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Nr. 22 März 2005

Wirtschaftswissenschaftliche Abteilung

Fiscal Policy Challenges for Ukraine[1]

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The current situation

Fiscal policy in recent years has been mostly successful in supporting macroeconomic stability in Ukraine. It has been characterised by strong revenue developments backed by impressive macroeconomic dynamics, improved budgeting, and increasing budget realism (Table 1). The fiscal position and the debt-to-GDP ratio have both improved considerably since the beginning of 2000. The fiscal position varied from a deficit of 2% of GDP in 2001 to a surplus of 0.7% in 2002. The debt to GDP ratio declined from 60% at the beginning of 2000 to 30% at the end of 2003. Interest payments are no higher than 1% of GDP and have declined as a share of consolidated fiscal expenditure.

Table 1 The consolidated (state and local) budget of Ukraine (in % of GDP)

	2000	2001	2002	2003	2004*
Revenues	26.7	25.5	28.1	28.6	27.7
Expenditures	27.3	27.4	27.3	28.8	30.4
Surplus/Deficit	–0.7	–1.9	0.7	–0.2	–2.8

Note: 2004 figures relate to the approved 2004 Budget including amendments of 17 June, 2004.

Source: Treasury statistics and IER calculations.

However, this prudent stance has been endangered by substantial pro-cyclical impulses in the course of the 2004 election year. In particular, both the recent 2004 budget amendments and the draft 2005 budget foresee unsustainable increases in social spending.

Expenditures

Ukrainian consolidated budget spending grew from 27.3% of GDP in 2000 to 30.4% of GDP, as projected in the 2004 budget, reflecting an expansionary trend made possible by favourable macroeconomic conditions and an accelerated pace of privatisation. Simultaneous improvements in the management of public funds and in the effectiveness of their use can be attributed to the approval of the Budget Code in 2001 and to an improved management of Treasury operations. The Budget Code introduced program-based expenditure execution and improved the assignment of responsibilities and of revenues between different levels of government.

However, the growing size of the government is not consistent with the objective of sustainable economic growth. Increases in the wage bill are almost entirely the consequence of minimum wage hikes. Furthermore, while sustainable growth requires investment in infrastructure and

[1] First published as Section 2.3 in: Stephan von Cramon-Taubadel et al., *Towards Higher Standards of Living. An Economic Agenda for Ukraine.* A Program of Work for the new Government of Ukraine, German Advisory Group on Economic Reforms with the Government of Ukraine and Institute for Economic Research and Policy Consulting, Kiev, December 2004.

human capital, Ukrainian public capital outlays have been directed towards building physical capital in industries in which the rationale for public funding is weak. In particular, the share of state aid in the form of capital transfers to enterprises in all capital expenditures rose from 22% in 2001 to 52% in the budget for 2004.

While the recent 2004 budget amendments and the draft 2005 budget foresee increases in social spending, the priority of fiscal expansion has over the recent years been in the least transparent functional group of expenditures, the support of 'economic activity'. The GDP share of this category increased from 3.5 to 6.5% of GDP between 2001 and 2004. Much of this reflects state support for the industries referred to above.

Problems with the composition, quality, and equity of public services provided still remain. Workable priorities and medium term planning are still absent and there is a lack of measurable targets to allow for ex post evaluation of program outcomes. An unbalanced approach to decentralisation has left local governments without adequate sources of finance.

Revenues

Sustainable development requires a tax structure founded on sound legislation and tax enforcement. Ukraine has taken steps toward reforming the Customs Code, the Personal Income Tax (PIT), and the Enterprise Profit Tax (EPT). Tax rates have been significantly reduced and there have been attempts to broaden the tax base. In particular, the EPT rate was reduced from 30% to 25%. PIT reform has initiated a shift to a flat tax rate, replaced the non-taxable minimum with tax credits for low-income taxpayers, reduced the average tax burden on wages, broadened the tax base, and eliminated some profession-based privileges. These steps – together with a better budgeting procedure and economic growth – have improved tax revenue performance.

VAT and excise taxes account for 43% of tax collections of the consolidated budget. This reliance on indirect taxes is in line with international best practice and is consistent with trade liberalisation: EPT and PIT may imply international trade distortions, while consumption taxes are neutral to the place of production. Moreover, while consumption taxes are regressive, the influence of income taxes on savings, investment decisions and growth is much more detrimental in the long run.

However, two aspects of the tax structure are of major concern. These are the level of payroll taxes and poor VAT administration that has resulted in sizeable VAT refund arrears. Payroll taxes inflate the wage bill, hence affecting employment decisions and contributing to the shadow economy. VAT arrears create a series of distortions in economic activity including an increased tax burden for enterprises in exporting sectors, and incentives for corruption. Underdeveloped credit markets make cash flow an important source of investment financing, but VAT refund arrears withdraw these funds from a firm's turnover. Also, VAT arrears distort the allocation of investment and create artificial incentives for vertical mergers.

Outlook

Official debt and deficit figures may underestimate real and contingent public liabilities. The financing of some state-guaranteed social privileges is in fact levied on enterprises: e.g., social transport privileges are only insufficiently covered by budget transfers. The total volume of unfunded but publicly guaranteed privileges was UAH 12.2 bn in 2003. Also, wage arrears are not included in public debt, although wage arrears to teachers alone amount to roughly UAH 3.5 bn.

We acknowledge the recent economic successes in Ukraine, successes based on prudent fiscal policies. In particular, we welcome the tax rate reductions, the attempts at tax base broadening, and the resulting decline in the debt to GDP ratio. At the same time, recent fiscal expansion via increases in current expenditures – especially via transfers to the population and minimum wage increases – could result in inflationary pressure. Indeed, there are indications that inflation is heating up in Ukraine, and there is a risk that beside the fiscal policy influences discussed here, monetary policy influences discussed above could exacerbate this trend and threaten macroeconomic stability in the country.

Current expenditures are re-current expenditures: expansions made while the economy is growing are, for political reasons, difficult to cut later on when growth slows. This could result in an increasing deficit and a growing debt burden in the event of a future economic downturn and/or reduction in privatisation receipts. All of the above highlight the need for further fiscal policy reforms that are consistent with sustainable growth in Ukraine.