



Comments on the Revenue Side of the 1st Draft of the Law 'On the State Budget of Ukraine for 2004'

(updated version)¹

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- While the Government plans a budget deficit of only UAH 2.4 bn, the **deficit might climb to more UAH 5.3 bn** under more conservative assumptions, and in case of implementing of the reduced 17% VAT rate, the deficit might climb up to UAH 6.6 bn.
- Macroeconomic assumptions are broadly realistic.
- The simultaneous decrease of personal income tax (PIT), enterprise profit tax (EPT), and value-added tax (VAT) represents a threat to the revenue side of the budget.
- The revenues from the new **PIT might be UAH 0.8 bn lower** than forecast.
- **Excise taxes** are assumed to be **overestimated by a magnitude of UAH 300 m.**
- Potential risks for non-tax revenue under-execution relate to the NBU profit, the dividends from state-owned enterprises, and the gas transit fee.
- Privatisation receipts (UAH 2.1 bn) are broadly realistic.

1. Assumptions

1.1. Macroeconomic Assumptions

The 4.8% real GDP growth forecasted for the budget 2004 (conservative scenario) is both realistic and well-balanced: it is better to be rather a little bit conservative than over-optimistic. According to the forecast of the Institute for Eco-

conomic Research and Policy Consulting, the real GDP will grow by 5.4% next year mainly due to positive developments in the private consumption because of personal income tax rate reduction. The role of investments is expected to be more moderate due to higher political uncertainty related to the presidential elections in 2004. The Government and the Institute forecasts on foreign trade trends coincide in as much as both expect higher growth rates of imports versus exports while maintaining a positive trade balance.

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Table 1: Macroeconomic Forecast for 2004: Cabinet of Ministers and IER.

	<i>Government forecast 2004</i>	<i>Our forecast 2004</i>
GDP growth, %	4.8	5.4
Inflation, %	6.0	7.0
Exchange rate, UAH/USD, aop*	5.42	5.42
Import growth, %	7.0	4.7
Export growth, %	5.4	4.0

* Exchange rate is taken as average of the year

Regarding the sectoral composition of economic growth, the budget draft is more optimistic concerning agriculture (9%), while less optimistic concerning industry (6%). If the present growth in manufacturing would continue, growth figures might be somewhat higher. A lot will depend on the world market trends in metals, and on domestic demand for products from machine building.

1.2. Tax legislation assumptions

1. The PIT was changed into a flat-rate 13% tax on income. Military personnel is now also obliged to pay PIT.
2. The rate of EPT is decreasing from 30% to 25%. Hence if everything else stay constant the revenues would decrease by UAH 2 bn. However, the government proposes to partially compensate the decrease by the proposal to come back to the old provisions of EPT related to depreciation allowances. A return to the old regulations implies that the 4th group of capital assets (e.g. computer devices) will be eliminated. Privileges in the metallurgical sector are eliminated, while those for publishers have been introduced.
3. The draft budget has been calculated on the basis of the old VAT rate of 20%. In the meanwhile, however, the Parliament has approved a new VAT rate of 17% (down from 20%).

2. Are the plans for the Consolidated budget revenues realistic?

2.1. Revenues from reduced tax rates

In 2003, the Verkhovna Rada (VR) has approved reductions of several important tax rates (PIT, EPT). The draft budget nevertheless assumes that there will be no shortfall in revenues. However, the following calculations show that the fiscal risks connected with these simultaneous tax cuts are tremendous. Actual tax revenues from 2002 and estimates for 2004 will be compared, with most of the figures originating from

the comment of the Government on the draft budget.

Personal Income Tax

The personal income tax (PIT) was turned into a flat-rate tax and reduced to a unified 13% of income to be paid.² The lion's share of the revenues from the PIT is supposed to go to regional and local entities, and around 5% are directed to the central budget. To offset reduced revenues from introducing the flat rate, some tax privileges have been abolished, as for instance those for employees of the military. Moreover de-shadowing effects lead to an expansion of the tax base to UAH 92.4 bn.³ The budget draft foresees tax revenues of (exactly) UAH 12500 m for 2004. The following critical issues have to be pointed out (see also table 2):

1. To offset the foregone revenues, the Government assumes that UAH 1.055 bn will be collected additionally due to a "de-shadowing" effect. This means that the tax income declared would be increased by the tax reduction by more than eight billion UAH, or roughly ten percent. This figure has been estimated as the difference of the previous *ex ante* tax estimations by the MinFin, and the actual tax revenues made by the STA.
2. The economic reasoning behind de-shadowing is that the expected benefits from hiding taxable income will become lower than the risk to be identified and punished by the authorities. Since taxes are only a minor part of the total burden on salaries (there are, more importantly, pension fund and other social contributions), employers still have a very strong incentive to hide income. Above all, this holds true for the lower salaries where there will hardly be a real reduction of the tax burden.

² See also IER policy paper S11 "Personal Income Tax Reform: How to Feed the Wolf and to Keep the Sheep", October 2002.

³ This figure does not take into account fixed tax payments by self-employed persons.

3. In addition to the de-shadowing revenue mentioned above, an expansion of revenues through an "elasticity of the tax base" of UAH 525 m is assumed. Unfortunately, the explanatory text does not explain what is meant exactly by this elasticity, and therefore makes it hard to scrutinise the assumption.
4. According to the budget code, the government should plan expenditures for equalisation transfers to local budgets out of the central budget on a formula basis. For the coming year, CMU also proposes to make amendments to the formula that implies more transfer revenues for local entities with greater claims for PIT social privilege. However, the amount of the transfers is calculated before the start of the budget period, and adjustments are not made automatically. In view of the high weight of PIT in the local fiscal revenues, the underexecution of this revenue source could lead to considerable unplanned fiscal deficits and hence disturb the fiscal stability at the local level.

Table 2: Revenues from Personal Income Tax in 2002 and 2004 (million UAH)

	2002	2003	2004		
	actual	planned	Draft Budget	Our estimate	Shortfall
PIT:					
Effective tax base	63223.3	69682.9	92450.2	86372.9	
Tax rate (for 2002/03: average tax rate)	16.8	16.7	13.0	13.0	
Revenue w/o fixed tax on entrepreneurs	10589.9	11623.1	12018.5	11228.5	
Total Revenue	10823.8	11883.1	12500.0	11710.0	-790.0

We believe that the results of the PIT revenue estimations are slightly too optimistic to serve as a base for fiscal planning in the first year of the tax reduction. To give an impression of the risks involved with this estimate, a calculation of the PIT with only half the above mentioned compensatory expansion of the declared taxable income are presented in table 2 ('Our estimate'). The consequent difference between the draft budget of the Government and the IER is almost UAH 800m.

Enterprise Profit Tax

The enterprise profit tax has been reduced from 30 % to 25 % of taxable profit. The compensatory revenues are intended to come from reduced depreciation allowances compared to the legislation valid for 2003, basically by returning to the old regulations governing depreciation allowances. The revenue losses from the reduced tax rate would thus be almost completely compensated, but there would still be a reduction of revenues in real terms compared to 2002 due to economic growth and inflation. Some open questions remain:

1. The re-introduction of the old system would eliminate the 4th group of durable assets, which had been created to cover equipment with a higher replacement speed due to technical progress, predominantly computers³ and similar devices. This step should be carefully considered in order not to re-erect impediments to productivity increases in ac-

tivities such as services and administration. The new system also envisaged an increase of all the depreciation rates by a factor of 1.6, so the government is evidently trying to compensate for the fall in the revenue due to the lower tax rate. However, it should be advised that the depreciation periods implied by the depreciation rates should be consistent with the observed life-span of investment goods.

2. In the area of enterprise profits, de-shadowing could be more likely the result of a lowered tax base than in the case of PIT, because enterprise *profits* - in contrast to salaries - are generally not subject to additional quasi-taxes. On the other hand, the scope for businesses to hide profits are higher than for employees. Thus, the absence of a de-shadowing assumption is appropriate.
3. The risk to the revenues from EPT rather stem from the fact that elections are coming up in 2004. This poses the risk that tax payments fall short of the expectations when businesses get involved in fund-raising activities.
4. The tax base of UAH 41060 m reported by the Government would increase to UAH 45320 m through the inclusion of reduced depreciation allowances and tax exemptions which are planned to be abolished. However, there are still exemptions existing, as for in-

⁴ E.g. computers will lose about 90% of their value in 10 years according to the old system, and in 4 years according to the new one.

stance for agricultural production,⁵ which are hard to justify with respect to equitable treatment of a all profits made in the National Economy.

5. Even when all exemptions were abolished, the tax base is probably underestimated, taking into account the huge tax arrears which have been accumulated by whole economic sectors (e.g. gas), and particularly in state-owned enterprises. A sober tax estimation should also try to make transparent the tax efficiency, measured by the **effective tax rate** (tax revenues / real tax base) divided by the nominal tax rate. Such an approach would remind the parliamentarians year after year again that still a lot has to be done in the area of taxation effectiveness and equity.

Despite all these rather general objections, we assume that the revenue estimate of the EPT is overall realistic, and thus make no alternative suggestions regarding revenue shortfalls.

Value-Added Tax

The VAT revenue calculation of the Government seems to be quite realistic on the assumption of a maintained statutory tax base of 20%. Legeida/Sologoub (2003) have estimated that the ratio between the effective and the statutory VAT rate is roughly 0.4 for Ukraine.⁶ The effective VAT rate calculated by the Government for 2004 implicitly comes close to this estimation, making the estimate of UAH 17 bn credible.

Most recently the VR has voted to reduce the VAT from 20% to 17%. The overcoming of the veto of the President on the draft Law that amends VAT, may cause additional risks on the

revenue side of the budget. At the same time, it was planned to offset reduced revenues by cutting exemptions on VAT. In the consideration of VAT reform, the following aspects are the most critical:

1. The calculations in table 2 clearly show that a change in VAT has a great leverage on overall tax income. Unfortunately the comments to the draft budget do not contain calculations which are based on a tax base estimation.⁷ Thus, we have taken final sales according to National Accounting estimates for 2002 and extrapolated this amount, correcting for growth and inflation assumptions for 2003 and 2004 (see table 3).
2. However, under the assumption that the basic VAT rate be cut to 17%, the VAT revenues would plummet by almost three billion UAH. However, the parliament has decided to abolish certain VAT privileges to offset the revenue losses. According to IMF estimations, the value of the VAT exemptions was UAH 5.3 bn in 2003. Of these, agriculture makes up 1.72 bn, and pharmaceutical products 1.24 bn. Allegedly, exemption for pharmaceuticals are intended to be kept, while the situation with agricultural exemptions is uncertain.

Due to the quite unclear situation about what will happen with the exemptions, our calculations assume that the VR will not manage to reduce the exemptions by more than 50%, and that only half of these potential revenues will be actually collected due to the notorious problems with VAT collection in Ukraine. This would mean that the revenue from VAT would be reduced by UAH 1.34 bn.

	2002	2003	2004			Shortfall
	actual	planned	Draft Budget	Our estimate	Our estimate	
VAT:						
Gross tax base	168750.0	188774.4	211861.1	211861.1	211861.1	
Nominal tax rate	20.0	20.0	20.0	20.0	17.0	
Effective tax rate	8.1	7.2	8.1	8.0	6.8	
Revenue with new effective tax rate					14406.6	
Revenue plus abolished exemptions	13747.0	13652.0	17070.0	16948.9	15727.6	-1342.4

⁵ See also policy paper S4 "Taxation and Ukrainian Agriculture after 2004", IER, July 2002.

⁶ Nina Legeida, Dimitry Sologoub: *Modelling VAT Revenues in a Transition Economy: The Case of Ukraine*. Working Paper No. 22, IER, Kyiv, July 2003

⁷ In the case of VAT, the discrepancy between the real tax base (final sales according to the National Accounting) and the effective tax base is probably very large.

Excise taxes

The revenue from the excise taxes (ET) for the year of 2004 is planned at the level of UAH 6.034 bn, which is 956 m or 18.8% higher than the amount expected for 2003. The government plans to obtain this difference through retaining the temporary excise rate on the mixed-type petrol (UAH 300 m), increasing the rates of excise taxation of tobacco and wine products, and introducing an ad valorem rate of taxing tobacco products sales (UAH 275 m). Hence, the share of the excise taxes in the total tax revenue (consolidated budget) is planned to increase from 9.7% (2003) to nearly 11% in 2004. The following comments seem to be necessary:

1. Apparently, the excise tax could be envisaged as another compensatory item for the losses to the tax revenue as incurred by the tax reform, but it actually provides such compensation mainly for the central part of the consolidated budget, and not for the local budgets.
2. It is likely that the increased tax rates will lead to decreased consumption of the consumer goods affected, which dampens the effective increase of revenues.
3. It is also fair to assume that the increased tax rates will lead to increased tax avoidance through smuggling etc.

It is harder to determine the real tax revenues as compared to the potential ones, but it may be reasonable to assume that the increases in tax revenue will be only 70 % of those actually projected, i.e. UAH 670 m. The increase in excise tax revenue would thus be UAH 286 m lower than estimated by the Government.

2.2. Risks concerning non-tax revenues

NBU transfers: it is unclear whether the NBU will be able to transfer UAH 500 m as a part of its profit to the budget 2004, because the NBU forecasts zero profit. The issue is discussed again every year, with high expectations from the political side, which frequently have to be lowered down during the budget negotiation process. At best, the NBU profits should be considered as a windfall profit, but not enter the budget planning from the start.⁸

Dividends: The Government plans to earn UAH 300 m from dividends accrued on state shares in joint companies in 2004. That seems rather unrealistic looking at the execution of this revenue item in 2001, 2002, and the preliminary results for

2003.⁹ This year, for 6 months, the Cabinet of Ministers got only 6% from this revenue item. Therefore, we would rather consider an amount of UAH 100 m as realistic.

Natural gas transit fee (from 'Naftogaz Ukrainy'): The amount planned to be obtained on this revenue item in 2004 is identical to the plan of 2002 and 2003 (UAH 2240 m). But the actual revenues from this position have been only half of those expected.¹⁰ Thus, we can expect that for the whole year the revenues may reach about UAH 1.2 bn and the fiscal gap may be about UAH 1.1 bn.

Privatisation: An amount of privatisation receipts of UAH 2.1 bn is estimated by the Government, which at least does not seem to be an over-estimation.

3. Conclusions

The analysis conducted so far has shown that the consolidated budget revenues of Ukraine for the year is prone to some risks on the revenue side, which are summarised in the following table 4.

The most important sources of risk are the reduced Personal Income Tax and the gas transit fees. The resulting fiscal gap of UAH 2.9 bn would add to the deficit of UAH 2.37 bn already estimated by the Government. The overall deficit of then roughly UAH 5.3 bn would represent nearly 2 percent of GDP.¹¹ Thanks to efforts to broaden the tax base and eliminate privileges, the gross revenue loss was made smaller than it would have been without such cuts. Nevertheless, the consolidated deficit in 2004 would be much higher as compared to 2003 deficit (0.9 % projected). Ukraine should be prepared to face the need of higher internal and external borrowing to cover the deficit than initially planned. The implementation of the reduced VAT rate might make things even worse by increasing the total fiscal gap up to UAH 4.2bn, hence in this case, the total fiscal deficit could reach UAH 6.6bn or 2.4% of GDP.

⁹ See also policy paper T5 "State-Owned Enterprises in Ukraine: How the Profit Should be Distributed", July 2003.

¹⁰ See also the recent IER policy papers S17, "The Ukrainian – Russian Gas Consortium (Kishiniv, October 2002) – A Comment – ", October 2002; and S21 "The EU Natural Gas Market and Ukrainian Policy on Russian Natural Gas Transit – Will Ukraine be a Gas Bridge to Europe?", January 2003; and S33 "Is the Ukrainian – Russian Gas Consortium in the Interest of Ukraine?", April 2003.

¹¹ In the EURO area, a deficit of 3 % of GDP is considered to threaten fiscal and macro-economic stability.

⁸ On the allocation of NBU profits, see IER policy paper S13 "NBU-Profit: Who should get how much?", October 2002.

Table 4: Summary of possible revenue risks for the 2004 budget (UAH million)

	<i>Government</i>	<i>Our estimate</i>	<i>Difference</i>
Personal Income Tax	12500	11710	-790
Excise taxes	6034	5748	-286
National Bank profits	500	0	-500
Dividends	300	100	-200
Gas transit fee	2243	1120	-1123
Total fiscal gap			-2899
plus planned deficit			-2369
Total deficit estimated			-5268
VAT	17070	15728*	-1342
Total fiscal gap			-4241
Total fiscal deficit			-6610

* our estimate of the VAT revenues under 17% tax rate

We admit that this is a quite conservative scenario, but it is supposed to indicate at the risks which are involved with the revenue side of the draft budget for 2004. Generally, Ukraine's growing economy should make it relatively easy for the

legislative powers to ensure fiscal stability for the near future. The all-at-once tax cuts foreseen for 2004, however, would perhaps require a more cautious approach to budget planning than the 1st draft reveals.

Annex

Table 5: Budget revenues

	<i>2003 planned</i>	<i>2004 planned</i>
CENTRAL BUDGET		
Tax revenues	34397	38595
Personal Income Tax	0	636
Enterprise Profit Tax	11668	11668
Value-Added Tax	13652	17070
Excise tax	4884	5964
Non-tax revenues	15623	16533
NBU profits	1255	500
Dividends accrued on state shares in joint companies	310	300
Rent payment for transit of gas	2243	2243
Funds from energy market	903	1280
Own funds of budgetary organizations	4684	5383
Official transfers	2383	2249
Other revenues	826	843
Total revenues	53229	58220
Privatization receipts	2153	2137
Local budgets		
Tax revenues	17364	16616
Personal Income Tax	12525	11863
Local taxes	590	480
Non-tax revenues	1802	1938
Other revenues	1194	1031
Total revenues (w/o accounting for intergovernmental transfers)	20360	19585
Transfers from the central budget	11266	12493
Total revenues	31626	32078
CONSOLIDATED BUDGET	71206	75556

* - Plan takes into account the amendments made to the Law till this moment