



UKRAINE

TECHNICAL ASSISTANCE REPORT—STRENGTHENING BUDGET FORMULATION AND FISCAL RISK MANAGEMENT

December 2019

This Technical Assistance Paper on Ukraine was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in December 2018.

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International Monetary Fund
Washington, D.C.

Ukraine

Strengthening Budget Formulation and Fiscal Risk Management

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Technical Report

January 2019

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ABBREVIATIONS AND ACRONYMS

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
PFM	Public Financial Management
SOE	State-owned Enterprise
TA	Technical Assistance
VR	Verkhovna Rada (Parliament of Ukraine)

PREFACE

In response to a request from the Minister of Finance, Ms. Oksana Markarova, a team from the IMF's Fiscal Affairs Department (FAD) visited Kiev, Ukraine during November 28 to December 10, 2018 to assist with strengthening budget preparation and fiscal risk analysis. The FAD team consisted of Amanda Sayegh and Michelle Stone (both FAD), Julien Dubertret and Martin Johnson (both FAD experts).

During the visit, the FAD team met with Ms. Oksana Markarova, Minister of Finance; Mr. Vladimir Lozytsky, State Budget Director; Ms. Oleksandra Betliy, Chief Economist, Mr. Oleksiy Zhak, Director General for Strategic Planning; Mr. Andrey Savenko, Head of the Fiscal Risk Management Division; Mr. Romaniuk Yuri, Director of the Department of Budget Revenue Projections and Accounting Methodology; Mr. Yaroslavl Tashuta, Head of Industrial Production Finances Division; Ms. Olena Machuluna, Deputy Director, Department of Local Budgets; and Mr. Denys Khrystoforov, Deputy Director, Debt Policy Department.

The FAD team also met with: Mr. Gennadii Dyki, Mayor of Bila Tserkva City and staff of the administration; Mr. Pavlo Kovtoniuk, Deputy Minister and Ms. Iryna Lytovchenko, Director General for Strategic Planning and European Integration of the Ministry of Health; Ms. Valeria Voytenko, Deputy Director, Economic Strategy and Macroeconomic Forecasting Department and Mr. Pavlo Onischenko, Head of the Unit for Economic Development in the Ministry of Economic Development and Trade; senior officials from the Ministry of Education; and Mr. Vasyl Amelchenko, the Deputy Chair of the Budget Committee of the Verkhovna Rada and members of the Budget Committee Secretariat.

In addition, the team met with representatives from a coalition of civil society organizations and experts, the European Union Delegation to Ukraine, and other public financial management capacity development.

The FAD team would like to thank the authorities and other participants for their collaboration during the mission. The team is also extremely grateful for the support given to the team by staff at the IMF Office, in particular Mr. Ihor Shpak for his excellent support in coordinating the mission. The team is also grateful to Mr. Serhiy Kolesnyk and Ms. Lisa Snegireva, for their excellent interpretation and translation efforts during the visit.

EXECUTIVE SUMMARY

Implementing strategic planning and a medium-term budget framework (MTBF) is a core component of Ukraine's Public Financial Management (PFM) reform strategy. A pilot MTBF conducted in 2017 formed the basis for amendments to the Budget Code in December 2018, which firmly establish a MTBF as the basis for budget preparation. The amendments also establish a legal basis for related reforms, including regular spending reviews and monitoring and managing risks to public finances.

Strengthening the Budget Preparation Process

Approval of the Budget Code amendments has paved the way for the first full-fledged MTBF, to be conducted in 2019. A detailed calendar to support medium-term budget preparation has been prepared by the MoF and is based on largely sound principles. There are nevertheless some aspects that warrant further review. The notification of macroeconomic parameters after line ministries have developed their baseline estimates may constrain the consistency and effectiveness of the strategic planning phase of the budget. In addition, the absence of a second update of the macroeconomic parameters prior to submitting the draft budget to the Verkhovna Rada may reduce budget reliability and introduce risks during the parliamentary procedure. The timing for notification and finalization of expenditure ceilings could also be extended, freeing up space earlier in the process for preparation of budget proposals. It will therefore be important to review the budget calendar after the first year of the MTBF to assess its efficacy.

The Budget Declaration prepared under the pilot MTBF contained important elements of a MTBF and should be built on in 2019 to enhance transparency and better support fiscal policy-making. The 2020–22 Budget Declaration should include: a detailed explanation of the main drivers of the medium-term macroeconomic and fiscal projections; a more detailed breakdown of medium-term expenditure projections; explanation of expenditure ceiling allocations; and, information on objectives, programs and performance for key spending units. Subsequent statements should also include reconciliation of the fiscal forecasts and medium-term expenditure limits from those presented in the previous year.

Roll-out of the MTBF is a significant exercise and will require substantial coordination and capacity building. It will be important for the MoF to support the reform through the urgent development of updated instructions and templates to line ministries and local governments. As capacity is developed within line ministries, they will be able to take increasing responsibility for managing their medium-term budgets.

Supporting an Effective MTBF

While the Budget Code amendments established the core elements of the MTBF, some key design elements have not yet been finalized. To underpin credibility, it will be important that the circumstances in which expenditure limits can be adjusted are clearly defined ex ante and limited

to a narrow set of circumstances. A central margin should also be established to accommodate budget volatility and meet the costs of genuinely urgent, unavoidable and unforeseeable expenditure pressures that may arise. To reinforce spending discipline, the margin should be tightly controlled, centrally managed and transparently reported.

Other aspects of the PFM system may also need to be reviewed to ensure the full benefits of an MTBF are realized. Multi-annual commitments are currently prohibited, with appropriations lapsing at the end of the year. This can undermine medium-term planning and reduce spending efficiency, particularly for capital projects. It would be timely to review these arrangements with the introduction of the MTBF, with a view to establishing procedures for multi-year commitments for capital projects, up to a limit and subject to Ministry of Finance approval.

Strategic planning should also be improved to provide a stronger basis for integrated policy-making, strategizing, planning and budgeting. Creating a robust strategic planning system would assist in this regard. Plans to implement a program of spending reviews will ensure baseline spending remains relevant, efficient and effective and is highly commendable. To ensure success, the process should be supported by strong leadership from the Ministry of Finance and methodological guidelines to govern the conduct of spending reviews.

Enhancing Fiscal Risk Analysis and Disclosure

The legal basis and institutional architecture within the MoF to support fiscal risk monitoring and management is now firmly established. Good progress has been made in fiscal risk analysis of state-owned enterprises (SOEs), and efforts are underway to broaden the scope of analysis to other sources of fiscal risk. This will require a substantial building of capacity and close collaboration across departments within, and outside, the MoF.

While a Fiscal Risk Management Division (FRMD) has been operational since 2017, its focus has primarily been on establishing a framework for monitoring and assessing SOE-related fiscal risks. Responsibilities for monitoring other sources of fiscal risks are fragmented across government. The FRMD will need to play a role in consolidating information on fiscal risks to ensure the government has a complete picture of its aggregate fiscal risk exposures. Responsibilities will need to be clearly defined in a CMU resolution and supported by the development of risk assessment methodologies, where these are not yet in place. The FRMD should also build on the work it has done on SOE fiscal risk assessment, by developing mitigating strategies in collaboration with relevant departments.

The fiscal risk statement published this year represents a significant advancement in disclosure. As analytical capabilities are further developed, the statement should be expanded to include quantitative analysis of macro-fiscal and public debt risks, enhanced disclosure of financial sector exposures, and more thorough and comprehensive analysis of SOE-related fiscal risks.

Table 0.1 contains a list of recommendation and indicative timeframe for their implementation.

Table 0.1. Ukraine: Summary of Recommendations

No.	Action	Next 6 months	July-Dec 2019	2020
Strengthening the Budget Preparation Process				
1.1	Review the appropriateness of the budget calendar after the first year of the MTBF			
1.2	Finalize and issue new budget instructions and templates to KSUs			
1.3	Develop a forward baseline estimates methodology			
1.4	Issue guidance and templates for local governments and conduct training			
1.5	Improve content of the Budget Declaration			
Supporting an Effective MTBF				
2.1	Clearly define conditions for technical adjustments in the Budget Declaration			
2.2	Establish a central budget margin and procedures for multi-year commitments			
2.3	Strengthen strategic planning to provide a stronger basis for the MTBF			
2.4	Prepare guidelines for the conduct of spending reviews and launch the second round of reviews			
Enhancing Fiscal Risk Analysis and Disclosure				
3.1	Establish clear responsibilities for fiscal risk assessment in CMU resolution			
3.2	Improve disclosure of fiscal risks in the annual fiscal risk statement			

I. STRENGTHENING BUDGET FORMULATION

A. Progress to Date

- 1. The Government of Ukraine has made significant progress in implementing a Medium-term Budget Framework (MTBF).** A pilot MTBF was undertaken for the 2018 Budget, and drawing on that process, detailed amendments to the Budget Code of Ukraine (BCU) were prepared and passed by the Verkhovna Rada (VR) in December 2018. An updated budget calendar to support the MTBF has also been prepared, which reflects the amendments.
- 2. The MTBF pilot, conducted in 2017, laid the groundwork for introduction of a fully-fledged MTBF, but enabling legislation was not in place for it to continue in 2018.** In 2017, based on specific legislation, a Budget Declaration, setting directions for the budget policy for the years 2018 to 2020, was approved by the Cabinet of Ministers (CMU) on June 1 and by Parliament in July. It contained many elements of a standard MTBF, although allowed for only limited bilateral negotiations between line ministries and the Ministry of Finance (MoF).¹ In 2018, however, in the absence of similar transitional legislation that had enabled the pilot in the previous year, the process digressed. Although there was a Budget Declaration, it did not set the expenditure ceilings or the revenue estimates and was not approved by Parliament. While the MoF endeavored to retain some elements of medium-term budget planning by informally sharing draft medium-term ceilings with KSUs, the process largely reverted to what it was before 2017, underscoring the need to enforce reform through law.
- 3. The legal basis for multi-year budgeting is now established.** A bill that extensively amends the BCU was adopted by the VR on December 6, 2018 taking into account a number of recommendations made by previous IMF technical assistance missions.² It places medium-term budgeting at the core of the budget process in Ukraine: a yearly multi-annual budget statement is established as the key outcome of the budget process (Art. 2) and its content is specifically defined (Art. 33 (7)); it is instituted as the framework within which annual budgets should be prepared (Art. 22.5.2); and, the responsibility of the MoF in the budget process is clearly asserted (Art. 33 (1-6)).
- 4. The BCU amendments also establish a legal basis for other important related PFM reforms.** Program budgeting is enhanced through the obligation to establish a strategic action plan for each program (Art. 20 (3)) and through the strengthening of the role of chief budget managers (Art. 20 (4-6) and 22 (5)). A clear mandate for monitoring and managing fiscal risks is established, with responsibility assigned to the MoF (Art.32 (1-5)) along with the requirement to

¹ Details of the content of the 2018-2020 Budget Resolution are set out in the IMF Technical Assistance Report: Sayegh, A. *et al*, "Medium-term Budget Framework and Fiscal Risk Statement" of July 2017.

² While the FAD reviewed earlier versions of the BCU amendments, there was not sufficient time to review in detail the full set of 2nd reading amendments passed by the VR during the visit.

submit a report on fiscal risks with the draft budget (Art. 38). The amendments also entrench regular spending reviews in the budget process (Art. 20 (10)).

5. The amendments to the BCU set up the main milestones of a revised and strengthened budget process calendar. In particular,, fixed dates are now set (Art. 33) for submission of macroeconomic projections and their updating (March 1, April 15, May 15) as well as for the process of approval of the Budget Declaration by the CMU (reception before May 15, approval before June 1 and submission to Parliament before June 5). The MoF has sought comment on the detailed budget calendar resulting from the amendments (see sub-section B).

B. Enhancing the Budget Process and Calendar

Strategic Budget Phase

6. Budget preparation in Ukraine has largely has been an annual process, with little opportunity to focus on issues of strategic resource allocation. Key Spending Units (KSU) have not participated in a strategic phase to consider trade-offs between policy options, embarking directly on detailed budget preparation during July and August. Information on key budget cost drivers, that would be required for updating baseline budget costs, has not been available to KSUs until the middle of the fiscal year. Opportunity for a strategic planning component has been further constrained by absent and weak strategic plans (see Chapter III).

7. Decisions on strategic budget allocation in an MTBF needs to be informed by an understanding of the available resource envelope for expenditure. This requires establishment of the macroeconomic framework early in the year to inform aggregate expenditure ceilings, consistent with fiscal rules and targets. It also allows the KSUs to calculate the fiscal costs of continuing to deliver their current services, and the MoF to calculate the fiscal resources available for allocation to new priorities. Policymakers are then better able to trade-off between competing policy priorities in the context of a proper understanding of their fiscal constraints as part of the strategic budgeting phase.

8. In Ukraine, adopting strategic budgeting is constrained by a laudably collaborative approach to macroeconomic and fiscal framework preparation. Establishing an approved macroeconomic framework currently involves cooperation among several partners across government over a three-month period. Policy assumptions for key budgetary variables (including minimum wage rates and social protection payments) are also developed through a consultative process within government. Aggregate and KSU expenditure ceilings are developed by the MoF towards the end of this process and are approved by Cabinet alongside the macroeconomic framework and key social parameters by June 1.

9. An attempt to introduce a strategic phase was made during the pilot MTBF exercise, but it was not fully effective due to compressed timeframes. The attempt would nonetheless have been constrained by unchanged timelines for generating the macroeconomic

framework, which is necessary to determine the fiscal resources available for new policy and by institutional arrangements that do not clearly distinguish baselines from new policies.

10. The new budget calendar attempts to establish the two-stage approach process. As detailed in Table 1.1, the first stage of the budget process (February to June) is intended to focus on the determination of new policy proposals to be adopted given the available fiscal envelope. The second stage (June to September) is intended to focus on the detailed annual budget preparation and development of the draft budget law. However, in practice, the effectiveness of the strategic phase may be constrained by the absence of early up to date assessments of the available fiscal envelope, with preliminary economic parameters updated after KSUs have prepared their budget proposals.

11. Ideally, the strategic budget phase would begin with an update of fiscal forecasts and cost drivers based on the latest available information. However, this would require a first version of the macroeconomic framework to be approved earlier in the budget process, with scope for subsequent updates as required. It would also require tentative initial assumptions for important socio-economic cost drivers at the same time (including minimum wage rates and social protection payments). It is possible that tentative initial assumptions issued prior to official approval for key socio-economic parameters may be politically sensitive and not feasible. Using existing values for the purpose of calculating baseline budget costs would be a politically neutral alternative. They would be adjusted centrally by the MoF, based on initial (confidential) proposals from relevant organizations within government. The information would be retained centrally, allowing aggregate baseline costs and fiscal resources available for new spending (the 'fiscal envelope') to be calculated.

12. Submission of KSU baselines and distinct new policy proposals would substantially strengthen strategic resource allocation decisions. Currently, there is no formal distinction between baselines and new policy proposals in KSU budget submissions and no formal calculation of the fiscal envelope for new policies by the MoF. In practice it is possible for KSUs to incorporate both forward baseline estimates and new policy initiatives within each and every existing program.³ Without a formal distinction between the two (baseline services and new policies), calculation of the fiscal envelope available for new policies becomes more difficult.

13. New methodology, institutional arrangements and enhanced capability will be required for a robust strategic phase to be fully introduced. This will include practical definitions for baselines, forward estimates and new policy initiatives. Whilst it will normally be clear what falls into each of these categories, disputes are inevitable in even the most mature systems. In an inaugural MTBF, where baseline and forward estimate concepts are new, this is especially true.

³ Forms 1 and 2 describe the allocation of the KSUs expenditure limit. Form 3 is used for requests for expenditure that exceed the KSUs expenditure ceiling.

- Definitions for key concepts constitute a starting point (Box 1.1). A range of technical issues will need to be mastered for a shared understanding of the boundary between baseline and new policies, including identification of cost drivers, treatment of investment expenditure, decisions over wage policy and accounting for transfers.
- Some of these issues are discussed (with examples) in an earlier FAD technical assistance (TA) mission report of April 2011.⁴ A subsequent FAD TA mission report of May 2017 also advised on the need to develop an official model (or series of models) to forecast key lines of spending under current policies and noted the corresponding need for extensive training in forward estimates modeling.⁵

Box 1.1. Potential Definitions for Strategic Budgeting Concepts

- **Baseline estimates** – the cost of existing services based on actual expenditure from the most recent complete budget year, after having accounted for one-off and other non-linear expenditure not representative of current service delivery commitments.
- **Forward baseline estimates** – the future cost of existing government services derived by applying agreed cost driver (both prices and volume) adjustments to baseline estimates.
- **New policy estimates** – the future cost of new policy initiatives distinct from and additional to forward estimates of the cost for existing government services.

14. Establishing a baseline on execution data from the most recent budget year should inform calculation of forward baseline estimates. Understanding reasons for deviations of expenditure from budget plans will be required to ensure future expenditure estimates are properly representative of service costs. Sources of deviations that reduce expenditures for one-off reasons (e.g., an unexpected reduction in utilities caused by favorable weather) should not influence forward baseline costs. Otherwise, one-off expenditures from the previous year (e.g., the cost of holding national elections) should be removed from the base data so as not to include them in forward baseline estimates.

15. Progressive expansion of MoF and KSU capabilities will be needed to develop forward estimates, focus attention on new policies and establish collaboration as the norm. It is understood that capabilities in many KSUs to develop robust baselines is limited. Within this context, maintaining the current centralized approach to adjusting the budget detail for cost drivers within the MoF, while simultaneously building capacity across government may be the best approach. This will provide opportunity for increasingly collaborative work between KSUs and respective MoF line departments, with responsibility for establishing baselines and forward estimates progressively passing from MoF to KSUs. Collaboration on KSU spending reviews will provide MoF line departments with an opportunity to expand their knowledge of sector policies and to base working relationships on partnership rather than confrontation—an important characteristic of international experience in MTBFs. Over time, this will help establish shared

⁴ Cangiano, M., *et al.* (2011) “Ukraine: Developing Medium Term Budgeting,” Fiscal Affairs Department, IMF.

⁵ Alves, M., *et al.* (2017) “Ukraine: Strengthening Public Finance Management,” Fiscal Affairs Department, IMF.

agreement on boundaries between baseline and new policies, increasingly automate routine tasks, simplify budget negotiation and allow greater time to be devoted to policy choices.

Budget Calendar

16. The annual budget calendar is to a large extent determined by the amended BCU.

The BCU now sets a series of deadlines to ensure the timeliness and quality of the budget process: preliminary macroeconomic projections are to be submitted by March 1 and finalized before April 15; the draft Budget Declaration is to be submitted before May 15 to the CMU that shall approve it before June 1 for transmission to Parliament by June 5. The annual budget calendar as a whole is driven, with limited flexibility, from these fixed milestones that drive the timing of the preparation and negotiation of the multi-year budget. The MoF's proposed budget timeline is summarized in Table 1.1 and described in full in Annex I.

Table 1.1. Ukraine: Simplified Budget Timeline for 2019 (2020–22 Budget)

February 15	MoF receives proposals from KSU
March 1	MoF receives revenue, tentative macro-projections, and social indicators
March 25	Finance Minister presents proposed budget indicators including aggregate expenditure ceiling to Ministers who discuss KSU 3yr ceilings and prioritization
April 5	MoF informs the KSU of their indicative ceilings
April 10	KSUs return information on their targets and expected results of activity
April 15	MoF receives final revenues and macro-projections
April 20	MoF submits to CMU targets and expected results of activity
Apr 21 – May 1	CMU conducts meetings for final harmonization and prioritization
May 15	MoF submits draft Budget Declaration to CMU
June 1	CMU approves macro-projections and Draft Budget Declaration
June 5	CMU submits draft Budget Declaration to Parliament
June 30	The Parliament makes its decision on the Budget Declaration
September 15	Deadline for CMU to approve and submit draft state budget law to the Parliament
October 20	Deadline for consideration of draft budget in the first reading
November 3	Revised budget submitted to Parliament
November 25	Deadline for consideration of draft budget in second reading
December 1	Deadline for adoption of draft Budget
January 1	<i>2020 budget year commences</i>

17. **If rigorously implemented, the revised budget calendar should constitute a more effective tool for the preparation of the MTBF and of the draft budget.** The mandatory nature of the most critical deadlines is beneficial and should be retained in future versions of the budget calendar. In particular, the June 5 deadline for the submission of the Budget declaration by the CMU to Parliament is a strong driver for discipline throughout the budget process. The June 5 deadline is demanding but considered achievable at this early stage of the reform. It also

allows room for the second phase of the budget process which is dedicated to the detailed allocation of appropriations within the ceilings before submission of the draft budget to the VR.

18. The durations allocated to the different stages of the budget process appear to be realistic and close to those in countries that undertake a full top-down / bottom-up reconciliation. The calendar allows for:

- Around four to five weeks (February 12 to March 20) for detailed discussions, mostly or exclusively at the administrative level, allowing for sufficient time to try to reconcile top-down and bottom-up approaches, including a thorough analysis of the baseline; at the end of this first stage, no technical issues should normally be pending;
- Around two weeks (March 25 to April 5) for negotiations at the level of Ministers on prioritization that informs the proposed ceilings provided to line ministries of 5 April;
- Around two weeks (April 5 to April 20) can be used to allow for the MoF to prepare for final CMU arbitrations and also, if possible, to settle some agreements through meetings of the budget sub-committee of the CMU; and
- Finally, a one-week period appears fit for the finalization of ceilings by the CMU, allowing more time at this stage would only risk re-opening the process.

19. Several issues are nonetheless worthy of attention and may require changes in the calendar, particularly in future years. These include:

- The absence of updated parameters issued to KSUs in preparation of baselines and to inform assessment of the available fiscal envelop for new policies or required saving measures, to ensure consistency with fiscal objectives (as discussed above);
- Issuance of a first set of ceilings at the end of March, long before the end of the budget process; and
- Difficulties that may arise with time with the early requirement for KSUs to submit budget proposals, and with the absence of macroeconomic update during the summer.

For some of these, it may only be possible to address over the medium term as the budget process matures and capacity is further enhanced. As 2019 will be the first year a more fully-fledged MTBF is properly executed, it is likely that further refinements will be required. The MoF has prudently laid the groundwork for subsequent amendments to the BCU, in its negotiations with the Budget Committee of the VR, should they be required.

20. The communication by the MoF to KSUs of initial indicative ceilings on April 5 does not appear to be consistent with the intended budget process. The new budget process is aimed at setting up a fully informed budget and policy dialogue between the MoF and KSUs, allowing for the integration of top-down and bottom-up visions and prioritization of public policy options through sequential stages of discussion and decision. In the proposed process, the issuance of ceilings is the ultimate act that closes the strategic stage of the budget process.

Rather than communicating 'ceilings' on April 5, it may be more appropriate that at this point in the process (which marks the end of meetings at Minister level) for a clear assessment to be made of the points of agreement and disagreement between the MoF and KSU to help better focus the last stages of the budget process.

21. The long period between finalization of ceilings by the CMU and their transmission to Parliament may turn out to be a window of vulnerability. According to the MoF's budget calendar, ceilings should be finalized by the CMU on May 1 and officially communicated to parliament on June 5 only. During this long five-week period, attempts by KSUs to question ceilings are likely to take place. Even if ceilings are made public on May 1, some attempts at obtaining higher ceilings may take place until the Budget Declaration is tabled in Parliament. Depending on actual experience in the coming years, there could be some substantiation for a later finalization of ceilings, closer to the May 15 deadline for submitting the draft Budget Declaration to the CMU.

22. Shifting the timeframe for finalization of the ceilings to a later date may also become necessary in time, as more onus is placed on KSUs. While this time limit may prove manageable for the time being, as KSUs still have limited capacity to get fully involved in the details of a budget discussion that also does not yet incorporate all the complexities of baseline analysis and program budgeting. Nonetheless, as the budget process gradually embeds these items and gets more elaborate, the May 1 deadline may prove difficult to comply with, which would reinforce the case for a finalization of ceilings closer to the May 15 deadline.

23. The early February 15 time limit for submission of KSU budget requests may prove challenging. The deadline set for the submission by the KSUs of full budget is set very early in the fiscal year. In the transition, this allows little time for KSUs to prepare their budget bids. This may not be too problematic, given that there is still a heavy onus on the top-down procedure. Nevertheless, the MoF will need to ensure that it informs KSUs of requirements early and provide active support to them in preparation of their budget proposals. In particular, the MoF should in the first year provide strong support to KSUs on the establishment of the baseline. Over time, the timetable may also entrench some disadvantages:

- Over the medium term it does not allow for KSUs to take into account the latest macroeconomic assumptions, leaving it to the MoF to centrally adjust requests.
- As capacity improves, the timeline could become incompatible with KSUs preparing robust forward baseline estimates and consistent strategic proposals for new policies. While this should not be a cause for serious concern in the short run, it may require within a few years a shift in the budget request submission deadline, by two to three weeks with consequent impacts to other deadlines.

24. The absence of an obligation to update the macroeconomic projections during the summer is likely to create risks during the parliamentary procedure. The new budget calendar expects the last macroeconomic update to have taken place before May 15, i.e., four

months before the Budget is tabled in Parliament on September 15. This long lapse of time puts the Government at risk of presenting to Parliament obsolete economic assumptions and therefore revenue estimates either too high or too low, with consequences on parliamentary debates: there would be a risk either of recycling additional revenues into new expenditure or of criticism on the sincerity of the MTBF and the Budget. It would, therefore, be advisable to consider the future establishment of an additional macroeconomic update that would be delivered around end August for incorporation in the budget prior to the Parliamentary debate.

C. Content of Budget Submissions

25. Existing rules for preparation of budget submissions do not allow requirements of the MTBF to be fully met. The rules governing the presentation of budget requests by KSUs and the corresponding templates have been defined by instruction No. 687 of 2012 and annual letters from the MoF to KSUs. However, these have a number of shortfalls in terms of effective implementation of the MTBF.

- As a hangover from the former budget process, existing rules require: (i) the presentation of appropriations within ceilings unilaterally and previously notified by the MoF; and (ii) additional requests made by KSUs above the notified ceilings. This approach is not consistent with a top-down – bottom-up reconciliation process.
- Current tables do not allow for separate requests for the baseline forward estimates and for new policies (including savings), whereas this constitutes a fundamental distinction for efficiently managing a fully effective MTBF framework.
- Current tables do not allow for a comparison between the three-year budget requests and the former MTBF, where any deviation should be highlighted and technically justified.
- Requests up to now provide information for three years (Budget year plus two), but with one table for the budget year and another for years two and three. Though this is a purely formal issue, this format is not in the spirit of an MTBF, which calls substantially for the same degree of budgeting requirement over the whole period. A single three-year table may therefore be preferable.
- Current tables require information on the execution of the previous year as well as on the budget of the current year, which should be maintained in the future. Nonetheless, the main issue here is to make sure these data on previous years are effectively used for the calculation of the baseline, i.e. that a real logical link exists between years in the request.

26. The MoF intends to prepare new instructions and tables to reflect the shift to full multi-year budgeting as well as separate baseline and new policies requests. It will be necessary to disseminate initial instructions for the 2019 year quickly, but these can be complemented or revised for the 2020 year. Templates should allow for: (i) the presentation, within one table, of the three-year budget request as well as of the execution of the past year and the budget of the current year; (ii) the highlighting of any deviation from the current MTBF;

and (iii) the distinction of requests (a) for the baseline and forward estimates; and (b) for new policies (including savings). Moreover, instructions should:

- set the degree of detail for the submission of requests, at a program level or at a more disaggregate level (especially in the case of large and complex programs);
- require detailed justification for any deviation from the current MTBF;
- require a strong financial linking between years, including with the current and past years, and the calculations that explain it, as an MTBF is not the stacking of annual budgets but a single multi-year budgeting process;
- separate baseline requests from new policies requests, making sure no implicit new policy gets conveyed through baseline adjustments.

27. The development of the baseline methodology is necessary and its full devolution to KSU level may need to be gradual. There is currently no generally accepted consistently applied methodology for baseline and forward baseline estimates. The concepts are not used in the current budget process, although the early notification of ceilings by the MoF, combined with requests by KSUs for new policies above these ceilings, may be considered as a very rough approach to it.⁶ The development of the use of baseline and forward baseline estimates is a key part of an effective MTBF, but its relative complexity may mean that some time will be needed before line ministries master it. In the first year of the reform, the baseline calculation could be made by the MoF, informed by information provided by KSUs. From the second year of the reform (2020), most KSUs should, with proper training, be able to increasingly participate in the preparation of their own baseline and forward baseline estimates. Annex II elaborates on the techniques of baseline and forward estimates.

D. Considerations for Roll-Out to Local Governments

28. The roll out of medium-term budgeting reforms to local government from the 2020 Budget is ambitious, particularly in the context of ongoing local government reform. The recently revised BCU requires all local budgets to be prepared on a medium-term basis and incorporate the submission of new local financial plans. This change affects thousands of oblast,

⁶ It may be tempting to consider the initial ceilings notified by the MoF in the current process comprise a *de facto* baseline estimate, and any separate request (presented in Form 3), a *de facto* new policy request. However, this is not technically correct. If the initially notified ceiling is above a true baseline, it would unintentionally provide space to finance new policies without discussion. On the other hand, if the initially notified ceiling is below the true baseline, additional funding will be necessary merely to continue delivering the same level of service as the previous year, or potentially undiscussed cuts in service delivery would be needed.

city and hromada governments, and is complicated by the ongoing local government reform process under which local communities may voluntarily amalgamate.⁷

29. Significant attention should be given to training and support for local government MTBF implementation. The task to support implementation is large given the number of entities involved in the reform. Adequate resources are needed to prepare detailed guidance and provide training. This should be done as early as possible so that local entities will be able to develop local medium terms budgets for the 2020 Budget, and local financial plans from the 2021 Budget as required by the BCU. It is likely to take some time before many local organizations will be able to participate fully in medium-term budget planning and flexibility in implementation may be required.

30. MTBF implementation will ultimately benefit local government planning through greater certainty about future receipts from the State budget. Improved predictability of receipts from the State budget will allow for better planning by local governments.⁸ In particular, the MTBF will provide a stronger basis for local governments to better plan their development budgets, which under the current framework is hindered by lapsing capital subventions and lack of a multi-year commitment framework (see Section II). Furthermore, providing earlier notice of final budget subventions, as is intended by the recent updates to the budget calendar, will also facilitate better planning and help avoid situations that require significant readjustment in local budgets with limited notice.

E. Budget Declaration

31. The 2018–20 Budget Declaration, submitted to the CMU under the pilot MTBF, contained several sound elements. The declaration included some core elements of a medium-term strategy document, including: medium-term macroeconomic projections; a statement of fiscal objectives, including deficit, debt and guarantee limits; description of new policies and strategic goals; presentation of medium-term projections, for revenues, expenditures, financing and deficit of the General Fund; expenditure ceilings for KSUs; and discussion of fiscal risks.

32. Further enhancements to the Budget Declaration will help to better explain the basis of fiscal plans, inform annual budget preparation, and improve transparency. Article 33 of the revised BCU defines the minimum content of the Budget Declaration. Within those parameters, the following improvements could be considered for the Budget Declaration to be prepared in 2019:

⁷ Ukraine was estimated to have a total of 9,300 subnational units of organization at December 2017 across four levels. The Department of Local Budgets within the MoF deals with larger subnational units directly and expects to have a direct relationship with around 2,000 units when local government reform is completed in 2020.

⁸ See *Ukraine: Fiscal Decentralization and Legal Framework for Fiscal Risk Management and Medium-term Budgeting*, IMF Fiscal Affairs Division, December 2017 for information on challenges facing local governments.

- **Describing the macroeconomic context.** The macroeconomic projections form the basis for medium-term fiscal forecasts. A chapter on the macroeconomic outlook, could include a discussion of the global and domestic context in which the budget is framed, disclose underlying assumptions, and include a detailed discussion on the GDP, unemployment, and price and income projections, and the main factors driving the future trajectories projected by the government. This not only helps explain the fiscal projections but can also be important in justifying the current and medium-term stance of fiscal policy and the source of budget volatility.
- **Explaining the medium-term fiscal projections.** In 2017, very little information was presented, other than in tables, on the fiscal projections. Understanding of these would be greatly enhanced by discussing for each revenue category, the forecast for the budget year and future trends with regard to their underlying economic drivers (e.g., demand, profitability, wages, excise taxes) as well as announced changes in policy. Similarly, expenditure forecasts should be broken down further, by economic and functional classifications, with explanation of new policies and underlying cost drivers.
- **Providing justification of the expenditure ceilings.** The Budget Declaration should explain expenditure ceiling allocations, including their linkages to the government's strategic objectives and new policy measures, so that the legislature and public can understand how these have been formulated and link with government policies.
- **Including information on objectives, performance, and programs for KSUs.** Including in the Budget Declaration a chapter on the major objectives and programs under KSUs, their medium-term allocations, and discussion of past performance with reference to key performance targets, would be beneficial. However, its development should be aligned with plans to better strengthen KSU strategic objectives and performance targets.

33. The MoF is currently studying best international experience regarding the content and format of budget documents prepared in other countries to enhance future budget declarations. To support these efforts, Annex III provides guidance on the possible structure for future Budget Declarations, drawing on good practice.

34. To underpin credibility of the MTBF future budget declarations should also explain how the macroeconomic and fiscal projections have deviated from the previous vintage. Indeed, this is now required by the BCU (Art. 33.8). At a minimum, a comparison of aggregate revenue, expenditure, and deficit projections to their previous projections should be presented along with an explanation of the main reasons for deviations from the previous year, including by differentiating between those driven by policy decisions, and those arising from macroeconomic and other adjustments. Good international practice would elaborate on this by including reconciliation tables that disaggregate the differences between the current MTBF and the one presented in the previous year into different components (Box 1.2).

Box 1.2. Reconciling Between Different MTBF Vintages

Reconciliation tables explain differences between different vintages of an MTBF. At the initial stages disclosing the change in revenues and expenditure plans that are due to policy decisions from other factors would be sufficient. More elaborate systems, also disaggregate changes in non-policy drivers into their different components. These can include adjustments due to revisions in macroeconomic parameters (e.g., GDP, exchange rates), adjustments due to volume changes, such as those arising from changes in the number of beneficiaries for programs (e.g., number of school children, doctor visits) or changes in prices for certain goods (e.g., for pharmaceuticals). An illustrative reconciliation table is show below.

	2019	2020	2021	2022	2023
	Current Year	Budget Year	BY+1	BY+2	
Expenditure (2020-22 Budget Declaration)	90	100	110	120	
Adjustment for policy decisions	0	0	2	3	
Adjustment for parameter changes	0	2	2	3	
Price variation	-1	-2	-3	-4	
Volume variation	0	3	4	6	
Technical Adjustment	1	1	1	1	
Total variation	0	2	4	6	
	Outcome	Current Year	Budget Year	BY+1	BY+2
Expenditure (2021-23 Budget Declaration)	90	102	114	126	145

F. Recommendations

Recommendation 1.1. Consider minor enhancements to the proposed budget calendar for 2019 and review its appropriateness after the first year of MTBF.

- For 2019, replace the communication of ceilings on April 5 by an assessment of agreements and disagreements between the MoF and KSUs for the purpose of finalizing the budget process;
- Assess the scope to shift finalization of expenditure ceilings to a later date, while still meeting the requirements of the BCU, and allowing for later submission of budget proposals by KSUs;
- Assess the appropriateness to establish a macroeconomic update around the end of August to ensure the draft budget is based on up-to-date economic data.

Recommendation 1.2: Finalize and issue new instructions and templates for preparation of KSU budget requests. The new instructions and templates should allow for: an overview of the three-year requests, the assessment of their link with previous years, the highlighting of deviations from the current MTBF and separation of requests for baseline and new policies estimates. (December 2018)

Recommendation 1.3 Develop a forward baseline estimates methodology.

- Define a standard approach for KSUs to produce robust forward estimates of spending under current policies and cater for training requirements in forward estimates modeling (December 2018)

- Maintain central updates of KSU baseline estimates in 2019, but progressively increase responsibility for this task as KSU capability increases, with the MoF maintaining a key role in reviewing and scrutinizing these estimates.

Recommendation 1.4: Develop and distribute guidance, templates and tools on medium term budget requirements for local governments (March 2019).

Recommendation 1.5: Further enhance the content of the Budget Declaration. Elaborate on the pilot MTBF Budget Declaration by including in the 2020–22 Budget Declaration:

- More detailed explanation of the main drivers of the medium-term macroeconomic and fiscal projections; medium-term expenditure by economic and functional classification;
- Explanation of the expenditure ceiling allocations as well as information on KSU objectives and performance; and
- In subsequent years, include a reconciliation of the fiscal forecasts and medium-term expenditure ceilings from those published in the previous year, distinguishing between those caused by policy decisions and those driven by economic and other parameter adjustments.

II. SUPPORTING AN EFFECTIVE MTBF

A. Design of the MTBF

Expenditure Limits and Technical Adjustments

35. The recent BCU amendments establish the framework for expenditure limits, but further design choices are needed. The BCU effectively establishes the limits linked to areas of spending, and with amounts attributable to the General and Special Fund separately identified. However, elements to do with technical adjustments and margins are yet to be developed. Some relevant considerations and trade-offs in designing expenditure limits are outlined in Box 2.1.

36. It will be important that the circumstances in which expenditure limits can be adjusted, are limited, and defined ex ante. At a minimum, these should be clearly set out in the Budget Declaration, and ideally, they would be reflected in the BCU. The MTBF would be enhanced by:

- Clearly defining the technical adjustments that flow through to changes in expenditure limits. The BCU is unclear on whether changes in macroeconomic and other parameters (e.g., exchange rate, inflation, interest rates on debt) flow through automatically to the updated calculation of expenditure limits, or other factors may be taken into account;
- Accommodating policy changes within existing expenditure limits wherever possible or limiting consideration of them to the strategic budget phase. If the passage of new laws generate an automatic increase in expenditure limits, this would undermine the discipline of the budget process and may reduce scrutiny of the affordability of policy changes;

- Clarifying the arrangements for special fund expenditure limits. Article 32 of the BCU provides for additional special fund revenues to be spent on defined categories of expenditure and flow directly through to increase in expenditure limits. It will also be necessary to ensure that expenditure ceilings are reduced if special fund revenues are less than expected. More generally, limiting earmarked revenue assists in strengthening budget management.

Box 2.1. Considerations in Designing Medium-term Expenditure Limits

Fixed or indicative expenditure limits. Jurisdictions may apply binding ceilings in the budget and forward years, or the framework may allow limits to be updated in clearly defined ways.

Future years' expenditure limits can be fixed in nominal or real terms. Generally, nominal spending limits are adequate for the purposes of the budget year. However, in high and volatile inflation environments, specifying that the limits will be calculated in real terms, with changes implemented as a technical adjustment, helps ensure that ceilings remain appropriate and provide a workable anchor. Consideration should also be given to the relative linkage between inflation, expenditure and revenues. For example, setting expenditure limits in real terms will put pressure on the budget deficit if revenues do not also increase in line with inflation.

Allowing technical adjustments for other macroeconomic parameters. Future years can be adjusted for other macro-economic parameters, including exchange rates, (which are a key source of budget volatility in Ukraine). Such technical adjustments should be made in both directions – that is to increase and decrease limits in line with movements in the underlying parameter.

Volatile areas of spending (e.g. debt interest) can be excluded from expenditure limits. Excluding volatile areas of spending that cannot be controlled by government and where compensatory changes in other policy settings would not be expected from ministries, helps boost accountability by applying limits only to areas of spending that can be controlled. However, it does not limit overall budget volatility.

The organizational level at which limits are applied. Ukraine has applied limits at the KSU level while piloting the MTBF. Applying limits at a higher level (e.g. ministry level) would allow for greater reprioritization and absorption of pressures within ministries but would weaken central control of where expenditure is directed.

While practices differ across countries, in general the higher the organizational level at which limits are applied, the broader the coverage of the expenditure limits. Conversely, the more detailed the level of the commitment—e.g., KSU-level or program level ceilings—requires lower coverage, as spending areas that are out of a ministry's direct control, such as debt interest, should be excluded from the ceilings.

37. Ultimately, the credibility of an MTBF depends on the government's ability to demonstrate that it is delivering on what it committed to previously. While changes to limits are at times unavoidable, reflecting exogenous changes in economic and external conditions, frequent and discretionary changes can undermine the credibility of the MTBF. The frequency of amendments to budget year limits should ideally be reduced from the recent practice. Further, changes should not be permitted to the current year budget, after the next year's budget has been approved by the VR (other than in exceptional circumstances). For example, further spending in 2019 should not be approved after the approval of the 2020-2023 budget in late 2019.

38. Adjustments in expenditure limits for budget year+1 and budget year+2 should be undertaken in the annual budget declaration. The budget process is the place to determine and apply the necessary technical and other adjustments to expenditure limits. For example, the expenditure limits for 2020 should take the limits approved in the 2019 budget as a base, adjust for execution of the 2019 year and updated macroeconomic parameters, and present the updated estimates for approval in the 2020 Budget Law (along with similarly updated estimates for 2021 and the creation of a new budget year, 2022).

39. To underpin accountability, the budget documentation should clearly explain deviations in multi-year budget plans. This requires reconciliation between vintages of MTBFs to explain changes in expenditure allocations in each update. The reconciliation should differentiate between changes resulting from policy decisions and those resulting from technical or other adjustments, and present successive vintages of budget allocations side by side to help build credibility (see Chapter I, sub-section E).

40. Ceilings are currently established for some 90 different KSUs, which creates a logistical challenge for the MoF in preparing for and undertaking negotiations. Importantly, it also means that generally ministries do not participate in strategic resource allocation decisions across their portfolio of KSUs. Whilst the absence of institutional arrangements for consolidation of the negotiation process would make it difficult to achieve over the short to medium term, establishing such an arrangement should be a consideration for the future.

Medium-term Commitments and Carryovers

41. The inability to secure funding for multi-year commitments can undermine expenditure quality. Current budget rules do not allow for multi-annual commitments, with funding lapsing at the end of the year. This demands rapid scoping, tendering and execution of such projects in discrete time-limited components. This problem particularly affects capital projects delivered by the State budget and those delivered through annual subventions to local governments. Creating a process for approval of multi-year commitments could facilitate improved planning and execution of multi-year projects.

42. While the MTBF opens the way for multi-year commitments to be made, robust commitment controls should be in place before widespread use is permitted. Allowing multi-year commitments requires an expansion to current commitment tracking procedures that are limited to the budget year. Tracking and monitoring such commitments on a multi-year basis is needed to ensure that future expenditure limits are not breached, and sufficient flexibility is retained. Were multi-year commitments to be introduced, these could be limited to specific commitments, such as only for approved multi-annual investment projects, and be subject to agreement with the MoF.

43. Allowing limited carryovers of unspent expenditure involves tradeoffs. Allowing the carryover of unspent funds into the following year would boost expenditure efficiency and

reduce the incentive for inefficient end-year spending. But, allowing carryovers can also lead to slower budget execution, increased budget volatility and greater difficulty in achieving fiscal targets. To minimize risks, a thorough evaluation of requirements needed to support an effective multi-year commitment system in Ukraine should be conducted prior to implementing a multi-year commitment scheme. To help manage the trade-offs, most mature MTBFs that permit carryovers, limit their amounts (Annex IV). The case for allowing carryovers is strongest for multi-year capital commitments where carryovers can assist implementation of multi-year investment projects. The first step in any reform should be establishing procedures for multi-year commitments, which can be implemented regardless of whether carryovers are permitted.

Reserves, margins and managing budget volatility

44. The methods to be implemented to reduce budget volatility under the MTBF are yet to be determined. A range of different approaches are used in jurisdictions that could guide the approach to be adopted by the MoF. Various approaches include: adopting conservative projections; provisioning for uncertainty through centrally managed contingency reserves; or, including a margin in aggregate or individual KSU expenditure ceilings. The MoF has undertaken an initial review of international experience in applying budget margins, although is yet to take a decision on the best approach for Ukraine. Table 2.1 sets out the advantages and disadvantage of different approaches and Annex V provides examples in select countries.

Table 2.1. Ukraine: Different Approaches to Managing Uncertainty

MECHANISM	ADVANTAGES	DISADVANTAGES
Conservative Forecasts: Forecasts for key parameters are set conservatively so it is likely actual performance is better than budgeted.	Provides a fiscal buffer and flexibility in the event expenditures increase.	Over time, it can undermine credibility in medium-term fiscal projections, particularly if assumptions are not transparent. It can also be hard to know how conservative the budget is in aggregate, given interactions.
Central margin or contingency Reserves: A provision is made in the budget for urgent and unforeseen expenditure pressures, and is centrally managed by the MoF.	Provides a transparent mechanism for reducing overall budget volatility, and in the event the reserve is not needed, it is not spent.	Can reduce incentive for KSUs to properly plan, is open to misuse in absence of tight criteria for access, and can make it harder to resist new spending pressures.
Margins in KSU expenditure ceilings: Margins are included in each KSUs ceiling, for expenditure pressures that could arise.	Allows for some flexibility for KSUs to meet urgent and unforeseen expenditure and is transparent if disclosed in ministerial allocations and execution reports.	Reduces incentive for KSUs to prepare accurate budgets and is likely to be fully spent even in circumstances where pressures are not urgent. Cannot be withheld if fiscal situation deteriorates.
Exclusion of certain spending from ceilings: Volatile or cyclical spending is excluded from expenditure ceilings for example, interest on State debt.	Provides flexibility by ensuring expenditure ceilings cover only spending that can be controlled.	Increases budget volatility and can undermine the government's ability to meet its fiscal objectives.

45. A central contingency margin for expenditure, that is centrally managed by the MoF, could be a useful first step in managing budget volatility. Any margin should be tightly controlled, and the purposes for which it can be drawn clearly defined. Its size can be informed by past budget volatility. In other countries, the size of unallocated expenditure reserves tends to vary between 1 to 3 percent of budgeted expenditure in years 2 and 3.

46. MTBF implementation provides an opportunity to improve the efficiency of capital expenditure. The IMF's June 2016 Public Investment Management Assessment (PIMA) identified the lack of a multi-year budget as a significant constraint on effective capital expenditure. The introduction of the MTBF will assist with the execution of the medium-term investment pipeline that has been developed by the Strategic Investment Committee. To better support capital expenditure execution, the PIMA also recommended introducing carryovers for capital spending up to a fixed level with MoF approval, while prohibiting reallocation from capital to other expenditure.

47. Stronger prioritization and integration of capital decision making in the budget process would improve the quality of infrastructure investment. Notwithstanding improvements since the 2016 PIMA there remains considerable room for strengthening infrastructure governance and improving the efficiency capital spending and may warrant future IMF follow-up assistance.

B. Linking Planning, Performance Evaluation, and the MTBF

48. Draft legislation to create a strategic planning system should provide a stronger basis for integrated policy-making, strategizing, planning and budgeting. Embedding clear processes through the promulgation of an updated strategic planning law is particularly important in light of the decision to roll out a MTBF across government from 2019 onwards. It should help Ukraine transition from the current state of annual budgeting based on weak or non-existent strategic plans, to medium-term budgeting underpinned by a well-established process for program budgets and performance management that are guided by an integrated system of strategic planning. Ultimately there should be a clear hierarchy of planning documents from national strategy to sector strategies and budgets.

49. This is important because effective policies depend on strong links with the budget that are steered by a clear national and sector strategic outlook. National and sector strategies provide organizing frameworks within which a strategic view of policy implementation can be set out, plans developed, and resource requirements identified. Along with expenditure reviews, they play an important role in testing the technical and financial feasibility of delivering on policy commitments and in determining the time frame within which achievements can be made in practice. This strategic overview is required to steer medium-term and annual budget decisions. Without it, KSUs compete to secure funding for all program priorities, irrespective of funding constraints.

50. The starting point for successful policy implementation is to ensure overall affordability. This means establishing a fiscal anchor (e.g., debt to GDP ratio) and associated operational rules at the outset to ensure consistency of strategies and budgets with sustainable public finances. Strategies require reliable information on likely resource availability for strategic goals and objectives to be feasible. Aggregate expenditure ceilings derived from sustainable deficit plans and revenue forecasts provide the first stage of a 'top-down' MTBF process.¹⁰

51. Once up and running, the new law should strengthen the basis upon which strategic decisions for KSU ceilings are made. A good strategy process underpins effective decisions on strategic resource allocation. Annex VI presents key components of good practice in strategy content. When decisions over the use of the available fiscal envelope for KSU ceilings are being taken during MTBF preparation, a strategic view of options is essential to inform consideration of policy choices and trade-offs. Further, where an important strategic goal relies on parallel funding of more than one program, for example, isolated decisions on use of the fiscal envelope for individual programs will begin to de-link strategic resource allocations from priority policies. Ensuring that KSU ceilings respect the aggregate expenditure envelope and reflect well-informed strategic allocation decisions would provide the second stage of a 'top-down' MTBF process.

52. In a well-functioning process, decisions on use of available fiscal resources and, by extension, the setting of KSU ceilings, will be informed by the content of sector strategies. In practical terms this means KSUs and the MoF should be considering the following when preparing and assessing budget proposals:

- Whether a proposed new spending initiative is consistent with strategic plans, and if not, what the justification would be to include it in the current budget process;
- To what degree is the proposal a priority, according to those plans; and
- Is the level of resources proposed commensurate with the policy's priority ranking.

53. The envisaged framework for strategic planning should sharpen prioritization by guiding the scope and scheduling of strategic objectives for programs. Once strategic plans are up and running, guidance for program managers can be improved by specifying strategic objectives in relation to goals set out in the respective strategy. Ensuring a strong link between strategic goals (strategy) and strategic objectives (programs) will become a vital part of the whole system, without which the link between budgets and policies will be weak. Preparing detailed budget submissions within the constraints of program ceilings that have been set by

¹⁰ Currently, the 2019 Budget Declaration caps the state budget deficit at 2.2 percent of GDP and government debt at 56 percent of GDP. It also limits guarantees approved over the budget period to an amount equivalent to 3 percent of revenue. Going forward Ukraine could look to use the MTBF to inform the development of medium-term fiscal anchors.

main budget managers within their KSU ceilings, including proposed performance information, provides the bottom-up component of a MTBF process.¹¹

54. The strategy process is being developed in conjunction with MTBF roll-out and an emerging practice of expenditure review. All three are new components of a system that will be based on performance planning, performance measurement and performance evaluation. KSU ceilings would ideally represent strategic resource allocation influenced by strategies, and compiled on the basis of the following:

- The baseline component represents costs of current service delivery. It is derived from recent spending after adding/removing one-off expenditure (e.g. cost of holding elections)
- Forward estimates = baseline adjusted by cost drivers (e.g. demographics, inflation, exchange rate), representing the future cost of current services for each MTBF year
- 'Fiscal envelope' = aggregate ceiling minus KSU forward estimates (amount available for new policies and investments in each MTBF year)
- Each KSU ceiling = KSU baseline + KSU share of the available fiscal envelope.
- Allocating the available fiscal envelope determines which KSUs can implement new policies and investments (a strategic center of government choice influenced by strategy).

55. Spending reviews, informed by performance evaluation, provide a stock check of the baseline and a reality check on policy. The regular business of government is slow to change. Once a baseline has been established, it does not require major revision from one budget to another. Periodic review of baselines is important, however, to audit performance and to assess if a restructuring is required. It ensures that baselines remain consistent with current government priorities and can point towards areas where services may need to be scaled back to release resources to higher priorities. Periodic expenditure reviews are important also as part of the policy design and review process. Once capability for undertaking expenditure reviews is established, they will become an important tool to instill confidence in baselines and to strengthen the content of strategic plans (discussed further below).

56. The law should enable sector wide discussions. Sector-wide approaches to determining budgets is important in areas such as health and education, where a joined-up approach is important for understanding major trade-offs (e.g. between public health and hospital services) and delivering balanced, coordinated and prioritized development.

57. Existing guidelines will need to be overhauled once the new strategic planning legislation comes into force. The current focus of guidelines is largely on developing program

¹¹ Program and performance budgeting has been in operation since 2002. Program planning is guided by strategic objectives, though set without the benefit of a strategic framework. Performance information includes plans for delivery of outputs and associated measures of efficiency, quality and unit cost. A monitoring framework demonstrates whether plans remain on course.

performance indicators for existing strategic objectives (program) to be met, without reference to technical feasibility or cost or, of course, links to strategic goals (strategy). They also overlook the implications of inter-linkages between programs and non-government actors in the planned achievement of strategic goals (strategy) (and inter-linkages beyond the immediate KSU) and the time frame is restricted to just three years. As a result, they currently correspond more to development of non-financial performance information for programs than the establishment of good practice in sector strategy formulation.

58. Institutional arrangements for managing and coordinating the components of the newly emerging system should not be overlooked. This will rely in part on creation of positions of sufficient seniority (Strategic Planning Directors and Performance Monitoring Directors). The links can be properly institutionalized through creation of a senior strategy, budgeting and performance team in each KSU, with participation from senior managers of each area (including program managers). An arrangement of this nature will be required if KSUs are to assume full responsibility for ensuring consistency of their budget plans and performance requirements with their strategies.

Spending Reviews

59. A pilot spending review took place on a small scale in 2018 but did not yield substantive results. A spending review was launched by the CMU in February 2018. It was deliberately limited to five Line Ministries (LMs), each choosing, in consultation with sectoral units in the MoF, specific areas within their portfolios for review.¹² Time to complete the review was short, with final reports to be completed by June, extended from an original April deadline. The results were limited, with only one out of the five spending reviews submitting a final report. The limited timespan, absence of a clear methodological framework for conducting the reviews, relatively narrow focus within reviews, and capability constraints, in part explain this outcome.

60. Nonetheless, the exercise has laid a foundation, which can be built on, for future larger-scale reviews. The pilot spending review incorporated many good elements, consistent with previous FAD advice and good international practice.¹³ This included a strong involvement of LMs, the setting-up of dedicated working groups, co-chaired by the MoF and the LM, incorporation of independent experts, and political backing in the form of the CMU resolution. The MoF intends to commence larger-scale spending reviews in early 2019, with results to be considered for the 2021 Budget, a more appropriate time limit for spending reviews in development stages. The requirement for the regular conduct of spending reviews has also been

¹² Line ministry is used in this section to enable spending reviews to consider activities that run across individual KSUs within the line ministry.

¹³ See IMF Technical Assistance Reports: Olden, B. *et al*, "Expenditure Review and Rationalization," of September 2015 and Olden, B. *et al*, "Developing a Spending Review Process and Assessing SOE Reform Progress" of December 2015.

embedded in the BCU. In time, consideration should be given to conducting sectoral or horizontal spending reviews to allow for consideration of programs and prioritization across LMs.

61. To reap the full benefits of spending reviews, several enhancements may be required. Chief amongst these is achieving a consensus on the objectives and expected outcomes of the spending reviews and establishment of common methodological guidance on how to conduct them. While it will take time to build up capabilities and information to conduct a robust evaluation of the effectiveness and efficiency of spending, a well-defined framework for its conduct could help better guide the exercise. Consideration could also be given to supplementing the organizational arrangements, with a high-level ministerial steering committee, which could meet at three points during the process – at the start to set the direction, mid-way to assess progress, and towards the end to review proposals.

62. International experience in spending reviews shows success depends on strong leadership from the MoF. This includes: ensuring high-level representation in the working groups as was envisaged in the CMU resolution; active participation, at the technical level, in challenging LMs in the analysis and development of policy proposals; and, generally supporting chairs in coordinating the process. Indeed, some countries, such as the Netherlands, have found it beneficial to establish spending review teams or secretariats within the MoF, responsible for coordinating the overall process and supporting working groups. This also has the advantage of ensuring the MoF builds its capabilities over time, through repeat participation.

63. To ensure reviews yield tangible results, the CMU may need to provide guidance on the level of ambition. Some countries require that spending reviews identify a minimum level of spending that is assessed to be low priority, inefficient or ineffective, and could be re-oriented, or re-allocated to higher priority areas. This can be done through setting specific targets or defining a minimum number of options to be developed for consideration. The MoF considers that, in the early stages of establishing a culture of spending reviews, setting targets may be counterproductive. Still, providing some guidance on the level of ambition for the reviews (for example, indicating it should develop two to three options to improve spending efficiency and effectiveness within the Ministry) could help focus the review's efforts.

C. Recommendations

Recommendation 2.1: Clearly define in the Budget Declaration the circumstances under which ceilings can be amended. Limit these to a narrow set of technical adjustments (e.g., interest on floating rate public debt service obligations or the impact of exchange rate movements on obligations under foreign currency denominated contracts) (June 2019).

Recommendation 2.2: Develop frameworks for establishing a central budget margin and multi-year commitments.

- Include a small central contingency reserve in the budget, with tight controls and transparency mechanisms (June 2020).

- Assess the supporting requirements needed to establishment an effective multi-annual commitment system (December 2019) and establish the legal basis for commencing with multi-annual commitments for capital projects, up to a defined level and subject to agreement with the MoF (December 2020).

Recommendation 2.3: Strengthen strategic planning to provide a stronger basis for medium-term budget planning.

- Modify the draft law on strategic planning to accommodate sector strategies, covering the strategic planning requirements of more than one 'central executive authority' where their respective services are sufficiently related to one another (July 2019)
- Overhaul the existing strategic planning guidelines in line with the new draft law and with good practice in sector strategy formulation (December 2019).

Recommendation 2.4: Establish methodological guidelines for the conduct of spending reviews and launch the second round of reviews.

- Develop a spending review manual setting the framework and objectives of the spending reviews, clearly laying out the different phases of the review (data collection, analysis, and policy development), providing guidance on how to conduct analysis and develop proposals, and providing templates and instruction for final outputs (March 2019).
- Launch the second round of spending reviews in early 2019 for completion in early 2020, with proposals available for potential incorporation into the 2021 budget.

III. ENHANCING FISCAL RISK ANALYSIS AND DISCLOSURE

A. Progress to Date

64. The MoF's mandate to monitor and manage fiscal risks is now well established. The role of the Fiscal Risk Management Division (FRMD) is firmly established in the regulation of the MoF (CMU resolution No. 375, amended in 2018). Furthermore, the recent amendments to the BCU now empower the MoF to identify, evaluate and monitor fiscal risks as well as develop measures to mitigate them (Art 32.1). The BCU enables the organizational and methodological basis for fulfilling this requirement to be established by CMU resolution and empowers the MoF to collect the information necessary to execute its fiscal risk function. In addition, the BCU mandates the publication of a regular fiscal risk statement (FRS) on the website of the MoF after its submission with the draft state budget to the VR.

65. Good progress has also been made on improving fiscal risks analysis and disclosure. A detailed methodology for assessing state-owned enterprise (SOE) fiscal risks, developed in line with FAD advice and good international practice, was approved by the CMU (No. 7 of 2018) in

January and is being carried out in practice. In addition, a list of 25 SOEs has been identified for which in-depth analysis must be conducted. A summary FRS was submitted to the VR in 2017, which was largely qualitative in nature, and this has been expanded on in 2018 with more in-depth assessment of certain fiscal risks. Reflecting these actions, many of FAD's earlier recommendations to strengthen fiscal risk analysis and management have been fulfilled.¹⁴ To further enhance fiscal risk analysis and management, the FRMD has sought advice on its roles, structure, interaction with other stakeholders, and main products.

B. Enhancing Fiscal Risk Analysis and Management

66. As the capacity of the FRMD improves, it should expand its activities to include provision of advice on fiscal risk mitigation. Thus far, the FRMD has primarily focused on developing a framework for monitoring and assessing budgetary risks from SOEs. However, its function should also include specification of fiscal risk mitigation measures. This task should be performed in collaboration with the MEDT and shareholding ministries. Box 3.1 sets out what the stages of an integrated fiscal risk management framework for SOEs may entail.

Box 3.1 Developing Mitigating Measures for SOEs

An integrated fiscal risk management framework for SOEs entails several steps:

- Identification of problematic SOEs that present large fiscal risks either in the form of direct budget flows or contingent liabilities and distinguishing those that require deeper analysis. This stage is already undertaken by the FRMD.
- Preparation of detailed SOE analyses, including weaknesses in management and governance; problems with operations; drivers of poor performance; and, risks;
- Development of a remedial action plan, in conjunction with the entity responsible for overseeing the SOE and the SOE Supervisory Board (or management where one does not exist) for submission to CMU for approval;
- Regular reporting on progress against the action plan by the SOE and entity that oversees it.

Different forms of remedial actions that may be necessary to enhance performance could include:

- Subjecting high-risk SOEs to more intense monitoring, including a requirement to report more frequently on their performance;
- Tighter controls on SOE transactions, including those that would have a material impact on the SOEs balance sheet, including limiting new borrowing, the disposal of assets, etc.;
- Requiring SOEs to take remedial actions to improve financial performance (e.g., disposal of non-core assets, restructuring of operations, reducing non-core activities where identified; and
- In more extreme cases, considering the need to restructure the entity.

¹⁴ See IMF FAD Technical Assistance Reports: Alves, M., et al "Strengthening Public Financial Management," of May 2017; and Sayegh, A., et al "Sayegh, A. et al, "Medium-term Budget Framework and Fiscal Risk Statement" of July 2017.

67. Expanding fiscal risk analysis and monitoring will require increased coordination and cooperation between the FRMD and various departments within, and outside, the MoF. Currently, responsibilities for monitoring and managing these risks are allocated among multiple departments. While individual departments and LMs should be accountable for identifying, estimating, analyzing, and monitoring specific fiscal risks that fall within their functions, the FRMD has an important role to play bringing the various parts of the picture together. Table 3.1 provides an overview of the various entities engaged in fiscal risk analysis and possible tasks, some of which are already currently being performed.

68. The FRMD should act as the focal point to consolidate fiscal risk analysis, disclosure and management across government. Centralizing this function in the FRMD, ensures the government has an aggregate picture of its risk exposures and can identifying any systematic relationships and interactions between risks. In addition to its current responsibilities for assessing SOE-related risks (detailed in Table 3.1), it could undertake responsibility for:

- Ensuring that appropriate regulatory and institutional architecture is in place for monitoring, assessing and managing fiscal risks, and is operating effectively;
- Developing methodological guidance for assessing specific fiscal risks and ensuring consistency in approaches, where appropriate;
- Assessing whether risk mitigation practices are adequate and recommending actions to strengthen them, where required;
- Coordinating and preparing the annual FRS and quarterly internal fiscal risk monitoring reports, which provide an update on major developments with potential to impact public finances, and monitor status of measures to mitigate risks.

69. It will be important that roles and responsibilities of the various entities engaged in fiscal risk assessment are clearly defined. The draft CMU resolution under development could be expanded to define specific roles and responsibilities for each government department or agency, including the risks they are accountable for monitoring, the analysis to be performed, and the information they will provide to the FRMD. As an example, currently the MEDT is assigned responsibility for macroeconomic risk analysis in the draft CMU. But, to appropriately assess the impact on the budget, the revenue forecasting department, budget department, and the macroeconomic analysis division (in the strategic planning directorate) of the MoF will need to be involved, with the FRMD coordinating and pulling outputs together.

Table 3.1. Ukraine: Fiscal Risks - Key Roles and Responsibilities

Fiscal Risk	Responsibility	Possible Tasks
SOEs	FRMD (primary); MEDT Shareholding Ministries, SOEs (where applicable)	<ul style="list-style-type: none"> • Maintain current database on SOE financial indicators • Conduct regular assessment of SOE related fiscal risks, in accordance CMU No. 7 • Conduct regular stress-testing on macro-significant SOEs to assess impact of shocks on direct budget flows and likelihood of other risks materializing (e.g. guarantees triggered, need for capital injection) • In collaboration with MEDT and shareholding ministries, develop remedial action plans for problematic SOEs for CMU approval • Report on progress in implementing action plans to CMU • Advise on risks of privatization receipt shortfalls (MEDT) • Provide input into quarterly fiscal risk monitoring reports and annual FRS (FRMD)
Macro-economic risks	MoED, MoF Strategic Planning Directorate (SPD), MoF Revenue Forecasting Dept. (RFD), FRMD (lead)	<ul style="list-style-type: none"> • Monitor macroeconomic conditions and risks • Prepare analysis of alternative macroeconomic scenarios and budget impacts for inclusion in FRS (MoED, RFD and SPD) • FRMD in collaboration with RFD and Budget Department consolidate the impact of alternative macro-fiscal scenarios on the budget for inclusion in FRMD • Provide input into quarterly fiscal risk monitoring reports and annual FRS (SPD and FRMD)
Financial Sector	NBU, MOF Financial Policy Department	<ul style="list-style-type: none"> • Monitor financial system stability and state-owned banks • Supervise compliance with financial regulatory framework (NBU) • Conduct regular stress tests and publish regular financial stability reports (NBU) • Provide input to annual FRS
Debt portfolio	Debt Policy Dept.,	<ul style="list-style-type: none"> • Assess and disclose the main debt portfolio risks • Develop framework for managing risks within context of medium-term debt management strategy • Provide input to annual FRS
Guarantees	Debt Policy Dept. and FRMD	<ul style="list-style-type: none"> • Maintain registrar of guarantees • Provide credit risk assessment to support decisions on approval of guarantees to SOEs • Advise on appropriate risk-based guarantee fees
Public-private partnerships	MEDT, FRMD	<ul style="list-style-type: none"> • Maintain registry of PPP (MEDT) including information on direct and indirect government obligations • Assess risks of proposed PPPs prior to their approval by CMU • Provide input on PPP exposures for annual FRS
Local governments	Dept. of Local Budgets	<ul style="list-style-type: none"> • Monitor budget execution, borrowing, arrears guarantees and other contingent liabilities of local government's
Long-term fiscal pressures	Pension Fund, SPD, Ministry Social Policy and Ministry of Health	<ul style="list-style-type: none"> • Assess the sustainability and risks around long-term fiscal pressures stemming from pensions (e.g., unfunded pension liabilities); health care costs and other demographically sensitive expenditures
Environmental risks	State Emergency Service	<ul style="list-style-type: none"> • Risk management framework for managing man-made, environmental and natural disasters

C. Improving the Fiscal Risk Disclosure

70. The FRS submitted with the 2019 draft budget represents a significant advancement in fiscal risk disclosure. The FRS included a qualitative discussion of macroeconomic risks and the channels through which they may impact the budget, the maximum exposure associated with government guarantees, analysis and assessment of SOE-related fiscal risks, as well as a general discussion of risks of shortfalls in anticipated privatization proceeds and risks associated with the financial sector.

71. The disclosure of SOE related fiscal risks was particularly impressive for an inaugural FRS. The FRS summarizes the overall performance of 628 enterprises and also discusses individual performance of a number of major SOEs, though not in substantial detail. The FRS identifies 25 enterprises that bear the highest fiscal risks. These are defined as those that are heavily leveraged, have significant assets and/or liabilities in foreign currency, or have borrowing backed by state guarantees. These entities comprise around 90 percent of total assets of all SOEs assessed. For this group, the FRS discloses the outstanding stock of guarantees provided; their total liabilities in foreign currency; and taxes paid to the budget. It discusses factors that could cause fiscal risks to materialize, and mitigating measures in place.

72. The MoF should look to further build on the FRS for submission with the 2020 draft budget and in subsequent years. The IMF's Fiscal Transparency Code 2014 and Fiscal Transparency Handbook 2018 provides good guidance on fiscal risk disclosure practices. Further, guidance provided in previous FAD reports can be used as a basis to improve fiscal risk disclosure.¹⁵ Specifically, the MoF can further elaborate on the following:

- **Macroeconomic Risks.** Once capacity is developed for sensitivity and scenario analysis, expand the discussion of macroeconomic risks to illustrate potential impact on the main fiscal aggregates of changes in those macroeconomic parameters most relevant to public finances;
- **Public Debt.** Include discussion of the composition of the government's debt portfolio (share in foreign currency, floating rate debt, average maturity, and share of debt maturing in under one year) and as capacity is developed, include in the FRS sensitivity of the value of the stock of debt to changes in key risk variables such as the exchange rate and interest rates;
- **Financial sector.** Include discussion of the governments explicit contingent liabilities arising from its commitment to provide back-up funding to the Deposit Guarantee Fund, including total insurance deposits and assets of the Fund, and historical information on previous payments from the fund or recapitalizations to the banking sector. To elaborate on the existing discussion, information on financial soundness indicators of the banking sector could also be provided;

¹⁵ See Annex 4 in Sayegh, A. *et al* "Medium-term Budget Framework and Fiscal Risk Statement," July 2017 and Annex 2 in Avril, H., "Fiscal Risk Disclosure," February 2018 FAD technical assistance reports.

- **SOEs.** Elaborate on existing information, by also disclosing for the 628 entities (and especially for the 25 highest risk entities) information on their total liabilities, profitability, and risk ratios (such as for their leverage, solvency and liquidity), and all direct transactions with government (subsidies received in addition to dividends and taxes paid, and loan obligations). In addition, efforts should be made to provide for a detailed discussion of their quasi-fiscal activities; and
- **Other specific fiscal risks.** Include a brief section in the FRS on local governments, including a summary of their liabilities (borrowing and arrears) including as a share of own source revenues, and by major region or city utilizing information already monitored by the Department for Local Budgets. In addition, include a brief discussion of natural disaster exposures (their historical fiscal costs and management strategies), PPP related risks and risks surrounding fiscal costs of security related activities.

D. Recommendations

Recommendation 3.1: Establish clear responsibilities and procedures for fiscal risk analysis in a CMU resolution (June 2019)

- Expand the set of risks covered. by the CMU resolution to include debt portfolio risks.
- Define, in CMU resolution, clear functions and responsibilities of the various departments involved in assessing fiscal risks and an explicit coordination role for the FRMD;
- Review existing risk methodologies and assess the need to update these or establish new frameworks for fiscal risk assessment.

Recommendation 3.2: Improve the disclosure and analysis of macroeconomic and specific fiscal risks in the annual FRS. Build on the FRS submitted with the 2019 draft budget, by incorporating the elements outlined in sub-Section C. (September 2020, and September 2021)

Annex I. Revised Budget Calendar

Deadline	Objectives/Executing Body
February 15	<p>MoF receives proposals from KSU concerning:</p> <ul style="list-style-type: none"> - New policies (reforms) including calculation of the cost of each one, prioritization and potential sources of their funding (with consideration of funds savings and reallocation); - Changes in KSU's cost structure (years 1 and 2 specified and year 3 added); - projections of revenues of the special fund
March 1	<p>MoF receives from:</p> <p>NBU tentative information on the revenues</p> <p>MEDT tentative macro-projections</p> <p>Ministry of Social Policy preliminary social protection standards</p> <p>High Council of Justice proposals concerning financial support to the judicial system</p>
March 20	MoF informs the NSDC on the size of the expenditures for defence and security for each year of the mid-term period
March 25	<p>Minister of Finance presents to the Ministers main approaches to the budget indicators planning.</p> <p>Ministers discuss possible finalization of the KSU ceilings for the years 1 and 2 and allocations for the year 3 according to the priorities <u>within the aggregate ceiling</u></p>
April 5	MoF informs the KSU on the ceilings (excluding proposals of the NSDC)
April 10	MoF receives from the KSU information on their targets and expected results of activity
April 15	<p>MoF receives from:</p> <p>NBU finalized indicators of the revenues to be collected to the State Budget</p> <p>MEDT finalized macro-projections</p> <p>NSDC allocation of expenditures for defence and security among the KSU for each mid-term period year</p>
April 20	MoF submits to CMU information on the targets and expected results of activity for purposes of reconciliation with the priorities established by the respective strategic documents and programs as well as by the expenditure ceilings
April 21 – May 1	CMU conducts meetings for final harmonization of the budget indicators (budget potential) with the national strategic priorities (including finalization of the KSU ceilings)
May 15	<p>CMU receives from:</p> <ul style="list-style-type: none"> - MoF Draft Budget Declaration; - MEDT macro-projections
June 1	CMU approves the macro-projections and Draft Budget Declaration
June 5	CMU submits draft Budget Declaration to the Parliament
June 30	The Parliament makes its decision on the Budget Declaration

Source: Ministry of Finance

New deadline in the Budget Code

Deadline stipulated before amendments

Annex II. Guidelines for Preparing Forward and Baseline Estimates

Concept of Forward Estimates

1. A medium-term budget should be based on a well-defined, bottom-up expenditure forecast for each ministry on a no-policy change basis, commonly described as forward estimates or baseline projections. This should be the basis of the expenditure projections and budget bids prepared by ministries and should be the best estimate of the cost of continuing all existing policies at current levels of service delivery over the next three years.

2. The forward estimates inform the setting of ministerial expenditure allocations over the medium term. Rather than holding baseline spending allocations unchanged from the last year's budget, or incrementally adjusting these for inflation only, forward estimates account for any one-off factors that won't be continued into the future, as well as identifying spending dynamics outside of ministries' control, which if not recognized would make an unchanged allocation unrealistic. For instance, if there was a growing number of school-age children, maintaining the spending allocation of the Ministry of Education fixed (even in real terms) at the level of the last budget would ignore the growing spending pressure from more students in school, and entail a reduction in spending per student. Similarly, if the number of students was decreasing, such an allocation would result in greater spending per student, an unconscious spending increase that uses finite resources that might alternatively be better used in higher priority areas.

3. Spending allocations will not necessarily be set in line with the forward estimates – they are not an entitlement for future budgets, a point to be made clear to all KSUs. For instance, a forward estimate may indicate that there are sharply growing spending pressures in one area of the budget (for instance in the transport sector, due to sharply rising fuel prices). The government may well consider such an increase unacceptable and set the spending allocation below the forward estimate forecast, requiring the ministry to identify savings. But the use of forward estimates will define just how large a savings decision will be necessary to bring the spending into line with the spending allocation, rather than simply ignoring the pressure to the budget.

4. The benefits of forward estimates are threefold:

- They link annual budgets to medium-term fiscal forecasts, providing better informed and more accurate assessment of the overall fiscal envelope available for new spending or fiscal savings required in future years.
- They identify early on any spending pressures and dynamics, which strengthens the basis for making new policy, and informs on spending areas where policy changes may be necessary.

- They provide a starting point for next year’s budget, based upon agreed models and spending projections automatically adjusted for exogenous inputs like inflation, wages and exchange rates. This simplifies budget negotiations considerably, releasing staff previously involved in discussing the minutiae of KSU budgets to instead focus on developing new policy and evaluating the quality of existing policy.

5. The forward estimates process will take time to mature. Initially, the forward estimates can be thought of as rough forecasts. They will inevitably contain mistakes, gaps and inconsistencies. Only through ongoing reassessment, interaction with KSUs and continual improvements will the forward estimates become more precise. As a first step in the implementation of the MTBF, the MoF could prepare baseline forward estimates for three years ahead.

6. Preparing forward estimates will pose a challenge to the KSUs. The LM have limited experience in expenditure forecasting, and there are a range of conceptual, modelling and practical issues that will likely need to be addressed over the immediate period. These include:

- Providing budget teams with a basic methodology for preparing forward estimates, and defining the concept of no policy change;
- Specific technical issues that will arise in dealing with areas such as investments, the wage bill and transfers to other entities;
- Verification of this first round of estimates, as well as issues relating to improving and updating the estimates in future rounds; and
- Developing other supporting tools, such as new policy proposals and spending reviews to strengthen the medium-term budgeting process.

Basic Methodology for Preparing Forward Estimates

7. Producing expenditure forecasts or forward estimates at the disaggregated level involves several steps. These are focused on understanding the existing budget; understanding and applying the medium-term cost drivers; and aggregating the forward estimates and summarizing the overall sources of variations. Each of these steps need to be identified, analyzed and ideally have the methodology agreed between the MoF and the LM, as the forward estimates form the basis of future budget allocations.

Defining No-policy-change Estimates and a New Policy Approval Process

8. The preparation of a baseline expenditure estimate requires an explicit understanding of what constitutes existing policy. The “No Policy Change” baseline could be defined, for example, as: The level of spending that will continue to occur over the next three years in the absence of any new or amended laws, decisions by the CMU or approvals by the MoF. This definition would include all of the fixed spending within the budget plus semi-fixed spending such as the wage bill and any other contractual or policy commitments that currently

receive funding. Earmarked reserves for ongoing social benefit programs would also be included within the no-policy-change baseline. The remaining flexible spending would only be included within the baseline if explicit commitment to the spending has previously been made, in order to avoid overstating the fixity of future budget allocations.

9. There is no perfect definition of existing policy. While it is relatively clear where the majority of spending falls, there are always difficult and continuous border disputes, even in the most mature systems. These should be anticipated, particularly early on in the process when existing spending is being assessed from scratch, and a clear process for deciding where it falls should be put in place. This is usually kept within the civil service, and not elevated to the political level, as it is a technical decision. In order to smooth the process, all new policy decisions should be clear and explicit about what is and what is not ongoing spending. This should be defined within the budgeting instructions established by the MoF.

Investment Spending

10. Investment spending, especially infrastructure, carries a number of particular challenges that will need to be overcome while preparing forward estimates. These include the multi-annual nature of decisions, unspecified annual profiles and frequent re-profiling, changes in costs and delays in implementing. The challenges also include the question over what precisely constitutes the existing policy that should be included within the baseline. Capital expenditure estimates will also tend to trail off in the outer years, as existing projects are completed, leaving room for new projects to be identified and funded as new policy proposals. In addition to the capital cost of projects, associated operating and maintenance costs should be included within the relevant parts of the forward estimates. These should be identified at the point of capital project approval, and should be treated as existing policy for those that are already approved.

11. For the immediate process of developing forward estimates, investments can be split into two categories: major projects and minor projects/capital purchases.

- **For the major projects:** establish multi-annual profiles of the project expenditure and confirm the basis upon which the project has been approved. These can then be aggregated and included within the estimates as administered expenses.
- **For the minor projects/capital purchases:** as a rule of thumb, treat the current level of spending as the baseline, and hold this steady, either in nominal, real or share of KSU's expenditure, particularly where these minor investments are made up of durable good purchases (cars, ICT equipment etc.) that can be treated as departmental expenditure.

Wages and Salaries

12. The treatment of compensation of employees or civil servants can be a tricky issue in developing forward estimates. Wages make up a large share of expenditure, but their future

direction is not always certain, and in Ukraine are very often linked to policy decisions about the minimum subsistence level. Choosing to keep the nominal wage bill flat over the three-year period will usually lead to a systemic understatement of expenditure within the forward estimates (which then results in an overstatement of the available fiscal envelope/underestimate of the savings task). On the other hand, including information on future wage changes can also pre-determine policy decisions.

13. The method usually deployed to address this issue is a standard wage and employment growth index that is linked to the macro parameters. This is applied uniformly to all civil service employment expenditures and can take the form of an average of inflation and minimum/average wage growth. This is then treated as the baseline (though not an entitlement), with any deviation from that treated as a policy change.

Transfers to Other Public Entities

14. There are generally several different forms of transfers:

- **Formula driven transfers:** Some grants to local governments are formula driven, where specified formula-based transfers are in place, their projections can be directly related to the macroeconomic or demographic parameters, or revenue that defines them. In Ukraine these are in place for some education and health subventions, as well as equalizing grants.
- **Gap based transfers:** In some areas, particularly social security, the government is responsible for ensuring that sufficient funds are available for the entity to fund legislated payments. In this case, reliable forecasts of the entities' finances (revenues, expenditures and deficits plus use of reserves) are required over the forward estimate period.
- **Fixed transfers:** some transfers are for fixed amounts, and often provided for specific purposes to other entities. While the fixed nature makes them easy to forecast, there may be greater uncertainty here on whether they should be included as part of the no-policy-change baseline. Inevitably, these will need to be assessed on a case by case basis, informed by the nature of the payment and the basis on which the payments are made—for example, are they discretionary, or fixed by law, or some multi-year agreement between levels of government/agencies.

Costing of New Policy Proposals

15. The preparation of medium-term expenditure costing for all measures and policy proposals is a key element of MTBFs. They require analysis over the longer-term impacts of policies, and their use acts as a discipline for decision makers from agreeing to policies without acknowledging costs that may grow significantly over time, leading to unsustainable fiscal policies. They also demonstrate the impact of policy changes against the baseline expenditure projections, in order to meet the fiscal rules. Once all new policy proposals are aggregated, the MoF will be able to calculate the available fiscal envelope, which will serve as a guide to LM in prioritizing their spending requests.

16. Costing should be prepared for all new policy proposals. In addition to new policies, they should also be prepared for changes to existing policies; and alterations to eligibility criteria or assistance rates of existing transfer or social security programs.

17. Policy costing should provide financial costing of new policies over the three-year period as well as a range of other information. They should identify different components of expenditure (for example wages and salaries and capital expenditure) as well as revenue impacts (for instance due to tax expenditures or increased own revenues). If the cost of the policy is likely to be significantly different in the years beyond the medium-term, for instance if the measure is not likely to commence within the medium-term period, there should also be a statement about the financial impact of the measure over the longer term.

18. New policy proposals should carry additional information to the medium-term costing for the policy to be assessed. This information should include the objectives of the policy, addressing the problem it is being introduced to solve; the expected impact of the policy; distributional impacts on different groups/income levels; any necessary legal or institutional changes; and impacts on other layers of government. For investment projects, the result of cost benefit analyses should be provided.

19. The preparation of costing should be undertaken on a similar basis as the baseline expenditure forecasts. This serves to ensure consistency between costing, but also aids the inclusion of new measures into the baseline projection for the next forecasting round. In most cases, the methodology should be based on a basic price multiplied by quantity approach, with an allowance built in for both factors to vary over time according to well identified parameters. In cases where fixed cash costing is provided, it will still be necessary to ensure that the amount provided is sufficient for the designated purpose. Costing should consider behavioral impacts of the new costing—for instance a first home buyers allowance would have a direct impact of increasing the number of first home buyers entering the market. These behavioral impacts should be identified, and the assumptions specified clearly.

Annex III. Transforming the Budget Declaration into Fiscal Strategy Statement

1. Budget Overview

An overview of the main objectives and priorities for fiscal policy and summary of the medium-term fiscal aggregates.

2. Macroeconomic Outlook

Discussion of the macroeconomic environment under which the budget was framed, including:

- Overview of recent developments in the domestic and global macroeconomic conditions.
- Discussion of the major macroeconomic projections for the budget and forward years.
- Table showing the medium term macroeconomic projections (current year, budget year, and two forward years) and their underlying assumptions
- Detailed discussion of the main components of GDP forecasts and their drivers (for example, consumption, investment, government, exports or by key sectors)
- Brief discussion of risks to the macroeconomic outlook.
- For future budgets: Discussion of how the forecasts have changed since previous budget forecasts.

3. Fiscal Strategy and Medium-term Fiscal Projections

Details of the government's fiscal objectives and medium-term fiscal projections including:

- Statement of medium-term budget policy objectives and limits on the main fiscal aggregates
- Medium-term projections of the main fiscal aggregates for State and Consolidated Budget (revenue, expenditure, deficit, debt).
- Discussion of revenue performance and revenue projections, including medium-term projections for the main revenue categories, along with explanation of these and new objectives for tax policy.
- Presentation of aggregate medium-term expenditure projections, and breakdown by economic and functional classification
- For future budgets: Discussion and reconciliation of medium-term fiscal projections from the previous year.
- Financing requirements and debt management, including projections for government debt.

4. Medium-term Expenditure Ceilings

- Discussion of medium-term expenditure priorities.
- Expenditure ceilings for KSUs.
- Strategic goals and outcomes for KSUs.

Summary Discussion of Fiscal Risks

- Summary discussion of macro-fiscal risks, main contingent liabilities, and other factors that could cause the fiscal projections to deviate from the baseline forecasts.

Annexes (amend as required by the Budget Code)

- Distribution of state capital Investments for public investment projects.
- Relationships of the state budget with local budgets.

Annex IV. Implicit and Explicit Margins in Other Jurisdictions

	<u>Implicit Margins</u>		<u>Explicit Margins</u>		<u>Total</u>
	GDP forecast	Other economic assumptions	Within estimated expenditure	Within budget balance	Contingency % of total expenditure
Canada	MoF uses average of indicative forecasts	MoF adds 0.5% to 1.0% to interest rates and runs through model	Contingency reserve of 1.5% to 2% of total spending	MoF targets a surplus of 0.1% of GDP despite balance rule	3.5% to 4.0%
United Kingdom	MoF uses GDP forecast 0.25% below trend	7 other economic assumptions explicitly cautious	Reserves and margins equal to 0.75% to 1.0% of total expenditure	MoF targets average surplus of 0.2% of GDP despite golden rule	2.5% to 3.0%
Sweden	Budget based on central assumptions for GDP and other variables		Budget margin in expenditure ceiling rising from 1.5% to 3.0% of total spending	None	1.0% to 3.0%
Netherlands	Deficit target and expenditure ceiling based on cautious economic scenario in which GDP is generally 0.5% to 1.0% below outturn		Central contingency reserve of 0.1% of total spending	Most recent CA targets structural surplus of 1.0% of GDP	1.1% to 2.0%
Australia	Budget is based on central economic assumptions	Conservative bias in forward estimates of 0.5% to 1.5% of expenditure	No central contingency reserve	None	0.5% to 1.5%

Source: Annual budget documents.

Annex V. Carryover Practices in Countries with Established MTBFs

	<u>Spending categories</u>			<u>Carryover limits and approval</u>
	Operations	Transfers	Capital	
Australia	Yes	No	Yes	Finance Minister Approval
Austria	Yes	Yes	Yes	Full
Finland	Some	Some	Some	Explore after 2 years
France	Yes	No	Yes	Up to 3% of budget
Sweden	Some	Yes	Yes	Up to 3% of budget
Netherlands	Yes	No	Yes	Up to 1% of budget
UK (1990-2009)	Yes	No	Yes	Full
UK (2010-)	MoF approval			None

Annex VI. Potential Structure for a Sector Strategy Statement

A draft law to create a strategic planning system has been prepared. This envisages development of 16 different types of strategy and planning document at national and sub-national level, including inter alia:

- Ukraine Development Strategy (15 years);
- Ukraine Regional Development Strategy (15 years);
- Strategic Plans of Central Executive Authorities (5 years);
- Strategy for Development of Cities, Towns, Villages, United Territorial Communities (5 years).

The Ukraine Development Strategy and Strategic Plans of Central Executive Authorities will be particularly important in influencing strategic planning for programs. National, sector and ministry strategies underlie strategic budget decisions in many countries, including those with established MTBFs. Good practice in strategy development caters for strategies to be formulated across sectors and horizontally across themes (e.g., wage costs; environment, gender). This expands strategic planning options, enabling trade-offs between related policy options that happen to be managed within different ministries in the same sector (and across a greater range of ministries with respect to horizontal strategies). Sector and horizontal strategies are not currently catered for in the strategic planning framework set out in the draft law.

The following points describe the typical content of international strategies prepared at sector level, illustrating the importance of a sector-wide view of strategic options.

- Vision - a concise description of what the sector hopes to achieve in the longer term, which should serve as a guide for making policy choices for current and future courses of action.
- Current state of affairs – a description of the current status across all major service delivery areas for the sector. Where previous strategic goals have been successfully achieved, a description of external and internal influencing factors and how they might be consolidated. Where progress has been unsatisfactory, a description of barriers to success and means of overcoming them.
- Desired future state of affairs – a description of intended service delivery status across all major service delivery areas for the sector.
- Overall structure of service delivery in the sector (government, non-government public sector, NGOs, private sector). Description of the role of government in the sector (direct delivery of service; public-private partnerships; regulation; taxation; subsidies). Description of planned role of government in the sector. Role partners (e.g., NGOs) and nature of collaboration (e.g., shared delivery of services; subsidized delivery of services). Role of the private sector and implications for government strategies and plans (e.g., regulated/unregulated; taxation; subsidies). Arrangements for sector coordination and cooperation.

- Structure of government involvement in the sector (ministries, agencies and their associated programs) and related arrangements for government-wide coordination and cooperation.
- Strategic goals and associated indicators and targets consistent with desired future state of affairs.
- Role of programs and other government actors in delivery of strategic goals in each main service area. Description of service delivery areas each program takes responsibility for, how they coordinate and collaborate with each other and with non-government actors.
- Major outputs (including public investment outputs) to be delivered over the life of the strategy plus associated indicators and targets.
- A projection of resources available for planning government spending over the lifetime of the strategy (under alternative financing scenarios), including sources of funds (e.g. national budget, international partners, public-private partnerships).
- A projection of costs for each year for each of the main service delivery areas of the strategy.
- Major implications of each financing scenario on ability to deliver key outputs and outcomes.
- A summary of any major initiatives requiring approval by the Council of Ministers including an estimate of the expected month/year when the initiative will be submitted to the or approval and the type of document that will be submitted (e.g., new or revised law or regulation; international agreement; strategy paper).
- Institutional arrangements for monitoring progress on sector strategy implementation.