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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

ON A PROPOSED DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF US\$500 MILLION

TO UKRAINE

FOR THE

SECOND DEVELOPMENT POLICY LOAN

July 30, 2015

Macroeconomics & Fiscal Management  
Belarus, Moldova and Ukraine Country Unit  
Europe and Central Asia Region

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## UKRAINE: GOVERNMENT FISCAL YEAR

January 1 – December 31

### CURRENCY EQUIVALENTS

(Exchange Rate Effective as of July 29, 2015)

Currency Unit = Ukrainian Hryvnia (UAH)

US\$ 1.0 = UAH 22.1

### ABBREVIATIONS AND ACRONYMS

AAA	Analytic and Advisory Activities	IFI	International Financial Institution
BEEPS	Business Environment and Enterprise Performance Survey	ILO	International Labor Organization
CEA	Country Environmental Analysis	IMF	International Monetary Fund
CPI	Consumer Price Index	LA	Loan Agreement
CPS	Country Partnership Strategy	M&E	Monitoring and Evaluation
DCFTA	Deep and Comprehensive Free Trade Agreement	NBU	National Bank of Ukraine
DFID	Department for International Development	NCRCS	National Commission for Regulation of Communal Services
DGF	Deposit Guarantee Fund	NEURC	National Commission for State Energy and Public Utilities Regulation
DPL	Development Policy Loan	NERC	National Energy Regulatory Commission
DSA	Debt Sustainability Analysis	OECD	Organization for Economic Cooperation and Development
EFF	Extended Fund Facility	PEFA	Public Expenditure and Financial Accountability
ESMAP	Energy Sector Management Assistance Program	PFM	Public Finance Management
EU	European Union	PPG	Public and Publicly Guaranteed
FDI	Foreign Direct Investment	PSIA	Poverty and Social Impact Analysis
FLEG	Forest Law Enforcement and Governance	SBA	Stand-By Arrangement
FSDPL	Programmatic Financial Sector Development Policy Loan	SDR	Special Drawing Rights
FY	Fiscal Year	SOE	State Owned Enterprise
GDP	Gross Domestic Product	TA	Technical Assistance
GMI	Guaranteed Minimum Income	UAH	Ukraine Hryvnia
HUS	Housing and Utility Subsidy	USD	United States Dollar
IBRD	International Bank for Reconstruction and Development	VAT	Value Added Tax
ICR	Implementation Completion and Results Report	WBG	World Bank Group

Vice President:	Cyril Muller
Country Director:	Qimiao Fan
Senior Practice Director:	Marcelo Giugale
Practice Director:	Satu Kristiina Kahkonen
Practice Manager:	Ivailo Izvorski
Task Team Leaders:	Sebastian Eckardt, Lalita Moorty

## UKRAINE

### SECOND DEVELOPMENT POLICY LOAN

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The Ukraine Second Development Policy Loan was prepared by a World Bank Group team consisting of (in alphabetical order): Oleksii Balabushko (GGODR); Rinku Chandra (GFMDR); Joel Lachlan Cooper (GTCDR); Dmytro Derkach (ECCUA); Sebastian Eckardt (GMFDR,TTL); Anastasia Golovach (GMFDR); Yevhen Hrebenuik (GFMDR); Tetiana Kovalchuk (ECCUA); Jana Kunicova (GGODR); Caterina Ruggeri Laderchi (GPVDR); Jan Loeprick (GTCDR); Lalita Moorty (ECCU2, TTL); Eugeniu Osmochescu (GTCDR); Katerina Petrina (GSPDR); Laura Pop (GFMDR); Julie Rieger (LEGLE); Luis M. Schwarz (WFALA); Yadviga Semikolenova (GEEDR); Iryna Shcherbyna (GGODR); Irina Shmeliova (GGODR); Viktoria Siryachenko (ECCUA); Tamara Sulukhia (ECCU2); Nithin Umapathi (GSPDR); and Moses Sabuni Wasike (GGODR). We gratefully acknowledge guidance from: Cyril Muller (ECAVP); Laura Tuck (VP GPSG2); Anna Bjerde (ECAVP); Qimiao Fan (ECCU2); Alejandro Cedeño (ECCU2); Marcelo Giugale (GMFDR); Satu Kahkonen (GMFDR); Ivailo Izvorski (GMFDR); Ranjit Lamech (GEEDR); and Adrian Fozzard (GGODR).



## SUMMARY OF PROPOSED LOAN AND PROGRAM

### UKRAINE

#### SECOND DEVELOPMENT POLICY LOAN

Borrower	Ukraine
Implementation Agency	Ministry of Economic Development and Trade
Financing Data	IBRD Loan Terms: Variable spread with 16 years total maturity, including 7 years of grace period; Front End Fee: 0.25 percent; Amount: US\$500 million.
Operation Type	Programmatic (2 of 2); Single tranche
Pillars of the Operation And Program Development Objective(s)	The proposed Program Development Objectives are to: i) promote good governance, transparency and accountability in the public sector (Pillar A); ii) strengthen the regulatory framework and reduce costs of doing business (Pillar B); and iii) reform inefficient and inequitable utility subsidies while protecting the poor (Pillar C).
Result Indicators	<ul style="list-style-type: none"> <li>- By the end of 2016, the share of competitive procurements is increased to 55 percent of total procurements (by value)</li> <li>- By the end of 2016, all new public investment projects are appraised and selected through a new selection and appraisal process</li> <li>- By end of 2016, all financial disclosures by elected and high level officials are subject to external verification</li> <li>- By end of 2016, state revenues are included in the external audit by the accounting chamber</li> <li>- By the end of 2016, the ratio of VAT refund claims older than 74 days/ quarterly flow of VAT refund claims is reduced to at least 20 percent</li> <li>- By the end of 2016, the number of business permits is reduced to 84</li> <li>- By the end of 2016, the Naftogaz financial deficit is reduced to less than US\$1 billion equivalent</li> <li>- By the end of 2016, the number of families who receive targeted housing and utility benefits is increased to at least 2 million</li> </ul>
Overall risk rating	High
Operation ID	P151479



**IBRD PROGRAM DOCUMENT FOR A  
PROPOSED SECOND DEVELOPMENT POLICY LOAN TO UKRAINE**

**1. INTRODUCTION AND COUNTRY CONTEXT**

1. **The Second Development Policy Loan (DPL2) in the amount of US\$500 million seeks to address key policy and institutional causes of the economic crisis in Ukraine and create conditions for an inclusive and sustainable recovery.**<sup>1</sup> The Program Development Objectives of the DPL series are to: (i) promote good governance, transparency, and accountability in the public sector; (ii) strengthen the regulatory framework and reduce the cost of doing business; and (iii) reform inefficient and inequitable utility subsidies while protecting the poor. The DPL2 sustains and deepens reforms supported by the DPL1 across the three objectives. While macroeconomic challenges have intensified since the DPL1, the objectives and specific policy measures supported by DPL2 remain relevant. Better governance, an attractive investment climate, a financially viable energy sector, and fiscally affordable and targeted social safety nets are all critical for Ukraine to return to economic stability and growth. This DPL is part of a coordinated package of international assistance to help Ukraine restore confidence and meet external and fiscal financing needs. The timing and policy content of the operation is closely coordinated with the IMF Extended Fund Facility (EFF), which was approved on March 11 2015 as well as support by other bilateral and multilateral partners.

2. **The reform program supported by the DPL series is being implemented against the backdrop of unprecedented challenges – a major economic and financial crisis compounded by a protracted conflict in the east.** Last year witnessed several momentous events: the “Maidan” uprising that led to the ousting of the previous President, Presidential elections in May, Parliamentary elections in October, and conflict in the east. In March 2014, the Autonomous Republic of Crimea and City of Sevastopol held referenda to join the Russian Federation, which were widely criticized and declared as “having no validity” in the UN General Assembly resolution 68/262.<sup>2</sup> The new Government that took office last December has a mandate for reforms but faces formidable challenges: containing conflict and restoring peace in the east; ensuring macroeconomic stability; tackling a major banking crisis; reducing the fiscal deficit in the midst of a recession without triggering social unrest and backlash against reforms; and reducing deep-seated corruption while contending with powerful vested interests that continue to oppose reforms.

3. **While the authorities began an ambitious macroeconomic adjustment in early 2014, the escalating conflict in eastern Ukraine in the second half of the year and ensuing loss of confidence prevented the adjustment program from achieving its intended objectives.** Ukraine is in the midst of a protracted economic recession accompanied by a large budget deficit, rising public and external debt, sharply depreciated exchange rate, surging inflation and a banking crisis. Disruptions to industrial production in the conflict-affected regions exacerbated the economic contraction. Weak revenue performance, especially in the east, higher security-related expenditures, and large financing needs for Naftogaz<sup>3</sup> hampered fiscal adjustment. Meanwhile, a weakening currency and deposit outflows exposed structural weaknesses in the banking sector. On

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<sup>1</sup> The Government of Japan will provide parallel financing of US\$300 million and the Government of Norway of NOK 200 million (US\$24 million equivalent).

<sup>2</sup> Crimea accounted for about 3 percent of GDP and 4.3 percent of Ukraine’s average annual population in 2013.

<sup>3</sup> National Oil and Gas Company of Ukraine.

the external side, the current account started to adjust following the depreciation but balance of payments pressures remain acute. Delays in official inflows, low foreign direct investment (FDI), and capital outflows put pressure on the currency which depreciated sharply since the beginning of last year. Reserves declined to low level and Ukraine's external financing needs to cover the balance of payments and rebuild reserves increased significantly.

4. **Macroeconomic adjustment and deep structural reforms, reinforced by adequate and timely external financial support, are essential for Ukraine to weather the crisis and return to a path of sustainable growth.** Macroeconomic stabilization and strengthening economic governance remain key priorities of the authorities. The coalition agreement underpinning the new government sets an agenda for reforms. Since the approval of DPL1 on May 22, 2014 the authorities have continued their efforts to address fiscal and external imbalances. The switch to a flexible exchange rate, and tighter fiscal and monetary policies have narrowed the external current account and contained deterioration of the fiscal position despite revenue shortfalls and spending pressures. The authorities also moved forward with institutional reforms, including those supported by this DPL series, aimed at curbing corruption, enhancing the business climate, addressing financial imbalances in the utility sector and protecting the poor. With support of a parallel Programmatic Financial Sector Development DPL (FSDPL) series, the authorities adopted measures to strengthen the banking sector. To cope with the protracted adjustment and higher financing needs, the authorities requested a new IMF EFF, approved by the IMF Board on March 11, 2015 which is providing additional financing and anchoring macroeconomic adjustment over a four-year program period. Additional support by the World Bank, the EU and several bilateral partners combined with a planned debt operation will help fill the large financing gap, restore confidence, and bolster reserves.

5. **The crisis threatens to reverse some of the gains Ukraine made in earlier years in reducing poverty and boosting shared prosperity.** As a result of rapid growth, especially before the global economic crisis, the poverty rate declined from 23.2 percent in 2007 to 6.2 percent in 2013.<sup>4</sup> From 2008 to 2013, the average income of the bottom 40 percent grew 50 percent faster than that of the rest of the population (4.2 percent vs. 2.8 percent annually), reflecting higher wage increases (4.6 percent vs. 2.7 percent annually). However, real incomes, including those of the poor and of the bottom 40 percent are under pressure as a result of the economic contraction, rising unemployment, pension and wage freezes, high inflation, and large increases in utility tariffs. Pension freezes affect women disproportionately as 70 percent of single pensioners are women and their pensions are 30 percent lower on average than those of men (as a result of a 26 percent wage gap and a difference of 5 years in retirement age in favor of men). After years of robust growth, domestic consumption is estimated to have declined by 7.4 percent in 2014 and by 15.4 percent in the first quarter of 2015. Poverty is estimated to have increased to 11.4 percent in 2014 and is expected to rise again in 2015 to at least 17.7 percent<sup>5</sup> given the challenging economic outlook. If macroeconomic and fiscal challenges intensify, there are risks of an even bigger poverty increase. The eastern regions, which tended to be poorer even before the conflict, are the most affected with internally displaced people being particularly vulnerable to becoming poor. The UN estimates that 60 percent of those displaced are women.

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<sup>4</sup> World Bank staff calculations using the actual income distribution and poverty line of 2012 fixed in real terms. This avoids the problems of adopting official poverty lines in Ukraine that are not constant in terms of purchasing power.

<sup>5</sup> These estimates are based on a scenario of distributionally neutral contractions of 6.8 percent in 2014 and 9.0 percent in 2015. To the extent that the poor are more vulnerable to different shocks, poverty could be higher.

6. **The DPL series supports a balanced distribution of the social burden of economic adjustment – thereby contributing to the World Bank Group’s corporate goals of supporting shared prosperity and reducing poverty.** A balanced social burden sharing is essential not only to sustain public support for reforms but also to safeguard welfare gains. In this vein, the DPL series supports reforms aimed at strengthening social safety nets to cushion the impact of reforms on the poor and vulnerable as well as measures to reduce leakage – including decisive steps to curb widespread high-level corruption – and closing loopholes for tax avoidance and evasion benefitting mostly large taxpayers. By contributing to stability and economic recovery, the DPL also lays the foundation for returning to a path of sustained improvements in living standards.

7. **Risks to the operation are exceptionally high.** While the confrontation in the east abated following the Minsk II agreement,<sup>6</sup> there is a considerable risk that the conflict may continue flaring up periodically. This could undercut efforts to stabilize the economy and would in turn, undermine the impact of the policy program supported by this DPL. Moreover, while the exchange rate has stabilized since March this year, instability could reemerge, especially as administrative controls in the currency market are relaxed. Higher-than-expected depreciation and inflation would, in turn, increase pressures in the banking sector and further erode Ukraine’s capacity to service public and external debt. Higher depreciation would also undermine the gains expected from gas and heating tariff increases, necessitating further tariff adjustments to contain fiscal and balance of payments risks associated with Naftogaz. Higher tariff increases would amplify inflationary pressures. Meanwhile, fiscal adjustment could prove more challenging in case of further weakening of the macroeconomic outlook. The economic downturn and revenue shortfalls in the east may undermine overall revenue performance despite policy changes and efforts to improve tax administration. On the expenditure side, cuts – especially in social spending – could kindle social discontent. Risks associated with external and fiscal financing gaps are also significant, especially given the reliance on the debt operation for a significant contribution to Ukraine’s financing needs. Failure to reach agreements in the ongoing discussions with private sector creditors on the debt operation could complicate external and fiscal financing. Finally, while there is wide consensus among Ukraine’s decision-makers on the need for macroeconomic and structural adjustment, vested interests remain strong and could derail reforms.

## 2. MACROECONOMIC POLICY FRAMEWORK

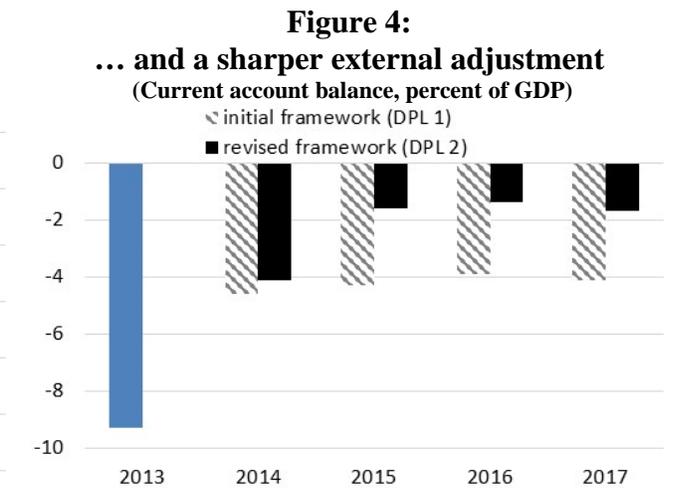
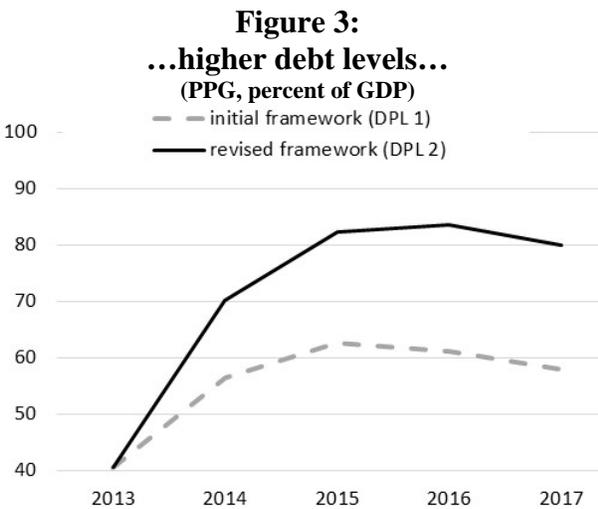
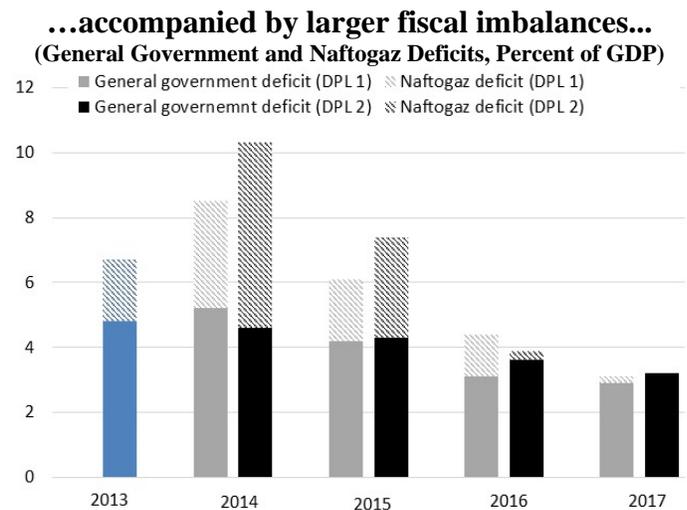
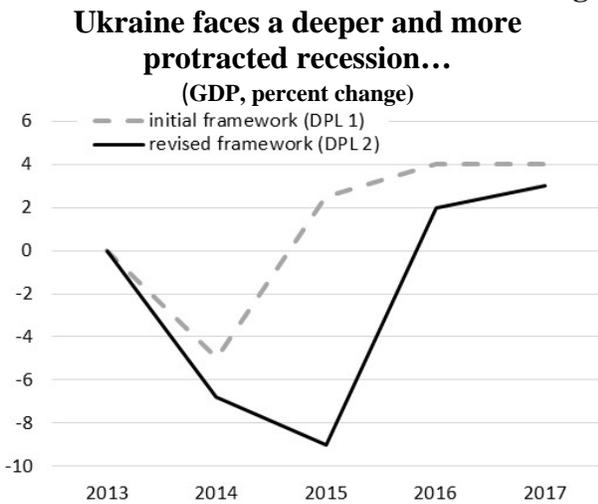
8. **Despite decisive efforts by the authorities to stabilize the economy, several risks identified in the DPL1 document have materialized.** The macroeconomic situation has deteriorated since the DPL1 Board approval, largely because of the escalating conflict in the east in the second half of last year and the ensuing loss of confidence. Disruptions to industrial production in the east and conflict-induced uncertainty hurt exports, exacerbated the recession, amplified fiscal pressures, and fueled capital outflows which in turn led to sharp currency depreciation. GDP declined by 6.8 percent in 2014 (Figure 1). The currency depreciated by about 50 percent in 2014, which together with increases in utility tariffs, pushed 12-month consumer price inflation to 24.9 percent y/y in December. Weak revenue collections from the east, higher spending on security, and a higher quasi-fiscal deficit of Naftogaz (in part due to the depreciation)

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<sup>6</sup> The Minsk II arrangement was signed by Governments of Ukraine and the Russian Federation, the Organization for Security and Cooperation in Europe, and representatives of some parts of the regions of Luhansk and Donetsk on February 12, 2015.

hampered efforts to reduce fiscal imbalances. The overall fiscal deficit, including Naftogaz, widened to an estimated 10.1 percent of GDP in 2014 (Figure 2). The combination of persistent fiscal imbalances, GDP contraction and currency depreciation pushed up the public debt-to-GDP ratio from 40.6 percent in 2013 to 70.3 percent in 2014 (Figure 3). While the external current account adjusted following the currency depreciation (Figure 4), balance of payment pressures remained significant in 2014 because of delays in official financing, low FDI, and capital outflows fueled by uncertainty. External financing needs to cover the balance of payment shortfall and rebuild reserves are estimated at US\$40 billion (equal to about 40 percent of GDP) over the next four years.

**Figure 1: Despite stabilization efforts the macroeconomic situation deteriorated largely due to escalating conflict in the east**



Source: World Bank staff calculations based on IMF EFF.

9. **The macroeconomic environment remains extremely challenging.** Real GDP contracted by 17.2 percent y/y in the first quarter. Inflation reached 57.5 percent y/y in June due to tariff increases and large currency depreciation during the first quarter. On the positive side, the

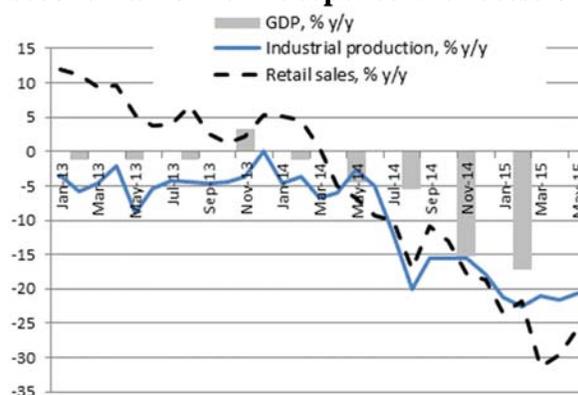
foreign exchange market has remained broadly stable since March 2015, largely due to administrative controls put in place in February. Capital flight and deposit outflows subsided. The current account turned positive in March and April as a result of the depreciation. This, together with the first IMF EFF disbursement of US\$5 billion, allowed for rebuilding of international reserves to US\$10.3 billion by end June 2015, although this is still less than 3 months of imports. The budget outturn in the first months of 2015 continued to be on track, partly due to high inflation. The authorities have reached staff level agreement with IMF on the first EFF review in early July. However, despite the prospective disbursement of the second EFF tranche, external and public financing risks remain significant, especially in light of the protracted negotiations with creditors on restructuring of Ukraine’s sovereign and quasi-sovereign Eurobonds.

10. **While risks are exceptionally high, the macroeconomic policy framework is adequate for DPL2, but hinges on the continued implementation of the Minsk II agreement and the IMF EFF along with the external financing it unlocks.** The macroeconomic framework, underpinning this operation is aligned with the IMF EFF. Additional external financial support and policy measures anchored in the four-year IMF EFF are expected to mitigate the impact of macroeconomic shocks. If these policies are consistently implemented and the situation in the east does not worsen, there is a good chance that the authorities would succeed in restoring fiscal and external sustainability over the medium term. The macroeconomic framework builds on the policies initiated under the earlier IMF Stand-by Arrangement (SBA) but allows for a longer adjustment period and unlocks more financial support to fill the larger financing gap. The core elements of the policy framework comprise exchange rate flexibility, monetary policies to contain inflationary pressures, fiscal consolidation, and measures to tackle banking sector risks. Macroeconomic stabilization is underpinned by a comprehensive structural reform program to address the root causes of the current crisis, including measures supported by the two World Bank DPL series. Frontloaded financial support under the IMF EFF to boost reserves is expected to regain confidence and stabilize the currency market, while the proposed debt operation would help meet financing needs and enhance debt sustainability.

## 2.1 RECENT ECONOMIC DEVELOPMENTS

11. **Against the backdrop of ongoing macroeconomic adjustment and the conflict in the east, real GDP declined by an estimated 6.8 percent in 2014 (Table 1).** Investment and consumption contracted due to a rebalancing of the economy which was compounded by uncertainty weighing on consumer and investor confidence. This was partly offset by a moderate positive contribution of net exports, which was driven by a sharp decline in imports after the depreciation. By sector, the decline was driven by falling industrial production (down 10.1 percent in 2014), transport (freight turnover down 10.7 percent and passenger turnover down 11.5 percent), wholesale and retail trade (down 17.9 percent and 8.9 percent, respectively) (Figure 5). Output rose only in agriculture (by

**Figure 5: The intensifying conflict in the second half of 2014 deepened the recession**



Source: World Bank staff calculations based on official data.

2.2 percent). The recession deepened significantly in the second half of the year, after the conflict in the east escalated and the output decline was particularly severe in the regions directly affected by the conflict. Donetsk and Luhansk account for 83 percent of the overall decline in industrial output, 44 percent of the decline in retail sales, and 66 percent of the decline in exports (Figure 6). The conflict is estimated to account for about 2.5-3 percentage points of the overall GDP decline in 2014 (see Box 1).

**Table 1: Key Macroeconomic Indicators**

	2013	2014	2015f	2016f	2017f	2018f
<b>Real economy</b>						
Nominal GDP, UAH billion	1465.2	1566.7	1981.8	2264.0	2562.7	2878.5
Real GDP, percent change	0.0	-6.8	-9.0	2.0	3.0	4.0
Consumption, percent volume change	5.2	-7.4	-14.3	-2.0	1.8	3.7
Investment, percent volume change	-8.4	-23.0	-24.6	13.4	8.6	9.5
Exports, percent volume change	-8.1	-14.5	-11.0	7.7	5.1	5.3
Imports, percent volume change	-3.5	-22.1	-23.3	3.8	4.8	6.5
Unemployment rate (ILO definition), percent	7.3	9.3	11.5	11.0	9.4	8.5
GDP deflator, percent change	3.1	14.8	39.0	12.0	9.9	8.0
CPI (pa), percent change	-0.3	12.1	50.0	14.2	9.9	7.0
CPI (eop), percent change	0.5	24.9	45.8	12.0	8.0	5.0
<b>Fiscal Accounts</b>						
Revenues, percent GDP	43.6	40.8	40.8	39.7	40.0	40.0
Expenditures, percent GDP	48.4	45.4	45.0	43.4	43.1	42.6
General Government Balance, percent GDP	-4.8	-4.5	-4.2	-3.7	-3.1	-2.6
General Government and Naftogaz Balance, percent GDP	-6.7	-10.1	-7.3	-3.9	-3.1	-2.6
PPG debt (eop), percent GDP	40.6	70.3	91.9	83.1	79.8	75.8
<b>Selected Monetary Accounts</b>						
Base Money, percent change	20.3	8.5	27.3	17.7	12.4	10.7
Credit to non-government (at program exchange rate), percent change	9.5	-15.6	-2.9	12.6	11.7	7.6
<b>Balance of Payments</b>						
Current Account Balance, percent GDP	-9.2	-4.1	-1.6	-1.7	-1.4	-1.7
Merchandise Exports, percent GDP	33.9	42.3	48.0	48.7	47.1	34.3
Merchandise Imports, percent GDP	45.8	46.9	59.8	50.9	49.1	36.1
Foreign Direct Investment, percent GDP	1.8	0.3	1.4	1.8	2.0	2.1
Gross Reserves, billion US\$, eop	20.4	7.5	18.3	22.3	28.5	28.5
In months of next year's imports	2.8	1.6	3.8	4.3	5.1	5.8
Percent of short-term external debt	30.3	17.4	34.7	43.7	50.4	60.2
External Debt, percent GDP	78.6	97.6	152.7	150.1	142.6	132.3
Terms of Trade, percent change	0.9	2.1	-9.6	-2.8	-0.1	0.0
Exchange Rate, UAH/US\$ (average)	8.2	12.1	...	...	...	...
<b>Memo:</b>						
Nominal GDP, US\$ billion	177.4	130.7	...	...	...	...

Source: Data through 2014: national data, IMF and World Bank staff estimates.

**12. The recession continued to deepen during the first quarter of 2015, with GDP declining by 17.2 percent.** The decline was broad-based across all sectors, including agriculture. Industrial production contracted by 21.4 percent in the first quarter because of the continued conflict in the industrialized east. Meanwhile, macroeconomic adjustment is affecting the rest of the country. Declining real incomes are weighing on consumption which contracted by 15.4 percent y/y during the first quarter, also reflected in plummeting retail trade which dropped over 25 percent y/y.

## Box 1 Economic Impact of the Conflict

**Figure 6: Conflict region contributed to the overall contraction**



Source: World Bank staff estimates based on official statistics.

the fiscal burden. Uncertainty is further eroding confidence beyond the directly affected areas with negative impacts on investment and consumer spending, which are already battered by the ongoing macroeconomic crisis.

While the situation in the east did not cause Ukraine's macroeconomic problems, it makes it more difficult to restore stability and return to a sustainable growth path. Luhansk and Donetsk are major industrial centers (including mining and energy production). Before the conflict, they accounted for 15.7 percent of GDP and almost a quarter of Ukraine's industrial production and merchandize exports. The territories currently under control of separatist forces – which are a part of Donetsk and Luhansk – are estimated to account for about 6-7 percent of GDP. The conflict has wide-ranging *direct and indirect* economic impacts that have undermined the overall macroeconomic situation. Economic activity is severely disrupted by the conflict. Production facilities and economic infrastructure in areas not controlled by the Ukrainian government have been destroyed or severely damaged. Large numbers of people are displaced. Weak revenue collection and security-related expenditure add to

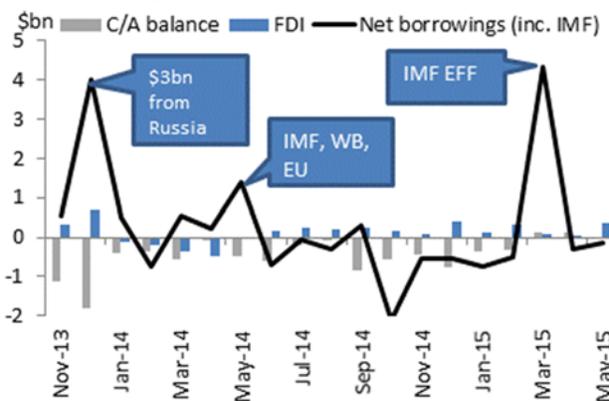
- **Real Sector Impact:** Industrial production in Luhansk and Donetsk declined by an estimated 42.0 percent and 31.5 percent in 2014 respectively, compared to a decline of 10.1 percent in Ukraine on average. About 78 percent of industrial capacity in Donetsk is currently in the territory, not controlled by the Government. In Luhansk region, about 84 percent of industrial capacity is currently in the territory, not controlled by the Government.
- **Labor Market Impact:** The virtual collapse of production and output in conflicted-affected areas resulted in job losses. Preliminary figures show that reduction in net employment in Donetsk has been around 40 percent and 70 percent in Luhansk. These reductions amount to a total of about 800,000 jobs by end 2014.
- **External Trade Impact:** Exports from the two regions declined by 37 percent, compared to 13.5 percent overall decline for Ukraine. This is a reflection of disruption to export industries located in the two regions but also of deeper trade links with the Russian market where substantially weaker demand was compounded by periodic trade restrictions. Meanwhile, because Ukraine's domestic coal is located in the territory, not controlled by the Government, coal had to be imported adding to foreign exchange pressures.
- **Banking Sector Impact:** The crisis also intensified pressures in the banking sector. While deposit outflows in 2014 were significant across the country, larger withdrawals were observed in the conflict areas with 57 percent outflow of household deposit in Donetsk and 50.9 percent outflow in Luhansk, compared to an outflow of 24.3 percent in the rest of the country.
- **Fiscal Impact:** Donetsk and Luhansk contribute nearly 22 percent of general government revenues. Budget revenues (excluding the pension fund) in the two regions declined about 53 percent and 35 percent, respectively, in 2014, putting pressure on overall budget performance. Meanwhile, expenditures in the two regions were executed as planned until November when the government suspended spending in the territory, not controlled by the Government. At the same time, security-related spending almost doubled to nearly 2 percent of GDP in 2014. In addition, there are rising spending needs to provide for the increasing number of internally displaced people.

13. **While economic contraction and the deteriorating situation in the east are putting pressure on fiscal accounts, consolidation measures contained the deficit during 2014 and fiscal performance remained on track during the first half of 2015.** Ukraine entered the current crisis with a large fiscal deficit of 4.8 percent of GDP in 2013. To contain the budget deficit during 2014, the Government adopted two consecutive rounds of fiscal measures in March and July 2014 to boost revenues while curtailing expenditures. These measures included cuts to discretionary

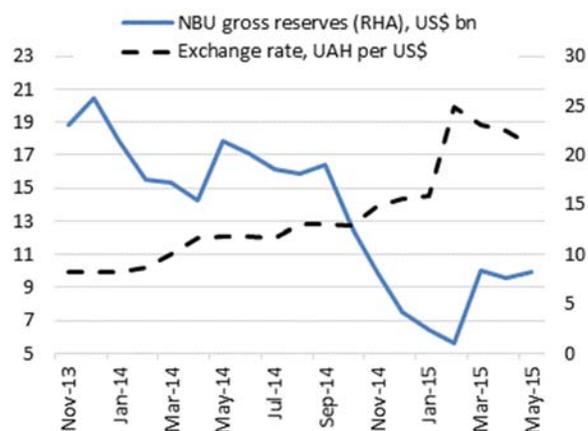
spending on subsidies, investment and goods and services as well as revenue measures to broaden the VAT base, tax rate increases for subsoil exploration and efforts to improve tax compliance. Despite this, revenue performance deteriorated due to sharper economic contraction and difficulty in collecting taxes in the east. Meanwhile security-related expenditures almost doubled to about 2 percent of GDP and depreciation increased interest payments by one percentage point to 3.3 percent of GDP. Despite the challenging environment, the general government fiscal deficit slightly improved to 4.5 percent of GDP in 2014 (lower than projected at the time of DPL1). During the initial months of 2015, fiscal performance remained on track because of tight control on expenditures and strong nominal revenue performance bolstered by high inflation.

14. **Meanwhile, the widening quasi-fiscal deficit of Naftogaz, partly driven by currency depreciation, eroded the overall fiscal position in 2014.** Despite tariff increases supported by DPL1, Naftogaz’s financial position deteriorated during 2014 due to the increased import price in Hryvnia terms following the devaluation and lower profits from gas sales to industrial consumers because of weak economic activity. The Naftogaz deficit widened to 5.6 percent of GDP, and together with the general government, brought the overall consolidated general government deficit to 10.1 percent of GDP. Government financing to Naftogaz was provided through below-the-line recapitalization bonds (monetized by the National Bank of Ukraine (NBU)), putting pressure on the public debt burden and on foreign exchange reserves.

**Figure 7:**  
Despite the current account adjustment, the balance of payments remains fragile...



**Figure 8:**  
...putting pressure on the currency and foreign exchange reserves



Source: World Bank staff calculations based on official data.

15. **After losing about 70 percent of its value since the beginning of 2014, the exchange rate has stabilized over recent months.** After the move to a flexible exchange rate in February 2014, the currency remained under acute pressure for most of 2014 and early 2015, aggravated by the fragile balance of payments and loss of confidence. Pressures in the currency market intensified in the fourth quarter of 2014 due to delays in official inflows, dwindling foreign exchange reserves and heightened devaluation expectations triggering capital outflows which in turn further exacerbated the loss of confidence. Downward pressure continued during first three months of 2015 bringing cumulative depreciation since January 2014 to close to 70 percent. After periodic interventions by the NBU eroded already low reserves and led to a growing parallel market, the

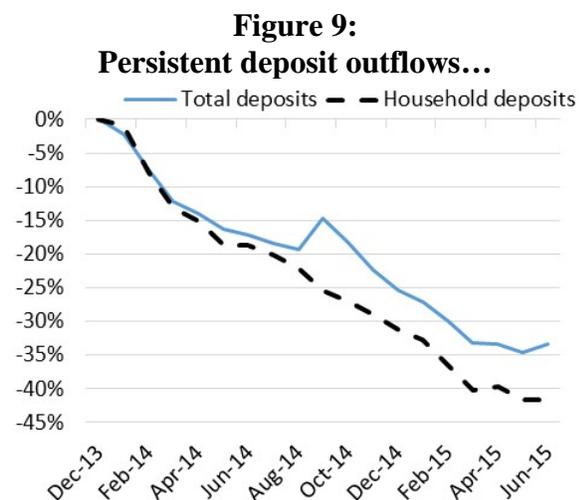
NBU abandoned all interventions in February 2015. The NBU resorted to a number of administrative measures<sup>7</sup> aimed to support foreign exchange supply, curb demand and limit currency speculation. These measures dampened further weakening and stemmed the outflow of reserves starting in early March (Figure 8). Since then the currency market remained broadly stable, with administrative controls still in place.

**16. Due to depreciation and utility tariff hikes, consumer price inflation has been on the rise.** Twelve-month consumer price inflation rose from near zero in January to 24.9 percent in December 2014 – the highest annual increase since late 2008. Inflation continued to increase in early 2015 to 57.5 percent y/y in June 2015 (just below the 60.9 percent y/y in April when tariffs were increased). To contain inflationary pressures, the NBU implemented consecutive hikes in the refinancing rate, first from 12 percent to 17.5 percent in late 2014 and then further to 33 percent in February 2015.

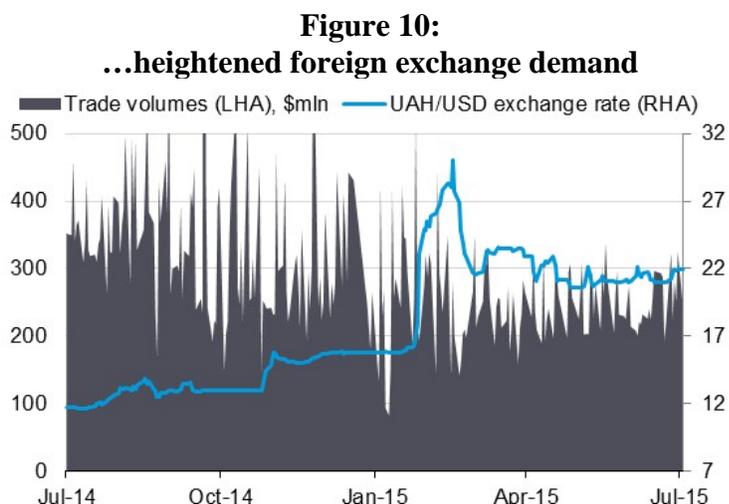
**17. After widening steadily in previous years, the external current account started to adjust, but the impact of currency depreciation was dampened by the conflict.** In 2013, the current account deficit widened to 9.2 percent of GDP as a result of a weak external environment, an overvalued exchange rate and loose fiscal policy. Currency devaluation following the abandonment of the long-standing de facto peg to the dollar in February 2014 and fiscal tightening led to an adjustment of the current account deficit. However, the impact of depreciation was dampened by conflict-related disruptions in export-oriented industries in the east, weak external demand, as well as imports of gas and coal (after local coal production was damaged in the conflict areas). As a result, the current account deficit amounted to 4.1 percent GDP in 2014. The external adjustment continued during the initial months of 2015. In the first quarter of the year, the current account deficit is estimated to a third of what it was in the same period last year mainly driven by a sharp compression of imports that more than offset the conflict related drop in exports.

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<sup>7</sup> In 2014, the NBU increased export surrender requirement to 75 percent, reduced the limit for individuals' foreign exchange purchases, banned transfers abroad of proceeds from over the counter sales of securities and dividend repatriation for such securities. In addition, the NBU implemented a list of measures in early 2015: (i) extension of the period local currency intended for foreign exchange purchases needs to be held in Bank deposits from two to three days; (ii) a tax clearance certificate from the State Tax Authority is required for foreign exchange purchases of US\$50 thousand and above; (iii) all import contracts over US\$0.5 million have to be backed by a letter of credit from an investment grade bank (contracts below this amount without legitimate letters of credit will be checked by the NBU directly); (iv) banks are not allowed to buy foreign currency for their corporate clients if these companies already have foreign exchange deposits exceeding US\$10 thousand.



Source: World Bank staff estimates.



18. **Despite the current account adjustment, balance of payments pressures intensified in 2014 and remain a concern in 2015.** During 2014, repayments of arrears to Gazprom, increased demand in the cash foreign exchange market stemming from deposit outflows from the banking system, and delays in official financing negatively affected the financial account. As expected, banking and corporate sector external debt rollover rates declined from 107 percent in 2013 to 85.4 percent in 2014 (slightly lower than the assumption of 89 percent at the time of DPL1). Official inflows, including the first tranche of the IMF SBA (US\$3.09 billion), DPL1 (US\$750 million), and FSDPL1 (US\$500 million) helped ease balance of payments pressures. However, delays in the disbursement of the IMF second/third review tranches as well as other official assistance in the second half of the year, coinciding with Eurobond repayments and clearance of payment arrears to Gazprom, put significant pressure on the financial account. Foreign reserves declined to US\$7.5 billion (1.4 months of import cover) by end year and dropped further to US\$5.6 billion by end-February. The first tranche of the IMF EFF (about US\$5 billion) in mid-March, together with other assistance (including US\$1 billion of Eurobond guarantee by the US) allowed for a rebuilding of reserves to around US\$10.3 billion by end June 2015 (2.2 months of imports).

19. **Currency depreciation and economic contraction have put significant stress on the weak banking system.** Since the beginning of 2014, 54<sup>8</sup> out of 180 banks have failed (including the 4th, 9th, and 16th largest banks by assets) and there are significant risks of additional bank failures. Although UAH retail deposits showed initial signs of stabilization in June 2015, almost 54 percent of foreign exchange-denominated retail deposits and 29 percent of UAH-denominated deposits have left the system since the beginning of 2014 (Figure 9), in turn putting pressure on the currency market (Figure 10). Meanwhile, depreciation is also straining the banks' capital adequacy ratio through proportionate losses generated from sizable open short foreign exchange positions and deterioration of the loan portfolio, given the large share of foreign exchange denominated loans (53 percent). Non-performing loans have increased from 12.9 percent at end-

<sup>8</sup> The 54 banks that have been declared insolvent and transferred to the DGF accounted for about 21 percent of total banking sector assets and 24 percent of total retail deposits as January, 2014. These banks had a total of UAH66.9 billion in insured household deposits that were covered via the DGF; UAH41.0 billion in uninsured household deposits; and UAH41.8 billion in uninsured corporate deposits. The large majority of the resolution decisions that have been made to date were liquidation, except for two Purchase and Assumption transactions and one bridge bank.

2013 to 24.7 percent in the first quarter of 2015, with the expectation that they will rise further in the coming months as the full effect of devaluation will be reflected in asset quality. The losses caused by devaluation and provisioning for bad loans have pushed the system-wide capital adequacy from 18.2 percent at the beginning of 2014 to 9.0 percent in end-June 2015.

20. **Exacerbated by persistent fiscal and external imbalances, lower GDP and currency depreciation, public and external debt to GDP ratios increased rapidly.** Public debt as a share of GDP increased from 40.6 percent of GDP in 2013 to an estimated 70.3 percent of GDP in 2014. While large net fiscal financing needs to cover the budget, Naftogaz deficits, and support the banking sector contributed to the increase, currency depreciation pushed up foreign exchange denominated debt (the valuation effect accounts for about 22 percentage points of the overall increase). About 56 percent of Ukraine's public and publicly guaranteed (PPG) debt is external. In addition, there is foreign exchange denominated domestic debt which accounts for another 6 percent of the PPG debt stock. Meanwhile, external debt increased from 78.3 percent of GDP in 2013 to 97.6 percent of GDP in 2014. Due to the economic contraction and exchange rate depreciation, the dollar value of Ukraine's GDP declined by about 27 percent during 2014 and with it, Ukraine's capacity to service its external debt.

## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

21. **GDP is expected to contract further in 2015.** We expect real GDP to decline by 9 percent in 2015 with a stronger contraction during the first half of the year, followed by a slowing decline during the second half of the year due to the low statistical base (given the deep decline during the second half of 2014). The decline is expected to be broad based and especially in metals and mining, which are most affected by the conflict. Retail trade is likely to further decline due to a notable drop in real disposable income triggered by a sharp increase in tariffs, currency depreciation and declining real wages. Problems in the banking sector are expected to continue. Combined with tighter liquidity in line with monetary policy objectives, this will imply further contraction of credit to the economy during 2015. On the external side, the positive impact of depreciation on exports will be undermined by conflict-related disruptions in major export industries and deteriorating trade relations with Russia (traditionally a key export market for Ukraine). At the same time, the contribution of net exports is still expected to be positive due to a sustained contraction of imports.

22. **Economic recovery is likely to set in later than initially projected and to be less pronounced.** If the situation in the east is resolved, a return of positive – albeit low – growth from 2016 onwards is projected driven by reconstruction in the east supported by external partners as well as recovery in net exports. Following four consecutive years of sharp decline, investment is projected to rebound modestly in 2016 from a low base with improving investor sentiment, contributing positively to economic growth. Recovery in investment will be underpinned by structural reforms, including those supported by the DPL which are expected to boost competitiveness and productivity of businesses. Equally, credit growth is expected to resume in 2016 provided problems in the banking sector are resolved through a strengthened Deposit Guarantee Fund and recapitalization of banks as supported by the FSDPL. Recovery in consumption is projected to be delayed due to further increases in tariffs, pension freezes, and a slow recovery of the labor market implying subdued real wage growth.

23. **Inflation is expected to pick up during 2015 and remain relatively high in 2016 due to**

**tariff increases.** Period average inflation is expected to rise to 50 percent in 2015 due depreciation and tariff increases. Tight fiscal policy accompanied with monetary measures, including positive real interest rates and monetary targeting (with targets for base money, net domestic and net foreign assets agreed under EFF) is likely to reduce inflation to 10 percent in 2017. While the NBU remains committed to move to targeting inflation over the medium term, it will require strengthening of the NBU's technical and operational capacity.

24. **The current account deficit is expected to continue to adjust due to the substantial decline in domestic demand engendered by exchange rate adjustment and fiscal consolidation.** The larger external financing needs, higher external debt levels and low reserve position will require a sharper adjustment of the current account (than initially projected at the time of DPL1), mainly driven by a significant depreciation of the real exchange rate and administrative measures. While the potential positive impact of depreciation and structural reforms on exports will initially be limited due to sluggish external demand and disruption of economic activity in the east, external adjustment will be driven by imports which are projected to contract significantly. The current account deficit is projected to decline to 1.6 percent of GDP in 2015 and to stabilize at this level to allow for a return to sustainable external debt levels.

**Table 2: Balance of Payment Financing Requirements and Sources**

	2014	2015f	2016f	2017f	2018f
<b>Financing requirements (US\$ billion)</b>	<b>52.2</b>	<b>48.8</b>	<b>47.8</b>	<b>45.5</b>	<b>45.2</b>
Current account deficit	5.3	1.2	1.6	1.5	1.9
Long-term debt amortization (excl. IMF)	12.5	18.8	16.1	13.2	12.0
Short-term debt amortizations	34.4	28.7	30.2	30.8	31.3
<b>Financing Sources (US\$ billion)</b>	<b>52.2</b>	<b>48.8</b>	<b>47.8</b>	<b>45.5</b>	<b>45.2</b>
FDI and portfolio investments (net)	-2.4	1.4	1.7	2.1	2.4
Long-term debt disbursements (excl. IMF)	11.1	14.2	13.5	12.5	13.6
Short-term debt disbursements	29.7	30.2	30.8	31.3	33.0
Change in reserves	12.9	-10.7	-4.0	-6.3	-6.6
IMF credit (net)	0.9	8.5	2.5	1.6	0.4
Debt operation	0.0	5.2	3.4	4.4	2.3

Source: World Bank staff calculations based on the framework underpinning the IMF EFF and official data.

25. **Despite the narrower current account deficit, balance of payment financing needs continue to be significant due to persistent pressures in the financial account (Table 2).** Capital outflows and erosion of reserves during 2014 together with large debt repayment needs<sup>9</sup> have heightened Ukraine's external financing needs which are estimated at more than US\$40 billion a year over the next four years. Inflows of FDI are expected to remain subdued during the projection period (at about 5 percent of the historical average 2005-2013). The rollover rates corporate and banking sector debt are assumed to drop to 70 percent and 94.4 percent in 2015 and then gradually recover to about 103 percent, by 2017.<sup>10</sup> During 2015-16, net outflows in the banking and corporate sector will be partially offset by inflows of official assistance, estimated at about US\$25 billion over the next four years, based on current commitments by major partners. Residual financing needs are expected to be covered by the envisaged debt operation, which is

<sup>9</sup> Over the next four years Ukraine's public external debt service payments amount to about a cumulative US\$30 billion (including private and official creditors), of which about US\$23 billion is for principal repayments. Debt service payments on the IBRD portfolio amount to about US\$270 million and US\$271 million in 2016 and 2017, respectively.

<sup>10</sup> While the maturity structure of corporate external debt is heavily weighted on the short term (around 32 percent), a large portion is for trade credits, thus limiting rollover risks.

estimated to contribute about US\$15.3 billion to the overall financing needs. Under the base case, therefore, available external financing is expected to be sufficient to meet balance of payments requirements. Frontloaded disbursements of the IMF EFF and other official inflows, expected to amount to more than US\$10 billion in 2015 will allow the NBU to shore up reserves. Going forward, macroeconomic stabilization supported by the IMF EFF and a resolution of the conflict in the east is expected to boost investor confidence and lower costs of external financing. A gradual buildup of international reserves to 5.2 months of imports cover is expected by 2018.

**Table 3: Key Fiscal Indicators**  
(Percent of GDP)

	2013	2014	2015f	2016f	2017f	2018f
<b>Revenues</b>	<b>43.6</b>	<b>40.8</b>	<b>40.8</b>	<b>39.7</b>	<b>40.0</b>	<b>40.0</b>
Tax revenues	37.9	35.8	35.1	35.7	36.1	36.2
Corporate profit tax	3.8	2.6	2.2	2.2	2.2	2.2
Personal Income tax	5.0	4.8	4.8	5.0	4.9	4.9
Payroll tax	13.3	11.8	9.6	10.1	10.2	10.2
Property tax	0.9	0.8	0.7	0.7	0.7	0.7
VAT	8.8	8.9	9.4	9.6	9.6	9.6
Excises	2.5	2.9	3.3	3.4	3.4	3.4
Taxes on international trade	0.9	0.8	1.8	1.1	1.1	1.0
Other taxes	2.7	3.2	3.3	3.6	4.0	4.2
Non-tax revenues	5.7	5.0	5.7	4.0	3.9	3.8
<b>Expenditures</b>	<b>48.4</b>	<b>45.4</b>	<b>45.0</b>	<b>43.4</b>	<b>43.1</b>	<b>42.6</b>
Current expenditures	46.2	44.3	41.8	40.7	39.6	38.9
Wages and compensation	11.5	10.4	9.2	8.9	8.4	8.4
Goods and services	7.1	7.5	7.4	7.1	7.0	7.0
Interest payments	2.5	3.3	5.3	5.1	4.6	4.2
Subsidies to corporations	2.0	2.4	1.5	1.2	1.2	1.2
Current transfers	23.1	20.7	18.4	18.4	18.4	18.1
Pensions	17.2	15.6	13.1	12.6	12.6	12.6
Unemployment, disability and accident insurance	2.0	1.4	1.3	1.2	1.1	1.1
Social programs	3.9	3.7	4.0	4.6	4.7	4.4
Other current expenditures	0.0	0.0	0.1	0.0	0.0	0.0
Capital expenditures	2.0	1.3	2.4	2.4	2.8	2.8
Reserve fund	0.0	0.0	0.2	0.1	0.4	0.4
Net lending	0.2	-0.2	0.6	0.2	0.3	0.5
<b>General Government Balance</b>	<b>-4.8</b>	<b>-4.5</b>	<b>-4.2</b>	<b>-3.7</b>	<b>-3.1</b>	<b>-2.6</b>
Naftogaz Balance	-1.9	-5.6	-3.1	-0.2	0.0	0.0
<b>General Government and Naftogaz Financing needs</b>	<b>6.7</b>	<b>10.1</b>	<b>7.3</b>	<b>3.9</b>	<b>3.1</b>	<b>2.6</b>
VAT bonds	0.0	0.5	0.0	0.0	0.0	0.0
Bank Recapitalization Requirements and DGF	0.1	1.7	7.7	0.0	0.0	0.0
<b>Total financing needs</b>	<b>6.8</b>	<b>12.3</b>	<b>15.0</b>	<b>3.9</b>	<b>3.1</b>	<b>2.6</b>

Source: World Bank staff calculations based on the framework underpinning the IMF EFF and official data.

26. **Fiscal consolidation efforts and a recovery in growth are expected to reduce the fiscal deficit over the next three years.** The general government deficit in 2015 is projected to decrease to 4.2 percent of GDP, followed by progressive, expenditure-led adjustment to 3.1 percent of GDP in 2017. The economic slowdown and the conflict in the east are expected to continue to dampen revenue collection, especially of direct taxes (corporate income tax, personal income tax, and payroll taxes) while devaluation and inflation sustain nominal collections of VAT, excises and

customs duties, therefore containing overall revenue shortfalls in 2015. On the expenditure side, the amended 2015 budget envisages several measures to structurally reduce the size of the budget footprint, mainly by lowering public consumption and current transfers. Specific measures include steps to address imbalances in the pension system (curtailment of early retirement and special pension benefits), rationalization of public employment to reduce the public sector wage bill, and reduction of subsidies. At the same time, the 2015 budget envisages additional allocation for social assistance spending to mitigate the impact of tariff increases (see below) on the poor and vulnerable.

**27. Steep gas and district heating tariff increases are expected to eliminate the quasi-fiscal deficit and financing needs of Naftogaz over the medium term.** As part of the gas sector reform and implementation plan, supported by this DPL, the authorities announced significant increase in residential gas and district heating tariffs to overcome financial imbalances in the energy sector: a 285 percent average increase<sup>11</sup> in the gas tariff and 67 percent increase in the district heating tariff in 2015 starting April 1, 2015. Tariff increases are expected to reduce the Naftogaz deficit to 3.1 percent of GDP in 2015. Over the medium term, further scheduled annual increases in gas and district heating tariffs and steps to improve collections under the IMF EFF, including distribution accounts for District Heating companies are expected to gradually eliminate losses of Naftogaz (Table 3).

**28. Meanwhile, banking sector stabilization measures may require significant fiscal resources during 2015.** Fiscal costs for the banking sector stabilization fall into three categories: 1) backup funding to the Deposit Guarantee Fund (DGF) to ensure sufficient liquidity to cover payouts to insured depositors; 2) recapitalization of State Owned Banks; and 3) recapitalization by the state of systemically important banks. To date, fiscal resources have only been utilized on the first and second categories, as no banks have been recapitalized by the state to date. Together, the potential cost of addressing banking sector issues could rise to up to 7.7 percent of GDP in 2015, far above the expectations at DPL1 board approval. Actual financing needs are contingent on how many banks will require and receive state support, and how many will be handed over to the DGF for resolution and require deposit payout. Measures to stabilize and restructure the banking sector are supported by the complementary FSDPL series.

**29. The Debt Sustainability Analysis (DSA) indicates that public and external debt sustainability is subject to high risks.** The baseline DSA projections are consistent with the general macroeconomic framework and take into account: 1) the successful implementation of the fiscal adjustment, 2) the stabilization of the exchange rate, 3) official financing inflows, and 4) the basic parameters of the debt operation agreed under the IMF program (see paragraph 30).

- **Public Sector DSA:** In the baseline scenario, public debt is expected to continue to increase rapidly from 70.3 percent of GDP in 2014 to 91.9 percent of GDP in 2015, driven mainly by large fiscal financing needs (banking sector and Naftogaz) and GDP decline. As a result of the debt operation, economic recovery, and primary surpluses, it will then steadily decline to 70 percent by 2020. Risks to the base case are high. Exchange rate risks are particularly critical given the large share of FX denominated debt (about 63 percent of total PPG). A real exchange

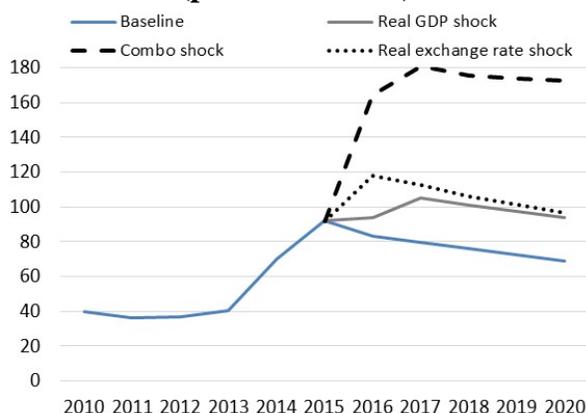
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<sup>11</sup> Increase in residential gas tariffs depends on consumption volume (above or below 200 m<sup>3</sup> per month) and the season (heating/non-heating).

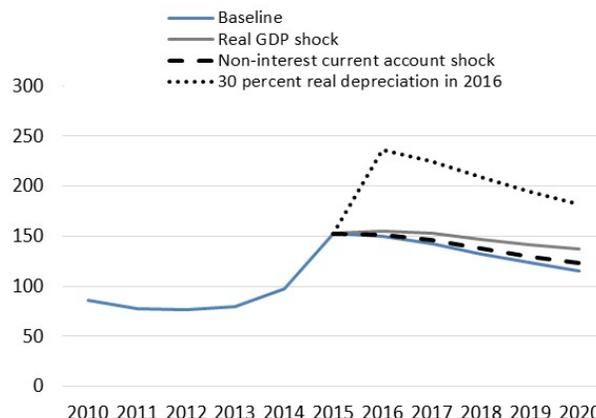
rate shock<sup>12</sup> could push the PPG debt level almost to 118 percent of GDP in 2016. A growth shock<sup>13</sup> would also push PPG debt to over 105 percent of GDP in 2017. Under these shock scenarios, debt levels would remain elevated during the projection period (Figure 11). At the same time, a combined macro-fiscal shock<sup>14</sup> increases PPG debt level to over 180 percent of GDP over the whole projected period.

- **External DSA:** In the baseline scenario, total external debt peaks at 152.7 percent of GDP in 2015 due to currency depreciation and GDP decline. Current account adjustment, economic recovery and the debt operation would lead to a steady decline of external debt to 115 percent of GDP by 2020. As with public debt, the external debt trajectory is subject to high risks. The external debt adjustment path is particularly sensitive to exchange rate shocks. A 30 percent real depreciation shock in 2016 would drive debt to about 237 percent of GDP in 2016. Lower GDP growth (by half a historical standard deviation or 2.5 percentage points) and a non-interest current account shock (one percentage point above the baseline) would keep the external debt to GDP ratio above the 140 percent threshold in the medium term (Figure 12).

**Figure 11:  
Public and Publicly Guaranteed Debt  
Dynamics  
(percent of GDP)**



**Figure 12:  
External Debt Dynamics  
(percent of GDP)**



Source: World Bank staff estimates.

30. **The debt operation is expected to help restore sustainable debt levels and smooth repayments needs for the period following completion of the EFF.** Given the high debt-to-GDP ratio and significant financing needs related to debt service payments on Ukraine’s external public debt, including to private creditors, private sector involvement is critical to resolving the balance of payment crisis and restoring sustainable debt levels. The objectives of the debt operation are threefold: i) to generate US\$15.3 billion savings in the public sector during the program period, ii) to enhance debt sustainability by bringing the PPG-debt-GDP ratio to under 71 percent of GDP by

<sup>12</sup> Maximum historical movement of the exchange rate and pass-through to inflation with elasticity of 0.3.

<sup>13</sup> Real GDP growth is reduced by 1 standard deviation for 2 consecutive years; revenue-to-GDP ratio remains the same as in the baseline; level of non-interest expenditures is the same as in the baseline; deterioration in primary balance lead to higher interest rate; decline in growth leads to lower inflation (0.25 percentage points per 1 percentage point decrease in GDP growth).

<sup>14</sup> Shock size and duration based on all macro-fiscal shocks (constant primary balance shock, real GDP growth shock, interest rate shock and real exchange rate shock).

2020 and iii) to keep gross financing needs of the government after completion of the IMF EFF below 12 percent of GDP a year with a four-year average of 10 percent of GDP. The debt subject to restructuring comprises: sovereign Eurobonds (US\$16.8 billion); quasi-sovereign guaranteed Eurobonds (US\$1.8 billion); sovereign guaranteed commercial loans (US\$0.7 billion); and non-guaranteed State Owned Enterprises' (SOE) liabilities (US\$3.4 billion). This amounts to US\$22.7 billion of debt to be restructured to generate US\$15.3 billion in savings during the IMF Program period (2015-2018) and includes both principal and interest payments.

31. **Risks to the macroeconomic framework are high and cannot be fully mitigated.** While policy measures together with increased external support enhance the prospects of resolving the economic crisis, risks are high and mutually reinforcing:

- *First*, while the macroeconomic policy framework could likely absorb additional moderate domestic and external shocks, resumption, escalation, or both of the conflict would undermine confidence building measures by the authorities, aggravate output losses, and derail overall stabilization efforts. Moreover, prolonged geopolitical tensions and trade-related disputes with Russia could also hamper the recovery, given the importance of the Russian market and the difficulty of substituting this export market in the short run.
- *Second*, a deeper contraction in 2015 and a more sluggish recovery in the outer years – stemming from lower domestic and external demand – would complicate fiscal and external adjustment. The rebound of investment, which is expected to lead the recovery, could be delayed in case political and economic uncertainties prevail. Moreover, the projected recovery in credit to the economy in 2016 may not materialize in view of the protracted banking sector crisis, thus tempering the projected recovery in investment. Consumption may also remain subdued due to the continued need for fiscal adjustment and a slower recovery in the labor market. The recovery of exports may be hampered by weak external demand and further disruptions in export industries located in the east.
- *Third*, if efforts to regain confidence fail and currency pressures remerge, Ukraine could again get caught in a predicament of mutually reinforcing depreciation, capital flight and inflation in turn aggravating the banking crisis and hampering efforts to restore external and fiscal sustainability.
- *Fourth*, risks to external and fiscal financing are significant. Failure to reach agreements with private creditors, consistent with the assumptions underlying the baseline macroeconomic framework would exacerbate external liquidity constraints, especially in 2016-17, when official inflows are expected to subside. Given the size of the expected private sector contribution to the overall financing requirements, negotiations of the debt operation are complicated. While a successful resolution of Ukraine's private creditor debt may be in the interest of bond holders, hold out creditors could complicate efforts to reach agreement. As a result, private creditor participation and the terms they are willing to accept could fall short of the targeted contribution. In addition, continued capital flight, lower than expected FDI and lower rollover rates of corporate and banking sector credit would imply a larger financing gap or a sharper adjustment. Shortfalls and/or delays in official financing due to slippages in macroeconomic and structural reforms could reduce external official assistance and complicate efforts to finance current account and fiscal deficits.
- *Fifth*, efforts to restore sustainable public finances could prove to be more challenging than expected. The economic downturn and conflict in the east could undermine revenue performance despite policy changes and efforts to improve tax administration. Also,

austerity measures could run into resistance and kindle further unrest. Pressures are exacerbated by the Naftogaz deficit and the fiscal financing needed to stabilize the banking sector – both major fiscal risks. While the government has committed to reduce Naftogaz deficit, the complex nature of the problem, the size of adjustment, and the political economy could make this challenging, especially in the short to medium term. While tariff increases are substantial, possible fall in collection rates could temper the impact on the Naftogaz deficit. Fiscal risks associated with the banking sector crisis are mitigated by a significant financial buffer built into the baseline framework.

- *Sixth*, broader loss of confidence in the banking sector could trigger a deposit run which would further aggravate instability in the banking sector and potentially increase pressure on the exchange rate. Problems in the financial sector could in turn create a vicious circle between initial macroeconomic shocks, balance sheet problems in banks, instability and liquidity in financial markets which then deepen the economic downturn and may increase the burden on the budget. The current macroeconomic crisis has already exacerbated risks in the banking sector because currency depreciation is putting pressure on banks' capital through losses generated from open short foreign exchange positions and an increase in already high non-performing loans. The deterioration in capital adequacy in turn is likely to force banks to make adjustments in their lending standards and the ensuing credit crunch would further weaken investment and spending, thus amplifying the economic downturn. This risk is partially mitigated by measures taken by the authorities to bolster confidence and resolve underlying risks in the banking sector, including conducting diagnostic audits of the largest banks to ensure that they are adequately capitalized, reducing the levels of related party lending in the banking system, and enhancing the capacity of the DGF, supported by the parallel FSDPL series.

### 2.3 IMF RELATIONS

32. **The IMF Board of Executive Directors approved a four-year EFF for Ukraine on March 11, 2015, which replaces the Stand-By-Arrangement from April 2014.** The EFF, approved under the IMF's exceptional access policy, is for SDR 12.348 billion (about US\$17.5 billion, 900 percent of quota). With Board approval, SDR 3.546 billion (about US\$5 billion) was immediately disbursed, with SDR 1.915 billion (about US\$2.7 billion) allocated to budget support. Further disbursements will be based on quarterly reviews. IMF's disbursements under the EFF are frontloaded, with SDR7 billion (US\$10 billion) expected to be disbursed in 2015, provided the quarterly reviews are completed. In addition to the extended program period, the EFF also extended the repayment period to 2028, increasing expected net disbursement while containing gross financing needs. In early July 2015, a staff level agreement was concluded on a set of policies needed for the First Review, which is expected to be presented to the IMF Board by the end of July. Completion of the review would enable disbursement of US\$1.7 billion.

### 3. THE GOVERNMENT'S PROGRAM

33. **The new Government that came into office in December 2014 embarked on a broad reform agenda and continues to be focused on restoring macroeconomic stability and growth.** The reform program<sup>15</sup> comprises constitutional, political and economic reforms, including decentralization, strengthening of checks and balances between all three branches of

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<sup>15</sup> The reform program is summarized at [www.reforms.in.ua](http://www.reforms.in.ua)

government, changes to the electoral system, national security and defense reforms, justice sector reform, public administration reform, energy sector reform and tax reform. The program aims to put Ukraine on a path to closer integration with EU, anchored in the Association Agreement and the Deep and Comprehensive Free Trade Agreement (DCFTA) signed in 2014. The Government program for 2015-2016 adopted in December 2014 comprise of ten pillars, key among which are:

- **New policy for public service delivery** through deregulation and decentralization; cutting the number of inspecting bodies in line with EU standards and DCFTA agreement; harmonization of national standards with EU; changes to Budget and Tax Codes in order to provide additional flexibility to regional authorities; and implementation of competitive selection for public servants.
- **New anticorruption policy**, through the formation of a national anticorruption agency as a preventive body and national anticorruption bureau as prosecuting body; disclosure of ultimate beneficial owners of companies and property; reform of Ministry of Internal Affairs; and judicial reform.
- **New economic policy**, through reducing the number of taxes; reducing the share of budget expenditures in GDP; reduction of tax burden on payroll and on small and medium enterprises; better implementation of transfer pricing law; signing of free trade agreements with a wide range of countries.
- **New policy of state property management** that envisages transparent privatization of state owned enterprises; changes in management of strategic state enterprises through application of international standards.
- **New agriculture policy**, through land reform; improvements in lease regulation; setting up a State land cadaster; and changes in the role of the State Agriculture Fund and efficient management of State Crop Corporation.
- **New policy of energy independence**, through restructuring of NAK Naftogaz in line with the Third Energy Package; attracting foreign investment into modernization of the gas transit system; modernization of the infrastructure of energy complex; and diversification of energy resources supply.
- **New policy of social protection**, by reforming ineffective subsidies; moving towards better-targeted social assistance; reforming labor legislation; and developing a private pension system.

## 4. THE PROPOSED OPERATION

### 4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

34. **DPL2 is the second and final lending operation in a series aimed at supporting high-priority reform measures, aligned with the Government's strategic objectives.** The operation has 10 prior actions structured around three pillars and aims to promote good governance, transparency and accountability in the public sector; strengthen the regulatory framework and reduce costs of doing business; and reform inefficient and inequitable utility subsidies while protecting the poor. All 10 prior actions have been completed.

35. **Reforms supported by this DPL series are based on several principles.** First, the program focuses on policy actions that are prioritized by the authorities and where the WBG has existing analytical work and ongoing dialogue (Table 5). Second, across the three pillars the program seeks to address serious governance challenges. Third, the program aims to balance the

distributional impact of the adjustment by cushioning the impact on the poor. Fourth, both DPLs in this series support reform measures that address roots of the current crisis and choice of actions under each was guided by balancing potential impact and feasibility. Fifth, with a compressed schedule, DPL1 included prior actions that could be completed quickly, while DPL2 contains actions that took time to complete. Finally, the reforms supported complement the efforts by other international partners.

**36. The program design remains valid despite the fluid macroeconomic environment.** The current crisis has been long in the making. Fundamental governance failures, state capture by vested interests, deep-rooted corruption and political instability have undermined the investment climate, resulted in a wasteful use of resources, and eroded government capacity as well as citizens’ trust in public institutions. Poor macroeconomic policies and delayed structural reforms have led to economic stagnation accompanied by widening and unsustainable internal and external imbalances. Better governance, an attractive investment climate, a financially viable energy sector and fiscally affordable and targeted social safety nets are all critical for Ukraine to return to economic stability and growth.

**37. The policy content of the program has been sharpened following discussions with the authorities.** One of the eleven initial triggers (Trigger 10 pertaining to the establishment of a social inspectorate) for DPL2 was dropped from the program. Organizational structures of many Ministries, including the Ministry of Labor and Social Protection are subject to changes due to the ongoing administrative decentralization. In this context, establishment of a centralized social inspection function within the Ministry has been postponed. At the same time, three prior actions (Prior Action 6 on deregulation, Prior Action 8 on Naftogaz restructuring and Prior Action 10 on improved targeting of social assistance programs) were substantively strengthened. These modifications, summarized in Table 4, do not affect the overall development objectives of the operation. In addition, given the more protracted adjustment and slower recovery, the timeline for the results framework has been recalibrated to reflect that impact of the program may take longer to materialize.

**Table 4 Program Modifications**

<b>Initial DPL2 Triggers</b>	<b>DPL2 Prior Actions</b>	<b>Reasons for change</b>
<b>Trigger 1:</b> Enact legislative amendments, including to the Budget Code, to improve the public investment management framework	<b>Prior Action 1:</b> The Borrower has introduced rules for transparent appraisal and selection and predictable financing of public investments for purposes of improving its public investment management framework, through enactment of Law of Ukraine # 288-VIII “On Amendments to the Budget Code of Ukraine on Public Investment Projects” dated April 7, 2015 (Official Gazette Golos Ukrainy April 25, 2015, Number 75).	No material change. Formulation was sharpened.
<b>Trigger 2:</b> Enact legislation to establish centralized external verification of financial disclosures	<b>Prior Action 2:</b> The Borrower has established a centralized external verification function for financial	No material change. Formulation was sharpened.

<p>by elected and senior public officials and disciplinary and administrative accountability for those who fail to comply with financial disclosure requirements or misrepresent financial information. Establish independent verification of asset declaration function</p>	<p>disclosures of publicly elected and senior public officials, and provided for disciplinary and administrative accountability for those officials who fail to comply with financial disclosure requirements or misrepresent financial information, through enactment of Law of Ukraine #1700-VII “On Prevention of Corruption” dated October 14, 2014 (Official Gazette Golos Ukrainy October 25, 2014, Number 206).</p>	
<p><b>Trigger 3:</b> Enact amendments to the Law on the Accounting Chamber to expand coverage of external audits to state budget revenue</p>	<p><b>Prior Action 3:</b> The Borrower has expanded the mandate of the Accounting Chamber of Ukraine to cover external audits of the Borrower’s budget revenues, through enactment of Law of Ukraine # 274- VIII “On Amendments to the Law of Ukraine ‘On the Accounting Chamber’ ” dated April 7, 2015, (Official Gazette Golos Ukrainy April 25, 2015, Number 75).</p>	<p>No change</p>
<p><b>Trigger 4:</b> Enact amendments to the Law on Transfer Pricing to reduce tax avoidance in line with OECD guidelines</p>	<p><b>Prior Action 4:</b> The Borrower has improved transfer pricing legislation and practices in line with the OECD Guidelines for purposes of reducing tax avoidance, through enactment of Law of Ukraine #72-VIII “On Amendments to the Tax Code of Ukraine Regarding Improvement of Tax Control of Transfer Pricing” dated December 28, 2014, (Official Gazette Golos Ukrainy December 30, 2014, Number 252).</p>	<p>No material change. Formulation was sharpened.</p>
<p><b>Trigger 5:</b> Improve VAT refund processing by extension of automatic VAT refund procedures and revising automatic refund eligibility criteria</p>	<p><b>Prior Action 5:</b> The Borrower has extended automatic VAT refund procedures and revised automatic refund eligibility criteria guidelines for purposes of improving VAT refund processing, through enactment of Law of Ukraine #71-VIII “On Amendments to the Tax Code and Certain Legislative Acts of Ukraine on Tax Reform dated December 28, 2014 (Official Gazette Golos Ukrainy December 31, 2014, Number 254).</p>	<p>No material change. Formulation was sharpened.</p>
<p><b>Trigger 6:</b> Enact legislation to rationalize construction permits, ease licenses, strengthen investor protection and establish a high-level regulatory reform coordination mechanism</p>	<p><b>Prior Action 6:</b> The Borrower established a deregulation framework, eased licensing and permit requirements, and harmonized food safety standards and procedures and technical</p>	<p>Scope of Prior Action was aligned with Government priorities and streamlined based on guidance received at the Concept Note review meeting.</p>

	<p>regulations and conformity assessments with European Union requirements for purposes of improving the investment climate, through enactment of Law of Ukraine # 222-VIII “On Licensing of Certain Types of Entrepreneurial Activities” dated March 2, 2015 (Official Gazette Golos Ukrainy March 28, 2015, Number 56); Law of Ukraine # 124-VIII “On Technical Regulation and Conformity Assessment” dated January 15, 2015, (Official Gazette Golos Ukrainy February 10, 2015, Number 23), Law of Ukraine #191-VIII “On Amendments to Certain Legislative Acts of Ukraine Regarding Simplification of Running Business (Deregulation)” dated February 12, 2015 (Official Gazette Golos Ukrainy April 4, 2015, Number 61), and Law of Ukraine # 1602-VII “On Amendments to Certain Legislative Acts of Ukraine on Food Safety” dated July 22, 2014 (Official Gazette Golos Ukrainy September 19, 2014, Number 179), Law of Ukraine #289-VIII “On Amendments to Certain Legislative Acts of Ukraine on Protection of the Rights of Investors” dated April 7, 2015, (Official Gazette Golos Ukrainy May 13, 2015, Number 82) .</p>	
<p><b>Trigger 7:</b> Enact legislation to abolish use of land as bank capital (State Land Bank)</p>	<p><b>Prior Action 7:</b> The Borrower has removed the possibility of counting land as bank capital through Decree of the Cabinet of Ministers of Ukraine #418 “On State Land Bank Abolishment” dated September 10, 2014 and through enactment of Law of Ukraine # 1507-VII “On Amendments to Certain Legislative Acts of Ukraine” dated June 17, 2014, (Official Gazette Golos Ukrainy July 8, 2014, Number 127).</p>	<p>No material change. Formulation was sharpened.</p>
<p><b>Trigger 8:</b> Enact amendments to the Law of Ukraine on Regulation of Communal Services to enforce independence of the national regulation of communal services by making it impossible to set tariffs below cost-recovery levels; the Government approves the draft law</p>	<p><b>Prior Action 8:</b> The Borrower: (a) has strengthened the independence of the national regulation of communal services by removing provisions that allow the Borrower’s Cabinet of Ministers to develop a mechanism for setting utility tariffs below cost-recovery levels, through</p>	<p>No material change. Formulation was sharpened.</p>

<p>on regulation of energy sector consistent with the Third Energy Package</p>	<p>enactment of Law of Ukraine #626-VIII “On Amendments to Some Laws of Ukraine in the Area of Communal Services)” dated July 16, 2015 (Official Gazette Golos Ukrainy July 24, 2015, Number 132); and (b) has strengthened the independence of the national regulation of the energy sector through approval by the Cabinet of Ministers on July 14, 2015 of the draft Law #2966 “On National Energy and Utilities State Regulatory Commission” that is compliant with the European Union’s Third Energy Package.</p>	
<p><b>Trigger 9:</b> Approval of concept for Naftogaz restructuring, acceptable to the World Bank</p>	<p><b>Prior Action 9:</b> The Borrower’s Cabinet of Ministers has approved the “Gas Sector Reform and Implementation Plan” through Order number #375-p dated March 25, 2015 to comprehensively restructure the gas sector, including gradual energy price increases (and accompanying social assistance measures); incentivizing domestic production through attracting more private and international investment to the sector; restructuring of Naftogaz and distribution companies; and improving governance of the sector through introduction of an accelerated gas and heat meters installation program.</p>	<p>The prior action was strengthened in two ways: First, the scope of the gas sector reform plan is more comprehensive, covering all needed and interrelated structural and institutional reforms in the Gas sector, including tariff adjustments and accompanying social assistance, reforms of the legal and regulatory environment (Gas sector Law), reforms of fiscal regime and licensing for upstream exploration and extraction, and unbundling of Naftogaz. Second, Cabinet approval will anchor these critical reforms at the highest level of Government.</p>
<p><b>Trigger 10:</b> Establishment of Social Protection Inspectorate</p>	<p>Dropped</p>	<p>This reform has been postponed given broader reorganization of the Ministry of Social Policy in the context of administrative decentralization.</p>
<p><b>Trigger 11:</b> Reforms to further improve targeting of social assistance spending</p>	<p><b>Prior Action 10:</b> The Borrower has introduced income testing of the housing and utilities subsidies and reduced the amount of such housing and utilities privilege benefits, replaced universal child benefits with a guaranteed minimum income (GMI) supplement for children of age 0-3, and has reduced the amount of the universal child-birth grant benefit, all for purposes of improving the targeting of social assistance to the poor, through Decree of the Cabinet of Ministers #106 “On Improvement of the Process of Housing Subsidizing”</p>	<p>This prior action was substantively sharpened to include specific actions to better target social assistance.</p>

	<p>dated February 28, 2015, and enactment of Law of Ukraine #221-VIII “On Amendments to Article 5 of the Law of Ukraine “ On Public Social Aid to Poor Families” Regarding Social Protection of Children”, dated March 2, 2015, (Official Gazette Golos Ukrainy, March 20, 2015, Number 50).</p>	
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38. **The design of the DPL series incorporates lessons learned from earlier budget support operations in Ukraine as well as the World Bank’s global experience.** While prepared in a crisis context, the programmatic nature of the operation is built on a sequenced set of critical structural and institutional reform measures that start to address some of the root causes of the crisis.<sup>16</sup> The program is underpinned by a robust analytical and technical assistance engagement that allowed the Bank to engage in substantive policy dialogue with the authorities and other development partners. In addition, the risk assessment provides a candid discussion of powerful vested interests that could likely slow the pace of reforms and undermine the impact and results of the operation. The civil society and development partners were consulted to strengthen demand for the reforms supported under the program and to leverage the limited World Bank lending resources.

#### 4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

##### **Pillar A: Promote good governance, transparency and accountability in the public sector**

39. **Ukraine needs to continue reforms aimed at improving governance, curbing state capture by vested interests, and ensuring accountability of the state to its citizens.**<sup>17</sup> The Government has embarked on reforms to address poor governance after it took office in March 2014. DPL1 supported initial steps but more needs to be done to address public discontent over governance failures, state capture by vested interests and deep-rooted corruption in delivery of basic public services. DPL2 builds on initial actions supported under DPL1 and aims at sustaining them by focusing on institutional reforms. It includes measures to increase transparency and efficiency of public investment allocation and strengthen external oversight of public funds. It seeks to strengthen accountability of senior public and elected officials through systematic disclosure and independent verification of their asset declarations. Finally, it reinforces measures to close loopholes in the tax system that have allowed for widespread tax avoidance by a select few and created opportunities for corruption.

40. **Results.** Prior actions under this pillar strengthen governance and promote transparency in the public sector by increasing the share of value competitive procurement selection from 35

<sup>16</sup>The previous DPL series – with three operations – was designed after the 2004 Orange Revolution when expectations were high. While overall direction of the reform agenda in the series was maintained, prior actions and expected development outcomes were changed in the second and third operations to reflect changing conditions – especially in the third operation that had to deal with the 2008/09 crisis. In this case, however, the situation is reversed. This series starts out with an operation to deal with a crisis, and is designed to use the subsequent operation to sustain reform momentum. But learning from the past, the time frame for this series is kept short. World Bank (2011), “ICRR on Second and Third Development Policy Loans,” IEG (2011), “ICR Review – Development Policy Loan 2.”

<sup>17</sup> Ukraine has persistently ranked low on critical aspects of governance. A range of indicators, such as the Index of Economic Freedom of the Heritage Foundation and the Corruption Perception Index of Transparency International reveal a further deterioration in the past three years.

percent in 2013 to 55 percent in 2016 (DPL1); making public investment management more transparent by improving project appraisal and selection (DPL2, prior action 1); reducing incentives for corruption by increasing the share of verified financial disclosures by elected and senior public officials from 0 percent in 2013 to 100 percent by 2016 (DPL2, prior action 2); strengthening checks and balances to revenue side of the budget by extending external audit coverage (DPL2, prior action 3); and attempting to balance costs of fiscal adjustment by closing loopholes in the transfer pricing law and reducing opportunities for tax avoidance mainly by large taxpayers (DPL2, prior action 4).

*Prior Action 1: The Borrower has introduced rules for transparent appraisal and selection and predictable financing of public investments for purposes of improving its public investment management framework, through enactment of Law of Ukraine # 288-VIII “On Amendments to the Budget Code of Ukraine on Public Investment Projects” dated April 7, 2015 (Official Gazette Golos Ukrainy April 25, 2015, Number 75).*

**41. This prior action supports establishing a public investment management framework for projects financed from the budget.** DPL1 supported improvements in public procurement to address leakages and inefficiency in budget execution. DPL2 seeks to strengthen the upstream process of budgeting and project appraisal – to ensure that the allocation public resources is aligned with strategic policy objectives which is important given the tight fiscal situation and the importance of public investment for future growth. The 2011 Public Expenditure and Financial Accountability Assessment and 2012 Public Investment Management Assessment identified public investment management as one of the weakest elements of the public financial management system in Ukraine. Previously, discretion in identification, appraisal and selection of public investment projects, coupled with weak monitoring of implementation, created opportunities for corruption and inefficiencies in public investment. To address this, the Government amended the Budget Code to better define public investment projects and delineate responsibilities and rules for transparent project appraisal and selection, predictable financing during whole project cycle, monitoring and evaluation. These amendments ensure that all public investment projects are subjected to economic analysis and scrutinized by an entity at arm’s length (Ministry of Economic Development) to align investment with strategic objectives and to ensure that quality is maintained. Decisions on project selection will be made by the commission consisting of representatives of all relevant government bodies. The list of commission’s members and detailed Guidelines for projects appraisal and selection will be adopted by a Cabinet of Ministers Resolution. In addition, the new framework provides priority funding to existing capital projects to ensure more predictable financing through the project cycle.

*Prior Action 2: The Borrower has established a centralized external verification function for financial disclosures of publicly elected and senior public officials, and provided for disciplinary and administrative accountability for those officials who fail to comply with financial disclosure requirements or misrepresent financial information, through enactment of Law of Ukraine #1700-VII “On Prevention of Corruption” dated October 14, 2014 (Official Gazette Golos Ukrainy October 25, 2014, Number 206).*

**42. This prior action supports the Government in further strengthening the requirements for asset declaration and establishing a verification mechanism.** It builds on the Law of Ukraine #1261-VII, supported by DPL1. The Law amends the anticorruption legislation of

Ukraine to centralize the system of verifications of financial disclosures by delegating the verification to the tax authority. While this provided for external means of control, such control remains vested within the executive branch of the Government. To make the verification function as independent of executive as Ukraine's constitution allows, this prior action for DPL2 supports establishing the independent verification of asset declarations function to ensure integrity of the information provided in declarations. This function is vested in a preventive anti-corruption agency as foreseen in the Law of Ukraine #1700-VII "On Prevention of Corruption", and adopted by the Rada on October 14, 2014 as a part of the anti-corruption package. The law entered into force on April 26, 2015. The Cabinet of Ministers adopted a decision on establishing of the preventive anti-corruption agency with verification functions on March 18, 2015. The Ministry of Justice has been developing secondary legislation allowing the creation of the anti-corruption agency and discussing the implementation of key provisions of the law, including e-filing of financial disclosures necessary for effective verification.

*Prior Action 3: The Borrower has expanded the mandate of the Accounting Chamber of Ukraine to cover external audits of the Borrower's budget revenues, through enactment of Law of Ukraine # 274- VIII "On Amendments to the Law of Ukraine 'On the Accounting Chamber' " dated April 7, 2015, (Official Gazette Golos Ukrainy April 25, 2015, Number 75).*

43. **To strengthen external oversight of public funds, DPL2 supports expanding the mandate of the Accounting Chamber to state budget revenue.** The Law on the Accounting Chamber of Ukraine limits coverage of external audit to expenditures of the state budget, omitting state revenues and a range of public institutions.<sup>18</sup> Approval of a legal framework for the Accounting Chamber expanded its authority to undertake external audits of state budget revenue, and thereby bringing the scope of the audit closer to standards under the Lima Declaration of Audit Precepts and the Mexico Declaration on Supreme Audit Authority Independence. By strengthening checks and balances on revenues, this prior action is expected to reduce opportunities for leakage and contribute to transparent management of state revenues. The Accounting Chamber has started selective audits of revenues but it needed to be formalized in the legislation and would also require efforts to build capacity. This law is better aligned with international good practice and now includes both expenditure and revenues of the state budget, and covers financial and performance audits. The Constitutional limitations still do not allow the mandate of the Accounting Chamber to be expanded to include proper financial statements audit of overall public sector including SOEs and local government. This would remain on the reform agenda going forward.

*Prior Action 4: The Borrower has improved transfer pricing legislation and practices in line with the OECD Guidelines for purposes of reducing tax avoidance, through enactment of Law of Ukraine #72-VIII "On Amendments to the Tax Code of Ukraine Regarding Improvement of Tax Control of Transfer Pricing" dated December 28, 2014, (Official Gazette Golos Ukrainy December 30, 2014, Number 252).*

44. **The prior action supports the Government initiative to improve transfer pricing legislation in line with OECD principles to close loopholes for tax avoidance.** The law "On the Introduction of Amendments to the Tax Code of Ukraine Regarding Improvement of Tax Control over Transfer Pricing", approved in December 2014, substantially strengthens controls and

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<sup>18</sup>The 2011 PEFA Assessment has scored external audit performance in Ukraine at D+ on an A to D scale, where D is the lowest score.

minimizes opportunities for profit shifting and tax avoidance through transfer pricing. These amendments, which became effective on January 1, 2015, are a significant improvement and more consistent with the principles detailed in the OECD Transfer Pricing Guidelines (2010). Key improvements include explicit introduction of the arm's length's principle and introduction of the comparability concept.<sup>19</sup> The amendments also eliminated a loophole arising from transitional arrangements that allowed for discretion in the application of transfer pricing rules in key export sectors (under Article 21 of the previous transfer pricing Law). This provision allowed for de facto exclusion of export of grains, oils, metals, minerals, chemicals, alcohol, and steel processing products (together about two thirds of Ukraine's merchandise export 2013-2014) from the application of transfer pricing rules. With the improved legislative framework in place, the Government recognizes that there are still areas for future improvement and significant work is required to effectively implement and administer the new framework.<sup>20</sup>

## **Pillar B: Strengthen the regulatory framework and reduce costs of doing business**

45. **Notable progress has been made in improving the legal framework regulating the business environment, but significant challenges remains, both in terms of further legislative change and consistent implementation of existing rules.** Since April 2014, Ukraine's Government and Parliament have passed a string of important legislative reforms in areas such as business start-up, food safety, and metrology and standardization. However further and more fully implemented reforms are required. Legislative reforms have not translated into effective implementation, reflected in discretionary application of laws and regulations. Business regulations are excessively focused on ex-ante controls, rather than in ex-post risk management resulting in an excessive number of licenses, permit requirements and inspections. In addition, regulations particularly those related to product standards, food safety, and land management are cumbersome and not aligned with requirements of key export markets. This DPL pillar supports actions to improve regulatory quality for a better investment climate with a particular focus on harmonizing key legislation with the requirements under the Deep and Comprehensive Trade Agreement (DCFTA), thereby laying the foundation for reducing non-tariff barriers in trade with the EU. The pillar also addresses a major potential distortion in the agricultural land market, by eliminating legislative provision that allowed for the creation of the State Land Bank.

46. **Results.** In combination, the expected results of these measures are to reduce the costs and risks of doing business in Ukraine by: streamlining VAT refunds and reducing the backlog on refund claims older than 74 days from 153 percent in 2013 to 20 percent by end 2016 (DPL1, prior action 3 and DPL2, prior action 5); and removing potential distortions in the agriculture sector through the State Land Bank by abolishing it (DPL2, prior action 7).

*Prior Action 5: The Borrower has extended automatic VAT refund procedures and revised automatic refund eligibility criteria guidelines for purposes of improving VAT refund processing, through enactment of Law of Ukraine #71-VIII "On Amendments to the Tax Code and Certain*

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<sup>19</sup> The arm's-length principle is generally applied in practice by establishing comparability between the conditions in a controlled transaction (i.e. transaction between the associated enterprises involved) and the conditions in uncontrolled transactions (i.e., transactions between independent parties). This concept of comparability analysis is used in the selection of the most appropriate transfer pricing method as well as in arriving at the correct arm's-length prices or profits or financial indicator (or range of prices or financial indicators), and thus plays a central role in the overall application of the arm's-length principle (OECD Transfer Pricing Guidelines, 2010).

<sup>20</sup> Technical assistance on implementation of transfer pricing legislation is currently provided by the World Bank.

*Legislative Acts of Ukraine on Tax Reform dated December 28, 2014 (Official Gazette Golos Ukrainy December 31, 2014, Number 254).*

**47. Building on the measures to improve transparency and accountability in the VAT refund process supported by DPL1, DPL2 supports changes to the automatic VAT refund system to ensure timely and transparent handling of refund claims.** Implementation of the automatic refund system started in 2011, but the risk criteria have limited its effective use for a majority of refund transactions. Out of 1,887 VAT refund claims by exporters in May 2014, only 304 claims were eligible for automatic refunds. To prevent accumulation of refund arrears and ensure transparent and non-discretionary process of handling refund claims, the Government will establish a truly automatic VAT refund window for low-risk taxpayers. The law on Amendments to the Tax Code was approved on December 28, 2014 simplified the criteria for automatic refunds starting from January 1, 2015 and included elimination of criteria of counterparty risk through invoice cross-checking and average wages of the company above 250 percent of the official minimum wage. The revised refund criteria have been officially communicated to taxpayers through all regional tax offices. This should allow for more efficient and transparent VAT refund process will reduce compliance costs for taxpayers, especially exporters.

*Prior Action 6: Borrower established a deregulation framework, eased licensing and permit requirements, and harmonized food safety standards and procedures and technical regulations and conformity assessments with European Union requirements for purposes of improving the investment climate, through enactment of Law of Ukraine # 222-VIII “On Licensing of Certain Types of Entrepreneurial Activities” dated March 2, 2015 (Official Gazette Golos Ukrainy March 28, 2015, Number 56); Law of Ukraine # 124-VIII “On Technical Regulation and Conformity Assessment” dated January 15, 2015, (Official Gazette Golos Ukrainy February 10, 2015, Number 23), Law of Ukraine #191-VIII “On Amendments to Certain Legislative Acts of Ukraine Regarding Simplification of Running Business (Deregulation)” dated February 12, 2015 (Official Gazette Golos Ukrainy April 4, 2015, Number 61), and Law of Ukraine # 1602-VII “On Amendments to Certain Legislative Acts of Ukraine on Food Safety” dated July 22, 2014 (Official Gazette Golos Ukrainy September 19, 2014, Number 179), Law of Ukraine # 289-VIII “On Amendments to Certain Legislative Acts of Ukraine on Protection of the Rights of Investors” dated April 7, 2015, (Official Gazette Golos Ukrainy May 13, 2015, Number 82).*

**48. The Government has continued to deepen the regulatory overhaul under DPL2.** This prior action supports enactment of a package of legislation to enhance the business climate, including in the areas of regulatory reforms, food safety and national quality infrastructure. A comprehensive deregulation law and a new law on licensing regime have started to eliminate of overlap and duplication in licensing and streamline procedures for their issuance. The deregulation framework law envisages an overhaul of the regulatory environment in Ukraine by modifying more than 50 existing laws pertaining to business registration; administrative services provided by the state and also envisage a reduction of licensed activities – from 57 to 40. In food safety, a new food safety law has introduced key principles and rules, consistent with EU requirements. Reforms to harmonize the national quality infrastructure with EU requirements have been completed by passing laws on Metrology and Metrological Activity, on Standardization; and on Technical Regulations and Conformity Assessment. These reforms are consistent with obligations under the Association Agreement with the EU and lay the legal foundation for a reduction of major non-tariff trade barriers with the EU market.

*Prior Action 7: The Borrower has removed the possibility of counting land as bank capital through Decree of the Cabinet of Ministers of Ukraine #418 “On State Land Bank Abolishment” dated September 10, 2014 and through enactment of Law of Ukraine #1507-VII “On Amendments to Certain Legislative Acts of Ukraine” dated June 17, 2014, (Official Gazette Golos Ukrainy July 8, 2014, Number 127).*

49. **This prior action annulled the legislative framework that allowed use of land as bank capital, thus removing a significant potential distortion and governance risk in the land market and banking system.** The State Land Bank – which was created in 2012 through a number of legislative amendments – combines agricultural financing with land administration functions. The legal framework allowed the State Land Bank to use the appraised value of land plots as part of its statutory (tier 1) capital, contradicting both the principles of Ukrainian banking legislation and Basel norms, which require statutory capital to be formed by cash (or state bonds in exceptional circumstances). The State Land Bank was also granted preemptive purchase rights for land plots, creating a quasi-monopolistic structure in the land market. This framework, established to serve vested interests, created significant risks to both the land market and the financial sector. Revoking legislation that allowed use of land as bank capital has addressed these concerns, lowered the risk of corruption, reduced potential banking sector risks and will contribute to competitive land market.

### **Pillar C: Reform inefficient and inequitable utility subsidies while protecting the poor**

50. **Independence of energy sector regulators and sector transparency are essential preconditions that ensure depoliticized tariff setting and proper governance.** With support of DPL1 and the IMF SBA, the authorities increased residential gas tariffs by 56 percent on average effective of May 1, 2014, and residential heating tariffs by 40 percent on average effective of July 1, 2014. These reforms brought residential gas prices closer to cost recovery levels; residential heating tariffs now reflect current financial costs of heat production. Despite these important steps, residential gas prices and prices utilities pay for gas to produce residential heat need to be increased further to reach full cost recovery while residential heating tariffs will need to be adjusted commensurately to pass these increases in gas price to final consumers. The Government has committed to further gradual increases of residential and utility gas prices as well as residential heating tariffs. A depoliticized and transparent tariff setting process is crucial for this commitment to be upheld and to ensure long term financial sustainability. DPL2 seeks to underpin the planned tariff adjustments through institutional changes to strengthen the independence of regulators responsible for heating and gas tariff increases. Increased independence of energy regulators will not just facilitate energy pricing reform to move forward, but also improve governance of the sector. To complement regulatory reforms, the pillar also supports measures to improve transparency of gas sector by adopting a comprehensive gas sector reform and implementation plan. Among other important elements such as the restructuring of Naftogaz, the plan also includes tariff increases that must be complemented by adjustments in social assistance to mitigate the impact on the poor. A better targeted social assistance system, as opposed the current untargeted system in Ukraine, not only protects the poor but is also fiscally sustainable.

51. **Results.** Sustained tariff increases for residential gas and heat supported under this pillar are a core element of the authorities’ fiscal and external adjustment program. The tariff increases

implemented under DPL1 (DPL1, prior action 6) helped partially mitigate the impact depreciation and higher import price for gas on the Naftogaz deficit.<sup>21</sup> As part of the gas sector reform and implementation plan the authorities announced further tariff increases to eliminate the Naftogaz deficit by 2018 and to assist Ukraine to fulfill its commitment to Energy Community to comprehensively liberalize the gas market (DPL2, prior action 9). Moreover, by supporting measures that will depoliticize gas and heat tariff setting, the prior actions under the pillar will facilitate further elimination of tariff differential for residential and utility gas, allow maintaining residential heating tariffs at cost recovery levels, thus sustaining incentives to improve energy efficiency on demand and supply sides (DPL2, prior action 8). Better targeting of the social assistance system and rationalizing the programs over the medium term would better enable it to protect the poor while improving fiscal sustainability (DP1, prior action 7 and DPL2, prior action 10) by increasing the share of means and income tested programs from 13 percent in 2013 to 20 percent in 2016.

*Prior Action 8: The Borrower: (a) has strengthened the independence of the national regulation of communal services by removing provisions that allow the Borrower's Cabinet of Ministers to develop a mechanism for setting utility tariffs below cost-recovery levels, through enactment of Law of Ukraine #626-VIII "On Amendments to Some Laws of Ukraine in the Area of Communal Services)" dated July 16, 2015 (Official Gazette Golos Ukrainy July 24, 2015, Number 132); and (b) has strengthened the independence of the national regulation of the energy sector through approval by the Cabinet of Ministers on July 14, 2015 of the draft Law #2966 "On National Energy and Utilities State Regulatory Commission" that is compliant with the European Union's Third Energy Package.*

**52. This prior action supports the Government's plans to strengthen independence of the energy regulator responsible for tariff setting in the communal service and energy markets.** In August 2014, National Commission for Regulation of Communal Services (NCRCS) and National Energy Regulatory Commission (NERC) have been abolished and a new energy regulator, National Commission for State Energy and Public Utilities Regulation (NEURC) was created. The new regulator is responsible for tariff setting in both the communal service market (district heating, water, etc.) and the energy market (gas and electricity). For the efficient operation of the energy sector, the NEURC needs to be able to set energy tariffs that reflect market prices, independently of political pressures. This requires that the NEURC performs its regulatory functions as an operationally and financially independent entity with a mandate to advance cost recovery in the energy sector. The *Law on the Regulation of the Energy Sector* puts in place the fundamental institutional framework to safeguard independence of NEURC in compliance with the requirement of the Third Energy Package,<sup>22</sup> including basic provisions for a) appointment of Commissioners through public, open competition; b) financial independence; and c) authority to issue binding decisions for energy companies, undertake investigations, receive information and to impose penalties. This law would ensure that NEURC is legally able to act independently, that its staff and

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<sup>21</sup> As discussed in more detail in paragraph 12, despite tariff increases the Naftogaz deficit expanded during 2014 due to sharp currency depreciation and shortfalls in revenues from commercial gas consumers.

<sup>22</sup> <sup>1</sup>The European Union's Third Energy Package is a legislative package for an internal gas and electricity market in the European Union. Its purpose is to further open up the gas and electricity markets in the European Union. Core elements of the third package include ownership unbundling, which stipulates separation of companies' generation and sale operations from their transmission networks, and establishment of an independent National Regulatory Authority for each Member State and the Agency for the Cooperation of Energy Regulators which provides a forum for national regulators to work together.

management act independently from any government or market interests and do not seek or take direct instructions from any Government or other public or private entity when carrying out regulatory tasks, as is required by EU Directive 2009/72/EC. In addition, amendments to the *Law on Regulation of Communal Services* remove a number of legal impediments that limit NEURC's independence in the regulation of the communal service market. Prior to these amendments, the law allowed the Cabinet of Ministers to approve a mechanism for setting utility tariffs below cost-recovery levels. This limits regulators' ability to perform its functions efficiently and puts at risk recently committed energy pricing reforms. The amendments to the *Law on Regulation of Communal Services* (and other primary legislation as necessary) removed this and other provisions that allowed the Cabinet of Ministers to undermine the Regulator's decision to set cost-reflective tariffs.

*Prior Action 9: The Borrower's Cabinet of Ministers has approved the "Gas Sector Reform and Implementation Plan" through Order number #375-p dated March 25, 2015 to comprehensively restructure the gas sector, including gradual energy price increases (and accompanying social assistance measures); incentivizing domestic production through attracting more private and international investment to the sector; restructuring of Naftogaz and distribution companies; and improving governance of the sector through introduction of an accelerated gas and heat meters installation program.*

**53. This prior action supports the Government in meeting its commitment to reform the gas sector.** The gas sector reform is fundamental to Ukraine's economic recovery and energy independence. In order to facilitate country's growth, a number of issues in the sector are to be addressed. Gas prices for households are low and do not reflect economic costs. In addition, gas prices to district heating companies are also heavily subsidized and as a result, district heating prices do not reflect full cost of district heat. Low energy prices support energy inefficient behavior of households and do not incentivize domestic gas production. The gas market structure in Ukraine is not in line with commitments to Energy Community. Corruption is the root cause of much of the malaise that has plagued the gas sector since independence. These issues are to be addressed comprehensively through coordinated actions of Ministry of Energy and Coal Industry, Ministry of Finance, Ministry of Economy and Trade, Ministry of Social Policy and Energy Regulator. The prior action supports development of a comprehensive Gas Sector Reform Implementation Plan that includes, among other things, gradual energy price increases during a transition period agreed with the IMF (including tariff hikes already adopted in April 2015); strengthening and capacity building of the social assistance programs to ensure proper mitigation of energy price increases impact on the most vulnerable; adoption of a new Gas Market Law and development of the accompanied secondary legislation; incentivizing domestic production through attracting more private and international investment to the sector; restructuring of Naftogaz and distribution companies; as well as improving governance of the sector through introduction of an accelerated gas and heat meters installation program. Implementation of the gas sector reform and implementation plan will be supported with a trust funded TA program, focused on supporting communication and public outreach.

*Prior Action 10: The Borrower has introduced income testing of the housing and utilities subsidies and reduced the amount of such housing and utilities privilege benefits, replaced universal child benefits with a guaranteed minimum income (GMI) supplement for children of age 0-3, and has reduced the amount of the universal child-birth grant benefit, all for purposes of improving the*

targeting of social assistance to the poor, through Decree of the Cabinet of Ministers #106 “On Improvement of the Process of Housing Subsidizing” dated February 28, 2015, and enactment of Law of Ukraine #221-VIII “On Amendments to Article 5 of the Law of Ukraine “ On Public Social Aid to Poor Families” Regarding Social Protection of Children”, dated March 2, 2015, (Official Gazette Golos Ukrainy, March 20, 2015, Number 50).

54. **The government took a number of steps to reform social assistance programs with the aim to put in place fiscally affordable safety nets and to mitigate the impact of the crisis on the poor.** These reforms generally aim to contain social assistance spending on universal and categorical programs while increasing the share of targeted assistance to low-income households. While overall significant policy steps to achieve fiscal consolidation were undertaken, the crisis and rapid escalation of energy tariffs are eroding some of these savings as eligibility for social assistance grows. Nevertheless, the policy steps undertaken in the context of DPL2 improved the composition of spending that has significantly shifted towards more poverty targeted assistance (Table 5). To contain fiscal spending over the past 12 months, legislative changes were introduced to eliminate some universal social assistance schemes and privileges and to limit social assistance benefits’ eligibility and generosity of remaining social assistance and privileges. Specifically, the Parliament enacted legislative changes replacing universal child benefits for 0-3 year olds with a supplement to the Guaranteed Minimum Income eligible households and measures to limit the spending on universal child birth grants, the single largest social assistance program in Ukraine. In October 2014 the Government implemented changes to the Housing and Utilities privileges and subsidies that reduce generosity of this program while making benefits progressive, depending on income levels of receiving households. Furthermore these changes will introduce a means-test to the existing privileges, and a phased transition of income-eligible HUS privileges beneficiaries to the new HUS subsidy program with the ultimate goal of eliminating privileges in 2015-16 (with the exception of privileges for war veterans). Moving forward the HUS will be significantly expanded to protect the poor from the rising energy prices requiring additional financing and measures to improve the administrative efficiency. To that end, the Cabinet passed a resolution for improving the procedures for housing and utilities subsidy administration to enable faster processing of applications, which are expected to increase following the tariff increases. However, the scale of energy price increases and other economic shocks raises risks of poverty increases despite these mitigation measures.

**Table 5: Fiscal Expenditures on Social Assistance Programs, Percent of GDP**

	2013	2014	2015
<b>Benefit to children under 3yo</b>	0.44	0.23	<i>Eliminated</i>
<b>Child birth grant</b>	1.96	1.30	1.16
<b>Social benefit to single parents</b>	0.22	0.22	0.12
<b>Social assistance to low income families (GMI)</b>	0.27	0.41	0.44
<b>Housing and utilities subsidy</b>	0.12	0.13	1.59

Source: World Bank staff estimates.

Notes: 1) 2015 estimates are simulation based projection that factors in income growth, and changes to the eligibility criteria; 2) HUS expenditures in 2015 based on further financing for Min of Social Policy based on Ministry of Finance projections of gas price increase subsidy savings.

**Table 6: DPL Prior Actions and Analytical Underpinnings**

Prior actions	Analytical Underpinnings
Pillar 1: Promote good governance, transparency and accountability in the public sector	
<b>Prior Action 1</b>	Fiscal, Structural and Governance TA (P130146); Ukraine Public Expenditure and Financial Accountability Assessment (P125931); Public Investment Management Assessment (P126844)
<b>Prior Action 2</b>	Fiscal, Structural and Governance TA (P130146)
Pillar 2: Strengthen the regulatory framework and reduce costs of doing business	
<b>Prior Action 3</b>	Fiscal, Structural and Governance TA (P130146); Ukraine Public Expenditure and Financial Accountability Assessment (P125931)
<b>Prior Action 4</b>	Country Economic Memorandum (P107252); Fiscal, Structural and Governance TA (P130146); State Tax Service Modernization Project (P057815)
<b>Prior Action 5</b>	Fiscal, Structural and Governance TA (P130146); State Tax Service Modernization Project (P057815); Country Economic Memorandum (P107252)
<b>Prior Action 6</b>	Country Economic Memorandum (P107252); Opportunities and Challenges to Private Sector Development in Ukraine (P133464); Fiscal, Structural and Governance TA (P130146); Doing Business Reports
<b>Prior Action 7</b>	Policy Note on Land Bank
Pillar 3: Reform inefficient and inequitable utility subsidies while protecting the poor	
<b>Prior Action 8</b>	Country Economic Memorandum (P107252); Modernization of the District Heating Systems in Ukraine: Heat Metering and Consumption-Based Billing, World Bank, 2012 - District Heating AAA (P112754); Gas and District Heating Tariff Reform in Ukraine: Mitigating the Impact of Tariff Increases through Targeted Cash Transfers and Energy Efficiency.- Forthcoming, World Bank - Gas and District Heating AAA (P112754); Ukraine District Heating Energy Efficiency Project (P132741), Fiscal, Structural and Governance TA (P130146)
<b>Prior Action 9</b>	Gas and District Heating Tariff Reform in Ukraine: Mitigating the Impact of Tariff Increases through Targeted Cash Transfers and Energy Efficiency.- Forthcoming, World Bank - Gas and District Heating AAA (P112754), Ukraine: Moving Forward Energy Tariff Reforms (P152593)”; “Advisory services and technical assistance to Naftogaz and the Government of Ukraine on the reform of the natural gas sector (P151927)
<b>Prior Action 10</b>	Gas and District Heating Tariff Reform in Ukraine: Mitigating the Impact of Tariff Increases through Targeted Cash Transfers and Energy Efficiency.- Forthcoming, World Bank - Gas and District Heating AAA (P112754); Country Economic Memorandum (P107252); Ukraine Social Safety Net Modernization (P128344)

### 4.3 LINK TO CPS AND OTHER BANK OPERATIONS

55. **This DPL series is aligned with the strategic directions set out in the Country Partnership Strategy (FY12-16).** The CPS is structured around two pillars: i) improving public services and public finances and ii) improving policy effectiveness and economic competitiveness. The lending engagement was calibrated to the pace and strength of reforms leaving scope for a programmatic, cross-sector DPL to support better governance and economic competitiveness. This DPL is linked to a parallel FSPDPL series that supports the authorities’ efforts to restore stability in the banking sector, make the system more resilient to future shocks and create conditions for resumed financial intermediation on a sustainable and affordable basis. The DPL series also complements investment lending operations, including the Social Safety Nets Modernization Project and the District Heating Energy Efficiency Project. The DPL builds on results of the “Ukraine: Moving Forward Energy Tariff Reforms” technical assistance financed by ESMAP Energy Subsidy Reform and Delivery Facility as well as “Advisory services and technical assistance to Naftogaz and the Government of Ukraine on the reform of the natural gas sector” financed by a joint EC-WB trust Fund. The DPL as well builds on results of the State Tax Service Modernization Project.

### 4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

56. **This DPL series was discussed with civil society organizations, IFIs and development**

**partners.** The World Bank team organized a presentation to civil society organizations, outlining the reform program supported by the DPL series and in particular DPL2. In addition, many of the reforms supported by the DPL, e.g., gas and district heating tariff reforms, targeted social assistance, public procurement, business environment, VAT refund, have been discussed publicly and extensively through the Bank's economic and sector work publications. The World Bank worked with other IFIs and development partners including EU, DFID, and the Governments of Japan and Norway, who are providing parallel financing. The World Bank team has also worked with the IMF on macroeconomic, structural and financial sector issues. In addition, legislative changes adopted as part of the DPL supported program have been subject to extensive deliberation by members of Parliament and with civil society.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT ASSESSMENT

57. **This operation supports reforms to enhance the growth potential of the economy thereby laying the foundation for improved living standards, shared prosperity and poverty alleviation.** The economic crisis threatens to reverse gains in poverty reduction and shared prosperity. Real incomes, including those of the poor and of the bottom 40 percent are under pressure as a result of the economic contraction, rising unemployment, pension and wage freezes, high inflation, and large increases in utility tariffs. After years of robust growth, private consumption is estimated to have declined by 7.4 percent in 2014. Poverty is estimated to have inched up to 11.4 percent in 2014 and is expected to rise again in 2015 to at least 15.8 percent,<sup>23</sup> given the challenging economic outlook. If macroeconomic and fiscal challenges intensify, there are risks of an even bigger poverty increase. While the adverse macro-economic conditions are likely to result in increased poverty, this DPL series includes measures that are expected to partially mitigate negative distributional consequences of the needed adjustment. Given the cross-cutting nature of many of the governance and business climate reforms supported, some of the expected social impacts of this DPL series are difficult to quantify. In the short run, the adjustment – necessary to restore a sustainable macroeconomic framework – may lead to adverse social impacts through income and employment shocks that may hurt the poor despite mitigation efforts. In the medium run, by laying the foundation for a sustainable recovery, the policy program is expected to generate positive social impacts through better public services, growth and employment channels. Measures aimed at curbing corruption and reducing the cost of doing business are expected to curtail opportunities for rent-seeking among those at the top of the income distribution, while facilitating higher investment and bringing benefits to the population at large, as well as to the poor segments of the population. Removal of barriers to trade in agricultural goods, supported by DPL2, is likely to open up new employment opportunities and increase returns of agricultural assets in a context in which deeper poverty is experienced in rural areas.

58. **The measures under pillar 3, aimed at reforming inefficient and inequitable utility subsidies, while protecting the poor, are expected to have the strongest distributional consequences.** In particular, through the gas sector reform and implementation plan and the adoption of the Law on Communal Services, a new system for gas and district heating prices to be

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<sup>23</sup> These estimates are based on a scenario of distributionally neutral contractions of 6.8 percent in 2014 and 6.5 percent in 2015. To the extent that the poor are more vulnerable to different shocks, poverty could be higher.

set at cost recovery level is being put in place. Such a move, if implemented in one go (equivalent to a one off increase by 473 percent in the price of gas and by 262 percent in the price of district heating) and without new mitigating measures, would potentially raise the poverty rate by 7.5 percentage points (an increase by 44 percent)<sup>24</sup> with respect to a simulated 2015 baseline (which incorporates the negative effects of the economic contraction on growth).

59. **However, several measures supported by the program are designed to cushion the adverse impact of these measures.** First, the Gas Sector Reform and Implementation Plan implies an implementation period of the tariff adjustment in 3 yearly increases. This implementation period would provide time for much needed complementary measures to enable households to manage their demand better to be put in place (metering of district heating and gas,<sup>25</sup> energy efficiency measures). Time would also be needed so scale up appropriately the social assistance response to the increase. Secondly, the social assistance programs have been reformed to improve their effectiveness (better targeted to poor households) and efficiency (phasing out of non-means tested measures).

60. **The reform of the Housing Utility and Subsidy program (HUS), to better target the poor, is the major plank of the social assistance response to recent tariff increases.** As discussed in section 4.2, the program has been reformed to provide much larger compensation to poorer households. In addition, the categorical Privilege program, which was mostly benefiting better off households, has been significantly cut. A third program, which was introduced as a temporary measure in May 1<sup>st</sup> 2014 and supported by DPL1, has now become redundant because the HUS program has been redesigned.<sup>26</sup>

61. **Simulations suggest that these reforms can contain the poverty impacts of the tariff increases.** The capacity of the system to scale up is, however, a crucial factor. Simulations of the impact of full cost recovery tariffs without scaling up of social assistance and only pre-existent beneficiaries receiving HUS benefits, show that poverty could go up to an estimated 24.5 percent.<sup>27</sup> In contrast, if all eligible households were to apply for the program,<sup>28</sup> poverty would go up by 2 percentage points only. Since the program provides compensation based on normative

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<sup>24</sup> Simulation based on HBS 2012 assuming a constant poverty line in purchasing power (equivalent to the Subsistence Minimum in 2012); no elasticity in modelling the demand response (as no parameter can account for behavioral changes in the face of such a large price increase; in addition, no demand response is consistent with qualitative evidence on poorer households having already cut down consumption to a bare minimum); perfect compliance with the payment of the bills (as opposed to, for example, accumulating arrears); a pre-October 2014 social assistance system. Details on the changes to the measures supported by this DPL to support energy consumption by the poor are provided below, and such changes have been simulated separately.

<sup>25</sup> Currently only about 30 percent of district heating residential consumption is billed on metered consumption, with roughly an additional 10 percent of consumption metered but billed on consumption norms as customers have the option of whether to be billed with metered consumption or not; in the case of gas, all households who heat with gas (large consumers) are believed to be metered, while a large number of small consumers using gas only for cooking and heating water are unmetered).

<sup>26</sup> In addition, qualitative evidence shows that there was relatively little awareness of this program, also among welfare office workers, who were encouraging households to apply to the HUS program instead, which offered the advantage of being a permanent program. Take up figures for the new program were therefore very low, and its expiry at the end of the 2014-15 heating season should have no significant distributional impact. This is in line with the findings of the PSIA for DPL1 which identified the capacity to administer and raise awareness around the new program as key for its potential benefits to materialize.

<sup>27</sup> This is an upper bound as for simplicity's sake, and in light of discussions on further radical cuts to the Housing and Utility Privileges, we simulate an extreme case of "no Privileges." To the extent that the program remains at least for some categories and those include some low income categories the poverty impact might be more reduced.

<sup>28</sup> Our simulations exclude those who would receive less than UAH50 a month, on the ground that their benefits would be too low to justify the costs of applying.

consumption only (not on effective consumption), recipient households consuming over the norm would not be fully insulated from the price shock, which accounts for the price increase. While penalizing households who consume over the norm (and among the poor those are mostly likely to be rural households with old and inefficient boilers)<sup>29</sup> this design feature of the HUS provides incentives for energy efficiency.

**62. In addition to reforming the energy-related benefits, the third pillar also supports other measures aimed at improving the targeting of social assistance.** Those include the reduction of the generosity of the universal child grant benefit, and the elimination of the universal child allowance for children of 0-3 age. The latter is to be compensated by an increase in the targeted compensation to poor children. The reduction in generosity of the universal child grant (increase for the first child, flat rate for subsequent children resulting in a de facto reduction for payments for higher order children) will have a minimal impact on poverty. Existing beneficiaries have been grandfathered. In contrast, the elimination of the universal child allowance for children aged 0-3 is expected to have an impact on poverty (0.7 percentage points), which will partially mitigated through the new GMI top-up benefit for children aged 0-3.

**63. Gender differentiated impacts and/or risks, associated with the operation are limited.** The majority of reforms supported by this operation are cross-cutting in nature and therefore expected to equally affect men and women in Ukraine. Reforms to reduce the number of permits and licenses, including specific legislation for the construction sector, are expected to have neutral or positive effects on gender equality. According to the 2008 Business Environment and Enterprise Performance Survey (BEEPS) for Ukraine, female-managed firms are as likely as male-managed firms to identify business licensing and permits as a major overall constraint. Female-managed firms also report that they require slightly more days to obtain an operating license and over six times as long to obtain a construction-related permit as male-managed firms. Improved legislation to reduce cost in doing business could therefore mean improved gender equality in access to economic opportunities in Ukraine. A qualitative study conducted in November 2014 shows that increases in heating and gas tariffs could likely elicit different responses from men and women. Women are more inclined to reduce heating expenditures by keeping the temperatures low when they can control it and/or generally avoid using additional sources of heating like electrical heaters. Men are more likely to save by using more energy-efficient technologies. Those using district heating have little or no control over their consumption, therefore improvements in HUS have a positive gender effect. Equal access to housing and utility subsidy (prior action # 7) for male-headed and female-headed households will be tracked.

**64. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World

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<sup>29</sup> The Regulator estimates that in the country about 20 percent of boilers are less than 70 percent inefficient, while the block structure has been designed based on the heating needs of an average sized rural home with a 90 percent of higher efficiency.

Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit [www.worldbank.org/grs](http://www.worldbank.org/grs). For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).

## 5.2 ENVIRONMENTAL ASPECTS

65. **Reforms supported by this operation are expected to have either neutral or positive environmental impacts.** Prior Actions 8 and 9 on energy sector and tariff increases are expected to lead to more efficient use of energy resources, including energy efficiency measures in the medium term. At the same time, targeted assistance to the poor to compensate for tariff increases – also supported by this operation (Prior Action 10) – will help prevent a potential negative impact of switching from gas to lower quality, higher emission residential fuels for heating and cooking. In parallel to this operation, the Borrower is implementing several programs to promote energy efficiency in municipal and residential applications, including with support from the World Bank, which will further reinforce the positive environmental impact of these measures. The overall result is likely to be an improvement in local air quality and reduction in CO<sub>2</sub> emissions. Prior Action 6 on improving the regulatory quality is expected to boost business development, including growth of industry. Potential impacts from increased industry will be managed by a well-developed system of environmental permits, environmental impact assessment and compliance monitoring. Attention will be given – by the World Bank and other development partners – to further strengthening this system and harmonizing with EU requirements. In particular, a recent Country Environmental Analysis (CEA) would inform the process of improvements to the efficiency and effectiveness of environmental policy and institutional framework and modalities at the local and regional level in the context of much needed de-centralization in public sector broadly and in environmental management. In addition, Phase II of the on-going Forest Law Enforcement and Governance (FLEG) Regional Program, financed by the European Commission, will support activities under Pillar I broadly, focusing on transparency, anti-corruption and governance in forestry sector. The prior action to abolish the State Land Bank is not anticipated to have any impact on the environment, natural resources or protected areas. Harmonizing food safety legislation with the EU will have a positive impact. Other actions supported by the operation have no significant environmental implications.

## 5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

### PFM, DISBURSEMENT AND AUDITING ASPECTS

66. **Public Financial Management.** The latest available Public Expenditure and Financial accountability (PEFA) assessment for Ukraine was undertaken in 2011. It concluded that Ukraine continues to have in place fundamental systems for macro-fiscal management, some elements of a framework to enable strategic allocation of resources, and selected tools for improving operational efficiency. The PEFA found that a consistent driver of performance improvement was expansion in the use of the Treasury system, supporting adequate internal controls and reporting. Key findings of the assessment were that weaknesses remain in: (i) disconnects between policy objectives, recurrent budget allocations, and decisions on capital investment; (ii) a fragmented budget with large special purpose extra-budgetary funds for social insurance etc. that are not subject to the same standards of financial reporting and oversight by parliament and the Supreme Audit Institution; (iii) a target driven approach to revenue collection that negatively impacted the cost of doing business; (iv) deficient oversight of state owned enterprises; (v) flaws in public

procurement that limited competitiveness; (vi) limited focus on systems performance by the internal audit function; (vii) limitations on the scope of work of the Supreme Audit Institution and weaknesses in parliamentary oversight. There are ongoing reforms supported by Bank financed operations in several of these areas, and the most critical have been considered and included in policy recommendations, prior actions and triggers for the Fiscal Adjustment and Institutional Reform DPL series.

67. **Foreign Exchange.** The latest IMF Safeguards Assessment<sup>30</sup> of the NBU was undertaken in 2014 with the final report issued in August 2014. The assessment observed a weak governance framework, recommending strengthening of the oversight mandate of the NBU Council by charging it with ultimate responsibility for internal controls and risk management, including the establishment of an audit committee. It also observed a lack of financial autonomy and significant operations financing government and commercial banks as main sources of safeguards risks. The assessment recommended changes to the legal framework to establish effective autonomy and a sound governance framework. Based on our review of the assessment, we observed no notable findings that directly impact the foreign exchange control environment and its effect on the proposed operation.

68. **The most recent audit opinion on the consolidated financial statements of the NBU for the financial year ended December 31, 2014 was unmodified.** However, the audit report included an “emphasis of matter” statement in which the auditors drew attention to disclosures in the financial statements that observed the impact of the continuing economic crisis and political turmoil in Ukraine and noted that their final resolution were unpredictable and may adversely affect the Ukrainian economy and the operations of the NBU and its subsidiaries.

69. **Disbursement Arrangements.** This operation is a single-tranche loan of US\$500 million. The loan proceeds will be made available to the Government upon loan effectiveness and meeting of the withdrawal conditions. Upon approval of the loan and notification by the Bank of loan effectiveness, the Government will submit a withdrawal application. The proceeds of the loan will be deposited by the International Bank for Reconstruction and Development (IBRD) in an account designated by the Borrower and acceptable to the World Bank at the NBU. The Borrower should ensure that upon the deposit of the loan proceeds into the said account, an equivalent amount in local currency is credited into the Treasury current account at the NBU. If the proceeds of the loan are used for ineligible purposes (e.g., to finance goods or services on the Bank’s standard negative list), the Bank will require the Government to promptly, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled. This condition is reflected in the terms of the Loan Agreement (LA). The Government will maintain accounts and records showing that the loan disbursements were made in accordance with provisions of the LA. Within seven days of remittance of funds by the Bank, the Borrower will provide a confirmation to the Bank that the funds have been received by the treasury account in the NBU and that these funds are available for financing budget expenditures.

70. **Overall Conclusion.** The public financial management systems, together with the

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<sup>30</sup> The purpose of a safeguards assessment is to provide reasonable assurance to the IMF that a central bank’s control, accounting, reporting and auditing systems are adequate to ensure the integrity of operations.

Borrower's commitment to reform, are adequate to support this operation.

#### **5.4 MONITORING AND EVALUATION**

71. **Since taking office, the Government has operated in an emergency mode, limiting focus on systematic M&E.** Through the preparation of this operation, in consultation with the authorities, a set of indicators were identified together with baselines and targets to assess the impact of the policy program. Going forward, the team will continue to work with counterparts to anchor M&E arrangements with the central coordinating unit for the DPL in the Ministry of Finance. In addition, M&E of the overall reform effort is also being coordinated by the Government under the National Reform Council of Ukraine.

#### **6. SUMMARY OF RISKS AND MITIGATION**

72. **Overall risks to this operation are high.** The following main risks can be identified:

73. **Political and governance risks.** Despite the Minsk II agreement, concluded on February 11 2015, the security situation in eastern Ukraine remains fragile. Renewed escalation of violence and prolonged confrontation could undermine the authorities' ability to continue reforms, including those supported by the operation. Escalation and/or widening of regional tensions could have serious economic consequences given Ukraine's strong ties to Russian economy in the past. Disruption in exports and/or gas supplies for a prolonged period are seriously affecting Ukraine's economic prospects in the short run and these risks cannot be mitigated by this operation. Moreover, while there is wide-spread public support for reforms, vested interest remain strong and continue to oppose certain reforms. These groups, in the presence of weak institutions, could undermine the reform program supported by the DPL series even if the Government maintains its strong commitment to reforms. In addition, public support may weaken if social impacts of austerity measures become more severe, especially if the burden sharing of reforms is perceived to be unfair. The design of the operation mitigates these political economy risks, at least partially. The program explicitly seeks to ensure a balanced burden-sharing of reforms, including compensatory measures to cushion the impact of reforms on the poor. The programmatic design of the operation moderates risks of reversals. In addition, the World Bank team worked with other partners and IFIs on designing and tracking the reform program and will remain engaged through policy dialogue, technical assistance, and public advocacy for strong reforms. Moreover, the team consulted civil society organizations that are energized following the "Maidan" uprising and may help keep pressure on the Government to sustain reforms.

74. **Macroeconomic risks.** The macroeconomic risks outlined in paragraph 31 could affect implementation, impact and sustainability of the reforms supported by this series. If currency pressures reemerge this could trigger mutually reinforcing depreciation, capital flight and inflation in turn aggravating the banking crisis and hampering efforts to restore external and fiscal sustainability. These risks are compounded by the fragile balance of payments situation and risks to external and fiscal financing. Failure to reach agreements with private creditors, consistent with the assumptions underlying the baseline macroeconomic framework would exacerbate external liquidity constraints, especially in 2016-17, when official inflows are expected to subside. Efforts to restore sustainable public finances could prove to be more challenging than expected, especially in case of a deeper and/or protracted downturn. Finally, problems in the financial sector can create a vicious circle between initial macroeconomic shocks, balance sheet problems in banks,

instability and liquidity in financial markets which in turn deepen the economic downturn and may impose a fiscal burden on the budget.

75. **Institutional capacity for implementation and sustainability.** The DPL series is focused on putting in place improved legal frameworks. Enacting good laws is an important and necessary first step, but consistent implementation is required for this to translate into effective change. Incomplete implementation either due to lack of resources, capacity constraints, resistance from special interest groups, or escalating violence could undermine the impact of the operation. While the Gas Sector Reform and Implementation Plan supported by this operation has helped to articulate a clearly defined and time-bound commitment to reform the gas sector. Moreover, the impact of the tariff increases already adopted as part of the Gas Sector Reform and Implementation may be undermined if collection rates drop significantly in response to tariff hikes. Technical assistance being provided to support implementation beyond the DPL as well as further engagement by the Bank and other donors partially mitigate these risks.

76. **Fiduciary Risk.** This assessment concludes that fiduciary risk for DPOs is substantial. This rating considers proposed prior actions and also takes into account: (i) ongoing PFM reform efforts currently being supported by the Bank, including support for modernizing public procurement legislation; (ii) modernization of treasury operations; and (iii) strengthening effectiveness of the Accounting Chamber (Supreme Audit Institution) and the Public Internal Financial Audit and Control function. It also considers the ongoing escalation of political and economic situation in Ukraine.

77. **Social and environmental risks.** Social risks are high. The macroeconomic adjustments necessary to restore a sustainable macroeconomic framework will have wide-ranging welfare effects and social impacts in the short run. Balancing the burden of the adjustment among different segments of the population is therefore an explicit focus of this operation and the Government program. Moreover, as highlighted in the PSIA section, gas and heating tariff increases will affect the welfare of households, including of the poor and vulnerable. The operation mitigates these risks by supporting explicit policy measures to provide targeted support to affected households. Despite these mitigation measures, the magnitude of the economic shocks affecting households, including poor and lower income households, raises risks of increases in poverty incidence and depth. The operation does not entail environmental risks while the reforms of the energy and utility sector are expected to contribute to higher energy efficiency with positive impacts on the environment.

**Table 7: Systematic Operations Risk-rating Tool**

<b>Risk Category</b>	<b>Rating (H,S,M,L)</b>
Political and governance	H
Macroeconomic	H
Sector strategies and policies	H
Technical design of program	H
Institutional capacity for implementation and sustainability	H
Fiduciary	S
Environment and social	H
Stakeholders	H
Other	n.a.
<b>Overall</b>	<b>H</b>

Note: High, Substantial, Moderate, Low

## ANNEX 1: UKRAINE - POLICY AND RESULTS MATRIX

Prior Actions DPL 1	Prior Actions DPL 2	Results
<b>Pillar 1: Promote good governance, transparency and accountability in the public sector</b>		
<p><b>Prior Action 1:</b> Enact<sup>31</sup> legislative amendments to reduce exemptions in public procurement from competitive procedures</p>	<p><b>Prior Action 1:</b> The Borrower has introduced rules for transparent appraisal and selection and predictable financing of public investments for purposes of improving its public investment management framework, through enactment of Law of Ukraine # 288-VIII “On Amendments to the Budget Code of Ukraine on Public Investment Projects” dated April 7, 2015 (Official Gazette Golos Ukrainy April 25, 2015, Number 75).</p>	<p>Share of competitive procurement selection by value (Source: State Statistics Service)</p> <p>Baseline 2013: 35%</p> <p>Target 2016: 55%</p> <p>Share of new eligible public investment projects appraised and selected through the public investment management system</p> <p>Baseline 2013: 0%</p> <p>Target 2016: 100%</p>
<p><b>Prior Action 2:</b> Government adopts and submits to Parliament legislation to establish centralized external verification of financial disclosures by elected and senior public officials and disciplinary and administrative accountability for those who fail to comply with financial disclosure requirements or misrepresent financial information</p>	<p><b>Prior Action 2:</b> The Borrower has established a centralized external verification function for financial disclosures of publicly elected and senior public officials, and provided for disciplinary and administrative accountability for those officials who fail to comply with financial disclosure requirements or misrepresent financial information, through enactment of Law of Ukraine #1700-VII “On Prevention of Corruption” dated October 14, 2014 ( Official Gazette Golos Ukrainy October 25, 2014, Number 206).</p>	<p>Share of Financial Disclosures Subject to External Verification:</p> <p>Baseline 2013: 0%</p> <p>Target 2016: 100%</p>
	<p><b>Prior Action 3:</b> The Borrower has expanded the mandate of the Accounting Chamber of Ukraine to cover external audits of the Borrower’s budget revenues, through enactment of Law of Ukraine # 274- VIII “On Amendments to the Law of Ukraine</p>	<p>Coverage of External Audit</p> <p>Baseline 2013: State Revenues not included in External Audit (2012 Budget execution)</p>

<sup>31</sup> Enact means legislation is approved by Parliament, signed by the President and published in official gazette.

	‘On the Accounting Chamber’ ” dated April 7, 2015, (Official Gazette Golos Ukrainy April 25, 2015, Number 75).	Target 2016: State Revenues included in External Audit (2015 Budget execution)
	<b>Prior Action 4:</b> The Borrower has improved transfer pricing legislation and practices in line with the OECD Guidelines for purposes of reducing tax avoidance, through enactment of Law of Ukraine #72-VIII “On Amendments to the Tax Code of Ukraine Regarding Improvement of Tax Control of Transfer Pricing” dated December 28, 2014, (Official Gazette Golos Ukrainy December 30, 2014, Number 252).	
<b>Pillar 2: Strengthen the regulatory framework and reduce costs of doing business</b>		
<b>Prior Action 3:</b> Enact legislation requiring publication of monthly data on VAT refund processing including claims, refunds, automatic refunds, and arrears; revoke order of the Ministry of Revenue and Duties that establishes targets for additional assessments and fines resulting from audits	<b>Prior Action 5:</b> The Borrower has extended automatic VAT refund procedures and revised automatic refund eligibility criteria guidelines for purposes of improving VAT refund processing, through enactment of Law of Ukraine #71-VIII “On Amendments to the Tax Code and Certain Legislative Acts of Ukraine on Tax Reform dated December 28, 2014 (Official Gazette Golos Ukrainy December 31, 2014, Number 254).	Ratio of VAT refund claims older than 74 days/ quarterly flow of VAT refund claims  Baseline 2013: 153%  Target 2017: 20%
<b>Prior Action 4:</b> Enact legislation to ease business and property registration and reduce the number of permits	<b>Prior Action 6:</b> The Borrower established a deregulation framework, eased licensing and permit requirements, and harmonized food safety standards and procedures and technical regulations and conformity assessments with European Union requirements for purposes of improving the investment climate, through enactment of Law of Ukraine # 222-VIII “On Licensing of Certain Types of Entrepreneurial Activities” dated March 2, 2015 (Official Gazette Golos Ukrainy March 28, 2015, Number 56); Law of Ukraine # 124-VIII “On Technical Regulation and Conformity Assessment” dated January 15, 2015, (Official Gazette Golos Ukrainy February 10, 2015, Number 23), Law of Ukraine #191-VIII “On Amendments to Certain	Number of Business Permits  Baseline (2013): 143  Target (2017): 84

	Legislative Acts of Ukraine Regarding Simplification of Running Business (Deregulation)” dated February 12, 2015 (Official Gazette Golos Ukrainy April 4, 2015, Number 61), and Law of Ukraine # 1602-VII “On Amendments to Certain Legislative Acts of Ukraine on Food Safety” dated July 22, 2014 (Official Gazette Golos Ukrainy September 19, 2014, Number 179), Law of Ukraine # 289-VIII “On Amendments to Certain Legislative Acts of Ukraine on Protection of the Rights of Investors” dated April 7, 2015, (Official Gazette Golos Ukrainy May 13, 2015, Number 82) .	
<b>Prior Action 5:</b> Cabinet adopts and submits draft law to Parliament revoking possible use of land as bank capital (State Land Bank)	<b>Prior Action 7:</b> The Borrower has removed the possibility of counting land as bank capital through Decree of the Cabinet of Ministers of Ukraine #418 “On State Land Bank Abolishment” dated September 10, 2014 and through enactment of Law of Ukraine #1507-VII “On Amendments to Certain Legislative Acts of Ukraine” dated June 17, 2014, (Official Gazette Golos Ukrainy July 8, 2014, Number 127).	
<b>Pillar 3: Reform inefficient and inequitable utility subsidies while protecting the poor</b>		
<b>Prior Action 6:</b> National Energy Regulatory Commission (NERC) adopts resolution to increase residential gas prices by 56 percent (weighted average) and National Commission for Regulation of Communal Services (NCRCS) adopts resolution to increase residential heating tariffs 176 licensees by 40 percent (weighted average)	<b>Prior Action 8:</b> The Borrower: (a) has strengthened the independence of the national regulation of communal services by removing provisions that allow the Borrower’s Cabinet of Ministers to develop a mechanism for setting utility tariffs below cost-recovery levels, through enactment of Law of Ukraine #626-VIII “On Amendments to Some Laws of Ukraine in the Area of Communal Services)” dated July 16, 2015 (Official Gazette Golos Ukrainy July 24, 2015, Number 132); and (b) has strengthened the independence of the national regulation of the energy sector through approval by the Cabinet of Ministers on July 14, 2015 of the draft Law #2966	Naftogaz Financial Deficit, US\$ equivalent Baseline (2013): US\$3.3 billion Target (2016): US\$1 billion

	<p>“On National Energy and Utilities State Regulatory Commission” that is compliant with the European Union’s Third Energy Package.</p> <p><b>Prior Action 9:</b> The Borrower’s Cabinet of Ministers has approved the “Gas Sector Reform and Implementation Plan” through Order number #375-p dated March 25, 2015 to comprehensively restructure the gas sector, including gradual energy price increases (and accompanying social assistance measures); incentivizing domestic production through attracting more private and international investment to the sector; restructuring of Naftogaz and distribution companies; and improving governance of the sector through introduction of an accelerated gas and heat meters installation program.</p>	
<p><b>Prior Action 7:</b> Cabinet adopts regulation to introduce new targeted program to compensate increase in gas and heating bills of the poorest 30 percent of the population</p>	<p><b>Prior Action 10:</b> The Borrower has introduced income testing of the housing and utilities subsidies and reduced the amount of such housing and utilities privilege benefits, replaced universal child benefits with a guaranteed minimum income (GMI) supplement for children of age 0-3, and has reduced the amount of the universal child-birth grant benefit, all for purposes of improving the targeting of social assistance to the poor, through Decree of the Cabinet of Ministers #106 “On Improvement of the Process of Housing Subsidizing” dated February 28, 2015, and enactment of Law of Ukraine #221-VIII “On Amendments to Article 5 of the Law of Ukraine “On Public Social Aid to Poor Families” Regarding Social Protection of Children”, dated March 2, 2015, (Official Gazette Golos Ukrainy, March 20, 2015, Number 50).</p>	<p>Number of families receiving Housing and Utility Subsidy (disaggregated by gender of household head)</p> <p>Baseline (2014): 1.1 million</p> <p>Target (2016): 2 million</p> <p>Share of means and income tested programs in overall social assistance spending</p> <p>Baseline (2012): 13%</p> <p>Target (2016): 20%</p>

## ANNEX 2: LETTER OF DEVELOPMENT POLICY

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12573/0/2-15 від 24.07.15

Лист Уряду України  
стосовно політики розвитку

Шановний пане Кім!

Уряд України засвідчує свою глибоку повагу Світовому банку та Вам особисто і, користуючись нагодою, висловлює вдячність за підтримку з боку Світового банку.

Ми високо цінуємо підтримку, яку Світовий банк надає Уряду України для проведення реформ, та очікуємо, що продовження нашого партнерства сприятиме стабілізації макроекономічної ситуації в Україні і відновленню економічного зростання.

### Макроекономічна ситуація

Ураховуючи складну економічну ситуацію, Уряд України продовжує впровадження заходів, спрямованих на забезпечення макроекономічної стабілізації.

Конфлікт на сході України спричинив відчутні втрати для економіки України, що посилило падіння внутрішнього валового продукту, негативно позначилося на довірі населення та бізнесу і призвело до проблем в банківському секторі та на валютному ринку. Це дещо ускладнило завдання Уряду щодо досягнення макроекономічної рівноваги через додатковий тиск на платіжний баланс та державні фінанси. Значна девальвація національної валюти збільшила дефіцит НАК "Нафтогаз України" навіть за умови значного підвищення тарифів на газ у 2014 році, що призвело до зростання консолідованого дефіциту сектору державних фінансів та обсягу державного боргу. Погіршення стану фінансового ринку, платіжного балансу та необхідність виплати кредиторської заборгованості за газ з минулих періодів призвели до значного скорочення валютних резервів. Загалом падіння економічної активності у 2014 році виявилось більш значним, ніж очікувалося, а дефіцит державних фінансів та платіжного балансу зберігався на високому рівні навіть за умови реалізації жорсткої фіскальної та монетарної політики. Перші статистичні дані за 2015 рік свідчать про продовження спаду у промисловості, торгівлі та будівництві в поточному році.

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Незважаючи на складну економічну ситуацію в Україні, Уряд готовий продовжувати вживати всіх відповідних заходів для подолання кризи. Зокрема, 11 березня 2015 р. Радою Директорів МВФ була затверджена угода для України в рамках механізму розширеного фінансування (EFF) на чотири роки на суму 17,5 млрд. доларів США (900 відсотків квоти і 12,35 млрд. спеціальних прав запозичення), за якою Україна отримала перший транш близько 5 млрд. доларів США, або 3,546 млрд. спеціальних прав запозичення, що передбачає активні заходи з макроекономічного корегування та масштабні структурні реформи, спрямовані на поліпшення економічних перспектив України та підвищення рівня життя населення.

Уряд та Національний банк України і надалі здійснюватимуть скоординовані заходи з реалізації фіскальної та монетарної політики з метою ліквідації диспропорції платіжного балансу та переходу до інфляційного таргетування. Фіскальну політику буде спрямовано на поступове зниження рівня дефіциту бюджету та послідовне впровадження структурних реформ. У цьому контексті важливою є невідкладна підтримка з боку Світового банку.

Проведені реформи у рамках системного проекту "Перша позика на політику розвитку"

Ми вдячні за підтримку Світовим банком політики розвитку у 2014 році, в рамках якої Уряд здійснив ряд важливих заходів.

Для покращення урядування і підвищення прозорості та підзвітності у державному секторі прийнято закони, зокрема, щодо підвищення прозорості здійснення державних закупівель, їх відкритості та цілісності, запровадження зовнішнього контролю щодо декларування доходів, проведення незалежних перевірок та запровадження адміністративної та дисциплінарної відповідальності.

З метою покращення умов ведення бізнесу вдосконалено нормативну базу. Зокрема, суттєво зменшено кількість документів дозвільного характеру; забезпечено перехід до більш простої, більш швидкої та менш витратної процедури утворення нових суб'єктів господарювання; запроваджено обов'язкове оприлюднення списку платників податку на додану вартість. Крім того, прийнято закони щодо утворення та функціонування єдиного національного органу стандартизації і удосконалення правових та організаційних засад національної стандартизації, розмежування регуляторних, наглядових (контрольних) та господарських функцій у сфері метрології.

Для підвищення ефективності системи енергетичних субсидій та покращення захисту малозабезпечених верств населення ухвалено ряд актів законодавства, якими передбачено можливість встановлення Національною комісією, що здійснює державне регулювання у сферах енергетики та комунальних послуг, економічно обґрунтованих тарифів на централізоване опалення та постачання гарячої води кінцевим споживачам (населенню); підвищення ефективності таргетування соціальної допомоги малозабезпеченим. З метою забезпечення державних соціальних гарантій у сфері житлово-комунального обслуговування, зокрема, зменшено відсоток платежу за житлово-комунальні послуги для сімей з низькими доходами,



дотримано принцип соціальної справедливості під час надання пільг і субсидій; запроваджено оцінку доходів домогосподарств під час розрахунку житлових субсидій.

Прогрес у рамках підготовки системного проекту “Друга позика на політику розвитку”

Уряд України в рамках виконання Програми діяльності Кабінету Міністрів України та Стратегії сталого розвитку “Україна — 2020” продовжує здійснювати заходи, які Світовий банк підтримує Другою позикою на політику розвитку. Вже досягнуто значного прогресу у виконанні попередніх заходів.

З метою забезпечення належного врядування, прозорості та підзвітності в державному секторі вдосконалено нормативну базу, зокрема прийнято:

Закон України “Про внесення змін до Бюджетного кодексу України щодо державних інвестиційних проектів”, що передбачає створення ефективної та прозорої системи управління державними інвестиціями, яка дасть змогу забезпечити обґрунтованість та послідовність прийняття рішень щодо фінансування державних інвестиційних проектів, підвищення ефективності використання державних коштів і результативності державних інвестиційних проектів;

Закон України “Про запобігання корупції”, який передбачає комплексне реформування системи запобігання корупції відповідно до міжнародних стандартів та успішних практик іноземних держав;

Закон України “Про внесення змін до Закону України “Про Рахункову палату” (щодо контролю за надходженням коштів до Державного бюджету України)”, що забезпечує реалізацію положень статті 98 Конституції України, створює правові основи для функціонування Рахункової палати як органу зовнішнього контролю (аудиту) відповідно до міжнародних стандартів аудиту державних фінансів та надає змогу забезпечувати право суспільства на отримання об’єктивної інформації про повноту і своєчасність надходження коштів до Державного бюджету України, а також їх цільове та ефективне використання;

Закон України “Про внесення змін до Податкового кодексу України щодо удосконалення податкового контролю за трансфертним ціноутворенням” з метою покращення існуючої системи державного регулювання трансфертного ціноутворення, усунення суперечностей та конкретизації норм, які негативно впливають на забезпечення реалізації податкової політики з урахуванням міжнародного досвіду та оптимального поєднання фіскальної та регулюючої функції оподаткування.

З метою удосконалення нормативної бази для зменшення витрат на ведення бізнесу прийнято нормативно-правові акти, зокрема:

Закон України “Про внесення змін до Податкового кодексу України та деяких інших законодавчих актів України”, яким запроваджується система електронного адміністрування податку на додану вартість, що передбачає комплексно вирішити питання адміністрування та бюджетного відшкодування податку на додану вартість;



Закон України "Про внесення змін до деяких законодавчих актів України (щодо припинення функціонування Державного земельного банку)", яким передбачено скасування можливості формування статутного капіталу банків за рахунок земельних активів;

Закон України "Про внесення змін до деяких законодавчих актів України щодо харчових продуктів" з метою гармонізації законодавства України із законодавством ЄС щодо безпечності та якості харчових продуктів, забезпечення високого рівня захисту здоров'я людей та інтересів споживачів, а також створення прозорих умов ведення господарської діяльності, підвищення конкурентоспроможності вітчизняних харчових продуктів та зменшення їх ціни;

Закон України "Про внесення змін до деяких законодавчих актів України щодо спрощення умов ведення бізнесу (дерегуляція)", яким передбачено скорочення функцій та оптимізація процедур адміністративного регулювання господарської діяльності, що сприятиме створенню більш сприятливих умов для ведення бізнесу в Україні та підвищенню рівня захисту суб'єктів господарювання, що дасть можливість Україні підвищити позицію у рейтингу Doing Business;

Закон України "Про ліцензування видів господарської діяльності", яким спрощено порядок отримання ліцензій, зменшено кількість видів господарської діяльності, що підлягає ліцензуванню, запроваджено сучасні електронні технології отримання ліцензій, у сфері ліцензування закладено фундамент більш прозорих партнерських стосунків між державою та бізнесом, а також забезпечено підвищення рейтингу України за класифікацією Світового банку шляхом створення більш сприятливих умов розвитку підприємництва та зростання інвестиційної привабливості України;

Закон України "Про технічні регламенти та оцінку відповідності", яким встановлюються єдині правові та організаційні засади розроблення, прийняття та застосування технічних регламентів і процедур оцінки відповідності, а також здійснення оцінки відповідності;

Закон України "Про внесення змін до деяких законодавчих актів України щодо децентралізації повноважень у сфері архітектурно-будівельного контролю та удосконалення містобудівного законодавства", що спрямований на удосконалення містобудівної діяльності, спрощення дозвільних та погоджувальних процедур у будівництві та удосконалення системи державного архітектурно-будівельного контролю і нагляду;

Закон України "Про внесення змін до деяких законодавчих актів України щодо захисту прав інвесторів", яким передбачається підвищити рівень захисту прав інвесторів шляхом запровадження похідного позову, впровадження відповідальності посадових осіб господарських товариств у випадку завдання шкоди товариству їх неправомірними діями, створення умов для переходу квазіпублічних акціонерних товариств у приватну форму, введення інституту "незалежних директорів";

постанову Кабінету Міністрів України від 20 серпня 2014 р. № 371 "Про утворення Державної регуляторної служби", згідно з якою діяльність



регуляторної служби спрямовується і координується Кабінетом Міністрів України, яка реалізує державну регуляторну політику та політику у сфері нагляду (контролю) у сфері господарської діяльності, є спеціально уповноваженим органом з питань ліцензування та дозвільної системи у сфері господарської діяльності.

З метою підвищення ефективності системи енергетичних субсидій та покращення захисту малозабезпечених верств населення прийнято, зокрема:

Закон України "Про внесення змін до статті 5 Закону України "Про державну соціальну допомогу малозабезпеченим сім'ям" (щодо соціального захисту дітей)", який передбачає підвищення розміру державної соціальної допомоги малозабезпеченим сім'ям, зокрема доплату на дітей із малозабезпечених сімей, що дасть змогу покращити соціальний захист таких сімей з дітьми та забезпечить належну державну підтримку таких родин;

постанову Кабінету Міністрів України від 28 лютого 2015 р. № 106 "Про удосконалення порядку надання житлових субсидій" з метою реформування системи надання субсидій населенню на відшкодування витрат на оплату житлово-комунальних послуг, окремих категорій громадян, які потребують підтримки держави, спрощення механізму призначення пільг і субсидій на оплату житлово-комунальних послуг, створення стимулу до енерго- та ресурсозаощадження населенням.

Верховною Радою України прийнято Закон України "Про внесення змін до деяких законів України у сфері комунальних послуг", що спрямований на забезпечення беззбиткового функціонування суб'єктів господарювання у сферах тепlopостачання та житлово-комунальних послуг, створення умов для залучення інвестицій у розвиток та технічне оновлення систем тепlopостачання.

Крім того, Уряд України має намір провести фундаментальні реформи газового сектору для забезпечення ефективних, надійних та доступних поставок газу населенню, а також конкурентоздатності та відокремлення операцій з постачання газу, його видобутку і реалізації відповідно до зобов'язань за Договором про утворення Енергетичної спільноти. Враховуючи невідкладність вирішення актуальних питань управління, прозорості, ефективності та енергетичної безпеки, Уряд поставив за мету провести широкомасштабне перетворення галузі. Проте ми усвідомлюємо, що для досягнення цих цілей необхідні належні часові рамки.

Тому в ході консультацій з Європейською Комісією, Секретаріатом Енергетичної спільноти, МВФ та Світовим банком розроблено детальний план реалізації реформ у газовому секторі. Кабінетом Міністрів України прийнято постанову, якою затверджується зазначений план. Прем'єр-міністр України здійснюватиме координацію та нагляд за виконанням завдань, визначених в рамках плану, різними міністерствами та державними органами та забезпечить повне і своєчасне виконання таких завдань.

План охоплює реформи за такими напрямками:

цінова політика та програма соціальної допомоги;

законодавче та нормативне забезпечення;



внутрішнє виробництво газу;  
транспортування та розподіл газу;  
прозорість та облік.

Для забезпечення виконання зазначеного плану прийнято Закон України "Про ринок природного газу", яким передбачено створення правової бази для реформи у газовому секторі. Для забезпечення відсутності прогалин у нормативно-правових актах до набрання чинності Законом України "Про ринок природного газу" (1 жовтня 2015 р.) у разі потреби будуть прийматися підзаконні акти, якими тимчасово регулюватимуться ціни на газ і тарифи на опалення для населення, забезпечуватиметься безперервність виконання програми житлово-комунального сектору, а також здійснюватиметься купівля газу, видобутого державними підприємствами, за підвищеними цінами відповідно до спільної з МВФ програми.

Для посилення незалежності Регулятора та збільшення його повноважень Урядом схвалено проект Закону України "Про Національну комісію, що здійснює державне регулювання у сферах енергетики та житлово-комунальних послуг" та подано на розгляд Верховної Ради України. Законопроект, зокрема, передбачає розширення повноважень Регулятора щодо його обов'язків у межах програми реформи газового ринку відповідно до законодавства ЄС в рамках Енергетичної спільноти. Законом про регулювання енергетичного ринку буде закріплено за Регулятором право пропонувати ціни в рамках "зобов'язань забезпечувати державні послуги" протягом дворічного перехідного періоду. Він визначає правові, економічні та організаційні засади здійснення державного регулювання енергетичних ринків та діяльності суб'єктів природних монополій у сфері енергетики; спрямований на забезпечення енергетичної безпеки та досягнення балансу інтересів споживачів, суб'єктів господарювання на енергетичних ринках і держави; ефективного функціонування та розвитку енергетичних ринків; сприяння інтеграції з енергетичними ринками держав — членів ЄС; усунення обмежень у торгівлі електроенергією та природним газом на міждержавному рівні.

#### Подальші кроки у впровадженні реформ

Запевняємо, що Уряд України залишається послідовним у впровадженні програми реформ, підтриманої Першою та Другою позиками на політику розвитку. Покращення урядування, забезпечення прозорості та підзвітності державного сектору, поліпшення інвестиційного клімату та проведення реформи енергетичного сектору та одночасне покращення захисту малозабезпечених верств населення залишаються нашими пріоритетами.

Уряд має намір надалі здійснювати заходи з макроекономічної стабілізації та реалізації структурних реформ і політики, спрямованої на консолідацію державних фінансів, оздоровлення банківської системи, реалізацію зваженої монетарної та валютно-курсової політики.

З урахуванням викладеного Уряд звертається до Світового банку щодо надання Другої позики для підтримки політики розвитку в розмірі 500 млн.



доларів США, що сприятиме подальшому реформуванню економіки та позитивній динаміці економічного зростання в Україні. Кабінет Міністрів України буде і надалі спрямовувати свої зусилля на виконання заходів у напрямках, передбачених позицією на політику розвитку. Відповідно до рішення Кабінету Міністрів України відповідальним за виконання Другої позики на політику розвитку є Мінекономрозвитку.

З повагою

Прем'єр-міністр України



Арсеній ЯЦЕНЮК



# Letter from the Government of Ukraine on the Development Policy

[UNOFFICIAL TRANSLATION]

**Dear Mr. Kim!**

The Government of Ukraine expresses its warm regards to the World Bank and you personally and takes this opportunity to express appreciation for your support at this critical juncture.

We especially thank the World Bank for helping to move the reform agenda in Ukraine forward and hope that our excellent partnership will help address the structural roots of current macroeconomic crisis as well as lay the foundation for future growth.

## **Macroeconomic Situation**

Despite an exceptionally tough environment, the Government of Ukraine continues to undertake measures to ensure macroeconomic stability, enhance governance and improve the business climate.

The conflict in eastern Ukraine caused significant damage to our economy through a large shock to the industrial base and to the financial and foreign exchange markets, thus aggravating the decline in GDP. This complicated our efforts to achieve macroeconomic stability. A significant devaluation of the national currency increased the deficit of *Naftogaz* even with a significant increase in tariffs in 2014, which resulted in the growth of consolidated general government deficit and public debt. The deterioration of the capital account of the balance of payments and the need to cover the natural gas payment arrears led to a significant reduction in foreign exchange reserves. Initial statistical data for 2015 show continuing decline in production, trade and construction sectors, stemming mainly from deep declines in the east.

Acknowledging challenging economic situation in Ukraine, the Government remain steadfast in implementation of reforms to deal with the economic and financial crisis. In particular, we requested the IMF to replace its Stand-By Program with an Extended Fund Facility (EFF) and on March 11, 2015 the IMF Board approved a program for Ukraine in the amount of USD 17.5 billion (900 percent of quota and SDR 12.35 billion) for four years. Ukraine already received USD 5 billion (or SDR 3.546 billion) to underpin macroeconomic adjustment (a flexible exchange rate, fiscal consolidation and monetary tightening) and structural reforms to straighten economic prospects of Ukraine and to increase leaving standards.

The Government and the National bank will continue to join their efforts in straightening of fiscal and monetary policies to reduce external imbalances and move to inflation targeting. Fiscal policy is aimed to reduce budget deficit gradually to unlock structural reforms. In this regard, the timely support of the World Bank is crucial.

## **Reforms implemented under the First Development Policy Loan (DPL1)**

We appreciate the support of the World Bank provided in 2014 under DPL1, which not only provided much-needed financing, but also supported critical reforms.

To improve governance and increase transparency and accountability in the public sector, we strengthened Public Procurement Law to increase efficiency of public resource use and prevent

corruption; we also took interim steps to move towards external verification of financial declarations by elected officials and senior public officials.

To help improve the investment climate, we took steps to reduce the number of permits; make opening of new businesses simpler, faster and less costly; making the list of VAT refund arrears public; and took initial steps to close the Land Bank which if functional, would have distorted the agricultural market considerably.

Finally, we took steps to improve the efficiency of energy subsidies while protecting the poor. We increased tariffs towards their cost-recovery levels and put in place measures to better target social assistance to the poor and vulnerable.

### **Progress under the Second Development Policy Loan (DPL2)**

The Government of Ukraine within the framework of its Activities Program and the Strategy for Sustainable Development "Ukraine - 2020" continues to take measures supported by the World Bank through the DPL2.

Regulatory framework has been improved in order to promote good governance, transparency and accountability in the public sector, including adoption of:

The Law of Ukraine "On Amendments to the Budget Code of Ukraine on Public Investment Projects", which provides for an effective and transparent management of public investments that will ensure transparent decision-making on public investment projects, link them to overall national development priorities; and provide more predictability in funding;

The Law of Ukraine "On Prevention of Corruption", which provides for a comprehensive system of preventing corruption in accordance with the international good practices; in particular, a preventive anti-corruption commission is being set up to independently verify the financial declarations of elected and senior public officials.

The Law of Ukraine "On the Accounting Chamber" (in line with the provisions of Article 98 of the Constitution of Ukraine) now creates a basis for the functioning of the Accounting Chamber as an external oversight agency (audit) in accordance with the international auditing standards and allows to ensure the right of the public to receive objective information on completeness and timeliness of revenues to the State Budget of Ukraine, as well as targeted and effective use of the State Budget;

The Law of Ukraine "On Amendments to the Tax Code of Ukraine concerning improvement of tax oversight over transfer pricing" aiming to improve the current system of government regulation of transfer pricing.

To improve the investment climate and reduce costs of doing business in Ukraine, we took the following measures:

The Law of Ukraine "On Amendments to the Tax Code of Ukraine and some other legislative acts of Ukraine" introducing electronic VAT administration system, which involves a comprehensive solution to the problem of administration and VAT refund from the State Budget;

The Law of Ukraine "On Amendments to Certain Legislative Acts of Ukraine" (regarding termination of the State Land Bank) aiming to abolish the possibility of accounting of land as bank capital;

The Law of Ukraine "On Amendments to Certain Legislative Acts of Ukraine regarding food products" aiming to harmonize the legislation in Ukraine with the EU legislation on food safety and quality, ensuring a high level of protection of health and consumer interests and creating transparent conditions for doing business, increasing competitiveness of domestic food products and reducing their cost;

The Law of Ukraine "On Amendments to Certain Legislative Acts of Ukraine on facilitating business (deregulation)", which provides for optimization of administrative regulation of economic activity that will help create more favorable conditions for doing business in Ukraine and increase the protection of businesses, which in turn will enable Ukraine to improve its ranking in Doing Business.

The Law of Ukraine "On Licensing of Certain Economic Activities", which simplifies the procedure for obtaining licenses, reduces the number of business activities subject to licensing, introduces modern electronic licensing technology, thus laying the foundation for more transparent partnerships between the government and business and make Ukraine more attractive to investors;

The Law of Ukraine "On Technical Regulations and Conformity Assessment" setting common legal and organizational framework; adopting and applying technical regulations and conformity assessment procedures, as well performing conformity evaluations;

The Law of Ukraine "On Amendments to Certain Legislative Acts of Ukraine decentralizing the responsibilities of architectural oversight and improve urban development legislation" aimed at improving urban development activities, simplification of licensing and approval procedures in construction and improvement of the state architectural oversight and supervision;

The Law of Ukraine "On Amendments to Certain Legislative Acts on investor protection," aiming to increase the level of investor protection through the introduction of the derivative claim, implementing liability for business partners when harm is caused to the partnership by their unlawful actions; creating conditions for the conversion of quasi-public companies into private ones; introducing "independent directors."

The Resolution of the Cabinet of Ministers of Ukraine # 371, dated 20 August, 2014 establishing the State Regulatory Service which activity is guided and coordinated by the Cabinet of Ministers of Ukraine. The Regulatory Service implements the state regulatory policy and supervision (oversight) policy in economic activity and acts as a specially authorized body on licensing and permits in business.

A number of legislative acts were adopted to improve the efficiency of energy subsidies and improve the protection of the poor:

The Law of Ukraine "On Amendments to Article 5 of the Law of Ukraine "On the State Support to Low-Income Families" (on social protection of children), which provides for the increase of the state social assistance to low-income families, including supplements for children living in low-income families that will improve social protection of such families with children and provide appropriate public support for these families.

The Resolution of the Cabinet of Ministers of Ukraine "On Improvement of Housing Subsidies" # 106, dated 28 February, 2015 aiming to reform the system of subsidies for reimbursement for housing and utility payments of certain categories of citizens who require

government support, simplify the mechanism for providing benefits and subsidies for housing and utilities, create incentives for energy and resource saving by the population;

Ukrainian Parliament adopted the Law “On Amendments to Some Laws of Ukraine in the Area of Communal Services”, aimed to prevent financial losses of the companies that operate in communal utility and heating sectors, to create favorable environment for attracting investment in development and technical straightening of the heating supply system. In addition, the Government of Ukraine intends to hold a fundamental reform of the gas sector to provide for efficient, reliable and affordable supply of gas to the population of Ukraine, as well as for competitiveness and separation of gas supplies from the upstream and downstream in accordance with our obligations under the Treaty establishing the Energy Community. Given the urgency of addressing management issues, transparency, efficiency and energy security, we aim to have a large-scale transformation of the industry. However, we recognize that to achieve these goals we need adequate time frame.

Therefore, in consultation with the European Commission, the Secretariat of the Energy Community, the IMF and the World Bank, we have developed a detailed plan for implementation of reforms in the gas sector. We are glad to inform you that the Cabinet of Ministers has approved the “Gas Sector Reform and Implementation Plan” through Decision number #375-p dated March 25, 2015.

The Prime Minister will carry out the coordination and supervision of the tasks assigned under the Plan to various ministries and government agencies, and will provide for full and timely implementation of these tasks.

The plan covers the reforms in five following areas:

1. Prices and social security
2. Legislative and regulatory support
3. Domestic gas production
4. Transport and distribution of gas
5. Transparency and Accounting

For the implementation of this Plan the Law on the Gas Market was approved by the Parliament. This creates a legal framework for reforms in the gas sector. To ensure absence of any gaps in the legal acts before the enactment of the Law on the Gas Market [October 1, 2015], and when necessary, we will be adopting by-laws that will temporarily regulate gas prices and tariffs for residential heating; ensure continuity of programs and procure gas produced by the state-owned enterprises at higher rates according to the IMF Program.

To enhance the independence of the Regulator and increase its authority, Government approved the draft law “On National Energy and Utilities State Regulatory Commission” that was submitted to the Parliament. This draft law aims to expand the regulatory powers of the Regulator in relation to its duties as part of the reform of the gas market in full compliance with the EU legislation and in the Energy Community framework. The law regulating the power market will reserve the right of the Regulator to offer prices as part of "obligations to provide public services" during a 2-year transition period. It defines the legal, economic and organizational principles of state regulation of energy markets and the activity of natural monopolies in the energy sector; aims at ensuring energy security and achieving a balance of interests of consumers and businesses on

the energy markets and the state; efficient operation and development of energy markets; facilitating the integration of energy markets of the EU member states and Ukraine; removing restrictions to trade electricity and natural gas at the international level.

#### **Next steps in implementing reforms**

We assure you that we remain strongly committed to implementing the reform program supported by the World Bank's DPLs 1 & 2. Our priorities are improving governance, transparency and accountability of the public sector, improving the investment climate and reform of the energy sector while protecting the poor.

The Government also strongly commits to continuing measures to stabilize the economy and the banking sector as well as structural reforms to jumpstart growth.

Considering the above, the Government of Ukraine asks the World Bank to support reforms under the Second Development Policy Loan in the amount of USD 500 million to jumpstart growth. The Cabinet of Ministers of Ukraine will continue its efforts to implement measures in the areas provided for by the development policy loans. The Cabinet of Ministers of Ukraine has identified the Ministry of Economic Development responsible for coordinating the Program.

Sincerely,

**Arseniy Yatsenyuk**

**The Prime Minister of Ukraine**

## ANNEX 3: IMF PRESS RELEASE

### IMF Executive Board Approves 4-Year US\$17.5 Billion Extended Fund Facility for Ukraine, US\$5 Billion for Immediate Disbursement

Press Release No. 15/107

March 11, 2015

The Executive Board of the International Monetary Fund (IMF) today approved a four-year extended arrangement under the Extended Fund Facility for Ukraine. The arrangement amounts to the equivalent of SDR 12.348 billion (about US\$17.5 billion, 900 percent of quota) and was approved under the Fund's exceptional access policy. The Board also took note of Ukraine's decision to cancel the Stand-By Arrangement (SBA) for Ukraine that was approved on April 30, 2014 (see [Press Release No. 14/189](#)).

The authorities' economic program supported by the Extended Fund Facility (EFF) will build on and deepen reforms launched under the SBA. The program aims to put the economy on the path to recovery, restore external sustainability, strengthen public finances, and support economic growth by advancing structural and governance reforms, while protecting the most vulnerable.

The approval of the extended arrangement under the EFF enables the immediate disbursement of SDR 3.546 billion (about US\$5 billion), with SDR 1.915 billion (about US\$2.7 billion) being allocated to budget support. Further disbursements will be based on standard quarterly reviews and performance criteria.

Following the Executive Board's discussion, Mr. David Lipton, First Deputy Managing Director and Acting Chair, said:

"Notwithstanding a strong policy-led adjustment effort in 2014, the Ukrainian economy continues to be affected by the conflict in the East and the attendant loss of confidence. The deep recession and sharp exchange rate depreciation aggravated existing vulnerabilities, weakened bank balance sheets, and raised public debt.

"Demonstrating strong resolve, Ukraine's authorities have developed a new program to restore macroeconomic stability and address long-standing structural obstacles to growth, including weak governance. The authorities recognize that the resolute implementation of the program is critical to restore confidence and growth, bring inflation to single digits, keep external deficits manageable, and replenish international reserves.

"The authorities recognize that the best support for the hryvnia is the restoration of confidence through strong policies and reforms. To support this new regime, appropriate reserve targets are included in the program. While program policies are taking hold, the authorities plan to maintain monetary policy rates positive in real terms to anchor inflation expectations, and remove capital controls and restrictions at an appropriately calibrated pace as the balance of payments improves.

"The authorities are determined to stabilize the financial system, maintain confidence in banks, and strengthen financial regulation and supervision. To this end, they have made progress toward recapitalizing systemic banks and resolving weak non-systemic banks. The decisive implementation of the banking strategy would be crucial to regain public confidence.

"Recognizing the need for fiscal consolidation, the authorities have launched an expenditure-led adjustment and frontloaded energy price increases to reduce quasi-fiscal losses and set debt on a firm downward path. Policies to underpin the fiscal adjustment include improving the pension system's sustainability, reforming public employment, and reforming the healthcare and education systems. The planned debt operation would also help secure program financing and restore debt sustainability with high probability. A successful debt operation with high participation will be a key consideration to proceed with the first program review.

"The authorities plan to eliminate the large quasi-fiscal losses of Naftogaz by 2017 by undertaking bold measures to increase tariffs, improve collection rates, and fundamentally restructure the company. Funding to

protect the most vulnerable from the impact of the energy price increases will be raised to alleviate social costs and build support for the reforms.

“Addressing deep-rooted structural problems is critical to create an enabling environment for investment and private sector activity. Tackling weak governance and improving the business climate is critical to increase investment and achieve higher growth. A comprehensive strategy to reform state-owned enterprises is important to enhance efficiency and reduce fiscal risks.

“The program is subject to exceptional risks, especially those arising from the conflict in the East, which may affect the country’s ability to sustain the stabilization efforts and deliver the structural overhaul needed to resume growth. On the other hand, the crisis provides an opportunity for the government to make a decisive break from the past and implement reform-oriented and sustainable policies with strong ownership. The authorities’ program responds appropriately to present challenges and deserves strong support. The implementation risks are being mitigated by a critical set of measures adopted as prior actions and by securing broad political support for program objectives and policies. These should help unlock sizable international official assistance and private capital inflows.”

## **IMF Statement on Discussions with Ukraine on First Review under the Extended Fund Facility Arrangement**

Press Release No. 15/243

May 31, 2015

An International Monetary Fund (IMF) mission visited Kyiv during May 12-29 to hold discussions on the first review under the Extended Fund Facility Arrangement (EFF) in support of the authorities’ economic reform program (see [Press Release No. 15/107](#)).

At the conclusion of the visit, Mr. Nikolay Gueorguiev, mission chief for Ukraine, made the following statement today in Kyiv:

“The mission held constructive discussions with the authorities on policies needed to complete the first review under the EFF arrangement. Understandings were reached on most issues and discussions will continue in the coming days to finalize a staff-level agreement that can be taken for approval to the IMF management and the Executive Board.

“The authorities’ commitment to the reform program remains strong. All performance criteria for end-March were met and all structural benchmarks due in the Spring are on course to be met, albeit some with a delay. This good program implementation has been achieved notwithstanding an exceptionally difficult environment, in part related to the unresolved conflict in the East, which took a heavier than expected toll on the economy in the first quarter of 2015. Accordingly, the mission has revised down growth projections for 2015 to -9 percent and projects end-year inflation at 46 percent. Inflation was mostly driven by one-off pass-through effects of the large exchange rate depreciation in February as well as the needed energy price increases.

“In recent months, signs that economic stability is gradually taking hold are steadily emerging. The foreign exchange market has remained broadly stable. Gross international reserves, although still very low, have increased to US\$9.6 billion at end-April. Banks’ deposits in domestic currency have been recovering. The budget outturn in the first months of 2015 was stronger than expected, partly due to temporary factors.

“The authorities recognize that decisive implementation of economic reforms is indispensable for entrenching financial stability and restoring robust and sustainable growth. They are committed to advancing fiscal consolidation and energy sector reforms, including further energy tariff adjustments to eliminate the large losses of Naftogaz, reduce energy consumption, and foster energy independence. They are also moving ahead with the rehabilitation of the banking system, and the improvement of the business environment to enhance the productive potential of the economy.

“The authorities are also determined to complete the ongoing debt operation in line with program objectives. This will ensure that public debt is sustainable with high probability and the program remains fully financed, which are requirements for the completion of the review. More broadly, continued financial support for Ukraine’s reform efforts from official and private creditors is vital for the success of the program.”

## **IMF Announces Staff Level Agreement with Ukraine on First Review under the Extended Fund Facility Arrangement**

Press Release No.15/315

July 2, 2015

Following further discussions between IMF staff and the Ukrainian authorities since the mission’s return from Kyiv (see [Press Release No. 15/243](#)), a staff-level agreement has been reached on a set of policies needed to complete the first review under the [Extended Fund Facility Arrangement](#) (EFF). The agreement is subject to approval by IMF management and the Executive Board, once the prior actions are completed and the conditions are in place for staff to assess that public debt is sustainable with high probability and the program is fully financed. The completion of the review would enable the disbursement of SDR 1.18 billion (about US\$1.7 billion).