Budget consolidation in Ukraine

Introduction

Budget consolidation is a very important issue for Ukraine. After events such as the toppling of Ukrainian president Viktor Yanukovych following the Revolution of Dignity, the annexation of Crimea and a subsequent military confrontation with Russia, the Ukrainian economy found itself in an extremely difficult condition. It should be taken into account that before the aforementioned factors came into play, Ukraine had already been experiencing grave problems, such as economic stagnation dragging on since 2012, the lack of reforms, pervasive corruption in the executive and judicial branches, an unbalanced external government borrowing policy, etc. These factors had a negative impact on Ukraine´s budget, contributed to a significant reduction in the budget deficit and domestic debt as well as worsened the possibility to generate profits and ensure budget revenues.

Despite some progress the Ukrainian government made with regard to its obligations to bring Ukrainian legislation into line with EU laws, the budget legislation in Ukraine has not been reformed thus far. Ukrainian legislation does not provide for budget consolidation in EU terms. However, Ukrainian legislation provides for some measures to be taken to stabilize the budget, ensure sound public finances, reduce budget spending and increase budget revenues. An important aspect of institutional and technical capabilities to consolidate finances is Ukraine's cooperation with the IMF.

In 2014, Ukraine and the IMF signed a Memorandum which provided for gradual implementation of budget consolidation through optimizing budget spending to reduce imbalances as well as reduce the number of government employees, strengthen public trust and facilitate economic growth.

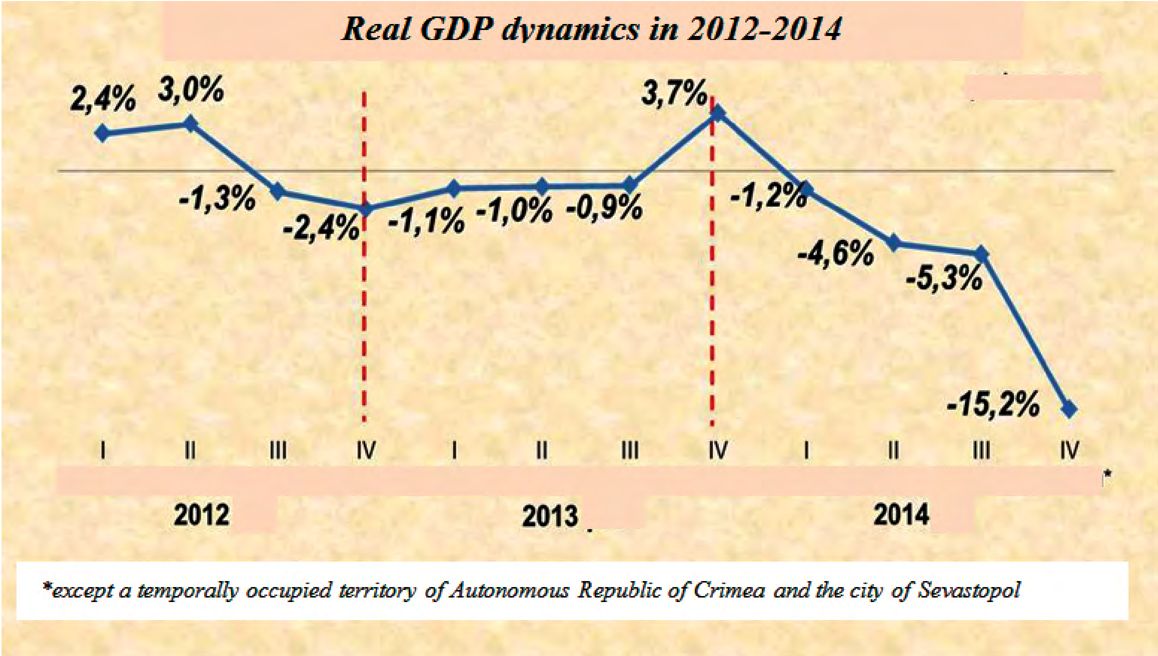
The main economic tendencies. For the past years, the Ukrainian economy has been influenced by a broad spectrum of negative factors, namely the annexation of Crimea, hostilities in Eastern Ukraine, growing public anxiety due to a sharp devaluation of the national currency, rapid inflation, the worsening of the investment climate, a drop in GDP, increased defense expenditures. The aforementioned factors had an adverse impact on the state budget. In addition, as of today, the Ukrainian economy suffers from significant structural imbalances, and is in need of reforms.

The budget and tax policies play a key role in stabilization of the economy. Fiscal consolidation appears, in a way, an anti-crisis strategy for tax and budget policies, which are being implemented within the context of overcoming the effects of the global financial crisis. The implementation of these policies allows for reducing the negative impact of the financial crisis on public finances and improving the general development of the national economy in the long-term perspective.

For Ukraine, the main goal of fiscal consolidation programs is to ensure greater sustainability of public finances (eliminating imbalances in public finances, strengthening state banks, limiting quasi-fiscal operations, improving the financial position of state funds as well as state non-financial corporations).

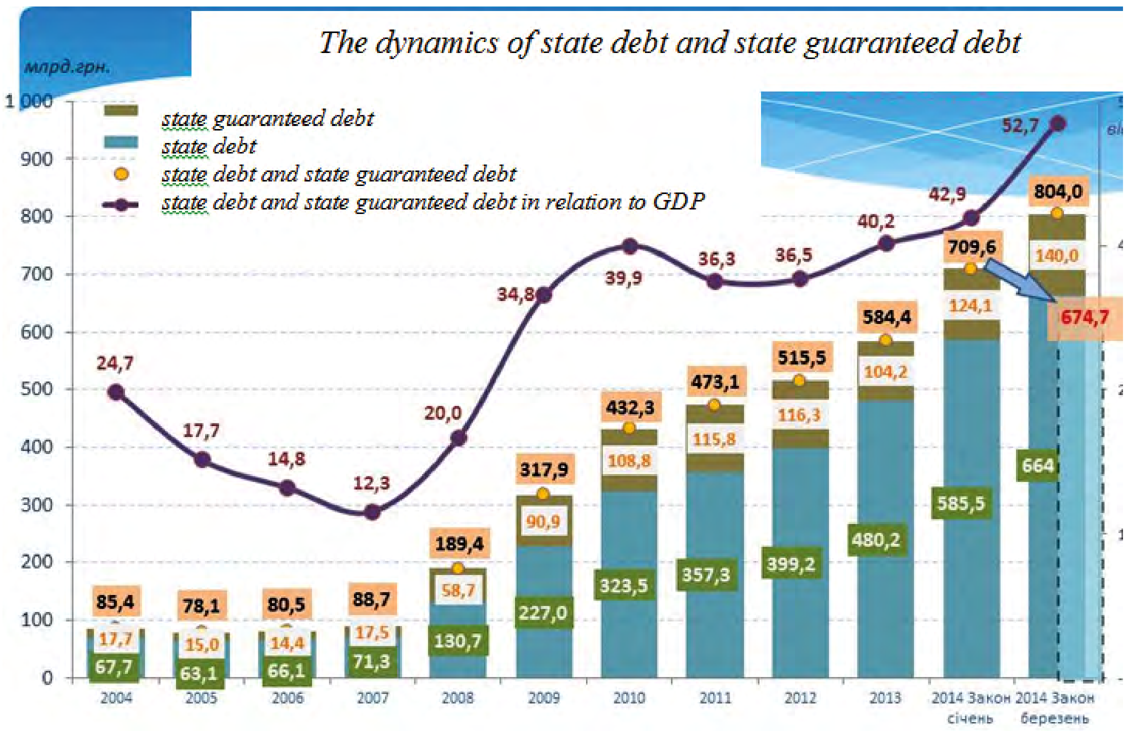
The economic situation reflected in the state budget has been influenced by the following factors:

- hostilities in Donbas, which led to a drop in economic output in the region, the worsening of conditions for external financing, increased budget defense expenditures as well as increased budget spending on the infrastructure damaged or destroyed as a result of hostilities in Donbas;
- the increased debt burden on the state budget due to the necessity to cover the deficit and debts of the national joint-stock company "Naftogaz of Ukraine", amassed over the past years;
- a significant increase in the deficit of the Pension Fund, which puts an additional burden on the state budget;
- the exhaustion of FX reserves, which makes it difficult for the National Bank to use interventions as instruments for constraining growing public demand for foreign currency caused by public anxiety and speculative attacks.



Beginning in 2012, a fall in industrial output has increased in the current year owing to a suspension of many businesses in the Luhansk and Donetsk regions as well as the loss of access to the Russian market. Ukraine's dependence on energy imports and the absence of alternative energy sources to the Russian gas will make enterprises introduce tough austerity measures, which will have a great impact on the volume of industrial production.

Problems with the execution of state obligations make the Ukrainian government borrow from internal and external lenders, with public borrowing increasing every year. Beginning from 2011, Ukraine's state debt and state guaranteed debt increased from 36.3% to 52.7%, according to the database of the Ministry of Finance of Ukraine. However, according to different estimates, these figures do not quite reflect the real situation: in 2014, state debt and state guaranteed debt amounted to more than 62% of GDP.



Ukrainian budget and tax system is characterized by a significant re-distribution through GDP According to various estimates, it amounts to 55% of GDP. Under Ukrainian budget legislation, the budget system includes state and local budgets. An aggregate of all budgets (the total number of budgets in Ukraine is more than 12 000) comprising the budget system makes the consolidated budget. The consolidated budget is used for the state regulation of the economic and social development.

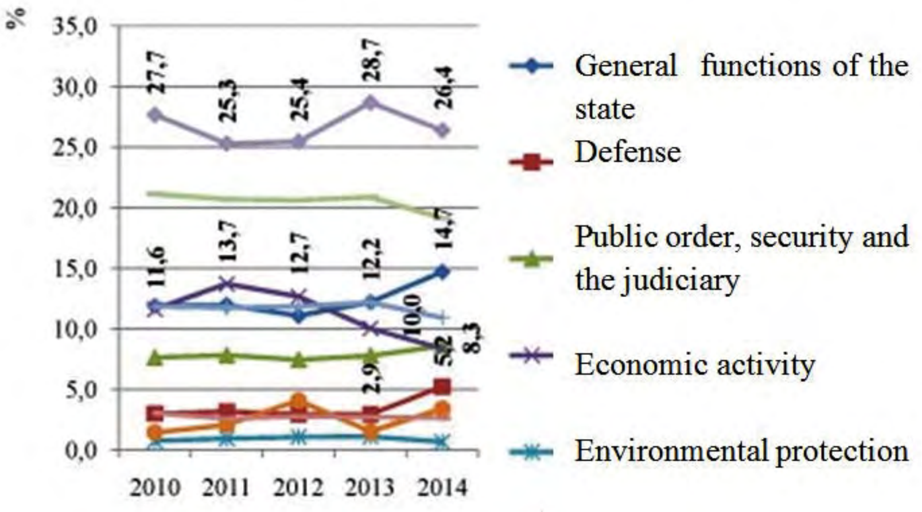
The major sources of budget revenues are as follows:

- value added tax charged on goods and services made and provided in Ukraine:
- value added tax charged on imported goods and services;
- corporate tax;
- excise tax;
- rent on subsoil assets;
- import duty.

In 2014, a share of consolidated budget revenues in GDP amounted to 29.1% (against 29.0 % in 2013), indicating the absence of important changes despite a gradual reduction in corporate tax rates as well as reduction in tax preferences. The excess burden of taxation adversely affects the investment climate in Ukraine in particular and the economic development in general.

In 2014, a share of consolidated budget expenditures in GDP amounted to 33.4 % (in 2013, the figure was 34.5 %), indicating the preservation of a high level of state obligations in connection with social services.

The dynamics of consolidated budget and state budget expenditures in 2010-2014, %



The main problems with the financing of consolidated and state budgets are as follows:

- **Consolidated budget expenditures continue to increase**, which resulted from the increase in spending on debt service, including due to the hryvnia depreciation, as well as spending on defense, public order, security and the judiciary. At the same time, spending on wages and social security has reduced.
- **The Pension Fund of Ukraine needs significant contributions from the state budget** – budget spending on Pension Fund transfer payments continues to increase. In 2014, the Pension Fund received UAH 75813.9 million, including to cover a Pension Fund deficit to be able to pay pensions worth UAH 14683.2 million, which is 32.5 % (UAH 7080.6 million) less than in the previous year.
- **A share of official transfer payments in local budgets has increased over the last ten years**. In 2002, it was 31.2 %, in 2010 - 49.5 %, in 2013 – 52.4 %, and in 2014 – 56.4 %, indicating increasing budget

centralization and inability of local authorities to ensure the independent development of territorial-administrative units[1].

The state budget deficit increased from 15.5% to 48% during 2010-2014. Taking into account the capitalization of “Naftogaz of Ukraine” PJSC, the budget deficit amounted to more than 10 % of GDP. The financing of “Naftogaz of Ukraine” was done mainly through borrowing. The deficit was financed, to a certain degree, through the issuance of government bonds in the US dollar, which will increase the debt exposure to currency risks. The financing of the budget deficit as well as debt service is a major challenge due to slow reforms and limited access to external borrowing.

The main indicators of revenues, expenditures and budget deficit in percentage terms in relation to GDP are as follows:

Subject	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
General government revenue	42.298	43.249	42.870	44.457	43.631	42.631	42.621	42.713	42.433	42.093	41.798
General government total expenditure	48.554	49.004	45.627	48.744	48.449	48.404	46.556	45.428	44.538	43.614	42.980
General government net lending/borrowing	-6.255	-5.755	-2.757	-4.287	-4.818	-5.773	-3.934	-2.715	-2.105	-1.521	-1.181
General government structural balance	-2.231	-3.859	-3.154	-4.397	-4.555	-3.490	-2.324	-1.985	-1.817	-1.521	-1.181
General government primary net lending/borrowing	-5.090	-4.129	-0.791	-2.374	-2.351	-2.362	0.638	2.397	2.908	3.121	3.100
General government net debt	31.936	38.416	34.455	35.169	38.709	65.327	71.429	69.338	64.923	57.593	49.875
General government gross debt	35.380	40.505	36.817	37.367	40.939	67.615	73.417	71.130	66.414	58.932	51.083

The chart above suggests that during 2008-2014 the level of revenues and expenditures in GDP almost did not change – 42% and 48% respectively. It is planned to reduce these indicators beginning from 2015 owing to the implementation of the Memorandum signed with the IMF, where budget consolidation is one of the key provisions. It also points to the increase in borrowing, with its peak in 2017, which means that state bodies will have to elaborate a strategy for debt management. Unfortunately, as of today, the debt management strategy in Ukraine is not effective, with its objectives and goals not corresponding to the current economic situation.

Under the Budget Code of Ukraine, “The maximum amount of domestic and foreign State debts, debt of the Autonomous Republic of Crimea, and debts of local self-government, and the maximum amounts of guarantees shall be established for each budget period, respectively, by the State Budget Law or budget decisions of local governments. The principal amount of the State debt cannot exceed 60 percent of the annual Gross Domestic Product of Ukraine. If the State debt exceeds the maximum debt amount stipulated under Section 2 of this Article, the Cabinet of Ministers of Ukraine shall undertake measures to reconcile the maximum amount with provisions of this Code.”

In March-April 2013, the Ukrainian government declared its intentions to take specific measures for fiscal consolidation. In fact, the following steps have been taken:

- a decision was taken to reduce non-priority expenditures;

[1] The National Institute for Strategic Studies. The analysis of imbalances in the budget sphere and its solution. http://www.niss.gov.ua/articles/1800/

- populist decisions of the previous government, not backed with real financing, have been revised;
- a realistic macro forecast has been made;
- amendments to tax legislation have been introduced, which would allow for additional budget revenues worth UAH 22.5 billion;
- amendments to the budget have been introduced, which decreased revenues by UAH 22.4 billion and expenditures by UAH 25.4 billion based on the realistic macro forecast.

The aforementioned measures allowed for balancing the 2015 budget, but did not solve systemic problems of public finances.

Based on the aforementioned concept, the Strategy for the Development of Public Finance Management was elaborated and subsequently adopted in 2013. According to the Strategy, the main measures regarding budget and tax consolidation are:

- The abolishment of tax preferences for individual enterprises and sectors
- The increase in tax rates for the emission of carbon dioxide
- The application of the system of taxation of immovable property items according to their value
- The balancing of interests of controlling bodies and taxpayers
- The introduction of legal instruments for the execution of the principle of commercial activities (arm's length principle).

According to the 2014 Public Financial Management Performance Report, the following key measures have been implemented:

- The regime of tax exemption for operations on medicines and medical products supplies, allowed for the production and consumption in Ukraine and included to the State Register of Medicines, have been cancelled;
- Property tax changes - a total area of residential properties instead of residential area have been introduced as a basis for immovable property(other than land plot) tax;
- Preferential taxation of UCITS with the enterprise profit tax have been limited;
- Taxation of income derived from operations with securities and derivatives at a reduced rate (10%) have been abolished;
- Income tax exemption for the hotel businesses, electricity industry enterprises, which produce electricity exclusively from renewable energy sources, have been abolished;
- Activities on timber cutting, industrial wood production (logs, poles), fuelwood production, deforestation for making land suitable for agricultural production were excluded from the list of activities covered by the special tax regime in agriculture, forestry, and fishery;
- Ineffective income tax exemptions which did not lead to the development of relevant industries have been abolished. These includes: biofuel production; extraction and use of gas (methane) of coal deposits; hotel services; light industry; sale of electricity; shipbuilding industry; aircraft construction industry; machinery construction for agriculture; publishing houses and organizations; printing enterprises; housing and communal services, etc.
- Reduction of the number of taxes, their consolidation
- Other measures

Problems:

At the present stage, there are following problems related to the fiscal consolidation:

- structural imbalances in the economy and untimely and ineffective implementation of structural changes;
- inefficient mechanism of taxation of market participants;
- a significant number of unprofitable state enterprises receiving subsidies;
- the budget expenditure structure inadequate to the existing financial possibilities of the state;
- a significant amount of shadow economic activities;

- misuse and inefficient use of public funds;
- inefficiency of finance and credit relations;
- constant increase in public debt

Main solutions:
- Reduction and changes to the structure of public spending;
- Rationalizing and improving the structure of budget crediting of market participants (especially state-owned enterprises and corporations);
- Enlargement of tax base (by limiting privileges or providing them under other conditions; limiting tax evasion);
- Streamlining the structure of subsidies for market participants changing the terms and conditions of their granting use (especially for state-owned enterprises and corporations); reforming energy prices and bringing them in line with the market prices; limiting subsidies for losses cover; reorganization of subsidizing for agriculture enterprises and enterprises that produce goods or provide services in the non-trading sectors (it is considered that economy stimulating through subsidies is inefficient and distorts pricing);
- Improving (reforming) mechanisms on the provision and use of social transfers (providing them to those whose consumption is lower than the accepted level (e.g. than minimum subsistence level); transition to targeted social protection system);
- Pension system reform (to ensure long-term sustainability of fiscal policy);
- Strengthening the focus of monetary policy on economic growth and budget revenues increase;
- Limiting quasi-fiscal operations (with the huge amount of fiscal operations in the real sector, in particular, "Naftogaz of Ukraine").
  - According to experts, the need for state apparatus reduction is 10-15% in Ukraine. It is advisable to spend part of the savings from the reduction of officials on increasing salaries for key figures in the sector, who will implement reforms.
  - reducing "energy subsidies" by raising energy prices (particularly, gas prices). It is advisable to spend savings on financing of targeted support activities and credit programs on increasing energy efficiency.
  - The third source of consolidation is pensions.
  - Analyzing the practice of fiscal consolidation (intensification of activities to reduce the deficit of the general government sector and limitation of the public and publicly guaranteed debt) in foreign countries, the following areas can be highlighted:

Cooperation with IMF

According to Memorandum with IMF, over 2016-2018, it is planned to continue the gradual expenditure-based fiscal consolidation to reduce imbalances, reduce the size of government, strengthen confidence, and facilitate growth.

Expenditure reforms

a. Parametric pension reform – the need for a comprehensive pension reform to revamp the overall objectives and design of the pension system. Despite low average pensions, low retirement age, early retirement options and generous occupational retirement conditions make the overall pension spending as a share of GDP is one of the highest in Europe.

It is planned to index pensions to prices and lower the threshold for pension benefits' income tax liability, as well as to unify special pensions' calculation rules with those of the general system.

b. Size and efficiency of government – ensuring more rational size of the budget-paid workforce with the goal of lowering the wage bill to around 9 percent of GDP over the medium term. It is planned to review salary structures to ensure competitive remuneration, especially at the managerial level of the central government. With the help of our international partners, reforms in the health and education sectors aiming to improve outcomes with more efficient use and mix of resources and resulting in budget savings will be designed and implemented.

c. Healthcare. Healthcare reform will aim to open up the sector to private financing and gradually move to a medical insurance system. In view of this, it is planned:

(i) Change the basis of public financing of the secondary healthcare by moving from hospital bed to service-based financing and for primary healthcare from infrastructure-based to capita-based financing.

(ii) Allow medical facilities to legally generate own revenue.

(iii) Change public procurement regulation to allow purchasing medicines and medical supplies through direct, multi-year procurement involving UN based organizations.

d. Education. The reform in education sector, commenced in 2014, aiming to improve the quality and efficiency of education spending, will continue. It is planned to optimize general secondary school system reducing the number of schools by 5 percent by consolidating small schools and reducing employment accordingly; and reducing public appropriation for training specialists depending on the needs of the economy and demographic trends.

e. Social assistance. To protect the most vulnerable groups from higher energy bills, it is planned to improve the design of existing social assistance programs (currently comprising of categorybased for housing utilities; means-tested subsidies for housing utilities; and a new tariff compensation scheme; the general guaranteed minimum income (GMI) program, as it is better targeted to low-income households, though this will require substantial administrative effort).

f. Investment. To support growth, it is planned to increase and maintain capital investment levels, from 1 percent of GDP in 2014 to over 3 percent of GDP by 2018, to fund Ukraine's immediate reconstruction needs and long-term infrastructure development objectives.

Tax policy reforms

g. Social security contributions. It is planned to continue reducing the social security contribution wedge, which should help encourage de-shadowing of wage payments. The pace of this reform will be closely linked to progress in reducing pension spending.

h. Agriculture VAT – the effect of the general VAT regime for the entire agricultural sector in line with international practice.

i. Personal income tax – steps to better detect and tax the income and wealth of high net worth individuals, drawing on technical support from the IMF.

j. Property taxes – elimination of exemptions and raising of tax rates. The additional revenue will help strengthen the own revenue base of subnational governments.

k. Extractive industry taxation – a new fiscal regime for the extractive industries from 2016 that will make a transition to taxation based on international best practice, including a review of the current level of royalties. It is planned to prepare and submit to parliament the relevant amendments to the tax code by July 1, 2015 and in parallel strengthen administrative capacity in this area, drawing on IMF technical expertise.

Conclusions

In order to achieve fiscal sustainability, a state legislatively defined budget strategy is required. It will ensure the predictability of budget system responses to the challenges and opportunities that may arise in the various versions of the global economic development, provide preventive use of an adequate set of measures under the negative impact of external economic factors. The fiscal consolidation programs are being accepted in Ukraine. However, due to the internal and external challenges, implementation of measures in the context of fiscal consolidation has mainly feebly marked positive effect. During further implementation of fiscal consolidation plans in Ukraine, it is reasonable to take into account the positive and negative experiences in order to improve its socio-economic effectiveness and avoid possible negative impacts.

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