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# Ukraine's Fiscal Budget Situation

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The collapse of the Soviet Union in 1991 gave Ukraine not only political independence, but also a host of economic and social problems that stemmed from the inefficiency of the Soviet economy. Ukraine inherited a highly energy-intensive industry (much of which was military-oriented), heavy reliance on trading partners from the former Soviet Union, and cumbersome public administration. The country entered a period of economic instability — with old economic ties disintegrating, flawed legislation that allowed well-connected individuals to take possession of state assets through poor privatization processes, rampant corruption, hyperinflation, and low living standards of the population.

During the early 1990's, the government heavily subsidized the country's struggling state-owned enterprises to keep them afloat. As a result, Ukraine's fiscal budgets were under extreme pressure, with deficits exceeding 5% of GDP, and even reaching 14% of GDP in 1992. Since revenue collection was inadequate, the government financed the fiscal deficits principally by increasing money supply, which led to hyperinflation (peaking at 10,250% in 1993.) In the mid-1990's, the government managed to curb inflation by rigid control of the money supply, but it resorted to external borrowing to finance its fiscal needs. External debt was growing steadily from $8 billion in 1995 to a peak of $12.4 billion (47% of GDP) in 1999.

The lack of fiscal discipline was the major problem of Ukraine's governments up to mid-1998. Over the years, the fiscal budgets had overestimated revenues and excessive expenditures; tax collection was inadequate due to the high degree of tax exemptions and privileges and widespread tax evasion.

It was not until 1998 that the country realized the need for a more balanced fiscal policy. The Asian crisis of 1997 and the Russian crisis of 1998, coupled with Ukraine's sluggish reforms, chilled foreign investors' attitude towards Ukraine. Without further international inflows, the country found itself unable to pay off large amounts of foreign debt due in 1998. Capital outflows led the central bank to use its international reserves almost entirely to keep the national currency from heavy depreciation. However, prompt and adequate actions taken by the government in the wake of the crisis (including foreign debt restructuring, tighter monetary policy mechanisms, and improved fiscal budget execution) kept Ukraine from

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government, which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country, support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

falling into economic demise and defaulting on its foreign debt obligations.

Since 1998, the government has been in control of the country's fiscal situation by means of better-managed expenditures, establishment of the State Treasury, and adoption of more transparent policies and practices. As a result of these measures to improve fiscal discipline, the fiscal deficit in the period from 1998 to 2002 was kept below 2% of the country's GDP, with fiscal surpluses in 2000 and 2002.

## Overview of the Fiscal Budget Situation

Ukraine is expected to continue a cautious fiscal policy in 2003. The country is running a fiscal budget with a target deficit of 1.2% of GDP, and the current budget execution data shows that the government is quite on track to meet this target.

In Ukraine, the consolidated fiscal budget is a combination of the State budget and the local budgets. The State budget is adopted by the parliament in the form of a law. The local budgets are adopted by the local authorities (cities and regions) based on the State budget. The State budget includes official transfers to, and receipts from, the local budgets.

The current state budget was adopted in December 2002 by parliament and was the result of consensus between the government and the parliament. The 2003 consolidated budget revenues amount to $12.7 billion (which represents 26.6% of the country's GDP), while the expenditures amount to $13.3 billion (or 27.8% of GDP), and the deficit is equal to $0.6 billion (or 1.2% of GDP.) In 2002, the fiscal budget showed similar performance in revenues and expenditures to yield a fiscal surplus of 0.7% of GDP.

The 2003 consolidated budget numbers represent a 10.6% increase from last year's planned budget in revenues, and an 8.7% increase in expenditures. However, the actual numbers of the 2002 budget were different from those planned: although the government succeeded in reaching the target level of revenues, the expenses were significantly below plan — only 84.7% of the expected figures. Thus, 2003 expenditures are planned to grow by about 17.4% over the actual 2002 figures.

The fiscal budget was drawn based on the assumptions that real GDP will grow by 4% (compared to 4.8% in 2002), CPI will equal 105.2% yoy, the situation of Ukraine's strategic products on world markets will remain stable, and the government will take an active stance in managing the economy — in particular, to improve revenue collection and pass amendments to tax legislation that will increase the tax base and reduce tax privileges. Robust growth of the economy in the first half of 2003, along with a favorable situation on the export markets, justifies the size of the current fiscal budget. Considering this, the 2003 budget looks fairly realistic in terms of revenues, and at the same time, one can expect the expenditures to be below plan again.

## History of Adopting the State Budget

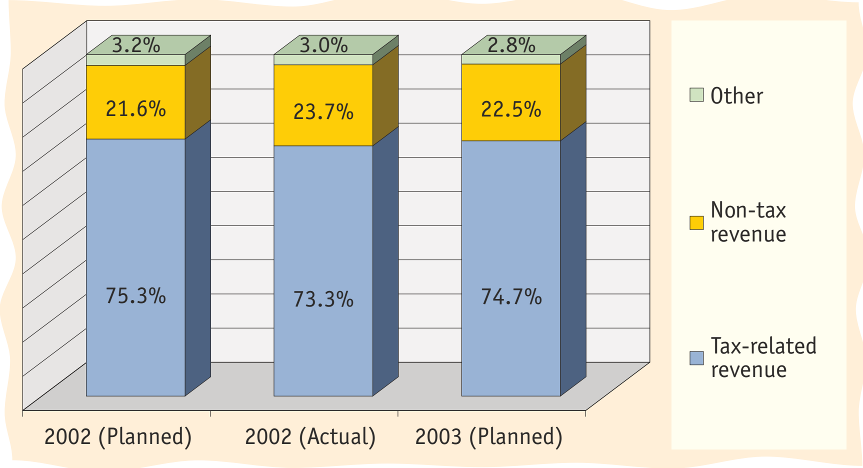
The final version of the Law on the 2003 State Budget was passed right before the end of 2002. The first reading of the budget law took place in October 2002, when two budget drafts (one prepared by the government, and another one by the parliament's Budget Committee) were presented. The major differences between the two drafts were that, according to international practice, the government chose not to include privatization receipts in the budget revenues. Also, the parliament, contrary to the government's view, suggested taking part of the profits of state-owned enterprises and including those into fiscal revenues. The Budget Committee's version received the parliament's approval and was sent for further elaboration.

The document easily passed its second reading in late November, after the government and the parliament compromised on some issues. However, further processing of the law was delayed by a major political event that happened on that day: the parliament voted on a new prime minister. The new government requested some time to review the budget draft and to suggest its amendments. In the numerous discussions that followed, the government insisted that the budget revenues be substantially reduced to avoid adopting an unrealistic budget. These discussions continued until late December 2002, when the parliament was left with nothing else to do but adopt the budget that was supposed to come into force days after. The flaws of this approach appeared immediately: for the first two weeks of 2003, the parliament saw five draft laws to make amendments to the just-adopted state budget.

## Fiscal Revenues

As noted above, the consolidated budget revenues amount to $12.7 billion, or 26.6% of GDP. This level of revenues is not excessive and compares well with the fiscal results for the period before the 1998 crisis (37.1% of GDP in 1996 and 30.1% of GDP in 1997.) The composition of planned fiscal revenues for 2003 is shown in Figure 1.

**Figure 1: Composition of the Consolidated Budget Revenues, as % of Total**

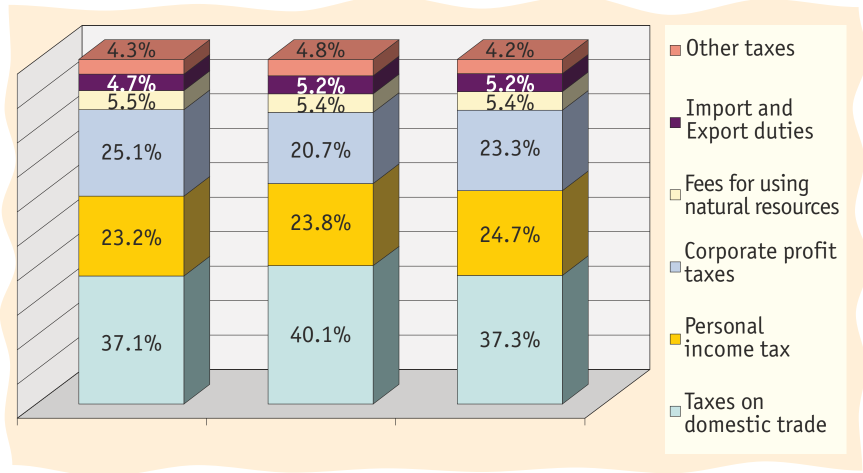



*Source: State Treasury of Ukraine*

Income derived from taxes makes up the largest amount of the fiscal revenues — about three quarters. It is a slight increase when compared to 2002's fiscal budget revenue.

Three major types of taxes account for 85% of total tax revenue: taxes on domestic trade (mainly VAT and excise taxes, accounting for 37.3% of tax revenue), personal income taxes (24.7% of tax revenue), and corporate profit taxes (23.3% of tax revenue) (See Figure 2).

**Figure 2: Composition of Tax-Related Revenues, as % of Total**

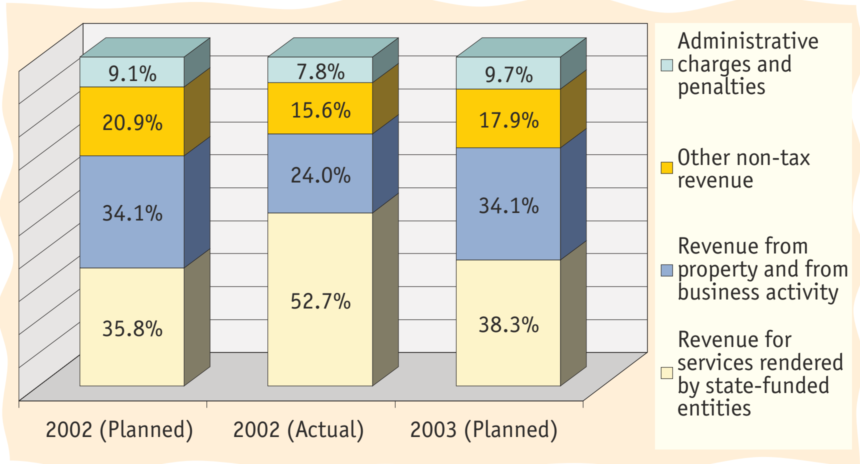



*Source: State Treasury of Ukraine*

The corporate profit tax proceeds planned for 2003 are the most vulnerable element here. As 2002 results showed, the corporate profit taxes collected lagged considerably behind the planned numbers. Thus, the government needs to take adequate measures to collect the expected amounts.

Non-tax revenues (about 23% of total fiscal revenues) include revenues from services rendered by state-funded entities (e.g., medical services, fees for licenses and permits, etc., 38.3% of non-tax revenue), revenues from property and from business activities of the state (e.g., share of profits of state enterprises, dividends on stocks held by the state, fees for oil and gas extraction and transportation, etc., 34.1% of non-tax revenue), administrative charges and penalties (9.7% of non-tax revenue), and other non-tax revenue (17.9% of total non-tax revenue) (see Figure 3).

**Figure 3: Composition of Non-Tax Revenues, as % of Total**




*Source: State Treasury of Ukraine*

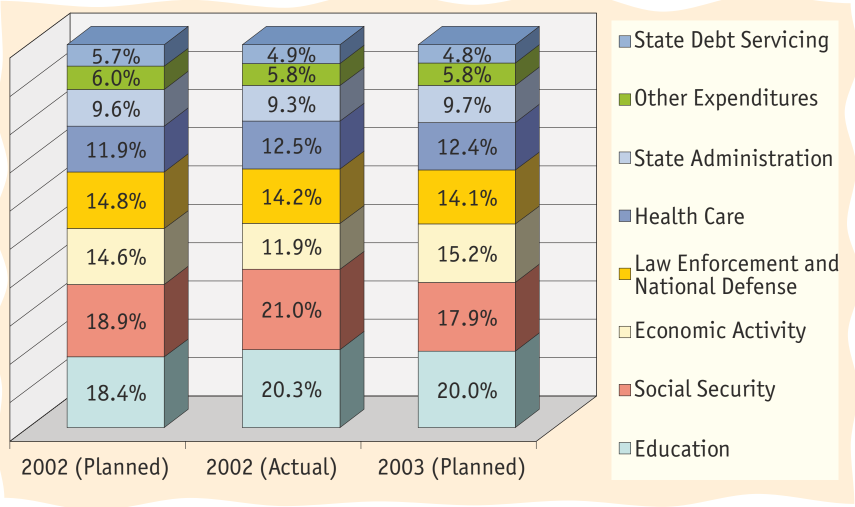
## Fiscal Expenditures

The 2003 consolidated budget expenditures are equal to $13.3 billion, or 27.8% of GDP. This level of fiscal expenditures is well balanced with the current fiscal revenues, well controlled through the established procedures and agencies, and comes as a result of continued tight fiscal policy (the fiscal expenditures peaked at 52.4% of GDP in 1994, reached about 37% before the financial crisis of 1998, and were gradually falling thereafter.)

Notably, about 50% of the consolidated budget expenditures are directed towards the needs of the social sector (20% for education, 17.9% for social security, and 12.4% for health care.) Support of state economic activities (e.g. government subsidies, support of agriculture, coal mining, etc.) will take only 15.2% of total fiscal expenditures, and another 9.7% will be used for maintenance of the state administration apparatus.

**Figure 4: Composition of the Consolidated Budget Expenditures, as % of Total**




*Source: State Treasury of Ukraine*

Many fiscal expenditure items are classified as "protected." These are related to the social sector and include pensions, stipends, social security payments, etc., and they receive top priority in financing.

## Current Fiscal Performance

According to recent data, budget execution in the first quarter of 2003 has been going rather successfully. The revenues have reached just over 101% of the planned numbers for this period, while expenses were 88.8% of those planned. In January alone, revenues were 100.2% of those planned, while expenses lagged behind considerably at about 62% of the planned numbers. Low government expenditures could be explained by the need to accumulate necessary resources to make large payments on foreign debt due in March.

April and May showed similar results with revenues exceeding 100% of the planned numbers, and expenditures lagging behind. However, the government met all of its obligations on "protected" items.

So, the rather good performance of the fiscal budget for the first five months of 2003 makes the government optimistic. The government has already stated that the budget is adequate, and it is actively working on reaching the planned targets.

## The Minimum Salary Issue

A major threat to the 2003 budget occurred when the parliament passed the Law on Minimum Salary that increased the minimum monthly wage from UAH 165 to UAH 185 as of January 1, 2003, and up to UAH 237 as of July 1, 2003 (about $31, $35, and $45, respectively.) Since all budget calculations were made based on the then-existing minimum wage of UAH 165 for all of 2003, the new minimum wage numbers made the budget outdated: both revenues and expenditures had to be reconsidered. Furthermore, additional resources to finance the increased expenditures had to be secured.

To meet the requirements of the new minimum salary law, the government will need to seek up to an additional UAH 7 billion to finance these expenditures. With the National Bank reluctant to finance excessive government expenditures with monetary policy instruments, this amount would need to be redistributed from other parts of the fiscal budget. The government already stated that it might reduce spending on road-construction and maintenance, machinery leasing programs in agriculture, supply of computers to rural schools, etc. Reduction in government spending would not benefit the development of particular industries and the economy in general; many social needs could be left unattended.

If, according to the new law, the minimum salary was increased further to UAH 237 as of July 1, many enterprises could face significant difficulties in making salary payments since, in many regions, actual salaries are lower than the proposed minimum salary. Many companies could have to equalize salaries of all employees to the minimum salary to compensate, thus destroying incentives for qualified employees. Wage arrears could grow, some enterprises might need to lay off their employees, and others could become unprofitable.

This is why the parliament was pressured to revise this regulation in order to postpone the second increase of the minimum salary. As a result of discussions between the President, the government, and the parliament, the latter passed a law amending the state budget in May 2003. The law increased the original fiscal revenues and expenditures by $551.3 million each, or by 5.9% and 5.6%, respectively. It also set December 1, 2003 as the new date for another minimum monthly salary hike to UAH 237 (instead of July 1, 2003.) Additional revenues are supposed to come from increased fees for oil and gas extraction, and from higher excise taxes imposed on alcohol and tobacco products. The greater revenues would be used to support agricultural producers that suffered from extremely severe weather conditions during the 2003 winter season. In addition, the government expects to allocate more funds to renew adequate salary ratios between qualified and non-qualified labor, which were lost as a result of the higher minimum wage introduced as of January 1, 2003. Finally, the increased revenues will help finance some social programs (higher pensions for former military officers and higher stipends for students.) Taking into account the rather good performance of the fiscal budget and the increase of planned revenues mentioned above, the government is expected to have just enough resources to cover the increased expenditures.

## The Issue of Privatization Proceeds

As noted above, one of the disputable issues while adopting the budget was whether to include privatization proceeds as a budget revenue item. Back in November 2002, following international practice, the government insisted on having fiscal revenues free of uncertain privatization money. This way, no socially-critical budget expenditure would be left unattended should the privatization fail to produce expected fiscal inflows. On the other hand, parliament believed that including privatization proceeds into the budget revenues could make the government take more rigid control over the privatization process in the country. By being more actively involved in the privatization, the government would both ensure that the process is going along successfully, and that it would fill the budget with the required amount of privatization proceeds.

The final version of the budget passed by the parliament has UAH 2.1 billion of privatization income included in the budget. However, it was included as a deficit financing item, rather than as a fiscal revenue item. This allowed the government to avoid excessive pressure on expenditures should the privatization go sour, while on the other hand, be sufficiently motivated to meet the target.

However, as represented in the 2003 results, privatization is not going very well. The budget received UAH 133 million of privatization income in January and February, which is just about 37% of the planned numbers for this period. By May 1, this number grew to UAH 299 million, and by the end of May it jumped up to about UAH 1 billion thanks to two large sales. Therefore, unless the government takes a firmer grasp of the situation, it cannot expect privatization proceeds to be a reliable source of fiscal deficit financing.

## Publicly Guaranteed Debt Issue

About 10% of Ukraine's debt, or about $1.5 billion, comes from foreign debt of Ukrainian enterprises issued with a state guarantee. For various reasons, many companies defaulted on their publicly guaranteed foreign debt, which was then transferred to the country's foreign debt. Needless to say, it is an additional burden on the country's budget, since this debt is unlikely to be repaid by the borrowers — over the last 10 years, the companies repaid the government only about $500 million of these debts. The government has to take measures to restructure its publicly guaranteed debt just like it restructured the country debt to Paris Club members.

According to the new legislation, the government would not provide a public guarantee for new corporate debt in 2003. Loans originating from international agencies, however, would still be publicly guaranteed.

## VAT Reimbursement Issue

Another important issue with regards to budget expenditures is reimbursement of the value-added tax (VAT) arrears of the state to businesses. The problem concerns companies, which are subject to reimbursement of VAT paid for the exported goods and services purchased domestically. A large portion of the money claimed by the companies to be eligible for reimbursement has in fact never been paid as VAT. Many companies use imperfections of the current legislation and procedures to receive VAT reimbursement for transactions that never took place.

The government has in fact considerably slowed down repayment of VAT arrears. The government currently has about $544 million in VAT reimbursement arrears. This year alone (by April 2003), the arrears have been reduced by $19.5 million, while the government has committed to pay off up to $94 million of the arrears by mid-year. Elimination of VAT reimbursement arrears has become one of the stumbling blocks in negotiations with the International Monetary Fund (IMF) and the European Union, which insist that the government should pay off those debts.

Recently, the government proposed to convert its VAT reimbursement arrears into some sort of government securities with maturities up to 10 years. Details of this deal are still under consideration, but it appears to be in fact a plausible solution to the problem. However, this decision should be combined with efforts to improve regulations covering VAT issues to avoid accumulation of further unjustified claims for VAT refunds.

## Financing of the Fiscal Deficit

The fiscal deficit for 2003 is planned to equal $585 million, or 1.2% of GDP. This amount is to be financed from privatization of state property, as well as from domestic and external borrowing, and the government is not likely to have problems with raising necessary funds. As noted before, privatization has already yielded about UAH 1 billion ($187 million) to the fiscal budget out of an expected UAH 2.1 billion ($403 million.)

As for external financing, the government has declared that it will take a rather cautious approach, even though the size of Ukraine's external debt (about $10 billion, or less than a quarter of GDP) is not excessive. The government has been able to face initial foreign debt payments due in the first quarter of 2003 (about $300 million) without seeking additional external financing. However, Ukraine has about $1.6 billion of foreign debt due this year, along with about $0.6 billion of domestic debt. Due to limitations of its fiscal budget, the country would not be able to avoid external financing. The government, however, was postponing this action until later this year. The main incentive for this is its expectation that international financial markets will view Ukraine as a less risky investment opportunity after seeing its timely debt payments and improved economic situation.

The above tactics proved right: in its May review, Standard & Poor's confirmed Ukraine's country rating at "B" level, and upgraded its outlook to "stable" (market-weight) from the "negative" (under-weight) outlook it imposed on the country in November 2002. Soon after, Ukraine successfully placed a 10-year $800 million Eurobond issue at a very low 7.65% rate, with the investors' total demand for this issue reaching $4.5 billion. The very attractive terms of this transaction indicate the investors' perception of Ukraine's good macroeconomic performance, including rather good control of the fiscal budget.

On the other hand, the government is actively using internal borrowing by means of short- to long-term government securities. As of June 1, the fiscal budget received $100 million from the sale of new government bonds issued since the beginning of the year. The central bank is acting rather cautiously in this respect not to allow excessive diversion of the money from working for the real sector of the economy.

## Ways to Improve Fiscal Performance.

As previous years indicate, the biggest problem with Ukraine's fiscal budget is not its adoption, but its execution. Revenues often fall short of the planned numbers, and the government is therefore required to cut expenditures accordingly to keep the budget balanced. What can be done to make the budget more adequate?

First of all, the country has long been in need of new tax legislation. First chapters of the new tax code got the parliament's approval in the first reading. The new tax legislation needs to create an environment to bring business out of the "gray" economy and thus significantly increase the tax base. To do this, it should reduce the company tax burden that makes most companies conceal their real cash flows. Reduction of personal income taxes starting from January 1, 2004, recently approved by parliament, is not really effective without adequate cuts in the social funds taxes that employers pay. Also, reduction of value added tax to 17% from 20%, proposed by parliament, should be accompanied by complete elimination of tax privileges.

Canceling tax privileges could be another measure aimed at adding significant resources to the budget. The privileges mainly include exemptions of (or reduction of) VAT and corporate tax payments for certain companies, often granted for political rather than economic reasons. Because of the tax privileges, the fiscal budget is estimated to have missed about UAH 56 billion in 2002, or nearly the size of the country's fiscal revenues. The decision to completely abolish tax privileges needs to be made despite strong lobbying from different interest groups.

In order to ensure the budget is executed fully and on time, the government needs to improve tax collection. The serious nature of the problem is proven by the fact that tax arrears to the budget more than doubled over 2002, reaching UAH 14.7 billion. The problem is closely related to the heavy tax burden that makes many companies stay in the "shadow," so the priority should be on creating a business-favorable tax climate. Also, the tax authorities should be encouraged to pursue unbiased and uncorrupt practices when dealing with companies. The above measures should be combined with an educational campaign to raise the "tax culture" of the public.

Another way to fill the budget would be to increase fees, duties, excise taxes, etc. for certain products (such as cars, jewelry, alcohol, tobacco, etc.) An immediate measure that would help the government to collect more revenue is to increase the price of services provided by the government and budget-funded entities. However, a reasonable approach should be taken here so as not to affect the poorest people, who might be using some of those services, and also not to cause overall price levels to go up fueled by increased minimum salaries.

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