THE BLEYZER FOUNDATION

Fiscal Policy 2005: Possible Risks and Consequences

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Introduction

Fiscal budget deficits are a concern to foreign and domestic investors because high fiscal deficits are normally the main cause of inflationary pressures. High inflation discourages investments because it makes sales, costs and profits more uncertain and difficult to predict. For these reasons, investors will require a much higher rate of return, limiting the number of possible investments in the country.

International experience and statistical analysis suggest that under most scenarios of economic growth, interest rates and country indebtness, the maximum fiscal budget deficit that a country can have on a sustainable basis is 3% of GDP. This is one of the reasons why the EU adopted the Stability Pact, which required EU countries to maintain deficits below 3% of GDP.

One of Ukraine's most significant achievements in economic policy-making in the past five years was taking control of the country's mismanaged fiscal budget system. The country's weak fiscal budget system, characterized by lack of fiscal discipline and politically motivated decisions, was at the root of the macroeconomic instability of the 1990s, with fiscal deficits in excess of 5% of GDP. The 1998 financial crisis helped the government realize the need to curb fiscal expenditures. Since then, until August 2004, the authorities kept the fiscal deficit below 1% of the country's GDP.

The decisions made in September 2004 on pension payments and minimum wages have changed the outlook for the fiscal budget. The new government pledged not only to preserve social benefits at the level provided by the previous government but even to increase them. In March 2005, the Verhovna Rada approved and the President signed the new version of the 2005 Budget. The amended budget includes additional increases in both revenues and expenditures, which pose a challenge for the execution of new budget parameters and may be detrimental to macroeconomic stability in general.

Government Proposal

The new fiscal budget for 2005 envisages a fiscal deficit of 1.6% of GDP. It is based on: (i) 8.2% growth of GDP, (ii) an inflation level of 9.8% yoy, and (iii) significant increases of 50% yoy in tax and revenue collections. Many investors, however, believe that the current targeted fiscal budget deficit of 1.6% may be difficult to achieve, as budget revenues may not increase by the amount of 50% needed to meet the target. Therefore, it is feared that inflation could be above the 9.8% target.

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The revenues of the state budget are forecasted to reach UAH 106.1 billion. The amount of expenditures is set at UAH 114.1 billion. Net lending for 2005 is estimated to be UAH 0.95 billion. These figures bring the budget deficit to UAH 7 billion, which translates to some 1.6% of Ukraine's GDP. According to the Bleyzer Foundation estimates, the new budget aggregates were calculated based on 16.5% yoy GDP deflator.[1]

Amended 2005 State Budget Parameters

Law on State Budget for 2005	Initial parameters		Revised parameters		
	UAH billion	% of GDP	UAH billion	% of GDP	% yoy growth
Revenues	86.361	21.1	106.135	24.3	+50.9
Expenditures	95.231	23.3	114.081	26.2	+41.7
Balance	−8.870	−2.2	−7.045	−1.6	−22.1
Consumer inflation, %	8.7		9.8		
Annual GDP growth, %	6.5		8.2		
Nominal GDP, UAH billion	409.9		436.0		

Source: Ministry of Finance, The Bleyzer Foundation calculations

The 2005 Budget is based on current tax legislation. However, there are several important changes introduced by the government that aim to increase budget revenues by some 50% yoy compared to last year. In particular, the government believes that growth in revenue will be secured by three main sources:

(i) general improvements in the macroeconomic situation, including formalization of the shadow economy;

(ii) increase in profit deductions from state companies;

(iii) elimination of all tax privileges and free economic zones (FEZ).

The increase in budget revenue will be spent mainly on social programs, which will be accompanied by some decrease in public investments. The Ukrainian government decided to further increase pensions (up 22% yoy) to an average UAH 383 retroactively from January 2005, and to raise the minimum wage to UAH 332 by the end of 2005 (an average 10% increase every quarter). Overall, the government needs over UAH 10 billion to finance the above mentioned increases in social benefits and the additional UAH 10 billion of social expenditures pledged by the President during the election campaign (particularly benefits for childbirth, social benefits to invalids, etc). The increase in social payments raises public support for government initiatives and reforms. However, it jeopardizes the economic stability of the country with a higher fiscal deficit, inflationary pressure and a decrease in public investments. Altogether, it may result in a slowdown of the country's economic growth.

Sensitivity Analysis

The sensitivity analysis below tries to assess the individual impact of the above three sources of improvements on budget revenues.

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1 GDP deflator is calculated based on the following formula: Deflator=GDP'05/(GDP'04*dGDP), where dGDP is a real GDP growth for 2005.

1. Macroeconomic Improvements

Macroeconomic improvements lead to an increase in domestic production and consequently raise the amount of revenue collected by government, regardless of what happens to other parameters.

In order to estimate the possible impact of the macroeconomic situation in 2005 on state budget revenues, we evaluated three possible scenarios. To isolate the impact of purely macroeconomic improvements on budget revenues, for all scenarios we maintained (i) GDP deflator for 2005 unchanged and fixed at its current level of 16.5% yoy; (ii) the ratio of state budget revenue to GDP was fixed at its average historical value for 2000–2004 at 20.4%.

State budget revenues/GDP

	2005	2004	2003	2002	2001	2000
Nominal GDP, billion of UAH	436.0	345.9	264.2	225.8	204.2	170.1
State budget revenues, billion of UAH	106.1	70.3	55.1	45.5	39.7	36.2
State budget revenues/GDP, %	24.3	20.3	20.8	20.1	19.5	21.3
Average revenue/GDP for 2000–2004, %	**20.4**					

Source: Ministry of Finance, The Bleyzer Foundation's calculations

The only variable parameter for each scenario is real GDP growth for 2005. The 2005 Budget was examined with GDP growth rates of (i) 8.2% yoy, the current government forecasted growth; (ii) 6.5% yoy, forecasted by the International Monetary Fund (IMF) as of March 2005. Although later the IMF updated its forecast of GDP growth to 7%, the initial forecast is believed to be more realistic, considering actual GDP growth of 5% yoy for January-April 2005; (iii) a GDP growth of 6% yoy, forecasted by other agencies.

The calculation of the state budget deficit is done based on the assumption of unchanged fiscal expenditures.

After sequences of simulations with fixed and variable parameters the following results were obtained.

Scenario I. GDP growth is 8.2%.

Results: (i) Nominal GDP for 2005 is estimated at UAH 436 billion; (ii) State budget revenues are estimated at UAH 89 billion; (iii) the deviation of calculated revenues from those initially projected by the government equals UAH 17.1 billion, which brings the total state budget deficit to 5.25% of GDP.

Scenario II. GDP growth is 6.5%.

Results: (i) Nominal GDP for 2005 is estimated at UAH 429 billion; (ii) State budget revenues are estimated at UAH 87.6 billion; (iii) the deviation of calculated revenue from those initially projected by the government equals UAH 18.5 billion, which brings the total state budget deficit to 5.66% of GDP.

Scenario III. GDP growth is 6.0%.

Results: (i) Nominal GDP for 2005 is estimated at UAH 427 billion; (ii) State budget revenues are estimated at UAH 87.2 billion; (iii) the deviation of calculated revenue from those initially projected by the government equals UAH 19 billion, which brings the total state budget deficit to 5.78% of GDP.

<u>General conclusion:</u> **Due to the changes in the macroeconomic situation with all other factors fixed and assuming an unchanged level of state budget expenditures (UAH 114.1 billion), the fiscal deficit is estimated to range from 5.25% of GDP to 5.78% of GDP.**

Summary of macroeconomic improvements

	Optimistic scenario	Consensus scenario	Pessimistic scenario
Real GDP growth for 2005, % yoy	8.2	6.5	6
Nominal GDP, UAH billion	436	429	427
Budget revenues incorporating macroeconomic improvements, UAH billion	89.0	87.6	87.2
Budget expenditures, UAH billion	114.1	114.1	114.1
Net lending, UAH billion	0.95	0.95	0.95
Official transfers, UAH billion	1.32	1.32	1.32
Deficit incorporating macroeconomic improvements, UAH billion	22.88	24.28	24.68
Deficit incorporating macroeconomic improvements, % to GDP	5.25	5.66	5.78

2. Profit Deductions of State Monopolies and Companies with State Shares

In the new 2005 Budget, the shares of tax and non-tax revenues amount to 69% and almost 29% of total state budget revenues, respectively. While the analysis of tax revenues is presented in the next section, investigation of the changes in non-tax revenues is also important for estimating budget performance in 2005. Non-tax state budget revenues have the following structure:

Structure of Non-Tax State Budget Revenues, % of total non-tax revenues

Selected non-tax revenue items	2005	2004	Change, percentage points, (+,–)
Commercial income	42.8	28.1	14.7
— profit deductions of state monopolies and enterprises with state shares	19.3	2.7	16.6
— rent payments	15.8	15.5	0.3
Other non-tax revenues	30.2	22.8	7.4
— revenue from the sale of gas in 2000 that was received as a fee for gas transit through the territory of Ukraine	3.3	0	3.3
— extra charge to current electricity and heating tariffs	6.8	4.3	2.5

In 2005, almost 36.5% yoy nominal growth in non-tax revenues is expected on account of the almost nine time increase in profit deductions from state monopolies and enterprises with state shares, the 38% yoy nominal increase in rent payments and a 81% yoy increase in other non-tax revenues. While collection of a considerable part of the non-tax revenues may be quite realistic (e.g., rent payments, extra charge to electricity and heating tariffs), raising some of them may be problematic. For instance, the 2005 budget foresees revenues from the sale of gas in 2000 that was received as a fee for gas transit through the territory of Ukraine in the amount of UAH 1 billion. The respective item of non-tax revenues was also anticipated in the budget for 2004; however, despite the fact that the amount (UAH 200 million) was significantly lower than that forecasted for 2005, it was not collected at all. Hence,

if not accomplished in 2005, this item alone represents a 0.23 percentage point contribution to the state budget deficit.

In the 2005 Budget, the government hopes to increase revenues by more than UAH 5 billion due to an increase in the profit deduction rate for state monopolies and joint stock companies with government shares in the statutory fund. According to Article 65 of the new 2005 Budget Law, 50% of net profit is to be transferred to the state budget by state monopolies and 30% of the state's part of the net profit of other state enterprises. Last year, these enterprises were required to pay only 15% of their net profit to the state budget, and these resources were claimed to be spent for investment purposes. In 2004, the state budget received only UAH 0.6 billion of profit deductions. The new provisions of the budget law on these enterprises with state shares may violate the norms of the law of Ukraine "On Business Associations" as they infringe on the property rights of non-state shareholders of joint-stock companies with government shares. Therefore, it may be challenged in the courts. These profit deductions from joint-stock companies and their affiliates are a fairly uncertain source of revenue for the budget. At the same time, part of the state monopolies' profit is a reliable source of fiscal revenue because the state is the only rightful owner of the mentioned companies and has the right to manage their profits at their discretion. Thus, the following analysis takes into account profit deductions of the state monopolies only.

Assuming no changes in the overall effectiveness of the state monopolies, the revenue to the state budget under the 50% rate of profit deductions should increase to UAH 1 billion in 2004 prices. In order to translate this figure into 2005 prices, it should be adjusted by the applicable GDP deflator (16.5%). Since three scenarios are possible, the amount of revenue provided to the state budget will differ depending on the rate of economic growth.

Scenario I. GDP growth is 8.2%.

Results: (i) Planned budget revenues due to profit deduction of state monopolies will increase by UAH 1.76; (ii) the total amount of state budget revenues due to macroeconomic improvements and profit deduction of state monopolies is estimated at some UAH 90.76 billion; (iii) the total budget deficit is estimated at UAH 21.12 billion or 4.84% of GDP.

Scenario II. GDP growth is 6.5%.

Results: (i) Planned budget revenues due to profit deduction of state monopolies will increase by UAH 1.74; (ii) the total amount of state budget revenues due to macroeconomic improvements and profit deduction of state monopolies is estimated at some UAH 89.34 billion; (iii) the total budget deficit is estimated at UAH 22.54 billion or 5.25% of GDP.

Scenario III. GDP growth is 6%.

Results: (i) Planned budget revenues due to profit deduction of state monopolies will increase by UAH 1.73; (ii) the total amount of state budget revenues due to macroeconomic improvements and profit deduction of state monopolies is estimated at some UAH 88.93 billion; (iii) the total budget deficit is estimated at UAH 22.95 billion or 5.37% of GDP.

General conclusion: **Due to the changes in profit deduction of state monopolies and other state companies and changes in the macroeconomic situation, and assuming an unchanged level of state budget**

expenditures (UAH 114.1 billion) the fiscal deficit is estimated to reach 4.84% of GDP — 5.37% of GDP.

Summary of macroeconomic improvements and profit deduction of state monopolies

	Optimistic scenario	Consensus scenario	Pessimistic scenario
Real GDP growth for 2005, % yoy	8.2	6.5	6.0
Nominal GDP, UAH billion	436	429	427
Planned budget revenues due to profit deduction of state monopolies and other state companies, UAH billion	2.52	2.48	2.47
Increase in budget revenues due to profit deduction of state monopolies and other state companies, UAH billion	1.76	1.74	1.73
Total budget revenues incorporating macroeconomic improvements and profit deduction of state monopolies and other state companies, UAH billion	90.76	89.34	88.93
Total budget expenditures, UAH billion	114.1	114.1	114.1
Net lending, UAH billion	0.95	0.95	0.95
Official transfers, UAH billion	1.32	1.32	1.32
Deficit incorporating macroeconomic improvements and profit deduction of state monopolies and other state companies, UAH billion	21.12	22.54	22.95
Deficit incorporating macroeconomic improvements and profit deduction of state monopolies and other state companies, % to GDP	4.84	5.25	5.37

3.Budget Revenues from Improved Tax Collection and Elimination of Tax Privileges

The increase in budget revenues as a result of improving the system of tax collection and the elimination of tax privileges can be forecasted based on the buoyancy approach. This involves forecasting future tax revenues based on an improved relationship between state revenues and GDP growth. The improved tax revenue performance is purely the result of all the measures, such as the increase in revenues, including taxes on state monopolies, better tax collection and elimination of privileges (including changes in tax bases and changes in tax laws).

Buoyancy of tax revenues

	2005	2004	2003	2002	2001
Real GDP growth, % yoy	8.2	12.1	9.5	5.2	9.2
GDP deflator, %	16.5	16.8	6.8	5.1	9.9
Real tax revenues of state budget, % yoy	40.06	7.48	15.57	25.35	2.10
Buoyancy	4.89	0.62	1.64	4.88	0.23
Average tax buoyancy for 2001–2004	1.84				
Average tax buoyancy for 2002–2004	2.38				
Maximum buoyancy over the period	4.88				

The analysis of the historical data of the Ukrainian state budget tax buoyancy shows that its average value for 2001–2004 was 1.84, while the average historical maximum (4.88) was registered in 2002. The 2005 budget is based on the assumption that the level of buoyancy can be increased from 0.62 in 2004 to 4.89. It is expected that the increase in buoyancy will be due to improvements in tax collection and elimination of all tax privileges. Such significant variation

in officially projected buoyancy from its historical value suggests that the 2005 Budget contains significant elements of risk.

Although certain improvements in tax collection will take place in 2005, it is still unclear how significantly these changes can affect the total value of budget revenues. This is due to the fact that buoyancy is only one of the factors affecting tax revenues. Depending on the rate of economic growth in 2005, three different scenarios are possible. Assuming that the government will be able to reach the forecasted level of buoyancy (4.89) the budget will be still in deficit.

Scenario I. GDP growth is 8.2%.

(i) Planned budget revenue in nominal terms will be UAH 100.37billion; (ii) bringing the total budget deficit to UAH 11.46 billion, which translates into 2.63% of GDP.

Scenario II. GDP growth is 6.5%.

(i) Planned budget revenue in nominal terms will be UAH 95.99 billion; (ii) bringing the total budget deficit to UAH 15.84 billion, which translates into 3.69% of GDP.

Scenario III. GDP growth is 6.0%.

(i) Planned budget revenue in nominal terms will be UAH 94.70 billion; (ii) bringing the total budget deficit to UAH 17.13 billion, which translates into 4.01% of GDP.

General conclusion: **Due to the changes in the system of tax collection and elimination of tax privileges, state budget revenues can reach UAH 94.70 billion — UAH 100.37 billion, and assuming unchanged level of state budget expenditures (UAH 114.1 billion) the fiscal deficit is estimated to reach 2.63% — 4.01% of GDP.**

Summary of changes due to improvements in tax administration and tax collection

	Optimistic scenario	Consensus scenario	Pessimistic scenario
Real GDP growth for 2005, % yoy	8.2	6.5	6
Nominal GDP, UAH billion	436	429	427
Buoyancy	4.89	4.89	4.89
Estimated tax revenue in 2005, in UAH billion	73.20	68.86	67.58
Non tax revenue in 2005, in UAH billion	30.53	30.53	30.53
Profit deductions from state monopolies	5.88	5.88	5.88
Planned budget revenues from state monopolies due to 50% tax rate for state monopolies, UAH billion	2.52	2.48	2.47
Non-tax revenues, incl. state monopolies and macro-economic adjustments	27.17	27.13	27.12
Total budget revenue	100.37	95.99	94.70
Budget expenditures, UAH billion	114.1	114.1	114.1
Net lending, UAH billion	0.95	0.95	0.95
Official transfers, UAH billion	1.32	1.32	1.32
Deficit, UAH billion	11.46	15.84	17.13
Deficit, % to GDP	2.63	3.69	4.01

Summary and Recommendations

The analysis presented in this note indicates that the following outcomes are possible in 2005:

- Under the optimistic scenario (8.2% of GDP growth, increases in profit deduction to state monopolies and increase in tax revenues due to elimination of privileges and free economic zones) the state budget deficit could be as low as 2.63% of GDP.

- Under a base line scenario (6.5% of GDP growth, increases in profit deduction to state monopolies and increase in tax revenues due to elimination of privileges and free economic zones) the state budget deficit would be about 3.69% GDP.

- Under a pessimistic scenario (6.0% of GDP growth, and low increases in profit deduction to state monopolies and increase in tax revenues due to elimination of privileges and free economic zones) the state budget deficit may be as high as 4.01% of GDP.

This analysis suggests that the deficit for 2005 is likely to be around 3.5%–4% of GDP, significantly exceeding the 1.6% of GDP envisaged by the government.

Given the excellent goodwill created by the Orange Revolution, it is quite likely that this deficit of around UAH 22 billion can be financed by additional foreign direct investments, larger debt financing, and additional privatization receipts. In fact, even if financed entirely by larger public debt, given that the level of debt is relatively low, the country can absorb this additional amount reasonably well. Internal and external debt would increase from about $16 billion (20% of GDP) to about $ 20 billion (or to about 25% of GDP, still a low number).

Although financing the fiscal deficit in 2005 is a feasible solution, it is clear that this option would become more difficult to repeat over time. In fact, over the long term, the government will need to carry out a comprehensive audit of the public sector in order to contain and improve the structure of fiscal expenditures. The government will need to define those activities that can be abolished, those that can be reduced in size, those that can be transferred to local authorities (with legislation to provide local authorities with their own source of financing), and those that can be subcontracted or privatized.

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