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TECHNICAL ASSISTANCE REPORT—MEDIUM-TERM BUDGET FRAMEWORK AND FISCAL RISK STATEMENT

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F I S C A L A F F A I R S D E P A R T M E N T

Ukraine

Medium-Term Budget Framework and Fiscal Risk Statement

Amanda Sayegh, Brian Olden, Miguel Alves, Avril Halstead, and Mikko Spolander

Technical Report

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CONTENTS

GLOSSARY

BCU	Budget Code of Ukraine
CMU	Cabinet of Ministers of Ukraine
FAD	Fiscal Affairs Department
FRMD	Fiscal Risk Management Division
FRS	Fiscal Risk Statement
IMF	International Monetary Fund
KSU	Key Spending Unit
LM	Line Ministry
MEDT	Ministry of Economic Development and Trade
MoF	Ministry of Finance
MTBF	Medium-term Budget Framework
NBU	National Bank of Ukraine
SOE	State-Owned Enterprise
TA	Technical Assistance
UAH	Ukrainian Hryvnia

PREFACE

In response to a request from the Minister of Finance, Mr. Oleksandr Danyliuk, a capacity development mission from the Fiscal Affairs Department (FAD) of the International Monetary Fund (IMF) visited Kiev, Ukraine during May 23 to June 2, 2017. The mission was led by Amanda Sayegh (FAD), and consisted of Brian Olden, Miguel Alves (both FAD), Avril Halstead, and Mikko Spolander (both short-term experts). Mr. Olden participated between May 23 to May 29, 2017. The technical assistance was provided with financial support from the Government of Canada.

The mission met with Mr. Oleksandr Danyliuk, Minister of Finance, Ms. Oksana Markarova, First Deputy Minister of Finance; Mr. Vladimir Lozytsky, State Budget Director; Mr. Andrey Savenko, Head of the Fiscal Risk Management Division; Mr. Olexiy Zhak, Head of Budget and Macroeconomic Indicators Division; Ms. Polina Yarova and staff from the Debt Policy Department; and Mr. Gladun Yevhen, Head of the Revenue Forecasting Department. In the Ministry of Economic Development and Trade the mission met with Mr. Maksym Nefyodov, First Deputy Minister; Ms. Olena Diachenko, Head of the Department of State Property Management; and Ms. Natalia Gorshkova, Director of the Macroeconomic Forecasting Department and her staff. The mission also met with senior officials from the Ministry of Health and Ministry of Education and representatives from the European Commission.

The mission would like to thank the authorities and other participants for their excellent collaboration during the mission. The mission is also extremely grateful for the support given to the team by staff at the IMF office, in particular to Mr. Ihor Shpak for his excellent support in coordinating the mission. The mission is also grateful to Mr. Viktor Verhun, Mr. Iouri Loutsenko, and Mr. Serhiy Kolesnyk for their excellent interpretation and translation efforts over the course of the mission.

EXECUTIVE SUMMARY

To strengthen the medium-term orientation of the budget, the authorities have committed to implement a full-fledged medium-term budget framework (MTBF) as part of their Public Financial Management Reform Strategy (2017–21). A pilot MTBF exercise was launched for the 2018 budget cycle, which will inform the roll-out of a more complete MTBF in 2019. The development of the MTBF has been supported by several FAD technical assistance missions in recent years, including in April this year.

Developing the Budget Declaration

The 2018–20 draft Budget Declaration, submitted to the Cabinet of Ministers on June 1, is a major step forward in terms of establishing a medium-term orientation to budget planning. For the first time, important elements of a MTBF were included in the budget documentation, including the presentation of detailed medium-term macroeconomic and fiscal forecasts and expenditure ceilings for 2018–20.

Nevertheless, there are several areas that can be enhanced in future years to better support fiscal policy decision-making. These include: a more comprehensive description of the main drivers of the macro and fiscal outlook, clarifying the characteristics of expenditure ceilings and explanation of their distribution among key spending units (KSUs), separately disclosing the baseline and target scenarios, quantifying the budgetary impact of new policies at the KSU level, reporting progress against key performance indicators, broadening the discussion of fiscal risks and their analysis, and reconciling differences between successive medium-term macro-fiscal forecasts and ceilings. Importantly, the draft Budget Declaration does not provide a sufficient level of information to demonstrate whether the expenditure ceilings for the general fund are consistent with achievement of the fiscal objectives. This should be addressed by including presentation of fiscal aggregates for the state budget (general and special fund) as well as for the general government sector.

Implementing the MTBF

The ability of the Ministry of Finance (MoF) to enforce compliance with ceilings during the annual budget will be critical to the success of the pilot exercise. The MoF will need to develop a robust report explaining the ceilings for cabinet discussion and for presentation to the legislature. It will also need to be empowered to execute the budget challenge function effectively by scrutinizing spending proposals to ensure consistency with the government's overall policy and fiscal objectives. To ensure transparency, any changes to expenditure ceilings made as part of the annual budget process should be explained in the budget documentation.

The pilot exercise revealed some challenges that will need to be addressed to strengthen the roll-out of the full-fledged MTBF. The macroeconomic parameters and forecasts were finalized too late in the process, compressing the time available to settle the expenditure ceilings and negotiate these with line ministries (LMs). Policy costings were estimated by LMs on a constant price basis and there was no preparation of bottom-up baseline expenditure estimates to inform fiscal space available at the KSU level. There was also limited discussion between the MoF and LMs on expenditure ceilings to minimize any points of difference before their submission to the cabinet. The mission made several recommendations to address these challenges, including:

- preparation of two macro-fiscal forecasting rounds timed to best support the preparation of the Budget Declaration and the annual budget;
- the inclusion of standardized templates for line ministry submissions in the budget circular, that request a greater level of detail on cost drivers for existing programs; require LMs to report on progress against key performance indicators for existing programs; and to provide a stronger rationale for new policy proposals;
- adoption of a revised budget calendar, that clarifies the inputs required by the various departments and agencies involved in the budget process and ensures sufficient time is dedicated to bilateral negotiations between the MoF and LMs.

The Budget Code of Ukraine will also need to be amended to facilitate the roll-out of the full-fledged MTBF and the authorities have committed to doing so by the end of 2017. The April FAD technical assistance mission provided guidance on the nature of these amendments. In addition, the amendments to the Budget Code should include a more-finely tuned budget calendar; the core components required for the Budget Declaration, as well as a clear definition of the circumstances and rules for adjusting ceilings in response to macroeconomic developments.

Improving Fiscal Risk Disclosure

The authorities have been taking steps to improve their understanding and disclosure of fiscal risks and have made significant progress with the inclusion of a summary fiscal risk statement in the draft Budget Declaration. Expanding the fiscal risk statement, as the authorities intend, will require current information gaps to be addressed. As a priority, steps need to be taken to validate the existing data on SOEs to correct for errors and inconsistencies. In addition, systems need to be established or improved to collect information on a wider set of fiscal risks (such as legal cases and obligations under public private partnerships); monitor fiscal support for individual SOEs and identify and quantify their quasi-fiscal activities. To reduce duplication and enhance the consistency and reliability of SOE data, it will be important that a central process is established for the compilation of their financial information and fiscal support.

The institutional structures to support fiscal risk analyses and disclosure are also yet to be established. The Budget Code should be amended to formally assign responsibility for fiscal risk monitoring and assessment to the MoF and to require publication of a comprehensive fiscal risk statement with the Budget Declaration. The mandate of the Fiscal Risk Management Division will also need to be expanded and the responsibilities of departments and agencies involved in preparation of the fiscal risk statement should be clearly specified in the form of a cabinet resolution.

I. DEVELOPING THE BUDGET DECLARATION

A. Background

1. **The government has launched a pilot medium-term budget framework (MTBF) for the 2018 budget.** Implementation of strategic planning and the MTBF is a core component of Ukraine's PFM reform strategy.[1] Integral to this process is the preparation of the Major Areas of Budget Policy (referred to as the Budget Declaration), which the authorities have prepared for the first time for the period 2018–20. The Budget Declaration outlining the medium-term macro-fiscal projections, budget priorities, and expenditure ceilings was submitted to the Cabinet of Ministers of Ukraine (CMU) on June 1, 2017. The preparation of the Budget Declaration was supported by this mission, and an earlier FAD technical assistance (TA) mission in April 2017.[2]

2. **The development of the Budget Declaration within a relatively short timeframe is a significant achievement.** Until this exercise, medium-term macroeconomic and fiscal forecasts were not well integrated with budget planning which was mostly incremental and annual in scope. Furthermore, fiscal policy formulation lacked strategic direction in setting priorities and objectives and there was no "top-down" approach to guide it. The new Budget Declaration represents an important step forward in addressing most of these issues, given the tight timeframe for its development and the challenging political and macroeconomic environment. The authorities intend to build on it over time.

B. Expanding the Content of the Budget Declaration

3. **Important elements of a MTBF were included in budgetary documentation, for the first time.** The draft Budget Declaration was prepared within the boundaries of the current requirements of the Budget Code for the "Major Areas of Budget Policy." This mission reviewed early drafts and proposed improvements to include more detailed discussion on the macro-fiscal context, an explanation of how the overall expenditure ceilings were derived, elaboration of key fiscal risks and further details of strategic objectives and new policies. Some of these recommendations were adopted in the 2018–20 Budget Declaration, which now includes:

- **Some discussion of the macroeconomic outlook.** The Budget Declaration presents the forecasts for GDP (and some components, such as exports), prices and employment and the assumptions underlying them, and summarizes the drivers of the previous year's economic outcomes. In addition, it provides two alternative macroeconomic scenarios (optimistic and pessimistic) to highlight uncertainty around the baseline. But, only limited information is provided to set the context for the evolution of medium-term fiscal projections.

[1] PFM Strategy 2017-2021, adopted by the Cabinet of Ministers of Ukraine (CMU) on February 8, 2017.

[2] Alves, M. et al (2017) "Ukraine: Strengthening Public Financial Management, "Fiscal Affairs Department, IMF.

- **A statement of fiscal objectives and the main policy indicators consistent with achieving them.** This includes projections for 2018–20 for revenue, expenditure, and the budget balance. It also sets out the budget policy rules and key policy parameters (e.g., minimum wage, minimum subsistence level, floor for capital investment).
- **Medium-term projections for revenue and main components.** The revenue forecasts include detailed forecasts for revenue, broken down into the main tax categories (personal income tax, corporate income tax, value-added tax, and excises) and non-tax revenue, setting a basis for explanation of changes in medium-term revenue estimates to be presented in future iterations.
- **A description of the main fiscal risks.** For the first time, the authorities presented the key fiscal risks that could impact the budget. The mission worked with the authorities to develop a more fulsome narrative on the sources of fiscal risk and their significance to raise awareness of their potential impact on the budget. Highlighting the risks and uncertainty around the medium-term forecasts informs fiscal policy decision making, enhances fiscal credibility and helps frame fiscal policy discussions with the legislature. The initial summary fiscal risk section of the Budget Declaration focused on a discussion of macroeconomic and public debt risks as well as fiscal risks related state-owned enterprises (SOEs), guarantees and the financial sector.
- **Description of new policy proposals and strategic goals.** A list of new sectoral policies designed to enable implementation of the Sustainable Development Strategy "Ukraine-2020" is presented only in qualitative terms for the pilot.[3]
- **Inclusion of expenditure ceilings for key spending units (KSUs).** These ceilings distribute the overall general fund expenditure envelope by each spending unit, setting the high-level framework for preparation of the detailed annual budget.

4. **Nevertheless, there are several areas that can be further enhanced to better support budget planning and decision-making.[4]** It was not possible for the authorities to address these areas for this year's declaration given the timeframe and availability of information, but as a priority, the next Budget Declaration (2019–21) should aim to include the following elements:

(i) A more detailed explanation of the medium-term macroeconomic and fiscal outlook.

[3] It is expected that future iterations of the Budget Declaration will include a fuller and more quantified presentation of significant government policies and their impact on the budget. For this year, the Budget Department plans to quantify the impact of each policy in fiscal indicators, on a trial basis, and include this information in internal explanatory notes to support discussions at the CMU.

[4] To support these enhancements, the mission shared with the authorities examples of well-designed fiscal strategy statements, including those of Austria (MTBF Act and Fiscal Strategy Report), Finland, France, and Georgia.

- An expanded discussion of the key drivers of the medium-term macroeconomic forecasts to provide a better context for the fiscal forecasts;
- A discussion of the key drivers of the fiscal aggregates over the medium term, including the impact of macroeconomic developments, policy decisions, underlying cost drivers (such as the number of public sector employees and pensioners) and other one-off factors on the main fiscal aggregates as well as a discussion of the outcome for the previous year, the updated budget forecasts for the current year (which serves as the basis for the projections), and three-year projections for revenue, expenditure, and the budget balance;
- A description of the revenue outlook and its key components, including a more detailed disaggregation of the main drivers of revenue and further elaboration and quantification of the impact of specific tax policies during the three-year period;
- Reconciliations between successive vintages of macro-fiscal forecasts and ceilings clearly differentiating between adjustments arising from macroeconomic and demographic developments and those arising from policy changes;
- Separate presentation of the baseline (no policy change) and target (incorporating the effect of new policies) scenarios to help define consolidation needs or identification of possible fiscal space; and presentation of the key fiscal aggregates for the state budget (general and special fund), the consolidated general government sector, and social security funds.[5,6] While local government budgets are not part of the MTBF, their disclosure is nevertheless important given that fiscal targets are currently defined on a general government basis under the IMF program, and to facilitate fiscal policy coordination.

(ii) An explanation of the expenditure ceilings.

- A description of how the overall expenditure envelope for the three-year period is derived (as a residual of forecasted revenue minus the fiscal target agreed under the IMF's Extended Fund Facility);
- Clarification on the nature (fixed or indicative) of both the aggregate and KSU ceilings for the budget year and the two outer years and a broad explanation on how the individual ceilings were defined (i.e. which factors underlined the distribution of the overall ceiling);

(iii) Quantification of the budgetary impact of new policies at the KSU level.

- Quantification of strategic goals and new policies, including identifying the contribution of each KSU in their implementation. This would provide a more transparent justification of the expenditure ceilings;

(iv) Expanded discussion of fiscal risks.

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[5] This will require macroeconomic parameters to be circulated to KSUs (ideally in the budget circular) so they can prepare projections of current policies under revised parameters.

[6] A good template for this would be the standard questionnaire that the MoF currently uses to submit information for publication in the IMF's Statistics Department *Government Finance Statistics Yearbook* database.

- Presentation of a more comprehensive fiscal risk statement (FRS) alongside the declaration covering all material fiscal risks and deeper analysis of their significance (see Chapter III).

5. In future years, additional components could be added to further enhance transparency and better support policy-making. This could include:

- Explanation of differences between the government's economic and fiscal projections and those of independent forecasters;
- Presentation of expenditure on an economic classification for the state budget and general government to facilitate its economic assessment;
- Inclusion of performance information with strategic objectives to hold KSUs accountable for achieving the objectives of the planned policies (see Chapter II, Section D); and
- Expanded quantification of fiscal risks, including assessment of their significance and likelihood of materialization.

C. Recommendations

Recommendation 1.1. Build on the 2018–20 Budget Declaration in future years to enhance the transparency and credibility of the MTBF.

- For the 2019–21 Budget Declaration, provide a discussion of the macroeconomic and fiscal outlooks in both qualitative and quantitative terms, clarify the ceilings' characteristics and disclose a justification for the KSU distribution, separately disclose the baseline and target scenarios, quantify the budgetary impact of new policies at the KSU level, broaden the FRS to cover all material fiscal risks and strengthen analysis, present fiscal forecasts for the general government, and explain the changes to the previous vintage of macro-fiscal forecasts and ceilings (*June 2018*);
- For the 2020-22 Budget Declaration, and subsequent versions, introduce a comparison with forecasts of independent forecasters, improve the quantification of fiscal risks, disclose key performance indicators (first for outputs and later also for outcomes) for government policies (*June 2019*).

II. IMPLEMENTING THE MEDIUM-TERM BUDGET FRAMEWORK

A. Background

6. An approved action plan to gradually implement a more complete MTBF for the 2019 budget has been developed. Over the course of 2017, the authorities will introduce new MTBF features and improve some of those implemented in the pilot, drawing on the lessons learned during that exercise and consistent with the constraints of the IMF program, which sets the basis for Ukraine's current fiscal framework. The April 2017 FAD TA mission recommended some specific actions toward that objective, namely:

- Defining contingency margins for the overall expenditure ceilings to help ensure their credibility;
- Integrating the Special Fund into the MTBF and presenting medium-term fiscal aggregates for the general government;
- Gradually moving toward more fixed ceilings for overall and KSU expenditure as the system matures;
- Expanding the scope of the strategic discussion of fiscal policy, aided by a rules-based fiscal framework and enhanced information;
- Developing and implementing a technical amendments model that specifies clear rules for the adjustment of ceilings following macroeconomic changes; and
- Developing and disseminating a methodology for forward baseline estimates to inform the MTBF discussions between the MoF and KSUs.

7. Implementation of these improvements will need to be combined with procedural changes to enhance the credibility of the MTBF. The remainder of this chapter provides guidance on the steps required to implement the current pilot in the 2018 budget formulation process and provides guidance to help strengthen implementation of the fully-fledged MTBF based on the lessons learned thus far from the pilot exercise.

B. Next Steps to Implement the Pilot MTBF

8. Negotiating and agreeing to the expenditure ceilings will present a major challenge for successful implementation of the pilot MTBF. Line ministry (LM) participation in the preparation of the draft budget declaration was primarily limited to the provision of requests for additional funding for existing and new programs, which were costed using existing parameters. Updates of expenditure estimates to include revised parameters and compilation of the final aggregate ceiling was performed by the MoF with limited discussions with LMs (the discussions that took place mainly focused on clarifications of requirements of the March 2017 circular). Consequently, the presentation of the Budget Declaration to the CMU will be the first time LMs are informed of their expenditure ceilings and accepted policy priorities.

9. The MoF will need to explain and defend the ceilings during the CMU discussion, and this will require compelling evidence. The preparation of a robust briefing explaining the determination of the overall expenditure ceiling and its distribution across KSUs would support this. Furthermore, the MoF must be prepared to produce quick costings of new policies brought to the table during the cabinet discussions, not only for the budget year, but also for the two outer years. Any policies that take expenditure above the proposed overall ceiling, will need to be compensated for by reductions elsewhere or be proposed for rejection.

10. In addition, the entrenched practice of introducing new policies during the formulation of the annual budget may pose additional difficulties. Although the MTBF process was explained to all key stakeholders, there is a risk that LMs or the Verkhovna Rada will seek to introduce new policy measures during the process (including resubmitting those proposals already put forward, but not incorporated in ceilings in the lead up to the budget declaration's approval). Mitigating this risk will require that the MoF's budget officers develop and be effective in their budget challenge function (Box 1), and make any policy change dependent on a consensus obtained within CMU, rather than a bilateral discussion between the MoF and LM. This will also be important for implementation of the full-fledged MTBF.

Box 1. Exercising the Budget Challenge Function

Standard analysis of expenditure patterns that inform the budget challenge function would include:

- Calculating real growth levels in resource allocations to assess whether it is in line with the cost of providing services.
- Comparing original budgets to actual spending (for example, are some areas or types of spending consistently under- or over-budgeted?)
- Monitoring changes in spending in different sectors and calculating how additional resources have been allocated to shift (or maintain) overall spending shares.
- Calculating the unit cost of outputs and how this changes over time.
- Calculating the cost of providing services per beneficiary, how this changes over time and how it is affected going forward.

In addition, the questions below—while not an exhaustive list—may usefully inform budget officers when faced with new spending requests:

- Is the policy consistent with government strategic plans and to what degree is it a priority? Are the level of resources proposed commensurate with these priorities?
- What is the overall policy objective, and are there more cost-effective ways of delivering the same objective—have all options been fully considered?
- Does spending set a new precedent or introduce a financial commitment that will be hard to reverse (for political, technical, legal reasons)?
- Does the policy create any significant fiscal risks?
- Does the policy directly affect other aspects of the macroeconomic or policy environment (e.g., tax base, inflation, growth, employment)?
- Who will lose/benefit from the policy, and by how much?
- Does the agency have the capacity to deliver the policy change?
- Is the policy or proposed expenditure consistent with the government's systems of central and local government fiscal relations?

Source: Extracted from Hadley S., and Welham, B. 2016, "The Ministry of Finance 'Budget Challenge Function', A Public Financial Management Introductory Guide", Overseas Development Institute, London. (originally sourced from CABRI. 2006, "Bridging the gap from policies to budget," Collaborative Africa Budget Reform Initiative. Pretoria.) Note that this ODI guide contains a myriad of resources and case studies on the budget challenge function and should be consulted to further to develop the function in Ukraine

11. The ambiguity regarding the nature of expenditure ceilings under the pilot may result in pressure to revise ceilings for the annual budget. Between now and the approval of the annual budget, there may be developments that result in changes to the macroeconomic and demographic assumptions underpinning the macro-fiscal forecasts. No clear rules have been disclosed about how such developments will be addressed, which could add pressure to ceilings above and beyond those resulting from changes in these parameters.

12. To ensure transparency, any revisions to ceilings between the approved Budget Declaration and annual budget should be explained. The annual budget should include a summary reconciliation, detailing the main components of any changes to ceilings (using the template provided in Table 1.1. of the March/April 2017 TA Mission report). In addition, the MoF should disclose in an annex to the 2018 Budget Proposal, explanatory notes on the detailed adjustment of each ceiling.

C. Strengthening the Process for the Full-Fledged MTBF

13. Though not complete, the pilot exercise has thus far highlighted some challenges that will need to be addressed to strengthen the roll-out of the fully-fledged MTBF. Some of these arise from design or technical issues, while others are more procedural in nature. The main challenges relate to: the timing and preparation of the macroeconomic forecasts; the lack of separation between baseline and new policy scenarios; the role of LMs and sequencing of tasks; the documentation requested from KSUs as input to the budget declaration; and, the supporting legal framework. The remainder of this section provides further guidance to address these challenges. In addition, it details some of the issues that will need to be considered in the design of the technical amendments model, which will be critical for the implementation of the fully-fledged MTBF.

Preparation of the Macroeconomic Forecasts

14. The final update of the macroeconomic forecast was not available until quite late in the process. The Budget Code and CMU resolution on development of the macroeconomic forecasts (No. 621 of 2003) only require the macroeconomic forecasts to be submitted to the CMU for approval on June 1, the same time as the Budget Declaration. Although indicative forecasts are required to be provided in March, the scope for their revision and late approval can complicate the formation of the expenditure ceilings. To assist the preparation of the MTBF, the macroeconomic forecasts should be prepared and submitted to the CMU before the budget declaration, ideally in March, and updated if necessary. This will facilitate the preparation of revenue forecasts and inform the overall expenditure envelope (derived from the top-down process) and enable KSUs to prepare their bottom-up baseline estimates. To help underpin their credibility, the macroeconomic forecasts should also only be submitted to the CMU for information and their formalization. The government’s commitment to establishing a process for independent external evaluation of the forecasts will also help strengthen their credibility.

15. Current practices also give rise to inconsistencies between the fiscal forecasts and the macroeconomic forecasts on which the budget is based. Currently, the baseline macroeconomic forecasts are based on existing policies at the time of their preparation and incorporate some new policy proposals.[7] But, the macroeconomic forecasts presented in the budget do not always fully reflect final policy decisions that may be decided late in the process. This introduces inconsistencies between the macroeconomic and fiscal forecasts and means the budget does not provide the most up-to-date assessment. As a general rule, the baseline macroeconomic forecasts should include the impact of those policies that have been approved by the CMU, and provide an update for any significant policy changes decided by the CMU or the Verkhovna Rada later in the process. Potential benefits to the forecasts from reforms, that have been agreed in principle, but are yet to be finalized and approved by the CMU, and their expected impacts, can be referenced in the text of the budget documentation.

16. Appropriate coordination between the preparation of the macroeconomic forecasts and of the MTBF would strengthen the process. It is important that the MEDT consult the MoF and relevant LMs on the critical inputs needed to prepare the macroeconomic forecasts and details of new policy proposals. But, a lengthy consultation process on the economic parameters and forecasts, seems unnecessary and introduces delays that risks their timely input into the MTBF process. To the extent possible, the forecasts presented to the CMU should represent the expert and professional view of the MEDT. There is also a strong case for the MEDT, as producer of the macroeconomic forecasts, to contribute to the drafting of the macroeconomic outlook of the budget declaration.

Preparation of Baseline Expenditures and 'New Policy' Scenarios

17. During the current pilot, expenditure ceilings were determined without recourse to baseline expenditure estimates. As LMs were not provided with updated economic parameters, the costings of existing and new programs in their submissions were prepared on a constant price basis (that is, holding 2017 prices constant in the out-years).[8] LMs therefore did not estimate the expected costs of continuing current programs over the medium term. The MoF was responsible for updating costings for revised parameters.

18. The lack of delineation between baseline expenditure estimates and new policy scenarios, makes it difficult to formulate fiscal policies. Fiscal space sets the room for maneuver for the revision of the medium-term expenditure envelope and the KSU ceilings. The absence of updated baselines that reflect the true costs of maintaining existing policies into the future, makes it difficult to assess the financing requirements of existing programs in coming years. As a result, it is also difficult to make informed decisions about the fiscal space available

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[7] For example, the baseline macroeconomic forecasts for 2018-2020 incorporates expectations of a moderate increase in foreign direct investment arising from future land reforms, the design of which is yet to be agreed.

[8] Programs affected by other macroeconomic variables, such as exchange rates and oil prices are prepared jointly with the MoF.

for new policy initiatives or the need to reprioritize existing expenditure. The risk is that new spending is approved without the full knowledge of current cost pressures, which can result in over-execution of budget plans or require future funding reductions for existing programs.

Sequencing of Tasks and Negotiation of Line Ministries

19. The pilot exercise highlighted the need for a clearer sequencing of tasks. It emphasized the need for: (i) earlier preparation of macroeconomic forecasts (referred to above); (ii) early engagement of the CMU to provide input on strategic priorities or size of any fiscal adjustments that may be required based on the revised macro-fiscal outlook; and (iii) expanded bilateral negotiation on the expenditure ceilings. The latter is critical to successful implementation of the MTBF. The budget timetable needs to be structured so as to allow sufficient time for bilateral negotiations between the MoF and LMs on their budget ceilings, and minimize the number of open issues that will need to be resolved by the CMU. The objective should be to free up the CMU as much as is possible, to focus on strategic new initiatives.[9] To help address these issues, Annex 1 provides a more detailed budget calendar, specifying the concrete steps required at each stage of MTBF cycle.[10]

20. A stronger negotiation phase will require LMs play a more active role in the determination of their expenditure ceilings. Requiring LMs to provide the first draft of their KSU ceilings, including separately disclosing changes in funding required to deliver existing policies (due to parameter and volume changes) and to prioritize new policies consistent with meeting the ceilings would enhance the ownership of the MTBF process in the LMs. In addition, LMs could play a greater role in prioritizing spending of lower level spending units, within the portfolio expenditure ceiling, rather than the MoF negotiating with these units on an individual basis.

21. Expanding the role of LMs should not diminish the important leadership role of the MoF in the process. This should include proactively engaging with LMs during the negotiation phase to minimize points of difference and enforcing compliance with ceilings through effective execution of the budget challenge function. For those issues that cannot be resolved through bilateral negotiations, the MoF should provide guidance and information to facilitate the CMUs decision.

Information to Support the Process

22. The information requested from LMs for the preparation of the budget declaration has some limitations. The March budget circular requested information from LMs on costings

[9] In these negotiations, special emphasis should be given to large-scale programs and capital investment plans, which are inherently multi-year, and have a tendency towards uneven spending profiles.

[10] The detailed budget calendar builds on the high-level calendar recommended by the previous IMF technical assistance mission as set out in Box 1.7, Strengthening Public Financial Management, IMF Technical Assistance Report, May 2017.

of new policy initiatives (on a constant price basis), additional funding required for existing programs resulting from changes in legislation or regulations as well as suggested savings. In addition, not all templates required were provided along with the budget circular, and, as a result, submissions differed across LMs (for example, review of submissions provided by the Ministries of Health and Education showed substantial differences in the presentation of information).

23. **The preparation of LMs' submissions and bilateral discussions would be enriched by a revised information template.** This should include a comparison of the estimated actual LM expenditure ceiling with the ceiling decided in the previous medium-term Budget Declaration. This would reduce the resources currently devoted to the preparation of unrealistic budget bids or lower priority initiatives. Table 1 provides an illustration of the information that could be provided by LMs to justify their expenditure proposals, and Annex 2 provides a template setting out the information requirements for new policy submissions.

Table 1. Proposed Template for KSU Expenditure Ceiling Proposal

Ministry [...][1]					
	2016 actual	2017 budget	2018 ceiling	2019 ceiling	2020 ceiling
Actual/Budgeted	**1000**	**1050**			
Ceiling acc. to Previous MT Budget Declaration [2]			**1000**	**1000**	**1000**
New commitments[3.i]**, of which**			**100**	**100**	**100**
by VR			50	50	50
by Government			50	50	50
Structural adjustments within the Budget[3.ii]					
Automatic adjustments[3.iii]**, of which**			**20**	**35**	**50**
volume factors			10	20	30
cost factors			10	15	20
Estimated baseline			**1120**	**1135**	**1150**
New policy initiatives, of which[4]			**70**	**100**	**30**
Initiative I			70	70	
Initiative II				30	30
...					
Overall impact of baseline and policy changes			**1190**	**1235**	**1180**

[1] The template is set at LM level. LMs collect the required information from the KSUs.
[2] The starting point is the existing ceiling decided in the previous medium term Budget Declaration.
[3] To reach the baseline estimate, the existing ceiling is updated to take into account of i) new commitments that the Verkhovna Rada or the Government has made, ii) technical adjustments within the budget and between the budget appropriations resulting from e.g. the changes in the structure of the budget line items iii) changes in volumes and costs that result from changes in the respective updated macroeconomic indicators. The changes in volumes concern e.g. the changes in the number of citizens entitled to benefits or allowances according to the existing social legislation. The changes in costs result e.g. from the indexation of social benefits to prices or wages.
[4] New policy initiatives are added line by line on top of the baseline to reach the proposal for the actual expenditure ceiling. More detailed calculations, further arguments or explanations and any other relevant information to support the assessment of the fiscal and broader economic impact of the proposed new initiatives should be presented in a separate annex.

24. There is also room for improvement in the performance information used to support the MTBF. While performance-related information was requested from KSUs as part of their submissions under the pilot exercise, the indicators submitted were largely drawn from LMs current budget passports and primarily consisted of input and output indicators. Furthermore, as in previous years' budget exercises, the performance information provided did not contain analysis of whether programs were on track to achieve performance targets set in previous years. The use of LMs medium-term budget submissions for policy prioritization, would be greatly enhanced with the inclusion of: (i) measurable performance indicators; and (ii) assessment of performance against the targets set in previous years. As the MTBF is more solidly established, consideration could be given to the development of more outcome orientated indicators over the medium term (Annex 3 describes the link between program objectives, outcomes, and outputs and provides an example of program indicators based on outcomes). Reporting progress against performance indicators will contribute to more effective allocation of resources and enhance accountability in the use of public funds.[11]

Amendments to the Budget Code

25. The provisions of the current Budget Code of Ukraine (BCU) constrained the scope of MTBF features included in the pilot exercise. The budgetary regime in Ukraine, with most rules defined by the BCU, determined substantially the structure and content of the budget declaration (see Chapter I). The decision to launch the pilot exercise ahead of revising the BCU was deliberate, to ensure that the legislative changes (planned before end-December 2017) could be informed by the pilot exercise.

26. The key lessons revealed by the pilot exercise thus far, as outlined in previous sections of this report, provide valuable input for the preparation of revisions to the BCU. These should be used along with the broad recommendations set out by the April TA mission to enshrine the fundamental features of the MTBF in Ukraine's legislation.[12] The pilot highlighted the need for the following amendments:

- Specifying the key components to be included in the Budget Declaration (as outlined in Chapter I);
- Defining the roles, responsibilities, and inputs of the key actors in the MTBF process, and information required at each stage of the MTBF as detailed in the sub-sections on "sequencing of tasks" and "information to support the process";

[11] Such an approach would be consistent with the gender-based budgeting reform initiated by the MoF in 2014, with support from a project—"Gender Budgeting in Ukraine" (2014-18)—funded by the Swedish International Development Cooperation (See Box 1.5 in the cited 2017 TA mission report). It also affords the opportunity to integrate the work on gender budgeting into the annual budget preparation process, down the track.

[12] See Annex 1 of the cited 2017 TA mission report, which contains an indicative list of identified amendments to the Budget Code that would support the phased implementation approach taken by the authorities.

- Establishing the requirement to present a FRS alongside the budget declaration and updating it in the annual budget, and detailing the requirements to support its preparation and minimum content (as outlined in Chapter III and in the April FAD TA report);
- Updating the budget calendar to allow for a more robust negotiation period, as recommended in Annex 1 of this report; and
- Clear definition of the built-in mechanisms for ceiling amendments in response to macroeconomic and demographic developments, as detailed in the sub-section below on "technical amendments".
- The "transitional period" chapters of the BCU and other relevant legislation (which specify the elements that are to take immediate force and those that are to become applicable at later stages) can also be informed by the proposed staged implementation of the several recommendations of this mission.

Other report sections of a more technical nature, for example, the delineation between baseline and "new policy" scenarios, should inform the development of secondary legislation and guidance manuals, rather than be detailed in the BCU.

Technical Amendments

27. The roll-out of the fully-fledged MTBF will require further definition of the conditions that can give rise to changes in overall or KSU expenditure ceilings. This will help to promote credibility of the MTBF as the government can explain and reconcile technical increases with a reference to pre-existing rules. These will be largely determined by the characteristic of the ceiling (fixed or indicative; still to be defined). But, the process would be more credible if the rules were further specified including through the elaboration on how specific exogenous developments may impact on different ceilings.

28. The conditions that give rise to technical amendments should originate from factors outside the control of the government. These could include actual and estimated changes in prices (CPI, PPI), interest rates and exchange rate as well as in the number of those receiving benefits and allowances which result from changes in underlying demographic or macroeconomic conditions, rather than from policy changes.[13] Expanding public programs or initiating new ones are policy decisions and should remain strictly outside the technical amendment procedure.

29. Allowing technical amendments for exogenous shocks may still require that the government re-prioritize policies to meet fiscal objectives. Where technical adjustments lead to increases in expenditures that would result in breaches of fiscal objectives, further prioritization would be required, either within the affected KSUs' allocation or across KSUs, to

[13] For example, extending the number of months that unemployed persons can receive unemployment benefits, increases the number of unemployment benefit recipients, as a result of changes in policy. Whereas, a reduction in economic growth that leads to a higher number of unemployment benefit recipients accessing current entitlements, is a parameter change, that could be subject to technical adjustment.

compensate for the adverse effect on the budget balance. Allowing technical amendments in these circumstances, provides the government with greater flexibility to manage the impact of exogenous shocks on the budget, as opposed to automatically requiring affected KSUs to absorb the full impact of the shock.

30. The need for further prioritization stems from an absence of buffers to absorb uncertainties and forecast errors. In some countries, budget margins can absorb the impact of unanticipated changes in macroeconomic parameters on expenditures, without requiring adjustments elsewhere in the budget. Other than the general budget reserve, Ukraine has not established a budget margin as part of its MTBF. Although these risks are minimized somewhat by the fact that few social programs are automatically indexed to prices or wages, decisions to adjust the minimum subsistence level in response to cost of living increases, can have sizeable impacts on expenditures.

D. Recommendations

Recommendation 2.1. Reinforce the credibility of the MTBF, by strengthening the pilot exercise's controlling mechanisms. Specifically:

- Develop a robust explanatory note supporting the ceilings proposed in the Budget Declaration *(June 2017);*
- Build budget challenge capacity of Budget Officers and empower them to enforce that capacity during the 2018 Budget formulation *(July 2017);* and
- Transparently disclose ceiling revisions and their main drivers in an annex to the 2018 Budget Proposal *(September 2017).*

Recommendation 2.2. Improve and expand the inputs for the MTBF *(June 2018)*

- Produce two macro-fiscal forecasts to inform planning, the baseline scenario (existing policies) at the beginning of the process (March) and an updated scenario including new policy initiatives decided by the CMU (May-June).
- To facilitate preparation of baseline scenarios, include macroeconomic parameters in the March budget circular and request LMs to submit information on their implications for existing policies;
- Design and circulate common templates for the LMs to explain deviations and submit information on factors driving the costs of existing programs and to support rationale and costings for new programs;
- To support the bilateral negotiations between the MoF and LMs, require the LMs to produce the first draft for the KSU ceilings under their branch.
- To strengthen the information base for policy prioritization, require LMs to report progress against key performance indicators in their budget submissions and end-year reports.

Recommendation 2.3. Clarify the roles and interaction of the stakeholders in the process for the MTBF.

- Ensure sufficient time is dedicated to bilateral negotiations between the MoF and LMs on KSU expenditure ceilings *(April 2018)*.
- Give LMs a stronger mandate to plan and manage portfolio finances, within the approved LM ceiling, by requiring that they prioritize the requests of lower level spending units and negotiate with the MoF on their behalf *(May 2018)*.

III. IMPROVING FISCAL RISK DISCOSURE

A. Background

31. The government is taking steps to improve its understanding of fiscal risks and their disclosure. It has established a Fiscal Risk Management Division (FRMD) in the MoF with a mandate to oversee SOE risks, established a methodology for assessing SOE-related fiscal risks, commenced disclosure of fiscal risks in the Budget Declaration, and committed to further strengthening disclosure and capacity to assess fiscal risks in its PFM reform Strategy (2017–21). The April FAD TA mission provided an assessment of fiscal risks and mapped out a phased approach to the development of a comprehensive FRS (see Annex V of that report). This chapter builds on the recommendations of that mission, by further elaborating on the steps required to expand fiscal risk disclosure for the 2018 budget and subsequent years.

B. Expanding Fiscal Risk Disclosure

32. The MoF is well placed to build on the current fiscal risk disclosure. The April 2017 FAD TA mission recommended that the 2018 FRS focus primarily on SOE related fiscal risks, and include discussion of macroeconomic risks, public debt exposures, and guarantees. The Budget Declaration, largely fulfilled this, although not all the elements related to disclosure of SOE risks envisaged by the previous TA mission were fully incorporated. This largely reflected the summary nature of the FRS included in the Budget Declaration, an intention decision so that it aligned with the broader structure of that document. The authorities intend to expand disclosure of SOE related risks, and present this as a separate statement as part of the 2018 budget documentation. To guide this process, the mission prepared and shared with the authorities a draft FRS (Annex 4). It may not be possible to incorporate all of its components in time for the 2018 budget, but the authorities are well placed to build on its reporting in future years:

- The FRMD has developed a methodology to assess risks related to SOEs and has collected and begun to analyze data on 48 SOEs that pose the most significant fiscal risk;
- The MEDT's macroeconomic forecasting department already includes alternative macroeconomic scenarios in its report to the CMU, which could be used as the basis for developing alternative macro-fiscal projections; and

- The debt department maintains records on government guarantees and has almost finalized its debt management strategy, which includes discussion of key risk exposures.

33. There are, however, some information gaps that will need to be addressed.

- There is a pressing need to validate the information collected by the FRMD on the group of 48 SOEs before it can be used as a basis for fiscal risk analysis, as a number of internal errors and inconsistencies in the data submitted by LMs were identified by the mission, along with some inconsistencies with other data sets (such as guarantees and budget subsidies). In addition, the FRMD indicated that forward looking information provided by SOEs on the basis of their strategic plans (2018–20) is not available for all 48 SOEs and does not provide a reliable basis for forward-looking assessment.
- The information on SOEs contained only a limited number of line items from the financial statements (e.g. total assets, debt and equity) and pre-calculated financial ratios. This limits the analysis that can be performed. The full set of financial information should be obtained to ensure data reliability can be assessed and to support more enhanced risk assessment methodologies over time.
- While aggregate data on guarantees and on-lending is available, the FRMD will need regular access to information on outstanding amounts, execution of guarantees, and loan performance for individual SOEs. This will likely require the debt department to augment its existing records on guarantees by creditor, to also include information and performance of guarantees by individual SOE.
- Information on quasi-fiscal activities of SOEs remains limited and unquantified, as identified in the March/April FAD TA report.
- For the future development of the FRS, systems will also need to be established to collect information and input on a wider range of fiscal risks – legal cases; public-private partnerships (direct obligations over their life cycle and contingent liabilities), local government liabilities by municipality and their contingent liabilities, and natural disasters – although this is a more medium-term exercise.

34. Formally establishing the necessary institutional structures in the MoF and other key agencies would smooth the coordination and preparation of the FRS. Whilst the FRMD must lead the process for monitoring and managing fiscal risks, they need to coordinate inputs from a number of stakeholders both within the MoF as well as other agencies. In particular, a close working relationship with the MEDT is required both with respect to the assessment of macroeconomic risks and also in assessing the risks arising from SOEs. The April FAD TA mission provided a suggestion for the allocation of responsibilities across departments and agencies, and recommended that these be formalized in a CMU resolution, but this is yet to be actioned. It also recommended amending the BCU to formally assign the role of fiscal risk monitoring and assessment to the MoF and expanding the mandate of the FRMD to cover all material fiscal risks as part of the amendments to be made later this year.

35. The FRMD will need to have a team dedicated to fiscal monitoring and management to fulfill this mandate. The FRMD currently has responsibilities for a large range of tasks (for example, in addition to overseeing large SOEs and those under the MoF, it also has responsibilities for procurement, regulation and state aid). It will be important that a dedicated team is assigned and accountable for fiscal risk monitoring, assessment, reporting and mitigation on a full-time basis, otherwise there is a risk these tasks are set aside by other competing demands. At the same time, there is a need to enhance the analytical capacity of FRMD over time, so that it can deepen its fiscal risk analysis.

36. Current institutional arrangements result in duplication in the collection of information on SOE financial performance. The MoF, MEDT, and LMs are all collecting and compiling financial information related to SOEs—an onerous task, given there are more than 1,800 operational SOEs. In addition, the MoF is compiling information on various forms of fiscal support provided to individual enterprises. The various ministries should work to harmonize the process of collecting information, with the aim of establishing a single process for data collection that meets the requirements of all stakeholders, including the timeframe for its provision. The development of a single central excel database, available to relevant stakeholders, containing the financial information and state support for the most significant SOEs and verified by specialist departments and SOE governing authorities would be a good first step. Certain supplements may still be required for information only relevant to targeted SOEs, so as not to over-burden companies. Over the medium-term, implementation of a central, electronic reporting platform capturing both financial and non-financial information that is made available to all stakeholders would help reduce reporting burdens on enterprises and ensure consistency and reliability of data.

37. While the fiscal risk methodology developed by FRMD for SOEs provides a good base for risk assessment, there may be scope to enhance this overtime. The current methodology, set out in a CMU resolution, determines the process for selecting the SOEs that will be subject to more detailed analysis and the approach to ranking them into risk categories to assess the government's risk exposure. In addition to the recommendations provided during the 2017 April TA mission to improve the methodology, consideration could also be given to:[14]

- Widening the set of ratios used to rank SOEs into risk categories, over time, to better pin point potential sources of risk specifically to include ratios to identify potential liquidity (e.g., current and interest cover ratios) or solvency challenges;
- Including, in the CMU resolution, the principles informing the selection of the SOEs for in-depth assessment (for example, macro-critical entities; those with liabilities above a certain threshold or those ranked among the highest risk categories). Further, the decree should

[14] The mission recommended supplementing the indicators with additional ratios (e.g. current ratio, interest cover ratio); collecting a wider set of financial information; benchmarking the SOEs against industry and international norms; and collecting a wider set of information on foreign currency exposures to enable sensitivity analyses to be conducted in future.

provide the MoF with the discretion to require in-depth assessment of other entities, where potential fiscal risks are identified;

- Comparing actual outcomes to the forward-looking projections to determine whether there are persistent biases in the projections provided by SOEs (and therefore under or overstatement of risk assessments based on forward indicators);
- Collecting supplementary data on all accrued arrears (in addition to wages and taxes); cash flow projections, capital expenditures, borrowing plans, and any contingent liability exposures, to enable more in-depth analysis of specific sources of risk;
- Using historical information to identify trends pointing to a deterioration in the financial performance or position of an SOE over time; and
- Meeting with the SOEs, supervisory authorities and regulators to allow a deep dive into potential drivers of fiscal risk.

38. The methodology for categorizing SOEs by risk should also be reviewed against future outcomes to ensure that it is providing appropriate forward-looking guidance. Where unexpected deviations from budget forecasts are caused by SOEs, the most recent risk categorization of the relevant SOEs should be noted. If they were not already identified as high sources of potential risk (e.g. risk category 1 and 2), this could indicate weaknesses in the methodology's predictive ability which should be addressed through refinements. Further, the methodology ranks highly leveraged, but profitable SOEs as more risky than unprofitable enterprises with lower leverage. This may well be appropriate, but it also seems plausible that some loss-making SOEs that are not highly leveraged may be more likely to generate fiscal risks than others that are more highly leveraged and have a track record of good profitability. In undertaking future reviews of the methodology, consideration should be given to introducing graduated thresholds for the ratios used to group entities into risk categories.

39. Further, relying on SOEs and supervisory authorities to self-evaluate fiscal risks may not generate accurate or consistent outcomes. Rather than requiring SOEs to self-assess risks, consideration should be given to soliciting specific information that would enable the FRMD to assess such risks (e.g. information on pledged assets; upcoming maturities of debts; or requiring SOEs to perform sensitivity analyses of their cash flows and balance sheet to changes in key parameters (e.g. exchange rate and commodity prices). Moreover, templates should be designed and provided to the SOEs that allow such information to be aggregated across all SOEs.

C. Recommendations

Recommendation 3.1. Verify the financial information already collected from SOEs and establish mechanisms to enhance the reliability of data.

- Verify the 2016 financial information for the 48 SOEs against their financial statements, and check the consistency with other data sources including the MEDT database for the top-100 SOEs, debt department data on guarantees and budget data on subsidies *(July-2017);*

- Streamline the collection of financial information from SOEs by establishing a single database (excel-based initially) for financial information, non-financial indicators and state support for SOEs to be made available use by all stakeholders *(March-2018)*.

Recommendation 3.2. Approve the updated methodology for fiscal risk assessment of SOEs, based on a richer information set.

- Update and approve fiscal risk methodology, in line with the improvements suggested in this report and by the March/April FAD TA mission *(June 2017);*
- Review the risk categorization against realized outcomes *(first review end-2019)*.

Annex I. Proposal for Budget Calendar

<table>
<tr><td>Feb 1</td><td>Start forward baseline estimate process</td></tr>
<tr><td></td><td>MoF issues circular requesting the preparation of the FBEs, providing an excel template, pre-filled with final outturn of previous years.

MEDT starts producing the baseline macroeconomic forecast including no new policies.
• Consultation with the MoF Revenue Department regarding tax revenue forecast.
• Consultation with MoF (Budget and other relevant departments) regarding budget policy assumptions for t+2.</td></tr>
<tr><td>Mar 1</td><td>Macroeconomic projections available</td></tr>
<tr><td></td><td>MEDT submits the baseline macroeconomic forecast and key assumptions to the CMU and at the same time circulates these to the MoF and the LMs/KSUs.

MOF revenue department updates revenue forecast.

LMs/KSUs update FBEs.</td></tr>
<tr><td>Mar 15</td><td>Baseline estimates available</td></tr>
<tr><td></td><td>MoF determines the draft expenditure envelope.
• The expenditure envelope is updated to take into account the updated macroeconomic baseline forecast. Technical amendments according to the predetermined amendments model.</td></tr>
<tr><td>Mar 31</td><td>Fiscal space and draft KSU ceilings determined</td></tr>
<tr><td></td><td>May result in consolidation needs or stronger fiscal balance.

MoF determines the draft KSU ceilings and sends the draft ceilings to the CMU.</td></tr>
<tr><td>Apr 15</td><td>CMU discussion and approval</td></tr>
<tr><td></td><td>CMU approves expenditure envelope and KSU ceilings according to fiscal framework and consolidation requirements/use of fiscal space.

MoF sends the draft KSU ceilings to the LMs/KSUs.</td></tr>
<tr><td>May 15</td><td>LMs proposal for KSU ceilings and updated macroeconomic forecast available</td></tr>
<tr><td></td><td>LMs send to the MoF their proposals for new policies.
• The proposals should include savings on existing policies, reallocation between existing policies and brand new policies. The proposals should be duly costed.

Macroeconomic forecast update if there is new information available pointing that the March forecast is clearly outdated.</td></tr>
<tr><td>Apr 30 – May 15</td><td>Bilateral negotiations between the MoF and LMs regarding the KSU ceilings</td></tr>
<tr><td></td><td>Updated macroeconomic forecast is integrated in the KSU expenditure.
• Technical amendments in the ceilings possible according to the predetermined amendments model.</td></tr>
</table>

	New policy initiatives are discussed and disagreements requiring decision at the CMU level are detected.
May 31	MoF submits the draft MT Budget Declaration and KSU ceilings to the CMU, with an explanatory note on pending disagreements
Jun 15	CMU considers and approves the MT Budget Declaration and the KSU ceilings and sends them to Verkhovna Rada
	All disagreements detected during the bilateral negotiations between the MoF and the LMs are settled. Macroeconomic forecasts are updated if necessary in the Budget Declaration to reflect any major policy decisions taken by the CMU that differ from the draft Declaration.
Jun 30	Verkhovna Rada approves the MT Budget Declaration and the KSU ceilings
	MoF sends the KSU ceilings to the LMs/KSUs.
Jul 31	LMs/KSUs send updated program information (expenditure and performance indicators) to the MoF
	Total KSU expenditure including all programs cannot exceed KSU ceiling. KSUs should include information on measures to comply with their ceiling. KPIs are updated.
Jun 30 – Aug 1	MEDT updates the macroeconomic forecast to include new economic information, policy initiatives approved by the CMU and specified in detail by the KSUs at program level
	Consultation with the stakeholders takes place. New baseline macroeconomic forecast available by 1 Aug.
Jul 31 – Aug 31	Bilateral negotiations between the MoF and LMs regarding the budget for the next year
	No new policy initiatives on the agenda, negotiations only on how to implement the agreed initiatives in the budget bill. New baseline macroeconomic forecast is integrated in the KSU expenditure. • Technical amendments in the ceilings possible according to the predetermined amendments model.
Sep 1	MoF submits the draft budget bill and the updated macroeconomic forecast to the CMU
Sep 15	CMU considers and approves the budget bill and macroeconomic forecast and submits the budget bill to Verkhovna Rada and the President of Ukraine

Annex II. Template for New Policy Proposals

LINE MINISTRY: < >

Implementing Spending Unit: < >

Program Name: < > ◯ New Program ◯ Existing Program (<program code>)

Reform: [Title]

<Describe proposed reform>

Financial Implications (‘000, UAH)

	2018	2019	2020
Change in Revenue	0.0	0.0	0.0
Change in Tax Revenue	0.0	0.0	0.0
Change in Administrative Fees	0.0	0.0	0.0
Change in Other Non-Tax Revenue	0.0	0.0	0.0
Change in Expenditure	0.0	0.0	0.0
Change in payroll expenditure:	0.0	0.0	0.0
Change in expenditure on G&S:	0.0	0.0	0.0
Change in other current expenditure:	0.0	0.0	0.0
Change in capital expenditure:	0.0	0.0	0.0
Total Impact on State Budget:	**0.0**	**0.0**	**0.0**
Change in staffing levels (‘000)			

Policy case:

- (if the reform is on an existing program, provide program’s description, including details of outcomes for the previous year and resource allocation for the current year, when it was introduced and recent amendments, if applicable).
- What is the public policy rationale for the reform? Is it a government priority?
- What are the intended objectives and outputs? How will the activity meet the policy objectives?

Impact and sensitivities:

- Who will be affected by the policy change? How many will be impacted?
- What is the financial impact/cost to those affected? Are any user-charges or co-contributions being introduced (or increased)?
- What are the social/economic consequences? Any regional/sectoral impact?
- Are there any implications (increase/decrease in costs) to other programs as result of reform?
- How will other stakeholders react? Are there any lobby groups/think tanks/institutions who will advocate for/strongly oppose the reform?

Implementation issues:

- How much time is required for implementation?
- Are there any one-off implementation costs? Are there impacts on departmental resourcing?
- Is legislative change required? By when?
- Is negotiation with third parties required? If so, describe anticipated position of those parties.?
- Were any other reform alternatives considered? What was the rational for selectin this one?
- Is further consultation required within government or with third parties? If so, detail the process.

Annex III. Objectives, Outcomes, and Output Indicators

A program should begin with a clearly defined objective, which sets out what the program is designed to achieve and the area in which it will operate. There should be a clear link between the problem the program seeks to address, the program intervention and the intended result.

Programs should be designed to have a longer-term impact on a particular area and as such have outcome indicators. These are typically broad public policy outcomes, such as longer life expectancy, better life quality, increased access to education and so on. Outcome indicators are generally high level and their specification is relatively stable over time.

Program measures refer to specific activities directed at achieving the broader program outcome and as such they have output indicators. These are the provision of public goods or services, such as the number of hospital beds, number of doctor visits, etc. Output indicators are generally easier to define, as they are more closely linked to specific activities, and are more regularly reviewed and revised as the program measures are adjusted in line with performance and changing priorities.

Example of Program Indicators – Schools

In general, performance indicators in Ukraine focus on readily measurable inputs or outputs. For example, Ukraine currently uses several quantitative indicators to assess performance of the program measures related to schools. Indicators on quality and timeliness are not yet developed. More useful performance indicators measure the desired outcomes from the program or program measure. This requires each program to have a clear objective, and allows for a better assessment of whether the spending under the program is achieving these goals. For example, Australian States are responsible for the delivery of primary education, and provide an example of the variety of indicators that can be used to assess performance.

Ukraine	Queensland	Victoria
• Number of students • Number of teacher certification centers • Number of competency standards issued • Number of people willing to participate in external assessments of learning outcomes obtained in full general education	• School attendance • Literacy and numeracy achievement from standardized tests • Retention through years • Transitions to further education, training and • employment • Outcomes for vulnerable or high priority groups	• Students with acceptable levels of school attendance • Students meeting the expected standard in national and international literacy and numeracy assessments • Course completion rates • Enrolment in specialized or high priority courses

In addition, the Australian programs include clearly defined objectives. The Queensland outcome for the school's program is that students are engaged in learning, achieving, and successfully transitioning to further education, training and work. Victoria alternatively includes broad programs related to achievement (Raising standards of learning and development) and engagement (aimed at increasing the number of Victorians actively participating in education and development).

An excellent guide to useful outcome/quality indicators can be taken from the OECD's Education at a Glance and Health at a Glance publications. For the security and justice sectors, a good reference is DFID's "Indicators of Inputs, Activities, Outputs, Outcomes, and Impacts in Security and Justice Programming".

Annex IV. Draft Fiscal Risk Statement

A. Macroeconomic Risks

The economic and fiscal forecasts presented in the Budget incorporate assumptions and judgments based on information available at the time of preparation. These medium-term forecasts are subject to uncertainty around the future evolution of economic conditions and implementation of government policies.

Unanticipated changes in macroeconomic conditions will cause fiscal forecasts to differ from those presented in the budget. For example, slower-than-projected GDP growth would result in tax revenue collection underperforming against the forecasts. The risks to the macro-economic outlook could arise from a weakening in global economic conditions and terms of trade which would impact on export volumes and earnings as well as the exchange rate, increased geo-political tensions and shocks in domestic conditions.

[The IMF's Debt Sustainability Analysis shows that a shock to economic growth, entailing lower growth by one historical standard deviation in 2018 and 2019 (to -4.0 percent and -3.6 percent, respectively) would lead to a deterioration in the primary balance to deficits of 1.7 and 5.7 percent of GDP, respectively.]

The forecasts presented in the budget are also predicated on the implementation of structural reforms to facilitate growth. Any delays in implementing these reforms may translate into lower than forecast economic growth, which would impact the fiscal position. On the other hand, the government has announced a number of reform measures, which have not been fully incorporated into the macroeconomic projections. Assessing the macroeconomic effects of these initiatives is challenging and can be assessed in more detail and taken into account in the projections once the content of the reforms is known in more detail. Successful implementation of these reforms could therefore result in higher than forecast economic growth.

[*Subsequent statements could replace IMF analysis with government scenario analysis:* The following two scenarios provide an indication of the sensitivity of expenditures, revenues and the budget balance to changes in the economic outlook over the medium-term forecast period. The first scenario incorporates weaker external conditions, lower agricultural commodity prices, reduced exports, a lower exchange rate, and nominal GDP. The second scenario assumes stronger than anticipated domestic growth because of more successful reform implementation, as well as more favorable trade conditions with major trading partners. [1]

The remainder of this section would summarize the alternative scenarios developed by the Ministry of Economy, by presenting a comparison table of the key macroeconomic assumptions for the key

[1] An alternative approach to publishing scenarios would be to include a summary table of the impacts on revenues and expenditures of changes in discrete macroeconomic parameters such as GDP, inflation, exchange rate, and key commodity prices.

aggregates – GDP, prices, employment, net exports – under the baseline and two scenarios, and showing the implications for total revenue, expenditure, budget balance, and debt].

B. Public Debt

General government debt is forecast to be [85] percent of GDP in 2018 and fall to around [70] percent of GDP by 2020. Deviations in macroeconomic parameters from forecasts will impact on government debt and debt servicing obligations. In particular, the debt portfolio is susceptible to changes in the external environment and exchange rate shocks, with around [70] percent of the debt portfolio denominated in foreign currency and around [65 percent] of public debt held by non-residents. The majority of debt denominated in foreign currency is denominated in [set out currency composition, i.e., share in USD, EUR for major currencies]. Given this, the debt portfolio is highly sensitive to fluctuations in the exchange rate. For example, the depreciation in the exchange rate in 2014–15 contributed to a 40 percent of GDP revaluation in the debt portfolio.

Refinancing risks are relatively modest. Around 7 percent of the debt portfolio has a maturity of less than one year and the average duration of the portfolio is around x years. The debt portfolio is subject to some interest rate risk, with around x percent of domestic denominated debt and around x percent of foreign currency debt denominated issued in variable interest rate instruments. [Table X shows the sensitivity of the debt portfolio to changes in interest rates and the exchange rate.]

Mitigating some of the risks has been the shift in composition of debt from private to official creditors with longer maturity and the projected decline in the share of foreign currency debt in coming years.

C. Government Guarantees

The government has provided guarantees on loans amounting to UAH 279 billion or 11.7 percent of GDP at end-2016. Of this, around UAH 170 billion (7.1 percent of GDP) relates to a guarantee provided on IMF loans to the National Bank of Ukraine (NBU). The remainder largely represent guarantees on borrowing of state-owned enterprises (SOE) to finance investment projects, which totaled around UAH 109 billion (4.6 percent of GDP). In addition, the government has provided a guarantee to a private company [specify], of UAH 273 million to ensure the fulfillment of defense contracts. The majority of state guarantees are provided on external borrowing and are therefore exposed to foreign currency risks (Table X).

The fiscal costs associated with servicing guaranteed debts has averaged 0.6 percent of GDP a year over the period 2010–17. The 2018 budget includes provision for anticipated future costs associated with servicing outstanding guarantees. [The government also seeks to recover the costs associated with servicing guarantees, total recoveries over the period 2010–17 amounted to UAH X million or x percent of GDP].

The Budget Code of Ukraine requires all guarantees to be approved by the Cabinet of Ministers of Ukraine. Further, limits on the annual issuance of new guarantees are set out in the annual budget law, with the limit on new issuance for 2018 set at [UAH x billion or x percent of GDP].

Table 1.1. State Guarantees

	2011	2012	2013	2014	2015	2016
Total Guaranteed Debt	**115.9**	**116.3**	**104.6**	**153.8**	**237.9**	**278.9**
Percent of GDP	*8.9*	*8.3*	*7.1*	*9.7*	*12.0*	*11.7*
Domestic Debt	**12.3**	**16.2**	**27.1**	**27.9**	**21.5**	**19.1**
Percent of GDP	*0.9*	*1.2*	*1.9*	*1.8*	*1.1*	*0.8*
Debt securities issued on the domestic market	5.8	10.0	21.1	21.6	16.4	16.0
Due to banks and other financial institutions	6.5	6.2	6.0	6.3	5.1	3.1
External Debt	**103.6**	**100.1**	**77.4**	**125.9**	**216.4**	**259.8**
Percent of GDP	*8.0*	*7.1*	*5.3*	*7.9*	*10.9*	*10.9*
Loans from International Financial Institutions	61.5	40.6	16.2	40.1	140.8	190.9
Loans from Governments of foreign countries	1.5	2.0	2.0	3.8	4.7	4.0
Loans from foreign banks and other foreign financial institutions	16.8	29.3	31.0	51.6	68.2	62.0
Outstanding securities in foreign markets	22.8	27.2	27.2	28.5	0.0	0.0
Other categories	1.0	1.0	1.0	1.9	2.7	3.0

D. State-Owned Enterprises

Under the Commercial Code of Ukraine, any entity in which the state holds an interest of over 50 percent or can exercise ultimate influence over the enterprise's operations is classified as an SOE. These enterprises take a variety of legal forms, of which the most common, particularly among the larger SOEs, are the state unitary enterprise and joint stock companies (JSEs). As at 31 December 2016, the state owned approximately [3,350] SOEs, although this number may be incomplete as there is no consolidated up-to-date register of SOEs. Many of these SOEs are not operational, including approximately [1500] SOEs that are in a protracted process of being liquidated. The government is currently undertaking an inventory of all SOEs.

The Constitution, Commercial Code of Ukraine and the State Property Law as well as resolutions, regulations, procedures and rules that have been issued provide the legal framework for the management of SOEs. Ultimate responsibility for the supervision of SOEs is vested with the Cabinet of Ministers (CMU), supported by the Ministry of Economy and the State Property Fund as well as the line Ministries and supervisory authorities assigned responsibility for overseeing specific SOEs.

The government is taking steps to reform the SOE sector. The most significant reforms include:

- Requiring the establishment of supervisory boards with independent directors for unitary state enterprises;
- Introducing new procedures for appointing and remunerating the heads of the largest SOEs;
- Initiating a process to corporatize unitary state enterprises dominated by commercial functions as joint stock companies to ensure they operate on the same footing as private companies;
- Introducing requirements that the financial statements of the largest SOEs must be prepared in accordance with international reporting standards and independently audited by internationally reputable auditors within [a specified timeframe] after the end of the financial year;
- Requiring SOEs publish financial statements on their corporate websites, or the websites of the relevant supervisory authority; and
- [Any other relevant reforms, particularly where they have relevant for fiscal risk].

Financial Performance

To evaluate the financial position and financial performance of the SOEs, financial information on 48 SOEs was collected. This group of SOEs was selected because they were either receiving state support, were large in terms of assets or revenue, had weak financial performance or large arrears. As at [31 December 2016] the 48 largest SOEs accounted for almost [90] percent of the total assets of all SOEs and around [85] percent of total SOE revenues. The SOEs operate in 9 different sectors with the most significant enterprises operating in the Oil & Gas; Transport and Electricity sectors which collectively account for half of the SOEs but more than 90 percent of their assets and revenues (Table X).

Table 1.2. Breakdown of the Top 48 State-Owned Enterprises by Sector (UAH million)

Sector	Number of SOEs	Percentage	Total Assets	Percentage	Total Revenue	Percentage
Oil & Gas	4	8%	1,197,700	59%	334,113	58%
Transportation	10	21%	449,506	22%	106,810	18%
Electricity	10	21%	291,199	14%	82,001	14%
Food & Agriculture	4	8%	47,793	2%	35,427	6%
Machine Building	4	8%	20,143	1%	8,481	1%
Real Estate	4	8%	8,745	0%	85	0%
Coal Mining	5	10%	6,936	0%	3,907	1%
Chemicals	4	8%	3,562	0%	2,655	0%
Other	3	6%	2,949	0%	4,700	1%
Total	**48**	**1**	**2,028,532**	**1**	**578,180**	**1**

Source: 2017 financial plans

Total assets of the 48 SOEs are around 2 trillion (82 percent of GDP) at end-2016, while total liabilities (both guaranteed and unguaranteed) are around UAH 530 billion (22 percent of GDP). Around 90 percent of liabilities are concentrated in the ten largest SOEs. Over the past three years, there has been consistent growth in the total revenue of the 48 SOEs. However, in 2017, operating losses in aggregate for the 48 SOEs are anticipated. Following losses in 2014 and 2015, net profits, have been improving and totaled UAH 41 billion (1.7 percent of GDP) in 2016. A similar outcome is anticipated for 2017. The return on equity (ROE), which is projected to be [4 per cent in 2017] is still low relative to the cost of government borrowings of [10-year bond yield in local currency].

Table 1.3. Financial Position of the Top 48 SOEs (UAH million)

	2014	2015	2016	2017	y-o-y % change
Summary Balance Sheet					
Assets	878,231	1,123,795	1,957,141	2,025,583	3%
Cash and cash equivalents	31,928	55,790	68,394	42,682	-38%
Liabilities	294,501	347,763	529,311	567,775	7%
Equity	583,621	773,399	1,428,067	1,460,477	2%
Summary Income Statement					
Revenue	212,103	295,775	454,233	573,479	26%
EBITDA	46,123	124,000	125,074	(38,204)	-131%
Net profit	(119,745)	(44,489)	41,197	51,223	24%

Source: 2014-2016 Annual Financial Statements; 2017 financial plans.

Significant improvements in the performance of Naftogaz and Ukrgasdobycha contributed to improvements in the aggregate SOE performance although this was offset by losses realized by Ukrtransgaz and a number of companies in the coal mining sector. The main drivers of this improved performance have been adjustments in energy tariffs for households and gas transportation, [explain the other drivers which could relate to: developments of coal mining companies in the non-government controlled area, impact of currency movements, slow-down or recovery in domestic economic conditions, movements in commodity prices, etc.].

In aggregate the leverage of the SOE sector is relatively low, with debt projected to account for only 28 per cent of the total assets as at the end of 2017. Some SOEs, however, are both highly leveraged and experiencing weak operating profitability, which could result in these enterprises facing some difficulties servicing their debt.

Table 1.4. Aggregate Financial Ratios for the Top 48 SOEs

	2014	2015	2016	2017
Profitability				
Increase in Net Income (%)		39%	54%	26%
EBITDA margin (%)	21.7%	41.9%	27.5%	(6.7%)
Net profit margin (%)	(56%)	(15%)	9%	9%
Return on equity (%)	(21%)	(6%)	3%	4%
Return on assets (%)	(14%)	(4%)	2%	3%
Leverage and Solvency				
Debt to Assets ratio	0.34	0.31	0.27	0.28
Net Debt to EBITDA ratio	5.7	2.4	3.7	(13.7)
Interest coverage ratio				

Source: 2014-2016 Annual Financial Statements; 2017 financial plans

Fiscal risk assessment

Poorer-than-anticipated financial performance, liquidity pressures or a weakening in the financial position of SOEs could result in lower dividends and taxes being received from SOEs; an increased need for subsidies or recapitalization; or an unanticipated call on government guarantees related to

SOE borrowing, all of which would result in actual budget outcomes and key fiscal metrics differing from the fiscal forecasts presented.

To begin to quantify the magnitude of fiscal risk posed by SOEs, the government has adopted a methodology to assess the likelihood of these risks materializing. The 48 SOEs were classified into risk categories based on the following criteria:

- Risk category 1: SOEs which are unprofitable, either at an operating profit or a net profit level and which have a high debt burden (i.e. Net debt to EBITDA exceeds 4);
- Risk category 2: SOEs which have a high debt burden;
- Risk category 3: SOEs which are unprofitable or have a negative ROE;
- Risk category 4: SOE which have a low profitability and a ROE below 1 percent; and
- Risk category 5: all remaining SOEs.

This categorization reflects the fact that when companies are not profitable they may not able to generate sufficient cash to service their obligations. Furthermore, where companies repeatedly realize significant losses, their equity is gradually eroded and eventually they may need to be recapitalized in order to continue operating. Over time the Ministry of Finance intends to expand the information that is collected on SOEs and elaborate on the methodology for assessing the fiscal risk arising from SOEs.

Twelve SOEs were assessed to be of the highest risk (risk category 1), with a further 21 assessed to be in risk category 2 and 3. Enterprises in risk categories 1 through 3 hold around three quarters of total liabilities of the sector, which amounts to around 15 percent of GDP. The remaining SOEs were assessed to be of lower risk (classified into risk categories 4 and 5). The two enterprises which have the largest debt exposure, were rated in risk category 1 and 2. Table X shows the maximum net debt exposure associated with enterprises based on their risk category. The extent to which any potential fiscal costs will be realized depends on whether these fiscal risks materialize and the government's response where there are no explicit obligations to provide support.

Table 1.5. Risk Categorization of the Largest 48 SOEs (2017)

Risk category	**Number of entities**	**Combined Net Debt (percent of GDP)**
1	12	5.2
2	20	9.8
3	1	0.1
4	6	2.8
5	9	1.5
Total	**48**	**19.4**

[Provide a description of the measures that will be taken to mitigate potential fiscal risks, in particular for those enterprises in risk categories 1 and 2.]

Subsequent statements should expand on this analysis and provide an overview of the performance of those enterprises deemed to pose the largest risk or those that are macro-critical from the perspective of their role in the Ukrainian economy (for example, Naftogaz; Ukrtransgaz; Ukryaliznytsia

(Railway company); Energoatom; Ukrgasdobycha; State Food and Grain Corporation; National Power Company Ukrenego; Regional Electric Network; Ukrkosmos; Production Association Yushny Machine Building Plant; Lisichanskvuhillya; Selydivvuhillya; Lvivvugillya).

Financial relations between the central government and SOEs

Direct financial transfers

Direct financial support in the form of grants and subsidies totaling [UAH X [billion] was provided to SOEs during [2016] and provision has been made in the budget for this to continue over the medium term. The support went mainly to companies in the transport, coal, chemicals and machine building sectors[15] [or rather name the specific companies and the amounts transferred to each company]. [Provide a brief discussion on the what the support was provided for].

Regular share capital increases [totaling UAH xx million] through the issuance of domestic government bonds to SOEs have been effected to cover losses. While this does not directly impact the budget deficit, it does increase sovereign debt levels and consequently has implications for fiscal sustainability. The primary recipient of the transfers was Naftogaz which received a total of UAH [xx] million [and any other significant recapitalizations]. Due to the improvement in Naftogaz' performance, it is not anticipated that further transfers will be required beyond [2017]. [Include details of any other significant recipients].

In 2014, the Ukrainian Parliament adopted the Law of Ukraine on State Aid to Business Entities, which came into effect in August 2017. The objective of the Law is to make the allocation of the state aid to business entities more systematic, in particular, to improve management of the state funds allocated to SOEs and to minimize any negative impact of the state aid on the competitiveness of Ukraine's economy.

Receipts from SOEs

Dividends received from SOEs for [2016] totaled [UAH 5.8 billion or 0.2 percent of GDP] of which the most significant amounts were from the Ukrainian Sea Ports Authority, the National Power Company Krenergo and Kyiv Boryspil International Airport. This represented a dividend payout ratio of 14 percent. [In 2017 these are expected to grow significantly to [UAH 19.8 billion] due to a [UAH 13.3 billion] dividend that is anticipated from Naftogaz.

The percentage of profit to be paid by SOEs as dividends to the state budget is regulated by the Law of Ukraine on Management of State-Owned Assets. Under this Law, unitary SOEs and their associations that represent natural monopolies and with budgeted net profits over UAH 50 million were required, in 2016, to pay 75 per cent of their profits as dividends, whilst other unitary SOEs paid 15 per cent of their net profit as dividends. The dividend payout ratio for JSCs was also set at 75 percent. Exceptions were made for [Ukrhidroenergo, [Ukrzaliznytsia], Energoatom, Ukrenergo, Centrenergo, and [the Defense Company]]. For energy sector SOEs, the net profit used as the basis for determining the dividends that are payable is reduced by the amounts to be allocated to investment

[15] Ukrkosmos, Lvivvugillya, Krasnolymanska, Selydivvuhillya, Lisichanskvuhillya, Ukremedpostach, Yuzhny.

projects and for the repayment of loans for the construction, maintenance and upgrade of facilities subject to CMU authorization. In 2017, the payout ratio for JSCs has been reduced to [xx] percent and for unitary state companies to [xx] percent.

Taxes received from SOEs amounted to [UAH X billion or X percent of GDP]. All SOEs (not including state institutions which are funded directly from the budget) are required to pay corporate income tax. With the exception of a number of companies in the coal mining sector, the majority of SOEs are up-to-date in their tax payments. [Specify whether the tax arrangements for SOEs are the same as obligations of private companies. List any tax exemptions to SOEs in general or particular SOEs].

Privatization

The Cabinet of Ministers has approved a list of enterprises to be privatized and plans privatizing 18 large companies which is projected to raise UAH 17 billion in 2017. This includes companies from the coal, electricity, transport and other sectors.[16] Steps are being taken to restructure and prepare the identified enterprises for privatization so as to increase their investment attractiveness, liquidity and the value that can be realized through privatization as well as to promote a competitive operating environment and prevent monopoly control of markets. Currently, amendments to the Law on Ukraine "On State Property Privatization", which are necessary to ensure a transparent and competitive process, are in draft form. Delays in the planned privatization of state assets would result in the proceeds realized from privatization being lower than anticipated, which would increase government debt compared to budget projections. To date, receipts from privatization have been disappointing. Achievement of the target for 2017 and beyond will require a concerted effort both on a political and technical level.

On-lending to SOEs

Loans are no longer being made to state-owned enterprises from the government's own resources, but the central government does on-lend to SOEs borrowings raised with International Financial Institutions (IFIs). The loans are provided to the SOEs at the same interest rate at which the funds are raised and the borrowing is recorded as part of central government gross debt. The total loan portfolio is around [UAH xxx billion or X percent of GDP] of which the most significant loans are to [key SOEs and the amounts outstanding]. While these loans are recorded as part of the central government debt, fiscal risks arise in the event that SOEs are unable to meet their repayment obligations, as the central government will need to service the loan. [Any mitigations that are in place.] Historical, accumulated arrears on loans from the government to SOEs amount to [UAH 49 million, of which UAH X is denominated in foreign currency].

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[16] The key legal act that defines the list of companies that will be privatized during 2016 includes companies such as: coal mining - Coal SE "Krasnolymanska", JSC "Lisichanskugol" separate units SE "Krasnoarmeyskugol" "Selydivvuhillya" "Lvovugol"; electricity - PJSC "Centrenergo", JSC "Zaporizhyaoblenergo", JSC "Mykolaivoblenergo" PAT "Khmelnitskoblenergo", JSC "Ternopiloblenergo", JSC "Dneprodzerzhinsk power plants"; Agricultural industry - SE "Equine Ukraiyiny"; the transport industry - SE "Southern Commercial Sea Port (ICC) Danube Shipping Company" chemical industry - JSC "Sumykhimprom", JSC "Odessa Port Factory"; financial sector - JSC "Ukrainian Bank for Reconstruction and Development"; other industries - DPAT Construction Company "Ukrstroy."

Contingent liabilities

As at [end-2016], explicit contingent liabilities associated with SOE related government guarantees totaled UAH [109] billion or [4.6 percent] of GDP, almost all of which are exposed to foreign exchange risk. Guarantees are only issued to support investment projects. The most significant exposures are with respect to Naftogaz (UAH [28.5] billion); Ukrenergo (UAH [13.6] billion). Fiscal costs associated with debt-servicing of guaranteed SOE debt averaged around 0.7 percent of GDO over the past five years. The budget includes a provision to meet anticipated calls on guarantees, specifically with respect to loans to the State Air Enterprise, Lisichanskugol and Energoatom.

Unguaranteed liabilities of the major SOEs totaled around [20] percent of GDP. Of these liabilities, [around x percent are denominated in foreign currency, and around [x per cent] fall due within one year. For Ukrzaliznytsia (Ukraine Railway) and the Regional Electricity Network, the State Food and Grain Corporation, Sumykhimprom, Dnieper HPP and Kryvorizka heating plant [if the data is correct] a significant proportion of the liabilities comprise overdue accounts.

The state is not obligated to service unguaranteed debts in the event that an SOE defaults. There are no limits on SOE borrowing, but the [Ministry of Finance/oversight authority] controls the level and cost of borrowing as well as the pledging of state assets as collateral for borrowing.

[*In subsequent reports:* Add discussion of interlinkages between SOEs (such as lending and overdue accounts payable/receivable, investments. In particular, include discussion of interlinkages between the SOE sector and state-owned banks].

The financial position of some enterprises may be impacted by their capacity to successfully collect outstanding receivables and deposits held in troubled banks. [Provide more information on the magnitude of the overdue receivables that it may not be possible to collect. Explain which are the SOEs that are the most affected]. As at [December 31, 2016], the deposits total about [7 percent] of the total cash holdings of the SOEs. Individual SOEs with large exposures relative to their cash position include the Research-Industrial Complex Pavlograd Chemical Plant, Agrarian Fund, Kharkivoblenergo, Regional Electricity Network, Urktransgaz, Antonov and Kyiv Boryspil International Airport. [There is a need to verify this data before it is disclosed, as some of it looks unreliable – cash held with problematic banks seems to exceed total cash holding].

Nonfinancial transfers

Generally, unitary SOEs do not have legal title for the assets that they operate. For example, the rail network and carriages of Ukrzaliznytsia (Ukraine Railways) are owned by the state not the company. Similarly, the pipelines that Naftogaz manages are the property of the state. In some cases, the government does not charge the SOE a commercial rate for use of the asset. SOEs are charged for the use of land in the form of a tax, which is set at a uniform rate, and which has been adjusted to bring it in line with the rates charged to private companies for the use of state land. [Briefly explain the current policy around the use of assets by unitary enterprises and the transfer of ownership of the assets to them if relevant.]

Quasi-fiscal activities

Quasi-fiscal activities are non-commercial activities undertaken by SOEs to fulfill a public policy objective that worsen their financial position. Whilst these activities usually contribute positively toward achieving public policy objectives, if SOEs are not properly compensated, they can erode the companies' profitability, thereby contributing to the likelihood of the company requiring fiscal support. In line with the reforms being undertaken to improve fiscal transparency, ensure sound public financial management and align with European Union standards, over time such activities will be replaced by on-budget payments to the corporations. As a first step, the government has begun to collect information on these activities. Significant identified quasi-fiscal activities include [below-cost tariffs for passenger rail, which are cross-subsidized from freight operations at an estimated cost of around UAH 8 billion; tariffs for households' water and sewerage that are set below the cost of delivery, the impacts of which are not yet quantified; [list other material known quasi-fiscal activities.]

The government has taken steps to reduce quasi-fiscal activities in the energy sector through tariff reforms. Over the period 2015-2017 electricity tariffs were increased to more cost reflective levels. Similarly, subsidies in the gas sector are also being phased out through increasing prices for households and heating utilities to import parity prices as well as adjustments to the costs of gas transportation. As a result, indirect subsidies to Naftogaz, which were significant in past years, are no longer envisaged over the medium term.

E. Financial Sector Exposures

Financial sector risks can arise from obligations to meet explicit obligations to provide back-up funding to the deposit insurance fund and to guarantee deposits of the state-owned Oschadbank, or from government decisions to recapitalize troubled banks which were not anticipated in the budget forecasts. At the end of 2015, the non-equity liabilities of the financial sector amounted to about 50 percent of GDP, with liabilities of the four state-owned banks (Oschadbank, PrivatBank, Ukreximbank and Ukrgasbank) around 30 percent of GDP.

The Deposit Guarantee Fund (DGF) insures deposits of individuals and sole traders up to a cap of UAH 200,000 per account holder. Since the beginning of the crisis, around 80 insolvent banks were transferred to the DGF, which has paid out UAH 85 billion to the depositors of these banks. The total volume of deposits guaranteed by the scheme is around UAH 300 billion (13 percent of GDP). Total assets in the fund amount to UAH X billion (X percent of GDP). In addition, all deposits in Oschadbank (around UAH 145 billion or 6.4 percent of GDP) have been guaranteed by the government.

Over the period 2014 to 2017, the government has provided 11 percent of GDP to finance the compensation of insured deposits in failed banks and to recapitalize other banks. Since the crisis, the government and the NBU have taken a number of steps to strengthen the banking system. These include measures to improve governance of state-owned banks, including through the establishment of independent professional supervisor boards, and requiring all banks with negative operating profitability to submit restructuring plans and meet capital adequacy requirements. The NBU has also completed diagnostic studies of the top-60 banks and assigned recapitalization schedules for those that needed them. In the case of the recently nationalized PrivatBank, the government is taking steps to ensure that its nationalization is efficient and transparent and minimizes costs to the State.

Systemic risks to the Ukrainian financial sector have been diminishing, with a recovery in banks funding base, recognition of the real quality of assets, and compliance with recapitalization programs by almost all large banks. However, should a deterioration in banking sector occur, this could give rise to additional fiscal costs. Table X summarizes some of the key financial soundness indicators for the banking system. Further discussion of the soundness of the financial sector is detailed in the NBU's Financial Stability Report.

Table 1.6. Financial Soundness Indicators

	2015	2016
Regulatory capital to risk-weighted assets	12.3	13.9
Share of Non-performing Loans to total loans	46.4	49.4
Credit growth (year over year percent change)	-19.4	-3.7
Loans in foreign currency to total loans	54.1	49.3
Deposits in foreign currency to total deposits	44.9	46.0
Liquid assets to total assets	33.0	...
Return on assets	-5.4	-1.2
Return on equity	-70	...
Number of banks not complying with banking regulations		
Not meeting capital adequacy requirements for Tier I capital	11	10
Not meeting prudential regulations	37	39
Not meeting reserve requirements	6	7