Ukraine
Review of the Budget Process
A Public Expenditure and Institutional Review

March 8, 2002

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region
**Currency Equivalents Units**  
*(Exchange Rate Effective June 29, 2001)*  
**Currency Unit**: Hrivnya  
US$1 = 5.37UAH

**Government Fiscal Year**  
January 1 - December 31

**Weights and Measures**  
Metric System

**ACRONYMS AND ABBREVIATIONS**

<table>
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<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tr>
<td>CAS</td>
<td>Country Assistance Strategy</td>
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<td>CEM</td>
<td>Country Economic Memorandum</td>
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<td>CFAA</td>
<td>Country Financial Accountability Assessment</td>
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<td>CoM</td>
<td>Cabinet of Ministers</td>
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<td>CPAR</td>
<td>Country Procurement Assessment Report</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>ESW</td>
<td>Economic Sector Work</td>
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<td>FAD</td>
<td>Fiscal Affairs Department (IMF)</td>
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<td>GDP</td>
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<td>GFMIS</td>
<td>Government Financial Management Information System</td>
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<td>GS</td>
<td>Government Secretary</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>Ministry of Economy</td>
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<td>Ministry of Finance</td>
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<td>MTEF</td>
<td>Medium Term Expenditure Framework</td>
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<td>NBU</td>
<td>National Bank of Ukraine</td>
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<td>NGO</td>
<td>Non-governmental organization</td>
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<td>OECD</td>
<td>Organization of Economic Co-operation and Development</td>
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<td>PAL</td>
<td>Programmatic Adjustment Loan</td>
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<td>PAYG</td>
<td>Pay-As-You-Go Pension System</td>
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<td>Public Expenditure and Institutional Review</td>
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<td>ROSC</td>
<td>Report on the Observance of Standards and Codes (IMF)</td>
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<td>STA</td>
<td>State Tax Administration</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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CONTENTS

EXECUTIVE SUMMARY AND RECOMMENDATIONS ........................................... ix

1. THE BUDGET PROCESS: OVERVIEW ......................................................... 1
   A. MAIN FEATURES OF THE BUDGET PROCESS ........................................ 1
   B. FISCAL TRANSPARENCY ..................................................................... 2
      Clarity of Roles and Responsibilities .............................................. 3
      Public Availability of Information .................................................. 5
      Open Budget Preparation, Execution, and Reporting ....................... 5
      Integrity of the Budget Process ...................................................... 6

2. LEGAL FRAMEWORK ........................................................................... 9

3. BUDGET PREPARATION ........................................................................ 15
   A. MAIN FEATURES OF THE BUDGET PREPARATION PROCESS ............... 15
      Division of Labor Between the MOF and MOE .................................. 15
      Sectoral Expenditure Policy ............................................................ 15
      Revenue Projections ....................................................................... 15
      Bargaining for Expenditure Limits .................................................. 17
      State Programs .............................................................................. 18
   B. RECENT IMPROVEMENTS INTRODUCED BY THE GOVERNMENT .......... 18
      Key Spending Units and Budget Programs ..................................... 19

4. BUDGET EXECUTION ........................................................................... 21
   Variations in Planned and Executed Expenditures ............................... 21
   Budget Execution Procedures Until 1999 ............................................. 22
   Budget Execution Procedures After 1999 ........................................... 23

5. INTERGOVERNMENTAL BUDGETING .................................................. 29
   Main Advantages of the New System ................................................. 32
   Conclusions and Outstanding Issues ............................................... 37

6. FISCAL SUSTAINABILITY ISSUES AND SIZE AND COMPOSITION OF
   PUBLIC EXPENDITURE .................................................................. 39
   A. FISCAL SUSTAINABILITY ............................................................... 39
   B. SIZE AND COMPOSITION OF PUBLIC SPENDING: AN INTERNATIONAL PERSPECTIVE .................................................................................................................. 41
      The Size of Government ................................................................. 43
      The Composition of Public Expenditures ......................................... 45

7. IMPROVING PUBLIC EXPENDITURE MANAGEMENT AND THE
   BUDGET PROCESS ........................................................................ 49
   Objective 1. Clarifying the Responsibility of Participants in the Budget Process ............................................................................................................................................................................. 49
   Objective 2: Improving Coordination .................................................. 52
   Objective 3. Strengthening Credibility .................................................. 59
   Objective 4. Improving the Public Availability of Information .............. 59

v
LIST OF TABLES

Table 1.1: Consolidated General Government Accounts, Percent of GDP .............................................. 1
Table 1.2: Extra-Budgetary Funds in Ukraine, 1997-2001 ........................................................................ 4
Table 1.3: Audit Outcomes Reported by KRU ...................................................................................... 6
Table 4.1: Budget Execution in 1996-2000, States and Local Budgets, Mln UAH ................................. 22
Table 5.1: Arrears of Budget Institutions Accumulated at Central and Local Levels, 1998-2000 ................. 29
Table 5.2: Local Expenditures, 1998-2001 .......................................................................................... 30
Table 5.3: Changes in Estimated per Capital Expenditures in 2001 versus 2000 (for cities and rayons) ............. 34
Table 6.1: Primary Balance Required to Stabilize Public Debt, Three Scenarios (Percent of GDP) .......... 41
Table 6.2: Structure of Public Expenditure, 1994-2000 (in Percent of GDP) ......................................... 42
Table 6.3: Changes in Estimated per Capital Expenditures in 2001 versus 2000 (for cities and rayons) .......... 34
Table 6.4: Composition of Public Expenditures in Selected Countries, 1999 (in Percent of GDP) ............... 47

LIST OF FIGURES

Figure 3.1: Changes in Revenue Projections During Budget Preparation, 2000 ...................................... 16
Figure 3.2: Change in Revenue Projections During Budget Preparation, 2000 ...................................... 16
Figure 3.3: Change in Expenditure Proposals During Budget Preparation, 2000 and 2001 ......................... 17
Figure 4.1: Budget Execution (in Percentage of Approved Budget) .......................................................... 21
Figure 4.2: Cash Balances on the Accounts of Central and Local Governments, in UAH Thousand ......... 25
Figure 6.1: Central Government Debt in Ukraine, % of GDP ................................................................. 40
Figure 6.2: Government Finance in Ukraine, % of GDP, 1992-2000 ...................................................... 46

LIST OF BOXES

Box 2.1: The New Budget Code .......................................................................................................... 12
Box 4.1: The Treasury System .............................................................................................................. 23
Box 5.1: How Berdiansk Reformed its Finances .................................................................................... 35
Box 7.1: The Budget Resolution ......................................................................................................... 53

ANNEXES

ANNEX 1: TABLES ............................................................................................................................. 61

ANNEX 2: BUDGET CLASSIFICATION .......................................................................................... 77
  Functional Classification ..................................................................................................................... 77
  Program Classification ....................................................................................................................... 78

LIST OF ANNEX TABLES

Annex 1-Table 1: Changes in Revenue Projections During the Preparation of the 2000 Budget. 61
Annex 1-Table 2: Changes in Revenue Projections During the Preparation of the 2001 Budget. 62
Annex 1-Table 3: Changes in Expenditure Policy During the Preparation of the 2000 Budget...63
Annex 1-Table 4: Changes in Expenditure Policy During the Preparation of the 2001 Budget...64
Annex 1-Table 5: Changes by the Executive and Amendments by the Verkhovna Rada for Special Funds During the Preparation of the 2001 Budget.......................65
Annex 1-Table 6: Budget Execution, 1996-2000..........................................................66
Annex 1-Table 7: Budget Execution, 1996-2000..........................................................67
Annex 1-Table 8: Budget Execution in 2000, by Economic Classification.......................70
Annex 1-Table 9: State Budget Execution, 1999............................................................72
Annex 1-Table 10: Monthly Execution of the State Budget, 2000 as a Percentage of the Rospis.73
Annex 1-Table 11: Budget Revenues in 1998-2000.......................................................74
Annex 1-Table 12: Public Expenditures in Selected Countries, 1999.................................75
Annex 2-Table 1: Program Classification........................................................................79

LIST OF ANNEX FIGURES

Annex 1-Figure1: Expenditure Flow as % of 1/12 of the Annual Budget, 1997-2000........68
Annex 1-Figure 2: Revenue Flow as % of 1/12 of the Annual Budget, 1997-2000..............68
Annex 1-Figure 3: Deviation of Actual Revenues from Monthly Target, Cumulative, 1997-2000..........................................................69
Annex 1-Figure 4: Deviation of Actual Expenditures from Monthly Target, Cumulative, 1997-2000..........................................................69
EXECUTIVE SUMMARY AND RECOMMENDATIONS

1. This report is a companion report of the Country Financial Accountability Assessment, which was recently discussed with Government. It presents an institutional analysis of the budget process, which is the process by which the government allocates funds to spending agencies. It analyzes the participants in the decision-making process related to spending and the institutions involved in the budgetary and financial management of government operations; as well as the modalities of preparation and execution of the budget. The report also updates the findings of the 1997 Public Expenditure Review concerning fiscal sustainability and the size and composition of public expenditure, which is discussed in an international context. Finally, the report provides recommendations on how to improve the management of public resources.

2. Budgeting took place until 1999 in a recessionary environment and the rationing of public funds was one of the main budgetary issues that decision-makers had to face. After 1999, as a result of major reforms undertaken by the government, economic performance improved considerably with a GDP growth rate above 5% in 2000. There has been major progress in fiscal management in recent years with the prohibition of central bank direct financing of the government, the setting up of a Treasury system, the adoption of a new Budget Code and other important budgetary reforms. Public finances also greatly improved with the elimination of budgetary offsets in 2001 and a sharp decline in budget arrears. There are still problems in fiscal management (e.g. commitment control and cash management) but these problems are being addressed by government. Fiscal discipline and accountability have been weak points of the fiscal reform efforts. For instance, there were, until 2000, few penalties for arrears or budget overruns. The Ministry of Finance has been able to exercise more financial control on expenditures but the Verkhovna Rada has shown little commitment to fiscal discipline (as shown in chapter 3). The focus of reforms in coming years should be to strengthen fiscal discipline and improve expenditure management in key sectors (as discussed in chapter 7).

3. Budgeting should have four objectives: (1) providing a consistent and realistic resource framework (aggregate fiscal discipline); (2) allocating resources to strategic priorities between sectors (allocative efficiency); (3) ensuring credible commitment to predictable and sustainable policies, and (4) giving autonomy to public agencies within a hard budget constraint, thereby increasing incentives to use funds efficiently and effectively (operational efficiency).

4. **Aggregate Fiscal Discipline.** At the political level, mechanisms to force recognition of the genuine resource limits based on sustainable fiscal targets, or to force political choices early on in establishing expenditure priorities are limited. Until recently there was little recognition of a budget constraint in the budgetary process. There was widespread use of budgetary offset schemes and an accumulation of arrears. As a result, the fiscal deficit, if correctly calculated, would be much larger than actually reported. The Government has moved to address these issues in recent years—the practice of budgetary offsets was partially eliminated in 2001 and arrears have declined.

5. **Allocative Efficiency.** The incentives for setting sectoral priorities are weak. This fact, combined with limited revenues, has led to the use of cash rationing during budget execution. Before 1999, even "protected" inputs (such as wages and salaries) had to adjust week-by-week, in an ad hoc fashion, to cash availability. Since 1999, the rationing of cash is done through the rospis (budget implementation sheet),
which for many years had been ignored, and the priorities are made at the top of government by the Prime Minister and a few persons in the CoM. They do not necessarily correspond to the approved budget appropriations.

6. **Operational Efficiency.** Managers of public expenditure programs are not sufficiently accountable, and there are few incentives for ensuring that spending programs are managed and delivered in a cost-effective manner.

**Fiscal Transparency Has Improved but More Progress is Needed**

7. Fiscal transparency is built around four principles: the clarity of the roles and responsibilities of government; the public availability of information; the openness of budget preparation, execution and reporting; and independent assurances of integrity. Progress has been made in recent years in terms of making information publicly available and making the budget process more open, though there is room for many improvements.

8. Confusion over the role of government is the major reason for the lack of transparency and accountability in Ukraine. The relationship between the three branches of government with respect to fiscal management is still evolving. It is difficult to make a clear separation between the technical basis for fiscal policy and political factors that influence revenue and expenditure estimates.

**The Budget Code Needs to be Bolstered with Improved Enforcement and Accountability**

9. The legal framework for the Budget has been greatly improved with the approval of the Budget Code, but work remains to be done to strengthen the enforcement of the code and the accountability of participants in the budget process. The areas of weakness of the new Budget Code are accountability and budget discipline. Credible enforcement mechanisms are lacking. The Code is weak on specifying which authority is accountable in cases of violations. The Budget Code does not have preeminence over other laws so that its provisions can be overturned at any time by other legislation.

**Consistent and Realistic Budget Preparation is the Foundation for Improved Policy**

10. The preparation phase of the budget is the phase where most weaknesses are noticeable. There are four main issues. First, budget preparation tasks are divided between the MOF and MOE. This division of labor (which is also found within line ministries themselves) undermines the process of drafting the budget as a single document with certain priorities and internal logic.

11. Second, budget expenditure estimates do not take into account the real capacity of the government to raise revenue and do not fully reflect the new role of the government in a market economy.

12. Third, there are few mechanisms to elaborate and implement realistic sectoral priorities and little institutional capacity in MOF, MOE or spending agencies to do so.

13. Fourth, there is no mechanism to force spending units to take budget ceilings into account while preparing their applications. The MOF is obliged to arbitrate the trade-offs resulting from the allocation of scarce financial resources—while this task should be done by the Cabinet of ministers acting as a collegial body, and/or line ministries who should, after all, be responsible for the efficient use of public resources in their sector.

14. Improving budget preparation would require adopting a strategic approach with the objective of moving toward the implementation of a performance-based budgeting system. It would be premature to
put in place a Medium Term Expenditure Framework (MTEF) similar to OECD countries. Intermediate steps are necessary before reaching that stage: institutional mechanisms should be developed to oblige all major actors in the budget process to commit themselves to operate within a strict strategic policy and expenditure framework.

15. The Ministry of Finance should be placed at the center of the budget process, within a framework that ensures budget discipline, in order to improve macroeconomic policy coordination and the technical capacity to prepare the budget. The functions of the Ministry of Economy related to the preparation of the capital budget should be transferred to the MOF to ensure closer linkage between current and capital expenditures.

16. The sectoral departments of the MOF should be merged with the budget department to ensure that common goals are pursued. The structure of the new sub-departments would be aligned with the structure of key spending units; their responsibilities would be to set and maintain expenditure ceilings by agencies and programs. This involves producing detailed estimates and handling dispute resolution at the technical level. The other sub-departments of the budget department would focus on the overall coordination of the budget process.

17. It is important to find a mechanism to overcome the “tragedy of the commons” that is pervasive in public finances and damages allocative efficiency. The “tragedy” is that spending tends to be excessive because, although collectively political groups have an interest in using funds rationally, individually, they have an interest in taking as much as they can get. It is recommended that political parties agree to “fiscal contracts” in the form of negotiated targets and ceilings for the budget. This could be difficult in the current political context, considering that a lot of unstable “deals” are made (and unmade) in the legislature, but external and internal pressure by international financiers and domestic watchdog organizations could contribute to the enforcement of such fiscal contracts.

18. Budgets would be more sustainable if they were based on sectoral resource envelopes (sectoral ceilings). The Cabinet should propose the latter for three years on the basis of affordability and inter-sectoral priorities. For the annual budget, sectoral ceilings should be set after key strategic policy decisions are made, also at the level of the CoM. Those budget ceilings would be a predictable basis on which appropriate strategic and efficient operational decisions can be made and implemented. The passage of time will test the credibility of the ceilings. Once credibility has been established, a more formal MTEF process could be established. The contribution of an MTEF to improving budgetary outcomes will depend on the ceilings delivering greater predictability than current arrangements.

19. The budget process must move away from being “funding driven” and be increasingly policy- and program-based. The focus of budgeting and policy development should be outcomes and outputs, and not inputs (wages and salary bill, operations and maintenance, etc). Both the MOF and line ministries should pursue measures to: (a) to strengthen macroeconomic projections; and (b) to improve the process of sector reviews. The latter process should consist of: (i) agreeing on objectives, outputs and activities; (ii) reviewing agreed programs and subprograms; and (iii) costing agreed programs. Detailed performance indicators should be developed for that purpose.

20. The internal review process should be strengthened to reduce the occurrence of problems and introduce corrective measures on time. The Cabinet Committee on Economic Issues should play an important role in this process. Revised revenue and expenditure projections should be prepared by MOF in collaboration with line ministries, revenue collections agencies (STA, Customs) and the Treasury. The formal mid-year review should be supplemented by improved monthly reports on budget outcomes prepared by the budget department of MOF.
21. A structured dispute resolution mechanism should also be established, lead by the Cabinet Committee on Economic Issues, to examine budget requests from ministries and establish any cost savings that would need to be made to hold them within the approved budget ceilings. The CCEI will base its decisions on policy options developed as a result of the internal budget request review process at the MOF. After consideration, the CCEI would pass on its recommendations to the full CoM.

**Effective Budget Execution Requires a Strengthened System for Commitment Controls**

22. Budget execution has been plagued with difficulties since independence. Between 1996 and 2000, the budget was systematically under-financed. The introduction of the Treasury has improved things but there are still problems.

23. The commitment control system is not yet operational. In some cases, spending units sign contracts for goods and services for amounts that exceed their appropriations, which increases accounts payable. However it is not possible to say whether the increase is within appropriations or exceeds assigned levels. Moreover, there is no proper mechanism of tracing those who are responsible for overspending and making them accountable. The State Treasury has introduced a system of commitment controls in January 2001, but it seems to be valid on paper only and has not entered in practice by all spending units. The commitment control system must become fully operational immediately.

24. Cash management in the public sector is still inefficient in spite of progress. To control spending, since 1999 the release of funds is performed by the Treasury in consultation with the MOF on a weekly basis. Funds are allocated to spending units proportionally to budget appropriations based on a budget implementation sheet (rospis) prepared by the higher echelons of the Ministry of Finance. In other words, when assigning funds, commitments made by the spending units are not taken into account. This cash management system is an improvement over the drastic day-to-day cash rationing system used before 1999, but it remains inefficient because it results in accumulation of Treasury cash balances with the banking system.

25. Inappropriate budget execution is exacerbated by the poor resource management. Spending units are not given the right to reallocate resources from other sources (e.g., special funds resources or funds at their accounts assigned for other purposes) to finance their urgent needs when expecting transfer of funds from the Treasury according to appropriations. This results in further accumulation of cash balances and creates cash gaps at the same time. Under such conditions it is impossible to reallocate funds both between the spending units and different expenditure items. Key spending units should be given the freedom to reallocate resources under certain conditions.

26. There have been numerous violations of the existing legislation, as reported by KRU and the Accounting Chamber, but violators have not been prosecuted. Improvements in accounting and information management capacity at the Treasury and in the Budget Department of the MOF are needed to track spending, cost, and performance. Finally, improvements in budget reporting and in fiscal transparency are needed to ensure that the public is informed about the use of public funds and the performance of budget programs.

**Better Intergovernmental Budgeting will Lead to Better Incentives for Sound Fiscal Management**

27. Ukrainian local governments (oblasts, rayons and cities) have significant expenditure responsibility. About 35 percent of expenditures were carried out at the sub-national level in 2000-01. Almost three-quarters of those local expenditures go to education, health and social protection.
28. A major reform of intergovernmental fiscal relations has taken place in 2001. The reform introduces a formula-based approach to determine intergovernmental transfers. It has received the support of a majority of local governments. Changes in the distribution of resources among different types of governments correspond to changes in their expenditure responsibilities thus contributing to a higher degree of accountability. The new system also contributes to a greater equalization of planned per capita expenditures among cities and rayons. The use of formulas to determine the transfers results in more timely preparation of budgets by local governments. Finally, the use of formulas provides better incentives for local governments to mobilize revenue and (although there is less evidence on that yet) to allocate expenditures.

29. Five important issues remain to be addressed. First, the timing of direct transfers from the central budget is not well defined, which can jeopardize the ability of some local governments to execute their budget effectively. Second, the transparency of the formula is undermined by the fact that it does emphasize that its aim is to provide equal spending opportunities (adjusted for the individual peculiarities of all local government types). Third, there have not been changes in the rights of local governments to make decisions on hiring/firing public employees. This right is necessary to move from “supply-driven” to “demand-driven” methods of public service provision. Fourth, disincentives for revenue mobilization may continue in some oblasts. More studies are necessary to identify the main factors that affect revenue mobilization incentives. Fifth, there have been several reported violations in the application of the formula by oblasts. The lack of adequate enforcement will prevent full transparency for the transfers, whether their allocation is conducted by the Ministry of Finance or will remain delegated to the financial authorities of oblasts.

Fiscal Sustainability Issues Remain a Priority

30. There are indications that Ukraine would benefit from further reductions in current expenditures, thus forcing the public sector to improve its operational efficiency. Debt management also continues to be a challenge for Ukraine. In order for the debt-to-GDP ratio not to increase and if a sustainable budgetary balance is to be achieved in the medium term in Ukraine, the government will have to maintain the primary fiscal surplus at the level of 2000, i.e., approximately 1.8 percent (depending on assumptions on economic growth and real interest rate).

31. Eliminating non-payments should be priority No.1 for the Government. Budget offsets were prohibited recently. New arrears must not be tolerated. The stock of existing arrears should be eliminated over a period of three years to levels comparable to international standards (i.e., from about 90 percent of GDP presently to the regional average of 20 percent). The Government should develop a comprehensive strategy to settle the stock of budget and tax arrears in a consistent and definite manner. The objective of this strategy is to close the gap between expenditures and revenues on cash and a commitment basis in the context of a sustainable medium-term fiscal framework, taking into account hidden contingent liabilities. A range of workout mechanisms (including debt conversion, securitization and bankruptcy procedures) will be applied to resolve overdue obligations and settle fiscal imbalances. The end result will be a realistic timetable to reduce the remaining budget and tax arrears, which will allow the Government to stay current thereafter.

Size and Composition of Public Expenditures Still Require Attention

32. After a decade of “forced downsizing” during which the public sector was adjusting to the new market economy environment and public spending declined from 70 percent to 37 percent of GDP, the overall size of government in Ukraine remains significant given the level of national income, but is no longer blatantly oversized.
33. In terms of composition, public expenditure in Ukraine does not appear to be excessively high in any of the major spending categories. Public spending on education and health care (at 10 and 8 percent of total public expenditures, respectively) amount to a smaller percentage of GDP in Ukraine than in other transition countries but it is not clear that higher government spending would lead to better outcomes. Ukraine spends 13.2 percent of GDP on social transfers. Given Ukraine’s per capita income level, its high tax burden and the problem of targeting correctly social assistance, the level of social transfers of Ukraine appear to be inappropriately high compared to advanced transition economies.

34. Ukraine’s overall gross (public and private) investment levels, though not particularly high (about 20 percent of GDP in 1999), are not far from those of other transition and market economies. But with less than 1 percent of GDP spent by the government on capital investment and maintenance, it would appear that Ukraine threatens its future growth potential by depleting its existing capital stock. This issue, however, needs to be explored further. Higher public investment does not automatically lead to higher growth. In fact, available cross-country evidence shows that shifting public spending away from capital outlays to current expenditure has been good for growth.

35. In summary, the key remaining shortcomings include the following:

- There are few effective mechanisms to force recognition at the political level of the resource limits that exist and to force political choices in establishing expenditure priorities;
- Budget expenditure estimates do not take into account the real capacity of the government to raise revenue and do not fully reflect the new role of the government in a market economy;
- There are few mechanisms to elaborate and implement realistic sectoral priorities, and little institutional capacity in MOF, MOE or key spending agencies to do so;
- There is no operational commitment control system so that it is not possible to trace those who overspend and to hold them accountable;
- The cash management system is deficient. Funds are allocated weekly proportionally to budget appropriations based on the rospis, with a significant degree of discretion; and
- There are few incentives for ensuring that spending programs are managed and delivered in a cost-effective manner. The focus is on protecting certain economic categories of expenditures, rather than on protecting critical expenditure programs.

36. Steps to overcome institutional obstacles to better budget management would include:

- Clarifying the Accountability of the Participants in the Budget Process, by
  - Further clarification of the legal framework on the respective roles of the President, the Cabinet of Ministers, the Minister of Finance and the Verkhovna Rada;
  - Leadership of the Process by the Ministry of Finance within a framework that ensures high-level support for budget discipline;
  - Better organization of the Ministry of Finance (see para. 7.12-7.16);
  - Movement towards a medium-term expenditure framework; and
  - Further strengthening of interbudgetary relations between tiers of government.

- Improving Coordination
  - Agreement on and maintenance of realistic, medium-term budget ceilings;
  - Preparing macro projections and linking those projections to fiscal targets;
  - Using sectoral reviews to agree on objectives, outputs and activities; to review agreed programs and subprograms; and to cost agreed programs;
  - Developing performance indicators or benchmarks;
Developing a strategy for the medium term for public expenditure management;
Developing the budget implementation review process; and
Instituting a mechanism for budget dispute resolution.

**Strengthening Credibility**

- Verification (e.g., putting a commitment control system in place);
- Establishing well functioning control and audit institutions; and
- Punishing violations.

**Improving the Public Availability of Information**

- More transparency and publicity of the debates and discussions during the preparation process of the budget would be beneficial and probably translate into better outcomes;
- Put in place procedures to allow the voice of stakeholders to be heard by those who draft the budgets;
- The annual budget should include statements of financial assets, and data on financial assets at the various levels of government, consolidated on a consistent basis;
- More data and information should be available to the public and the media specializing in economic and financial issues; and
- Finally, the MOF should take the initiative in organizing debates on specific fiscal issues with members of the specialized media; NGOs and academic groups.
1. THE BUDGET PROCESS: OVERVIEW

1.1 This report is a companion report of the Country Financial Accountability Assessment (CFAA), which was recently discussed with Government. It examines the budget process and the government functions of financial management related to budgeting. This chapter briefly describes the main features of the public expenditure system, and discusses fiscal transparency. Several excellent reports on budgeting in Ukraine have been published in recent years, including the 1999 TACIS-financed “Open budget for Ukraine” report¹ and the 2000 report from the IMF.² This report takes stock of important reforms that have taken place over the past three years during the term of office of the Yushchenko government. It focuses not only on the budget rules, but on incentives, i.e., on the informal aspects of budgeting, on how participants behave and how their actions are affected by budget rules. When rules do not take sufficient account of the interests and behavior of budgetary participants seemingly good rules can generate perverse incentives and lead to unwanted outcomes.

A. MAIN FEATURES OF THE BUDGET PROCESS

1.2 Basic budgetary indicators are shown in Table 1.1. In the early 1990s, the sharp GDP decline was accompanied by an increase in budget expenditures (as a percentage of GDP) to support basic public services. Since then public spending has contracted at a faster rate than the rate of GDP decline. The reduction of public expenditures with stagnant or declining revenue led to an increase in domestic debt to 12 percent of GDP in 1998 (after restructuring, 8.3 percent of GDP in 1999). Foreign debt also increased to 44 percent in 1999. Since 1995, the budget deficit has been financed through arrears in the form of overdue wages, pensions, social allowances, and unpaid gas and electricity bills and/or were covered using various money surrogates (mutual settlements, promissory notes [veksels] and payments in-kind).

Table 1.1: Consolidated General Government Accounts, Percent of GDP

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Revenues</td>
<td>41.9</td>
<td>37.8</td>
<td>36.7</td>
<td>38.0</td>
<td>36.0</td>
<td>34.7</td>
<td>34.5</td>
</tr>
<tr>
<td>Current Expenditure</td>
<td>47.0</td>
<td>40.2</td>
<td>38.6</td>
<td>43.0</td>
<td>38.0</td>
<td>36.6</td>
<td>34.1</td>
</tr>
<tr>
<td>Deficit</td>
<td>-5.1</td>
<td>-2.3</td>
<td>-1.9</td>
<td>-5.0</td>
<td>-2.1</td>
<td>-2.0</td>
<td>-2.0</td>
</tr>
<tr>
<td>Capital Expenditure</td>
<td>3.6</td>
<td>2.5</td>
<td>1.3</td>
<td>0.6</td>
<td>0.7</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Foreign Financing</td>
<td>-0.1</td>
<td>0.2</td>
<td>1.8</td>
<td>0.2</td>
<td>1.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Memo: privatization receipts average 0.2% of GDP in 1993-97 and 0.6% of GDP in 1998-99.

Source: World Bank, PAL President’s Report.

1.3 Economic growth was negative from independence until 1999. Budgeting, thus, took place in a sharply recessionary environment and the rationing of public funds was one of the main budgetary issues that decision-makers had to face. However, at the end of the decade, in large part as a result of major reforms undertaken by the government, economic performance improved considerably, with GDP growth becoming positive in 2000. There has clearly been progress in fiscal management in recent years with the prohibition of central bank direct financing of the government, the setting up of a treasury system, the adoption of a new Budget Code, a new budget classification system, the creation of the external audit function and improved availability of fiscal information. Thanks to these important budgetary reforms,

the Ministry of Finance was able to exercise more financial control on expenditures. Public expenditures have declined from 43% to 34.1% of GDP from 1997 to 2000 while public revenues have declined from 38% to 34.5% of GDP over the same period, and public finances have greatly improved with the elimination of budgetary offsets in 2001 and a sharp decline in budget arrears. There are still problems in fiscal management (e.g. commitment control and cash management) but these problems are being addressed by government. Fiscal discipline and accountability have been weak points of the fiscal reform efforts. For instance, there were, until 2000, few penalties for arrears or budget overruns. In the administration, budgeting is still influenced by the legacy of central planning and, at the same time, lacks some important financial discipline features that were typical of the old soviet system. Moreover, the Verkhovna Rada has shown little commitment to fiscal discipline (as shown in chapter 3).

1.4 In spite of significant improvements that took place in 2000-01, the budget process in Ukraine still lacks realism. This report will highlight three sets of issues:

- There has been significant administrative progress in budget preparation and execution (as discussed below) but, at the political level, not all mechanisms are functioning to force recognition of the genuine resource limits based on sustainable fiscal targets, or to force politically appointed officials to make choices, early on in the budget process, in establishing expenditure priorities. In some instances, budget expenditure estimates do not take into account the real capacity of the government to raise revenue and have yet to reflect the changed role of government in a market economy. Political pressures encourage overoptimistic assessments of the capacity of the economy to generate revenues;

- The incentives to elaborate and implement realistic sectoral priorities, and the institutional capacity to do so, are limited especially in key spending agencies. The emphasis on "needs" (and the use of often unrealistic input norms) can compromise the setting of realistic priorities, in spite of the efforts of the MOF to request additional explanatory material from spending units to justify their expenditure requests. This has led to the use of cash rationing (sequestration) during the execution of the budget; and

- There are few incentives for ensuring that spending programs are managed and delivered in a cost-effective manner. The focus is on protecting certain economic categories of expenditures, rather than on protecting critical expenditure programs. This discourages program managers from seeking to maximize the efficiency of their overall allocations (by reallocating expenditures away from protected items, such as wages, toward lower cost methods of achieving targets). There is no framework to gauge the performance of managers and hold them accountable for their decisions. Finally, there is insufficient open, public debate on key budget issues both in the Verkhovna Rada, between budget managers in the executive branch, and in the public at large.

The focus of reforms in coming years should be to strengthen fiscal discipline and expenditure management in key sectors, i.e. on allocative efficiency (as discussed in chapter 7).

B. FISCAL TRANSPARENCY

1.5 Several deficiencies in the budgetary arrangements can be related directly to the lack of clear responsibilities given to each budget participant; the low accountability of the participants for the decisions they make; and the relative lack of openness in preparing the budget. Fiscal transparency according to the broad definition found in the IMF Code of Good Practices on Fiscal Transparency is built around four basic principles: (a) clarity of the roles and responsibilities of government; (b) public

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3 Art. 20-22 of the new Budget Code defines spending units as entities provided with the authority to receive budget appropriations. Key spending units are equivalent to budgetary chapters and include the main organs of the State.
availability of information; (c) open budget preparation, execution, and reporting; and (d) independent assurances of integrity. The Ukrainian authorities have prepared, in September 1999, a report on the observance of standards and code (hereafter, ROSC) on fiscal transparency by Ukraine.

Clarity of Roles and Responsibilities

1.6 The lack of clarity over the role of government—whether it results from an impossibility for different political factions to agree on what this role should be or from other causes—is one of the reasons for the lack of transparency and accountability. For example, in agriculture and industry, the state is still very much in the business of controlling enterprises, through the Committee on Industrial Policy and other organs, rather than monitoring their behavior in the public interest. However, the government is making progress in some areas and has taken significant steps to redefine the roles of government in accordance with the needs of a market economy. For example, it has established the National Bank of Ukraine (NBU) as a relatively independent central bank (although amendments are required to clarify the role of the supervisory council). The Law on the NBU formally prohibits it from buying government debt on the primary market. NBU interest rates are, at times, well below market rates and thus involve an element of quasi-fiscal activity. The government has adopted an international budget classification (the IMF’s Government Finance Statistics—GFS—classification) though it does not meet international standards in all respects (see Annex I-Table 3 on budget classification).

1.7 It is recognized, however, that much remains to be done and many complex issues remain unresolved. Further clarification is required on many aspects to allow more constructive public participation. At a fundamental level, the relationship between the three branches of government with respect to fiscal management is not well defined in the legislation and is still evolving. It is also too early to judge how the Budget Code, signed into law by the President on July 11, 2001, will be used in practice (see Box 2.1 below). This applies to the budget process, which has been substantially improved through the new Budget Code, and fiscal relationships between the national government and different levels of three-tier local government that are also still evolving and have not previously had a well-structured legal framework.

1.8 The Government supports public and private enterprises in a variety of ways, through the budget (including state orders and tax expenditures), through guarantees, and by directed lending from the banking sector. However, some significant forms of public support for enterprises are not included in the budget (for instance, tax arrears for gas and electricity companies).

1.9 Within the Government, the role of the Ministry of Finance, Ministry of Economy and other parts of the Cabinet still remain to be defined more clearly. Macroeconomic policy coordination and technical capacity in establishing an economic framework for the budget needs to be improved. The new Treasury is improving budget and accounting controls for the State budget expenditures; and producing regular fiscal reports and the single treasury account in the NBU covers all funds of the central government and extends budget controls to several extrabudgetary accounts. However, as the ROSC points out, it remains difficult to make a clear separation between the technical basis for fiscal policy and political factors that influence revenue and expenditure estimates.

1.10 The 1997 laws on the enterprise profit tax and the value added tax (VAT) provide a sound basic legal framework but the numerous exemptions and subsequent amendments—as discussed above—reduce

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5 See http://www.imf.org/external/np/rosc/ukr/index.htm from which much of this discussion is borrowed.
<table>
<thead>
<tr>
<th>#</th>
<th>Name of Fund</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001 (Plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
</tr>
<tr>
<td>1</td>
<td>Pension Fund</td>
<td>R: 9,614,000</td>
<td>E: 9,531,000</td>
<td>R: 12,038,400</td>
<td>R: 15,425,400</td>
<td>R: 16,452,277</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 9,749,000</td>
<td>E: 9,702,000</td>
<td>E: 12,067,669</td>
<td>E: 14,293,100</td>
<td>E: 13,568,273</td>
</tr>
<tr>
<td>2</td>
<td>Social Insurance Fund</td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
<td>Out of the Budget</td>
<td>Included into the Budget</td>
<td>Out of the Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 1,242,300</td>
<td>E: 1,186,800</td>
<td>R: 1,222,400</td>
<td>R: 1,553,200</td>
<td>R: 1,414,300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 1,182,700</td>
<td>E: 1,166,100</td>
<td>E: 1,186,700</td>
<td>E: 1,414,300</td>
<td>E: 1,414,300</td>
</tr>
<tr>
<td>3</td>
<td>Unemployment Fund **</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>E: 40,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 217,800</td>
<td>E: 198,900</td>
<td>R: 457,000</td>
<td>R: 550,794</td>
<td>R: 47,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 331,756</td>
<td>E: 521,100</td>
<td>E: 521,100</td>
<td>E: 521,100</td>
<td>E: 40,000</td>
</tr>
<tr>
<td>4</td>
<td>Fund For Social Protection Of Disabled ****</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>E: 1,414,300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 57,950</td>
<td>E: 48,977</td>
<td>R: 51,078</td>
<td>R: 54,496</td>
<td>R: 47,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 50,729</td>
<td>E: 51,905</td>
<td>E: 51,905</td>
<td>E: 51,905</td>
<td>E: 40,000</td>
</tr>
<tr>
<td>5</td>
<td>State Innovation Fund **</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 266,458</td>
<td>E: 228,000</td>
<td>R: 682,589</td>
<td>R: 1,066,384</td>
<td>R: 1,182,880</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 160,116</td>
<td>E: 246,590</td>
<td>E: 1,161,095</td>
<td>E: 1,161,095</td>
<td>E: 1,671,095</td>
</tr>
<tr>
<td>6</td>
<td>Environment Protection Fund</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 3,627</td>
<td>E: 3,546</td>
<td>R: 43,560</td>
<td>R: 59,173</td>
<td>R: 43,586</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 30,288</td>
<td>E: 51,767</td>
<td>E: 51,767</td>
<td>E: 51,767</td>
<td>E: 122,922</td>
</tr>
<tr>
<td>7</td>
<td>Chernobyl Fund</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 1,698,448</td>
<td>E: 1,716,664</td>
<td>R: 1,416,253</td>
<td>R: 283,011****</td>
<td>R: 1,445,514</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 1,420,089</td>
<td>E: 1,420,089</td>
<td>E: 1,420,089</td>
<td>E: 1,420,089</td>
<td>E: 1,420,089</td>
</tr>
<tr>
<td>8</td>
<td>Fund For Fuel And Energy Complex Development*</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Out of the Budget*</td>
<td>Out of the Budget*</td>
<td>Out of the Budget*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 178,408</td>
<td>E:*</td>
<td>R:*</td>
<td>R:*</td>
<td>R:*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E:*</td>
<td>E:*</td>
<td>E:*</td>
<td>E:*</td>
<td>E:*</td>
</tr>
<tr>
<td>9</td>
<td>Road Fund *****</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
<td>Included into the Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>R: 778,800</td>
<td>E: 778,800</td>
<td>R: 1,285,393</td>
<td>R: 1,790,049</td>
<td>R:* **</td>
</tr>
<tr>
<td></td>
<td></td>
<td>E: 1,275,649</td>
<td>E: 1,740,522</td>
<td>E: 1,740,522</td>
<td>E: 628,065</td>
<td>E: 628,065</td>
</tr>
</tbody>
</table>

**NOTES:**

* The expenditures for this fund was not specified in the Budget. And for the following years this fund was not specified in the Budget at all. For the moment this fund hasn't been eliminated, but there is no information about its revenues and expenditures.

** The Revenues and expenditures of these Funds are included into the budget, but the supervision is made by proper Ministries.

*** 1998 the difference in the amounts is explained in the text part of the budget and consists of the following: the sum of 10 000 UAH is transferred to the Center for marrow transferring of Science center of radiation medicine of the Academy of Sciences of Ukraine as a debt payment.

**** This fund has special funding for social protection of disabled coming directly from State Budget, varied year by year according to the approved State Budget.

1999 the difference in the amounts is explained in the text part of the budget and consists of the following: the part of VAT in payments to the budget in amount of 1.346.800.000 UAH is transferred directly to the Chernobyl fund.

***** This fund has specific status, because it is the location of resources, directed for the road measures and specified in the Revenues and Expenditures items in the Budget.

The Revenues for this "fund" include enterprise deductions and state Budget financing. For the year 2000 the revenues was not specified in Budget. And in the year 2001 it was excluded from the Budget.
transparency. Tax laws are only available to the public with great difficulty because of the many changes and exemptions and compliance with tax law is unsatisfactory.

1.11 Basically all the extrabudgetary funds at the central level have either been incorporated into the budget, ceased to exist as earmarked funds or been completely eliminated except for the social insurance funds (see Table 1.2). The social insurance funds will be managed on a “triptite” basis with representation of the state, employers and trade unions in all the managerial bodies. There are, however, some earmarked expenditure items in the budget that are outside the MOF control. For example, Chernobyl-related expenditures that include various environmental, social, health and other programs are run by the Ministry of Emergencies and Consequences of Chernobyl and the MOF has no authority to make any adjustments to these expenditure items even if the government falls short of revenues. There is little information about how these funds are spent. The effectiveness of these programs remains to be assessed. These programs are run in parallel with similar programs of the Ministry of Social Policies and Ministry of Health, and there is little coordination, if any, between them. There is also very little published information about extrabudgetary funds at the local level; about which little is known and which would require a separate study.

Public Availability of Information

1.12 There is a constitutional requirement to publish data on budget execution and to make year-end financial reports available to the public. In practice, however, budgetary data are not easy to access in spite of significant efforts made by the Government. Article 28 of the new Budget Code specifies that “the Ministry of Finance shall publish the draft budget and quarterly information on budget execution” in a Government newspaper Uryadovy Courier within seven days after its submission to the Verkhovna Rada.

1.13 The Ministry of Finance prepares the Monthly Budget Review reports providing macroeconomic and fiscal indicators. The Monthly Budget Review is publicly available on the internet at www.minfin.gov.ua but data seem to be posted irregularly. The Ministry of Economy prepares a quarterly report on “Economic Trends” (GDP, consumption, investments, prices, employment, balance of payments, exchange rates, etc) which is also available on the web at www.me.gov.ua. The State Committee on Statistics regularly issues a Statistical Bulletin covering selected data on public sector, such as accounts receivable and payable, investments, and state owned shares in privatized enterprises.

1.14 No statements are published by the Government giving the extent of tax expenditures, tax exemptions or quasi-fiscal activities. The annual budget law contains provisions permitting the Government to issue guarantees within a certain limit. The budget document does contain information on the debt of the central government. The annual budget does not include statements of financial assets, and data on financial assets at the various levels of government are not recorded or consolidated on a consistent basis.

Open Budget Preparation, Execution, and Reporting

1.15 In spite of important reforms that have taken place recently, the budget process in Ukraine suffers from a number of problems which are described in the next chapters. Without doubt, a lot of progress in improving the transparency of the budget process has been made, but much remains to be done. The budget is broadly classified according to international standards. Macroeconomic and fiscal forecasts are discussed with some representatives of non-government organizations, and information is being made available to the public. But budget estimates are unreliable because of political factors and

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lack of clearly defined assumptions. The MOF has a limited capacity to develop a medium-term framework for budget estimates; to produce statements of fiscal risk, contingent liabilities, or assess the long-term fiscal sustainability of government policies—let alone share these and debate this assessment with the public.

1.16 Government accounts are being developed and a lot of progress has been made recently in this area. Internal government fiscal reports on the state budget and extra-budgetary operations of the central government spending units are prepared each month by the Treasury (including separate reports on payments arrears) within one month after month-end. Key fiscal indicators are being published monthly. Final accounts on the state budget include all central government earmarked funds, but not the Pension Fund and Social Insurance Fund, which are reported separately. These reports are presented to the Chamber of Accounts a few months after year-end and reports are available to the public. The present accounting system is on a cash basis. Cash-based revenue and expenditure data are accompanied with data on arrears accrued and some steps are being taken to move toward a modified accrual system. Work is underway to develop balance sheets including all financial assets and liabilities. No statement of accounting policies is made with the budget or final account reports.

**Integrity of the Budget Process**

1.17 There have been numerous violations of the existing legislation, as reported by KRU and by the Accounting Chamber.

1.18 The Control and Revision Department (Kontrolnano Revizyine Upravlinna, KRU) has reported numerous cases of illegal expenses and breaches of rules and regulations, as shown in table 1.3. below. According to article 26 of the Budget Code, the KRU and the Accounting Chamber of Ukraine are responsible for external control and auditing of financial and economic activities. Though KRU is external to the ministries, it is fully controlled by the executive, since it reports directly to the President and the Cabinet of Ministers, and in that sense, performs an internal audit role. The KRU Chairman and deputy heads are appointed (and dismissed) by the president and not by the Cabinet of Ministers. KRU prepares analytical material on violations of rules and regulations and makes suggestions for legal amendments aimed at fostering financial control and preventing abuses. A general perception amongst line ministries is that KRU was driven by the need to report maximum number of offences thereby increasing the amount of fines and penalties it can levy to prove its efficiency. But after 2000, KRU stopped received a percentage of the fines and penalties—resulting from KRU inspections—as extra budgetary resources to finance its expenditures. Even assuming that the criticism was true to some extent, it remains the case that internal controls in the spending units and treasuries are weak.

**Table 1.3: Audit Outcomes Reported by KRU**

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illegal Disbursement, Theft and Other Violations (in UAH Billion)</td>
<td>1.1</td>
<td>1.6</td>
<td>1.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Officials Implicated</td>
<td>16,000</td>
<td>14,000</td>
<td>13,500</td>
<td>17,000</td>
</tr>
<tr>
<td>Officials Dismissed</td>
<td>1,700</td>
<td>1,500</td>
<td>1,200</td>
<td>1,000</td>
</tr>
</tbody>
</table>

*Source: KRU.*

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7This issue is not examined here since it is reviewed by the Country Financial Accountability Assessment.

8Internal and external control are discussed in details in the Country Financial Accountability Assessment.
1.19 The Accounting Chamber (Rakhunkova Palata)—the supreme external audit institution which was established in 1997—asses the compliance with the budget law as executed by the executive and the cost effectiveness and timeliness of the use of public resources. Audits carried out by the AC between 1997 and 2000 revealed many cases of illegal and ineffective budget fund use for a total amount of UAH 9 billion. Some 8 and 16.6 percent of expenditures in the 1998 and 1999 budgets, respectively, involved violations. The data for 2000 indicated that not much improvement was made on this front. The AC reports to the Verkhovna Rada and has often been accused of lacking independence. According to the AC, the main causes of violations of the legislation include the lack of transparency in the preparation of the budgetary legislation; the lack of clarity in the appropriate level of responsibility, and the fact that those who commit violations are not punished. Concerning lack of transparency, the Accounting Chamber writes that: (a) the preparation of the budget is in the hands of a few experts and that there is no public oversight and monitoring; (b) the expenditures are not detailed (which makes it difficult to audit); (c) the monthly/quarterly budget reports do not circulate widely; and (d) the quality of those reports do not allow to look at legality and timeliness of spending decisions. According to the Accounting Chamber, in 1998 and 1999, State executive power bodies issued normative acts aimed not at executing the budget law but at the actual amendment of its provisions. The misuse of the “Reserve Fund of the Cabinet of Ministers” (UAH 200 million) in 1998, 1999 and 2000 is a good example of violation of the legislation on the budget. The Reserve Fund is supposed to be used for calamities and unanticipated events but, in practice, it is used by ministers to finance many activities which are, according to the AC, extremely disputable. Resolutions on financing expenditures from the Reserve Fund are adopted in an ad hoc manner, often not at Cabinet of Ministers meetings.
2. LEGAL FRAMEWORK

2.1 Until 2001, the basic "rules of the game" for budgeting were contained in the Constitution (articles 96-98, 119, 143) adopted by the Verkhovna Rada on June 28, 1996 and in a series of laws related to the budgetary process. Under this framework, the beginning of the budgetary process (usually by July 1), was the VR approval of an overall framework for the budget, which contained guidelines on fiscal policy and macroeconomic indicators for the next year's budget (revenues, expenditures and deficit, spending priorities and so called "protected items" in the budget). This was supposed to play the role of binding framework for the budget. However, under pressure from various parties and lobbying groups, the budget proposal was significantly altered at different stages of the process. Certain priorities, reflected in a "Program of activities of the Government" (e.g., fundamental research, regional development, specific aspects of health care and education etc) were announced by the President each year. However, there was a very weak correlation between these priorities and actual budget appropriations.

2.2 The Budget Code, which was signed into Law in July 2001, supersedes these many laws regulating the budgetary process between 1995 and 1999 and will apply fully for the first time in the 2002 budget formation. This new Code sets out a new set of "rules of the game". However, nowhere was budgetary politics more in evidence than during the parliamentary discussions of the Budget Code. Deciding who should have ultimate authority over key budget parameters—the Rada or the Government—has been a legislative battleground.

2.3 The new Budget Code defines participants in the budget process in a broad manner. Article 20 effectively specifies that any actor with a budgetary authority is a participant in the process. Article 22 provides somewhat more detail, specifying key actors of the budget process, including the Verkhovna Rada of Ukraine, the President of Ukraine, the Cabinet of Ministers of Ukraine; ministries, other central executive authorities [including heads of oblast administrations, i.e., governors], institutions and organizations that are referred to in the Constitution or are members of the Cabinet of Ministers of Ukraine, and—for budget appropriations envisaged by other local budgets—heads of local state administrations, executive bodies of radas and secretariats thereof, heads of main departments, departments, sections, and other independent divisions of local state administrations, executive bodies of radas.” Given the large number of political parties and interest groups in Ukraine, there is plenty of room for shifting alliances both within the Verkhovna Rada and inside government.

2.4 Only in Chapter 6 of the Budget Code are roles and responsibilities made clearer. The Cabinet of Ministers is given clear authority to develop the budget ( in years past a heated debate existed over whether this was the responsibility of the Government or the Verkhovna Rada). The Minister of Finance is given responsibility for determining the general level of budget revenues and expenditures and evaluating the amounts of required financing. No later than June 1st or the first day of the plenary session of the VR after this date hearings take place on a report on the Guidelines of Budgetary Policy. This Report must be submitted by the Cabinet of Ministers to the VR no later than three days prior to the

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The Guidelines for Budgetary policy also draw on proposed monetary guidelines provided by the NBU by April 1st of that year. Based on the parliamentary hearings the VR adopts a resolution (the Budget Resolution) taking into consideration the guidelines of Budget Policy for the next period. The Resolution may include proposals of the VR relating only to those items set out in footnote 11 (see article 33 of the Budget Code), including directives to the Cabinet of Ministers.

2.5 The Ministry of Finance then prepares instructions for the preparation of budget requests for the spending units. These instructions may include organizational, financial and other limitations with which all spending units will be obliged to comply. The Ministry of Finance then analyzes requests of the key spending units from the viewpoint of their conformity with the goals, priorities and efficiency of use of budget resources. Based on this analysis, the Ministry of Finance submits a draft State Budget to the Cabinet of Ministers. The Cabinet of Ministers should adopt the draft State Budget and submit it with supporting materials to the Verkhovna Rada no later than September 15th of the year which precedes the planned year.

2.6 Within five days of the submission of the draft budget to the Verkhovna Rada, the Minister of Finance must present it to a plenary meeting of the Rada.(Article 39). The Head of the Budget Committee at the same time presents a report to the Verkhovna Rada on the compliance of the draft State Budget Law with the Budget Code and the approved Budget Resolution. Based on the results of the debate the Verkhovna Rada may reject the draft if it does not comply with the Code or the Budget Resolution. If this is the case the Cabinet of Ministers shall resubmit the draft State Budget Law within one week. If the draft Law is accepted, no later then October 1st, the Verkhovna Rada shall review the draft State Budget Law and submit proposals to the Budget Committee. (Article 40) Proposals to increase state expenditure shall identify the sources for funding these expenditures and, likewise, proposal to reduce state revenues must identify sources to cover the losses of revenues or the expenditures that are to be cut. If these requirements are not met, the proposal will not be considered by the Budget Committee.

2.7 By October 15th, the Budget Committee together with authorized representatives from the Cabinet of Ministers, shall review proposed amendments to the draft State Budget Law and prepare “Conclusions and Proposals to the State Budget Law” as well as tables of the proposals made that are recommended for acceptance or rejection. These Conclusions and accompanying Tables must be submitted three days prior to the first reading of the Budget. At the first reading, the Head of the Budget Committee presents the Conclusions, which is first voted upon in general. If the Conclusions are rejected in this vote, then an article-by-article vote is made. The decision on the Conclusions shall be considered as the adoption of the State Budget Law for the first reading and this should occur by October 20th.

2.8 No later than November 3rd, a revised draft State Budget Law, taking into account the Conclusions voted upon in the first reading, shall be submitted to the Verkhovna Rada by the Cabinet of

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The Report must include the amount of the deficit as a share of GDP, the share of GDP to be redistributed through the budget, the limit of state debt and its structure, the amount of intergovernmental transfers as a share of state budget expenditures and the coefficient of equalization, capital expenditures as a share of State Budget expenditures and high priority purposes for the use of capital expenditures, relationships between the State Budget of Ukraine and local budgets in the next budget period, amendments to be introduced into legislation for purposes of implementation of the State’s budget policy, a list of key spending units of the State budget of Ukraine, a list of protected expenditure items and the reasoning for separation of the budget into general and special funds.

The supporting materials include: information on the State’s economic situation and major projected macroeconomic indicators; estimates of revenues and other funds to cover budget expenditures; explanations of the main provisions of the draft state budget including amounts of outlays for functions and programs; information on the extent to which account is taken of proposals of the VR on the Budget Resolution; the proposed framework for intergovernmental fiscal relations; information on State debt repayments; the consolidated budget; a list of tax exemptions and estimated revenue losses due to these exemptions; future expenditures for multi-year projects; summary on State debt and guarantees; a list of investment programs, a report on budget execution for the current period, draft estimates of all earmarked funds; and key spending units’ explanations.
Ministers (Article 42). No proposals in addition to those proposed on the Conclusions shall be considered in the second reading. The Head of the Budget Committee Reports on the extent to which the revised draft takes into consideration the Conclusions presented in the previous reading. The second reading shall be concluded by November 20th and provides the total amounts of the deficit (or surplus), revenues and expenditures, the amount of intergovernmental transfers and the provisions necessary for local government budget formulation. These are not subject to review during the third reading. Articles not adopted during the second reading are postponed to the third reading.

2.9 The draft State Budget is to be finalized and submitted to the Verkhovna Rada for the third reading no later than November 25th. Both the Head of the Budget Committee and the Minister of Finance report to the Verkhovna Rada and the Rada votes on the articles not approved in the second reading and on the Law in general. If the Law is not approved on the Law in general, individual votes are taken on the proposals of the Budget Committee. The Law shall be adopted by December 1st and signed by the President.

2.10 Although the new Budget Code sets out specific steps and functions for the different players in the development of the budget uncertainties in the process remain as a result of the unclear division of powers between the President, the Government and the Verkhovna Rada. Ukraine is a Presidential regime. In many Presidential regimes, one of the balance of power mechanisms between the executive and the legislature that is in place is the fact that the legislative has limited powers of dismissal of the executive branch but it has more sweeping powers to amend and modify the budget proposed by the executive than in a parliamentary regime. In a typical parliamentary regime, the legislative has the power to dismiss the government but it is given less power over the budget. Ukraine has a Constitution that is half way between those two models: the Verkhovna Rada has extensive powers to amend the budget and to dismiss the Government. Contrary to other presidential regimes, the executive branch is exposed to a high level of threat of dismissal by the legislative branch. This implies that even with the new rules of the game, the budgetary process remains a complicated process of reaching consensus between the Cabinet of Ministers, the Parliament and the President. This has been evidenced by the difficulties in implementing Budget Code deadlines in preparation of the 2002 budget due to divergent views between the Government and the Verkhovna Rada.

2.11 In terms of budgetary process, the role of the ministry of Finance has been substantially increased and relations between the Ministry of Finance and the line Ministries are more clearly defined. The Budget Code sets out clearly the process of appropriations and the Treasury is given a key role in budget execution. As mentioned above, it supports transparency by requiring the Government to publish the budget in the Government newspaper Урядовий Курьєр within seven days of its submission to the Verkhovna Rada. The Code also introduces program-based budgeting.

2.12 In addition to detailing the process of budget preparation, the new Budget Code includes a number of other key reforms. It supports improved macroeconomic management by: setting a three-year financial planning horizon with clearly defined targets; requiring the Government to report on budget execution on a monthly basis, and to initiate changes to the annual budget law (with the approval of Parliament) if need be; explicitly limiting the size of public debt to 60 percent of GDP, and banning extra-budgetary funds.

2.13 The Budget code has also introduced substantial reforms to the system of intergovernmental finance. The Code defines the expenditures responsibilities of the different levels of government, and explicitly sets out the revenues to be allocated to lower-level governments. It introduces a formula-based transfer system that allocates resources directly to about 700 local budgets and thus reduces the negotiations-based elements of the budget and sets out a more transparent and predictable system. This, in turn, encourages localities to increase their revenue raising efforts (see Chapter 5 below).
2.14 While the Budget Code has made considerable improvements in the budget system of Ukraine, there are areas in which it needs further strengthening. These include the following:

- The main areas of weakness of the new Budget Code are accountability and enforcement. The law does not include credible enforcement mechanisms and, as a result, the law has a declaratory character. Without such enforcement mechanisms the credibility of the Code will only become clear with its implementation as part of the budget process in the years to come;
- In terms of accountability, the Budget Code establishes clear responsibilities for the participants in the budgetary process, but it is weak on specifying which authority is accountable in cases of violations. There are provisions defining budget offences but none specifying budget offenders;
- In terms of enforcement, the Code is not explicit about how budget entities will be held accountable for implementing the provisions of the Code and what sanctions shall hold, should they violate the Code; and
- The Budget Code is an organic law but it does not have preeminence over other laws (i.e., priority status in the hierarchy of laws, like the Constitution does) so that its provisions can always been overturned by other legislation.

2.15 One disappointing omission is the fact that there is no provision indicating that the budget should be a strategic document for the country’s development or specifying what the general aims of budgetary policies are or linking the budget to general government goals. Further details of the new Budget Code are discussed below in Box 2.1.

Box 2.1: The New Budget Code

We review in this box the main features of the new organic budget law for Ukraine called the “budget code”. The section concerning intergovernmental fiscal relations is discussed in a separate chapter.

Transparency

Art. 7 (principles), 20 (budget participants) and 28 (publicity) contain general provisions on openness and transparency. Article 28 specifies that the MOF shall publish the draft budget in the government newspaper Uryadovy Courier within 7 days of its submission to the Verkhovna Rada. However, comparing with similar legislation in neighboring countries, the provisions on openness in the Polish law for example are stronger: a separate chapter is devoted to openness and budget debates of parliament and local self-government bodies have to be open.

Accountability

The main provisions are Chapter 2, Art. 7 and 11 (Principles of the Budgetary System); Chapter 4, Art. 26 (financial control and audit); Chapter 17, (control over compliance by various institutions) and Chapter 18, especially Art. 124 and 125, which determine penalties for budget violations. The law aims to establish clear responsibilities for the participants in the budgetary process. Art. 7, 11 specifies that they shall be accountable for their actions as well as their inactions. Art. 26 mandates that internal audits of on-going activities must take place. Art. 110 and several other articles give a strong role to the Accounting Chamber. However the budget code is weak on specifying which authority (what level of the administration) is to be held responsible in cases of violations. Two articles are devoted to specifying budget offences but none to defining budget offenders.

Budget Process

Procedures are comprehensively spelled out (in Chapters 4 to 10 of the new code). Art. 20-22 defines spending units, i.e., entities provided with the authority to receive budget appropriations. Art. 35 specifies that spending units
Box 2.1: The New Budget Code (continued)

shall prepare requests in accordance with procedures established by the MOF and that key spending units are responsible for the quality and contents of requests. The MOF is not required to announce approximate spending amounts per ministry early in the process. By contrast to section 25 of the 1995 law, there is no terminology such as "minimum necessary outlays" upon which spending units base requests: this is an improvement. Another improvement is that key spending units are asked to plan stressing results and efficiency (Art. 22, 4). Art. 38 specifies what the draft budget should contain. Art. 39 states that the Rada can reject the draft budget (before the first reading), if it does not comply with the Constitution or the Budget Code. This provision creates an additional political hurdle for getting the budget passed. Although the initiative of the MOF on setting overall revenues and expenditures is strengthened compared to the 1995 law (section 28), Art. 40 still leaves the Rada with the power to increase expenditures (or reduce revenues) as long as some offsetting proposal is provided. Art. 45 is a provision which gives the President the power to resolve the conflict with the Rada if the latter does not approve the budget within a certain time limit—if such a change in the constitution based on the April 2001 referendum were to be adopted. Art. 54 specifies what is to be done in case of revenue shortfall and, in effect, enshrines in the law the practice of cash rationing (sequestration). The MOF can unilaterally impose spending restrictions in case of monthly revenue shortfalls. In the case of quarterly revenue shortfalls of more than 15% of the approved budget, the CoM and the Rada have to agree on cash rationing in a rather lengthy process (a decision on cash rationing would be made approx. 10 weeks after the end of the quarter during which revenues fell short). There can be no spending restrictions on "protected items" which are not specified by the Code but presumably would include salaries and pensions. Finally, Chapter 10 considerably strengthens the provisions on accounting: the new code is far more specific on reporting procedures (timeframe, content, etc.) than the 1995 law (Art. 59-62).

Fiscal Discipline

The Constitution of Ukraine (Art. 95) specifies that "the state aspires to a balanced budget" and is thus declaratory. Art. 18 of the budget code introduces a restriction on total consolidated debt similar to the European Union's Maastricht Treaty stating that the principal amount of the debt must not exceed 60 percent of annual GDP. However it does not establish a clear mechanism to achieve this target and only states that the Cabinet of Ministers shall take appropriate measures to reach it. Several provisions establish specific limitations to borrow. Art. 15, 2 states that "The Cabinet of Ministers may borrow funds within the limits allowed by the State Budget Law. Borrowing should not be used to provide financial resources for the government's current expenditures, except for cases when this is needed to maintain the general economic balance." The latter part is formulated so weakly that any amount of borrowing is theoretically possible. The Rada has the power to increase the total size of the budget (Art. 40) which leads to the possibility of introducing more or less "realistic" increases in revenues if increased expenditures are desired. MOF may assent to such increases in the expectation that it can later cut expenditures when revenues fall short. However, Art. 40, 2 specifies that the Rada may not increase the deficit from what is suggested in the draft submitted by the CoM. This is somewhat in contradiction to Art. 43, 3 stating that the total amount of revenues and expenditures as well as the deficit is approved in the 2nd reading (and there is no clarification of what happens if the CoM and the Rada do not agree on a limit). Therefore, it is unclear whether the deficit is set from the very beginning by the CoM or whether it is subject to negotiation between the government and the Rada. Art. 72 deals with borrowing by subnational entities and specifies that local budgets may only borrow to cover capital but not current expenditures, and only those municipalities with more than 800,000 inhabitants may borrow abroad.
3. BUDGET PREPARATION

3.1 This chapter analyzes the budget preparation process and changes in spending proposals and revenue forecasts observed during the preparation stages (from Ministry of Finance to final vote in Parliament) for the years 1996-2000. It also highlights some technical and institutional shortcomings.

A. MAIN FEATURES OF THE BUDGET PREPARATION PROCESS

Division of Labor Between the MOF and MOE

3.2 For the preparation of the budget by the executive, current and capital budgets are prepared separately. The Ministry of Economy submits proposals to the MOF on the scope of public investments and financing needed for various State programs (on computerization, scientific research, etc). This division of labor complicates the process of drafting the budget as a single document with certain priorities and internal logic and requires a lot of coordination. This division of labor is also found within line ministries themselves. In the latter, separate departments are responsible for budget preparation—one for current expenditures and the other one for capital expenditures.

3.3 The Ministry of Finance prepares revenue projections and the current expenditure budget, while the Ministry of Economy is responsible for macroeconomic forecasting. While progress has been made in budget preparation at the macroeconomic level in recent years, further improvements in this area would require setting up spending limits based on Government priorities and finding mechanisms to enforce them, to improve coordination between the preparation of the current and capital budget, and to ensure coordination between the main actors of the budgetary process.

Sectoral Expenditure Policy

3.4 Line ministries and local governments prepare their request for funds based on norms and on the financing "needs" of the existing network of spending units (budgetary institutions). There is no mechanism to force them to take spending ceilings into account while preparing their applications. The Ministry of Finance is the institution which has to arbitrate the trade-offs resulting from the allocation of scarce financial resources—not the Cabinet of Ministers acting as a collegial body, nor line ministries who should be responsible for the efficient use of public resources in their sector. This reduces the linkage between policy goals and priorities of the government in individual expenditure areas.

3.5 In addition to macroeconomic considerations (ensuring that the budget constraint operates in the aggregate), the budget preparation process would need to focus on policy choices and evaluation of their fiscal implications. This would require a thorough analysis of how public funds are spent at the microeconomic level and what is the most effective way of achieving government's objectives in each sector—which does not take place.

Revenue Projections

3.6 Revenues forecasting is done by the Ministry of Finance based on various approaches depending on the type of revenue. In some cases, revenue forecasts are based on actual collection data for previous periods; in others, tax arrears are taken into account. Sometimes revenue projections are based entirely on macroeconomic projections, and sometimes they are a combination of the approaches mentioned above.
Revenue projections are based on effective tax legislation. However, in some cases they are based on changes and amendments of the current tax legislation without adjustment for possible effects on economic activities. There is little analysis behind projections on how amendments to the current legislation (such as centralization of depreciation deductions, introduction of free economic zones, etc.) would affect the behavior of economic agents and, thus, the level of tax collections. In addition, the Parliament sometimes increases (i.e., overestimates) revenue projections to match the overestimated expenditure levels they would like to adopt.

3.7 A comparison of revenue projections in the draft budgets submitted by the Government with those approved by the Parliament demonstrates substantial fluctuations. Figures 3.1 and 3.2 (as well as the more detailed Tables 1 and 2 in Annex I) show the fluctuations in revenue projections at various stages of budget preparation for the 2000 and 2001 budgets, respectively. The Ministry of Finance projected 20 percent less revenue for 2000 and 11 percent less for 2001 in the initial budget document than the final budget approved by the Verkhovna Rada. The Parliament increased both tax revenues and non-tax revenues, though the latter was a much more significant increase than the former. The most striking example of how the Parliament increased non-tax revenues was in the 1999 Budget: under the
pressure of the budget committee of the VR, gas transit collections were included into the approved budget at the remarkably high level of UAH 1.6 billions (almost 10 times the level suggested by the Government). Actual collections happened to reach the level of UAH 137 millions—very close to what the Government had projected.

**Bargaining for Expenditure Limits**

3.8 There is limited recognition of an aggregate budget constraint in the budgetary process. On the one hand, spending agencies systematically overestimate their needs and, on the other hand, several laws (or Presidential decrees or other legal acts) that significantly increase public expenditures are quite often adopted outside of the budgetary framework. Line ministries are aware of spending ceilings at the beginning of the budgetary process but do not perceive them as binding constraints. Rather, they submit proposals justifying higher spending levels based on the principle "the more you ask and the more you get". The process is also driven by bargaining and lobbying once the budget reaches the legislative discussion stage.

3.9 This is illustrated by Figure 3.3 which shows the stages of elaboration of the budget for 2000 and 2001. More sectoral details are provided in annex Tables 3 and 4. From beginning to end of the budget preparation process, total expenditures in the State budget increased by more than 45 percent. For some items (including health and education, which are to a great extent expenditures “mandated” by law with little discretionary power to exercise), budget allocations were very close to those proposed by the Government while, for other sectors (including construction, transportation and communication, state administration, social protection, and extrabudgetary “state special purpose funds”), expenditures increased dramatically between the governmental and legislative preparation phases. Some of them reflect priorities of the Government (social protection) but others contradict them (state administration).'

Figure 3.3: Change in Expenditure Proposals During Budget Preparation, 2000 and 2001

![Figure 3.3: Change in Expenditure Proposals During Budget Preparation, 2000 and 2001](image)

Stages of Budget Preparation: See Legend to Figures 3.1-3.2.

*Source:* Ministry of Finance Data.

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12 Each line item in tables A.3 and A.4 tells a different “story.” For instance, for construction, an amount 22 times greater than what was proposed has been approved by the Verkhovna Rada, while for education, health and social sectors, the amount is only 1.2 or 1.3 (because most of the expenditures in the budget for those sectors are wages and salaries for services that are mandated by law). It is beyond the scope of this PEIR to analyze each sectoral story in details.
State Programs

3.10 Many unfunded State programs are created by law. This legislation on State programs creates a lot of problems for the budgetary process because it increases state obligations. There is little linkage between the legislative acts adopted by the Parliament that contemplate various state programs, the budgetary appropriations needed for their implementation and available public resources. They are usually lobbied by numerous groups with vested interests and neither public policy priorities nor available public resources are taken into account. In many instances, such programs become an important channel for public resource leakage and provide a substantial support to economic sectors which should finance themselves. Once these programs are approved by the Parliament, there is no practice in place to review existing legislation and stop some of the legal provisions in case of an (internal or external) change in conditions.

3.11 Figures 3.1-3.3 (as well as Annex I-Tables 1 to 5), which present the changes made in revenue projections and in expenditure proposals during the various budget preparation stages in 2000 and 2001, indicate clearly that there are no mechanisms in place to enforce financial discipline on the participants in the budgetary process and to allocate resources toward strategic priorities once the latter have been agreed upon in an open discussion in cabinet and in parliament.

B. RECENT IMPROVEMENTS INTRODUCED BY THE GOVERNMENT

3.12 Reforms require a strategic approach with the objective of moving toward the implementation of a performance-based budgeting system. Institutional mechanisms will need to be developed to oblige all major actors in the budget process to commit themselves to operate within a strict strategic policy and expenditure framework. Many OECD countries now operate within a Medium Term Expenditure Framework (MTEF). Annual budget decisions are made in terms of aggregate and sectoral limits on expenditures for three to five years. An MTEF provides a framework for the budget process focusing on the need to adapt policies to reflect changes in macroeconomic conditions as well as changes in strategic priorities of the government. Australia led the way in the MTEF movement during the 1980s by expanding its forward estimates into multiyear targets. In Australia, the MTEF was not grafted onto the pre-existing budget process, it became the budget process. Ukraine is gradually moving toward the adoption of such a framework and has taken some steps in that direction. It would be premature to put in place an MTEF similar to that adopted by OECD countries. Intermediate steps are necessary before reaching that stage.

3.13 Following the Address of the President to the Verkhovna Rada of Ukraine, the Action Program of the Cabinet of Ministers of Ukraine was adopted on April 29, 2000 (Resolution #747). It sets out a number of tasks regarding the application of medium-term planning principles in budgeting and the development of program-based budget planning including the development of three-year tax and budget forecasts and the structure of program classification of the state budget expenditures.

3.14 Prior to that, several significant steps were taken in the direction of program-based budgeting. In 1998, the MOF introduced budget request forms requiring key spending agencies to determine the main goal of their activity, key tasks for the planned year, as well as to provide an analysis of the results achieved during the previous budget year, the expected results for the current year, and a justification for allocation of the amounts by function and areas of activity. Separate names of functional classification codes were applied for a certain number of key spending agencies. This can be regarded as the

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introduction of budget programs (discussed below). The spending agencies were given the possibility to redistribute their expenditures in order to prioritize them, both when preparing their budget request and, during budget execution, when compiling the rospis (budget implementation sheet).

3.15 For the 2002 draft state budget, a list of budget programs is being identified and a program classification is being developed. The budget request form is being improved and the MOF tries to ensure that it is correctly filled out by key spending agencies. Budget programs are prioritized by key spending agencies; some elements of medium-term planning are being applied and benchmarks for budget programs are being established. Finally, a list of indicators for monthly/quarterly reporting is being developed for key spending agencies. Moreover, the elaboration of the state budget for 2002 started much earlier than in previous years and will proceed according to the following steps, which are different from previous years.

Key Spending Units and Budget Programs

3.16 Since the 2000 budget, the number of key spending units (equivalent to budgetary chapters, covering the main organs of the State) has been reduced from 201 to 78. Despite this reduction in number, budget appropriations and management responsibilities are still not fully aligned with the range of programs in their designated sectors.

3.17 According to the new approach to budgeting adopted by the CoM, a budget program can be implemented only by one key-spending unit. The State programs (discussed in para. 3.11) that are of multi-sector nature or are implemented by several central executive power bodies (e.g., the national program “Children of Ukraine”) have to be divided into separate budget programs for the same key-spending unit. One important advantage of the new program approach is that it will now be possible to compare budget programs (by key spending unit, by one subsection of function classification, by types of activity, etc.). For example it will be possible to compare the volume of expenditures for training courses in different ministries and their effectiveness.

3.18 In terms of content, budget programs refer to a section of the functional classification. But unlike a function, which is a general category determining a specific area of government activity, a budget program has clear goals and tasks and measurable benchmarks are given for the outcomes that are expected from the implementation of this program.

3.19 The key spending unit must know how the outcomes of this program will be measured. This can be done quantitatively or, if the goal of the program is complicated and/or cannot be expressed quantitatively, qualitatively. In the latter case, “outcome” means (a) the possibility to effectively carry out its functions; (b) direct product (goods or services); (c) whether society or some categories of population (youth, pensioners, etc.) benefited from the final product; (d) number or category of population which are the beneficiaries of the final product; and (e) changes that can be caused by the implementation of the program.

For example, МНС – КФКВ 210112 “Identification and destruction/desarmament of the remnants of chemical weapons sank in the exclusive (marine) economic zone of Ukraine”, or the Derzcomstat program—КФКВ 010501 “Conducting statistical studies and censuses.

Budget Programs are discussed below and Budget Classification is discussed in details in the Annex I-Table 8.

This section draws on work done by A. Maksiuta, Director of the Budget in the MOF, and his staff, with assistance from Viktor Zafra, US Treasury Adviser.

See Annex I-Table 8 on Budget Classification.

The budget program name itself describes the activity for which budget funds are spent. For example, the program “Training of specialists for agroindustrial complex in higher education establishments” refers to one function “Education” and subfunction “Higher education” and the name of this program discloses the main content of the action (program).
The program approach to budgeting adopted by the Government of Ukraine will introduce several new elements in the budget process, which should improve it significantly:

- Budget allocations for key spending agencies will be prepared and approved on a program-by-program basis. (Currently they are approved in accordance with the existing budget expenditure functional classification);
- The new procedures should force participants to specify an overall medium term objective, as well as short-term objectives and specific tasks for the programs;
- The prioritization done by each key-spending unit for its budget programs will need to be consistent with the functional objective and tasks set for the spending agencies by laws and normative acts;
- The approach will introduce a modicum of medium-term budget planning: when determining its expenditures, each key spending unit will have to evaluate the budget resources that are needed and available to continue the program in subsequent years, as well as the expected results and the future impact of the program;
- The approach will allow the development of performance criteria to determine whether expected outcomes are achieved, effectiveness is satisfactory and volume of expenditures is met;
- One entity will be accountable for the implementation of each program (either a sub-unit of the ministry, agency or body subordinated to it) and, accordingly, should bear full responsibility for its implementation; and
- The new procedures should facilitate reporting by key spending agencies of outcomes achieved in the process of implementing the respective budget programs.

However, moving to a longer-term budgeting approach is a complex task which would require a shift in the way budgeting is currently done in Ukraine. As the experience of OECD countries shows, success hinges on several factors, including:

- Political agreement at the highest political levels of the State—budget committee of the Verkhovna Rada, Presidency and Cabinet Committee on Economic Issues—and commitment mechanisms that the parties involved in approving the budget will abide by the difficult decisions involved;
- Willingness to subject policy decisions with financial implications, made outside the budget process, to the discipline of the MTEF;
- Understanding of, and commitment to, the difficult decisions at the line ministry level;
- Political commitment and endorsement at the Cabinet of Ministers level—the highest level in government—to make and abide by the difficult decisions involved in the restructuring of expenditures. Some ministries may need to scale back their activities so that more resources can be directed to higher priority sectors;
- Commitment at all levels to abide by the budget decision so that new expenditure decisions are not introduced during budget implementation that would require reallocation of resources;
- Improvements in expenditure control so that decisions are not undermined by over-expenditures and reallocation of funds during budget implementation; and
- Improved macroeconomic management and revenue collection so that revenue shortfalls do not necessitate adjustments to the budget estimates; and improvements to expenditure reporting on results.

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4. BUDGET EXECUTION

4.1 This chapter discusses issues related to budget execution including the functioning of the new treasury system. It analyses budget variations, i.e., the differences in planned and executed budgets and describes the problems related to previous budget execution procedures and the improvements, changes made and outstanding issues to be addressed.

Variations in Planned and Executed Expenditures

4.2 There have been substantial differences between the approved and executed budget during the last five years. Until 1999, aggregate expenditure approved by the Verkhovna Rada was under-financed, i.e., financed only partially. The level of financing has varied between 87 and 98 percent for the consolidated budget (73-84 percent for the state budget). In 2000, aggregate expenditure has been over-financed in the sense that expenditures exceeded forecasted revenues by 11 percent.

4.3 One important reason for the poor execution of the budget is the mismatch between assigned responsibilities and revenues, particularly at the local level (see Table 4.1). During 1996-2000 there was systematic over-spending at the local level, and this was compensated (except in 2000) by under-spending at the central level. Subnational governments do not have the necessary resources to finance adequately the existing network of public institutions (wages in public sector and social contributions, purchasing of food and medicines, transfers to the population etc). As a result, budget arrears accumulated at the subnational level.

4.4 Because of the revenue shortfall until 2000, average expenditures have accounted for only a fraction of the planned budget, for instance 92.2 percent in 1997 (see Table 4.1). However this average figure masks the fact that some of the items were substantially over-financed (housing and community affairs by 180 percent in 1997, state administration 123 percent, physical culture and sports 120 percent, education 118 percent, etc.) while, at the same time, other items were seriously under-funded (international activities 44 percent, protection of environment 55 percent, basic research 78 percent, etc.). This illustrates that budget priorities have been substantially modified during budget execution.

Figure 4.1: Budget Execution (in Percentage of Approved Budget)

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20Internal and external control are discussed in the companion Country Financial Accountability Assessment (CFAA).
4.5 In terms of share in total expenditures, some expenditure categories have been very stable during 1996-1999, while others have been rather unstable both over time and in comparison to what had been planned. Among the most stable ones are health care, justice, law enforcement and state security, while international activities, national defense and state administration are among the least stable. Overall, the standard deviation between planned and executed budget shrinks from 4.95 in 1996 and 5.47 in 1997 to 4.03 in both 1998 and 1999. Despite some fluctuations in the level of budget execution for various items, it is obvious that “protected items” (meaning wages and salaries) have been the priority. The so-called “protected items” in the budget have been financed fully and on a priority basis. Annex I-Table 7 shows budget execution in 2000, looking at the economic classification of expenditures.

4.6 Turning now to the financing of the budget on a monthly basis, the data show that there has been a dramatic change in the financing of the budget in 2000 as compared to previous years. Annex I-Figures 1-4 show budget execution on a monthly basis and Annex I-Tables 9 and 10 compare budget execution with the rospis, i.e., the budget implementation sheets. In 1999, all expenditure items were systematically under-financed until September or October. Then, in the last quarter, they received more financing than planned (in order to partially pay civil servants and suppliers). In 2000, the monthly profile of budget execution (shown in Annex I-Table 10) improved greatly.

4.7 However, resource management exhibits great similarities in 1999 and 2000. First, a substantial acceleration in budget execution takes place at the end of each quarter (and especially at the end of the year) related to an increase in the inflow of funds. Second, some functional budget categories are systematically “over-financed” (e.g., defense, state administration, state security and law enforcement). Surprisingly, in 2000, even education appeared to be among the most over-financed items.

### Table 4.1: Budget Execution in 1996-2000, State and Local Budgets, Mln UAH

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidated Budget:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approved</td>
<td>39,008</td>
<td>36,180</td>
<td>33,142</td>
<td>35,492</td>
<td>42,323</td>
</tr>
<tr>
<td>Executed</td>
<td>34,183</td>
<td>33,345</td>
<td>30,506</td>
<td>34,821</td>
<td>48,148</td>
</tr>
<tr>
<td>%</td>
<td>87.6%</td>
<td>92.2%</td>
<td>92.0%</td>
<td>98.1%</td>
<td>113.8%</td>
</tr>
<tr>
<td><strong>State Budget:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approved</td>
<td>27,715</td>
<td>25,292</td>
<td>21,980</td>
<td>22,005</td>
<td>36,263</td>
</tr>
<tr>
<td>Executed</td>
<td>22,422</td>
<td>19,759</td>
<td>15,969</td>
<td>19,005</td>
<td>35,533</td>
</tr>
<tr>
<td>%</td>
<td>80.9%</td>
<td>78.1%</td>
<td>72.7%</td>
<td>83.7%</td>
<td>98.0%</td>
</tr>
<tr>
<td><strong>Local Budget:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Approved</td>
<td>11,293</td>
<td>10,889</td>
<td>11,163</td>
<td>12,783</td>
<td>13,678</td>
</tr>
<tr>
<td>Executed</td>
<td>11,761</td>
<td>13,586</td>
<td>14,538</td>
<td>15,816</td>
<td>18,417</td>
</tr>
<tr>
<td>%</td>
<td>104.1%</td>
<td>124.8%</td>
<td>130.2%</td>
<td>123.7%</td>
<td>134.6%</td>
</tr>
</tbody>
</table>

Source: The Ministry of Finance.

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21 Alex Sundakov, personal communication.
4.9 Cash rationing was first introduced in late 1994 as an emergency measure to deal with hyperinflation. While cash rationing is an effective tool in the very short term, once retained for more than a few months it becomes extraordinarily destructive and dramatically reduces its efficiency. In fact, it keeps generating the very crisis it is trying to address. There are two reasons for this. First, cash rationing divorces the underlying fiscal policy from the budget that is presented to Parliament, removes Parliamentary oversight and gives the government considerable discretion over spending priorities. The officials involved along the entire chain of command gain in stature and power from the exercise of discretion. Second, it creates an extreme disincentive for the administrators of spending programs to adjust their policies. Cash rationing means that payments tend to be directed towards “hot spots”. One can generate a hot spot by accumulating large unpaid claims on the government. Consequently, the best strategy for the manager of a program is to change as little as possible, and to keep accumulating claims. A manager who attempts to learn to live within the available budget does a disservice to his organization, because it reduces the likelihood and the frequency of receiving funds. As a result, cash rationing prevents fiscal reform.

Budget Execution Procedures After 1999

4.10 Budget execution improved after 1999. One major factor which has contributed to this improvement is the introduction of a modern Treasury system. The development of the Treasury seems

<table>
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<th>Box 4.1: The Treasury System</th>
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Budget execution functions formerly carried out by the financing departments of the Ministry of Finance have been gradually taken over by a new Treasury system which is operational since 1999. The State Treasury started taking over budget execution functions in 1997. The State Treasury is gradually upgrading its functions as a government paymaster, accountant, and cash manager. The existence of the new treasury system appears to have improved budget execution.

Coverage. Over the 1997-2000 period, the Treasury system has been gradually extended to cover all central government budget operations, including former extra-budgetary funds and off-budget revenue activities of the central government institutions. Treasury coverage here means full banking and accounting controls over the operations initiated by government institutions. The operations that are currently outside full Treasury coverage include Customs, selected national security related agencies, Pension Fund, and Social Insurance Fund. The Treasury has begun extending its coverage to local budgets. Under a separate pilot, local governments of Dnipropetrovsk and Cherkasy oblasts are covered by treasury local budget execution system since July 1999. The adoption of the Budget Code provides a legal basis for extending treasury coverage to all local budgets of Ukraine. Treasury coverage of local budget execution will allow uniform application of expenditure and procurement control regulations as well as timelier information to both local and central governments about the fiscal position of any level government budget in Ukraine.

Since the 2000 budget, the Government of Ukraine has substantially strengthened the budget implementation process. Former off-budget activities of budgetary institutions and most extra-budgetary funds have been covered by formal budget appropriations. The Treasury has become a central accounting system for all specific amounts of budget authority and subsequent changes introduced during the year. This has established the basis for initiating commitment registration and controls in treasury offices, which took place in early 2001. The new commitment registration procedure complements treasury accounting controls performed during the payment process and facilitates the enforcement of government procurement regulations. However, this procedure should be improved to establish good internal controls for all expenditure stages, including: (i) registration of appropriations, (ii) establishing individual spending unit budgets and subsequent changes to these budgets, (iii) registering and controlling commitments, (iv) registering vendor’s invoices; (v) verifying receipt of goods and services, (vi) registering and settling payment requests.
Cash Management. Periodic cash releases are performed by the Treasury in consultation with the Minister of Finance. This result in accumulation of treasury cash balances with the banking system. The Treasury has initiated establishing an internal payment system and processing all payments through a single correspondent account with the NBU for a region in order to establish a new technical basis for improving treasury cash management. Two regions have launched pilots to channel all payments and collect all receipts through a single correspondent account with the regional office of the NBU. During 2001 the Treasury should complete implementing the internal payments system in all regions of Ukraine and initiate activities for concentrating all banking transactions through a single correspondent account at the central level. After reaching the objectives of cash pooling in order to reduce the net long-term interest cost of servicing government financial assets and liabilities the Treasury will continue to face the task of establishing appropriate instruments for managing treasury liquidity, making and liquidating short term financial investments.

Budget Classification, Accounting and Reporting. The treasury-based government accounting system meets the periodic fiscal reporting requirements reasonably well. Monthly fiscal reports for the operations of state budget and local budgets are produced about 20 to 25 days after end of month. Fiscal reports produce information that is GFS compatible. The reporting system has been upgraded to accommodate monthly and quarterly data on accounts payable and accounts receivable of government institutions. The latter does not yet cover the accounts payable and accounts receivable not clearly assigned to government institutions.

The reporting system on budget institutions commitments is emerging and still lacks data on other expenditure stages. Despite the recent progress in improving the accounting system it still does not meet the reporting requirements consistent with international accounting standards. The treasury chart of accounts evolves in a manner that is very different from the chart of accounts for budget institutions. The treasury chart of accounts is compatible with the chart of accounts of the banking system, while the chart of accounts for budget institutions evolved from the old soviet pattern into one consistent with the international and national accounting standards. In the future incompatible charts of accounts will complicate producing good quality consolidated financial statements for the Government of Ukraine. Most deficiencies with the new treasury chart of accounts emerge in recognition of assets and liabilities, treatment of revenue and expenditure according to the rules of cash basis of accounting.

Since 1999 the Treasury is establishing a computerized transactional Treasury Ledger System, which would serve as the accounting backbone for the Government Financial Management Information System. The GFMIS will be based on the new chart of accounts and allow registering initial budgets and subsequent changes, cash allocations, transactions related to stages of expenditures, post receipts against respective heads of accounts, performing basic accounting functions, produce reports for the treasury and budget management, as well as auditing purposes. Currently, the basic TLS is operational at the level of Oblast and Rayon treasury offices. It is fully consistent with the functionality of the treasury internal payment system to operate through correspondent accounts with the NBU. Improvements in the TLS functionality and procurement of computer and communications equipment and system software will allow putting a fully functional system in place by the end of 2001.

Implementation of a centralized government payroll system would remain one of priorities following more urgent tasks to be competed during 2001 and 2002. Before shifting the focus on establishing a payroll system current tasks of the Treasury development should be completed first, including the countrywide rollout of the computerized transactional TLS, covering all expenditure stages with the centralized accounting arrangements, concentrating government banking, improving the cash management system, and extending treasury coverage to remaining outside the Treasury extra-budgetary funds, government agencies and local budgets. Implementing an automated payroll system would allow making direct deposits on employee bank accounts instead of cash payments and reducing reliance on physical movements of cash. Currently the Treasury checks and validates the payroll calculation made by a budget institution. Implementing a centralized payroll system operated by the Treasury would involve taking away from individual spending units a substantial part of their functions and reducing workload on their staff. This reform would require both changes in legislation and strengthening the banking system. Moreover, most employees would need to regain faith in bank services to give up receiving their payment in cash.

Sources: Janis Platais, IMF Treasury advisor, personal communication, and World Bank, Treasury Project supervision missions.
to have progressed in a satisfactory fashion from the technical point of view. For an overall assessment, see Box 4.1. The Ministry of Finance still has problems ensuring on-line access to the fiscal performance information that the Treasury provides on a monthly basis to the staff in the budget departments of the MOF and line ministries. Despite the latter, the volume of information requests continues to grow irrespective of the cost of producing it. Unpredictability here causes excessive staffing at the Treasury offices and increases in the cost of performing and registering transactions.

4.11 The commitment control system is not yet operational. This can lead to situations in which spending units sign purchasing contracts for goods and services for amounts that exceed their appropriations. This has the effect of increasing accounts payable but it is difficult to distinguish between accounts payable within appropriations and those that exceed assigned levels. Moreover, there is no proper mechanism of tracing those who are responsible for overspending of public resources and holding them accountable. The State Treasury has introduced a system of commitment controls on January 1, 2001 but, it seems, on paper only. It is not part of the day-to-day practice of the spending units.

4.12 Cash management in the public sector has improved but is still not efficient. To control spending, since 1999, the release of funds is performed by the Treasury in consultation with the Minister of Finance and is done on a weekly basis. Funds are allocated to spending units proportionally to budget appropriations based on a budget implementation sheet (rospis) prepared by the higher echelons of the Ministry of Finance. In other words, when assigning funds, commitments made by the spending units are not taken into account. This cash management system is an improvement over the drastic day-to-day cash rationing system used before but it remains inefficient because (a) the rospis leaves the door open to discretionary bargaining, and (b) it results in accumulation of unnecessary cash balances with the banking system. Cash balances during the period January 2000 – March 2001 are shown below in Figure 4.2.

Figure 4.2: Cash Balances on the Accounts of Central and Local Governments, in UAH Thousand

4.13 In the course of 2000, the cash balances of the consolidated budget increased monthly by UAH117.8 million, i.e., almost 10 percent in comparison with their initial level. During 2000 cash balances increased almost threefold. The cash balances of extrabudgetary funds accrued at the highest rate (UAH66.7 million per month) followed by cash balances of local budgets (UAH36.1m. per month).
In absolute terms, cash balances of the central government increased the most (UAH81.7m per month), although in relative terms their rate of increase is the slowest one. This trend cannot be explained solely by an increase in budget revenues and expenditures, since—compared with 1999—revenues increased by 12 percent while expenditures of the state budget increased by 36 percent. At the same time, both revenues and expenditures of local budgets dropped by 12 percent.

4.14 There are three major factors responsible for the increase in cash balances in Treasury accounts.

4.15 The first one is technical, and is related to the slow transfer of funds from taxpayers to spending units. The process starts when taxes are paid to commercial banks and funds are transferred to the regional department of the NBU, and later on to the oblast department of the NBU. That process takes at least one day. Funds can then be further transferred to the State Treasury account with the NBU only the following evening. Despite the fact that taxes are transferred to the Treasury account with the NBU in a slow manner, cash balances are still increasing. It takes 3 to 5 days to allocate the funds from the Treasury accounts of the line ministries to the spending units of the second level. In general, the process lasts the whole week and funds are circulating in the system first “bottom-up” and then “top-down”, which results in stocks being accrued at each level.

4.16 Another factor is the introduction of the new procurement law and procedures requiring that expenditures be made solely on a competitive basis and tender purchases usually last for 3-4 months. The precondition for starting a tender procedure is to have money sitting in the account of the spending unit up front, which means that this money will be used neither by Treasury nor by spending unit. This could cause cash balances to increase.

4.17 The third reason is the use of the rospis (budget implementation sheet). Using the rospis to allocate funds to spending units means that commitments made by the spending units are not taken into account when assigning funds. Cash balances can start accruing when a spending unit cannot spend all the funds received under the rospis or when the allocations given are not enough to finance certain expenditure items such as wages.

4.18 Inappropriate budget execution is exacerbated by poor resource management which results from the difference between flow of funds (i.e., cash payments to finance certain expenditures) and flow of appropriations (i.e., assignment of control rights to a spending unit to be able to use certain amount of public funds instead of transferring the funds themselves). When spending units are not given the right to reallocate resources from other sources (e.g., special funds resources or funds at their accounts assigned for other purposes) to finance their urgent needs when expecting transfer of funds from the Treasury according to assigned appropriations, this can result in further accumulation of cash balances and create cash gaps at the same time. Under such conditions it is impossible to reallocate funds—either between the spending units or between different expenditure items.

4.19 Until late 2000, only a relatively small portion of revenues was collected in cash and there was widespread recourse to in-kind and offsetting operations in budgetary accounts, creating serious constraints for orderly budget execution. These budgetary offsets had three negative fiscal implications: (a) they distorted the priorities of government expenditure policy, (b) they distorted the revenue structure by creating a sizeable “hidden part” which is different for different taxes, and make revenue projections difficult, and finally (c) they created perverse incentives for taxpayers. The practice of budgetary offsets was partially eliminated in 2001.\footnote{The practice was first prohibited by Resolution of the Cabinet of Ministers in June 2000 except for a limited number of cases. A new mechanism of mutual settlements was then used (in the form of one-day loans issued mainly to energy distribution companies by commercial banks, which allowed transparent budget offsets to clear the stock of arrears, based on a valid credit instrument). Although the new mechanism effectively assumed the use of cash transactions and reduced substantially the stock}
the use of offsets in the future. However, there were numerous appeals to the Ministry of Finance to allow energy companies to compensate their tax arrears at the expense of energy privileges and subsidies to households financed from the budget. Even though it is prohibited by the 2001 Budget Law, there might be a serious pressure to adopt special Government decrees to allow such transactions in special cases.

4.20 This chapter indicates that there are still deficiencies in the execution of the budget. Some of these deficiencies should be overcome with (a) the adoption of the Budget Code (which should facilitate upgrades in the budget process), (b) clarifications in determining information requirements, and (c) the completion of the Treasury accounting and fiscal reporting system to allow the latter to operate in a useful and cost effective manner. However, in the future, budget reform should also address the balance between the centralized treasury controls and the responsibilities of the heads of financial management of the various budgetary institutions.

of budgetary and tax arrears, in its nature it was still a netting operation with all the negative fiscal implications. In 2000, the scope of such operations reached the level of 7.5 billion and incentives remain in some sectors (especially, energy) to increase tax arrears in order to qualify for the new offset mechanism.
5. INTERGOVERNMENTAL BUDGETING

5.1 Important changes in the way budgeting is carried out between different tiers of government were introduced in 2001. These new intergovernmental fiscal relations are discussed in this section. Lower levels of government now have more incentives than under the previous system to raise their own revenues and to spend more effectively.

5.2 In Ukraine, financing to subnational governments is mostly provided through transfers passing in 'cascade' fashion through the oblast, then the rayon, to the city, settlement or village. The amount of transfers for each local government level was determined by assessing the minimum expenditure “needs” of the existing network of public sector facilities. Key decisions concerning staffing and material norms for service provisions were made at the center but the responsibility for payments rested with the lower levels of the government. Since the sources of revenues assigned to local budgets were, in most localities, insufficient to finance prescribed expenditures, growing shortfalls developed. They were covered by subsidies which were “negotiated” politically by mayors and governors, or resulted in arrears. Local governments were given a lot of expenditure responsibilities but were not given sufficient funds to accomplish these tasks. Arrears thus accumulated. (see Table 5.1).

Table 5.1: Arrears of Budget Institutions Accumulated at Central and Local Levels, 1998-2000

<table>
<thead>
<tr>
<th>In million UAH</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State Budget</td>
<td>Local Budget</td>
<td>State Budget</td>
</tr>
<tr>
<td>Arrears</td>
<td>2553</td>
<td>2878</td>
<td>2831</td>
</tr>
<tr>
<td>Arrears in Education Sector</td>
<td>418</td>
<td>883</td>
<td>442</td>
</tr>
<tr>
<td>Arrears in Health Sector</td>
<td>47</td>
<td>680</td>
<td>92</td>
</tr>
<tr>
<td>In % of Total Arrears of the Corresponding Budget</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arrears, %</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Arrears in Education Sector, %</td>
<td>32</td>
<td>68</td>
<td>41</td>
</tr>
<tr>
<td>Arrears in Health Sector, %</td>
<td>2</td>
<td>24</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.

5.3 Until 2001, there were virtually no incentives at local level to collect revenue or to spend effectively because every marginal hryvnia of own revenues raised locally was offset by a reduction in the share of central taxes received from the government. The most striking example was the city of Khmelnytskyi, where the municipal government had managed to substantially raise revenues from local taxes (especially from market fees). Local taxes amounted to 10 percent of the city’s overall revenues while the Ukrainian average share of own revenues in total local revenues amounts to only 4 percent. The Khmelnytskyi municipality was “punished” for its efforts by a proportional reduction in the share of central taxes that it was allowed to retain.

5.4 When fiscal incentives are strong—i.e., if an increase in the local tax base results in a nearly equal increase in budgetary revenues—governments can easily increase their tax base without having to pursue predatory policies toward private businesses. In contrast, if fiscal incentives are weak so that the local government’s ability to increase its marginal revenue by increasing its tax base is close to zero, budget revenues are not affected by changes in governmental policy toward business. Economically unjustified political intervention into business, such as excessive regulation and governmental subsidies to large inefficient enterprises, lowers the governmental tax base. In a system with stronger local fiscal
incentives, one should observe smaller subsidies, more benign regulation, and higher growth than in a system with weaker fiscal incentives. In addition, stronger fiscal incentives should lead to higher efficiency in providing public goods, because a smaller portion of public expenditures is wasted.

5.5 The Ukrainian system of intergovernmental finance until 2001 embodied weak fiscal incentives but also had other shortcomings. First, sub-national revenue sources were limited to the taxes that had little or no growth potential. Second, the system was very unpredictable. Local authorities had great difficulties planning their spending because there were large variations in retention rates for major taxes from year to year, with corresponding fluctuations in budgetary transfers defined in each year budget law. Transfers are used to achieve revenue equalization objectives. Their overall level and allocation across oblasts changed annually to reflect the variations in revenue-sharing schemes. The lack of objective and predictable rules and principles for determining tax sharing rates and the amount of subventions undermined the equalization goal, and placed all levels of local budgets at the mercy of political decisions made at higher levels.

5.6 Ukrainian local governments have significant expenditure responsibility. A high share of expenditures was and still is carried out at the sub-national level, and varies widely across sectors. Almost three-quarters of all local expenditures go to education, health and social protection (Table 5.2).

Table 5.2: Local Expenditures, 1998-2001

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001 plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of Local Expenditures in Consolidated Government Expenditures, % of Total</td>
<td>48</td>
<td>45</td>
<td>36</td>
<td>32</td>
</tr>
<tr>
<td>Share of Local Expenditures as % GDP</td>
<td>14</td>
<td>12</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Share of Local Expenditures for Different Sectors, In % of the Consolidated Budget for that Sector</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>90</td>
<td>91</td>
<td>85</td>
<td>78</td>
</tr>
<tr>
<td>Education</td>
<td>76</td>
<td>74</td>
<td>62</td>
<td>61</td>
</tr>
<tr>
<td>Social Protection (excluding Pensions)</td>
<td>68</td>
<td>63</td>
<td>55</td>
<td>66</td>
</tr>
<tr>
<td>Housing and Communal Services</td>
<td>99</td>
<td>99</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: The Ministry of Finance.

5.7 The responsibilities assigned to each level of government were unclear until recently. Faced with budgetary difficulties, the central government has tended to put lower echelons of government in a situation where they have to make the most unpopular funding cuts. Similarly, oblasts shifted the responsibility for many expenditures to the rayon and city governments. This has resulted in a situation of "unfunded mandates" in which the responsibilities of local governments do not match their decision-making authority nor their resources to finance them. For example, social allowances and the social safety net, since 1994, have been funded on a highly decentralized basis. Policies are determined at the

23 Own revenues sources of local government include taxes on motor vehicles, payments for water employed by industry, utility fees, revenues from privatization of communal property and other non-tax revenues (hotel occupancy, parking fees, pet licenses, advertising, lotteries, auctions, market stall rentals, etc etc.)
24 Revenues from national taxes and levies are shared between the central and sub-national governments. The tax retention rates, i.e., the proportion of the taxes collected within their boundaries that the regions are allowed to retain, are set annually in the Budget Law. Oblasts assign a proportion of their respective tax-sharing rates to their subordinate governments, which in turn do the same to the cities and settlements subordinated to them. Retention rates, historically, have varied considerably since independence depending on the type of tax (value-added tax, personal income tax, enterprise income tax, and excises) and on the percentage shared between state and oblasts budgets as well as within oblasts themselves. For example, in 1998, both value-added tax and excise duty on goods manufactured in Ukraine were revenues of the State budget, whereas enterprise income tax and personal income tax went in full to local coffers. In 1999, personal income tax, enterprise income tax and excise duties were again distributed among oblasts on the basis of differential retention rates. In 2000 and 2001, the personal income tax goes to local governments in full. Receipts from excises on goods manufactured in Ukraine and enterprise income tax were shared between the central and local budgets in 2000.
national level but the responsibility to finance social assistance programs have been shifted to the local level without allocating sufficient transfers. The mismatch between policy and expenditure assignment, on the one hand, and available revenues, on the other, for social protection has implied in practice that the amount of benefits provided to various needy population groups has varied substantially across rayons and cities, depending on the tax base, and that income disparities have increased.

5.8 Each oblast had the power to reassign expenditures between oblast, rayon and municipal governments. This resulted in a highly diverse pattern of sub-oblast expenditures across Ukraine. Differences in the distribution of fiscal responsibilities across oblasts are the result of economic and demographic differences but they are also the product of negotiations over time between different levels of government. There appeared to be a lot of confusion within oblasts over which level of government should pay for communal services.

5.9 The situation changed with the 2001 Law on the State Budget. In this law, the central government is assigned the responsibility for—judiciary activities, international activities, fundamental research, science and technology, national defense, state security, management of state stocks and reserves, state debt servicing, elections and referenda, assistance to regional development, and state investment projects. The financing of public administration, education, health care, social protection and social safety programs, culture, sports and law enforcement is shared by all levels of government. Cities, settlements and villages are entitled to finance preschool education within their boundaries. Municipalities under rayon authority are deprived of the responsibility for secondary education, which is now mainly financed by municipalities under oblast authority and rayon administrations. Vocational as well as higher education is the responsibility of state and oblast level governments. Medical aid stations with obstetric services are financed by local self-governments while general hospitals and polyclinics are generally financed by municipalities and rayon administrations. The financing of specialized polyclinics and hospitals is the responsibility of the oblast government. The central government is responsible for sanitary epidemiological services and medical research institutions. Cities under rayon authority, settlements and villages are not financing any activities in the area of law enforcement.

5.10 The reform of intergovernmental fiscal relations begun with the Law on the 2001 State Budget continued with the Budget Code. Intergovernmental transfers are channeled down to the oblast, rayon and city level but the amount of the transfers is calculated using a uniform methodology known in advance to all participants. The same formula has to be applied for intra-oblast transfers to rayons and cities. Oblast governors are no longer able to tailor rayon and city budgets as they wish. The suggested transfer method makes budgetary planning for rayons and cities under oblast authority more transparent and predictable. Budget planning of cities under rayon subordination, however, remains at the total discretion of rayon chief officials.

5.11 The methodology introduces a uniform formula that subtracts a measure of local budget’s revenue capacity from a measure of its expenditure needs. The difference constitutes either a transfer to

\[ \text{Transfer} = \text{Expenditure Needs} - \text{Revenue Capacity} \]

\[ \text{Revenue Capacity} = \text{Assigned Revenues} + \text{Own-Source Revenues} \]

\[ \text{Expenditure Needs} = \text{Shared Taxes} + \text{Fixed Agricultural Taxes} + \text{Other Own-Source Revenues} \]

\[ \text{Assigned Revenues} = \text{Personal Income Tax} + \text{Land Tax} + \text{Stamp Duty} + \text{Fines and Penalties} \]

\[ \text{Fixed Agricultural Taxes} = \text{Communal Property Tax} + \text{Boarding School Fees} \]

\[ \text{Other Own-Source Revenues} = \text{Proceeds from Privatization} + \text{Boarding Schools’ Fees} \]

\[ \text{Shared Taxes} = \text{Shared Income Tax} + \text{Shared Land Tax} + \text{Shared Stamp Duty} + \text{Shared Fines and Penalties} \]

\[ \text{Fines and Penalties} = \text{Violations of Tax Legislation} + \text{Small Business Flat Tax} \]

\[ \text{Proceeds from Privatization} = \text{Sales of Communally Owned Non-Agricultural Land Plots} \]

For example some municipalities are still financing activities that are strictly assigned to the national government, such as defense and justice. Their expenditures cover military registration and enlistment offices or building housing for prosecutors. On the other hand, financing of some expenditures which are typically local, e.g., the kindergarten network, is still the responsibility of the central government.

In order to estimate local budget revenue capacity, assigned revenues and own-source revenues are measured. Assigned revenues include (i) shared taxes (personal income tax, land tax, stamp duty, fee for issuance of license, state registration fee, trade patent fee, fines, penalties for violation of tax legislation, and small business flat tax); (ii) receipts from a fixed agricultural tax for the local budget; and (iii) proceeds from the sale of communally owned non-agricultural land plots. The basket of shared taxes is estimated on the basis of actual revenues for 1998-1999 and the first ten months of 2000. Local taxes and levies, of which most important are proceeds from privatization of communal property and boarding schools’ fees, constitute own-source revenues for local budgets. In transfer formula for the year 2001 revenues from local taxes and levies were estimated based on the respective data of the past year budget plan multiplied by 0.75. Since local self-governments are entitled to the proceeds from
Main Advantages of the New System

5.12 Based on the first six months of implementation of the intergovernmental reform, it is possible to make the following preliminary remarks:

- The formula approach to determine intergovernmental transfers contained in the new Budget Code is supported by many local governments;
- Observed changes in the distribution of budget resources among different types of subnational governments correspond to changes in their expenditure responsibilities thus contributing to a higher degree of accountability of local governments;
- Greater equalization of planned per capita expenditure resources is observed among cities and rayons;
- Use of formulas for determining transfers has resulted in more timely preparation of budgets by local governments; and
- Use of formulas provides better incentives for revenue mobilization by local governments. Although it is difficult to provide measurable evidence, the new system also provides better incentives for expenditure economy.

There are four positive elements in the new intergovernmental fiscal system.

Revenues in Excess of Annual Targets are Shared

5.13 In 2000, revenues collected in excess of what was projected were shared equally between the oblast and the state. This allowed, for instance, the Sumskas and Chernihivskas oblasts and the city of Sevastopol to obtain substantial additional revenue (UAH 80, 16, and 5 million, respectively). In fact, Sumskas oblast improved its per capita expenditure ranking from 23-27 to four. However, in 2000, within the oblast, sharing of excess revenues remained subject to bargaining between government authorities of different levels.

5.14 Because of that, city mayors put pressure to extend the provisions regarding sharing excess revenues between the oblast and sub-oblast budgets. As a result, Article 45 of the 2001 Budget Law states that revenues in excess of annual targets are distributed among the State and lower level budgets according to the following allocative scheme: 50 percent is going to the State budget, 12.5 percent to oblast budgets and 37.5 percent to city and rayon budgets. Rayon-subordinated cities (which are in fact the main tax providers) are entitled to 15 percent of the share assigned to rayon budgets, which means they will cease to beg rayon administrations for funds. It is likely that the new approach will help to revive small and middle towns’ interest in developing their own tax bases.

5.15 The new system represents an incentive for municipalities to increase revenues from personal income tax. For the first time oblasts have incorporated fixed personal income tax retention rates for cities and rayons in their budgets. If actual tax collections exceed annual targets, then 75 percent of the

the sale of communally owned non-agricultural land plots on their territories, this means intensifying the market for land, and strengthening local self-government financial sustainability.


28The Crimean Republic has a share of 62.5 percent

32
surplus will go to the budgets of cities and rayons, whereas the remaining 25 percent will be forwarded to
the respective oblasts’ budgets.

**Shift Towards More Realistic Budget Planning**

5.16 Before 2001, in the initial stage of annual budget planning, oblast governments never bothered
much to provide the Ministry of Finance with realistic and accurate estimates of their budgets. Moreover,
during bargaining at the oblast council in Kyiv, governors argued that the revenues projected for their
oblasts by the MOF were overstated. Having convinced the Ministry to lower their revenue projections,
however, oblasts regularly exceeded these projections at the end of the year by 10 to 50 percent. For
instance, the difference between the Ministry’s projections and those approved by the oblast council
amounted to UAH 1 billion in 1999 and UAH 3 billion in 2000. Municipalities suffered the most from
these tricks: to execute their boosted budgets, oblasts either increased their share of taxes or cut transfers
to subordinate cities.

5.17 Since the 2001 Budget, local revenues are calculated with a uniform formula, and the Ministry of
Finance and the financial departments of each oblast use the same transparent calculations. Local
communities will do their best to develop their tax bases.

5.18 There is still a disincentive to develop local tax efforts in 2001 because local own revenues have
not been excluded from the transfer calculation despite strong local pressure. Hence every transfer
hryvnia is to be offset by a hryvnia of additionally collected revenues. Local self-governments would
hence think twice before they decide whether to raise their own revenues. This issue is addressed by the
Budget Code.

**New Approach to Estimating Local Expenditures**

5.19 The 2001 Budget Law stipulates that expenditures should no longer be input-based (i.e., based on
the “needs” of the existing network of service-providing public institutions) but rather be related more
directly to outcomes. Uniform per capita norms are used to calculate transfers. They are based on per
capita amounts (for public administration, health care, culture, mass media and sports), per student
(education) or per person entitled to social protection allowance, or per square meter of housing, streets
and roads (for housing and communal utilities).

5.20 Recent survey data published by the Fiscal Analysis Office\(^2\) indicate that, from an equity point of
view, the reform has brought about greater equalization for rayons and cities. The FAO report compares
estimated 2000 and 2001 data. See Table 5.3. The data show that the overall growth in per capita
spending of local governments is accompanied by a marked decrease in the coefficient of variation: while
in 2000 the coefficient of variation was 46 percent for cities and 21 percent for rayons, in 2001 these
coefficients were 25 percent and 18 percent, respectively. However the data also show that, unlike rayons
and cities, oblast budgets have not been equalized. On the contrary the coefficient of variation in oblast
budgets increased from 38 to 45 percent.

5.21 Cities and rayons can be divided into two groups in terms of their gains or losses resulting from
the reform. The first group includes the winning oblast-subordinate cities such as, for example, the city of
Nizhnyn in Chernihivska oblast, which—compared to the 2000 executed budget—has gained an additional
UAH 2 million to be spent on education. This group has benefited the most from the new system. In Box
5.1, we provide an example of “winning” city. The second group includes the losing rayon-subordinate
cities. The city of Komsomolsk in Poltavska oblast is an example. The new formula affected noticeably

the city’s financing for education, and its budget was reduced by 15 percent. Another example is the city of Lebedyn in Sumsk Oblast, whose education-related expenditures decreased by 6 percent in 2001. Similar decreases in sports-related spending will take place in Berdytsiv in Zhytomyrska Oblast. There is also an “intermediate” group of rayons (which wins on some counts and loses on some others) with varying benefits due to additional expenditure assignments and the new transfer formula.

Table 5.3: Changes in Estimated per Capita Expenditures in 2001 Versus 2000
(for cities and rayons)

<table>
<thead>
<tr>
<th>Oblast</th>
<th>2000 Average</th>
<th>2001 Average</th>
<th>Change 2000 versus 2001</th>
<th>Standard Deviation</th>
<th>Coefficient of Variation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>City</td>
<td>Rayon</td>
<td>City</td>
<td>Rayon</td>
<td>City</td>
</tr>
<tr>
<td>Crimea</td>
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<td>176</td>
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<td>Donetsk</td>
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<td>152</td>
<td>17.6</td>
<td>0.18</td>
<td>0.11</td>
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<tr>
<td>Zhytomyrska</td>
<td>104</td>
<td>152</td>
<td>18.1</td>
<td>0.22</td>
<td>0.11</td>
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<tr>
<td>Zakarpatska</td>
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<td>152</td>
<td>18.3</td>
<td>0.20</td>
<td>0.17</td>
</tr>
<tr>
<td>Zaporizska</td>
<td>133</td>
<td>178</td>
<td>19.4</td>
<td>0.20</td>
<td>0.13</td>
</tr>
<tr>
<td>Ivano-Frankivska</td>
<td>133</td>
<td>178</td>
<td>19.1</td>
<td>0.22</td>
<td>0.10</td>
</tr>
<tr>
<td>Kyivska**</td>
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<td>152</td>
<td>19.5</td>
<td>0.20</td>
<td>0.09</td>
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<tr>
<td>Kievohradsks</td>
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<td>20.1</td>
<td>0.22</td>
<td>0.11</td>
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<tr>
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<td>20.4</td>
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<tr>
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<td>117</td>
<td>167</td>
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<td>0.22</td>
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<tr>
<td>Odesa</td>
<td>117</td>
<td>167</td>
<td>20.4</td>
<td>0.22</td>
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</tr>
<tr>
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<td>20.4</td>
<td>0.22</td>
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<tr>
<td>Rivnenska</td>
<td>133</td>
<td>178</td>
<td>20.4</td>
<td>0.22</td>
<td>0.13</td>
</tr>
<tr>
<td>Sumsk</td>
<td>117</td>
<td>167</td>
<td>20.4</td>
<td>0.22</td>
<td>0.13</td>
</tr>
<tr>
<td>Ternopilska</td>
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<td>167</td>
<td>20.4</td>
<td>0.22</td>
<td>0.13</td>
</tr>
<tr>
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<td>20.1</td>
<td>0.22</td>
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<tr>
<td>Khersonska</td>
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<td>0.22</td>
<td>0.13</td>
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<tr>
<td>Khmelnytsks</td>
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<td>20.4</td>
<td>0.22</td>
<td>0.13</td>
</tr>
<tr>
<td>Chernivetska</td>
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<td>20.4</td>
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<tr>
<td>Chernihivska</td>
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<td>0.22</td>
<td>0.13</td>
</tr>
<tr>
<td>Average</td>
<td>145</td>
<td>195</td>
<td>20.4</td>
<td>0.22</td>
<td>0.13</td>
</tr>
</tbody>
</table>

Source: FAO, Kyiv.

5.22 The group of cities that are losers, in many cases, had developed an extensive network of well-financed and well-maintained budgetary institutions providing education or health services with little relevance for the population. The new method of calculating transfers forces local self-governments to optimize the financing for the budgetary institutions under their control. The formula determines the level of funding that local budgets can rely on for the provision of a certain range of services for their population, and encourages local governments to initiate education and health care restructuring. Local councils are free to decide on how the equalization grant received from the State budget will be used. Thus operational efficiency issues are addressed indirectly by influencing the behavior of local decision makers. Reducing central government transfers while rewarding cost-saving efforts at the local level is an efficient incentive scheme. Moreover, local governments have localized information on schools, hospitals, etc. and can decide better than the central authorities whether they want to increase own revenues or reduce costs. To facilitate the transition toward the new system of allocation of expenditures, oblasts are allowed to form and administer a fund not distributed on a formula basis. This fund must not exceed 10 percent of oblast consolidated revenues, i.e., oblasts are required to distribute 90 percent of their revenues according to the formula, whereas the other 10 percent can be directed to smooth possible imbalances in their budgets.
Box 5.1: How Berdiansk Reformed its Finances

Berdiansk is a rayon center in Zaporizhzhia oblast located in the South-East of Ukraine. It has a population of 135 thousand people. It has a big commercial seaport and a developed industrial base with powerful and well-known chemical and machine building enterprises. Berdiansk is also a unique recreation center of the Azov sea region. Chart 1 shows the demographic structure of Berdiansk population. The city has a relatively young population and relatively low unemployment level.


In 1998, a young and energetic mayor won the elections. He came to power together with a strong reform-minded team. Within a period of three years, they managed to streamline municipal budget expenditures and to find new non-traditional sources of revenues. As a result, in the last two years, per capita budget expenditures in the city of Berdiansk grew by more than 70 percent (See Chart 2).

Chart 2. Per Capita Budget Expenditures in Berdiansk, UAH

Berdiansk gained from the 2001 intergovernmental transfer reform. The public resources that it had at its disposal in 2001 substantially increased in comparison with previous years. This allowed the municipal authorities to allocate more funds to social protection and education. The next paragraphs highlight the main public expenditure management issues.

The bulk of the city budget is spent on health, education, and social protection (See Chart 3). The amount of budgetary resources available for health and education is similar than in the rest of the country. However, not all local authorities take serious steps as Berdiansk did, to live within their means. Berdiansk municipality is among a handful that decided to create a special economic department dealing with the issue of efficient use of public resources in budgetary units. They approached the issue of optimization of the network in a very wise manner. While closing some of the facilities, they tried to take into account the interests of different social groups and of those who would be affected. For example, they started with one big kindergarten.
Box 5.1: How Berdiansk Reformed its Finances (continued)

which occupied three buildings that were in very good shape. The occupancy rate of the kindergarten was very low, so they closed it and moved remaining kids to other kindergartens. At the same time, they relocated three centers—the Territorial center for disabled and elderly people, the Center of family doctors and the Center for the rehabilitation of the disabled—that were previously in terrible conditions to the former premises of the kindergarten. Thus the network of public premises was reduced but simultaneously the old buildings were leased and earned a decent rent. The decision of the mayor was very popular and his reputation increased.

City authorities streamlined the network of medical facilities through the merger of several health care units under one roof: in each case, the best premises in terms of location, quality of building, equipment, etc. were used. Citizens were very supportive of such measures but health care administrators strongly opposed them. These measures allowed to achieve two cost saving goals: (i) raising municipal revenues through leasing proceeds; and (ii) reducing expenditures through downsizing administrative staff and reducing energy bills.

In education, the municipality managed to gradually reduce positions, although the merger of schools is still on the agenda of tasks to be accomplished. The consolidation of schools is a very unpopular measure which local authorities try to postpone until after the next elections.

For privileges such as free pharmaceuticals for certain categories of disabled and war veterans, the Mayor created a network of municipal pharmacies located all over the city. It allowed the municipality to raise additional revenues that were used to cover the free drugs. Since municipal pharmacies have lower mark-ups than private ones (but still remain profitable), their prices are substantially lower than in private pharmacies. As a result of this competition, all pharmacies were forced to reduce their prices and all the citizens benefited.

In 2000, an inventory of municipal property was undertaken. It became a significant source of revenues for the municipality. On a case-by-case basis, the authorities decided on measures to better use the existing premises (e.g., revise the leasing agreements, sell the buildings, lease non utilized buildings, etc). Overall, such an inventory lead to an increase in budget revenues of 30 percent.

The new system of intergovernmental fiscal relations based on formula in allocating transfers is strongly supported by Mayor of Berdiansk city, since from his point of view it is more fair and creates additional incentives to raise resources and to use them more efficiently. It allows him to be more independent in his decisions and not to waste his political skills in the negotiating process to obtain resources for his city. However, the PIT sharing scheme requires further improvements.
New Subsidy Mechanism for Social Allowances and Housing Subsidies

5.23 A new subsidy mechanism for social allowances and housing subsidies was introduced in 2001. It involved shifting the responsibility for and financing of social allowances and housing subsidies to the national level. As explained above, the center has been delegating this responsibility to the regions and social allowances and housing subsidies were chronically underfunded, resulting in an accumulation of arrears in local budgets. Oblast administrations, which initially had to fund these benefits, shifted the responsibility to city and rayon governments. Allowances to families and housing subsidies are a classic example of “unfunded mandates” because the entitlements promised by law (or decrees from the central government) are twice or three times larger than the funds made available to local governments. As a consequence, mutual settlements between energy providers and budget institutions became a common practice all over the country as a “solution” to this problem. As recently as 2000 (when mutual settlements were prohibited) the problem persisted in many oblasts. For instance, in Poltavska and Kharkivska oblasts—where many gas providers are located—mutual settlements were routinely used to cover housing subsidies. This resulted in the lowest rate of cash energy payments in the country.

5.24 The system now used is that a targeted subsidy from the State budget is paid to local budgets for housing subsidies and other such privileges. The total budget for this amounts to UAH 3 billion in 2001. Revenues from rental payment for natural gas and oil extracted in Ukraine and shared fees for transit of natural gas through the territory of Ukraine are earmarked for such subsidies. However, these proceeds may be insufficient to cover all planned subsidies. In 2000, the above mentioned sources earmarked for the subsidies generated only UAH 412 million, i.e., seven times less than the amount needed. The central government is considering issued short one-day credit as a possible adjustment. The mechanism of mutual settlements would then work as follows:

5.25 The main idea of this mechanism is to make the central government responsible for social protection programs and to finance them through targeted subsidies to local governments. In the 2001 Budget Law, this principle was implemented with respect to housing subsidies and privileges.

Conclusions and Outstanding Issues

5.26 Fiscal relationships between the central government and lower tiers of government have evolved considerably since 2000. In this area, the Budget Code represents a major step forward. The Budget Code clarifies the intergovernmental legal framework by introducing permanently in the organic budget law the provisions on intergovernmental transfers contained in the 2001 budget legislation: (a) a clearer division of expenditure assignments; (b) formula-based calculation of transfers for local expenditures and use of a uniform formula for planning the transfers; (c) uniform revenue capacity estimation; (d) unbiased determination of tax sharing, with rates fixed for three years; (e) incentives for local governments to broaden their tax bases, especially for the personal income tax; and (f) prohibition for oblast councils to increase their revenues above the amounts determined by the Ministry of Finance.

5.27 The new system has four main positive effects:

- Budgeting should become more realistic and planning more predictable for local governments since the amount of transfers received is known;
- Local governments should have more freedom since they can now choose how they will allocate their revenue resources among competing expenditure demands;
- Local governments should receive more predictably targeted subsidies to cover social protection programs; and
- The transparency of the allocation of resources to lower levels of government has improved considerably.

5.28 The first months of the reform have raised a number of issues that will need to be addressed:

- The timing of direct transfers from the central budget is not very well defined and can jeopardize the ability of some local governments to execute their budget effectively when they are not able to secure an adequate flow of transfers through daily deductions;
- The current presentation of formula used for calculating expenditure needs does not indicate clearly the conceptual base for the formula—which is providing equal spending opportunities properly adjusted for specific cost adjustments for local governments of a particular type;
- The change from supply-driven to demand-driven provision of budgetary resources is not supported by adequate changes in rights of local governments to make important decisions on employment levels in providing services that the local governments are responsible for. Depriving local governments of greater control over such decisions is contrary to the idea of giving greater accountability to local governments pursued by the reform;
- In a few oblasts strong disincentives for revenue mobilization may continue to exist in 2001. While further verification of these observations is required, more thorough studies may be necessary to identify major factors that affect revenue mobilization incentives; and
- Violations uncovered in application of the formula (and optional additional adjustments) by oblasts made the process of the transfer calculations less transparent than it should be. Lack of adequate enforcement measures may result in repetition of those violations.
6. FISCAL SUSTAINABILITY ISSUES AND SIZE AND COMPOSITION
OF PUBLIC EXPENDITURE

6.1 In this chapter, we analyze selectively the outcomes of the budget process. The focus will be on sustainability of fiscal outcomes and the appropriateness of the composition of spending. We will update some of the findings of the 1977 Public Expenditure Review (PER) of the World Bank. Section 1 discusses fiscal sustainability while section 2 examines allocative efficiency issues by comparing the size and composition of public expenditure in Ukraine and in other countries.

A. FISCAL SUSTAINABILITY

6.2 The 1997 PER, while recognizing that substantial reductions had been achieved in terms of public spending until then, recommended further cuts in current expenditures and a realignment of spending to reflect the government’s new priorities in public expenditure management. Four years later, are these recommendations still relevant?

6.3 The 1997 PER viewed current expenditures in Ukraine as too high, even after the substantial reductions that took place between 1992 (54.3 percent of GDP) and 1996 (38.6 percent). It was determined that a fiscal deficit of about 3 percent of GDP would be a sustainable level for Ukraine, based on an analysis of the financing options available. In order to achieve this goal, the PER 1997 recommended that Ukraine cut non-interest current spending by as much as 10 percent of GDP over the medium term. Does non-interest current spending need to be cut further?

6.4 Between 1997 and 2000, the budget deficit was reduced progressively from 5.4 to 1.3 percent of GDP on a cash basis, while overall current expenditure levels declined from 43 to 35.4 percent of GDP. That is, while the budgetary deficit target is met, spending cuts in current expenditures have been much less than the initial recommendation. Meanwhile, interest payments rose from 1.8 to 3.2 percent of GDP. Therefore, it appears that the recommended spending cuts have not been fully accomplished.

6.5 There are other indications that Ukraine may benefit from further reductions in current expenditures, thus improving its operational efficiency. For example, even though the government has made significant progress in reducing wage and pension arrears, the stock of those arrears still stood at one percent of GDP by the end of 2000 and other budgetary arrears are poorly measured or recorded. Non-cash transactions in the form of promissory notes and tax offsets are frequently used to curb the accumulation of expenditure arrears. Moreover, the government’s contingent liabilities, of which the full effect is yet to be fully understood, also threaten to pose additional fiscal risks.

6.6 In traditional fiscal sustainability analysis, only direct and explicit government liabilities are considered. However, it is appropriate to also consider other major types of liabilities because they also increase fiscal risks:

- One major source of contingent liabilities are state enterprise foreign loans guaranteed by the government. Since 1992, they total more than US$ 2.4 billions. The agricultural sector accounts for 57 percent of these loans. The main creditors are Germany (53 percent of government guaranteed loans) and the USA (34 percent). Starting in 1995 the Government

31On a commitment basis, the budget balance turned from a deficit of 5 percent of GDP to a small surplus of 0.2 percent of GDP.
adopted dozens of resolutions so that the budget could be reimbursed for the repayment of those guaranteed loans but, by early 2000, enterprises had financed only 6 percent of their cost and the budget the rest. By early 2000, the indebtedness of enterprises vis-à-vis the budget for guaranteed loans increased to US$860m;

- The pension system represents another fiscal risk because of the arrears that have accumulated until 2000. The pension system is another major source of contingent liabilities. The existing law on pension insurance promises a generous replacement rate between 55-75 percent of earnings. However, since the Pension Fund was created in 1992, the real replacement rate has fluctuated between 21-48 percent for lack of resources. In 1995, the Pension Fund's own revenues met only 16 percent of the payment obligations, and arrears started to accrue in both the contributions into the fund and the payment of pension benefits; and

- Finally, the situation of the health care system is clearly not fiscally sustainable in the long run and requires changes in entitlements. This is an explicit, not a contingent, fiscal risk. The government has increasingly used partial private financing from individuals, enterprises and special funds to keep health care institutions afloat. Health expenditures amount to 4.2 bln UAH in 1999 while private sources were estimated to reach 4.7 bln UAH (or 7 percent of GDP). Both official and unofficial private sources are mainly used to support the personnel and, to a much lesser extent, to cover maintenance of buildings, housing and communal services, electricity bills, etc.

**Figure 6.1: Central Government Debt in Ukraine, % of GDP**

![Figure 6.1](source: World Bank Data.)

### 6.7 Debt management continues to be a challenge for Ukraine.

As seen in Figure 6.1, public debt rose rapidly in recent years when it was relied upon as a main source of financing for public expenditures. Although the Ukrainian government was able to avoid a major debt crisis by successfully restructuring its external sovereign debt with private creditors in 2000, the pressure remains for prudent fiscal practices because of continued debt service burden. The appropriate medium term fiscal position is typically linked to the concept of public debt sustainability—which answers the question: what primary fiscal balance is desirable in order for the debt-to-GDP ratio to be non-increasing? Table 6.1 calculates different scenarios for the required primary balances to stabilize the public debt in Ukraine between 30-50 percent of GDP, based on six assumptions of potential growth rates of the economy and three assumptions on real interest rates. With a primary surplus at 1.8 percent of GDP in 2000, Ukraine's current fiscal position corresponds to the average scenario in the table. Clearly, if a sustainable budgetary balance is to be
achieved in the medium term in Ukraine, the government will have to maintain primary surpluses at similar levels.

Table 6.1: Primary Balance Required to Stabilize Public Debt, Three Scenarios (Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Debt at 30 % of GDP</th>
<th>Debt at 40 % of GDP</th>
<th>Debt at 50 % of GDP</th>
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<td></td>
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<td>r = 8%</td>
<td>r = 9%</td>
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<tr>
<td>g = 1%</td>
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<td>g = 5%</td>
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<tr>
<td>g = 6%</td>
<td>0.2</td>
<td>0.5</td>
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</table>

Note: Assuming seigniorage financing is low (0.1% of GDP) in the near future.

6.8 Finally, it should be mentioned that despite efforts to modernize the tax system, Ukraine still faces problems of high tax burden, narrow tax base, inefficient tax structure, and low compliance rate. In 2000, further progress was made to reduce the discretionary tax exemptions with the elimination of the "zero-rate" VAT for the energy sector. A new tax code is being discussed which proposes to reform both local and national taxation systems by bringing the existing 36 types of taxes down to 13 national taxes. Nevertheless, because large sections of the economy remain in the shadow and taxpayers' compliance costs are still high due to corrupt tax enforcement practice, revenue collections have been declining steadily.

6.9 The return of economic growth and the successful restructuring of the external debt in 2000 have put Ukraine in a much more favorable fiscal position today than it has ever been since independence. The need of further cuts in current non-interest spending is less urgent, and the amount to be cut less significant, today than at the time of the 1997 PER. Nevertheless, continued expenditure restraint and improvements in allocative and operational efficiency are at the top of the agenda, as it would give the government more room of maneuver for reforms to foster growth.

B. SIZE AND COMPOSITION OF PUBLIC SPENDING: AN INTERNATIONAL PERSPECTIVE

6.10 Public spending in Ukraine declined steadily and substantially in the 1990s. Against a backdrop of continuous economic contraction, there was a reduction in public spending both in absolute terms—with real total expenditure declining by 70 percent between 1992 and 1999—and as a proportion of GDP. Although the change in budget classification in 1998 does not make it straightforward to compare some expenditure items before and after 1998 with those after, the general trend is clear: overall public expenditure declined from 60 percent of GDP in the early 1990s to around 35 percent in 1999/2000.

6.11 The bulk of the adjustment took place prior to 1995, although the trend continued unabated in the second half of the decade. As noted in the 1997 PER, the most drastic reduction in government spending took place in subsidies to “priority” economic activities. In real terms, such expenditures, of which directed credits made up half of the total, declined by 90 percent between 1992-1995 and another 60

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31In Ukraine, the tax rates for each of the main taxes are broadly in line with international standards, but the overall level is high because each tax is at the high end of the spectrum.

32The tax structure, which sets high rates on abundant resources or commodities but low rates for scarce resources or luxury goods, does not favor efficient use of resources and causes revenues losses. See World Bank 1997 CEM.

34As a result, discretionary tax exemptions dropped from 12 percent of GDP in 1999 to less than 5 percent of GDP in 2000.
percent between 1995-1999. By the end of the 1990s, the various forms of subsidies to the economy amounted to about 2 percent of the GDP, down from 24 percent in 1992.

Table 6.2: Structure of Public Expenditure, 1994–2000 (in Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expenditure</td>
<td>50.6</td>
<td>42.7</td>
<td>39.9</td>
<td>43.6</td>
<td>38.4</td>
<td>35.8</td>
<td>37.0</td>
</tr>
<tr>
<td>Administration/Justice</td>
<td>2.5</td>
<td>2.6</td>
<td>2.8</td>
<td>3.2</td>
<td>2.8</td>
<td>2.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Defense</td>
<td>1.8</td>
<td>1.9</td>
<td>1.7</td>
<td>1.6</td>
<td>1.3</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Education</td>
<td>5.2</td>
<td>5.4</td>
<td>4.9</td>
<td>5.3</td>
<td>4.4</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>Health Care</td>
<td>4.6</td>
<td>4.7</td>
<td>3.8</td>
<td>4.2</td>
<td>3.5</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Social Programs</td>
<td>5.8</td>
<td>6.4</td>
<td>5.0</td>
<td>5.9</td>
<td>4.0</td>
<td>3.3</td>
<td>3.6</td>
</tr>
<tr>
<td>Pension Fund</td>
<td>7.4</td>
<td>7.6</td>
<td>8.6</td>
<td>9.0</td>
<td>8.6</td>
<td>8.5</td>
<td>8.8</td>
</tr>
<tr>
<td>National Economy</td>
<td>14.5</td>
<td>4.7</td>
<td>4.2</td>
<td>3.0</td>
<td>2.3</td>
<td>2.2</td>
<td>N/A</td>
</tr>
<tr>
<td>O/w Directed Credits</td>
<td>2.4</td>
<td>0.2</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Capital Expenditures</td>
<td>3.6</td>
<td>2.5</td>
<td>1.3</td>
<td>0.6</td>
<td>0.7</td>
<td>0.9</td>
<td>0.5</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>1.1</td>
<td>1.5</td>
<td>1.6</td>
<td>1.8</td>
<td>2.4</td>
<td>2.4</td>
<td>2.7</td>
</tr>
<tr>
<td>O/w Domestic</td>
<td>0.5</td>
<td>1.1</td>
<td>0.5</td>
<td>1.0</td>
<td>1.6</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Foreign</td>
<td>0.6</td>
<td>0.4</td>
<td>1.0</td>
<td>0.8</td>
<td>0.7</td>
<td>1.4</td>
<td>1.7</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.

6.12 The composition of the expenditures changed significantly too. For example, spending on public administration and law enforcement, which changed little in real terms throughout the decade, has increased in importance. Together, they absorb more than 10 percent of total public expenditures today, compared to just 2.4 percent ten years ago. Wages and operating costs for various executive bodies, especially in local governments, and financial/fiscal bodies (including state tax administration and customs services) increased significantly in recent years.

6.13 Government expenditures on national security declined continuously in real terms. By late 1990s, spending on national defense and other (internal and external) security-related activities was only a quarter of what it was in 1992. As a share of total public expenditures, however, both national defense and internal security spending has been relatively stable at around 3.5 and 4.0 percent, respectively.

6.14 In a general context of rapidly declining public resources, social spending, i.e., expenditures on education, health and the various social programs, has been relatively protected. That is, although the amount of public spending in these areas declined by an average of 60 percent in real terms in a decade, their contractions in relation to GDP decline have been milder than other sectors and the shares of education, health, and pension payments in total consolidated spending have gone up. Today, more than half of total public expenditures can be classified as social spending compared to less than 40 percent a decade ago. The exception is the public spending for social security programs (other than old age pension). Such spending declined by nearly 80 percent in the 1990s, with three quarters of the contraction occurring in the first few years. However, there were significant variations between the many existing social programs. While public spending declined for some programs like family allowances, maternity benefits and the protection offered to Chernobyl victims, more was spent on housing allowances and social privileges for war veterans.

6.15 In contrast, spending cuts in capital expenditures (public investments) have been extremely severe. Between 1992-2000, real capital expenditures declined by 95 percent. By the end of the period, only 1 percent of total public expenditures was spent on capital investments as compared to over 7 percent at the beginning.

35The STA employs 56,500 persons and Customs 18,200 persons.
6.16 Finally, with the rising public indebtedness mentioned above, central government public debt swelled from 5 percent of GDP in 1992 to 60 percent in 1999, and interest on the public debt became an increasingly important item in government expenditures. Interest payments, which were nonexistent at the beginning of the decade, rose to 7.4 percent of total public expenditures in 2000. As noted in the 1999 CEM, because of the unfavorable terms on which the external debts were contracted and the sharp devaluation of the Hryvnia in 1998, the overwhelming majority of the interest payments in 1999 and 2000 were for external debts.

The Size of Government

6.17 Table 6.3 compares revenue, expenditure and deficit levels in Ukraine and in other comparable market and transition economies. The same cross-country data excluding social funds can be found in Annex I-Table 12. Note that public expenditure data are not fully comparable across countries so that the table have to be interpreted with caution.

6.18 The size of Ukraine’s public sector appears to be in line with its socio-economic development levels. That is, compared to neighboring transition countries which, on average, have twice as much incomes as Ukraine, and with selected West European countries, Ukraine’s government operation is roughly 20 percent smaller. Compared to other middle-income market economies, however, Ukraine’s government is about 50 percent larger than the average. Given that countries with higher incomes tend to have larger governments and that transition countries have a history of big states, the size of Ukraine’s public sector today does not seem to be too much of an “outlier”. Moreover, at 2.4 percent of GDP, Ukraine’s current budget deficit is moderate compared to most countries.

6.19 What this simple comparison seems to suggest is that, after a decade of “forced downsizing,” the overall size of government in Ukraine remains significant for its level of national income, but is no longer blatantly oversized. Indeed, the economic literature offers limited theoretical and empirical guidance on the appropriate size and scope of government. From a limited role of providing public goods and services in the early times, the government is expected nowadays to assume the additional responsibilities of correcting the inequalities in income distribution and to pursue macroeconomic stability and external sustainability. Several factors have been identified as determinants of the size of the state, though no conclusion has been reached on the net impact of their aggregate influences. Moreover, empirical studies often yield starkly different results for rich and developing countries concerning the same factor.

6.20 To determine whether the size of Ukraine’s current government is of an appropriate size for its development level, we use a model developed by Barbone and Polastri. This empirical model allows us to show statistically that social variables, such as secondary school enrollment and old age dependency ratio, coupled with variables such as the level of public debt and cultural, philosophical and religious traditions, have greater explanatory power than per capita GDP alone for a country’s level of public spending. Figure 6.2 compares actual levels of public revenue and expenditure in Ukraine with those predicted by the model.

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36 On a cash balance. Since social arrears have been recently reduced, the commitment balance is smaller (1.4 percent of GDP).
37 Common among the transition economies of the former Soviet Union, spending cuts were often a result of the lack financing options rather than purposeful rationalization of the government expenditures.
38 Cross-country evidence shows that the size of government is highly correlated with per capita GDP.
6.21 Clearly, the actual public expenditure levels in Ukraine are moving away from—and below—the levels predicted for the country based on its socio-historical experiences. The discrepancy between the two is widening from 1992 to 2000, which raises the question as of whether the government, at its current levels of public expenditures, is able to provide sufficient social services to meet the needs and expectations of the people.

6.22 Simultaneously, actual revenue levels converge steadily toward predicted levels in Ukraine, suggesting that the extra revenue capacities, which are often detected in transition economies at early stages of the reform process, are being exhausted.

6.23 Moreover, despite the relatively restrained budget deficit level in recent years, the predicted deficit level remain significant. What this implies is that, while Ukraine demands a relatively extensive range of social services because of its socio-political development level, the underdeveloped national economy (and the level of rent seeking) prevent the government’s ability to meet such demands. The existing socioeconomic trend of decreasing proportion of older people and higher public indebtedness

\[ \text{Predicted spending levels for Ukraine and most other European countries are comparable. Empirical evidence shows that, all else being equal, European countries tend to have larger public expenditures than others while Latin American and Asian countries have lower demand for public services. Had Ukraine been a country without European influences and aspirations, the predicted levels of its public spending would have been at least 15 percent less.} \]

\[ \text{The gap between predicted revenues and predicted expenditures.} \]
lessens the social demand for old age transfers on the one hand, but raises the debt repayment obligation on the other hand. Therefore, closing the predicted deficit gap will require rapid economic growth and the formalization of the gray economies to boost revenue collections.43

The Composition of Public Expenditures

6.24 Apart from the question of the appropriate size of the state so that public spending can have maximum impact on (socially and environmentally sustainable) growth, the composition of public expenditures also matter. In times of fiscal austerity, the question that arises is: which component of government expenditure should be reduced? The answer depends, presumably, on the contribution of these components to economic growth and social welfare. If economic theory and empirical evidence provide few clear-cut answers to the size of government, even less is known about how the composition of public expenditure affects a country’s socio-economic achievements. Table 6.4 attempts to shed some light on whether the current spending mix in Ukraine is appropriate by making a few broad comparisons between Ukraine and comparable countries.44

Figure 6.2: Government Finance in Ukraine, % of GDP, 1992-2000

6.25 Studies that investigate the relationship between the components of public expenditures and economic growth distinguish two broad categories of spending—“productive” and “unproductive”. While it is commonly agreed that government investment in core infrastructure areas provides an enabling environment for growth, there is disagreement exists on the role of some expenditures such as defense or education on economic performance.

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43 The CEM argued, however, that the only viable option for Ukraine is to reduce expenditures. Therefore, Ukraine needs to reduce the size of its government.

44 Data inconsistency may exist due to definition and measurement differences across countries. The comparisons here are more for establishing broad trends than exact levels.
6.26 Consistent with the broad implications of Table 6.3. on the size of government, Table 6.4. suggests that public expenditures in Ukraine do not appear to be excessively high in any of the major spending categories. Moreover, they do not seem to differ significantly from those in other transition and West European economies, even though major discrepancies exist between Ukraine and other middle income countries concerning some items (e.g. health and social transfers). The following observations can be made.

6.27 Although public spending on education and health care amount to a smaller percentage of GDP in Ukraine than in other transition countries, at 10 and 8 percent of the total public expenditures for education and health care respectively, Ukrainian government is giving similar relative importance to these two sectors as governments in other transition economies. As there is no clear consensus on whether higher government spending would necessarily lead to better results in education and health care, and given Ukraine's severe budgetary constraints, the country's current levels of aggregate spending in these sectors cannot be considered inappropriate.

Table 6.4: Composition of Public Expenditures in Selected Countries, 1999 (in Percent of GDP)

<table>
<thead>
<tr>
<th>Functional Classification</th>
<th>Economic Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>1.2 3.0 3.7 3.0 13.2 .. 1.9 2.4 0.9</td>
</tr>
<tr>
<td>Belarus</td>
<td>1.3 3.4 6.1 4.7 10.6 7.3 2.1 0.6 11.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>1.0 3.9 3.8 2.6 13.2 9.1 2.3 7.4 5.9</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1.0 3.7 6.2 4.6 11.7 9.4 0.3 1.5 5.5</td>
</tr>
<tr>
<td>Poland</td>
<td>1.5 4.3 5.7 4.2 19.3 7.0 0.8 3.1 3.5</td>
</tr>
<tr>
<td>Romania</td>
<td>2.3 2.3 3.4 2.7 10.0 4.5 1.1 3.6 3.9</td>
</tr>
<tr>
<td>Russia</td>
<td>3.1 4.1 3.4 2.4 10.2 6.2 0.1 4.5 3.8</td>
</tr>
<tr>
<td>Average</td>
<td>1.7 3.6 4.8 3.6 12.5 7.3 1.1 3.5 5.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>2.5 2.3 3.8 1.7 2.3 2.7 .. 3.3 4.2</td>
</tr>
<tr>
<td>Egypt</td>
<td>2.9 2.4 4.5 1.0 0.1 6.0 1.7 6.0 7.4</td>
</tr>
<tr>
<td>Korea</td>
<td>2.9 1.9 3.6 0.1 1.9 2.2 0.2 0.5 3.8</td>
</tr>
<tr>
<td>S. Africa</td>
<td>.. .. .. .. 14.5 1.0 5.7 3.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>1.6 2.0 4.3 1.6 0.8 6.3 0.3 1.0 12.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>2.9 2.8 4.0 1.4 3.4 8.5 0.1 12.9 2.5</td>
</tr>
<tr>
<td>Average</td>
<td>2.6 2.3 4.0 1.2 1.7 6.7 0.7 4.9 5.5</td>
</tr>
<tr>
<td>France</td>
<td>.. .. 6.0 7.1 .. 10.8 1.9 3.8 4.4</td>
</tr>
<tr>
<td>Germany</td>
<td>1.3 4.0 4.5 9.0 21.9 9.3 .. 3.6 4.6</td>
</tr>
<tr>
<td>Greece</td>
<td>2.6 2.4 3.3 2.2 5.5 8.6 0.2 9.0 5.2</td>
</tr>
<tr>
<td>Italy</td>
<td>.. .. 4.8 5.3 .. 10.7 .. 7.0 5.1</td>
</tr>
<tr>
<td>Spain</td>
<td>1.1 3.7 4.2 5.4 14.5 9.9 0.8 5.1 4.5</td>
</tr>
<tr>
<td>UK</td>
<td>2.7 2.9 1.4 5.9 13.9 2.3 0.5 2.9 1.5</td>
</tr>
</tbody>
</table>

Average 1.9 3.3 4.0 5.8 14.0 8.6 0.9 5.2 4.2


4On average, other middle income market economies spend more on education and less on health care. It is the reverse for richer West European countries.
6.28 Ukraine spends 13.2 percent of GDP on social security and social welfare payments. Only West European countries and a few advanced transition economies such as Poland and Hungary match Ukraine’s level of social transfers. Some economists argue that while such spending provides utility to households, it lowers long-term economic growth because of the higher taxes needed for its finance. Given Ukraine’s development level, its already high tax burden and the problem of targeting in social assistance, the level of social transfers of Ukraine appear to be inappropriately high compared to GDP.

6.29 Despite its growing public indebtedness, interest payments remain relatively low in Ukraine compared to most countries. Such expenditures amounted to 6.5 percent of total public spending in Ukraine, compared to an average of 16.4 percent for middle income market economies and 10.9 percent for West European countries. Given Ukraine’s debt structure and the rising debt service burden, such expenditures will increase in years to come (see World Bank 1997 (CEM), pp 22-23) thus requiring a downward adjustment in non-interest expenditures.

6.30 The most striking feature of Table 6.4 is the level of public investment in Ukraine. With less than one percent of GDP spent on capital investment and maintenance, Ukraine threatens its future growth potential by depleting its existing capital stock. This stands in stark contrast with the level of capital spending in fast-growing transition and market economies such as Hungary, Egypt, Thailand, Greece and even Belarus, which spend between 10 and 45 percent of the total public expenditures on capital outlays, compared to 1.2 percent in Ukraine. This does not mean ipso facto that higher public investment leads to higher growth. The empirical evidence presented by Devarajan et al (1996) shows that, in developing countries where capital expenditures have been high historically, as was the case in Ukraine, shifting public spending away from capital outlays to current expenditure items has been good for growth. Moreover, Ukraine’s overall gross (public and private) investment levels, though not particularly high (about 20 percent of GDP in 1999), are not far from those of other transition and market economies.

6.31 The comparison of the composition of public spending in Ukraine and in other economies suggests that the expenditure mix in Ukraine could be converging toward a pattern common to other transition countries. However there are also indications, given current trends, that Ukraine’s fiscal adjustment path is not appropriate for long-term growth.

6.32 Has the new role of the government implied by the transition to a market economy been reflected in changes in budgetary allocations? The 1997 PER stated that “changes in the sectoral allocation of Ukraine’s public spending during the last four years appear consistent with the Government’s new role in a market economy.” Data from Table 1 suggests that this trend has continued between 1997 and 2000, with the provision of social services (including education and health care discussed in the next section), absorbing the bulk of public expenditures. However, within these priority sectors, there were few improvements in operational efficiency: spending cuts were made, in general, not with a view to ensure the best delivery of the best services within limited resources, but with a view to protect the personnel and other inputs.

6.33 Employment and Chernobyl Funds. The 1997 PER recommended the elimination of these two special funds. Since then, a new law was passed on the Employment Insurance Fund, which maintained the extra-budgetary fund but transferred its decision-making responsibility to a tripartite board. Payments of unemployment and other benefits are now based on contribution history rather than length of services. As for the Chernobyl Fund, the special payroll tax for its financing was eliminated in 1999 and it has been funded through the general budget, as the PER recommended.

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47Social transfers absorb 35 percent of Ukraine’s total public expenditures, as compared to the average of 29 and 28 percent, respectively, for West European and other transition countries.
Pension System. The 1997 PER made several concrete recommendations on what the Ukrainian government should do in order to reform its pension system. A pension reform concept was approved by the President in 1998, which envisions fundamental restructuring of the pension system into a multi-pillar system. Such an initiative goes in the right direction. However it has to be remarked that the introduction of a funded private pension scheme in an environment of underdeveloped financial markets could potentially worsen the problems faced by the pay-as-you-go (PAYG) part of the system and expose depositors in the private scheme to fraud if not properly regulated. In the short to medium term, the government will need to address the problems faced by the current PAYG system and develop a viable financing reform strategy.\footnote{The World Bank, ECSHD, Necessity and Opportunity: Pension Reform in Ukraine, mimeographed, March 2000.}
7. IMPROVING PUBLIC EXPENDITURE MANAGEMENT AND THE BUDGET PROCESS

7.1 The main shortcomings of the budget process have been discussed in previous chapters:

- There are few effective mechanisms to force recognition at the political level of the resource limits that exist and to force political choices in establishing expenditure priorities;
- Budget expenditure estimates do not take into account the real capacity of the government to raise revenue and do not fully reflect the new role of the government in a market economy.
- There are few mechanisms to elaborate and implement realistic sectoral priorities, and little institutional capacity in MOF, MOE or key spending agencies to do so;
- There is no operational commitment control system so that it is not possible to trace those who overspend and to hold them accountable;
- The cash management system is deficient. Funds are allocated weekly proportionally to budget appropriations based on the rospis, with a significant degree of discretion; and
- There are few incentives for ensuring that spending programs are managed and delivered in a cost-effective manner. The focus is on protecting certain economic categories of expenditures, rather than on protecting critical expenditure programs.

7.2 Identifying budget programs and improving the budget classification would amount to little more than a technical exercise if other shortcomings in the budget process are not addressed simultaneously. For convenience, we have grouped our recommendations to overcome institutional obstacles under separate headings.

Objective 1. Clarifying the Responsibility of Participants in the Budget Process

7.3 One of the major reasons for the lack of fiscal transparency and accountability in Ukraine is the excessive number of participants vying for power and the lack of clarity over their function in the budgetary process. The large number of players probably results from the fact that having some measure of power means having access to rent-seeking opportunities. The lack of clarity results from an impossibility for different political factions to agree on what these functions should be.

Constitutional Constraints

7.4 The relationship between the executive and legislative branches of government with respect to fiscal management is still evolving. The new Budget Code does not represent a great improvement over past arrangements in this area. In the new Code, the responsibilities of the Verkhovna Rada, the President and the CoM have not been delineated clearly enough and credible enforcement mechanisms have not been devised.

7.5 In most countries that have a Presidential regime, it is normal to give to the legislature broad powers with respect to the budget and limited power to dismiss the government. The constitutional balance of power mechanism devised in the Ukrainian 1996 Constitution is rather unique: the Verkhovna Rada has broad powers to dismiss the government (thus contributing to the instability of policy reforms) and relatively broad powers with respect to the budget. The VR has not used its powers in a very constructive manner. It has produced unrealistic revenue projections and has failed to recognize resource limits in setting spending priorities.
7.6 According to the Constitution of 1996, the Prime Minister is responsible for submitting the state budget to the Verkhovna Rada. The President, who—by and large—is not accountable to the VR in budgeting matters, has some powers vested to him by the Constitution with respect to budgeting. The problem is that the actions of the Prime Minister and of the President with respect to the budget have sometimes been in contradiction.

7.7 Improving communication between the government and the Verkhovna Rada should be viewed as a priority though this will not be easy because the political problems have constitutional foundations. It would have been helpful to have included explicitly in the new Budget Code a provision indicating that the budget is a strategic document for the country's development and linking the budget to four major objectives: (a) developing a consistent and realistic resource framework; (b) improving the allocation of resources to strategic priorities between sectors; (c) increasing commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained; and (d) providing key spending units with a hard budget constraint and increased autonomy, thereby increasing incentives for efficient and effective use of funds.

7.8 However, simply enshrining these objectives in the law will serve little purpose if there is no strong political will to abide by the process and to enforce the penalties. Without the direct involvement of political leaders, a public expenditure framework is little more than a technical exercise, more a matter of projections than of policy decisions. Moreover, without a firm commitment to constrain future spending, the forward estimates would be regarded by government as an entitlement to more money in future years and as a weapon to obtain bigger allocations from the budget. Therefore we present below some recommendations aimed at developing a resource framework; improving the sectoral allocation of resources and increasing credible commitment.

Leadership of the Process by the Ministry of Finance

7.9 Within the Cabinet, two separate ministries are in charge of separate budgeting tasks. The existing division of labor between MOF and MOE (in which the Ministry of Economy is responsible for macroeconomic forecasting, and for proposals on public investments and State programs) is not conducive to a coherent budget preparation process.

7.10 The Ministry of Finance should be at the center of the budget process within a framework that ensures high-level support for maintaining budget discipline. This implies that the functions of the Ministry of Economy related to the budget should be progressively transferred to the MOF. This would greatly improve macroeconomic policy coordination and the technical capacity to prepare the economic framework for the budget.

7.11 The division of labor currently found between the MOF and MOE is also found within line ministries themselves. In the latter, separate departments are responsible for budget preparation, one for current expenditures and the other one for capital expenditures. This artificial separation should also progressively disappear.

Organization of the Ministry of Finance

7.12 Within the Ministry of Finance, the nature and scope of the work undertaken during the budget cycle needs to change, and the adoption of a MTEF should be a clear medium term goal for the government. In dealing with this change, there are two issues related to the current organizational structure of the MOF. First, the sectoral departments are structured on a sectoral rather than a key spending units (and/or program) basis. This may create administrative difficulties if ceilings are to be set on a key spending unit basis. Second, several sector departments appear to have become advocates for
spending within their sectors instead of assuming a role of enforcing discipline in the use of limited funding.

7.13 The 1998 functional review of the MOF and MOE recommended that the sectoral departments be merged with the budget department and their role within the budget department changed, so that they focus on enforcing the fiscal discipline rather than advocating for their sector's interests. Keeping the sectoral departments in place and simply aligning their structure with key spending units could exacerbate the situation as their alignment with spending units rather than programs is likely to increase their links with the spending units and trigger their increased support to spending units' needs.

7.14 The Government may wish to consider restructuring the sectoral departments and merging them with the budget department. This would ensure that common goals are pursued. The functional structure of the new sub-departments would be aligned with the structure of key spending units, and their responsibilities would be to set and maintain expenditure ceilings by agencies and programs under the leadership of the State Secretary (or Deputy Secretary) in charge of the Budget. This involves detailed estimates examination and dispute resolution. The other sub-departments of the budget department would focus on the overall coordination of the budget process.

7.15 A full reorganization of the Ministry of Finance is premature given that there will be a need for further reorganization of ministries and spending agencies in the future as Ukraine moves toward a more disciplined budget process. In the medium term (three to five years), a formal MTEF should be adopted as a routine framework. Changes in the organizational structure of the ministries and spending units should result from the adoption of an MTEF as a routine framework and, therefore, further changes in the organizational structure in the Ministry of Finance itself may be necessary. The Budget Department will need to build a stronger coordination capacity to assist in setting and monitoring the budget constraint and facilitating a flow of structured analytical information to other ministries and to the Verkhovna Rada. The MOF as a whole will need to have a more active role in assisting the CoM and its Cabinet Committee on Economic Issues to prioritize and restructure expenditure policies. This will require CoM and CCEI staff to acquire a deeper understanding of the programs operated by their counterpart key spending units.

7.16 As part of the public administration reform agenda, a process of efficiency reviews in ministries has been initiated. The main focus of these reviews is on how to improve ministerial efficiency and effectiveness through an institutional development program. This requires a detailed analysis of the current operations of the ministry at central, regional and local administration levels, the cost structure of the ministry, the quality of services provided, detailed proposals for cost recovery, divestiture and privatization, the identification of staff development and training requirements, and an action plan for change. These efficiency reviews can be used as a vehicle for reforming the ministries in order to address the problems outlined in this report regarding the budget process. The delegation of power to ministries and other spending units to make decisions on priority spending within their ceilings should take place only after the efficiency reviews are completed and ministries are reorganized in a way that enables them to work more efficiently.
Intergovernmental Finance: Relationships Between Tiers of Government

7.17 The recommendations below are based on the list of outstanding issues discussed above:

- Review the timing of direct transfers. Direct transfers must be provided when the under-execution of the transfer plan through the daily deduction norms becomes evident;
- Improve formulas for calculation of the relative expenditure needs. Formulas should have three main components: a per capita expenditure norm, population in a particular rayon, city or oblast and budgetary need coefficients (indexes) that account for a position of a particular locality relative to the average across Ukraine. Consideration should also be given to developing an aggregate per capita need norm in which the formula would contain coefficients accounting for the share of main functions in total expenditures;
- Review the scope of rights of local governments in determining the level of employment in providing public services. Increased rights of local governments to determine the level of employment may be accompanied by the per capita norms of minimum expenditure level that should be maintained by local governments in both planning and executing their budgetary appropriations for health and education;
- Review procedure for additional adjustments, as they may be necessary over the transition period. In particular, the procedure should define all acceptable criteria for such adjustments and corresponding coefficients; and
- Develop indicators of progress to monitor periodically reform implementation. The list of such indicators should, in particular, include:
  - Degree of equalization (coefficient of variation) in per capita spending among rayon and cities as well as among oblasts;
  - Dynamics of expenditure arrears of local governments; and
  - Degree of correlation between changes in the amount of transfers and unplanned revenue results and between the amount of transfers and the value of any expenditure economies.

Objective 2: Improving Coordination

7.18 The determination of budgets for different ministries is a typical "tragedy of the commons." Such a phenomenon, pervasive in public finances, damages allocative efficiency. The "tragedy" is that spending tends to be excessive because, although collectively political groups have an interest in using funds rationally, individually, they have an interest in taking as much as they can get. A cooperative solution to this problem is to give the Ministry of Finance a strong role to monitor the respective line ministries and "punish" them if they propose budgets that exceed the budget that is appropriate from a macroeconomic point of view. This can be done in parliamentary regimes with one-party governments. With multi-party coalition governments the problem is more complex since different parties are likely to have different spending priorities and monitoring and enforcement functions must inevitably be given to one of the parties. In parliamentary regimes with a coalition government, one would expect budget deals to be made at the cabinet level when the portfolios are distributed, while in presidential regimes, one would expect deals to be made in the legislature.

7.19 An alternative solution to the tragedy of the commons problem is for political parties to agree to "fiscal contracts" in the form of negotiated targets and ceilings. A strong Ministry of Finance can act as the agent of the line ministers in facilitating the collectively optimal outcome by monitoring the actions of

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Box 7.1. The Budget Resolution

The budget preparation process begins with a Budget Resolution. In OECD countries, the typical arrangement is an address to the Parliament by the Minister of Finance (usually taking place a few months before the presentation of the budget) on the present economic situation, the outlook for the planning period, the strategic goals of fiscal policy, and the global estimates for the next three years. The objective is to focus the discussion on the economic and fiscal strategy and to have a framework within which the budget formulation will take place. In some countries, like Sweden, the baseline is approved and becomes law. In others, it is merely indicative. The main advantage of this preliminary discussion is to provide ministries with a signal on how far they can go with their demands.

In order to prepare the Budget Resolution, it is necessary to have a solid macro-fiscal framework. This implies that the MOF and MOE use consolidated figures for the general government (i.e., including the budgets of the oblasts and lower level governments, and those of the pension and other social funds). This also implies that a reporting and monitoring system which can track the expenditures of all sectors of government is in place. Finally, this also implies that, once aggregate-level decisions are made, fiscal targets cannot be changed. We recommend to put in place a Forward Estimates Control System. An FECS involves a baseline projection of expenditure for future years, thus providing estimates of the future financial consequences of present and expected new policies. The estimates would be revised on an ongoing basis to include the effects of new policies and programs and changes in the economic parameters. The FECS would therefore constitute the starting point of the budget preparation process.

An FECS would have several advantages. The discrepancies between estimates and actuals would be examined, explained and, if necessary, appropriate adjustments would be made. A contingency reserve could be included to accommodate new policies or priority changes. An FECS also has risks. Letting agencies know the projected resource availability may pose certain problems, especially in uncertain macroeconomic environments. There is a real risk that unless the MOF educates agencies about the purpose of the FECS, they may try to represent future projections as firm allocations. The best antidote to this behavior is to learning-by-doing. The periodic revisions of the projections would continually reinforce their indicative nature, along with direct participation of the agencies in revising their spending forecasts. Spending units should also benefit from the introduction of a FECS. Presently a lot of energy is devoted to pursuing gains in allocation by generating budgetary bids which do not comply with the limits issued by the MOF. Under FECS, the preparation of baselines becomes more of a technical exercise, saving time and scarce resources, and providing a more certain planning environment for line ministries. The baseline projections would be a powerful deterrent in budget negotiations by clearly showing the margin available for the adoption of new spending programs. Moreover, they would force budget institutions to focus on the incidence of present decisions on future budgets. In particular, they would reveal the operating costs of new capital projects; the full-year costs of programs starting late in the budget year; and new or ongoing programs with small incidence on the present budget but which will grow in future years.

Most OECD countries prepare forward estimates using a time horizon of three or four years. A longer period is usually considered too risky, especially if the estimates are official. A shorter horizon could not adequately accommodate the implications of most investments, nor the full run out of many policy changes. This does not imply that longer time horizons should not be used. On the contrary, given the weight that education, health, and contributory benefits have in total spending, and the growing impact of guarantees, it is possible that, at least for these sectors, ten years or more may be used as an additional aid in budget planning.

An important element of the FECS is to plan a contingency reserve. Such contingencies permit the accommodation of uncertainties of different kinds: forecasting errors, exogenous factors like natural disasters or rises of raw material prices, inflation rates higher than expected, and new and changing policy priorities. Since uncertainties grow with the future, it is advisable to make the reserve increase during the planning period. International experience is mixed. The United Kingdom starts with a small contingency reserve of about two percent in the budget year and this is doubled and tripled in the first and second year of the forward estimates, respectively. This implies that every year the reserve is already used at the beginning of the year by commitments assumed the previous year. Australia includes a small reserve in the budget and forward years, but has supplementary appropriations mid-way through the budget year.

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spending ministries and punishing those ministers who defect. Unfortunately, in the present political context, given the lack of willingness by political groups to make compromises which would hurt their immediate interest, the prospects for stable fiscal contracts are not good. However, external pressure by international financiers or internal pressure by domestic watchdog organizations can, to a certain extent, contribute to such “fiscal contracts.”

7.20 Agreeing on fiscal contracts with negotiated budget targets is not synonymous with using cash rationing. As we have seen, the use of fiscal targets before 1999 has led to a “culture” of cash rationing in Ukraine. This is because fiscal contracts were not negotiated in advance and because incentives to cooperate were missing. In order to allocate funds on a weekly basis, the only “fair” mechanism to accommodate all political persuasions that was found was an allocation proportionally to budget appropriations using the rospis but this method leads to hidden pressure, backroom negotiations and ultimately a lot of discretion in the allocation of funds.

7.21 Based on the general remarks made above, the paragraphs below discuss procedures to improve budgeting, taking as a point of departure the reforms already undertaken by the Government (discussed above). The focus of the recommendations is not on the “mechanics” of budget preparation and on the complex steps that have to be followed to aggregate the information from every oblast that is necessary to prepare the budget, but on the steps that will provide the right incentives for coordination and cooperation in budgetary matters.

**Budget Ceilings**

7.22 The crucial stage of the budget process is that the Cabinet should make medium-term resources allocation decisions on the basis of affordability and inter-sectoral priorities. This is done by defining budget ceilings (i.e., sector resource envelopes) for a period of three years.

7.23 Budget ceilings imposed from above (“top-down”) are a basis for predictability so that appropriate strategic and efficient operational decisions can be made and implemented. Sector resource envelopes can be derived by establishing a sustainable macro ceiling for government expenditures over the medium term, then breaking it down. A division between discretionary and nondiscretionary expenditures should be made. A medium-term perspective increases the scope of effective discretion, e.g., over staffing levels and salary obligations. Unallocated contingencies like the “Reserve Fund” are legitimate means to cope with uncertainties and to allow adjustments for unanticipated expenditures but should be kept to a minimum since they have been criticized for having become a “slush fund”.

7.24 Given the political aspect of resource allocation, it would be wise to reach an agreement between the main political forces on the criteria to be applied to key sectoral allocations. Agreement on criteria provides guidance on how to adjust to new or altered circumstances and can increase discipline and predictability. Sector envelopes reflect the inertia associated with existing policy and the dynamic of the changing priorities of government—political, economic and social. The envelopes should be defined in a way that provides incentives for trade-offs between policies and programs at the sector level. Aid and local domestic funding, and capital and recurrent expenditures should be incorporated within a single guideline. This comprehensive approach should result in pressure to unify the budget and to reduce bias in the choice between development and recurrent expenditure. This comprehensive approach takes time to implement at the government-wide level.

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49 For reports on this topic, see Fiscal Analysis Office at http://www.fao.kicv.ua/index_e.html
7.25 Expenditure ceilings should be set for a three year period (which is the period generally covered by a MTEF), for the 15 major line ministries so as to align budgetary envelopes with the accountability of budget managers. Since each ministry will have a set of programs, and the initial allocation to programs will be carried out by the MOF, this leaves flexibility for the MOF and the line ministries to discuss and agree on more detailed ceilings.

7.26 The test of the budget ceilings is their credibility. They should be formulated so as to be tighter through the three-year cycle: indicative in the outer years, reasonably firm for formulation of the annual budget, and very tight during budget execution. The very nature of the budgetary imbalances means that forward-year ceilings will be, at best, indicative. Sector level managers must understand that the ceilings will be reset during each annual budget cycle to reflect changing macroeconomic conditions and policy priorities (and, more simply, better information).

7.27 Once credibility has been established, a more formal MTEF process can be established. The contribution of an MTEF to improving budgetary outcomes will depend on the ceilings delivering greater predictability than current arrangements. For the annual budget, sectoral ceilings should be set after key strategic policy decisions are made at the level of the Cabinet of Ministers. These ceilings, in turn, must be provided to sectors in sufficient time for the minister and officials to be able to reprioritize on a programmatic basis.

Preparation Macro Projections and Linking those Projections to Fiscal Targets

7.28 Sustainable reallocation based on ceilings will not occur as long as the focus of policy-making is on inputs (wages and salary bill, operations and maintenance, etc). To engage policy makers, the reconciliation of "needs" with affordability must move away from being funding driven and be increasingly policy and program based. For this it is necessary to prepare (a) macroeconomic projections, (b) sector reviews.

7.29 The first step to set realistic fiscal targets is the preparation of macroeconomic projections. The macroeconomic and fiscal projections prepared by the MOE are done, since April 2000, for a three-year period. This is a major progress over previous years. However, these forecasts should be accompanied with a detailed statement of the risks and assumptions used for the forecasts as well as a detailed set of budget revenue forecasts, supporting information showing tax arrears and revenues from budget offsets and netting transactions. The macroeconomic projections should be conservative, taking into account all major risks and including contingent risks. The Ministry of Finance should coordinate the preparation of these forecasts, in close cooperation with the MOE. The Cabinet Committee on Economic Issues (CCEI) would request the views of the NBU, the statistical agency and other relevant agencies, as well as outsiders. The debates and documents should be publicized as much as possible.

7.30 Both short-term and medium-term fiscal targets (public debt, overall fiscal deficit, etc.) should be juxtaposed to the status quo fiscal forecast. Ministers would thereby be made aware of any emerging resource gap and could review the recommendations and rationale on the mix of revenue and expenditure actions required to fill this gap. In current practice, the fiscal targets are discussed by the CCEI and the latter prepares a resolution to be submitted to the CoM. Once it is approved, MOF staff develops the detailed revenue and expenditure measures. Cabinet-sanctioned information on the status quo forecast, the gap, and the fiscal plan would be transmitted to line ministries. This would provide the authorities the necessary context for the preparation of revenue and expenditure measures.

55The ceilings for the remaining 63 key spending units may need to be set individually or in groupings of similar functions.
7.31 Macroeconomic analysis and modeling in the departments responsible for the development of the macroeconomic framework also needs to be strengthened, since this framework is the basis for the projections of revenues and expenditures for three years and a necessary step in achieving aggregate fiscal discipline. Restrained decision making requires that the link between economic projections and fiscal targets be made clearly and that a broad political, and not only a technical, discussion take place widely on these trade-offs.

**Sectoral Reviews**

7.32 In parallel with the development of the macroeconomic framework, it would be necessary to carry out a sector review process through which sector/ministry objectives and activities are agreed and then costed. This step is largely missing in Ukraine: neither the MOF sector departments nor line ministries have sufficient capacity and prior experience to operate in this way. The sector review process consists of three stages:

- Agreeing on objectives, outputs and activities;
- Reviewing agreed programs and subprograms; and
- Costing agreed programs.

7.33 These three functions need to be strengthened within the MOF and line ministries. This will require the development of training and technical assistance programs.

7.34 Once ministries have reviewed and costed programs and subprograms, they also need to go through a process of prioritization to make program costs fit within available resources. This involves agreeing on which activities are to be scaled back, postponed until the following year or dropped altogether. The impact of these reductions on targets such as pupil-teacher ratios or kilometers of roads rehabilitated will also need to be identified. This information is provided to the MOF and used to develop the framework for expenditure management and the budget ceilings. During this stage, ministries can develop performance indicators for agreed programs and subprograms so that, over time, there can be greater emphasis on what ministries are achieving with the resources they are given.

7.35 The use of performance indicators or benchmarks is important because it will allow to clearly measure the outcomes of the public funds that are used, their effectiveness (i.e., correlation between results and expenditures) and the length of the program, and whether is really meets the stated objectives and needs. It also gives the possibility to compare budget programs over time, by agencies within one ministry and/or by sector, with other countries, etc. and finally to select the most effective budget programs when distributing limited budget resources. The performance indicators already prepared by the MOF should be extended. These indicators should include:

- **Expenditure indicators** determining the volume and structure of resources envisaged to implement the program (e.g. Number of staff, number of entities, equipment etc.);
- **Output indicators** establishing the number of users of goods (works, services) produced by the program (e.g. number of students, patients, library users, museum visitors etc);
- **Outcome indicators** to evaluate whether the stated goals have been achieved (e.g. number of trained specialists);

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52 Models can assist in identifying problems by checking the internal consistency of proposals and by generating accurate forecasts. Models can also illustrate trade-offs between alternative uses of resources and can make explicit the underlying assumptions about relationships and priorities. Constructing a model can expose differences in assumptions about what drives decisions or relationships and reveals deficiencies in data.

53 Ministry of Finance, Budget Department, Resolution No. 021-05/81 (28 February 2001), Annex 2.
- **Effectiveness indicators**: resource expenditure per one benchmark unit or output (number of students per one professor); and
- **Quality indicators** showing the benefits from implementing the budget program (e.g. for example, a 2 percent decrease in level of TB cases versus previous year).

**Public Expenditure Management Framework**

7.36 The Ministry of Finance will be in a position to develop a strategic framework for public expenditure management once the macroeconomic framework and the sector review outputs are in place. This strategic framework enables the analysis of trade-offs between and within sectors of certain funding decisions and is the basis for the establishment of sector expenditure ceilings for the upcoming budget year as well as for the two outer years. This stage has not been yet reached in Ukraine but a lot of progress toward that goal has been made in the last 2 years.

7.37 The strategic framework should be used to guide the deliberations of the CoM making strategic resource allocation decisions. This framework must enforce aggregate fiscal discipline, which demands a high-level of consensus among the key players. This consensus is essential to ensure that there is discipline in adhering to expenditure targets and to the procedures that have been agreed for adjusting them. This requires harmony between the objectives pursued by the President’s Administration, the Cabinet and the Verkhovna Rada. It also requires that budgetary “deals” be made, as much as possible in the open and not secretly.

7.38 The strategic framework should cover a time frame of three years and must include clear statements on the following:

- The broad objectives of policy and the role of government in the economy;
- The need for discipline in macroeconomic management;
- Targets for broad aggregates of public revenue and expenditure;
- Procedures for setting and revising the expenditure framework; and
- The responsibilities of key agencies.

7.39 The consensus that emerges must include political and technical levels. However, leadership must come from within the government if improvements in planning and budgeting are to be durable.

7.40 It is desirable to have a strong Ministry of Finance to act as agent of the line ministers in facilitating the collectively optimal outcome. The task of the MOF would be to monitor the actions of spending ministries and to “punish” those ministers who overspend. The MOF is currently too weak to accomplish this function but, if this direction is taken, over time, the majority of “players” will begin to realize that the benefits of cooperation exceed the benefits of not abiding by the rules and overspending.

**Developing the Budget Implementation Review Process** 54

7.41 A number of budget execution problems have been described in Chapter 3. We recommend to strengthen the internal review process to reduce the occurrence of problems and introduce corrective measures on time. The first review of budget implementation should be carried out around July-August every year. This will allow the Cabinet Committee on Economic Issues to discern within-year trends and compare them with expectations. The observed divergence from expectations may reflect forecast errors in inflation, in projected program take-up, discretionary policy changes after the budget is approved,

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54This section and the next draw on IMF, “Ukraine. Implementing Expenditure Reforms” (February 2000).
unexpected administrative difficulties in implementing programs or collecting taxes, or other factors. In most OECD countries, this is an intensive exercise involving the MOF, the Treasury and the line ministries.

7.42 The review should culminate in the preparation by the MOF of a formal "Economic and Fiscal Update" paper submitted to the CoM for consideration. It should be accompanied by revised macroeconomic projections and, as the case may be, include proposals for corrective fiscal policy adjustments to emerging fiscal imbalances. The Minister of Finance should then issue publicly a statement on the review and a report to the Verkhovna Rada along with any legislation required to implement the needed fiscal adjustments.

7.43 The revised revenue and expenditure projections should be prepared by MOF in collaboration with the line ministries, revenue collections agencies and the Treasury. To assist in the formulation of an appropriate response, this revised fiscal forecast would include a breakdown of revised estimates into its main sources of variation: policies, administrative changes, developments in economic parameters, and other unexplained changes. At the same time, a separate review of macroeconomic developments would be undertaken.

7.44 The formal mid-year review should be supplemented by monthly reports on budget outcomes (with comparisons to a similar period one year before) prepared by the budget department of MOF. The MOF receives the information from the Treasury but does not process it and does not make it widely available.

Instituting a Mechanism for Budget Dispute Resolution

7.45 The present budget process is largely ineffective in resolving disputes involving, on the one hand, arbitrarily determined ceilings by the MOF and, on the other, unrealistic “norms based assessments” by the line ministries. The differences are so large that discussions simply appear to involve bargaining over small increases in the MOF budget allocation. Program objectives and possible alternative ways of meeting those targets are rarely discussed.

7.46 A structured budget examination process is needed in which the Cabinet Committee on Economic Issues would examine budget requests from ministries and establish any cost savings that would need to be made to hold them within the approved budget ceilings by late July/early August. The CCEI will base its decisions on policy options developed as a result of the internal budget request review process at the MOF. After consideration, the CCEI would pass on its recommendations on both sets of proposals to the full COM.

7.47 In examining the estimates submitted by ministries, the MOF would use the estimated adjustments proposed by ministries for the previous year and the revised estimates for the previous year to determine the base of comparison for three-year projections. In presenting material to the CCEI, the MOF could be selective and choose to concentrate on the largest spending programs. 55

7.48 Until there is a functional reorganization of the government, the sector departments should be instructed to review estimates submitted by line ministries rather than estimates of the entire sector, which may be covered by more than one line ministry. Given the importance of this change in procedures, this action may require endorsement by the CoM.

55 The largest 50 programs of the state budget account for almost 95 percent of spending.
Role of the Verkhovna Rada

7.49 Several improvements are desirable for presentation and passage of the budget through the Verkhovna Rada. First, there is a need to enhance the transparency of the budget process and documents presented to the Verkhovna Rada to encourage a more focused debate on budget constraints and priorities.

7.50 Second, there needs to be a clear distinction of spending financed from cash resources and those financed from netting operations during the budget approval process. The budget constraint applying to netting transactions should be the same as that which applies to cash spending. The revenue estimates in the budget should similarly distinguish cash and netting operations.

7.51 Third, the Verkhovna Rada has to be accountable about the impact that their input in the formulation of the budget on the overall budget constraint. A legal arrangement whereby all new spending proposals made by the Verkhovna Rada have to be offset either by realistic revenue measures or alternative expenditure cuts so that the overall budget constraint is preserved. Such provisions are common in the constitutions and organic budget laws of a number of European and Baltic countries. Article 27 section (2) specifies such an arrangement in the Budget Code and it will be important to assure that this is fully implemented.

7.52 Fourth, where there are shortfalls during the year, in order to facilitate the reprioritization of expenditure programs (some of which could involve cuts in "protected" items), it would be desirable to eliminate the emphasis on "protecting" certain economic transactions found in the budget laws for recent years. In the new Budget Code, the MOF can unilaterally impose spending restrictions in case of monthly revenue shortfalls. In the case of revenue shortfalls over a whole quarter, the CoM and the Rada have to agree on rationing cash in a rather lengthy process.

Objective 3. Strengthening Credibility

7.53 Strengthening the credibility of the budget process requires at least three elements which are only partly present in the Ukrainian system:

- Verification (e.g., the commitment control system is not yet in place);
- Well functioning control and audit institutions; and
- Last but not least—punishing violations. Ukraine has plenty of good laws but many influential and powerful persons violate the law and violations go unpunished. As long as this is the case, the credibility of the process will be undermined.

Objective 4. Improving the Public Availability of Information

7.54 To conclude, it is important to emphasize that more transparency and publicity of the debates, discussions and preparation process of the budget will be beneficial and probably translate into better outcomes.

7.55 Reports prepared by spending units on budget implementation do not contain details on how effectively they use public resources. These reports reflect neither the outputs nor the outcomes of sectoral activities. There is no procedure in place to allow the voice of stakeholders to be heard by those who draft the budgets.

7.56 The annual budget should include statements of financial assets, and data on financial assets at the various levels of government, consolidated on a consistent basis.
Data regarding the Monthly Budget Review of the MoF which is available on the internet, (www.minfin.gov.ua) should be available more frequently. More data and information should be available to the public. Moreover data should be published by the government, through the media and the internet, on (a) extra-budgetary funds; (b) the cost of tax policies and tax administration, tax exemptions and quasi-fiscal activities; (c) government guarantees (above a certain limit); and (d) data on financial assets at various levels of government.

Finally, the MOF should take the initiative in organizing debates on specific fiscal issues with members of the specialized media; NGOs and academic groups.
### ANNEX 1: TABLES

Annex 1-Table 1: Changes in Revenue Projections During the Preparation of the 2000 Budget  
(Corresponding Line Item in the Budget Approved by the Verkhovna Rada = 100)

<table>
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<tr>
<th>Revenue Item</th>
<th>Defined at the Stage of Setting Ceilings for Line Ministries</th>
<th>Submitted to the Cabinet of Ministers on August 15</th>
<th>Submitted to the Cabinet of Ministers after Reconciling on September 2</th>
<th>Submitted for the Second Reading with Amendments Based on MPs' Proposals</th>
<th>Submitted for the Second Reading</th>
<th>Approved by Verkhovna Rada on December 31</th>
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Annex 1-Table 2: Changes in Revenue Projections During the Preparation of the 2001 Budget

(Corresponding Line Item in the Approved Budget = 100)

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### Annex 1-Table 3: Changes in Expenditure Policy During the Preparation of the 2000 Budget

(Corresponding Line Item in the Budget Approved by the Verkhovna Rada = 100)

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## Annex 1-Table 5: Changes by the Executive and Amendments by the Verkhovna Rada for the Special Funds During the Preparation of the 2001 Budget (Approved Budget = 100)

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**NOTE:** Special Funds: All extrabudgetary funds were brought into the budget in 2000 with the exception of the Pension Fund and of other social and labor-related funds (which account for less than 2% of GDP) but are listed separately as “special funds.”
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<td>95%</td>
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<td>98.8%</td>
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<td>111.7%</td>
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## Annex 1-Table 7: Budget Execution for 1996-2000, as % of Total Expenditures

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<td>Approved</td>
<td>Executed</td>
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<td>0.4</td>
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<td>4.4</td>
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<td>5.1</td>
<td>7.9</td>
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<td>3.4</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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Annex 1-Figure 1: Expenditures Flow as % of 1/12 of the Annual Budget, 1997-2000

Annex 1-Figure 2: Revenues Flow as % of 1/12 of Annual Budget, 1997-2000
The following two figures show that on a cumulative basis for the first time both the revenues and expenditures exceed the approved level.

Annex 1-Figure 3: Deviation of Actual Revenues from Monthly Target, Cumulative, 1997-2000

Annex 1-Figure 4: Deviation of Actual Expenditures from Monthly Target, Cumulative, 1997-2000
### Annex 1-Table 8: Budget Execution in 2000, by Economic Classification

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<thead>
<tr>
<th>Item</th>
<th>General and Special Funds</th>
<th>General Fund</th>
<th>Expenditure item share of total approved expenditures, %</th>
<th>General and Special Funds</th>
<th>General Fund</th>
<th>Expenditure item share of total planned expenditures, %</th>
<th>Execution Rate, %</th>
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<td>9761,1</td>
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<td>98,9</td>
</tr>
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<td>Medicine and Bandaging Materials</td>
<td>179,9</td>
<td>134,5</td>
<td>0,50</td>
<td>163,9</td>
<td>118,8</td>
<td>0,47</td>
<td>91,1</td>
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<td>Food products</td>
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<td>318,2</td>
<td>1,42</td>
<td>476,6</td>
<td>314,5</td>
<td>1,37</td>
<td>92,7</td>
</tr>
<tr>
<td>Business Trip Expenditures</td>
<td>134,5</td>
<td>77,9</td>
<td>0,37</td>
<td>127,8</td>
<td>72,0</td>
<td>0,37</td>
<td>95,0</td>
</tr>
<tr>
<td>Materials, Inventory, Construction, Capital Repair, and Special Measures</td>
<td>468,1</td>
<td>131,6</td>
<td>1,29</td>
<td>525,8</td>
<td>130,0</td>
<td>1,51</td>
<td>112,3</td>
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<tr>
<td>Payments for Public Services and Energy</td>
<td>1118,8</td>
<td>658,9</td>
<td>3,09</td>
<td>879,9</td>
<td>611,3</td>
<td>2,53</td>
<td>78,6</td>
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<td>Payments for Heat Supply</td>
<td>384,1</td>
<td>256,3</td>
<td>1,06</td>
<td>311,8</td>
<td>236,4</td>
<td>0,90</td>
<td>81,2</td>
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<td>Payments for Water Supply and Drain-piping</td>
<td>121,8</td>
<td>51,9</td>
<td>0,34</td>
<td>77,6</td>
<td>48,8</td>
<td>0,22</td>
<td>63,7</td>
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<td>386,7</td>
<td>258,3</td>
<td>1,07</td>
<td>319,6</td>
<td>244,2</td>
<td>0,92</td>
<td>82,7</td>
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<tr>
<td>Payments for Natural Gas</td>
<td>140,4</td>
<td>56,9</td>
<td>0,39</td>
<td>96,7</td>
<td>50,7</td>
<td>0,28</td>
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</tr>
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<td>Payments for Other Public Services and Energy Supply</td>
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<td>35,6</td>
<td>0,24</td>
<td>74,2</td>
<td>31,3</td>
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<td>86,5</td>
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<td>Research and Development, State Programs</td>
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<td>11,17</td>
<td>3627,5</td>
<td>1761,2</td>
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<td>4303,6</td>
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<td>79,7</td>
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<td>Subsidies and Current Transfers</td>
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<td>6652,5</td>
<td>18,72</td>
<td>13110,8</td>
<td>12451,1</td>
<td>37,74</td>
<td>193,7</td>
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<td>Subsidies and Current Transfers to Enterprises, Institutions and Agencies</td>
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<td>2587,7</td>
<td>7,48</td>
<td>2332,0</td>
<td>2226,0</td>
<td>6,71</td>
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<td>4064,7</td>
<td>11,24</td>
<td>4300,8</td>
<td>4298,5</td>
<td>12,38</td>
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<td>17,53</td>
<td>6176,3</td>
<td>5626,7</td>
<td>17,78</td>
<td>97,4</td>
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<td>Pensions and Assistance</td>
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<td>4227,2</td>
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<td>4578,5</td>
<td>4101,0</td>
<td>13,18</td>
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<td>Scholarships</td>
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<td>238,1</td>
<td>230,4</td>
<td>0,69</td>
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<td>362,2</td>
<td>1,01</td>
<td>301,7</td>
<td>299,9</td>
<td>0,87</td>
<td>82,7</td>
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<td>957,5</td>
<td>5,00</td>
<td>2084,5</td>
<td>845,2</td>
<td>6,00</td>
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<td>Acquisition of Fixed Capital Assets</td>
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<td>659,8</td>
<td>4,14</td>
<td>1445,5</td>
<td>585,3</td>
<td>4,17</td>
<td>96,9</td>
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<td>224,6</td>
<td>1,65</td>
<td>570,4</td>
<td>200,1</td>
<td>1,64</td>
<td>95,6</td>
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<td>290,2</td>
<td>1,41</td>
<td>503,9</td>
<td>244,8</td>
<td>1,45</td>
<td>98,8</td>
</tr>
<tr>
<td>Capital Repair</td>
<td>389,9</td>
<td>144,9</td>
<td>1,08</td>
<td>375,3</td>
<td>140,4</td>
<td>1,08</td>
<td>96,3</td>
</tr>
<tr>
<td>------------------------------------------------------</td>
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<td>-----------</td>
<td>-----------</td>
<td>-----------</td>
<td>-----------</td>
<td>-----------</td>
</tr>
<tr>
<td>State Reserves and Stocks</td>
<td>1,2</td>
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<td>0,00</td>
<td>365,6</td>
<td>1,2</td>
<td>1,05</td>
<td>30749,5</td>
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<td>Purchases of Land and Assets</td>
<td>12,5</td>
<td>9,3</td>
<td>0,03</td>
<td>11,2</td>
<td>9,3</td>
<td>0,03</td>
<td>89,6</td>
</tr>
<tr>
<td>Capital Transfers</td>
<td>299,1</td>
<td>287,2</td>
<td>0,83</td>
<td>258,2</td>
<td>249,4</td>
<td>0,74</td>
<td>86,3</td>
</tr>
<tr>
<td>Capital Transfers to Enterprises, Institutions and Agencies</td>
<td>175,3</td>
<td>163,5</td>
<td>0,48</td>
<td>149,2</td>
<td>141,4</td>
<td>0,43</td>
<td>85,1</td>
</tr>
<tr>
<td>Capital Transfers to Other Levels of National Government</td>
<td>97,5</td>
<td>97,5</td>
<td>0,27</td>
<td>82,0</td>
<td>81,7</td>
<td>0,24</td>
<td>84,1</td>
</tr>
<tr>
<td>Capital Transfers to Population</td>
<td>21,4</td>
<td>21,4</td>
<td>0,00</td>
<td>19,3</td>
<td>21,1</td>
<td>0,06</td>
<td>28,4</td>
</tr>
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<td>Retained Expenditures</td>
<td>244,6</td>
<td>240,0</td>
<td>0,68</td>
<td>251,2</td>
<td>250,4</td>
<td>0,72</td>
<td>102,4</td>
</tr>
<tr>
<td>Lending Minus Repayments</td>
<td>75,3</td>
<td>69,4</td>
<td>0,21</td>
<td>21,4</td>
<td>15,2</td>
<td>0,06</td>
<td>28,4</td>
</tr>
<tr>
<td>Payments to the Budget</td>
<td>141,4</td>
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<td>212,5</td>
<td>150,3</td>
<td>96,0</td>
<td>94,5</td>
<td></td>
</tr>
<tr>
<td>TOTAL EXPENDITURES</td>
<td>36171,6</td>
<td>29508,0</td>
<td>100,0</td>
<td>34738,2</td>
<td>27896,9</td>
<td>100,0</td>
<td>96,0</td>
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Annex 1-Table 9: State Budget Execution, 1999 (In Percentage of the Rospis, i.e. Budget Implementation Sheet)

<table>
<thead>
<tr>
<th>Category</th>
<th>I quarter</th>
<th>II quarter</th>
<th>III quarter</th>
<th>IV quarter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Administration</td>
<td>63.70%</td>
<td>91.93%</td>
<td>98.26%</td>
<td>118.87%</td>
<td>93.33%</td>
</tr>
<tr>
<td>Judiciary</td>
<td>53.20%</td>
<td>69.51%</td>
<td>61.10%</td>
<td>111.66%</td>
<td>74.37%</td>
</tr>
<tr>
<td>International Relations</td>
<td>52.60%</td>
<td>43.45%</td>
<td>45.98%</td>
<td>44.64%</td>
<td>46.14%</td>
</tr>
<tr>
<td>Scientific research</td>
<td>29.60%</td>
<td>77.22%</td>
<td>40.47%</td>
<td>73.83%</td>
<td>56.40%</td>
</tr>
<tr>
<td>National Defense</td>
<td>51.50%</td>
<td>83.08%</td>
<td>105.70%</td>
<td>117.62%</td>
<td>91.13%</td>
</tr>
<tr>
<td>Law Enforcement and State Security</td>
<td>60.20%</td>
<td>78.33%</td>
<td>93.73%</td>
<td>126.63%</td>
<td>90.72%</td>
</tr>
<tr>
<td>Education</td>
<td>42.70%</td>
<td>79.35%</td>
<td>86.35%</td>
<td>122.70%</td>
<td>84.34%</td>
</tr>
<tr>
<td>Health Care</td>
<td>32.60%</td>
<td>55.51%</td>
<td>58.90%</td>
<td>94.34%</td>
<td>61.84%</td>
</tr>
<tr>
<td>Social Protection and Social Care</td>
<td>71.60%</td>
<td>91.84%</td>
<td>116.89%</td>
<td>74.50%</td>
<td>89.61%</td>
</tr>
<tr>
<td>Housing and Communal Affairs</td>
<td>0.00%</td>
<td>8.02%</td>
<td>82.97%</td>
<td>71.88%</td>
<td>45.58%</td>
</tr>
<tr>
<td>Culture and the Arts</td>
<td>27.20%</td>
<td>381.53%</td>
<td>30.11%</td>
<td>52.32%</td>
<td>35.81%</td>
</tr>
<tr>
<td>Mass Media</td>
<td>26.80%</td>
<td>68.24%</td>
<td>58.11%</td>
<td>101.26%</td>
<td>70.21%</td>
</tr>
<tr>
<td>Physical Culture and Sports</td>
<td>9.20%</td>
<td>69.11%</td>
<td>95.99%</td>
<td>135.82%</td>
<td>87.74%</td>
</tr>
<tr>
<td>Industry and Energy</td>
<td>67.40%</td>
<td>91.42%</td>
<td>94.71%</td>
<td>76.94%</td>
<td>83.35%</td>
</tr>
<tr>
<td>Construction</td>
<td>52.30%</td>
<td>50.11%</td>
<td>37.60%</td>
<td>13809.24%</td>
<td>73.89%</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishery and Hunting</td>
<td>49.60%</td>
<td>55.49%</td>
<td>54.04%</td>
<td>228.48%</td>
<td>85.27%</td>
</tr>
<tr>
<td>Transportation, Roads, Communication, Telecommunication and Information</td>
<td>108.70%</td>
<td>90.30%</td>
<td>106.90%</td>
<td>116.41%</td>
<td>105.42%</td>
</tr>
<tr>
<td>Other Services Related to Economic Activities</td>
<td>34.80%</td>
<td>35.52%</td>
<td>54.94%</td>
<td>119.27%</td>
<td>56.53%</td>
</tr>
<tr>
<td>Measures Related to Liquidation of Chernobyl Disaster Aftermath and Social Protection of Population</td>
<td>85.10%</td>
<td>112.14%</td>
<td>83.52%</td>
<td>61.16%</td>
<td>82.75%</td>
</tr>
<tr>
<td>Protection of the Environment and Nuclear Safety</td>
<td>37.60%</td>
<td>55.33%</td>
<td>57.06%</td>
<td>110.76%</td>
<td>63.26%</td>
</tr>
<tr>
<td>Prevention and Liquidation of Accidents and Aftermath of Natural Calamities</td>
<td>34.30%</td>
<td>68.33%</td>
<td>89.14%</td>
<td>141.20%</td>
<td>82.29%</td>
</tr>
<tr>
<td>Replenishment of State Stocks and Reserves</td>
<td>95.80%</td>
<td>82.81%</td>
<td>118.78%</td>
<td>84.49%</td>
<td>95.46%</td>
</tr>
<tr>
<td>State Debt Servicing</td>
<td>96.90%</td>
<td>50.66%</td>
<td>106.10%</td>
<td>85.63%</td>
<td>87.09%</td>
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### Annex 1-Table 10: Monthly Execution of the State Budget, 2000 as a Percentage of the Rospis, i.e. Budget Implementation Sheet (General Fund)

<table>
<thead>
<tr>
<th>Category</th>
<th>January</th>
<th>February</th>
<th>March</th>
<th>April</th>
<th>May</th>
<th>June</th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Administration</td>
<td>36.65%</td>
<td>78.53%</td>
<td>125.50%</td>
<td>80.99%</td>
<td>64.45%</td>
<td>89.74%</td>
<td>98.56%</td>
<td>100.08%</td>
<td>90.01%</td>
<td>89.02%</td>
<td>106.45%</td>
<td>219.09%</td>
</tr>
<tr>
<td>Judiciary Authorities</td>
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<td>136.27%</td>
<td>85.72%</td>
<td>62.92%</td>
<td>102.82%</td>
<td>66.56%</td>
<td>67.64%</td>
<td>86.78%</td>
<td>100.61%</td>
<td>112.90%</td>
<td>206.72%</td>
</tr>
<tr>
<td>International Activities</td>
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<td>86.38%</td>
<td>83.96%</td>
<td>36.17%</td>
<td>34.74%</td>
<td>169.15%</td>
<td>121.16%</td>
<td>96.62%</td>
<td>89.51%</td>
<td>71.02%</td>
<td>138.32%</td>
<td>327.07%</td>
</tr>
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<td>91.73%</td>
<td>117.17%</td>
<td>196.41%</td>
<td>62.56%</td>
<td>81.63%</td>
<td>76.07%</td>
<td>58.43%</td>
<td>56.27%</td>
<td>85.19%</td>
<td>111.99%</td>
<td>313.52%</td>
</tr>
<tr>
<td>National Defense</td>
<td>58.90%</td>
<td>89.07%</td>
<td>133.14%</td>
<td>99.14%</td>
<td>98.86%</td>
<td>98.90%</td>
<td>106.62%</td>
<td>114.34%</td>
<td>96.34%</td>
<td>126.65%</td>
<td>63.70%</td>
<td>106.33%</td>
</tr>
<tr>
<td>Law Enforcement and State Security Affairs</td>
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<td>90.51%</td>
<td>100.94%</td>
<td>323.45%</td>
<td>110.44%</td>
<td>124.53%</td>
<td>90.04%</td>
<td>108.24%</td>
<td>84.38%</td>
<td>134.89%</td>
<td>108.51%</td>
<td>122.04%</td>
</tr>
<tr>
<td>Education</td>
<td>7.26%</td>
<td>108.15%</td>
<td>100.26%</td>
<td>80.53%</td>
<td>95.70%</td>
<td>97.97%</td>
<td>84.78%</td>
<td>59.56%</td>
<td>85.16%</td>
<td>120.10%</td>
<td>102.61%</td>
<td>158.65%</td>
</tr>
<tr>
<td>Health Care</td>
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<td>76.65%</td>
<td>75.56%</td>
<td>71.01%</td>
<td>69.34%</td>
<td>51.09%</td>
<td>38.11%</td>
<td>77.27%</td>
<td>119.10%</td>
<td>336.61%</td>
<td>207.81%</td>
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<tr>
<td>Social Protection and Social Care</td>
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<td>85.77%</td>
<td>187.55%</td>
<td>331.58%</td>
<td>70.29%</td>
<td>87.77%</td>
<td>138.52%</td>
<td>111.61%</td>
<td>97.17%</td>
<td>102.88%</td>
<td>84.28%</td>
<td>37.66%</td>
</tr>
<tr>
<td>Housing and Community Affairs</td>
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<td>0.00%</td>
<td>0.00%</td>
<td>97.10%</td>
<td>34.30%</td>
<td>71.82%</td>
<td>97.08%</td>
<td>89.42%</td>
<td>28.45%</td>
<td>293.10%</td>
<td>207.31%</td>
<td>272.62%</td>
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<td>68.73%</td>
<td>44.73%</td>
<td>52.45%</td>
<td>44.23%</td>
<td>71.81%</td>
<td>146.51%</td>
<td>209.29%</td>
</tr>
<tr>
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<td>197.97%</td>
<td>92.72%</td>
<td>98.04%</td>
<td>97.94%</td>
<td>36.21%</td>
<td>30.28%</td>
<td>47.22%</td>
<td>63.13%</td>
<td>170.81%</td>
<td>277.00%</td>
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<tr>
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<td>75.48%</td>
<td>108.04%</td>
<td>79.03%</td>
<td>81.95%</td>
<td>80.86%</td>
<td>93.43%</td>
<td>73.98%</td>
<td>60.38%</td>
<td>197.09%</td>
<td>181.48%</td>
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<tr>
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<td>106.91%</td>
<td>94.44%</td>
<td>153.72%</td>
<td>145.61%</td>
<td>163.39%</td>
<td>44.71%</td>
<td>64.02%</td>
<td>161.74%</td>
<td>195.59%</td>
<td>229.82%</td>
</tr>
<tr>
<td>Construction</td>
<td>-6563.64%</td>
<td>-146.15%</td>
<td>216.42%</td>
<td>2.21%</td>
<td>3.88%</td>
<td>3.15%</td>
<td>8.45%</td>
<td>96.68%</td>
<td>33.36%</td>
<td>38.25%</td>
<td>111.59%</td>
<td>229.82%</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishery, and Hunting</td>
<td>21.58%</td>
<td>78.66%</td>
<td>112.98%</td>
<td>166.48%</td>
<td>77.47%</td>
<td>83.84%</td>
<td>76.05%</td>
<td>111.14%</td>
<td>92.82%</td>
<td>107.17%</td>
<td>196.99%</td>
<td>349.93%</td>
</tr>
<tr>
<td>Transportation, Roads, Communications, and IT</td>
<td>2.17%</td>
<td>114.53%</td>
<td>25.87%</td>
<td>149.76%</td>
<td>198.54%</td>
<td>108.41%</td>
<td>80.39%</td>
<td>51.37%</td>
<td>68.40%</td>
<td>130.31%</td>
<td>165.55%</td>
<td>268.78%</td>
</tr>
<tr>
<td>Other Services Related to Economic Activities</td>
<td>41.89%</td>
<td>102.32%</td>
<td>100.28%</td>
<td>190.21%</td>
<td>41.28%</td>
<td>17.59%</td>
<td>67.54%</td>
<td>19.68%</td>
<td>28.00%</td>
<td>38.95%</td>
<td>407.34%</td>
<td>189.15%</td>
</tr>
<tr>
<td>Liquidation of Chernobyl Catastrophe Aftermath and Social Protection</td>
<td>-0.09%</td>
<td>0.08%</td>
<td>262.94%</td>
<td>429.99%</td>
<td>95.13%</td>
<td>105.68%</td>
<td>102.63%</td>
<td>80.32%</td>
<td>109.76%</td>
<td>98.93%</td>
<td>121.40%</td>
<td></td>
</tr>
<tr>
<td>Protection of Environment and Nuclear Safety</td>
<td>15.92%</td>
<td>97.58%</td>
<td>125.50%</td>
<td>169.83%</td>
<td>86.00%</td>
<td>62.96%</td>
<td>61.76%</td>
<td>56.18%</td>
<td>40.72%</td>
<td>60.35%</td>
<td>181.00%</td>
<td></td>
</tr>
<tr>
<td>Prevention and Liquidation of Accidents and Natural Disasters</td>
<td>27.63%</td>
<td>88.49%</td>
<td>110.74%</td>
<td>186.30%</td>
<td>85.05%</td>
<td>78.73%</td>
<td>78.28%</td>
<td>75.17%</td>
<td>77.08%</td>
<td>98.05%</td>
<td>97.33%</td>
<td></td>
</tr>
<tr>
<td>Replenishment of State Stocks and Reserves</td>
<td>9.82%</td>
<td>77.54%</td>
<td>138.82%</td>
<td>150.27%</td>
<td>66.38%</td>
<td>69.63%</td>
<td>21.44%</td>
<td>66.85%</td>
<td>27.05%</td>
<td>68.47%</td>
<td>220.64%</td>
<td></td>
</tr>
<tr>
<td>State Debt Servicing</td>
<td>98.53%</td>
<td>98.35%</td>
<td>68.88%</td>
<td>81.13%</td>
<td>28.86%</td>
<td>89.79%</td>
<td>73.91%</td>
<td>33.60%</td>
<td>55.38%</td>
<td>309.43%</td>
<td>74.99%</td>
<td>75.25%</td>
</tr>
<tr>
<td>Expenditures Not Included in Major Groups</td>
<td>-0.98%</td>
<td>0.06%</td>
<td>17.31%</td>
<td>16.08%</td>
<td>-14.28%</td>
<td>8.96%</td>
<td>7.05%</td>
<td>12.51%</td>
<td>18.87%</td>
<td>8.79%</td>
<td>26.00%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>50.63%</td>
<td>80.07%</td>
<td>154.90%</td>
<td>92.26%</td>
<td>69.40%</td>
<td>97.89%</td>
<td>94.11%</td>
<td>90.83%</td>
<td>29.32%</td>
<td>21.38%</td>
<td>91.29%</td>
<td>263.39%</td>
</tr>
</tbody>
</table>
### Annex 1-Table 11: Budget Revenues in 1998-2000, Million UAH

#### State Budget Revenues in 1998-2000, Million UAH

<table>
<thead>
<tr>
<th></th>
<th>1998 Actual</th>
<th>Plan % Of Plan</th>
<th>1999 Actual</th>
<th>Plan % Of Plan</th>
<th>2000 Actual</th>
<th>Plan % Of Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenues</td>
<td>10,311.69</td>
<td>11,510.27</td>
<td>89.59</td>
<td>14,168.31</td>
<td>15,989.27</td>
<td>88.61</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>1,322.94</td>
<td>1,168.85</td>
<td>113.18</td>
</tr>
<tr>
<td>Enterprises Profit Tax</td>
<td>221.39</td>
<td>0.00</td>
<td>0.00</td>
<td>1,528.30</td>
<td>1,317.27</td>
<td>116.02</td>
</tr>
<tr>
<td>Value-Added Tax</td>
<td>7,460.10</td>
<td>8,756.40</td>
<td>85.20</td>
<td>8,409.24</td>
<td>8,302.73</td>
<td>101.28</td>
</tr>
<tr>
<td>Excises on Domestic Goods</td>
<td>1,029.48</td>
<td>1,029.96</td>
<td>99.95</td>
<td>992.92</td>
<td>1,364.65</td>
<td>72.76</td>
</tr>
<tr>
<td>Non-Tax Revenues</td>
<td>2,079.57</td>
<td>3,137.44</td>
<td>66.28</td>
<td>2,850.23</td>
<td>5,132.58</td>
<td>55.53</td>
</tr>
<tr>
<td>Receipts from Privatization</td>
<td>358.99</td>
<td>1,040.00</td>
<td>34.52</td>
<td>693.98</td>
<td>675.00</td>
<td>102.81</td>
</tr>
<tr>
<td>Total State Revenues</td>
<td>15,705.00</td>
<td>20,510.97</td>
<td>76.57</td>
<td>19,723.96</td>
<td>23,513.04</td>
<td>83.89</td>
</tr>
</tbody>
</table>

#### Local Budgets Revenues in 1998-2000, Million UAH

<table>
<thead>
<tr>
<th></th>
<th>1998 Actual</th>
<th>Plan % Of Plan</th>
<th>1999 Actual</th>
<th>Plan % Of Plan</th>
<th>2000 Actual</th>
<th>Plan % Of Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenues</td>
<td>11,536.65</td>
<td>7,790.06</td>
<td>148.09</td>
<td>10,962.10</td>
<td>117.16</td>
<td>11,721.99</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>3,570.57</td>
<td>3,528.10</td>
<td>101.20</td>
<td>3,111.49</td>
<td>112.28</td>
<td>6,377.79</td>
</tr>
<tr>
<td>Enterprises Profit Tax</td>
<td>5,694.46</td>
<td>2,327.90</td>
<td>244.62</td>
<td>4,824.20</td>
<td>142.61</td>
<td>2,082.78</td>
</tr>
<tr>
<td>Value-Added Tax</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Excises on Domestic Goods</td>
<td>60.35</td>
<td>584.28</td>
<td>97.00</td>
<td>998.01</td>
<td>150.59</td>
<td>88.69</td>
</tr>
<tr>
<td>Non-Tax Revenues</td>
<td>517.22</td>
<td>559.99</td>
<td>92.36</td>
<td>551.64</td>
<td>119.51</td>
<td>1,769.78</td>
</tr>
<tr>
<td>Receipts from Privatization</td>
<td>111.63</td>
<td>127.80</td>
<td>44.19</td>
<td>821.79</td>
<td>284.01</td>
<td>215.09</td>
</tr>
<tr>
<td>Total Local Revenues</td>
<td>13,210.82</td>
<td>9,250.65</td>
<td>142.81</td>
<td>13,152.46</td>
<td>122.47</td>
<td>14,206.99</td>
</tr>
</tbody>
</table>

#### Consolidated Budget Revenues in 1998-2000, Million UAH

<table>
<thead>
<tr>
<th></th>
<th>1998 Actual</th>
<th>Plan % Of Plan</th>
<th>1999 Actual</th>
<th>Plan % Of Plan</th>
<th>2000 Actual</th>
<th>Plan % Of Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Revenues</td>
<td>21,848.33</td>
<td>19,306.33</td>
<td>113.20</td>
<td>25,132.40</td>
<td>157.16</td>
<td>31,342.13</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>3,570.57</td>
<td>3,528.10</td>
<td>101.20</td>
<td>4,343.43</td>
<td>112.55</td>
<td>6,377.79</td>
</tr>
<tr>
<td>Enterprises Profit Tax</td>
<td>5,915.85</td>
<td>2,327.90</td>
<td>254.13</td>
<td>6,352.50</td>
<td>135.16</td>
<td>7,727.08</td>
</tr>
<tr>
<td>Value-Added Tax</td>
<td>7,460.10</td>
<td>8,756.40</td>
<td>85.20</td>
<td>8,409.24</td>
<td>101.28</td>
<td>9,437.69</td>
</tr>
<tr>
<td>Excises on Domestic Goods</td>
<td>1,089.83</td>
<td>1,029.96</td>
<td>105.81</td>
<td>1,577.20</td>
<td>80.36</td>
<td>1,962.67</td>
</tr>
<tr>
<td>Non-Tax Revenues</td>
<td>2,596.79</td>
<td>3,697.43</td>
<td>70.23</td>
<td>3,401.87</td>
<td>60.81</td>
<td>5,594.19</td>
</tr>
<tr>
<td>Receipts from Privatization</td>
<td>470.62</td>
<td>1,064.94</td>
<td>44.19</td>
<td>821.79</td>
<td>114.14</td>
<td>2,290.44</td>
</tr>
<tr>
<td>Total Consolidated Revenues</td>
<td>28,915.83</td>
<td>29,761.61</td>
<td>97.16</td>
<td>32,876.42</td>
<td>107.37</td>
<td>48,443.68</td>
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</table>
### Annex 1-Table 12: Public Expenditures in Selected Countries, 1999 (excl. Social Funds)

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (Million)</th>
<th>GDP Per Capita (PPP, $)</th>
<th>Government Finance (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Revenue</td>
<td>Expenditure</td>
</tr>
<tr>
<td>Ukraine</td>
<td>49.9</td>
<td>3,178(^1)</td>
<td>34.7</td>
</tr>
<tr>
<td>Belarus</td>
<td>10.2</td>
<td>6,088(^1)</td>
<td>38.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.1</td>
<td>10,814</td>
<td>39.9</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.7</td>
<td>6,292</td>
<td>22.8</td>
</tr>
<tr>
<td>Poland</td>
<td>38.7</td>
<td>7,980</td>
<td>37.3</td>
</tr>
<tr>
<td>Romania</td>
<td>22.5</td>
<td>5,664</td>
<td>24.4(^2)</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>146.5</td>
<td>6,271</td>
<td>31.8</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>-</td>
<td>7,185</td>
<td>32.4</td>
</tr>
<tr>
<td>Colombia</td>
<td>41.5</td>
<td>5,954</td>
<td>12.3</td>
</tr>
<tr>
<td>Egypt, Arab Rep.</td>
<td>62.4</td>
<td>3,263</td>
<td>28.9(^2)</td>
</tr>
<tr>
<td>Korea, Rep.</td>
<td>46.8</td>
<td>14,806</td>
<td>20.3(^2)</td>
</tr>
<tr>
<td>South Africa</td>
<td>42.1</td>
<td>8,503</td>
<td>43.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>61.7</td>
<td>5,757</td>
<td>15.3</td>
</tr>
<tr>
<td>Turkey</td>
<td>64.3</td>
<td>6,177</td>
<td>23.8</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>-</td>
<td>7,410</td>
<td>24.0</td>
</tr>
<tr>
<td>France</td>
<td>59.1</td>
<td>21,858</td>
<td>34.1(^2)</td>
</tr>
<tr>
<td>Germany</td>
<td>82.0</td>
<td>22,604</td>
<td>32.1</td>
</tr>
<tr>
<td>Greece</td>
<td>10.5</td>
<td>14,542</td>
<td>26.4(^1)</td>
</tr>
<tr>
<td>Italy</td>
<td>57.6</td>
<td>20,983</td>
<td>42.6(^1)</td>
</tr>
<tr>
<td>Spain</td>
<td>39.4</td>
<td>16,994</td>
<td>35.2(^2)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>59.1</td>
<td>20,906</td>
<td>38.7</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>-</td>
<td>19,648</td>
<td>34.8</td>
</tr>
</tbody>
</table>

*Note:* \(^1\) 1998. \(^2\) 1997.

Functional Classification

1. The budget classification introduced in Ukraine in 1997 comes close to meeting international standards (new IMF standards for public finance statistics) but did not meet them fully. In 2001 a new functional classification was introduced, containing 10 sections, in full conformity with new international standards and reflecting all the general functions of the state.

2. The budget for 2002 was prepared on the basis of program classification. From now on, the functional classification of budget expenditures will be used exclusively in analytical and statistical documents (compiling indexes of consolidated budget, macroeconomic analysis, comparable characteristics analysis with budgets of other countries, etc.) and the introduction of essential or frequent changes is not envisaged.

3. Preparing a “transition table” regarding the functional classification (comparison of the current one with the new one) enabled to determine the most difficult transition elements, those requiring a detailed analysis on the part of MOF departments and key spending agencies. On one hand, a number of the same/similar codes of the current functional classification have to be assigned/referred to different sections depending on the key spending unit and assignment. First of all these are expenditures for maintaining central executive body apparatus/staff, applied scientific developments and capital investments that have to be referred to a category of the respective industry (e.g., Scientific applied research on education should be referred to the Section “Education”, maintenance of the Ministry of Culture staff—to the Section “Culture”, capital investments for the construction of hospitals—to the Section “Healthcare”). On the other hand, there codes of the current functional classification that deals with one key spending unit, though they include the areas of activity in different industries. For example, in the expenditures for maintaining law-enforcement structures it is necessary to single out a social and cultural sphere which currently is mostly reflected under the КФКВ 050000 “National Defense” and 060000 “Law enforcement activity” (in particular, military sanatoriums, rest homes and hospitals—to the Section “Healthcare”, military schools—to the sections “Education” etc.).

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56See Ministry of Finance, Budget Department, Resolution No. 021-05/81 (28 February 2001). Annex 2: Features of the program-based for the budget process in the elaboration of the draft State Budget for 2002.”

57The Ukrainian functional classification consisted of 25 sections (according to the new IMF standards, there are 10 sections), some of which do not reflect at all the general functions of the state. The main ones were “catch-all” categories which, as has been noted by the Accounting Chamber, allowed a lot of “fudging”: e.g. КФКВ 240000 “Earmarked/targeted funds”, КФКВ 250000 “Expenditures not referred to other categories”. Subsections of current functional classification contained elements of sector/industry classification (e.g. КФКВ 020002 “Supreme Court of Ukraine”, КФКВ 061001 “Department of the state security of Ukraine”), of economic classification (e.g. КФКВ 050200 “Purchasing of armament and military equipment”, КФКВ 150101 “Capital investments”) and sometimes directly the names of programs. Given that the functional classification code names were used for approving budget assignments in the Law on the State Budget of Ukraine, they were changed frequently, including upon recommendation of the Verkhovna Rada, and as a result they agreed less and less with international standard requirements and did not correspond to the purpose of the functional classification.
4. The structure of the program classification code is as follows:

- the first part of the code (first, second and third digit of the code number) indicates the key spending unit (the respective code under the current sector classification of the state budget expenditures);
- the second part of the code (fourth digit of code number) indicates the key entities responsible for the implementation of programs in the system of the key spending unit (in case the responsible entity is directly a structural subunit of the central apparatus of a key spending unit, this part of the code is “1”, but if a separate power body or an agency with legal entity status in the system of the key spending unit is directly responsible for the implementation, then this part of the code contains numbers from 2 to 9);
- the third part of the code (fifth and sixth digit) indicates type of a program within one entity responsible for the implementation of the program in the system of the key spending unit (if the program is related to maintaining state power bodies apparatus (mainly these are codes of the current functional classification in the Section “State management”, this part of the code is “01”, all others – “02”, “03”, “04” etc. within one responsible entity in the system of the key spending unit.)
- the fourth part of the code (seventh digit) indicates the type of subprogram or area of activity in one program (code is from 1 to 9): for 2002 this part may not be applied in full in order to simplify the system and try it out in practice (therefore “0” could be found here).

5. A mandatory condition is the link of the code of a certain program with the respective code of the new functional classification, which gives the possibility to group automatically budget program indicators by functional classification.

6. The name of the program must reflect its essence. In the majority of cases it is necessary to take as a basis for determining a budget program the list budget assignments of a certain key spending unit according to the approved functional classification (the Law of Ukraine “On the State Budget of Ukraine for 2001”) to analyze the organizational structure of such key spending unit in order to identify responsible implementing entities and to study in detail the goals of the action/program to be achieved and the tasks to be fulfilled for achieve these goals at the expense of the respective budget assignment.

7. The name of each code of program classification (program) should be unique, i.e. it should be different from other names of codes of program classification (programs).

8. With the aim to improve transparency and controllability of the use of budget funds, the budget program whose expenditure volume is more than 1-1.5 percent of the total volume of the state budget expenditures should be divided into several smaller budget programs.

9. Example: the code of Ministry of Health’s program classification is 2302020 “Development and implementation of new technologies for diagnosis and treatment in hospitals under scientific and research institutes”: 230—code of sector/branch classification of the Ministry of Health; 2—code of the body responsible for the implementation within the system of the Ministry of Health (Academy of medical sciences of Ukraine); 02—internal code of the program. At this, the program corresponds to code 0732 of the new functional classification “Specialized hospitals” (code 080202 of the current functional classification). If needed such program could be broken down by specific areas of activity (which will differ in the last digit of the code, but will correspond to one and the same code of the functional classification to which the program on the whole corresponds (0732).
Annex 2-Table 1: Program Classification

<table>
<thead>
<tr>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Name</th>
<th>КФКВ New</th>
<th>КФКВ Current</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>230</td>
<td>0</td>
<td>00</td>
<td>0</td>
<td>Ministry of Health of Ukraine</td>
<td></td>
<td></td>
<td>Aggregate Code</td>
</tr>
<tr>
<td>230</td>
<td>1</td>
<td>00</td>
<td>0</td>
<td>Ministry of Health Apparatus (Staff)</td>
<td></td>
<td></td>
<td>Aggregate Code</td>
</tr>
<tr>
<td>230</td>
<td>1</td>
<td>01</td>
<td>0</td>
<td>Management in the Sphere of Healthcare</td>
<td>0760</td>
<td>010113</td>
<td>Applied as a Concrete Program</td>
</tr>
<tr>
<td>230</td>
<td>2</td>
<td>00</td>
<td>0</td>
<td>Academy of Medical Sciences of Ukraine</td>
<td></td>
<td></td>
<td>Aggregate Code</td>
</tr>
<tr>
<td>230</td>
<td>2</td>
<td>02</td>
<td>0</td>
<td>Development and Implementation of New Technologies for Diagnostics and Treatment in Hospitals of Scientific and Research Institutes</td>
<td>0732</td>
<td>080202</td>
<td>Applied as a Concrete Program</td>
</tr>
<tr>
<td>230</td>
<td>2</td>
<td>02</td>
<td>1</td>
<td>(Description of Areas)</td>
<td>0732</td>
<td>080202</td>
<td></td>
</tr>
<tr>
<td>230</td>
<td>2</td>
<td>02</td>
<td>2</td>
<td>(Description of Areas)</td>
<td>0732</td>
<td>080202</td>
<td></td>
</tr>
</tbody>
</table>

10. Program classification of state budget expenditures will be specified and re-approved annually in accordance with budget assignments established by the Law on the State Budget of Ukraine. Some programs may be reviewed every year in terms their content and name accordingly, some programs will be of a one-year nature etc.