UKRAINE

TECHNICAL ASSISTANCE REPORT—STRENGTHENING PUBLIC FINANCIAL MANAGEMENT

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Ukraine

Strengthening Public Financial Management

Miguel Alves, Amanda Sayegh, Alessandro Gullo, Karla Vasquez Suarez, Clemens Mungenast, Philip Kenworthy, and Glen Granger
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GLOSSARY

BCU  Budget Code of Ukraine
CMU  Cabinet of Ministers of Ukraine
DLB  Department of Local Budgets
DSA  Debt Sustainability Analysis
DPD  Debt Policy Department
FAD  Fiscal Affairs Department
FBE  Forward Baseline Estimates
FRMD Fiscal Risk Management Division
FRS  Fiscal Risk Statement
GRB  Gender Responsive Budgeting
IMF  International Monetary Fund
KSU  Key Spending Unit
LM  Line Ministry
MEDT  Ministry of Economic Development and Trade
MoF  Ministry of Finance
MTBF  Medium-term Budget Framework
NBU  National Bank of Ukraine
PPP  Public Private Partnership
PFM  Public Financial Management
PIM  Public Investment Management
QFA  Quasi-Fiscal Activities
SOE  State-Owned Enterprise
TA  Technical Assistance
UAH  Ukrainian Hryvnia
VR  Verkhovna Rada (Parliament of Ukraine)
PREFACE

In response to a request from the Minister of Finance, Mr. Oleksandr Danyliuk, a technical assistance mission from the Fiscal Affairs Department (FAD) and Legal Department (LEG) of the International Monetary Fund (IMF) visited Kiev, Ukraine during the period March 22-April 4, 2017. The mission was led by Miguel Alves (FAD), and consisted of Amanda Sayegh (FAD), Alessandro Gullo, Karla Vasquez Suarez (both LEG), Glen Granger, Clemens Mungenast, and Philip Kenworthy (FAD short term experts).

The mission met with Ms. Oksana Markarova, First Deputy Minister of Finance; Mr. Vladimir Lozitsky, State Budget Director; Mr. Yuriy Heletiy, Director of the Financial Policy Department; Mr. Vasyl Shkurakov, Director of Debt Policy Department; Mr. Andrey Savenko, Head of the Fiscal Risk Management Division; Ms. Olena Skrypkina, Head of Legal Department; Mr. Olexiy Zhak, Head of Budget and Macroeconomic Indicators Division; and Mr. Mikhailo Bosak, Head of State Budget Planning Division. In the Ministry of Economic Development and Trade the mission met with Ms. Olena Diachenko, Head of the Department of State Property Management; Ms. Iryna Novikova, Head of PPP Division; Ms, Natalia Gorshkova, Director of the Macroeconomic Forecasting Department; and Mr. Oleksandr Zadorzhnyi, Deputy Head of the Industrial Policy Department; and Ms. Oksana Gryshkevych, Deputy Chair of the Investment Department.

The mission also met with the Ms. Liliia Hrynevych, Minister for Education and senior representatives from Education Ministry; Mr. Pavlo Kovtonyuk, Deputy Ministry of Health; Dr. Viktor Dovhan, Deputy Minister for European Integration, Ministry of Infrastructure; Mr. Serhiy Sharshov, Deputy Chair of Local Self-Government Department, Ministry of Regional Development; senior representatives of the Pension Fund of Ukraine, and the National Bank of Ukraine and members of the Budget Committee of the Verkhovna Rada. In addition, the mission met with Ms. Maja Bosnic, Team Leader of the Gender Budgeting in Ukraine Project, Ms. Oleksandra Betliy, Leading Research Fellow of the Institute for Economic Research and Policy Consulting, Mr. Ivan Miklos and Mr. Pavlo Kukhta of the Strategic Advisory Group for Support of Ukraine Reforms, and representatives from the World Bank and the European Commission.

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

After a deep economic crisis caused by a difficult external environment, an armed conflict in the East, and delays in the implementation of structural reforms, Ukraine has been showing some signs of recovery. To achieve a more sustainable fiscal consolidation, the Ukrainian authorities have recently adopted a broad Public Financial Management (PFM) System Reform Strategy, paving the way to decisive action in critical areas including medium-term budgeting, analysis and management of fiscal risks, and public investment management (PIM).

Implementing the Medium-term Budgeting Framework (MTBF)

Fiscal policy in Ukraine has been hampered by the lack of a medium-term orientation for the State Budget. Medium-term macroeconomic forecasts are regularly produced, but these are not well integrated with budget planning, which remains mostly incremental and annual in scope. The Budget Code only requires the preparation of multi-year budget projections (essentially a forecast exercise), with little impact on fiscal discipline. Furthermore, fiscal objectives, absent the conditionality included within the IMF supported program are vague. While the main drivers of fiscal policy are defined in the Spring, there is no systematic strategic approach to budgeting: “top-down” spending envelopes based on a credible fiscal framework.

Recent reform initiatives have prioritized the development of a medium-term budget framework to the forefront of the reform agenda, but additional steps are required for it to be fully implemented. A pilot MTBF exercise, with a clear objective to amend the Budget Code by the end of the year is now underway and, while this approach demonstrates commitment to reform, the current design largely replicates the existing annual budget approach, albeit extended over a three-year horizon. There is still time to improve the credibility of this process, with the objective of preparing all stakeholders to be able to implement a more complete MTBF exercise for the 2019 budget. Specific measures for the pilot could include:

- Adopting a fixed overall expenditure ceiling for the State General Fund for 2018 and indicative ceilings for outer years (i.e., 2019 and 2020) and indicative ceilings for each of the Key Spending Units (KSU) in each year;
- Defining contingency margins for the overall expenditure ceilings and committing to presenting a reconciliation of any changes to the ceilings during the successive stages of the 2018 budget cycle.

For subsequent budget years, the authorities should consider further developing the MTBF process by:

- Integrating the Special Fund into the MTBF and presenting it to include the impact on general government;
- Gradually move toward more fixed ceilings for overall and KSU expenditure as the system matures;
• Expanding the scope of the Budget Declaration, to encourage a more strategic discussion of fiscal policy, aided by a rules-based fiscal framework and enhanced information;
• Developing and implementing a technical amendments model that specifies clear rules for the adjustment of ceilings following macroeconomic changes; and
• Developing and disseminating a methodology for forward baseline estimates to inform the MTBF discussions between the Ministry of Finance (MoF) and KSUs.

**Strengthening Fiscal Risk Management**

Ukraine’s public finances are exposed to several important fiscal risks. Macroeconomic and geopolitical risks create substantial volatility in nominal GDP and government revenue, while government debt is highly exposed to exchange rate fluctuations. Fiscal exposures emanate from a large and poorly performing State-owned Enterprise (SOE) sector. Liabilities of the largest 100 enterprises are around 25 percent of GDP, and around one-third of these were loss-making in 2015. In this context, government guarantees of SOE borrowing, which amount to around 5 percent of GDP, have a high likelihood of materializing. The financial sector has also been a significant source of fiscal risk in recent years, with fiscal cost of bank bailouts and deposit guarantees amounting to around 11 percent of GDP over the last four years. Finally, Ukraine’s pension system coupled with an ageing population creates large and uncertain fiscal costs.

The lack of a comprehensive fiscal risk management system affects the credibility of the budget, the sustainability of the public debt and the efficient allocation of public resources in accordance with policy priorities. This is exacerbated by a lack of sufficient information about the sources and likelihood of such risks, and by fragmented and inadequate frameworks for SOE oversight (including from a legal standpoint), public guarantees, and asset management.

The authorities should take steps to strengthen the monitoring, management, and reporting of fiscal risks, notably by:
• Strengthening and broadening the fiscal risk management mandate of the MoF, including the development of fiscal risk control and mitigation policies;
• Establishing a comprehensive reporting framework for fiscal risk management; and
• Publishing an annual fiscal risk statement as part of the budget documentation, focusing initially on SOE and macroeconomic related risks and gradually expanding the coverage of and methods used to assess them over time.

**Strengthening Public Investment Management**

Ukraine has undertaken a range of reforms in public investment management, designed to tackle some of its weaker institutions. Nevertheless, the strategic planning process remains unfit for purpose and does not facilitate prioritization of capital investment projects. Furthermore, a significant share of Ukraine’s public investment continues outside the scope of the improved
appraisal and selection process launched in 2015, including its framework for intergovernmental coordination.

The government’s PFM strategy outlines significant reform plans for PIM. These include: the establishment of an independent expert body, the Strategic Council, which will take an advisory role in the strategic planning process; the development of strategic sectoral plans; and development of a medium-term public investment plan. In this context, the authorities should consider taking steps to address PIM institutional gaps by:

- Setting up an Investment Planning Unit under the MEDT, with the responsibility for development of a national public infrastructure strategy, which integrates both sectoral strategic plans and public investment priorities. This would help investors identify investment opportunities in Ukraine;
- Expanding the role of the MoF in the appraisal and selection process, regarding the assessments on “whole-of-life” budget affordability of investment projects and fiscal risks;
- Developing and implementing a single online database of information (including costs) for all investment projects, irrespective of their funding source;
- Gradually extending the new project appraisal and selection process to all major investment projects, irrespective of their funding source, with consideration for materiality and fiscal risks.

**Legal Implications**

Strengthening all of three areas will require comprehensive legal reforms. Specifically, the MoF needs to be empowered to permit it to effectively execute its functions. Enshrining the MTBF in legislation will grant legal legitimacy, strengthen credibility and clarify the institutional roles of the legislative and executive branches of government. Strengthening the legal mandate of the MoF to monitor, assess, and manage fiscal risks would ensure that adequate mechanisms to facilitate the collection of information necessary for fiscal risk analysis are in place. In addition, the integration between the budgetary regime and the framework for public investment should be improved, and the role of the MoF strengthened for different investment processes, including PPPs. Changes to primary legislation will also need to be accompanied by implementing regulations such as Cabinet resolutions, to allow for flexibility on technical issues and to ensure that the stronger role of the MoF is accompanied by adequate involvement of line ministries through a collegial decision-making process.

Table 0.1 sets out the recommendations of the report and an action plan for their implementation.
<table>
<thead>
<tr>
<th>Recommendation</th>
<th>April–December 2017</th>
<th>2018</th>
<th>2019/2020</th>
<th>Responsible Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Implementing the Medium-term Budgeting Framework</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1 Define ceilings for pilot MTBF</td>
<td>Fixed overall expenditure ceiling for 2018 (indicative for outer years) and indicative KSU expenditure ceilings for the General Fund for each year</td>
<td></td>
<td></td>
<td>MoF</td>
</tr>
<tr>
<td>1.2 Determine the rules of the pilot</td>
<td>Define margins for the budget year and the subsequent two years Reconcile any changes for the draft budget.</td>
<td>Reconcile any changes in the “Fiscal Strategy Document” for MTBF triennium 2019-2021. Reconcile any changes in the final accounts.</td>
<td></td>
<td>MoF, KSUs</td>
</tr>
<tr>
<td>1.3 Improve design of MTBF</td>
<td>Integrate the Special Fund into the MTBF</td>
<td>Binding overall expenditure ceiling and KSU expenditure ceilings for the General and Special Funds for 2019</td>
<td></td>
<td>MoF, CMU</td>
</tr>
<tr>
<td>1.4 Strengthen credibility and transparency of MTBF</td>
<td>Commit to gradual increase in the fixity of ceilings in the Budget Code Develop a technical amendments model Provide for appropriate margins, and the reconciliation of changes to ceilings throughout the whole budget cycle.</td>
<td>Implement the technical amendments model and apply it for MTBF triennium 2019-2021 Increase timeliness and independence of macro-economic forecasts Limit overspending of the Special Fund and reduce the amount of earmarking revenues in the state budget Present MTBF in a general government perspective</td>
<td>Apply technical amendments model for MTBF triennium 2020-2022</td>
<td>MoF, CMU</td>
</tr>
<tr>
<td>1.5 Develop a forward-baseline-estimates methodology</td>
<td>Develop a forward-baseline-estimates methodology for the state budget in the MoF. Run an MoF internal test in Autumn 2017</td>
<td>Apply the methodology for the preparation of the Strategic Budget Document 2019-2021. Provide training on the FBE methodology to KSUs.</td>
<td></td>
<td>MoF, KSUs</td>
</tr>
<tr>
<td>1.6 Amend Budget Code to support MTBF implementation</td>
<td>Include key elements of the MTBF in Budget Code</td>
<td>Prepare and adopt CMU resolutions as to the technical details of the for MTBF triennium 2019-2021</td>
<td></td>
<td>MoF, CMU</td>
</tr>
</tbody>
</table>
### Strengthening Fiscal Risk Management

<table>
<thead>
<tr>
<th>Recommendation</th>
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<th>2018</th>
<th>2019/2020</th>
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</tr>
</thead>
<tbody>
<tr>
<td>2.1 Strengthen and broaden the fiscal risk management mandate of the MoF</td>
<td>Broaden FRMD’s mandate cover all material fiscal risks Amend BCU to incorporate fiscal risk management functions Transfer oversight of financial and commercial operations from the FRMD to supervisory boards, as established</td>
<td></td>
<td></td>
<td>MoF</td>
</tr>
<tr>
<td>2.2 Establish a comprehensive reporting framework for fiscal risk management</td>
<td>Update the functional responsibilities of government departments Establish templates for exchange of information</td>
<td></td>
<td></td>
<td>CMU, MoF</td>
</tr>
<tr>
<td>2.3 Prepare and publish an annual fiscal risk statement (FRS)</td>
<td>Amend BCU to include FRS Publish initial FRS</td>
<td>CMU approve responsibilities for producing broader FRS Expand FRS to cover broader set of fiscal risks</td>
<td></td>
<td>FMRD</td>
</tr>
<tr>
<td>2.4 Strengthen analysis and disclosure of macroeconomic risks</td>
<td>Publishing a qualitative discussion of macro-fiscal risks in FRS</td>
<td>Publish assessment of past forecast errors in the FRS</td>
<td>Undertake and publish macro-fiscal sensitivity analysis</td>
<td>FRMD, BD, MEDT</td>
</tr>
<tr>
<td>2.5 Strengthen the information base and capacity to undertake fiscal risk assessment of SOEs and commence quarterly internal reporting of SOE risks</td>
<td>Expand and approve draft methodology for SOE risk assessment Build capacity to undertake financial ratio analysis Submit first quarterly reports to CMU</td>
<td>Establish a single central database (excel-based initially) of SOE financial indicators and state support Develop capacity to undertake sensitivity and scenario analysis of SOE sector</td>
<td></td>
<td>FMRD, MEDT</td>
</tr>
<tr>
<td>2.6 Disclosure of SOE fiscal risks</td>
<td>Preliminary analysis of aggregate SOE risks in FRS, explicit liabilities to them, QFAs and transactions with government</td>
<td>Add analysis of high-risk SOEs and details on individual SOEs (high risk and macro-critical)</td>
<td>Add information on SOE contingent liabilities</td>
<td>FRMD</td>
</tr>
</tbody>
</table>
Table 0.1. Ukraine: Recommendations and Action Plan (Concluded)

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>April–December 2017</th>
<th>2018</th>
<th>2019/2020</th>
<th>Responsible Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.7 Long-term sustainability</td>
<td></td>
<td></td>
<td>Prepare and publish long term estimates of pension costs</td>
<td>Pension Fund, MoF</td>
</tr>
<tr>
<td>2.8 Debt Management</td>
<td>Discuss main exposures in FRS</td>
<td>Undertake and publish sensitivity analysis</td>
<td>Undertake and publish debt sustainability analysis</td>
<td>DPD</td>
</tr>
<tr>
<td>2.9 Other explicit and implicit contingent liabilities</td>
<td>Disclose fiscal risks related to guarantees and loans to SOEs in FRS</td>
<td>Add legal claims, financial sector exposures, PPPs, local government</td>
<td>Add natural disaster risks</td>
<td>See table 2.2</td>
</tr>
<tr>
<td>2.10 Strengthen controls on, and management, of contingent liabilities</td>
<td>Restrict foreign currency subnational borrowing to sub-lending</td>
<td>Develop tracking indicators of fiscal stress for subnationals and require published external audits</td>
<td>Establish methodology for assessing credit risks of guarantees and charge risk-based fees</td>
<td>DPD, DLG, BD</td>
</tr>
</tbody>
</table>

Strengthening Public Investment Management

| 3.1 Enable the development of a national infrastructure strategy              | Set up an Investment Planning Unit under the MEDT. Define the role of the strategy and the process for consideration and acceptance | Begin development of the strategy                                          | Complete the strategy                                | MEDT, MoF, CMU                                          |
| 3.2 Expand the role of the MoF to include budget affordability and risk assessments of public investment projects | Begin introducing the process in concert with the MTBF pilot                     | Full MoF assessment conducted for 2019 budget funded items                 |                                                                                                   | MoF                                                   |
| 3.3 Create a single online database of information for all investment projects.|                                                                                     | Commission the building of the database                                   | Database operational                                 | MoF, MEDT                                              |
| 3.4 Extend project appraisal and selection approach to all major national public investments | Extend to PPPs and SoE investment financed by government loans or equity injections | Extend to major projects funded by intergovernmental transfers            | Extend to externally financed projects                                                              | MEDT                                                  |
| 3.5 Adapt requirements to size and risk of projects                           |                                                                                     | Make revisions in time for the 2019 Budget process                         |                                                                                                   | MEDT                                                  |
| 3.6 Revise the definition of PPPs                                             |                                                                                     | Make revisions in time for the 2019 Budget process                         |                                                                                                   | MEDT                                                  |
I. IMPLEMENTING THE MEDIUM-TERM BUDGET FRAMEWORK

A. Background

1. **The budget reform agenda in Ukraine has been primarily determined by external drivers.** Under the economic programs financed by the IMF, the Ukrainian authorities have consistently committed to improving the state of public financial management (PFM), namely through moving to a medium-term orientation of the budget.\(^1\) Similarly, under the EU-Ukraine Association Agreement, the authorities have committed to take actions in the area of budget policy, including on developing a medium-term budget forecast/planning system.

2. **Progress in this area has been slow, notwithstanding significant capacity development activities since 2011.** FAD fielded two consecutive technical assistance (TA) missions in 2011 and 2012, focusing exclusively on medium-term budgeting. In 2014, a broader mission reviewing the overall status of public financial management, provided recommendations on urgent measures in the areas of cash management, expenditure controls, and fiscal oversight of SOEs, and outlined a strategy for medium-term PFM reforms. There has been limited implementation of the previous missions’ recommendations.

3. **A recently adopted PFM strategy brought medium-term budgeting again to the forefront of the reform agenda.** On February 8, the Cabinet of Ministers of Ukraine (CMU) adopted the PFM Strategy 2017–21 that lays out the Government’s plans for the implementation of a medium-term budget framework (MTBF), setting out ambitious objectives and outputs (Box 1.1). In order to implement the strategy in this area, a law “On Implementing Amendments to Section VI Final and Transitional Provisions” of the Budget Code of Ukraine was passed by the Verkhovna Rada on March 23, which permits the presentation of a detailed forecast of the state budget of Ukraine for 2018 and 2019, and a draft of Major Areas of Budget Policy (Budget Declaration) for 2018–20 of Ukraine, both by June 1 (as opposed to the original deadline of April 1). The law stipulates review and approval by the CMU within two weeks and subsequent submission to the Verkhovna Rada.

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\(^1\) Three successive Stand-By Arrangements since 2008, followed by an Extended Fund Facility in 2016.
**Box 1.1. Objectives and Outputs of the PFM Strategy on Medium-term Budgeting**

**Planned objectives:**

1. Implementation of the mid-term budget declaration as a tool of integrating strategic priorities of the state with budget opportunities
2. Creating a reliable medium-term framework for budget planning
3. Strengthening role of key spending units in the budgeting process
4. Approval of an updated budgeting time schedule
5. Improving the level of budget discipline through introduction of fiscal rules
6. Strengthening responsibility of subjects of legislative initiatives over assessment of the budget impact of legislative and regulatory initiatives

**Planned outputs:**

1. Adoption of the 2018–20 budget declaration specifying expenditure ceilings.
2. Basing the 2019 budget on the relevant indicators of the 2018-2020 budget declaration, with any variations explained.
3. Implement the medium-term budget planning software in 2018.
4. Develop the appropriate amendments to the Budget Code of Ukraine for setting fiscal rules are developed in 2018.

---

**B. State of Play on MTBF Prerequisites and Implementation Strategy**

4. **A successful MTBF needs to maintain credibility and legitimacy in its domestic political context, while enabling the enforcement of greater fiscal discipline.** Internationally, systems that provide these outcomes are generally characterized by procedural and analytical mechanisms that deliver political commitment, systematic prioritization, financial control, and accountability for delivery. The effectiveness of these mechanisms—the rules and conventions of the exercise—determine whether the MTBF will play a full role as a lever for better decision-making and performance in government, or instead be relegated to a bureaucratic exercise with little impact. The detailed design of appropriate mechanisms is inherently contextual, and therefore specific to each country and its needs.

5. **The prerequisites for effective MTBFs are not yet fully established in Ukraine.** While successful MTBF systems vary in their design, the prerequisites for successful implementation, include: credible annual budgets, prudent macroeconomic projections, a solid medium-term fiscal framework, and a unified comprehensive budget process. The current state of play in Ukraine regarding each of these aspects can be summarized as follows:

   - **Credible annual budgets:** Deviations between the Budget plans initially approved by Verkhovna Rada and the reported outturns have been significant, averaging around 5 percent of expenditure in absolute terms for the state budget and 20 percent for the special fund (Figure 1.1., panels a and b).
• **Prudent macroeconomic projections:** Forecasts are prepared around 10 months before the year to which they apply, and therefore do not take into account of the full suite of information available at the time the budget is prepared. The system of preparing the forecasts is hampered by the requirement for a lengthy consultation period (3 months) with Line Ministries (LMs). In addition, the volatile macroeconomic environment makes it difficult to produce reliable forecasts, with an average absolute forecast errors for real GDP growth of 4 percent (Figure 1.1, panel c).

• **Medium-term fiscal framework:** The budget law sets out a quantitative target for gross debt as a share of GDP, but operational rules and objectives for fiscal policy have not been developed in Ukraine. For the time being, the IMF Extended Fund Facility program provides for annual deficit targets for the general government deficit.

• **Unified comprehensive budget process:** The state budget expenditures (including transfers to local budgets and social security funds) represented about two-thirds of general government activity in 2015 (Figure 1.1, panel d). Including an estimate of SOE activities, the share of the state budget in relation to the public sector is around 50 percent.

![Figure 1.1. Assessment of Prerequisites for Effective Medium-term Budget Framework](image)

2 Source: IMF Government Finance Statistics Yearbook. The increased share from 2014 onward reflects the increase in transfers to local government units as a result of the decentralization efforts.
c. Real GDP Forecast Errors (percent)

- Absolute error
- Error adjusted for volatility

d. State Budget Share of General Government (percent)

Source: MEDT, Annual Budget, IMF, GFS and IMF staff estimates.
Note: Real GDP forecasts for Ukraine are from 2005–15, while for other countries forecast errors are from 2000–15.

6. While this adds some complexity to successful implementation, the introduction of a MTBF can still provide a lever for more resilient public finances. The implementation strategy will need to take account of the Ukraine’s challenging domestic economic circumstances, high macroeconomic volatility, difficult external conditions and on-going wider reforms. There is a risk of trying to do too much too quickly, with substandard results that compromise the credibility of a fundamentally new approach to budgeting. A measured implementation strategy that mitigates this risk should comprise three elements:

- **Continued development of the prerequisites for a successful MTBF, progressively closing the gaps in the PFM system identified by the government’s PFM strategy.** A strong PFM system that provides robust information is foundational for delivering a functioning MTBF.

- **Deliver a 2018–20 MTBF tailored to Ukraine’s current circumstances.** The approach to the initial 2018 MTBF should be pragmatic, taking account of the challenging political and macro-economic environment while remaining realistic about what is achievable in a short time period. Given the high macroeconomic volatility in recent years, a specific framework for dealing with macroeconomic volatility needs to be designed (see elaboration on this topic in Section D below)

- **From 2019 onwards, continue developing modalities for control and flexibility within the MTBF, progressively building its sophistication.** The 2018–20 MTBF should be a starting point, the design of which can be progressively refined to deliver a “ratchet effect” on budget discipline and predictability in the coming years.
7. **Initiatives currently under way fall short of a fully-fledged MTBF, but are a positive step forward in the Ukrainian context.** The authorities have recognized the need to conduct a pilot and subsequently introduce material changes to the budget code, informed by a more strategic approach to budgeting in the context of an MTBF. The following two sections analyze first, the authorities design and implementation plan for the pilot exercise, and second, the ways in which the pilot framework could be strengthened and refined to build towards a fully-fledged MTBF.

C. **Pilot Medium-Term Budget Framework 2018–20**

8. **In line with the ambitions of the PFM strategy, the Government of Ukraine launched an MTBF pilot in early 2017, to be presented in the June Budget Declaration.** Alongside the MTBF a statement of key performance indicators and policy goals for each KSU shall be annexed. These outputs represent the documentation of an incipient MTBF system, which the Ministry of Finance explained in a letter to KSUs in February.

**Pilot Medium-Term Budget Design**

9. **The pilot was designed to cover state budget over a three-year period, with an overall general fund expenditure ceiling and subceilings for KSUs and presuming annual rolling MTBF updates thereafter.** The special fund of the state budget (containing expenditure financed by earmarked revenues and external sources), which currently represents around 8 percent of total state spending, will not be subject to ceilings in the pilot exercise, given its current non-discretionary nature. Other notable details regarding the functioning of the pilot have not yet been set in official communications. For example, the MoF has not yet set out an approach for expenditure margins, or a methodology to reconcile changes between the MTBF and the adopted annual budgets.³

10. **The nature of the ceilings needs clarification for the pilot to be effective.** The status (fixed or indicative) and legal standing of the overall and KSU expenditure ceilings has still not been determined. The credibility of the MTBF, as perceived by various actors across government and the public at large, will define the success of the exercise. In this context, no ambiguity should remain as to the nature of the expenditure ceilings and related government commitments. This will require making clear whether the ceilings are fixed or indicative and for what time period (Box 1.2).

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³ According to the PFM strategy, the possibility of introducing budget margins will be considered after passing through the first two cycles of medium-term budget targets.
Box 1.2. Fixed versus Indicative Ceilings of an MTBF

The degree to which expenditure ceilings are fixed is one of the crucial design issues of MTBFs.

“Fixed” ceilings establish an upper limit, which is to be respected. Transgressing this limit constitutes breaking the rules of the MTBF. Such an upper limit may be defined in nominal terms or subject to a rule defining this limit with respect to indicators. Their legal nature may differ: CMU decisions or declarations, or laws, depending on the commitment involved and the legal-administrative culture setting the context.

“Indicative” ceilings establish a clear direction as of the moment when they are defined, but transgressing them does not constitute breaking the rules of the MTBF. The commitment to sticking to them and defending them is therefore lower, and some changes are to be expected.

Possible qualities of commitment in the Ukrainian setting:

11. **The three-year rolling framework and limited scope of the pilot seem reasonable to start with.** A three-year rolling framework is a common approach amongst international comparators and provides a degree of flexibility and responsiveness (compared to periodically setting a multi-year framework) that seems appropriate in Ukraine’s current circumstances. Limiting the scope of the pilot to only the general fund curtails the comprehensiveness of the pilot, but in view of the ambitious timetable, the premium importance of making the pilot deliverable, and the focus on learning for the future, this decision seems reasonable.

12. **Overambitious commitments risk undermining the credibility of the whole framework.** A strong commitment to honor a ceiling is a crucial element of the pilot, but that commitment must be credible and realistic. Differentiated levels of seniority for different ceilings could help to mitigate this risk. While keeping the first year (budget year) aggregate ceiling fixed, KSU sub-ceilings and outer year aggregate ceilings could be indicative. In case of the Government adopting new macroeconomic indicators that feed into higher spending, a reconciliation would have to be provided (Table 1.1. presents a template for disclosure of such reconciliation).

13. **Judicious use of margins improves the prospects for defending an overall ceiling.** All countries face a degree of inherent future policy uncertainty. This is particularly acute in Ukraine, due to the difficult current circumstances. Margins to account for relatively small policy changes will be needed, therefore, in addition to allowing macroeconomy-driven adjustments. In countries with mature MTBFs, margins ranging from 1 percent in the first to 3 percent in the third year are common (see Annex II). As a general rule, margins should be centrally managed and not distributed ex ante to the KSUs.
### Table 1.1. Template for Reconciliation of Consecutive Vintages of Ceilings

<table>
<thead>
<tr>
<th>KSUs</th>
<th>General Fund</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling</td>
<td>Ceiling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>restricted</td>
<td>restricted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>expenditure</td>
<td>expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(budget)</td>
<td>(budget)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Technical”</td>
<td>“Technical”</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>amendments</td>
<td>amendments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Policy</td>
<td>New Policy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decisions</td>
<td>Decisions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in</td>
<td>Changes in</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volume</td>
<td>Volume</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>Other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ceiling</td>
<td>Ceiling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>restricted</td>
<td>restricted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>expenditure</td>
<td>expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(draft budget)</td>
<td>(draft budget)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Margin</td>
<td>Margin</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(draft</td>
<td>(draft</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>budget)</td>
<td>budget)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Pilot Medium-Term Budget Framework Implementation

14. **The authorities’ approach to implementing the pilot largely replicates the existing approach for annual budgets, extended over three years.** The MoF’s letter to KSUs, in February, requested the return of spending plans for three years, and statements of policy priority with associated key performance indicators. The letter explains that KSUs should clearly justify any new spending, and be realistic as to the fiscal constraints that Ukraine is under, but does not lay out any process to disclose baseline (“no policy change”) estimates and the costs of new policies separately, or anticipate any changes to the standard process of preparing the Budget from June onward.

15. **The pilot contains little time or scope for a strategic prioritization phase and remains largely a bottom-up exercise.** The pilot does not start from a top-down assessment of fiscal space and major policy priorities, but instead from the aggregate of KSU requests based on their policies and priorities for the planning period. Most budgets are forecast by simply uprating the previous year’s envelope and therefore it will be very difficult to strategically determine where consolidation should occur versus what should be prioritized (Box 1.3. presents the main characteristics of the strategic budgeting process in the UK). The MoF has attempted to move towards a greater medium-term focus on target policy outcomes and KPI’s in the information it has requested from KSUs, but the historic approach to determining budgets is entrenched, so this is likely to require sustained efforts.

16. **The negotiation process to establish the KSU ceilings could be adapted to better defend the overall ceiling.** An enhanced focus on outcomes, rather than inputs, within restricted KSU envelopes will aid a more efficient prioritization in the use of resources. Going into
these negotiations, the MoF should aim to retain fiscal negotiating space beyond a formal margin (a “tactical margin”), to prevent the early exhaustion of all available resources due to concession in negotiation.

**Box 1.3. The Strategic Phase of the Budgeting Process in the UK**

The strategic prioritization phase of a UK “spending review,” which determines the MTBF for the following four years (the UK establishes a new MTBF every three years, not on a rolling basis) starts, as per best practice, with the calculation of overall fiscal space.

HM Treasury (the UK’s finance ministry) combines forecast baselines of “Annually Managed” (i.e. variable) expenditure, provided by the independent Office for Budget Responsibility, with its pre-existing aggregate spending assumptions for future “Departmental Expenditure Limit” (i.e. fixed) expenditure. This provides a forward baseline that dictates, when combined with the UK’s fiscal rules and independent revenue forecasts, the need for consolidation or the existence of fiscal space.

A strategic document, containing an explanation of the fiscal and wider policy goals of the spending review is published to officially launch the prioritization process.

HM Treasury then writes to line ministries, requesting that they model a range of medium-term adjustments to their “resource” (i.e. current) spending budgets, as well as inviting reform proposals to limit variable expenditure, and works with line ministries on potential reforms to improve affordability and efficiency. Separate from, but informed by, this process, HM Treasury determines an affordable capital investment envelope, and instructs line ministries to bid for all proposed capital spending (including existing programs), by providing business cases that appraise the social net present value of investments, in line with HM Treasury guidance.

The outputs of these exercises inform an intensive period of inter-ministerial negotiation, with difficult issues escalated to senior ministers, before final Cabinet sign-off of departmental settlements. The spending review (i.e. the MTBF), which details these settlements, is then published. The strategic phase of the most recent UK Spending Review took five months in total, as depicted by the diagram below.

![Diagram of the strategic phase of the budgeting process in the UK](image)


17. **The Budget Declaration that includes the pilot MTBF also presents an opportunity to improve wider fiscal disclosure.** Some narrative to explain recent economic context could be added, as well as main fiscal aggregates for the state and consolidated budgets, fiscal ratios and
other key statistics. A simplified fiscal risk statement focusing on the major macro-level risks (see Annex IV for a template of such a statement) could also be integrated.

**Recommendations**

18. **Recommendation 1.1.** Define the nature of ceilings in the pilot exercise, with a view to preparing for the implementation of a fully-fledged MTBF, as follows:

- A fixed overall expenditure ceiling for the State General Fund for 2018 and indicative overall ceilings in 2019 and 2020.

19. **Recommendation 1.2.** Determine the rules of the pilot concerning General Fund expenditure: define margins for the budget year and the subsequent two years—growing into outer years—and commit to presenting a reconciliation of any changes at each stage of the budget cycle (the draft budget 2018, the finally approved budget 2018, the Budget Declaration 2019 and the outturn for 2018).

D. **Developing the Medium-Term Budget Framework Further**

20. The MoF’s plans to incorporate a fully-fledged MTBF in the Budget Code, by end-2017, in light of the lessons learned through the pilot phase, are welcome. This signals the MoF’s determination to make substantial progress in a short period of time. However, there are a number of points that will need to be clarified, if the MTBF is to be effective in the future, notably:

- A fiscal framework that firmly anchors the MTBF in broader fiscal policy, and also determines the trajectory of the public finances, to which the MTBF should give effect, is needed.
- The design features of the MTBF need to be reconsidered, with a view to building on the pilot for increasing specificity and control over time.
- Implementation needs to focus on capacity building, to ensure that what the rules dictate can be delivered in practice, and on mainstreaming new processes.

21. **Furthermore, legal reforms are required to embed medium-term budgeting in Ukraine’s budgetary framework.** The current provisions of the Budget Code include certain basic elements for the preparation of medium-term macroeconomic forecasts and strategic, fiscal planning, and their implementation by the authorities goes, in certain instances, beyond the minimum requirements of the law. As the introduction of a MTBF would entail a radical innovation in Ukraine’s budgetary framework, the Budget Code—that is, the key PFM law in Ukraine—should be revised to reflect such innovation. More importantly, legal underpinnings to the implementation of the MTBF will build the credibility and legitimacy of the process.

22. **Certain features of Ukraine’s legal system pose delicate challenges for the implementation of an effective MTBF.** There is no hierarchy in the legislative acts of the
Parliament, with the consequence that the Budget Code and the annual budget law have the same ranking. In light of such hierarchy and in the absence of any constitutional constraint (e.g. on fiscal rules), it is in principle conceivable that the provisions of the Budget Code (or of the law approving the MTBF) would be superseded by the annual budget laws or other laws enacted by the Parliament.4

**Basic Fiscal Framework**

23. **In the near future, the fiscal targets in the IMF program can act as a surrogate fiscal framework, but Ukraine will require its own fiscal rules in due course.** For this purpose, the MoF will need to consider, in light of the broader economic circumstances, fiscal risks, demographic projections, etc., what combination of stock and flow rules, and contingency clauses will best promote long-term stability.

24. **Further work will be needed to determine what specific rules are most fitting.** As a starting point, Ukraine could consider adopting additional operational fiscal rules to complement the existing debt ceiling set in the BCU. Over time, these rules could be made more compatible with EU fiscal convergence criteria for accession countries in light of the ongoing EU-Association Agreement. Once rules are decided, they could be integrated into the Budget declaration for 2020–22, to be adopted by the CMU and Verkhovna Rada.

25. **More timely and independent macroeconomic forecasts that underlie the fiscal framework, the MTBF and the fiscal policy document should be provided before submission to CMU.** Currently, the budget declaration utilizes economic projections from February of the year preceding the budget. To determine these projections, there is a lengthy consultation with KSUs. While consultation on inputs may be appropriate, the requirement to consult KSUs on the final macroeconomic forecasts seems unnecessary. Steps to depoliticize and professionalize these as well as revenue projections, such as the introduction of independent scrutiny, would be welcome. In keeping with this theme, the scrutiny of key macroeconomic and revenue forecasts by competent institutions would present a quickly achievable and materially beneficial reform to the budgeting process.

26. **A strategic document outlining the key tenets of the Government’s fiscal policy and providing enhanced context and transparency could replace the existing Budget Declaration.** Examples of such additional useful information would be an explanation of recent economic context, the addition of main fiscal aggregates for state and consolidated budget and general government (Box 1.4).

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Box 1.4. Developing the Budget Declaration to a Fiscal Strategy Statement

Current Information:
- Macroeconomic forecast and main objectives of fiscal policy (deficit and debt), key fiscal indicators (for budget year plus two).
- Priorities of fiscal policies and focus points for draft bill.

Additional Information:
- Explain recent economic context.
- Add main fiscal aggregates for state and consolidated budget and general government, fiscal ratios and other key statistics.
- Present fiscal rules in the context of the macro-economic forecast.
- Optimistic and pessimistic economic scenarios.
- Note of recent forecast errors.
- Key risks to the economic outlook.

MTBF:
- Ceilings: overall and KSUs.
- Rules of the MTBF, margins, technical amendments etc.
- Reconciliation tables and justification of changes to the ceilings.

Performance Management:
- Strategic goals and outcomes of KSUs.
- Gender budgeting statement.

Fiscal Risk Statement (see Chapter 2).

27. There are significant ongoing efforts to strengthen performance-oriented program budgeting, consistent with the broader drive for more strategic resource allocation. In the context of a fiscal framework and MTBF that will require improved fiscal discipline, a more performance-oriented approach will help to optimize value for money. In this context, the authorities are implementing reforms to strengthen outcome-oriented budgeting, with support from international donors, including an extensive project of gender responsive budgeting (Box 1.5).
Box 1.5. Gender Responsive Budgeting in Ukraine

In conjunction with broader public financial management (PFM) reforms, the Ministry of Finance initiated the introduction of gender-based budgeting in 2014, with support from a project—“Gender Budgeting in Ukraine” (2014–18)—funded by the Swedish International Development Cooperation (SIDA).

The CMU approved an updated 2017–20 PFM reform strategy, which provides for the integration of a gender-based approach to budgeting in Ukraine, including the definition of performance indicators that will increase the efficiency and quality of public services to meet the needs of social groups, including gender groups, and to strengthen the accountability of spending units and budget transparency. (CMU from 08.02.2017, the number 142).

Current results

For the gender analysis of budget programs at the state level, four pilot ministries were selected—Ministry of Youth and Sports, Ministry of Social Policy, Ministry of Education, and Ministry of Health. The ministries have so far examined two budget programs and, on the basis of their analysis, prepared recommendations on the inclusion of gender indicators in budget documents—passports of budget programs and budget requests. The analysis showed that Ukraine’s current system of statistical indicators needs to be improved in terms of data disaggregation by gender.

Next steps

The MoF, with support from the “Gender Budgeting in Ukraine” project, is developing guidance on the use of gender-based budgeting by key spending units and plans to conduct workshops to present these recommendations.

Design of the Medium-Term Budget Framework

28. **A fully-fledged MTBF should aim for the maximum feasible coverage.** The exclusion of the State Special Fund should be avoided for the full MTBF as it creates unhelpful incentives in the longer-term. The MTBF works by creating pressure to prioritize expenditure within a given ceiling, in order to maximize outcomes within affordability constraints. Excluding certain categories creates distortions, because it means not all forms of spending are evaluated against each other when prioritizing. Retaining the exclusion of the Special Fund will also encourage lobbying for even greater earmarking, and likely push more expenditure outside the constraints of the budget ceilings. This not only undermines the MTBF as a prioritization tool, but also undermines its effectiveness as a tool for delivering the medium-term fiscal objectives.

Earmarking enables any over-performance in revenue categories to be spent without having regard to potential under-performance in other revenue categories. This creates increased pressure on expenditure adjustments elsewhere in the budget to compensate for shortfalls, or non-compliance with fiscal objectives.

29. **Moving to a MTBF that also subjects the Special Fund to ceilings will require an approach to accommodating budget carry-overs in the framework.** There are different ways to achieve this, through margins and/or the design of ceilings. For reasons of fiscal discipline and transparency, internalizing carry-overs within margins seems preferable. The relatively small margins typically included in MTBFs are too limited, however, to accommodate the scale of
fluctuations observed in the Special Fund in recent years (Figure 1.1., panel b). Limiting these fluctuations by progressively reducing the size of the Special Fund and the amount of revenue earmarking, up to and including discontinuing the Special Fund altogether, should be considered.\(^5\)

30. **Integration of a general government perspective is an important step to enrich the macro-fiscal discussions that take place in Government and the Verkhovna Rada.** The MTBF can only be a tool for controlling spending that is at the discretion of the central government, but given that the financial position of government as a whole is ultimately more important, it is key that information about the state budget is augmented with a whole of government perspective. This is particularly important in the current context given Ukraine has agreed general government deficit targets as part of the IMF program. Recent policy reforms in Ukraine, which have seen substantial fiscal devolution to the regional level, make this all the more important.

31. **An MTBF is a set of credible and enforceable rules, which provides a legitimate route to constraining spending in line with wider, often long-term, affordability and sustainability considerations.** Internationally well-regarded MTBFs exhibit sufficiently sophisticated rules-based frameworks to handle contingencies, such as one-off windfall revenues or macroeconomic shocks, without requiring frequent ad hoc adjustments to the system. In the context of Ukraine’s state budget MTBF, the pressing questions in this respect are:

- What is the appropriate mix of fixed versus indicative ceilings, given the need to strike the right balance between constraint and credibility?
- How to make the system adaptive to exogenous volatility from the macro-economy, and endogenous unpredictability in spending caused by large-scale reforms and technical capacity issues?

32. **The effectiveness of the MTBF depends on the credibility of the expenditure ceilings.** This tend to be built up over time by fulfilling previous commitments and is harder for governments to gain than to lose. There is scope to build progressively on the ceiling definitions of the pilot, gradually increasing the degree to which ceilings are fixed, as credibility is established. Following the integration of the Special Fund, overall ceilings for the General and Special Funds will be required, as well as corresponding ceilings for KSUs (Figure 1.2. depicts how the aggregate and KSU ceilings could evolve over time). To accompany the transition to fixed ceilings, an escape clause should also be designed to ensure that the MTBF does not inhibit an effective government response in the case of force majeure.

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\(^5\) With respect to the margins for Special Fund expenditure: The fixed KSU ceilings envisaged in the medium-term (see Figure 1.2) would have to be defined with rules for drawing on the overall margin within the Special Fund ceiling. An alternative approach would be to define the Special Fund ceiling itself net of carry-over expenditure, allowing any proportion of funding carried-over to float above the ceiling, but this is less advantageous in terms of fiscal control.
33. **After a transitional period, the Verkhovna Rada could approve the fixed ceilings as a law.** Currently, the Budget Declaration is adopted by the CMU, submitted to the Verkhovna Rada and approved as a resolution. However, consideration should be given to having the Budget Declaration, setting out the key elements of the MTBF (including the ceilings), approved by the Verkhovna Rada as a law. This would give ceilings the same legal status as the annual budget law, thus giving prominence to the strategic decisions of the MTBF and providing for a thorough involvement of the Verkhovna Rada on such strategic decisions at an early stage. While it could always be legally possible that the annual budget law (or any other law) supersedes the law approving the Budget Declaration, enshrining such declaration in a law would clarify the institutional roles of the legislative and executive branches of government and foster transparency and accountability. The legal technicalities of this approach would need to be carefully considered, as the timing and procedures for the enactment of a law are rather different than those envisaged for a Parliament resolution.

**Mechanism to Deal with Macroeconomic Volatility**

34. **Recent levels of macroeconomic volatility may compromise the integrity of the MTBF, unless a predetermined set of rules that specifically accommodates macroeconomic fluctuations is embedded in the framework.** Macroeconomy-driven revisions may be necessary not only for annual MTBF updates, but potentially also following serious in-year deviations of macroeconomic indicators from projected values. Although changing the MTBF numbers reduces credibility, this effect can be somewhat mitigated if such changes follow a pre-existing set of rules, which have established the relationship between certain macro-indicators and expenditure ceilings prior to revisions being made.

35. **In practice a technical amendments model can be developed, that specifies which macroeconomic indicators are allowed (fully or partly) to change budgets allocations, feeding through to higher or lower ceilings.** All budgets would be considered fixed in policy

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6 Alternatively, a specific category of variable expenditures could be defined, which are “indicator driven” because their level is explicitly linked to economic-cycle (e.g. unemployment benefits) or inflation (e.g. pensions are often automatically indexed). All other spending remains fixed, and can only be amended through policy-choices, requiring trade-offs within the ceiling. This system works well when the category of such indicator driven policies is reasonably narrow, which is not the case in Ukraine, rendering this approach inappropriate.
terms, but free to take on these predetermined “technical” adjustments. In this way, the government can explain and reconcile technical increases with reference to pre-existing rules, retain flexibility should technical increases be truly unaffordable, and bank technical decreases in line with pre-existing rules (Box 1.6).

**Box 1.6. Illustrative Example of a Simple Technical Amendments Model**

In the table below two expenditure categories—wages and goods and services—are adjusted for a new inflation forecast, feeding into a higher KSU ceiling.

<table>
<thead>
<tr>
<th>KSU</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>50.0</td>
<td>54.5</td>
<td>58.6</td>
<td>62.1</td>
</tr>
<tr>
<td>Goods and services</td>
<td>30.0</td>
<td>32.7</td>
<td>35.2</td>
<td>37.3</td>
</tr>
<tr>
<td>Other</td>
<td>20.0</td>
<td>22.0</td>
<td>24.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Ceiling based on inflation forecast 1</td>
<td>100.0</td>
<td>109.2</td>
<td>117.7</td>
<td>125.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Inflation forecast 1</th>
<th>9%</th>
<th>8%</th>
<th>6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation forecast 2</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>KSU</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>50.0</td>
<td>60.0</td>
<td>69.0</td>
<td>75.9</td>
</tr>
<tr>
<td>Goods and services</td>
<td>30.0</td>
<td>36.0</td>
<td>41.4</td>
<td>45.5</td>
</tr>
<tr>
<td>Other</td>
<td>20.0</td>
<td>22.0</td>
<td>24.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Ceiling based on inflation forecast 2</td>
<td>100.0</td>
<td>118.0</td>
<td>134.4</td>
<td>147.4</td>
</tr>
</tbody>
</table>

| "Technical" amendment of the ceiling | 8.8 | 16.7 | 22.1 |

Key macroeconomic indicators, such as inflation, interest rates, energy prices and exchange rates, can make up the independent variables of the technical amendments model. The degree to which those indicators are permitted to feed into higher/lower ceilings needs to be determined based on analysis.

36. **Once the MTBF develops and matures, the approach to the MTBF margin can become more sophisticated, with rules-based restriction on usage.** The notion of the margin is new in the Ukrainian system, and it may be hard to defend it throughout the budget execution in the first few years. Once the notion of maintaining a margin in planning is established, however, the margin can be reinforced with the introduction of rules governing when KSUs can access it. For example, rules could be introduced dictating that the margin can only be used for amendments not specified by the technical amendment framework, and which are unavoidable, unforeseeable, and urgent.

**Implementation of the Medium-Term Budgeting Framework**

37. **Implementing an MTBF in practice involves embedding a yearly cycle of a strategic prioritization phase and an iterative implementation phase.** The strategic phase involves using forward baseline estimates (FBEs) to calibrate the underlining consistency of current policies with fiscal targets, determine top-down budgets and inform policy negotiations with the KSUs. The implementation phase, which starts once the MTBF has been published and runs until the start of the next strategic phase, involves the iterative assessment of whether KSUs are still
on track to deliver policies on budget, and in compliance with the MTBF. This requires close collaboration with KSUs to track policy developments, constructively challenge plans, and re-baseline current programs accordingly. Special emphasis should be given to large-scale capital investment plans, which are inherently multi-year, and have a tendency towards uneven spending profiles. Where reassessment of programs suggests that KSU’s are over-spending, programs must be reprioritized accordingly to maintain compliance with the MTBF overall.

38. **The introduction of the MTBF calls for a stronger role for the MoF as the gatekeeper of public finances.** If KSUs introduce a new policy with spending implications, its medium-term impacts should be costed for integration with the MBTF. The legal framework requires that draft laws be subject to an assessment of impact on the public finances, based on a methodology to be developed by the MoF. It is important that this requirement is operationalized, and that strict impact assessments are conducted with respect to draft bills—whether they are prepared by members of the Verkhovna Rada or by KSUs.

39. **Introducing a meaningful strategic phase for the MTBF requires a new budget calendar (Box 1.7).** The legislated temporary changes to the BCU to allow the pilot to proceed with a budget declaration in June, rather than April will need to be permanently instituted to create sufficient time for the estimation of FBEs and a full strategic phase on an ongoing basis.

<table>
<thead>
<tr>
<th>Box 1.7. Proposal for Budget Calendar</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Feb: Start forward baseline estimate process (prepared by MoF, implemented with LM)</td>
</tr>
<tr>
<td>1. Mar: Macroeconomic projections available</td>
</tr>
<tr>
<td>15. Mar: Baseline estimates available</td>
</tr>
<tr>
<td>30. Mar: Fiscal space determined</td>
</tr>
<tr>
<td>15. Apr: CMU approves overall ceilings according to fiscal framework and consolidation requirements/use of fiscal space: MoF sends out draft ceilings to MSUs</td>
</tr>
<tr>
<td>15. May: MSUs transmit information to MoF; macroeconomic projections update available</td>
</tr>
<tr>
<td>Mid-May till mid-Jun: Intensive negotiation phase between MSUs and MoF about ceilings and fiscal measures to comply to theses; integration of macro-economic update</td>
</tr>
<tr>
<td>15. Jun: CMU approves fiscal strategy document</td>
</tr>
<tr>
<td>30. Jun: Verkhovna Rada approves the fiscal strategy document: MoF sends ceilings to MSUs</td>
</tr>
<tr>
<td>31. Jul: MSUs transmit documents on program level within ceilings and proposal for measures to comply to the ceilings; MoF starts 2nd Forward baseline estimate exercise with focus on these measures and updates Updated macroeconomic projections available</td>
</tr>
<tr>
<td>31. Aug: New baseline estimates available</td>
</tr>
<tr>
<td>15. Sep: CMU approves the Budget bill and submits it along with relevant materials to the Verkhovna Rada and the President of Ukraine</td>
</tr>
</tbody>
</table>

40. **Forward baseline estimates are the main technical tool for running an MTBF, and crucial to both the strategic and the implementation phase of the medium-term budget**
cycle. The forward baseline estimate is the building block through which the government assesses whether medium-term fiscal plans are feasible in their current state or require reform. FBEs are also the tools through which the MoF and KSUs can strip temporary effects such as one-time spending items due to court decisions or the sale of assets out of their past record, to provide a truer reflection of the underlying sustainability of their plans.

41. **The practical implementation of a strong system of FBEs involves some analytical and practical complexity.** The MoF, in collaboration with KSUs, will need to develop an official model (or series of models) to forecast key lines of spending under current policies. Such models can start relatively simple, and then be refined over time by adding or flexing variables, in light of their revealed predictive power ex post. Practically implementing such a system will require extensive training of government officials in the use of FBE modelling, as well as grounding the official model and its key parameters in secondary legislation.

**Recommendations:**

42. **Recommendation 1.3. Improve the design of the MTBF, by:**

- Integrating the special fund of the state budget into the MTBF.
- Introducing overall ceilings for the General Fund and the Special Fund of the state budget as well as KSUs ceilings for 2019 and commit to progressively fixing both the overall and KSU ceilings, excepting technical amendments or the triggering of an escape clause, for budget formulation and execution in the budget year while retaining their indicative status for all ceilings the two following years.

43. **Recommendation 1.4. Support the credibility and transparency of the MTBF, by:**

- Expanding the scope of the Budget Declaration, to induce a more strategic discussion of fiscal policy.
- Basing it on more timely and independent macro-economic forecasts.
- Limiting overspending of the Special Fund and reducing the amount of earmarking revenues in the state budget.
- Approving the fixed ceilings (included in the Budget Declaration) as a law enacted by the Verkhovna Rada, from 2020 onwards.
- Developing and implementing a technical amendments model with rules that define how specific ceilings can be adjusted when new macroeconomic projections are adopted by the Government.
- Providing for appropriate margins, and the reconciliation of changes to ceilings throughout the whole budget cycle.
- Presenting the state MTBF in a general government perspective in an annex to the “Strategic Budget Document.”
44. **Recommendation 1.5. Develop a forward-baseline-estimates methodology in the MoF.** Test it in Autumn 2017 with a view to introducing it for the preparation of the Strategic Budget Document 2019–21. Provide training on the FBE methodology to KSUs.

45. **Recommendation 1.6. Revise the Budget Code to include the fundamental features of the MTBF, delegating authority to regulate specific aspects in subsidiary regulations to the CMU and the MoF.**

- The law would need to include the key elements required to be in MTBF, such as preparation and adoption of the multi-year forecast and the fiscal strategy document, and a revised budget calendar that would take into account the interaction between the MTBF and the annual budget laws, including for the purposes of the margin and the reconciliation processes. In doing so, it will empower the government and the MoF to prepare the medium-term strategic fiscal policy documents, provide for the appropriate involvement by the Parliament in the discussion of such strategy, and hold these institutions accountable within their own respective mandates.

- At the same time, retain flexibility by leaving the decision on a number of technical details to CMU resolutions, such as with respect to margins and reconciliation.

II. **STRENGTHENING FISCAL RISK MANAGEMENT**

A. **Background**

46. **Ukraine’s public finances are exposed to several important fiscal risks.** These include: macroeconomic and geo-political risks; government guarantees of borrowing of state-owned enterprises (SOEs) as well as other exposures emanating from the sector, which is loss-making overall; and to a lesser extent, local government and public private partnerships (PPPs). The financial sector has also been a significant source of fiscal risk in recent years, with the failure of a large number of banks, whose deposits were backed by government guarantee. Table 2.1. provides an overview of the main fiscal risks in Ukraine and their relative importance.

47. **Disclosure of fiscal risks is limited and fragmented and frameworks for their management are underdeveloped.** The budget includes information on some fiscal risks, such as guaranteed debt of SOEs and partial disclosure of their quasi-fiscal activities, while further information on the performance of SOEs and local governments is available in other publications. But there is no disclosure of risks from macroeconomic shocks, public debt, or the financial sector, which are important sources of fiscal risks. Methodologies for managing fiscal risks are either lacking, or are not applied, where they exist. In an environment of limited fiscal space—public debt to GDP in Ukraine is around 70 percent of GDP—it is critical that the government strengthen its understanding, monitoring, and management of these risks.
Table 2.1. Fiscal Risks in Ukraine

<table>
<thead>
<tr>
<th>Risk</th>
<th>Disclosure</th>
<th>Importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic</td>
<td>Not reported</td>
<td>High</td>
</tr>
<tr>
<td>State-owned Enterprises</td>
<td>Partially reported in monitoring reports on the top 100 SOEs and annual budget</td>
<td>High</td>
</tr>
<tr>
<td>Guarantees</td>
<td>Reported on MoF website</td>
<td>Medium</td>
</tr>
<tr>
<td>Public-Private Partnerships</td>
<td>Not reported</td>
<td>Low</td>
</tr>
<tr>
<td>Financial Sector Exposure</td>
<td>Partially reported in Financial Stability Report</td>
<td>High</td>
</tr>
<tr>
<td>Public Debt Exposures</td>
<td>Debt liabilities disclosed, but risks not reported</td>
<td>High</td>
</tr>
<tr>
<td>Local government</td>
<td>Reported in execution reports and government finance statistics</td>
<td>Low</td>
</tr>
<tr>
<td>Natural Disasters</td>
<td>Not reported</td>
<td>Medium</td>
</tr>
<tr>
<td>Legal claims</td>
<td>Not reported</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Ministry of Economy, IMF staff estimates.

48. Recognizing this, the government has taken steps to strengthen fiscal oversight of SOEs and has committed to improving the management and disclosure of fiscal risks. In 2016, the government established a Fiscal Risk Management Division (FRMD) in the MoF with a mandate to oversee SOE risks. The government has also made fiscal risk management a key component of its PFM Reform Strategy (2017–21), aiming at: the development of an annual fiscal risk statement; strengthening capacity to assess fiscal risks arising from SOEs; improving interagency coordination in the monitoring and management of fiscal risks; strengthening safeguards to provide government guarantees; and improving the database on public sector assets.

49. This chapter examines current arrangements for monitoring, managing, and disclosing fiscal risks and discusses steps to strengthen them. It also provides an assessment of the main fiscal risks in Ukraine. It is not intended to be exhaustive, but rather aims to provide an indication of the potential exposures that authorities should consider in developing a comprehensive framework for the management and disclosure of fiscal risks.7

B. Institutional Arrangements

50. The MoF does not have an explicit legal mandate to monitor, assess, and manage risks to public finances. Certain responsibilities for the management of some fiscal risks are instead dispersed through various specialized departments and agencies (for example, the Debt Policy Department is responsible for the management of guarantees, while the Local Budget Department has oversight of local government finances). The lack of comprehensive fiscal risk management framework means that no department has aggregate perspective on the range of fiscal risks that can impact public finances. Understanding aggregate fiscal risk exposures is

7 Some potential sources of fiscal risks, such as operational risks related to the PFM system at large, political risks, or potential risks from natural disasters, are not considered in this report. The IMF's Fiscal Transparency Code provides a coherent framework for assessing country practices in management and disclosure of fiscal risks, in addition to fiscal reporting and budget planning.
important for medium-term fiscal planning and policymaking, as discussed in Chapter I, and in understanding the potential interactions between various sources of fiscal risks.

51. **The recent establishment of the FRMD is a positive step but its mandate should be reconsidered.** This is particularly important given the fragmented ownership and oversight arrangements of SOEs that currently exist in Ukraine. The FRMD will have responsibility for monitoring the financial performance of SOEs, analyzing fiscal risks associated with the sector, and providing recommendations for their management. However, as highlighted by the FAD TA mission in November 2015, the role of the FMRD goes beyond the typical functions of a fiscal risk unit. The FRMD also has responsibility for overseeing and improving the efficiency of financial and commercial operations of large SOEs and natural monopolies whose financial plans are subject to approval by the CMU. This task had been delegated by the CMU to the MoF before the establishment of the FRMD. Still, its ongoing role in overseeing commercial operations of SOEs risks undermining reforms to the governance structure of SOEs where the emphasis is on increasing the accountability of supervisory boards and managers and reducing political interference in their operations. It will therefore be important that these functions are wound down, as supervisory boards are established in SOEs.

52. **The MoF’s mandate to manage fiscal risks needs to be strengthened and widened.** The legal basis for SOE oversight function is weak. The FRMD’s mandate to support a system for managing the fiscal risks associated with SOEs is established by a ministerial order, and has been subsequently complemented by a CMU Resolution. However, the authority may not be sufficient to empower the MoF to carry out its functions effectively. In order to ensure that these powers are duly supported by enforcement mechanisms, the mandate should be provided under the primary law, in the Budget Code. Implementing a comprehensive fiscal risk management framework, as is envisaged in the PFM strategy, will also require a widening in the FMRD’s mandate to cover all material fiscal risks. Other countries that have established comprehensive systems for fiscal risk monitoring and management, have supported these through explicit legal mandates (see Box 2.1).

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8 See for example, Olden et al (2015) “Reforming Management and Oversight of State Assets.” Fiscal Affairs Department, IMF.


10 CMU Resolution No. 662 of 2015 and subsequent amendments in CMU Resolution 820 of 2016.

11 The authorities are preparing draft amendments conferring the MoF a fiscal risk oversight mandate with respect to SOEs. While this is certainly a positive step, it is appropriate that a broad mandate, covering all material fiscal risks is provided for under the Budget Code.
Fiscal risk oversight must be underpinned by a legal framework covering the different phases of such oversight: monitoring through the reporting of information, analysis of the various sources of risks, and disclosure of such analysis and mitigating actions through publications of reports and fiscal risks statements.¹

**Legal mandate.** A number of jurisdictions favor a centralized fiscal risk oversight function, usually under the MoF. This function should be supported by a robust legal framework providing for clear institutional arrangements and an explicit legal mandate for overall fiscal risk monitoring and management.

**Powers to collect information.** The various sources of fiscal risks tend to be spread over a range of government institutions, entities and (published or unpublished) material. The agency in charge of fiscal oversight needs to have the legal authority to require the relevant information from different government entities, agencies and SOEs, allowing it to identify and analyze the risks, quantify their interrelationships and evaluate mitigation measures.

**Disclosure.** The preparation of a fiscal risk statement and the disclosure of information on fiscal risks by the relevant fiscal oversight agency should have the necessary legal basis at the level of primary law to i) ensure that such information is duly integrated with the budget process, and that the analysis on fiscal risk is subject to independent assessment; ii) allow transparency on risk mitigating measures; iii) facilitate parliamentary scrutiny.

For country examples of legislative provisions on fiscal risk oversight (see Annex III).

¹ This Box examines the phases, without entering into the specific mitigating actions that might be taken.

53. **A comprehensive fiscal risk management reporting framework should be put in place to support the FRDM’s functions.** Effective fiscal risk management is currently hampered by lack of sufficient and reliable information about sources and likelihood of risks. The MoF should be provided with broad powers to collect all types of information necessary for its fiscal risk assessment. To support this, templates specifying the range of information needed should be developed by the MoF.

54. **To facilitate effective fiscal risk monitoring, the responsibilities of various agencies need to be clearly assigned.** While the responsibility for identification, estimation, analysis, and monitoring of specific fiscal risks should be retained within specialist departments at the MoF or other ministries (primarily responsibility for management of public debt and guarantees should remain with the DPD for example), the FMRD will need to play a role in coordinating and consolidating this analysis, forming an aggregate view on fiscal risk exposure, and recommending mitigating actions.

**Recommendations**

55. **Recommendation 2.1. Strengthen and broaden the fiscal risk management mandate of the Ministry of Finance.**
• Amend the Budget Code to assign responsibility for fiscal risk monitoring and assessment to the Ministry of Finance (end-2017);

• Broaden the mandate of the FRMD to include coordination of the management of overall fiscal risks among the different departments and government entities through a CMU resolution (end-2017); and

• Transfer the function of oversight of financial and commercial operations of SOEs from the FRMD to supervisory boards, once they have been established.

56. **Recommendation 2.2. Establish a comprehensive reporting framework for fiscal risk management.**

- Update the functional responsibilities of government departments to clearly specify their roles and responsibilities in fiscal risk monitoring and management (March-2018).

- Define information templates for exchange of information between specialized department in the MoF and other government agencies, and timetable for their submission (Jan-2018).

**C. Developing a Comprehensive Fiscal Risk Statement**

57. **There is limited disclosure of fiscal risks in the budget documentation.** The Budget Code (Article 38) establishes the list of documents to be submitted to parliament with the annual budget bill including, amongst other things, loans and guarantees to SOEs and their quasi-fiscal operations, although the latter is not yet complete (see sub-Section E). There is no discussion in the budget of the fiscal risks associated with macroeconomic shocks, public debt exposures, or other contingent liabilities. Some additional information related to fiscal risks is available in other publications, for example, the financial position of SOEs and local governments (see sub-Sections E and H), but these are not used as input to budget formulation or risk mitigation.

58. **Publication of a comprehensive statement on fiscal risks would help policymakers better understand their underlying fiscal position and risks to the outlook.** Identification and disclosure of fiscal risks ensures that policymakers, the public, and legislature understand the risk exposures and their potential impact to public finances. It also provides the basis for development of risk mitigation strategies. Further, disclosing fiscal risks can help underpin credibility and market confidence by signaling that the government is aware of these risks and has strategies in place to mitigate them. When information is spread across different reports, or missing altogether, it becomes difficult for policymakers to understand aggregate risk exposure, form assessments about which are the most important risks and determine the appropriate policy responses. To support this, a fiscal risk statement (FRS), identifying, quantifying where possible, and setting out the governments strategies for mitigating risks should be published with the budget declaration in June, and updated for material changes, in the annual budget (see Chapter I, Section D). Annex IV provides a suggested template for a comprehensive fiscal risk statement.
59. **The FRS should initially focus on the most significant fiscal risks and be broadened over time to include all material risks to public finances.** Developing a comprehensive FRS will require a concerted effort to develop the necessary analytical skills, gradually build knowledge and experience within the MoF and other parts of government. For this reason, the fiscal risk statement included in the 2017 budget declaration, should focus on disclosure of fiscal risks related to the SOE sector, as well as include a qualitative discussion of macroeconomic risks and public debt exposures. Over time, the FRS should be broadened to cover all material fiscal risks and provide more detailed analysis about their potential impact. Recommendations on assessment and disclosure of macroeconomic and specific fiscal risks are discussed in more detail in the subsections below. Annex V provides a suggested action plan for developing the FRS over the next three years.

60. **The development of the FRS will also require close cooperation between the FRMD and other departments and other agencies.** The FRMD should be responsible for compiling the FRS, drawing on data, analysis, and input from the different departments within the MoF and other agencies. The responsibilities of the various departments and government agencies should be clearly defined by a CMU resolution, or where necessary, memorandums of understanding (for example, with the NBU). Table 2.2. provides a tentative proposal for how this work could be organized across government.

<table>
<thead>
<tr>
<th>Risk</th>
<th>Data Provision</th>
<th>Analysis</th>
<th>Drafting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic</td>
<td>MFD (macroeconomic scenarios)</td>
<td>MFD, RFD, BD, FRMD</td>
<td>MFD, FRMD</td>
</tr>
<tr>
<td>Debt</td>
<td>DPD</td>
<td>DPD</td>
<td>DPD, FRMD</td>
</tr>
<tr>
<td>SOEs and Guarantees</td>
<td>LMs, MEDT, BD, FRMD, DPD</td>
<td>FRMD</td>
<td>FRMD</td>
</tr>
<tr>
<td>Local Government</td>
<td>DLG</td>
<td>DLG</td>
<td>FRMD</td>
</tr>
<tr>
<td>PPPs</td>
<td>MEDT, BD</td>
<td>FRMD</td>
<td>FRMD</td>
</tr>
<tr>
<td>Financial Sector</td>
<td>NBU, FPD</td>
<td>FPD</td>
<td>FPD</td>
</tr>
<tr>
<td>Legal Claims</td>
<td>MoJ</td>
<td>MoJ</td>
<td>MoJ, FRMD</td>
</tr>
<tr>
<td>Natural Disasters</td>
<td>MENR, BD</td>
<td>MENR</td>
<td>MENR, FRMD</td>
</tr>
</tbody>
</table>

Note: MFD – Department of Economic Strategy and Macroeconomic Forecasting, MEDT; FRMD – Fiscal Risk Management Division, MoF; RFD – Revenue Forecasting Department, MoF, DPD – Debt Policy Department, MoF; BD – Budget Department of MoF; FPD – Financial Policy Department, MoF; DLG – Department of Local Budgets, MoF; MoJ – Ministry of Justice, MENR; Ministry of Ecology and Natural Resources.

**Recommendations**

61. **Recommendation 2.3. Prepare and publish an annual fiscal risk statement as part of the budget documentation.**

- Amend Article 38 of the Budget Code to require submission of a FRS with the budget declaration and update, as necessary, for submission with the annual budget law (end-2017).
• Define, in a CMU resolution, the responsibilities of the various agencies, required inputs, timetable for their provision, and approval processes, to facilitate preparation and publication of the FRS (February 2018).

• For 2017, publish a qualitative discussion of macro-fiscal risks, preliminary assessment of SOE-related fiscal risks (including guarantees, transactions with government, and quasi-fiscal activities) in the budget declaration and, update as necessary, for the annual budget (June and September 2017).

• From 2018, gradually expand the fiscal risk statement to cover all material fiscal risks to public finances and include sensitivity and scenario analysis and risk mitigation strategies (2019 and 2020 budgets).

D. Macroeconomic Risks

62. Macroeconomic volatility creates large fiscal risks in Ukraine. Ukraine’s reliance on global demand and the composition of its exports, mean its economy is particularly exposed to developments in major trading markets and global commodity prices. Metal and mining, for example account for almost one-third of Ukraine’s exports, and international trade and mineral taxes make up around 10 percent of state budget revenues. The ongoing military conflict in the eastern part of Ukraine has also been the cause of significant uncertainty in recent years, contributing to a sharp contraction in growth, depreciation in the exchange rate and financial market turmoil. The depreciation in the exchange rate over 2014–15 was largely responsible for driving a 40 percent of GDP increase in general government gross debt over that period.

63. Volatility in the nominal economy, and as a result, government revenues, is high. Figure 2.1 shows the volatility of nominal GDP and general government revenue (measured as the standard deviation of growth rates) for Ukraine and selected comparator countries. Nominal GDP growth volatility is well above that experienced by emerging European and some CIS countries. This has contributed to a relatively volatile revenue base.

Figure 2.1. Volatility of Nominal GDP and Revenue Growth
(percent, 2005–15)

Source: IMF WEO database, October 2016.
Note: Volatility is measured by the standard deviation of the annual growth rate. Revenue is general government. Comparator countries include the commonwealth of independent states and emerging Europe.
64. **Economic volatility has also resulted in sizeable deviations in macroeconomic and fiscal outcomes from forecasts.** As outlined in Chapter 1, budget year real GDP forecasts in Ukraine have deviated from outcomes by a sizeable margin (around 4 percentage points, on average), reflecting the difficulty of forecasting accurately in a volatile economic environment. Adjusting for volatility significantly reduces the average deviation between forecasts and outcomes, but forecast errors nevertheless remain large.

65. **Despite the large exposure to macroeconomic risks, the budget does not include a discussion of them or their potential implication for public finances.** The government generally publishes two medium-term scenarios for the major macroeconomic variables, a baseline scenario and an alternate scenario, which includes the impact of economic reforms. However, these forecasts, which are published as a resolution of the CMU and on the MEDT’s website, are not accompanied by a discussion of the main risks to the economic outlook, or the potential for these risks to impact the key fiscal aggregates. Nor is there any discussion on risks to the macroeconomic outlook in either the budget declaration or annual budget.

66. **Macro-fiscal risk analysis should be a key input to fiscal policymaking.** Analysis of the fiscal impacts of potential deviations in macroeconomic variables from their forecasts is essential to ensuring fiscal policy settings are sustainable even in the face of plausible alternative economic developments. Developing capacities for macro-fiscal risk analysis will take some time and require close cooperation between the Budget Department and Revenue Forecasting Division in the MoF, and the Department of Economic Strategy and Macroeconomic Forecasting in the MEDT.

67. **A first step towards reflecting macro-fiscal risks in the FRS is to disclose forecast errors in the macroeconomic and fiscal forecasts for previous years.** This would include analysis comparing medium-term macroeconomic forecasts (budget year, one-year ahead, and two-years ahead) with outcomes. Similar analysis should be included for revenue and expenditure, albeit with forecast comparisons only for the budget year. Once the MTBF is in place, the analysis can be expanded to include the comparison of outer-year forecasts to outcomes. Assuming that past forecasts errors are a guide to future forecast errors, this analysis provides a sense of the degree of uncertainty surrounding the budget forecasts.

68. **As capacity is developed, the FRS could be expanded to include sensitivity analysis or alternative macro-fiscal scenarios.** Sensitivity analysis can be a useful tool to illustrate how changes in discrete macroeconomic variables (such as, real GDP, inflation, exchange rate, oil prices, interest rates etc.) impact on the key fiscal aggregates (expenditure, revenue, debt and deficit). Historical evidence can inform the size of the shocks applied under sensitivity analysis. For example, GDP sensitivity analysis could consider a shock equal to one standard deviation of

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12 For a good illustration of this presentation of forecast errors, see Australian Budget Paper No 1, Statement 7: Forecasting Performance and Scenario Analysis, 2016-17.
the growth rate observed over the past decade or so. Table 2.3 illustrates the medium-term path for the primarily budget balance and government debt after unanticipated shocks from different variables are applied. A more integrated approach, would involve estimating the fiscal implications of a range of alternative macroeconomic scenarios to capture the interactions between the various macroeconomic variables.13

<table>
<thead>
<tr>
<th>Table 2.3. Ukraine: Illustration of Sensitivity of Fiscal Aggregates to Real GDP Shock (change, percentage points of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP Shock</strong></td>
</tr>
<tr>
<td>Real GDP Forecast</td>
</tr>
<tr>
<td>Real GDP Alternative Scenario</td>
</tr>
<tr>
<td>Increase in Debt (percent of GDP)</td>
</tr>
<tr>
<td>Impact on primary balance (percent of GDP)</td>
</tr>
</tbody>
</table>

Source: Debt Sustainability Analysis, Ukraine Staff Report for the 2016 Article IV Consultation and Third Review, 2017.
Note: Real GDP shock based on one historical standard deviation in 2018 and 2019. Analysis is based on IMF staff forecasts prepared for the third review. These have since been updated, with real GDP now forecast to grow by 2 percent in 2017 and 3.2 percent in 2018.

**Recommendations**

69. **Recommendation 2.4. Strengthen analysis and disclosure of macroeconomic risks** by:

- Publishing a qualitative discussion of macroeconomic risks in the budget declaration and annual budget for 2018 (June 2017); and
- Include an assessment of past forecast errors in the FRS for the 2019 Budget and expand on this in the 2020 Budget to include macro-fiscal sensitivity analysis for the most fiscally-relevant macroeconomic variables and/or scenario analysis (June 2019).

**E. Fiscal Risks Related to State-Owned Enterprises**

70. **Ukraine’s SOE sector is a large source of fiscal risk.** There are around 3,350 SOEs in Ukraine, although only around 1,800 of these are generating economic activity (the remainder exist in name only). The MEDT has estimated that the largest 100 nonfinancial SOEs account for about 90 percent of the total assets and 80 percent of net income of the sector. Total assets of the top 100 SOEs were around UAH 1.4 trillion (70 percent of GDP) at end-2015, while their non-equity liabilities were around UAH 490 billion (25 percent of GDP). In addition, there are four state-owned banks with liabilities worth around 25 percent of GDP (see sub-Section E).

13 For a good illustration of sensitivity analysis see either the Armenia Budget Statement on Risks to the Budget Plan, or the Philippines Fiscal Risk Statement. 2015-16, for good examples of scenario analysis include Australia, New Zealand, and Georgia.
71. **To varying degrees, SOEs also rely on State fiscal support.** This includes direct budget subsidies, as well as debt-servicing support and guarantees. Direct subsidies from the budget were around 1 percent in 2016, which is down substantially from 2.5 percent of GDP in 2015.\(^{14}\) Indirect subsidies, associated with Naftogaz provision of below-cost energy, have been reduced substantially following energy tariff reforms, and are no longer envisaged over the medium term. In addition, SOEs benefit from credit support and state guarantees on their borrowing, with the State budget servicing of guaranteed loans averaging around 0.7 percent of GDP per year in guarantees over the past five years. The implementation of EU state aid requirements from August 2017 will have implications for the delivery of new state support to SOEs.\(^{15}\)

72. **The weak performance of the sector exposes the government to significant fiscal risks.** In 2015, around one-third of SOEs were loss-making, with combined losses of these entities amounting to around 2.9 percent of GDP. While these losses were partially offset by earnings of profitable enterprises, the sector as a whole was loss-making in 2015 (Figure 2.2). In 2015, the sector generated net loss of 2 percent of GDP in total, and an average rate of return of around -6 percent. The government has not yet published monitoring reports for 2016, but aggregate data for the top 50 companies suggests the performance of the sector is improving.

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\(^{14}\) Two-thirds of fiscal support to SOEs are provided by local governments, while one-third is provided by the State government.

\(^{15}\) Under the EU-Ukraine Association Agreement, Ukraine is required to roll out state aid regulation. The Law on State Aid, No 34. of 2014, becomes effective from August 2017. The framework assigns responsibilities to the Antimonopoly Committee to assess whether new state aid measures are justified and compatible with competition. This may have implications for the delivery of subsidies, debt-servicing, guarantees, and other benefits to SOEs, where they confer a competitive advantage other than for the purposes of promoting economic and socio-economic development.
73. **A more detailed assessment of the financial performance of the largest SOEs suggests that a number of entities were facing financial difficulties in 2015.** Financial indicators for 2015 show that of the 100 largest nonfinancial SOEs (ranked in terms of size of liabilities):

- One-third of enterprises were failing to make a profit on their operating activities;
- 15 percent had a negative return on assets greater than 10 percent;
- Around one-quarter were highly leveraged (with a debt to equity ratio greater than one); and
- Around one-quarter had negative shareholder equity, that is, their liabilities exceeded their total assets. Further, some of these entities were also loss-making, further eroding shareholder equity (Figure 2.3).

74. **A draft methodology for assessing fiscal risks of SOEs has been developed by the FRMD and provides good basis for risk assessment.** The methodology ranks SOEs into five different risk categories, based on their profitability and leverage. SOEs that are both loss-making and highly leveraged (their net debt to earnings ratio exceeds four) are placed in the highest risk category. This is a practical approach and is consistent with IMF advice on fiscal oversight of SOEs. In addition to ranking entities based on financial ratios, consideration should be given to automatically assigning to risk category one, entities whose debts are being serviced by the government or who have received capital injections within the past three years. Those SOEs that are deemed to be of high risk should be subject to more intense monitoring and potentially stricter financial controls and be required to put in place mitigating measures. In addition, larger public corporations that are macro-critical, should also be subject to strict oversight, even if the risk they pose is low.

75. **Monitoring a set of financial indicators is, however, only a first step.** While these indicators can point to signs of trouble, deeper company-specific analysis (as is envisaged in the draft methodology) will need to be carried out in order to determine whether there is actually a problem and inform any mitigating measures that may be required.

76. **Consideration should also be given to expanding the set of financial indicators outlined in the methodology.** The methodology outlines a set of financial indicators and information on state support which will form the basis of fiscal risk analysis. In addition, it examines other nonfinancial indicators that can impact on performance, such as managerial independence, relations with government and management structure, as outlined in an earlier IMF framework on assessing SOE risks. Consideration should be given to expanding the set of

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financial ratios and, in some cases consolidating indicators that are overlapping. Advice on potential amendments to the methodology is set out in Box 2.2.

**Box 2.2. Improving the Methodology for Assessing Fiscal Risks of SOEs**

The following changes to the draft methodology for SOE fiscal risk assessment could be considered to strengthen the information base and approach for ranking SOEs.

- Require that the information underlying the ratios used for risk analysis also be submitted including: total income, operating income, total expenses, operating expenses, interest costs, short-term liabilities, and current assets.
- Expand the set of indicators on foreign currency exposure to include: debt and assets held in foreign currencies, and interest expenses and interest income in foreign currencies. This will facilitate more robust analysis of the impact of exchange rate shocks on SOE financial positions.
- Add the current ratio to supplement one of the methodology. The current ratio (current assets to short-term liabilities) measures the ability of an enterprise to meet debt obligations falling due over the coming year from current resources. While the level of the ratio that is deemed to be reasonable will depend on the stability of an entities cash flows, generally a ratio of two or higher is considered to be acceptable, while a ratio less than one is cause for concern.
- Move the interest coverage ratio (earnings before interest and tax to interest expenses) to supplement one, and remove the financial condition indicators from supplement three as these are duplicative;
- Benchmarking SOEs against industry and international rate of return indicators should be done in a way that shows the percentage deviation from the benchmark (as opposed to stating whether the ratio is above or below the benchmark). This will highlight the degree of over or under-performance, which is relevant, and also enable comparisons over time about whether the entity is moving closer or further away from the benchmark.
- While supplement two requires important information to be submitted on actions SOEs are undertaking to strengthen their financial performance and mitigate fiscal risks, the requirement for SOEs and LMs to self-evaluate fiscal risks (indicators 4-6) is unlikely to generate reliable contributions. Consideration should instead be given to asking specific questions that may give rise to risks such as:
  - information on economic factors that may result in specific activities being loss-bearing;
  - non-profit activities conducted for policy purposes;
  - liabilities of SOEs where servicing may become a problem; and
- information on contingent liabilities of SOEs (such as pending legal cases against the SOE or guarantees, or letters of comfort provided by the SOE to third parties).

77. **To minimize the reporting burden on LMs and SOEs and ensure consistency, it will be important that a single database encompassing all required information is developed.** Many of the financial indicators required by the MoF to undertake its risk assessment are currently collected by the MEDT for the publication of the top-100 SOE monitoring report. The two ministries should work on harmonizing the process of collection and the timeframes.
78. The Government has taken a number of steps to mitigate fiscal exposure from the SOE sector and strengthen transparency. These include:

- Reducing quasi-fiscal activities (QFAs) of the state-owned Naftogaz and requiring disclosure of QFAs, for the first time in the 2017 Budget;
- Strengthening the governance of SOEs by requiring that supervisory boards be established with a majority of independent members for SOEs with more than UAH 2 billion in assets or net income exceeds UAH 1.5 billion;\(^\text{18}\)
- Transparency reforms, including: publishing quarterly and annual monitoring reports on the financial performance of the largest 100 SOEs; requiring large SOEs (as above) to have their financial statements audited by an approved auditor, and recommending similar arrangements for unitary enterprises.\(^\text{19}\)

79. The disclosure of QFAs is a welcome initiative, but the list is not yet complete. CMU resolution No. 692 of 2012 lists thirteen forms of QFAs and agencies responsible for disclosing them, but only 5 categories were disclosed in the 2017 Budget. Missing, for example, was information on QFAs undertaken by railway sector SOEs, who charge below-cost prices for passengers, and subsidize this from their cargo operations. The cost of this subsidy is estimated to be around UAH 8 billion.\(^\text{20}\)

80. To further enhance transparency, the Government has committed to publishing an assessment of SOE-related risks in the 2018 Budget. This will be a preliminary assessment, to be expanded over time. The initial assessment should include: (i) aggregate statistics for the size of the sector; key financial performance indicators for the sector (such as earning and rate of return ratios), and total assets and liabilities; (ii) guarantees on SOE debt; (iii) sub-lending to SOEs; (iv) expanded information on QFAs; (v) transactions with the government (dividends, subsidies etc.); and (vi) measures to strengthen SOE performance and minimize fiscal exposures. For subsequent statements, analysis should be expanded to include a wider set of indicators.

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\(^\text{18}\) This would require around 44 SOEs to have supervisory boards. There has, however, been very little progress in installing supervisory boards over the past year. The authorities hope that the recent CMU resolutions on appointing members of supervisory boards will jump start the process. CMU Resolution No. 146, approved on 10 March 2017 sets out the method for selection and criteria of independent supervisory board members, including that they must not occupy an elected positions and not be officials of state or local government bodies. However, even in those cases where independent supervisory boards have been established (for example, Naftogaz), their functions remain purely advisory, therefore calling to complementing these reforms with passage of a new governance law.

\(^\text{19}\) The government had sought to make external audit of financial results obligatory for all state unitary enterprises, however, this provision was amended in Parliament. The Government is also considering how to respond to a stock-exchange ruling that would effectively remove the obligation for public joint-stock companies (and therefore joint-stock SOEs) to publish audited financial statements.

\(^\text{20}\) See Olden et al Reforming Management and Oversight of State Assets”, Fiscal Affairs Department, IMF.
(including debts past due to the government and third parties); and individual assessment of fiscal risks arising from the largest SOEs.

81. **As capacity is developed, more sophisticated risk analysis tools can be adopted, and incorporated into the FRS and internal reports.** As outlined in the FAD March 2015 TA report, risk assessment tools including scenario and sensitivity analysis can be applied to SOE budget plans to determine the impact of sizeable shocks to exchange rates, commodity prices and other key variables and inform assessment of the likelihood of risks to the government’s budget materializing. This will, however, require a scaling up of analytical capacity over time.

**Recommendations**

82. **Recommendation 2.5. Strengthen the information base and capacity to undertake fiscal risk assessment of SOEs and commence quarterly internal reporting on SOE fiscal risks.**

- Amend the draft methodology for assessing SOE fiscal risks to include the expanded set of financial indicators outlined in Box 2.2 and codify in a CMU Resolution (*June-2017*).
- Establish a single central database (excel-based initially) of SOE financial indicators and state support (*March-2018*).
- Strengthen capacity in the MoF to undertake financial ratio analysis (*end-2017*) and, over time, develop sensitivity and scenario analysis to estimate the impacts on the SOE sector and the budget of a variety of shocks (*end-2018*).
- Submit quarterly reports on SOE financial performance and risks to the CMU (including an assessment of financial performance for the sector in aggregate as well as more detailed analysis of those SOEs deemed to be high risk or macro-critical) and require SOEs in risk category one to prepare action plans to mitigate risks and regularly report on progress against them (*end-2017*). SOE action plans should be reviewed and monitored by the shareholding ministry and FRMD, with this role shifting to supervisory boards as they are established.

83. **Recommendation 2.6. Improve disclosure of SOE-related fiscal risks by:**

- Including in the budget declaration preliminary analysis of SOE fiscal risks, including aggregate information on the financial position of SOEs, guarantees and loans to SOEs, QFAs, and budget support provided to SOEs, and updating this as necessary, for the annual budget (*June 2017*);
- Expanding disclosure in subsequent FRS, to include more detailed analysis on the financial performance and fiscal risks created by the largest SOEs as well as their contingent liabilities

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21 Op cit.
(June 2019); and sensitivity analysis to estimate the impacts on the SOE sector and the budget of a variety of shocks, including in particular the exchange rate (June 2020).

F. Long-term Sustainability

84. Ukraine’s pension system coupled with an ageing population creates large and uncertain fiscal costs. As outlined in the most recent Article IV Consultation Report, Ukraine has one of the highest levels of pension spending in Europe, despite having a low average benefit. This is a result of a very large number of beneficiaries. Further, a low contribution rate and compliance has resulted in a large deficit of the Pension Fund of around 6 percent of GDP in 2016 (Figure 2.4). Fiscal pressures are expected to grow over the medium term as the population continues to age. Absent policy changes, the number of pensioners to contributors is expected to increase from a ratio of 1 to 1 now, to a ratio of 1.3 pensioners to every contributor in 2040, the highest increase in comparator countries (Figure 2.5). The authorities have committed to implement reforms to put the pension system on a more sustainable basis, including by expanding the base for social security contributions and providing incentives for workers to defer retirement.

85. Assessments of the long-term costs of the pension system are not systematically conducted or published. The Pension Fund conducts periodic actuarial assessments of longer-term pension costs, but these are ad hoc and are not published. There is no assessment of other long-term cost pressures that may be generated by the broader social-security system or health sector.

Recommendations

86. Recommendation 2.7. Publish long-term estimates of the fiscal costs associated with the pension system.
• Publish long-term estimates of pension contributions and pension benefits in the annual report of the Pension Fund and prepare long-dated (at least 30 year) projections of the budgetary costs of financing the Pension Fund deficit for publication in the FRS for the 2020 Budget (June-2019).

G. Debt-Related Risks

87. Ukraine has a large debt portfolio, with a large share denominated in foreign currency. General government debt was around 70 percent of GDP at end-2016. About three-quarters is denominated in foreign currency. Given the volatility of the exchange rate, this creates large fiscal exposures (Figure 2.6). However, the share of foreign currency debt is projected to decline in coming years.\(^{22}\) The sharp depreciation in 2014–15 contributed to around a 40 percent of GDP revaluation in the debt portfolio (Figure 2.7). As a result, some restructuring of external debt has taken place.\(^{23}\) The share of public debt held by nonresidents is high (at around two-thirds), although the shift from private to official creditors is reducing this risk somewhat. Rollover risks are mitigated somewhat by the fact that only a small share of debt (around 7 percent) has a maturity of less than one year. There is some interest rate risk, with around 30 percent of debt issued in variable interest rate instruments.

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**Figure 2.6. Exposure to Forex General Government Debt**

Source: FSI, Eurostat, WEO.
Note: Forex debt in 2015, exchange rate volatility is standard deviation/average exchange 2000-2015. Euro area in blue.

**Figure 2.7. Reconciliation of Changes in Government Debt** (percent of GDP)

Source: IMF Staff Report for the 2016 Article IV Consultation, 2017.

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22 IMF Staff Report for the 2016 Article IV Consultation and Third Review Under the Extended Fund Facility, 2017.

88. **All borrowing is approved by the CMU and authorized by Law.** The Budget Code (Article 18) further specifies an aggregate ceiling of 60 percent of GDP on public debt and publicly guaranteed debt, which has not been complied with in recent years. The annual budget law sets a cap on new issuance during the year.

89. **While the government reports regularly the stock of government debt outstanding, no reports discuss the main risks to the debt portfolio.** The MoF reports regularly on the stock of State debt by instrument and by creditor. There is no current debt management strategy in place, with the last strategy published in 2013 for the period 2013–15. Efforts are underway, however, to develop the next debt management strategy with the assistance of consultants. The Debt Policy Department (DPD) doesn’t currently conduct debt sustainability analysis (DSA), but has signaled an interest in developing this capacity.

**Recommendations**

90. **Recommendation 2.8. Strengthen disclosure of fiscal risks related to the debt portfolio by:**

   - Including a qualitative discussion of the main debt exposures in the FRS for the 2018 Budget (June 2017);
   - Expanding this to include quantitative sensitivity analysis of the debt portfolio to changes in exchange rates and interest rates (June 2018), and debt sustainability analysis along the lines of the IMF DSA framework. (June 2019).

**H. Contingent Liabilities and Implicit Fiscal Risks**

**Guarantees**

91. **Government guarantees represent a fairly significant source of fiscal risk in Ukraine.** At end-2016, the stock of guaranteed debt was UAH 278.9 billion or 12.2 percent of GDP (Figure 2.8). A large share of this relates to loans provided to the NBU from the IMF (around UAH 170 billion or 7.5 percent of GDP), which are guaranteed by the Ukrainian government. The remainder are guarantees issued to SOEs, with one exception where a guarantee was provided to a private company to ensure fulfillment of a defense contract. The bulk of state-guarantees are provided for external borrowing. The likelihood of fiscal risks materializing from state-guarantees is high, with fiscal costs associated with debt servicing of guaranteed debt averaging around 0.7 percent of GDP over the past five years (Figure 2.9).

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24 Budget Code, Article 16.

25 Article 18(2) of the Budget Code provides a procedure for the authorization to exceed the debt limit and a remedial action to be proposed by the CMU and approved by the Parliament.
92. **The legal framework imposes certain controls on the issuance of guarantees.** The Budget Code requires all guarantees, including those issued by local governments, to be approved by the CMU. Article 18 of the Budget Code imposes an aggregate ceiling on public debt and state guarantees of 60 percent of GDP, although this has been exceeded in recent years, primarily due to the sharp depreciation in the currency. Limits on the annual issuance of new guarantees are also set in the annual budget law (as required by the Budget Code) and the current IMF program. The annual budget also includes a provision for expected calls on guarantees.

93. **While risk assessments are required prior to issuance of guarantees, the methodology for conducting these is not well-established.** CMU resolution No. 131 of 2011, requires that risks associated with the financial condition of the borrower and financial viability of the project to be financed through the guarantee be assessed. The MEDT is responsible for providing opinion on the financial viability of the project, while the MoF is responsible for providing an opinion on credit risks. However, there have been some cases where the CMU has not abided by the opinion provided by the MoF, and some reports of the CMU approving guarantees, without the benefit of an MoF opinion. Furthermore, there is no established methodology within the MoF for assessing credit risks associated with guarantees. Given that the bulk of guarantees are issued to SOEs, such a framework could draw on the methodology being used to assess SOE-related fiscal risks. Box 2.3 provides examples of approaches that have been adopted for assessing credit risks of guarantees. As capacity is developed in the FRMD, they should play a greater role in the process of approving guarantee on SOE borrowing.

94. **Similarly, there is no clear criteria or methodology for charging guarantee fees to beneficiaries.** Guarantee fees can represent an effective mechanism to internalize the cost of the guarantee to the beneficiary. However, neither the Budget Code, nor supporting resolutions on guarantees require that risk-based fees be charged to beneficiaries of state guarantees. The
introduction of state aid regulations from August 2017 is likely to require risk-based fees on guarantees that are not in aid of economic or social-economic development. However, currently there is no methodology or procedures for determining in what circumstances guarantee fees will be charged, or their amount.

Box 2.3. Country Approaches to Assessing Credit Risks and Establishing Risk-Based Guarantee Fees

Countries rely on a range of techniques to quantify credit risks associated with guarantees, each involving different levels of sophistication. There are a variety of approaches to credit risk analysis, including: basing assessments on historical data where this is available (for example, default rates on guarantees to groups of individuals such as student loans, farmers, export finance); using third party (credit rating agencies) or market information where available; credit scoring; financial ratio and statistical approaches; or applying analytical techniques such as stochastic simulations. The approach adopted needs to have regard to the characteristics of the guarantee portfolio, sovereign risk exposure, and the resources and capacity in the public sector.

Third party and market information on beneficiaries and the sectors they operate can be useful where this available. Third party information may include risk assessment by banks, rating agencies, or credit bureaus. Where beneficiaries have borrowed without the benefit of government guarantees in the past, credit risk (and thus guarantee fees) can be implied by comparing average bond spreads for the beneficiary (or borrowers with similar characteristics) with those of the government.

Credit scoring is a more sophisticated approach, which involves scoring and aggregating individual risk factors to arrive at an ordinal risk rating for an entity that can then rank them against other entities. Score cards tend to include financial ratios, firm specific factors such as degree of diversification and management structure. Indonesia and Tukey are examples of countries who have adopted this approach. Developing scorecards and scoring guidelines requires a deep understanding of industry-specific risk drivers and ratings can be subjective.

Some countries have adopted statistical approaches to assess credit risk. Credit quality is measured using observable indicators such as financial ratios, to measure the likelihood that a credit event will occur (i.e. Default probability). The Altman Z-score is a common method which combines a set of financial indicators (weighted by their historical significance in predicting bankruptcies) to come up with a single estimate of how close an entity is to bankruptcy. Both Turkey and Armenia have used the Altman Z-score for assessing guarantee or SOE risks.

95. The MoF regularly discloses information on the value of guarantees. The Budget Code requires the MoF to maintain a register of state and local government guarantees, including specification of its conditions. The registries do not include the outstanding amount of the loan guaranteed, however, the MoF regularly discloses the value of outstanding guaranteed debt, by creditor, on its website. CMU resolution No. 131 of 2011 also requires that the basic terms of the agreements, the rationale for the issuance of the guarantee, and risk assessments should be published each quarter on the MoF’s official website, but information on the latter aspects is sparse.

96. There is scope to enhance the reporting on guarantees in the FRS. In addition to providing summary information on the stock of guarantees, the FRS should also include
information on fiscal flows associated with guarantees, including the costs of servicing guarantees as well as fee revenues received and recoveries. A brief description of guarantees above a materiality threshold should be provided, including: the beneficiary, the purpose of the guarantee, and its past performance (such as whether the guarantee has been triggered).

Financial Sector

97. **As the recent crisis showed, the financial sector creates large fiscal risks.** In the past few years, the government has injected capital into a number of banks, nationalized another, and financed the compensation of insured deposits in failed banks. The fiscal costs of bailouts and compensation has totaled about 11 percent of GDP over the past four years (Figure 2.10). Since then, the government and NBU have taken steps to strengthen financial sector oversight. Nonetheless, the poor asset quality of the sector means that fiscal risks remain important. At the end of 2015, the (non-equity) liabilities of the sector amounted to about 50 percent of GDP, not especially high for Europe, but still large relative to the size other risks discussed in this section. The liabilities of state-owned banks account for around half of the total liabilities of the sector.

98. **Explicit liabilities arise from the deposit guarantee scheme and a blanket guarantee on the deposits of one state-owned bank.** The Deposit Guarantee Fund (DGF) insures the deposits of individuals and sole traders up to a cap of UAH 200,000 per account holder and the scheme provides for back-up funding from the government where required. Since the beginning of the crisis, around 80 insolvent banks were transferred to the DGF, which has paid out UAH 85 billion to the depositors of these banks. The total volume of deposits guaranteed by the scheme is around UAH 300 billion (13 percent of GDP). In addition, the total deposits in the state-owned Oschadbank (around UAH 145 billion or 6.4 percent of GDP) have been guaranteed by the government. A law extending this guarantee to Ukreximbank and Privatbank was passed by the Parliament at the height of the crisis, but has not been ratified by the President.
99. **Fiscal risks also arise from interlinkages between nonfinancial and financial SOE.**

SOEs hold a high share in assets and liabilities of State-owned banks. Almost 90 percent of SOE deposits are placed with state-owned banks and they finance about two-thirds of SOE borrowing from the domestic banking sector (Figure 2.11). This creates concentration risks for State-owned banks and increases correlations between problems in the nonfinancial state-owned sector and state banking sector. For example, the NBU has reported that some SOEs only partially service their debts, compounding challenges in State-owned banks, while some monopolies redistribute their credit liabilities between State-owned banks, compensating the payments to one bank with new borrowings at another. Recognizing these risks, the CMU approved a Development Strategy for State-owned Banks, which provides that State-owned banks will lend to SOEs strictly in line with the prudential requirements of the NBU (including compliance with concentration requirements), strengthens governance by establishing independent supervisory boards, and outlines a timetable for the privatization of minority stakes at Oschadbank and Ukreximbank.

100. **The National Bank publishes a bi-annual report on financial stability.** The report analyzes the main risks to the financial sector, reports past bank recapitalizations as well as exposures associated with the DGF. The NBU has completed diagnostic studies of around 60 banks, and the results of these, including aggregate stress testing were included in the past two stability reports. However, the government does not separately report on its explicit exposures associated with the DGF or the guarantee of deposits in one of the state-owned banks in the budget or other publications.

**Subnational Governments**

101. **Subnational governments have low debt-levels, but make up a sizeable share of public sector activity.** Although subnational governments are permitted to borrow for investment purposes, few entities outside of the City of Kiev do so, other than on-lending arrangements related to loans provided by international financial institutions to the State. Reported liabilities of subnational governments are low, totaling 0.7 percent of GDP at end-2015, while debt-service costs comprise about 2 percent of local government own-source revenues (Figure 2.12), but there have been some past instances where subnational governments have faced difficulty meeting their debt obligations. Despite recent decentralization reforms, subnational governments continue to be reliant on central government transfers to finance their expenditures, with own-source tax revenues making up only about 30 percent of their expenditure (Figure 2.13). The total expenditures of subnational governments were around 13 percent of GDP in 2015.

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27 The City of Kiev was responsible for about 95 percent of all new borrowing in 2016.
102. **There are strong controls on local government borrowing.** The Budget Code (Art. 18) limits borrowing of local governments to 200 percent of forecast local development revenues (400 percent limit for the City of Kiev), while Article 74 limits the amount that can be spent on debt servicing in any year to 10 percent of the local budgets general fund. The Budget Code also explicitly states that the State is not liable for local government debt. Only large local authorities (at the level of Oblasts, rather than districts) are permitted to borrow from external sources, other than international financial organizations and all borrowings require approval by the MoF. Local governments are also required to seek approval from the MoF to issue debt guarantees, although approval is not required for non-loan guarantees such as those associated with PPPs.

103. **There is regular monitoring and reporting on local government finances.** The Treasury publishes monthly and annual execution reports that include consolidated flows of subnational governments. Local governments are also required to submit regular budget execution reports to their councils according to the timetable set out in the Budget Code. The MoF also maintains a registry of local government guarantees, although these do not report total amounts outstanding. Still, there is no summary reporting on the financial position of individual Oblasts or cities, and no analysis is conducted of key financial stress indicators for individual local government budgets.

104. **Monitoring of fiscal risks from subnationals may need to be stepped up in future.** Decentralization, by its design, entails greater risks of significant fiscal imbalances in some local governments. Quarterly monitoring of execution reports and key financial stress indicators (such as debt-service to revenue ratios) should enable the MoF to identify revenue shortfalls or expenditure overruns and monitor budgets which are chronically in deficit or running up arrears, which may require State intervention. Strengthening in year-monitoring will also require a
strengthening in external audit requirements for local authorities. Currently, State Financial Inspection audits are carried out once every three–five years and identify shortcomings too late.28

105. **Greater autonomy for subnationals will also need to be accompanied by stronger intergovernmental fiscal cooperation.** Currently, local governments are accumulating sizeable deposits as their own-source revenues out-perform expectations. This partly reflects difficulties of local governments in executing investment spending. Still, the accumulation of deposits increases the capacity of local authorities to finance investment spending in future years. Strong intergovernmental cooperation will be required to ensure that fiscal objectives (including general government deficit targets agreed as part of the IMF extended fund facility program) can be achieved.

**Public-Private Partnerships**

106. **PPPs and concessions are not a large source of fiscal risk in Ukraine.** Currently, most projects that include participation of the private sector require no explicit funding from the government budget, as they take the form of concession contracts. At the end of 2014, 243 concession agreements had been entered into, compared with 33 projects involving some form of state participation. Since the passage of the 2010 PPP Law, only two very small projects have been procured under its provisions.

107. **There is no central database that records total fiscal commitments (direct and contingent) under PPPs.** As detailed in the 2015 Public Investment Management Assessment (PIMA), the MEDT and the State Property Fund maintain registries of PPP/Concession arrangements, but neither records the projects’ direct obligations or contingent liabilities. Financial information is limited to total cost and funding (MoE) and the concession fees paid by the concessionaire (SPF).

108. **The government is ill-equipped to manage fiscal risks that may arise from PPPs, which calls for a stronger role of the MoF.** Although the PPP Law requires that all PPPs are subject to fiscal risk assessment, and methodology for risk assessment has been developed and approved, it is not systematically applied. Further, the MoF plays a very limited role in the PPP/Concession approval procedures. MoF approval is only required for explicit government funding, through direct payments or loan guarantees. As such, important fiscal risks of a more implicit nature are not assessed by the MoF. The absence of multi-year budgeting and commitment controls, together with the absence of full lifetime costing and analysis of individual PPP arrangements, also limits the MoF’s ability to identify the fiscal impact of individual PPP arrangements, over the medium and longer-term. Addressing these deficiencies and strengthening the gateway function of the MoF will become more important as the government looks to meet more of its development needs through PPPs in the future.

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Legal Claims

109. Legal claims are a potentially significant source of fiscal risk. While the mission did not undertake a thorough assessment of pending legal cases against the state, there is at least one known type of claim that creates risks to the budget. This relates to the repeal of various laws establishing social entitlements that were never disbursed, the repeal of which was deemed unconstitutional. The decision prompted the enactment of a Law about the Guarantees of the State in relation to Implementation of Court Decisions, setting out the parameters for the reimbursement by the State of the relevant claims. A large number of individual claims were submitted and awarded by Ukrainian courts. However, the State Treasury of Ukraine has not been able to satisfy the outstanding claims, as they were never budgeted for. The amount of entitlements due to be paid is estimated to be around UAH 10 billion or 0.4 percent of GDP (of which claims of 3.2 billion have been made), and is not currently factored into the government’s fiscal reports. The MoF is examining appropriate financing arrangements for the outstanding amounts arising from the court claims.

110. Care needs to be taken when disclosing pending legal claims against the State. Where there are pending cases, it may be sufficient to disclose the case without quantifying potential exposure, so as not to prejudice the position of the State in individual cases that are subject to court decision. However, in some cases, it may be possible, and even desirable, to quantify potential exposure. This relates to those cases where a determination has already been made, but for which claims have either not yet been made, or not yet settled.

Recommendations

111. Recommendation 2.11. Strengthen disclosure of explicit and implicit contingent liabilities by:

- Disclosing fiscal risks associated with explicit and implicit contingent liabilities in the fiscal statement commencing in the 2019 Budget, in line with the phased approach suggested in Annex V (June 2018).

112. Recommendation 2.12. Strengthen controls on, and management, of contingent liabilities by:

- Developing and implementing a methodology for assessing credit risks of guarantees, and amend the Budget Code to require that risk-based fees be charged and specify the minimum fee (mid-2019);
- Amending the Budget Code to restrict foreign currency borrowing of subnational governments, only to loans issued by international financial institutions (end-2017);

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• Strengthening monitoring of local government finances through the establishment of tracking indicators of fiscal stress and enhancing reliability of local government reporting by requiring that all Oblasts and cities publish an external financial audit on an annual basis (end-2018);

• Amending the PPP and Concession Laws to establish a clear role for the MoF in assessing budget affordability and fiscal risks of PPPs (end-2017).

III. STRENGTHENING PUBLIC INVESTMENT MANAGEMENT

A. Background

113. Ukraine has undertaken a range of reforms in public investment management (PIM), with a view to tackling some of its weaker institutions. In June 2016, an IMF Public Investment Management Assessment (PIMA) noted the urgent need for increased public investment in Ukraine, given the continuous decline in its public capital stock.30 To address this trend, largely driven by weaknesses in the institutional framework, the Ukrainian authorities launched some important reforms, including:

• Creation of an online public procurement portal and development of a new procurement law, designed to minimize corruption;

• Creation of a project appraisal and selection process for national infrastructure projects, but only applied to projects funded by the state Budget, including central oversight by the Ministry of Economic Development and Trade (MEDT);31 and

• Beginning the process for implementing a medium-term budget framework, crucial for effective public investment management, and covered in Chapter 1 of this report.

114. Addressing the many institutional gaps remaining, in the context of constrained public finances, requires a prioritization of the reform agenda. While the recommendations of the PIMA covered the three broad dimensions of PIM (strategic planning, investment allocation, and project implementation), this mission focused primarily on the specific areas that the PIMA considered of more relevance in the Ukrainian context: strategic planning, appraisal and selection, and coordination of decision making.

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30 Olden, B. et al (2016) "Ukraine: Public Investment Management Assessment", Fiscal Affairs Department, IMF. A summary of relevant PIMA findings, linked to the relevant recommendations in this report, is provided in Annex 6.

31 In 2015, the MEDT established a mechanism for identification, preparation, appraisal and selection of public investment projects for the 2016 budget. Cabinet resolution No. 571 of 22.07.2015 establishes an Interdepartmental Committee assessment process for public investment projects and detailed procedures for preparation, appraisal and assessment of these projects. Projects are reviewed by an Interdepartmental Committee comprising nine ministers and nine parliamentarians.
B. Strategic Planning
Institutional Arrangements

115. The PFM reform strategy includes a number of measures to strengthen planning:

- Establishing a Strategic Council, which will, inter alia, “maintain a balance of interests, coordinate policy documents and strategic planning documents, review them and issue recommendations for the Government with regard to adopting (adjusting, reversing) state strategic planning.”
- Developing a consistent procedure and time schedule for line ministries to prepare strategic plans and develop the plans in 2018.
- Developing a mid-term public investment plan within the scope of the mid-term budget planning (the public investment element is separate to strategy elements identified in the PFM plan).\(^32\)

116. There is a risk of a disconnect between the strategic planning documents and public investment plans envisaged under the PFM reform strategy. Actions relating to strategic planning broadly, and actions specifically related to planning of public investments, are not explicitly aligned. Multiple international examples show the potential to integrate both strategic planning and investment planning within a single framework.\(^33\)

117. The intention for individual ministries to prepare strategic plans increases the risk that the resulting planned investments will not be well coordinated. It is essential that as part of any problem and solution identification process underpinning public investment choices, links between potential investment options are considered globally. For example, decisions about land use planning (such as where population growth will be allowed to occur), particularly in urban areas, will have wide ranging ramifications. They will affect both plans for utilizing existing infrastructure and demands for new infrastructure across many sectors, including transport, social infrastructure, power and utilities, telecommunications, and more.

118. The development of a national investment strategy by a single unit can create the conditions to deliver a higher quality product. An investment planning unit, set up under the MEDT, could be given a mandate to produce a national infrastructure strategy. This unit could (i) take a better account of the government priorities; and (ii) better interact with the MoF with the view of integrating this strategy into the MTBF. Such a process is likely to involve increased costs and take more time, but the alternative process of developing disparate strategies is likely to still be time consuming and costly yet add less value. On balance, a strong role for this unit in


\(^{33}\) See for example, Infrastructure Strategies developed by the Victorian and New South Wales State Governments in Australia, or the Eddington study in the UK, described at Annex 7.
developing a single coherent strategy is appropriate but is likely to require an appropriate legal basis.

119. **Strategic problem and solution identification, and bottom up technical analysis of likely investment options, are both crucial elements of a strategy.** International experience shows that the benefits of a coordinated strategy will be maximized if it includes the key elements set out below. It is especially important that the “bottom up” and “top down” analysis pieces are given sufficient weight, and that all elements wrap together cohesively. Core elements of an integrated strategy would include:

- **Methodology for developing the strategy and recommendations:** this is essential for transparency and buy in to the strategy.
- **Identification of objectives, problem/challenge identification, and options to address challenges:** if the analysis of projects jumps too quickly to a consideration of investment options/solutions, the analysis will be limited. It can then easily miss the opportunity for less expensive low, or no investment options to solve the relevant problems.
- **Recommendations and description of investments:** this includes full costing and underlying technical analysis (which may be either preliminary or more detailed depending on how well developed a specific proposed investment is, and far in the future it is likely to happen).

120. **The strategy should play a strong role in all major future investment decisions involving public funding or public support.** This would cover not only the investment appropriated under the State Budget but also the investment financed through special funds, such as the Road Fund, or local government budgets. This could be enabled by requiring the decision makers to prioritize investments identified in the national infrastructure strategy, and to consider alignment with the national infrastructure strategy in decisions to fund other investments. The strategy could be responded to (ideally within 3 months), and either adopted by the government as presented or with amendments. The final process for the response to and adoption of the strategy by government and/or other decision makers should be specified at the inception of the strategy and be designed to ensure maximum buy-in on the final outcome.

121. **Including a suite of costed investments in the national strategy would signal Ukraine’s national public investment priorities.** In the context of constrained fiscal space for investments for the foreseeable future, presentation of a coherent list of well-scoped investment projects will assist investors in identifying investment opportunities in Ukraine. This will be especially valuable if a substantial proportion of investment continues to be funded by grants and concessional loans by foreign governments and organizations, and as Ukraine looks to ramp up PPP activity. Costed investments in infrastructure strategies can also facilitate subsequent

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34 A table setting out elements of similar strategies developed internationally is provided in Annex 7.
project appraisals: while this analysis would not usually substitute for a full project appraisal to be done in support of a government decision, it may comprise a valuable input.

122. **Obtaining the broadest possible buy-in and acceptance of the Strategic Council’s advisory role, membership and mandate will be critical for the effectiveness of its advice.**

Unless there is a strong consensus built around the need for the council and the type of people that need to be on it, there is a strong likelihood that any findings will carry little weight with decision makers, and in the eyes of the civil society. This should be reflected in the legal design of the council and its role, including the appointment process. Internationally, such advisory boards usually include a mix of private and public sector expertise, with the chair and multiple board members completely independent from government (any appointed public sector employees are removed from political decision making). The approach could be enabled through a clear terms of reference to be provided to the council, ensuring broad institutional support. Among other things, the terms of reference and legal basis for the council could:

- Give the council the authority to request the planning unit, line ministries, government bodies and agencies, and regional and local governments to provide information on the national investment strategy and investment options put forward;

- Set out the selection criteria for members to be appointed to the council in line with strict qualification and disqualification criteria, such as those suggested below:
  - enough members (i.e. at least seven) should be appointed, the majority of which should be independent. This would help protect the technical advisory role of the council from the risk of political interference.
  - qualification criteria should emphasize the experience of the members, drawing from a diverse mix of backgrounds including: infrastructure development, operation and financing, economics (e.g. credible, experienced business leaders, consultants, academics).
  - the chair of the council should be completely independent of any direct government or other business interests that would cause a conflict. For example, the chair would ideally have prior experience in the management of large infrastructure firms with a strong track record of delivery in key areas such as transport. The chair would ideally have a minimum of 15 years relevant experience.
  - include a requirement for potential council members to declare any real or perceived conflicts of interest, and have a robust conflict management strategy in place, including the basis for disqualification.

- Provide the necessary resources for the council to perform its functions.

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35 For example, requiring members of the Strategic Council to be nominated by the Cabinet, and approved by the Interdepartmental Committee (consisting government ministers and parliamentarians), would give Parliament a role in the process.
The Process for Developing a Robust National Infrastructure Strategy

123. **Extensive public transparency and consultation would enhance the robustness and credibility of the strategy.** Public transparency can reduce the risk that the process or result is unduly influenced by special and or private interests. International experience shows that the best strategies are consulted on widely, using a range of consultative methods to allow buy in from all stakeholders, including the government and the public. Public transparency bolsters more formal government assurance processes (such as the audit role of the Chamber of Accounts). The consultation practices used in examples of international strategies are set out in the table in Annex VII. To enable the consultation process, the investment planning unit would need to be empowered to publish consultation and supporting documents on its own authority. A typical process for consultation would involve the following steps:

- Publishing a brief consultation/discussion document early on that steps out a clear process for engagement (e.g., written submissions, public forums) that describes how feedback will be used. This can be followed up with a consultation draft.
- Disclosing the process for getting to solutions/conclusions (e.g., metrics used to rank/assess options).
- Publishing technical and supporting information to the greatest extent possible, and publishing a draft strategy.
- Avoiding setting up the analysis so as to preclude transparency (e.g., relying heavily on commercial in confidence information to make decisions).

124. **Developing a coherent national infrastructure strategy will take time.** An indicative timeline is shown in Figure 3.1, incorporating the release of a discussion/consultation paper early in the process. International experience (see Annex VII) suggests a 12- to 18-month timeline would be realistic for delivery of a strategy of this nature, assuming that the institutional and support arrangements are firmly in place at inception.

**Figure 3.1. Indicative Timeline for Development of a National Infrastructure Strategy**

125. **The right resourcing and supports will be essential to enable the investment planning unit to ensure delivery of a robust strategy.** Providing sufficient resources to line ministries could be done by developing a high-level draft resourcing and project plan for the development of the strategy, including estimates of the resources required for key tasks.
(e.g., jointly prepared by the MEDT and MoF). Based on this plan, the MoF could make recommendations to the government about any resourcing needs. To ensure it has its own dedicated resource base, the investment planning unit could be empowered to recruit a special taskforce, selected through a merit-based process. The taskforce could include at least 15–20 people with the following skills, drawing on expertise across the Ukrainian Government, private sector secondees, and experts from international organizations:

- Governance
- Strategic policy development (objectives, options analysis)
- Technical skills including subject matter expertise in respect of the areas covered
- Contract/consultancy management
- Project and risk management
- Communications and stakeholder management

**Recommendations**

126. **Recommendation 3.1.** Enable the development of a national infrastructure strategy by:

- Setting up an investment planning unit under the MEDT and empowering it to develop a national infrastructure strategy, including by clearly defining the mandate, coverage and process for developing the strategy. This should be enshrined in the appropriate legal instrument.
- Describing the role of the strategy, and the process for its consideration and acceptance.
- Describing the process for appointment of the members of the Strategic Council in accordance with strict selection criteria, in a way that maximizes the potential for broad based acceptance and credibility of the Strategic Council members.

**C. Project Appraisal and Selection**

**The Role of the MoF**

127. **Under the current process for appraising national budget funded projects, the role of the MoF remains limited to setting the overall fiscal ceiling.** The current process is illustrated in Figure 3.2. It shows that the MoF does not play a role in looking at specific projects. Although depicted as a single stage process, in practice, since there is no MTBF, this process results in a multiple gateway assessment, as projects must come forward each year for funding.
The appraisal process would support a stronger role for the MoF in assessing fiscal risks and affordability of projects. This could involve:

- The MoF undertaking a two-stage assessment of fiscal risks and whole-of-life costs for a proposed project, firstly at the concept stage, and secondly in parallel with the assessment of project documentation undertaken by the MEDT.
- The MoF assessment should be included in the MEDT’s assessment of project merits, provided to the Interdepartmental Committee under the existing process.
- The intervention points for the MoF, within the context of the existing process, are set out in the figure below, including the role the Ministry is expected to provide in the MTBF recommended in Chapter I.
129. **Without an MTBF, the MoF cannot hold KSUs accountable to a baseline level of capital spending.** Among other limitations, this means that project selection processes need to capture all projects to ensure central oversight of capital spending proposals, regardless of their size.

130. **Even after the introduction of an MTBF, the oversight process will not extend far enough into the future.** Public investment projects, particularly major ones, require a very long lead time to identify, plan and deliver, and operating and maintenance costs must be factored in over the entire useful life of the asset. As an example, the current Ukrainian project “Restoration and adaptation Mariinsky Palace on ul.Grushevskogo, 5a, Kiev Creating a cultural arts and museum complex ‘Art Arsenal’” is expected to run from 2005 to 2018. In some international jurisdictions, Line Ministries are required to plan their capital expenditures up to 10 years into the future. In the longer term, following the introduction and maturation of an MTBF, longer term capital planning could be done by LMs, overseen by the MoF, allowing earlier engagement on fiscal risks and fiscal space for investments. An indicative illustration of how that process could work is shown in Annex VIII, Figure 2. In summary:

- Capital spending plans would be prepared by KSUs, and go out significantly beyond the three-year forward estimates period planned for the MTBF (ideally 10 years into the future, given the long timeframe for major infrastructure projects).
- KSUs would be required to justify any major variations in previously forecasted years.

131. **The MoF’s involvement in PPP assessment similarly occurs mostly at the end of the process, after negotiations have been completed, but prior to awarding the contract.** As a result, the capacity of the MoF to influence decisions is limited at key phases, notably during the planning and selection processes for the value for money and budget affordability assessment. See Annex IX for a summary of roles assigned to the MoF under the current PPP Law.

**The Role of the MEDT, and Line Ministry Capacity**

132. **The current role of the MEDT seems appropriate, but the practice needs to be well resourced and embedded.** The MEDT should continue to exercise discretion in respect of the amount of documentation required by the Interdepartmental Committee process, depending on its assessment of overall project size and risk, ahead of the introduction of formal thresholds, as recommended later in this report.

133. **The current appraisal process will need to be integrated with the recommended strategic planning approach.** Options recommended by the national infrastructure strategy will likely be costed and designed to varying levels of detail. Some proposals may be well enough developed to go forward to government for consideration, while others will require further work.

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36 Source: Ukrainian authorities (see page 51 of the PIMA report).
to enable a government decision to proceed. This will be a matter of judgement for the Interdepartmental Committee, as advised by the MEDT.

134. **Line Ministries need to understand the project appraisal methodology and how to oversee the work of external experts.** While the Interdepartmental Committee process is robust on paper, it will require time to mature, and further capacity building will be required across the government. In particular, capacity building is needed in respect of the abilities of KSUs to examine the merits of public investment projects, and develop the cost and implementation elements of appraisal documents. Existing MEDT plans for additional capacity building, and guidance to be provided by the MEDT, should be supported by appropriate resourcing, to further embed the Interdepartmental Committee process and associated requirements. This will include resourcing to the MEDT, but also to support the creation of the right institutional arrangements within LMs and KSUs.

**Recommendations**

135. **Recommendation 3.2.** Strengthen the role of the MoF in the Interdepartmental Committee process, by introducing a role to review the budget affordability and fiscal risks for specific projects. In the longer term, as the MTBF matures, strengthen this role further by requiring longer term forecasting and oversight of capital expenditure.

**D. Coordination**

136. **The decentralization agenda will increase the fiscal space for subnational governments to undertake public investments.** However, it may make coordination more difficult between national and subnational governments, and also between different subnational governments. That is why it is crucial that the strategic planning process, referred to in Section B, includes input from regional and local governments, and that future investments are closely linked to the outcomes of that process.

137. **The selection process only applies to national projects funded and financed by the national budget.** There is a stronger rationale for tailoring the appraisal process to overall project risk and materiality thresholds, than to the source of funds. Of course, different funding and financing sources may be a factor in assessing overall project risks. The appraisal processes that apply to projects, based on the different financing sources, are described in Table 3.1.
**Table 3.1. Ukraine: Different Processes Applied to Project Selection**

<table>
<thead>
<tr>
<th>Funding/Financing Source</th>
<th>Process Applied</th>
</tr>
</thead>
<tbody>
<tr>
<td>National projects funded by the State Budget</td>
<td>Interdepartmental Committee process described in Section C.</td>
</tr>
<tr>
<td>Projects funded by intergovernmental transfers to subnational governments</td>
<td>Investment programs of local government are supplemented by 3 transfers; the Regional Development Fund, the Subvention for Social and Economic Development and the Subvention for Infrastructure in Amalgamated Communities. Projects funded under the subventions are not vetted by the central government. However, Article 24 of the Budget Code requires the Oblast Councils to submit regional project proposals that can be funded through the Regional Development Fund by May 1 each year. The Ministry of Regional Development is required to check that appropriate processes have been followed and documentation provided.</td>
</tr>
<tr>
<td>IFI or bilateral concessional loans or grants</td>
<td>Ukrainian government review of proposals is not integrated with the Interdepartmental Committee process: a separate unit reviews projects to be funded through externally financed loans or grants.</td>
</tr>
<tr>
<td>PPPs/concessions</td>
<td>Not subject to systematic appraisal or assessment.</td>
</tr>
<tr>
<td>State owned enterprises</td>
<td>Capital plans are approved by the government through the annual Financial Plan process, in which the government approves spending plans of SoEs. Capital investments are monitored by the Ministry of Finance. Major projects are not subject to the Interdepartmental Committee assessment process, including those funded by public resources (such as loans from IFIs). It is unclear whether projects funded by the newly created Road Fund would be subject to the Interdepartmental Committee process</td>
</tr>
</tbody>
</table>

Sources: Ministry of Finance, Ministry of Economic Development and Trade, IMF.

138. **It is unclear whether major projects to be funded by the newly created Road Fund will be subject to the Interdepartmental Committee process.** Neither Law 47 “On Sources of Financing of Roads Ukraine” or the supporting Cabinet regulation 1731 mentions the Interdepartmental Committee in discussions of allocations of funding, although Law 47 notes that the Cabinet will approve the list of projects of national significance. The Budget Code statement that the Interdepartmental Committee process should apply to projects funded by the state budget is not qualified in this respect, so it may be open to interpretation whether it applies to the Road Fund. There would be benefit in clarifying that the process should apply to major projects funded by the Road Fund from 2018, with the definition of “major” to be defined by the MEDT and MoF, in consultation with the State Roads Agency.

139. **There is room to improve coordination and robustness of the processes by bringing them together.** For example, investments undertaken by SOEs, where the investment involves the use of public equity injections or loans, are not subject to a central oversight and appraisal process (including the Road Fund, as noted above). This provides a potentially substantial avenue for the government to be funding projects external to the centrally coordinated process.

140. **Bringing the processes together by progressively widening the scope of the Interdepartmental Committee process from 2017 onward would be efficient and timely.** Now that the Interdepartmental Committee process is in place and starting to become embedded, the opportunity exists to expand its remit, to enhance coordination of decision
making across the multiple funding avenues for public investment. It will also ensure that the scrutiny of the Interdepartmental Committee process is not avoidable by pursuing particular funding/financing avenues.

**Recommendations**

141. **Recommendation 3.3.** Strengthen coordination and information sharing across government and with subnational governments by creating a single online database of information (including costs) for all investment projects, irrespective of their funding source. To avoid duplication and risks of inconsistencies, this system could be used by Line Ministries and KSUs to track their spending commitments and be accessed centrally by the MEDT and the MoF.

142. **Recommendation 3.4.** Strengthen the newly established project appraisal and selection approach and gradually extend the Interdepartmental Committee appraisal and selection process to all major public investment projects, as set out in the Table 3.2.

### Table 3.2. Ukraine: Progressive Application of the Interdepartmental Committee Process to all Projects

<table>
<thead>
<tr>
<th>Project Type</th>
<th>When the consistent process should be applied</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>For the 2018 Budget Process</td>
</tr>
<tr>
<td>Public Private Partnerships and Concessions</td>
<td></td>
</tr>
<tr>
<td>Major projects financed by loans or equity injections from the state budget to SoEs</td>
<td></td>
</tr>
<tr>
<td>Projects financed by capital transfers to subnational governments</td>
<td></td>
</tr>
<tr>
<td>Concessional external loans</td>
<td></td>
</tr>
<tr>
<td>External grant funded projects</td>
<td></td>
</tr>
</tbody>
</table>

Note: The timing in the table has been based on an assessment of the likely risks of each project type, and consideration of the size of the various funding streams. The result suggests that PPPs/concessions, and major SoE projects that are supported by state funded loans or equity injections should be brought into the framework first. The definition of what constitutes a ‘major’ SoE project should be defined by rules agreed between the MEDT and the MoF, ahead of the introduction of clear thresholds for all projects (Recommendation 3.5)

143. **Recommendation 3.5.** In the medium term, once a mature MTBF is in place to support central oversight of capital investments by line agencies against prior year baselines, introduce project materiality and risk thresholds, and use these thresholds to apply different project appraisal and selection criteria and processes (indicative thresholds and processes are described in the Table 3.3).
### Table 3.3. Ukraine: Indicative Thresholds and Processes for Project Appraisal and Selection

<table>
<thead>
<tr>
<th>Requirement and threshold (million UAH)</th>
<th>&lt;10m</th>
<th>10m–30m</th>
<th>&gt;30m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of costs and benefits</td>
<td>Cost ratio analysis/benchmarking of cost rates&lt;sup&gt;37&lt;/sup&gt;</td>
<td>Cost ratio/benchmarking of cost rates, or cost effectiveness analysis, as directed by the MEDT</td>
<td>Cost effectiveness or cost/benefit analysis, as directed by the MEDT</td>
</tr>
<tr>
<td>Centralized review of project case and project risk (MEDT)</td>
<td>Not conducted unless by specific direction of MEDT</td>
<td>Review of business case documentation by MEDT</td>
<td>Multi-stage review of business case documentation by MEDT, sign off on project risk ratings</td>
</tr>
<tr>
<td>Fiscal risk/funding source assessment (MoF)</td>
<td>Picked up through central review of capital plans – MoF to advise MEDT any concerns</td>
<td>Reviewed by MoF</td>
<td>MoF sign off on fiscal risk ratings</td>
</tr>
</tbody>
</table>

Note: Levels have been formulated with reference to the existing thresholds specified in Cabinet Resolution 571.

**144. Recommendation 3.6.** Revise the definition of PPPs within the PPP General Law to be sufficiently broad to encompass any long-term arrangement where there is: (i) private sector execution (service provision) and financing of public investment; and (ii) risk transfer from the government to the private sector.

<sup>37</sup> For example, the cost per square meter of gross floor area (GFA) delivered, measured against an appropriate benchmark rate (e.g. based on the type and location of the GFA delivered).
Annex I. Indicative List of Legal Reforms to Strengthen PFM in Ukraine

The following sets out the necessary amendments to the budget code and secondary legislation to strengthen the MTBF, fiscal risk oversight, and the PIM framework in Ukraine.

I. MTBF

1. Amendments to the Budget Code:
Putting in place an effective MTBF in Ukraine as recommended in this report requires a number of legal amendments that introduce the key elements for medium-term economic forecast and strategic fiscal planning. The amendments should also reflect a phased approach for the introduction of a fully-fleshed framework. The following considerations could be given for the reforms:

- Fully-fledged MTBF:
Repeal of Article 33 to introduce a new Section on Medium Term Budget Planning:

i. (Article 33 Budget Code) Replace the “Main Goals” document with a Fiscal Strategy Document (FSD) including, without limitation, the following:
   a. The government’s medium-term fiscal framework with measurable fiscal objectives and key fiscal indicators;
   b. Updated and comprehensive medium-term macroeconomic and fiscal forecast covering current developments and multi-year projections;
   c. The government’s medium-term budget framework including expenditure ceilings for overall General Fund and Special Fund and corresponding KSUs expenditures;
   d. Performance management including strategic goals and outcomes of KSUs;
   e. Comprehensive and quantitative fiscal risk statement; and
   f. Others as established in secondary regulation by the CMU.

ii. (Article “X” Budget Code) Establishing the procedure for approval of FSD
   a. Presentation of FSD by the MoF to the CMU for approval by June 1;
   b. Approval by the CMU by June 15 and submission to the Verhovna Rada; and
   c. Approval by the Verhovna Rada by enactment of a law by June 30.

iii. (Article “X” Budget Code) Include provisions on Expenditure Ceilings to:
   a. Define scope: General Fund and Special Funds;
   b. Define legal effects of the ceilings: i) binding for the overall and KSU ceilings for the budget year, ii) indicative for the outer years; and iii) built-in mechanisms of technical amendments of ceilings for changes in macro- economic indicators (technicalities defined by secondary regulation by the CMU);

1 This list addresses legal amendments related to selected aspects of budget execution as recommended in the report.
c. Require that margins and reconciliation are provided but details of be regulated through secondary regulation by the CMU; and
d. Define escape clauses.

- **Transitional period (Amendments to Section VI of the Budget Code):**
  Incorporate transitional provisions to the Budget Code that defer application of approval of the FSD by the Verhovna Rada by enactment of a Law for the budget preparation exercise of 2020, subject to verifying what elements of the Budget Declaration would be approved in the main text of the law. Approval by Verhovna Rada for the 2019 budget preparation period would follow usual procedure according to Article 33 (approval by Verhovna Rada Resolution).

- **Other amendments in the Budget Code:**
  i. Article 2 (Definitions) New definitions should be introduced including expenditure ceilings (including definition on fixed and indicative), Fiscal Strategy Document, margins, reconciliation, etc.)
  ii. Article 7 (MTBF principles)
  iii. Article 21 (multi-year forecast)
  iv. Articles 34–38 (instructions for budget requests, budget calendar, approval of CMU of draft state budget law)
  v. Articles 39–40 (approval of the state annual budget)

2. **Other amendments in primary and secondary legislation:**
   - Law “About the Regulation of the Verhovna Rada”
   - Law on the Cabinet of Ministers of Ukraine
   - CMU Resolution and Ministerial Order\(^2\)

### II. FISCAL RISK OVERSIGHT

The strengthening of the fiscal risk oversight function by the MoF requires a number of legal amendments, with respect to the legal basis for the MoF mandate, the institutional arrangements for cooperation (both between the MoF and other government agencies and within the different units of the MoF) and to the management and disclosure of specific fiscal risks.

1. **Amendments to the Budget Code.**
   - **Introduction of a new Section on Fiscal Risk Oversight covering** (See table below for country examples of these provisions):
     i. Article “X” Budget Code. Introduce new legal provision that:
        a. assigns the MoF the legal mandate for fiscal risk oversight;
        b. specifies the scope of fiscal oversight—including but not limitative to—macroeconomic risks; public debt related risk; government guarantees; SOEs

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\(^2\) Such CMU Resolution and Ministerial Order would regulate *ex novo* procedural rules related to the MTBF decisions.
risks—including information on financial position, guarantees and loans to SOEs, QFA, budget support provided to SOEs; local government risks; PPPs; financial sector risk; and natural disasters; and

c. requires that secondary regulation (CMU Resolution) clearly defines the roles and responsibilities in fiscal risk monitoring and management of all government departments and agencies.

ii. Article “X” Budget Code. Introduce new provision that:

d. grants the MoF the power to collect information from different; government entities, agencies and SOEs, with the appropriate safeguards to protect confidential information; and

e. requires that secondary regulation (CMU Resolution) defines the responsibilities of various agencies, required inputs, timetable for their provisions, approval processes, etc. Guidelines in Table 2.2 of this report.

iii. Article “X” Budget Code. Introduce new provision dedicated to the Fiscal Risk Statement. The provision should:

f. provide the MoF the responsibility for preparation and publication of a FRS;

g. specify the minimum content of the FRS: general macroeconomic risks and their implications for public finances, as well as contingent liabilities and other specific fiscal risks that have the potential to materially impact the budget. This general formulation would not be considered an exhaustive list, and will enable the introduction of more information through secondary legislation;

h. timeline for its publication—that is, with the FSD and accompanying the budget documents presented with the Draft State Budget Law; and

i. require secondary regulation to provide a template for FRS.

iv. Amend Article 38 of the Budget Code as appropriate.

• Other amendments for specific fiscal risks management:

i. Government guarantee risk: Amend Article 17 of the Budget Code to require establishment of a risk-based fee for the issuance of government guarantees specifying a minimum fee to be applied.

ii. Local Government risk: Amend Article 18 and 74 of the Budget Code to restrict foreign currency borrowing, for all subnational governments, to loans issued by international financial institutions. Amend Section III of the Budget Code to require that all Oblasts and cities publish an external financial audit on an annual basis.

iii. PPPs risk: Amend the PPP and Concession Laws to establish a clear role for the MoF in assessing budget affordability and fiscal risks of PPPs.

2. Other amendments to secondary regulation:

i. CMU Resolution 662 on SOEs efficiency (methodology for analysis of SOEs fiscal risks, mechanisms for collection of information and cooperation among the MoF and other ministries and with the CMU).

ii. CMU Resolution 692/2012 (quasi-fiscal activities).
iii. CMU Resolutions n.131 and 460 of 2011 (state guarantees).

III. PUBLIC INVESTMENT MANAGEMENT

The legal framework for public investment management consists of several pieces of legislation in different areas of the law. From the perspective of the integration of public investment management with the budgetary framework and of the role of the MoF through different public investment processes, the following legal amendments should be considered:

- Amendments to the pertinent laws including the Budget Code, PPP Law, Law on Concessions, Law on Sources of Financing Roads of Ukraine, Law on State Strategic Planning, and secondary regulations\(^3\) to explicitly recognize the role of the MoF in assessing the budget affordability and risk management analysis for investment projects whether they are considered by the procedures established for national projects funded by state budget, subventions, Regional Development Fund or externally-financed investment projects.

- Amendments to Articles 13 and 23 of the Budget Code to prohibit reallocation from capital to other expenditure without parliamentary approval.

- Broaden the definition of Public-private partnership in the PPP General Law to encompass any long-term arrangement where there is: (i) private sector execution (service provision) and financing of public investment; and (ii) risk transfer from the government to the private sector.

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\(^3\) Such as CMU Resolutions n. 571 of 2015 establishing the inter-departmental committee; n. 70 of 2016 on loans from IFIs, and n.196 of 2015 on the regional development fund.
# Annex II. Reserves and Margins in MTBFs

<table>
<thead>
<tr>
<th></th>
<th>Implicit Margin</th>
<th>Explicit Margin</th>
<th>Total Contingency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP forecast</td>
<td>Other economic assumptions</td>
<td>Within expenditure estimate</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td>MoF uses average of indicative forecasts</td>
<td>MoF adds 0.5% to 1.0% to interest rates and runs through model</td>
<td>Contingency reserve of 1.5% to 2.0% of total spending</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>MoF uses GDP forecast 0.25% below trend</td>
<td>7 other economic assumptions explicitly cautious</td>
<td>Reserves and margins equal to 0.75% to 1.0% of total spending</td>
</tr>
<tr>
<td><strong>Sweden</strong></td>
<td>Budget based on central assumptions for GDP and other macro variables</td>
<td></td>
<td>Budget margin within expenditure ceiling rising from 1.5% to 3.0% of total spending</td>
</tr>
<tr>
<td><strong>Netherlands</strong></td>
<td>Deficit target and expenditure ceiling based on cautious economic scenario in which GDP is 0.5% to 1.0% below outturn</td>
<td>Central contingency reserve of 0.1% of total spending</td>
<td>Most recent cycl. adjusted targets structural surplus of 1.0% of GDP</td>
</tr>
<tr>
<td><strong>Australia</strong></td>
<td>Budget is based on central economic assumptions</td>
<td>Conservative bias in forward estimates of 0.5% to 1.5% of spending</td>
<td>No central contingency reserve</td>
</tr>
</tbody>
</table>
### Annex III. Legal Provisions for Fiscal Risk Management

#### Country Examples

<table>
<thead>
<tr>
<th>Country</th>
<th>Legal Mandate for Fiscal Risk Analysis and Management</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cyprus</strong></td>
<td><strong>Fiscal Responsibility and Budget Law</strong></td>
</tr>
<tr>
<td></td>
<td>“Article 11. [...] the Minister (MoF):</td>
</tr>
<tr>
<td></td>
<td>(l) monitors and evaluates the fiscal risks arising</td>
</tr>
<tr>
<td></td>
<td>from various sources, through preparation of fiscal</td>
</tr>
<tr>
<td></td>
<td>risk exposure according to subsection (1) of Article</td>
</tr>
<tr>
<td></td>
<td>58.</td>
</tr>
<tr>
<td></td>
<td>Article 58. 58. - (1) The Minister [MoF] is</td>
</tr>
<tr>
<td></td>
<td>responsible for the supervision of fiscal risks that</td>
</tr>
<tr>
<td></td>
<td>have a significant impact on the financial</td>
</tr>
<tr>
<td></td>
<td>perspective, recognizing and analyzing such risks</td>
</tr>
<tr>
<td></td>
<td>and prepares and submits financial risk exposure</td>
</tr>
<tr>
<td></td>
<td>with the budget and published in accordance with the</td>
</tr>
<tr>
<td></td>
<td>provisions of this Law...”</td>
</tr>
<tr>
<td><strong>New Zealand</strong></td>
<td><strong>Public Finance Act</strong></td>
</tr>
<tr>
<td></td>
<td>“Section 26G. Principles of responsible fiscal</td>
</tr>
<tr>
<td></td>
<td>management (1) The Government must pursue its policy</td>
</tr>
<tr>
<td></td>
<td>objectives in accordance with the following</td>
</tr>
<tr>
<td></td>
<td>principles (the principles of responsible fiscal</td>
</tr>
<tr>
<td></td>
<td>management): …. (d) managing prudently the fiscal</td>
</tr>
<tr>
<td></td>
<td>risks facing the Government […];”</td>
</tr>
<tr>
<td><strong>Cyprus</strong></td>
<td><strong>Fiscal Responsibility and Budget Law</strong></td>
</tr>
<tr>
<td></td>
<td>“Article 58. (2) For the purposes of subsection (1),</td>
</tr>
<tr>
<td></td>
<td>the Minister - (A) may require any financial</td>
</tr>
<tr>
<td></td>
<td>statements, information and information relating to</td>
</tr>
<tr>
<td></td>
<td>financial risks from any economic operator and any</td>
</tr>
<tr>
<td></td>
<td>other entity General Government, any State sponsored</td>
</tr>
<tr>
<td></td>
<td>organization, any State run by any person or entity</td>
</tr>
<tr>
<td></td>
<td>obtains guarantees and loans from the Republic; and</td>
</tr>
<tr>
<td></td>
<td>(B) specifies the information submitted to the</td>
</tr>
<tr>
<td></td>
<td>Minister, and the timing and the procedure.”</td>
</tr>
<tr>
<td></td>
<td>Article 58 - (3) The Minister may require from -</td>
</tr>
<tr>
<td></td>
<td>(a) the Accountant-General and the Head of the</td>
</tr>
<tr>
<td></td>
<td>Management Office</td>
</tr>
<tr>
<td></td>
<td>(A) Public Debt to collect and submit data in and</td>
</tr>
<tr>
<td></td>
<td>information on the outstanding loans and guarantees</td>
</tr>
<tr>
<td></td>
<td>of the Republic to third parties;</td>
</tr>
<tr>
<td></td>
<td>(B) the Head of a Public Debt Management Office, to</td>
</tr>
<tr>
<td></td>
<td>submit a risk assessment to guarantees and loans</td>
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<td>Republic to third parties […];</td>
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<td></td>
<td>(C) the Ministry of Interior and The General</td>
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<td></td>
<td>Accounting Office to collect and to submit data and</td>
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<td></td>
<td>information on outstanding guarantees and loans</td>
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<td>granted or taken by the Local Authorities;</td>
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<td></td>
<td>(D) the heads of financial institutions to collect</td>
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<td></td>
<td>and to submit any data and information on General</td>
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<td></td>
<td>Government entities, state agencies and the State</td>
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<td>enterprises that are under their jurisdiction; and</td>
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<td></td>
<td>(E) the Governor of the Central Bank, the President</td>
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<td></td>
<td>of the Commission Capital, the Superintendent of</td>
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<td>Insurance and the Registrar of Funds Welfare and</td>
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<td></td>
<td>any other entity responsible for overseeing financial</td>
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<td></td>
<td>organizations or other business activities to</td>
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<td></td>
<td>gather information in relation to financial risks</td>
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<td></td>
<td>of entities that are below their supervision and</td>
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<td></td>
<td>to submit them.</td>
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<tr>
<td><strong>Colombia</strong></td>
<td>**Organic Law on Budget, Fiscal Responsibility and</td>
</tr>
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<td></td>
<td>Transparency**</td>
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<td></td>
<td>“Article 9. Required information. Companies or</td>
</tr>
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<td></td>
<td>companies in which the Nation or its decentralized</td>
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<td></td>
<td>entities have a stake in their capital stock greater</td>
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<td>than fifty percent (50%) must report, within their</td>
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<td></td>
<td>powers, to the Ministry of Finance and Public Credit</td>
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<tr>
<td></td>
<td>and to the National Planning Department, the</td>
</tr>
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<td></td>
<td>Information of budgetary and financial nature that</td>
</tr>
<tr>
<td></td>
<td>is required in order to comply with this law.”</td>
</tr>
</tbody>
</table>
**UK**

**Budget Responsibility Act**

Section 9. Right to information. (1) The Office (Budget Responsibility office) has a right of access (at any reasonable time) to all Government information which it may reasonably require for the purpose of the performance of its duty under section 4 [examine and report on the sustainability of public finances including the main risks which the Office consider relevant]; (2) The Office is entitled to require from any person holding or accountable for any Government information any assistance or explanation which the Office reasonably thinks necessary for that purpose; (3) “Government information” means information held by any Minister of the Crown or Government department.

**Portugal**

**Budget Framework Law**

Budgetary Stability - Article 91. Reporting obligations

“1 – The Minister of Finance may require that general government sector bodies provide detailed and well-grounded information on observance of the measures and procedures that they must comply with pursuant to this law.

2 – Where there is any circumstance in the budget of any of the general government sector bodies that may cause a budgetary situation that is incompatible with observance of the stability measures referred to in Article 86 [budgetary stability objectives and measures], the entity in question shall immediately send the Ministry of Finance detailed and well-grounded information on the case, identifying the revenue and expenditure originating them, and a settlement proposal.

3 – The Minister of Finance may request Banco de Portugal as well as credit institutions and financial companies all the information relating to any general government body deemed pertinent for monitoring compliance with this law.”

**New Zealand**

**Public Finance Act**

“Section 26Z. Power of Secretary to obtain information (1) The Secretary may request any department, any departmental agency, or any entity referred to in section 27(3)(a) to (f), or any entity that manages an asset or liability of the Government, to supply to the Secretary any information that is necessary to enable the preparation of any fiscal forecasts and projections referred to in sections 26L, 26N, 26NA, 26O, 26Q, 26S, and 26T.”

**Disclosure of Information**

**Brazil**

**Fiscal Responsibility Law**

“Article 4. The Budgetary Guidelines Law must enclose a Fiscal Risk Appendix, evaluating contingent liabilities and other risks that may affect public accounts, and detailing the measures to be taken, should such occur.”

**New Zealand**

**Public Finance Act**

Section 26Q. Fiscal forecasts.

(3) The fiscal forecasts must also include—

[…] (b) a statement of specific fiscal risks of the Government as at the day on which the forecast financial statements are finalized—

(i) that sets out specific fiscal risks that relate to—

(A) the Government decisions and other circumstances required by section 26U to be incorporated in the economic and fiscal update prepared under section 26O; and

(B) any other contingent liabilities (including any guarantees or indemnities given under any Act); and

(ii) that discloses the rules used to determine what is and is not a fiscal risk;”
Annex IV. Template for Annual Fiscal Risk Statement

1. **Macroeconomic Risks**
   a. Discussion, in qualitative terms, of the main macroeconomic risks (both, both upside and downside;
   b. Analysis of how macroeconomic and fiscal outcomes have differed from forecasts in recent years, with explanation of the main reasons for these differences; and
   c. Sensitivity analysis of the impact on the main fiscal aggregates (revenue, expenditure, deficit and debt) of changes in key economic assumptions (e.g. real GDP, inflation, exchange rate).

2. **Debt Management**
   a. Main debt aggregates: domestic debt (domestic and foreign currency components); external debt (including currency composition);
   b. Discussion of key risks: Exchange rate risk (share of foreign currency debt); Interest rate risk (share of variable rate debt); rollover risk (maturity structure and share of short-term debt)
   c. Quantitative analysis: Sensitivity analysis showing nominal value of debt under different scenarios for key macroeconomic variables, progressing debt sustainability analysis; and
   d. Summary of government’s strategy for managing public debt.

3. **Nonfinancial State-Owned Enterprises**
   a. Overview of the size of the SOE sector, including number of entities, total assets and liabilities;
   b. Details of the main financial aggregates (Table 1) and financial performance indicators (Table 2) of the sector as a whole;
   c. Details of government support or explicit contingent liabilities to the sector (including subsidies, capital transfers, guarantees (can cross-reference guarantee section), sub-lending (Table 3);
   d. Quasi-fiscal activities, including: type of activity; rationale for performing this activity through the SOE rather than the state budget; cost of activity to the SOE; mechanism and size of compensation provided;
   e. Contingent liabilities of SOEs, including: guarantees provided by them to third parties; letters of comfort, and legal proceedings initiated against the SOE; and
   f. Statement of measures to mitigate fiscal risks.
### Table 1. Financial Position of SOEs

<table>
<thead>
<tr>
<th></th>
<th>Latest Year</th>
<th>Previous Year</th>
<th>Change (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
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<td></td>
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<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term liabilities</td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating revenue</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Non-operating revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest paid on debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Net profit</strong></td>
<td></td>
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</tbody>
</table>

### Table 2. Financial Performance Indicators for the SOE Sector

<table>
<thead>
<tr>
<th></th>
<th>Latest Year</th>
<th>Previous Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profitability</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Operating margin / EBITDA margin</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Cost recovery ratio</td>
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<td></td>
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<tr>
<td>Return on equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Solvency</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net debt / EBITDA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest coverage ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Worth (total assets less total liabilities)</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

### Table 3. Financial Performance Indicators for the SOE Sector

<table>
<thead>
<tr>
<th></th>
<th>Latest Year</th>
<th>Previous Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deferrals of tax liabilities</strong></td>
<td></td>
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</tr>
<tr>
<td><strong>Tax benefits</strong></td>
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<td></td>
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<tr>
<td><strong>Direct budget Subsidies</strong></td>
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<tr>
<td><strong>Recapitalizations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial SOEs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-financial SOEs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Sub-lending</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Outstanding Stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repayments made</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payments in arrears</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Guarantees</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outstanding Stock</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Servicing of debt on guaranteed loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantee fees collected</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recoveries on guarantees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dividends paid to the budget</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4. **Guarantees**
   a. Summary table on the stock of outstanding loan guarantees by beneficiary;
   b. Fiscal costs of servicing guarantees; recoveries; and revenue from any guarantee fees; and
   c. Paragraph describing each loan guarantee above a certain materiality threshold, including the amount; reason for granting the guarantee; maturity; and history of past servicing.

5. **Public-Private Partnership Contracts**
   a. List a list of PPP projects; details of new PPPs approved since the previous FRS; details of the cumulative multi-year fiscal commitments of the PPP program; gross exposure from guarantees and other contingent commitments attached to PPP contracts.

6. **Local Governments**
   a. Total debt and guaranteed debt of local governments; and
   b. Breakdown of key financial stress ratios (including, debt, payment arrears, debt-servicing to revenue ratios) for individual Oblasts and major cities.

7. **Financial sector**
   a. Explicit liabilities to the financial sector, including details of the DGF (total insured deposits and total assets) and size of government guarantees provided on deposits in state-owned banks;
   b. Liabilities of the financial sector broken into liabilities of state-owned banks explicitly guaranteed; other liabilities of state-owned banks; and liabilities of private banks;
   c. History of past fiscal support to the banking system;
   d. Summary of financial soundness indicators (with reference to some key financial indicators such as capital adequacy ratios and proportion of non-performing loans) drawing on and referencing the NBUs latest financial stability report; and
   e. Summary of mitigating measures to protect the soundness of the financial system.

8. **Natural Disasters**
   a. Discussion of the main risks from natural disasters, average economic costs resulting from past natural disaster events and their frequency; fiscal costs associated with reconstruction and repair and compensation to individuals and businesses from past natural disasters;
   b. Summary of measures to mitigate the risks of natural disasters.

9. **Long-term Fiscal Pressures**
   a. Long-term (at least 30 year) projections for pension entitlements and pension contributions, and the expected amounts to be financed from the budget.

10. **Other Material Fiscal Risks**
    Other material fiscal risks may comprise events that are not captured in the budget because their timing or magnitude is not known. Material fiscal risks are those risks that, if omitted or misstated, could influence the decisions or assessments of users made on the basis of this statement.
### Annex V. Phased Approach to Development of the Fiscal Risk Statement

<table>
<thead>
<tr>
<th></th>
<th>2018 Budget</th>
<th>2019 Budget</th>
<th>2020 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macroeconomic Risks</strong></td>
<td>Qualitative discussion of macroeconomic risks</td>
<td>Qualitative discussion and analysis of past forecast errors to highlight uncertainty around macroeconomic and fiscal forecasts</td>
<td>Present analysis of past forecast errors and sensitivity or scenario analysis showing the impact on fiscal aggregates of different outcomes for key macroeconomic variables.</td>
</tr>
<tr>
<td><strong>Public Debt Exposure</strong></td>
<td>Discuss key risks to debt portfolio related to FX exposure; non-resident holdings; interest rates, refinancing and other relevant factors</td>
<td>Discussion key risks to debt portfolio and sensitivity analysis of changes in debt to deviations in key variables (exchange rate, interest rates)</td>
<td>Discussion key risks to debt portfolio and debt sustainability analysis</td>
</tr>
<tr>
<td><strong>Sub-lending</strong></td>
<td></td>
<td>Disclose sub-lending by borrower and amounts outstanding, with discussion on performance and any restructuring</td>
<td></td>
</tr>
<tr>
<td><strong>SOEs</strong></td>
<td>Present balance sheet and key financial indicators for SOEs (top 100) in aggregate, and by sector; transactions between SOEs and the budget; expanded list of QFAs; stock of guarantees and loans to SOEs; summary of strategy to strengthen SOE performance and reduce fiscal risk exposures.</td>
<td>Present balance sheet and key financial indicators for SOEs (top 100) in aggregate, and by sector; transactions between SOEs and budget; QFAs; guarantees and loans to SOEs; assessment of higher-risk and macro-critical SOEs including more detailed discussion on the individual entities; and discussion of risk mitigation strategies.</td>
<td>Present balance sheet and key financial indicators for SOEs (top 100) in aggregate, and by sector; transactions between SOEs and budget; QFAs; guarantees and loans to SOEs; assessment of higher-risk and macro-critical SOEs including more detailed discussion on these entities; contingent liabilities of SOEs; and risk mitigation strategies.</td>
</tr>
<tr>
<td><strong>Guarantees</strong></td>
<td>Present outstanding stock of guarantees to SOEs (split between domestic and external) and history of performance (past guarantee calls).</td>
<td>Present outstanding stock of all guarantees (split between domestic and external) at aggregate level, and also present guarantees by beneficiary (above a materiality threshold) along with a brief description of each guarantee and past history of performance (past guarantee calls).</td>
<td></td>
</tr>
<tr>
<td><strong>Local Governments</strong></td>
<td>Disclose local government liabilities in aggregate and by municipality, local government guarantees and other contingent liabilities; and discussion of risks related to transfers.</td>
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</tr>
<tr>
<td><strong>PPPs</strong></td>
<td>Disclose direct fiscal costs of PPPs over their life cycle.</td>
<td>Disclose direct fiscal costs of PPPs over their life cycle and present discussion of each major contract (above materiality threshold) and disclose any associated contingent liabilities.</td>
<td></td>
</tr>
<tr>
<td><strong>Financial Sector Exposures</strong></td>
<td>Disclose explicit obligations to financial sector (deposit scheme); liabilities and performance of state-owned banks; previous fiscal costs associated with bank recapitalizations, discussion of fiscal risks and risk mitigating measures (e.g. reform of state-owned banks.</td>
<td>Disclose current legal proceedings against the state, including brief description and quantification of the past legal determinations which give rise to fiscal obligations, but where claims have not yet been processed</td>
<td>Include long-term projections for pension contributions, entitlements, and budget funding of the pension deficit.</td>
</tr>
<tr>
<td><strong>Legal Claims</strong></td>
<td></td>
<td>Disclose current legal proceedings against the state, including brief description and quantification of the past legal determinations which give rise to fiscal obligations, but where claims have not yet been processed</td>
<td>Discussion of potential fiscal implications from natural disasters and history of past budgetary costs.</td>
</tr>
<tr>
<td><strong>Pensions</strong></td>
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<tr>
<td><strong>Natural Disasters</strong></td>
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</table>
Annex VI. RecommendationsMapped to Relevant PIMA Findings

<table>
<thead>
<tr>
<th>PIMA Finding</th>
<th>Most Relevant to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>National strategic plans do not prioritize capital investment projects.</td>
<td>Recommendation 3.1: Development of a national infrastructure strategy by the MEDT’s investment planning unit. Require the strategy to cover recommendations and description of investments, including costings and underlying technical analysis.</td>
</tr>
<tr>
<td>Some but not all sectoral strategies include prioritized capital investments with costing information.</td>
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<tr>
<td>The existing strategic planning process is largely dysfunctional, consisting of a myriad of programs that often overlap and pay little heed of the resourcing constraints posed by the budget.</td>
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<tr>
<td>The MEDT examination of investment projects focuses on ensuring that the formal criteria for project development and appraisal are complied with, whereas the actual selection is based on ad hoc prioritization in the inter-agency committee.</td>
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<tr>
<td>The selection of investment projects is directly linked to the annual budget process, and there is currently no pipeline of projects for subsequent inclusion into the budget.</td>
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<tr>
<td>Starting with the 2016 budget, a list of major public investments is included as an annex to the Budget and includes an estimate of the remaining lifetime costs of the project.</td>
<td>Recommendation 3.4: Strengthen the newly established project appraisal and selection approach and extend this to all major state investments.</td>
</tr>
<tr>
<td>However, this relates only to those projects defined as public investments under the Budget code and does not include other capital projects which constitute more than 90 percent of capital expenditure.</td>
<td></td>
</tr>
<tr>
<td>Most capital projects currently in the budget have not been subject to standardized cost/benefit analysis, but the recently established public investment project mechanism provides a framework for conducting such analysis in the future. In 2015, the Ministry of Economy established a mechanism for identification, preparation, appraisal and selection of public investment projects for the 2016 budget. Projects are reviewed by a committee comprising nine ministers and nine parliamentarians. For the 2016 budget, 36 projects were prepared and submitted for assessment in accordance with this new mechanism.</td>
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<tr>
<td>To date, only a small fraction of government capital projects are covered by the new mechanism. The total allocation for these projects in 2016 of 1 billion UAH must be compared to expected total general government capital spending during the year of 30-40 billion UAH. However, the mechanism does cover a large share of new central government investment projects.</td>
<td></td>
</tr>
<tr>
<td>The new public investment project mechanism provides a standard methodology for project appraisal in line with international good practice.</td>
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</tbody>
</table>

Source: IMF

---

41 Cabinet resolution No. 571 of 22.07.2015 establishes an Interdepartmental Committee assessment process for public investment projects and detailed procedures for preparation, appraisal and assessment of these projects.

42 Since capital spending is not specified in budget documents, we do not have a precise estimate for 2016.
### Annex VII. National Infrastructure or Transport Strategies: Country Examples

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Produced by</th>
<th>Coverage</th>
<th>Timeframe</th>
<th>Consultation process</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Victoria’s 30 Year Infrastructure Strategy 2016</strong></td>
<td>Led by: Seven-person Board comprising an Independent, expert Chair (former Executive Director in Corporate Finance); Deputy Chair with investment and legal experience; major commercial cruise operator, one academic, and three senior (apolitical) public officials. <strong>Produced by:</strong> Infrastructure Victoria</td>
<td>Central/middle/outer Melbourne and regional Victoria. Population growth, health infrastructure, physical activity and participation, communities, accessibility, social and affordable housing, justice, education infrastructure, freight supply chains, water security, landfill and waste recovery facilities, and environment.</td>
<td>18 months</td>
<td>Close collaboration with government and private and community sector organizations that have a role in planning, funding and delivering infrastructure</td>
</tr>
<tr>
<td><strong>NSW State Infrastructure Strategy 2012 (updated 2014)</strong></td>
<td>Led by: Eleven-person Board comprising a Chairman, CEO, five private sector members, three Director Generals (Department of Premier and Cabinet, Director of Planning and Infrastructure, and Department of Trade, Investment, Regional Infrastructure and Services), and a Secretary from the NSW Treasury. <strong>Produced by:</strong> Infrastructure NSW</td>
<td>Global/Greater Sydney and Regional NSW. Urban roads, bus and light rail, passenger trains, international gateways, regional and interstate transport, energy, water infrastructure, health infrastructure, social infrastructure, and justice.</td>
<td>18 months</td>
<td>Consultation with line departments, private sector proponents and other significant stakeholders including Infrastructure Australia.</td>
</tr>
<tr>
<td><strong>The Eddington Transport Study 2006 (updated 2010)</strong></td>
<td>Commissioned by: Chancellor of the Exchequer and the Secretary of State for Transport <strong>Produced by:</strong> Sir Rod Eddington and a team of ten civil servants drawn from the Department of Transport and the Treasury.</td>
<td>Potential for strategic transport decisions to affect the productivity, stability and growth of the UK economy. How transport can contribute to economic success, identifying strategic economic priorities for the UK transport system, prioritizing the most effective policies, and enabling the system to deliver better</td>
<td>18 months</td>
<td>Extensive evidence gathering process involving discussions with businesses, logistics operators, transport operators, suppliers and users of various modes, regional and local government, and environmental organizations.</td>
</tr>
<tr>
<td><strong>Australian Infrastructure Plan 2016</strong></td>
<td>Led by: Twelve-person Board comprising an expert chair, nine private sector members, one academic, and one senior (apolitical) public official. <strong>Produced by:</strong> Infrastructure Australia</td>
<td>Productive cities and regions, efficient infrastructure markets, sustainability and equitable infrastructure, and better decisions and delivery</td>
<td>18 months</td>
<td>Over 100 formal submissions from jurisdictions, a wide range of industry associations, public interest groups, local government bodies and individuals in response to the <em>Northern Australian Audit</em> and the <em>Australian Infrastructure Audit</em></td>
</tr>
</tbody>
</table>
Annex VIII. National Infrastructure Strategy and Longer-Term Capital Budgeting Processes

Figure 1. Illustration of How the National Infrastructure Strategy May Relate to Broader/Overarching Planning

1. Integrated hierarchy of planning documents – integrating strategic and investment planning
   - 15 year overarching economic narrative
     - Authority: President or Parliament

2. Strategic Council
   - Advice
   - MEDT Investment Planning Unit + Strategy development taskforce
     - Composed of MoF, MEDT, line ministries’ secondee, expert advisors

3. Categorise costed investment priorities by sector, short and long term, stage of maturity, likely funding sources
   - Next 5 years (highest priority/most ready projects)
   - 5-10 years (longer term, priorities, more work required)
   - 10-15 years (long term vision)

4. Detailed costings, technical and sectoral analysis

Figure 2: Illustration of the Longer-Term Capital Budgeting Process Described in Recommendation 3.2

December - February
- Start of annual Budget process
- Proposed 10 year KSU data provided by KSUs to Ministry of Finance
- Major drivers of variations are explained
- Final Project appraisals justify major investments

February - April
- Approval of specific projects and capital plans
- Engagement between line Ministry and Ministry of Finance

May - June
- Revised 10 year capital planning limits set within overall KSU ceilings
- Agreed 10 year Ministry data. Preliminary appraisals feed into consideration for future years.
## Annex IX. Assigned Roles and Responsibilities to the MoF in the PPP Process

<table>
<thead>
<tr>
<th>Phase</th>
<th>Description of Functions of Leading Authority (LM-MEDT)</th>
<th>Role MoF under the Law</th>
<th>Recommended Role for the MoF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning</td>
<td>Initial prefeasibility study/ initial Value for money assessment</td>
<td>None</td>
<td>Evaluate pre-feasibility analysis and initial VfM assessment. Evaluate budget affordability and ensure consistency with overall fiscal goals and priorities, review impact on the macro scenario and undertake initial risk assessment. <em>MoF should recommend or not to initiate the process.</em></td>
</tr>
<tr>
<td>Selection</td>
<td>Prepare feasibility analysis and update VfM</td>
<td>No</td>
<td>Evaluate budget affordability. <em>MoF should recommend the continuation or not of the process.</em></td>
</tr>
<tr>
<td>Design and tender preparation</td>
<td>Prepare tender documents</td>
<td>No</td>
<td>Approve of reject tender documents – in line with specifications in planning and selection phases</td>
</tr>
</tbody>
</table>
| Bidding and Contract awarding | Receive tender bids/select bidder Negotiate contract | No | **Bid documents:** Ascertain VfM of the bid. Ascertain fiscal implications of preferred bid and ensure consistency with overall fiscal goals and priorities. *MoF should recommend or not to approve issuance of bid documents.*  
**Negotiation:** Review VfM of the contract documents. *MoF should advice decision making organ to approve/reject contract.* |
| Risk management assessment in case of state support | Risk assessment in case of state support. | | The MoF, according to the current legal framework of state direct support or issuance of government guarantees or borrowing performs the fiscal risk assessment of the project. |
| Construction and operation | Renegotiation | | MoF recommends approval/rejection of renegotiated contract to ad hoc Government Committee |
| Registry | MEDT | MoF | |
| Disclosure | No requirements of disclosure of PPP arrangements in budget documents | | |