ICR Review
Operations Evaluation Department

Report Number : ICRR11599

1. Project Data:		Date Posted :	09/12/2003	
PROJ ID :	P070693		Appraisal	Actual
Project Name :	Ukraine: Programmatic Adjustment Loan	Project Costs (US$M)	250	250
Country:	Ukraine	Loan/Credit (US$M)	250	250
Sector(s):	Board: PS - Central government administration (35%), Compulsory pension and unemployment insurance (25%), General industry and trade sector (20%), General agriculture fishing and forestry sector (10%), General energy sector (10%)	Cofinancing (US$M)		
L/C Number:	L4639			
		Board Approval (FY)		02
Partners involved :	PHRD Grant for project preparation for US$490 658 and Dutch Government grant for US$2.4 million to finance implementation of CPAR and CFAA actions plans.	Closing Date	12/31/2002	12/31/2002
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2. Project Objectives and Components

a. Objectives

To build key missing institutions of a market economy and improve public and private sector governance, while maintaining macroeconomic stability through: (1) improved fiscal and financial discipline; (2) a better regulatory framework; (3) creation and protection of clear property rights; (4) strengthened public sector accountability; and (5) improved social and environment risk management.

b. Components

Actions taken prior to Board Presentation (First Tranche) comprised the following. (1) Improved fiscal and financial discipline through(a) elimination of budgetary offsets; (b) elimination of pension arrears, reduction of wage and social protection arrears by at least 27 percent from the January 1, 2000 level, and reduction or containment of all other budget arrears at the level of January 1, 2000; (c) Measures to reduce electricity and gas payment arrears including (i) restructuring the debt of six Oblenergos to the wholesale electricity market; (ii) giving Oblenergos the legal right to disconnect all nonpaying electricity customers; (iii) disconnecting 23,000 delinquent electricity customers (out of more than 33,000 debtors); (iv) increasing cash collections by the wholesale electricity market from Oblenergos to at least 50% of current charges; and (v) increasing cash payment for gas sold by Naftogas to at least 50% of other customers. (2) Creating a better regulatory framework through (a) securing easier business entry through the 1- stop shop for new business registration, (b) put in place a simplified licensing system based on single license and a streamlined application procedure; and (c) reduce number of inspections by an additional 20 percent with respect to 1999 level; (3) creation and protection of clear property rights through : (a) Transformation of the ownership/organizational structure in agriculture through (i) Presidential decree on reforming the agricultural sector; (ii) issuing land certificates to 6.5 million eligible individuals on the basis of which 1.3 million land title deeds were issued; and (iii) reducing the Government monopoly in the procurement of agricultural inputs and purchase of agricultural output to one tenth of pre-reform levels; (b) Progress in transparent privatization of industrial and energy enterprises through: (i) issuing competitive tenders for transparent privatization of 83 industrial enterprises in 2000; (ii) transparent sales of controlling blocks of shares for at least 8 industrial enterprises (excluding energy companies) in accordance with transparency criteria approved by the Privatization Advisory Group (PAG); (iii) completing the sale of 6 Oblenergos to strategic investors (using international advisors); and (iv) signing a contract with a reputable auditor to carry out phase II of the three-year program to audit Naftogas following international standards; (c) Telecom privatization progressing through (i) passage of telecom privatization law allowing a strategic investor to acquire a minimum of 25% plus 1 shares through a competitive process and gain operating control of the telecom company (i.e. 50 percent +1 of shares) by receiving for management an additional block of shares owned by the state, and issuing a competitive tender to here an advisor for the privatization of Ukrtelecom; and (d) Progress in resolving the Bank Ukraina problem through revocation of its banking license and appointment of a liquidator; and (4) strengthened public sector accountability through (a) improved budget transparency through (i) replacing discretionary determination of intergovernmental fiscal transfers with a formula-based system applied to oblasts and, indirectly, to lower levels of government in the 2001 budget; (ii) reforming public administration through creating a smaller and more efficient cabinet with less than 20 members representing a reduced number of central government bodies (from over 80 to 50 including 16 ministries; (ii) establishing specialized cabinet committees; and (iii) improved function of the Cabinet of Ministers (CoM) Secretariat and adaptation of its structure to meet cabinet needs; and (b) elimination of tax exemptions; and (5) improved social and environment risk management through (a) improving the institutional and technical framework for pension system reform through introducing personal pension accounts; (b) improved social assistance through (i) preparing and using a unified targeting methodology for all means-tested programs; (b) creating 750 territorial social care centers and expanding out-reach services to an additional 10,000 elderly and disabled persons; (c) improving health and education through (i) starting pilots in Donetsk Oblast and Kiev to test the TB DOTS methodology adapted to national conditions; (ii) creating new family medicine centers and a new university specialization in family medicine was introduced to improve primary health care; (iii) health resource allocation pilot started in Lviv; (iv) improved methods of education management and finance have been piloted in Lviv; and (v) a national program of 12-year compulsory education has been adopted; (d) special privileges have been reviewed and professional privileges not justified on poverty and equity grounds have been discontinued .

Second Tranche conditions comprised the following . (1) Improved fiscal and financial discipline through (a) eliminating budget offsets and disallowing budget offsets for the future and in the budget for 2002, (b) reducing budget arrears through (i) staying current on pension payments, (ii) further reducing budget arrears on wages by 50% and on energy payments by 75%, and (iii) preventing an increase in other budget arrears compared to July 1, 2002 levels; and (c) Reducing electricity and gas payment arrears through (i) quantifying domestic debt to Naftogas and preparing a restructuring plan; (ii) increasing cash collection by the wholesale electricity market from Oblenergos to at least 60% of current charges (measured over the last six months ending in November 2001); and (iii) increase cash payments for gas sold by Naftogas to at least 60% (measured over the last six months ending in November 2001; (2) Improved regulatory framework by maintaining the improvements achieved for first tranche release; (3) Improved property rights by (a) continuing reforms in agriculture by issuing 1.3 million land titles to specific plots of land and (b) maintaining progress in transparent privatizations through (i) completing PAG transparency review of privatization done during the first three quarters of 2001; (ii) submitting to Parliament a list of enterprises to be privatized in the year 2002 consistent with the budget deficit financing needs; and (iii) resuming the process of privatizing Oblenergos to strategic investors through transparent sales; (4) Public Sector Efficiency and Accountability through (a) improved budget transparency : (i) evaluate implementation of formula-based intergovernmental fiscal transfers during the first nine months of 2002; (ii) continue to use a formula based system in determining intergovernmental transfers to oblast and lower levels of government in the 2002 Budget; (b) Improved use of public resources: (i) achieve satisfactory progress in implementing the single Treasury account; (ii) discuss CFAA report and adopt an action plan on improved financial management of public monies (September, 2001); achieve satisfactory progress in its implementation in the last quarter of 2001; (c) Elimination of tax exemptions and refrain from granting any future tax exemptions through CoM decisions /orders; and (5) Social and Environmental Risk Management; (a) Institutional and technical framework for pension system reform through (i) transfer pension determination function to the Pension Fund; and (ii) Create a unified social insurance database; (b) improved health and education through (i) approving a health sector reform strategy; and (ii) approving an education sector reform strategy; and (c) special privileges review- disallow professional privileges not justified on poverty or equity grounds in 2002 Budget.

c. Comments on Project Cost, Financing and Dates

The project cost $250 million financed by an IBRD loan in two tranches. The first tranche (US$150 million) was released on effectiveness (September 21, 2001) and the second tranche (US$100 million) in December, 2001. The project was appraised in January, 2001, approved by the Board on September 20, 2001, made effective on September 21, 2001, and closed on schedule on December 31, 2002.

3. Achievement of Relevant Objectives:

All of the first tranche conditions noted above were achieved prior to Board presentation .

The implementation record of second Tranche conditions is as follows . (1) Improved fiscal and financial discipline through (a) non-transparent budget offsets were eliminated in the 2001 budget and subsequently, (b) budget arrears were reduced (i) pension arrears have been eliminated since September 2000 and government has stayed current since then, (ii) budget arrears were further reduced by reducing arrears on wages by 60% in 2000 and by 97 % as of

November, 2001. Energy arrears were reduced by 75% during 2000 and the first two months of 2001. Social protection arrears were reduce by 26 percent through the first quarter of 2001. (iii) see shortcomings below on preventing an increase in other budget arrears compared to July 1, 2002 levels; and (c) Reducing electricity and gas payment arrears through (i) the domestic debt of large electricity debtors to Naftogas was identified and the debt of six oblenergos was restructured; (ii) Cash payments from the oblenergos to the Energomarkt increased dramatically from 10.7% of electricity bills in January 2000 to 75.5 percent as of October 1, 2001 (target had been 60% for 6 months to November 1, 2001) (iii) the level of cash payments for natural gas was, as of November 1, 2001, 90.2%, target was at least 60%; (2) The improved regulatory framework was maintained after first tranche release; (3) Improved property rights by (a) Land titles continued to be issued to specific plots of arable land after the 1.3 million goal was reached for first tranche release, and by November 1, 2001, 1.81 million land titles had been issued. The state monopoly on procurement of agricultural inputs and the purchase of agricultural outputs was further reduced and now stands at less than one-tenth of pre-reform levels. (b) maintaining progress in transparent privatizations through (i) The PAG was formed to review privatization, including a review of privatization of eight large industrial enterprises according to a pre-set list of transparency criteria, and PAG confirmed that the privatization process was acceptable and the majority of privatization tenders reviewed in January -September, 2001 met the transparency criteria; (ii) see comment privatization list under " shortcomings"; and (iii) the six oblenergos for which debt had been restructured were privatized by selling them to strategic investors . (ICR does not comment on transparency); The Telecom privatization law was passed as stipulated above and a competitive tender to hire an advisor for the privatization of Ukrtelecom was issued and an advisor was selected (but see shortcomings below) The banking license for Bank Ukraina was revoked and formal foreclosure procedures were started through the appointment of a liquidator. (4) Public sector efficiency and accountability is being strengthened through : (a) improved budget transparency: (i) The formula-based calculation of transfers had a positive impact on the fulfillment of local budgets which were 100 percent fulfilled in the first 10 months of 2001. (ii) the formula is being used in 2002 budget in determining intergovernmental transfers to oblast and lower levels of government; (b) Improved use of public resources: (i) there was satisfactory progress in implementing the single Treasure account . By the end of PAL I, all departments of the State Treasury had been included into the electronic payment system of the National Bank of Ukraine. Introduction of a State Treasury account was completed in all oblasts of Ukraine by December 1, 2001; (ii) an action plan based on the CFAA report approved by the CoM Commission for improving the system of financial control of Ukraine. This plan was prepared by he Ministry of Finance with the participation of representatives of ministries and department and coordinated with World Bank Experts . In parallel, an action plan of the Country Procurement Assessment Report (CPAR) was also adopted; (c) Regarding elimination of tax exemptions, the ICR states that tax exemptions granted by the CoM were eliminated and that the CoM decided to cancel 256 earlier CoM resolutions resulting in less distortion from the tax system and a substantial increase in Ukraine's tax base . (5) Social and Environmental Risk Management; (a) Institutional and technical framework for pension system reform through (i) determination function was transferred to the Pension Fund, a unified system of personal pension accounts was introduced; and (ii) a unified social insurance database was created; (b) improved health and education through (i) a health sector reform strategy was approved; and (ii) an education sector reform strategy was approved; and (c) special privileges were reviewed and professional privileges not fully justified by means testing were disallowed in the 2002 Budget.

4. Significant Outcomes/Impacts:

Real GDP growth increased from 5.9% in 2000 to 9.2 percent in 2001 and a lower but still respectable 4.8 percent in 2002, while exports in increased in those years by 18 percent, and 10.7 percent respectively. External public and publicly guaranteed debt decreased from 49.9 percent of GDP in 1999 to 24.6 percent of GDP in 2002. The fiscal balance was in surplus in 2000 and 2002, with only a small deficit (0.3 percent of GDP) in 2001 (but see also shortcomings, below). The current account of the balance of payments has been in surplus since 1999, averaging 5.4 percent of GDP. It is not clear, however, to what extent exogenous circumstances, and, in particular, the recovery or the Russian economy, was responsible for this .

Reflecting improvements in cash payments, particularly in the energy sector, barter transactions in the economy have fallen by more than 50 percent from their peak and represented less than 4 percent of GDP by mid-2002.

Improved regulatory framework reflected in surveys done by USAID and IFC : (1) official cost of registration has gone down from US$192 in 1997 to US$ 22 in 2001. Time needed to register a new business has decreased from 34.7 days in 1997 to 12.1 days in 2001. Number of licenses needed per enterprise has gone down form 3 in 1997 to 1.5 in 2001. The number of inspections has been brought down from an average of 30 per enterprise in 1998 to 12 in 2001.

In the energy sector, electricity tariffs have been increased and to full cost recovery levels . The regulatory agency has demonstrated independence in setting tariffs for commercial users (85% of the market), though more progress needs to be made for setting household tariffs .

Concerning privatization, the PAG confirmed that 8 privatizations fully met stringent conditions, thereby meeting the PAL 1 benchmark. These privatizations were selected by the government for PAG review, as stipulated under PAL

1, but they are to be the models for privatizations under PAL II for which the PAG will have random access to confirm the quality of privatizations.

Land reform has substantially moved forward under PAL I, with further reforms including improving the quality of land titles through cadastral surveys being supported by other projects.

5. Significant Shortcomings (including non-compliance with safeguard policies):

Despite improvements in financial discipline, VAT refund arrears from the budget to exporters contributed to the budget surplus in 2002. This problem is being addressed in 2003 as part of the reforms supported by the PAL process.

Although some progress was made in Naftogas' financial framework, Naftogas is still substantially delinquent on past taxes. This is being addressed through the PAL process with a full audit of Naftogas scheduled to be available in 2005 and a workout to be devised based on material developed in the full audit.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Satisfactory	The outcome is fully satisfactory in view of the effective implementation of the large number of reforms supported by PAL I, despite a few shortcomings noted in Section 5. The outcome rating will be revisited (as intended for all PAL operations) at the end of PAL III. See recommendation for an audit in section 8.
Institutional Dev.:	Substantial	Substantial	
Sustainability:	Likely	Likely	
Bank Performance:	Highly Satisfactory	Highly Satisfactory	
Borrower Perf.:	Satisfactory	Satisfactory	
Quality of ICR:		Satisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

1. PAL documentation should place the medium-term reform program in a clear perspective so that Bank management and reviewers can more readily assess how far a PAL, or set of PALs, takes the country along a reform/transformation path. 2. The concept of benchmarks, as opposed to conditionality takes the Bank out of the situation of imposing terms and conditions, and can enhance Borrower ownership and implementation capacity. 3. PALs need not necessarily be a sequence of one-tranche operations. They can be formulated as a two-tranche operation as a way of reducing risks.

8. Assessment Recommended? ● Yes ○ No

Why? This is a complex operation which is difficult to evaluate. PAL I should be audited as PAL II and PAL III are completed, to assess whether the operations are satisfactory when more information and more complete perspectives are available.

9. Comments on Quality of ICR:

The ICR should have presented some material with greater clarity, such as the privatization program supported by the PAL and the expectations for it, the quality of the land reform program to date, and the status and effectiveness of the energy regulator. It could have also have commented more completely on the IMF program and how the problems with its implementation relate to the PAL program.