Section III

Ukraine: Fiscal Snapshot
Real GDP (in percent change from previous period)
Ukraine & NIS: Real GDP Growth in 2001 & seven months of 2002
Consolidated Budget Balance
(in percent of GDP)

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Consolidated Budget Revenues & Expenditures
(in percent of GDP)

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<td>1999</td>
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<td>2000</td>
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<td>2001</td>
<td>34%</td>
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<td>2002</td>
<td>36%</td>
<td>40%</td>
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Evolution of Deficit and Its Financing: Three Periods


3. Nowadays: Mix of domestic and external financing as well as of privatization proceeds.
Evolution of Deficit and Its Financing

- The consolidated budget deficit steadily improved from 1994 to 2001, and it has stabilized since then at the level of 1.6% of GDP.
- The positive adjustment is mostly due to the expenditure retrenchment: their share in GDP has contracted by almost 10 percentage points.
Consolidated Budget Execution (% of the approved budget; net of PF)
Budget Execution (in percentage of approved budget)
Budget Discipline Improved: Revenues

Deviation of actual revenues from monthly target, cumulative, 1997-2000

Source: WB
Reasons Behind Improved Budget Execution

- More Realistic Revenue Forecast
- More Experienced Ministry of Finance is More Tough in Bargaining on Expenditure Limits with Key Spending Units and Local Governments
- Treasury: More Strict Commitment Control and More Sophisticated Cash Management But Still a Long Way to Go
- Proliferation of Budget Offsets Used to Distort the Efficiency of Cash Management
Trends in Revenue Composition

- The share of GDP redistributed through budget revenues fell from 39% (1997) to 37.2% (2002, expected).
- Share of payroll taxes and PIT is on the rise while...
- EPT’s share continues to slide down (to 3.8% of GDP in 2002).
- VAT’s share shrank from 8% of GDP to 6%, but has stabilized recently.
On the contrary, PIT revenues move upward because...

- The share of labor payments in GDP increases
- PIT is assigned to subnational governments who have a better grasp of it

Excises are on the rise but still their share in revenues is tiny (compared to other countries)

Non-tax revenues:
Ukraine’s reliance on gas transit fees and...

...own resources of budget entities: at least a portion of the shadow economy has been legalized
Landmarks of Revenue System Evolution

- **1992** - *Turnover tax* is substituted with *VAT*; *corporate and personal income taxes* are also in place.
- **1993-1994** - Laws (Decrees) on *PIT, excises and local taxes* are enacted and have remained basically unchanged since then.
- **1994** - The Parliament, in order to lure foreign investment, grants generous tax holidays to joint ventures. The first loopholes start eroding the system. Efforts to cancel this special treatment has had a mixed effect so far (as a result, Hrv 1-2 bln of tax revenues are foregone each year).
Landmarks of Revenue System Evolution

- 1996 - the State Tax Administration (STA) is created
- 1997 - Basic VAT and enterprise profit tax laws are enacted, and since then they have been amended dozens of times - mostly with new benefits and exemptions
- 1998 - gradual reduction of payroll taxes starts (in its peak, its cumulative rate reached 45%).
- 1999-2000 - the last remains of turnover taxes (road fund tax & payments to the Innovation fund) are abolished. Presumptive (simplified) taxation is introduced.
Landmarks of Revenue System Evolution

- 2000 - a “new” revenue source emerges legalizing at least a portion of the shadow economy - “own resources of budgetary entities” (2.5% of GDP)
- 2001 - the controversial Collection Law is enacted
- This law launches a wide-scale tax amnesty…

...and new tax administration procedures: 1) Kartoteka-II is eliminated; 2) new mechanisms to recover tax debts (tax notices, tax pledge, seizure of assets, right to appeal etc)
- 2002 – certain improvements are observed in the administration of excises (tolling transactions) and VAT (curbing the use of promissory notes at the border)
Composition Of Budget Revenues in 2002

- VAT: 22%
- PIT: 18%
- EPT: 14%
- Excise: 7%
- Non-Tax: 22%
- Other: 17%
VAT (in % of GDP & total revenues)
The Saga about VAT

- Ukraine’s strong external position and inflow of new claims for VAT reimbursement
- VAT administration: “butterfly” companies, energy market, inter-enterprise arrears etc.
- Politicizing VAT: Turnover Tax as a Comeback Kid
- Outstanding VAT overdue refunds
- New Tax Code & VAT reform
EPT (in % of GDP & total revenues)
PIT (in % of GDP & total revenues)
PIT Revenues (in 1997 Hrv)
Excises (in % of GDP & total revenues)
Excise Revenues (in 1997 Hrv)
Tax Expenditures

- Proliferation of tax expenditures (special treatment of certain industries and regions)
- 10 per cent of Ukraine’s territory is a FEZ now
- As of today, there are 328 types of tax expenditures…
- ...11,5% of registered taxpayers enjoy them…
- …as a result, at least one fifth of consolidated budget revenues is estimated to be foregone
Tax Expenditures

Several examples:

- constantly renewed “tax experiment” in the metallurgical industry (50% of EPT liability);
- proliferation of free economic zones and expanding the list of preferential activities to be carried there;
- special taxation regime for agriculture;
- EPT credits for enterprises investing in the construction of the housing stock for military personnel;
- New Law on innovative activities…etc…etc.. etc
Tax Expenditures: On the Rise

Number of Exemptions per Source of Revenues

- Customs Duty
- Land Tax
- CIT
- VAT

Comparison between 2001 and 2000.
The bulk of tax expenditures is concentrated in VAT and EPT (revenues foregone constitute 30% of actual revenues);

Revenues foregone in the Q1 of 2002 compared to the Q1 of 2001 increased by 15 per cent

From now on, local governments will be penalized for granting exemptions on PIT and land tax
Tax Arrears (in percent of GDP)

- High tax burden
- Narrow tax base getting still narrower
- Low compliance rate, though claimed to be on the rise (from 55 to 70%; in Hungary it is 96%)
- Shadow economy
- Attempts to improve tax administration practices: six Large Taxpayers Offices recently set up and new tax enforcement techniques introduced
- Tax arrears management needs improvement
Penalizing “good” taxpayers, forgiving deadbeats

Questionable results: Hrv 6,8 bln (3% of GDP) of net growth in new arrears since 1.01.2002.

80 % of the growth is attributable to EPT and VAT, primarily in the energy sector.
Contribution of Major Taxes to Revenues Foregone in 2002, % of total

- VAT: 37%
- EPT: 30%
- PIT: 11%
- Land Tax: 12%
- Customs: 3%
- Other: 7%
Tax Reform: Five Years of Talks

- Tax Code whereabouts in the Parliament
- A temptation to reduce tax rates and entrench existing exemptions
- Russia’s Tax Reform Contagion: Flat PIT and cuts in EPT rate
- A piecemeal approach
Budget Discipline Improved: Expenditures

Figure 4: Deviation of actual expenditures from monthly target, cumulative, 1997-2000

Source: WB
Trends in Expenditure Composition

- The share of GDP redistributed through budget expenditures fell from 50% (1994) to 37.4% (2001-2002)
- Social expenditures are gaining larger share
- Subsidies to national economy have been moving downward but the trend may be reversed
- …the most entrenched are those to the coal-industry (Donbas)
- Expenditure arrears under control
- The expenditure ratio between central and local governments: 60:40 (20,3% vs 13,7% of GDP)
Expenditures of local governments in Europe

Expenditures of local governments in European Economies (as % of GDP)

- Sweden
- Netherlands
- Ukraine
- Hungary
- France
- Albania
- Poland
- Romania
- Greece

0 5 10 15 20 25 30
Landmarks of Expenditure Evolution

1992-1994 - Populism-driven expenditure policies:
- generous (not income tested) benefits granted (prosecutors, judges, other civil servants);
- a locked-in rule to tie wages of budgetary employees to the average wage in economy
- Chornobyl payments: a burden inherited from the Soviet Union
- generous subsidies to producers
Landmarks of Expenditure Evolution

1995-1998 - An attempt to impose harder budget constraints:
  – expenditure arrears skyrocket;
  – mutual settlements distort efficiency and transparency (in some villages, pensions were paid in coffins);
  – Treasury net starts unfolding;
  – interest payments dramatically increase as the bubble T-bill market reaches its peak
Landmarks of Expenditure Evolution

- 1999-2001 - First signs of recovery:
  - a number of key spending units downsized;
  - wage increases for budgetary employees;
  - a victorious combat with expenditure arrears;
  - medium-term strategy & performance-based budgeting are introduced;
  - more efficient use of resources: meters have been installed, kids are increasingly bussed to rural schools etc);
  - new loan mechanisms for agriculture
Landmarks of Expenditure Evolution

2002

- Professional benefits reinstated;
- Two pension increases;
- Wage increases for budgetary employees (i.e. for teachers starting Febr. 1 and Sept. 1);
- A single Treasury account is in place;
- Local budgets’ revenues are handled by Treasury; PF and local expenditures will be served by Treasury later;
- Expenditure arrears re-emerged – 0.6 bln of overdue Chornobyl payments + 0.2 bln of payments to low-income families
Recent Expenditure Measures

- Moving from cash rationing to cash management (e.g. new mechanism for allocating transfers to local budgets)
- Stricter commitment control: special attention drawn to energy bills
- Bidding procedures introduced for government purchases
Recent Expenditure Measures

- Income-tested social protection transfers to be introduced
- Legally authorized expenditures exceed threefold revenue potential: Annual budget law used to suspend unfinanced mandates but...Art.48
- Achilles' heels of Ukraine’s budgetary system: lack of accountability...
- ... and weak enforcement of the existing legal budget framework
Composition of Consolidated Budget Expenditures (2002)

- **Education**: 20%
- **Health Care**: 13%
- **Other**: 20%
- **Social Protection**: 20%
- **Debt Servicing**: 6%
- **Law Enforcement**: 8%
- **Industry**: 13%
- **Health Care**: 13%
- **Education**: 20%
- **Social Protection**: 20%
Social Protection

% of GDP
% of Consol Bud Exp

Education

% of GDP
% of Consol Budg Exp

Interest Payments

![Graph showing interest payments as a percentage of GDP and consolidated budget expenditure from 1994 to 2002 with an expected value for 2002.]
Structure of Public Expenditure, in percent of GDP

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Source: MinFin, WB
Social Payments Arrears (in millions of Hrv)

- Soft budget constraints
- Exaggerated revenue optimism
- Proliferation of offsets
- Funds parceled out manually (cash rationing)
- Just nascent Treasury system
- Populism-driven expenditure policies
Actual Expenditures & Social Arrears (as per cent of GDP)

Expenditure and Arrears Deficit over the years:
- 1996: Expenditure 40.4%, Arrears 4%, Deficit -6%
- 1997: Expenditure 44.2%, Arrears 3%, Deficit -5%
- 1998: Expenditure 38.7%, Arrears 4%, Deficit -2.8%
- 1999: Expenditure 36.1%, Arrears 2%, Deficit -2.4%
- 2000: Expenditure 36.4%, Arrears 1%, Deficit -1.2%
- 2002: Expenditure 37.3%, Arrears 0.4%, Deficit -1.6%
Government Expenditure: Ukraine & OECD Countries (as % of GDP, 1999)

USA
UK
Sweden
Slovak
France
Poland
Hungary
Czech
Ukraine
Public Debt (in percent of GDP)

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<td>2003 exp</td>
<td>31.3</td>
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<td>2003 exp</td>
<td>60.1</td>
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Budget Code constraint
Achievements of 2000-2002

- New Budget Code in Place
- Multi-Year Budget Horizon
- Performance-Based Budgeting
- Formula-Based Transfer System for Local Governments
- Single Treasury Account Set Up
- Privatization Proceeds Below the Line
- Extrabudgetary Funds Eliminated (except for PF and other social funds)
- Mutual Settlements with Budget Wiped Out, Barter in the Economy Shrinking
A Closer Look at Ukraine’s Fiscal Sustainability

Looming Challenges
Baseline Scenario: Key Assumptions

- Primary surplus: at least 0.5 % of GDP starting 2003 (-0.1% in 2002 budget)
- Inflation rate – not more than 4 % throughout 2010
- Real interest rate on domestic debt - from 9 to 7 %

![Graph showing Real GDP growth from 2001 to 2010](chart.png)
Fiscal Sustainability of Ukraine: Baseline Scenario

Debt in % of GDP
Looming Vulnerabilities & Possible Offsets -1

- External vulnerability through a depreciated exchange rate and higher interest rate on external debt
- A fragile domestic economy, with higher domestic interest rates
- Other vulnerabilities, including the impact of lower economic growth and deteriorated fiscal balance
Looming Vulnerabilities & Possible Offsets -2

- Policy Developments in Energy Sector
- Pension Reform
- Costs and Benefits of EU and WTO Accession
- Political Fear of In-Depth Structural Reforms
How Realistic is a Projection of 4% Growth?

Issues Jeopardizing/Enhancing Fiscal Sustainability-1
Issues Jeopardizing/Enhancing Fiscal Sustainability-2

- External & Domestic Fragility of Existing Energy Infrastructure and Energy Supplies
  - On Agenda: Diversification of Energy Imports and More Efficient Use of Resources (Ukraine spends US $3.5 bln annually on gas purchases)
  - Depletion of Ukraine’s Energy System Infrastructure: Assets Close to Full Depreciation (52% of industrial fixes assets are depleted; 1/3 of communal plumbings are obsolete; 40% of bridges are dilapidated; at nuclear stations, 60% of equipment should already have been replaced due to its full depreciation).
Some Important Revenue Sources May Disappear

If Ukraine is Bypassed by Russia’s Oil & Gas Companies, Revenues Amounting to 1-1.5% of GDP May Be Lost
Energy Market: Possible Compensating Revenue Measures

- Odesa-Brody Oil Pipeline: Inaugurated on Aug. 19, 2001
- Capacity: 12 mln tons per year
- Possible Revenue Yield: 0.02-0.1% of GDP
Issues Jeopardizing/Enhancing Fiscal Sustainability-3

- Unfolding Pension Reform and Problems of the Current System:
- Looming Insolvency in Coming Years if the Present Solidarity System is Preserved
- High Payroll Taxes Crowd Out Taxpayers to the Shadow Economy
- Urban Population Subsidizes Pensions to Rural Retirees
- The gap between minimal and maximum pensions: up to 31 times
- Low replacement rate (32%)
The Wish-List for Pension Reform...

- Ensuring fiscal sustainability
- Increasing the replacement rate
- Stronger correlation between contributions and benefits
- Fully funded system assets as an important source of investment (But, with Ukraine’s underdeveloped stock market, where to invest?)
Retirees per Every 1,000 of Labor Force in Ukraine

“War” Kids: Time To Launch Pension Reform
Three-Pillar Pension System to Be Introduced

- A Minimal Pension Based on a Solidarity System
- Individual Saving Accounts (Mandatory)
- A Voluntary Savings Tier
- The draft Law was passed in the 1st reading on November 15, 2001 and no progress since then
Unsustainable New Pension Law? (deficit/surplus as % of GDP)
Overall Fiscal Sustainability Endangered

- Pension Fund Deficit Will Eat Up the Required Primary Balance
- Cost of Pension Reform Financing
- Increasing Taxes?
- Recourse to Borrowing?

![Chart showing Optimal Primary Balance and Pension Fund Deficit over years 2002 to 2010.](chart.png)
Concerns About the Version Voted in the 1st Reading

- Fiscally Unsustainable in The Medium and Long Run
- Current Surplus of the Pension Fund is Eaten Up
- Generous Hand-Outs for the “Sacrificed” Generation
- Institutional Bottlenecks: Pension Fund as a Collection Agency, Custodian and Investment Manager
Recent Pension Increases….

- Not only endanger the fragile Pension Fund surplus but also send it into the deficit (as expected, 0.7 per cent of GDP in 2003)
- Downsized transfers from the State budget do not match PF’s corresponding obligations further increasing the deficit
Issues Jeopardizing/Enhancing Fiscal Sustainability-4

Costs and Benefits of EU & WTO Accession

- Based Upon Experience of Vyshegrad Countries, the Cost of Accession May be Up to 3-4 % of GDP (alignment with EU and WTO procedures needs to be reached in all sectors: agriculture may be most prone to painful measures)

- But: EU Financial Assistance (Phare, SAPARD and ISPA programs) May Compensate up to 1-2% of GDP Worth of Incurred Expenses

- Higher Growth Resulting from EU-induced Reforms May Offset and Even Surpass the Residual Costs of Accession to EU and WTO
Issues Jeopardizing/Enhancing Fiscal Sustainability-5

- Need for Speeding Up Structural Reforms
- Ukraine’s Heavy Reliance on Unsophisticated Industries Inherited from the Planned Economy Hampers Its Competitiveness
- Coal Mining Sector Being the Most Troublesome Problem
Issues Jeopardizing/Enhancing Fiscal Sustainability-5

- Pandemic of AIDS in Ukraine. In UN experts opinion, additional healthcare costs and loss of labour could cost the country 1-2 per cent growth in GDP
- The latest UN report: Ukraine is the 6th in the world by the pace of AIDS proliferation
Stress-Testing Scenario

- (+) With the positive (on balance) results of Ukraine’s accession to EU & WTO,
- (-) With some non-tax revenues lost as a result on Ukraine’s lower reliance on gas transit proceeds,
- (-) With pension reform eating up the required primary balance,
- (-) With structural reforms stalled,

→ Ukraine’s primary balance may shrink by 2 percent of GDP. As a result
Stress-Testing Scenario

Ukraine's Public Debt in percent of GDP

Baseline scenario

Stress-testing scenario