Report No. 114826-UA

UKRAINE

SYSTEMATIC COUNTRY DIAGNOSTIC

TOWARD SUSTAINABLE RECOVERY AND SHARED PROSPERITY

April 28, 2017

WORLD BANK GROUP

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Executive Summary

1. **Ukraine has experienced acute political, security, and economic challenges during the last three years.** Following the "Maidan" uprising that led to the ousting of the previous President in November 2013, the last three years have witnessed several momentous events: developments in Crimea and Sevastopol in March 2014 which led to the UN General Assembly resolution 68/262 affirming the territorial integrity of Ukraine; the outbreak of conflict in the Donetsk and Luhansk regions in eastern Ukraine; and Presidential, Parliamentary and local elections in 2014-2015. The Government that took office in December 2014 had a mandate for reforms in the face of formidable challenges, including: containing conflict and restoring peace; ensuring macroeconomic stability; tackling a major banking crisis; reducing the fiscal deficit in the midst of a recession without triggering social unrest or backlash against reforms; and reducing deep-seated corruption while contending with powerful vested interests that continue to oppose reforms. After September 2015, the pace of reform moderated due to increasing political uncertainty and the influence of vested interests. In April 2016, a new government took office and issued a program and action plan covering a wide ranging reform agenda in May 2016. An updated medium term action plan for 2017-2020 was adopted in April 2017.

Figure 1

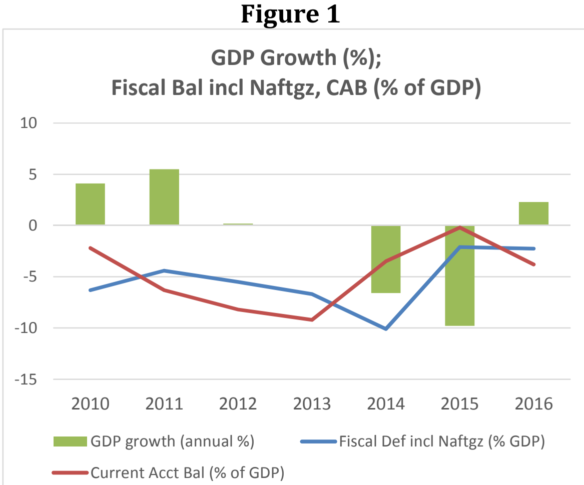
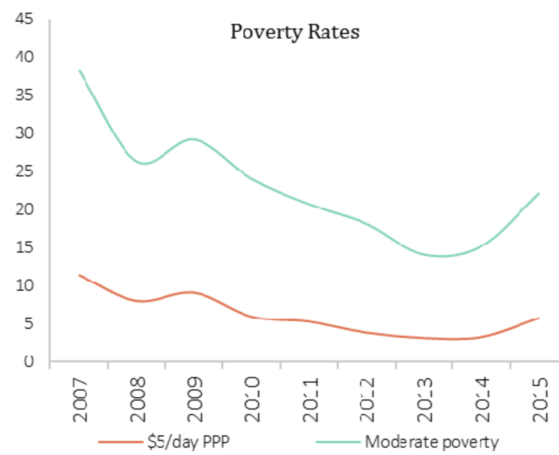


Figure 2



2. **Severe shocks combined with a history of slow progress on structural reforms to result in a serious economic crisis in Ukraine in 2014-2015.** The economy was hit by unprecedented double shocks from the conflict in eastern Ukraine and a considerably weaker external environment, including lower global commodity prices. The conflict caused significant contraction of industrial production and revenues in the Donetsk and Luhansk regions, led to widespread disruption in supply and distribution chains, and undermined confidence in the overall economy. In addition, the drop in global commodity prices resulted in a serious deterioration of Ukraine's terms of trade and recession among its trading partners. As a result of these factors, real GDP contracted sharply by 6.6 percent in 2014 and by a further 9.8 percent in 2015. Furthermore, structural bottlenecks and accumulating imbalances preceding the crisis necessitated a considerable fiscal and external adjustment in response to the shocks, which further compressed domestic demand. The currency depreciated by

47 percent in 2014 and a further 33 percent in 2015, while the consolidated fiscal deficit, including Naftogaz, reached 10.1 percent of GDP in 2014 and public and guaranteed debt spiked to 79 percent of GDP in 2015. The deep recession and depreciation caused deposit outflows, rising levels of nonperforming loans, and large numbers of bank failures, further reducing confidence in the economy.

3. **Poverty increased significantly since 2015, with access to services and livelihoods particularly impacted in conflict affected areas.** The deep recession, depreciation, and compression of public current expenditures contributed to significant contraction of disposable incomes in Ukraine, with both labor and non-labor incomes contracting in 2015 in real terms. As a result, the estimated poverty rate (under $5/day in 2005 PPP) increased from 3.3 percent in 2014 to 5.8 percent in 2015, while estimated moderate poverty (Bank's national methodology for Ukraine) increased from 15.2 percent in 2014 to 22.2 percent in 2015. Poor households, which spend a significant share of their budget on heating and utilities, were also affected by the dramatic increase in energy prices in 2015. The rapid expansion of the new means-tested housing utility subsidy program (with up to 5 million households covered at end-2015) helped to mitigate the impact on poverty. Labor market conditions deteriorated, with nominal wage growth lagging inflation, and real wages down on average by 20 percent in 2015. Unemployment increased from 7.8 percent in 2013 to 9.5 percent in 2015. Joblessness, access to services, social tensions, and livelihoods more broadly were particularly impacted in conflict affected areas. Furthermore, with about 1.7 million people estimated to have been internally displaced, these social and humanitarian impacts are felt by both displaced and host communities.

4. **The "Maidan" uprising of 2013-14 generated demand for change in Ukraine, and the authorities undertook decisive reforms in 2014-2015 to stabilize and reform the economy.** Key reforms implemented included: (i) moving to a flexible exchange rate to stabilize external imbalances; (ii) undertaking considerable fiscal consolidation by compressing expenditures, averting contingent liabilities from the financial sector, and reforming energy tariffs to reduce a key quasi-fiscal deficit, while strengthening social assistance to cushion the impact on the poor; (iii) stabilizing the banking sector by putting in place a framework to resolve and recapitalize banks and strengthen supervision; (iv) streamlining the business environment; and (v) taking initial steps to enhance accountability in the public sector by establishing anti-corruption agencies.

5. **Ukraine today is at a crossroads: the economy has stabilized but economic prospects remain weak, and addressing longstanding structural bottlenecks on multiple fronts will be critical to advance development prospects and deliver tangible benefits for the population.** As a result of the reforms since 2014, the economy has stabilized and large imbalances have been reduced at least for the short term. Real GDP grew by 2.3 percent in 2016, while the general government deficit, including Naftogaz, was down to 2.1 percent of GDP in 2015 and 2.3 percent in 2016. However, poverty is up significantly and livelihoods have been disrupted from the serious shocks to the economy and the resulting economic crisis. Furthermore, prospects for economic recovery remain weak in light of the weak global economic environment, continuing conflict in eastern Ukraine, and the deep structural bottlenecks and governance challenges that have

constrained sustainable growth and shared prosperity for the last decade and half. Addressing many of those longstanding structural bottlenecks and governance challenges will be central to supporting sustained economic recovery and shared prosperity going forward.

6. **Even prior to the current crisis, macroeconomic imbalances and weak productivity growth deriving from deep structural bottlenecks and governance challenges led to more than a decade of unsustainable growth enabled by favorable external conditions.** Growth averaged 7 percent annually during 2000-2007, driven mostly by favorable external conditions and rebound from the sharp post-transition contraction. Ukraine's terms of trade (TOT) improved by 50 percent between 2001 and 2008, including higher steel prices on the export side and beneficial pricing of natural gas on the import side. Capital inflows surged after 2005 while credit growth boomed, fueled by external borrowing of commercial banks. These favorable external conditions enabled an expansionary fiscal policy with accumulating structural deficits including rising pension spending, Naftogaz and other subsidies, and a growing public wage bill. Public capital expenditures were squeezed, while limited structural reforms were undertaken, with the result that productivity growth slowed and the sophistication of Ukraine's export basket experienced limited improvement. The economy stagnated during 2008-2013, with growth averaging -0.7 percent annually during this period. Furthermore, imbalances accumulated from 2005, with the current account shifting into deficit from 2006 and averaging -5.7 percent of GDP during 2008-2013 compared to a +3.7 percent during 2000-2007. The fiscal deficit including Naftogaz averaged 5.5 percent of GDP during 2011-2013.

7. **Poverty declined between 2000 and 2013, but less so since 2008, while household incomes have relied heavily on pensions and social transfers, raising concerns about the sustainability of poverty gains.** The share of the population under the moderate poverty line declined from 79 percent in 2002 to 15 percent in 2014, while the share of the population under $5 PPP declined from 46 percent in 2002 to 3.3 percent in 2014. While the overall pace of poverty reduction since 2002 was strong, it slowed since 2008 due to the overall stagnation in the economy. Furthermore, household incomes have relied heavily on pensions and social transfers. Out of income growth of 4.5 percent per year during 2009-2014 for the bottom 40 percent of the population, pensions and social assistance accounted for a large portion (2 percent per year), while labor income accounted for 2 percent per year. This raises concerns about sustainability of the gains in reducing poverty, particularly because of the large cost of pensions (11 percent of GDP in 2016). Furthermore, the bottom 40 percent have lower labor market outcomes and levels of educational attainment and access to utilities, which have an impact on their quality of life and ability to generate incomes.

8. **Ineffective services and weakly targeted assistance have contributed to inadequate employment outcomes, the reliance on transfers, and the unsustainable pattern of poverty reduction.** Ukraine spends a large share of GDP on social services and assistance, although this does not translate into high quality service delivery. Access to services has improved over time in a number of areas, although outcomes, delivery mechanisms, and targeting remain ineffective. Infant mortality has decreased from 17 per thousand live births in 1990 to 8 in 2014, while under-5 mortality and maternal mortality have also improved over the same period. However, life expectancy

has not changed much over the last 20 years and the hospital sector remains oversized and inefficient. With 70 percent of spending on education, health, and social services passing through subnational governments, improving delivery mechanisms at the subnational level can help enhance the effectiveness of services. Finally, in light of the impact of the conflict, providing targeted social assistance and services to conflict affected populations can help mitigate the impact.

9. **Corruption and state capture have been entrenched in Ukraine and are a dominant impediment on the path to sustained recovery and shared prosperity.** Corruption permeates all walks of public life in Ukraine. On many aggregate measures of corruption, Ukraine scores closer to the poorest economies than to the EU which it aspires to join. Ukraine was in the 15th percentile worldwide in the WGI (World Governance Indicators) Control of Corruption indicator in 2014, well below Poland and Romania (71st and 53rd percentile, respectively), as well as averages for low middle income countries (37th percentile), the ECA region (64rd percentile), and sub-Saharan Africa (30th percentile). With such extraordinary levels of corruption and state capture, powerful vested interests across a wide range of sectors seriously impede Ukraine's path toward sustained recovery and shared prosperity. For example, widespread tax evasion and related party lending undermine macroeconomic stability, a highly concentrated and anticompetitive production structure inhibits productivity and job creation, and weaknesses in the management of public resources impedes delivery of effective services and targeted assistance to the population.

10. **Ukraine has struggled with corruption and state capture since its independence and the vested interests have established deep roots.** Privatized state assets were concentrated in a few hands in the early transition years. State-regulated commodity prices, underpriced leases of large tracts of agricultural land, and budget subsidies have also helped strengthen the hand of vested interests. As a result, a small number of oligarchs have dominated large sectors of the Ukrainian economy, extracting rents, and influencing public institutions, including through direct representation in political parties and the Parliament. The symbioses linking oligarchs with politicians and state officials stand in the way of reforms to level the playing field and eliminate rents. Vested interests have financed political parties and expensive election campaigns, while civil society has been too weak to counter such deep-seated influence, although some successes are emerging recently, for example, with NGO watchdogs advocating for an effective launch of the electronic asset declaration system.

11. **Conflict and shocks is another important constraint impeding Ukraine's path toward sustained recovery and shared prosperity.** As discussed, the conflict has had a widespread impact on economic activity and prospects in Ukraine. Disruptions in industry, transport, and small and medium enterprise activity led to widespread job losses and overall confidence in the economy was seriously undermined. The conflict also had a considerable human cost, with vulnerable groups in conflict areas, especially pensioners, women, children and people with disabilities most at risk, and large numbers of internally displaced persons (IDPs). Continuing insecurity means that Ukraine must go the extra step to bolster confidence in its economy. Managing the human cost of the conflict will also require providing targeted services and supporting employment generation among conflict affected populations and host communities. In addition to the conflict, Ukraine was hit by very large

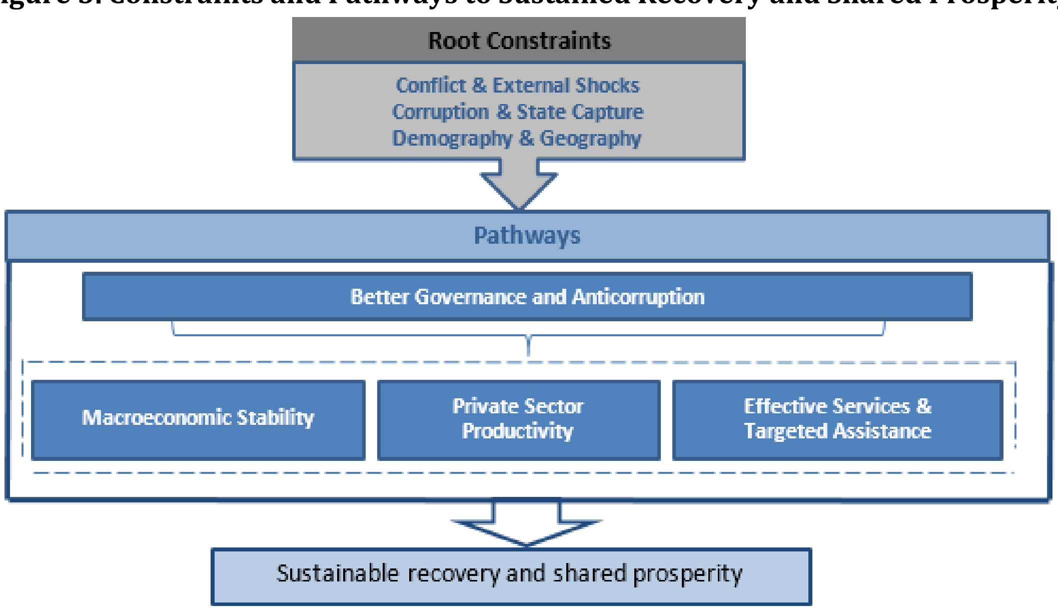
external shocks, including the sharp fall in global commodity prices and recession and depreciation in export markets. Given the weak external outlook, Ukraine will need to go the extra mile to manage macroeconomic imbalances and support confidence in its economy.

12. **Demography and geography are also at the root of Ukraine's development challenges.** Ukraine's working age population has been declining while the elderly population has been rising due to high mortality, low birth rates, and out-migration. The working age population has fallen from around 34 million in 2000 to 32 million in 2013 and is projected to keep on declining to reach 25 million by 2050, while the elderly population is projected to rise. These demographic factors have significant implications for Ukraine's development challenges, including a larger role for productivity and capital accumulation in driving growth, and initiating a nationwide dialogue on the social contract for sustainable old age pensions support. Ukraine also has a unique geography, with a rich endowment of agricultural and other natural resources, and adjacent to the EU to the west, Russia to the East, and the Black Sea to the south. The large adjacent markets can be tapped for developing a more diversified export base. On the other hand, the rich endowment of natural resources leads to significant challenges relating to corruption and rent seeking.

Pathways and Priority Interventions

13. **Based on the foregoing analysis of development challenges, this Systematic Country Diagnostic (SCD) identifies a set of pathways and priorities toward achieving sustainable recovery and shared prosperity in Ukraine.** *The challenges described above point toward four key pathways: safeguarding macroeconomic stability, boosting private sector productivity, and providing more effective services, while building institutions of better governance and anticorruption*. While the measures taken to date have been important in stabilizing the economy, the large backlog of reforms and structural bottlenecks, coupled with the weak economic outlook, considerable vulnerabilities,

Figure 3. Constraints and Pathways to Sustained Recovery and Shared Prosperity



and higher poverty mean that advancing further reforms on multiple fronts will be critical to put Ukraine on a path toward sustained recovery and shared prosperity. First, in light of the difficult external environment, persisting vulnerabilities, and history of large imbalances, ***safeguarding macroeconomic stability*** will be critical to move from stabilization to sustained recovery. This will require reforms to consolidate the structural fiscal deficit and strengthen the financial sector, while maintaining a flexible exchange rate. Second, in light of the history of weak productivity growth and labor market outcomes, Ukraine will need to ***improve private sector productivity***. This will require investing in infrastructure, creating a level playing field in the private sector, reforming land markets, and taking advantage of trade opportunities. Third, in order to reduce expenditure pressures, ensure that the benefits of recovery are broadly shared, and generate tangible improvements in the quality of life of the population, Ukraine will need to ***provide more effective services and targeted assistance to the population***. This will require reforming health care financing, optimizing the school network, enhancing skills of the workforce, and improving targeting of social assistance. Finally, in light of the high degree of corruption and state capture, ***building institutions of better governance and anticorruption*** will be critical to the success of reforms across the board.

14. **Progress toward the World Bank's twin goals in Ukraine going forward will depend critically on the pathways to sustained recovery and shared prosperity presented in this SCD.** One of the critical impediments to progress toward the twin goals going forward is that Ukraine has not yet established the environment for sustained economic growth. The history of volatile and unsustainable growth fueled by large macroeconomic imbalances, coupled with a pattern of weak productivity growth, has meant that progress toward the twin goals in the past has had to rely on increasingly unsustainable social protection. Going forward, in order to generate sustained progress toward the twin goals, a new model of poverty reduction and shared prosperity based on sustained economic recovery coupled with more effective services will be critical. Sustained economic recovery will require breaking the underlying drivers of large macroeconomic imbalances and weak productivity growth. Furthermore, more effective services will ensure that the poorer segments of the population can also benefit from labor market opportunities, while ensuring that the benefits of growth are broadly shared in a sustainable manner.

15. **The first pathway is safeguarding macroeconomic stability by addressing the largest sources of fiscal and financial sector vulnerability.** Ukraine has made important progress in 2014-16 in managing fiscal and financial sector imbalances in the face of unprecedented shocks. Going forward, the focus will need to be on the deeper structural roots of the vulnerabilities. Considerable fiscal adjustment has been implemented in 2014-16 through tight controls on nominal spending coupled with inflation, as well as energy tariff increases. Going forward, the largest medium term fiscal vulnerabilities come from a narrow tax base, weak tax administration, and an ineffective pension system. Reforming the tax system will require broadening the tax base by removing exemptions and loopholes, improving international taxation arrangements, and strengthening tax administration. The pension system in Ukraine not only represents a major fiscal vulnerability (expenditures of 11 percent of GDP in 2016), but also provides elderly benefits that are far too inadequate (the average old age pension is only about $2 a day). Reform options include restructuring the benefit package to strengthen sustainability, adequacy, and transparency, as well

as parametric measures to address categorical benefits, early retirement, and provide incentives to retire later. In the financial sector, deep-rooted related party lending and weaknesses in supervision have combined with the economic downturn to result in large numbers of bank closures and an increase in non-performing loans. Going forward, reforms will need to focus on continuing to implement the framework put in place to resolve and recapitalize banks and strengthen supervision, but also put in place measures to support a resumption of lending by strengthening corporate governance of state owned banks and facilitating work out of NPLs.

16. **The second pathway is boosting private sector productivity by strengthening infrastructure investment, creating a level playing field in the private sector, reforming land markets, and tapping trade opportunities.** Ukraine has made important progress in streamlining its business environment in recent years, with its Doing Business ranking improving from 140th in 2013 to 80th in 2017. However, deeper structural bottlenecks remain that have, for an extended period, undermined the emergence of a more productive private sector and a more sophisticated export structure. These bottlenecks include weak infrastructure, a highly concentrated and anticompetitive market structure, and weak land management. Addressing these bottlenecks is all the more important under the current environment in which the conflict and weak external conditions continue to undercut investor confidence. Improving infrastructure will require creating fiscal space for public investment and strengthening public investment management, while improving governance and transparency in the important energy and transport sectors. Creating a level playing field for the private sector will require further deregulation, more effective implementation of competition legislation, and improving corporate governance of ineffective state owned enterprises. Perhaps most critical for the private sector is to reform land markets. Weak land governance seriously undermines investment and productivity in the high-potential agriculture sector, as well as other sectors. Reforming land markets will require improving state land management through a new legal framework, while gradually opening sales for private agricultural land ensuring transparency and equal access.

17. **The third pathway is providing more effective services and targeted assistance by optimizing the financing and improving the quality of health and education, further improving targeting of social assistance, and providing effective support to conflict affected people.** Despite spending a large share of GDP on social services and assistance, the quality and effectiveness of health and education services is weak, while social assistance is weakly targeted. Providing more effective services and targeted assistance can, therefore, not only reduce expenditure pressures, but also help improve employment outcomes and result in tangible improvements in the quality of life for the population. The most important priorities are in the areas of health, social assistance, and targeted support to conflict affected people. In health, a key priority is to reform the health financing model from a focus on hospital care and input-based norms toward a payment system where money follows the patient. In social assistance, key priorities include improving the targeting of the housing and utilities subsidy (HUS) program which has provided temporary relief from energy tariff increases, but also continuing to move from categorical to targeted benefits for the overall social assistance package. In light of the continuing conflict and large numbers of IDPs, providing targeted support to conflict affected people is a high priority. This will require providing effective skills,

training, and enterprise support in affected areas and extending systematic assistance to vulnerable households.

18. **The fourth and cross-cutting pathway is building institutions of better governance and anticorruption.** These include institutions of public financial management (PFM), anticorruption, justice, public administration, and citizens' engagement. Strengthening PFM institutions would help improve efficiency, accountability, and transparency in the use of public resources, including for service delivery, public investment, and state-owned enterprises. This would help reduce fiscal risks and contribute to more effective infrastructure and service delivery. Building effective anticorruption and justice institutions would contribute to overall transparency, accountability and fairness in the interface between citizens, businesses, and the state, while providing the tools necessary to battle grand corruption, state capture, and the influence of vested interests in order to re-establish public trust in the public sector. Improving public administration by building a more professional and motivated civil service and more efficient institutions will help reduce incentives for corruption while improving delivery of public services. Finally, enhancing citizens' engagement efforts in advancing key structural reforms and monitoring the effectiveness of service delivery will be important in harnessing and channeling the energy and enthusiasm for change in Ukraine since the Maidan uprising.

19. **In fact, a two-pronged strategy is important in addressing Ukraine's governance and corruption challenges.** The first prong of the strategy involves building the institutions of better governance and anticorruption that would have a cross-cutting impact in supporting progress along the other pathways to sustained recovery and shared prosperity. The second prong of the strategy involves advancing reforms across the three other pathways of macroeconomic stability, private sector productivity, and service delivery to disempower vested interests. Reforms in tax administration and the financial sector can help not only contain macroeconomic imbalances, but also disempower powerful underlying vested interests by cutting tax evasion and reining in opportunities for related party lending. Similarly, streamlining business regulations, increasing competition, and reforming land markets would not only help level the playing field and support productivity growth, but also undercut rents for powerful vested interests. Furthermore, effective decentralization can not only help deliver more effective services under the right circumstances, but can also undercut a centralized system of influence and rebuild public support for government institutions. This means that an important prong of a better governance and anticorruption strategy for Ukraine involves pushing progress on reforms across the board that undermine vested interests.

20. **The following table provides a summary of the pathways and priority interventions identified by this SCD.** Four pathways and sixteen priorities are listed. While this is narrowed down from a wider universe of possible pathways and priorities, sixteen priorities is still a large number and not all of them are equally critical in helping Ukraine generate sustained recovery and shared prosperity. Nor can all of them be expected to be implemented over the same time horizon. Each of the priorities are, therefore, assigned a criticality rating of "critical", "high", or "medium" and a time horizon of "immediate", "short", or "medium" over which progress is needed and can be expected.

Summary of Pathways and Priorities

Cross Cutting Pathway: Better Governance and Anticorruption Institutions		
Priorities	Criticality	Time horizon
Public financial management: Implement updated PFM Strategy, including medium term budgeting, streamlining performance based budgeting, and introducing fiscal risk assessment framework.	High	Short, Medium
Anticorruption and Justice Institutions: Effectively implement new anti-corruption laws; strengthen public trust in justice system by improving enforcement and HR reform.	Critical	Short, Medium
Public administration reform: Improve policy and decision-making; streamline personnel while improving human resource management; undertake merit-based appointments and optimize salaries.	Critical	Short, Medium
Citizens Engagement: Build on successful post-Maidan mobilization by promoting more systematic planning, management, and communications based on information and evidence-based analysis.	Critical	Immediate, Short

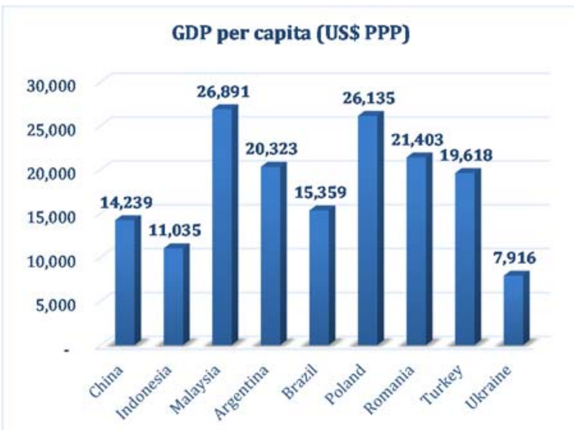
Pathway 1: Macroeconomic Stability		
Priorities	Criticality	Time horizon
Tax Reform: Broaden tax base by removing exemptions and loopholes; improve international taxation treaties; and strengthen tax administration	High	Immediate, Short
Pension Reform: Restructure benefit package to better link contributions to benefits; parametric reforms to address categorical benefits, early retirement, and provide incentives to retire later	Critical	Immediate, Short, Medium
Strengthen Financial Sector: Implement framework to recapitalize and resolve banks and strengthen supervision; restore credit growth by putting in place effective NPL resolution framework; and improve governance of state owned banks	Critical, High	Immediate, Short

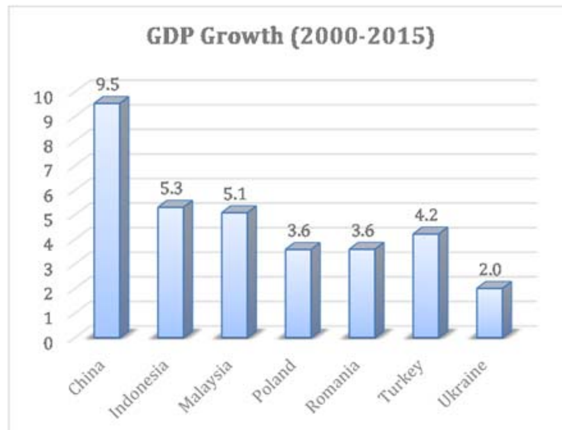
Pathway 2: Private Sector Productivity		
Priorities	Criticality	Time horizon
Strengthen PIM and Expand Infrastructure:	High	Short
•Create fiscal space for public investment and strengthen PIM systems	High	Medium
•Energy sector – improve governance and transparency, reduce losses, and reduce high energy intensity	Critical/High	Medium
•Transport sector – promote efficient multimodal transport system to unleashing Ukraine's trade potential	Medium	Medium
Create Level Playing Field in Private Sector:	High	Short
•Deregulation – further streamline business regulatory environment	High	Short/Medium
•Competition Policy – enhance capacity of AMC to implement legislation and streamline state aid for enterprises to reduce distortion of competition	High	Medium
•SOE Reform – triage of SOEs; strengthen accounting and financial reporting; and improve corporate governance	High	Short
Land Reform: Increase efficiency of state land management through new legal framework; open sales market for private agricultural land ensuring transparency and equal access; and clear status of unclaimed property.	Critical	Short/Medium
Trade Facilitation: Strengthen and harmonize quality and standards arrangements to tap potential of international trade agreements	Medium	Short

Pathway 3: Effective Services and Targeted Assistance		
Priorities	Criticality	Time horizon
Health Reform: Revise health financing model from input-based norms toward payment systems where "money follows" the patient	High	Short
Education: Implement "hub schools" program to optimize school network while prioritizing investments in quality-enhancing inputs	Medium	Short
Subnational delivery mechanisms: Improve norm-based financing for services, increase financial autonomy, and clarify roles and responsibilities	Medium	Short
Social Assistance: Continue shift from categorical to targeted benefits and improve targeting of the housing utility subsidy (HUS) program	Critical	Immediate, Short
Targeted support to conflict affected people: skills, training, and MSME in affected areas and host communities and extend systematic assistance to vulnerable households	High	Immediate, Short

I. Introduction

1. **Ukraine has tremendous potential that has not yet been reached.** Ukraine is endowed with intelligent, energetic, and entrepreneurial people; extraordinary fertile land; considerable natural resources; and a geographic location at the crossroads of Europe and Asia. There is no reason why Ukraine, under the right conditions, should not be among the league of prosperous and successful nations. The circumstances today, however, are of course, still far from that ultimate target. Ukraine's GDP per person in 2015 was $2,115, while the corresponding figure was $12,500 for Poland, around $9,000 for Turkey and Romania, and $9,800 for Malaysia, and $13,000 for Argentina. The flip side of the current circumstances is that if Ukraine is able to put in place the right conditions, it will experience a period of strong economic growth as it catches up and converges to the levels of income of more prosperous nations.





2. **Two important factors explain why Ukraine today finds itself considerably below potential: (i) a history of deep structural bottlenecks and governance challenges; and (ii) serious shocks from political, security, and economic challenges during the last three years.** The history of structural bottlenecks and governance challenges has led to large macroeconomic imbalances, weak productivity growth, and ineffective social services in Ukraine for an extended period. This has in turn led to a pattern of unsustainable economic growth and poverty reduction. Growth averaged only 2 percent per year in Ukraine during 2000-2015, compared to 3.6 percent in Poland, 4.2 percent in Turkey, and 5.1 percent in Malaysia. Second, Ukraine has been hit by unprecedented shocks on two fronts in 2014-2015: the conflict in eastern Ukraine and the deterioration in the global economic environment, including sharply lower commodity prices. The impact of the dual shocks has been very significant. Real GDP contracted by 6.6 percent in 2014 and by a further 9.8 percent in 2015. The currency depreciated sharply in 2014-2015 and the consolidated fiscal deficit, including Naftogaz, reached 10.1 percent of GDP in 2014. A large number of banks have failed and the level of nonperforming loans increased.

3. **The economic crisis has been an opportunity for change in Ukraine.** For much of the last 15 years, Ukraine faced very favorable external conditions. Capital flowed freely into Ukraine and other emerging markets, while commodity prices boomed. As a result, Ukraine was able to grow

without structural reforms or significant improvements in efficiency. All this led to an unsustainable pattern of growth. The economic crisis since 2013 has forced change and Ukraine has taken advantage of the opportunity. Considerable reforms have been implemented in the last three years to stabilize the economy in the face of shocks, reduce large imbalances, and cushion the impact of the shocks on the population. Key reforms adopted include moving to a flexible exchange rate; undertaking significant fiscal consolidation; reforming energy tariffs and strengthening the social safety net to cushion the impact on the poor; stabilizing the banking sector by putting in place the framework to resolve and recapitalize banks, and strengthen supervision; streamlining the business environment; making public procurement more transparent and improving public investment management; and putting in place key instruments of anticorruption.

4. **Much more needs to be done to move from economic stabilization to durable recovery and shared prosperity for the population.** Strong and sustained recovery have not yet taken hold and poverty has increased significantly in light of the economic crisis. Ukraine needs to now address the deeper structural bottlenecks and governance challenges on multiple fronts that have constrained sustainable development for the last 15 years. This will help translate economic stabilization into lasting economic growth and tangible improvements for the population. It will also contribute to the political and social sustainability of the reform program. Across the board, making progress on the reforms will require intensifying anti-corruption and governance efforts to reduce the influence of vested interests. Without new reform momentum, economic prospects will remain very weak, large macroeconomic imbalances could re-emerge, and the population will continue to hurt from the impact of the economic downturn. With new reform momentum to bolster investor confidence and productivity and deliver more effective services to the population, economic growth could pick up to 4 percent or more in the medium term and the population would experience tangible improvements over time. With even greater reform momentum, Ukraine would be able to generate the conditions for rapid economic growth and convergence to the income levels of the community of prosperous, socially equitable, and successful nations where it belongs.

5. **This Systematic Country Diagnostic (SCD) for Ukraine is intended as an evidence based diagnostic of the constraints and priorities to reduce poverty and promote shared prosperity in a sustainable way.** The SCD is intended as an evidence-based and integrative analytical report, combining analysis of growth, inclusion, and sustainability. The SCD is **not** intended to be limited to expected areas of World Bank Group (WBG) engagement, but is instead intended to assess what the country itself should do to advance its growth, poverty reduction, and shared prosperity objectives in a sustainable way.

6. **This SCD is structured as follows.** The next section covers the analysis of growth and sustainability. The third section covers the analysis of poverty and shared prosperity. The fourth section uses the analysis from the prior two sections to lay out the framework for the SCD, including the constraints and pathways to sustainable recovery and shared prosperity for Ukraine. The fifth, sixth, seventh, and eighth sections elaborate on the pathways to achieving sustainable recovery and shared prosperity in Ukraine.

II. Growth and Sustainability: Patterns and Sources

Key Takeaways
• After a rebound and boom during 2000-07, growth stagnated on average during 2008-13 and collapsed in 2014-15. • The unsustainable growth path and overall stagnation in growth since 2008 resulted from large macroeconomic imbalances and instability associated with structural bottlenecks and a weak policy stance. • Weak productivity growth has also contributed to the unsustainable growth path and overall stagnation in Ukraine's growth performance since 2008. • Limited progress in diversifying and enhancing the sophistication of Ukraine's export and production base has contributed to weak productivity growth.

1. **Growth in Ukraine over the last fifteen years has been characterized by three phases: rebound and boom during 2000-2007; stagnation during 2008-2013; and crisis and collapse during 2014-2015.** Following the breakup of the former Soviet Union, Ukraine experienced one of the sharpest and most protracted output contractions among transition economies. By 1999, real GDP collapsed to a mere 38 percent of its 1989 level. From 2000, positive external conditions, along with some initial stabilization and reform efforts, contributed to rebound and growth from highly depressed levels. Growth averaged 7 percent per year during 2000-2007. Ukraine's terms of trade (TOT) improved by 50 percent between 2001 and 2008, including higher steel prices on the export side and beneficial pricing of natural gas on the import side. As external conditions deteriorated following the global financial crisis of 2008-2009, the economy contracted sharply in 2009 and then mostly stagnated through 2013. Between 2008 and 2013, growth averaged -0.7 percent per year. Finally, as Ukraine was hit by the double shocks of the conflict and lower global commodity prices in 2014-2015, the economy contracted sharply by 8.7 percent per year during 2014-2015. The economy stabilized and grew by 2.3 percent in 2016.

Figure 4

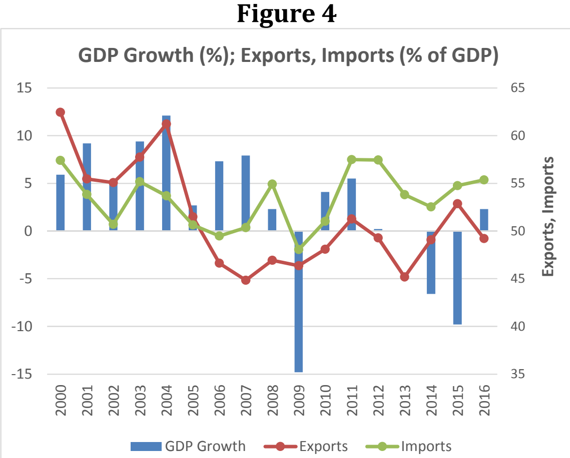


Figure 5

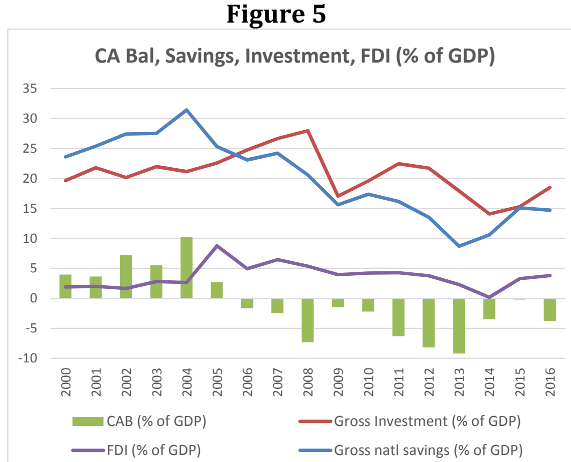


Table 1. Structure of Aggregate Demand (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	SHARE OF GDP (%)														
HH Consumption	54.4	57.0	57.1	56.4	53.3	57.9	59.6	60.6	64.0	64.5	62.9	66.8	68.3	72.7	71.4
Govt Consumption	20.9	19.6	18.4	19.0	18.1	18.6	18.4	18.3	17.0	20.1	20.3	17.4	18.6	18.4	18.6
Gross Investment	19.6	21.8	20.1	22.0	21.1	22.6	24.8	26.7	27.9	17.1	19.6	22.4	21.7	18.1	14.1
Net Exports	5.0	1.6	4.4	2.6	7.5	0.8	-2.8	-5.5	-8.0	-1.7	-2.8	-6.6	-8.7	-9.3	-4.1

2. **Unsustainable macroeconomic policies and limited structural reforms contributed to an unsustainable growth path since 2004.** Capital inflows surged after 2005 while credit growth boomed, fueled by external borrowing of commercial banks. Given the positive external conditions fueling the boom, limited structural reforms took place. Ukraine's exports actually declined from 61 percent of GDP in 2004 to 45 percent in 2007, pointing to an erosion of competitiveness of tradables. The authorities continued to pursue unsustainable macroeconomic policies during this period, so that the current account deficit grew to 9.2 percent of GDP in 2013. Gross national savings declined steadily after 2004, while gross investment actually increased, suggesting that growth since 2004 was associated with a credit fueled consumption boom and investment in nontradables sectors.

3. **An unsustainable fiscal stance fueled large imbalances and macroeconomic instability even before the current economic crisis.** Between 2005 and 2009, while general government revenues averaged around 41 percent of GDP, general government expenditures increased from 43 percent of GDP in 2005 to 47 percent in 2009 and further to 49 percent in 2010. As a result, the consolidated general government deficit, including Naftogaz, increased from 1.8 percent of GDP in 2005 to 9 percent of GDP in 2009. The growth of expenditures was fueled by current spending, which increased from 39 percent of GDP in 2005 to 46 percent in 2010. The large fiscal imbalances combined with a rigid exchange rate regime compounded the credit fueled consumption boom, so that when external conditions deteriorated, the economy contracted sharply by 14.8 percent in 2009.

Table 2. Key Economic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017P	2018P	2019P
Nominal GDP, *UAH billion*	721	948	913	1,083	1,300	1,405	1,465	1,587	1,980	2,383	2,735	3,085	3,450
GDP per capita, *US$*	3,090	3,916	2,560	2,992	3,784	4,080	4,216	3,119	2,122	2,174	2,277	2,464	2,736
Unemployment Rate	6.4	6.4	8.8	8.1	7.9	7.5	7.3	9.3	9.1	8.8	9.2	8.8	8.5
Real GDP, *% change*	7.9	2.1	-14.8	4.1	5.5	0.2	0.0	-6.6	-9.8	2.3	2.0	3.5	4.0
Gross Domestic Investment, % GDP	26.7	27.9	17.1	19.6	22.4	21.7	17.9	14.1	15.3	18.5	18.6	19.2	18.6
CPI, *% change eop*	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	10.2	7.0	6.0
Current Account Balance, *% GDP*	-3.7	-7.1	-1.5	-2.2	-6.3	-8.2	-9.2	-3.5	-0.2	-3.8	-4.1	-3.0	-3.3
Exports of G&S, *% GDP*	43.0	45.8	44.4	48.1	51.3	49.3	45.2	49.1	52.9	49.2	49.5	50.0	48.5
Imports of G&S, *% GDP*	48.7	53.8	46.1	51.0	57.5	57.4	53.8	52.5	54.7	55.4	54.7	54.1	52.7
External debt, *% GDP*	58.6	83.6	90.8	85.0	77.6	76.6	78.6	97.6	131.5	129.6	131.6	125.4	107.5
International Reserves, *US$ billion*	32.5	31.5	26.5	34.6	31.8	24.5	20.4	7.5	13.3	15.5	21.8	29.5	29.8
In months of next year's imports	4.0	7.0	4.6	4.4	3.7	2.9	3.3	1.9	3.2	3.4	4.6	5.8	5.4
Budget revenues, *% GDP*	40.0	42.3	40.4	43.9	42.9	44.5	43.6	40.3	42.1	38.4	38.8	38.9	39.0
Tax revenues, *% GDP*	36.7	37.8	37.2	39.3	38.4	38.9	37.9	35.8	35.5	33.1	34.3	34.8	34.8
Budget expenditures, *% GDP*	42.1	45.4	46.8	49.2	45.7	48.9	48.4	44.8	43.2	40.6	41.9	41.5	41.4
Current expenditures, *% GDP*	36.9	40.1	44.7	46.4	42.3	45.7	46.2	44.3	41.0	37.4	38.6	37.8	37.5
Capital expenditures, *% GDP*	5.2	5.3	2.1	2.8	3.0	2.9	2.0	1.3	2.2	3.1	2.8	2.9	3.1
Fiscal balance, *% GDP*	-2.1	-3.1	-6.4	-5.3	-2.8	-4.4	-4.8	-4.5	-1.2	-2.2	-3.1	-2.6	-2.4
Consolidated deficit, incl Nagtogaz, %	-2.1	-3.1	-8.9	-6.3	-4.4	-5.5	-6.7	-10.1	-2.1	-2.3	-3.1	-2.6	-2.4
Public and Guaranteed Debt, *% GDP*	12.4	20.0	35.4	40.5	36.3	36.6	40.6	70.3	79.4	81.2	88.8	83.5	75.9

Source: Ukrainian Authorities, WB projections

4. **After a spurt of productivity growth in part associated with improved capacity utilization during 2000-07, productivity has stagnated in Ukraine.** During 2000-2007, out of total growth of 7.2 percent per year, total factor productivity (TFP) growth accounted for 6.3 percent, while capital accumulation accounted for 1.1 percent and the labor force actually contracted slightly, pulling growth back by 0.26 percent. While TFP growth of 6.3 percent per year looks impressive at face value, rough estimates suggest that a good part of this productivity spurt was due to the rebound in capacity utilization following the sharp post-transition contraction when real GDP in 1999 reached 38 percent of its 1989 value. Of course, the rebound in capacity utilization after 2000 was itself supported by initial reforms directed at macroeconomic stabilization and very favorable external conditions with Ukraine's terms of trade improving significantly. However, Ukraine did not make significant progress in tapping export markets for new products and in new destinations or moving up the export quality ladder, all of which would have laid the foundation for more durable productivity growth. As a result, when external conditions deteriorated from 2008 onward, productivity growth stagnated. In fact, during 2008-2013, TFP growth actually averaged negative 1.52 percent per year, contributing to overall contraction of GDP by 0.7 per year. Furthermore, as Ukraine was hit by the dual shocks of the conflict and the sharp decline in global commodity prices during 2014-15, TFP plummeted further by 8.3 percent per year. While some of this is undoubtedly a result of lower capacity utilization, the overall story is one of limited reforms and progress in generating productivity growth which has contributed to a pattern of unsustainable growth over the last fifteen years. In fact, in 2015, total factor productivity was only 27 percent above its 1999 level, which largely explains why real GDP in 2015 was only 42 percent above its 1999 level.

Figure 6

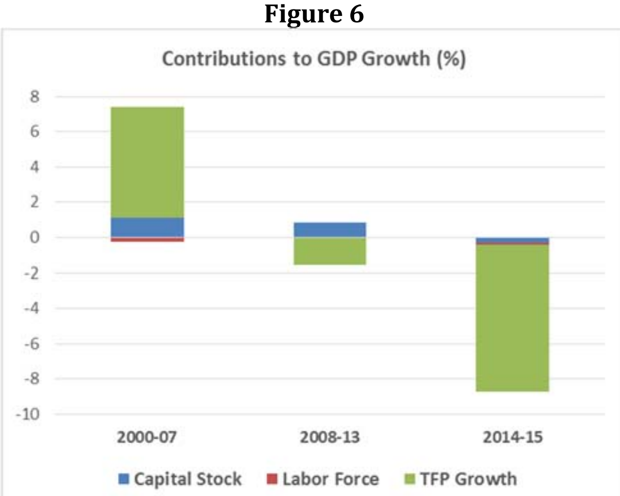
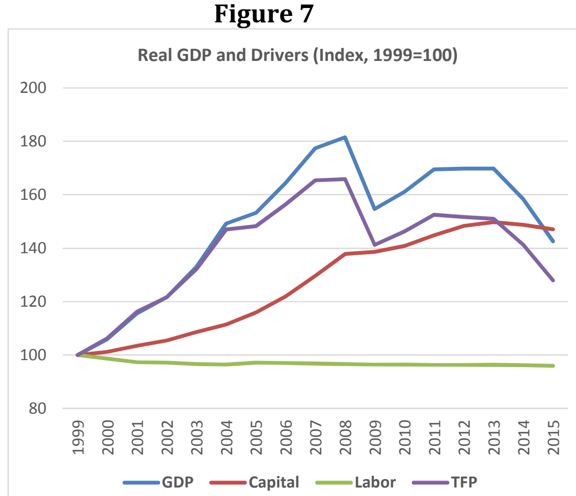


Figure 7



5. **Agriculture has served as a steady driver of growth, while industry and services drove the strong rebound and growth of 2000-2007, they also stagnated during 2008-13 and contracted sharply during 2014-15.** Ukraine has an abundant endowment of fertile agricultural land and is a major producer and exporter of wheat, corn, barley, and sunflower oil. This has resulted in a steady contribution of agriculture to growth over an extended period of time. On the other hand, agriculture remains a relatively small part of the economy, accounting for 14 percent of GDP in 1999 and dropping to 7.5 percent in 2007 before increasing again to 12.5 percent in 2015. Industry and

services, which account for the bulk of the economy, played a major part in driving rebound and growth during 2000-2007, but also played a major part in driving stagnation during 2008-13 and collapse in 2014-15. During 2000-2007, out of total growth of 7.4 percent, industry accounted for 3.4 percent and services accounted for 3.5 percent, while the contribution of agriculture was 0.6 percent. As Ukraine emerged from the depths of the post-crisis transition starting in 2000, its large industrial base rebounded supported by improving global commodity prices, while the services sector expanded as the new market economy took hold. The expansion of services following 2004 was also driven by the unsustainable credit fueled consumption and investment boom as banks borrowed externally to expand their portfolio in Ukraine. Since 2007, however, the story of industry and services has largely been one of stagnation and collapse. During 2008-13, industry contracted by 1.3 percent per year, while services contracted by 2.1 percent per year. During 2014-15, industry contracted by 14.1 percent per year, while services contracted by 7.1 percent per year. In contrast, agriculture grew steadily by 6.6 percent per year during 2008-13 and contracted only slightly during the economic collapse of 2014-15.

Figure 8

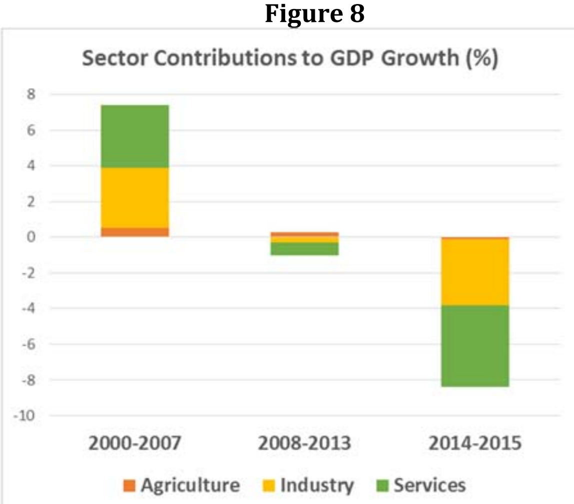


Figure 9

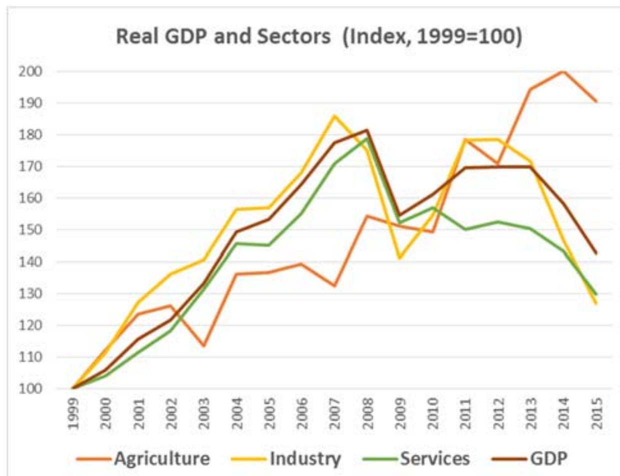


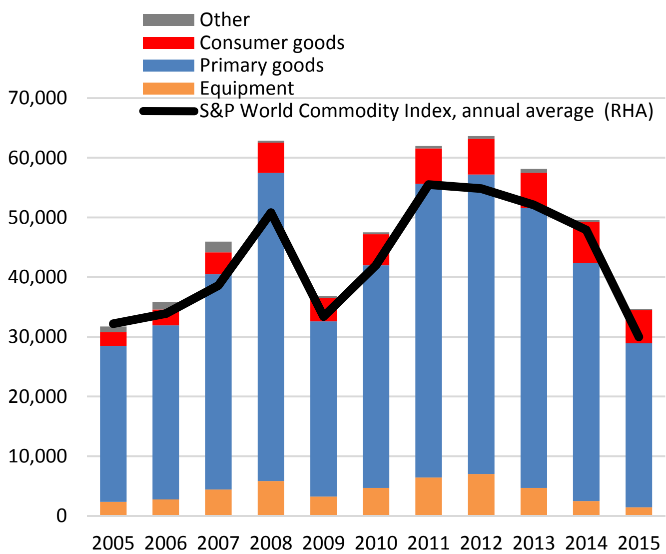
Table 3. Sectoral Structure and Sources of Growth

	SECTORAL SHARE OF GDP (%)				SECTOR GROWTH RATE (%)			SECTOR CONTRIBUTION TO GROWTH (%)		
	1999	2007	2013	2015	2000-2007	2008-2013	2014-2015	2000-2007	2008-2013	2014-2015
Agriculture	14.3	7.5	10.2	12.5	3.56	6.62	-0.97	0.55	0.31	-0.10
Industry	38.5	36.7	26.2	24.4	8.05	-1.30	-14.05	3.35	-0.30	-3.70
Services	47.2	55.8	63.6	63.1	6.92	-2.11	-7.13	3.53	-0.73	-4.56
Total GDP	100.0	100.0	100.0	100.0	7.43	-0.72	-8.36	7.43	-0.72	-8.36

6. **Ukraine has not succeeded in generating sustained growth in exports over the last decade**. In fact, exports have fluctuated considerably in line with the volatility in the global commodity prices. Primary goods comprised over 80 percent of total exports on average over the last 10 years. With export dynamics depending heavily on commodity prices, exports grew significantly during 2005-2008, but subsequently collapsed by over 40 percent during the global crises in 2009. Exports recovered again during 2010-2012, but have declined again since 2013 due to lower global commodity prices and disrupted trade relations with the Russian Federation. In fact,

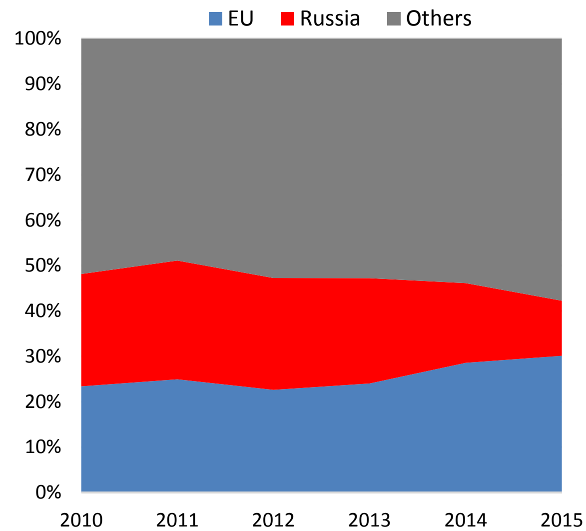
looking at export destinations, the Russian Federation was Ukraine's major trading partner through 2013, with Russia and other CIS markets accounting for 35 percent of Ukraine's exports in 2013. On the other hand, the share of exports going to the EU-28 countries was relatively stable at 26 percent in 2013, compared to 23 percent in 1996. Following the conflict in eastern Ukraine and disrupted economic relations with Russia, exports to Russia have declined to 12 percent of total exports in 2015, while the share going to the EU-28 countries grew to 30 percent in 2015.

Figure 10: Ukraine Exports (types of goods, $mn)



Source: NBU, WB estimates

Figure 11: Geographical structure of exports



Source: NBU, WB estimates

Figure 12: Export Structure (% of Total)

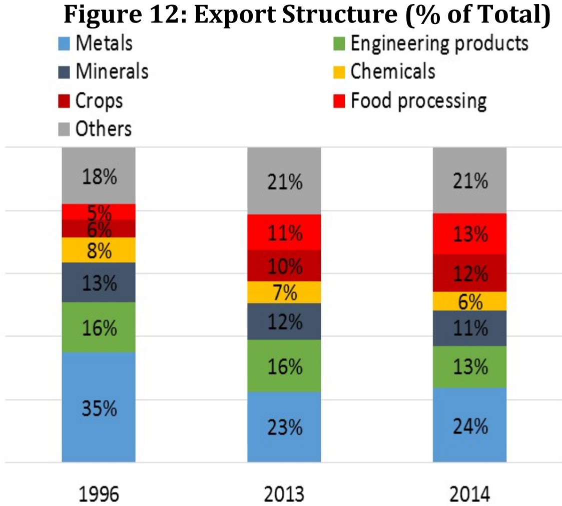
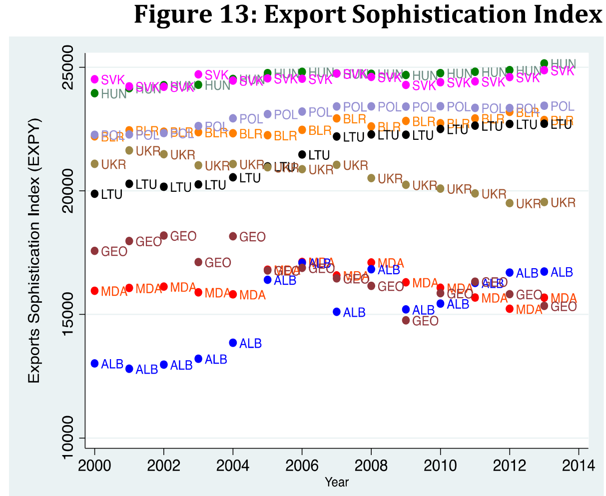


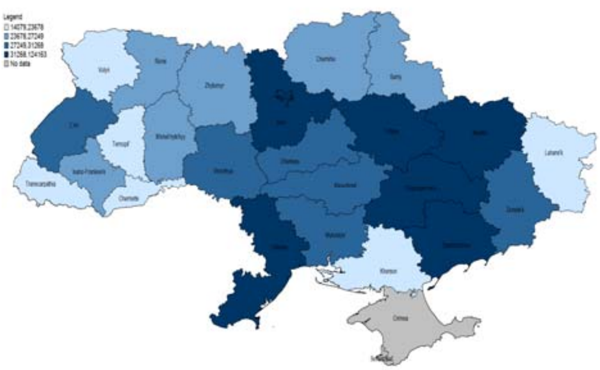
Figure 13: Export Sophistication Index



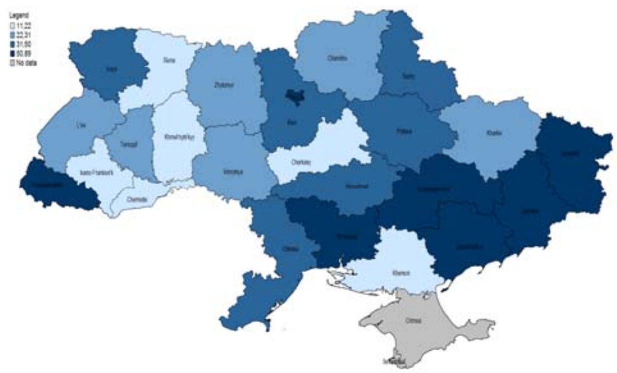
7. **Ukraine has made limited progress in diversifying its export base and enhancing the sophistication of its exports.** Ukraine's export structure has remained largely unchanged with a predominant share of resources. The consolidated share of metals, minerals and crops amounted 45 percent in 2014, which is only 9 percentage points lower than in 1996. The share of engineering

products has remained unchanged. In 2000, the level of sophistication of Ukraine's exports was almost the same as that of Poland, Lithuania and Bulgaria. However, over the last 5 years, Ukraine's export sophistication has declined below the level of 2000, while that of peer countries has improved significantly.

Gross Regional Product per capita (UAH, 2014)



Regional Exports (% of GRP, 2014)



8. **The distribution of output and exports across oblasts also suggests that Ukraine has not yet made sufficient progress in moving beyond commodity exports and leveraging its other comparative advantages.** The oblasts with the highest levels of output per capita and exports are those where Ukraine's commodity based exports are concentrated. The oblasts with the highest levels of output per capita in 2014 include Kyiv, Dnipro, Zaporizhia, Kharkiv, Poltava, and Odessa, while the oblasts with the highest export shares in 2014 include Dnipro, Zaporizhia, Donetsk, Luhansk, and Mykolayiv. On the other hand, those oblasts that are home to Ukraine's other comparative advantages (agriculture and greater proximity to the large EU market) generally have lower levels of output per capita and export shares. This points toward a significant opportunity to create the enabling conditions for the private sector in Ukraine to tap its other comparative advantages by leveraging the agriculture sector and by integrating into European production chains, particularly at a time when traditional comparative advantages in commodities has been affected by shocks..

9. **Going forward, the prospects for generating sustained moderate growth in Ukraine will require combining an increase in both productivity growth and investment from recent trends.** The burden on investment and productivity growth are particularly high in Ukraine given that its labor force is projected to continue to decline gently going forward due to demographic factors. The labor force is projected to decline by about 0.1 percent per year during the next ten years. A number of scenarios of investment and TFP growth rates required to generate given GDP growth rates during 2017-2021 are shown in table 3 below. In order to generate a growth rate of 5 percent per year during 2017-2021, with investment at 20 percent of GDP, the TFP growth rate necessary is a staggering 4.5 percent per year. Such a TFP growth rate is very high by international standards for a sustained period of time, and also considerably higher than Ukraine's average TFP growth rate of 1.2 percent during the last 15 years. If investment rises to 30 percent of GDP, the necessary TFP growth rate is still a formidable 3.4 percent. In order to generate a more modest GDP

growth of 3 percent during 2017-2021, with investment at 25 percent of GDP, TFP growth will have to average about 2 percent per year. These scenarios demonstrate that Ukraine needs to increase investment and productivity growth from recent trends in order to generate reasonable economic growth rates going forward.

Table 4: Ukraine: Growth Scenarios for 2017-2021

Growth	Investment (%GDP)	TFP Growth
5.0%	20%	4.5%
5.0%	25%	4.0%
5.0%	30%	3.4%
5.0%	35%	3.1%
3.0%	20%	2.5%
3.0%	25%	2.1%
3.0%	30%	1.9%
3.0%	35%	1.6%
Actual Growth (for Comparison): 2001-2015		
2.0%	21%	1.2%

Source: World Bank staff estimates.

10. **Generating the necessary increase in investment and productivity will require both a more sustainable macroeconomic stance and deep structural reforms.** Gross national savings has averaged 12.5 percent of GDP during the last five years (2011-2015). This was due to both low private savings (13.5 percent of GDP) and negative public savings (-1.0 percent of GDP) during this period. So, in order to increase investment to 25 percent of GDP (from the average of 18 percent during the last five years), Ukraine will need to increase both private and public savings. Increasing public savings will require significant consolidation of current expenditures going forward. While private savings is difficult to influence through policy, sound macro-financial policies, pension reform, and improvements in financial intermediation can help. Beyond the increase in national savings, Ukraine will also require higher levels of foreign direct investment. Both this and the necessary increase in productivity will require deep structural reforms to improve infrastructure, level the playing field for the private sector, and take advantage of international trade opportunities.

III. Poverty and Shared Prosperity: Patterns and Trends

Key Takeaways

- Poverty has declined significantly in Ukraine since 2000, although the pace of poverty reduction slowed during 2008-13, before poverty increased significantly in 2014-15.
- Household incomes have relied on large pension and social assistance spending, raising concerns about the sustainability of poverty reduction.
- With higher education levels, households enjoy the double benefit of higher employment rates and higher returns, though for the B40s these education premia appear to be more restrained than for the rest of the population. This suggests that better education – combined with measures to raise overall productivity in the economy and especially in the sectors the B40 tend to be employed in – could be an important driver of a more sustainable model of poverty reduction.

11. **Between the turn of the century and 2013, Ukraine experienced a significant reduction in poverty, though the pace has slowed since the global financial crisis of 2008-09.** Since 2002, the earliest date for which comparable estimates are available, the country witnessed significant poverty reduction, in both urban and rural areas. According to the recently developed World Bank national methodology for Ukraine, "moderate poverty" declined from 79 percent in 2002 to 38 percent in 2007. In rural areas, the decline was from 85 percent in 2002 to 50 percent in 2007, while in urban areas, moderate poverty declined from 76 percent in 2002 to 33 percent in 2007. The global financial crisis brought a trend reversal in 2009, especially in urban areas. Subsequent years, however, saw a resumption of poverty reduction with moderate poverty declining further to 14 percent in 2013. The breakout of conflict and economic crisis led to a reversal of trend, with poverty up significantly since 2014-15.

Figure 14

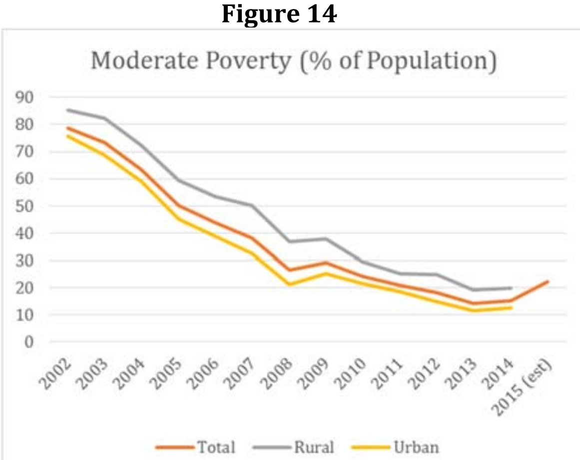
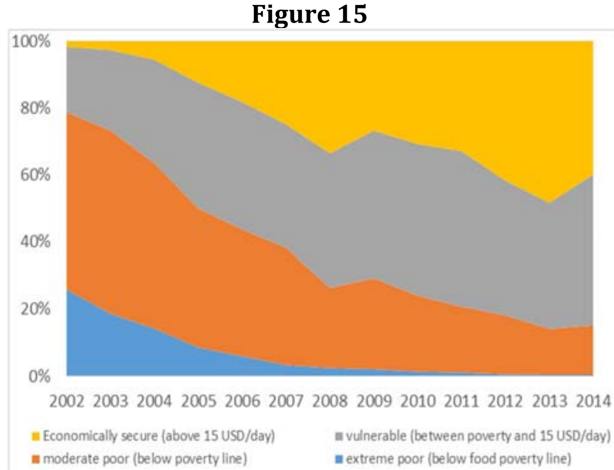


Figure 15



12. **Poverty trends based on the ECA wide regional poverty line ($5 a day, 2005 PPP) are consistent with trends for the "moderate poverty" measure.** The two poverty measures use

different consumption aggregates but nevertheless yield similar trends. The share of the population below the $5 PPP poverty line decreased from 46 percent in 2002 to 8 percent in 2008 and 3.2 percent in 2013. Beyond moderate poverty and the $5 PPP per day line, other measures of extreme poverty based on the national food poverty line or the $2.5 PPP per day line suggest that extreme poverty is largely not present in Ukraine. The extreme poverty rate based on the food line declined from 26 percent in 2002 to 0.4 percent in 2014, while the poverty rate based on $2.5 PPP per day declined from 6.5 percent in 2002 to 0.1 percent in 2013.

Measuring poverty in Ukraine

This SCD uses multiple lines to look at poverty trends given the complementary insights they provide. Given the lack of a reliable national indicator, the robustness of trends to different methodologies is comforting on the estimates' ability to capture welfare dynamics in the country. The official poverty methodology to measure extreme poverty is based on a measure of income per capita and adopts the official Subsistence Minimum (SM) as a poverty line. This is problematic as the SM is a policy variable rather than a technical one – while based on a basket intended to cover subsistence needs, it is reviewed and approved by the Cabinet of Ministers based on policy considerations as it acts as an anchor for a number of benefits, as well as pensions and the minimum wage. Trends analysis based on the SM can therefore prove misleading as it is based on a varying yardstick. To obviate the methodological shortfalls of the official methodology the World Bank introduced in 2016 a new poverty line, based on a new consumption aggregate and the cost of basic needs methodology. This is the line adopted here to present "moderate poverty" estimates, though the methodology provides also an extreme poverty line covering only the food component of the moderate poverty line. As this line is not part of the official set of poverty lines and is not yet familiar to Ukrainian audiences, the SCD also reports estimates based on the well-established ECAPOV methodology (the 5 USD a day and 2.5 USD a day, 2005 PPP lines). This line is mostly intended for international comparisons, though the methodology suffers from a special shortcoming in the case of Ukraine, in that there is a perception among audiences familiar with Ukraine that the 2005 PPP might overestimate household welfare when compared to other countries in the region.

For comparison purposes when looking at different estimates it is worth considering that the WB moderate poverty line is set in 2014 prices at 1045 hryvnia per month. This is equivalent to 8.5 USD a day in 2005 PPP, and is somewhat lower than the official poverty line (SM) for 2014, which was set at 1176 hryvnia per month. Note however that it yields a poverty incidence estimate which is much higher than the ECAPOV methodology (15.2 rather than 3.3 percent) due to differences in the consumption aggregate adopted; and twice as high as the official poverty estimate which is based on an income rather than a consumption aggregate.

13. **The long term decline in poverty was accompanied by a sizeable increase of those living in economic security, though since 2008 the ranks of those living in near poverty have swollen significantly.** Looking more broadly at the distribution, Ukraine has adopted as a target for its 2020 Strategy increasing the number of people living in economic security, i.e. with low vulnerability of falling into poverty (defined as having more than 15 USD a day in PPP). This group has grown significantly between 2003 and 2008. The global financial crisis reversed this trend – and then again the current crisis is reversing the gains made between 2011 and 2013. An important element that emerges from Figure 15 is the growing number of people who over the decade have been able to escape poverty, but not to the extent of being considered economically secure.

14. **Poverty is estimated to have increased significantly in 2015.** The deep recession, depreciation, and compression of public current expenditures have resulted in significant contraction of disposable incomes in Ukraine. As a result, moderate poverty is estimated to have increased from 14.1 percent in 2013 to 22.2 percent in 2015, while the poverty rate (under $5/day in 2005 PPP) is estimated to have increased from 3.2 percent in 2013 to 5.8 percent in 2015. Labor market conditions have deteriorated, with nominal wage growth lagging inflation, and real wages down on average by 13 percent (year-over-year) in December 2015. Unemployment increased from 8 percent in 2013 to 9.5 percent in the second half of 2015.

Table 5. Poverty Rates (based on different poverty lines, % of population)

	Moderate Poverty			Extreme Poverty	$5 PPP	$2.5 PPP
	Total	Rural	Urban	(food pov line)	(ECA regional)	
	(percent of population)			(percent of population)		
2002	78.8	85.3	75.5	25.9	46.4	6.5
2003	73.3	82.3	68.7	18.7	36.8	3.5
2004	63.5	72.5	59.0	14.2	28.5	2.9
2005	50.0	59.5	45.3	8.6	18.5	1.2
2006	43.7	53.6	38.9	6.0	14.7	0.7
2007	38.3	50.0	32.5	3.3	11.5	0.5
2008	26.4	36.8	21.3	2.4	8.1	0.1
2009	29.2	37.9	25.1	2.1	9.1	0.3
2010	24.1	29.5	21.5	1.4	6.0	0.1
2011	20.8	25.1	18.7	1.1	5.3	0.1
2012	18.2	24.8	15.1	0.6	3.9	0.1
2013	14.1	19.4	11.6	0.4	3.2	0.1
2014	15.2	20.1	12.7	0.4	3.3	0.0
2015 (est)	22.2				5.8	0.1

15. **Despite significant poverty reduction over time, geographical gaps in poverty incidence remain significant.** The rural-urban gap in moderate poverty has hovered around 7-8 percentage points in recent years. In 2014, poverty incidence in rural areas was 20.1, while in urban areas it was 12.7. Overall, a significant share of the poor live in rural areas and key demographic groups, such as pensioners, are even more concentrated in rural areas. Poverty incidence also appears to vary significantly across regions (possibly by as much as a factor of 8 between Kyiv and other parts of the country, though for most regions the difference in incidence is more contained). Despite the relevance of these regional disparities to current policy debates, such comparisons need to be considered purely indicative, due to questions about whether data at the regional level are sufficiently representative and because data availability limits the extent to which a regional price index can capture fully differences in purchasing power across regions.

16. **The conflict has had significant impacts on poverty and the well-being of large populations in eastern Ukraine, although the regional data has its limitations.** Over 4 million Ukrainians in the east of the country have been affected. Donetsk has one of the highest populations of the B40 in absolute terms. It also had the highest number (1.4 million) of pensioners before the outbreak of conflict in early 2014, while the number was 730,000 in Luhansk region. The conflict and

its impacts on livelihoods and social and economic opportunities has pushed such households further into poverty and created additional pressures on Ukraine's already overstretched social protection systems. Insecurity has also interrupted service delivery and infrastructure. Vulnerability is particularly acute for forcibly displaced households living in areas with significant conflict-related damage and the 800,000 persons living in areas close to the "line of contact" between government and non-government controlled areas. For these communities, damage to homes and businesses and interruptions in public services (from electricity and water to health and education), livelihoods, travel routes and supply chains, compounded by the psychosocial stresses of living in a conflict zone, and the dangers and constraints resulting from land mines and explosive remnants of war, all result in a state of high vulnerability. Opportunities for employment in mining and heavy industry in the east has also been impacted considerably. As a result, IDPs from the heavy industrialized areas of the eastern Ukraine often face a mismatch between their skillsets and the economic opportunities in communities where they settle.

17. **Labor market trends and particularly real wage growth played an important role in driving the poverty decline observed up to 2013.** Indeed, the boom period of 2000-2007 saw an increase in the number of employed and of the employment rate, with a relative stable labor force participation rate. This period was also characterized by very high real wage growth (on average above 15 percent annually) which more than tripled real wages during the period of 2000-2007 (Figure 16). After 2008 the economic crisis coincided with a decline in the working age population due to long term demographic trends. After a significant fall in 2009 as a reaction for the deep recession the employment rate grew moderately until 2013, despite a decline in the absolute number of employed over the period. Despite the crisis, because of the tightening of the labor market, average real wage growth in Ukraine for the period 2008-2013 was relatively high at the level of 6.4 percent.

Figure 16: Labor market trends 2000-2015

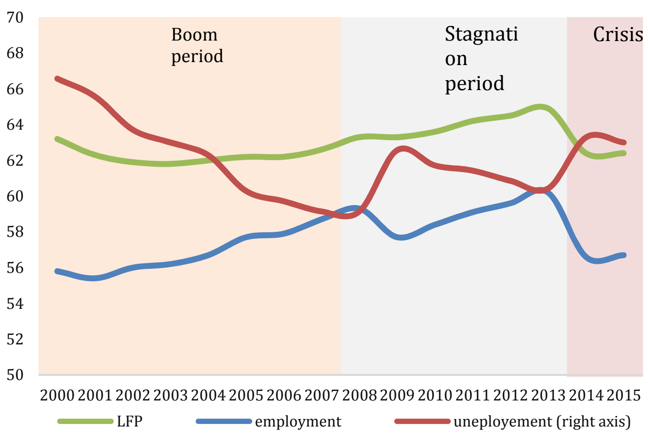
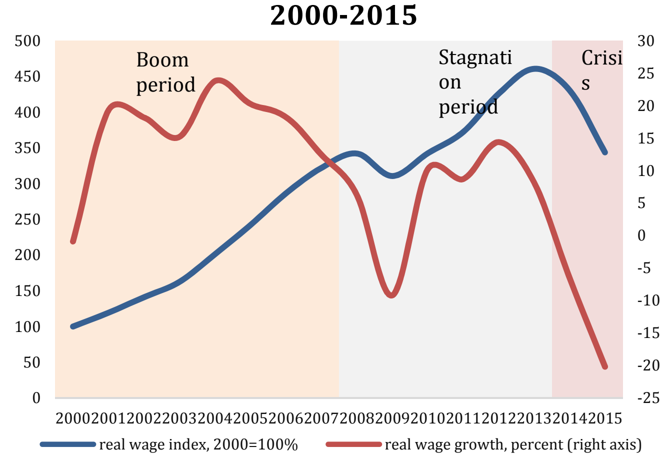


Figure 17:Real wages and real wage growth 2000-2015



18. **The crisis in 2014-2015 saw labor market adjust through the rise of unemployment and a real wage correction**. During the crisis of 2014-2015 both employment and labor force participation rates and absolute numbers sharply declined while the unemployment jumped to over

9 percent levels. On the background of high inflation wages declined in real terms by one quarter over two year period and returned to the levels of 2008.

Figure 18: Income Growth of B40 vs Total Pop

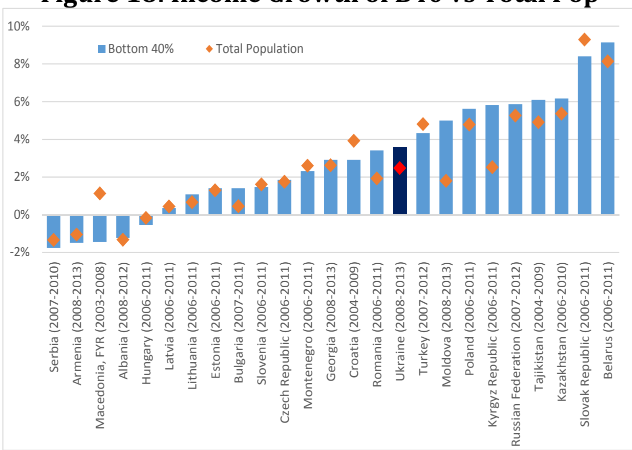
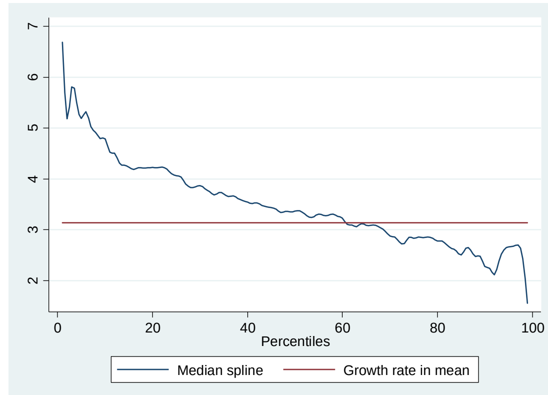


Figure 19: Growth Incidence Curve, 2008-13

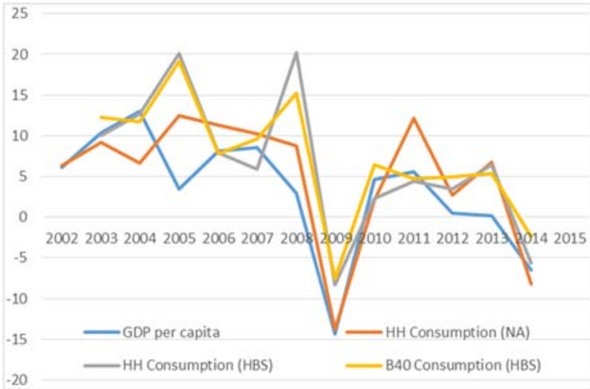


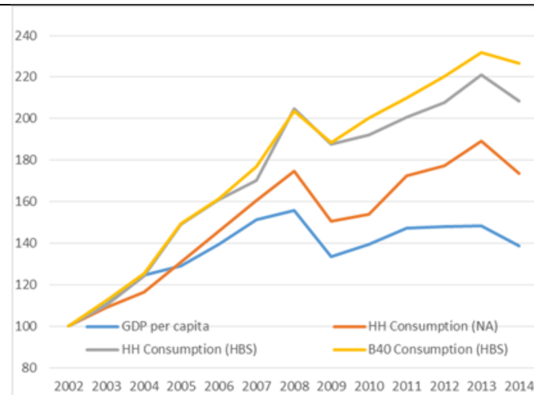
Source: Bank staff estimates using household budget surveys

19. **Income growth of the B40 population in Ukraine exceeded that of the total population during 2008-13, although questions about data quality remain.** A comparison of shared prosperity indicators across the ECA region indicates that Ukraine performed favorably relative to other countries in the region, including many EU member states. The data indicates that during 2008-13, income growth of the bottom 40 percent of the population in Ukraine exceeded that of the total population. This assessment, however, needs to be tempered by a consideration of some of the weaknesses that characterize the data, particularly the likely underestimation of the top incomes in the distribution. While common to the region, this problem is likely to result in a rosier picture of the relative growth performance of the bottom 40 percent. The belief that the survey might be missing a large part of the higher end of the income distribution is well-established among local researchers and supported by the fact that estimates of private consumption in the survey are less than 60 percent of estimates from national accounts. Furthermore, the available data on professional and high skilled wages from human resource firms show that they are significantly higher than those captured by the survey. Finally, while the perception is that the upper end of the income distribution in Ukraine is extremely well-off, the evidence from the household survey points to very limited inequality (a Gini of about 24 percent in 2013).

Comparison of HBS and National Accounts Consumption Growth

The significant decline in poverty incidence, particularly during the 2008-13 period of stagnant growth, raises questions about the underlying drivers. The analysis in this chapter suggests that two factors could be responsible for this. The first is the considerable dependence of income growth on pensions and social assistance, which will be discussed in the next section. The second is that consumption growth in the household survey has exceeded that in national accounts, as shown by the figures in this box.





A comparison of consumption growth in the household survey and in national accounts turns up a number of interesting findings. The first is that consumption growth in the household survey overall and particularly for the B40 population exceeded consumption growth in national accounts. This is likely because national accounts do not fully take account for the large unobserved economy. The second is that consumption growth exceeds growth of GDP per capita, in part because transfers and social assistance, along with a compression of savings, enabled households to increase consumption faster than their incomes. Both of these findings can partly explain why poverty was declining during a period of stagnant growth in 2008-13. Further analysis on this issue would be useful going forward.

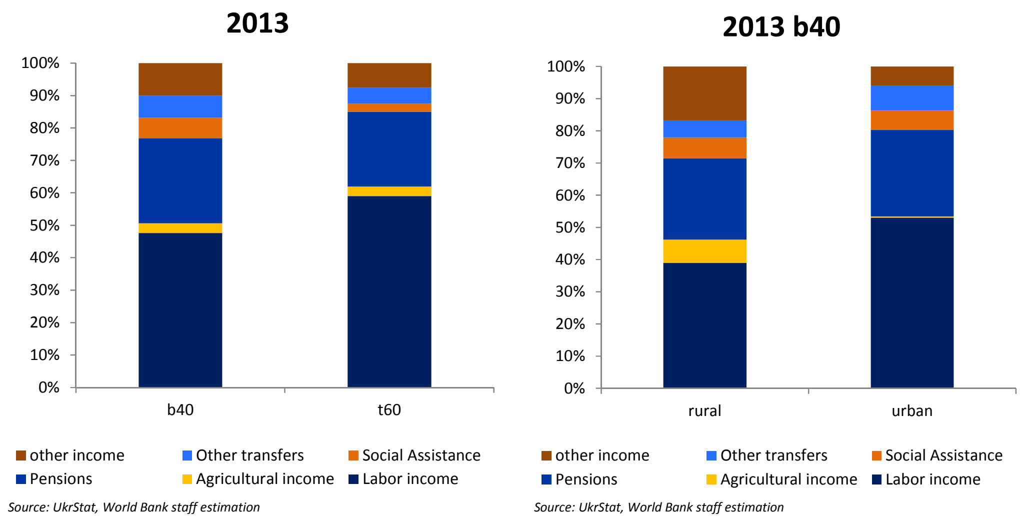
Reliance on Pensions and Transfers

20. **Overall, a significant portion of household income in Ukraine and particularly for the poor comes from pensions and transfers, raising concerns about the sustainability of poverty reduction.** The figure below provides a snapshot of the income streams of households in the bottom 40 percent of the population (B40) and in the top 20 percent (T60) in 2013. The figure also shows how this differs across rural and urban areas for the B40. Overall, the B40 derive less of their income from labor and employment and more from pensions, social assistance and other transfers. This type of income profile is very common in Eastern Europe and Central Asia, where the B40 rely on public transfers more than in other regions of the world. Disaggregating the income profile of the B40 by urban and rural shows that the biggest differences across areas are in the extent to which they depend on labor income (driven by wage income) and agricultural incomes. This difference matters as, while both labor income and agricultural income are produced by labor (the B40 in rural Ukraine are unlikely to be enjoying rents from land), agricultural income is more likely to vary with exogenous shocks, such as changes in commodity prices or weather shocks.

21. **Social assistance accounted for 6 percent of the income of the B40, with little difference between urban and rural areas.** It is noticeable, however, that also the T60 in 2013 received 3 percent of their income from social assistance. Detailed analysis of the system for 2012 shows indeed that as many as 49 percent of those living in the top decile were being reached by some form of social assistance. In addition to a variety of "privileges" which were untargeted, the major social assistance programs was the child birth grant (that would give increasing amounts of money for children of higher order). Other programs included subsidies for energy consumption, and a small targeted

guaranteed minimum income program. As lower income groups have more children, the child birth grant had an element of "self-targeting" and could amount to as much as 38 percent of the resources of those in the bottom decile that would receive it. For the top decile the same indicator of generosity would amount to 4 percent, which is not trivial considering that those were meant to be the richest groups in the population. Reforms undertaken since 2014 have addressed some elements of regressivity in the system, with reforms of the Housing and Utility Subsidies, and introducing a fixed amount per child in the birth grant, resulting in an increase on the first child and decreases on subsequent children. However, considerable challenges remain in achieving a more targeted package of social assistance going forward.

Figure 20: Income sources of the B40 and the T60 for urban and rural population



Note: Other transfers= other public transfers + private transfers; Other income= Proceeds from sales of personal and household effects+ Proceeds from sales of the real estate+ other proceeds + income from properties.

22. **Concerns about sustainability of poverty reduction are also reflected in a breakdown of sources of household income growth, with pensions and transfers again a prominent source.** During 2009-2014, out of an annual B40 household income growth of 4.5 percent, pensions and social assistance accounted for 2 percent, while labor income accounted for 2 percent. In fact, these patterns are also reflected, although to a somewhat lesser extent, in the earlier boom period. During 2002-2007, out of annual B40 household income growth of 17.6 percent, pensions and social assistance accounted for 8 percent, while labor income accounted for 9.3 percent. Between 2008 and 2013, both social assistance and pensions grew in weight in the budget of those who received it, particularly for those in the B40 (social assistance from 8 to 13 percent). This reflected the impact of two different factors. First, social assistance is anchored to the Subsistence Minimum Income (SMI) which grew significantly more than the CPI over this period (it was subsequently frozen in 2013 and adjusted, albeit rather marginally when compared to inflation, in 2016). In addition, some of the programs changed, with the birth grant in particular increasing over the period. In the case of pensions, changes to the SMI appear to be the main driving force behind the observed increase. The parametric reforms introduced in 2011 are unlikely to already have had an impact on incomes,

though in the long run elements of the reform – such as increasing the pensionable age – will result in increases in the pension income recipients will get.

Figure 21: Growth of HH Income Sources, B40 versus T60, 2009-2014 and 2002-2007

Note: WB own estimates for 2008-2013 based on UkrStat data.

28. **While the heavy reliance of household incomes on social benefits is a serious concern for sustainability of poverty reduction, more targeted programs have played an important role since 2014 in cushioning the impact of the large shocks.** In the wake of the large energy price and income shocks, targeted social assistance programs have played an important role in cushioning the impact on the vulnerable population. The means-tested housing and utilities subsidy (HUS) program has been expanded significantly, with coverage increasing from 1 to 5 million households by end-2015. Furthermore, the authorities have taken initial steps toward containing non-targeted social assistance programs. While the HUS has proved an effective crisis response tool, going forward, as households adjust to a new price environment and complementary measures (e.g. improving energy efficiency) are rolled out, the HUS program will need further reform to enhance targeting and fiscal affordability.

23. **Improved education provides an important route out of reliance on social benefits, with higher education levels leading to a higher share of labor income and lower reliance on social benefits.** For households in the T60 group whose head has tertiary education this share reached 67 percent, while for B40 it is 10 percentage points lower. Similar gaps in the labor share characterize households whose heads have other educational levels. These differences in labor shares as a function of education depend on the effects of education on both wages and levels of employment. On the wage side, the premium for tertiary education comparing to complete secondary (or even incomplete tertiary) is 18 percent for the B40 and 30 percent for the T60. For the B40 this premium is much higher in rural areas, while for T60 it is of the same size in urban and rural locations. It is also higher for the T60 for both genders. Also on the employment sides higher education has high pay offs. On average tertiary educated people in T60 have employment rate higher than 80 percent (higher employment rates are recorded for men in urban areas), that is 10-15 percentage

points more than for secondary education. In the B40 group the gap between levels of education is as big as in the T60, but the levels themselves are lower – 67 percent on average.

Table 6. Share of labor income by education levels

	total				rural				urban			
	b40		t60		b40		t60		b40		t60	
	2008	2013	2008	2013	2008	2013	2008	2013	2008	2013	2008	2013
tertiary	55.2%	56.1%	68.4%	66.9%	40.6%	49.0%	51.4%	53.5%	59.0%	57.5%	70.5%	69.2%
full secondary	48.3%	46.6%	62.3%	56.5%	39.3%	41.1%	45.9%	43.7%	54.7%	50.1%	68.0%	62.4%
incomplete secondary and below	38.6%	42.6%	49.1%	49.8%	31.0%	32.5%	28.5%	31.5%	47.8%	52.2%	61.9%	61.7%

	total				male				female			
	b40		t60		b40		t60		b40		t60	
	2008	2013	2008	2013	2008	2013	2008	2013	2008	2013	2008	2013
tertiary	55.2%	56.1%	68.4%	66.9%	58.8%	59.3%	69.1%	67.8%	52.7%	54.1%	67.9%	66.2%
full secondary	48.3%	46.6%	62.3%	56.5%	51.4%	50.6%	65.4%	59.2%	45.9%	43.3%	59.4%	54.0%
incomplete secondary and below	38.6%	42.6%	49.1%	49.8%	44.8%	48.2%	53.2%	54.1%	34.0%	38.2%	45.7%	46.6%

Note: WB own estimates for 2008-2013 based on UkrStat data.

24. **While education offers a premium through both higher wages and higher employment levels, the B40 appear less able to capitalize on these benefits**. Education leads to higher shares of labour income due to both its employment and wage effects: for households in the T60 group whose head has tertiary education the labour income share reached 67 percent, while for B40 it was 10 percentage points lower. Similar gaps in the labor share characterize households whose heads have other educational levels. On the wage side, the premium for tertiary education comparing to complete secondary (or even incomplete tertiary) is 18 percent for the B40 and 30 percent for the T60. For the B40 this premium is much higher in rural areas, while for T60 it is of the same size in urban and rural locations. It is also higher for the T60 for both genders. Also on the employment sides higher education has high pay offs, but less so on the B40. On average tertiary educated people in T60 have employment rate higher than 80 percent (higher employment rates are recorded for men in urban areas), that is 10-15 percentage points more than for secondary education. In the B40 group the gap between levels of education is as big as in the T60, but the levels themselves are lower – 67 percent on average.

<u>Profile of the Bottom 40 and Poor</u>

25. **Overall, the bottom 40 percent of the population feels more deprived and expects more state support.** Overall, when asked where they would classify themselves, 80 percent of the respondents from this group consider themselves poor rather than middle class. In contrast, only 56 percent of the rest of the population consider themselves poor. Interestingly, this is a group where people feel more entitled to state support and less able to look after themselves: over 1/3 of respondents feel that the state has the main or full responsibility to ensure the welfare of its citizen, against about one quarter in the rest of the population.

Figure 22: Education and Labor Market Outcomes for B40 and T60, share of population

Source: WB staff calculations based on HLCS by UkrStat

Source: WB staff calculations based on HLCS by UkrStat

26. **The bottom 40 percent live in households with higher dependency ratios.** Households in the bottom 40 percent are more likely to live in families with children – indeed 55 percent of T60 live in households of adults only as compared to 33 percent for the B40. In contrast, the incidence of households of pensioners only is similar across the two groups. This has two important implications: one is that, as a result of this demographic structure, children represent almost one quarter of the B40 (as opposed to 15 percent for the T60); the other is that the young-dependency ratio for the B40 is 54 percent against 30 percent for the T60. In other words, any B40 adult has many more children to support than is the case for the T60. While this is an empirical regularity across the world and not exclusive to Ukraine, it nevertheless suggests that appropriate services may be needed to facilitate labor market participation for women in the bottom 40 percent.

27. **The B40 have less education and weaker labor market outcomes than their richer counterparts**. Only 28 percent of the adults in this group have some form of tertiary education, against 47 percent of the T60. The bulk of the B40 has completed secondary education. It seems likely that low education compounds the impacts of rural location in reducing the opportunities for B40 households to access jobs, and especially good jobs. The B40's employment rate (for 15-64 age group for both genders) is only 48 percent, against 65 for the T60. They are also more likely to be inactive (36 percent vs 28), and especially unemployed (16 percent of this groups is unemployed versus 7 percent for the T60). As far as job quality is concerned, the HBS provides scant information about it. Self-employed workers with no employees might be a proxy for a low quality segment of

the market. The share of people with this type of jobs is higher for the B40 in rural areas, while in urban areas there are more self-employed with employees. These indicators, however, are quite volatile (in 2008 the situation was different).

28. **The education profile of the B40 and their concentration in sectors such as trade, manufacturing, and agriculture helps explain their low wage premia, suggesting that raising productivity economy-wide and particularly in these sectors would support shared prosperity and poverty reduction.** The B40 are most likely to be working in trade (21 percent), manufacturing (12 percent), and agriculture (10 percent). Furthermore, the construction and transport sectors each employed about 8 percent of the B40. These sectors generally employ workers with lower levels of education. In addition, with the exception of transportation, these sectors appear to provide jobs which tend to pay less than average wages. Public sector services (education, health and public administration and defense), which generally employ workers with higher levels of education, provided employment to almost one quarter of the B40 (11 percent in education, 8 percent in health, and 5 percent in public administration and defense). Of these public sector jobs, only those in public administration and defense appear to pay higher than average wages. In addition to the variation across sectors in B40 employment, it is also likely that the B40 are employed in less education-intensive and lower paying jobs within sectors. Over time, the share of B40 employment has risen in agriculture and trade, but declined in manufacturing and public administration and defense. These patterns could be related to employment and growth patterns across sectors in light of the serious shocks to the economy since 2014. Manufacturing, which has been seriously affected by the conflict and saw a decline in output as well as overall employment, also saw a decrease in the share of B40 workers. On the other hand, the share of B40 in the transport, trade, and agriculture increased significantly, suggesting a shift of B40 workers into these sectors between 2009 and 2014.

Figure 23: Employment by Sectors of B40, percent

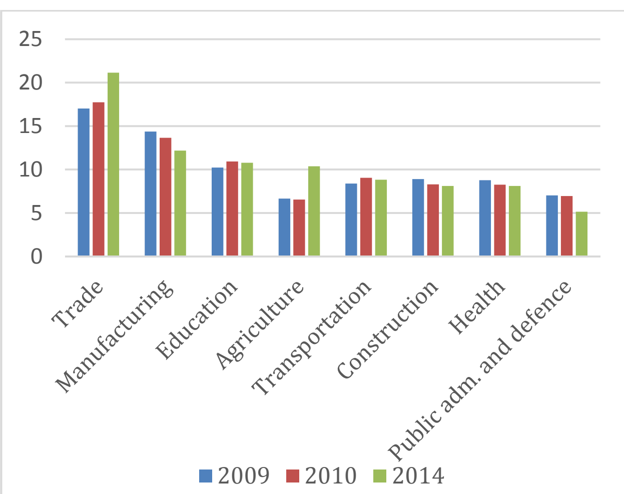
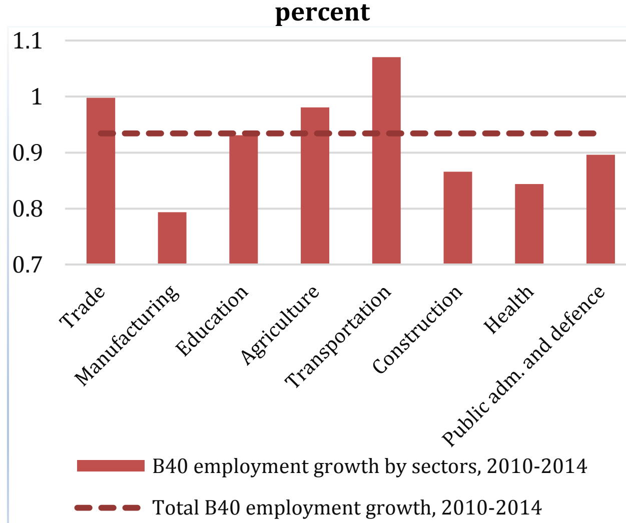


Figure 24: Employment Growth of B40 percent



Source: Bank staff estimates using household budget surveys

29. **People in higher quintiles are better educated, and as it is typically the case, they are more likely to report serious cardiovascular health issues, although data on a broader range of health indicators in not captured in the household survey.** The share of the population with tertiary education is higher for richer quintiles (table 7). This pattern applies for both genders though women are more likely to have tertiary education than men. As far as health indicators are concerned, people at higher income levels tend to report more problems with their health, for example chronic cardiovascular diseases (table 8). This is generally attributed to some "reverse causation" where better access to diagnostics and medical services in general makes them more aware of their health status. Similar patterns apply to gender, with women who are typically found to be more health conscious more likely to report cardiovascular disease (note that mortality data suggest that this should not be the case). The household survey does not cover questions of access, so it is not possible to test the importance of access to services in driving these findings.

Table 7. Level of Education by Quintiles in 2014, Percent of Population above 21

	Total population					Male					Female				
	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th
Tertiary (copmplte or incomplete)	31.9	42.9	44.5	52.2	62.2	28.2	37.2	37.1	46.6	56.7	34.7	47.7	51.0	57.2	67.2
Complete general secondary	57.1	45.6	44.5	38.2	30.8	63.6	53.7	54.8	46.0	37.8	52.1	38.8	35.6	31.3	24.5
Incomplete general secondary or below	11.0	11.5	10.9	9.6	7.0	8.2	9.1	8.2	7.4	5.5	13.1	13.6	13.3	11.5	8.3

Note: Bank staff estimates using household budget surveys.

Table 8. Share of Population Reported Chronic Diseases by Quintiles in 2014, Percent

	Total population					Male					Female				
	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th
Hypertension (high blood pressure)	6.6	10.4	12.6	13.3	14.4	3.9	5.7	6.7	8.5	9.8	8.9	14.8	17.8	17.8	18.8
Cardiovascular diseases	4.4	6.9	7.8	8.6	9.6	2.9	4.7	5.8	7.0	8.3	5.6	8.9	9.5	10.2	10.7

Note: Bank staff estimates using household budget surveys.

30. **The characteristics of the poor are similar to those of the B40.** Like the B40, poor people are more likely to live in rural areas and small towns. They also tend to live in bigger households with more children and higher young dependency rates (table 9). The old age dependency ratio is also somewhat higher for the poor than for the non-poor. As with the B40, the poor have less education – the share of people with tertiary education is more than half among the poor that among the non-poor. The poor also have worse labor market outcomes than the rest of the population, with lower employment and labor force participation rates. They are also more likely to be employed in less productive sectors with lower levels of incomes.

31. **Regional variation in human capital compounds differences by income groups.** In addition to the differences in education levels and household characteristics highlighted above, regional differences also play a significant role. Those are hard to capture with the existing household survey as even before the conflict, coverage by administrative region was uneven. Estimates of regional variation based on four macro-regions are, therefore, more reliable from a statistical point of view, but also a lower bound for the real variation given the higher level of aggregation than administrative boundaries we adopt. Both poor and non-poor people in Western and Central regions on average have lower levels of education and are less likely to be in employment than in the rest of

the country, while Southern and Eastern have higher levels of both indicators. The more industrial Southern and Eastern regions are more urbanized. Their populations are characterized by smaller families with less children and lower young age dependency rates. These variations in social indicators across regions apply to both the bottom 40 percent of the population (depicted in the maps below) as well as for the rest of the population.

Table 9. Social indicators for Bottom 40% of Population by Regions, percent

Young age dependency ratio

Share of people with complete tertiary education

Share of employed in working age population

Note: Bank staff estimates using household budget surveys.

32. **Significant differences emerge also in access to utilities and other communal services, especially in the rural areas.** While most of households in urban areas do have access to water and sewerage (the share is above 90 percent for all quintiles), this is not the case for rural ones (table 10). Access to this type of services is higher for households with higher incomes. In rural areas only 45 percent of the poorest quintile have access to water and sanitation, against 66-67 percent for the top quintile. In urban areas the rich are more likely than the poor to have access to district heating (though the share of poorer households connected to district heating is over 40 percent) – in rural areas access to individual heating is better for richer rural households than for poor. The same pattern of richer households more likely to have access than poorer ones applies also to other utilities, (central gas, bath or shower, home telephone).

Table 10. Access to Utilities by Quintiles for Urban and Rural Population in 2014, Percent

	Total population					Urban population					Rural population				
	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th
District heating	24.3	29.1	34.1	40.1	48.5	41.2	49.4	54.6	61.5	66.3	0.1	0.4	0.2	0.6	1.3
Individual heating system	50.9	50.8	47.9	44.7	40.3	44.5	41.0	38.5	32.4	28.5	60.0	64.7	63.6	67.4	71.4
Water mains	72.1	78.2	79.8	83.8	89.7	91.2	91.5	94.7	95.4	98.0	44.9	59.4	55.1	62.3	67.6
Waste water disposal system	71.5	77.4	79.5	83.6	89.2	90.4	90.8	94.4	95.3	97.8	44.6	58.4	54.8	61.9	66.5
Hot water supply	25.1	37.6	40.5	41.9	53.4	37.7	47.1	54.9	58.7	65.9	7.3	24.2	16.7	10.7	20.3
Gas-fired water heater	16.9	16.0	17.9	19.2	14.7	21.4	18.6	18.3	17.6	14.1	10.6	12.2	17.3	22.2	16.2
Centralised gas supply	76.2	82.4	80.4	82.7	81.7	85.0	90.1	87.9	87.6	85.9	63.7	71.4	68.0	73.6	70.4
Bottled gas	14.4	9.7	12.9	10.3	9.2	6.4	3.6	6.0	3.4	3.0	25.7	18.4	24.1	23.1	25.7
Bathtub or shower	66.4	72.9	75.7	80.0	86.4	85.3	87.0	91.3	93.6	95.4	39.4	53.0	49.9	54.6	62.6
Home telephone	35.2	40.1	39.6	48.7	56.9	46.7	54.1	48.5	59.9	64.2	18.8	20.1	24.9	28.2	37.7

Note: Bank staff estimates using household budget surveys.

33. **While the rich enjoy better access to utilities everywhere, the gaps between richer and poorer households vary significantly by region, and rural/urban areas within region.** Access to main utilities (water and heating) is different across the four macro-regions. While richer household tend to have better access to central heating and water supply everywhere (table 11), the gap between rich and poor varies across region, being particularly marked for access to water in rural parts of the East region, and of the West. In rural areas of the Central region even the rich have less access than poorer households in other regions. Eastern regions had the biggest gap in access between urban and rural areas in 2014, though the conflict is likely to have changed significantly this picture.

Table 11. Access to Utilities by Quintiles for Urban and Rural Population in 2014, Percent

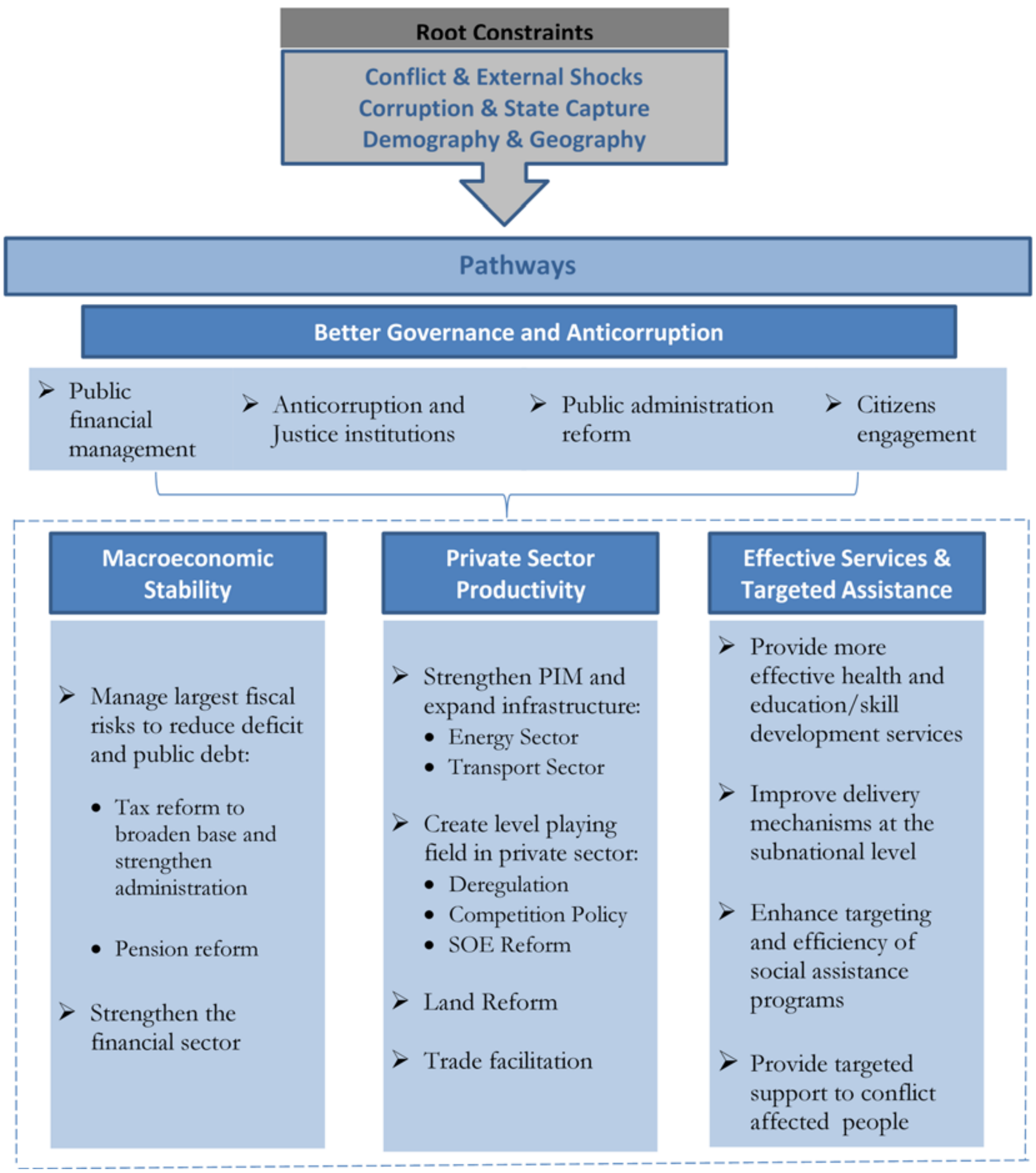
	Total population					Urban population					Rural population				
	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th	1st	2nd	3rd	4th	5th
Region 1 (West):															
District heating	15.2	17.5	12.9	18.6	13.7	33.1	38.1	30.4	40.9	23.4					
Individual heating system	46.1	53.0	54.1	51.1	64.4	44.9	39.7	51.0	48.9	58.7	47.2	64.2	56.4	52.9	70.3
Water mains	67.0	75.8	74.7	77.0	89.6	91.4	86.4	94.5	97.7	98.5	46.2	66.8	60.1	61.1	80.1
Region 2 (Center):															
District heating	28.9	33.3	43.9	48.4	61.5	44.5	56.0	63.3	69.1	81.9					
Individual heating system	55.2	49.2	47.9	39.4	31.3	46.8	39.6	35.0	25.8	17.1	70.9	63.3	77.0	71.2	74.2
Water mains	69.1	72.0	80.3	80.3	86.8	86.4	90.6	94.2	93.8	98.5	36.9	44.7	49.1	48.5	51.7
Region 3 (South):															
District heating	29.4	42.2	45.2	49.9	52.0	44.3	59.2	63.8	68.6	65.9					
Individual heating system	55.1	47.3	40.3	42.7	39.3	44.3	38.1	32.4	28.1	32.2	76.4	68.6	59.2	81.7	65.8
Water mains	84.8	87.0	81.9	91.2	93.4	95.6	97.1	95.4	96.8	98.8	63.2	63.5	49.7	76.5	73.2
Region 4 (East):															
District heating	33.6	34.8	43.1	42.2	59.6	46.0	42.6	52.1	54.1	68.6					
Individual heating system	46.8	54.2	46.0	49.5	28.8	37.8	51.3	39.5	37.4	20.8	69.9	67.5	77.3	92.4	81.6
Water mains	71.3	88.4	89.0	92.6	90.5	94.1	94.9	95.3	94.3	94.5	13.0	59.4	58.6	86.5	63.6

Note: Bank staff estimates using household budget surveys.

IV. Framework: Pathways and Constraints

34. **The analysis in the two prior chapters shows that Ukraine faces key challenges in achieving sustainable recovery and shared prosperity: macroeconomic imbalances, weak productivity growth, and inadequate service delivery.** Large macroeconomic imbalances and instability, including large fiscal and current account deficits and an insolvent banking sector, not only stifle confidence under the current crisis, but also contributed to an unsustainable growth path in the pre-crisis period. Weak productivity and inadequate progress in diversifying exports contributed to economic stagnation after the initial spurt of rebound and growth during 2000-07 fueled by external conditions. Weak labor market outcomes also generated an excessive reliance on unsustainable pensions and social assistance in improving incomes of the bottom 40 percent of the

Figure 25: Ukraine SCD Framework



population. Inadequate and inefficient service delivery has constrained labor market outcomes, particularly for the bottom 40 percent of the population, while contributing to macroeconomic imbalances, and squeezing resources for public investment. In addition to the challenges described above, Ukraine also faces the fundamental challenge of extraordinary levels of corruption and powerful vested interests that seriously impede development progress across the board. This will be described in more detail below. *The challenges described point toward four key pathways toward sustained recovery and shared prosperity in Ukraine: safeguarding macroeconomic stability, boosting private sector productivity, and providing more effective services, while building institutions of better governance and anticorruption*.

35. **The rest of this chapter is organized as follows.** The next section describes the prioritization methodology that is used in this SCD. The specific priority interventions to address within the pathways, while summarized in the framework graphic above, will be discussed further in the subsequent chapters on each of the four pathways. This chapter also describes three "initial conditions" or root constraints facing Ukraine: conflict and shocks; demography and geography; and corruption and state capture. These constraints are important factors in gaining a better understanding of the types of interventions necessary to make progress along each of the pathways identified in this SCD.

Prioritization Method

36. **The prioritization method utilized in this SCD involves a three step process.** These three steps include: (i) identifying the broad pathways to address Ukraine's overarching development challenges; (ii) identifying priority interventions to address the more specific challenges within each of the pathways; and (iii) assessing the criticality for twin goals and time horizon for each of the priority interventions.

37. **The first step involves identifying the pathways that address Ukraine's overarching development challenges.** As part of this first step, the diagnostics of growth, sustainability, poverty, and shared prosperity have contributed to identifying the pathways of macroeconomic stability, private sector productivity, and more effective service delivery. Furthermore, the subsequent analysis of some of the initial conditions and constraints affecting progress along the three pathways shows that better governance and anticorruption institutions is a cross-cutting pathway important in achieving Ukraine's development objectives across the board. In particular, the analysis will show that addressing the governance challenge will require a two-pronged strategy that includes building better governance and anticorruption institutions and advancing reforms along the three other pathways that disempower vested interests. In this sense, the cross-cutting pathway is not so much a filter for priorities and interventions within the other three pathways, but rather a foundation to facilitate progress across the three pathways.

38. **The second step in prioritization involves identifying priority interventions to address the specific challenges within each of the pathways.** This second step relies on the analyses of the SCD as well as extensive deliberations and consultations across multiple sectoral teams engaged

in Ukraine. First, the analyses of growth, sustainability, and poverty goes beyond the identification of pathways and also informs the selection of priorities and interventions within the pathways. Second, the analyses in the subsequent chapters on the cross-cutting and three other pathways further informs the selection of priorities and interventions. Third, extensive deliberations and consultations have taken place across the sectoral teams in the context of: preparing the policy notes delivered to the new government of in June 2016; the extensive inputs prepared and consultations undertaken for the SCD across different sectoral teams; the work by the different sectoral teams in their respective engagements on development prospects and priorities in Ukraine; subsequent prioritization discussions held across the full country team in October 2016; external consultations held with the government, private sector, civil society, and development partners in October-December 2016.

39. **The third step involves assessing the criticality and time horizon for the priority interventions.** The first two steps result in four pathways and fifteen priorities. While this is narrowed down from a wider universe of possible pathways and priorities, fifteen priorities is still a large number. Not all of them will be equally critical in helping Ukraine generate sustained recovery and shared prosperity. Furthermore, not all of them can be expected to be implemented over the same time horizon. Therefore, the analyses in the subsequent chapters on the cross cutting and three other pathways assigns a criticality rating of “critical”, “high”, or “medium” for each of the priority interventions. For example, pension reform is assessed as critical since is represents a fundamental source of fiscal and macroeconomic vulnerability. In addition, the assessment of the state of affairs, challenges, and prospects for progress within each priority area is used to determine the time horizon (“immediate”, “short”, or “medium”) over which progress is needed and can be expected. For example, while public administration reform is critical for better governance, progress cannot be expected immediately, but rather over the medium term.

40. **It is important to note that significant complementarities exist across the different pathways and priorities.** In other words, the priorities within the pathways do not contribute to addressing mutually exclusive challenges. For example, improving the effectiveness of service delivery can help consolidate Ukraine’s large current expenditures and thus contribute to macroeconomic stability. Similarly, improving financial sector stability not only contributes to macroeconomic stability, but also facilitates growth of credit to the private sector, which enables productivity and job creation. Finally, building institutions of better governance and anticorruption contribute to progress across the three other pathways.

Constraints

41. **The rest of this chapter discusses three important constraints that affect development progress in Ukraine: conflict and shocks, demography and geography, and corruption and state capture.** First, the double shocks from the conflict and lower global commodity prices in 2014-15 triggered macroeconomic instability, depressed economic activity, employment and livelihoods, and disrupted delivery of services. This added to a history of volatile external conditions with the commodity boom and free capital flows of 2000-07 followed by the global financial crisis of 2008-09.

Second, the demographic pattern of a declining working age population puts a larger burden on productivity and capital accumulation in driving growth and leads to larger social insurance obligations that need to be supported by fewer workers. In addition, Ukraine's geography with a rich endowment of natural resources can inhibit export diversification and provide a ready habitat for corruption and rent seeking, although its location adjacent to large markets represents a significant opportunity to developing its export base. Third, state-capture and corruption are at the heart of many of the structural bottlenecks facing Ukraine, including fiscal liabilities for the energy sector, insolvent banks, inadequate protection of property rights, anticompetitive business practices, and inefficient delivery of services. Combatting state capture and corruption will, therefore, require reforms across a number of areas to disempower vested interests, as well as efforts to strengthen institutions specifically dedicated to PFM, anticorruption and justice, and public administration.

Conflict and External Shocks

42. **The conflict has had a widespread impact on economic activity and prospects in Ukraine, so that extra effort will be needed to bolster confidence in the economy.** The implications for economic activity in Ukraine's eastern industrial heartland were drastic. Before the conflict, the Donetsk and Luhansk regions accounted for almost one-quarter of Ukraine's industrial activity and an equal share of its exports. In addition, disruptions in industry, transport and small and medium enterprise activity led to widespread job losses and overall confidence in the economy has been seriously undermined. Continuing insecurity means that Ukraine must go the extra step to bolster confidence in its economy.

43. **The conflict has also had a considerable human cost, and will require targeted services and opportunities for affected populations.** With the Donetsk region home to a large population of the bottom 40 percent, and with large numbers of pensioners in Donetsk (1.4 million before the conflict) and Luhansk (730,000 before the conflict), the human cost on populations in conflict affected areas has been severe. Vulnerable groups in conflict areas, especially pensioners, women, children and people with disabilities are most at risk, especially as a result of a lack of access to quality housing, water and electricity and health care. While the wellbeing of vulnerable groups in conflict areas is a concern, the footprint of the conflict extends much more widely. According to UN estimates, the conflict has resulted in 9,800 deaths through January 2017. Furthermore, large scale displacement means that social and humanitarian costs are felt by both displaced and host communities—service delivery deficits, overburdened social welfare services, joblessness, increasing social tensions, and deteriorating debt and credit relations. It is estimated that as a result of the conflict, about 2.5 million people have been displaced both internally (1.7 million) and outside Ukraine (1 million). This represents approximately 5 percent of Ukraine's population. Managing the human cost of the conflict will require providing targeted services and supporting employment generation among conflict affected populations and host communities.

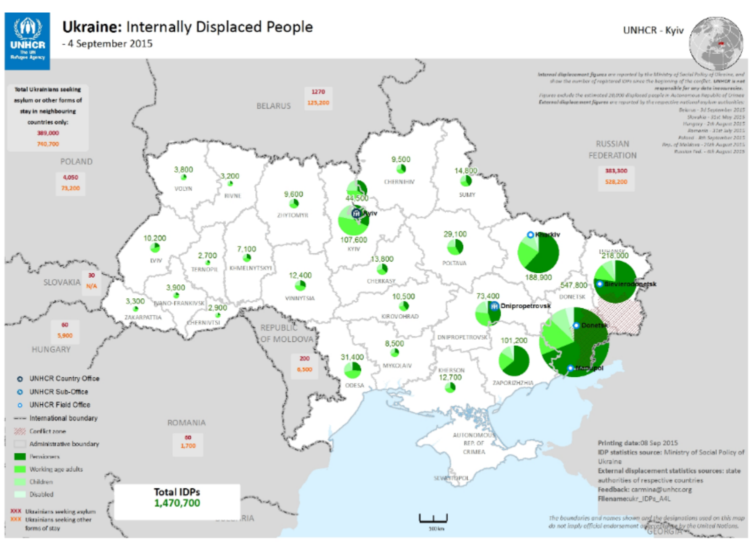
Development Impact of the Conflict

Conflict in eastern Ukraine has had a severe impact on the lives and livelihood opportunities of millions of Ukrainians. Since the outbreak of fighting in 2014, about 9.800 people have been killed, over 2.7 million displaced (about 5 percent of Ukraine's population) and over 4 million people in the eastern Donbas region have been directly affected. As the conflict spills into its third year, there are mounting development challenges alongside humanitarian concerns, including pressures on the economy, lack of investment, joblessness, service delivery deficits, and social tensions.

Economic Impacts	Social Impact
• Disruption of economic activity in Ukraine's eastern industrial base (one quarter pre-crisis industrial production) and significant decline in exports • Crisis of investor confidence: Uncertainty related to the conflict undermines investor confidence • Widespread job loss. Net employment in Donetsk and Luhansk down by 40 and 70 percent, respectively (about 800,000 jobs) by end 2014. • Fiscal pressures – Revenues from Donbas down 40 percent in 2014 and military expenditures up to 5 percent of GDP in 2015.	• Acute impacts for over 4 million people living in conflict-affected areas/800,000 living close to the 'line of contact' • Insecurity has interrupted service delivery, infrastructure, urban development • Over 1.7 million IDPs: socio-economic pressures on displaced and host communities • Over 200,000 veterans integrating back into communities

The conflict, along with the sharp decline in commodity prices, has had a considerable impact on Ukraine's economy and its development prospects. The Donbas region was an important part of Ukraine's industrial base. The conflict has caused significant contraction of production and revenues, disrupted supply chains and trade, and undermined investor confidence. The conflict has also put significant burden on the national budget. However, industry in eastern Ukraine was outdated and obsolete prior to the outbreak of fighting and recovery efforts could offer the opportunity to build back better—to modernize industry, push new technologies, and pursue efficient energy sources.

The direct impacts of the conflict are faced by eastern populations but also by internally displaced persons, former combatants, and host communities across Ukraine. More than half of IDPs have stayed in Donetsk and Luhansk regions near the conflict zone, but IDPs have also settled throughout the country in search of opportunity. The overall economic situation and the increasingly protracted nature of the challenge means IDPs are becoming increasingly vulnerable. As the conflict continues, development impacts are felt by both displaced and host communities—service delivery deficits, overburdened social welfare services and housing markets, joblessness, and social tensions.

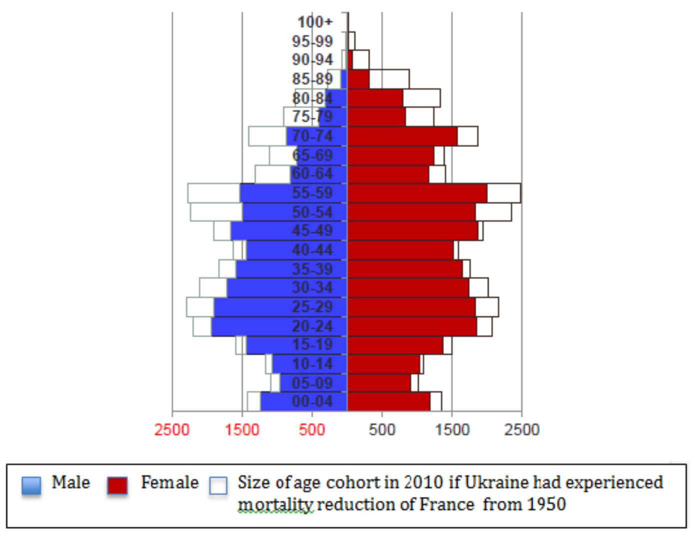


44. **In addition to the conflict, Ukraine has been hit by large external shocks, another reason why extra effort will be needed to bolster confidence.** Global commodity prices have declined sharply since 2014. This has not only impacted Ukraine's exports of commodities globally, but it has also meant that many of Ukraine's resource rich export markets have been hit by recession and have experienced sharp depreciation in their currencies. Given the weak external outlook, Ukraine will need to go the extra mile to restore macroeconomic balances and confidence in its economy. The weak outlook for commodity markets also presents an opportunity for Ukraine to develop a more diversified export base. In fact, Ukraine's reliance on commodity markets has contributed to its volatile and unsustainable growth path in the pre-crisis period.

Demography and Geography

45. **Ukraine's working age population has been declining while the elderly population has been rising due to high mortality, low birth rates, and considerable out-migration.** The working age population fell from around 34 million in 2000 to 32 million in 2013 and is projected to keep on declining to reach 25 million by 2050. Ukraine ranks second in the world together with Bulgaria and Georgia and after Moldova in terms of the pace of aging. The share of elderly population is projected to rise significantly. This demography shift has significant implications for sustained recovery and shared prosperity.

Figure 26: Ukraine Population Age Distribution



46. **Low fertility and high mortality rates result in low life expectancy at birth (71 years in 2013) that lag EU and the OECD averages by more than 10 years.** The main losses in life expectancy are due to excess mortality from non-communicable diseases (NCD) among the male, especially the rural population. Low life expectancy today is the result of a steep loss at the beginning of the 1990s common to other former Soviet countries caused mostly by stress-related heart attacks, alcoholism and accidents, and slow improvements subsequently but only after 2011 when Ukraine reached pre-transition life expectancy levels. The recent conflict in the East and the economic crisis that followed could jeopardize the positive trend in life expectancy of the last few years. The decline

in working age population and the increase in the elderly population means that health care services will need to be improved significantly not only for the elderly, but also for the working age population through a scaling up of preventive and primary care.

47. **In addition to the human costs of low life expectancy, the decline in fertility and marked excess mortality among working age men have significant economic consequences.** If Ukraine had experienced the same mortality reductions as France since 1950, its labor force would be 19 percent larger than it is today. This implies a loss of productive potential, on top of the human costs of the lives lost. This loss of working-age population to high adult mortality rates has the potential of raising the economic dependency ratios to levels that are unsustainable. In addition to the loss of productive population, the decline in the working age population raises significant questions about the sustainability of social insurance systems.

48. **The declining working-age population means that substantial growth in productivity is needed to generate higher per capita incomes.** This challenging requirement puts a premium on the range of factors necessary to improve productivity, including better infrastructure, entry or more productive firms and exit of less productive firms and productivity improvements within firms, tapping international trade opportunities, and effective functioning of the labor market. The free movement of labor across firms, sectors, and geographical areas is an important component of productivity growth. Evidence suggests that the degree of internal migration in Ukraine is less than in other ECA countries, and within-country migration appears to be taking place towards lower productivity and lower wage areas.

49. **Ukraine has a unique geography, with a rich endowment of natural resources which are assets but have also encouraged rent seeking and stymied reforms and diversification.** Ukraine is endowed with considerable natural resources, including: rich deposits of various metal ores (more than 5 percent of the world reserves of iron ore), one-quarter of the world's black soil (over 60.4 mn ha), the world's largest number of mineral rock deposits; native sulfur, potash salt, in addition considerable fuel and energy reserves that have been discovered. The natural resources lead to significant economic potential for development of such industries as agriculture and food processing, metallurgy, chemicals, as well as the production of ceramic articles and construction materials. At the same time, the rich endowment of natural resources coupled with the commodity boom of 2000-2007 discouraged diversification and encouraged rent seeking and corruption. The influence of vested interests has also been a serious obstacle for structural reforms.

50. **Ukraine's geography also puts it at the center of major markets and leads to significant potential to develop exports.** Ukraine's geographic location is at the center of Eastern Europe, at the crossroads of major transportation routes from Europe to Asia and from the Scandinavian states to the Mediterranean region. This presents a very favorable environment to develop international trade. Ukraine is adjacent to the EU to the west, Russia to the East, and the Black Sea to the south. Ukraine may also benefit from the recent signing of DCFTA agreement with the EU, which can ease access to the large and competitive EU market.

Corruption and State Capture[1]

51. **Corruption and state capture are entrenched in Ukraine and a dominant constraint impeding reforms and progress toward sustained recovery and shared prosperity.** Corruption permeates all walks of public life in Ukraine. On many aggregate measures of corruption, Ukraine scores closer to the lowest income countries than to the EU which it aspires to join. Ukraine was in the 15th percentile worldwide in the WGI (World Governance Indicators) Control of Corruption indicator in 2014, well below Poland and Romania (71st and 53rd percentile, respectively), as well as averages for low middle income countries (37th percentile), the ECA region (64rd percentile), and sub-Saharan Africa (30th percentile). With such extraordinary levels of corruption and state capture, powerful vested interests across the board seriously impede Ukraine's pathways toward sustained recovery and shared prosperity. Widespread tax evasion and related party lending undermine macroeconomic stability, a highly concentrated and anticompetitive production structure inhibits productivity and job creation, and weaknesses in the management of public resources impedes efficient and effective delivery of public services to the population.

52. **Ukraine has struggled with corruption and state capture since its independence more than two decades ago.** Privatized state assets were concentrated in a few hands in the early transition years. In addition, commodities were often bought at state-regulated prices and sold at full market prices, while underpriced leases of large tracts of agricultural land, budget subsidies, and low-interest bank loans were made available to favored persons. All this has been made possible by partial and incomplete market reforms. As a result, a number of oligarchs have dominated large sectors of the Ukrainian economy (energy, metallurgy, mining, chemicals and more recently agriculture), extracting rents, and influencing public institutions, including through direct representation in political parties and the Parliament. The symbiosis linking oligarchs with politicians and state officials stands in the way of reforms that could level the playing field and eliminate rents. Vested interests have financed political parties and expensive election campaigns, and influenced decisions of officials in state-owned enterprises, courts and presidential administrations[2] in order to create and maintain a non-level playing field to their benefit. Civil society has been too weak to counter these influences, rendering politicians and state officials accountable more to the few than to the many who voted for them.

53. **Systematic evidence points to a high degree of corruption facing Ukraine.** According to Transparency International's 2015 Corruption Perception Index (CPI), Ukraine ranks 130th out of 167 countries; only Tajikistan, Uzbekistan and Turkmenistan in the ECA region performed worse. The *Global Corruption Barometer 2013* shows that 95 per cent of Ukraine's citizens believe that corruption levels had either worsened or stayed the same over the previous two years, with the judiciary and the police being perceived as the sectors most affected by corruption. Anticorruption

[1] State capture is defined as the actions of individuals, groups, or firms both in the public and private sectors to influence the formation of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials (Hellman and Kaufmann, 2001).
[2] See Aslund (2009) and Aslund (2015)

institutions in Ukraine have been ineffective, with financial declarations of high level officials and civil servants hard to verify and lacking accountability for containing false information. Until very recently, conflict of interest was not adequately legislated. Work is now underway to establish a preventive anticorruption agency, broaden and publicize income and asset declarations, and implement conflict of interest provisions. At the same time, rightsizing the public sector could create the fiscal space to align remuneration with the market and help increase the attractiveness of the civil service and bring in qualified staff.

Figure 27. Corruption Perceptions Index, 2015

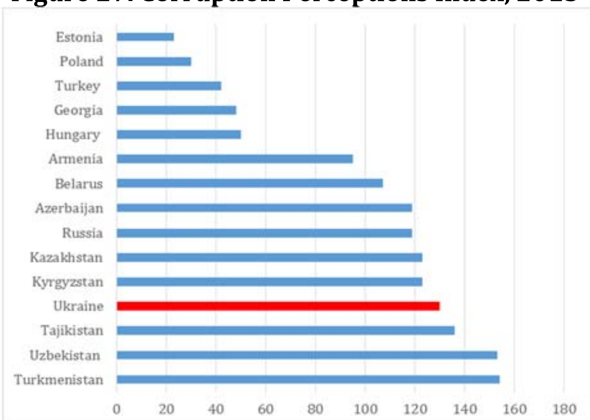
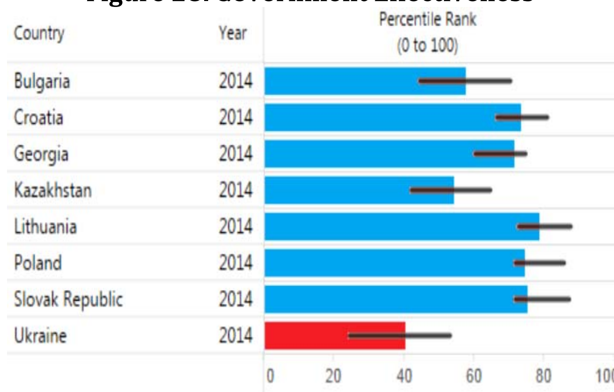


Figure 28. Government Effectiveness



Sources: TI Corruption Perceptions Index and World Governance Indicators

54. **Poor governance, including a broken social contract between citizens and the state, is a major structural impediment to effective provision of public services.** Ukraine scores below most comparator countries in terms of government effectiveness, as reflected in the World Governance Indicators. The government has an outsized role in the economy (with general government spending 43 percent of GDP in 2015), but government effectiveness is poor. An ineffective public sector undermines health and education service-delivery, public investment in infrastructure, and protection of property rights for the private sector. Furthermore, the weak independence and low quality of the judiciary has a direct bearing on prospects for improving governance across the board. Unless government effectiveness is strengthened and impunity removed from the state, Ukraine will face difficulty in making progress along its pathways toward sustainable recovery and shared prosperity.

V. Cross-Cutting Pathway: Better Governance and Anticorruption Institutions

55. **A two-pronged strategy is important in addressing Ukraine's governance and corruption challenges.** *The first prong of the strategy involves building the institutions of better governance and anticorruption that would have a cross-cutting impact* in supporting progress along the pathways to sustained recovery and shared prosperity. These include institutions of public financial management (PFM), anticorruption, justice, and public administration. Strengthening PFM institutions would help improve efficiency, accountability, and transparency in the use of public resources, including for service delivery, public investment, and state-owned enterprises. This would help reduce fiscal risks and contribute to more effective infrastructure and service delivery. Building anticorruption and justice institutions would contribute to overall transparency and accountability in the interface between the citizen, businesses, and the state, while battling state capture, administrative corruption, and the influence of vested interests across the board. Improving public administration by building a more professional and motivated civil service and strengthening strategic planning and coordination will help reduce incentives for corruption while improving delivery of public services.

56. **The second prong of the strategy involves advancing reforms across the three pathways of macroeconomic stability, productivity, and service delivery to disempower vested interests.** Reforms in tax administration and the financial sector can help not only contain macroeconomic imbalances, but also disempower powerful underlying vested interests by cutting tax evasion and reining in opportunities for related party lending. Similarly, streamlining business regulations, increasing competition, and reforming land markets would not only help level the playing field and support productivity growth, but also undercut rents for powerful vested interests. Furthermore, effective decentralization can not only help deliver more effective services under the right circumstances, but can also undercut a centralized system of influence All this means that an important prong of a better governance and anticorruption strategy is to push progress on reforms across the board that undermine vested interests.

57. **The analysis in this chapter suggests that building better governance and anticorruption institutions are critical for Ukraine, although improved outcomes may be realized in the medium term.** Building better anticorruption, justice, and public administration institutions are critically important for Ukraine and would have far reaching ramifications for progress along each of the other development pathways. At the same time, building such fundamental institutions takes time and actual improvements may be realized in the medium term. Nonetheless, it is important to continue to push for specific implementation steps in areas where the process has been initiated, such as effective implementation of anticorruption laws. And in other areas that are at a more incipient stage, such as justice and public administration reform, it is important to launch the process. While these critically important reform processes are underway, immediate and systematic efforts to enhance citizens' engagement will be critical in facilitating progress. The following table summarizes the priority interventions for building better governance and anticorruption institutions identified through the analysis in this chapter.

Priorities	Criticality	Time horizon
Public financial management: Implement updated PFM Strategy, including medium term budgeting, streamlining performance based budgeting, and introducing fiscal risk assessment framework.	High	Short, Medium
Anticorruption and Justice Institutions: Effectively implement new anti-corruption laws; strengthen public trust in justice system by improving enforcement and HR reform.	Critical	Short, Medium
Public administration reform: Improve policy and decision-making; streamline personnel while improving human resource management; undertake merit-based appointments and optimize salaries.	Critical	Short, Medium
Citizens Engagement: Build on successful post-Maidan mobilization by promoting more systematic planning, management, and communications based on information and evidence-based analysis.	Critical	Immediate, Short

Public Financial Management

58. **Strengthening PFM institutions is a key component of improving governance in Ukraine by improving efficiency, accountability, and transparency in the use of public resources.** In the face of substantial fiscal pressures in recent years, fiscal management in Ukraine has been dominated by short-term consolidation needs, while long term institutional improvements have been sidelined. In recent years, progress has been made in budget transparency, revamping intergovernmental transfers, and changes to procurement to allow for implementation of e-procurement and reduced number of exemptions from competitive tenders. However, progress has been slow in such important areas as the policy alignment of budgeting, multiyear fiscal planning and budgeting, expenditure consolidation and fiscal risk management, and internal control. The PFM system in Ukraine thus hampers efficient service delivery. The budget process does not have a strong policy or strategic focus and a medium-term fiscal strategy to guide the budget process is lacking. Performance information is included in program budgets but tends to focus on outputs rather than outcomes and results. Weak links between sector plans and budget allocations and weaknesses in public investment management both at selection and implementation stages are not conducive to efficient targeting of resources to strategic policy priorities.

59. **Ukraine's PFM system is control oriented and rigid.** The control environment is burdensome and obliges those responsible for the delivery of public services to focus their efforts on compliance rather than improving performance and the effectiveness of service delivery. Cash rationing practices have helped curtail the deficit during the fiscal crisis, but will add further rigidity budget system once the fiscal situation normalizes. Ongoing efforts to improve internal audit and external audit and focus on performance auditing are only likely to have an impact on the performance orientation of the PFM system over the longer-term.

60. **A key step in strengthening PFM institutions going forward is to continue implementation of PFM reforms that enable efficient service delivery and ensure fiscal discipline.** The reform process is shaped by the recent adopted PFM Reform Strategy as a long-term vision for reform, along with an extended action plan for the period 2017-2020. Key reform elements include: moving forward with implementation of medium term budgeting including establishing

multi-year ceilings for line ministries and agencies; streamlining performance based budgeting by reducing the number of programs and linking results with the decisions making process at both the parliament and executive levels; fully institutionalizing and introducing a fiscal risk assessment framework. The governance arrangements to implement the PFM Strategy would be essential to success of the reform process. High level leadership's upfront commitment to clear and measurable results, and monitoring implementation of the PFM reform actions is required. Ukraine has made considerable process in bringing budget legislation to good international practice in many areas. The challenge going forward is to ensure transformation of practices. Practice changes would require building institutional and human capacity across all government agencies. Development and implementation of a PFM ICT Strategy will enable a comprehensive and cost efficient ICT support to all the reforms.

Anticorruption and Justice Institutions

61. **Effective implementation of new anti-corruption laws aimed at battling grand corruption and state capture is crucial in improving governance in Ukraine.** In 2014, a number of anti-corruption laws were adopted, institutionalizing some of the anti-corruption initiatives aimed at battling corruption and state capture. Most notably, a package of anti-corruption laws was passed in October 2014, which establish the Anti-Corruption Bureau with investigative functions and the Specialized Anti-Corruption Prosecutor's Office (SACPO) to prosecute high-level corruption crimes. Another law creates a corruption prevention body, National Agency for Corruption Prevention (NACP), whose responsibilities include verification of asset declarations of public officials and implementing conflict of interest provisions. Both the Bureau and NACP are still in early days of their operations. Another newly adopted law regulates the provision of information on ultimate/beneficial ownership, closing some of the loopholes for not declaring assets that are formally registered to other individuals or entities. An important law was adopted in October 2015, introducing comprehensive rules on financing of political parties and assigning supervisory powers over political financing to the NACP. In 2015, Ukraine also adopted laws that establish an Agency for Tracing, Recovering and Managing Criminal Proceeds and the State Bureau of Investigations that will deal with corruption at the middle and lower levels of government. The success of the Bureau, SACPO and NACP, as well as other new agencies, hinges on their financing, staffing and full cooperation from other government bodies.

62. **While the passage of these laws is an important step, to strengthen Ukraine's commitment to fight corruption, the government will need to publicly endorse a set of ambitious yet achievable anti-corruption goals.** Such goals should focus on ensuring the success of the new anti-corruption institutions by providing political and financial support and working to ensure the cooperation and collaboration of other government bodies. The Bureau and the NACP will focus both on investigating and prosecuting existing corruption as well as on preventing it by addressing conflicts of interest, illegal financing of political parties and ensuring the filing and publication of accurate asset declarations. If done well, these efforts could markedly increase the accountability of public officials and transparency about their assets – a worthy anti-corruption goal

in itself. The Government should focus on selected achievable activities in order to build success one step at a time.

63. **The justice system is poorly trusted and ineffective.** Public trust in the courts has been as low as 9 percent (December 2014 survey, Democratic Initiative Fund). In addition, international comparisons show Ukraine performing well behind a number of regional comparators in terms of the effectiveness of its rule of law. The sources of Ukraine's weak justice sector governance are complex, and have resulted in limited reforms to restrain arbitrary state actions and for legal redress. Ukraine's justice sector shares governance challenges with many transition countries, suggesting that historical legacies could play an important role, such as the emergence of oligarchs who have sponsored political parties and often exercise strong influence over government institutions and officials across all three branches of state. In addition, some unfinished justice reforms have severely impacted the state's ability to collect revenues. The significance of the challenge is illustrated by the high cost of enforcing contracts in Ukraine (46 percent of the total cost of the claim (compared to the ECA average of 26.2 percent according to DB2016) and the impact of non-enforcement of civil claims (Ukraine's recovery rate is estimated to be 3 cents on the dollar compared to, for example, 27 cents for the US).[3] Civil society, while strong, has not yet become a force to consistently influence policy-makers to act in the public interest. Social collective action is often hampered by the juxtaposition of unrealistically high expectations of what the state should deliver on justice reform, against low confidence in its ability to do so.

Ukraine: Constitutional Amendments to Strengthen Justice and Anti-Corruption Reforms

The Verkhovna Rada (parliament) in mid-2016 adopted several constitutional amendments and a new law ("On the Court System and the Status of Judges"), which together aim to strengthen judicial independence and streamline the functioning of the justice system. Some legal experts have opined that if implemented properly, they could reduce corruption and enhance judges' accountability and system efficiency. The seven key changes comprise:

a) ***Abolition of existing High Courts (reducing the number of court tiers from four to three), changes to Supreme Court functions and composition, and establishment of two new High Courts.*** The three existing High Courts[4] (above the courts of appeal and below the Supreme Court) will be abolished and the Supreme Court will consist of four courts of cassation (criminal, civil, commercial and administrative) and a grand chamber. This will eliminate Ukraine's system of three parallel independent specialized high courts and aims to reduce – over time - forum-shopping, inconsistencies, unpredictability and corruption. A High Specialized Court on Intellectual Property and a High Specialized Court on Anti-Corruption will be set up; their place in the judicial system remains unclear.

b) ***Actions to improve judicial independence, competence and ethics***: Judges will be appointed by the President of Ukraine upon nomination by the Supreme Council of Justice, a new state body to be established to replace the current High Council of Justice. The competence to appoint and to remove judges was transferred to the Supreme Council of Justice from the Parliament of Ukraine. The probation period of five years will be revoked for newly appointed judges, and significantly increased base salaries will be

[3] As a result of high recovery costs and low recovery rates on debt collection, private companies in Ukraine are increasingly turning to private debt collection companies (including some foreign firms) to address debt collection. This has become a growing but completely unregulated industry in Ukraine.

[4] High Court of Civil and Criminal Cases, High Commercial Court and High Administrative Court

provided. Sitting judges will be tested on professional expertise and ethics. Failure to demonstrate compliance, or refusal to participate in the review, will constitute grounds for dismissal.

c) ***Stronger anti-corruption provisions for judges:*** Each judge will have to submit two additional annual declarations, one to disclose on family relations and the other a declaration of integrity, to be made publicly available. Judges have to confirm the legality of the source of their assets, with failure to justify sources of funds and other assets being treated as grounds for dismissal. Judges' blanket immunity from prosecution will be lifted; immunity from criminal liability will only be limited to functional immunity[5].

d) ***Changes to the prosecutorial function.*** The amendments abolish the wide general supervisory authority of the general prosecutor's office and limit its functions to (a) pre-trial investigations, (b) supporting public prosecution in courts and (c) representing the state's interest in courts.

e) ***Representational monopoly of advocates.*** The Constitutional amendments also propose to regulate representation of litigants before courts: from January 1, 2017 only licensed advocates can represent clients in cassation matters; from January 1, 2018 in appeal matters and from January 1, 2019 in courts of first instance. (Currently, any duly authorized individual can represent any person in court except in criminal proceedings).

f) ***Greater access to the Constitutional Court*** has been provided to all individuals and companies where there are claims that a final court decision contradicts the Constitution. A complaint may be filed only after all other remedies have been exhausted in regular Ukrainian courts. This amendment could significantly improve access to justice, obviating (in many cases) the need for remedies from international tribunals (e.g. the European Court of Human Rights).

64. **Justice reform is an important component of strengthening governance in Ukraine and facilitating its aspirations of joining the European Union.** In order to accomplish this, it will be important to systematically implement the integrated justice reform strategy, where credible results will depend on how Ukraine's authorities address a number of key challenges in the justice system. First, pervasive corruption and state capture in the courts and prosecution has resulted in persistently low public trust and credibility. Second, slow and non-transparent enforcement of civil cases has locked up scarce capital, impeded the business climate and adversely impacted the economy including the banking sector[6]. Enforcement reportedly commences on less than 10 percent of civil decisions, with thousands of civil decisions – whose number, monetary value and pendency are not yet accurately assessed - remain unenforced, denying justice to firms and individuals. Third, ensuring access to justice for vulnerable groups and businesses will be important in supporting broad-based employment generation and inclusive growth. Fourth, reversing the effects of decades of under-performance and over-staffing, compounded by structural and institutional dysfunctions and conflict-wrought infrastructure loss and damage. Finally, improving the enforcement of judicial decisions could enable Ukraine to collect considerable sums from private entities who, for years, have owed money to the state.[7]

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[5] Judges will be protected from liability only in respect of judicial actions and can be prosecuted for other offences.

[6] The banking system faces significant constraints associated with shortcomings in court decisions and enforcement related to nonperforming loans, transfer/sale of assets, foreclosing of collateral, and other issues.

[7] According to the Ministry of Justice data, more than 400 billion hryvnias (equivalent to $16 billion) are 'locked up' in unenforced civil claims pending with public bailiffs in the Kyiv headquarters unit of the State Enforcement Service (SES) Department under the Ministry of Justice. According to World Bank staff estimates, at least a quarter of this amount represents debts owed to the state by private sector debtors, and another quarter represents debts owed by private sector debtors to Ukraine's cash-strapped SOEs including Naftogaz.

Public Administration Reform

65. **Improving public sector performance requires professional, motivated and well-managed personnel.** Public administration in Ukraine suffers from low effectiveness, an ingrained culture of corruption and lack of a service culture, all of which translates to only 8 percent of the population expressing trust in the government according to the 2015 Gallup poll. The public sector in Ukraine employs a very large number of people, while the level of salaries is low and uncompetitive, reducing attractiveness, weakening retention of staff with high-level competences and skills, and leading to incentives for corruption. The public wage bill amounted to 9.4 percent of GDP in 2015, while public sector employment in 2013 was over 1 million employees in public administration and national defense, and an additional 1.7 million in education and 1.2 million in healthcare. Over 1 million employees, almost quarter of the total public employment, worked in a very large SOE sector represented by 1,833 active entities. These data point toward system-wide inefficiencies and poor service delivery. According to the Gallup poll barely half of the population are satisfied with educational services, while only 22 percent are satisfied with Ukraine's health services.

66. **The challenge facing the Government is to improve transparency in policy and administrative decision-making, appoint public servants based on merit and increase salaries while streamlining state personnel and improving human resource management.** To do that effectively, it will be important to have access to accurate and up-to-date personnel information, including a central personnel database, which currently does not exist. In addition, opening the policy dialogue to increased citizen engagement and monitoring of the performance of public institutions should help to improve the effectiveness of Ukraine's public administration. The Government took first steps in this directly by publishing quarterly reports of its activities online. The quarterly report for the second quarter of 2016, includes information on the Government's recent initiatives and decisions, including the initial implementation of the civil service law, process of institutional streamlining of central executive bodies, introduction of e-licensing for construction permits, creation of Business Ombudsman Office and enhancing transparency in public procurement.

67. **The Government of Ukraine has identified a transparent public administration and professional civil service as one of priorities.** In June 2016, the Government approved a Public Administration Reform (PAR) Strategy. The strategy aims at improving effectiveness, efficiency and transparency of the public administration in line with the Principles of Public Administration developed by SIGMA. The PAR Strategy seeks to: (i) overhaul the system of policymaking and strategic planning to make it transparent, accountable and results-oriented; (ii) significantly improve the performance and accountability of the civil service; (iii) better align organizational structure of the public administration with the key government functions and strategic goals; (iv) improve the quality, access and efficiency of government services; and (v) achieve effectiveness, efficiency and transparency in the management of public resources through enhancing the public financial management system. To implement the goals of Public Administration Reform Strategy, the Government, particularly the Public Administration Reform unit of the Secretariat of the Cabinet of

Ministers will need to assume a leadership role to coordinate, monitor and support reforms, and hold responsible institutions accountable.

Citizens' Engagement

68. **During the Euromaidan protests of 2013, civil society emerged as a central vehicle for change in Ukraine.** The pivotal role played by civil society organizations (CSOs) and ordinary Ukrainian citizens in pushing for change, heightened civic activism and fundamentally altered the way Ukrainians engaged in the governance of the country. The Maidan and the period after – which included the Maidan-appointed interim government – illustrated the real and potential role of a maturing civil society, better organized and a stronger force on key issues. The strengthened social capital also illustrated how young professionals could be empowered to stimulate change and demand for change. These transformations are only partially reflected in demand-side governance indicators. Ukraine reached a sub-rating of 3 (partly free) on the 2016 Freedom House scale (1= most free and 7 =least free) on key civil rights indicators, up from 4 under the Yanukovych regime, but still pressured by the struggle in conflict-areas. Disaggregated indicators show that while the voice of Ukrainian citizens has improved, the country is yet to see a marked improvement in accountability.

69. **Civil society engagement to more systematically promote the design and implementation of the reform agenda is essential.** While civil society has played a central role in pushing for change in Ukraine since the Maidan, harnessing its energy and enthusiasm to engage more systematically and effectively on the reform agenda going forward will be important. Civil society is now composed of a myriad of formal and informal, active and inactive, and mostly voluntary CSOs. Despite its successes, civil society organizations lack planning and management skills, are yet to develop professional communications skills with its members and the press, and to channel high levels of motivation into coordinated systems necessary for effective coexistence. Moreover forums for dialogue over reforms are immature, and platforms for coordination with government are far from effective (e.g. the civic councils). A key role for civil society organizations will be helping to change the mindset of citizens from that of passive beneficiaries – a legacy from the Soviet era – to active users of services. To optimize its potential, civil society will need to organize itself to: (i) maintain and focus the successful mobilization of 2013-14; (ii) ensure the engagement of professionals and the media; (iii) act as transparently as possible, ensuring an integrity far beyond the state; (iv) optimize the channels and openings made available by the shift of civil society representatives into parliament; (v) mobilize the youth and professionals to contribute to the dialogue; and (iv) translating the technical aspects of the reform process into meaningful, tangible discourse that citizen understand.

70. **Improving the performance of state institutions and functions will require the continued engagement of Ukrainian citizens, and an active and informed civil society.** The momentum and transformational capacity demonstrated by civil society in Ukraine now needs to be sustained and harnessed by all actors to support medium and long term reform. This reform agenda is complex and far reaching, but there is much benefit to be gained from direct and immediate engagement with citizens and CSOs: more targeted allocation of local resources, improved

accountability and responsiveness of service providers, greater ownership of reforms and sustainability of investments, as well as the emergence of a more open and responsive government in which citizens have voice and agency. This engagement will require vast improvement in transparency and access to information, the platforms for average citizens to participate at the local and national levels as well as efforts to tailor approaches to suit the significant regional variation. Opportunities for eastern populations to engage the national Government and increased avenues for dialogue and outreach will also combat growing east-west divides, and contribute to overall confidence in the reform process.

71. **Enhancing citizens' engagement on the quality and effectiveness of service delivery will require access to reliable and timely information, as well as the opportunity to better understand and use information.** Citizens and users of services need to know their rights and responsibilities, national targets and standards, the budgets available, and about performance – how the services they receive compare with others. Data from 2014 (DIF) suggests that 9 percent of Ukrainians are fully satisfied that government was informing them about its work, 39 percent of citizens report that the information provided does not correspond to reality. Yet there is experience of successful pockets of action, even in the most problematic reforms. Government efforts to raise awareness for the need for higher energy tariffs and the energy efficiency measures that can help households cope with higher prices radically improved the way information on an issue critical to livelihoods was imparted. It involved public opinion research, a redesign of a TV-based awareness campaign and the development of understanding of journalists and other intermediaries. As a result of these efforts, in 8 months, enrollment in the subsidy program increased from 1.25 million to 5.5 million households, energy consumption dropped significantly in 2015 and the new government appears to be committed to continuing the reforms.

VI. Pathway 1: Macroeconomic Stability

72. **Safeguarding macroeconomic stability is a critical pathway to sustainable recovery and shared prosperity**. The crisis of 2014-15 exacerbated large fiscal and external imbalances, along with a fragile banking sector. Such large macroeconomic imbalances seriously undermine investor confidence. Furthermore, the analysis of growth in the pre-crisis period showed that such imbalances contributed to a volatile and unsustainable growth path in the pre-crisis period, with growth essentially stagnating on average during 2008-13. In light of the tremendous vulnerabilities facing the economy, reducing macroeconomic imbalances and safeguarding macroeconomic stability will be critical to put Ukraine on a path toward sustainable recovery.

73. **Addressing a number of structural priorities in the areas of fiscal and financial sector stabilization will be important.** In fact, many of the drivers of macroeconomic imbalances in Ukraine are structural in nature. Some of the greatest fiscal vulnerabilities, for example, come from a narrow tax base and weak tax administration, and an ineffective pensions system. As a result, reducing structural fiscal imbalances will require a focus on tax reform to broaden the tax base and strengthen tax administration; and pension reform to reduce the large pension fund deficit. Until recently, the gas sector has also been the source of a large structural deficit, so going forward, monitoring the drivers of the Naftogaz deficit will be important. In the financial sector, deep-rooted related party lending and weaknesses in supervision have combined with the economic downturn to result in large numbers of bank closures and an increase in non-performing loans (NPLs). Strengthening the financial sector will require implementing the framework put in place to resolve and recapitalize banks and strengthen supervision, but also put in place measures to strengthen corporate governance of state owned banks and facilitate work out of NPLs. The following table summarizes the priority interventions for safeguarding fiscal and financial sector stability identified through the analysis in this chapter.

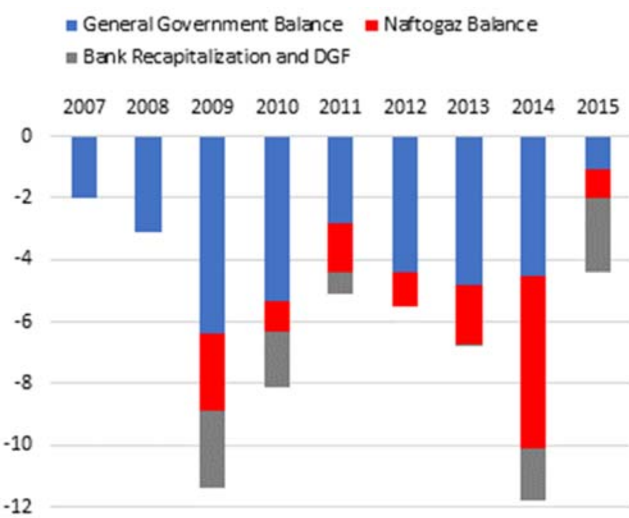
Priorities	Criticality	Time horizon
Tax Reform: Broaden tax base by removing exemptions and loopholes; improve international taxation treaties; and strengthen tax administration	High	Immediate, Short
Pension Reform: Restructure benefit package to better link contributions to benefits; parametric reforms to address categorical benefits, early retirement, and provide incentives to retire later	Critical	Immediate, Short, Medium
Strengthen Financial Sector: Implement framework to recapitalize and resolve banks and strengthen supervision; restore credit growth by putting in place effective NPL resolution framework; and improve governance of state owned banks	Critical, High	Immediate, Short

Fiscal Consolidation

74. **Large fiscal deficits with structural roots are a major source of macroeconomic vulnerability for Ukraine.** Ukraine has been running fiscal deficit over the last 20 years. The fiscal position deteriorated considerably since 2009 when budget revenues declined as a result of the macroeconomic slowdown, while expenditure continued to grow due to increase in social spending related to the political cycle. In addition, the structural deficit of Naftogaz grew rapidly as the

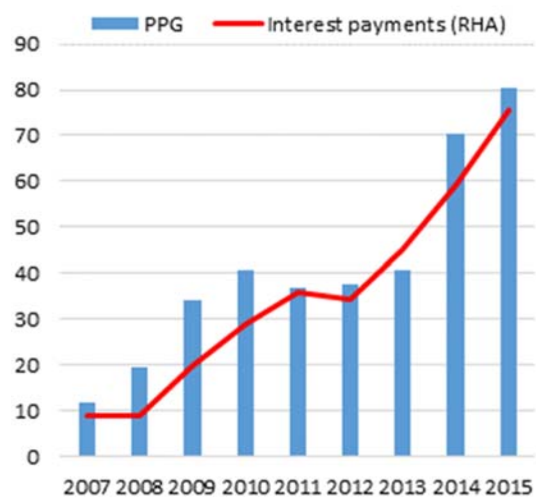
authorities refused to adjust gas tariffs in line with the increase in import gas prices. Conflict in the east and the 2014-2015 economic crises exacerbated fiscal problems further due to revenue loses and increased security spending. In addition, the quasi-fiscal deficit of Naftogaz widened due to increased import gas value in Hryvnia terms following devaluation and lower sales to industrial consumers because of weak economic activity. Despite some fiscal tightening and increase in gas tariffs, the consolidated fiscal deficit including Naftogaz reached 10.1 percent of GDP in 2014. Banking sector capitalization added 1.7 percent of GDP to these fiscal financing needs. While fiscal tightening measures (nominal expenditure restraint coupled with high inflation) and an increase in gas tariffs helped to significantly reduce the consolidated fiscal deficit in 2015 and 2016, the fiscal outlook remains challenging.

Figure 29. Fiscal and quasi-fiscal balances (percent of GDP)



Source: World Bank staff estimates

Figure 30. Public and Guaranteed Debt (PPG) and Interest Payments (percent of GDP)



Source: Ministry of Finance, World Bank staff estimates

75. **Public debt is very high in Ukraine and represents a major source of vulnerability.** Public debt became unsustainable and was restructured. Currency depreciation, accumulated fiscal imbalances, large quasi-fiscal losses of Naftogaz, and bank recapitalization needs led to a rapid expansion of public and publicly guaranteed debt, which exceeded 70 percent of GDP in 2014 (vs 40 percent of GDP in 2013). Debt servicing became unaffordable, requiring Ukraine to negotiate a restructuring of its external public debt with private creditors in November 2015. As a result, public and publicly-guaranteed debt stabilized at 86 percent of GDP at end-2016, although this remains large and a major source of vulnerability for Ukraine going forward.

76. **In the face of crisis during 2014-2015, an ambitious fiscal adjustment program has been implemented to reduce the general government deficit.** Tight controls on nominal spending across the board, coupled with inflation, as well as energy tariff increases, helped to reduce the general government deficit, including Naftogaz, to 2 percent of GDP in 2015 and 1.2 percent in 2016. At the same time, many of the expenditure controls implemented during the last three years have been done in crisis mode (including the wage bill in social sectors, including health and

education, and social protection) and are not sustainable over the medium term. Furthermore, the revenue measures that have contributed to the adjustment have been temporary, rather than durable.

77. **Despite the recent consolidation, the fiscal outlook remains challenging, and a systematic fiscal consolidation effort linked to durable improvements in expenditure efficiency will be needed.** The fiscal framework actually projects an increase in the consolidated fiscal deficit to 3.2 percent of GDP in 2017 (because of medium term fiscal pressures, along with the recent cut in the social security contribution rate and the increase in the minimum wage). The consolidated deficit is projected to decline to about 2 percent by 2020 if structural reforms to manage the medium term fiscal pressures move forward. Meeting this deficit target will prove challenging because of the weak growth outlook and the challenging nature of the necessary reforms. A systematic fiscal consolidation strategy based on durable improved in tax revenues and increased efficiency of expenditures will be particularly important to reduce public debt.

78. **Ukraine is subject to considerable fiscal risks arising from a wide range of quasi-fiscal liabilities.** The largest quasi-fiscal liabilities arise from subsidies to the energy sector, subsidies to other state owned enterprises (SOEs), and financing for bank recapitalization and the deposit guarantee fund (DGF). In 2015, while the Naftogaz deficit had been reduced to 0.9 percent to GDP, subsidies to all other SOEs amounted to roughly 2 percent of GDP, while financing for bank recapitalization and the DGF amounted to 2.4 percent of GDP. The finances of SOEs, including budget subsidies, are not transparent and their fiscal risks, as well as the efficiency of their investments, are not under consistent government supervision. For example, the Naftogaz deficit is not disclosed in its financial reports, which only include loss incurred by the company. Beyond these quasi fiscal risks associated with SOEs and the financial sector, Pension Fund expenditures (about a third of general government expenditures in 2015) use their own charts of account, with their reports neither linked to public finance reporting nor subject to Parliament scrutiny. On the whole, quasi-fiscal risks are considerable and not adequately managed. Improving transparency and predictability of quasi fiscal liabilities is critical to reducing fiscal vulnerabilities in Ukraine.

Tax reform

79. **Tax reform is an important part of addressing fiscal vulnerabilities and complementary challenges going forward.** Despite recent reforms, the current system is still complex, inequitable, and eroded by exemptions. The large number of exemptions and loopholes for special interests results in a narrow tax base and a high effective tax burden on the law-abiding citizens and companies. Second, the tax administration is large, inefficient and widely perceived to be corrupt. Third, international taxation and related profit shifting and tax base erosion are particularly weak areas for Ukraine. All three of these problems undermine Ukraine's competitiveness and a level playing field for firms, encourage widespread informal economic activities, and stunt the country's growth prospects.

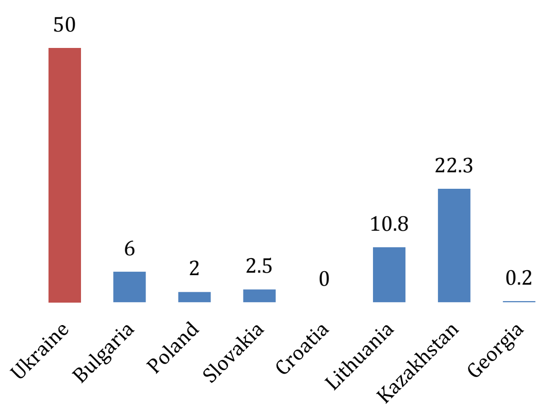
80. **The cut in the payroll tax rate in 2016 undermines medium term fiscal stability and raises the urgency of broader tax reform.** Since January 2016, the social security contribution (SSC) rate was cut from 40 percent to 22 percent through amendments to the Tax Code approved by Parliament. Overall, the motivation to reform the Tax Code was well placed, as the tax regime undermined the country's competitiveness and created strong incentives to under-report wages and employment. The cut in the SSC rate brought the total tax on labor income in Ukraine down from 56 percent to 38 percent, which is in line with the average for European countries. The reduction of SSC rate was also aimed at shrinking the informal economy and improving compliance. However, the necessary complementary measures to strengthen tax administration have not yet been addressed. As a result, the estimated short term revenue losses were about 4 percent of GDP. This raises the urgency of reforms to broaden the tax base, strengthen tax administration, and rationalize current expenditures.

Table 7: Tax Expenditures from VAT exemptions (percent of GDP)

	2011	2012	2013	2014
Agriculture	1.29	1.01	1.01	1.21
Printing	0.06	0.07	0.06	0.04
Pharmaceutical	0.2	0.22	0.21	0.07

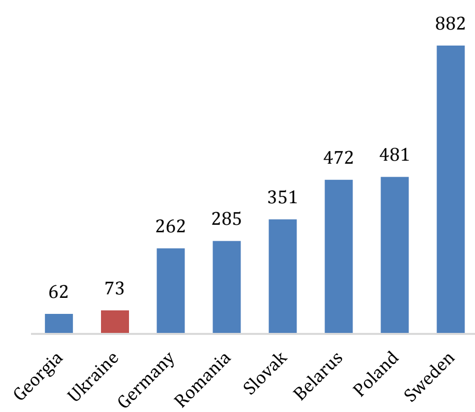
Source: State Statistics Committee, Tax Administration

Figure 31: Firms expected to pay bribes to tax officials, percent, 2013



Source: World Bank Enterprise Survey.

Figure 32: Taxpayers per Staff: Ukraine vs Comparators



Source: IOTA

81. **Ukraine's tax base has been eroded by exemptions, tailor-made waivers, and loopholes that have enabled special interests to engage in tax avoidance and tax evasion.** In particular, Ukraine is prone to considerable profit shifting and tax base erosion arising from its international taxation arrangements. The Cyprus treaty is notable in this regard as Cyprus maintains a very preferential status even after the 2012 renegotiation of the treaty, accounting for over 30 percent of FDI into Ukraine and 90 percent out of Ukraine. Removal of these exemptions, tailor-made waivers and lucrative loopholes would not only broaden the tax base and increase revenue collection, it will also help promote a level-playing field for the private sector. This should be a top priority for any tax reform in Ukraine. In addition, VAT has been subject to several exemptions, with major ones being agriculture, publishing and pharmaceuticals. At present, the exemption for agriculture—which

previously enabled agriculture producers to keep VAT for reinvesting in their fixed assets—has been removed. Furthermore, printing services in the publishing sector are exempt from VAT. Pharmaceutical products and medical equipment were not subject to VAT before 2014 and then a reduced rate of 7 percent was imposed. As a result, in 2013, actual VAT collection was only 44 percent of potential VAT collections - the VAT revenues that would be generated if the statutory rate were applied to all tax payers.

82. **Second, tax administration is large, inefficient, and widely perceived to be corrupt.** In Ukraine, over 54,000 staff work in the tax administration agencies – that is one tax administration official for every 74 tax payers, compared to 882 in Sweden, 481 in Poland, 351 in Slovakia, 262 in Germany, and 146 in Bulgaria. While SFS staff was reduced to 41,178 full time equivalents in 2016, inefficient tax administration continues to result in a high cost of compliance. In Ukraine, firms spend 350 hours a year filing, preparing and paying taxes. This compares with an average of 247 hours for Central Asia and Eastern Europe, and an even lower average of 173 hours for EU and EFTA countries. The revenues lost from compliance gap are sizeable, with the estimated VAT compliance gap for 2014 at over 5 percent of GDP. Tax administration reform should therefore be part and parcel of any tax reform proposal in Ukraine. Tax administration in Ukraine is also associated with perceived high levels of corruption. According to the latest Business Enterprise Survey, 2013 released in May 2014, 15 percent firms stated that bribery is frequent in dealing with taxes, over 50 percent stated they were expected to give gifts in meetings with tax inspectors, while only 19 percent considered corruption to not be not a problem. In addition, limited use of risk management in tax administration results in poor collection effort. The bulk of the State Fiscal Service (SFS) audit coverage is achieved through unplanned audits, which are triggered by criteria within the law. Planned audits, for which companies are selected based on risk profiling, yield much better results. The 2015 data shows that planned audit on average yielded 7 times better results than unplanned.

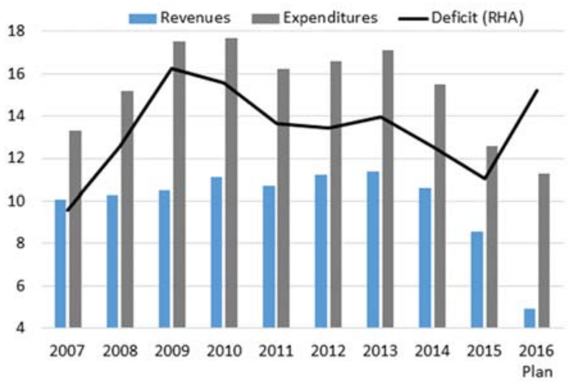
Pensions

83. **The pensions system in Ukraine represents a major fiscal vulnerability.** Pension expenditures amounted to 13.4 percent of GDP or 31 percent of total public expenditures in 2015. While this is down from 17 percent of GDP in 2013, the deficit of the pension system remains significant. Payroll taxes amounted to 9.6 percent of GDP in 2015, and fiscal transfers to the pensions system constituted 3.8 percent of GDP. Following the cut in the social contribution rate, payroll taxes declined to 5.8 percent of GDP in 2016, and fiscal transfers to the pension fund increased to 6.5 percent of GDP. This represents a major fiscal burden for Ukraine, undermines macroeconomic stability, and crowds out resources for public investment and other critical expenditures. As a result of large current expenditure obligations, public investment has been chronically low in Ukraine, averaging only 2.3 percent of GDP, which undermines growth prospects.

84. **Fiscal vulnerabilities from pensions have been exacerbated by the recent cut in the social contribution rate, which raises the urgency of pension reform.** To stimulate participation in the formal pension system, the social contribution (SSC) rate was reduced from 40 to 22 percent effective 2016. The authorities anticipated that cutting the SSC rate would shrink the informal economy and improve compliance. However, the short-term revenue losses were about 4 percent of

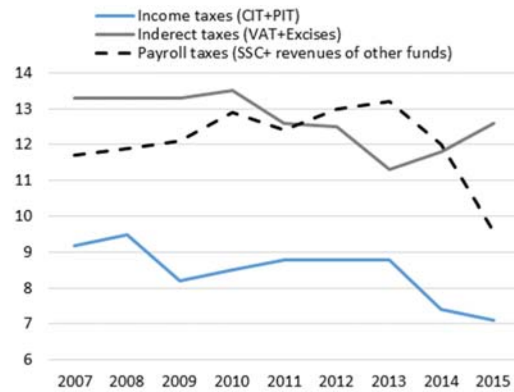
GDP, which has created a larger long term deficit in the pension system and raised the urgency of pension reform, along with measures to broaden the tax base and strengthen tax administration.

Figure 33.
Fiscal burden from Pension Fund (% GDP)



Source: IMF WEO, World bank estimates

Figure 34.
Tax revenue (% of GDP)



Source: IMF WEO, World Bank estimates

85. **Demographic pressures going forward are considerable.** The country now has around 12.3 million pension beneficiaries and about 14 million contributors. Demographic projections indicate that going forward, the cohorts entering retirement will be considerably larger than the young cohorts entering the labor market. As a result, system dependency would increase, further burdening the system. Estimates indicate that in 20-25 years, the ratio of contributors to pensioners will fall to two thirds.

86. **The fiscal burden is amplified by a host of categorical benefits and the minimum subsistence top-up, which also undermine incentives to contribute.** The structure of pension expenditures are heavily influenced by the costs of various categorical benefits, privileges, and the minimum subsistence top-up, which jointly constitute over one-third of the total pension expenditures. This translates into a heavy fiscal burden and creates non-transparent subsidies between different programs administered by the Pension Fund, leading to erosion of incentives to participate in the pension system.

87. **The system is on a path of converting from an earnings-related benefit to a de-facto flat benefit program, undermining incentives to contribute.** The government tops any pension benefit up to the subsistence minimum level, irrespective of the degree of the individual's participation in the system. This undermines the fundamental premise of a contributory pension program, which is to grant benefits proportional to past wages and length of service. Furthermore, benefit indexation remains complex and ad-hoc, eating up considerable value of individual benefits over time and producing a benefit structure that is non-transparent and unmanageable.

88. **The adequacy of pension benefits is undermined by the current policy of indexing only the minimum pension amount at or below inflation.** Indexation to inflation or below was intended to contain pension expenditure pressures, but the large proportion of beneficiaries under

the subsistence minimum implies that costs have not been reduced much. Furthermore, under such scenario, the replacement rates for existing benefits will fall to around 20 percent of the average wage in the long run. This will in turn exert pressures on the political system to address social inequities.

89. **Initiatives to reform pensions have been ad hoc to date.** In 2015, the authorities introduced some saving measures by cutting benefits of working retirees and by unifying provisions for eligibility and pension benefit calculations for various categories. The indexation of pension benefits was also temporarily suspended. A draft pension bill also proposed a mandatory defined contribution component, which could slightly improve individual benefits but only in the very long run, given the time needed to accumulate savings. The fundamental challenges of the current pension program, however, remained unaddressed.

90. **A comprehensive strategy and vision, supported by assessments of fiscal costs and adequacy of resulting benefits, are needed as part of considering reform options.** A number of reform options are available to both improve financial sustainability of the pension system and enhance its adequacy and transparency. Parametric options for improving financial sustainability of pensions include: (i) Gradually increasing the retirement age for both men and women or creating a retirement age corridor between a lower and regular level of benefits; (ii) Increasing the minimum service required for normal retirement; (iii) Increasing the eligibility age for social pension from 63 to 65 years, which will initially affect a small number of citizens but will produce considerable savings over time as the share of individuals ineligible for the old age pension will steadily increase over the next decade; (iv) Including all categorical and compensatory payments, and the earnings of working pensioners, in the calculation of the subsistence top-up; and (v) Adopting a moratorium on reducing statutory retirement age any special categories or professions, unless properly funded.

91. **Beyond the parametric reforms under consideration, restructuring the current benefit package can help improve both sustainability and adequacy, as well as enhancing transparency of the pensions system.** A key option in this regard would be to restructure the current benefit package into either two separate elements, including a basic income component that is universal and flat for all retiring individuals, funded from the general budget, as a new social contract between the state and citizens; and an earnings-related insurance component funded from contribution revenues. Another key element would be to introduce clear and equitable rules for indexation of individual pension benefits. It is important to institute rules that preserve the benefit value and that are simple to understand and fiscally affordable. Indexation formula could be some combination of price inflation and the wage growth, which is consistent with both the historic trend in Ukraine and international precedents. The indexation should be clearly defined for basic, insurance, and poverty components. Finally, when conditions are right for a Defined Contribution component, it could be introduced as a supplementary mechanism. It could operate on a voluntary basis funded by employee contributions and would help fund early retirement and/or higher future benefits. However, important preparatory work would be required, so this should component should not be rushed.

Financial Sector Strengthening

92. **The financial sector has been under severe stress since 2014, as a result of the economic shocks and long standing structural bottlenecks, which has amplified macroeconomic instability.** Bank liquidity and asset quality were hit hard by the precipitous depreciation of the Hryvnya (by 65 percent since the start of 2014), the large contraction in GDP (16 percent over two years), and the security crisis. This stress was magnified by accumulated risks from deep-rooted structural problems persisting for over 20 years, including widespread related lending, substantial banking supervision weaknesses, inefficiencies in financial markets, and an underdeveloped financial infrastructure. All this triggered an outflow of deposits and decline in capital adequacy of banks. The stress in the financial sector has in turn reinforced the economic downturn and macroeconomic vulnerabilities.

Reforms to safeguard financial sector stability

93. **The authorities have responded proactively to put in place a framework to resolve and recapitalize banks and strengthen supervision, which is helping to stabilize confidence.** The authorities' banking sector reform program is focused on three areas: (i) strengthening the financial and operational capacity of the Deposit Guarantee Fund (DGF); (ii) ensuring that the largest banks are adequately capitalized; and (iii) improving regulation and supervision of the banking system. As a result, an unprecedented cleanup of weak and nontransparent banks has been underway. A total of 85 banks (including several large and medium-sized banks) out of 180 banks were declared insolvent and sent for resolution to the DGF.

Table 8. Key characteristics of the banking sector

	March 2016	End 2015	End 2014	End 2013
Banking sector assets to GDP (%)	-	64.08	85.19	88.18
Banking sector assets (UAH million)	1,288	1,220	1,316	1,278
o/w domestic private banks (%)	35.6	36.2	48.4	56.2
o/w domestic public banks (%)	30.1	28.1	21.8	18.2
o/w foreign banks (%)	34.3	35.7	29.8	25.6
Top 5 banks asset concentration ratio (%)	56	55	43	40
Number of banks	109	117	163	180
o/w domestic private banks	78	86	131	150
o/w domestic public banks	6	6	8	8
o/w foreign banks	25	25	24	22

Source: NBU website

94. **Bank restructuring and recapitalization plans have been adopted following asset quality reviews.** The authorities have conducted asset quality and related party exposure reviews in 2014 and 2015 which revealed significant capital shortfall in the largest banks that cover 85 percent of the banking system. Following the diagnostic, the National Bank of Ukraine (NBU) adopted recapitalization and restructuring plans for affected banks, with three year plans adopted to bring capital requirements and the level of related party exposures in line with NBU's prudential

regulations. In most instances where owners were unable to bring in the necessary capital, banks were resolved. While monitoring the implementation of adopted recapitalization and restructuring plans, NBU intends to complete the AQR and related party exposure review for the rest of the banking system in 2017 as well. In December 2016, the Cabinet of Ministers approved a decision on state participation in the recapitalization of PrivatBank, the largest and systemic bank in Ukraine, with transfer of full ownership to the state. This became necessary after the failure of the former owners to implement recapitalization plans, and is an important part of the authorities' broader policy to safeguard financial sector stability. Going forward, professional management and an independent supervisory board to effectively restructure the Bank will be important.

95. **The NBU has undertaken significant steps to improve regulation and supervision of the banking sector, though further important reforms are underway.** The measures adopted include improving the process for identifying problem banks; bolstering the operational capacity of the banking supervision and licensing; enhancing supervisory and regulatory requirements for systemic banks; and creating the Financial Stability Council to improve coordination among regulators, ensure early identification, and minimize risks. A key focus has been to make progress in addressing high levels of related-party lending in the system. To this end, the banking law and associated regulations have been amended to broaden the definition of bank related parties and increased accountability for violations, including criminal charges in cases where a bank was brought to insolvency by unlawful actions of bank managers and owners. These actions are expected to create a level playing field for banks with a good governance and transparent ownership structure, which do real lending to the economy. Albeit significant progress was achieved so far, further essential reforms are requires to bring bank regulatory and supervisory framework in line with Basel Core Principles and EU directives.

96. **Reforms to stabilize the financial sector help mitigate vulnerability of the poor to the crisis and can support economic recovery.** Global experience has shown that financial crises lead to an increase in poverty. In Ukraine, strengthening the Deposit Guarantee Fund's institutional and financial capacity to ensure continuous payout of insured deposits serves as a safeguard against higher poverty from loss of vital savings by the vulnerable population, with close to 30 percent of insured deposits transferred to the DGF. Reforms to recapitalize and clean the system of non-viable banks can also support economic recovery by forcing bank owners to bring capital back to the system.

97. **The authorities will need to further enhance the bank resolution framework, complete restructuring of the banking system, and continue to strengthen supervision.** It will be important to invest in the institutional capacities of DGF and effectively utilize new bank resolution powers in line with good international standards. Significant progress was made by transforming DGF into a bank resolution agency in 2012 and streamlining deposits payout and resolution functions in 2014-15 to give DGF more legal powers, enhance resolution tools, and expedite time of payouts to insured depositors. However, additional work is needed to further strengthen DGF as an institution and bring the bank resolution and deposit insurance framework in line with good international practice and EU Directives.

Facilitating credit growth through NPL resolution, corporate governance reforms and enhanced access to finance

98. **In addition to continuing to safeguard financial sector stability, reforms to facilitate a resumption of credit growth will be important.** While the banking sector has pretty much stabilized, credit growth has not resumed. Furthermore, the cost of capital remains elevated. As the banking sector continues to de-leverage and the government attracts a greater share of local currency savings to cover fiscal needs, the private sector continues to suffer from limited access to finance. Households and SMEs have restrictive access to credit. Restoring the ability of the banking sector to resume credit growth will help support economic recovery. This will require reforms to reduce non-performing loans and improve governance specifically of state owned banks.

99. **An effective NPL resolution framework will be important.** The crisis has resulted in higher non-performing loans (NPLs). Officially reported NPLs increased 15 percentage points over 2014-2015 to 31 percent at end-September 2016[8], this share could continue to increase (due to the time needed for deteriorating asset quality to be fully reflected in balance sheets). Furthermore, the real level of NPLs (using a broader definition) may be higher. Since higher NPLs lead banks to become more conservative in lending, an effective NPL resolution framework is needed to facilitate NPL work out, sale, and transfer, including a multi creditor out of court debt restructuring facility. This is also crucial for DGF where the failure of 85 banks has resulted in a significant volume of asset accumulation to be sold or worked-out in the process of bank liquidation. The institutional capacity of the DGF to work with these assets has been significantly enhanced in 2015 and needs to lead to increased asset recoveries via operationalizing the Consolidated Office for asset management and sales.

100. **Governance of state owned banks needs profound reform.** State-owned banks (SOBs) represent 25 percent of deposits. The AQR has revealed significant weakness in the governance structure of the core SOBs and highlighted a need for comprehensive reform. Currently the authorities possess significant influence over decision making in those banks which historically resulted in poor credit quality and significant costs for the government. The authorities should introduce independent governance structures and enhance the risk management practices to prevent use of these banks to fund political interests using the savings of the population. Currently the second and third largest banks in the country are state owned and improving their governance and business-models making them self-sustainable is essential for possible privatization in the future, while the state's exit from other non-core banks would give a clear message that the government is committed to enhancing competition in the market.

101. **Post crisis growth and access to finance oriented developmental policies are needed**. After the stabilization of the banking system following the 2014-2015 crisis, Ukrainian authorities, besides implementing policies aimed at general improvement of financial setor policies, will also have to turn their attention to policies stimulating long-term developmental credit growth and access

[8] System-average IFRS based NPLs ratio, as estimated by the rating agencies, stood at about 44 percent in end-2015

to finance, especially for SMEs and exporters, who are now adjusting to the fundamental reorientation of terms of trade for Ukraine from Eastern to EU markets driven by EU-Ukraine Association Agreement.

Enhancing the diversification of the financial sector and improving financial infrastructure

102. **Developing non-bank financial institutions (NBFIs) will help diversify the financial sector and enhance access to finance in the country.** Currently the NBFI sector is underdeveloped with a poor regulatory framework and an unjustified large number of weak institutions operating in different markets. The unification of supervisory functions in the country is a vital first step to enhance the quality of sectoral supervision, mitigate the possible regulatory arbitrage and clean-up the system from non-viable institutions. This would create a level playing field for healthy NBFIs and further foster competition and access to alternative financial instruments in the market.

103. **Developing effective financial market infrastructure in Ukraine can help.** Although the private credit reporting market is well developed, it is not well regulated and is quite fragmented in terms of information coverage. Improved supervision and access to other debt information sources could effectively improve the credit reporting framework and thus improve credit decision making by the banks. The development of the payment systems infrastructure and secured transaction framework are other strategic aspects of financial infrastructure for the authorities to consider. Capital and money markets development in the country will depend on quality financial infrastructure as well.

VII. Pathway 2: Private Sector Productivity

104. **Weak private sector productivity growth has been at the heart of the unsustainable model of growth and poverty reduction in Ukraine.** Productivity growth has averaged a paltry 1.2 percent per year over the last fifteen years. Even in the pre-crisis period, after a spurt in productivity during 2000-07, productivity essentially stagnated during 2008-13, leading to stagnation in economic growth. The sharp economic downturn of 2014-2015 has exacerbated these trends by undercutting private sector confidence. Thus, in order to achieve sustained economic recovery and growth, it will be important to unlock productivity and confidence of the private sector. This will require conditions to support more dynamic entry of more productive firms and exit of less productive firms, as well as productivity improvements within firms. It will also require diversifying into new products and markets for Ukraine's exports. This means that *existing* subsectors within manufacturing, services and agriculture must modernize and raise productivity-levels. In addition, new subsectors with higher productivity levels would need to be added to each sector. Labor will need to increasingly move from lower productivity jobs to higher productivity ones.

105. **Improving productivity is all the more important in an environment with a declining working age population and also helps support improved employment outcomes.** Raising incomes in Ukraine will require higher productivity growth to offset the fall in labor-force. Furthermore, improved employment outcomes are also important in creating a more sustainable model of poverty reduction. Unemployment stands at about 9.5 percent though hidden unemployment is larger given that informal workers comprise a significant portion of total employment. Many of the employed are thus in low-productivity and low-wage jobs. Measures to improve private sector productivity can help improve employment outcomes by moving workers from lower productivity to high productivity jobs.

106. **Ukraine would need to generate a shift in its export and production structure into new products and markets.** Productivity growth has often been associated with an expansion of exports into higher-value skill-intensive goods and services. While three-fifths of Ukraine's current merchandise exports comprise of minerals, metals and agriculture, a greater share of exports going forward can consist of highly differentiated, higher-value, and higher-productivity metal and agricultural products. The same can be true of current machinery and service exports. While rapidly expanding and shifting the composition of exports can be challenging, it has been done by other countries in the region. Open access to the markets of European Union (EU) countries is a great start but a lot more will have to be done behind the border at home to make domestic markets more competitive and increase export competitiveness.

107. **Boosting private sector productivity will require strengthening infrastructure investment, creating a level playing field in the private sector, reforming land markets, and tapping trade opportunities.** Ukraine has made important progress in streamlining its business environment in recent years, with its Doing Business ranking improving from 140th in 2013 to 84th in 2016. However, deeper structural bottlenecks remain that have, for an extended period, undermined the emergence of a more productive private sector and a more sophisticated export

structure. These bottlenecks include weak infrastructure, a highly concentrated and anticompetitive market structure, and weak land management. Improving infrastructure will require creating fiscal space for public investment and strengthening public investment management, while improving governance and transparency in the important energy and transport sectors. Creating a level playing field for the private sector will require further deregulation, more effective implementation of competition legislation, and improving corporate governance of ineffective state owned enterprises. Perhaps most critical for the private sector is to reform land markets. Weak land governance seriously undermines investment and productivity in the high-potential agriculture sector, as well as other sectors. Reforming land markets will require improving state land management through a new legal framework, while gradually opening sales for private agricultural land ensuring transparency and equal access. The following table summarizes the priority interventions for boosting private sector productivity identified through the analysis in this chapter.

Priorities	Criticality	Time horizon
Strengthen PIM and Expand Infrastructure:	High	Short
•Create fiscal space for public investment and strengthen PIM systems	Critical/	Medium
•Energy sector – improve governance and transparency, reduce losses, and reduce high energy intensity	High	Medium
•Transport sector – promote efficient multimodal transport system to unleashing Ukraine's trade potential	Medium	
Create Level Playing Field in Private Sector:	High	Short
•Deregulation – further streamline business regulatory environment	High	Short/Medium
•Competition Policy – enhance capacity of AMC to implement legislation and streamline state aid for enterprises to reduce distortion of competition	High	Medium
•SOE Reform – triage of SOEs; strengthen accounting and financial reporting; and improve corporate governance	High	Short
Land Reform: Increase efficiency of state land management through new legal framework; open sales market for private agricultural land ensuring transparency and equal access; and clear status of unclaimed property.	Critical	Short/Medium
Trade Facilitation: Strengthen and harmonize quality and standards arrangements to tap potential of international trade agreements	Medium	Short

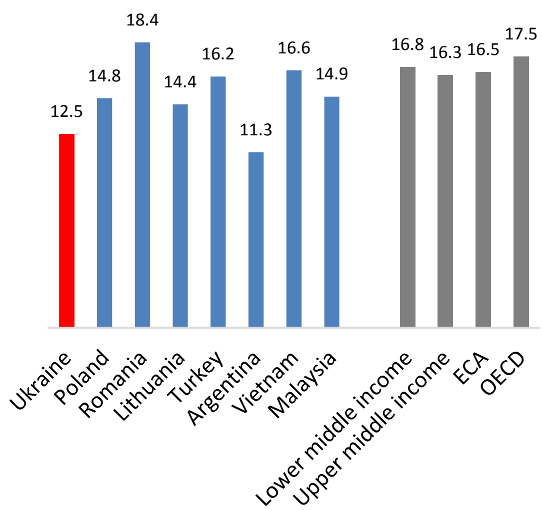
Public Investment Management & Infrastructure

108. **Supporting productivity, job creation, and exports will require improved public investment and infrastructure to reduce costs and equip firms to produce more competitively.** With levels of private and public investment hovering at around 16 percent and 2 percent of GDP respectively during 2009-14, the necessary expansion of investment is daunting[9]. Private investment depends on the incentives that investors – both domestic and foreign – face in the country. Improved incentives depend on macroeconomic stability, a competitive and level playing field including a favorable business and regulatory environment, and good quality infrastructure services. Ukraine is

[9] Strong and enduring growth requires high levels of investment. According to the Growth Commission report; countries with strong growth of productivity and GDP had average total investment rates of 25 percent with public investment in infrastructure of 5-7 percent of GDP.

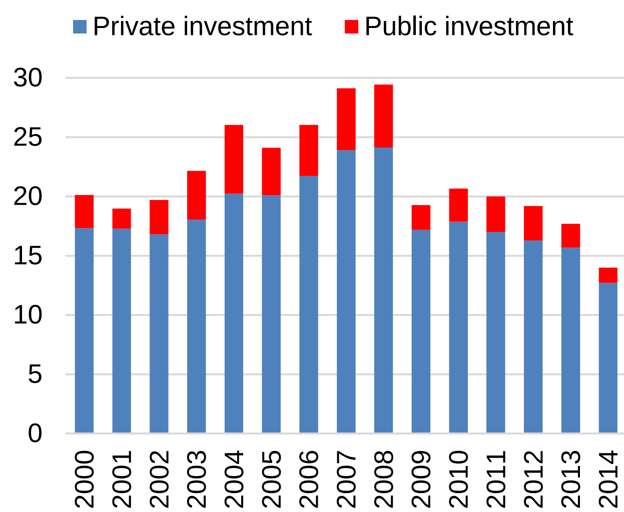
starting from a low base on all these counts and the challenge is not only to improve on the current situation, but also to improve sufficiently to be competitive in the region.

Figure 35. Private Investment (percent of GDP, 2010-2015)



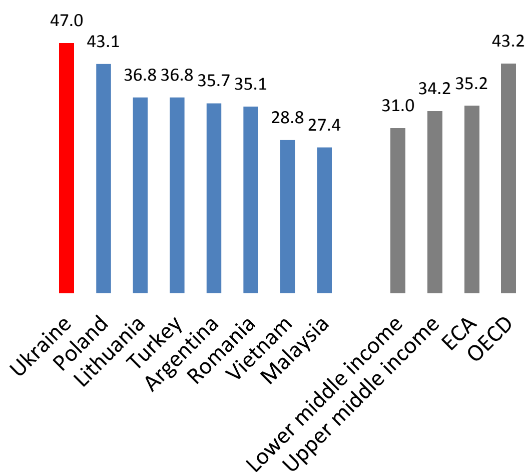
Source: IMF WEO, World Bank staff estimates.

Figure 36. Public and Private Investment, (percent of GDP)



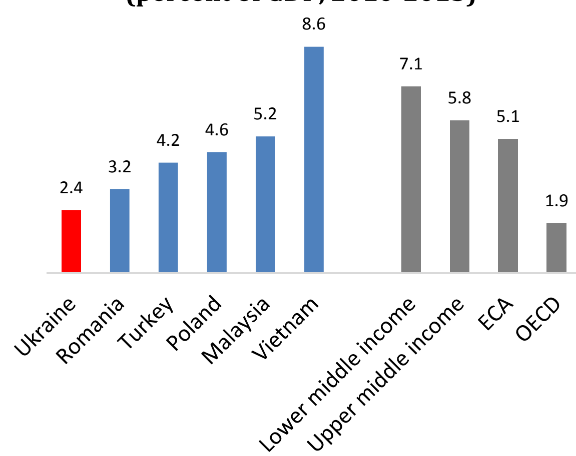
Source: IMF WEO, World Bank staff estimates.

Figure 37. Gen. government expenditures, (percent of GDP, 2010-2015)



Source: IMF WEO, World Bank staff estimates.

Figure 38. Public capital expenditure (percent of GDP, 2010-2015)



Source: IMF WEO, World Bank staff estimates.

109. **Improving infrastructure in Ukraine will require creating fiscal space for capital expenditures and also improving public investment management (PIM).** While overall public spending in Ukraine is higher than comparator countries, public capital expenditures are among the lowest of comparator countries. This is because public spending in Ukraine is skewed toward current expenditures, including social transfers, subsidies, and the wage bill, all of which crowd out government investment. In fact, during 2010-2015, public investment in Ukraine averaged 2.4 percent of GDP, compared to 4.2 percent in Turkey, 4.6 percent in Poland, and 8.6 percent in Vietnam.

Social expenditures have absorbed a large and growing share of public resources in Ukraine. Spending on social benefits including, most importantly, pensions, expanded from an already high 19.6 percent of GDP in 2007 to 23.4 percent in 2013. This increase was driven both by increasing benefits (many of which are indexed to wages) and larger number of beneficiaries which is rising due to demographic developments. Since 2014, the authorities reduced social security expenditures by temporarily freezing pension benefits in nominal terms and by reducing some pensions for special categories. However, the fiscal space was absorbed by interest payments. Thus, capital expenditures dropped to 1.3 percent of GDP in 2014 and increased only modestly in 2015 to 2.4 percent of GDP.

110. **Ukraine needs to make further progress in strengthening its public investment management (PIM) systems.** The 2012 Public Investment Management Assessment (PIMA) considered public investment management as one of the weakest aspects of Public Finance Management (PFM) in Ukraine and an area which is vulnerable to corruption because of a high level of discretion at various stages of the PIM cycle. As a result of inefficiencies of the PIM system and governance issues, the cost of construction in Ukraine is 22 percent higher than in the EU, despite lower labor costs. These problems are magnified by vast investment needs of Ukraine estimated at $100 billion over the next 10 years. Despite some improvements implemented in 2015, the PIM system is still fragmented and not conducive for efficient targeting of resources to strategic policy priorities. The latest version of the Budget Code required selection of public investment projects based on cost-benefit analysis and clearly established criteria. However, the new rules do not include SOEs' investment projects, projects implemented by state guarantees, or those implemented by the Fund for Regional Development or the State Road Fund. As such, the reforms have affected a low share of total capital spending in 2015.

111. **Enhancing infrastructure, especially in transport and energy, is an important priority for raising private sector productivity.** Increased public investment and institutional reforms in these important infrastructure areas will be key to improving efficiency and quality of infrastructure services. As discussed, the crowding out of infrastructure investment by current spending is a longstanding issue in Ukraine. However, the ongoing fiscal consolidation presents an opportunity to create the fiscal space necessary for higher public investment.

Energy Sector

112. **Energy supply reliability and security is a source of major vulnerability in Ukraine that also undermines productivity growth and job creation.** Possible disruptions of electricity, gas, and/or heat supply can have serious repercussions for productivity and output, particularly given the high energy intensity of Ukraine's economy. In addition, universal access to electricity and gas coupled with the cold climate means that the reliability and security of supply are an essential need for the population, and particularly the poor who cannot afford alternatives.

113. **Despite improvement, Ukraine continues to be reliant on gas imports, which are not well diversified.** In 2015, Ukraine's gas consumption was 34 billion cubic meters, of which about 20 billion cubic meters was produced domestically and the rest was imported. Diversification of gas imports improved in 2015 with European gas supplies accounting for about 63 percent of gas

imports. According to the International Energy Agency, Ukraine can achieve self-sufficiency in the next decade by utilizing its conventional and non-conventional gas reserves and realizing its energy efficiency potential. However, this will require improving the investment climate and the licensing regime and investing in supply and demand side energy efficiency.

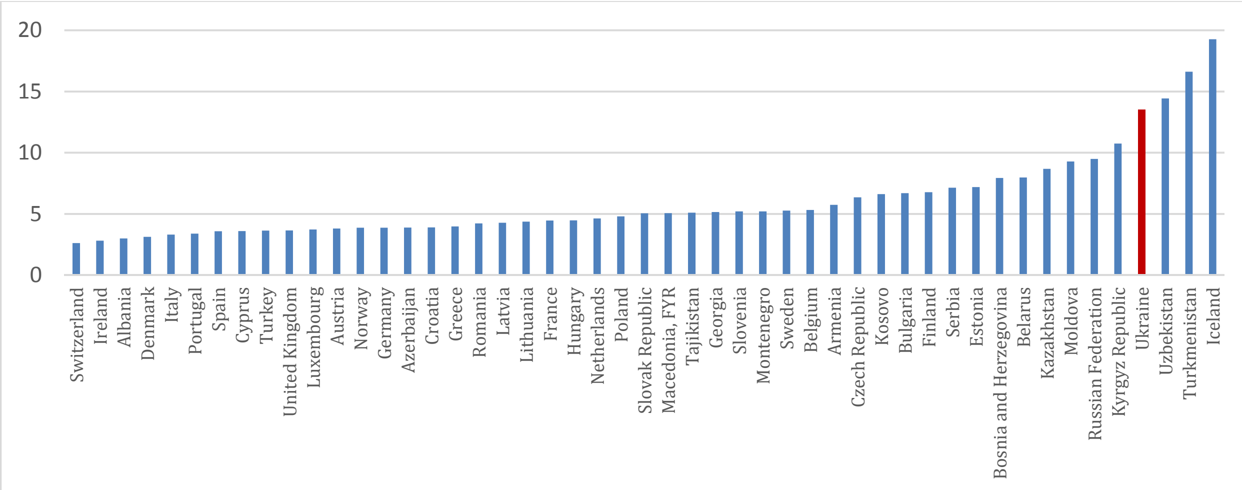
114. **The energy sector suffers from low efficiency and lack of investments; underlying these challenges are poor sector governance and lack of transparency.** The gas sector is largely state owned and dominated by the vertically integrated oil and gas company, Naftogaz, which has operations in exploration and production of crude oil and natural gas; processing and supply to customers, and transit of Russian gas via Ukraine to European markets. The organizational structure of Naftogaz is complex; nine subsidiaries and affiliates carry out day-to-day operations but general operational and financial decisions as well as the functions of asset management are entrusted to the holding company. The ownership of the regional gas distribution and supply companies is concentrated and the lack of transparency hinders competition and operational efficiency improvement in the gas distribution and supply. Losses in the gas network are estimated to be nearly twice as high as in Western Europe and gas flows and balances are difficult to trace due to incomplete metering and reporting and inadequate system of checks and balances.

115. **An ambitious reform program in the energy sector is underway with largely positive outcomes, and it is essential to continue the reform momentum going forward.** The reform agenda includes: (i) bringing household gas and district heating prices to import parity price levels by 2017[10]; (ii) mitigating the impact of price increases on vulnerable households with social assistance; (iii) supporting Naftogaz restructuring to reduce losses and improve its governance; and (iv) promoting efforts to enhance energy efficiency and raise investment and domestic production. Immediate actions should be taken toward strengthening sector governance and accountability and improvement of its financial viability.

116. **The unbundling of gas transmission operations from Naftogaz is a priority reform step.** To facilitate Government's informed decision making about the unbundling model, a study of unbundling options compliant with the EU's 3rd Energy Package was commissioned under the joint EC - World Bank Facility. Based on a multi-criteria assessment and the overarching objectives of achieving an efficient and fully competitive market in Ukraine, the study recommended that the immediate restructuring step should be separation of transmission, storage and system operator functions from the production and supply functions of Naftogaz. Consistent with the recommendations of this study, in July 2016 the Government approved ownership unbundling model for transmission and storage operations through establishment of two new entities. The implementation of the unbundling plan will need to begin without additional delay, be transparent, accompanied by reform of the regulatory framework, and take advantage of the transition period to foster improvements in transmission and storage operations.

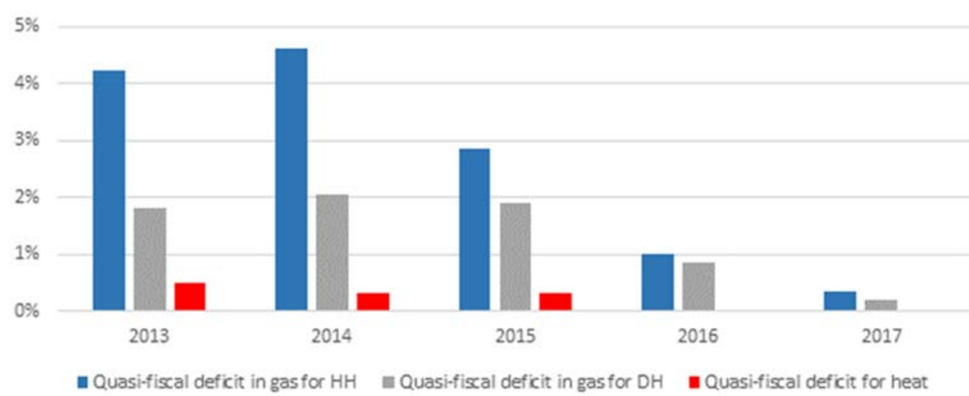
[10] The Government is estimated to have accomplished this a year earlier in 2016, taking advantage of low import prices.

Figure 39. Energy intensity level of primary energy in 2012 (MJ/$2011PPP)[11]



117. **Ukraine's energy intensity is very high (see figure), which will require both efficiency investments and sustaining pricing reforms.** Energy intensity in Ukraine is among the highest of comparator countries. The potential for energy efficiency improvement is significant in power and heat supply, in industry and in residential buildings. For example, comprehensive thermal retrofit of buildings constructed during the Soviet era could potentially reduce heat load by up to 50 percent or more, which would make a significant contribution to reducing demand for natural gas. On the other hand, while sustained increases in tariffs to cost recovery levels would help to moderate demand, complementary investments in energy efficiency are also needed to contain total energy expenditures, improve resilience of the population, and limit fiscal liabilities.

Figure 40. Quasi-fiscal deficits in Energy Sector (% of GDP)[12]

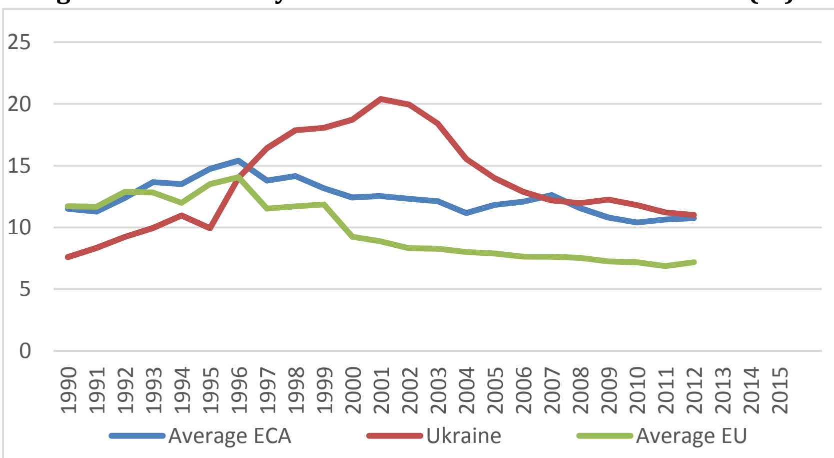


118. **Quasi fiscal deficits of the energy sector have been large in recent years but reduced significantly in 2015-16, and sustaining pricing reforms will be critical in maintaining this progress.** Until recently, energy pricing policies have generated substantial quasi-fiscal deficits,

[11] Source: World Bank SCD database, GTF
[12] Source: World Bank analysis

encouraged excessive use, discouraged investments, and created opportunities for corruption and rent seeking. In 2013, residential tariffs for gas, electricity, and heat were 18, 19 and 64 percent of cost, with delayed adjustment to world prices. To deal with this, the authorities increased gas, electricity and heating tariffs considerably during 2014-2016. As a result, the Naftogaz deficit has been reduced from 5.5 percent of GDP in 2014 to 0.9 percent in 2015 and a projected 0.3 percent in 2016. To mitigate the impact on the vulnerable population, up to 5 million households received benefits from the new Housing and Utilities Subsidy Program at end-2015. The program improves significantly the resilience of the poor population to further fluctuations in energy prices.

Figure 41: Electricity transmission and distribution losses (%)[13]



119. **Electricity supply unreliability is a major vulnerability undermining growth in private sector productivity.** The security and supply reliability of electricity is exacerbated by the wear and tear of its infrastructure and shortages of peaking power capacity. The electricity sector needs significant investments to modernize the generation capacity, to remove bottlenecks in the transmission capacity, and to reduce losses in distribution system. Despite reduction in transmission and distribution losses, they remain high compared to EU-28 countries. Power supply reliability is further jeopardized by low peaking capacity[14]. The unreliability of supply is also reflected in 2016 DB ratings on getting electricity where Ukraine is rated as 137th globally. It is difficult for producers and exporters to be competitive with others when it has to pay high cost of supply disruptions and shortages that others do not face.

120. **Lack of cost recovery and resulting poor financial viability undermine Ukraine's energy security.** Ukraine needs to attract financing to upgrade and expand aging generating capacities to meet the demand for electricity/heat and to start implementing measures to integrate the power system of Ukraine into the European Network of Transmission System Operators for Electricity (ENTSO-E). Investments in the sector and energy efficiency have been hampered by below-cost recovery pricing and extensive cross-subsidies between sub-sectors and different

[13] Source: World Bank SCD database, GTF

[14] With a 25GW available power generation capacity, the capacity margin for 2015 is estimated at -6% against the recommended minimum of 15%.

consumer categories. The 2015 decision of the National Energy and Utilities Regulatory Commission (NEURC) to gradually bring electricity tariffs to cost recovery level for the population by 2017 while eliminating cross-subsidies, is an important step, which should be consistently enforced.

121. **Power market reforms aimed at increased sector transparency, unbundling and liberalization have been slow and without a clear roadmap for their timely planning and implementation**. Power market reforms are part of Ukraine's commitments as part of its membership to the European Energy Community. An important step for establishing new electricity market rules, mechanisms and adequate market monitoring is the adoption of the new Electricity Market Law#4493 and the Energy Regulator Law. In addition, the Government will need a roadmap that will outline the detailed implementation steps for market reforms, including initiation of Day Ahead, Intraday, Balancing and Ancillary Services markets, unbundling needed to align with EU 3rd Energy Package, increasing competition, and stimulating efficiency improvements.

122. **The conflict had mixed impacts on the energy security and supply reliability.** The on-going conflict has reduced access to domestic energy sources: coal is a major source of domestic energy, but the government currently has no access to 60 percent of coal mines and has started importing coal. At the same time, the conflict fostered diversification of sources of gas supply; thus in 2014, share of non-Russian imports reached one third of the imported natural gas in Ukraine while in 2015 this share increased to 63 percent.

Transport

123. **High quality transport is a prerequisite to unleashing private sector productivity.** Ukraine's geography and structure of output generates five times the transport volume per unit of GDP compared to the EU-15 countries implying that transport costs make up a proportionately large part of the final price of many goods. To be successful in tapping trade opportunities, greater regional connectivity and improvements to transit corridors will be needed.

124. **An efficient multimodal transport system is critical to unleashing Ukraine's trade potential, including its central role in the global food supply chain.** This includes realizing the full potential of the association agreement with the EU, the Deep and Comprehensive Free Trade Agreement, and removing constraints from the development of the domestic agricultural and manufacturing industry. The current transport strategy for Ukraine seeks a balanced development of different transport modes, with rail transport retaining its role as the dominant mode for heavy bulk goods and the road network being developed to serve higher-value goods and to support better connection with Ukraine's neighbors. Increasingly, emphasis is also being given to the waterways sector as a means of relieving some of the harvest-time bottlenecks on the railways but also as a means of getting bulk cargoes off the roads to reduce congestion and road deterioration.

125. **Ukraine is ranked 80th from a total of 160 countries in the World Bank's Logistics Performance Index 2016 (LPI).** With the ranking going down over the last five years, Ukraine lags the best performers in the region and all EU member states. According to the 2016 LPI, Ukraine still

requires substantial reforms to improve customs performance, infrastructure, competency of logistic operators, international shipments, and the capacity to track and trace shipments. The logistics costs for moving grain, the Ukrainian key export commodity, from farms to the Black Sea ports are approximately 40 percent higher than costs for comparable services in France and Germany, and about 30 percent higher than costs in the United States. In addition to the overall logistics framework, there is also a need for sub-sectoral reform, particularly in the rail and road sectors, to increase efficiency and ensure that these key sectors are operating on a sustainable financial basis. The Bank is providing advice in all these areas with trust funded activities in logistics, railways reform, and road reform.

126. **Given the strong private sector focus of the logistics industry and the need for government to facilitate the productive areas of the economy, there is a strong interest in developing the logistics industry.** The Bank has undertaken analytical work on Agro-Logistics and is working with other development partners on developing a more comprehensive and green logistics action plan for the country. Some of the areas being looked at include: (i) reviewing tariff policies in the railways and ports sectors; (ii) supporting with prioritization of road corridors and addressing overloaded trucks on road network; (iii) assessing the option for the railways to expand into the provision of logistics services through adding value to line-haul services and attracting multi-modal traffic to railways; and (iv) developing the waterways to alleviate peak time pressure on rail and roads. Investing in port logistics, developing transparent methodologies for raising fees at the port, and facilitating cross-border trade logistics by introducing automatic customs procedure systems will be crucial to support competitiveness of Ukrainian Black Sea ports.

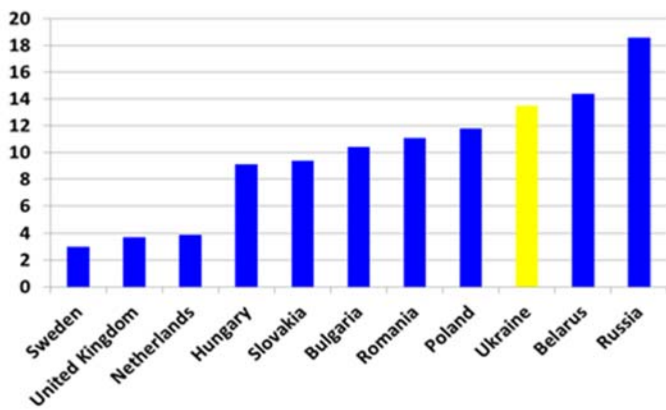
127. **Roads:** current financial and institutional arrangements in the road sector in Ukraine have not delivered results and the shortage of maintenance funding, combined with a large share of overweight trucks, has resulted in premature deterioration of the network. Ukraine has a road network of about 169,600 km, of which 49,200 km are national roads and 120,400 km are regional and local roads. It is now estimated, that roughly 51 percent of the national network does not meet national road roughness requirements and 39 percent does not meet the strength requirements. With traffic growth, standard two lane roads have begun facing capacity bottlenecks, compounding the road safety issue resulting from the overall poor condition of the network. Ultimately average traffic speeds are affected, with average speeds ranging between one- half and one-third of Ukraine's western European neighbors.

128. **A road map for road sector development in Ukraine for 2015–2017 was published by the Ministry of Infrastructure in June 2015.** The strategic objectives of the road map areas are threefold: (a) the protection of roads from early deterioration, (b) the reform of Ukravtodor and their dependent construction and maintenance companies; and (c) a sustainable financial structure and collection of new revenues. The first priority will be dealt with through improved weight control (particularly from overloaded grain trucks), the implementation of a road asset management system and the rolling out of a modern system of maintenance. The second priority area will lead to a more dynamic market, with private sector involvement in the design and maintenance of roads. It will include restructuring of the joint stock companies that currently maintain the network and transfer

of assets from Ukravtodor to the oblast state administrations and the divestiture of non-key assets of Ukravtodor, including the design institutes. The third priority area aims to secure existing revenues from fuel levies and so on to the road sector and to raise new revenues through the introduction of a truck tolling scheme.

129. **The roads sector, particularly maintenance, is underfinanced.** Although there has been a continuous increase in the revenues from excise duties on fuels, expenditures on road maintenance have been falling since 2011 and debt servicing has almost tripled since 2012. The shortfall in resources will affect sustainability of the network, with the current level of funding for maintenance of the network at about half the minimum level. Addressing these shortages will require higher charges on road users including through increasing the fuel levy, increasing vehicle registration fees and by starting to toll (or use vignette) the main highways in the country. In the short term, it is also important that the authorities enforce axle load controls and introduce systematic monitoring of existing maintenance expenditures.

Figure 42: Road Safety (Fatalities per year per 100,000 population)



130. **Road safety is a problem which requires more attention and commitment to deliver continuous improvement.** During the period from 2004-2014, fatalities from road accidents fell from 7,000 deaths per year in 2004 to just under 4,500 deaths in 2014. Over the last few years the reduction in road traffic fatalities has stagnated with fatality rates over four times those found in the better-performing European countries. . Road traffic injury was estimated by the 2013 Global Burden of Disease study to be the main cause of death for Ukrainians Aged 15-24 and the second main cause of death for Ukrainians Aged 5-14. While improved safety conditions and some new infrastructure have helped stabilize the number of road traffic fatalities and injuries, these activities are not sufficient to deliver improvements to the level of the European context and to half road deaths by 2020. Ukraine's road safety institutional capacity, management practices and standards need to be significantly improved to sustainably reduce road death toll. Serious improvements in road safety are therefore among the priority objectives for road transport system development.

131. **Railways**: Railways carry over 70 percent of non-pipeline freight traffic (measured in ton/km) and around 38 percent of public long-distance passenger traffic (measured by passenger/km). An efficient rail network is therefore essential for: (i) efficient and environmentally

sustainable transportation of Ukraine's natural resources and metallurgical products; (ii) transit traffic; and (iii) connecting many of Ukraine's large cities located 200-600 km from Kyiv. Ukraine ranks well (25th out of 104 countries) in the Global Competitiveness Index on the quality of its railroad infrastructure. However, shrinking profits, over-aged assets (70 percent of the rolling stock was purchased in the 1980s and needs urgent replacement) and lack of timely renewal, rehabilitation and upgrading of assets will ultimately lead to the deterioration in the quality of service and adversely affect the safety of the railway network.

132. **The key sector challenge, and major risk, is the lack of sustainable financing for railway investment and operations.** This risk is further exacerbated by the uncertainty regarding the traffic from/to Russia and the need for reconstruction of railway infrastructure destroyed in the east of the country. The Government of Ukraine has embarked on a major reform, many years in the making, to modernize Ukrzaliznytsia (UZ) and enhance its organizational, operational and financial efficiency. A law adopted by Parliament in 2013 enabled creation of a joint stock company for public railway transport. UZ has potential to be financially sustainable given its strong traffic base and its dense railway network with a total length of track of about 22,000 km, the 14th largest network in the world. UZ's freight transport task is about 260 billion ton km. This, together with about 450 million passenger trips per year, makes the Ukrainian railways the 6th most densely operated railway in the world (measured in ton km plus passenger km per route km).

133. **Urban transport:** Good urban mobility (passenger and freight) is particularly relevant to increase productivity while improving the quality of life of the citizens. This is particularly relevant in an environment like Ukraine which has one of the highest urbanization rates in Europe, with around 69% of the total population living in urban areas. However, due to the lack of investments in public transport infrastructure and rolling stocks over the recent years, their condition has much deteriorated. The service integration among public transport modes is generally weak; in particular, the services operated by private operators are entirely separate from, and often compete with, those operated by municipal companies. Moreover, the urban mobility plans have not fully responded to the spatial expansion of the cities, growing motorization and changing mobility patterns. Under these circumstances, urban areas experience increasing traffic congestion, and consequently, deterioration of the air quality, increase in travel time and costs, and increase in road traffic crashes and casualties.

Private Sector: Creating a Level Playing Field

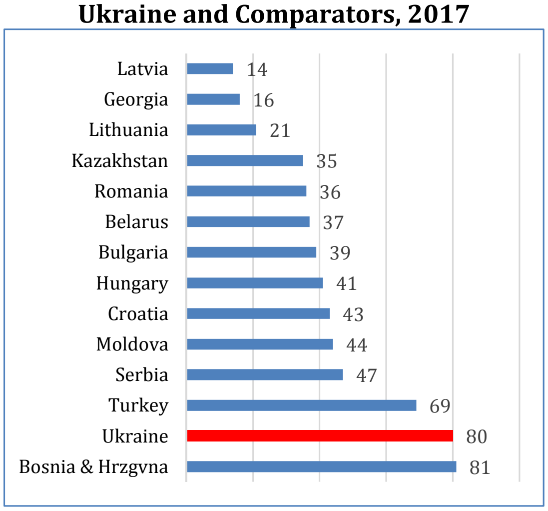
134. **Ukraine's highly concentrated and anticompetitive production structure, along with the absence of a level playing field in the private sector, are serious impediments to productivity and job creation.** The 2014 WBG report on "Opportunities and Challenges for Private Sector Development" found that Ukraine's tepid private sector growth is reflected in: (i) the stagnant structure of the country's industry and exports, where old industries such as steel, machine-building and chemicals continue to dominate and operate at low levels of productivity; (ii) the low inflow of high value-added FDI, especially in export-oriented manufacturing; and (iii) the relatively limited role of SMEs in the private sector, with larger firms and business groups dominating. All these factors

suggest that the market-driven and competitive process of entrepreneurship, innovation, and productivity growth does not function properly in Ukraine.

135. **Creating a more competitive and level playing field in the private sector will require streamlining the regulatory environment, strengthening competition policy, and reforming state owned enterprises.** Complicated regulatory barriers hinder market contestability, fuel corruption opportunities, and ultimately lead to an environment where only a small number of politically connected firms are able to function at low levels of productivity. Despite recent progress in streamlining the regulatory environment in selected areas, Ukraine lags comparator countries by a considerable distance. Second, with many sectors exhibiting high concentration of firms and low rates of firm entry and exit, weak implementation of competition policy does not help address the problem. The Anti-Monopoly Committee (AMC), the competition watchdog, is supported by a relatively strong legal framework, while the main challenge is weak implementation of the law. Third, the large and inefficient state-owned enterprise (SOE) sector is often able to operate at low levels of productivity and transparency with preferential access to resources, markets, and influence, thus crowding out entry and growth of more productive firms. Generating a more competitive private sector in Ukraine will, therefore, require comprehensive reform of SOEs, including improving transparency, governance, and accelerating preparations for transparent privatization.

Deregulation: streamlining the regulatory environment

Figure 43. Doing Business Ranking Ukraine and Comparators, 2017



Source: World Bank Group

Figure 44. Doing Business Ranking Regulatory Dimensions, Ukraine, 2017

Source: World Bank Group

136. **Ukraine has taken steps to improve its regulatory environment, but still lags other countries in the region by a considerable distance**. Improving the business environment is critical not only for encouraging private investment but also for moving investment to more productive and more profitable subsectors. The 2017 Doing Business (DB) Report ranks Ukraine 80th globally, which makes it 22nd in the region. Ukraine's ranking has improved significantly from 140th in 2013, 112th in 2014, and 96th in 2015, indicating steady progress over time. However, Ukraine's ranking lags those of the new EU member states that rank among the top 20-50.

Furthermore, while Ukraine has improved its ranking in some areas (20^{th} in getting credit and 20^{th} in starting a business in 2017) in recent years, it ranks poorly in several other important areas (150^{th} in Resolving Insolvency, 140^{th} in Getting Construction Permits, 130^{th} in Getting Electricity, and 115^{th} in Trading across Borders). Also, it is important to note that the Doing Business rankings represent only a small part of a larger investment climate. Ukraine is 79th in the Global Competitiveness Index 2015-2016, down from being 73rd just three years earlier. The European Business Association Investment Attractiveness Index shows little improvement in the business environment from 2011 to 2015. Findings from IFC surveys consistently show that Ukrainian firms describe the framework of permits, licenses, certifications, and inspections as burdensome.

137. **Reform efforts to streamline the regulatory environment so far have not been systematic and comprehensive.** Instead, reforms have been sporadic and have had a limited effect on businesses. This has resulted in continuing dissatisfaction of businesses with the regulatory environment. For example, the business start-up process has been streamlined, but voluntary business exit remains highly difficult, and completing mostly non-reformed licensing requirements for many types of licenses is still time-consuming. Business inspections and permitting procedures continue to be viewed by businesses as cumbersome, especially by SMEs. Despite reduction in the number of permits during recent years, a large number of permits and licenses have not been eliminated or streamlined, but simply renamed in order to bypass relevant laws. Poor implementation of the 2007 Law on Inspections is aggravated by an excessive number of inspectorates with a mandate to visit businesses in Ukraine and international best practice on risk-based inspections is not followed. Regulatory policy is also plagued by low transparency and weak impact assessment. The quality of the Regulatory Impact Assessment (RIA), with a main goal to assess the economic effects of proposed legislation and ensure that the benefits of a policy action are likely to be greater than the costs, is generally poor and does not meet the requirements of the RIA Methodology. As a result, many regulatory acts are not business-friendly.

138. **Going forward, Ukraine will need to take a number of systematic steps to streamline its regulatory environment.** These include: implementing reforms in the areas of construction permits, resolving insolvency and trading across borders, as measured by Doing Business; bringing the Regulatory Impact Assessment (RIA) in line with international practice and the Methodology, including the SME Test; improving regulations governing business inspections and canceling the moratorium imposed on such inspections; making an inventory and revision of 'hidden' permits and permitting procedures outside the scope of the Law on the Licensing of Commercial Activity and the Law on the List of Permits; and increasing the use of declarations instead of permits or licenses and improving the procedure of submission of such declarations to state authorities.

<u>Competition Policy</u>

139. **Enterprise ownership in Ukraine remains concentrated in a few large business groups.** While other transition economies have shifted toward more diversified industries and dynamic markets, the concentration of ownership of Ukraine's key resources in a few large business groups has prevented dynamism and diversification from taking hold, a missed opportunity for growth. Promoting competition is not easy in this environment, but a fair and balanced enforcement of anti-

monopoly rules, enforcing disclosure of ultimate owners, identifying and limiting related-party lending to prudential norms can all help.

140. **The Anti-Monopoly Committee (AMC) is supported by a relatively strong legal framework, while the main challenge is weak implementation of the law.** The Antimonopoly Committee generally has adequate legal powers but needs to reinforce its independence, and its capacity to apply anti-monopoly rules in a fair and balanced way. It should also have the obligation to disclose ultimate owners of businesses. Enforcement is also a problem, with less than 10 percent of fines imposed by the AMC actually paid. The Committee is over-burdened with cases that do not pose risk to competition, and the Committee is empowered to excessively intervene in ordinary market activity. Going forward, it will be important to fully harmonize Ukrainian legislation with that of the European Union and international good practice as well as implementing the National Competition Program 2014-2020, including enhancing capacity of AMC to carry out its responsibilities and providing adequate resources to ensure that the AMC can maintain high standards of performance and accomplish its mission. Moreover, enhanced competition would require better-trained judges adjudicating competition cases, including a checks and balances approach in reviewing the imposed fines, truly competitive public procurement and nondistortionary state aid, and stronger awareness and involvement of the civil society. The legislation on state aid has been adopted but its enactment is planned for August 2017. As a result, there is no the control of state support for sectors and companies that risks distorting competition.

State Owned Enterprise (SOE) Reform

141. **SOEs have a large share in the Ukrainian economy, contributing approximately 20 percent of GDP, but are grossly inefficient.** In 2015, Ukraine had about 3,500 SOEs, of which only half were operating. SOEs have a strong presence in several sub-sectors, including energy, transport, agriculture, and machine-building. The government owns 25 percent of total farmland and provides product-specific subsidies in agriculture, including area payments for horticulture, viticulture and hops; as well as substantial support for poultry and sugar production. SOEs are the largest employer in Ukraine: about 1 million people, roughly 5 percent of the work force. The SOE sector reported an aggregate loss of UAH 115 billion in 2014, about 7 percent of the GDP. Out of the largest 100 SOEs, only 57 were profitable in 2014 and net profit margins were, on average, very low. Furthermore, these entities are non-transparent, poorly supervised and governed, and plagued by corruption, which undermines public trust in both SOEs and the larger public sector. With reported profits and losses likely distorted due to vested interests of officials and specific business groups, a good first step is to introduce transparent and competitive recruitment of top management of the most important SOEs and to insist on international corporate governance principles. The SOE sector requires urgent reforms as these enterprises distort the economy and limit growth opportunities for the private sector. Trading enterprises and alcohol production are important examples, among others.

142. **Improving transparency and accountability in SOEs and the private sector is important.** Ukraine needs to strengthen its corporate financial reporting standards and practices,

as well as transparency and public availability of reliable financial information. This is important to improve public trust in financial reports of SOEs and private companies, but will require improving regulation and building capacity to comply. Although national accounting standards were approximated to the International Financial Reporting Standards (IFRS) in 2000, and direct application of IFRS by certain categories of businesses was introduced since 2012, most entities in Ukraine continue using outdated accounting standards to report their financial statements. This leads to incomplete financial reporting by SOEs and private enterprises. Audit regulations also need reform: Ukraine adopted the International Standards on Auditing (ISA) in 2003, but effectiveness of the regulatory system proved to be inefficient. The EU Association Agreement requires approximating financial reporting, accounting and audit laws to those of the EU.

143. **Improving governance of SOEs is important to provide a stronger commercial focus to SOE operations.** At the moment, there is no oversight body in charge of managing the state's commercial assets. SOEs are managed by various individual line ministries or agencies, in cooperation with private shareholders, in cases of joint ownership. As a result, SOEs are governed by a complicated and heterogeneous set of management practices, with no clear delineation of responsibilities between SOE management, relevant state agencies and, where applicable, private shareholders. Such a situation undermines accountability.

144. **Restructuring, privatization, and in some cases, liquidation, of SOEs on a case-by-case basis will be needed.** Cumbersome and outdated procedures greatly impede the efficient privatization, restructuring or liquidation of SOEs. An assessment of the current framework is planned, following which the legal and regulatory framework for privatization would be updated and simplified, followed by a Privatization Action Plan.

Land Reform

145. **Weak land governance seriously undermines investment and productivity in agriculture and other sectors in Ukraine.** The full realization of Ukraine's agricultural potential, especially in ways that include small and medium scale producers, is possible only if land tenure is secure for the long term and land rights are transferable. As Ukraine is a major global exporter of agricultural products, the quality of land governance in Ukraine also has implications for global food security. About 71 percent of Ukrainian territory (42.7m ha) is classified as agricultural land. State land comprises 25 percent of Ukraine's agricultural land base. There are about 23m private landowners and users (of which 90 percent are natural persons) and about 5m users of state land (10.5m ha). About 21.5m ha of agricultural land is cultivated by about 45,000 commercial producers (of which about 36,000 are below 200 ha). Thus, the quality of land governance affects the wellbeing of a significant portion of country's population and efficiency of several industries that use land as a factor of production or are vertically integrated with such industries.

146. **Results of a monitoring survey point toward a number of considerable challenges associated with land governance.** The results show that the level of registration of state land is significantly lower than that of private land (24 vs 71 percent), which is a source of non-transparent

practices and considerable losses of state revenues. Second, the rental price for agricultural land is one of the lowest in Europe and CIS countries, reducing the wellbeing of rural land owners and providing for inefficient use of land resources. Third, the sales market for land (outside of Moratorium for agricultural land) is extremely thin primarily due to lack of financial instruments and difficulties with using property and rental rights as a collateral. The primary type of transactions for agricultural land is rent (about 4.7 rental agreements with average duration of 7.6 years) with substantial informal rental market reinforced by recent legal initiatives to increase the minimum duration of rental contracts to 7 years. Fourth, the number of taxpayers for land tax (about 7.3 mln) is substantially lower than the number of private land owners and land users.

147. **In order to address the challenges associated with land governance, a number of initiatives will be important.** These include (i) improving institutional arrangements and transparency of land governance including establishment of permanent land governance monitoring system based on administrative records of Land Cadaster and other government authorities; (ii) increasing efficiency of state land management through a new legal framework and transparent procedure to clearly demarcate the state land and transfer it out of state ownership by either auctioning or transferring to communal ownership (preferably at rayon level) based on clear criteria; (iii) clearing legal status, formally registering and establishing a clear management arrangement over unclaimed property and unclaimed privatization shares, land of former collective farms (windbreak, forest strips, farm yards, field roads), (iv) opening up of the sales market for private agricultural land, possibly in a decentralized way and (iv) testing, monitoring, evaluating and improving efficiency of land reform.

Trade Facilitation

148. **Ukraine needs a balanced trade policy to increase export sophistication and linking domestic with global value chains.** It will be important to promote more sophisticated export products with higher value addition in the country (from grains to meat and dairy, from wood to furniture, from steel to machinery). Market opening and targeted investment promotion will be important to reach this goal. However, it should be noted that export sophistication and commodity exports are not necessarily mutually exclusive. Many developed countries, including France, Germany and the USA are successful net exporters of commodities and high tech products at the same time. Due to limited domestic commodity markets with shrinking population future growth will mainly be generated by export growth. Every ton of commodity produced will lead to almost one ton more export. However, trade logistics are under-developed and logistics costs are much higher in Ukraine to cope with future export growth. For example port logistics costs at Ukrainian Black Sea ports are about 20 $ per ton of grain and 7.5 $ in France and Germany. Investments in infrastructure and logistics (ports, railcars, river transport, storage, just-in time supply systems) combined with regulatory reforms are important means to facilitate trade and to make specific industries stronger and competitive. For Ukraine to overcome its crisis, it needs to integrate with Europe and the world.

149. **Trade facilitation, standards and competitiveness.** The trade agreement with the EU is deep (it's about tariffs and standards) and comprehensive (it covers almost everything). EU markets are highly competitive and Ukraine feels this challenge already. Ukraine needs strong commitments

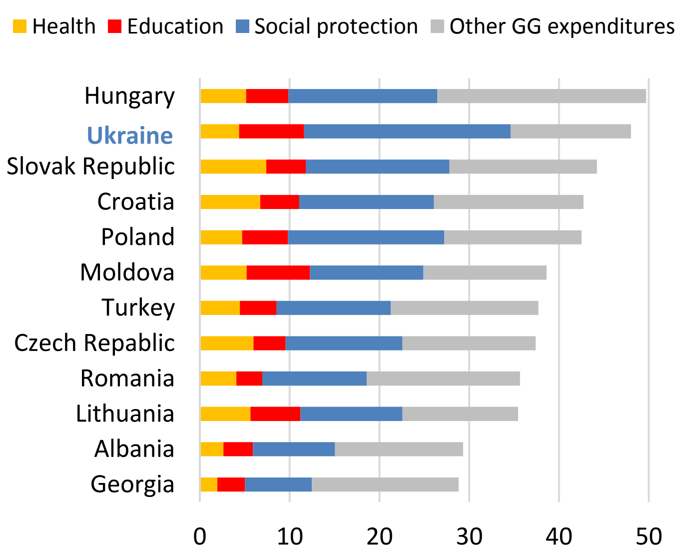
to adapt its trade procedures and standards to facilitate trade across borders for its own industries to integrate into global markets and value chains. Also, the WTO Trade Facilitation Agreement with its focus on removing non-tariff barriers to trade would be an important reform anchor. Key reform measures would focus on the operating environment for traders, simplifying border clearance procedures, improving the National Quality Infrastructure (investing in metrology, adapting conformity assessment to trade partners, internationalize private and public safety and sustainability standards, promote mutual recognition of accreditation bodies) and modernization of logistics infrastructure and trade services.

150. **Ukraine has considerable potential across the broad agribusiness sector.** This potential is capable of helping to address global food security challenges over time. The sector has shown remarkable resilience and competitiveness in times declining global commodity prices and crisis, increasing its export share to about 40 percent of total exports. However, its potential has been only partly realized as specific challenges in the sector include raising farming efficiency and yields, improving farmers' access to financing, developing storage, transport and distribution infrastructure, modernizing food processing and agricultural processing especially in industries with strong linkages to other sub-sectors across the whole economic value chain, and supporting the development of local companies with high potential which have been among those the hardest hit by the crisis. Uncertainty about the future of the land ownership limits investment and yields in the sector as significant shares of agricultural land remain underutilized.

VIII. Pathway 3: Effective services and targeted assistance

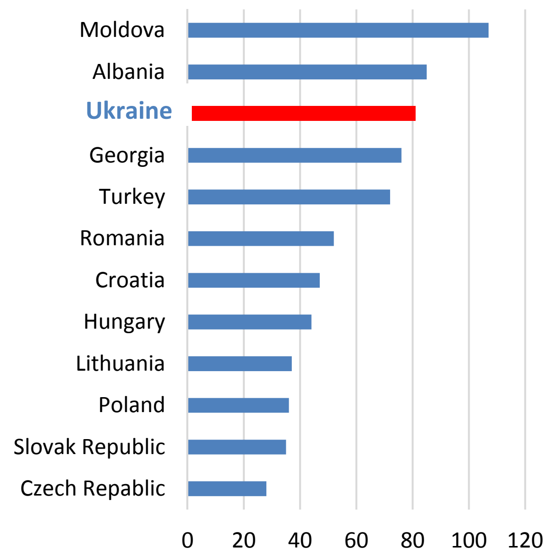
151. **Effective service delivery is important not only to enhance skills and labor market outcomes, but also to ensure that the benefits of growth are broadly shared in a sustainable way.** Social sector expenditures are high in Ukraine: 5.8 percent of GDP on education and 4.5 percent on health. However, the population, including the bottom 40 percent, has not been well served. Health outcomes are poor relative to comparators and though general education outcomes (e.g. years of schooling, completion of secondary/tertiary education) are better, firms in Ukraine find that skills for highly-skilled and/or middle-skilled jobs are in short supply. Similarly, while expenditures on social protection (pensions and other social assistance–17 percent and 4 percent of GDP respectively) are one of the highest in the region, social assistance is not well targeted. The bulk of payments for social assistance go to those outside the bottom 40 percent and many vulnerable groups are not adequately protected via social care services. In fact to become more effective, social care services in Ukraine need to address problematic funding and accountability arrangements. Finally, there are concerns that social expenditures in Ukraine are unsustainably large, squeezing resources for public investment and raising risks of macroeconomic imbalances. All this suggests that service delivery in Ukraine needs to focus on greater efficiency and effectiveness, while social assistance will require improved targeting.

Figure 45: Composition of general government expenditure, Ukraine vs peers, 2013



Source: IMF GFS for 2013

Figure 46: Human Development Index Rank 2014 (lower rank means higher development)



Source: UNDP, 2014

152. **General government spending in Ukraine is considerably higher than that of countries at similar levels of income.** Ukraine's general government budget revenue, including social security contributions, amounts to 41 percent of GDP on average for the last ten years, which is notably higher than the averages for ECA and lower-middle income countries of 33 and 31 percent, respectively. Ukraine also spends more than countries at similar levels of income and countries in the ECA region.

At over 45 percent of GDP on average for the last ten years, Ukraine's general government expenditures are about 10 percentage points higher than the ECA regional average and about 15 percentage points above the average for lower-middle income countries.

153. **The high level of expenditure does not translate into higher quality of public service delivery.** Despite falling student numbers, expenditures on education increased from 5.9 percent of GDP in 2007 to 7.2 percent in 2013 before declining back to 5.8 percent in 2015. Health care expenditures also increased, albeit from a relatively low 3.7 percent of GDP in 2007 to 4.2 percent of GDP in 2013. Wage increases pushed up spending on the public sector wage bill from 10.1 percent of GDP in 2007 to about 11.5 percent in 2013. Interest payments have also picked up reaching 2.5 percent of GDP in 2013 driven by greater debt issuances during the crisis period. On the other hand, capital spending contracted most sharply over the same period, down from 5.4 percent of GDP in 2007 to 2 percent of GDP in 2013.

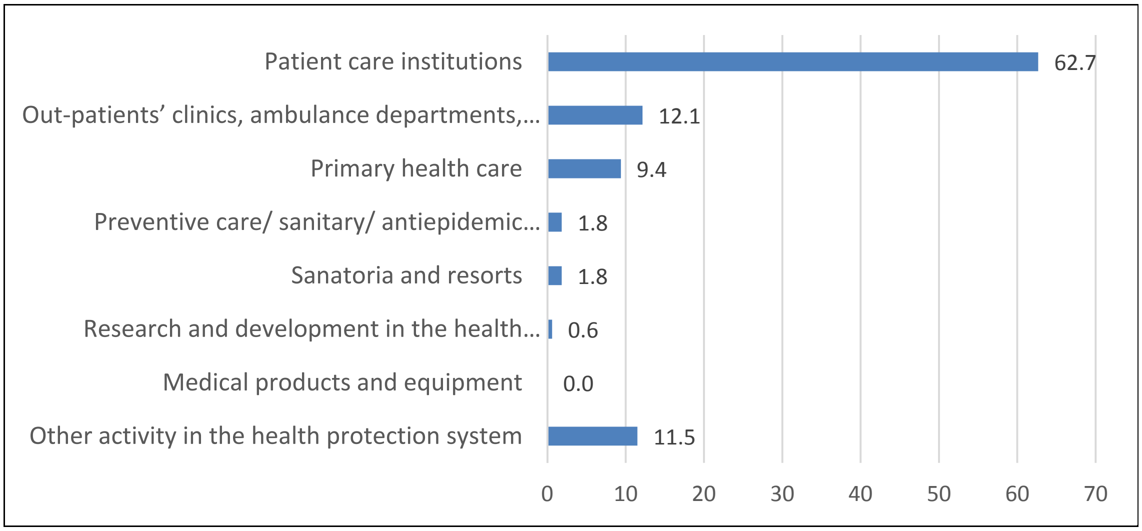
154. **More effective services and targeted assistance will require optimizing the financing and improving the quality of health and education, further improving targeting of social assistance, and providing effective support to conflict affected people.** The most important priorities are in the areas of health, social assistance, and targeted support to conflict affected people. In health, a key priority is to reform the health financing model from a focus on hospital care and input-based norms toward a payment system where money follows the patient. In social assistance, key priorities include improving the targeting of the housing and utilities subsidy (HUS) program which has provided temporary relief from energy tariff increases, but also continuing to move from categorical to targeted benefits for the overall social assistance package. In light of the continuing conflict and large numbers of IDPs, providing targeted support to conflict affected people is a high priority. This will require providing effective skills, training, and enterprise support in affected areas and extending systematic assistance to vulnerable households. The following table summarizes the priority interventions for providing more effective services and targeted assistance identified through the analysis in this chapter.

Priorities	Criticality	Time horizon
Health Reform: Revise health financing model from input-based norms toward payment systems where "money follows" the patient	High	Short
Education: Implement "hub schools" program to optimize school network while prioritizing investments in quality-enhancing inputs	Medium	Short
Subnational delivery mechanisms: Improve norm-based financing for services, increase financial autonomy, and clarify roles and responsibilities	Medium	Short
Social Assistance: Continue shift from categorical to targeted benefits and improving targeting of the housing utility subsidy (HUS) program	Critical	Immediate, Short
Targeted support to conflict affected people: skills, training, and MSME in affected areas and host communities and extend systematic assistance to vulnerable households	High	Immediate, Short

More Efficient Health Services

155. **Provision of better and more comprehensive health care is a priority.** Ukraine is facing a serious health situation and needs to take urgent, appropriate and deep reform actions to improve its health services and to reverse the progressive deterioration of its citizen's health. The overarching goal of these reforms should be to create a health system that is responsive to clients, transparent, effective and equitable in preventing and controlling non-communicable diseases (NCDs) by scaling up preventive and primary care.

Figure 47. Distribution of resources by type of services/activities (% of total), 2014



156. **Most resources are spent on in-patient and specialized outpatient care and around 10 percent on primary and preventive care.** Of all premature deaths (at under 75 years of age) in 2004, 17 percent could have been avoided with adequate prevention of major risk factors (smoking, alcohol, diet and road traffic accidents). Also 80 percent of deaths among working-age males and 30 percent of deaths among working-age females were from illnesses that could have been treated adequately at the primary care level.

157. **The Government spends about 12 percent of total public expenditure on health, which is comparable to other countries in the region.** Most government health financing comes from general taxation, and it is allocated according to inputs and mainly to cover recurrent costs (96 percent of total costs). In 2013, direct funding to health facilities was mainly spent to cover salaries of personnel (e.g. 84 percent of total budget spent on personnel in out-patients clinics and 74 percent in general hospitals in 2013, BOOST data). Ukraine has an oversized health care infrastructure with about 40 percent more beds per capita than the WHO European Region average. This infrastructure consumes most of the available funding, often providing only very basic inpatient and outpatient services. In 2014, more than a half of public spending on health was allocated for in-patient facilities and less than a tenth on primary health care disease prevention.

158. **Out of pocket payments are high, which is a barrier to access for all and particularly for the rural and the poor population.** High levels of out of pocket payments (OOPs) create a barrier to access health services for the poor and the bottom 40 percent and can generate catastrophic expenses for those seeking urgent care, or those affected by chronic diseases requiring medicines. Private households' expenditure, mainly patients' out of pockets (OOPs) at the point of service delivery, amounted to 43.6 percent of total health expenditure or 3.3 percent of GDP in 2012, and have grown further since. De jure, all medical services should be provided free of charge for patients, but in practice patients pay for treatment. Anticipation of high expenditures associated with use of health care services puts another barrier to timely and regular access to medical service.

159. **Ukraine is losing its human capital due to ineffective and poorly performing health system, something it can ill afford with a declining working-age population[15].** Life expectancy at birth (LEB) is low (71 years in 2013); it lags more than 10 years behind EU and OECD. The low LEB is mainly explained by excess mortality due to non-communicable diseases (NCD) among male and rural population. Taken together, evidence shows that Ukraine is facing a health crisis and needs to undertake urgent, appropriate, and deep reforms to reverse the progressive deterioration of its citizens' health and in their trust of the system. Better governance would be a key lever for implementation of the needed changes.

160. **The main reason of premature deaths and disabilities is a high burden of NCDs, and it significantly contributes to avoidable productivity loses.** NCD-related morbidity and mortality is very high in Ukraine: the age-standardized mortality rate from NCDs in 2012 accounted for 749 cases per 100,000 population, while in neighboring Poland it was 494 cases, and 533 in Slovakia. The existing healthcare system is not shaped to effectively control epidemic of NCDs in the country. The current health service delivery is not oriented towards prevention, early detection and effective management of NCDs; it stays mainly unchanged since country's independency and focused at control of infectious diseases and provision of curative medicine instead of health promotion. High levels of consumption of alcohol (13.9 liters of pure alcohol per person per year) and tobacco (21% prevalence as of 2014), unhealthy diets and low physical activity are among key risk factors explaining high burden of NCDs.

161. **Strong leadership and the stewardship function at the central level are needed particularly in the new decentralized environment**. At present, 81.5 percent of total government expenditure on health is channeled through local governments, and 18.5 percent through central institutions, including the Ministry of Health. In the new decentralized environment, MoH should develop the role of planner, coordinator, and evaluator of health services' standards and results, with local authorities at regional, city, district, and community levels assuming the role of implementing actors. Instead, the ministerial orders, often outdated, continue to impose extremely detailed input-based "norms" (on personnel, infrastructure, etc.) on all individual facilities, and has focused mainly on procuring (very inefficiently) inputs such as drugs for the national programs. The local authorities

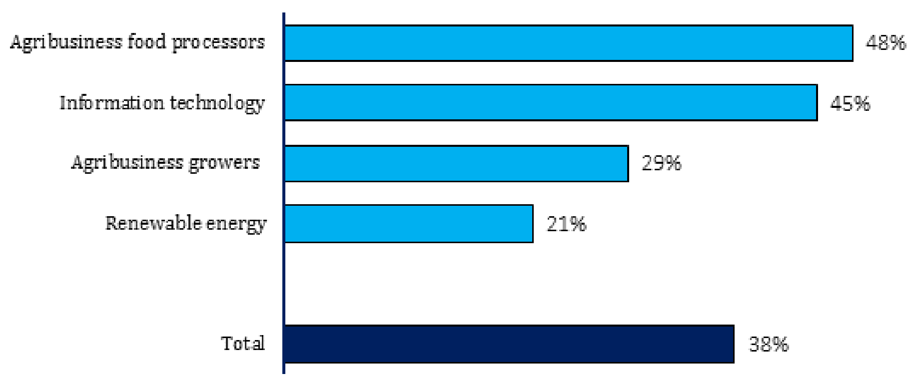
[15] Bloom et al (2004) find that increase of life expectancy by 1 year raises the steady state GDP per capita by about 4 percent.

are having limited flexibility for effective system management and act without clear mandates in terms of service standards and results.

Skilled Labor Force

162. **With firms complaining about the shortage of skilled labor, Ukraine's training and education institutions need to become more responsive.** While the country performs at the top end in terms of educational outcomes like average years of schooling and tertiary education attainment, there is increasing evidence that skills that employers need are deficient. According to a firm survey in 2015, most firms in four key sectors of economy (i.e. agribusiness food processors, Agri-business growers, ICT, and renewable energy) report that the education system does not train students to get the skills that employers need. About 70 percent of the firms surveyed reported that graduates of the general education system and technical vocational education and training (TVET) system do not have practical skills or up-to-date knowledge. Close to four firms out of ten report that their employees' skill gaps prevent them from achieving business objectives. This is true for roughly half the firms in the food processing and ICT sectors (Figure 48)

Figure 48. Share of firms reporting a significant skill gap, %



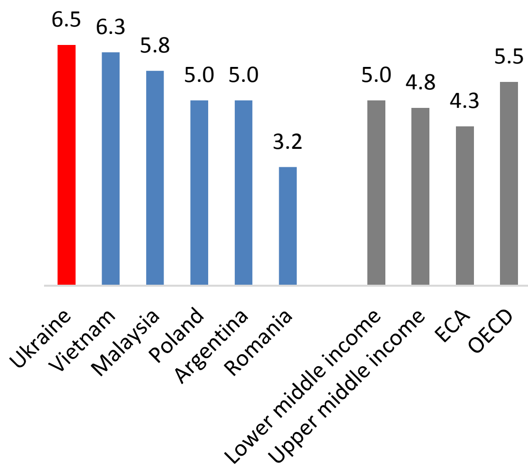
Source: Del Carpio and others forthcoming

163. **The skills most demanded by employers include a mix of technical, socio-emotional and advanced cognitive skills.** The firm survey shows that advanced cognitive skills that allow workers to analyze and solve problems, manage their time, gain new knowledge and learn new methods, and communicate effectively, are highly demanded in Ukraine. Employers not only look for workers who think well but also for those who demonstrate socio-emotional skills that help manage one's emotions and behaviors (like self-management, resilience, ethics), goal setting and willingness to learn (achievement motivation), and the ability to work with others (teamwork). The technical skills sought are typically occupation or job-specific, like sales skills, knowledge of markets and products, and advanced computing skills.

164. **Formal education institutions are the most fertile ground to build skills, but the current system lacks flexibility, quality standards, and relevance for today's labor market needs.** Six out of ten firms from four key sectors report a skills gap. Ukraine's eighth-grade students

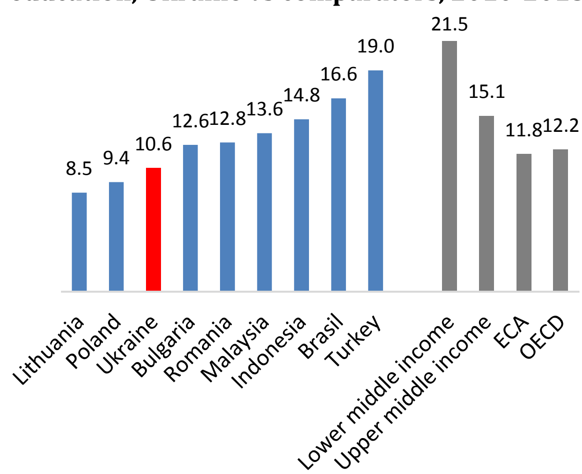
scored well in the 2011 international assessment conducted as part of the Trends in International Mathematics and Science Study (TIMSS), ranking in the same group as high-income countries like Italy, Norway, or Sweden. However, beyond credentials and students' basic academic skills, there are questions about the relevance of the workers' education, particularly those graduating from vocational education institutions. Over the years, the supply of university graduates has increased beyond actual demand, although there are questions about the quality of instruction. Curriculum formation is mostly a top-down process with limited private sector involvement. This lack of interaction between employers and the formal education system exacerbates skill mismatches. A large segment of the labor force is trained for professions that are no longer in demand, creating a surplus of unneeded skills. While firms also seek to partner with education institutions to provide inputs to their curricula, less than a quarter of all firms surveyed actually have regular contact with education or training institutions.

Figure 49: Public expenditure on education, 2010-2015, percent GDP



Source: Find My Friends using the Ed Stats Database

Figure 50: Pupil-Teacher Ratio in secondary education, Ukraine vs comparators, 2010-2015



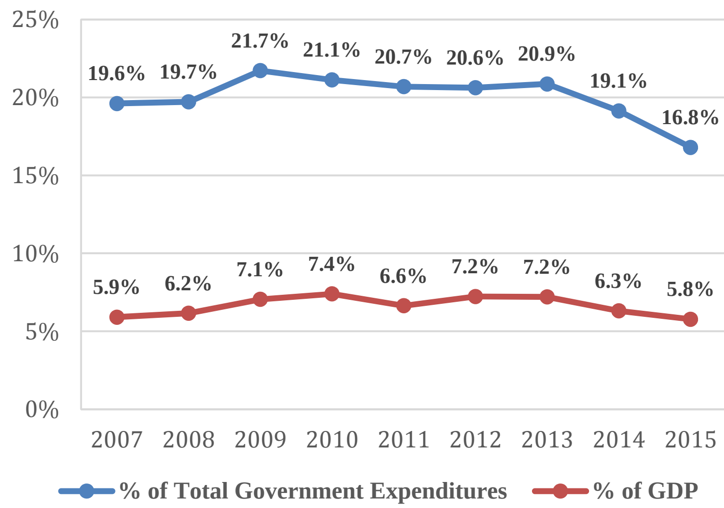
Source: Find My Friends using the Ed Stats Database

165. **By most metrics, Ukraine's public expenditure on education has been high in recent years.** However, the recent economic turmoil took its toll on the level of public funding for education. Between 2013 and 2015, budget financing of the sector shrank from 7.2 percent of GDP to 5.8 percent (from 21 percent to 17 percent of total government expenditures). Following the sharp devaluation of the hryvnia, public education spending declined by 35 percent in real terms over two years. This decline brought Ukraine closer to international benchmarks in terms of the share of national wealth devoted to the financing of education. Ukraine is now on par with such countries as Slovenia, Israel, France, and the UK and closer to the OECD and EU averages of 5.3 percent of GDP.

166. **However, the efficiency of public spending in education remains questionable.** The public budget finances the maintenance of an oversized school network. The number of teachers and schools has remained nearly the same despite a severe decline in student population (by forty percent over the last two decades). Efficiency indicators, including the average school size and the student-teacher ratio, have been falling sharply—the ratio of 8.5 students per teacher is among the

lowest in the world. Large allocations to non-personnel recurrent costs and non-means tested scholarships affect all levels of the education system—from preschool through university.

Figure 51: Ukraine Public Expenditure on Education (% of GDP and % of Total Government Expenditure, 2007-2015)



Source: Ukraine PFR 2016.

167. **In 2016, the Government has begun to address some of these concerns.** The launching of the “hub schools” program is aimed at beginning the long overdue optimization of the general secondary school network in line with the declining student population. Further reallocations of public resources should prioritize investments in quality-enhancing inputs to improve education quality and make the sector adaptable to new economic needs. Targeting scarce public funds toward their most optimal uses—such as capital investment and ensuring equitable access to learning materials and well-qualified teachers for all students—should be the priority. Meanwhile shifting away from subsidizing non-quality enhancing expenditures—such as unnecessarily small class sizes or generous scholarships for non-needy students—can create fiscal space for more pressing budget needs.

168. **At the same time, concerns regarding declining access to quality education for the poor and the bottom 40 percent should be taken seriously.** The quality of basic education is becoming highly differentiated for different groups within Ukrainian society. Unequal access to quality education creates barriers for social mobility and negatively affects higher levels of education. There are anecdotic cases providing evidence of dramatic differences in public financing among elite and non-elite schools and preschool organizations. More than half the parents disagreed with the statement that secondary education give equal access to everybody for free, in a recent poll. There is also public perception of unequal access to the best higher education institutions. This issue has not been an object of any in-depth studies so far but may require further investigation in the future.

Subnational Delivery Mechanisms and Municipal Utilities

169. **In fiscal terms, Ukraine is highly decentralized, although administrative decentralization is lagging considerably.** Subnational expenditures account for 31 percent of consolidated government spending. This places Ukraine in the company of such countries as Austria, Poland, and Italy, and ranks it considerably more decentralized than Romania and Bulgaria. Most subnational spending occurs at the second (raion and city-of-oblast-subordination) tier. Together, second-tier subnational governments accounted for 65 percent of total subnational spending in 2015. Top-tier subnational governments (Kyiv and the oblasts) accounted for 27 percent of subnational spending. Third-tier subnational governments accounted for the remaining seven percent.

170. **The vast majority of subnational spending is devoted to the social sectors, while spending on economic infrastructure, such as roads, accounts for only seven percent of total expenditure.** Local governments in Ukraine bear the full cost of running schools, hospitals and social welfare facilities (including the wage cost associated with the provision of these services). In addition, social assistance-related cash benefits, which are usually fully administrated by relevant central government bodies in other countries, are passed through the budgets of local governments in Ukraine as well. In 2015, 78 percent of total subnational spending is devoted to education, health and social protection. Spending on 'housing' including subsidies to cover the arrears of utility companies, accounts for another six percent. Capital expenditure at the local level is low for a lower middle income country. Despite notable progress to increase capital expenditures, which were scaled up from a low of 0.9 percent of GDP in 2014 to 1.6 percent of GDP in 2015, the level is yet very low given the transition status of the country and its growing needs for investments injections.

171. **Ukraine's intergovernmental fiscal relations provide an adequate level equalization, but falls short of promoting efficient service delivery:**

- The inter-budgetary transfer system is rigid and based on an official registered number of citizens and outdated input-based "norms" dis-incentivizing rationalization of education and healthcare networks. It not only undermines efficient service provision but recently became a bottleneck for timely and effective financial support of conflict-affected territory and people.
- Revenue sharing arrangements are not aligning resources with services - corporate income tax, for example, is not a suitable source of revenue for subnational governments; and limited tax base for property tax (i.e., high square area thresholds and exclusion of industrial and commercial property) will limit the yield of the property tax.
- Ongoing amalgamation of villages and settlements may fall short of expectations of improved service delivery and local accountability. The key decentralization goals, such as determining the territorial and administrative organization of different tiers of government to support subsidiarity, local accountability and sound fiscal management at the subnational level would be difficult to reach within existing design of the voluntary amalgamation of communities.

172. **Access to municipal utilities is more constrained for the B40 population, with the sector suffering from decades of underinvestment, poor maintenance, and low quality of service delivery.** Estimates based on the household survey indicate that in 2013, only 27 percent of the B40 population had access to district heating, compared to 43 percent of the T60 population. Similarly, 23 percent of the B40 population had access to hot water compared to 38 percent of the T60. The need to invest in enhancing the efficiency, access, and quality of district heating, water, and sanitation is considerable. Furthermore, low tariff levels are a major limitation to the sustainability of these utilities.

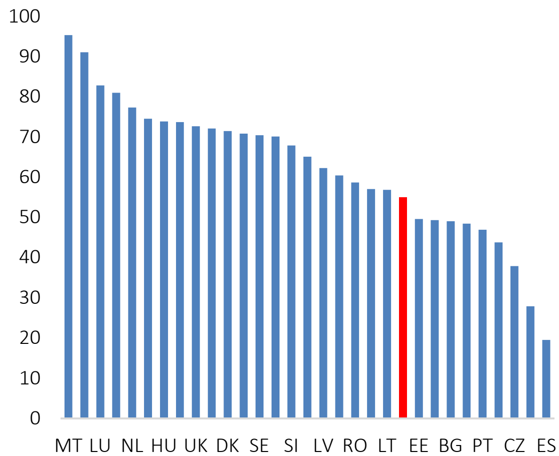
173. **Protracted underinvestment in district heating sector has led to physical and economic inefficiency and high heat losses in production, transmission and distribution.** On the demand side, building energy efficiency in Ukraine is estimated to be about 2-2.5 times worse than in Western Europe. However, until recently, consumers have had very little incentive to conserve heat due to low tariffs and the low level of heat consumption metering. As a result, about 30 percent of all heat is lost during end use. In 2012, the government approved a master plan to improve energy efficiency in the DH sector based on a large scale investment program in energy efficiency measures and reforms of the social safety net to protect vulnerable consumers. However, implementation of this action plan has been slow. Reforms in DH sector continued with moving the regulatory responsibilities for the sector to the newly established regulator. However, going forward, this new regulator requires capacity building, especially in the area of incentive-based regulation for utilities.

174. **The need for rehabilitation is exacerbated by high overall energy consumption in water production and wastewater treatment.** It is estimated that energy intensity in Ukraine is one of the highest in the region. Improving service delivery through the rehabilitation of infrastructure and the promotion of energy-efficiency solutions offers the possibility of driving utilities toward financial sustainability while providing improved services. In addition, institutional capacity building for water and sanitation utilities is also critical.

Social Assistance

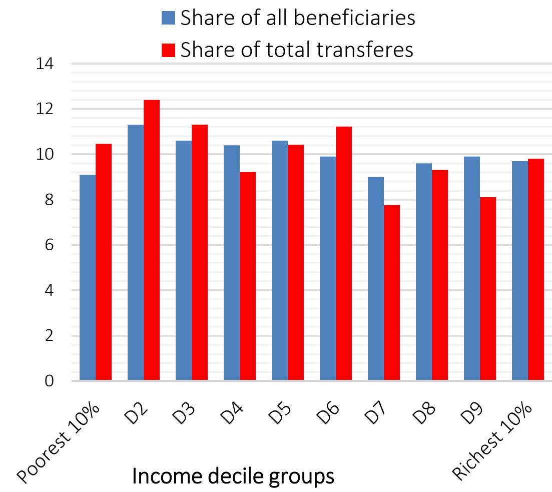
175. **Ukraine spends a considerable amount on social assistance, although much of it is not well targeted.** Social assistance spending increased significantly between 2009 and 2012, chiefly due to increases in child and family related benefits. Although spending has declined since 2012, Ukraine remains one of the highest spenders on social assistance in the region. Yet, the bulk of the spending does not reach the poor. According to prior analysis, only a third of all transfers reached the poor. Spending is dominated by the child-birth benefit and various categorical benefits, while the means-tested low-income family benefit accounts for a small portion. Prior to 2014, expenditures also included a large portion on universal energy subsidies.

Figure 52: Coverage rate for various countries, 2012 and for Ukraine, 2014



Sources: WB staff based on BOOST,

Figure 53: Share of total beneficiaries by deciles and share of total transfers by deciles of expenditure



Sources: WB staff based on BOOST
Note: (Direct and indirect beneficiaries, 2014 HBS)

176. **Despite the high rates of welfare spending, Ukraine ranks low in providing protection through social assistance.** The rate of coverage for poor in Ukraine is among the lowest in the region, while welfare spending is sizeable. In other words, the cost-effectiveness and equity resulting from social assistance is not commensurate with the amount of resources spent. Ukraine only covers around half of the poorest quintile through social assistance, lower than most other countries in Europe.

177. **Despite on-going fiscally expansive efforts to support the population such as the enlarged Housing and Utilities Subsidy (HUS) program, overall support to vulnerable households suffers from both low coverage and low adequacy.** Ukraine inherited a welfare system dominated by categorical benefits. Many of these programs are aimed for groups that are not poor on average. As a result, despite high rates of spending Ukraine ranks low in providing protection through social assistance - Ukraine only covers around half of the poorest quintile through social assistance, lower than most other countries in Europe. The generosity of targeted social assistance is also low; on average social programs amounts only to about 17 percent of expenditures of the poorest quintile. During 2014-15, the Government of Ukraine implemented a range of measures to reform social assistance programs with the broader aim of containing spending and to reallocate resources to increase the share of transfers targeting the poor. At the same time, overall support to low-income households still is not adequate.

178. **Since 2014, the authorities have implemented a number of measures to reform social assistance programs.** These measures aim to put in place fiscally affordable safety-nets programs and mitigate the impact of the crisis on the poor through targeted assistance. The reforms should have increased the share of targeted assistance reaching low-income households and helped contain

social assistance spending. However, the economic crisis and the rapid escalation of energy tariffs are eroding these savings as the need for social assistance has increased.

179. **Despite the efforts, challenges remain that suggest a number of areas for further attention going forward.** First, on the composition of spending, the child birth grant remains a poor policy choice with attendant high cost and low social return. Second, while overall social assistance reaches a large share of the population (with 55 percent of the population benefiting directly or indirectly from at least one form of social assistance), adequacy of support measured by generosity of payments is generally low. Third, the system is in need of administrative modernization, to improve accessibility, administrative efficiency and targeting.

180. **The HUS program has served an important function of mitigating the impact of the energy tariff increases on the population, but the program needs to be better targeted going forward, including possible consolidation with the GMI program in the longer term.** While the HUS program is means-tested, the benefit is received by around six million households, making it a poorly targeted. In the medium term, a key priority is to improve targeting of the program and in the longer term, it should also be considered for consolidation with the GMI program. While Ukraine has a number of targeted programs, these have their own eligibility rules and targeting methodologies which are not achieving the needed targeting accuracy. Therefore, it is recommended that a common targeting approach be adopted that takes advantage of economies of scale made possible by a common platform. The unified approach would enable better quality information, more effective cross-checks, verification, data sourcing, analytics, and data sharing protocols between agencies. In the short term, the HUS should continue to be given priority for improving the Management Information System (MIS), streamlined procedures, and improving human resources through training and appropriate remuneration. More transparent financial management of the HUS is also important to replace an opaque system of inter-institutional settlements that results in waste, fraud and errors.

Targeted support to conflict-affected

181. **Targeted support to conflict affected people is an urgent priority.** The direct impacts of the conflict are faced by the population in conflict affected areas, but also by internally displaced persons, returning combatants, and host communities across Ukraine. As the conflict enters its third year, while there is still an urgent need for humanitarian assistance, conflict-affected communities, displaced Ukrainians, and the communities that host them also face considerable broader development challenges, including employment, education, health, and psychological and social stress. Preexisting social inequalities and regional divides are often exacerbated and there are considerable strains on service delivery systems and already depressed labor markets.

182. **There is an urgent need for a national vision and development strategy, developed with conflict affected citizens, in response to the socio-economic impacts of the conflict**—targeting both eastern populations and conflict-affected communities across Ukraine (including IDPs, former combatants, and host communities). The 2015 Recovery and Peacebuilding Assessment for eastern Ukraine (jointly prepared by the World Bank, United Nations, and European

Union at the request of Government) and the Ukraine State Target Program for Peacebuilding and Recovery of the Eastern Regions (planned for release in late 2016) and led by MOT, provide priorities for action in this regard. Target areas include:

- ***Restoring critical infrastructure and key social services*** in such fields as education, health care, social protection, public buildings and housing, energy, transport, water supply and removal, and environmental protection. In areas hosting IDPs, this would also include reducing the burdens on overstretched service delivery systems;

- ***Promoting economic recovery*** by considering viable options for economic revitalization in eastern Ukraine implementing local economic planning, creating new jobs, skill training and building human capital, providing support to micro-, small and medium-size business, expanding access to financial services;

- ***Strengthening social resilience, peacebuilding and community security*** by restoring citizen confidence; providing legal assistance and ensuring access to justice; monitoring the situation in communities in terms of vulnerability, risks and social bonds; providing psychological and social support to the conflict-affected populations.

183. **Across all target areas, modified local delivery mechanisms and strengthened local governance will be required**, including innovative mechanisms for delivering services and support in high-risk and insecure settings. Engaging conflict-affected citizens is a critical starting point for the development of appropriate locally-relevant responses. Government outreach and support to eastern regions will help build confidence and trust and to promote longer-term stability, integration and development progress.

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The SCD was prepared by a team of technical and policy experts nominated by Practice Managers across the Global Practices, IFC, and MIGA. The table of SCD team members and focal points and their respective practice managers is below. The work of the SCD was steered by an informal advisory Group comprising the Country Director (Satu Kahkonen and previously Qimiao Fan), Gallina Vincelette/Ivailo Izvorski (MFM Practice Manager), Carolina Sanchez (Poverty Practice Manager), Rufat Alimardanov (IFC Country Manager), Kartick Kumar (IFC Strategy Officer), Alejandro Cedeno (CPC), Feng Zhao (HD Program Leader), Ludmilla Butenko (SD Program Leader), Faruk Khan (Lead Economist and EFI Program Leader, co-TTL), and Caterina Laderchi (Senior Poverty Economist, co-TTL).

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