs indicative estimates of expenditures and loans issued from the budget, for the two budget years following the budget year²⁷.

104. Upon the reception of the budget circular the line ministries and other CPAs are given approximately one month to prepare their budget requests²⁸. In practice it consists in filling in the forms annexed to the budget circular. In one form requests for additional expenditures can be made and motivated. The requests should contain reliable and comprehensive information and be submitted to the Ministry of Finance on time (see box 3). According to article 35 of the Budget Code, the budget requests should take into account the reports on the implementation of budget programs as envisaged in the passports of the previous year. The line ministries and other CPAs should also provide information about the contribution of the requested resources to the stage-by-stage implementation of priority programmes. Finally, line ministries and other CPAs should put up “activity plans” for the budget year and the following two years which provide information about the policies to be funded by the requested resources.

105. The budget requests are sent electronically to the Ministry of Finance. The Ministry of Finance checks the conformity of the requests with the expenditure ceilings and assesses the effectiveness and efficiency of the proposed policies²⁹. They are subsequently discussed and agreed between line ministries and the Ministry of Finance according to the schedule of conciliation meetings. If the Ministry of Finance fails to reach an agreement with a line ministry (or other CPA), the Ministry of Finance will note the lack of agreement when it submits the budget bill to the Cabinet.

²⁷ Art. 21 of the 2010 Budget Code of Ukraine.

²⁸ According to art. 2 of the Budget Code, budget request is a document developed by a key spending unit containing duly substantiated proposals on amounts of budget funds required to conduct its activities in the future budget periods.

²⁹ Art. 36 of the 2010 Budget Code of Ukraine.

106. Following the budget request assessment and the conciliation meetings, the Ministry of Finance develops a budget bill for the forthcoming budget year, which is then submitted to the Cabinet of Ministers of Ukraine along with the relevant materials. The Cabinet delivers the budget bill to the Verkhovna Rada of Ukraine and the President of Ukraine by 15 September.

Box 3.

Budget Formulation process in a line ministry (or other CPA)

Line Ministries (or other CPAs) are requested to submit information on structural changes and make preliminary requests for additional expenditures in March–April of the year preceding the budget year.

Following these preliminary requests, line ministries receive from the Ministry of Finance a circular fixing the expenditure ceilings and providing guidelines for preparing budget requests. Line ministries issue similar circulars for their budget holders prescribing expenditure ceilings and providing instructions for request preparation. The budget holders are required to provide their budget request to the financial directorate of their line ministry. Upon the reception of these requests the financial directorate draws up a single budget request for the Ministry of Finance.

According to the representatives of the Ministry of Education, the real expenditure needs usually surpass the expenditure ceilings of the Ministry of Finance by approximately 30%, therefore the budget request exceed the expenditure ceilings. The ministry sees the ceilings as not binding and has learned over time that they can be increased through negotiation.

When the budget bill is being scrutinised in the Verkhovna Rada, line ministers have another opportunity to explain the potential use of additional resources, not however, to plead for changes since they have to respect the budget bill as submitted by the Cabinet of Ministers. Upon the approval of the State budget law line ministries within 45 days following approval of the budget law draw up programme passports in co-ordination with the Ministry of Finance on the basis of the information provided in the budget requests. The line ministries also report on a half-yearly basis and at the end of the year on the programme performance results as targeted in the passports.

2.3 Medium-term planning

Medium term budgetary framework

107. The new Budget Code (2010) has introduced a forecast of the State budget for the two years following the upcoming budget year. The forecast is developed by the Ministry of Finance jointly with the Ministry of Economic Development and Trade, the National Bank together with other relevant ministries and CPAs and includes the following indicative forecasts³⁰:

1. major macro-indicators of economic and social development (nominal and real GDP, consumer and producer price indices, annual average and end-of-year exchange rate of hryvnia, enterprises' profits and payroll costs, unemployment level, exports and imports of goods and services, as well as other indicators used in the development of a draft budget);
2. the consolidated budget of Ukraine by major types of revenues, financing, expenditures, and borrowing;
3. the State budget by major types of revenues, financing, expenditures, and lending;
4. expenditures for budget programmes ensuring implementation of priority programmes, including those financed by loans (borrowings) attracted by the government from foreign countries, banks, and international financial institutions;

³⁰ Art. 21 of the 2010 Budget Code of Ukraine.

5. the grants to local governments.

108. The State budget indicative forecast for two out-years is submitted to the Verkhovna Rada together with the budget bill. It is adjusted to comply with the adopted version of the State budget and approved by the Cabinet of Ministers of Ukraine within one month after the Law on the State Budget is published.

109. The indicative forecast for the State budget of Ukraine for the two out-years is seen by the authorities as a target indicator for the line-ministries for the medium-term.

110. The newly introduced two out year forecast of the state budget in Ukraine resembles to some extent a medium-term budgetary framework³¹ (MTBF) as defined by the European Union. However, the framework, according to the EU, includes medium-term budgetary objectives or ceilings, not just forecasts. The role of a MTBF consists in helping to ensure fiscal discipline. Furthermore, the existence of a MTBF may facilitate monitoring by providing benchmarks against which budgetary developments can be assessed over time. The strengthening of the MTBF usually serves as a complement to the introduction of other institutional reforms such as the introduction of an expenditure rule or top down budgeting. Almost all EU countries³² (except Greece, Cyprus, Hungary, Luxemburg and Portugal) have budgetary frameworks covering from two to five out-years.

111. Medium-term budgetary planning has a very important role in OECD countries. Objectives or ceilings focus on the expenditure side of the budget and take the form of medium term expenditure frameworks (MTEFs). The level of commitment with regard to MTEFs in these countries is generally high which promotes better fiscal discipline and improves budgetary outcomes (low deficit or surplus and low debts). As of 2008, 20 OECD countries³³ have been working with expenditure frameworks establishing ceilings or targets for periods covering from three to five years (see box 4).

³¹ In the EU fiscal governance database, the medium-term budgetary frameworks (MTBFs) are defined as those fiscal arrangements that allow government to extend the horizon for fiscal policy making beyond the annual budgetary calendar.

http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm

³² As of 2008.

³³ OECD budget database.

Box 4.**Medium-term expenditure frameworks in OECD countries**

An expenditure framework is a normative instrument capturing policy objectives of the government and imposing limits on spending over the medium term. The design of expenditure frameworks differs across countries. The frameworks can be either flexible (annually updated year in light of the previous year's outcomes, new estimates of the consequences of current policies and new political priorities) or fixed (when the figures remain unaltered from year to year once they have been set).

The major advantage of a flexible framework in comparison to no framework is that at the time of budget formulation the multi-annual consequences of all policy changes have to be traded off against each other and against the adjustment of medium-term targets. This guarantees that the consequences of new spending initiatives in future years (which may be larger than in the first year, so-called "camel noses", are accounted for. Similarly, it makes possible that savings measures which phase in slowly - which is the case with most major measures since they require changes of the law or reorganisation of administrative units - are duly considered.

A few countries (notably the Austria, the Netherlands, Sweden and the United Kingdom) have fixed expenditure frameworks. The major advantage of a fixed expenditure framework over a flexible framework is that it is (more) effective in realizing multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realized as long as the framework is maintained. Although only few OECD countries work with a fixed expenditure framework, many others seek to keep their expenditure framework as stable as possible from year to year (without formally committing to a fixed framework).

An expenditure framework can be rolling like in Austria and Sweden, or it can be periodical like in the UK and France. In a rolling framework, an additional year is added at the end of the framework period when the first year (or budget year) expires. In a periodical framework, a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new cabinet period.

Expenditure frameworks can be distinguished along several other dimensions, notably the number of future budget years covered, the number of ceilings they establish, and their comprehensiveness (how much of government spending is subject to the framework). In terms of future budget years covered, many frameworks cover a three-year (France, Sweden) or four-year period (Finland, the Netherlands) of future budgets. The UK moved from a three to a five-year forward framework with the 2010 Comprehensive Spending Review. In terms of the number of sub-ceilings, some frameworks establish only a single aggregate ceiling on expenditures (Sweden), while others contain a number of binding sub-ceilings at the ministerial (the Netherlands, UK) or policy area level (France). In terms of comprehensiveness, some governments argue that particularly volatile items or items determined by entitlements should not be subject to multi-year ceilings (for instance interest payments or unemployment benefits).

112. The State Budget forecast for 2013 and 2014 which were developed in accordance with the new Budget Code will serve as a basis for the formulation of the draft State budget for 2013. Yet to get closer to the comprehensive medium term budgetary planning, the Ukrainian Government may consider shifting from a forecasting approach to a targeting approach. The best solution could be a flexible framework. While a flexible framework can be annually updated, it provides a better fiscal discipline: the multi-annual consequences of all changes have to be traded off against each other and against the adjustment of medium-term targets for expenditures, revenues or the deficit. The framework should be decided at the start of budget preparation after the preliminary request of line ministries and other CPAs have been received, be approved by the Cabinet of Ministers and communicated by the Minister of Finance as binding guidelines for the preparation of definitive requests. It is essential (also in a flexible framework approach) that they cannot be changed anymore during budget preparation (nor during budget execution). Negotiations may affect allocation within the ceilings but not the ceilings themselves.

Baseline estimates

113. In order to be credible and realistic, an expenditure framework should rest on multi-annual estimates on the basis of current policy or current law ("baseline estimates").

Box 5.
Baseline estimates in OECD countries

OECD countries which work with expenditure frameworks produce and update multi-annual baseline estimates. Each programme has its own particular set of factors that will affect outlays, for instance economic variables, demographic developments, price changes or participation rates. The baseline estimates capture the cost of current law and/or current policy over the medium term and are essential for the allocation of financial resources in the annual budget negotiation. They are essential to ensure the consistency of current law or policy with the multi-annual ceilings. Best OECD practice shows that baseline estimates are frequently updated to reflect any changes in the underlying variables (usually monthly or quarterly) and be prepared at a line item level (the same level of detail as the annual budget) and they should be part of the annual budget proposal submitted to parliament (OECD 2002). The baseline estimates should also be agreed between the line ministry and the Ministry of Finance. They are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution. During execution they alert at an early stage to overspending, which should immediately trigger correcting measures (not in the next budget).

Establishing the expenditure framework can be seen as a top-down process and preparing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line-item estimates is central to a disciplined budget process.

114. The data on structural changes and preliminary request estimates to be submitted by ministries and other CPA's at the start of budget preparation (see para. 102) are somewhat similar to the baseline estimates in OECD countries. The similarities consist in that they are provided by line ministries, they capture the cost of current law and/or current policy and they are used by the Ministry of Finance to establish expenditure ceilings (for the upcoming year). However, the estimates in Ukraine cover only one (budget) year and do not cover out-years. They are not updated further and are not sufficiently comprehensive as they focus only on changes expected in the budget year, while the concept of baseline estimates implies providing all costs of current law and/or current policy. Therefore, the preliminary request estimates do not fulfil the key baseline estimates' purpose to attain consistency between current policy and medium-term fiscal objectives (as provided by an expenditure framework).

2.4 Fiscal sustainability

115. Fiscal sustainability, the major objective of fiscal policy, rests primarily on fiscal rules. The 2008 financial crisis has particularly exposed the importance of well-designed fiscal rules (supported by other fiscal institutions reinforcing fiscal discipline, such as medium-term expenditure frameworks, fiscal councils). Therefore, OECD countries consider fiscal rules as one of the most important fiscal institutions and consistently work on adopting the most efficient design and combination of fiscal rules.

116. According to the definition of a fiscal rule proposed by Kopits and Symanski (1998), a fiscal rule is "a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance (...). A critical feature of a fiscal rule is that it is intended for application on a permanent basis by successive governments in a given country." Fiscal rules can serve different goals and their role in

promoting budgetary control varies. Fiscal rules can be applied to various fiscal aggregates, such as measures of expenditure, revenue, budget balance or debt.

117. Ukraine has introduced a debt rule. According to the new Budget Code, the total amount of public debt and state-guaranteed debt at the end of the budget year should not exceed 60 percent of annual nominal GDP³⁴. A debt rule of this type is suitable for providing an anchor to fiscal policy in the long run. However, it does not provide sufficient guidance for fiscal policy when debt is well below its ceiling, which is the case in Ukraine (see chapter 1).

118. Next to the debt fiscal rule, the new Budget Code contains a provision that applies to the revenue side (art. 53 of the Budget Code). It says that if actual revenues of the State budget exceed the revenues approved in the Law on the State Budget, the extra-revenues should be spent on top-priority investment programmes (projects) approved under the procedure established by the law and perform actions related to social reforms. This rule is accompanied by the following clause: “the fact of exceeding the targeted State budget revenues is recognised (...) based on the results for three quarters in the event the indicators of the State budget revenues (...) exceed the target by more than 15 percent”. This rule raises several concerns.

119. First, this provision promotes pro-cyclical spending³⁵. Second, the provision is ambiguous. It outlines that the extra revenues should be spent “on top-priority investment programmes (projects) approved under the procedure established by the law and perform actions related to social reforms”. The regulation prescribing the procedure for defining top-priority investment programmes has not been established, and it is not clear what actions related to social reforms are. Such obscure provisions allow spending outside the regular budget process and undermine fiscal discipline.

120. Together with debt and revenue rules, OECD countries use expenditure and balance rules. Expenditure rules in OECD usually set limits on total, primary, or current spending in growth rates of GDP, or in percent of nominal or structural GDP. An expenditure framework is not an expenditure rule (because it is not permanent), but its effect in the medium term is comparable. Expenditure rules and expenditures frameworks must be anchored in a structural balance rule in order to guarantee long term sustainability (public debt remaining constant as share of GDP or converging toward a sustainable level, for instance 60 percent of GDP). Steering on the expenditure side rather than on an annual cyclically adjusted deficit constraint is more transparent and possibly less susceptible to manipulation (Anderson and Minarik 2006).

121. Fiscal rules should also apply to local government (see Box 6 for the funding of local government in Ukraine). According to the Budget Code local authorities formulate and execute their local budgets independently. However, art. 18.3 of the Budget Code puts constraints on debt and guarantees. In particular, the total amount of local debt and debt guaranteed by the Autonomous Republic of Crimea or an oblast as of the end of the budget year should not exceed 100 percent (400 percent for the city of Kyiv) of the average annual projected volume of revenues in development budget (net of the amounts of local domestic and foreign borrowings) defined under the forecast of the corresponding local budget for

³⁴ Art.18 of the Budget Code of Ukraine.

³⁵ It may be argued perhaps that the 15 percent margin serves to identify “structural revenue gains” as opposed to cyclical windfalls, but even in this interpretation, it would be safer to maintain the separation between expenditures and revenues and reserve the structural revenue gains for tax relief. Revenue rules of this type exist in several OECD countries (the Netherlands, USA).

the next two years following the budget year. Should this threshold be exceeded, then the Verkhovna Rada of the Autonomous Republic of Crimea and the corresponding oblast council can take measures to bring the total amount of debt in compliance with the provisions of the Budgetary Code.

Box 6.
Intergovernmental Financial Relations

Ukraine is a unitary state with three levels of local government:

1. Oblasts (24), the Autonomous Republic of Crimea (1), the cities of Kyiv and Sevastopol (2);
2. Rayons (488) and cities in Oblasts and in the Autonomous Republic of Crimea (177);
3. Districts in cities (55), towns (278), settlements (782) and villages (10279).

Funds can be transferred between the State budget and the local budgets of the 1st and 2nd levels except the Autonomous Republic of Crimea (691 in total), as well as the local budgets of different levels in accordance with Articles 92, 93 of the Budget Code.

Decentralisation of public service provision. According to the officials of the Ministry of Finance, the division of tasks between the State and local governments is based on the principle of subsidiarity, which implies that public services are provided by the government that is as close to the citizens as possible while respecting equal rights to basic services and taking into account economies of scale and spill-over effects. The share of local budget expenditures in the expenditures of the consolidated budget of Ukraine is about 44%.

Grants from the central government. Local budgets receive non-earmarked equalisation grants, as well as other grants and subventions from the State budget (an additional service costs related equalisation grant, subventions for social protection programmes, subventions for investment programmes, and other grants and subventions). The share of such transfers in the consolidated budget of Ukraine is 24,8% (in 2011). According to the State Treasury, the transfers from the State budget account for about 52% of the total revenues (local and special fund) of local budgets.

The non-earmarked equalisation grants account for 51.9% of the total amount of transfers from the state budget to local budgets. The remaining grants (48.1%) are earmarked for specific services, such as service cost related equalisation grants, social protection subventions, subventions for the social-economic development of the regions, etc.

Equalisation grants. Equalization grants can be provided to all local governments of the first level. The size of equalisation grants is determined in accordance with the Budget Code of Ukraine using the following parameters:

- financial ratios of budget adequacy and their adjustment factors;
- population level and the number of consumers of guaranteed services;
- relative taxation potential index of the relevant budget;
- estimated volume of the revenue basket of local budgets;
- equalization factor;
- target ratio of the number of employees of local self-government bodies in relation to the population level.

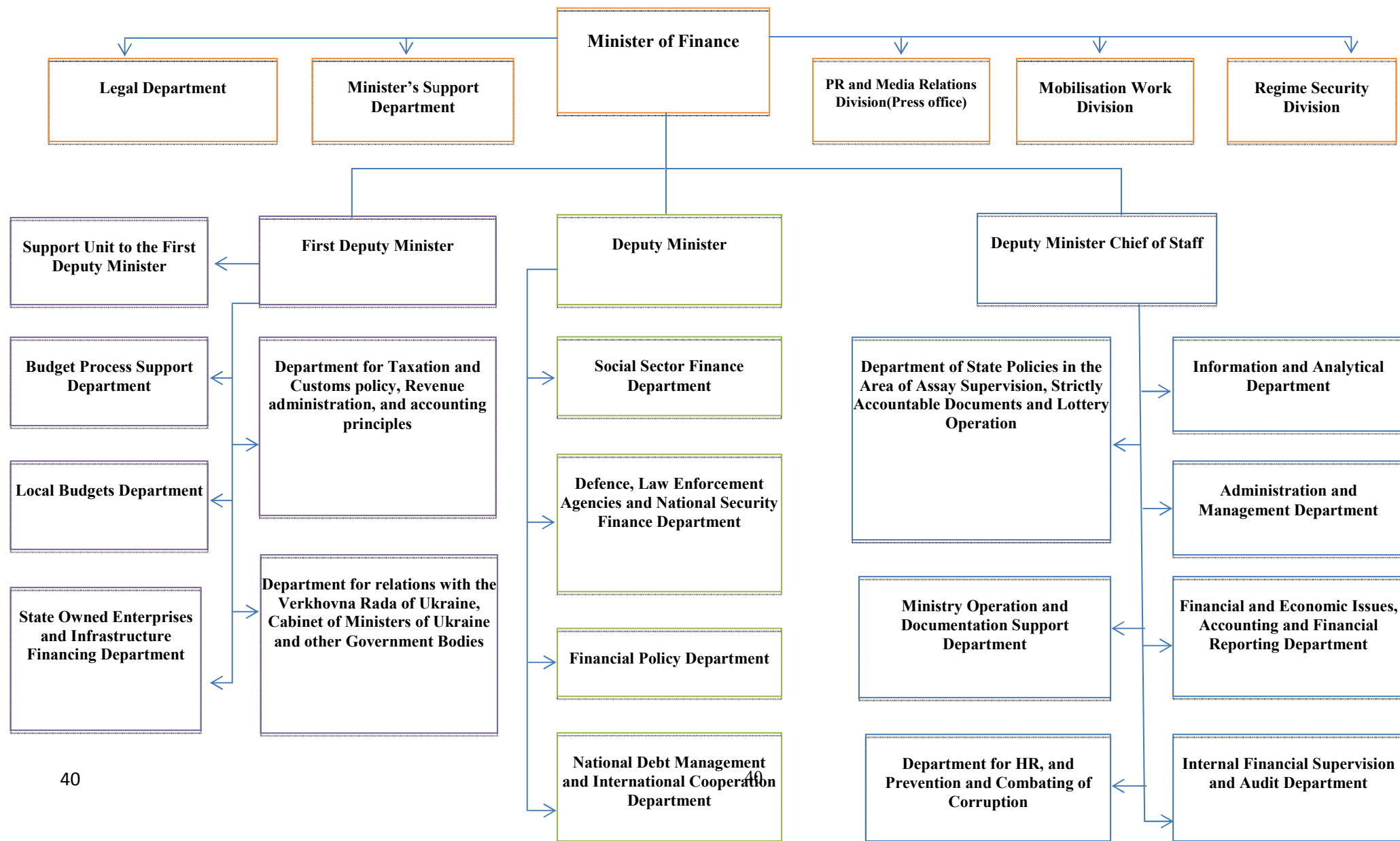
The relative taxation potential index is a factor that expresses the level of potential tax revenue of the local government in comparison with the national average on a per-capita basis.

2.5 Organisation of the Ministry of Finance

122. The Ministry of Finance of Ukraine is led by the Minister of Finance, the First Deputy Minister and two Deputy Ministers (figure 3). The first Deputy Minister is in charge of the State and Local budget's departments, and of finances of public enterprises. The budget department (with staff of 60 people) is the core department in the budget preparation process, where contributions of the expenditure divisions are brought together and reconciled in the budget bill. The First Deputy Minister also supervises the Department for Taxation and Customs policy, Revenue administration, and accounting principles. One of the two Deputy Ministers is in charge of sectoral finances, including the social sector, the state debt and international cooperation. The other Deputy Minister is in charge of administrative affairs of the Ministry.

123. The total staff of the Ministry of Finance amounts to 900. Overall, the Ministry of Finance plays a central role in the budgetary process of Ukraine. It has considerable power, establishing expenditure ceilings for line ministries, and allocating resources within line ministries. The Ministry coordinates the work of the State Treasury, the Customs and Tax Administrations, and the Financial Inspection. This strong position of the Ministry of Finance is positive for the budget discipline, especially at times of fiscal consolidation. However, the power of the Ministry of Finance should not overwhelm the role of line ministries. In OECD countries there is a common trend to make line ministries more responsible, to give them more discretion over their budget in line with broad strategic expenditure priorities. A strong and independent role of line ministries enables the Ministry of Finance to focus on the larger picture and strategic issues.

Figure 3. Organisation of the Ministry of Finance



2.6 Conclusions

124. Since 2002 the State budget of Ukraine is programme based. The number of budget programmes amount to 900-950 with a decreasing trend in recent years. There are about 580 budget programmes in the State budget of Ukraine for the year 2012. Each programme has a passport developed by a line ministry (or other CPA) defining objectives, budget holders in charge, indicators of effectiveness and other programme characteristics. It serves to guide the implementation the programme and to assess its performance.

125. The introduction of a programme classification is an important step forwards in the modernisation of public finance management in Ukraine. However, there are two remaining concerns. First, the expenditures of the State budget law are presented in a number of independent tables that make it difficult to fully identify the expenditures under each programme. For instance interest payments and grants to local governments are presentend in different tables than operational expenditures. The OECD Secretariat recommends presenting all expenditures by programmes in a single table. This will contribute to the transparency of the budget.

126. The second concern relates to the proliferation of priority programmes. The priority programmes aim to anchor State priorities for the medium and long term. Budget programmes provide funding for priority programmes in the budget year. At present there are various priority programmes which overlap or are out of date and there is a lack of coordination between them. The need to streamline priority programmes has already been acknowledged by the Ukrainian government. The OECD Secretariat recommends to decrease the number of priority programmes or abolish them entirely. In OECD countries sectoral priorities are usually laid down in sectoral medium or long-term plans that are under the responsibility of line ministers and serve to guide budget requests. They have no special status in the budget process.

127. Ukraine uses cash-based appropriations. According to OECD experience, this is a suitable appropriation standard. Introduction of elements of accrual accounting should be considered carefully and should not hamper the transparency of the budget and scrutiny by parliamentarians.

128. Ukraine has made progress with medium-term financial planning but further improvements are possible. The new Budget Code of 2010 requires the Cabinet to adopt a forecast of the consolidated and State budget by major types of expenditure and revenues for two out years in the month following the adoption of the budget law. This forecast does not provide a solid medium term framework and has little impact on fiscal discipline.

129. To further strengthen medium term planning, Ukraine needs an effective mechanism which imposes expenditure ceilings on ministries and other CPAs for the medium term (upcoming budget year and two or three out- years). This requires that an expenditure framework be adopted before the moment when line ministries are asked to submit their budget requests. In view of the volatility of the economic developments in Ukraine, the OECD Secretariat recommends a "flexible framework" approach. This implies expenditure ceilings for the budget year and two or three out-years, which are rigorously maintained during budget preparation and execution, but which can be updated annually at the start of a new budget cycle. Moreover the ceilings should cover both capital and current expenditures.

130. Next to a medium term expenditure framework, base line estimates are an essential component of medium term planning. Realistic and up to date estimates on the basis of current policy or current law are a necessary prerequisite for drawing up a medium term expenditure framework. In addition they

provide the basis for enforcing budgetary discipline. All overspending, including overspending in out-years, should be compensated immediately when it is observed (which may be the moment the estimates are updated during budget preparation and execution). The preliminary requests of ministries and other CPAs can be seen as a first step in the direction of developing base line estimates. However, to provide a sound ground for building up a credible expenditure framework, the preliminary requests need to be frequently updated, cover the medium term and provide all costs of current law and/or current policy. Many OECD countries update base line items quarterly.

131. The programme passports compiled by line ministries in co-ordination with the Ministry of Finance after the approval of the State budget provide the basis for performance assessment of budget programmes. Responsible line ministries report on a quarterly basis and at the end of the year on the programme performance results as targeted in the passports. Experience in some OECD countries shows that reporting performance data in the budget (or in the supporting material) can overload the budget documents and impair their transparency. Therefore, the Ukrainian practice to keep performance assessment apart from the budget process and under the responsibility of line ministers is sensible. However, the frequency of this reporting may be reduced to every half a year rather than quarterly in order to prevent bureaucracy.

132. Ukraine has introduced a debt rule (the debt should not exceed 60% of annual nominal GDP) and a rule for extra-revenues. The provision of the Budget Code regarding the extra-revenues could be improved in order to avoid any doubt about spending extra-revenues not exceeding the threshold of 15% and to prevent pro-cyclical spending. At the sub-national level there are constraints on debt and guarantees. The existing set of fiscal rules is useful, but does not sufficiently safeguard fiscal sustainability in the long term.

133. OECD countries are currently changing their domestic fiscal rules in order to make their fiscal framework more solid. Implementation of expenditure rules or an expenditure frameworks anchored in a structural balance rule³⁶ is a common tendency in the leading countries. Introducing a structural balance rule seems to be premature for Ukraine at the moment; however the first steps towards expenditure and balance rules can be already taken. With this regard Ukraine may consider the introduction of an expenditure framework targeting total or primary spending as percentage of trend GDP. The expenditure framework should be coupled with a balance rule, which makes the targets of the expenditure framework dependant on the trend revenue.

³⁶ The structural fiscal balance is obtained by removing the cyclical component from the headline fiscal balance. The cyclical component depends on two factors: the size of the output gap; and the output elasticity of the tax yield, which indicates the extent to which the tax yield reacts to fluctuations in GDP. The determination of the output gap is not always an easy exercise also for OECD countries and there are ongoing political discussions about the calculation procedures.

CHAPTER 3

ROLE OF THE LEGISLATURE

3.1 The Ukrainian Parliament – Verkhovna Rada

134. The Verkhovna Rada (Rada) is the sole body of legislative power in Ukraine. Article 113 of the Constitution establishes the accountability relationship between the VR and the executive branch: “The Cabinet of Ministers of Ukraine is responsible to the President of Ukraine and is under the control of and accountable to the Verkhovna Rada of Ukraine within the limits envisaged in Articles 85 and 87 of the Constitution of Ukraine.” The “authority” of the Rada includes “approving the State Budget of Ukraine and introducing amendments to it; controlling the implementation of the State Budget of Ukraine and adopting decisions in regard to the report on its implementation” (Art. 85.4).³⁷

135. Since 2008 elections and changes in government (and in 2009, the financial crisis) have often disrupted the normal budget cycle in parliament (see chapter 1, par. 19-25).

136. The Rada’s role in the budget process is regulated by the Constitution of Ukraine (art. 85 (4) as cited above), the Budget and the Rules of Procedure, specifically Chapter 27 on the “Adoption of the State Budget of Ukraine and Supervision of its Implementation”. The Rules of Procedure provide the most detail in terms of parliament’s role in the budget process and as of February 2010 the Rules of Procedure have the status of a law.

3.2 The Budget Committee

137. Committees play a vital role in the work of the Rada. In a 2009 survey a clear majority of deputies reported that committees are the most important place for deliberation on proposed legislation.³⁸ The Rada determines the composition of committees according to the Constitution (Art. 89), the Rada’s Rules of Procedure, and the Resolution on the List, Composition and Competencies of Committees of the Verkhovna Rada of Ukraine. Committee membership and leadership reflects the political composition of the Rada. There are currently 26 standing committees ranging in size from seven to 34 members and one ad hoc committee with 37 members. The Rada also has the right to establish “temporary special” and “temporary investigative” commissions to consider issues of public interest.

138. All committees participate in the review of the draft budget but the main committee charged with budget related matters is the Budget Committee. The above mentioned resolution on committees defines its competencies as: state budget policy and intergovernmental fiscal relations; the State budget

³⁷ Article 85 of the Constitution stipulates that the Rada has to give consent to the appointment of the Prime Minister by the President. Article 87 of the Constitution refers to the power of the VR to undertake a vote of no confidence in the Cabinet of Ministers.

³⁸ Response of 68.8% of the 125 deputies surveyed in February - April 2009 by the Parliamentary Development Project for Ukraine II (PDP II). This is the sixth survey since 1998 and tracks attitudes and opinions of deputies on a variety of issues.

of Ukraine (including revenues, expenditures, and budget execution); the budget process; assessment of the budget's compliance with the Budget Code of Ukraine; activities of public financial institutions; and the Accounting Chamber.

139. Membership on the Budget Committee is highly sought after and with 34 members it is the largest standing committee.³⁹ All political parties and factions represented in the parliament have the right to delegate at least one representative to the Budget Committee and the Chair and First Deputy Chairs are normally from different parties. The current Budget Committee leadership comprises a Chair, two First Deputy Chairs and three Deputy Chairs.⁴⁰ Additional members chair the eight Budget Committee Subcommittees on:

1. Monitoring the Impact of Draft Laws on Budget Indicators;
2. State Debt and Debt Financing;
3. Revenues;
4. Expenditures;
5. Local Budgets;
6. Social Programs;
7. Investment Programs;
8. Activities of the Accounting Chamber and control of budget implementation.

140. A representative of both the Ministry of Finance and the Accounting Chamber are required to attend meetings of the Budget Committee. The Budget Committee also regularly invites representatives from other government entities and outside experts to participate in their meetings and provide opinions.

141. The Budget Committee is supported by a Secretariat which comprises around 30 professional staff.⁴¹ All are civil servants (thus largely protected from political shifts in the parliament) and most have previously worked in the Ministry of Finance. While not formally assigned to cover specific areas of the budget, in practice staff tend to have areas of specialisation. The Budget Committee Secretariat reviews the draft budget and prepares relevant analyses. Depending on the issues at hand, it may also call on outside experts and institutions.

3.3 The Parliamentary Approval Process

142. The fiscal year follows the calendar year except in extraordinary circumstances.⁴² The Rada's involvement in the budget cycle can be broken down into four main stages: (1) examination and adoption

³⁹ The second largest standing committee has 27 members. It should be noted that the Budget Committee is a focal point for lobbying from the business community and that many parliamentarians come from business backgrounds and maintain strong links to the business community.

⁴⁰ The current Chair is from the People's Party (Lytvyn Bloc) and the Deputy Chairs are from the All-Ukrainian United Fatherland (BYuT Bloc) and the Party of Regions.

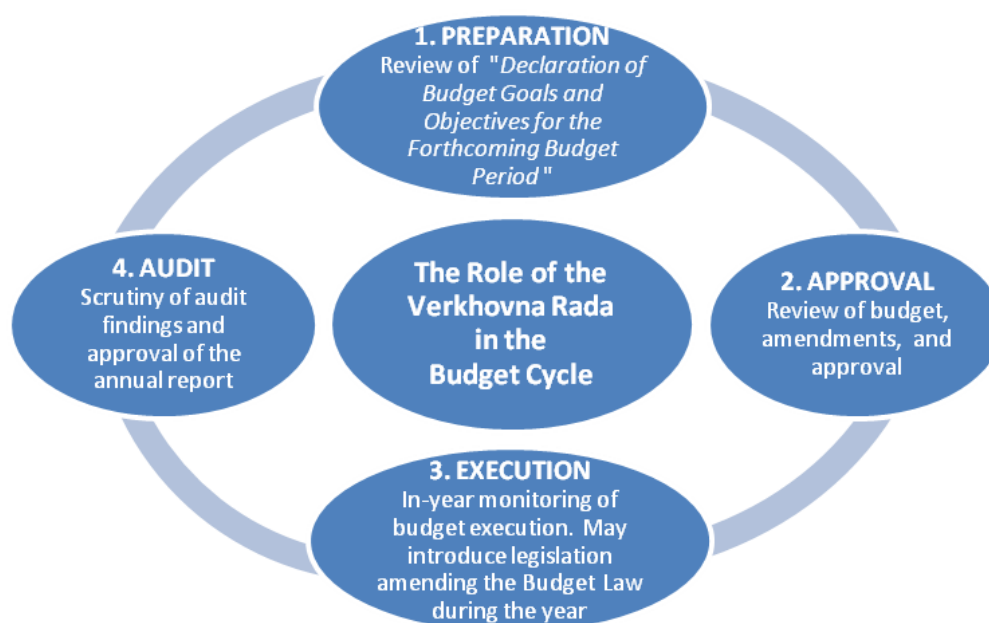
⁴¹ One Head of Secretariat, three Deputy Heads, 15 General Counsel, six Senior Consultants, three Consultants, and one Specialist. Consultants are permanent staff. Deputies may also seek assistance from their faction's secretariat or their personal staff on budgetary matters, but this is not common practice.

⁴² Such as martial law or a state of emergency (Art. 3 of the Budget Code).

of a resolution approving or “taking into account” the executive’s *Budget Declaration*; (2) review, amendment and approval of the executives draft budget; (3) in-year monitoring of budget execution; and (4) scrutiny of the Accounting Chamber’s audit findings. This chapter focuses on the first two phases.

143. Article 33 of the newly amended Budget Code stipulates that the Cabinet of Ministers of Ukraine develops and approves the Budget Declaration not later than 1 April of the year preceding the planned one, and, within a three-day term submits it to the Verkhovna Rada. Previously the Rada received this document at the end of May which limited time for debate. Upon receipt, deputies and committees develop their proposed amendments which are forwarded to the Budget Committee.⁴³ The Budget Committee summarises these proposals and prepares a draft resolution. The government prepares the draft state budget with reference to the Rada’s resolution on the Budget Declaration.

Figure 4. The Role of the Verkhovna Rada in the Budget Cycle



144. The government has monopoly of legislative initiative with regard to the budget. Article 116.6 of the Constitution and Articles 32 and 34-37 of the Budget Code establish the role of the Cabinet of Ministers and the Ministry of Finance in drafting the budget. Article 96 of the Constitution requires the Cabinet of Ministers to submit the draft Budget to parliament no later than September 15.⁴⁴ The Rada then has approximately two and a half months to review the budget. This is slightly less than the three months recommended by the *OECD Best Practices for Budget Transparency* (OECD, 2002). In addition, the bulk of the work of the standing committees on the budget is undertaken by 1 October.

⁴³ Article 152 (2-4) of the Rules of Procedure.

⁴⁴ It is also published in the Government “Courrier” seven days after submission to parliament (Art. 28 (2) of the Budget Code).

Table 7. Parliamentary Budget Approval Timetable

| | |
|-------------------------------------|--|
| Within three days of 1 April | <i>Declaration of Budget Goals and Objectives for the Forthcoming Budget Period</i> submitted to Parliament. |
| 1 May | Government submits annual report on execution of the budget for the previous year |
| 1 June | Parliament adopts a resolution on approval or consideration of the <i>Declaration of Budget Goals and Objectives for the Forthcoming Budget Period</i> . Parliament also approves its own budget for the upcoming year at this time. |
| 15 September | Draft Law on the State Budget submitted to Parliament by the Cabinet of Ministers. |
| 20 September | Presentation of the Draft Law on the Budget by the Ministry of Finance, first plenary debate, referral to the Budget Committee and other relevant committees. |
| 1 October | Deputies and committees submit proposed amendments to the Budget Committee. |
| 15 October | The Budget Committee (in consultation with government representatives) prepares a first opinion. |
| 20 October | First reading. Draft budget with proposals sent back to Government for revision. |
| 3 November | Government submits revised draft budget. |
| 20 November | Second Reading. After the second reading, no additional proposals can be made. |
| By 1 December | Bill adopted and sent to President. |

145. Following the introduction of the executive's budget proposal, deputies are given roughly five days to acquaint themselves with the budget. Around 20 September the Minister of Finance presents the draft budget in the plenary followed by a debate in which deputies may ask questions.⁴⁵ The draft budget is then referred to the Rada committees.

146. The standing committees and individual members of parliament have until 1 October to submit proposals for amendments to the Budget Committee. Amendments must show sources of funding should they entail additional expenditure. As part of the scrutiny process committees may conduct public hearings within the scope of their competencies. Government representatives are present at, and participate in, all parliamentary committee meetings.

147. Authors of amendments come to the Budget Committee to discuss them. A representative of the Cabinet of Ministers is also present during these discussions. The outcomes of these discussions are minuted and used by the Budget Committee staff to create a comparative table of the amendment proposals and the Budget Committee's opinion on whether they should be adopted or rejected. Based on this comparative table the Budget Committee's opinions and proposals are prepared, debated and voted on in the plenary in the first reading on 20 October. More, specifically, a first vote is taken to dismiss all amendments rejected by the Budget Committee. If however, the author of the amendment objects to its rejection, then the amendment is discussed in the plenary. Amendments that are not dismissed are

⁴⁵ The Rada is allowed to return the draft budget if it is missing documents or is not in line with the Budget Code and the *Declaration of Budget Goals and Objectives for the Forthcoming Budget Period*. In this case, the government would be obliged to revise the draft budget and resubmit it within seven days. In practice this is rare, although it did happen once in the late 1990s.

discussed article by article and voted on.⁴⁶ Parliament then sends the draft budget with their proposals back to the government for revision. At this stage during revisions the government may accept or reject parliament's proposed amendments. The government also has the opportunity to make other changes, including changes to key budget indicators set earlier in the year.⁴⁷

148. The government submits a revised budget to parliament by 3 November. The Budget Committee then reviews this revised budget, in particular whether the government has taken parliament's views into account. At this stage only the Budget Committee can propose additional changes, although any changes cannot change total amounts but rather would consist of moving allocations from one part of the budget to another. The Budget Committee produces a second opinion recommending that the Rada adopt the revised draft as is, or amend it. If the parliament cannot agree to the revised draft as a whole, it may vote article by article. The budget must be adopted by 1 December. Typically the budget is adopted as of the second reading although there is a procedure for a third reading in place. The approved consolidated budget includes general parameters of the state budget and distribution of its indicators under budget classification (primarily, in terms of key spending units and budget programs) and some additional details in accordance with the Article 40 of the Budget Code.

149. As with any other legislation, once parliament has adopted the Budget Law and sent it to the President for signature, he or she has fifteen days to sign it (accepting it for execution and officially promulgating it) or return it to parliament "with substantiated and formulated proposals for repeat consideration" (Art. 94 of the Constitution).⁴⁸ The President has only vetoed the Budget Law once and typically signs it within three to five days. If the Budget Law is not in force by the beginning of the new budget year, Article 41 of the Budget Code regulates spending by the Council of Ministers allowing for monthly expenditure not exceeding one-twelfth of the budget expenditure approved for the previous budget year.

150. Parliament also plays an oversight role in the execution and audit phases. According the Budget Code, the Treasury must report to the Rada on budget execution on a monthly, quarterly, and annual basis.⁴⁹ Reports include both financial and budget information (with the latter defined as progress on budget execution in terms of budget classification). During the year the Rada (as well as the President and the Cabinet of Ministers) may propose and the Rada may adopt legislation modifying the State Budget Law. As demonstrated in Table 8, this happens in practice with a small number of laws adopted each year.

⁴⁶ If the budget is not balanced at this point, it can be submitted for a second first reading.

⁴⁷ In 2009 these changes were quite significant due to the financial crisis.

⁴⁸ Article 94 continues:

- In the event that the President of Ukraine has not returned a law for repeat consideration within the established term, the law is deemed to be approved by the President of Ukraine and shall be signed and officially promulgated.
- If a law, during its repeat consideration, is again adopted by the Verkhovna Rada of Ukraine by no less than two-thirds of its constitutional composition, the President of Ukraine is obliged to sign and to officially promulgate it within ten days.
- A law enters into force in ten days from the day of its official promulgation, unless otherwise envisaged by the law itself, but not prior to the day of its publication.

⁴⁹ Monthly reports are issued within 15 days (state budget) and 25 days (consolidated and local budgets) of the close of the reporting period. Quarterly reports are issued within 35 days of the close of the quarterly reporting period.

Table 8. Changes to the State Budget Law of Ukraine during the fiscal year in 2006-2010*

| Fiscal Year | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-----------|-----------|-----------|-----------|-----------|
| Total proposed draft laws modifying the Budget Law | 11 | 17 | 63 | 43 | 32 |
| <i>Proposed by Verkhovna Rada</i> | 10 | 11 | 51 | 27 | 27 |
| <i>Proposed by the President</i> | - | 1 | 4 | 2 | - |
| <i>Proposed by the Cabinet of Ministers</i> | 1 | 5 | 8 | 14 | 5 |
| Total adopted legislation by the Verkhovna Rada modifying the Budget Law | 8 | 5 | 9 | 14 | 14 |
| <i>Proposed by the Verkhovna Rada</i> | 7 | - | 4 | 7 | 9 |
| <i>Proposed by the President</i> | - | - | 3 | 1 | - |
| <i>Proposed by the Cabinet of Ministers</i> | 1 | 5 | 2 | 6 | 5 |

* Information in this table was obtained from the Secretariat of the Budget Committee.

151. The Budget Code also defines the content of the constitutionally mandated annual report on budget execution submitted to parliament no later than 1 May of the following year (Art. 61). This report is made public. The Accounting Chamber then has two weeks to submit its own report analysing the government's report (Budget Code Art. 62). Article 161(6) of the Rules of Procedure further states that the Budget Committee must consider the government's report in conjunction with the Accounting Chamber and prepare its own recommendations within 15 days. The Cabinet of Ministers, representatives of the Accounting Chamber and Budget Committee must all make presentations to the Rada. The parliament must then "conduct a full discussion and adopt a resolution on approval of a report on implementation of the State Budget of Ukraine for the previous year" (Rules of Procedure Art. 162 (2)). The relationship between the Rada and the Accounting Chamber is discussed further in Chapter 6 on audit.

3.4 The Impact of Parliament

152. The Ukrainian Parliament enjoys wide amendment powers which it uses in practice. There are no limits to the number of amendments that can be proposed and it is not atypical for upwards of 2000 amendments to be submitted in the period before the first reading.⁵⁰ As noted earlier, 2008, 2009, and 2011 were atypical but nevertheless saw proposals for between 500 and 1000 amendments. Amendments and the vote on the budget are not seen as a confidence vote in government. The data in Annex I shows the effects of the amendments submitted and approved by the parliament on the overall budget revenues and expenditure. According the Budget Committee Secretariat total changes can range anywhere from 1 to 10%. However, changes to the various parts of the budget may be more substantial. Given that the government has the opportunity to revise its draft budget during the parliamentary review process it is somewhat difficult to distinguish between the changes initiated by parliament and the changes initiated by the government. This is particularly true for changes in revenue and expenditure as

⁵⁰ In 2006, 2233 amendments were submitted and 1900 were recommended for consideration to the government following the first reading. In 2007 the numbers were 2330 and 1800 respectively.

the government may dramatically revise macroeconomic indicators between the first and second reading of the draft budget.

3.5 Conclusions

153. The budget approval process in Ukraine differs from many OECD countries in that it can be characterized as more of a continuous negotiation between government and parliament. The draft budget goes back to the Government for revision following the first reading. And while the government typically takes parliament's viewpoints and proposals into consideration, their revisions may or may not include them. In addition, government representatives are present at, and participate in, all parliamentary committee meetings. This allows committee members to ask questions and engage in an ongoing dialogue.

154. The Budget Committee in particular, and the parliament more generally, benefits from significant non partisan staff support for budget analyses.

155. Parliament enjoys wide amendment powers which it uses in practice. Its potential impact on the budget is significant. However recent years marked by political turmoil, as well as changes in key legislation such as the Budget Code, have restricted parliamentary procedures for debating and amending the draft State budget in the first and second reading. The parliament would benefit from additional time for debate in line with OECD best practices for budget transparency (OECD, 2002), in particular, extending the period for review by the sectoral committees.

156. Parliament's relationship with the Accounting Chamber, and use of audit findings, could also be improved (see further discussion in Chapter 6 on Audit).

CHAPTER 4

BUDGET EXECUTION

4.1 Organisation of budget execution

157. The Cabinet of Ministers of Ukraine is responsible for budget execution, with the Ministry of Finance providing overall management of budget execution (Art. 42 of the Budget Code). The State Treasury, operating as agency of the Ministry of Finance, has a central role in budget execution. It is responsible for managing payment transactions, financial control of commitments, and accounting.

158. Ukraine has implemented a Single Treasury Account (STA) held at the National Bank of Ukraine (NBU).⁵¹ The STA is the main account used by the State for financial transactions and management of state and local budget funds. Payments are made through the electronic payments system of the National Bank of Ukraine. The State Treasury of Ukraine keeps current accounts in foreign currency opened on its behalf in the National Bank of Ukraine and the State Export and Import Bank of Ukraine. It assures timely and complete recording of all operations, providing the users with real time information about the state of assets and liabilities and budgets execution. The Treasury operates at three levels which approximate the administrative and territorial division of Ukraine. The first is the central level, the second is the regional level with 27 departments and the third is the district level with 633 departments, making a total of 660 local bodies with around 16,000 employees.

159. Within one month period after the budget law is approved by the Parliament, the Ministry of Finance draws up a disbursement schedule of the state budget, the *rozpys*. This document provides a monthly breakdown of planned expenditure approved by the budget law. In particular, the disbursements to the budget holders by budget programmes are allocated on a monthly basis. The approved *rozpys* is transferred to the State Treasury for execution. The approved *rozpys* is amended during the year in the following events:

- approval of changes to the State budget law by the Parliament;
- reallocations by the Government with the approval of the the Budget Committee of the Verkhovna Rada among budget holders or among budget programmes of the budget holder;

Changes to the State budget *rozpys* result in introduction of changes to the individual monthly plans of budget institutions.

160. As part of the process of budget execution (but also for the purpose of assessment and budget formulation), budget holders are required to submit “passports” for budget programmes to the Ministry

⁵¹ The STA is divided into 27 technical accounts.

of Finance. These documents include planned expenditure, as well as other information such as goals, tasks, activities, and expected results (see par. 81 of chapter 2)⁵².

161. The commitments are incurred and the expenditures are accounted for by the budget holders only within the limits of budget appropriations as set by the budget law. Documents incurring commitments and payment orders are signed by the heads of the budget institutions and their chief accountants. The State Treasury is responsible for registration and accounting of commitments and payments of budget holders and records them in the reports on the budget execution. If a commitment is approved, it is registered (Treasury keeps a register of all commitments). The bodies of Treasury reconcile the Register of the budget holders commitments submitted by the budget holder and the supporting documents in respect of compliance of the data with that included in the Register. During the registration and accounting for the budget commitments the compliance of the budget funds application with the budget appropriation, passports of the budget programme (in the event of application of the programme based method in the budget process) is audited. The audited Registers of budget commitments are included in the data base of the Treasury. Should the commitments be incurred by the budget holder with the violation of legislative requirements, such commitments are not viewed as budgetary commitments and cannot lead to payment from the budget funds. Such commitments are not registered by the Treasury. On eliminating the irregularities, the budget holder submits the commitments to the Treasury for registration anew. The commitments not registered in the Treasury are not subject to payment from the budget funds.

4.2 Cash management

162. Through the STA, the Treasury maintains real-time data about the available cash balances. The short term debt management is the responsibility of department in the Ministry of Finance, the Department of Public Debt. Treasury and the Department of Public Debt communicate on a weekly basis but work from different forecasts, although both use the *rozpys*.

163. The Treasury prepares rolling three-month forecasts of cash flows based on the *rozpys*, actual cash flow data, and historical patterns. These forecasts are circulated to the Ministry of Finance and the National Bank of Ukraine.

164. A 2010 Public Finance Assessment of Ukraine by SIGMA⁵³ indicates that there have been improvements in debt and cash management, and that the World Bank will continue to support work in this area (see chapter 1, par. 38). There is also a project is underway with the European Union to explore other countries' experiences as the basis for the development of a regulatory framework for cash management which is currently lacking (see Box 7).

⁵² According to Article 20 (8) of the budget code, "The key spending unit (budget holder) together with the Ministry of Finance of Ukraine shall develop and approve the budget program passport within 45 days following the date when the Law on the State Budget of Ukraine comes into effect."

⁵³ OECD Sigma 2010.

Box 7.
Models of Cash Management

Three basic models of cash management exist in OECD countries, although the majority have adopted a single treasury account.

In the decentralised model, all budget holders have their own accounts with commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash flow estimates and cash allotment decisions. Budgetary institutions then make payment orders by drawing on their own accounts.

In the centralised model, budget holders are not allowed to have their own accounts with commercial banks. There is only a single account (with sub-accounts), usually kept at the Central Bank, which belongs to the Treasury. Since the Treasury is not allowed to borrow from the Central Bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budgetary institutions have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the hybrid model, budget holders are allowed to have their own bank accounts with a single commercial bank, but any positive balances on these accounts are daily transferred to the Treasury account with the Central Bank and bank accounts are daily supplied with cash advances. The contract with the commercial bank is usually auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget holders make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term debt management at the Treasury.

4.3 Budgetary discipline

Overspending and reallocation

165. Budgetary discipline during execution is fairly strict. Pursuant to Article 23 of the Budget Code, no budget obligations or payments can be made without a corresponding budget authorisation in the State Budget Law (or local budget). If additional resources are needed, the State Budget Law must be amended. The Cabinet of Ministers, President or the Parliament may propose legislation modifying the State Budget Law. This happens in practice with a number of laws adopted each year.

166. The reallocation regime in Ukraine is also fairly strict. Art. 23 of the Budget Code regulates the budget relocations from one budget holder to another, reallocation between budget programmes within the overall budget of a ministry or other CPA, the increase of development expenditures at the expense of other expenditures and the reallocation of the State grants among territorial units. Reallocation can be decided the Cabinet of Ministers of Ukraine with the approval of the Budget Committee at the Verkhovna Rada.

Carry-overs

167. Budgetary control is fairly strict when it comes to carry-overs. Unused line item funds cannot be transferred to the next budget year. With the exception of the special fund, the only way to transfer unused funds is re-appropriation in the up-coming year's budget. For the special fund, any remaining cash balances are kept by the Treasury to cover the same types of expenses in the next budget period. In the

event of absence of relevant budget allocations for the next budget period, the cash balances of the special fund are transferred to the general fund of the budget (Article 57 of the Budget Code).⁵⁴

Government Reserve Fund

168. The Government Reserve Fund is for extraordinary expenditures, for example responding to natural disasters and, , humanitarian aid. The reserve fund should not exceed 1% of the total budget.⁵⁵ In 2010 the reserve fund was in the amount of UAH 1.5 billion (190 million USD). The Cabinet of Ministers decides on the allocation of resources from this fund (Art. 24 of the Budget Code). The decision on the allocation of resources from the Government Reserve Fund is taken by the Cabinet of Ministers of Ukraine, the Rada of Ministers of the Autonomous Republic of Crimea, local state administrations and executive bodies of respective councils of local government (art. 24 of the Budget Code). The Cabinet of Ministers (the Council of Ministers of the Autonomous Republic of Crimea, the executive authorities of local government) report to the Rada of Ukraine (the Rada of Ministers of the Autonomous Republic of Crimea, the councils of local government) on a monthly basis on the use of the resources (art. 24 of the Budget Code). The Reserve Fund of the State budget is included in the State budget of Ukraine and accordingly approved by the Rada of Ukraine.

4.4 Conclusions

169. The organisation of budget execution in Ukraine has improved markedly over recent years and is generally in accordance with OECD practice.

170. Cash management is still in development. The Treasury together takes appropriate measures to develop the instruments with the aim of improvement of cash flow management (supported by a twining project of the World Bank). It is important that in the co-operation with the World Bank appropriate emphasis is put on the reliability of financial plans.

171. The Budget Code (Art. 23) regulates the procedures for reallocation once the budget is approved by the Verkhovna Rada. It stipulates that a Government decision on reallocation has to be approved by the Budget Committee the Verkhovna Rada. At the occasion of a next revision of the Budget Code the Ukrainian authorities may take into account that many OECD countries allow small reallocations between line items (within certain thresholds as percentage of existing appropriations) within a ministry without supplementary budget laws, possibly after notification of the Parliament.

172. Carry-overs of appropriations can be allowed in Ukraine on an ad hoc basis in view of the implementation of the midterm planning scheme for budget programmes. At the occasion of a next revision of the Budget Code the Ukrainian authorities may take into account that many OECD countries allow carry-overs within certain margins or with compensation in the next budget year (so that carry-overs cannot accumulate over the years).

⁵⁴ Balances of the state budget funds of the Ukrainian institutions operating abroad also remain on the accounts opened abroad in order to make expenditures in the next budget period in accordance with their cost estimates.

⁵⁵ However an exceptional case was noted in 2008 when following summer floods, Parliament voted to increase the reserve fund and reduce expenditure elsewhere.

CHAPTER 5

PUBLIC ADMINISTRATION AND SERVICE DELIVERY

5.1 Organisational Structure

Central government

173. In December 2010 the President signed a Decree which established a new structure of central government⁵⁶. The number of ministries has been reduced from 21 (including the Prime Minister and one minister without portfolio) to 17 (including the Prime Minister). The Cabinet decides collectively, all members of the Cabinet have equal voting power. The Prime Minister's vote decides in case of a draw⁵⁷.

174. Prior to the reform, the central government consisted of 20 ministries and 87 other Central Public Authorities and governmental public management bodies. In order to streamline the execution of State policy the President of Ukraine re-organized the executive branch of government and reduced the number of ministries to 16 and other Central Authorities to 58(74 CPA's in total).

175 The current 16 line ministries are:

1. Ministry for Economic Development and Trade [the Minister is also the First Deputy Prime Minister]
2. Ministry for Infrastructure [the Minister is also Deputy Prime Minister]
3. Ministry for Regional Development, Construction and Housing [the Minister is also Deputy Prime Minister]
4. Ministry for Social Policy [the Minister is also Deputy Prime Minister]
5. Ministry for Agriculture and Foodstuffs
6. Ministry for Internal Affairs
7. Ministry of Culture
8. Ministry for Emergency Situations
9. Ministry of Education, Science, Youth and Sports
10. Ministry of Health
11. Ministry of Environment and Natural Resources
12. Ministry of Finance
13. Ministry of Justice

⁵⁶ Constitutional amendments of 2004 had shifted the competency to create ministries and CPAs from the President to the Cabinet of Ministers. In October 2010, these amendments were rescinded by the Constitutional Court (see par. 21 of chapter 1).

⁵⁷ Art. 52 of the Law on the Cabinet of Ministers.

- 14. Ministry of Defence
- 15. Ministry of Foreign Affairs
- 16. Ministry of Energy and Coal Industry

176. There is no clear division of tasks between ministries and other CPAs (State Services, Agencies, Commissions, etc.). Both ministries and other CPAs may perform executive, supervisory and regulatory tasks. One of the key objectives of the administrative reform was to create a government structure with a clearer division of tasks between ministries on the one hand and various types of other CPAs on the other hand. Another objective was to create more uniformity in the internal structure of CPAs, for instance concerning their financial administration. These objectives have not yet been fully realised.

177. In some OECD countries, there has been a tendency in the last two decades to move executive agencies out of the core ministries and provide them with a separate financial administration ("arm's length agencies"). These reforms have contributed to accuracy of information about the costs of policy execution. However, these agencies remain firmly under the ministerial responsibility. In the limited number of cases where independence of policy execution is required for appropriate task execution (one can think of the Electoral Committee or the Statistical Office) the executive agencies still remain under the ministerial responsibility as far as operational management is concerned. Next to government agencies, OECD countries have organised some public agencies in the form of public non-profit institutions with legal personality separate from the State (for instance cultural institutions and the universities). These institutions may receive grants from the State, but their expenditures and revenues are not part of the State budget. A further clarification of the status and competences of other CPAs other than ministries would be useful. Important criteria should be:

- Policy development should remain the task of core ministries: no policy development in executive agencies. If policy execution is transferred to an agency, the financial administration of the agency should be completely separated from that of the core ministry (including payment for support services still provided by the core ministry), so that the financial administration of the agency provides accurate insight in the costs of policy execution;
- All agencies should remain under the ministerial responsibility except a limited number of agencies for which independence is essential for appropriate task execution; also for the latter agencies responsibility for operational management should rest with the minister;
- Public non-profit agencies with legal personality should be separated from the State budget.

Local government

178. The local government at the level of oblasts, rayon and cities has representative bodies, the regional councils ("radas"). The councils consist of deputies that are elected by the residents on the basis of general, equal and direct suffrage by secret voting for a term of five years. The oblast and rayon councils and the councils of the cities of Kyiv and Sevastopol have no executive bodies. The rayon and oblast councils delegate the executive powers indicated by the Law to the respective local state administrations. The local government is maintained from the local budgets.

179. The local state administrations serve as executive bodies in oblasts, rayons and the cities of Kyiv and Sevastopol. The Heads of the local State administrations are appointed by the President of Ukraine on the recommendation of the Prime Minister for a term in office equal to that of the President. The Heads of the local State administrations are responsible for the organization and staffing of the local State administrations. The local state administrations are maintained from the State budget.

180. A thorough reform of the structure of local government and the territorial division of the country below the regional (*oblast*) level is already being discussed for more than 10 years. Under the auspices of the Ministry of Regional Development and Construction a reform programme has been finalised and adopted by the Cabinet of Ministers. According to this programme the number of *rayons* is reduced from the current 488 to ca. 170; the number of local governments of the first level is reduced from the current ca 12.000 to some 1.500. This new structure was expected to meet the requirements of the EU for territorial governance and public administration and the requirements of the EU statistical office EUROSTAT, known as *Nomenclature des unités territoriales statistiques – NUTS*. Compliance to the EU requirements and NUTS is an important precondition to qualify for European structural funds. This reform programme was temporarily put on hold when President Yanukovich took office in the spring 2010. However, its main content is expected to be maintained and a slightly revised programme is expected to be adopted in 2011.

5.2 Service Delivery

Service delivery by central government

181. Central government organisations provide collective services in the sectors defence, public order and safety, environmental protection, penitentiary services, basic research, and transport. For instance, the central government agency in charge of roads (“Ukravtodor”) maintains about 170,000 kilometres of national roads.

182. Individual services provided by central government comprise higher education (universities) and some forms of public health services. For instance, public health facilities which specialise on particular diseases are under the direct command of the Ministry of Health. All other forms of public health services, as well as primary and secondary education are delivered by local governments. The public health system is fully tax-financed and officially provided free of charge to the population. Old-age and disability pensions, unemployment, sick-leave, work accident and temporary disability benefits are provided by social security funds which are financed by mandatory pay-roll contributions.

183. For the delivery of administrative services such as licenses and permits, the Ukrainian government is currently setting up a web-based database which will help to identify the type of service provided by each Central Public Authority (CPA).⁵⁸ Once completed, this inventory shall serve as a basis for the development for an e-government portal which will allow the citizen to receive some services on the basis of an online application. Central government services are sometimes provided directly by the CPA in Kyiv⁵⁹; however, the majority of services is provided through de-concentrated offices of the CPA at the regional level.

184. A number of services is provided against payment of a fee. The charging and collection of fees is not always clearly regulated. Fees are not necessarily channelled through the single treasury account. These deficiencies have recently been officially recognised, and the President has instructed the Cabinet of Ministers to develop a draft law to address these issues. The law will prescribe among other things that all non-tax revenue generated by fees for services will be included in the State budget.

⁵⁸ Register of government services (<http://reestr.center.gov.ua/>).

⁵⁹ Examples comprise the issuing of registered seals for doctors and a number of licenses and permits in the field of environmental protection which are issues exclusively in the capital Kyiv.

Service delivery by local government

185. Local governments are providing the majority of services in the sectors education, public health, housing and public utilities. Table 9 illustrates the distribution of functions between the levels of local government.

Table 9. Distribution of functions over levels of government

| | Oblasts | Kyiv Sebastopol | Cities in Oblasts and in the Autonomous Republic of Crimea | Rayons | Cities | Villages | Settlements |
|---|---------|--------------------|--|--------|--------|----------|-------------|
| Education | | + | + | + | + | + | + |
| a) preschool education | | + | + | + | + | + | + |
| b) school education | + | + | + | + | + | + | + |
| c) higher education (universities) / (professional education) | (+) | + | | | | | |
| Primary health care* | | + | + | + | + | + | + |
| Secondary health care* | + | + | + | + | | | |
| Tertiary health care* | + | + | | | | | |
| Outpatient, polyclinic and secondary health care | | + | + | | | | |
| Social security | + | + | + | + | | | |
| Culture and arts | + | + | + | + | + | + | + |
| Sports | + | | + | + | | | |
| Transport | + | + | + | + | + | + | + |
| Development of housing, utilities and economy | + | + | + | + | + | + | + |

* The terms “primary”, “secondary”, and “tertiary” health care refers to degrees of complexity of treatment. Primary health care is usually provided by the general practitioner; secondary health care is more specialised treatment usually by a hospital; tertiary health care refers to highly specialised treatment like oncology, etc. by a hospital.

* The distribution of functions is provided in compliance with the Budget Code under circumstances of the year 2011.

Sources: Zimmermann, Zhuravel (2008), World Bank (2008).

186. In the majority of cases (social protection, education, public health) the service providers are public agencies owned by local government. In some cases (for instance waste-disposal) local governments may contract out service provision to the private sector; in others (for instance water and waste water transport and treatment) local governments may award concessions to the private sector without transferring ownership of the infrastructure.

Table 10. Expenditures of sub-national budgets by functions
(million UAH, 2006)

| | Oblasts | Kyiv, Sebastopol | Rayons | Cities | Villages | Settlements |
|--|----------------|-------------------------|---------------|---------------|-----------------|--------------------|
| Education | 2 899 | 8 419 | 7 863 | 425 | 799 | 400 |
| Health care | 5 662 | 5 271 | 3 549 | 19 | 691 | 136 |
| Social protection | 2 018 | 3 571 | 4 440 | 7 | 15 | 7 |
| Public administration | 400 | 1 592 | 276 | 141 | 1 143 | 200 |
| Economic activity* | 3 769 | 3 199 | 613 | 184 | 350 | 199 |
| Housing | 1 662 | 5 062 | 256 | 176 | 126 | 121 |
| Culture, media and physical development | 1 037 | 1 026 | 763 | 25 | 271 | 50 |
| Public order, security, judicial power | 1 | 13 | 10 | 1 | 11 | 12 |
| Environmental and nuclear safety, emergency services | 29 | 28 | 37 | 3 | 19 | 3 |
| Subtotal, Mio. UAH | 17 477 | 28 181 | 17 807 | 981 | 3 425 | 1 128 |
| Share of total, % | 25.3 | 40.8 | 25.8 | 1.4 | 5.0 | 1.6 |
| Share of total, % | 92% | 8% | | | | |

Includes: construction, agriculture, forestry, fishing and hunting, transport, roads, communication and other economic activities.

Source: Zimmermann, Zhuravel (2008).

187. A large majority of local services is provided through oblast and rayon administrations on the basis of mandates in State laws (so-called delegated competences). However, there is a considerable problem of unfunded mandates, in that the grants from central governments are not sufficient to provide the services prescribed by law. In particular local governments have to use a large part of non-earmarked grants and local taxes to fund mandated services, leaving very little room left to fund local services not mandated by law.

5.3 General government employment

Size and remuneration

188. Size and Employment in general government consists of civil servants and other employees. The status of the first is regulated by the Law on the Civil Service of 1993, except for certain provisions of the Labour Code which are applicable to all employees including civil servants. The status of other employees is regulated by the Labour Code

189. Table 11 provides an overview of employment in general government, including employees on temporary contracts. This excludes public employment in State Owned Enterprises (SOEs). The figure for “public administration” includes the police, the judiciary, and permanent (professional) military personnel. Military personnel serving under conscription is not included. It is acknowledged that data for public employment may not be fully compatible with OECD national accounts data. However, overall figures suggest that the share of public employment in Ukraine is substantially higher than the OECD average.⁶⁰

Table 11. General government employment in Ukraine
(in 1000 of employees and percent of domestic employment)

| | 2000 | 2005 | 2007 | 2008 | 2009 |
|--|---------------|---------------|---------------|---------------|---------------|
| Public Administration | 1198.6 | 1028.9 | 1036.4 | 1067.5 | 1078.6 |
| Education | 1609.7 | 1668.2 | 1693.7 | 1702.4 | 1698.4 |
| Public Health and Social Security | 1379.6 | 1356.6 | 1359.0 | 1369.9 | 1348.1 |
| Public Services, Culture and Sports | 0.660 | 0.817 | 0.833 | 0.840 | 0.784 |
| Total public sector | 4188.6 | 4054.5 | 4089.9 | 4140.6 | 4125.9 |
| Total domestic employment | 20175.0 | 20680.0 | 20904.7 | 20972.3 | 20191.5 |
| Public sector in per cent of total employment | 20.76% | 19.61% | 19.56% | 19.74% | 20.43% |

Source: OECD estimates based on data obtained from State Statistics Committee.

190. When comparing the share of general government compensation of employment in GDP, Ukraine does not score particularly high⁶¹ due to low remuneration levels. The share of public sector salaries in per cent of GDP was at around 10 per cent in 2007; in 2010 this is likely to have risen to exceed 12 per cent. The share of compensation of employment in the budget of central government is at around 18 per cent. This figure includes civil servants working in regional (oblast and rayon) administration, who belong to the national civil service and are financed by the State budget. The salaries of officials at the regional level who do not have the status of civil servants (and thus are not paid from the State budget), together with the payroll costs of all public employees of first level local government are included in the local budgets. The share of compensation of employment in the local budgets is considerably higher and amounts to some 40 per cent (see table 12).

⁶⁰ OECD (2009), p. 67

⁶¹ OECD (2009), p. 63

Table 12. Public sector pay as share of central and local government expenditure
(percent of total expenditures and of GDP)

| | 2007 | 2008 | 2009 | 2010 |
|---|-------------|-------------|-------------|-------------|
| Share of public sector pay in central government expenditures | 18.7 | 18.0 | 18.6 | 18.1 |
| Share of public sector pay in local government expenditures | 38.2 | 39.1 | 44.6 | 49.4 |
| Total public sector pay in % of GDP | 10.1 | 10.3 | 11.6 | 12.3 |

Source: Ministry of Finance annual budget implementation reports.

Civil Service

191. The civil service is regulated by the Law on Civil Service of 1993. The law was amended as part of the administrative reform of November 2011, with the aim of ensuring necessary conditions for promotion of prestige of the civil service. The amendments concerned among other things the definition of the status of civil servant, quality requirements for the services rendered by the civil servants, implementation of a transparent mechanism for accession to the civil service, guaranties for the politically neutrality of the civil service, implementation of an effective mechanism for prevention of corruption, conditions for transparent administrative procedures and social and financial protection for civil servants.

192. The total number of civil servants in Ukraine as of year-end 2009 amounts to almost 300,000. Of these, more than one half is working in the regional (second level local government) administrations. The number of civil servants has grown by one third over the period from 2000 to 2009, with the largest share of growth at the regional level.¹⁹³ According to an administrative reform announced by President in December 2010⁶², the number of civil servants working in central government agencies including their decentralised branches will be reduced by one third.

⁶² Decree 1085 of 9 December 2010.

Table 13. Number of civil servants and other employees 2007-2011

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|---------|---------|---------|------------|----------------------------|
| Civil servants, total | 276,559 | 290,765 | 296,461 | | |
| of which: constitutional authorities ^a | 2,620 | 2,737 | 12,631 | of 181,051 | will remain ca. 127,000 |
| of which ministries, CPAs Kyiv ^b | 13,076 | 12,945 | 13,321 | | |
| of which ministries, CPAs de-concentrated ^c | 145,726 | 152,045 | 155,099 | | |
| of which regional administrations | 73,243 | 75,340 | 73,438 | | |
| Other employees of local government | 98,948 | 100,582 | n.a. | | |

a. Administration of the President, of Parliament, Secretariat of the Cabinet of Ministers

b. Ministries and other CPAs, based in Kyiv

c. Regional branches of CPA

n.a.: data not available

Source: OECD estimates based on data obtained from Main Department of Civil Service,

194. Entry to civil service is open to every citizen of Ukraine possessing ‘appropriate education and professional training’⁶³. Admission to civil service positions is normally granted following a competitive selection procedure.⁶⁴ The competitive selection procedure follows a general regulation approved by the Cabinet of Ministers in 2002. According to this regulation, recruitment is entrusted to the head of each CPA. The procedure establishes that the head of a CPA or regional administration decides to start a procedure if there is a vacancy; the CPA or administration is obliged to announce a competition in the mass media one month prior to the competition. Candidates have to pass an examination before a competition commission. The examination questions include knowledge of the Constitution, the Law on Civil Service and professional legislation. The competition commission recommends successful candidates to the head of the CPA or administration who takes the ultimate decision.

195. Article 15 of the Law on the Civil Service states that the President of Ukraine, the Head of the Verkhovna Rada of Ukraine, members of the Cabinet of Ministers, as well as the Heads of regional administrations have the right to select and appoint their deputies, heads of the press service, consultants and secretaries without the need for these persons to undergo the competitive selection procedure as described henceforth. Once appointed, these people are given the status of a civil servant. This system is called “patronage service” in the law.

196. Civil servants are classified by categories of positions, which depend on the organisational and legal level of the body employing them, the scope and nature of work to be performed and the role and place of the positions in the structure of the state body.⁶⁵ Promotion is based on performance and tenure. Every civil servant is required to participate in training courses regularly (at least once in every five years).

⁶³ Art. 4 of the Law on the Civil Service.

⁶⁴ Art. 15 of the Law on the Civil Service.

⁶⁵ Art. 25, 26 of the Law on Civil Service of 1993.

A number of long- and short-term courses⁶⁶ are offered by state-run public administration academies. This education is provided free of charge to civil servants.

197. Performance appraisal systems are formally in place but need to be developed further. On joining the civil service an employee is assigned a rank within a category. To obtain the next (more senior) rank within the category, the civil servant needs two years of service and satisfactory performance appraisal. Each category is divided in a number of seniority ranks. The amount of rank related bonus remuneration increases with rank.

198. Civil servants may be removed from their position only for reasons of severe misconduct⁶⁷; dismissals following change in cabinet are formally not provided for, except for positions under the patronage service. In practice, however, changes in cabinet regularly result in deep-cutting personnel changes in the staffing of CPAs. Staff replacements often reach as deep as to the Head of Department level, affecting the third level from the highest civil service level. Civil Servants may submit a request for resignation for reasons of health or 'principal disagreement' with decisions by superiors⁶⁸. After dismissal or resignation from a post, re-entry to civil service is permitted.

199. The Minister, the First Deputy Minister and Deputy Ministers are not civil servants but "political persons". The Deputy Minister in charge of administrative affairs is formally a civil servant of the second category. However, in the past Deputy Ministers could be asked to leave office after appointment of a new minister. Much discussion has evolved around the introduction of the institute of 'state secretaries' or Deputy Ministers, who are (better) protected against the 'hire and fire' personnel rotation following changes of cabinet. Thus far, the status of state secretaries does not exist. In practice, some deputy ministers remained in their position irrespectively of changes of cabinet, largely because of their expert knowledge of the subject (this applies, for instance, to the Deputy Minister of Finance in charge of the State Budget). As a result of the administrative reform of December 2010, each Ministry now has one Deputy Minister in charge of administrative affairs.

200. A designated government agency is dealing with issues related to the management and development of the civil service. This agency, the National Agency of Ukraine on Civil Service (Natsderzhsluzhba of Ukraine), is not subordinated to any Ministry but reports directly to the government Cabinet of Ministers. Its tasks comprise the planning and development of human resources for the public sector, supervision of the 'personnel reserve' and integrity and anti-corruption matters⁶⁹. The MDCS also has an important role in further development of the structure of central government.

201. The basic salary of a civil servant depends on category and rank. Apart from that, civil servants may be paid additionally for high records of performance, for extremely significant work, for the knowledge of foreign languages and its application in work and provided with additional allowances for a scientific degree and an honourable title. The bonuses are added to the basic salary. The share of pay for tenure

⁶⁶ SIGMA 2006 government assessment.

⁶⁷ Art 30, Civil Service Law.

⁶⁸ Art 31, Civil Service Law

⁶⁹ Art 10 and 11 of the Statute.

[number of years served] ranges between 10 percent (at least 3 years) and 40 percent (at least 25 years) of the sum of position salary and rank related additional payment⁷⁰.

202. Within the limits of the approved payroll, the heads of CPA's and local State administrations are entitled to pay bonuses to the employees on the basis of their contribution to the overall performance results within the limits of the bonus fund. The bonus fund amounts to at least 10 per cent of pay-roll fund for basic salaries and may be augmented by savings on the pay-roll fund. The criteria, procedures and size of the bonus payments are defined in bonus regulations of the administrations concerned.

203. The pay-budget allocated to a government organisation is calculated on the basis of the number of staff to be normally employed by the organisation. This normative staff-number is endorsed by the Cabinet of Ministers, and revised only infrequently. The factual staff numbers are usually below the normative number; the difference can be used to add to the bonus budget.

204. The ratio of basic to bonus pay used to be unbalanced with up to 80 per cent of a CPA or administration's budget available for bonuses.⁷¹ This practice was considerably affected during the times of the economic crisis when the bonus-budgets were significantly cut. Since 2008-09 the ratio of bonus to basic pay tends to be closer to 50 percent, varying quite significantly across CPAs. The need to bring pay structure for the civil service into closer alignment with international standards is recognised by the Ukrainian government and the objective is to increase the role of the position salary in the salary composition and to improve the system of additional payments and allowances.

205. Until 2007, salaries in the civil service compared relatively fortunate to the average salaries in other sectors. Depending on the region, civil servants' salaries were between 10 and 70 per cent higher than average wages⁷². In the regions with a less developed economy, especially in rural western Ukraine, employment in civil service was financially more attractive compared to the private sector than it was in the industrialised regions of eastern Ukraine. In the capital Kyiv, the large number of high level jobs in civil service resulted in a financially highly attractive public employment. The situation changed when the generous bonus payments were cut back in reaction to the economic crisis. In addition to stricter limitations for bonus payments, the Ukrainian government refrained since 2008 from pay rises for the civil service (except of pay rise levels to compensate for inflation) as part of the successive financial assistance packages obtained from the IMF (see par. 30 and 34).

5.4 Public procurement

206. Public procurement in Ukraine made up 11.5 per cent of GDP in 2009. In 2010 it is estimated to have risen to 17 percent of GDP⁷³. These figures are comparable with the lower end of the range found in the OCED 19 countries⁷⁴.

⁷⁰ Art 33, Civil Service Law.

⁷¹ OECD Sigma (2006).

⁷² Morgner, Wesemann (2009)

⁷³ Prognosis by the Economist Intelligence Unit (Economist Intelligence Unit 2011).

⁷⁴ OECD (2009), p 111.

Table 14. Public procurement as share of GDP, 2008 – 2010
(percent of GDP)

| | 2008 | 2009 | 2010* |
|-----------------------------------|-------|-------|---------|
| GDP (billion UAH)] | 948.1 | 914.7 | 1 008.3 |
| Total procurement [billion UAH] | 167.3 | 105.3 | 172.1 |
| Share of total procurement of GDP | 17.7% | 11.5% | 17.1% |

* Prognosis

Source: Data obtained from State Statistics Committee.

207. Since July 2010, the legal framework for public procurement in Ukraine is provided by the Law on Public Procurement. The law was developed in close cooperation with EU and World Bank experts and is regarded to be broadly in compliance with WTO and EU-requirements. The current law applies to procurement worth more than UAH 100,000 (around € 10.000) for goods and services and UAH 300,000 (around € 30.000) for works. Irrespective of the value, procurement in a number of sectors of the economy is not subject to the provisions of the Law. Such exemptions apply to cases where state secrets or sovereign rights (like printing bank notes) are affected. Another exemption applies to procurement related to the preparations for the UEFA soccer championship 2012, which is less convincingly explained by deadlines for completing the preparations for the event. Since the adoption of the law, a number of ministries have attempted to seek other exemptions for some parts of procurement in their area of responsibility. Such attempts received critical comments by the EU and World Bank experts as they would undermine the objective of the procurement law to provide for unified and transparent regulation in this sector.

208. The procurement law provides for equal treatment of domestic and foreign bidders. In contrast to previous regulations the law now clearly establishes complaint-procedures. It provides for a centralised publication of procurement notes and results. Amongst the shortcomings noticed by the expert community are the excessive requirements for information to be submitted for publication of procurement notices, the lack of provisions for the use of e-procurement and too ample opportunities for rejecting bidders or cancelling tender procedures.

209. According to the law, the Ministry of Economic Development and Trade acts as the government authority responsible for appropriate procurement procedures. In case of complaints, the Antimonopoly Committee is the responsible authority. The Ministry of Economic Development and Trade implements the provisions of the law. It provides for uniform procedural standards to be applied at the procurement departments of every CPA; it maintains a centralised source of public information for all planned procurements; and publishes the results of the procurements.

210. The procurement procedure as such is carried out by each CPA or local government which thereby becomes the “procuring entity”. Each procuring entity establishes a competitive bidding committee and draws a procurement plan. Each committee consists of at least 5 members. If an authorised personnel complement of the procurement subject is less than 5 persons, the number of the procurement committee members shall equal the authorised personnel complement of the procurement subject.

211. Information about planned procurements is published in printed form, and on an Internet portal “Public Procurement” managed by the Ministry of Economic Development and Trade. The Internet portal

“Public Procurement” also provides information on the results of the single source procurement. The procuring entities may additionally publish information on procurement plans and results on their own web-sites. Potential bidders can thus receive information about procurement plans from both the ministry and the procurement entity.

212. The Law on Public Procurement provides for the following forms of public procurement:

- open bidding;
- two-stage bidding;
- request for price quotations;
- pre-qualification of participants;
- single source procurement.

213. The law further defines criteria for selecting the appropriate procedure. Open bidding is the main procurement procedure. A two-stage bidding procedure may be applied if the procuring entity is unable to determine in advance the required specifications of goods or works and if it is necessary to hold preliminary negotiations with participants in order to make an optimal procurement decision. Price quotations may be requested in cases of procurement of goods and services for which a permanently active market exists, provided the procurement value does not exceed UAH 200,000. The single-source procurement procedure is a procedure according to which a procuring entity enters into agreement with a single bidder following the negotiations with one or several bidders and acceptance of the successful bidder’s proposal. The responsibility for selecting the appropriate procedure rests with the procurement committee set up at the procuring entity.

214. The number of public procurement tenders carried out annually usually exceeds 100.000 tenders per year (but in 2009 when the Ukrainian economy was hit hard by the economic crisis the number was lower). The majority of tenders apply the open tender procedure.

Table 15. Public procurement, by type of procedure applied, 2008 - 2010

| Procurement procedures | 2008 | | | 2009 | | | 2010 | | |
|-------------------------------------|-----------------------------|----------------------------|--------------------------|-----------------------------|----------------------------|--------------------------|-----------------------------|----------------------------|--------------------------|
| | Number of tender procedures | Share of number of tenders | share of funds disbursed | Number of tender procedures | Share of number of tenders | share of funds disbursed | Number of tender procedures | Share of number of tenders | share of funds disbursed |
| Open bidding | 73 677 | 72.7 | 43.6 | 62 648 | 75.2 | 67.3 | 75 310 | 78.9 | 56.2 |
| Reduction* | 3 598 | 3.6 | 3.0 | 18 | 0.02 | 0.6 | 1 157 | 1.2 | 0.4 |
| Restricted bidding | 1 289 | 1.3 | 1.1 | 565 | 0.7 | 0.9 | 388 | 0.4 | 0.9 |
| Two-stage bidding | 321 | 0.3 | 3.1 | 523 | 0.6 | 0.6 | 367 | 0.4 | 0.4 |
| Request for quotations | 13 561 | 13.4 | 1.2 | 17 168 | 20.6 | 2.1 | 15 345 | 16.1 | 1.4 |
| Single-source procurement procedure | 8 906 | 8.8 | 48.0 | 2 391 | 2.9 | 28.5 | 2 794 | 2.9 | 40.7 |
| Total | 101 352 | 100 | 100 | 83 313 | 100 | 100 | 95 361 | 100 | 100 |

* This procedure is no longer applicable since the adoption of the procurement law

Source: Data obtained from State Statistics Committee

215. Public enterprises are responsible for the largest part of public procurement as shown in table 16.

Table 16. Public procurement, by client, 2008 – 2010
(million UAH and share of total procurement)

| Origin of funding | 2008 | | 2009 | | 2010 | |
|---|----------------|-----------------------------|----------------|-----------------------------|----------------|-----------------------------|
| | mln. UAH | share of total (percentage) | mln. UAH | share of total (percentage) | mln. UAH | share of total (percentage) |
| State Budget of Ukraine | 28,149 | 16.8 | 23,993 | 22.8 | 23,058 | 13.4 |
| Budget of the Autonomous Republic of Crimea | 2,386 | 1.4 | 204 | 0.2 | 364 | 0.2 |
| Local budgets | 22,558 | 13.5 | 13,635 | 13.0 | 13,394 | 7.8 |
| Funds of public enterprises | 18,719 | 11.2 | 31,359 | 29.8 | 58,952 | 34.3 |
| Funds of joint stock companies with public ownership >50% | 90,918 | 54.4 | 35,206 | 33.5 | 73,757 | 42.9 |
| Other* | 4,565 | 2.7 | 868 | 0.8 | 2,595 | 1.5 |
| Total | 167,295 | 100,0 | 105,265 | 100.0 | 172,120 | 100.0 |

* Other includes: social security funds, the National Bank.

Source: Data obtained from State Statistics Committee.

5.5 Public Enterprise Sector

216. The public enterprise sector can be divided in two main parts: public enterprises which are owned and controlled by the State or by local government on the one hand; and joint stock companies in which the State or local government owns a part of the shares, on the other hand. According to the statistics maintained by the State Property Fund of Ukraine, there are 4 148 public enterprises owned and controlled by the State (State Owned Enterprises, SOEs). They are active in many sectors of the economy (see table 17).

Table 17. State Owned Enterprises by sector of economic activity

| Sector of economic activity | Number |
|--|--------------|
| Electricity generation | 30 |
| Metallurgy | 18 |
| Chemistry | 60 |
| Engineering and metal's processing | 273 |
| Timber processing and paper production | 124 |
| Construction materials | 49 |
| Light industry | 38 |
| Food production and processing | 196 |
| Transport | 238 |
| Construction | 219 |
| Agriculture | 780 |
| Other (for instance real estate) | 2 100 |
| not specified | 23 |
| Total | 4 148 |

Source: Data obtained from State Property Fund.

217. Apart from the above mentioned SOEs, the State holds shares in a further 664 joint stock companies. In 290 of the latter the public share exceeds 50 percent. Ownership rights are executed by the State Property Fund and other bodies of government.

218. The State portfolio of public enterprises (including joint stock-companies with more than 50 percent State shares) has reported losses over the past years (see table 18).

Table 18. Aggregated financial results of SOE and joint stock-companies with state shareholdings >50%

| Year | Public enterprises | Joint stock companies with state shareholdings >50% |
|------|--------------------|---|
| 2006 | - 784.8 mn UAH | - 40.1 mn UAH |
| 2007 | - 734.6 mn UAH | - 553.1 mn UAH |
| 2008 | - 836 mn UAH | - 692.2 mn UAH |
| 2009 | - 1764.7 mn UAH | - 1,250.5 mn UAH |

Source: Ministry for Economic Development and Trade estimates.

219. Amongst the SOEs are natural monopolies like “Ukrenergo” (power generation and distribution), “Naftogaz Ukrainy” and “Ukrtransgaz” (natural gas transport); “Ukrposhta” (postal services);. Their profitability can usually be secured by regulated prices for their services. However, in the past two crisis-affected years, this was not always possible as the examples of Naftohaz, which was subsidised with 24.4 bn UAH in 2009, show. About one quarter of the SOEs (1789 SOEs, 26.3 percent all SOEs) operate in the real estate sector, mostly letting premises in public buildings at market conditions; or acting as intermediaries for the provision of public services.

220. In accordance with the Commercial Code of Ukraine, SOEs have to draft annual financial plans. In cases of the natural monopolies, or if the financial plans show planned profits exceeding 50 million UAH, these financial plans have to be approved by the Cabinet of Ministers. In all other cases, the plans are subject to approval by the relevant ministry. The financial plans set a figure for the expected payments to the State budget.

221. In cases where SOEs incur losses, the government takes an ambiguous position. As of April 2010, some 440 SOE were believed to be bankrupt. However, bankruptcy laws do not apply to SOEs and joint stock companies with more than 25 of public shares. Officially, a “no bail-out” policy applies, but “Naftogaz” alone in 2009 received financial support of 24.4 billion UAH (which equalled 2.7 % of GDP in that year). Moreover, entire sectors of the economy benefit from quasi-permanent subsidies. Coal-mining, where officially no privatisation has yet taken place, is each year receiving funds from the State budget for investment in the equipment and infrastructure. Subsidised or regulated (at below market rates) tariffs for electricity or natural gas are beneficial for both public and private enterprises in the chemical and metallurgic industries. In more fragmented sectors like agriculture, regulated tariffs are more frequently creating market imbalances when applied preferentially to public agricultural businesses.

222. The joint stock companies were expected to contribute 297.8 million UAH from dividends to the State budget 2009 (up from 263.8 million UAH in 2007 and 273.8 million in 2008). This target for 2009 was actually overshoot, and a total of 435 mn UAH was transferred to the budget. Apart from the revenue from dividends, the State budget receives income from taxes paid by the joint stock companies (855 mn UAH in 2008, 470 mn UAH)⁷⁵.

⁷⁵ Source: State Property Fund, annual reports.

223. In Ukraine, there is still a number of enterprises which are regarded as attractive assets for privatisation. The question whether to start the privatisation process for several of these assets has been debated for quite some years and is influenced by political considerations about the "strategic importance" of such enterprises, lobbying of domestic business-groups and the state of the economy, which has caused some planned privatisations to be postponed in view of market conditions. Under the current government, privatisation activity has increased again (see par. 64 of chapter 1).

5.6 Conclusions

224. The Government of Ukraine has embarked on an ambitious programme to modernise its public administration and arrangements for service delivery. In 2010 new legislative frameworks for administrative reform and for public procurement have been adopted. New legislation regulating the civil service, delivery of public services and the organisational structure of local government is being prepared and is expected to be adopted in 2011. After years of slow progress in these areas it is important that these reforms are pursued energetically.

225. The reduction of the number of ministries from 21 to 16 ministries brings the structure of the government of Ukraine closer in line with that of comparable OECD countries such as Poland, the Czech Republic and the Slovak Republic, France and Spain, which all have between 15 and 17 ministries.⁷⁶

226. Recently progress has been made with the clarification of the status and competences of CPAs other than ministries. A "Scheme of the CPAs Organisation and Interaction" was approved by a Decree of the President of Ukraine of December 2010⁷⁷. The organisation, competences and activities of ministries and other CPAs (services, agencies and inspections) are governed by the Law on the CPAs.⁷⁸

227. Local governments have an extensive mandate to provide public services. However, local governments often lack sufficient resources to fund their mandates. The government should review the mandates in the light of available resources and make sure that all mandates can be funded by earmarked and non-earmarked grants.

228. Local Government finances are administered by the central tax service (revenue), and the Treasury (expenditure), which provides for effective enforcement of the existing rules of financial administration.

229. The share of public employment in Ukraine is larger than in most OECD countries. The share of total public employment has remained at around 20 percent of total domestic employment over the last 10 years. The number of civil servants as part of public employment has grown by almost 50 per cent between 2000 and 2009. Currently the government has embarked upon a 30 percent reduction of the number of civil servants.

230. In spite of recent adjustments, public sector pay still consists for a large part in bonuses and other allowances not included in basic salaries. In OECD countries bonuses and other incentive payments, if they exist at all, generally comprise a small share of the basic salary. The authorities may consider to reduce the bonus part of the salary with a simultaneous increase of the position salary.

⁷⁶ OECD (2009), p 37.

⁷⁷ Decree 1085 of 9 December 2010.

⁷⁸ Law 3166-VI of 17 March 2011.

231. The sector of public procurement in per cent of GDP is comparable with OECD average. Unified legislation has been adopted to regulate the sector following a period of insufficient oversight. Given the vulnerability of public procurement for corruption, the enforcement of the current legislation should be pursued.

232. Ukraine has a very large public enterprise sector that is characteristic for a number of Eastern European countries. The sector is fragmented and there is no consistency in the status of companies. Subsidies and tariff regulations can lead to market distortions. It is important that the government pursues its policies aimed at reduction or abolition of subsidies and price or tariff regulations.

233. Since late 2010, the Government has increased privatisation policy after a period of limited activity, but privatisation policies are not always transparent. It is important that privatisation policies are resumed with vigour now the market circumstances are improving again. Transparency on the procedures should be a primary concern in this effort.

CHAPTER 6

ACCOUNTING AND AUDITING

6.1 Accounting

234. The accounting methodology is regulated by the Ministry of Finance of Ukraine which coordinates the activities of the State Treasury of Ukraine.

235. The accounts of the State Budget and the local budgets of Ukraine are kept at the State Treasury of Ukraine. The accounts reflect all expenditures and revenues of the State and local budgets as well as the assets and liabilities of the State and local governments.

236. The State Treasury has a single treasury account at the National Bank for executing of financial transactions and for an effective management of the resources of the State and local budgets through the electronic payment system of the National Bank. To carry out transactions in foreign currency related to the execution of the State budget the State Treasury has accounts in foreign currency opened on its behalf in the National Bank of Ukraine and the State Export and Import Bank of Ukraine.

237. State debt, liabilities of budget holders, revenue and expenditure transactions are accounted for at the moment the payments are made (cash basis), while the transactions related to the funding of budget are accounted for at the moment the funds are credited to an account. Certain agencies and funds apply the accrual method in their accounts, according to which the transactions and events are recognized at the moment they arise irrespective of the date of payments.

238. In the period 2007-2015 a thorough reform of the accounting methods in the government is being pursued. Pursuant to the strategy of the accounting system modernisation in the state sector for the years 2007 to 2015⁷⁹, the national accounting standards are planned to be applied in the state sector starting from the year 2013. The strategic goal of this reform is the strengthening of the public sector accounting system with consideration of the international standards requirements. The Treasury and the Accounting Chamber have agreed a common format for the financial reports on the budget execution. Starting from 2013, the ministries and other CPAs are expected to compile the financial reports according to the national accounting standards.

239. The chief accountant of the ministry or other CPA assures that the financial statements and budgetary reports are compiled and submitted in compliance with the set requirements. The forms of financial reporting and the order they are filled in is set by the Ministry of Finance. The State Treasury is responsible for the composition, consolidation and presentation of the reports on budget execution.

240. There are monthly, quarterly and annual financial reports. A monthly report is presented to the Parliament, Cabinet of Ministers, Accounting Chamber and the Ministry of Finance not later than 15 days after the end of the reporting month. Summary indicators of State budget execution, information about

⁷⁹ Approved by Decree 34 of the Cabinet of Ministers of 16 January 2007.

the use of particular budget articles and information of the use of the reserve fund are presented not later than 25 days after end of the reporting month. A report on the development of public debt is presented not later than the first day of the second month after the end of the reporting month. A quarterly report is presented not later than 15 days after the end of the reporting quarter. It contains sections like: summary indicators of monetary developments, the development of State debt, summary indicators of State budget execution and state guarantees. An annual report on the execution of the State Budget is presented not later than the first of May of the year following the reporting year. It contains similar sections as the quarterly reports and in addition summary indicators of the execution of local budgets and explanatory information demanded by the Cabinet of Ministers. The Ministry of Finance takes care of the publication of all financial reports.

241. The annual financial report is reviewed in Parliament. The Minister of Finance presents the report and makes a speech. The Chairman of the Audit Chamber and the Chairman of the Budget Committee present their own reports. The review is completed by a parliamentary resolution acknowledging the government report. Parliament does not approve the report.

6.2 Internal audit

242. The establishment of internal audit units in accordance with international best practice is a relatively new development in Ukraine. This initiative is governed by the concept of public internal financial control for the period until the year 2017 (hereinafter referred to as the Concept)⁸⁰ and the Action plan on its implementation(hereinafter referred to as the Action plan).

243. According to the Concept and the Action plan, in the first stage (the years 2008 to 2011) the legal framework for public internal financial control (PIFC) was adjusted to the EU requirements. In addition measures were taken concerning the training of personnel and information supply.

244. Starting from 2012 the next stage of the Concept and the Action plan implementation will be launched, namely the establishment of internal audit units in the Ministries and CPAs.

245. The budgetary legislation of Ukraine (Constitution, Budget Code, decrees of the Cabinet of Ministers) clearly identifies the obligations of the budget holders including those for internal financial control and internal audit (see in particular art.26 of the Budget Code). Ukraine develops internal financial control and internal audit in accordance with European standards⁸¹.

246. In addition, the Government decree regarding internal audit subdivisions and the conduct of internal audit in the Ministries and other CPAs, as well as the Internal audit standards and the Code of Ethics for Internal Auditors must be adopted in the year 2011.

⁸⁰ Approved by Government Decree #158-p dated 24.05.2005 (revised # 1347-p dated 22.10.2008 and #1601-p dated 23.12.2009)

⁸¹ In the last decade international financial organisations have started to put much emphasis on the notion of "Public internal financial control", but in many OECD countries this notion did not exist as a separate set of requirements on financial management. However, these countries do have regulations in place that define the duties and responsibilities of budget holders, which can retrospectively be interpreted as "public internal financial control".

247. Traditionally, some of the functions of internal control were fulfilled in Ukraine by the Main Control and Revision Organisation (MCRO) and decentralized subdivisions inspecting the ministries and other CPAs.

248. At the end of 2010, the actual number of employees in the MCRO was 7818, while that in the decentralized subdivisions inspecting the ministries and other CPAs was 1446 employees. The administrative reform of December 2010⁸² will lead to a 20% reduction of the number of employees of the Financial Inspection and its local bodies.

249. The internal audit units at the Ministries and other CPAs that are expected to be established starting from 1 January 2012, will be based on the currently acting decentralised inspecting subdivisions for ministries and CPAs of the MCRO and will perform the function of internal audit in the system of the PIFC in Ukraine.

250. As long as the internal audit units at the Ministries and other CPAs as part of the PIFC arrangement are not yet developed to the extent necessary to assure an adequate level of internal control the Ukrainian authorities consider it necessary to maintain external fiscal inspection by the MCRO on behalf of the Government.

251. Pursuant to the Concept, the MCRO is defined as the body in charge of implementation of reforms in the PIFC system in Ukraine and the Ministry of Finance is defined as the coordinator of reforms in the area of public finance.

252. A separate structural subdivision of the MCRO fulfils since 2007 the tasks of coordination, methodology development and supervision of the acting decentralised inspecting subdivisions at the ministries and other CPAs. This subdivision, the Administration for PIFC Harmonization (with a staff of 11 persons) performs currently the function of the central harmonisation unit in the European sense.

253. In OECD countries internal financial control is entirely left to budget holders (the Anglo-Saxon and Nordic model) or to budget holders and relatively small units of controllers reporting to the Minister of Finance but often located in the line ministries and agencies (the Southern European model). However, this refers to preventive control, not to ex post assessment. The latter is in OECD countries the exclusive domain of internal and external audit institutions.

254. In the view of the OECD Secretariat, Ukraine is progressing steadily to a comprehensive arrangement of internal control and audit. In due course this arrangement will encompass three elements:

- Preventive internal control by budget holders through effective administrative procedures;
- Preventive control by the Treasury on commitments and payment (see par. 4.1);
- Ex post control by internal audit units in the ministries and other CPAs, building forth on the current decentralised internal control subdivisions for the ministries and other CPAs.

255. If this arrangement is fully developed in a few years time, there will be no need any more for decentralized subdivisions inspecting the ministries and other CPAs or ex ante inspectors as exist in Southern European countries. This implies that the role of the MCRO should in the medium term be reconsidered, making sure that the best possible use is made of their valuable expertise, either in the

⁸² See par. 193.

new internal audit units, or in the financial directorates of the ministries, or elsewhere, in a way that further contributes to the quality of financial management in Ukraine.

256. In OECD countries internal audit units (as opposed to the central steering and co-ordination unit) are placed within the ministries and agencies and they report to ministers and agency heads. This is an important requirement for the effective execution of their primary task, which is the identification of financial risk and supply of advice to budget holders on risk reduction. A relation of confidence with budget holders is an essential prerequisite for the fulfilment of this task. In this respect the current intentions of the government of Ukraine are fully consistent with OECD practice.

6.3 External audit

Legal basis and budget

257. In 1996 the Accounting Chamber of Ukraine (ACU) received constitutional status. The organisation and activities of the ACU are regulated by the Constitution, the Law on the Accounting Chamber, the Budget Code and other legislative acts (secondary legislation).

258. According to the Law on the ACU, the Chamber is subordinated and accountable to the Parliament. The ACU operates independently of any other State authority.

228 The appropriation for the ACU in the State budget 2009 amounted to UAH 54 million (about 5 million euro) which is relatively little vis-à-vis comparable OECD countries.

260. During budget preparation the ACU has to submit its budget request to the Ministry of Finance. This is felt by the ACU as a violation of her independence as the Chamber has to control the Ministry of Finance. However, the submission of budget requests to a Ministry (not always the Ministry of Finance) is common practice in OECD countries, as some ministry has to take care of the budget law for the high colleges of State. It is important though that the Supreme Audit Authority can bring its views on its own budget to the attention of Parliament.

Competences and tasks

261. The ACU is the supreme audit authority of Ukraine. It audits the expenditures of the State budget and reports about its finding in public reports. It also provides public advice on the budget law submitted by the government to Parliament and issues reports on budget execution (art. 243 of the Law on the ACU). In addition it audits the preservation and use of State property. The ACU also audits classified (secret) expenditures concerning national security and defence.

262. A constitutional amendment of December 2004, stipulated that the remit of the ACU would be extended with the audit of State revenues. Before that amendment the ACU had no right to control the revenue side of the Budget. However, recently the Constitutional Court declared the constitutional amendments 2004 invalid. As a consequence the ACU has lost the right to audit revenues. On the other hand the ACU has expert knowledge on revenues and can issue analytical reports on the revenue side of the budget. In addition the ACU can issue opinions on the completeness and timely collection of revenues as part of its reports on budget execution. In this context the ACU can also identify deviations from the approved revenue estimates in the budget, observe and analyze violations and make proposals regarding their rectification (art. 22 of the Law on the ACU).

263. The ACU has no right to audit the expenditures of local budgets. It can, however, audit the State grants to local government which make up more than 90 percent of the revenues of local budgets.

22964. The ACU produces both financial audits and performance audits. Financial audits assess the accuracy and reliability of the financial reports and the compliance with prevailing legislation. Performance audits assess the effectiveness and efficiency of expenditures. Audit reports contain recommendations on correction of errors and deficiencies as well as on measures to increase effectiveness and efficiency of the use of public resources.

265. The audit reports are sent by the Accounting Chamber to the Verkhovna Rada, heads of the relevant ministries and other CPAs, enterprises and other institutions subject to audit. The detected violations of law and inflicted damage to the State are communicated by the Accounting Chamber to the Rada. In the event of violations entailing administrative or criminal responsibility, the Board of the ACU can decide to pass the materials concerned to the law enforcement agencies (art. 26 of the Law on the ACU). The Board of the Accounting Chamber can decide, if necessary, to send an advice to the President of Ukraine, the Cabinet of Ministers, the Ministry of Finance, and other CPAs about the audit findings.

23066. The ACU issues quarterly reports on budget execution. In addition, the Budget Committee of Parliament reviews jointly with the ACU the annual report on budget execution submitted to Parliament by the Cabinet of Ministers by 1 May following the budget year. To prepare the review, the ACU issues a report on the disbursement of public funds within 15 days after submission of the report to Parliament. The ACU has no formal right to approve the annual report on budget execution. Parliament and government can just “draw lessons” from the opinion of the ACU on how to improve budget execution in future.

267. One third of the constitutional membership of the Parliament can order the ACU to perform an audit on a specific subject.

268. The ACU is of the opinion that performance auditing should be an exclusive task of the internal audit units and the ACU. In its view the Financial Inspection should not perform performance audits. The ACU is also of the opinion that the Financial Inspection should be placed in the Ministry of Finance if it is to be reshaped as a steering and co-ordination unit for internal audit.

Organisation and working methods

269. The Board of the ACU consists of: the Chairman, two Deputy Chairmen, the Secretary and nine Chief Controllers. The members of the Board are appointed by Parliament by means of a secret ballot for a term of 7 years.

270. The ACU has 10 departments headed by a Chief Controller. The ACU includes regional offices covering the whole country and directs some of its tasks to the regional offices. The regional offices conduct their own audits under the direction of the central management of the ACU (taking into consideration the annual audit working plan).

271. As of December 2009 the total staff amounted to 479 employees. The central office of the ACU had 362 employees and the regional offices had 117 employees.

231. The ACU is a member of EUROSAI Governing Board. Currently, the project for Implementation of Twinning Fiche Terms of Reference is being developed in co-operation with the Swedish National Audit Office. Furthermore, the Accounting Chamber has been selected the external auditor for OSCE.

23273. The College of the Accounting Chamber formulates the work plan of the Chamber on the basis of proposals from the department directors. The College takes into account the suggestions of the commissions of the Verkhovna Rada and its committees. The College ensures that the work plan includes the obligatory consideration of addresses and proposals from the President of Ukraine and the Cabinet of Ministers of Ukraine.”

Results

274. In 2009 the ACU issued 130 reports. Of the audit reports 20 concern State priority programmes (see par. 83 of chapter 2). In addition 610 letters and notifications were sent to public authorities with requests to react to detected violations and deficiencies and to take action to recover public funds.

275233. In 2009 25 reports were forwarded to the General Prosecutor’s Office (14 by ACU Board decision, 11 on request of the General Prosecutor). The ACU never lost a single case in the Court, when a prosecution took place.

276. Every year, by December 1, the ACU submits an annual report to Parliament on its activities the costs of these activities. The report also contains summary information on the audit reports and the frequency of detected infringements. In addition, information bulletins are published regularly and available on the web-site of the ACU. Communication about results is also promoted by press-conferences and briefings, interviews, public speeches and articles in electronic and printed mass-media.

Follow up of the reports

277. Ministries and other CPAs are supposed to react to the findings and recommendations of the ACU but their reactions are not always complete and adequate.

278. The Cabinet of Ministers reviews the completed audit reports and informs the ACU of the actions taken. The ACU maintains a database on recommendations and actions taken.

279. Regularly, but at least twice a year, committees of the Parliament scrutinize ACU reports and notifications. This may lead to proposals for the amendment of the budget law or substantive laws.

280. The Parliamentary resolution on the review of the annual report on budget execution (see par. 252 above) generally includes a range of proposals to eliminate ineffective or inefficient policies to be taken into account during the preparation of the upcoming budget.

Revision of the Law on the Chamber of Accounts

281. The ACU elaborates a revision of the Law on the Chamber of Accounts. This draft clarifies the role and competencies of the ACU in many respects. The draft has been prepared with the help of foreign experts. The draft supposes adjustment of article 98 of the Constitution (reinstatement of the amendment allowing the audit of State revenues).

6.4 Conclusions

282. In recent years a thorough reform of the accounting methods in the government has been pursued. The strategic goal of this reform is the strengthening of the accounting methodology and the creation of a single methodological basis of accounting and reporting in accordance with international standards. Important progress has been made, but the reforms have not yet been completed and should be pursued.

283. The budgetary legislation of Ukraine (Constitution, Budget Code, decrees of the Cabinet of Ministers) clearly identifies the obligations of the budget holders including those for internal financial control and internal audit (see in particular art. 26 and 111 of the Budget Code). Ukraine develops internal financial control and internal audit in accordance with European standards. For that purpose it will adopt legislative acts (secondary legislation, including a decree by the Cabinet of Ministers) required for the establishment of internal audit units in the ministries and other CPAs.

284. Ukraine is progressing steadily to a comprehensive arrangement of internal control and audit. If this arrangement is fully developed in a few years time, there will be no need any more for decentralized subdivisions inspecting the ministries and other CPAs or ex ante inspectors as exist in Southern European countries. This implies that the role of the MCRO should in the medium term be reconsidered, making sure that the best possible use is made of their valuable expertise.

285. In OECD countries internal audit units (as opposed to the central steering and co-ordination unit) are usually placed within the ministries and agencies and they report to ministers and agency heads. This is an important requirement for the effective execution of their primary task, which is the identification of financial risk and supply of advice to budget holders on risk reduction. A relation of confidence with budget holders is an essential prerequisite for the fulfilment of this task. In this light it is recommended to the authorities of Ukraine that audit units are not centralised but placed inside ministries and other CPAs.

286. The Chamber of Accounts of Ukraine has developed into an effective and well organized supreme audit institution. Its production of audit reports (both financial and performance audits) is impressive and its contribution to the quality of financial reporting and the effectiveness and efficiency of the use of public funds is generally acknowledged.

287. In some OECD countries the Supreme Audit Institution can audit state revenue and the budgets of local governments. The authorities may consider a similar extension of the remit of Supreme Audit Institution in Ukraine.

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ANNEX -- Dynamics of Planned Indicators of the State Budget in 2006-2010⁸³*(changes from introduction of the draft budget bill to adoption and in year modifications)*

| (mn. UAH) | | 2006 | | | | |
|------------------|---|-------------------------|------------------------------------|---------------|---|-----------------|
| | | Government Draft Budget | State Budget Law adopted by the VR | % change | State Budget Law following modifications during the fiscal year | % change |
| | | 15-09-2005 | 20 December 2005 | when approved | throughout 2006 | throughout 2006 |
| I. | REVENUES | 118,706.0 | 124,945.1 | 5.26% | 127,516.6 | 2.06% |
| II. | FINANCING (DEFICIT) | 9,898.4 | 12,909.0 | 30.42% | 13,245.7 | 2.61% |
| III. | CREDITING | 1,160.5 | 772.7 | -33.42% | 562.9 | -27.15% |
| IV. | EXPENDITURES - total, of which: | 127,443.8 | 137,081.5 | 7.56% | 140,199.4 | 2.27% |
| 1 | Transfers to local budgets | 23,955.4 | 32,701.4 | 36.51% | 35,057.8 | 7.21% |
| 2 | Verkhovna Rada of Ukraine | 572.9 | 606.6 | 5.87% | 606.6 | 0.00% |
| 3 | Public affairs management | 632.7 | 605.3 | -4.33% | 615.7 | 1.72% |
| 4 | Cabinet of Ministers of Ukraine | 217.5 | 233.0 | 7.13% | 233.0 | 0.00% |
| 5 | Ministry of Finance (including tax and customs services, Main Control and Auditing Office, State Property Fund) | 10,758.6 | 10,792.0 | 0.31% | 9,889.0 | -8.37% |
| 6 | Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences | 10,286.7 | 10,559.6 | 2.65% | 10,566.3 | 0.06% |
| 7 | Ministry of Healthcare | 3,232.7 | 3,147.2 | -2.64% | 3,154.7 | 0.24% |
| 8 | Ministry of Labor and Social Policy and transfers to the Pension Fund | 32,681.6 | 29,714.4 | -9.08% | 30,393.8 | 2.29% |
| 9 | Ministry of Defense and Administration of the State Border Guard Service | 7,844.6 | 8,135.9 | 3.71% | 8,780.9 | 7.93% |
| 10 | Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry | 10,733.6 | 11,075.2 | 3.18% | 11,109.8 | 0.31% |
| 11 | Judicial authorities | 1,507.6 | 1,628.3 | 8.00% | 1,687.9 | 3.66% |
| 12 | Ministry of Fuel and Energy and Ministry of Coal Industry | 4,329.1 | 5,184.9 | 19.77% | 5,285.6 | 1.94% |
| 13 | Ministry of Agrarian Policy | 4,224.1 | 5,657.6 | 33.93% | 5,662.1 | 0.08% |
| 14 | Ministry of Transport and Communications and State Road Service | 5,498.1 | 5,325.3 | -3.14% | 5,403.6 | 1.47% |
| | | 91.39% | 91.45% | | 91.62% | |

⁸³ Information in this table was obtained from the Secretariat of the Budget Committee.

| (mn. UAH) | | 2007 | | | | |
|-----------|---|-------------------------|------------------------------------|---------------|---|-----------------|
| | | Government Draft Budget | State Budget Law adopted by the VR | % change | the law on the budget considering the introduced amendments | % change |
| | | 14-09-2006 | 19 December 2006 | when approved | throughout 2007 | throughout 2007 |
| I. | REVENUES | 140,290.3 | 147,888.1 | 5.42% | 157,287.0 | 6.36% |
| II. | FINANCING (DEFICIT) | 15,148.4 | 15,715.7 | 3.74% | 19,066.0 | 21.32% |
| III. | CREDITING | 1,980.8 | 1,784.9 | -9.89% | 1,721.5 | -3.55% |
| IV. | EXPENDITURES - total, of which: | 153,457.9 | 161,819.0 | 5.45% | 174,631.5 | 7.92% |
| 1 | Transfers to local budgets | 38,424.9 | 42,199.8 | 9.82% | 47,315.0 | 12.12% |
| 2 | Verkhovna Rada of Ukraine | 606.6 | 696.6 | 14.84% | 720.0 | 3.35% |
| 3 | Public affairs management | 618.3 | 689.6 | 11.52% | 777.6 | 12.77% |
| 4 | Cabinet of Ministers of Ukraine | 1,879.9 | 300.7 | -84.00% | 307.1 | 2.12% |
| 5 | Ministry of Finance (including tax and customs services, Main Control and Auditing Office, State Property Fund) | 11,541.9 | 12,636.7 | 9.49% | 12,841.6 | 1.62% |
| 6 | Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences | 12,091.7 | 12,423.7 | 2.75% | 13,219.5 | 6.41% |
| 7 | Ministry of Healthcare | 3,870.8 | 4,350.2 | 12.39% | 4,534.2 | 4.23% |
| 8 | Ministry of Labor and Social Policy and transfers to the Pension Fund | 25,981.5 | 26,010.9 | 0.11% | 28,604.2 | 9.97% |
| 9 | Ministry of Defense and Administration of the State Border Guard Service | 9,482.6 | 9,901.5 | 4.42% | 10,571.6 | 6.77% |
| 10 | Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry | 13,101.0 | 13,812.6 | 5.43% | 14,994.2 | 8.55% |
| 11 | Judicial authorities | 1,704.4 | 1,812.0 | 6.31% | 1,896.8 | 4.68% |
| 12 | Ministry of Fuel and Energy and Ministry of Coal Industry | 5,915.8 | 8,733.4 | 47.63% | 9,132.2 | 4.57% |
| 13 | Ministry of Agrarian Policy | 7,574.2 | 6,649.2 | -12.21% | 6,854.0 | 3.08% |
| 14 | Ministry of Transport and Communications and State Road Service | 6,312.6 | 6,559.0 | 3.90% | 6,802.8 | 3.72% |
| | | 90.65% | 90.70% | | 90.80% | |

| (mn. UAH) | | 2008 | | | | | |
|-----------|--|--|---|--|---------------|--|-----------------|
| | | draft budget, proposed by the Government | draft budget, proposed by a <u>new</u> Government | the law on the budget, adopted by the Verkhovna Rada | % change | the law on the budget considering the introduced amendments | % change |
| | | 14-09-2007 | 26-12-2007 | 28 December 2007 | when approved | Throughout 2008 | Throughout 2008 |
| I. | REVENUES | 191,125.7 | 215,359.4 | 215,359.4 | 0.00% | 231,932.0 | 7.70% |
| II. | FINANCING (DEFICIT) | 18,945.0 | 18,500.3 | 18,822.2 | 1.74% | 25,020.2 | 32.93% |
| III. | CREDITING | -1,860.4 | 1,642.6 | 1,809.6 | 10.17% | 3,744.3 | 106.91% |
| IV. | EXPENDITURES - total, of which: | 211,931.0 | 232,217.1 | 232,372.0 | 0.07% | 253,207.9 | 8.97% |
| 1 | Transfers to local budgets | 56,279.7 | 59,544.2 | 59,634.2 | 0.15% | 62,712.4 | 5.16% |
| 2 | Verkhovna Rada of Ukraine | 797.4 | 852.4 | 860.4 | 0.94% | 860.4 | 0.00% |
| 3 | Public affairs management | 1,015.6 | 1,236.9 | 1,236.9 | 0.00% | 1,241.3 | 0.36% |
| 4 | Cabinet of Ministers of Ukraine | 389.1 | 428.1 | 428.1 | 0.00% | 428.1 | 0.00% |
| 5 | Ministry of Finance (including tax and customs services, Main Control and Auditing Office, State Property Fund) | 13,847.8 | 20,286.4 | 20,241.4 | -0.22% | 20,767.0 | 2.60% |
| 6 | Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences | 17,818.5 | 18,072.3 | 18,090.2 | 0.10% | 18,202.5 | 0.62% |
| 7 | Ministry of Healthcare | 5,570.6 | 5,725.8 | 5,745.8 | 0.35% | 5,780.0 | 0.60% |
| 8 | Ministry of Labor and Social Policy and transfers to the Pension Fund | 29,794.5 | 38,743.5 | 38,775.5 | 0.08% | 45,241.6 | 16.68% |
| 9 | Ministry of Defense and Administration of the State Border Guard Service | 11,251.1 | 11,949.7 | 11,949.7 | 0.00% | 11,976.2 | 0.22% |
| 10 | Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry | 18,363.8 | 19,180.7 | 19,180.7 | 0.00% | 19,374.7 | 1.01% |
| 11 | Judicial authorities | 2,428.4 | 2,839.6 | 2,839.6 | 0.00% | 2,838.6 | -0.03% |
| 12 | Ministry of Fuel and Energy and Ministry of Coal Industry | 9,495.3 | 12,241.8 | 12,241.8 | 0.00% | 16,004.3 | 30.74% |
| 13 | Ministry of Agrarian Policy | 11,834.7 | 9,849.6 | 9,849.6 | 0.00% | 10,994.6 | 11.62% |
| 14 | Ministry of Transport and Communications and State Road Service | 8,888.9 | 11,381.2 | 11,381.2 | 0.00% | 12,191.5 | 7.12% |
| | | 88.60% | 91.44% | 91.43% | | 90.29% | |

| (mn. UAH) | | 2009 | | | | | |
|-----------|--|--|--|--|---------------|--|-----------------|
| | | draft budget, proposed by the Government | revised draft budget, proposed by the Government | the law on the budget, adopted by the Verkhovna Rada | % change | the law on the budget considering the introduced amendments | % change |
| | | 15-09-2008 | 23-12-2008 | 26 December 2008 | when approved | Throughout 2009 | Throughout 2009 |
| I. | REVENUES | 288,098.1 | 237,547.2 | 238,931.3 | 0.58% | 245,309.4 | 2.67% |
| II. | FINANCING (DEFICIT) | 17,380.2 | 31,000.0 | 31,105.0 | 0.34% | 31,563.0 | 1.47% |
| III. | CREDITING | 3,293.6 | 2,920.1 | 2,715.9 | -6.99% | 2,715.9 | 0.00% |
| IV. | EXPENDITURES - total, of which: | 302,184.7 | 265,627.1 | 267,320.4 | 0.64% | 274,156.4 | 2.56% |
| 1 | Transfers to local budgets | 68,530.4 | 59,533.1 | 60,819.7 | 2.16% | 61,483.2 | 1.09% |
| 2 | Verkhovna Rada of Ukraine | 1,043.7 | 661.9 | 740.8 | 11.93% | 758.1 | 2.34% |
| 3 | Public affairs management | 1,624.7 | 753.2 | 832.2 | 10.49% | 817.4 | -1.77% |
| 4 | Cabinet of Ministers of Ukraine | 501.1 | 281.2 | 281.2 | 0.00% | 281.2 | 0.00% |
| 5 | Ministry of Finance (including tax and customs services, Main Control and Auditing Office, State Property Fund) | 31,333.3 | 23,932.8 | 23,980.6 | 0.20% | 23,163.6 | -3.41% |
| 6 | Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences | 21,175.3 | 20,990.4 | 21,079.7 | 0.43% | 21,079.7 | 0.00% |
| 7 | Ministry of Healthcare | 7,385.5 | 5,545.8 | 5,545.9 | 0.00% | 5,904.2 | 6.46% |
| 8 | Ministry of Labor and Social Policy and transfers to the Pension Fund | 49,228.8 | 52,593.2 | 52,593.7 | 0.00% | 53,330.9 | 1.40% |
| 9 | Ministry of Defense and Administration of the State Border Guard Service | 20,152.6 | 12,864.3 | 13,566.0 | 5.45% | 13,566.0 | 0.00% |
| 10 | Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry | 27,208.4 | 19,573.8 | 20,548.4 | 4.98% | 20,548.4 | 0.00% |
| 11 | Judicial authorities | 3,784.7 | 2,281.4 | 2,323.4 | 1.84% | 2,447.7 | 5.35% |
| 12 | Ministry of Fuel and Energy and Ministry of Coal Industry | 17,965.4 | 5,703.3 | 5,703.7 | 0.01% | 5,719.2 | 0.27% |
| 13 | Ministry of Agrarian Policy | 11,980.6 | 5,737.6 | 5,738.9 | 0.02% | 5,738.9 | 0.00% |
| 14 | Ministry of Transport and Communications and State Road Service | 12,561.6 | 15,902.8 | 16,270.3 | 2.31% | 12,770.3 | -21.51% |
| | | 90.83% | 85.22% | 86.05% | | 83.02% | |

| (mn. UAH) | | 2010 (as of November 2010) | | | | | |
|-----------|---|--|---|--|---------------|--|-----------------|
| | | draft budget, proposed by the Government | draft budget, proposed by a <u>new</u> Government | the law on the budget, adopted by the Verkhovna Rada | % change | the law on the budget considering the introduced amendments | % change |
| | | 16-09-2009 | 23-04-2010 | 27 April 2010 | when approved | Throughout 2010 | Throughout 2010 |
| I. | REVENUES | 284,691.9 | 267,452.0 | 267,452.0 | 0.00% | 252,751.2 | -5.50% |
| II. | FINANCING (DEFICIT) | 46,748.3 | 57,745.4 | 57,745.4 | 0.00% | 54,095.4 | -6.32% |
| III. | CREDITING | 7,168.2 | 1,641.2 | 1,180.9 | -28.05% | 1,180.9 | 0.00% |
| IV. | EXPENDITURES - total, of which: | 324,272.0 | 323,556.2 | 324,016.5 | 0.14% | 305,665.7 | -5.66% |
| 1 | Transfers to local budgets | 83,807.1 | 77,440.9 | 77,556.1 | 0.15% | 78,014.2 | 0.59% |
| 2 | Verkhovna Rada of Ukraine | 578.9 | 839.4 | 875.7 | 4.32% | 822.2 | -6.11% |
| 3 | Public affairs management | 984.3 | 1,051.0 | 1,051.0 | 0.00% | 946.7 | -9.92% |
| 4 | Cabinet of Ministers of Ukraine | 331.3 | 313.9 | 317.4 | 1.12% | 311.8 | -1.74% |
| 5 | Ministry of Finance (including tax and customs services, Main Control and Auditing Office, State Property Fund) | 31,673.7 | 23,187.0 | 23,210.0 | 0.10% | 22,862.9 | -1.50% |
| 6 | Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences | 20,347.5 | 23,078.4 | 23,113.9 | 0.15% | 22,617.8 | -2.15% |
| 7 | Ministry of Healthcare | 6,292.5 | 6,700.1 | 6,700.1 | 0.00% | 6,135.1 | -8.43% |
| 8 | Ministry of Labor and Social Policy and transfers to the Pension Fund | 60,441.7 | 72,339.0 | 72,339.0 | 0.00% | 69,229.2 | -4.30% |
| 9 | Ministry of Defense and Administration of the State Border Guard Service | 15,183.6 | 15,751.3 | 15,770.3 | 0.12% | 13,584.8 | -13.86% |
| 10 | Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry | 23,069.8 | 23,163.2 | 23,163.2 | 0.00% | 22,805.2 | -1.55% |
| 11 | Judicial authorities | 2,839.3 | 2,877.0 | 2,877.0 | 0.00% | 2,806.5 | -2.45% |
| 12 | Ministry of Fuel and Energy and Ministry of Coal Industry | 9,921.2 | 7,182.3 | 7,182.3 | 0.00% | 6,278.3 | -12.59% |
| 13 | Ministry of Agrarian Policy | 6,008.8 | 7,242.5 | 7,144.5 | -1.35% | 5,754.5 | -19.46% |
| 14 | Ministry of Transport and Communications and State Road Service | 14,845.2 | 7,934.9 | 7,934.9 | 0.00% | 9,095.2 | 14.62% |
| | | 85.21% | 83.17% | 83.09% | | 85.47% | |