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Ukraine

Special Focus Note:

Fiscal pressures and reform options

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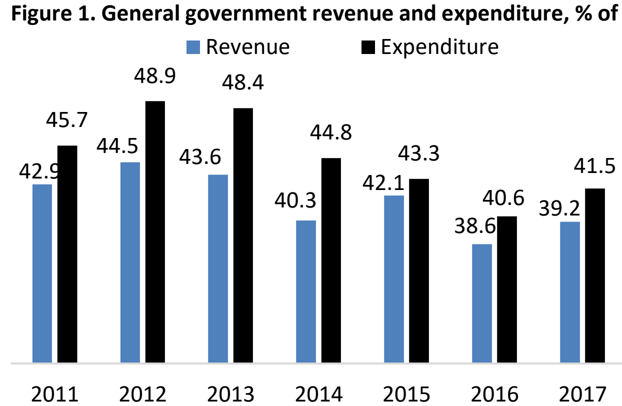
- ***Ukraine has made progress in reducing its large public spending since 2014, but sustaining these gains while also improving the effectiveness of services will require fiscally affordable implementation of reforms in education, health, public administration, pensions, and social assistance.***
- ***Improving compensation for teachers, doctors, and public servants is important to strengthen incentives and attract quality personnel, but this should be coordinated with measures to optimize staffing and the school and hospital network.***
- ***Improving effectiveness and fiscal sustainability of the social protection system will require improving targeting of social assistance, while safeguarding incentives to contribute to the pension system.***

Sustaining fiscal consolidation will require affordable implementation of recent reforms

Ukraine has historically spent a large share of GDP on the public sector, but the quality and effectiveness of public services has been low. Public expenditures were 47 percent of GDP on average during 2010-2015 in Ukraine, compared to 37 percent in Lithuania and Turkey, 35 percent in Romania, and 35 percent on average in the Europe and Central Asia (ECA) region[1]. Current expenditures account for the bulk of Ukraine's large public spending, with public capital expenditures amounting to only 2.4 percent of GDP during 2010-2015, compared to 5 percent in the ECA region. Despite the large public-sector footprint, Ukraine has scored worse than comparator countries on government effectiveness in the World Governance Indicators: 35th percentile in 2015, compared to 69th percentile for the ECA region. Further, Ukraine's rank in the Human Development Report has been worse than comparator countries: 84th in 2015, compared to 36th for Poland, 50th for Romania, and 71st for Turkey. Life expectancy in Ukraine is 10 years less than the EU average, while the hospital sector is oversized and inefficient. Although general education outcomes (e.g. years of schooling and completion of secondary/tertiary education) look good, firms have difficulty finding workers with the necessary skills. Spending on social benefits (pensions and social assistance) has ranked among the highest in the region, but pension benefits have been low, and a high share of social assistance has gone to relatively higher income households.

Ukraine has made progress in reducing the size of public spending and fiscal imbalances since 2014, but much of the consolidation was driven by a freeze in wages and benefits, rather than deeper structural reforms, which is not sustainable. General government expenditures were reduced from 48.5 percent of GDP in 2013 to 40.6 percent in 2016, before rising to 41.5 percent in 2017. A large part of this consolidation was achieved through a freeze in wages and pensions in nominal terms, together with high inflation. As a result, pension spending fell from 17.2 percent of GDP in 2013 to 10.7 percent in 2016, while the public sector wage bill declined from 11.5 percent of GDP in 2013 to 9.3 percent in 2016. This reduction in spending, together with significant increases in heating tariffs toward cost recovery, reduced the consolidated fiscal deficit, including Naftogaz, from 10 percent of GDP in 2014 to 2.3 percent in 2017.

Figure 1. General government revenue and expenditure, % of GDP



In 2017, major reforms were adopted in pensions, education, and health, but expenditure pressures have re-emerged due to increases in wages and social benefits. The pension reform, which seeks to improve adequacy of benefits without escalating fiscal costs, included a one-time increase in benefits for existing pensioners, clear rules of indexation, and incentives to contribute to the system and retire later. The education and health reforms seek to improve quality and effectiveness through structural measures. These reforms, plus the public administration reform, also seek to improve compensation for teachers, doctors, and public servants to strengthen incentives and attract quality personnel. However, the reforms have not yet specified a fiscally affordable implementation plan for raising salaries. Moreover, in 2017 wages in the public sector were already increase significantly: the minimum wage was doubled and wages of teachers and doctors were increased by over 40 percent. Total spending on wages and good & services increased from 16 percent of GDP in 2016 to 17.2 percent in 2017 (starting in 2017, the government paid for health services—which includes wages). In addition, the cost of housing utility subsidies (HUS) increased further in 2017, with social assistance spending rising to 4.9 percent of GDP. Total public expenditures increased to 41.5 percent of GDP in 2017. This was balanced by strong revenue growth, driven by payroll tax (20 percent in real terms, due to the hike in wages), VAT (17 percent, due to higher proceeds from imports) and personal income tax (16 percent). As a result, the fiscal deficit remained flat and on target at 2.3 percent of GDP in 2017.

Meeting the fiscal deficit targets for 2018 and 2019 will be challenging. Additional increases in wages and pensions are likely through the 2019 election cycle. In fact, the 2018 budget stipulates further increases in wages and higher spending on primary health care, with expenditures on wages and goods and services projected to grow further from 17.2 percent of GDP in 2017 to 18.7 percent in 2018. Furthermore, the updation of military

[1] The Europe and Central Asia (ECA) region includes countries in Eastern Europe, the former Soviet Union, and Turkey.

and other public-sector pensions will involve some additional cost. As a result, meeting the fiscal deficit target of 2.5 percent of GDP in 2018 and 2.7 percent in 2019 will be challenging. The 2018 budget envisages a reduction in social assistance from 4.9 percent to 4.4 percent of GDP, but pressures on HUS spending are likely to continue. Furthermore, the revenue targets in the 2018 budget are optimistic, with payroll tax and VAT revenues expected to grow by 34 and 22 percent in nominal terms, respectively. In fact, state budget revenues in the first quarter of 2018 fell short of the target by 3.1 percent. In this context, meeting the deficit targets will require improving the targeting of HUS, identifying affordable options to update public sector pensions, and making further wage increases contingent on measures to optimize the school and hospital network and public sector staffing.

Adjusting wages and employment levels for better public services, while reducing the wage bill

Public sector employment has remained flat despite significant wage increases in 2017-2018. After doubling of the minimum wage in 2017 and introduction of additional top-ups to bring the base pay to the minimum wage, remuneration in education and health sectors (that together comprise over 50 percent of the total wage bill) grew by 40 percent. The base pay in the civil service (10 percent of wage bill) grew by 15 percent in 2017. However due to the opaque remuneration structure (where the basic pay still represents less than 50 percent of total compensation) the overall increase in remuneration in the civil service also amounted to 40 percent in 2017. The employment levels, however, remained broadly unchanged and even increased slightly in health and public administration. As a result, the total wage bill is estimated to have grown over 50 percent in 2017.

Figure 2. Real Compensation per worker

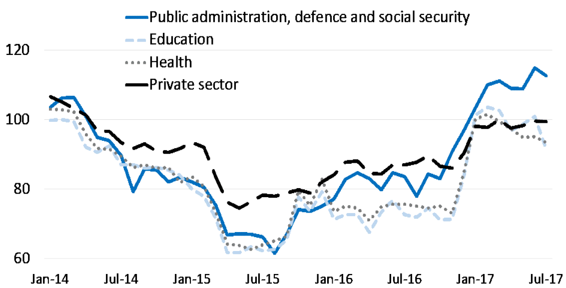


Figure 3. Employment, thousand persons

	2015	2016	2017
Education	1,475	1,468	1,459
Health	969	946	952
Other sectors	455	460	466
Public administration	237	232	243
Public sector total (excl. military and judges)	**3,136**	**3,106**	**3,119**

Further increases in compensation for teachers, doctors, and public servants need to be coordinated with realistic, time-bound measures to optimize staffing and the school and hospital network. The recently adopted laws stipulate further wage increases, but the plan to optimize staffing and the school and hospital network are not clearly specified. In 2018, in addition to the increase in the public sector minimum wage by 16 percent, the basic pay for teachers was increased by another 10 percent, while some doctors were moved up to higher levels of the unified wage grid. An additional 30 percent increase in the basic pay for civil servants is also envisaged in 2018. These increases are not fiscally affordable unless they are coordinated with realistic and time-bound measures to optimizing the workforce and the school and hospital network. In the education sector, this means accelerating implementation of the hub schools program by providing transportation to students and leveraging the fact that a quarter of teachers are over the age of 55. In the health sector, this means swiftly developing a hospital sector plan that includes optimizing the network. In public administration, this means accelerating functional assessments to adjust staffing and strengthening information systems so that salary allocations can be made based on actual staffing rather than vacancies.

Improving effectiveness and fiscal sustainability of the social protection system

The social assistance package in Ukraine requires rethinking since it is not only fiscally costly, but also does not provide adequate support to the poor. Ukraine's spending on social assistance is much higher than most middle-income countries. The HUS is the largest program, costing 2.6 percent GDP in 2017. While the cost of HUS was mitigated by reducing generosity, the coverage has increased to 45 percent of all households. The overall targeting effectiveness of social programs in Ukraine is poor: with only 30 percent of assistance going to the bottom 20 percent of the population, while the richest 40 percent receive almost as much. Generosity is also relatively low, with assistance received by the bottom 20 percent accounting for about 30 percent of pre-transfer expenditures. In this context, improved targeting of the large HUS program is urgently needed. This can be achieved by modifying the eligibility threshold in the benefit formula and/or reductions in the maximum amount of energy consumption covered by the subsidy. In addition, plans to monetize HUS at the household level should seek to reduce leakages, create incentive for more efficient use of energy, and catalyze a gradual shift from the HUS to a GMI program.

The recently adopted pension reform helped improve adequacy of benefits and stabilize fiscal costs; additional initiatives going forward should avoid undermining these core objectives of the pension system. The recent pension reform law introduced a new benefit formula, revised age-eligibility requirements for retirement, and strengthened indexation provisions. However, the bill left several policy areas unaddressed, such as pensions for the military and judiciary. It also provided for the introduction of a funded pension scheme starting from January 2019. Two different initiatives to introduce a funded pension pillar have primarily focused on the administrative aspects of managing records and the pool of funds. However, it is critical to carefully consider more fundamental questions, such as the overall objectives of the pillar, timing, its impact on the pay-as-you-go (PAYGO) system, contingent fiscal liabilities, and adequacy of financial instruments in the country. The status of these fundamentals indicates that the timeline of introducing the funded pillar by January 2019 is unrealistic. In the future, once the fundamentals are in place, any introduction of the funded pillar should be done in a way that does not undermine revenues and incentives to contribute to the PAYGO system. One option is to provide for automatic enrollment with a universal opt-out provision. But before moving forward, an assessment of how a funded pension pillar could complement the reformed PAYGO system is needed, including funding options, resulting benefits, and any contingent fiscal risks.

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