BUDGET POLICY: PRAGMATIC APPROACHES TO STRATEGIC DECISIONS
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Budget policy — Pragmatic approaches to strategic decisions:


The study develops the provisions of Economic Pragmatism Policy presented in July 2015 and contains an analysis of the approaches used in Ukraine in the formation of the fiscal policy in previous years, discusses the ways of the budget system evolution, relationship between fiscal, tax, social policy, macro-economic impact of budgetary imbalances. The paper identifies promising areas of fiscal policy as a tool for economic growth, recommendations and practical steps to reform the budget system of Ukraine.

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INTRODUCTION

The issue of public finance management improvement has been paid a lot of attention in recent years by both the Ukrainian government and foreign donors and creditors of Ukraine, such as the IMF, the World Bank or the European Union. It is under pressure of the latter the major reforms took place, whether they were included in the reform programs prepared by the Ukrainian government, or contained in documents developed by donors or creditors. The objectives of the legislative changes that were recommended by foreign partners included achieving transparency of the fiscal process, budget consolidation (reduction of budget operations in the economic system in order to reduce the budget deficit), strengthening financial control and introduction of multi-year budget planning, formation of public debt policy.

An important event in terms of improving the budget legislation was the adoption in 2010 of a new version of the Budget Code of Ukraine. However, lack of reform strategy has led to the fact that numerous amendments started to be made in this document that often had nothing to do with the budget laws, but were procedurally necessary to implement other resolutions. This has led to the chaotic code amendments and disruption of the fiscal system. Since then 65 amendments have been made to the Budget Code. In addition, the use of the Budget Code encounters a common problem of the Ukrainian legislation — its poor enforcement.

To systematize the fiscal system reforming process the government, along with experts from the European Commission in 2013 prepared and approved the Public Finance Management System Development Strategy and an action plan for its implementation, which are performed now, and are a kind of the road map of reforming the fiscal system in general and budget laws in particular. IMF Budget Issues Department in January 2016 issued the Technical Assistance Report — a review of public finance management, which sets out the vision of the key creditor of Ukraine of further reforms of public finance, in particular the fiscal system.

However, neither the adoption of the new Budget Code, nor approval of the Public Finance Management System Development Strategy, nor the above report resolved radically the key issues of public finance in Ukraine — its imbalances and inhibitory effect of fiscal instruments on economic development. The public debt amount at the end of 2015 almost reached the size of GDP, and the GDP has been falling dramatically for two consecutive years. Due to inability to pay the debt, Ukraine has been forced to restructure its commercial part, whose terms are very controversial in terms of their impact on the country’s development prospects. In 2016, Ukraine has lost access to market borrowing instruments and may only receive external funding from international financial institutions and other public entities on a bilateral or multilateral basis. This significantly reduces the already limited independence in shaping its own economic policy, actions of the state institutes, in particular — in the implementation of development strategies.
This study, for the development of the Economic Pragmatism Policy\(^1\) elaborated by the Institute for Social and Economic Studies, analyzes the current situation in the fiscal system of Ukraine, the practice and effectiveness of the state budget as the most powerful instrument of government policy, relationship of the fiscal policy problems with the national economy development. Based on the identified problems and contradictions, the authors suggest a systematic approach to changes in the budget relations on the basis of the economic pragmatism ideology to ensure the effectiveness of fiscal policy as a lever of economic growth strategy and structural modernization of the economy.

1. EMERGENCE, DEVELOPMENT AND DECLINE OF THE BUDGET SYSTEM OF UKRAINE

1.1. Stages and features of Ukraine’s own budget system development after gaining independence

The budget system of independent Ukraine developed in three stages. The first stage began just after gaining independence and lasted until 2002. During this stage, the budget stabilized, the Budget Code was approved and key institutions were established. The second stage — from 2003 to 2008 — was characterized by slowing down and collapse of public sector reforms under the influence of dynamic growth and significant revenues from privatization of the state property. In general, this stage can be characterized as a period of the budget system deregulation and lost opportunities for its reform. The third stage began during the crisis of 2008-2009 and continues until now. It had such features as the budget system transformation into the tool servicing political interests of major oligarchic groups and its gradual degradation. The stage is characterized by rapidly growing public debt and making public finance actual bankrupt.

At the beginning of the first stage, the Ukrainian financial system was an artificially isolated part of the Soviet system without its own objectives, methodology, capable institutions and integration into the international public finance management. Budgeting was carried out under the Soviet regulations and instructions configured to manage the statised financial system. In this system, public finance performed a secondary function, derived from the original function of state planning.

Having become independent the Ukrainian state faced the need to tackle multiple challenges of building its own financial system. These challenges included the following:

• Balance the financial system. It was necessary to create and agree on the key national balances, including: budgetary or fiscal (domestic), payment (external), financial resources (covering all financial resources with defined sources of origin and areas of use);

• Create a system of fiscal relations between the Centre and territories (intergovernmental relations), which would stimulate the development of regions, provide approximately the same level of public services and prevent the disintegration of the state and signs of «financial separatism»;

• Make an inventory of the state and municipal property and put it into account, defining the cost and management strategy of this property;

• Create its own banking system and financial resources market that would not only provide cash management and deposit services to the state, business and
citizens, but also performed the functions of accumulation and redistribution of financial resources and their investment in the economy development.

Almost none of these objectives have been achieved so far. However, building the budget system in the first stage can serve as an example of successful reforms in the country’s interest and the efficient use of donor assistance.

The task was complicated by the economic situation rapidly deteriorating during this period. The economy decline was measured by double-digit rates, and inflation — by four digits. Under these circumstances, budget planning was almost impossible because of the situation unpredictability. For example, in 1994, the government submitted for approval, and the Parliament approved the budget with a zero deficit. However, that year the actual budget deficit was 10% of GDP and was financed by the National Bank using the issuing funds. Thus, it was necessary to simultaneously solve economic problems and stabilize the financial system of the state, without which it was impossible to count upon loans from the international financial institutions, especially the entry of private loans into the market, which Ukraine badly needed to form its own foreign reserves and manage the balance of payments and public debt.

Based on these objectives, the Ministry of Finance of Ukraine in cooperation with the Administration of the President of Ukraine and Budget Committee of the Verkhovna Rada organized efforts to create the new budget law and institutions that would implement it. Substantial assistance was received from external donors: the United States Agency for International Development (USAID), the US Treasury, the British and Swedish governments, the French state international technical cooperation agency ADETEF and a number of other partners. The cooperation with donors was coordinated by the World Bank and the IMF.

A characteristic feature was the simultaneous presence in the said period of all the necessary conditions for successful reform:

• real strategy for the budget system reform;

• team of skilled Ukrainian professionals who are both authors of the reforms and their performers;

• massive foreign aid of not «missionary» but rather «advisory» nature as it should be;

• presence of the political will to reforms when political interests coincided with agreement on the specific steps and actions.

Perhaps the most significant factor of the fact that all participants in the reform process could unite was the situation «as bad as all that». The actual uncontrollability of the budget process resulted in threatening macroeconomic effects, worsening of living standards, threats of the centrifugal motion of the regions, some of which occasionally refused to transfer funds to the central budget, arguing that they cannot ensure performance of the powers delegated to them by the state. Through the efforts of the National Bank of Ukraine to fight inflation by restricting the money in circulation, the country’s economy was destroyed by non-payments and massive use of a different type of netting, clearing and barter, including state and local budgets. Significant discounting of the assets value at the time of barter facilitated the process of initial accumulation of capital and formation of the first financial and industrial groups, which later formed the basis of the oligarchic system.

Meanwhile, the area of public administration and the social and humanitarian sphere degraded due to the rapid reduction in funding without reform. During this period, Ukraine lost a significant part of the scientific potential, entire health care and education systems were destroyed, in fact. Without state funding, they were commercialized in unbridled way due to disordered and opaque private contributions.
and payments, using the public fixed assets, including costly equipment. The rapid impoverishment of the civil servants with simultaneous enrichment of business groups laid the foundations of systemic corruption in Ukraine.

Since 1996, there has been a significant change in the budget legislation as well as in the organization of the budget process. That year, there was a series of key events in the history of independent Ukraine, they include — the Constitution and monetary reform with the introduction of the national currency — hryvnia. This enabled to begin structuring the budget system, based on the provisions inherent in the Constitution of Ukraine regarding state and administrative and territorial structure. Moreover, the introduction of the national currency ensured certain order in the monetary system. However, the main problem of recession and imbalances in public finance still remained and needed resolution.

The objectives of the budget system reform in this period were:

- bring the budget system and budget process in Ukraine in line with the best world practice and Ukrainian Constitution;
- change the budget classification, bringing it in line with the international standards of budget indicators comparison to make planned and reporting data clear to international organizations and investors;
- determine the system of relations between the state budget and local budgets, which would approach Ukraine to the European principles of building relationships and alignment of the economic potential of the regions;
- define the relationship between the various authorities in the preparation, approval, execution of the budget and evaluation of the execution results;
- turn the budget to means to achieve the objectives of the state reforming and economic growth.

The Ministry of Finance started to create its own Ukrainian budget process methodology based on the recommendations of international partners and own initiatives of the team of experts from the Ministry, which had worked closely with foreign advisors. They fundamentally changed the classification of revenues and expenditures, which was extremely important for the budget planning and implementation. Modern detailed classification with the codification was introduced instead the Soviet one, which was hard to understand and too generalized, which made it possible to analyze the origin of their income and economic nature, while expenditures — b the departmental affiliation, functionality and economic entity. They started to approve the budget by the key spending units instead of generalized function, as it used to be.

This had changed the budget process philosophy. If, for example, until then the state budget was approved spending on the function of «education», performed by a number of key spending units (ministries), now the budget was approved by the Ministry of Education, who had a number of functions. That is responsibility for the preparation and execution of the budget was personified in key spending unit, whose budget could include the functions of government, education, health, defense etc. This approach enabled the key spending units to take a more flexible approach to financial support of their policy implementation, managing funds and redistributing them among various functions within the same ministry and therefore make budget requests to the Ministry of Finance.

Sectoral ministries in the new system had to prepare their budgets themselves within the limits established by the Ministry of Finance and then be accountable to the Government and the Parliament not for the amount spent as it used to be, but for the results achieved. Thus the Ministry of Finance was to become the center of a
balanced financial policy that ensures financial stability and methodological support of the budget process.

Unfortunately, this technique was not fully implemented and was discredited to some extent at the second and third stages of Ukraine’s budget system development.

**At the first stage, the following important structural and methodological and legislative measures were taken:**

1. The Budget Code was adopted as an organic law on the budget system. In fact, this law was not a classic code since it preserved a lot of parallel regulations which also regulated the budgetary relations, but was so named only to provide it certain legal advantages over other laws. This document was based on a model law on the budget system recommended by the IMF and addressed several important issues. It systematized the process of budget preparation, execution and reporting, regulated the relationship between the legislative and executive branches on procedural aspects of the budget process, established the distinction between revenues and expenditure levels of the budget system.

2. A new system of intergovernmental relations was formed. Instead of Soviet «dolls» when lower-level budgets were included as a component in higher levels, the new system was formed, which included the separation of revenues and authority for expenditures, introduction of equalization transfers (grants) and conditional grants (subventions) calculated by a special formula that was to make intergovernmental relations transparent and independent. With the full implementation of this concept, local budgets would not have to wait for the state budget to be approved, and they could independently calculate their budgets and approve them. To do this, calculation of taxable capacity was laid down as the basis for the equalization formula. This ratio reflects the level of tax inflow in the territory of a particular local authority in relation to other such authorities. It was expected that it would be stable for three years, and all the revenue growth due to the improvement of the index would remain in the local budget and be spent on the development of relevant community or territory. However, they failed to comply with the principle of the three-year stability and began to change this factor every year. This undermined incentives laid for local development.

3. The State Treasury was created as the Single Treasury Account (STA) Management System, which united all budget system accounts (both state and local budgets). This made it possible to significantly improve the management of state and local budgets, eliminate their dispersion on separate budget accounts and reduce the risks of inefficient «hanging» in the accounts of the key spending units in the commercial banks. The second main function of the State Treasury was paying bills instead of spending. That is the functions of budget commitments and payment or repayment were divided (both functions were previously performed by the key spending units), which involved the strengthening of current expenditure control and efficient management of the TSA resources. Unfortunately, the system created was not able to implement all the concepts that were laid down during its development. Instead of the TSA as a single account, which manages the whole system, a set of accounts united under one department was created. This bureaucratized greatly the process of payments with their considerable delay. Instead of unconditional payment of budget commitments in accordance with the law, the treasury system began to pay «within available funds in the account». Besides, the situation was impacted by irrational (in recent years) use of the mechanism of loans from the TSA, primarily — to the Pension Fund. It destroyed the idea of treasury execution of the budget as part of the budget management. In essence, the previous system of budget accounts remained, but under the Single Treasury Account, and spending units could not pay their bills just as well.
4. Ukrainian budget system was integrated into the international system of information collection and dissemination. Turning to international classification, it could be «read and understood» by the investors, which greatly simplified foreign borrowings and cooperation with international financial organizations.

Thus, at the first stage, the basic principles and methodological foundation were formed, on which budgetary system is based until now. It was expected that the establishment of this foundation will make it possible to use the budget and budget system as an effective tool for economic and social development. However, the subsequent history of the budget system not only failed to confirm these expectations and largely destroyed the achievements of the first stage.

At the second stage (2003-2008), Ukraine was on the economic rise (averaging 7% of real GDP growth per year), which created conditions for an increase in revenues that could be spent on stimulating economic development. But consumer model was chosen instead of investment one. Only in 2004, due to softening of the NBU monetary policy and implementation of programs to support the economy growth, investment exceeded the consumption growth rate, which gave real GDP growth by 12%. Since 2005, model, which included stimulation of growth of personal income and consumer credit with the abolition of incentives for investment and the liberalization of imports of consumer goods, began to be implemented.

Apart from the fact that at that moment the budgetary instruments necessary for economic growth and effective use of the budget had been created — program performance budget method, formation of the development budget in the state and local budgets, prediction of a number of budget programs to support agriculture, industry, they were not applied properly. On the contrary, as a result of political decisions, these efficient tools were reduced to formal procedures, which created a lot more papers and reports, but did not affect the budget process efficiency and were not provided with real resources.

Example of program performance budgeting (hereinafter — PPB) is representative. The question of expediency of this method introduction arose in the early 2000s, when major reforms had already been carried out and aligned the budgetary system of Ukraine with international standards. International donors have noted it and were ready to further support the reforms. The question arose: what reforms are needed? Then management of the budget sector in the Ministry of Finance in cooperation with USAID and other partners, decided to introduce PPB in Ukraine. This proposal was supported by the political leadership of the country and the relevant provision was included in the Budget Code (Article 10).

Reference. Performance-based budgeting is typical of Anglo-Saxon model of building public finance. It was first introduced in the USA in the mid 60’s in the Ministry of Defense. The method is based on borrowing strategic approach used in the business of large corporations. It is widely implemented in such countries as the UK, Australia, New Zealand and other Commonwealth countries. With the formation of the European Union, PPB principles formed the basis of budget reforms in member countries. The method involves planning, implementation and evaluation of budget execution through programs that include goals, objectives, and performance indicators. Unlike traditional continental method that came out of state functions and the need for financial support, this approach focuses on results, as measured by the criteria of achieving goals and efficiency of funds spent. Therefore, this method is called in English Performance-based budgeting, and a budget made on this approach, — Performance Budget (or Program Performance Budget). In Ukraine, PPB was

2 In accordance with the Budget Code of Ukraine, performance-based budgeting method is a method of budget funds management to achieve specific results at the expense of the budget using assessment of performance of the budgetary funds at all stages of the budget process.
first introduced in the preparation of the budget for 2002 and was officially fixed on the basis of the Concept of Performance-based Budgeting approved by the resolution of the Cabinet of Ministers of Ukraine dated September 14, 2002.

PPB implementation was essentially another step to change the spending philosophy of the budget process to achieving the results. The Ministry of Finance together with the line ministries carried out a huge work to define missions of ministries, list of goals, objectives and performance indicators, drawing up and approval of the program expenditure classification. Procedures for preparation and implementation of budgets of budget-funded institutions were standardized, the status of responsible executors of budget programs was defined, rules for drafting budget program passports and performance analysis of their indicators were implemented. It was a shift to meaningfulness budgeting, finding out what money is spent and what social benefits achieved during this process. However, to make this method really work a number of mandatory conditions was required: presence of long-term development strategy for Ukraine, introduction of medium-term economic and budget planning (medium-term budget approval), approval of government programs based on objectives arising from these strategies and plans. Unfortunately, this has not been created so far. Therefore, PPB without these terms is used only formally. Ministers continue to report on «how much we were underfinanced» and not «what we have done for the allocated funds», key spending units spend a lot of time and paper to draw up budget program passports and report on their implementation, but these programs do not solve problems the country faces.

Example of PPB implementation is characteristic for the second stage of the budgetary system, which can be characterized as a period of unused instruments amid favourable macroeconomic situation and global growth. It ended with the world economic and financial crisis, a critical drop in Ukraine’s GDP and a rapid accumulation of public debt.

The third stage we mentioned began during the said crisis and continues until now. It is characterized by the degradation of Ukraine’s financial system as a whole and budget system in particular, as well as by the reproduction of problems of the past that had already been solved owing to the reforms carried out in previous phases.

Fiscal policy (in terms of revenues, expenditures and budget deficit) was the only means of financial stabilization policy, not development. Too strict limits on expenditures were one of the reasons for continued economic decline, reduced export earnings, investment and consumption. As a consequence, the procedure and the rules governing the state budget were systematically and grossly violated. The structure of both budget revenues and expenditures is the result of random political decision and not the result of reform policy, confidence of both ordinary citizens and businessmen to fiscal policy remains low as the main tool of Government policy. Control of the validity of the cost estimates of budget-funded institutions, which are the basis for the taking of budgetary commitments, is almost lost. Blending of function and performance-based budgeting led to lack of control of the budget planning and execution. While the current (at stage of bill payment) and the following (check of a financial transaction already carried out) types of financial control although poorly but work, there is almost no preliminary control (evaluation of appropriateness and reasonableness at the budgeting stage, budget program preparation and budget estimates).

As will be shown in subsequent paragraphs, in this period, the budget mechanism virtually lost its function as a tool of economic development. Constant «experiments» with the tax system and failures of the decentralization of public finance, increased corruption in budget spending, including investment funds, lack of public sector reforms and of social transfer system have led to fiscal system imbalances in general and threatening growth of public debt. Attempts of the foreign partners to help restore public finance balance and sustainability through programs are exposed to
weak institutional and human resources capacity of the budget system. The latter is progressively detached from the real sector and becomes «virtual» with an emphasis on obtaining financing instead of budget revenues, and balance problem is solved not by economic growth but by reducing still unreformed public sector. This, in turn, further undermines institutional capacity and system recoverability. The degradation apex is neglect of procedures for draft state budget development and adoption.

Thus initially strong system of public finance of Ukraine created for reform and economic growth has gradually turned into passive addition to politically unsettled and economically weak public administration system.
1.2. Evolution of budget revenues

The nature of the budget system impact on the situation in the country’s economy, in particular — the level of fiscal policy favorableness for economic growth is largely determined by the social product redistribution through the budget, which is characterized by the revenues amount and structure of the state and consolidated budgets.

Overall, the share of GDP redistribution through the consolidated budget of Ukraine ranges around 30%, with some decrease in crisis periods of 2009 and 2013. Dynamics of fiscal redistribution demonstrates attempts of its countercyclical use, as evidenced by the increase in the budget expenditure excess over revenue in the depression and crisis periods (Figure 1.1). However, the efficiency of countercyclical measures depends largely on the budget expenditure structure that will be discussed in the next section.

For correct comparison of fiscal redistribution to the practices of other countries, it should be noted that European practice usually includes in the consolidated budget the income of social funds. According to Eurostat, in EU-28, the figure reached in 2014 45.2% of GDP (particularly in European neighboring countries: the Czech Republic — 40.1%, Poland — 38.6% and Slovakia — 38.9%, Hungary — 47.4%). The biggest indicator of this is in Norway, Sweden, Finland, Denmark, France and Belgium — over 50% of GDP. In Ukraine, in 2014 the general government revenues on the basis of own revenues of the Pension Fund of Ukraine and social insurance funds amounted to 40.3% of GDP, and in 2015 — about 42%. Thus, the general level of fiscal redistribution in Ukraine is close to the European average.

![FIG. 1.1. DYNAMICS OF GDP REDISTRIBUTION THROUGH THE CONSOLIDATED BUDGET OF UKRAINE IN 2003-2015.](source: State Treasury of Ukraine, State Statistics Service of Ukraine)
There is a widespread opinion that in the developed countries fiscal redistribution index tends to be higher than in developing countries\(^3\). This conclusion is based on the assumption that the developed countries due to the perfect budget policy institutes are able to effectively redistribute consolidated resources through fiscal mechanisms, while less developed countries do not have adequate institutes for this. According to estimates of national researchers, amid the imperfections of the market institutions, with low performance of the government, growth in GDP redistribution share through public sector leads to a decrease in the rate of GDP growth by 6%\(^4\).

However, this position is somewhat controversial. Because developed institutional structure inherent in the leading countries enables to solve a number of tasks that are the responsibility of the state (internal security, law enforcement, social services, etc.) without the use of budget funds by institutional self-organization. However, underdeveloped countries require specific state action to enhance public education, health care, reduce inequality and poverty, for human development, infrastructure development, etc., without which retardation of their economies is preserved in the modern world. Thus, the classical vision comes true, especially for sustainable division of the countries into and highly-developed and underdeveloped countries that focus on changing their status in the global distribution, not the level of fiscal redistribution but the structure of fiscal exemptions (budget revenues) and efficiency and focus on growth and structural shifts in expenditures become fundamental.

The study of impact of budget revenues on economic activity in the country examines primarily tax revenues. In the structure of state budget revenues of Ukraine, their share ranged around 63-76% in 2000-2010, and subsequently increased sharply (by 81-83%) as a result of changes in taxation related to the adoption of the Tax Code of Ukraine (e.g., the increase in excise tax, improved administration, etc.) as well as a result of a purely statistical reasons as under the Tax Code some tax payments (primarily rent and target premium to the rates — up to 2011) were accounted for as tax (Fig. 1.2).

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{fig12.png}
\caption{Revenues of the Consolidated Budget of Ukraine in 2005-2016.}
\end{figure}


It should be emphasized that the general tendency to reduce the amount of the tax burden on the real economy and facilitation of tax administration, which was observed in 1997-200, is considered by experts as one of the preconditions for recovery in Ukraine of economic growth after the transformation crisis. The impact of softened tax burden on setting trends in economic growth in Ukraine is confirmed by empirical calculations.

Significant positive shifts in tax policy at that time included income tax and VAT rate reduction from January 1, 2004, as well as the transition to a flat income tax rate of 13%. This reduction resulted in reducing the share of fiscal GDP redistribution in 2004 (Tab. 1.1), positively affected the volume of funds that are available to businesses and people, which contributed to the expansion of domestic demand, development of economic entities, weakened incentives of the shadow economic activity.

**TABLE 1.1. MAIN TAX EXEMPTIONS IN RELATION TO GDP IN THE ECONOMIC GROWTH RECOVERY PERIOD, IN %**

<table>
<thead>
<tr>
<th>Index</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate income tax</td>
<td>4,50%</td>
<td>4,10%</td>
<td>4,20%</td>
<td>5,00%</td>
<td>4,70%</td>
<td>5,30%</td>
<td>4,80%</td>
<td>4,80%</td>
</tr>
<tr>
<td>Personal Income tax</td>
<td>3,80%</td>
<td>4,30%</td>
<td>4,80%</td>
<td>5,10%</td>
<td>3,80%</td>
<td>3,90%</td>
<td>4,20%</td>
<td>4,80%</td>
</tr>
<tr>
<td>VAT</td>
<td>5,60%</td>
<td>5,10%</td>
<td>6,00%</td>
<td>4,70%</td>
<td>4,80%</td>
<td>7,70%</td>
<td>9,30%</td>
<td>8,20%</td>
</tr>
<tr>
<td>Excise duty</td>
<td>1,30%</td>
<td>1,30%</td>
<td>1,80%</td>
<td>2,00%</td>
<td>1,90%</td>
<td>1,80%</td>
<td>1,60%</td>
<td>1,50%</td>
</tr>
<tr>
<td>Tax exemptions in total</td>
<td>18,40%</td>
<td>18,00%</td>
<td>20,10%</td>
<td>20,30%</td>
<td>18,30%</td>
<td>22,20%</td>
<td>23,10%</td>
<td>22,40%</td>
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However, the process of reducing the tax burden gained further development through the introduction in 2005 of a package of amendments to several legislative acts in the field of taxation adopted by the Verkhovna Rada together with the changes to the Budget 2005 (generally, amendments were made to more than 90 laws and the existing tax incentives for businesses registered in the SEZ, PDT and industrial parks were abolished, and for various industries such as aircraft, automotive, space engineering, armored vehicle manufacturing, etc., excise tax rates were increased, etc.).

As a result of these measures, the level of tax burden resumed growth, reaching in 2006 a record of 23.1% of GDP. In 2007, certain tax benefits granted prior to 2002 as part of investment programs in the automotive sector were resumed, which ultimately reflected slight decrease in fiscal burden. A significant increase in income tax exemptions in 2005 is clearly correlated with a sharp drop in investment dynamics in this period, as well as easing the tax burden on income in 2006-2007 may be associated with the resumption of active investment dynamics.

Another attempt to improve the tax system was made in 2010, with the adoption of the Tax Code. Document streamlined tax system, established principles of reducing the fiscal burden, settled stimulating function of taxes. It was expected that gradual reduction of income tax rate from 25 to 16% (in 2011 — 23%, in 2012 — 21%, in 2013 —

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19%, in 2014 — 16%) was to provide incentives for investment of earnings. Since 2014, VAT rate reduction to 17% was predicted.

Valuable feature of the Code provided for incentives aimed to encourage energy saving, such as: exemption from part of the corporate income tax on income derived from the production and sale of certain energy-efficient industrial goods and part of the revenues resulting from the implementation of energy efficiency measures and energy efficiency projects by the companies that deal with development and use of the energy-saving measures and energy efficiency projects; temporary income tax exemption for biofuels producers for the production of electricity and heat, and profits from the extraction and use of natural gas from coal deposits. Encouraging entrepreneurial activity was to be promoted by a number of innovations for the improvement of tax administration, tax reporting, payment mechanisms etc.

Meanwhile, full implementation of tax innovations was impeded by short-term priorities for fiscal balance with the relentless increase of expenditures amid the expansion of economic depression trends, and then — the crisis in 2014. Increase in fiscal redistribution in the post-crisis period was secured by the weight of indirect taxes (Tab. 1.2).

**TABLE 1.2. MAIN TAX EXEMPTIONS IN RELATION TO GDP IN 2010-2015, IN %**

<table>
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<tr>
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<th></th>
</tr>
</thead>
<tbody>
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<td>5</td>
<td>3,6</td>
<td>3,7</td>
<td>4,2</td>
<td>4</td>
<td>3,8</td>
<td>2,5</td>
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<tr>
<td>Personal Income tax</td>
<td>4,8</td>
<td>4,9</td>
<td>4,7</td>
<td>4,6</td>
<td>5,1</td>
<td>5</td>
<td>4,7</td>
<td>5,1</td>
</tr>
<tr>
<td>VAT (balance)</td>
<td>9,7</td>
<td>9,3</td>
<td>8</td>
<td>10</td>
<td>9,8</td>
<td>8,8</td>
<td>8,8</td>
<td>9</td>
</tr>
<tr>
<td>Excise duty</td>
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<td>2,6</td>
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<td>2,7</td>
<td>2,5</td>
<td>2,8</td>
<td>3,6</td>
</tr>
<tr>
<td>Tax exemptions in total</td>
<td>24</td>
<td>22,8</td>
<td>21,7</td>
<td>25,7*</td>
<td>25,7</td>
<td>24,2</td>
<td>23,2</td>
<td>25,6</td>
</tr>
</tbody>
</table>

* Change in tax exemptions in 2011 was also related to changes in the budget classification by income — income from royalties started to account for as a part of tax revenues.

Tax changes in 2014 involved reducing the number of taxes and some simplifying of administration. Reform continued the trend of reducing the number of taxes (Tab. 1.3). At the same time, being adopted during the sharp increase in the need for pumping the budget changes were primarily focused on increasing the fiscal burden: new charges for the financing of the defense (defense tax) were introduced, taxation of passive income of individuals as well as higher pensions, increased rates of excise, payments for use of subsoil and radio frequency resources. Reducing the number of taxes both in 2011 and in 2015, has not significantly affected the revenues to the budget, as it took place primarily by their unification rather than abolition. Abolition affected only inefficient taxes and fees, which had no material impact on the budget performance or business. Thus, the list of excisable goods included electrical energy due to the abolishment of fee as a surcharge to the current tariff for electricity and thermal energy; single payment for the use of natural resources was set, that is 4 taxes and fees consisting of royalties (royalty for subsoil use, fee for using the radio frequency resource of Ukraine, fee for special use of water, fee for special use forest resources) were concentrated; local tax on property now consists of: tax on property other
than land; vehicle tax; payment for the land (the latter transferred from the state budget). Essential for the growth of budget revenues in 2015 were the introduction of import duty, defense tax, increased rent and excise payments.

**TABLE 1.3. CHANGES IN THE TAX SYSTEM STRUCTURE OF UKRAINE IN THE REFORM PROCESS**

<table>
<thead>
<tr>
<th>LAW OF UKRAINE «ON TAXATION SYSTEM»</th>
<th>TAX CODE OF UKRAINE</th>
</tr>
</thead>
<tbody>
<tr>
<td>By 2010</td>
<td>2011</td>
</tr>
<tr>
<td>Total taxes and fees</td>
<td>Total taxes and fees</td>
</tr>
<tr>
<td>40</td>
<td>23</td>
</tr>
<tr>
<td>State</td>
<td>25</td>
</tr>
<tr>
<td>Local</td>
<td>15</td>
</tr>
</tbody>
</table>

Despite a long reforming period, the tax system of Ukraine preserves significant drawbacks related to both imperfect and excessive administrative burden, and the continuation of the practice of selective law enforcement by the fiscal authorities. Representatives of local domestic business claim the preservation of depressing impact of fiscal procedures on the business climate, practices of advance deductions and non-refunding VAT\(^7\). Thus, in 2014, advance transfer of corporate income tax amounted to UAH 26.5 bln., and in 8 months of 2015 — UAH 14.8 bln. A significant impediment to business development is the constant volatility of tax legislation that does not allow entities to clearly predict the areas of their activity.

Dynamics of the structure of tax revenue shows a strong tendency to increase in the share of revenues from indirect taxes, including VAT, excise taxes and duties. Mainly due to this component, since 2002, there has been a general tendency to increase the total tax burden on GDP. In particular, the VAT and excise taxes in 2002 financed 28.3% of revenues of the Consolidated Budget, in 2005 this figure reached 34.3% in 2008, in circumstances that preceded the financial and economic crisis it rose to 35% in 2010 — up 36.4%, 2015 — 38.2% and in 2016 it may reach 45.5%.

By its nature, indirect tax depends on the price of the object of taxation and has no direct relation to the level of income, and hence to the performance of the taxpayer’s activities. Therefore, such a tax structure makes it easier to collect taxes, but does not make fiscal authorities objectively interested in improving the national economy. Accordingly, the tax policy does not address this problem as a priority.

The need for filling the revenues also traditionally conflicts with the goals of business activity by reducing the tax burden and the use of tax incentives of development. It is this that determines periodic intents of fiscal authorities to cancel the simplified tax system and resistance to proposals to use internationally tested tax incentives, particularly for investment. The main reason for the negative attitude to the preferential tax tools is the lack of effective control mechanisms for the intended use of tax incentives and methodological support of their effectiveness analysis\(^8\). The predominance of indirect taxes in tax revenues to the budget determines dominance VAT exemptions in the total tax costs. However, in this case the amount of money that the business entity receives through this exemption does not depend on the effectiveness of its operations, which is not conducive to the target of this stimulus. Getting VAT exemptions is often the result of lobbying the group interests and way of winning in price competition. However, VAT exemptions are direct budget losses due to short-received «living» funds whose availability with the taxpayer does not depend on the exemption.


Direct taxes (mainly corporate income tax and personal income tax), reducing income of their taxpayers, directly affect the volume of investment and consumer demand. From a fiscal standpoint, they are inferior to indirect taxes in terms of uniformity of their revenue, but have a significant share in the tax revenues to the budget (in 2014, the share of PIT in tax revenues in the consolidated budget amounted to 16.5%, CIT — 8.8%, in 2015, 15.3% and 6.0% respectively). Exemptions from payment of direct taxes, especially on income tax, encourage increasing profitability and efficiency of the company’s resources.

Thus, the structure of tax revenues in Ukraine has developed under the influence of prioritization of fiscal penalties that creates a conflict with the objectives of the structural changes needed to strengthen the national economy competitiveness. Tax policy is not used as a lever to stimulate economic growth and positive structural changes.

Among the non-tax revenues, primacy belongs to the funds of the National Bank of Ukraine. Since 1999, the Law of Ukraine «On the National Bank of Ukraine» fixed the provision on transferring to the state budget amounts exceeding the NBU revenues over its spending and adequate funding of the NBU from the state budget if it has losses. The share funds of transferred by NBU in the state budget revenues ranged from 0.5% (in 2002) — 1.8% (2004) in the first years of economic growth, from 2008 it began to actively grow and in 2015 it was 11.6%.

The NBU’s source of income in this period was exchange income related to the devaluation of the hryvnia and income from operations with government securities due to active budget lending through indirect purchase of the government bonds by the National Bank.

In fact, the presence of the relevant provision and existing right to fix by the Law on Budget the revenue sources and their volumes helped to get around the provision prohibiting budget lending at the expense of equity funds established in Article 15 of the Budget Code and Article 54 of the Law of Ukraine «On the National Bank of Ukraine». That means filling the state budget by the funds of the National Bank was carried out almost manually, and the NBU income was «stable and predictable» source of budget revenues.

International financial organizations have repeatedly drawn attention to the problem in question. This resulted in the initiated amendments to the Law of Ukraine «On the National Bank of Ukraine», which reinforced the need to deduct the share of NBU profits to the NBU reserves and the state budget on equal terms. However, the Law on the State Budget of Ukraine for the relevant year suspended the provisions once again or replaced with «anti-crisis» laws. The last time, at the insistence of the IMF and the World Bank, in 2015 the Law of Ukraine № 541-VIII «On Amendments to Certain Legislative Acts of Ukraine on Institutional Capacity building of the National Bank of Ukraine» has once again confirmed the transfer of profit to the state budget based on the year-end results rather than by «advance» payments. However, an artificial delay in the formation of the National Bank (which determines the audit company for auditing the National Bank, based on which Rada approves the amount of National Bank profit and its distribution) is an obstacle to full implementation of such a mechanism in 2016.

Own revenues of the budget-funded institutions and proceeds from administrative services also form a significant proportion of revenues to the consolidated budget (UAH 36.0 bln. in 2010, UAH 59.5 bln. in 2015, representing 9.1% of consolidated budget), but their legal normalization was done only in 2010 with the adoption of the new wording of the Budget Code. Article 13 identified types of such revenues and areas of use within the special budget fund for the needs of these institutions. The process of streamlining of administrative services is ongoing.

Income from property and business activities of the state in terms of transfer of part of the net profit (income) of the state or municipal unitary enterprises and associations, as well as dividends (income), interest on stocks (shares) of economic companies, whose authorized capital contains

state or municipal property, have a much smaller share of total revenues (0.1% in 2001 to 1.1% in 2015). Annual efforts to increase this revenues item have created a number of problems for entities in the public and utilities sectors related to the withdrawal to the state budget of a significant proportion of these profits, that is contrary to the objectives of their modernization and competitiveness. This also leads to lower quality of services provided by natural monopolies, with a relative over estimation of these services.

After 2010 in Ukraine there was a growth in the share of the state budget general fund and reduction of special one. Until then the share of revenues of the consolidated budget general fund was less than 78%, starting from 2011 it was over 82%. In particular, since 2011 the general fund included fee of a surcharge to the current tariff for electricity and thermal energy (currently in the excise tax), and from 2015 — excise taxes and import duties on petroleum products and vehicles, fee for social and economic compensation for the population’s risk, living in the observation area, environmental tax in part payable to the state budget (since 2016, 80% of revenues from environmental tax were sent to a special fund of the local budgets).

The main reason for these changes is the attempts of the Ministry of Finance supported by the international lenders to enhance the flexibility of the budget expenditures, which in theory is correct and progressive. Given the current weak budgetary planning and deficiencies in the management of the treasury system, withdrawal of certain programs from a special fund means the loss of sources of funding and, eventually, termination of the programs themselves. Therefore, the correct idea of the transfer of the special fund to the general one can be implemented only after the development of the budget planning and execution system will be at the level of the countries which have practically implemented this approach.

Thus, the structure of both tax and non-tax revenues of Ukraine’s budget reinforces the negative impact of fiscal exemptions on economic activity. Theoretically, this inhibitory effect could be compensated by means of proactive fiscal policy, however, as will be shown below, in practice, adequate compensation does not occur. Weak planning and budget performance forecasting system with substandard macroeconomic projections encourages the existence of submission to the fiscal authorities of overestimated revenues plans, which lead to the actual violation by the fiscal authorities of the budget and tax legislation with a view to the implementation of these plans, regardless of whether the revenues are secured by the real economy resources.
1.3. Structural features of budget expenditures

High level of fiscal redistribution in Ukraine puts high demands on the orientation of the structure of budget spending to support economic growth and structural modernization of the country. In between 2003 and 2015, the average proportion of consolidated budget expenditures in GDP was 32.2% (Fig. 1.3). The increase in the share of expenditures in times of depression was likely to have stimulating impact on economic recovery, but the quality was not accompanied by structural changes, as evidenced by preservation of the substantial crisisgenic nature and uneven dynamics of the domestic economy. Inadequate institutional environment causes significant risks of inefficient use of public funds.

The structure of expenditure by functional classification (Fig. 1.4) shows the subordination of fiscal policy to the changes in the political sphere, mainly oriented to meet current challenges and meet the first urgent needs of social and economic development as opposed to strategic objectives and tasks of economic restructuring.

As shown in the Table 1.4, the largest share in the Consolidated Budget of Ukraine belongs to social spending (on health, spiritual and physical development, education, social protection and social security, housing and utilities) — on average, for the period 2003-2015, they were 60 % of total consolidated budget expenditures, while in 2010-2013 they reached peak values of 65-66%. Expenditures for execution of the governance powers by the state (general state administration, defense, security and public order) were mostly at the level of 22-23% and increased in 2014-2015 because of the economic crisis and the armed aggression against Ukraine.
The study presents data for 2016 according to the information published by the Treasury on targets according to the Law of Ukraine «On the State Budget of Ukraine for 2016».

### TABLE 1.4. DISTRIBUTION OF CONSOLIDATED BUDGET EXPENDITURES BY FUNCTIONAL CLASSIFICATION IN 2003-2016, IN% OF GDP

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
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<td>3.6</td>
<td>3.5</td>
<td>3.7</td>
<td>3.4</td>
<td>3.3</td>
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<td>3.7</td>
<td>4.1</td>
<td>4.9</td>
<td>5.9</td>
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<td>1.2</td>
<td>1.3</td>
<td>1.2</td>
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<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
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<td>2.6</td>
<td>2.7</td>
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<tr>
<td>Public order, security and judiciary</td>
<td>2.2</td>
<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
<td>2.6</td>
<td>2.9</td>
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<td>2.6</td>
<td>2.9</td>
<td>2.8</td>
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<td>Economic activity</td>
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<td>4.3</td>
<td>5.0</td>
<td>5.6</td>
<td>5.4</td>
<td>4.4</td>
<td>3.9</td>
<td>4.2</td>
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<td>4.0</td>
<td>3.6</td>
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<td>0.8</td>
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<td>7.8</td>
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<td>33.2</td>
<td>33.4</td>
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<td>33.8</td>
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</table>

10 The study presents data for 2016 according to the information published by the Treasury on targets according to the Law of Ukraine «On the State Budget of Ukraine for 2016».
### Table 1.5. Ranking of Priorities of Fiscal Policy of Ukraine in 2003-2015.

<table>
<thead>
<tr>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<td>Education</td>
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<td>Health care</td>
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<td>Utilities and housing</td>
<td>Defense</td>
<td>Defense</td>
<td>Defense</td>
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<tr>
<td><strong>Spiritual and physical development</strong></td>
<td>Spiritual and physical development</td>
<td>Utilities and housing</td>
<td>Defense</td>
<td>Utilities and housing</td>
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<td>Spiritual and physical development</td>
<td>Spiritual and physical development</td>
<td>Utilities and housing</td>
</tr>
<tr>
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</table>
Ranking shares of the areas of finance in the expenditure structure of the Consolidated Budget of Ukraine gives grounds to determine trends in changes if fiscal policy priorities of Ukraine in 2003-2016. (Tabl.1.5).

<table>
<thead>
<tr>
<th>Year</th>
<th>Social protection and social security</th>
<th>Education</th>
<th>General state functions</th>
<th>Health care</th>
<th>Economic activity</th>
<th>Public order, security and judiciary</th>
<th>Spiritual and physical development</th>
<th>Defense</th>
<th>Utilities and housing</th>
<th>Environmental protection</th>
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<tbody>
<tr>
<td>2010</td>
<td>Social protection and social security</td>
<td>Education</td>
<td>Economic activity</td>
<td>Health care</td>
<td>General state functions</td>
<td>Public order, security and judiciary</td>
<td>Defense</td>
<td>Defense</td>
<td>Utilities and housing</td>
<td>Environmental protection</td>
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<tr>
<td>2011</td>
<td>Social protection and social security</td>
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<td>Economic activity</td>
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<tr>
<td>2012</td>
<td>Social protection and social security</td>
<td>Education</td>
<td>General state functions</td>
<td>Health care</td>
<td>Economic activity</td>
<td>Public order, security and judiciary</td>
<td>Defense</td>
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<td>2013</td>
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<td>General state functions</td>
<td>Health care</td>
<td>Economic activity</td>
<td>Public order, security and judiciary</td>
<td>Defense</td>
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<tr>
<td>2014</td>
<td>Social protection and social security</td>
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<td>2015</td>
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<tr>
<td>2016*</td>
<td>Social protection and social security</td>
<td>General state functions</td>
<td>Education</td>
<td>Health care</td>
<td>Economic activity</td>
<td>Public order, security and judiciary</td>
<td>Defense</td>
<td>Economic activity</td>
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</table>
Most significant share in the structure of expenditure on social protection and social security are allocations for social protection of pensioners, which in 2003 amounted to about 35% and in 2015 rose to over 56%, and by the planned performance in 2016 will amount to 61.1% of the total expenditure on this activity (Fig. 1.5). In absolute terms, these expenditure items exceed the budget deficit amount. The rapid growth of expenditure on social security of pensioners is explained by a high budget deficit of the Pension Fund of Ukraine, which forces to cover this deficit at the expense of the state budget. In 2015, out of UAH 94.8 bln. of the expenditures from the state budget under «Social Security of Pensioners» one third — 31.8 bln. — was allocated to pay off the deficit. Under 2016 Plan, these expenditures increased to UAH 144.9 bln., of which the deficit repayment was already 60.5%, or UAH 87.7 bln. Thus over 60% of pensioners receive a pension that does not exceed the subsistence minimum for disabled persons.

Populist practice of «distribution» in pre-election periods of special pension payments to different categories of population also affected the amount of expenditures. A significant need for funds to support the elderly leads to constraints on funding of other items, including social protection of family, children and youth. This certainly has a negative impact on population reproduction and social reintegration of the young generation.

**FIG. 1.5. STRUCTURE OF EXPENDITURES ON SOCIAL PROTECTION AND SOCIAL SECURITY**

Education is the second by importance area of expenditures in the social sector (Fig. 1.6). The structure of expenditures on this functional item in the State Budget more than 75% accounts for spending on higher education (75.2% in 2015 and 92.6% of the planned in 2016), as the main burden of funding the primary and secondary education falls on local budgets. Accordingly, in the Consolidated Budget, the majority of funding accounts for the secondary schools (over 43.5%). The effectiveness of public spending on education is evidenced by their structure: in 2014, current expenditures accounted for 97.6% of the consolidated budget expenditures on education funding, including 54.0% accounted for wages. Thus, the relatively high quality of Ukrainian education (in 2015, in the world ranking of secondary schools Ukraine ranked 38th, in the higher education ranking — 41) is based mainly on the exploitation of the inherited capacity, while there is almost no investment in strengthening the financial base of the sector. A direct consequence is to increase the differences in the quality of educational services (especially in urban and rural areas), lag in specialists’ training according to the requirements of the labour market, forming the basis for informal cash fees for formally free-of-charge educational services.
Inefficient structure is also inherent in financing of the health care sector, the largest share of which goes to the operation of hospitals and spa and resort facilities (about 52% in the structure of health care expenditures are from the State Budget — and more than 64.8% from the Consolidated Budget — Fig. 1.7). In 2016 Plan, share of this Consolidated Budget item decreased to 59.6%. Current expenditures in 2014 reached 96.5% of consolidated budget expenditures, of which 54% accounted for wages. 83.9% of health care expenditures are made (in 2015) by the local budgets, which increases the importance of efficient functioning of the local network of outpatient and inpatient outpatient facilities. Characteristic is the fall in the share of funding for sanitation and anti-epidemic measures and institutions that determine the general orientation of the health sector in Ukraine is much more expensive processes to overcome the disease instead of cheaper disease prevention. Negative demographic figured — high mortality and low life expectancy (148th in the world), significant incidence of socially dangerous diseases, including — HIV/AIDS, tuberculosis etc confirm the general inefficiency of spending public funds on health care in Ukraine.
Expenditure on utilities and housing also have, in our opinion, to be considered in the context of social spending as they directly affect the conditions and quality of citizens’ life. Apart from 2012, when there large infrastructure projects for Euro 2012 were implemented, the share of expenditure on utilities and housing needs remained insignificant and in 2015 was planned at 1% of the consolidated budget expenditures. Thus 99.6% of expenditures were made from local budgets.

A residual principle of utilities and housing financing has led to neglect of the strategic objectives of modernization and the prevalence of current «hole patching». In particular, in 2010-2012, UAH 15,662,300,000.00 was provided for the National Program for Housing Reform and Development, and in fact UAH 1,236 mln. has been allocated from the state budget, that is underfunding was 92.1%.

As a result, the utilities and housing sector accumulated structural problems, which not only significantly impair the quality of livelihood of the population of Ukraine, contain risks of aggravating the environmental, sanitary and epidemiological and technological situation, but also serve as a basis for a growing need in budgetary subsidies for the population to compensate for too high tariffs, whose value includes, inter alia, low efficiency, high losses in the utilities sector and inefficient organizational model of its operation. Funds for modernization and technical re-equipment of engineering infrastructure partly are involved through cooperation with international financial organizations, which are accounted for under separate budget items.

Thus consistently high share of social expenditures in Ukraine currently does not provide adequate social security and adequate living standards, implementation of the provisions embedded in the Constitution that the Ukrainian state is social. Unreformed nature of social components leads to a waste of a significant proportion of the resources withdrawn through fiscal instruments of the state. This makes the existing model of social policy hinder the economic growth and unfavorable for the development of human capital of Ukraine.

Given the intensification of economic stagnation in 2012-2015, there was an increase in expenditures for general state functions (include spending on higher public administration bodies, local authorities and local self-governments, financial and foreign policy, debt service, intergovernmental transfers, etc.). This increase is primarily due to an increase in spending on public debt servicing, which in 2014 compared to 2012 increased by half, or by UAH 24.2 bln., while total expenditures under the item — only UAH 21.8 bln.. Thus, expenditures on higher government bodies and local authorities, including to pay salaries in these bodies during this period in nominal terms virtually remained unchanged, while the number of civil servants and local government officials even increased slightly (by 1.9%). Too «cheap» public administration staff (a significant number of employees with very limited funding) lead to poor quality of governance through the «washout» of specialists in the sector and laying grounds for corruption.

The share of defense expenditure in the consolidated budget expenditures during the period under study declined steadily, dropping in 2013 to 0.97% of GDP. This is explained by a significant reduction in the number of military personnel and a decrease in funding of programs aimed at modernization of military equipment and rearmament in general. Such neglect of the army needs has adversely affected its combat capacity and development of the domestic defense industry. The situation has changed dramatically since 2014 when the Government under severe budget constraints had to implement an increase in defense spending in connection with the resolution of the military conflict in Ukraine, and they increased it by 1.9 times in comparison with 2013. In Budget 2015, the share of defense funding reached 2.63% of GDP. The upward trend in spending has remained in the plan for 2016.
Over the last decade, the share of spending on economic activities has rapidly decreased in the consolidated budget expenditures — from 18.5% in 2004 to 6.9% in 2015, and in plan for 2016 — 7.3%. The reasons for this decline is a change in the principles of state support on the reorientation of direct budget funding to establish tax incentives and increase the share of other expenditures, particularly in the performance of the state social functions and public debt servicing. The total value of spending on economic activities against GDP is very low (Fig. 1.8).

Consolidated budget expenditures for economic activity do not ensure the economy stabilization, creation of the necessary market environment, maintaining the priority and basic industries, development of knowledge-based innovative technologies, modernization of infrastructure, etc., which indicates the inefficiency of the economic functions of the state.

The use of public funds for economic activity usually is determined by specific political and economic priorities and involves, inter alia, various forms of subsidies to various kinds of economic activities and industries. It should be emphasized as follows:

1. So-called «priority» of the industry plays an important role in providing funding (for example, according to the functional classification of expenditures, fuel and energy complex in 2010-2015 was funded by 95-88% of the plan, agriculture, forestry, hunting and fishing — by 94-69%, transport — 79-89%, environmental protection — by 38-56% etc. At the same time, funding of allocations for health care, spiritual and physical development, education, social protection — over 95%
2. Allocation of budget funding to finance specific programs is affected both by objective and subjective factors. The objective ones include shortfall of funds to the special fund of the state budget, the subjective ones — delayed approval of the use of budget funds, complexity of the mechanisms of obtaining funds by economic entities, inefficient spending of time during tenders etc.

3. Returnable financial assistance from the budget (lending) in Ukraine is not applied in sufficient volume and concerns mainly budget-funded programs:
   - in housing, to provide housing for young people, teaching staff, village developers;
   - in agriculture: the operations of leasing of agricultural machinery, heifers and cows, farm support;
   - in the electricity sector, reconstruction of hydro power plants, increasing the reliability of electricity supply, construction of overhead lines (but mostly these are loans from international financial organizations accounted for in the budget);
   - to support small businesses: from 2010, it was planned to spend UAH 46.2 mln., but actually the program was funded only in 2013 — for 9.8 mln.. (40 micro loans provided).

Essentially, loan is a more effective way of support than direct budget funding, as it implies a return to the budget and minimize the possibility of misuse of funds. The risk is that these funds are provided mainly at the expense of pre-defined revenues and therefore underfunding is not rare.

4. Compensation for interest rates and share of lease payments. For a long time this mechanism has been used in agriculture (from 2000 nearly UAH 4.5 bln. was spent). It was launched in 2000 and showed very positive effect at the first stages of its application. For example, only in 2001 the balance of debt on loans has almost doubled. Overall, during 2000-2015, balance increased from UAH 745 mln. to UAH 53,098 mln. However, the mechanism of partial compensation of interest rates on loans is not an incentive to lower interest rates in the banking system as a whole. Therefore, this mechanism can only be used for the short-term effect.

5. Increasing the authorized capital of the companies by the budget funds in Ukraine is widely used for:
   - housing construction — to replenish the authorized capital of the State Fund for Youth Housing in 2009-2015 UAH 172.6 mln. was spent.;
   - agriculture — NAC «Ukragroleasing» increased its authorized capital by UAH 846.4 mln. in 2006-2014;
   - military and industrial complex and state-owned enterprises for 2006-2012. — by UAH 245.9 mln (including UkrOboroProm (Ukrainian Defense Industry) — UAH 100 mln. Ukrainian Special Trade — UAH 5 mln.);
   - aviation industry — domestic aviation enterprises received to replenish their authorized capital in 2009-2012 almost UAH 820.7 mln.. However, funds were directed primarily to repay existing arrears in wages and debt to contractors;
• financial institutions — in 2006-2010, the state banks (excluding bank recapitalization by exchanging through exchange of the bank shares for government bonds) and the State Mortgage Institution received UAH 2.8 bln.;

• implementation of national projects, 8 state enterprises were established to implement 12 national projects. About UAH 800 mln. was spent on the formation of their authorized capital.

The influence of government support on competition and effectiveness of public spending in Ukraine is practically uncontrolled. There is a delay in the introduction of instruments of control and assistance provided by the Law of Ukraine «On State Assistance to Business Entities» harmonized with the EU legislation. Similarly, little attention is paid to the study of feasibility and proportionality of state assistance for the implementation of strategic development benchmarks.

As shown in Fig. 1.9., the biggest in budgetary expenditure on economic activity is the proportion of expenditure on transport — an average of 36.5%, fuel and energy sector accounts for 20.7%, agriculture, hunting — 15.3%, other production and construction — only 1.9%. During the period under study, there was the shortest drop in spending on transport needs, energy sector and agriculture (Fig. 1.9.). Moreover, break occurred during the economic crisis of 2008-2009. Expenditure on basic and applied research and development in areas of the economy have always been the lowest in the consolidated budget expenditures on economic activity and reached its maximum values in 2005, 2007 and 2008 — 0,14% of GDP, and in 2015 historical minimum was financed from the budgets — 0.04% of GDP.

It should be noted that the costs of economic activity in OECD countries on average amount to 9.5% (as of 2013) and range from over 25% in Greece to less than 7% of Denmark, Israel, Portugal and the United Kingdom.

**FIG. 1.9. UKRAINE’S CONSOLIDATED BUDGET EXPENDITURES ON ECONOMIC ACTIVITY, UAH BLN.**
The share of expenditure on transport between 2007 and 2015 dropped from 2.0% to 1.6% of the GDP. In 2016, funding of 1.2% of the GDP is planned. Over 80% of expenditures in this area are spent on road maintenance. In fact, development of transport as the economy sector is allocated a relatively small share of the budget: pipeline and other transport — 4.1% (average from 2003 to 2015), railway — 3.5%, automobile — 0.9%, air — 3.1%, water — 0.7% of the total expenditures allocated for transport (Fig. 1.10).

Meanwhile, the level of funding road works over the past 10 years was 14-34% of the scientifically based minimum needs\textsuperscript{11} and funding allocated to the road sector in Ukraine and brought to 1 km of road of public use is several times less compared to European countries. Due to generally little funding, expenditures cannot have a significant impact on the condition of roads in Ukraine. Improvements do not have a systemic nature and focus on the main roads, while the local road network remains in critical condition and significantly limits the settlements transport accessibility. In terms of strength and smoothness the existing roads do not meet modern technical requirements by 40-50% of the total length of the network.

Thus, according to the Law of Ukraine «On the State Budget of Ukraine for 2015», the relevant amendments to the Tax and Budget Codes of Ukraine, financing of roads from the target sources, revenues from which were previously accumulated in a special fund of the state budget, was canceled, and funding of all expenditures road complex was to be made from the general budget fund. This made long-term work planning impossible.

\textbf{FIG. 1.10. CONSOLIDATED BUDGET EXPENDITURES ON TRANSPORT, UAH BLN.}

\textsuperscript{11} Concept of public roads state administration reform, approved by the Cabinet of Ministers of Ukraine dated 03.08.2011 №739-p «Some Issues of Public Roadways State Administration Reform». 
The largest share of expenditures on the development of the fuel and energy sector are expenditure on state support for coal mining companies, due to the overall industry loss ratio (Fig. 1.11). Expenditures under this Article have been constantly increasing from 2008, and with the general trend to reduce spending on fuel and energy sector against GDP growth, there are to further cuts in other areas: electricity, oil and gas etc. Insufficient capital investments in these sectors failed to implement Ukraine’s energy strategy. Most of the programs of modernization and construction of power generating and network facilities that were provided for by the Energy Strategy 2006 have not been implemented. For example, in 2014 the implementation of Energy Sector Reform and Development Program was financed only by 14.9%, state support for construction of coal and peat mining enterprises, technical re-equipment of these enterprises — by 59.7%. However, the program of coal industry privatization involves the sale of stakes in profitable enterprises, and low-profit or unprofitable businesses remain state-owned. Under such conditions, the state will be forced to either permanently subsidize low-profit or loss-making coal mines, or carry out bankruptcy proceeding and close the company.

Lack of market mechanisms to encourage the improved efficiency of coal mines, including coal market, prevents the allocation of budget financing for the real upgrade of the sector, maintenance of its role in the energy security of Ukraine, as provided for by the Energy Strategy of Ukraine.

FIG. 1.11. CONSOLIDATED BUDGET EXPENDITURES ON FUEL AND ENERGY COMPLEX, UAH BLN.

In terms of energy intensity, Ukraine’s GDP is several times higher than in developed countries of Western and Eastern Europe. Thus, the energy intensity of GDP in Ukraine in 2010 amounted to 0.55 tons of standard fuel per USD 1,000 of GDP compared to 0.1 — for Germany, 0.2 — for Poland and 0.46 — for Russia.
The share of expenditure on agriculture, forestry, hunting and fishing in the consolidated budget expenditures on economic activity in 2015 was 10.7% (compared to 23% in 2003), with the majority support accounting for agriculture. At the same time, the share of spending on these activities in GDP declined almost threefold during the period, and in 2015 was 0.31% of GDP, and the plan for 2016 — 0.23% of GDP. The structure of support to agriculture is primitive and does not exhaust the range of facilities and areas of support under the WTO agreements. As a result, Ukraine is able to compete only on agricultural commodity markets. Positive development trends observed in the agricultural sector of Ukraine in recent years indicate the presence of sufficient prerequisites for improvement of economic dynamics even in the reduction of state support. Profitability of agriculture remains relatively high compared to other economic activities in the real sector of economy of Ukraine. However, the production structure of the sector is influenced by external economic conditions, there it is simplified, «minor» activities unclaimed in the global market are lost, which adversely affects the completeness of domestic agricultural resources and rural employment.

Increasing focus of public spending on current consumption is evidenced by overall trend of decline in the share of capital expenditures in the total consolidated budget expenditures (Fig. 1.12, Tab. 1.6). Having reached 10.1% after the crisis of 2008-2009 (due to the impact of preparation for Euro 2012), in 2014, this figure decreased to 3.9% in 2015 — increased to 6.9%. The share of budget investments in fixed assets in GDP dynamics should decrease — from 3.4% in 2007 to 0.9% in 2015 (Fig. 1.13). It should be emphasized that in recent years New EU member-states, in contrast, sees the increase of budget investments on GDP, due to the objectives of infrastructure modernization in these countries (this figure in many countries exceeds 5% of GDP\textsuperscript{13}). However, it should be remembered that such investment usually receives support from European structural funds, to which Ukraine has no access.

FIG. 1.12. STRUCTURE OF THE CONSOLIDATED BUDGET EXPENDITURES, IN % TO TOTAL EXPENDITURE

\textsuperscript{13} I.O. Lunina Problems and prospects of public finance development in Ukraine. // Finance of Ukraine. — 2010. — No. 2. — P. 3-12
TABLE. 1.6. STRUCTURE OF SOURCES OF CAPITAL INVESTMENT FINANCING IN UKRAINE IN 2006-2015, IN %

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>state budget funds</td>
<td>6.5</td>
<td>6.8</td>
<td>5.7</td>
<td>4.3</td>
<td>5.8</td>
<td>7.1</td>
<td>5.8</td>
<td>2.4</td>
<td>0.7</td>
<td>2.4</td>
</tr>
<tr>
<td>local budget funds</td>
<td>4.5</td>
<td>4.2</td>
<td>4.6</td>
<td>3.1</td>
<td>3.4</td>
<td>3.4</td>
<td>3.1</td>
<td>2.7</td>
<td>2.6</td>
<td>5</td>
</tr>
<tr>
<td>own funds of enterprises and organizations</td>
<td>59.8</td>
<td>58.6</td>
<td>59.3</td>
<td>66.1</td>
<td>60.8</td>
<td>58.6</td>
<td>59.7</td>
<td>63.8</td>
<td>71.5</td>
<td>67.4</td>
</tr>
<tr>
<td>bank loans and other borrowings</td>
<td>3.4</td>
<td>15.2</td>
<td>15.8</td>
<td>13.3</td>
<td>12.3</td>
<td>16.3</td>
<td>17.1</td>
<td>15.3</td>
<td>8.8</td>
<td>7.3</td>
</tr>
<tr>
<td>foreign investments</td>
<td>3.4</td>
<td>3.3</td>
<td>3</td>
<td>4.2</td>
<td>2.1</td>
<td>2.8</td>
<td>1.7</td>
<td>1.8</td>
<td>2.7</td>
<td>3.1</td>
</tr>
<tr>
<td>public housing funds</td>
<td>14.3</td>
<td>8.2</td>
<td>7.7</td>
<td>5.3</td>
<td>11.1</td>
<td>7.5</td>
<td>8.8</td>
<td>10.6</td>
<td>10.5</td>
<td>12</td>
</tr>
<tr>
<td>other sources of funding</td>
<td>8.1</td>
<td>3.7</td>
<td>3.9</td>
<td>3.7</td>
<td>4.5</td>
<td>4.3</td>
<td>3.8</td>
<td>3.4</td>
<td>3.2</td>
<td>2.8</td>
</tr>
<tr>
<td>total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

FIG. 1.13. CAPITAL EXPENDITURES OF THE CONSOLIDATED BUDGET IN THE TOTAL EXPENDITURES AND AGAINST GDP, IN %

Given period is characterized by chronic reduction of the budgeted capital expenditure plan (Tab. 1.7), which is due to residual financing investment principles and practices of reduction of investment costs in order to limit the cash budget deficit. The systematic underfunding of plans for capital expenditure budgets of all levels means that started in the past projects are not completed and therefore not achieved the expected impact of their implementation. This results in blocking the implementation of state programs, budget spraying, regional development impediment, growing number of construction projects mothballed. The above increases distrust of investors in partnership with the state in investment projects, reduces private sector participation in strategically important investment projects. Given that the state remains the owner of stakes in a number of strategic enterprises, weak investment by the state, as well as the requirements for withdrawal of profits of these enterprises to the state budget, leads to a loss of competitiveness and the market value by such companies, which negatively affects the budget revenues in case of the decision on privatization.
TABLE 1.7. MAIN INDICATORS OF BUDGET CAPITAL EXPENDITURE IN UKRAINE IN 2006-2015.

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP, UAH mln.</th>
<th>Capital investments, UAH mln.</th>
<th>Share of capital investments in GDP, %</th>
<th>Capital investments at the expense of the state and local budgets, UAH mln.</th>
<th>Share of budget capital investments in GDP, %</th>
<th>Capital expenditures of the consolidated budget (plan), UAH mln.</th>
<th>Capital expenditures of the consolidated budget (fact), UAH mln.</th>
<th>Plan performance, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>544153</td>
<td>148972</td>
<td>27.4</td>
<td>16338</td>
<td>3</td>
<td>28918</td>
<td>24536</td>
<td>84.8</td>
</tr>
<tr>
<td>2007</td>
<td>720731</td>
<td>222679</td>
<td>30.9</td>
<td>24448</td>
<td>3.4</td>
<td>43391</td>
<td>38690</td>
<td>89.2</td>
</tr>
<tr>
<td>2008</td>
<td>948056</td>
<td>272074</td>
<td>28.7</td>
<td>27901</td>
<td>2.9</td>
<td>50741</td>
<td>41153</td>
<td>81.1</td>
</tr>
<tr>
<td>2009</td>
<td>913345</td>
<td>192878</td>
<td>21.1</td>
<td>14275</td>
<td>1.6</td>
<td>32100</td>
<td>20052</td>
<td>62.5</td>
</tr>
<tr>
<td>2010</td>
<td>1120585</td>
<td>189061</td>
<td>16.9</td>
<td>17320</td>
<td>1.5</td>
<td>42402</td>
<td>30648</td>
<td>72.3</td>
</tr>
<tr>
<td>2011</td>
<td>1349178</td>
<td>259932</td>
<td>19.3</td>
<td>27196</td>
<td>2</td>
<td>57856</td>
<td>41947</td>
<td>72.5</td>
</tr>
<tr>
<td>2012</td>
<td>1459096</td>
<td>293692</td>
<td>20.1</td>
<td>26290</td>
<td>1.8</td>
<td>61593</td>
<td>40745</td>
<td>66.2</td>
</tr>
<tr>
<td>2013</td>
<td>1522657</td>
<td>267728</td>
<td>17.6</td>
<td>13717</td>
<td>0.9</td>
<td>52235</td>
<td>29380</td>
<td>56.2</td>
</tr>
<tr>
<td>2014</td>
<td>1566728</td>
<td>204062</td>
<td>13</td>
<td>6788</td>
<td>0.4</td>
<td>38876</td>
<td>20200</td>
<td>52</td>
</tr>
<tr>
<td>2015</td>
<td>1980441</td>
<td>251154</td>
<td>12.7</td>
<td>18538</td>
<td>0.9</td>
<td>60237</td>
<td>46745</td>
<td>77.6</td>
</tr>
</tbody>
</table>

Reducing the share of investments from state and local budgets in the overall financing of capital investments in Ukraine from 11.0% in 2006 to 3.3% in 2014 indicates a weakening of state influence on the structure of investment in Ukraine. In 2012-2015, funding from these sources fell dramatically in both absolute (with 18.4 and 8.8 bln. UAH in 2011 to 1.5 and 5.2 bln. in 2014, respectively) and in relative volume (from 7.1 and 3.4% in 2011 to 0.7 and 2.6% in 2014, respectively). In 2015 the situation improved slightly: the share of investments from state and local budgets in the general funding of capital investment in Ukraine reached 7.4%.

However, the structure of budget investment in fixed assets in this period has significantly changed towards decentralization: in 2006, local budgets funded only 41.2% of the total investment cost, in 2014, already 77.7% and in 2015 this share decreased slightly (Fig. 1.14).

FIG. 1.14. STRUCTURE OF CAPITAL INVESTMENTS FROM BUDGET SOURCES, %

- Share of the capital investment from state budget in total budget investment, %
- Share of the capital investment from local budgets in total budget investment, %
Reference. The scope of state investment activities in the leading developed countries covers from 5 to 20% of total investment. By means of spending on investment, the state rather actively influences the rate of accumulation, its level and dynamics, which contributes significantly to accelerating the pace of capital accumulation and economic growth. Thus, according to the OECD in 2013 the average share of public investments in total investments was 15.9%. Compared to 2009, most OECD countries have reduced public investment through the implementation of austerity programs of, but public investment has not fallen below the level of 2007, in contrast to Ukraine and such OECD countries as Spain, Austria, Ireland, Turkey and Russia. Greece is a country with the largest share (23.2%), followed by Slovenia and Luxembourg (22.6% and 22.1% respectively).

The governments of OECD countries are mainly engaged in long-term investments in public infrastructure, as well research and development that can contribute to balancing the economic cycles, creating new jobs and increasing productivity through the use of counter-cyclical policies. In 2013, the governments of OECD countries invested on average 7.8% of total government spending (the rate varies from 17.2% in Korea to 4% in Ireland).

A significant share in the structure of capital expenditures accounts for capital transfers (30-50% — Fig. 1.15), which are sent from the state budget to local budgets, ensuring alignment of inter-regional differentiation of economic development. For some types of transfers (socio-economic development of regions, development of housing and utilities) funds are actually distributed in proportion to population, based on the formula, but their share and dynamics are unsustainable. Thus, the distribution of grants for investment projects is carried out in the manner determined by the Cabinet of Ministers of Ukraine, taking into account the objectives and activities of the State Strategy of Regional Development, regional development strategies based on formal parameters, based on actual and forecast indicators of economic and social development of the territory.

The obvious problem is not only lack of funding but also inefficient management of the public investment process, correct selection of investment targets due to limited budgetary resources, reaching the target focus and cost optimization, ensuring investment project implementation outside the budget year.

To sum up, we may conclude on the actual lack of accountability of the budget expenditure policy to the strategic objectives of development and structural modernization of the economy of Ukraine. The state faces a challenge of achieving proper efficiency and effectiveness of spending of scarce budgetary resources, and ensuring the level and structure of public spending that would meet the strategic priorities of state policy.

The obvious problem is not only lack of funding but also inefficient management of the public investment process, correct selection of investment targets due to limited budgetary resources, reaching the target focus and cost optimization, ensuring investment project implementation outside the budget year.

1.4. Improvement of mechanisms of budget planning and administration and manual control spreading factors

The fiscal policy efficiency depends largely on the availability of mechanisms and practices of budget planning and administration that would correspond to the condition of the state budget system and the economy as a whole. Due to the lack of strategic vision of reform goal and under the influence of constant violations of the law, Ukraine formed «hybrid» budget model, which has a negative impact on financial stability and the possibility of economic development. This model is characterized by the fact that the Ministry of Finance actually imposes sectoral ministries and local authorities their budgets and structural reforms, which they should perform. Thus the Ministry of Finance assumes no responsibility for consequences and shits it to sectoral ministers and local officials who under the law are really responsible for the budget preparation and execution of the corresponding sector of public administration or local self-government. MOF little defers to the opinion of the ministries when it proves limits for drafting budget requests and hardly discusses draft budget with the ministers or does this formally (basic discussion is carried out with the IMF).

Meanwhile, sectoral ministries receiving neither money nor reform, nor at least proper procedure for discussion of budget requests try to solve their budget problems through non-transparent negotiations with the Ministry of Finance or lobbying their interests in the budget committee of the Verkhovna Rada. This leads to opacity of approving the budget allocations and impeding reforms in relevant areas due to lack of sufficient funds.

After the adoption of the budget and approval of the budget plan by the Ministry of Finance, there is the process of approval of passports of budgetary programs and estimates of budget-funded institutions. The adoption of these documents gives the right to assume budgetary commitments on behalf of the state and their payment by the State Treasury. However, the passports of budgetary programs (which are drafter by the key spending units and agreed upon by the Ministry of Finance), and estimates of budget-funded institutions (approved by the key spending units according to the figures of the State Budget Plan) do not reflect the way of achieving the goals and objectives identified in the budgetary programs and allocations provided for them achievement. The appropriations as a way of maintaining budget-funded institutions are an attribute of the functional approach to budgeting, where the principal thing is to ensure certain existence standards.

Reference. Historically, the international practice developed two conventional types of budget process and budget system construction, they can be roughly defined as centralized and decentralized. The principal difference between them is in the role of the Ministry of Finance as the authority responsible in the government for drafting the budget and its implementation. In countries with centralized type of organization, responsibility for budgeting and for its implementation lies with the Ministry of Finance. It controls not only the total amount of spending of the sectoral ministries, but calculation of expenditures by items, compliance with
the budget legislation and budget discipline through subordinated Treasury and the final result of the use of funds through subordinated financial control and audit bodies. The role of the sectoral ministries and, consequently, sectoral Ministers is to submit to the Ministry of Finance the necessary budgeting information, to answer its questions, get the budget and ensure its implementation in accordance with the instructions.

In a decentralized system, function of budgeting and budget execution lies with the sectoral ministries, and the Ministry of Finance is responsible for compliance with the overall fiscal balance, budgeting methodology and is involved in the coordination of financial markets, which cover the gaps in the budget financing. The entire responsibility for budgeting rests with the sectoral ministers.

If in case of the first type the fiscal balance (deficit or surplus) is the result of budgeting, then in case of the second, they are a baseline for this budgeting. In Ukraine, the Ministry of Finance first summarizes the needs of the key spending units, calculated in accordance with the law, then announces that they far exceed projected revenues, and proposes to amend the legislation, reducing the need for expenditure and increasing revenues by introducing new taxes or increasing rates of existing ones. This makes the budgetary process unpredictable when the tax system in the planning year, real purpose for the key spending unit or transfer to the local community depends on the final vote on the budget law, which often is not reviewed by most MPs and which is revised by results of voting.

Budget planning and administration policy was first improved in Ukraine within the introduction of Program Performance Budget, which came into place of itemized expenditure planning. Program Performance Budget should help to identify and solve important problems of the state, regions and local communities — that, in fact, is called the reforms. However, this approach requires a much higher level of interaction between all participants in the budget process and observance of mutual obligations, starting with setting strategic goals of the state, providing funds and ending with provision of funds to the smallest budget program in the smallest community. That is budget preparation and implementation process assumes not financial character but rather economic and administrative.

The introduction of PPB was aimed to reduce as more significantly as possible the influence of the «human factor» (or, rather, realization of ambitions of political influence centers) on the budget allocation and spending. It was suggested that the concentration of expenditure on certain perspective goals and objectives of individual areas with further monitoring of spending effectiveness and, as expected, — mandatory funding of these programs, including — using funds from other sources, will be an effective way to improve the efficiency of budget system.

A new stage in PPB use began in 2010, with the adoption of the new wording of the Budget Code of Ukraine. It improved approaches to the formation of strategic documents — Key Areas of the Fiscal Policy and forecasting of the State Budget of Ukraine for two budget periods following the planned, normalized list of documents (indicators, explanations, figures) to be developed and submitted by the key spending units, laid the foundations of comparison of the indicators covered in the budget requests with plans of key spending units. During the following years, number of budget programs was optimized (it was reduced from 901 in 2011 to 532 in 2015).

However, attempts to introduce Performance-based Budgeting and medium-term budget planning and forecasting proved too dependent on political and economic conditions and mainly were not really implemented in practical activity of the government. Indicative in this respect are:

1. The laws of the State Budget of Ukraine for the relevant years. Although the Budget Code of Ukraine and the Regulation of the Verkhovna Rada of Ukraine clearly defined deadlines for submitting the draft state budget to the Verkhovna Rada of Ukraine (September 15) and its consideration (in three readings during September-November), the government failed to enforce
them. Only in 2002, law on the budget was adopted on time. There appeared practices of further recalling of the draft budget formally submitted in due time (e.g. draft budgets for 2013, 2015 and in 2016). There is a practice of the adoption of budget laws in a package of other laws that significantly changed the tax environment or bases of the spending units’ activities, or the inclusion of relevant provisions directly to the text of the budget law. This made it impossible to correct budget planning, as forecast of revenues and/or expenditure needs were formed under the pending law.

2. Main fiscal policy areas for the relevant year. Deadlines for submission and consideration of the Budget Code of Ukraine set by this document and the Regulation of the Verkhovna Rada of Ukraine do serve as the basis for its adoption. For example, in 2013, 2014 and 2015 the Parliament of Ukraine failed to take adopt Main Areas. Thus the Cabinet of Ministers of Ukraine tried to comply with both formal deadlines for the document submission and determining main indicators and provisions laid down in Article 33 of the Budget Code of Ukraine. The document contained the minimum indicators and criteria and was written in general terms that in the future in the direct formation of the draft state budget, made it possible to adjust the parameters without breaking formally the approved document. Therefore, despite all their importance, the main fiscal policy areas have not become the founding document (or a benchmark) for the formation of the fiscal policy.

3. State Budget Forecast for two budget periods following the planned one. Unfortunately, despite the inherent purpose of the existence of such a document as a first step for the implementation of the overall strategic planning and forecasting system, rules of its formation established by Article 21 of the Budget Code of Ukraine, the forecast has not gained enough weight in the budget process.

According to the Budget Code of Ukraine, PPB components in the budget process are the budget programs, responsible performers of the budget programs, passports of the budget programs, performance indicators for budget programs. Meanwhile, in practice, these components have inherent significant drawbacks:

• plans of the key spending units are made without taking into account the development strategies, there no mechanisms for evaluation and comparison of plans with the strategic objectives and priorities of the state and the individual territories, according to their capacity and growth points;

• lack of transparency of the approval process of expenditures in budget requests and allocation of budget funds in manual mode «by agreement» lead to a fragmented and unstable funding plans as capital investments planning is made solely by the Ministry of Finance, excluding the priorities of implementation of state programs, however, the Ministry of Economic Development, which is a leading authority in the implementation of public investment policy, is not involved in this process;

• due to imperfect procedures for the selection of investment projects within budget programs there are numerous cases of amendments to the list of projects/facilities approved by the relevant resolutions of the Cabinet

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15 Amendments to Article 33 of the Budget Code of Ukraine on finding public investment projects under the capital expenditures determined by Ministry of Finance were adopted on 07.04.2015, but the implementation of these rules in practice is still not defined.
of Ministers of Ukraine only in the second half of the year, in which it is necessary to implement projects under the budget programs as a result of late start the budget funds are is used inefficiently or not used at all, there is actually a manual manipulation of expenditures;

- there is no analysis of budget program indicators in terms of their relationship with the objectives set by the state documents in their respective fields;

- use of performance indicators is formal, statistics data are without a clear idea of the degree of achievement of the objectives and effectiveness of budget funds cannot be used to make decisions about the appropriateness of further funding for program implementation.

Article 18 of the Law of Ukraine «On State Target Program» authorizes the Ministry of Economic Development to carry out methodical works on the development and implementation of programs to analyze the projects/programs in order to balance resources necessary for their implementation, to consider and agree proposals of the state customers to amend the programs. However, currently there is no document on the basis of which the Minister would determine the degree of priority areas for socio-economic development, and there are no clear criteria for feasibility of the target program adoption. Too broad issues of state programs in the absence of priorities for their formation, lack of coordination of their funding with budget capacities within the execution period lead to excessive number of state programs, of which less than half are funded.

So while the state target program is recognized regulatory component of forecast and program documents of economic and social development, they become a real tool for the implementation of socio-economic development. Significant amounts of funds for their implementation are often spent without tangible results for society and provided PPB concentration on defined goals and priorities of development was replaced by «manual control» of the budget expenditures. Signs of this «control» are obvious at all stages of formation, adoption and implementation of the state budget:

- At the stage of the budget drafting, definition by the key spending units of their needs in funding, both short and long term, is almost leveled the. At the final stage of the budget consolidation, appropriations for the spending units is determined by the Ministry of Finance, for reasons of allocation of scarce resources, which may differ significantly from the amount of the budget request. Reasons for this are overstating needs in budget funds by the spending units, poor system of needs planning by the key spending units, discrepancy of needs to fund the total number of programs over budget capabilities etc.

- At the stage of the budget approval — Verkhovna Rada of Ukraine has never adopted the budget in the wording of the Cabinet of Ministers of Ukraine. Thus, in 11 out of 15 budgets considered in years under discussion (2000-2014) budget expenditure, approved by the Parliament, were higher than laid down in the original government draft, by an average of 4.5%. However, the government draft budgets were too conservative and parliamentary changes to them — too optimistic\(^\text{16}\). Generally, the increase of expenditure is a result of political compromise, not as the result of a reasoned vision of the

possibilities and feasibility of providing just such an increase.

• At the stage of the budget execution, there are numerous cases of non-systemic changes to already approved financial plan of the state. The largest number of amendments to the budget was made in 2012 — 38, the least — in 2002 — only 4. Redistribution of the state budget by the resolutions of the Cabinet of Ministers of Ukraine agreed with the Budget Committee of the Verkhovna Rada of Ukraine, there were over 90 in 2012 and in 2013, in 2014 — over 40, in 2015 — almost 70. Reasons for amendments include:
  • Change in economic performance indicators and budget execution indicators (stated case under Chapter 9 of the Budget Code of Ukraine), review of funds channeling to meet the specific needs of a social nature. The initiator of change — the Cabinet of Ministers of Ukraine;
  • Need to change the funding of certain programs. Mainly, the initiators of these changes are MPs;
  • Redistribution of funds between different budget programs in the system of key spending unit. The mechanism implemented from 2011, on the one hand, simplified the procedure of budgetary funds use, on the other — showed the shortcomings of needs planning by the key spending units.

Resort to «manual control» of the budget expenditures is primarily due to the influence of the following factors.

1. Low-quality forecasting system of budget revenues indicators. As shown in practice, macroeconomic forecasting system, mechanism and timing of which are determined by the resolution of the Cabinet of Ministers of Ukraine dated 26.04.2003 No. 621 «On Development of Forecast and Program documents of Economic and Social Development and the State Budget Drafting », was not used in full, the deadlines for submission of the relevant documents were not met, macroeconomic forecasts were calculated practically «for the budget». While forecasting system has been established at the Ministry of Economic Development and Trade, the results of prepared forecasts are constantly subjected to «political» adjustments from both the Government and the Ministry of Finance to increase the income distribution and from the IMF to agree with its own forecasts, which are laid in cooperation programs with Ukraine. This resulted in chronic underperformance of state budget targets for both revenue and expenditure. For example, revenues of the consolidated budget in the 2012-2014 were performed for 93-94% of the plan considering its adjustment during the year; expenditures — for 92.4% in 2012, to 91.2% in 2013 and only 88.9% in 2014. The risk of failure to perform the revenues plan led to the introduction of budget revenues performance planning when appropriate tax collection plans were brought to the tax service, distorted mechanism of advance payment of income tax and increasing the state debt on VAT refunds was introduced, as mentioned above. Cash deficits due to budget shortfall form the basis of «manual» selective implementation of the planned allocations by the Ministry of Finance and the State Treasury.

2. «Political» factors associated with taking populist decisions to increase social standards in general and expenditure for specific sectors in the period before the parliamentary and presidential elections. Short political cycles that encourage efforts to get quick results for the next election rather than to lay foundation for systemic change in the country.
3. Drawbacks of the treasury system of budget performance. Creation of the State Treasury focused all budget funds on a single treasury account to improve the efficiency and flexibility of management and formed the basis for strengthening current control over the spending of state and local budget funds. It was to provide constant liquidity of the fiscal system within the approved parameters, so the state had to be the most reliable and liquid financial partner for businesses and citizens. However, none of these functions have been satisfied properly so far by the Treasury. The weak development of the financial market Ukraine does not allow the flexibility to manage liquidity of the treasury account, either surplus or a deficit of funds is accumulated on it. As the state budget is the largest participant in the financial market, such fluctuations negatively affect both macroeconomic stability (especially at the end of the fiscal year, when there is a massive payment of invoices that were not paid on time), and the confidence to state that untimely performs its obligations or fails to perform them at all.

4. Insufficient quality of public financial control. In practice, the system of internal audit in budget-funded institutions does not ensure prevention of violations in the budget process. The reasons for this — both subjective (lack of understanding by the heads of budget-funded institutions essentially the internal financial control and audit, practice of «mutual aid») and objective (imperfect regulatory framework in matters of internal control, including responsibility and accountability of the heads of budget-funded institutions). Renaming of the Chief Control and Revision Office in the Ministry of Finance into the State Financial Inspection and its selection as an independent executive agency not increased the efficiency of this structure. Its regular reformattting is ongoing — into the State Audit Service. Formation of the Accounting Chamber as the supreme body of the external audit of the state also had to influence its quality. With the adoption in 2015 of the new Law of Ukraine «On the Accounting Chamber» basic principles and approaches to external financial control have been revised, the status of the Accounting Chamber as the supreme authority of external audit of public finance was clarified and its mandate in terms of control of the state budget revenues was expanded, state companies were audited etc. However, this does not overcome the problem of actual duplication of the Accounting Chamber and State Financial Inspection against the background of continued waste and outright corruption during budgeting. For fiscal institutions, control measures mean considerable expenses and time lost on the work with auditors, which are often not experts in the relevant field and cannot conduct quality assessment and test the effectiveness and legitimacy of budget operations. Significant amount of violations that are made public by these bodies of financial control are often simply estimated by considerations of these bodies’ officials, which are even neither properly designed nor confirmed.

5. The existence of corruption schemes and lack of transparency of budget performance. In particular, imperfect legislation in public procurement, permanent amendments to it in terms of non-application of the basic law on the purchase of certain goods (works, services) and entities), drawbacks in tenders (high use of non-competitive procedures) and a low level of competition in the procurement create opportunities for subjective decision making. In 2015, the State Financial Inspection prevented violations during the procurement of goods, works and services for state funds totaling almost UAH 2.7 bln.. In particular, the tenders in excess of UAH 1.6 bln. were canceled and contracts worth nearly UAH 1.1 bln. were terminated. Lack of
transparency in key spending units has remained a major problem for a long time. To solve this problem in 2014-2015 it was legally regulated to ensure publication in the press and on the websites of major spending units of the information on state and local budgets and reports on their performance, and from October 2015 the Unified Portal for Use of Public Funds (http://e-data.gov.ua/) started to operate in test mode, which published information according to Law of Ukraine «On the Open Use of Public Funds». Appropriate efforts were made on local budgets as well — websites of KSCA, Lviv Regional State Administration etc are working in the test mode.

Overcoming the practice of «manual control» and the actual implementation of PPB in the budget process requires substantial reform of the budget system of Ukraine, improvement of procedures for defining strategic priorities of fiscal policy. In 2013, at the initiative of the European Union, Ukraine has intensified measures for improvement in public finance, which resulted in the development and approval of Public Finance Management Strategy. The strategy covers a number of components of the public finance management system, including the tax system, medium-term budget forecasting, medium-term budget planning, PPB, strategic planning at the level of ministries, key spending funds, public finance and public debt liquidity management, quasi-fiscal operations, accounting system in the public sector, public procurement system, public investment, public internal financial control, external independent financial control, anti-corruption, public access to information on the budget. The rules of the Strategy apply until 2017.

The European Union pays special attention to further reform of public procurement in Ukraine. Accession of Ukraine in 2016 to the WTO Agreement on Government Procurement means opening access for Ukrainian companies to the global public procurement market, and at the same time — opening of national public procurement markets to international competition, which involves the introduction of international standards for procurement. In particular, until November 2016, the EU project «Harmonization of the Procurement System in Ukraine with EU Standards»17, will apply, aimed at supporting the development of public procurement and state assistance system in Ukraine in line with EU standards. Chapter 8 of the Ukraine–European Union Association Agreement envisages reform of the public procurement system through the development and implementation of the fully functioning procurement systems, determining their priority and drawing up a plan for their implementation. In order to reform the procurement system, there is a work on the improvement of public procurement legislation: the Law of Ukraine «On Public Procurement» lays the foundation for the next stage of public procurement reforming and complete transition of public procurement into electronic ProZorro18 system (transition will take place in 2016: from April 1 central executive bodies and state enterprises transfer the purchases into electronic mode, and from August 1 — all others).

The sign of lack of proper orientation of public spending for development in strategic terms is the state investment policy, which includes the implementation of state programs, direct investment from the state and local budgets and

17 [Electronic resource]. Assessed on: http://eupublicprocurement.org.ua/
providing investment guarantees. As shown in the previous paragraph, this policy is characterized in Ukraine by the lack of certainty in the priorities of public investment, lack of validity and predictability of public investment, failure of relevant executive bodies to effectively manage investment projects undertaken by public funds, constant underfunding (versus planned) of the investment projects freezes invested state funds and postpones receiving the desired effect, low discipline on the targeted use of public funds for investment purposes. As a result, funds allocated from the budget for investment purposes do not give the desired effect for economic growth.

The results of analysis and monitoring of investment projects financed or otherwise supported by the state are not published. There are no public reports on the analysis of budget and social efficiency of the capital investments because such an analysis and monitoring are not carried out. Moreover, there are no set legal requirements for a clear relationship between investment by the state and increase in the value of state assets and requirements to the corresponding monitoring, resulting in inefficient use of funds.

State support for state guarantees for investment projects, investment projects in priority sectors of the economy or public-private partnership is provided under a very confusing scheme. Examination, analysis and selection of projects are being very complicated and long in bureaucratic terms, but economically primitive ways, so the number of projects across the state is negligible\textsuperscript{19}. Since 2016, according to the Budget Code, there are new rules apply to the public investment projects for the selection and funding from the state budget. However, this only applies to public investment in state property objects using state capital investments and/or loans attracted by the state or under government guarantees. For other investment projects, which receive state support in the form of co-financing or lending, the procedure remained old.

The above shows that Ukraine has formed the public capital investment planning and use system, which is inefficient, opaque, unbalanced, with blurred priorities that eliminate its impact on economic growth, but continues to be a rich ground for corruption schemes.

An attempt to strengthen targeted and systematic investment budget in the ways of institutionalization was the implementation policy of national projects carried out in 2010-2013 under the leadership of the State Agency for Investment and National Projects of Ukraine (the State Agency for Investment). The purpose of this policy was to ensure effective use of investment resources of the state, attracting investors to the implementation of priority projects for the country, accelerating economic recovery and transition to its sustainable growth\textsuperscript{20}. The argument for launching national projects was the presence of successful international experience in the application of this instrument. Meanwhile, in practice national project model in Ukraine has not achieved the expected

\textsuperscript{19} According to the excerpt from the State Register of Investment Projects and Project (Investment) Proposals only 53 are registered for such projects—proposals in the period from 2012 to 2014 and only one project in the priority sectors of the economy. None of registered investment projects received the state support.

results — both as a result of the incompleteness of the formation of such investment programming model, and due to the administrative inefficiency of the project administrators.

First, we should note the absolute predominance of public funding of national projects. The national project did not become a point of the private investment concentration, and hence investment budget did not become, as expected, the multipliers of the priority sectors. Post-crisis weakness of national and international finance left some mark, but the main cause is still unattractiveness of the mechanisms proposed to investors.

The essential problem was duplication of state target programs by the national projects. At the managerial level, program coordination and subordination has been achieved, leading to competition for resources and management influences.

Dispersion of management effort and costs was due to an excessive number of national projects, there were a total of 16 in various stages of implementation. For comparison, only 4 projects implemented in Russia; in India — 2, Ireland, Serbia, of Denmark, Brazil, Australia — 1 national project that are best integrated into the government and industry development programs with minimum (and sometimes lacking) public funding.

As witnessed by the domestic experience in implementing infrastructure projects in the preparation to the European Football Championship 2012 (which, incidentally, is the only one relatively successful de facto national project implemented in practice in Ukraine), administrative problems in this area actually are inherited from the common problems of state governance efficiency in Ukraine in general and the implementation of the state target programs in particular. However, a significant amount of financial resources involved in foreign markets under state guarantees, and repayment made to the state budget has the indirect negative impact on budget expenditures.

The lack of effective legal and regulatory mechanisms of coordination of administrative efforts and concentration of financial resources naturally weakens the effectiveness of strategic investment planning, this naturally gives grounds for corrupt schemes that absorb national importance of the projects and redirect them from the national interests to the narrow corporate one.

It should be emphasized that failure of the first attempt should not be grounds for curtailing the national project planning. Analysis of international experience, features and needs of the national economic system highlights the need for further development of this institute on the basis of improving its administrative efficiency, formation of organizational and economic national project management model adequate to the conditions of the Ukrainian economy, integrating it into the existing system of the state strategic and budget planning. In the future they could replace current inefficient system of state programs.

Thus, the lack of effective expenditure planning mechanisms in the medium term and ensuring compliance with their practical implementation necessitates

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the establishment, consolidation of legislative and institutional implementation of the procedure for budget strategy development as a tool for a pragmatic approach to budget planning to implement the reform program in Ukraine. It has become an integral subsystem of public investment planning and forecasting within the state economic development strategy that will allow the government to coordinate the volume of state functions with existing budgetary resources and provide the economy with the sufficient budgetary investments for the necessary structural modernization.
1.5. Budget decentralization contradictions

Problems of distribution of powers between the Centre and the regions have been a stumbling block for the Ukrainian government during the time of independence. Delegation of some of the functions and obligations of the state to the local level is necessarily associated with appropriate financial support, that is changes in interbudgetary relations. If the distribution of powers could be achieved in the course of political agreements, changes in allocation of budget flows are normally inhibited by tough deficit of the budget resources. On the other hand, the position of local authorities is often focused on the fight for more budgetary resources — but without assuming the additional functions and tasks. The movement in this vicious circle defined fiscal decentralization model, which Ukraine carried out for 23 years.

As a result, despite combination of centralization and decentralization in exercising government power announced in 1996, regional development was overtly dominated by the first one. Terms Center of the dominance simultaneously affected the relations between the authorities of regions with regional communities. After all, local government was under the influence of pervasive directives, guidelines and recommendations that stepped down the government and the presidential vertical and often did not take into account the interests of residents of certain settlements and territories.

Since 1998, intention of fiscal decentralization has been announced, which would contribute to greater financial independence of local governments and stimulated the development of local communities. Already in the first phase, the announced decentralization was not comprehensive and not accompanied by administrative and territorial reform. Administrative division of Ukraine was inherited from the USSR, and the system of executive bodies and local self-governments was established on the basis of vertical decision-making system. Hierarchical management system in the country under «President — Government — RSA — DSA — community» pattern was a constant source of conflicts, a breeding ground for corruption and an obstacle to regional development. To destroy this pattern in the first phase of decentralization (early 2000’s) direct relations of the state budget with regional, district budgets and cities of regional importance were established. This removed some conflicts, especially between regional and city authorities. The next logical step was to be the reform of administrative and territorial division and the creation of economically strong communities that could take responsibility for public services and ensure this responsibility by the financial resources. But this was not done that slowed completion of decentralization. Only in 2014, there was an attempt to create the united communities and establish direct budgetary relations with them.

The main feature of over-centralization of intergbudget relations is subsidized nature of the absolute majority of local budgets. Share of transfers and revenues transferred from the state budget grew steadily, although the reverse process had been repeatedly declared. 74% of all expenditures were financed from the state budget during 2003-2015. The share of transfers in the local budget revenues in 2000 amounted to 23.7%, in 2005 — 43.5% and in 2010 — 49.5%. The share of own revenues of local budgets in the consolidated budget has decreased over the years from 29.1% to 25.6% (from a
peak of 32.3%). Symbolic «break» of the fiscal decentralization began in 2010, when the share of own local revenues and transfers from the state budget were equal (Fig. 1.16). Subsidized nature of the local budgets currently reaches almost 60%, and that of local communities’ budgets exceeds 70%, more than 500 communities are subsidized by the state budget by 90%.

Meanwhile, the root of the problem is not in the level of subsidized nature, but rather in uneven economic development. Subsidized communities are those where there is a significant difference between their economic development, and thus the tax base and the amount of public services enjoyed by the community members.

**FIG 1.16. THE DYNAMICS OF OWN AND FIXED INCOME OF LOCAL BUDGETS AND INTERBUDGET TRANSFERS, UAH BLN**

Enhanced budget centralization is confirmed by the share of local budget revenues in GDP. It albeit somewhat increased during 2000-2014 (11.0% and 14.9% at the beginning and end of the period, respectively), but does not exceed 16% (Fig. 1.17). In parallel to this, there was a significant reduction of «contribution» of the local budgets to the consolidated budget, reflecting the strengthening of fiscal redistribution through the state budget (Table 1.8)). The latter limits the autonomy of local councils in solving problems of social and economic development of the territory, depriving them of incentives to expand their budget revenue base (even if the real potential of the territory enabled to do so), reinforces paternalistic reliance on obtaining subsidies from the Centre.

**FIG. 1.17. DYNAMICS OF THE SHARE OF LOCAL BUDGET REVENUES IN GDP AND THE CONSOLIDATED BUDGET OF UKRAINE, %**
TABLE 1.8. STRUCTURE OF THE ACTUAL PERFORMANCE OF CONSOLIDATED BUDGET OF UKRAINE FOR THE PERIOD OF 2003-2015, UAH BLN.

<table>
<thead>
<tr>
<th>Year</th>
<th>Consolidated budget</th>
<th>State budget</th>
<th>Local budgets</th>
<th>Budget centralization ratio</th>
<th>Budget decentralization ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>75,8</td>
<td>56,1</td>
<td>33,8</td>
<td>0,74</td>
<td>0,45</td>
</tr>
<tr>
<td>2004</td>
<td>101,4</td>
<td>79,5</td>
<td>40,4</td>
<td>0,78</td>
<td>0,4</td>
</tr>
<tr>
<td>2005</td>
<td>141,7</td>
<td>113</td>
<td>53,5</td>
<td>0,8</td>
<td>0,38</td>
</tr>
<tr>
<td>2006</td>
<td>175,3</td>
<td>137,1</td>
<td>75,8</td>
<td>0,78</td>
<td>0,43</td>
</tr>
<tr>
<td>2007</td>
<td>226,1</td>
<td>174,3</td>
<td>104,9</td>
<td>0,77</td>
<td>0,46</td>
</tr>
<tr>
<td>2008</td>
<td>309,2</td>
<td>241,5</td>
<td>139</td>
<td>0,78</td>
<td>0,45</td>
</tr>
<tr>
<td>2009</td>
<td>307,4</td>
<td>242,4</td>
<td>136,3</td>
<td>0,79</td>
<td>0,44</td>
</tr>
<tr>
<td>2010</td>
<td>377,8</td>
<td>303,6</td>
<td>159,8</td>
<td>0,8</td>
<td>0,42</td>
</tr>
<tr>
<td>2011</td>
<td>416,9</td>
<td>333,5</td>
<td>181</td>
<td>0,8</td>
<td>0,43</td>
</tr>
<tr>
<td>2012</td>
<td>492,5</td>
<td>395,7</td>
<td>222,6</td>
<td>0,8</td>
<td>0,45</td>
</tr>
<tr>
<td>2013</td>
<td>505,8</td>
<td>403,5</td>
<td>219,8</td>
<td>0,8</td>
<td>0,43</td>
</tr>
<tr>
<td>2014</td>
<td>523,1</td>
<td>430,2</td>
<td>225,6</td>
<td>0,82</td>
<td>0,43</td>
</tr>
<tr>
<td>2015</td>
<td>653,5</td>
<td>573,5</td>
<td>262,8</td>
<td>0,88</td>
<td>0,4</td>
</tr>
</tbody>
</table>

Amendments to the Budget and Tax Codes, which were made in late 2014, as expected, had to create a new financial base of local government reform and financial framework for performance of the powers transferred to the community level. Thus nominally the next stage of fiscal decentralization was launched and the creation of self-sufficient and powerful community was declared one of the state priorities.

Since 2015, the sources of local budget revenues were expanded by transfer from the state budget to local level of a number of taxes and the introduction of new fees. Budget decentralization provided new opportunities for filling the budget of communities by: 80% of environmental tax, 100% of single tax, 100% of corporate income tax of the municipal companies, 100% property tax (real estate, land, transport), 100% excise tax on trade. On November 26, 2015, the issue of state and local budgets revenues redistribution was normalized in connection with the transfer to local government and local state administration of the powers to provide administrative services in the state registration of legal entities and individual entrepreneurs. Currently, the local budgets receive 100% payment for administrative services, 100% of the state fee, 10% of corporate income tax (although only regional budgets), 100% of the land tax etc.

Meanwhile, the rest of the sources, which previously provided significant income (eg, personal income tax, which sometimes exceeded 95% of tax revenues of local budgets), were significantly reduced, which could adversely affect the local budgets in areas with weak business development. Despite the transfer of shares of state taxes and fees to the united communities’ budgets, the latter still suffer from a lack of resources and up to 90% of them have remained subsidized, indicating priority for community economic development over the attempts of only technical manipulation of revenues and expenditures of their budgets.

Despite the budget decentralization course declared by the Coalition Agreement (p. 1.2.2.), autonomy in several areas of community was even further restricted. Thus, the money for current expenditures for education and health care are concentrated in the state budget (in contrast to the situation in 2014, when they were in the local budgets) and transferred to local budgets as appropriate subsidies. This reduces the responsibility of local authorities in these areas.
Till March 2015, indicative was the philosophy of distribution of funds of the State Fund for Regional Development (SFRR) opposite to the decentralization logic, which did not meet its basic task — to create conditions for additional support to the development of regions with less potential for economic development.

In 2014, distribution procedure was changed: previously, 70% of the funds were distributed subject to the number of people living in the region, and 30% — on the basis of socio-economic development in accordance with the gross regional product per capita. Currently, the ratio is 80 and 20% respectively. That the most densely-populated regions that already are usually in a better economic situation, receive more opportunities for investment projects at public expense, whereas depressive (especially old industrial) ones — have fewer opportunities to obtain funds for restructuring.

So, despite a number of major changes, introduced in December 2014 and December 2015 by the amendments to the Budget and Tax Code of Ukraine, a number of problems remain in the area of interbudget relations:

1. Not all local budgets received substantial tax sources and therefore the required volume of revenues. The budgets of regional centers and united communities have been significantly strengthened, regional budgets received new sources, and the budgets of grassroots communities remain subsidized. In addition, previously existing substantial tax revenues were taken away from them. Thus, under the new legislation, local taxes include only a property tax, a single tax, fees for parking, tourist tax, proceeds of which do not exceed 10% of the revenues of local budgets. As before, the bulk of revenues (45.6% by the results of 2015) is the national personal income tax.

2. The share of transfers in local budget revenues continues to grow while reducing the share of their own revenues. The gain of interbudget transfers in 2015 compared with the previous year was 12.7%, and their growth was much faster than the growth of local budgets. The subsidy, which is non-target transfer, allows local authorities to spend money at their discretion, although their decision is significantly affected by the need to ensure budget programs with funding of services provided by the decision of the central authorities. On the other hand, reliance on subsidies threatens wasting money on minor areas of expenditure; therefore increased attention to target transfers can be explained by the desire to ensure the provision of basic social services in transition period.

3. There’s a discrepancy between the estimated transfers and actual community needs in them. This leads to lack of funding of specific expenditure responsibilities, rapid accumulation of debt payments, increased paternalism of the community regarding the state budget and the simultaneous strengthening of the state leverage on local budgeting. This is directly contrary to the principles of local self-government.

4. Unregulated support of expenditures on the needs of the community adversely affects the community development. Local budget expenditures are by more than 70% allocated to perform state functions: education, health care, culture, art, physical education and sport. Accordingly, small amount of money remains to perform the actual local development functions — operation of housing and utilities, road maintenance system, communal property management, regulation of land relations. In addition, local governments do not get the funds needed for the maintenance of social infrastructure transferred to municipal ownership.

5. The distorted nature of the budgets development and spending has clearly manifested itself within the local budgets. Development budget would be an additional source of spending for capital purposes. However, neither the volume of the budget, nor its share in local revenues is significant. In 2014, revenues of
the development budget (including funds transferred from the general budget fund to the development budget, and local borrowings) amounted to UAH 11.1 bln., which is by 15.9% less than in 2013; share of the development budget was 11.0% of local budget revenues without interbudget transfers. In Q1 2015, the development budget revenues amounted to UAH 2.0 bln., which is by 19.2% less than in 2014. This significant reduction of the development budget was due to a single tax exclusion from the list of sources of this budget. In addition, the Budget Code of Ukraine has no provision for fixing the development budget amount that can lead to a lack of such budgets with the community at all.

6. In general, the decentralization of the budget system is incomplete. This problem is partially mitigated with the intensification of the community unification. United communities in their «budget» status are equal to the cities of regional significance and districts. The issue of further decentralization of the budget system is important due to the current formation of the promising plans of the united communities — uniting several financially weak communities into one will reduce costs for the maintenance management system and increase the amount of funds for current needs, which in turn will simplify mechanism for establishing the direct fiscal relationship between the state and this community. Unfortunately, fiscal decentralization is carried out at this stage in violation of the general logic of reform of territorial and local government organization. After all, unification of communities and the actual transfer of new financial and other powers shall be preceded by fixing the institutional framework of the new power distribution (including through appropriate amendments to the Constitution) and administrative and territorial reform on this basis.

With such inconsistency, conflicts are inevitable, which accompany the community unification, economically powerful communities got the necessary leverages of financial impact and weaker ones- turn into «unnecessary ballast». In addition, the formation of the budget framework for the creation of powerful and wealthy communities without actually updating local authorities is often evaluated by the latter solely in terms of new corruption opportunities.

Low-skilled managerial staff of local authorities, dominance of personal interests over the public, inadequacy of local budgets formation to the objectives of the social and economic development of the territories for a long time will be the main characteristics of local government in Ukraine that cannot but affect the overall efficiency of budget decentralization.
1.6. Deficit financing and public debt

Significant need for critical budget expenditure with limited sources of income causes chronic budget deficit in Ukraine. Throughout the history of observations, Ukraine’s budget was mainly deficit (except for some periods, such as in 2000 and 2002). Thus, the deficit was mainly formed by the state budget and ranged from 0.33% of GDP in 2001 to 5.73% of GDP in 2011 (Table 1.9). Indicative is consistently high level of deficit in the period after the crisis of 2008-2009. From our point of view, it can be explained by attempts to use in this period the countercyclical budgetary leverage, when the economy, since 2012, began to fall into a recession. Meanwhile, wrongly chosen model stimulating consumption through increased fiscal burden only exacerbated macroeconomic imbalances.

It should be noted that global the safe level of the budget deficit is its amount of no more than 3% of GDP. The corresponding rate was fixed by the EU Maastricht Treaty. Requirements imposed under the IMF loans are fixed approximately at the same level.

Reference: The Maastricht Treaty defines 5 criteria for countries aspiring to join the EU, the budget deficit should not exceed 3% of GDP; public debt should not exceed 60% of GDP; state for 2 years should participate in the European exchange rate mechanism and ensure the stability of the national currency against euro; inflation should not exceed the average of the three EU member states with the most stable prices by more than 1.5 percentage points; long-term interest rates on government bonds should not exceed more than 2 pct the average of the corresponding rates in the three countries with the lowest inflation; independence of the central bank must be ensured the.

Meanwhile, the problem of balancing public finance of Ukraine is not limited to the official budget deficit. The widespread practice of «hidden» deficit caused by the accumulation of debts of budget-funded institutions and public companies, as well as conversion of budgetary commitments of the state into the public debt. In particular, in 2008, Ukraine has introduced the practice of financing these obligations by issuing government securities. In particular, this concerned the capitalization of state banks, state entering the capital in private banks and support to NJSC «Naftogaz of Ukraine» by exchanging their shares for government bonds and exchange of state debt to taxpayers for uncefunded VAT for government bonds.

Thus, sovereign bonds were issued in:

- in 2008 to increase the authorized capital of Ukreximbank and Oshchadbank (for UAH 17.5 bln.);
- in 2009, to recapitalize the banks (UAH 23.3 bln.) and increase the authorized capital of NJSC «Naftogaz of Ukraine» — by 43.2 bln.;
- in 2010 — to recapitalize Ukreximbank in the amount of UAH 6.4 bln., to repay arrears of previous years in VAT refund — UAH 16.4 bln., to increase the authorized capital of the State Mortgage Institution — by UAH 2 bln., to capitalize NJSC «Naftogaz of Ukraine» — by UAH 7.4 bln.;
### TABLE 1.9. DEFICIT OF THE STATE, LOCAL AND CONSOLIDATED BUDGET OF UKRAINE IN 2000-2015, UAH MLN.

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>State deficit/profit</td>
<td>-697.3</td>
<td>680.7</td>
<td>-1119.4</td>
<td>1043.1</td>
<td>10223.5</td>
<td>7936.4</td>
<td>3776.6</td>
</tr>
<tr>
<td>% GDP</td>
<td>-0.41</td>
<td>0.33</td>
<td>-0.5</td>
<td>0.39</td>
<td>2.96</td>
<td>1.8</td>
<td>0.69</td>
</tr>
<tr>
<td>Local deficit/profit</td>
<td>-272</td>
<td>-87.3</td>
<td>-516</td>
<td>-536.4</td>
<td>792.5</td>
<td>-139.3</td>
<td>-75.9</td>
</tr>
<tr>
<td>% GDP</td>
<td>-0.16</td>
<td>-0.04</td>
<td>-0.23</td>
<td>-0.2</td>
<td>0.23</td>
<td>-0.03</td>
<td>-0.01</td>
</tr>
<tr>
<td>Total deficit/profit</td>
<td>-969.4</td>
<td>593.4</td>
<td>-1635.4</td>
<td>506.7</td>
<td>11016</td>
<td>7797.1</td>
<td>3700.8</td>
</tr>
<tr>
<td>% GDP</td>
<td>-0.57</td>
<td>0.29</td>
<td>-0.72</td>
<td>0.19</td>
<td>3.19</td>
<td>1.77</td>
<td>0.68</td>
</tr>
<tr>
<td>GDP</td>
<td>170070</td>
<td>204190</td>
<td>225810</td>
<td>267344</td>
<td>345113</td>
<td>441452</td>
<td>544153</td>
</tr>
</tbody>
</table>

- in 2011 — to replenish the authorized capital of Oshchadbank and capitalize «Rodovid Bank» and «Ukrzbank» in the amount of UAH 8.9 bln., capitalize NJSC «Naftogaz of Ukraine» — by UAH 12.5 bln.. Lending to Agrarian Fund — for UAH 5 bln.;
- in 2012 — to replenish the authorized capital of JSC «UHE» in the amount of UAH 1.0 bln., to capitalize NJSC «Naftogaz of Ukraine» — UAH 6.0 bln.. Lending to Agrarian Fund — UAH 2.6 bln.;
- in 2013 — to capitalize NJSC «Naftogaz of Ukraine» (UAH 8.0 bln.), Oshchadbank (UAH 1.4 bln.), PrJSC «Ukrainian Danube Shipping Company» (UAH 0.3 bln.) and to form PJSC «Agrarian Fund» (UAH 5.0 bln.);
- in 2014 — to capitalize NJSC «Naftogaz of Ukraine» (UAH 96.6 bln.), increase the authorized capital of Oshchadbank (UAH 11.6 bln.) and Ukreximbank (UAH 5 bln.), loans to Individuals’ Deposit Guarantee Fund (UAH 10.1 bln.), provision of subsidies from the state budget to local budgets for payment for natural gas from NJSC «Naftogaz of Ukraine» and compensate for the difference in tariffs for heat energy for the population (UAH 11.1 bln.), to refund VAT (UAH 6.9 bln.);
- in 2015: to increase the authorized capital of NJSC «Naftogaz of Ukraine» (UAH 29.7 bln.), in exchange for promissory notes issued by the Individuals’ Deposit Guarantee Fund (UAH 43.0 bln.), capitalize additionally PJSC JSB “Ukrgazbank” (UAH 3.8 bln.).

Replenishment of the authorized capitals of the public sector entities at the expense of government bonds in the conditions of crisis seemed acceptable. In addition, the level of public and publicly guaranteed debt remained at a fairly low level — 20% of GDP in 2008 (with statutory restriction of 60% of GDP). However, this practice leads to a gradual accumulation of «securitized» deficit in the form of the public debt (Table 1.10), and in case of prolonged depressive tendencies in the economy entails strengthened public debt burden on the economy, as happened in 2013-2014.
### TABLE 1.10. «HIDDEN» STATE BUDGET DEFICIT, UAH MLN.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>deficit</td>
<td>9842,9</td>
<td>12502</td>
<td>35517,2</td>
<td>64265,5</td>
<td>23557,6</td>
<td>53445,2</td>
<td>64706,7</td>
<td>78052,8</td>
<td>45150,6</td>
</tr>
<tr>
<td>% GDP</td>
<td>1,37</td>
<td>1,32</td>
<td>3,89</td>
<td>5,73</td>
<td>1,75</td>
<td>3,66</td>
<td>4,25</td>
<td>4,98</td>
<td>2,28</td>
</tr>
<tr>
<td></td>
<td>-2141,2</td>
<td>-1622,5</td>
<td>1740,9</td>
<td>419,4</td>
<td>-499,7</td>
<td>-2659,5</td>
<td>-1116,4</td>
<td>-6022,3</td>
<td>-14265,5</td>
</tr>
<tr>
<td>% GDP</td>
<td>-0,3</td>
<td>-0,17</td>
<td>0,19</td>
<td>0,04</td>
<td>-0,04</td>
<td>-0,18</td>
<td>-0,07</td>
<td>-0,38</td>
<td>-0,72</td>
</tr>
<tr>
<td></td>
<td>7701,7</td>
<td>14124,5</td>
<td>37258,1</td>
<td>64684,9</td>
<td>23057,9</td>
<td>50785,7</td>
<td>63590,3</td>
<td>72030,5</td>
<td>30885,1</td>
</tr>
<tr>
<td>% GDP</td>
<td>1,07</td>
<td>1,49</td>
<td>4,08</td>
<td>5,77</td>
<td>1,71</td>
<td>3,48</td>
<td>4,18</td>
<td>4,6</td>
<td>1,56</td>
</tr>
<tr>
<td></td>
<td>720731</td>
<td>948056</td>
<td>913345</td>
<td>1120585</td>
<td>1349178</td>
<td>1459096</td>
<td>1522657</td>
<td>1566728</td>
<td>1979458</td>
</tr>
</tbody>
</table>

Source: Treasury, State Statistics Committee, own calculations

«Hidden» deficit:

- affects the condition of the state budget because of the need to focus additional spending on debt service;

- encourages the sale by the public sector entities of government bonds on the domestic market at a discount, which is the market practice, but in Ukrainian realities it gets a speculative nature (according to certain publications in the press, the discount reached 40%);

- forces the National Bank to redeem government bonds on the secondary market (share of issued T-bills held by the National Bank increased from 48.3% in 2008 to 72% in March 2016, and in certain periods it was greater than 75%). Since the funds received by the public sector entities and, above all, the Individuals’ Deposit Guarantee Fund, are directed to the current consumption the above leads to imbalances in the conduct of monetary policy and needs for sterilization of money stock growth.
Thus, to determine the real complexity of budget deficit for Ukraine it is necessary to consider the tools and sources of funding.

Article 15 of the Budget Code of Ukraine establishes that the sources of budget deficit financing are:

- funds from the state (local) domestic and external borrowing;
- proceeds from the state property privatization (including other income directly related to the privatization process) — regarding the state budget;
- return of budget funds from deposits, revenues from the sale/presentation of securities;
- free balance of the budget under the conditions defined by the Code.

The source of the budget may not be issuing funds of the National Bank of Ukraine.

The main instrument of state borrowing in Ukraine is the sale of government securities. Currently, securities are issued for 99.5% of internal and 51.3% of external direct public debt. Law of Ukraine «On Securities and Stock Market» defines types of government securities that may be issued in Ukraine:

- treasury bonds (can be denominated both in national and foreign currency);
- government bonds (denominated in foreign currency);
- target government bonds (with indication provided by the State Budget of Ukraine for the year the area of use of funds raised from the placement of such bond. The funds raised from their placement are used exclusively to finance state or regional programs and projects on terms of their return in volumes provided for this purpose by the State budget of Ukraine for the year — in Ukraine this type of securities has not been issued yet).

According to the Ministry of Finance, as of the end of 2015, Ukraine accounted for the debt on government bonds — amounting to UAH 505.3 bln. and treasury bonds — UAH 17.3 bln.. Domestic debt guaranteed by the state also includes UAH 16.7 bln. of the debt on the bonds of: the State Mortgage Institution (UAH 6.2 bln.), NJSC «Naftogaz of Ukraine» (UAH 4.8 bln. and Ukravtodor (UAH 4.4 bln.).

Moreover, Ukraine issued:

- treasuries in local and foreign currency, which attracted funds from the public. Relevant issues, for example, were carried out in 2012 in foreign currency; in 2014 — Military treasuries. Though treasuries provide some income to the state budget (according to the Ministry of Finance, as of 30.09.2015 the debt obligations under the treasuries amounted to UAH 97.6 mln.), their implementation in the planned scope failed. The main reason was that because they are placed among individuals, their yield must be competitive compared to the interest rates offered by the banks;
- treasury bills — in 2002 and 2013. In 2013-2014, the Laws on State Budget of Ukraine granted the Cabinet of Ministers of Ukraine the right to restructure actual budget indebtedness by the defined public expenditure, arrears in difference in utility tariffs for the population, which was formed in connection
with the incompatibility of the actual cost of services with approved tariffs and issue VAT refunds from the budget by the issue of financial treasury bills. However, this financial instrument was not popular with the business entities. In 2013, total issuance volume of the financial treasury bills in the amount of UAH 24.59 bln. defined by certain resolutions of the Cabinet of Ministers of Ukraine. The Treasury issued them only worth UAH 1.3 bln.. In 2014 this practice was abandoned;

• state derivatives. They were introduced in 2015 as part of the public external debt restructuring as securities placed by the state on international stock markets and confirming Ukraine’s obligations under the terms of the placement of securities to make payments to the owner in case of reaching certain figures of gross domestic product of Ukraine, as well as to make other payments.

Direct loans from international financial institutions (USD 14.0 bln. at the beginning of 2016) and the individual states (USD 1.4 bln.) form 44.8% of the external debt of Ukraine. The major institutional creditors of Ukraine is the IMF (debt of USD 5.3 bln.), IBRD (USD 5.2 bln.), EU (USD 2.4 bln.), EBRD (USD 0.58 bln.), the European Investment Bank (USD 0.5 bln.). Major sovereign creditors include Russia (UAH 605.9 mln.), Canada (USD 288.1 mln.) and Japan (USD 233.7 mln. dollars.). The state also guarantees foreign loans from international financial institutions by UAH 5.9 bln.. (of which USD 5.3 — from the IMF), USD 2.8 bln. of loans from financial investors from different countries (including UAH 1.6 bln. — from China).

Cooperation with international financial organizations should be seen not only as a source of deficit financing, but also as an important structural factor that can give a significant impetus to meet the challenges of a strategic nature. In particular, the agreement with the IMF on Extended Fund Facility (EFF) provides for substantial changes in the public finances sanitation area and ensures the foundation of macroeconomic stability. The subject matters of agreements with the World Bank — projects for the rehabilitation of hydropower plants, improved electricity transmission, urban infrastructure, social support etc., EBRD and EIB finance the construction of the subway in Dnipropetrovsk, high-voltage overhead transmission lines, roads on the approaches to Kyiv etc.

Therefore, the loans, especially from international financial organizations, are more effective in Ukraine compared to borrowings in the form of bonds, because they have targeted purpose or require corresponding reforms. To fulfill this potential, Ukraine shall be provided targeted nature and efficient expenditure of the credit facilities received. Currently, significant shortcomings of the project implementation provided by the international financial institutions (excluding IMF loans, which have a clear financial purpose), according to the Accounting Chamber of Ukraine, is a significant backlog of projects implementation from the planned deadlines, shortcomings in the management and monitoring of their performance, including the procurement, poor planning etc.

Proceeds from the privatization of the state property have not become a real source of the state budget revenue. Over the past 10 years, the privatization plan proceeds were overdone only twice — in 2005 as a result of Kryvorizhstal privatization and in 2011 — of Ukrtelecom privatization (Table 1.11). The reasons for failure are ineffective planning of privatization facilities, lack of investor interest, unfavorable macroeconomic conditions for the sale of property (the latter is best seen from the results of privatization in crisis 2009, 2013-2014.).
**TABLE 1.11. PLANNED AND ACTUAL PRIVATIZATION REVENUES TO FINANCE THE STATE BUDGET, UAH MLN.**

<table>
<thead>
<tr>
<th></th>
<th>Defined by law</th>
<th>Fact</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>10247,9</td>
<td>20758,9</td>
</tr>
<tr>
<td>2006</td>
<td>2121,5</td>
<td>558,8</td>
</tr>
<tr>
<td>2007</td>
<td>10587,7</td>
<td>2458,8</td>
</tr>
<tr>
<td>2008</td>
<td>607,1</td>
<td>482,3</td>
</tr>
<tr>
<td>2009</td>
<td>8501,2</td>
<td>807,85</td>
</tr>
<tr>
<td>2010</td>
<td>6350</td>
<td>1093,4</td>
</tr>
<tr>
<td>2011</td>
<td>10000</td>
<td>11480,3</td>
</tr>
<tr>
<td>2012</td>
<td>10000</td>
<td>6763,5</td>
</tr>
<tr>
<td>2013</td>
<td>10900</td>
<td>1480</td>
</tr>
<tr>
<td>2014</td>
<td>17000</td>
<td>466,9</td>
</tr>
<tr>
<td>2015</td>
<td>17000</td>
<td>151,5</td>
</tr>
</tbody>
</table>

Meanwhile, reliance on privatization as the tangible source of the budget deficit financing contains, in our opinion, more risks than benefits. Since change of ownership should first lead to more efficient use of the property. The predominance of fiscal targets in privatization has led to the uncontrollability of post-privatization performance of the companies, according to the Institute of Economics and Forecasting of NASU, out of companies privatized in 2002-2004, in 2010 more than half are wound up.

Possibilities of deficit financing of the budget expenditures are limited not only by the limit size of the budget deficit, but the acceptable amount of public debt. The Budget Code of Ukraine stipulates its maximum level — 60% of GDP, which is consistent with Maastricht Treaty. Despite a significant increase in the share of public debt during the crisis in 2009 and after it, it was within the acceptable limits (Table 1.12). During the crisis cessation in early 2010, speculative sentiments were clearly manifested in the financial market — government bonds were placed under 22-25% per annum (for comparison, the rates for loans in the interbank market fluctuated during this period at 4.5-8.6%). Against this background, foreign borrowings with interest rates within the 6-9% annual seemed more attractive, which led to their significant increase. During 2011-2013, external debt increased by USD 5.1 bln., including on issued securities — by USD 10.3 bln. (direct debt to institutional lenders and foreign financial institutions decreased by USD 5.2 bln.). However, borrowings in foreign currency were the source of significant exchange rate risks. The rapid growth of public debt relative to GDP in 2014-2015 necessitated its restructuring was the result of a sharp devaluation of the hryvnia. In other words, because of the lack of coordination between the financial, economic and debt policies in the state forming and implementing them (the Cabinet of Ministers of Ukraine and the National Bank) foreign borrowings of «cheap» source of resources have become one of the main problems of fiscal policy. In 2015, due to the sharp rise in foreign debt through a deep devaluation of the hryvnia, Ukraine’s direct public debt exceeded legally defined public debt threshold.

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Reference: A number of researchers, including — K. Reinhart, K. Rogoff and M. Savastano\textsuperscript{24}, calculated that among middle-income economies 40% of defaults and debt restructurings have taken place in countries with a level of debt burden in the range of 41% to 60% of GDP, and 13% of defaults and debt restructuring — in countries whose foreign debt was less than 40% of GDP. According to the IMF, emerging economies are not able to ensure debt sustainability, if public debt exceeds 50% of GDP and general public debt level acceptable for a typical emerging economy amounts to only 25% of GDP\textsuperscript{25}.

Involvement of loan resources during the crisis 2014-2015 was dependent on of the main goals before the fiscal authorities. The problems of the state budget filling led to emphasis on domestic borrowings in 2014. During the year, domestic debt increased by UAH 204.0 bln.. External debt thus increased by UAH 2.9 bln.. Due to the growth of revenues in 2015, the need for hryvnia borrowings fell sharply, domestic debt increased by only UAH 7.0 bln. in a year time. Instead, the focus shifted to borrowing to ensure the solvency of Ukraine on foreign debts — foreign debt (increased by USD 3.6 bln., while debt reduction was USD 1.3 bln. as a result of restructuring).

\begin{table}[h]
\centering
\caption{Ratio of public and guaranteed debt to GDP, %}
\begin{tabular}{|c|c|c|c|c|c|c|c|c|c|c|c|}
\hline
\hline
\textbf{Total} & 24.7 & 17.7 & 14.8 & 12.3 & 20 & 34.8 & 39.9 & 36.3 & 36.6 & 40.6 & 70.1 & 79.4 \\
\hline
\textbf{Public debt} & 19.6 & 14.3 & 12.1 & 9.9 & 13.8 & 24.9 & 29.9 & 27.4 & 28.3 & 33.3 & 60.4 & 67.4 \\
\hline
\end{tabular}
\caption*{Source: Ministry of Finance, State Statistics Committee, ISES calculations}
\end{table}

At the end of 2015, direct domestic debt of Ukraine amounted to UAH 508 bln., foreign — USD 34.4 bln.. High levels of public debt and its structure determine the specific need for public debt policy, which would not only take into account the need for deficit financing, but also determine the optimal ratio of available borrowing sources and uses of debt resources.

Restructuring of the public debt (a total restructured debt worth USD 12 bln.) considerably affected the value of debt in 2015. Although the Ministry of Finance said the only positive consequences for Ukraine as a result of the restructuring, the restructuring terms are ambiguously perceived in Ukraine: on the one hand, it has a positive impact in the short term (for example, only in terms of public debt service in 2016 Ukraine will pay USD 1.7 bln. instead of USD 2.8 bln.). On the other hand — the terms of the restructuring implemented so-called «cost recovery tool» which provides that if Ukraine’s GDP growth will be 3%, then Ukraine will pay nothing to the creditors; if GDP grows by 3 to 4% per year, creditors will receive 15% in excess of 3% of GDP; if growth exceeds 4% a year — creditors will receive 40% of the value of every cent


which exceeds this growth. This may inhibit the economic growth, which, according to our calculations, should reach an average of 7% per year\textsuperscript{26}.

In 2010, the adoption of the new version of the Budget Code of Ukraine provided for the establishment of public debt management strategy, which is being developed for two years (which can be considered a strategic document essentially due to the timing of the issuance of debt instruments) and reviewed annually by the Cabinet of Ministers of Ukraine taking into account the forecast of the State Budget of Ukraine following the planned two budget periods and includes the identification of priority goals and objectives of public debt management in the medium or long term and means to implement them. It also provides for consideration in the forecast of the State Budget of Ukraine for two budget periods following the planned ones the indicative parameters of public debt and state guaranteed debt. Unfortunately, the political, economic and debt crisis that began in 2014 did not permit to fully implement the concept of strategic planning of public debt parameters. The last time the Strategy was adopted in 2013, and now it is clearly outdated.

1.7. Budget issues impact on macroeconomic situation in Ukraine

The analysis of the features of budget system of Ukraine has shown that a high level of fiscal redistribution of the social product is a feature of the national economy model. The main factors of this model are:

- substitution of accelerated GDP growth strategy with short-term macroeconomic stabilization programs which squeezed the economy and social sphere, exacerbating disparities and imbalances;

- inherited high level of paternalism with the population, which is the basis of preservation, substantial state commitment in the social sphere, despite more than two decades of market reforms;

- objective need for significant social expenditure due to the nature of the age structure of the population (higher proportion of disabled) and its quality (low level of public health) etc;

- ineffectiveness of planning and spending in the public sector, which inflates its funding requirements;

- lack of established mechanisms for the implementation of decentralized functions, which are forcibly imposed on the state (getting a decent income by the workers, business social responsibility, pension and health insurance, etc.);

- availability of powerful lobbying groups intending to control part of the budget resources to implement their own corporate interests and obtain excess profits.

Reliance on economic development stimulation fiscal policy has become a feature of political rhetoric since mid-2000s and remained unchanged even in the radical change of government teams. However, in practice fiscal policy development is under pressure to meet the interests of various groups of political and economic impact, problems of operational balancing of macroeconomic situation, requirements of international financial organizations and meeting short-term political ambitions. This prevents adequate mastery of areas and instruments of national fiscal policy. Fiscal policy has not become in Ukraine a mechanism for state strategy implementation in the area of structural reforms, and many decisions in the area of fiscal policy are not subject to strategic economic considerations, but are subject to external and internal political «bargaining».

A direct reflection of the need for significant budget spending is high tax burden and the significant role of tax administration measures aimed at increasing revenues, tax overpayments, penalties, non-refunds to the exporters. Mandatory nature of the need in the majority of expenditure dictates fiscal policy deformation. Its benchmarks are «upside down»: it is intended to raise funds to the treasury as much as needed, not to ensure the most effective use of funds that may be raised.
An important problem is that the current tax system of Ukraine, based on the benchmarks to maximize current income, as was shown earlier, simultaneously inhibits objectively business development and positive structural changes. De facto fiscal policy in Ukraine is traditionally used as a means of sterilization of money supply growth, as funds received in the domestic market due to growing consumer demand are immediately withdrawn by fiscal channels and do not have time to service processes of enterprises’ development.

Revenues primarily from indirect taxes also create additional opportunities for rapid filling of the budget through inflation and depreciation «taxes» — if the size of the tax base is measured in foreign currency (including taxes on imports). Thus, in certain periods the government may seek to use this method of reducing the deficit, and fiscal policy may come into direct conflict with the macroeconomic stabilization objectives. However, the positive effect of increasing production efficiency and increasing profits for budget revenue become increasingly significant — especially as the inflation and devaluation usually lead to loss of profits.

Specific features of VAT are that it, as a tax on consumption, has only apparent neutrality of the companies’ finance. Obviously, the higher is the deficit of working capital for the company and the larger the amount of added value (i.e. the more complex are the outputs), the more burdensome is VAT itself. Thus, by its nature VAT facilitates and lowers technological level of the national economy structure.

Under these conditions, in terms of fiscal expediency, the export activity is unfavorable for the budget because it is associated with the decrease in balance of VAT revenues due to its refund. The dilemma that arises between fiscal priority and significant role of the exporters in the formation of GDP, employment, foreign exchange earnings etc., have been traditionally solved in Ukraine through selective obligations of VAT refund (constant growth of this indicator has twice led to the need to execute it with the government securities (VAT — treasuries)). However, a positive fiscal effect of the accelerated growth of imports (due to VAT and excise duties on goods imported to Ukraine, and import duties) conflict with the goals of import substitution and improving the balance of foreign trade.

In the absence of coordination between fiscal and monetary authorities fiscal policy measures can sometimes provoke inadequate preventive action of the National Bank, undertaken in response to increased inflation risks. Such risks may arise in case of excessive accumulations forming on the Single Treasury Account, implementation of large payments from the budget localized in time etc.

In particular, under braking, especially — falling real incomes during the crisis much weight gets adequate funding for basic social expenditures. Meanwhile, the flow of additional funds into the market due to increased social payments does not meet the proper response of proposals from domestic production through taxation depressive effect. This increases inflationary risks and leads to the need for restrictive anti-inflation monetary policy purposes. Thus, due to the double «cooling» effect of the tax system and the Central Bank, stimulating effect on economic growth is finally leveled, which is traditionally found in the increase of budget expenditures. Preventing such hyper reaction, which will have an undesirable depressing impact, requires operational coordination of the National Bank and Ministry of Finance.

Analysis of fiscal policy in Ukraine demonstrates the important role of budget expenditure as a factor of economic dynamics. The share of direct consumption of general public administration in GDP consumption is not very large and has been at the level of 18.6% of GDP in recent years. Much more tangible is the effect of budget expenditure in the consumer market. The share of social assistance and other transfers in the total income of the population is over 37%, which amounted to UAH 570 bln. in 2014, or 36.4% of GDP. Added to this is also the payroll of the employees of budget-funded organizations, which is very roughly estimated at 12%
of GDP. Thus, total budget expenditures correspond to consumption of at least two-thirds of Ukraine’s GDP.

This calculation shows a significant inhibitory potential, which may involve a mechanical reduction of budget expenditure, and even delay or non-systemic nature of budget spending. In the absence of synchronous compensation from both private domestic and foreign demand, contraction of expenditures can be harmful not only for economic growth but also counterproductive to budget balance, as recession threatens to launch a spiral of demand reduced. Fiscal contraction can occur only with a positive response from the private economic sector to increase in the potential development resources that end up at its disposal.

The limited tax base with significant needs in budget expenditure leads to the impossibility of financing all needs in full, the structure of expenditure provides financing primarily to the current once, while investment funding is carried out by residual. This prevents systemic activity in sectors which are financed from the budget, but like other economic activities require complete reproduction of capital. In fact, due to limited funding is additional capitalization of these sectors, manifested in the deterioration of depreciation of fixed assets, «creeping privatization» of the assets for shadow income, loss of human capital due to the outflow of workers and unattractiveness of the sector for new staff. Insufficient funding of public sectors prevents reform, since the latter is usually not possible without a substantial improvement of the financial base.

Current savings in budget expenditure translates into strategic threatening consequences. Additional capitalization steadily increases the amounts of financial resources that are needed for further recovery of public sector functionality: the problem is not simply shifted to the future, but becomes disproportionate onerous in financial terms. A deterioration in the quality of human capital and scientific and educational potential results in reduced promising competitiveness of the national economy. Lack of social efficiency reduces quality of life and increases the tension in society and clumsy and corrupt system of government destroys public confidence in the state.

A direct consequence of the imbalance of fiscal obligations and opportunities of funding is a chronic state budget deficit. This depressing role of the fiscal burden and lack of focus of the expenditure on development objectives impede the proper expansion of the tax base by reproducing budget deficit. There is a permanent need for government borrowing, increasing share directed to repay previously received loans.

The scale of government borrowing makes them tangible factor influencing the financial situation in the country. Based on the domestic financial market, the government absorbs liquid resources of the banking sector. In the depressive period, redistribution can be considered a positive factor, as it redirects funds «frozen» in the banking sector due to weak effective demand for loans, increase in domestic demand. However, while such funding creates a «depressive trap» through the development of the classic «crowding out»27, in which growth in borrowings to the real economy is carried out through greater profitability of public borrowing.

Under conditions of deepening economic depression and economic crisis when the banking sector liquidity has exhausted resources that can be directed to the purchase of government securities the mechanism of their acquisition for target NBU refinancing was launched, then in the next stage of these securities came under the ownership of the Central Bank. Thus the emission mechanism of indirect

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27 Crowding out means that when the state raises funds in the money market, it leads to a reduction in available financial resources and therefore increases the interest rates, leading to lower private investment and, consequently, production.
lending to the government was simplified, with which money supply growth supports demand through government expenditures, while it does not support response to the supply of goods and services because it does not lead to cheaper credit and its expansion. The inflationary potential of this issue is pushing the National Bank to active sterilization operations: deficit financing does not encourage, but rather hinders economic dynamics.

External borrowing is often perceived as a more affordable and cheap source of financing. However, revenues from such loan and pay for its maintenance affect the balance of payments, and hence — is closely linked to the exchange rate dynamics. Devaluation appears paradoxically useful at the stage of obtaining external revenues, bringing greater supply of hryvnia to the budget, but further increases the cost of foreign debt and complicates its servicing.

In addition, external financing of the budget deficit creates a pending «depressive trap». If the servicing and repayment of further domestic borrowing is de facto an additional fiscal stimulus of private sector, to which back these funds are returned, similar payments on external debt deduct money from the country and will have in a period of maturity payments a «chilling» effect on the economy, which is especially true if such borrowings are related to the financing of current consumption and not development. The measures proposed by the Government of Ukraine during the restructuring of foreign debt in 2015 «tools to increase the value» are a classic example of such burden for Ukraine’s economy at the stage of growth.

Loans from international financial institutions are a cheaper, and in some cases — the only available source of external funding, but it should be noted that the requirements imposed as a condition for granting/extension of credit, not always serve the development of the economic foundations for the next debt repayment, limited to objectives of general solvency of the country, primarily taking care of current stabilization. This pattern is typical for requirements of the IMF, which are concentrated around the objectives of fiscal consolidation and exchange rate stabilization.

Thus, a large proportion of fiscal redistribution gives the state budget a number of determining factors of the dynamics of the Ukrainian economy. Meanwhile, the increase in the share of GDP fiscal redistribution was not actually accompanied by the implementation of the spending policy by the state, which would be subordinate to the implementation of the strategic objectives of economic development and lead to the rationalization of spending of scarce resources of the society. High level of fiscal redistribution largely played the role of equalizer of losses from unreformed areas of expenditure in the areas of current consumption and high «corruption tax». However, the restriction of budget financing for long-term economic stagnation after the crisis of 2008-2009 made this has compensation unacceptably onerous, putting on the agenda the task of expenditure rationalization and tax reduction.

Currently, there is a stalemate in the choice of fiscal policy models. On the one hand, the state is limited in conducting liberalization strategies and budget cuts because of the extremely poor elasticity of the majority of the latter. On the other hand, it is also unable to complete paternalistic policy — with appropriate financing of current expenditures and development expenditures — as economy overloaded with fiscal pressure does not create adequate budgetary resources. Thus deformed model of fiscalized chronically scarce economy, focused on «eating away» the development resources.

The way out of this «trap» requires overcoming fiscal gap that inevitably arises when the tax reduction and deregulation lead to physical reduction of budget revenues, while the economy still does not provide the acceleration of economic growth due to incentives received. We can assume that in modern Ukraine, which is characterized by imperfection of the institutional economics, numerous
depression traps and prevalence of pessimistic expectations, the depth and duration of this gap can be quite significant.

The above confirms the importance of a systemic reform of the budget system in which the weakening of fiscal burden will occur simultaneously with the improvement of expenditure policy, taking into account the diversity of macroeconomic and social consequences of changes in the budget system, as well as challenges for fiscal policy arising from the evolution of the national economy, society and the global community. Budget reform should be seen as part of a wider task — building of economic model alternative to the existing based on principles of economic pragmatism, entrepreneurial initiatives, consolidated social responsibility.

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1.8. Fiscal policy challenges

The accumulated contradictions of the budget system of Ukraine require systemic changes in fiscal policy, reorienting it to encouraging active development, consistent overcoming of obstacles and addressing contradictions that hinder the construction of the current economic model, which with appropriate economic and social efficiency fulfills the potential of Ukraine on the basis of economic pragmatism, strengthening real economic independence. It should be realized that the modern state is responsible for the effective functioning of the entire complex of market economy relations. Therefore, the state budget should be seen not only as an estimate of revenue and expenditure, but first of all — as a means of ensuring macroeconomic balance and economic growth, strategic financial plan that provides for harmonious development of the society in the long term. In fact, the implementation of structural and catalytic functions gives the budgetary process the strategy properties, therefore it is through their perspective that the effectiveness of fiscal policy in the country should be ensured.

As shown above, focusing mainly on the fiscal budget functions (fiscal policy fiscalization) leads to the loss of strategic guidelines and the destruction of potential long-term economic growth. Meanwhile, one of the main factors of the fiscal policy fiscalization is the absence, inconsistency or ambiguity of strategic priorities of the country as such. As part of the economic pragmatism strategy, fiscal policy should be considered in the context of a much broader set of problems of social development.

The limited budgetary resources require their concentration at critical areas, and therefore — determination of responsibilities of the state on the basis of an open public dialogue. Optimization of fiscal policy should be supported by consistent legalization of the economy and ensuring strict appropriateness of budget spending based on the reform of components of public sector. The effectiveness of budget planning based on forecasting economic development should ensure rational allocation of expenditure in time, avoid the extremes of accumulation of undistributed funds in the event of «exceeded» macroeconomic indicators and increase the cash deficit in the event of deterioration in revenues, which also often lead to waste or even the loss of the state’s financial resources.

The new fiscal policy has to respond to a combination of these system challenges, which are formed by both the current situation of the national economy, and global and regional economic trends.

1. Resumption of economic growth as soon as possible, which should be subject to one and all components of economic policy. This is a proactive fiscal policy, which, on the one hand, maximally stimulates entrepreneurship through tax liberalization and reducing the share of fiscal redistribution of the social product, and on the other — promotes resource mobilization of domestic demand, much of which, as has been shown in the...

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preceding paragraph, is generated just by budgetary expenditure. The solution to this paradoxical problem is seen in the concentration of fiscal liberalization in the first stage mainly in tax procedures (administration) and the reduction of the basis of the level of shadowing of the economy and the «corruption tax» and to improve the structure and mechanisms of expenditure and appropriate dissemination of catalytic function. Tangible potential is in expanding the tax base through multidimensional tax policy, involving in taxation the wider sources of direct or indirect income, real estate, natural resources etc. The stimulating function of taxes is an integral proactive fiscal policy, but all tax expenditures should be of guaranteed targeted nature while maintaining the defining role of indirect taxes in budget revenues for a transitional period.

2. Targeted support to the modernization of the national economy and strengthening its competitiveness. The rapid changes in the global competitive environment and the global redistribution of flows of goods and capital required to adapt to these challenges of national economies. This objective is particularly relevant given the historically high openness of the economy of Ukraine and the need for reorientation to new markets after losing the majority share of the Russian market. In the absence of adequate financial capacity of direct budget involvement in the modernization changes in the form of the state investment is extremely limited, but this limitation is compensated concentration structure of spending on areas that are able to create a positive synergetic effect on economic growth. These are investments in the infrastructure sector, the development of information and communication environment, lowering transaction costs and more business. The main emphasis of proactive fiscal policy must be placed on institutional support for partnership funding of the modernization programs as well as creating an enabling environment for private investment, tax incentives, information, favorable business and investment environment etc. An important support of modernization change is the development of education and science.

3. Providing a positive trend of human development. Socio-political crisis in Ukraine demonstrated the impossibility of further economic development outside dimensions of human development. Providing not only the basic foundations of quality of life, but also the conditions for the implementation of labor and creative potential of citizens and increase on this basis of the nation’s wellbeing is one of the key objectives of fiscal policy. However, current budgetary constraints do not give reason to expect to solve this problem on the basis of traditional Ukrainian policy of social paternalism. A new quality of social policy may be achieved through the implementation of potential human capital of the nation as a key competitive advantage of the modern globalized economy. Spending on education, health, cultural development have to be considered and formed primarily as an investment in increasing the value of human capital.

4. Disclosure of regions’ potential on the basis of fiscal decentralization. Improving interbudget relations and expanding the practical powers of regional authorities on accumulation and resource development must empower involvement in economic turnover of potential resources of the region, bring the results of the regional economy to the needs of the local population. Expanding economic powers of the regions while strengthening their financial base is a zero-option way for territorial reintegration of the country and overcome risks of centrifugal tendencies in the future.

5. Financial support for the revised defense policy. Military conflict imposed on Ukraine by the Russian Federation has led to the revision of the Military Doctrine of Ukraine and led to a substantial increase in public spending on current needs of the Armed Forces and strengthening their combat capability in the long term. Engaging Ukraine into the abyss of increasing defense spending is undoubtedly one of the destructive purposes of «hybrid warfare». The way to counter this risk is through the transformation of defense expenditure stimulator of the national economy on the basis of the widest
possible distribution of the introduction of market principles in defense spending within the internal market.

6. Ukraine’s integration into the global system of human development, objectives of which are defined at a UN Millennium Development Goals. They identified: poverty reduction, provision of quality lifelong education, gender equality, reducing child mortality, improving maternal health, reducing the spread of HIV/AIDS and tuberculosis and slowing down their scale, environmental sustainability. Integration into the global development goals opens space for international dialogue of Ukraine, simplifies obtaining legal and financial support at the international level, opens the possibility of national economic capacity in implementing international humanitarian programs support the underdeveloped countries, which in turn promotes international economic partnership.

After the signing Ukraine — the EU Association Agreement vectors of changes in economic policy are guided by the implementation framework defined in the Agreement. In this document, Ukraine commits to make every effort to build a functioning market economy and gradually approximating its policies to the EU in accordance with the fundamental principles of macroeconomic stability, balanced public finances and balance of payments, and undertakes a number of specific obligations with respect features and tools of fiscal policy and should be considered in the process of restructuring the latter. These obligations, in particular, include the following.

1. Non-discrimination in taxation of foreign trade, which would put the Ukrainian counterparty in a better position than their foreign partners. This includes the abolition of tariff restrictions defined schedule under the FTA, and application of national treatment to any and all entities engaged in trade in the internal market (Chapters 1-5 of Section IV of the Agreement).

2. Ensuring a transparent, non-discriminatory, competitive and open tendering process for public procurement with establishing appropriate coordination and control institutions that provide equal access of all entities to this instrument of public policy, justification for eligibility requirements and criteria for determining the winning bidders (Chapter 8 of Section IV of the Agreement).

3. Cancelation of any type of assistance using the state resources, which distorts or threatens to distort competition by providing benefits to individual undertakings or the production of certain goods. This determined the acceptability of benefits on the basis of full transparency and accountability and meet European standards (Chapter 10 of Section IV of the Agreement).

4. Ensuring development of fiscal policy and robust internal controls and external audit based on international standards and compliant with the fundamental European principles (Chapter 3 of Section V of the Agreement).

5. Improvement and development of the tax system. There should be a gradual approximation to the taxation structure defined in the EU acquis and implementation of European principles of good governance in the tax area (Chapter 4 of Section V of the Agreement).

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6. Use of external financial assistance coming through the appropriate mechanisms and instruments of EU funding on the basis of programs, in cooperation and coordination with other donor countries, donors and international financial institutions and in accordance with international principles for effective aid. It has to be ensured prevent fraud with the funds received (Section VI of the Agreement).

contained in the current Memorandum of Economic and Financial Policies of Ukraine agreed upon with the International Monetary Fund\(^\text{32}\). In the document, Ukraine declares intends to focus its strategy on consolidation of expenditure, focusing on smaller and more effective government in the provision to the tax system of the friendly to growth, efficient, balanced character (p. 21 of the Memorandum).

Ukraine is also committed to reduce the fiscal deficit to the level necessary to ensure sustainable public debt dynamics in a balanced and socially fair way. The calculation takes the general public administration deficit, including off-budget funds and NJSC Naftogaz. In order to achieve these goals in the short and medium term, a number of important changes are provided, such as:

- introduction of VAT for farmers;
- reform of the unified social contribution;
- reducing the taxation of natural resources;
- reforming the tax administration;
- simplification, transparency and competitive public procurement;
- pension reform and the abolition of special pensions;
- health care reform, education reform;
- reduction of employment in the public sector;
- reforming the social assistance.

It is important to realize that reforms envisaged in the Memorandum actually are not such, because their purpose is narrowly limited by pure objectives of reducing public spending to ensure the solvency of Ukraine for its public debt. This narrowing of the objective is a logical consequence of the lack of alternative strategies to achieve the same goal — solvency — but in its combination with a wide range of tasks of national economic, social and civil development. The approach to the restructuring of the fiscal policy from the standpoint of economic pragmatism allows us to offer these alternative ways not damaging the long-term development objectives.

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2. BUDGET SYSTEM REFORM AREAS AND TOOLS

2.1. Formation of the budget strategy

Despite the spread of liberal models of economic, fiscal instruments in the world is a powerful tool of influence on economic development and business environment. Formation of a new fiscal policy is an important part of implementing the economic pragmatism policy, aimed at the implementation of Ukraine’s own strategic priorities.

State budget strategy should be seen in the context of socio-economic system and the political and legal reforms that Ukraine badly needs at the moment. While Ukraine has established the National Council of Reforms and agreed the strategic development principles, stated in the Sustainable Development Strategy of Ukraine till 2020\(^3\), approved by the President of Ukraine in January 2015, identified 17 key reforms to be implemented soon, practical tools of the reform remains uncertain. Therefore, government activity is focused primarily on the «fire» responding to current challenges, virtually no reforms have brought to the stage of tangible results. This is rises misunderstanding both in the society and foreign donors, for which commitments to reforms was the basis for providing financial assistance to Ukraine.

To a large extent this situation emerged due to the lack of a clear strategy of the state in the public sector, which would define opportunities, power and consistency of financial security changes that must take place in the economy and in society in general. In the absence of strategic approaches, fiscal policy appears again and again subordinated to short-term fiscal benchmarks, which are reduced to the parameters of revenue and expenditure, budget deficit and government capacity to service its debt obligations. Attempts to deviate from fiscal routine (e.g., tax reform) immediately cause resistance from the fiscal authorities concerned about the risks of the budget unbalancing.

The answer to this concern can only be a strategic approach that clearly defines the integral relationship between the proposed changes in the public sector — and its positive implications for fiscal sustainability. After correctly located in time reform often lead to counterproductive results and not funded reforms give no results at all.

Instead of doing all reforms in one year (which causes them to stop), it is necessary to have a plan of reform for several years, which will agree:

- list of reforms;
- cost of developing and implementing every reform;
- impact of each reform on budget revenues and expenditure;
- period during which it is expected to implement the reform plan;
- fiscal balance for each year during which the reform plan will be implemented;

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• sources of imbalance funding with division into internal and external, including additional revenues from their economic growth and deshadowing and borrowings and grants provided from the outside and will need to be returned or meeting certain conditions of donors and creditors.

Realistic nature of the budget strategy depends on realistic forecasts for different areas of public life and pragmatic goals that the current government poses to society. Therefore, the success of the strategy is directly related to the integrity of the whole chain of processes and strategic documents: the long- and medium-term forecasting, forming ideologies, trends, objectives and priorities of the strategy, development forecast-targets of the plan (program) implementation, implementation in practice of the authorities (including in the budget process).

We shall emphasize that the introduction of mid-term budget planning is paid dominant attention in the Public Finance Management System Development Strategy by the government along with the European Commission. Unfortunately, the Strategy is implemented mostly formal and integrated system of medium-term forecasting and planning is not created. Article 346 of Ukraine- the EU Association Agreement provides for cooperation to ensure the development of fiscal policy and robust internal controls and external audit based on international standards and comply with the fundamental principles of accountability, transparency, economy, efficiency and effectiveness. Article 347 states on cooperation of the parties in development of the system of medium-term budget forecasting/planning, improvement of performance-based approach in budgetary process and analysis of the effectiveness and efficiency of budget programs, improving the exchange of experiences and information on the planning and execution of the budget and the state of public debt. Under Article 351, the parties of the Agreement shall cooperate in matters of improvement and development tax system and tax administration of Ukraine, including strengthening the capacity of collecting and monitoring, with particular emphasis on procedures for VAT refunds to avoid accumulation of arrears, to ensure effective tax collection and strengthening the fight against tax fraud and tax evasion, introducing European principles of good governance in the tax area.

Meanwhile, the public perception of the new budget strategy depends on understanding the purpose of its implementation. Fiscal reform cannot be implemented for purely fiscal objectives to balance the budget, and even more broadly, macroeconomic and financial stability based on the so-called fiscal consolidation. Instead, reform must strengthen the instrumental nature of budget strategy as one of the most powerful tools of implementation of system strategy of reforms in Ukraine, radically extending the effects of fiscal policy beyond the actual budget system.

The task of system strategy is identified by the main shortcomings of the domestic economy that have accumulated as a result of a long period weakness and inconsistent government economic policy and turned Ukraine into

• mostly raw country in the international system of specialization and cooperation;
• exporter of labour and «brain» in the international division of labour;
• chronic debtor in the world system of distribution of financial resources.

Priorities for reforming the fiscal policy are defined by the basic principles of the Economic Pragmatism Policy developed by us, based on which Ukraine is able to overcome the vicious circle of economic degradation and achieve sustainable, dynamic

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investment-based economic growth, the results of which will be used primarily to ensure the quality of life of Ukrainian citizens\(^\text{39}\).

A long-term priority of fiscal policy in Ukraine should be creating conditions (fiscal space) for speeding up the transition from recession to sustainable economic recovery.

Principles of the budget strategy within the framework of this policy are as follows:

- compliance of the budgetary policy with the national interests;
- ensuring the sovereignty of the state in the implementation of national fiscal policies;
- implementation of a reasonable medium-term planning aimed at reconciliation in the budget process of current (annual) and strategic objectives of economic development policy;
- providing realistic fiscal policy objectives and the reasonableness of concentrating the resources to achieve them;
- strengthening the state capacity through provision of financial resources, the feasibility of its functions in the implementation of domestic and foreign policy;
- rationalization of the state «size» in the economy: list of functions, responsibilities, financial shares in circulation, volume of the state property;
- reduction of the scale of direct budget support to economic activity in favour of tax incentives and tools and creation of a favourable business climate;
- Delineation of current expenditures and expenditures on the development, refinement and expansion of sources from which expenditures for development should emerge, institutionalization of their use;
- rationalization and streamlining of social expenditure on social reform and strengthening the targeted nature of the system of privileges, subsidies and social benefits;
- ensuring full and timely fulfillment of financial obligations of the state at all levels, unconditional rule of law and legal procedures;
- dissemination of public-private partnership to achieve the objectives of economic and socio-humanitarian development;
- ensuring the integrity and unity of the budget system as a financial basis and preconditions for integrity and unity of the state;
- construction of interbudget relations on the basis of a rational centralization of basic state functions and the consequent widening of the capacity and powers of local government.

Providing proactive strategy nature to the fiscal policy, implemented in the principles of economic pragmatism will require focusing on several important landmarks:

- restoration of the active role of fiscal policy in promoting economic growth and strategically oriented development of the society;

\(^{39}\) Ibid, P. 21-22.
BUDGET POLICY: PRAGMATIC APPROACHES TO STRATEGIC DECISIONS

• active implementation of the investment potential of public finances, creating favourable conditions for investment-oriented development model and its innovative focus;

• restoration of the active role of tax policy on economic development, giving it character, «friendly» for entrepreneurship and favorable for economic growth, establishment of socially just taxation;

• concentration of state resources (including the bulk of the investment budget) on building economic environment conducive to entrepreneurship, effective competition on the principles of free movement of resource and information flows free of unreasonable restrictions and anti-competitive procedures;

• priority of building a new social and humanitarian systems in society that contribute to the development and disclosure of human capital of the nation;

• sharp reduction of public sector corruption capacity based on the simplification of administrative procedures and the introduction of advanced technologies and control;

• restoration of public confidence in the policy in the public sector by ensuring full transparency of formation and use of budget funds spending accountability, the widespread use of public initiative in expenditure planning and monitoring their implementation.

As mentioned above, the implementation of the new budget strategy should be in a clear agreement with all complex economic reforms implemented in the country. Achieving consistency guidelines and objectives of fiscal policy with other policy components — the only possible way consistent implementation strategy defined budget objectives. On the other hand, transformation of budget policy is necessary that requires simultaneous reform of the related sectors of the national economy, which will reduce the need for budgetary spending, rationalize their spending etc.

The main areas of such synchronization include the following:

1. Tax reform. Improving the tax system, simplifying administrative procedures should help to increase tax revenue. This also will facilitate and expand the reach of the tax base. However, rationalization of public spending is essential to mitigate the negative effect of «fiscal gap», so should precede the decision to reduce the tax rate. The necessary components of tax reform should be reform of the DFS, which include changes in criteria for evaluating employees and service units, as well as reform of the tax legislation, which should minimize the uncertainty of the tax system.

2. Regulatory reform and restructuring of entrepreneurship stimulation policies. The expected deshadowing of the economy, especially — small and medium businesses, will have a positive impact on revenues. Meanwhile, targeted government funding improve the business environment (provision of information, training, support for the development of microcredit, development of market infrastructure, communications, etc.) and open access to lending will facilitate business community sensitivity to positive signals of the deregulation.

3. Reform of social protection and social security system. Increased targeting of social protection will reduce the need for budgetary expenditures while maintaining their desired social effect. The same applies to pension reform, which has to gradually eliminate the necessity of subsidizing the pension fund deficit. Nevertheless, social spending budget should adequately mitigate the negative effects of reforms in other areas, in particular — the introduction of market principles in setting housing and utilities tariffs.
4. Reform of social components. Qualitative changes that occur in the process of reforming the health and education should rationalize public expenditures for services in these areas. On the other hand, these reforms will require additional special budgetary expenditures (investments in the resource base, communication infrastructure, etc.).

5. Administrative reform. Based on the functional review and improve the efficiency of the administrative and managerial staff as a result of deregulation, decentralization of information, are able to save significant proportion of the budget setting required its size and wages that would secure society against corruption as a means of compensation resources not provided by the state for normal management process. However, as in the previous case, the construction of modern control and management requires network specialized investments. The risk of reduction in revenue in the period of management model transformation is not excluded.

6. Reform of the army and law enforcement agencies. Consideration of this reform impact is important because it is necessary to protect national security and sovereignty of Ukraine, forming an important part of budget expenditure, which was still overloaded by imperative social spending. Reverse effect of these reforms to the budget is remote but critical.

7. Administrative and territorial reform. Holding a closer alignment of regional policy should relieve the system of interbudget transfers and strengthen financial self-sufficiency of administrative units. Competent local authorities should also make better use of local budgets, which is required for consistent reforming of the social components.

We shall emphasize that a large part of these reforms is outside the fiscal policy. Therefore, this report we will focus on those components that are directly related to the budget system.
2.2. Tax reform benchmarks

Quality restructuring of the fiscal policy of Ukraine is inseparable from the restructuring of the tax system as a major source of financial resources of the state and local communities. Although the topic of tax reform requires a separate detailed consideration, it is expedient to describe within this report the basic principles and guidelines of the tax reform, which will guide the changes in fiscal policy of the state.

Considerable variability of the tax system, characteristic of the Ukraine, is a powerful desimulator of the business activity — especially in strategic terms, and one of the important factors of tax evasion. To achieve stability in the tax system it is necessary to clearly establish key principles that ensure its functionality regardless of political cycles. These long-term tax reform guidelines that meet the concept of economic pragmatism are:

- achieving uniformity of the tax burden;
- gradual advance and a decrease in the tax burden;
- minimizing the cost of implementation and administration of the tax laws; broadening the tax base;
- availability of clear, meaningful, limited in time and space tax instruments to stimulate economic activity;
- social justice of taxation;
- consistent unification of tax legislation with the EU requirements.

Efforts to reduce the tax reform only to lowering the tax rates expecting the stimulating effect of this reduction for business and economic growth (including the deshadowing of the economy) contains significant risks as critically depends on the sensitivity of the economy to such incentives, positive expectations, business climate, availability of financial resources, sufficient capacity markets. Moreover, the absence of these conditions the funds that are at the immediate disposal of economic entities and the population as a result of easing the fiscal burden may cause further inflation and devaluation pressure, causing the brakes on the effect of macroeconomic stabilization measures. So that reduction in the tax burden was not accompanied by a reduction in revenues, tax reform should contain stimulating ingredients that have contributed directly to revitalized economic growth and compensation for the loss of tax revenues due to growth in the tax base during the first stages of this reform.

In the same context, it is necessary to consider the cost of liquid resource to the enterprise which is removed in the form of tax, which is particularly obvious on VAT example. Thus, in other equal conditions intensification of monetary policy at the same time increases the fiscal burden on business, and monetary easing will enhance tolerance to higher tax rates.

Over-simplification of the tax system appears undesirable, which is generally regarded as marginal decrease in the number of taxes, use of only «flat» undifferentiated rates and minimizing exceptions, exemptions and privileges. Indeed, in this case the state gets rid of one of the most important instruments of economic policy, lost
the flexibility to reach the base, which increases diversity. Complications of tax base and rate of differentiation and appropriate control at this stage are made possible through a broad informational accounting of tax liabilities.

Therefore, the content of the tax reform should include a moderate attitude towards lowering taxes, implementation of the effective mechanisms of taxation under which taxes, serving as a source of fiscal resources, properly perform as socio-leveling and regulatory and catalytic functions.

In the circumstances, when tax reduction is complicated by significant needs of budget revenues in the first stage of tax reform should focus on components that reduce business transaction costs to pay taxes without affecting their own financial revenues. These particularly include expenses for accounting and reporting, maintenance of tax audits, training of financial and economic departments of enterprises or using the services of a third party accountant (for small businesses) and others. Solving these problems ensured the improvement of procedures and introduction of modern information technology. One way of improving the legal instruments which the state uses to implement fiscal policy is the introduction of the Tax Regulation that would detail provisions of the Tax Code.

Active informatization of the tax field will ensure distribution of control over business transactions without increasing reporting requirements and audits of taxpayers. Further use of algorithms of risky transactions identification will establish objective monitoring by the fiscal authorities, reduce corruption capacity of the tax system. With the full amount of reliable information available for small business, further simplification of taxation is possible through the agreement of the entrepreneur, charging him the tax payments by tax authorities. Radical improvement of tax control forms shall be the basis for the next lower tax rates and the effective use of tax incentives.

Achieving transparency in the tax base should be accompanied by the decriminalization of responsibility in the field of taxation and providing priority to the service functions of the fiscal authorities (assistance in calculating the correct tax liability). Responsibility in taxation may occur only in case of direct damage to the country and shall have primarily the form of financial compensation. Criminal prosecution should occur when the payer is obviously in violation of the law, for example by making double documentation, commission of fictitious activities for tax performance distortion, false information, i.e. violating knowingly the requirements of the law. It is necessary to absolutely stop any attempts to plan revenues from penalties to the state budget and «making profit» by most of the fiscal authorities on violators of tax laws.

We shall remind that under Ukraine- the EU Association Agreement, the Parties shall cooperate to improve good governance in the tax area, implement the principles of transparency, exchange of information and fair tax competition. Ukraine- the EU Association Agreement sets clear list of the provisions of the EU directives that regulate VAT and excise tax, to which Ukraine should approximate its legislation. In particular, it will encourage reviewing VAT e-administration with depositing funds, which violates the Directive 2006/112 of the European Union. Reform of the VAT according to the European model, with the simplification of administration, will further expand the range of payers of this tax.

As for other taxes, mandatory changes in the Association Agreement are not fixed, but the gradual implementation of the best European models is the benchmark for the development of tax system of Ukraine.

Focus of the fiscal policy on creating the conditions for dynamic economic growth requires significant restructuring of stimulating tax policy instruments aimed at implementing the tasks of economic strategy of the state. Ukraine should move from corrupted and prohibited to the international rules sectoral preferences to tax incentives of functional nature, which ensured equal access to all businesses
regardless of ownership or sectoral affiliation. An integral part of tax reform should be the establishment of clear and transparent criteria and methods of tax preferences.

Among the possible tax incentives that meet the functional principle and should help create an environment conducive to economic growth, we should note the following:

- exemption from taxation of retained earnings, which invested in Ukraine to upgrade/expand of fixed assets;
- exemption from taxation of businesses, aimed at training and retraining, the cost of social security (pensions, health insurance, health improvement, etc.) with equating them to investments in human capital;
- exemption of enterprise funds allocated to research funding (from equating them to invest in intellectual capital);
- exemption from taxation of the funds allocated to the implementation of energy saving industrial and office buildings;
- tax preferences to enterprises engaged in export and import-substituting production, working in excessive labour or are in depressed regions, etc. — to the extent and in the areas stipulated by relevant state programs (policy on SEZ and TPD could evolve in this area);
- introducing accelerated depreciation of equipment purchased in the period, for which preference is set (e.g. 2016-2018);
- exemption from import duty on the equipment, analogues of which are not produced in Ukraine, and which are purchased as part of investment projects (currently this exemption applies to equipment related to energy efficiency and alternative energy, nanotechnology, etc.);
- preferential tax of commercial banks’ profits obtained as the result of long-term loans to business entities for investment projects;
- deduction from the personal income tax base expenditure on measures to protect and promote health, education for themselves and family members, payments to fund pension and medical insurance, energy housing etc. (the possibilities of this lies in the legislation, but practical methods of providing tax credits yet to be developed);
- introduction of the tax incentives for investments in self-employment, development of personal subsidiary economy in rural areas, the purchase of capital goods for individual businesses, to contribute to the creation of a small business or a business partnership, etc.

It is possible to avoid excessive budget losses due to improper receipt of tax benefits through the use of incremental method of taxation. Under this method, gain of profit earned after the simulated actions within the part of the profits directed to the appropriate investment is exempted from tax, this makes the tools of tax incentives intangible for tax revenues, while a positive impact for the budget as a result of revenue growth from indirect taxes and taxes on individuals should be expected. It is important to form a single registry to provide funds or guarantees to prevent abuse.

Appropriate tool that would provide targeted tax incentives should be the accumulation of funds received by enterprises through preferential taxation on their special accounts at the legislative mechanisms determining expenditure of these funds and monitoring its end use.
In our opinion, the tax incentives administration mechanisms should be explicitly defined directly in the Tax Code of Ukraine. In particular, a separate section should provide for a comprehensive list of tax incentives, criteria for granting them, procedure for deciding on the right to use tax incentives and mechanisms to monitor their intended use. Regulations on tax incentives should be consistent with European state aid rules, laid down in the basis of the Law of Ukraine «On State Assistance to Business Entities».

It is also appropriate to introduce the reporting procedure for Cabinet of Ministers of Ukraine to the Verkhovna Rada on the volume of tax exemptions and incentives with the assessment of the economic and social efficiency of this resource — appropriate provisions should be included in the Budget Code.

Expanding the tax base should ensure coverage of economic activities in connection with the rent. It is advisable to increase royalties for mining in particular — iron ore and non-ferrous metals, etc., given the dynamics of prices on world markets.

The importance of the implementation of the export potential of Ukraine makes unacceptable continuing practice of VAT refunds in the «manual mode». Ukraine has a corresponding liability to the IMF and the European Union. Therefore it is necessary to introduce uninterrupted automatic VAT refund to exporters using modern information technology to monitor the validity of applications for refund.

The subject of special attention should be reforming the simplified system of taxation. The latter is under the constant risk of cancellation because of the prevalence of the practice of using small businesses — the single tax payers in schemes to minimize tax liabilities, harboring or hiring companies under artificial adjustment system by «crushing», «laundering» money and receiving illicit cash unreasonable use a simplified system for super-profitable activities. To overcome these possible risks by narrowing the list of activities that fall under the simplified system, the exclusion of sectors related to receiving passive income, excess profits and so on. It is reasonable interpretation of the simplified tax system as a variety of benefits, which in this case must be targeted and specific. Deep devaluation of hryvnia distorted introduced in Ukraine cost criteria of the category of small businesses that may require a separate input upper limit for access to the simplified taxation system.

In contrast to the tax incentives, means of implementation of socio-leveling function of the tax system are mostly a kind of direct tax benefits. The purpose of these benefits is some shift of the tax burden to the categories of the population with higher income levels and providing indirect financial support to low-income categories, which ultimately reduce the need for direct budget expenditures.

With a view to the proper implementation of the social function of the budget it is important to introduce some important changes, including:

- deeper progression of personal income tax: the introduction of a reduced income
Tax rate not higher than the living wage, increasing the number of gradations of the progressive scale;

- extension of excisable goods with such objects excise tax foods that are harmful to health;

- introducing a reduced rate of VAT on essential goods (social goods);

- increasing the property tax rates based on its market value, providing social benefits for persons residing in their own housing.

Tax changes approved together with the draft State Budget for 2016, laid a number of important improvements to the implementation of these tax reform guidelines. However secrecy of change development, lack of consultation with business and expert discussions, questionable predictive validity does not give reason to consider tax reform in Ukraine completed. It must be renewed on the basis of the above principles, guidelines and objectives.

Further tax changes should be introduced in the H1 2016 in order to be systematically included in the budget process in 2017. This should put an end to the annual situational making tax changes in «fire» mode under the pressure of fiscal needs of the government. Provisions of the tax system adopted and approved within a broad economic dialogue should be fixed by the moratorium on changes for a certain period (minimum 3 years) with the state responsibility regulatory defined for any damage caused to business in case of violation. Thus during the period of the moratorium terms of the planned changes in rates, tax mechanisms of action tax incentives etc can be pre-defined.
2.3. Optimization of current budget expenditures

Saving the budget expenditure by improving procedures even while maintaining inefficient structure of public sector may mitigate the problem of fiscal imbalance and lack of financial resources of the state, however — only in the short term. Systemic solution to these problems within fiscal policy restructuring based on economic pragmatism will require structural changes aimed at:

- optimization of the responsibilities of the state, local government, increasing social responsibility of the society and business;
- optimization of social obligations of the state and the transition from paternalism in the social sphere to partnership between the state, business and citizens in all aspects of social assistance;
- organizational restructuring of the processes that are subject to state funding (provision of services in education, health, culture, administrative services, perform basic government functions: management, security and defense, etc.);
- improving financial support of these processes (energy efficiency, quality of service, personnel requirements, etc.).

The combination of tasks of rationalizing public spending and reducing the budget reallocation — and preventing deterioration of quality of life will require restructuring of social policy on the basis of a substantial increase effectiveness of social expenditures due to the improvement of their structure and strengthened target orientation. Benchmarks of this restructuring should be:

- increased selectivity of the social assistance through strict control over the validity of assistance and incentives, the introduction of audit (verification) social benefits — and thus help bring the segments that really need it, to an adequate standard;
- gradual replacement of the benefits, which act as social support for vulnerable people, targeted social assistance (monetization of benefits);
- development of private social (including pension) insurance;
- cancellation of expenditures not typical of social security, significant reduction of administrative costs of social insurance funds, which will increase the share of Single Contribution directed to the Pension Fund.

Unacceptable situation in which a significant deficit of the Pension Fund is combined with the apparent lack of pensions for decent old age vast of the
majority of citizens, determines the need for consistent pension reform. In order to rationalize budget expenditure on pensions, it is necessary:

• return several level of the pension system to insurance principles, which means that the person who paid more contributions will receive a larger pension;

• implement a phased transition to a parallel system of mandatory and voluntary pension insurance based on personalized pension contributions, under voluntary insurance it is possible to implement specialized occupational pension schemes, the accumulation of which is at least partially funded by the employer.

Meanwhile, in the medium and long term reduction in public spending on pensions is only possible with the introduction of mandatory funded pension system. This step will lead also to adequate social security of the pensioners, and in the future — to increase in budget revenues due to the emergence of «long» investment resources in the financial system of Ukraine and its investment focus.

We should emphasize separately that the provision of target orientation and individual approach to the provision of social support from the state, implementation of mechanisms of monetization of social benefits and the principle of «money follows the person» can be achieved only through the introduction of a unified information-analytical system, information to which will come not only from social protection bodies, but also from other organizations that accumulate certain information on citizens: the ministries of justice, health, education, Interior, Finance and others. Formed on the basis of identification of needs of base of the beneficiaries and providers of social services and benefits will prevent abuse in this area and will result in the efficient use of budget funds for these purposes.

Given the objective need to create the conditions for maintaining the life of able-bodied citizens through effective implementation of their employment potential, social policy should be focused on priority investments in human capital: to provide education and training, efficiency citizens, labor market infrastructure, promote labor mobility etc.

Expanding opportunities for own labour and creative fulfillment of citizens will lower sensitivity of the society to the social populism, and therefore — to minimize its use during political cycles.

Amid existing hard budget constraints significant increase in financing social facilities in Ukraine is impossible. However, its reform to improve the quality of social services will require additional financial resources. The solution to this contradiction is possible through priority streamlining social sphere management, oriented to maximize the effectiveness of budget appropriations and the diversification of its funding. The main steps in that direction are:

• systematic energy audit in the public sector and the implementation of priority investment in energy saving measures, with the active involvement of the international financial assistance;

• optimization of the structure of educational institutions for their adequate financial support and staffing, with the foresight necessary social compensators (school bus for schoolchildren, more space in the dormitories for higher and secondary special schools, preferential fare of urban and intercity transportation for students etc);
• consistent implementation of health reform, focused on the priority measures of prevention, early detection of diseases and institutions stepped structure depending on the complexity of the required services;

• introduction of compulsory health insurance with the preservation and improvement of the system of free basic medical care and formation mechanisms of redistribution of funds received from paid services in health, to finance emergency medical care;

• expansion of credit and insurance financing principles of expenditure on education, housing;

• diversification of social services providers by bringing the competitive private companies to perform certain types of work, including paid services, promote social entrepreneurship;

• consistent de-institutionalization of social protection of children who are currently in institutions with boarding form content, by developing a system of social services in communities and inclusive education in a residence for children with special needs, placing the maximum number of children who are in residential facilities into family care, particularly family-type homes, foster families, and foster homes etc.;

• introduction of public-private partnerships through joint funding with private partners to provide social services, on the prevention and treatment of workers, preservation and restoration of social and cultural infrastructure in the settlements, where the major production facilities of vocational education and others. — it may require improvement of legal regulation of charity and philanthropy.

The quality of services in the health care and efficiency of budget funds allocated to this sector will be positively impacted by the autonomization of health care facilities, which involves changing organizational and legal status of the institutions from the state institution to the state or municipal enterprise, commercial company, etc. This should allow hospitals to form budget to attract additional funding. Autonomization of the institutions will have a positive impact on the education sector as evidenced by the experience of higher educational establishments.

As noted above, maintaining a significant level of defense spending is a forced need for Ukraine, at least in the medium term. Depressive impact of this unproductive budget spending item may be avoided, ensuring the highest possible multiplier effects of defense spending as a component of domestic demand, which is not only out of the crisis, the domestic defense industry, but also extend the effect of recovery in the economy. This will be facilitated by:

• placing the state defense order (except when it comes to purchasing special types of equipment and weapons, production of which focus on specific enterprises) on a competitive basis, using, if necessary, the consortium principles of performance, forming the legal framework to accommodate the production of arms and military equipment to private companies;

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36 In particular, there is a practice of minors insurance savings with subsequent payment of the accumulated amount after they reach adulthood for tuition.
• ensure broad competition for defense procurement needs for non-military and dual-use goods and services and targeted expansion of the suppliers;

• rationalization of the volume, structure and location of the property and land that are in the operational management of the armed forces, sale and conversion of surplus infrastructure withdrawn from the military use;

• introduction of the rational approach to upgrading the Armed Forces, in particular — the use of methods of rebuilding, upgrading existing technology according to modern business models, involving domestic defense industry instead of import;

• Encouraging progress towards the sale in the open market of machinery and equipment of dual-use produced under the state defense order, subject to the full satisfaction of the latter, facilitating parallel introduction of conversion samples;

• development of international military cooperation within NATO and partners, implementation on this basis the of joint projects for the production and modernization of weapons, military and special equipment, attracting foreign investment in the Ukrainian defense industry;

• extension of instruments to fund the defense needs, in particular — in the form of targeted securities, proceeds from which are spent on the technological modernization of the national army, for sale to the individuals and legal entities in the domestic market as well as for external placement (among the subjects of neighboring friendly countries, Ukrainian diaspora, etc.).

In determining the terms for placement of the state defense order and other procurement for defense needs it is necessary to take advantage of the fact that under WTO provisions duplicated by Art. 143 of Ukraine — the EU Association Agreement, on parties of such purchases associated with the production of weapons, ammunition or materials for warfare or trade in them and the economic activity carried out directly or indirectly for the purpose of providing military forces it is not prohibited to set special requirements that would otherwise be regarded as a breach of competition.

Administrative reform will have a significant impact on the rationalization of public spending in the medium and long term. The expected effect will be in direct reduction of expenditure on the functions of public administration and improved efficiency of distribution of other expenditures and control over their optimal use. In this context, it concerns:

• deregulation and reduction of licensing and control procedures, transfer of control and reporting procedures in automatic form, and through this — reducing the cost of maintenance management system;

• consistent implementation of e-governance at the national and regional levels, which should reduce the need for premises and staff, improve the quality and efficiency of administrative procedures to ensure equal accessibility to administrative services for all areas of the country, create conditions for maximum transparency in fiscal policy at all levels;

• delegation of control and management functions to local self-government, which they will perform on the principles of sustainability, preventing the need for budget spending (international practice of such delegation relates primarily to technical regulation);
• expanding the powers of local government and «unloading» of the central government from a number of administrative functions: it is assumed that local authorities are able to streamline the administrative staff in accordance with local requirements.

It should be emphasized that effective government can not be «cheap», and savings in administrative budget expenditure should not be done at the expense of mechanical reduction, but through the introduction of new procedures and the redistribution of powers.
2.4. Development expenditure expansion and their improved efficiency

Implementation of the strategic function of fiscal policy is inherent in the implementation of budgetary investment and expenditure, creating favorable conditions for economic growth and development. In the broader context, public development expenditure can be considered not only the direct costs of the central and local budgets, among which the investment plays a leading role, but also the related costs of public sector economy. The studies of the fiscal policy also include in such expenditure a part of the provided tax benefits (so-called «tax expenditures»), which are to free development resources for economic entities. In terms of hard budget constraints and underdeveloped financial system maximum impact of fiscal policy may be achieved through combining these components.

The effect of budget investments may be enhanced by the combination of public and private investments within the partnership financing of important projects. The most promising appears to be the cost-sharing in the areas of housing and utilities, energy saving measures, environmental protection measures, educational services, scientific research etc. The partnership will be effective not only in the case of joint projects, but also during normal coordination of public institutions and enterprises in the implementation of complementary (complementary and interrelated) functions — such consistency can be achieved by the conclusion of appropriate agreements, development of the plans of consolidated actions of the state (local government) and private companies and in the course of discussion when planning local development budgets.

To consolidate development expenditure it is also necessary to ensure compliance with the regulations on directing funds received from state property privatization for innovation projects of strategic importance to the economy and security. First of all, it may concern cases of partial privatization of large state-owned corporations (eg, Ukrzaliznytsia (Ukrainian Railway Company)).

Based on the principles of economic pragmatism, the main areas of public investment must be investment in areas which have considerable social importance, but are unattractive because of low (or no) profitability; will enhance the effectiveness of current expenditure; create conditions for strengthening entrepreneurship and accelerate economic development.

Under current circumstances, the main priorities of budget direct investment and indirect development expenditure should be investing in the development of infrastructure industries, such as:

- transport — as pertains to regional accessibility (road network), organization of socially important transportation (students, health care), inter-regional communications, local transport (mainly local budget funds);
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- communication — to create free access to the Internet and technical basis for the formation of e-government, the full distribution of television and radio broadcasting;

- financial — in terms of formation or public participation in the existing financial institutions, whose activities will focus on the implementation of government programs targeted support (small business, research and innovation, social assistance, etc.);

- social — to modernize the buildings involved in the provision of social services, administrative services for the population, especially — to reduce energy loss and equipment of health services, and — to ensure the availability of appropriate services amid the administrative and territorial reform;

- educational — to modernize buildings, equipment of training processes, restructuring of educational institutions amid the administrative and territorial reform;

- housing — with the priority areas of energy efficiency, introduction of modern metering equipment and the formation of an integrated network of social housing.

Indirect development expenditures shall be considered as expenditure of the state to create an environment conducive to growth and innovation development, to which small and medium businesses are the most sensitive. In particular:

- creation of research centers on public-private financing (including the Center for Economic and technological predictions within Ukrainian Development Corporation), focused on providing application intelligence on the state of commodity markets, macroeconomic risks, investment prospects, labor market needs, technological predictions etc.;

- provision of the basic information free of charge to the organizations that provide financial, consulting, marketing, information and communication, legal, educational services;

- formation of state order for training of scientific and engineering staff in higher and secondary special education based on the long-term prognosis needs of the domestic labour market;

- national public procurement of innovative products, including — in the framework of the state program of energy saving, development of information and ICT, defense procurement, etc;

- stimulation of the investment oriented and innovative development infrastructure, industrial parks, technology parks, business incubators, venture financing institutions (including National Innovation Venture Fund under Ukrainian Development Corporation) etc.;

- various forms of direct or indirect subsidies, grants, donations, sales at preferential prices (including the state property privatization) if they encourage or create the conditions for business development.

Ensuring maximum efficiency of public spending and creating conditions for partnership and diversified and partner financing of the socially important investment projects require application of the practice tested in many countries of delegating tasks of direct accumulation of financial resources and their subsequent distribution to the specialized financial institutions. According to this model, the state at the expense of the budget funds is involved in the formation
and securing capital of these institutions and determines their statutory objectives and strategic goals of activities. Specialized financial institutions in their further activities independently determine the criteria and conditions under which the companies will be given the financial resources in the form of loans or subsidized interest and guarantees, decide on areas of investments, loans and subsidies, etc., can provide loans at interest rates lower than market ones, guarantees for loans subsidies, seed capital, micro-credits, etc., as well as attract additional financial resources by selling their own securities and/or raising funds on deposit. This allows for objective assessment of commercial projects, adequate support for their implementation and securing funding from the annual changes associated with changes to the budget expenditures. Meanwhile, the activities of these institutions shall be carried out within the investment, technology and innovation strategy and policy of the state.

Within the Economic Pragmatism Program, institutionalization of public spending will be carried out through a network of institutions, united by the Ukrainian Development Corporation37. A key role in this network for the expenditure distribution will be played by the State Bank of Reconstruction and Development (SBRD).

SBRD shall be established by appropriate law as a specialized financial institution, similar to the same institutions that function and operate today in many other countries. SBRD funds shall be formed by the budget expenditures, which have an investment purpose, part of the revenue from the use of state property, sale of government securities, proceeds from the state property privatization, borrowings, including — borrowings from the international financial markets etc.

SBRD should be empowered to select its own investment projects for target lending with an interest rate no higher than the official rate of inflation. Preference shall be given to projects with mixed financing, with the possibility of subsequent sale of the share, held by the Bank, after achieving the project objectives. SBRD may be selected as the operator of special accounts, which will receive funds of tax credit provided under tax incentives for businesses. To this end, the Bank and the entity shall enter into an agreement that will provide for the obligation of the payer on the targeted use of funds received and its liability for breach of this obligation.

The evaluation and selection of projects for funding should be carried out by highly qualified specialists who have relevant experience in identifying credit risk and creditworthiness of borrowers. Effectiveness of SBRD modeled on other financial institutions will be determined on the basis of indicators of increasing credit portfolio value subject to the requirements of increasing market value of the share capital of the Bank. These indicators should be used to select a rational strategy of the bank and conditions (factors) for its implementation.

It is also necessary to take into account the world experience of monitoring, control and evaluation of SBRD activities, by creating the most transparent supervisory bodies, management, control procedures, consideration of conflicts of interest, attracting budgetary funds and funds of international financial organizations. The rules and procedures should be spelled out in law, which covers all conditions and regulation of the bank operation, in order to create long-term guarantees to investors and lenders on the stability, transparent

intentions and prevention of dependence on the government policy changes.

Institutionalization of development expenditures with the pronounced regional dimension should be ensured through establishment of the State Regional Development Fund as a separate financial institution with a corresponding network of regional offices. The Fund will concentrate spending of the central budget aimed at regional development objectives, and will act as operator of the international financial assistance provided for the purposes of regional development. In addition, the regional units of the Fund will be used to co-finance local projects of the state and local budgets (through SBRD) and local businesses.

Ensuring maximum efficiency and targeted use of budgetary investment involves radical increase in the efficiency of processes of selection of budget investment objects, administrative, technical capacity of national institutions to effectively manage investment projects etc. Streamlining the budget investments process should with the framework of the medium-term program of public investment and coordination of sectoral long-term programs and concepts with it. This process requires an inventory of programs that provide for budget funding, termination of those of them who have lost their relevance, or are improperly performed.

As part of the development of public strategic planning system and improving the budgetary mechanism it is necessary to provide for the development of a new document at the state level — budget development strategy in the medium term, which will determine the marginal funding of expenditures on the functional classification, appendices to which are:

- Public capital investment plan for the planned period and for two fiscal periods following the planned period (with a list of investment projects), which define areas of state support of investment and the volume of its financing;

- Regional capital investment plan for the planned period and for two fiscal periods following the planned period (with a list of investment projects), which includes investment projects implemented using the funds of the State Regional Development Fund.

Meanwhile, it is necessary to streamline the state support and distribution of public capital investment for all investment projects (including those carried on under public-private partnership), including:

- unify legal terminology in the field of public investment with the budget classification and statistical reporting;

- introduce new principles of project identification, project proposals and their evaluation procedures and to develop procedures for the formation of public (local) capital investments plans;

- agree on the procedure of forming the Public Capital Investment Plan with the budget process, placing the responsibility for creating the plan on SBRD, develop agreed procedures and terms of determining annual expenditures to finance the Public Capital Investment Plan, changes in initiation, submission and approval of the relevant budget programs and requests, powers of other participants in these processes;

- organize similar state support for investment programs and regional development projects (including cooperation projects and voluntary association of communities) aimed at regional development, infrastructure
and innovative industrial parks and meet the priorities set out in the National Regional Development Strategy and related regional development strategies, develop procedure for such projects through the State Regional Development Fund on the terms of co-financing from local budgets based on Regional Capital Investment Plan;

• organize the examination of completed projects, monitoring, analysis, evaluation of performance and the steps to be implemented in case of inefficient use of public funds, with their mandatory publication;

• develop a procedure for acquiring state share of corporate rights in exchange for financial budgetary aid, which should include the transformation of state aid to investment, providing opportunities for further participation in the management of enterprises (particularly strategic enterprises), receive income from dividends on invested capital, and use the to form the development budget.

Effective coordination of public expenditure in terms of the national economy as a whole will facilitate implementation based on progressive international experience of modern national mechanism of project development, which takes into account the shortcomings and failures of the «national projects» of 2010-2013. To this end, it is necessary to form the acceptable criteria for selection and composition of these projects and effective system of administration in view of the principles of medium-term budgeting and country’s development planning.

As part of the «national project», there should be aggregation of the complementary state programs, coordination of their implementation and avoidance of duplication, coordination of the implementation of related private investment projects, as well as possible involvement of international organizations. This will streamline public investment by significantly increasing their multiplier effect for economic growth and structural upgrading.

Particular importance attached to the regional component of the socio-economic development, priorities of fiscal decentralization lead to strengthening the importance of active involvement of all components of local development budgets. It is the impact of the budget formation and implementation that is one of the elements of the transition from budget support to indirect budget regulation and is the basis of pragmatic fiscal decentralization — the community takes responsibility for its own development, livelihoods of residents and their welfare.

Reforming the system of development budgets as a part of local budgets should take place primarily by giving communities more rights to mobilize local revenues, and by expanding the list of revenue sources of the budgets. Immediate efforts should be directed at expanding the sources of budget revenue development — towards increase in revenues from operations (capital, property, etc.). In addition, it is important to thoroughly look at the structure of development budget expenditures distinguishing and gradually reducing those which only nominally belong to development expenditures and are inappropriate and inefficient in terms of impact on the development community.

These objectives can be achieved by the following steps:

• enshrine in the legislation the amount of development budget of at least 10% of general revenues fund of the relevant local budget. This will allow the first phase to implement capital expenditures at least at the minimum required level;

• broaden the tax base budget of a part of the local budget to include her of
income tax on profits of private companies;

- transfer apart of personal income tax and of the single tax to the development budget. It will constantly push local governments to expand economic activities in the territory under their control and to increase employment (as opposed to the active connivance of labour migration of the working population);

- expand the list of sources of development budget through domestic and external borrowing for investment purposes, contributions from the placement of local bonds. Due to this, management of funds on local development will gain market characteristics and will move away from absolute priority of social spending on the promising and multiplier projects;

- facilitate opportunities for loans from one local budget to the other. These solutions ensure stable income for some communities, the possibility of quick and easy fundraising — for the other, and together — will help unite the territories around common goals and through interdependence;

- use MTEF to the development budget that will enhance the effectiveness of spending as long duration of investment projects determines the features of development expenditures.

The full use of the whole spectrum of public expenditure requires appropriate regulation of state assistance system in Ukraine under Ukraine — the EU Association Agreement and adopted in 2014 by the Law of Ukraine «On State Assistance to Business Entities». In particular, the said law includes in the state assistance grants, scholarships, tax incentives or grace periods, soft loans, selling at prices below the market and increase in the state share in the authorized capital of business entities or increase in the value of the state share on the terms unacceptable for private investors.

Ukraine — the EU Association Agreement (Chapter 10) provides for adoption of the law and the formation of an independent body within three years after its entry into force, the formation of the state aid register — for five years to bring existing schemes and measures in line with EU state aid rules — for seven years. The authorized body within one year of its formation has to comply with all newly adopted regulations on state assistance.

After the adoption of the abovementioned Law of Ukraine, which will take effect from July 2017, and defining the Competent Authority, which is the Antimonopoly Committee of Ukraine (powers of the AMC in this area came in force with the publication of the Law), it is necessary to develop and approved method of evaluating the acceptability of state assistance to business entities for competition, which is taken into account when assessing the drafter regulations providing for the allocation of budgetary funds, tax exemptions, government guarantees and other forms of support, as well as training of interested central executive bodies, recipients of government support, industry associations prior to performance of the obligations on the regulation of state assistance. Efficient application of state assistance will serve as the definition of medium- and long-term goals, to achieve which such assistance will be involved, and specific types of such assistance. Meanwhile, a parallel task of the relevant executive bodies should be development of new assistance tools that meet the requirements introduced.

Pursuant to Article 262 of Ukraine — the EU Association Agreement, the following assistance is acceptable: of social character, granted to individual consumers for damages caused by natural disasters or emergencies, to promote economic development of regions with an extremely low standard of living or with
significant unemployment, to promote the implementation of an important project for a common European interest or to remedy significant violations of normal operation of the economy of Ukraine or one of the EU member states, to facilitate the development of certain economic activities or of certain economic areas, if it has no adverse effects on trading conditions, for investment to ensure compliance with mandatory standards set by the EU directives on environmental protection etc.
2.5. Deficit financing

The substantial backlog in the capacity to accumulate the funds to state and local budgets against the needs of their expenditure gives reason to predict a long period of conservation of permanent budget deficit in Ukraine. Thus the problem of sources of funding, including the leading role played by government borrowing, gains strategic importance.

A pragmatic approach to the fiscal policy requires the transition from passive debt financing of the budget deficit to conversion of the debt policy into a tool for implementing the strategic development marks and structural modernization of the national economy. As noted above, determining the optimal ratio of debt in the domestic and foreign markets is dictated not only by comparing the value of these resources, but also subject to branched macroeconomic effect of the chosen type of deficit financing.

Attracting foreign borrowed resources has no negative impact on the parameters of national monetary policy and, conversely, increases the supply in the foreign exchange market. But at the same time it provides a perspective outflow of budgetary funds abroad in the form of obligations on external debt service, and subsequently repayment, which may negatively affect the exchange rate. Funds withdrawn through these fiscal mechanisms through play no positive role in the domestic market that works together as a braking factor. Instead, internal borrowing risks include inhibition of the economy through the «crowding out effect» in the period of borrowing, but the service and repayment of debt will be associated with stimulating monetary influences on the entities of domestic economy.

The economic depression period is characterized by increasing the share of savings that are not used due to lack of investment flexibility and attractiveness of the financial system for their proper mobilization, negative investment expectations, low profitability of potential investments. There is a slowdown in money supply, which increases the role of monetary restrictions brake Rates that responds to the risk of monetary overhang that is created. Removal of temporarily idle funds through domestic borrowing instruments creates the possibility of returning them to the economic cycle. Withdrawing «unrelated» and therefore — inflation risk funds, government borrowings counteract inflation and devaluation risks, contribute to the weakening of «overheating» of the markets that are traditionally used as an alternative means of savings: housing, currencies and precious metals.

Thus, nowadays in Ukraine there are conditions in which attraction of the domestic loan resources to finance this deficit seems more productive than using external sources.

This, however, does not mean denial of access to foreign debt markets, but it should be determined solely need funding obligations of the state on previously accumulated foreign debts. Getting loans from institutional lenders may be an exception, as typically it has tough target determination.

In favour of expediency of distribution of loan finance of the public investment
projects in Ukraine, it should be emphasized that amidst underdeveloped stock market and a system of «long money» we should not expect in the medium term significant «crowding out effect» traditional for the developed economies. The budget and the real economy are not competitors for loans because of low solvency of the latter, thus lending to the economy by the commercial banks is limited by mostly weak solvency of borrowers, and government borrowings in the domestic market accumulate surplus funds that ceteris paribus would not be aimed at the investment needs.

Moreover, such «crowding out» may be acceptable if used to adjust the investment structure — redistribution of investment resources of the «heated» areas for strategically important needs, including — infrastructure development. Currently, IMF researchers argue that government spending can stimulate private investment (crowding in effect38).

«Crowding out effect» from domestic government borrowings may be weakened due to the following areas of state debt policy:

- increasing the share in total debt financing of municipal borrowing, placed among the enterprises and the population of the region, the proceeds of which will be directed to finance projects of physical and social infrastructure of local scale;

- delegation to specialized non-budget financial institutions (first of all, components of Ukrainian Development Corporation, other banks, funds, investment companies, etc.) that can be created in full or partial by the state participation in the capital, part of the functions of the concentration of loan resources for their next investment;

- when selecting sources of borrowing focusing attention on the resources that do not have active financial form, in particular — cash savings that could be attracted by the retail treasury bonds, foreign debt securities, target loans etc.

To mobilize unused financial resources apart from the above borrowing tools, we should distinguish «diaspora» bonds, which are placed among the diaspora of immigrants from Ukraine. According to the Ministry of Foreign Affairs, the Ukrainian diaspora consists of 12 to 20 mln. people, which is comparable with the third of Ukraine’s population. Such bonds usually have a long maturity and low profitability, and their occupancy rate is mostly not for profit but for patriotism. An important role for raising funds abroad should play Ukrainian embassies and consulates, providing information and promoting the «diaspora» bonds, which shall be issued for retail sale in a wide range of denominations39.

A significant amount of public debt accumulated by Ukraine and, accordingly, the burden of its servicing, causes the need for strict binding of new loans to create economic resource for their repayment, which should be achieved by channeling loan funds for development goals, and above all — public investment. The percentage that is paid on borrowed funds must be offset for the public by the return on public investment.

It is appropriate to introduce in Ukraine at the legislative level so-called «golden rule», which links the central government budget deficit to the volume of capital expenditures, applied in number of European countries (up to 1950-60) and applies in Great Britain and Germany until now. In particular, the UK legislation provides


that the government has the right to borrow only to finance capital expenditures. In Germany, the constitution stipulates that the federal government budget deficit may not exceed its gross investment expenditures\(^{40}\).

In Ukraine the situation is much more complex, as the majority of loans is made to cover previous commitments and cannot be directly correlated with the development costs (excluding loans from international financial organizations and some foreign institutions — the EBRD, the World Bank, EIB, KfW, etc.). This requires thorough strategic approaches to debt management to be coordinated with fiscal and monetary policy, correlated with the introduction of medium-term planning and forecasting in the budget process. In addition, due to the lack of effective regional programs and projects, which would provide real income, Ukraine issued the target government bonds as provided for by the Law of Ukraine «On Securities and Stock Market».

In order to reform public debt policy it is necessary to conduct work in the following areas:

1. Develop strategic approaches to debt management, including the longer term. This will require appropriate amendments to the Budget Code of Ukraine and is correlated with the introduction of medium-term planning and forecasting in the budget process.

2. Ensure the development of a wide range of indicators to improve the control of possible risks. It is advisable to introduce indicators relating to: the ratio of external public debt and domestic debt denominated in foreign currency, the annual exports of goods and services; the ratio of the total payments on public debt to the state budget revenues; maximum amount of state guarantees etc.

3. Ensure mutual coordination of the debt policy with the fiscal and monetary ones. There should be clearly regulated limits of such cooperation, exchange of information, rapid response to crisis.

4. Set the target indicators of state guarantees to prevent a repetition of the practice of substituting direct public debt with the guaranteed one. Converting of guaranteed debt in direct public debt should occur only in case of the relevant legal decisions.

5. Expand the range of tools borrowings, for example, establish the possibility of issuing inflation-linked bonds, provide opportunities for access by individuals to government bonds etc.

6. Clarify approaches to formation of quasi-fiscal operations\(^{41}\), implement method of assessing the impact of contingent liabilities in public debt.

The allocation of budget capital expenditure in a separate development budget, the execution of which is delegated to the Bank of Reconstruction and Development, which is authorized to carry respective share of borrowing seems to be the optimal. In that case, we can talk about the landmark of the remaining budget (current budget expenditures) with a zero deficit. According to experts, the selection of individual development budget would facilitate attracting loan


\(^{41}\) In 2016, the Ministry of Finance created a separate unit that would practically assess fiscal risks of the public sector, which is consistent with the streamlining of the implementation of quasi-fiscal operations.
resources for public investment, especially — in infrastructure projects to link debt with future cash flow and return on investment⁴².

Control over the use of loan funds coming from institutional donors also requires improvement. Performance of the conditions of the target use of such funds is crucial not only to continue lending programs, but also to reproduce opportunities for a repayment of borrowed funds in the future. Optimization of the use of funds from the institutional lenders will be facilitated by:

• integration of lending programs with strategic donor sectoral programs and regional development, implemented in Ukraine, based on achieving synergies in this international assistance, public and private investment;

• development of a viable mechanism of interaction between the central executive authorities, the legislature and local administrations and local authorities in the stages of approval and implementation of projects funded by international organizations;

• creation of specialized coordination body under the Cabinet of Ministers of Ukraine on cooperation with international financial institutions — the Agency for Use of Foreign Assistance whose tasks should include interagency coordination of the implementation of donor programs;

• improved staffing of the management structures engaged in development and support of the projects by providing the relevant state order for training of specialists, including — studies abroad, necessary training and internships;

• formation of automated information processing systems and provision of data on the course of the preparation and implementation of projects and providing technical support to entities which carry out routine maintenance of the projects.

2.6. Rationalization of interbudget relations and expansion of the financial base of local budgets

The effective spending of budget resources for local development goals and needs shall be primarily ensured through convergence of spending units and consumer of the expenditure effect. Therefore, decentralization of governance and empowerment of local governments must be organically combined with further financial decentralization.

The expansion of local self-government financial autonomy does not mean withdrawal of the State from supporting the communities in need. Pragmatic nature of interbudget relations provides a common responsibility of local authorities and the state for the development of territories, which is aimed at strengthening the capacity of these territories areas to ensure livelihood of communities.

Financial resources should be transferred organizationally to capable communities (their associations) in an amount which corresponds to the new powers of such communities. To achieve this, it is necessary:

• gradually move from the norm «state security» to the norm of «social security». That is the basis for calculating the financial needs of the communities should be the principle of universal provision of administrative and social services of appropriate standard. This will allow a new approach to financial equalization procedures, including the possibility of horizontal (between the budgets of other levels) interbudget leveling;

• finally resolve the issue of delegated state powers at the community level. The community should take the amount of authority that it is able to realize in terms of availability of organizational, personnel and financial resources;

• guarantee financing delegated state powers at the expense of funds allocated from the State Budget of Ukraine to reach the direct correspondence to local issues of funding — the amount of own revenues, remaining expenditure shall be funded by the fixed incomes of local budgets and interbudget transfers, as well as funds temporarily raised to the local budget;

• establish a direct relationship between the state budget and the budgets of the united communities as soon as possible which will require streamlining of organizational, informational, personnel and technical support for this process;

• organize the process of the regional development strategizing through appropriately authorized and approved strategies, with the provision of
funds of the State Regional Development Fund only for projects envisaged by such strategies.

Local governments must become an effective tool of economic policy oriented at stimulating role of the local economy. This will require:

• priority direction of local budget expenditures on strategic directions for community development, which in the long run will provide economic returns on public expenditures;

• overcoming fragmentation of expenditures, streamlining existing programs funded from local budgets, increased monitoring of funds use;

• promotion of investment in regions by using the instrument of state orders for the manufacture of a product;

• widespread use of performance-based budgeting and moving to medium-term planning of local budgets (in the first place — the development budgets), which will help fund large-scale local project, whose implementation period of exceeds one budget period.

The ultimate goal of fiscal decentralization should ensure the financial viability of communities, based on the direct dependence of local revenues from the level of economic activity locally. This will be the motivational component of decentralization and will interest the communities in the development of their own economy. This area includes:

• amendments to the Tax Code of Ukraine regarding the advertisement tax and market fees that have proven their importance as an important source of revenues of local budgets, as well as to the Budget Code of Ukraine concerning the right of local governments to impose a advertising tax and market fees and set their size limits;

• revision of rates of land tax and rent for land and establish their boundary parameters take into account when calculating land tax data of both money (normative) and economic and expert evaluation of land to reflect the real situation in the sphere of land relations;

• regulation on management of municipal property and common property of local communities: local authorities and local self-governments should not be rivals for the management of municipal facilities that will transform the latter into effective entities with appropriate budgetary return;

• introduction of mechanisms for planning the financial performance of municipal enterprises on the basis of commercial calculation, monitoring their financial plans and the possible transfer of municipal property, operation of which is not directly connected with the implementation of social tasks, to the commercial management of private sector entities based on the mechanisms of state-private partnership;

• distribution of various mechanisms of interaction between private companies and the executive authorities and local governments (including interregional level), based on the economic (resource support, sales market, public procurement) and image (implementation of social infrastructure, environmental protection projects, etc.) benefits of such interaction.

Transfer of control levers to the community level means increased activity of the local authorities to find alternative sources of local budget replenishment. This involves the
transformation of local borrowing into important and financially effective instrument for financing local development, in particular by:

- increasing interest of local councils and investors in the production and acquisition of municipal securities, increasing their liquidity, market reorientation to the increase in the long-term municipal bonds;

- diversification of uses of municipal securities to include additional areas: housing finance, building mini-thermal power plants, industrial waste management, upgrading of water supply, street lighting, roads, renewal of public passenger transportation;

- issue of certain types of municipal securities in predictably lucrative projects;

- income tax exemption for municipal bonds, which will reduce the rate of interest on such securities compared with bonds of corporations;

- channeling borrowed funds solely for investment purposes;

- contests held by the city councils in order to select the best projects/programs that would ensure high profitability of the project implementation;

- establishment of the services for managing municipal securities at the local council;

- promoting the development of infrastructure of municipal securities market to improve the quality of management bond market, facilitating the entry by local councils of the capital market and improving the efficiency of the use of funds from the sale of municipal bonds;

- institutional framework of joint investment institutions at the regional level, increasing the share of municipal bond loans in the assets of collective investment scheme;

- revitalization of the credit unions that would provide financial services, which could be the buyers of municipal securities and provide additional income to local governments.

Extension of the financial base of local budgets is inseparable from the overall development of the regional (local) economy through improving the investment climate and creating conditions for the inflow of investment resources, which is to become one of the leading budget policy benchmarks of the local governments. In particular, this concerns:

- organization of local regional development funds as SRDF units, authorized to finance medium-term programs and projects in the priority areas of local, regional or inter-regional importance;

- ensuring effective investor protection through appropriate organization of regional and local regulatory, supervisory bodies, services, administrative services, to prevent corruption and ensure transparency in these areas;

- support cooperation between enterprises in related industries within the region for joint investment attraction; joint ventures for the production of specialized products and processing of local raw materials, including involving local authorities in the implementation of projects. Local authorities should create preferential treatment for economic activity of private enterprises by providing access to credit at lower rates, preferential rates of local taxes and fees;
creating conditions for the development of industrial parks. The functions of local authorities in this direction may include initiation of creation, allocation of land and settlement of land acquisition issues for placement of infrastructure and production facilities of parks; connecting engineering networks; disseminating information about these parks to attract professionals to work in them; assisting the industrial park participants in search of sales market for products and contractors etc.;

promotion of investment infrastructure network development — advisory, intermediary organizations and agencies, regional development agencies, which will form an attractive image of the territories and provide potential investors with information on investment objects and investment proposals.
2.7. Improvement of budget law and reform of public finance management system

Implementation of identified benchmarks and systematic steps to restore the functions of the budget as a tool to finance the enforcement by the Government of the state development strategy and its component — economic strategy in the medium and long term, the return to fiscal policy and budget process (as its tool) their important primary mission of GDP redistribution to ensure the performance of public functions, stimulate economic growth and maintain social stability, will require appropriate changes in legislation and the reform of management practices in the areas of budget preparation, execution, monitoring and evaluating the effectiveness of budget funds. This will involve achieving the following goals.

1. Adoption of the Law of Ukraine on strategic planning, which must renew system of strategic documents of the state development, regulate the main issues of strategic policy documents development and adoption, define the relationship between forecast and program economic and social development documents, including mid-term budget as a means of implementation of the reform strategy and achieving economic and social objectives. Without medium-term economic program, it is impossible to make mid-term budget of the country, which means the use of program-based budgeting in full. In particular, PPB goals in the budget process should be defined in the program of the government activities, correspond to the economic strategy, which must be approved at the political level and reflect public priorities.

2. Change in the procedure for adoption of the state budget, which provides for its division into two stages, each of which ends with adoption of appropriate laws of Ukraine. The first stage — determining budget macroparameters for the planned period and for the next two years; the second — approval of budget allocations by the main spending unit for the planned year and the next two years. In the first stage, which runs from May to July, the government will provide the Parliament with the mid-term forecast of the economy (macroindicators), and based on it calculation of income by basic items of expenditure for the basic functions, amount of public debt, amount of capital investment and as well as budget policy areas for the planned and the next two years. These indicators are fixed by the Law and cannot be changed by the Government before submitting the draft budget to the Parliament. In the second stage (September to November), the government will present the budget with the detailed breakdown by the key spending units, budget programs, items, investment projects and it will be considered with the discussion of not macroeconomic indicators or changes to legislation and the impact of fiscal policy on the development of specific business sectors and social sector and reasonableness of calculations. The powers of the Parliament in this stage should be limited to redistribution of expenditure between spending units and items within the general indicators adopted at the first stage.
3. Legislative completion of the definition and delimitation of powers and responsibilities between the Ministry of Finance, functional and sectoral ministries. Under the circumstances prevailing in Ukraine, it is expedient to form the decentralized budgeting system.

First of all, it is useful to delimitate the strategic planning functions and budget performance function. To this end, the administrative reform process on the basis of the Ministry of Economic Development and departments of the Ministry Finance responsible for budgeting, it is necessary to create a ministry with a conditional name: Ministry of Economic Development and Budget Strategy. This ministry should focus on macroeconomic forecasting, strategic development planning and budget planning (budgeting). Combining these functions in one ministry will eliminate the contradictions that now exist between fiscal objectives and goals of economic development. It should be headed by the First Vice Prime Minister. As part of this ministry, there should be separate departments with administrative autonomy rights (and, perhaps, have the posts of ministers in the Ministry):

- Economics and Forecasting;
- Budgeting;
- Collection of Taxes and Fees;
- Cash Budget Execution and Interaction with Financial Markets;
- Financial Control;
- State Property Management.

Thus, the new ministry should focus on the capitalization of the country and increase its competitiveness, using financial instruments and incentives. To this end, it is necessary to implement budget preparation and execution reports on an accrual basis, as well as to work on the books to reflect the assets and liabilities of the country and the dynamics of their change. This will enable to make their own economically informed decisions on the development models and strategies. In addition, this ministry is to create a single information system of the government, members of which should be all executive agencies involved in strategic planning and budgeting.

Sectoral ministries also have to assume all responsibility for the formation and execution of the budgets of relevant sectoral programs and carry out the reforms in accordance with the state development strategy and programs of the Government. Ministers also have to report to the Parliament on the objectives stipulated in their budget programs. But for that purpose the Treasury must ensure the full financing of the approved budget programs, even at the cost of deficit growth.

It is also necessary to change the rules of the Government to ensure transparency in the discussion and formation of budget indicators not behind the scenes, but with the participation of all ministers. Functional and sectoral ministers should feel themselves budgeting participants, not opponents to the Ministry of Finance. For this purpose, it is advisable to create a Council for Budget Planning at the Prime Minister of Ukraine to include vice prime ministers and chief functional ministers. The purpose of its activities should be discussion and coordination of fiscal policy and budget and macroeconomic indicators at all stages of the budget process prior to their submission to the Cabinet of Ministers.

After approval of the draft budget and its submission to the Verkhovna Rada, the ministers are to participate in the relevant parliamentary committees, but may not submit proposals for amendments in budget parameters.

1. Enshrining in the legislation of the creation of clear mechanisms and period for the budget process. This includes full implementation of PPB in full, medium-term planning and forecasting systems, forming plans of key spending units. In particular:
• compliance with the terms of the preparation and adoption of key documents in the budget process — forecast of the State Budget of Ukraine for two budget periods following the planned period and budget policy guidelines, ensuring full use of medium-term budget forecasting shall become the basis for the transition to the medium-term budget planning;

• orientation of revenues and expenditures forecasting system on realistic indicators of economic and social development; full implementation of the approach «forecast-budget» and not «budge- forecast» used today;

• ensuring full accountability of key spending units and spending units of lower level for the quality of the submitted budget requests and implementation of budget programs. The first steps in this area have been implemented with the adoption of the new wording of the Budget Code of Ukraine (Article 22). It is essential to the form the legal framework for the compilation of key spending units to plan their activities for the planned period and two budget periods following the planned one. Key spending units shall draw up plans for their activities, clearly defining the expected results of activities;

• revision of the legal framework to identify qualitative and quantitative performance indicators for budget programs, identify their maximum relationship with activities of the use of public funds set out in budget requests and budget program passports, according to the priorities of state policy.

2. Formation of an effective system of internal and external control. For this purpose it is necessary to reform of the State Audit Office and the Accounting Chamber of Ukraine, a clear separation of powers, the implementation in their activities the standards of the International Organization of Supreme Audit Institutions (INTOSAI) and other international practices and techniques, improving controls and personnel selection, separation of internal and external control and improved efficiency of internal financial controls in budget institutions. It is reasonable to implement risk-based approach in the course of audits.

3. Development of the system of treasury servicing of the budget funds. The prevailing situation with timely financing of budget expenditures raises significant complaints about the activities of the Treasury, particularly in terms of the realization of functions of operational management of the state budget revenues and expenditures and access to funds by the spending units. It is necessary to focus on implementing automation of audits by the Treasury compliance with the budget legislation of payments documents submitted by spending units, ensuring staffing, exchange of information between the Treasury and other financial control bodies, openness of data on expenditures of budget-funded institutions etc.

4. It is necessary to amend the regulations that would ensure automatic payments by the Treasury in case of claims to be paid, established in accordance with the law. Failure to execute the budget in terms of revenues cannot be grounds for refusal to pay bills. such reason can only be the change budget allocations due to amendments to the law on the state budget or the relevant decision of the local council.

5. Transition to reporting on the budget execution based on accrual method rather than cash method, as it is today. This would make it possible not only to see cash flow statement in the Government accounts, but also liabilities in the form of accounts receivable and payable, financial and investment commitments of the state, their impact on the current situation and the problems that will arise in the future. This would make us rethink the budget process from short-term cash distribution to long-term valuation of the state as investment object. That is this would encourage to turn from the goals of
«filling the treasury» to the goals of «capitalization» of the country, increased value of its assets, which are now artificially devalued and sold. Accordingly, it would have a positive impact on the situation and business in Ukraine and its capitalization.

6. Further reform of fiscal service, increased responsibility of the employees and reducing corruption. The above reform should be carried out as part of tax reform. The criterion of the tax service operation should be not performance of proceeds targets, but identification of revenue base and maximum tax payment within this base.
2.8. Strengthening confidence in the state and willingness to pay taxes

One of the most important missions of fiscal policy restructuring based on economic pragmatism — restoration of mutual trust between the state and society, confidence of the community in the ongoing state policy, and not only in the fiscal area. Such confidence will also have clear economic dimension, create positive expectations, consumer confidence, business and investment climate. This gives reason to expect a consolidation of community around the problems of getting comprehensive real independence as a prerequisite for economic prosperity, free and successful future of Ukraine and the Ukrainian people.

The confidence will result from the synergy of systemic changes that will take place during the implementation of new fiscal policy principles, namely:

- openness of information about the revenue and expenditure, their implementation period, timing and expenditures by the spending units, frank discussion of issues of sufficient revenue sources, feasibility of expenditure, need to balance the desired and possible — this should prevent shadowing and direct embezzlement of budget funds, promote understanding the complexity of the tasks of balancing public finances, show specific areas and actions to which taxpayers’ money is spent;

- simplification of tax administration, equalization of access to tax incentives, clear social function of taxation — will enable to feel responsible for filling the budget, to overcome mistrust between business entities and negative attitude to businesses from certain segments of the population currently generated by uneven tax burden and tax evasion — and end — will promote tax culture and strengthen fiscal discipline;

- distribution of the partnership mechanisms in the implementation of current and strategic functions of the state — increases the stimulatory effect of public spending for the economy, expands opportunities for public control over the efficiency of expenditures and display of civic initiatives in this field, streamlines budget spending;

- strengthening the efficiency and providing target spending of budget funds on principles of budget process components reform — proves real interest in the rational use of funds collected in the community, increases willingness to pay taxes, directly connects reform to the quality of social, administrative or other state services, thus — generally increases the confidence of the community in the reform policy.

The synergistic effect of this will be facilitated by special measures in the area of information and communication policies that will intensify community participation in the budget process:

- ensuring the widest possible public access to information related to state and local budgets, establishing appropriate information infrastructure (Internet websites), preparation and publication of operational analytics, infographics, etc;
• ensuring transparency and prompt updating of statistical information related to the state of implementation of state and local budgets, and — not only from the Treasury, but spending units;

• purposeful work of the authorities at all levels with the media to publicize the available data on the situation in the public sector, existing and potential problems, plans of the authorities, and — practical activity of execution by the state and local governments of their functions and their results obtained;

• ensuring transparency in the use of budget funds, which includes the implementation of the Law of Ukraine «On Openness of Public Data», access to relevant information on the results of monitoring, creation, distribution and use of public funds by the spending units and recipients of the funds of the state and local budgets and the bodies of the Pension Fund and compulsory state social insurance funds, etc. (for this purpose portal eData is already running in test mode);

• public actions to reduce corruption in the public sector, which includes the activities of specialized bodies to combat corruption — National Anti-Corruption Bureau, the National Agency for Preventing and Combating Corruption, open implementation of the Anti-Corruption Strategy measures, effective application of the verification of declarations of public officials on property, income, expenses and financial obligations, strict application of transparent competition procedures for the civil service posts, as well as posts of the heads of public sector economic entities, etc;

• achieving transparency in public procurement, in particular, ensure transparency of information on public procurement carried out by both public bodies and entities in the public sector, preventing the occurrence of fraud, etc;

• public debates at national and local levels (including discussion of regional issues nationwide level) in the process of next year’s budget drafting, development, and implementation of reforms of the public sector components, tax reform, issues that require local funding etc. extremely important is establishing the feedback on the practical consideration of the results of such hearings;

• establishing a network of efficient public control in the public sector by ensuring the full functioning of public councils of the fiscal authorities, creation at the community initiative of the supervisory boards at the public sector, information and organizational assistance to independent institutions that publish and carry out control and analytical work in the public sector;

• dissemination of economic knowledge, including — specific issues of the public sector, by organizing relevant educational events, programs and publications in the media, the Internet, economic education in schools, vocational schools and universities of non-economic profiles, «Universities of the Third Age» etc. — to improve the qualifications of attitudes and expectations of ordinary citizens, productivity of their participation in the budget process.
SUMMARY

IN THE DEVELOPMENT PROCESS, INITIALLY STRONG SYSTEM OF PUBLIC FINANCE OF UKRAINE CREATED FOR REFORM AND ECONOMIC GROWTH HAS GRADUALLY TURNED INTO PASSIVE ADDITION TO POLITICALLY UNSETTLED AND ECONOMICALLY WEAK PUBLIC ADMINISTRATION SYSTEM.

Fiscal policy is developing under pressure of need to meet the interests of various groups of political and economic impact, tasks of operational balancing of macroeconomic situation, requirements of international financial organizations. Fiscal policy has not become in Ukraine a mechanism for implementation of the state strategy in the area of structural reforms, a lot of decisions are not subject to strategic economic considerations, but is subject to external and internal political «bargaining».

Attempts to introduce Performance-based Budgeting and medium-term budget planning and forecasting proved too dependent on political and economic conditions and mainly were not really implemented in practical activity of the fiscal government and concentration on identified development objectives and priorities was gradually superseded by «manual control» of the budgetary expenditure.

STRUCTURAL FEATURES OF THE BUDGET REVENUES REINFORCE THE NEGATIVE EFFECT OF THE FISCAL BURDEN ON ECONOMIC DEVELOPMENT.

Despite a long period of reforming, the tax system Ukraine retains significant drawbacks associated with both imperfect and excessive administrative burden, and with the continuation of the practice of selective application or violation of the law by the fiscal authorities. Tax policy does not work as a leverage to stimulate economic growth and positive structural changes. Share of indirect taxes increases among tax revenues, which are convenient for collecting, but especially onerous for complex productions, as well as not related to the taxpayer’s performance.

A share of in the budget revenue of the National Bank profits increases, which is in fact a direct monetary financing of the budget.

Excessive withdrawal to the state budget of a part of profit of the state and public utility companies contradicts the objective of investment-oriented development, leading to loss of competitiveness or a reduction in service quality.

HIGH SHARE OF SOCIAL SPENDING DOES NOT SOLVE SOCIAL PROBLEMS, SCARCE CAPITAL SPENDING DOES NOT ENSURE ECONOMIC DEVELOPMENT.

The structure of expenditure indicates the focus mainly in meeting the urgent needs of social and economic development as opposed to strategic goals and
tasks of economic restructuring. Consistently high share of social spending does not ensure proper quality of life and the development of human capital due to unreformed social components. The deterioration of human capital and scientific and educational potential quality reduces the national economy competitiveness. The residual financing of capital expenditures in the public sector leads to loss of financial and human resources and prevents their reformation.

The problem of the inefficient management of public investment process is evident. Investment policy in Ukraine is characterized by the lack of certainty in investment priorities, inability to effectively prepare and administer investment projects, permanent underfunding of the latter.

**FISCAL POLICY DOES NOT ENSURE REAL DECENTRALIZATION.**

Reduction in the «contribution» of local budgets to the consolidated budget over the past two years reflects the strengthening of fiscal redistribution through the state budget. This limits the autonomy of local councils in addressing the socio-economic development of territories, destroys incentives to expand revenues of their budgets, and reinforces paternalistic reliance on obtaining subsidies from the Centre.

**DIRECT CONSEQUENCE OF IMBALANCES OF FISCAL OBLIGATIONS AND THEIR FUNDING OPPORTUNITIES IS A CHRONIC DEFICIT OF THE STATE BUDGET.**

There is a permanent need for government borrowing, increasing share of which is spent to repay previously received loans. The scale of government borrowing makes them tangible factor influencing the financial situation in the country, creating the risk of the classic «crowding out effect» and spending the funds raised mainly on consumption and debt repayment instead reproduces chronic dependence on external financing. Burden of external debt is growing rapidly due to currency devaluation.

**THERE IS A DEFORMED MODEL OF FISCALIZED CHRONICALLY DEFICIT ECONOMY, FOCUSED ON «EATING AWAY» THE DEVELOPMENT RESOURCE.**

In choosing a fiscal policy model the state, on the one hand, is limited to conducting liberalization budget strategy due to inability to reduce vast majority of expenditures for social or political reasons. On the other hand, it also cannot continue to pursue a paternalistic policy because the economy overloaded with the fiscal pressure is not creating adequate budgetary resources.

**BUDGET REFORM SHOULD BE SEEN AS PART OF BUILDING OF THE ECONOMIC MODEL ALTERNATIVE TO THE EXISTING ONE BASED ON PRINCIPLES OF ECONOMIC PRAGMATISM.**

Systematic reform of the budget system is required, in which easing of the fiscal burden will be synchronous with improving expenditure policy and adequate funding will be secured by the extension of the tax base as a result of economic growth. Therefore, the state budget should be seen primarily as a means of ensuring macroeconomic balance and economic growth.

The new fiscal policy should strengthen the instrumental nature budgetary strategy as one of the most powerful tools of reform strategy implementation in Ukraine, spreading the effects of fiscal policy beyond its own budget system and creating a favorable fiscal space for accelerated transition from recession to sustainable economic recovery.
FINANCIAL SUPPORT TO REFORMS REQUIRES STRENGTHENING OF SOCIAL AND STIMULATING FUNCTIONS OF THE TAX SYSTEM.

The essence of the tax reform should be a moderate attitude towards lowering taxes, implementing effective taxation mechanisms under which taxes, serving as a source of fiscal resource, properly perform socio-leveling and regulatory and catalytic functions. So that reduction in the tax burden was not accompanied by a reduction in revenues, tax reform should contain stimulating ingredients that have contributed directly to revitalized economic growth and compensation for the loss of tax revenues due to growth in the tax base. Therefore, the first step should be to focus on components that reduce business transaction costs for taxes, including — through active computerization of the tax field. Radical improvement of tax control forms the basis for the next lowering of the tax rates and the effective use of tax incentives.

Provisions of the tax system agreed and adopted under the broad social and economic dialogue should be fixed by the moratorium on changes for a certain period (minimum 3 years) with the regulatory defined responsibility of the state for any damage caused to the entities in case of violation.

CURRENT SAVINGS OF EXPENDITURE SHALL BE REPLACED BY OVERCOMING THE STRUCTURAL IMPERFECTIONS ON THE PRINCIPLES OF ECONOMIC PRAGMATISM.

The reform in terms of expenditure will include optimization of state and local governments as part of administrative reform; optimizing the social obligations of the state and the transition from paternalism in the social sphere to partnership between the state, business and citizens in all aspects of social assistance; organizational restructuring of the processes that are subject to state funding (provision of services in education, health care, culture, administrative services, performance of basic government functions: management, security and defense, etc.).

With existing hard budget constraints, primary management rationalization of the social sphere is required, focused on maximization the effectiveness of budget appropriations and the diversification of its funding when implementing scientifically justified national standards for all types of social services.

Since maintaining of a significant level of defense spending is a forced need for Ukraine, at least in the medium term, it is important to ensure the greatest possible role of defense spending as a component of domestic demand to avoid the depressive effect of this unproductive budget expenditure item.

Funds released as a result of rationalization of current expenditures enable to focus on implementing budgetary development mechanisms.

There should be the development of a new document at the state level — budgetary development strategy in the medium term, appendices to which are Public Capital Investment Plan and Regional Capital Investment Plan for the planned period and two budget periods following the planned period.

Ensuring maximum efficiency of public spending and creating conditions for a diversified partnership funding of the socially important investment projects requires a specialized practice of delegating to financial institutions the tasks of direct accumulation of financial resources and their subsequent
distribution. The Economic Pragmatism Program provides for creating a network of institutions, united by the Ukrainian Development Corporation. State Bank of Reconstruction and Development and the State Fund for Regional Development play the key role in this network for the distribution of expenditure as separate specialized financial institutions.

The full use of the whole spectrum of public expenditure settlement also requires the state assistance system in Ukraine, for which purpose it is necessary to develop and approve the method of evaluating the acceptability of state assistance to business entities for competition, sets medium- and long-term goals to achieve which such assistance is involved, and works out new tools of assistance that meet the requirements introduced.

**IT IS NECESSARY TO TRANSFORM THE DEBT POLICY INTO THE IMPLEMENTATION TOOL OF STRATEGIC DEVELOPMENT GOALS AND STRUCTURAL MODERNIZATION OF NATIONAL ECONOMY.**

A significant amount of public debt accumulated by Ukraine determines the need for strict binding of new borrowing to cover budget deficits prior to creating economic resource for their repayment, which should be achieved by introducing a «golden rule», which links the central government budget deficit to the volume of capital expenditures, and the allocation of budget capital expenditure budget in a separate development budget, the implementation of which is delegated to the State Bank of Reconstruction and Development. Control over the use of loan funds coming from institutional donors also requires improvement.

The budget and the real economy are not competitors for loans. Government borrowings in the domestic market accumulate surplus funds that ceteris paribus would not be spent on the investment needs. Thus, in Ukraine there are conditions, under which attraction of domestic loan resources to finance this deficit seems more productive than using external sources.

**PUBLIC ADMINISTRATION DECENTRALIZATION AND EMPOWERMENT OF THE LOCAL GOVERNMENTS MUST BE ORGANICALLY COMBINED WITH FINANCIAL DECENTRALIZATION.**

The ultimate goal of fiscal decentralization should ensure the financial viability of communities, based on the direct dependence of local revenues from the level of economic activity locally. This includes streamlining of municipal property management on the basis of commercial calculation and dissemination of interaction between local governments and private enterprises. Improved local borrowing instruments play an important role in the financial decentralization.

**RECOVERY OF THE BUDGET FUNCTIONS AS A STRATEGIC GOVERNMENT TOOL IS ENSURED BY EFFICIENCY OF FISCAL POLICY REGULATIONS AND PROCEDURES.**

To recover effective budget process throughout its length it is necessary to change the procedure for adoption of the state budget, which provides its division into two stages, each of which ends with adoption of appropriate laws of Ukraine: definition of the budget macroparameters — and approval of budget allocations by the key spending units for the planned year and the next two years. It is also necessary to regulate relationship between forecast and program economic and social development documents, including mid-term budget strategy as a means of implementing reforms and achieving
economic and social objectives, the law stipulates the establishment of clear mechanisms and period for the budget process, defines and delimitates powers and responsibility between the Ministry of Finance and the sectoral ministries, regulates automatic payments by the State Treasury.

**POSITIVE EXPECTATIONS AND CONSUMER SENTIMENT, BUSINESS AND INVESTMENT CLIMATE, STRENGTHENED WILLINGNESS TO PAY TAXES IS FORMED BY THE CONFIDENCE IN THE STATE FISCAL POLICY.**

Restoration of mutual trust between the state and society, confidence of the community in the ongoing state policy in the fiscal area on the basis of information transparency, simplification of tax administration, distribution of partnerships, strengthened efficiency of budget spending, special information and communication policy.
BUDGET POLICY: PRAGMATIC APPROACHES TO STRATEGIC DECISIONS

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