**PROGRAM INFORMATION DOCUMENT (PID)**

**CONCEPT STAGE**

April 15, 2014

Report No.: AB7568

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| **Operation Name** | Development Policy Loan 1 |
| **Region** | EUROPE AND CENTRAL ASIA |
| **Country** | Ukraine |
| **Sector** | General public administration sector (70%);General energy sector (30%) |
| **Operation ID** | P150313 |
| **Lending Instrument** | Development Policy Lending |
| **Borrower(s)** | UKRAINE |
| **Implementing Agency** | Ministry of Economic Development and Trade |
| **Date PID Prepared** | April 14, 2014 |
| **Estimated Date of Appraisal** | April 25, 2014 |
| **Estimated Date of Board Approval** | May 22, 2014 |
| **Corporate Review Decision** | Following the corporate review, the decision was taken to proceed with the preparation of the operation. |

1. **Key development issues and rationale for Bank involvement**

**The First Development Policy Loan (DPL1) is being prepared against the backdrop of political uncertainty.** After months of protests, Ukrainians now have heightened expectations that the newly-formed government will promote transparent governance, deliver public services free of corruption, and provide enabling conditions for creation of good quality jobs and rising standards of living that are comparable to those in the neighboring EU. The political unrest that began in November 2013 culminated in a change of Government, reinstatement of the 2004 constitution transferring powers from the President to the Parliament, and a call for early presidential elections now scheduled for May 25 2014. Geopolitical tensions and deep-rooted domestic divisions over the future direction of the country create an exceptionally fragile political environment. The outcome of the Presidential election is uncertain and risks of renewed instability are acute.

**Amidst these political uncertainties, the Government needs to undertake daunting economic reforms.** After a virtual reform paralysis over the past years, Ukraine urgently needs to restore macroeconomic stability, undertake a complex structural reform agenda, and confront a crisis of poor governance. Economic growth has come to a halt while a combination of de-facto fixed exchange rate and loose fiscal policy – together with considerable quasi-fiscal subsidies in the energy sector – has led to accumulation of unsustainable macroeconomic imbalances. These pressures are compounded by significant political risks, a still weak global economic environment, and rising regional tensions. Meanwhile, poor governance and corruption that permeates virtually every aspect of public service delivery have undermined the investment climate, resulted in wasteful use of public money, and eroded government capacity as well as citizen’s trust in public institutions. Deteriorating public infrastructure, a burdensome tax environment, byzantine laws and regulations, and poor contract enforcement have depressed private investment and growth.

**The Government Action Plan was articulated by the Prime Minister in February 2014.** Government plans to review subsidies that inhibit competition and undermine fiscal discipline. In addition, by raising energy tariffs, the plan aims at reducing fiscal and quasi-fiscal deficits and coupling this with increases in social protection to the poor and vulnerable. The Government Action Plan also emphasizes transparency and anti-corruption measures. Additionally, the Government Action Plan also aims at several structural reforms to improve the investment climate by removing restrictions that hinder competition and by limiting the role of state “control” in economic activities.

**The operation reinforces critical reform measures included in the government’s action plan.** Across the three pillars, the program is focused on policy actions that are a government priority and where the WBG could rely on existing analytical work and an established engagement to underpin a substantive policy dialogue with the authorities even within the short timeframe, available to prepare this operation. While designed around a frontloaded program of short-term reform measures, the programmatic design will help sustain momentum beyond the immediate actions supported by this first operation.

1. **Proposed Objectives**

**The DPL1 supports a program of high-priority reforms to address structural roots of the current economic crisis in Ukraine and to lay the foundation for inclusive and sustainable growth.** This proposed DPL1 – first in a series of two operations – in the amount of US$ 750 million has been prepared on an accelerated timeline responding to the Government’s request for urgent support and building on strong government commitment to move ahead with difficult reforms. The DPL series aims to:

1. promote good governance, transparency, and accountability in the public sector;
2. strengthen the regulatory framework and reduce cost of doing business; and
3. reform inefficient and inequitable utility subsidies, while protecting the poor.

The results of the actions supported by this operation include (1) curbing corruption by improving transparency of public finance, accountability of elected and senior public officials, and closing loopholes in tax legislation; (2) supporting improvements in investment climate by reducing cost and risk of doing business in Ukraine; and (3) reducing fiscal and quasi-fiscal subsidies in the utility and energy sector while strengthening social safety nets.

1. **Preliminary Description**

**DPL1 supports range of government reforms to achieve three objectives of the program**. As regards to promoting good governance, transparency and accountability in the public sector, DPL1 supports elimination of exemptions from public procurement law, establishing the public investment management system, and strengthening accountability of public and elected officials through the systematic disclosure and verification of asset declarations. The operation supports improvements to investment climate and competitiveness: streamlining VAT refund processing; improving the regulatory environment in Ukraine through a package of legislative changes to business registration, investor protection, construction permitting, and other licensing and permit requirements, food safety and standardization; and eliminating the legal provisions that led to the creation of the State Land Bank to eradicate a major governance risk from both the financial system and the land market. DPL1 also supports reforming inefficient and inequitable energy subsidies and protecting the poor by gradual tariff increases for residential gas and district heating services to improve financial cost recovery accompanied by new targeted social assistance allowance which will neutralize the impact of tariff increases on the bottom three deciles of the population (this program is intended as short-term fix to mitigate the immediate shock of tariff increases during the upcoming heating season).

1. **Poverty and Social Impacts and Environment Aspects**

*Poverty and Social Impacts*

**While the overall impact of this DPL is expected to be positive for poverty reduction and shared prosperity, some of the measures supported by this DPL are expected to have negative distributional effects, and required that appropriate compensatory measures are put in place.** This operation seeks to bolster Ukraine’s fiscal balance, while addressing key reforms which will lead to higher growth and more opportunities, particularly for some of the most vulnerable groups such as parts of the rural population. At the same time, under pillar III this DPL supports significant increases in the costs of gas (56 percent) and district heating (40 percent). The impact of these increases is going to be felt mostly when the “cold season” (October 15-April 15) starts. Concerns over the ability of existing programs to protect the poor adequately have led to the introduction of a new targeted program aimed at insulating entirely the bottom 30 percent of the distribution from the planned tariff increases, for one year. The program operates in conjunction with the other two as households might cumulate them. An important dimension in which the new energy program is more equitable than existing ones is gender. Indeed 48 percent of beneficiaries are female headed households, as opposed to 43 percent for housing and energy subsidies combined (after the tariff increase). The design of this measure is based on analytical work carried out by the Bank, in particular Gas and District Heating Tariff Reform in Ukraine: Mitigating the Impact of Tariff Increases through Targeted Cash Transfers and Energy Efficiency.

*Environment Aspects*

**Reforms supported by this operation are largely expected to have either neutral or positive environmental impacts.** Prior action on reforming inefficient and inequitable energy subsidies will lead to a more efficient use of these resources, including energy efficiency measures in the medium term. 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. Prior action on easing business registration is expected to boost business development, including growth of industry. Potential impacts from increased industrial 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 the EU requirements.

1. **Tentative financing**

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| Source: | ($m.) |
| Borrower | 0 |
| International Bank for Reconstruction and Development | 750 |
| Borrower/Recipient |  |
| IBRD  Others (specifiy) |  |
| Total | 750 |

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