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Fiscal loosening during the 2004 Presidential election campaign: three steps towards instability [1]

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The current paper analyses the draft budget for 2005
submitted to the Verkhovna Rada on 14 September 2004.

Summary and Recommendations

The 2004 Presidential election campaign has left a deep effect on the budget process 2004-2005, which came about in three steps: (1) In the course of amending the 2004 budget, privatization receipts were misused to finance higher minimum pension payments, raising net public liabilities in the future. (2) The draft budget 2005 envisages further increases in transfers to the population and in sector-specific state aid. If all liabilities are taken into account, the resulting deficit of the central budget will reach 3% of GDP in 2005, provided there is no correction on the expenditure or revenue side. This is extremely inappropriate in a high growth environment as Ukraine's. (3) Fulfilling all social promises made by presidential candidates during the campaign will create an additional fiscal gap of some 1.9% of GDP in 2005. Besides, there are high risks on the revenue side that might result in an additional fiscal gap up to 3% of GDP, and doubtful privatization receipts that may increase the need for external borrowing, raising serious fiscal sustainability concerns.

The ensuing fiscal instability would negatively affect the so far excellent overall macroeconomic situation. Rapid increases of transfers to the population will contribute to price pressure on the final goods market. There is thus an urgent need to implement corrective measures, which, however, are subject to various, mostly political constraints. As we consider the political costs of renegotiating the 2004 budget amendments to be too high to be taken on, we rather propose:

- not to incorporate additional social promises into the draft budget 2005, such as those made by the presidential candidates during the 2004 campaign;
- to restrict state aid to coal mining and agriculture;
- to continue to broaden the tax base by cutting tax privileges.

While all this will help to decrease the fiscal imbalances outlined above, it will not be sufficient to prevent price pressure from the budget. Solving the fiscal and macroeconomic imbalances brought about during the election campaign thus calls for a joint fiscal and monetary policy response.

[1] Originally written for German Advisory Group / Institute for Economic Research and Policy Consulting, Kyiv, December 2004.

1. The 2004 presidential elections and fiscal loosening

The 2004 presidential election campaign had a heavy effect on the budget process 2004–2005. This came about in three steps of expenditures expansion, while additional risks loom on the revenue side.

1. In the course of amending the 2004 budget, higher than expected receipts from privatization were misused to finance increases in recurrent public expenditures. These amendments increased the projected 2004 central budget expenditures from 19.2% to 23.5% GDP (columns A and B in Table 1). In particular, in September 2004 the government approved payments of additional social aid to pensioners, whose monthly pensions are lower than UAH 284. In effect, this amounts to an increase of the minimum nominal pension payment from UAH 132.8 to UAH 284 per month,[2] and means higher payments to nearly 80% of all pensioners.

   During 2004, this requires an additional monthly financing of UAH 1 bn. We expect a continuation of this practice in the future also for political reasons. As pensions in Ukraine are indexed to inflation and wage growth, the need for social aid to cover the gap between low pensions and the minimum nominal monthly pension payment fixed at the level of UAH 284 will decline over time. Still, net public liabilities have been considerably increased for 2005 and beyond, when the government must find other sources for financing the additional bill once privatization receipts are fully used.

2. The draft budget 2005[3] continues this expansionary path and envisages further increases in social welfare payments, pension payments, wage payments of budget sector employees, and state aid. The main items are various social benefits to pensioners and compensation for losses of Sberbank depositors from the early 1990s. (for details, see Table A1 in the Appendix). What is more, the 2005 draft budget does so far not incorporate the increased minimum pension payment liabilities taken on by the government in September 2004. If these liabilities are taken into account (column D in Table 1), and provided there is no correction on the revenue and/or the expenditure side, the resulting central government fiscal deficit will reach 3% of GDP in 2005.

   At the same time, the draft budget 2005 contains tax revenue risks associated with inconsistencies with other legislative provisions and administrative difficulties. In particular, the budget is drafted on the assumption that tax privileges terminated by the 2004 State Budget Law will not be recovered in 2005. However, there are so far no legislative provisions to ensure this, and the consequent loss in revenues might reach up to 2.75% of GDP.[4] Also, the budget is based on a 20% rate of value added tax (VAT), which provides almost one third of consolidated fiscal revenues. If the provisions of the Budget Resolution for 2005[5] concerning the VAT rate reduction to 17% are applied, the revenue loss might equal UAH 1 bn (0.2% of GDP).[6] An additional risk relates to personal income tax (PIT) revenues, the share of which is about 13% in consolidated fiscal revenues. The increase of the subsistence minimum, adopted by the Verkhovna Rada in October 2004, which defines the number of people eligible for social privilege, might cause a reduction in net PIT revenues. Furthermore, administrative difficulties may cause an additional gap in tobacco excise collection if the minimum amount of ad-valorem excise, applied under the State Budget 2004 law, will not be re-introduced for 2005.

3. A further expansion of public expenditures, e.g. via incorporating the additional social promises made by presidential candidates during the 2004 campaign, would pose an even higher danger for the fiscal and macroeconomic stability. Fulfilling these social promises would again raise re-current expenditures, creating an additional fiscal gap of some 1.9% of GDP in 2005.

This policy is extremely inappropriate in a high growth environment such as Ukraine's and the resulting fiscal instability will negatively affect the so far excellent macroeconomic situation.

[2] UAH 284 is the 2004 monthly subsistence minimum for persons unable to work.

[3] In this paper, the Draft Budget Law 2005 refers to the version submitted to the Verkhovna Rada on 14 September, 2004.

[4] IMF estimate.

[5] The Budget Resolution was adopted by the Verkhovna Rada in June 2004.

[6] According to Ministry of Finance estimates.

Table 1: **Fiscal expansion: selected central fiscal expenditure items in 2004 and 2005**
(% of GDP*)

	A	B	C	D	E	D + E
	2004 state budget law[1]	2004 amended state budget law[2]	2005 draft budget[3]	2005 draft budget including obligations from the 2004 budget amendments	Estimate of additional social promises 5	
Transfers to the Pension Fund	0.7	1.3	1.3	3.0[4]	0.5	3.5
Compensation of savings of Oschadbank	0.1	0.1	1.6	1.6	-	1.6
Transfers to local budgets for social welfare and privileges to population	1.5	1.5	1.5	1.5	0.2	1.7
State aid (Agriculture, coal)	1.6	1.8	2.2	2.2	-	2.2
Wages	3.9	4.2	4.4	4.4	1.2	5.6
Sum	**7.8**	**9.1**	**11.0**	**12.7**	**1.9**	14.6
N.B.: Total central budget expenditures	**19.2**	**23.5**	**23.0**	**24.7**	**1.9**	**26.6**
Central fiscal deficit[6]	**1.8**	**2.4**	**1.3**	**3.0**		**4.9**

* For the table we used IER nominal GDP forecasts: UAH 334 bn in 2004, UAH 404 bn in 2005.
1 Source: The Law on State Budget for 2004, N1344-IV, 27 November, 2003.
2 Source: The Law on State Budget 2004 with amendments from June 2004 (the Law N1801-IV), The Resolution of the Cabinet of Ministers N1335, 8 October, 2004.
3 Source: The Draft Law on State Budget for 2005, N6000.
4 Including UAH 7 bn, needed to finance social aid to pensioners introduced in September 2004.
5 Estimate of the minimum cost of increasing social expenditures proposed on average by the two leading Presidential candidates before November 1[st]; this includes increases of minimum pensions and the minimum wage to the level of the subsistence minimum for 2005 and higher social welfare payments to the population. Source: own estimates.
6 Without correction on the revenue and/or the expenditure side.

2. Political promises and risks

2.1. Pension payments

The Pension Fund budget is planned to be increased by around UAH 10 bn up to UAH 43.6 bn in 2005. So far, this includes a State Budget transfer of UAH 5.1 bn, UAH 2.6 bn higher than in 2004.[7] However, the 2005 Pension Fund budget had been drafted before the CMU introduced additional social aid to pensioners in September 2004. Hence, it does not foresee the funds needed to finance this social aid. Since the Pension Fund has limited own sources of revenues, and as the State Budget is the ultimate source of financing its deficit, this will have to be financed at the expense of state budget money. Due to pension increases, the number of pensioners eligible for social aid will next year be lower than in 2004. Nevertheless, in order to cover all liabilities, the Pension Fund's budget will have to amount to at least UAH 50 bn. Consequently, its approximate deficit, and respective increase of the State budget transfer, amounts to about UAH 7 bn, which increases 2005 central government expenditures by 1.7% of GDP (see Table 1, column D).

2.2. State aid expansion

One of the priorities of the recent fiscal expansion is state support to commercial sectors, in particular to agriculture and coal mining. There is little economic rationale for executing these expenditures at the expense of public budget funds.
Agriculture: The draft budget for 2005 almost doubles state support to agriculture, pushing it up to 7.5 % of total central budget expenditures. Ukraine's intended WTO accession poses several limits on state support of the agricultural sector. In particular, this concerns the reduction of 'Amber box' measures of state aid in the form of subsidies, tax privileges, cheap credits, intervention operations with grain, etc. However, the 2005 draft budget envisages almost doubling funds for such measures to UAH 3.6 bn. By contrast, the financing of 'Green Box' measures (permitted by WTO agreements) for the development of rural areas, R&D, education, pest and crop control, etc. is increased by only 1.5 times in comparison

7 This comparison does not yet take into account the additional transfer provided in 2004 for financing social aid introduced in September 2004. If taken into account the transfer is increased by UAH 0.5 bn.

to 2004 to UAH 2 bn. Hence, the perceived increase in state aid to agriculture is not compatible with the targeted WTO accession, sustainable development objectives, and an efficient use of public funds.

Coal mining: State support of coal mining is summarized in the 'Ukrainian Coal' program approved by the government in 2001. To finance this program, the draft budget for 2005 increases expenditures by UAH 0.5 bn (Table 2). Funds assigned for subsidizing current costs of operation are planned to be even higher than envisaged by the 'Ukrainian Coal' program, at the cost of capital transfers. As evidence from the past suggests, state aid to coal mining will most probably be increased by parliament during the budget process.

Table 2: **Central fiscal expenditures for coal mining support** (UAH bn)

	Program "Ukrainian Coal" for 2005	*State budget 2004 with amendments*	*Draft budget 2005*
Current cost subsidies	0.5	0.7	0.8
Capital transfers	2.3	1.5	1.8
Restructuring	0.3	0.8	0.8
Total	**3.3**	**2.9**	**3.4**

Sources: Law on State budget 2004 with latest amendments, draft budget for 2005, state program "Ukrainian Coal" from 19.09.2001 #1205.

3. The real costs of fiscal expansion: loss of fiscal stability and inflationary pressure

3.1. Loss of fiscal stability

The expansionary nature of the 2004 budget amendments and the draft budget for 2005, in conjunction with further election promises by politicians, threaten fiscal stability and even sustainability. The problem is exacerbated in 2005 by risks related to the revenue side, exhausted privatization receipts, and limited sources of borrowing.

Privatization: Privatization prospects for 2005 are highly uncertain. The Draft Budget 2005 foresees privatization receipts of about UAH 4 bn. The principal part of this is to come from the sale of 42.86% of national fixed line operator Ukrtelecom (some UAH 4 bn is expected) and 94.54% of the Odessa portside chemical factory (more than UAH 1 bn expected), the sale of which were suspended before the presidential elections. While the privatization of Ukrtelecom in the next year is uncertain, the Government has already approved a moratorium on the privatization of the Odessa portside factory.

Borrowing: External borrowing will remain the only source of financing the budget deficit due to the limited domestic demand for bonds. Borrowing opportunities for Ukraine on international capital markets have increased as the sovereign credit rating has been repeatedly upgraded and international reserves have steadily grown in 2004. Total nominal state debt stood at USD 14.5 bn at the end of 2003 and is expected to reach USD 15.5 bn at the end of 2004. It is to be increased further during 2005 to USD 15.6 bn according to the 2005 draft budget thus growing by more than 7.6% since the year 2003. Without even taking account of the revenue risks described above, the worst case scenario on the expenditure side described in Table 1 (Column D+E) would drive up state debt to about USD 19.2 bn (25.1% of GDP). Repeated deficit financing at that order of magnitude will not only hamper the fiscal position but also endanger external stability.

However, it would be extremely unwise to utilize the opportunity for state borrowing at the time of economic growth rather than to preserve it for a time where there's less opportunities to tax a growing economy. The policy of expanding state debt even in times of economic boom is unsustainable in the long run and is represents a dangerous attitude towards state finances. Pursuing state borrowing when revenues are relatively high is a short-sighted practice as it negatively affects the state's borrowing chances later in the business cycle when such borrowing is crucial for balancing the budget and stimulating the economy.

3.2. Inflationary pressure

The Ukrainian economy is growing at an impressive rate of 13% a year in 2004 and is expected to show 8% growth in 2005. This naturally puts upward pressure on prices, as the economy operates close to full capacity. Price responses also depend on the ability of producers to expand as a reaction to higher demand. Unfortunately, recent state interventions in price formation certainly discourage producers from investing and expanding production. In this situation, fiscal imbalances will soon spill over to create other macroeconomic imbalances: high transfers to the population will add to price pressure, especially if these transfers are increased at discretion rather than according to a foreseeable schedule.

Tentative IER estimates, based on Derzhkomstat statistics, show that the market size for agricultural and food-industry products consumed by Ukrainian households constitutes some UAH 4-5 bn per month,[8] while the amount of additional payments from the fiscal expansion is about UAH 1 bn per month only for pensioners. Assuming that half of this is directed towards purchases of food products, the resulting increase in demand amounts to 11-14%. Unless supported by expanded production, which is unlikely as pointed out above, this additional demand will turn into price increases. Given the generally low elasticity of demand for food products, these price increases can be expected to be quite significant. However, due to temporary delays of pension payments and social aid for pensioners payments, caused by political situation, the pressure on prices has lowered recently. Consequently, the IER forecasts quite high 9.1% yoy CPI change for 2005[9] in comparison to 7% assumed in the draft budget.

Price increases may over the medium term translate into continuous inflation if they trigger off rising wages, which in turn again result in higher prices, i.e. in a price-wage spiral. This danger is especially immanent if such a price-wage spiral is accommodated by monetary policy. This will be very much of an issue after the end of this year, when markets expect a softening of the fixed exchange rate policy of recent years, and thus a higher autonomy of the central bank over the money supply.

[8] This market size estimate for agricultural and food-industry products consumed by Ukrainian households results from a combination of two approaches. (1) Approximate the size of the market on the basis of final households consumption from national accounts statistics. (2) Estimate size using output in agriculture and food industry in 2004 and the output shares of these sectors consumed by households as provided in the input-output table for 2002.

[9] Price trends observed in November 2004 have been in line with IER forecasts: inflation was 11.3% yoy. In December 2004 the monthly consumer price inflation is forecast at 2%. It is expected that current uncertainties on the durable goods market will have a very minor impact on the price index since the share of these products in the CPI bundle is low.

4. Solutions and (political) constraints

The 2005 central fiscal deficit might significantly exceed the 1.3% of GDP currently projected by the 2005 draft budget. Accounting for the recurrent obligations from the 2004 budget amendment and incorporating the social promises of presidential candidates (Table 1), the deficit to GDP ratio might even be in excess of 5%, if some risks on the revenue side (section 3.1) materialize.

Ways out of this situation are subject to political, fiscal and macroeconomic constraints. A small part of the problem might be ‘solved’ by inflation that might be higher than government estimates. This will both reduce the real value of increased social transfers to the population and also most probably cause higher increases in government revenues than in its expenditures, taking Ukrainian evidence into account. However, this will by no means be sufficient to cover the gap outlined in the worst case scenario described above. Accepting and financing this higher deficit would require:

- Increasing privatization receipts: however, this source of windfall revenues is already exhausted.
- Increasing borrowing: we strongly recommend to refrain from a policy of expanding state debt during times of high economic growth, which is unsustainable in the long run and represents a most dangerous attitude towards public finances.

There is thus a clear-cut need to implement corrective measures, i.e. expenditure cuts and/or revenue increases. However, all of these options are subject to constraints.

1. Cut expenditures

- Cancel social aid to pensioners: this will increase social and political pressure.

Social aid to pensioners is provided to around 11 m people, i.e. to about one fourth of the population. Cutting back on social aid would inevitably provoke social and political problems. Moreover, a selective social expenditure cut is difficult to explain. However, the government should *not incorporate additional political promises*, such as those made by the candidates during the Presidential campaign 2004 (Table 1, column E), into the draft budget 2005.

- Reduce state aid to some sectors: in the short run, full elimination of state aid will cause social problems.

Nevertheless, the government should revise its policy on state aid. Sticking to the nominal amount of finance envisaged by the “Ukrainian Coal” program and not increasing state support to agriculture directly out of the budget, as compared to 2004, might free resources of some 1% of GDP in the 2005 budget.

2. Increase revenues

- Increase tax rates: this is incompatible with the tax reform path.
- Cancel tax privileges, thus expanding the tax base: this will also increase government’s VAT payments, i.e. the net budgetary effect is smaller than appears.

The most promising source of additional revenues is the elimination of tax privileges. According to Ministry of Finance estimates, the total amount of revenues lost due to tax privileges is some UAH 8.8 bn (or 2.1% of GDP) in 2004. It is thus worth to continue the course of cutting tax privileges, with the exception of canceling already existing special economic zones. In particular we recommend that privileges to car producers and to the publishing sector be cut. According to Ministry of Finance estimates, this will provide additional resources of UAH 1 bn and UAH 1.3 bn, respectively.

While this will help decrease the fiscal imbalances outlined above, it will not be sufficient to prevent a price pressure effect from the budget. To counter this will, in turn, *require a more active anti-inflationary policy stance from the NBU* than has been necessary in recent years. In sum, solving the fiscal and macroeconomic imbalances brought about during the election campaign calls for a *joint fiscal and monetary policy response*.

PostScript: Second version of the draft budget for 2005

The new version of the draft budget for 2005 that was submitted to Verkhovna Rada on 14 December 2004. The new version incorporates some improvements in comparison to the previous version. For instance, it does not include additional social promises, some social expenditures were cut. Furthermore, it provides additional funds to the Pension fund. In addition, the state support of agricultural sector is reduced significantly. At the same time, it heritages several negative features from the previous version of the draft budget for 2004. These issues are beyond the scope of this paper, and may be covered in the next work.

Appendix

Table A1: **State budget expenditures for social protection and welfare according to the Draft Budget 2005**

Title of article	2005 m UAH	Change in 2005 as compared to 2004	
		m UAH	%
Social protection and social provision	***17,292.3***	***8,934.1***	***106.9***
Social protection of persons unable to work	405.4	50.5	14.2
Social protection of pensioners	7,046.9	2,649.1	54.6
Pensions to persons directly affected by the Chornobyl catastrophe or living in the radioactively polluted areas	470.4	110.1	30.5
Compensation of pensions, [1] additional payments established by different state pension programs, state aid to people not eligible for pensions and disabled people	1,820.2	559.2	44.3
Pensions to military personnel	3,535.4	900.0	34.2
Transfer to the Pension Fund for pensions to retired employees that worked underground *	710.0		
Contributions to the non-state pension fund of budgetary employees *	400.0		
Contributions for compulsory state pension insurance paid for some groups of population *	110.9		
Social protection of veterans of war and work	284.8	140.8	97.8
Social protection of families	149.0	67.9	83.7
Aid for providing dwelling	872.2	198.9	29.5
Social protection of other groups of the population	7,865.2	5,762.9	274.1
Gradual compensation of savings of Oschadbank	6,500.0	6,000.0	1,200.0
Transfers to local budget for social programs	***6,157.1***	***1,067.0***	***21.0***
Cash assistance to low-income families and families with children	2,006.1	211.5	11.8
In-kind privileges (utility, energy, communication services, etc.)	4,150.9	855.5	26.0
N.B.: Total central fiscal expenditures	92,663.9	14,087.7	*17.9*

* New program.

[1] Transfer to the pension fund to replace contributions that should be made by agricultural producers according to the Pension Law.