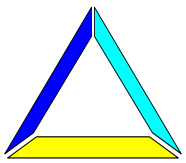
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**S35**

# Medium-Term Guidelines for the Fiscal Policy in Ukraine

**Most important structural problems in fiscal policy are:**

- Administration of VAT,
- Low revenue from dividends on state-owned assets,
- Remaining non-cash settlements with the budget for the purposes specified in budget law,
- Disproportionably high expenditures on the military and police at the expense of social protection of households, investment in education, healthcare and infrastructure,
- Local governments lack responsibility for administration of taxes that would be compatible with their responsibility for the administration of expenditure.

**To improve fiscal policy in the medium-term we recommend:**

- To improve management of government holdings in commercial enterprises and the management of state-owned enterprises,
- To ban non-cash settlements with a budget completely (to eliminate the possibility of mutual debt cancellation envisioned for specific sectors),
- To abolish the State Committee on Material Reserves,
- To eliminate social and pension benefits based on professional privileges,
- To increase investment in infrastructure, education and healthcare, and introduce the state involvement in the infrastructure development using diverse methods, such as the public-private partnerships,
- To reduce subsidization of loss-making enterprises,
- To reduce defense, security and civil order spending,
- To use a pure formula-based approach for the calculation of Central budget transfers.
- To consider shifting administration of selected taxes to the local level, which will reflect increasing responsibility of local governments.

## 1. Introduction

In spite of progress in some areas of tax and budget legislation, the fiscal situation in Ukraine is still marked by a number of structural problems that are more or less directly related to the budget. Some, like the mounting tax arrears and the government refunds arrears, constrict the tax base and reduce the budget revenue. Others, such as the subsidies to the loss-making enterprises and disproportionably large spending on defense and police, allocate scarce budget resources away from the under funded education and healthcare. And finally the asymmetric structure of the revenues and expenditures of local budgets relative to the central leave the local budgets dependent on large transfers and limit the ability of regions to take the responsibility for their own social and economic development.

Resulting budgetary stringency jeopardizes sustainable growth of the Ukrainian economy. To secure the stable economic growth and social development, superficial cosmetic changes will not suffice. The above-mentioned structural fiscal problems will require deep systemic changes, which cannot be implemented in one year. That is why we present in this paper improvements and changes, which will require legislative and institutional reforms over a medium-run period of several years. They will help make the budget an effective tool for the stable economic and social development of Ukraine.

The proposals presented below are not completely new. Rather, this paper attempts to summarize our past recommendations, which are relevant for the process of the budget preparation, in a clear and concise format.

The structure of the paper is as follows. In part 2 we discuss budget revenues. The expenditures are discussed in part 3. Part 4 deals with intergovernmental relations, and part 5 concludes the paper.

## 2. Structural problems related to budget revenues

The budget code of Ukraine divides the revenues into tax revenues, non-tax revenues, receipts from operations with capital, and transfers.

### 2.1. Tax revenues

Despite the excessively high tax rates the budget revenues fail to accumulate resources urgently needed for the development of the infrastructure, education and healthcare. The most serious factor responsible for this problem is the eroding tax base. Even with the relatively strong economic growth during the last for years the amount of declared profits relative to GDP has been declining. In 1999 enterprise profit tax collections constituted 5% of GDP, in 2000 it was 4.45% of GDP, in 2001 only 4.1% of GDP, and only 3.92% in 2002.

The Value Added Tax was subjected to a concerted attack by various lobbies, resulting in hundreds of exemptions steadily deteriorating the VAT tax base. Ukraine applies a basic value added tax rate of 20%. Yet, VAT collected in 1999 was only 6.61% of GDP, in 2000 it was 5.46% of GDP, in 2001 only 5.12% of GDP, and 5.61% in 2002. For comparison,

Austria, which also applies 20% VAT rate, collected 8.2% of GDP. Netherlands collected 7.0% of GDP with a 17% tax rate[1] (see charts below).

Chart 1. Tax revenue from the VAT and EPT as the percentage of GDP in Ukraine.

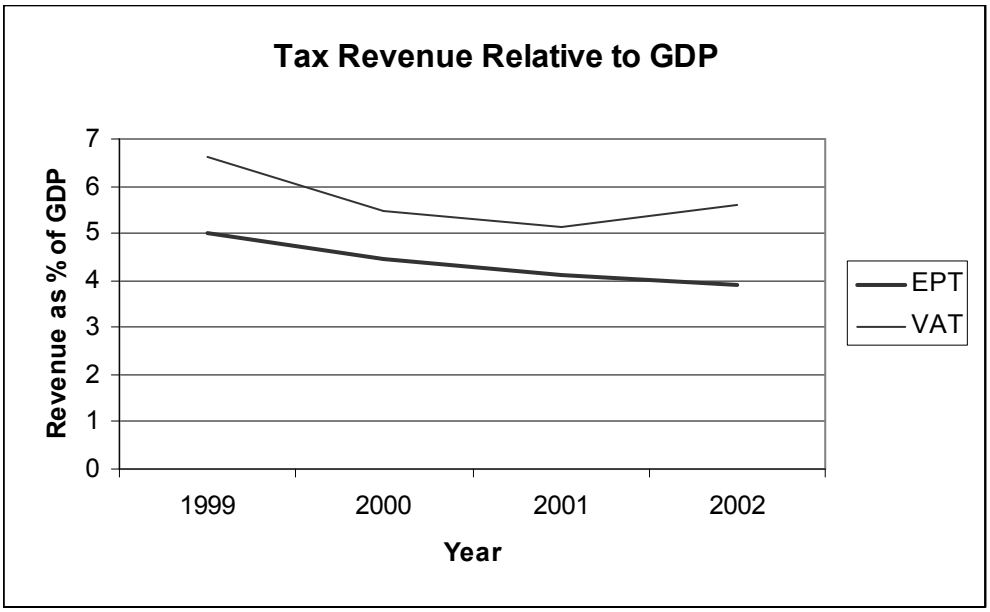
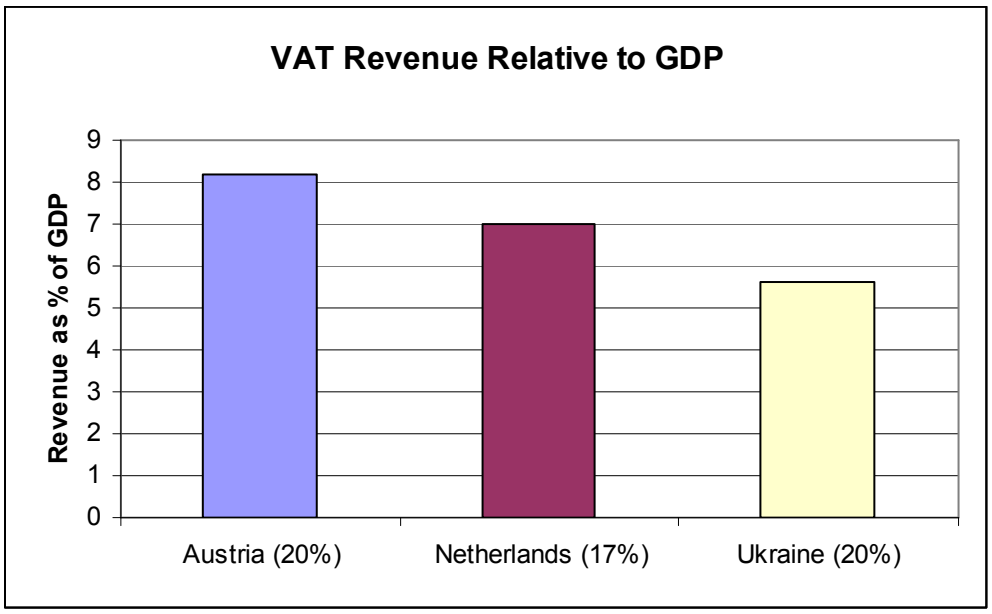



Chart 2. International comparison of VAT revenues relative to GDP




The most important reasons for the shrinking tax base are:

- Tax privileges and exemptions, which were granted extensively after passing the tax laws.

[1] See.: I. Lunina: Riven dokhodiv biudzhetiv Ukrainy ta viznachalni yogo dinamiki.

The tax privileges result in a significant loss of the budget revenue[2]. For the 9 months of 2002, the privileges reduced the revenue from the enterprise profit tax by UAH 12.152 bn (about 30% of the total revenue lost due to all tax privileges)[3]. Revenue lost from VAT is estimated at UAH 17.64 bn (about 45% of total revenue lost due to all tax privileges), and from the land payment 7.8 bn (about 20% of total revenue lost due to all tax privileges), which is the part of local budget revenues. Prevalence of tax privileges does not just erode the tax base; it also deepens inequity and inefficiency. Tax exemptions cause unequal distribution of tax burden and distort the optimal allocation of economic resources. Tax exemptions, while reducing the budget revenue, hamper the long-run economic growth[4]. Nonetheless, new privileges are envisaged the in the future, for example for book editors[5].

- Providing preferential tax treatment of persons on professional basis as a social benefit

Currently, some professions and groups of population in Ukraine receive a preferential tax treatment, which is not based on their income level. This leads to an extensive list of exemptions and privileges. In order to avoid the resulting deterioration of the tax base, the modern internationally accepted practice of building the social safety net is based on a different approach. The social safety net should consist of programs, which are financed from the expenditure side of the budget, and do not interfere with the budget revenues. The tax system needs to be as simple and transparent as possible, minimizing potential loopholes. Such a tax system fills the budget with the resources needed to provide the benefits to the needy.

- Tax rates are excessively high and the tax administration is complicated.

Excessively high tax rates result in the growing shadow economy. Together with extensive tax privileges, they further reduce the tax base[6].

- Loss carry-forward

Loss Carry Forward (LCF) is one of the major articles mentioned in the official form #13 devoted to the privileges granted to the juridical persons[7]. The attempts to amend procedures of LCF culminated on

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[2] The total loss was estimated at the level of 39.2 bn, which is higher than the total tax revenues executed for the considered period.

[3] For the 9 months the revenues from EPT amounted 5.5 bn UAH, while the revenues from VAT reached 9.9 bn UAH, payment for land 1.3 bn UAH. (This data is available form the State Tax Administration web-site: www.sta.gov.ua/news.php322527).

[4] Nina Legeida. The Economic Implications of Government for the Steel Industry: The case of Ukraine. September 2002 (IER WP 16);
Nina Legeida. Implicit Subsidies in Ukraine: Estimation, Developments and Policy Implications. October 2001 (IER WP 10);
Serhiy Demyanenko and Serhiy Zorya. Taxation and Ukrainian Agriculture after 2004. October 2002 (IER WP 18).

[5] The Law "On the introducing amendments of some laws of Ukraine on taxation" as of 16.01.03 #2114.

[6] Personal Income Tax Reform: How To Feed The Wolf And Keep The Sheep, advisory paper S11, German Advisory Group for the Economic Reform in Ukraine, 2002.

[7] This form as of 01.01.01 reports that its amount is about 1.97 bn UAH.

January 15, when the President signed the law "On amendments on EPT Law". The amendments will become effective on January 1, 2004 and stipulate that the amount of LCF is unlimited, but it could be implemented only during the period of next three years. This measure will improve the situation, even though additional restrictions limiting the share or amount of losses that could be taken into account in any particular year could further reduce the room for tax fraud.

- VAT refund arrears

In spite of legislative provisions introduced in 2002 to curb the VAT tax fraud, the refund of VAT overpayments is still a major problem. At the enterprise level, it reduces the cash flow desperately needed by firms (especially taking into account the weak banking system). At the macroeconomic level, it undermines the confidence of potential investors and undermines potential for future growth. The consolidation of the VAT as an essential source of the budget revenue needs to include the elimination of VAT privileges, and the expedient payment of VAT refund arrears, starting with the exporters[8].

- Tax arrears

According to the STA, the total tax arrears doubled during the year 2002 and reached the level of 14.7 bn UAH. The biggest part of the tax arrears has accumulated in the fuel and energy sectors. For the period of 10 months of 2002, more than half of tax arrears were due to the fuel and energy sectors. Among the enterprises of this sector, Naftogaz has the largest budget arrears. The tax arrears in the amount of 4.9 bn were uncovered in a tax administration inspection, which attests to a widespread tax evasion.

Accumulation of tax arrears and shadow transactions give the enterprises a great freedom in determining their tax obligations independently. This phenomenon prevails among both the big enterprises of "strategic branches" (that are able to lobby tax write-offs and mutual debt cancellation with a budget) and small enterprises (that have more possibilities to hide their income from taxation).

To reverse this trend, it is important to completely eliminate the non-monetary operations with the budget, and to reform the fuel and energy complex by privatization, improved tariffs policy, increased payment discipline of final consumers[9].

### 2.2. Non-tax revenues

Non-tax revenues contribute to the shortfall of the budget revenues. The major factors responsible for their underperformance are:

- Poor performance of state-owned enterprisers

The revenue from dividends of state-owned assets remains low. In 2001 revenue from government holdings in commercial enterprises amounted

[8] VAT Refund Crisis in Ukraine: Causes, Risks, Solutions, advisory paper Q18, German Advisory Group for the Economic Reform in Ukraine, 2002.
[9] The Next 1000 days: An economic Reform Agenda for Ukraine, German Advisory group on Economic Reform, Kyiv, November, 1999.

to UAH 67 m, in 2002 it was UAH 175 m. In 2003 these revenues are projected to increase up to UAH 310 m. But the previous experience makes the fulfillment of this task unlikely. The rate of execution of the annual plan for revenues from dividends in 2002 was 38.8%. Such underperformance indicates the continuing inefficient management of state-owned enterprises. The top management has an incentive to minimize their contribution to budget.[10] The management of state assets needs to be improved simultaneously with privatization. The control over government holdings in commercial enterprises needs to be strengthened and the responsibility of top management of state-owned enterprises for meeting their budget obligations must be enforced.

- Non-monetary settlements with a budget

Despite the general prohibition of non-monetary settlements with budget, the budget law permits mutual debt cancellation for:

-Public debt related transactions,

-Settlements of agricultural farms arrears for defaulted loans under the government guarantees by previous deliveries to the state reserves,

-Settlements of budgetary arrears incurred by the Ministry of Defense through the tax arrears cancellations accumulated by the enterprises-creditors to military units. Mutual debt cancellations erode the cash collections to the budget, undermine transparency of budget revenues and provide unfair competitive advantage to the least efficient firms. It is therefore important to eliminate the non-monetary settlement with the budget completely.

- Underexecution of the receipts from privatization

Revenues from privatization have been much smaller than planned. The most important factor responsible for this negative development has been inadequate execution of the privatization projects. To attract investors, innovative forms of privatization, such as public-private partnerships should be used[11].

## 3. Structural problems concerning budget expenditures

The budget spending in Ukraine now uses the basic principles of program budgeting. Despite the progress, the process is still marked with deficiencies in the following areas:

- Expenditures are not clearly assigned

Contrary to one of the basic principles of program budgeting, expenditures form the Reserve Fund are assigned without the responsible person defined. This reduces the transparency of fiscal operations and complicates the control over the expenditures.

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[10] Currently no organ of state financial control has the power to control the state-owned property in the entrepreneurial sector regularly. Control and Audit Department of the Ministry of Finance is authorized to check the given enterprise only after the special order of the Cabinet of Ministers; Accounting Chamber is deprived of such authority altogether.

[11] Public Private Partnership as Alternative to Privatization, With an Application to OJSC "Ukrtelecom", advisory paper S20, German Advisory Group for the Economic Reform in Ukraine, 2003.

- Procedures which reduce competition in bidding for government procurement

The procedure of government procurement has been significantly improved. The method of asking price in Ukraine is the most popular one. Although this method is widely used in international practice and simplifies the procedure of procurement, the rules of the particular procurement projects often exclude many bidders to give some firms unfair advantage. It is important to make the process more transparent.

- Government subsidies to enterprises

Government subsidies to inefficient enterprises in the market economy distort competition and decreases welfare of the country. The resources used to subsidize selected companies can be used better to finance training and re-qualification of labor force, as well as investment in the infrastructure. Overall, the state involvement in the development of infrastructure remains inadequate, while subsidies to inefficient enterprises are still significant. The broader involvement of the state can have does not have to be limited to direct investment, but it can have diverse forms, such as public-private partnerships[12]. Instead of continuing government subsidies to enterprises, the funds should be used for the investment in infrastructure.

- State Committee on Material Reserves

The State Committee on Material Reserves continues to channel uncontrolled subsidies to the enterprises. The non-transparent economic interventions of the Committee extend to numerous sectors of the economy, vaguely justified as for the security and defense purposes. The existence of this Committee seriously reduces transparency of the expenditure. The budget and the economy would be well served if this Committee and its activities in all economic sectors were abolished.

- Insufficient social orientation of the budget

Despite to the fact that social protection is recognized as a priority, the allocation of budget resources does not reflect this. The education and healthcare spending from the general fund increase in 2003 only marginally. Compared to 2002, expenditures on healthcare sector increase by UAH 866 m or 0.08% of GDP, and those on education by UAH 1.46 bn or 0.16% of GDP. Spending on social protection has been cut by 0.38% of GDP.

The fall in expenditures on social protection is partly due to the reduction in budgetary transfers to the Pension fund. Provisions of the current legislation stipulate that Pension fund benefits for privileged pensions (to military personnel, government employees, researchers, Chornobyl victims etc.) are to be covered from State budget. Pension fund contributions that could be used to increase regular pensions are used instead as budget revenue, and are redistribute towards other uses. In light of the international experience presented in the Appendix, the social

[12] Public Private Partnership as Alternative to Privatization, With an Application to OJSC "Ukrtelecom", advisory paper S20, German Advisory Group for the Economic Reform in Ukraine, 2003.

orientation of the budget requires to increase the investment in education and healthcare.

- Relatively high spending on the military and police

Expenditures on the military and police are increasing substantially, while spending on social protection of households is reduced.[13]. According to the statistical yearbook of Ukraine 2000, the principal staff of civil order and security system constituted 0.3% of the population in 2000. This is nearly equal to the average proportion of total police staff in population of the countries of middle-income group[14]. The total wage bill constitutes about 60% of the expenditures. The approximate number of servants of ministry of internal affairs of Ukraine is 300 thousands[15], while the crime rate[16] is close to the average crime rate in other countries. However, the equipment of law enforcement is inadequate and depreciated.

- Existence of special budget funds

The division of the budget into general and special funds obscures the indicators of consolidated budget performance. This is a result the overexecution of the special fund of the budget, which offsets underexecution of the general fund. This sets implicit priorities for expenditures from special funds. The residual funds are accumulated at the accounts of the special fund, hence, the expenditures of the special fund in the unfair position of the general fund. The best way to increase transparency would be to join the special funds and the general fund and to unify the procedures of budget expenditures.

## 4. Structural problems concerning intergovernmental fiscal relations

The relationship between the central budget and local budget is one of the most serious obstacles of regional development in Ukraine. We analyze the most important problems in this area.

- Narrow revenue base of local governments

In the current system of intergovernmental relations in Ukraine, there exists a significant asymmetry between the functions and responsibilities of local governments and their own revenues. Increasing the role of local budgets in the 2003 consolidated budget of Ukraine marks a positive development. However, the narrow revenue base of the local budgets, together with their high dependency on transfers from the Central budget, remain to be the acute problems of the current system of intergovernmental fiscal relations in Ukraine.

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[13] However, there are also positive changes like increase of the expenditure on the program oriented toward social and professional adaptation of retired military servants from 0.9 mln UAH to 3.1 mln UAH.

[14] World Bank statistics on public sector employment and wages available from the web-site: www1.worldbank.org/publicsector/civilservice/development.htm.

[15] Press Center of the Ministry of Internal Affairs of Ukraine.

[16] The crime rate in Ukraine in 2001 was 1047 for 100 thousand of population, which is comparable to the average crime rate in other countries. International dataset is available from the web site of United Nations office of Drug and Crime www.undcp.org/pdf/crime/sixthsurvey/TotalRecordedCrime.pdf.

The increase in local budget revenues is a result of both the increase in transfers, as well as the increase in the real taxation of personal incomes.[17] The rise in local budget expenditures also reflects the shift of some expenditure obligations from the central to the local level, and not increased funding of existing local programs. Some of the centrally administered sources of budget revenue should be transferred to the local level to make their revenues more consistent with their expenditures. These taxes should be relatively stable and their collections should depend on collection effort of the local authorities.

- Application of the transfer formula that favors "depressive" regions

In 2003, the government adjusted the transfers from the Central budget to budgets of cities, oblasts and rayons for "depressivity", a factor that should account for the lack of economic activity. Application of the loosely defined "depressivity" coefficients will establish grounds for political bargaining and ad hoc distribution of Central budget transfers. Moreover, the new formula favors "depressive regions" while leaving the better performing regions without stimulus to enforce the tax collection. This bias can be addressed by the use of the pure formula-based approach for

## 5. Conclusion

Significant achievements that were accomplished in recent years started a process of fundamental changes, which will be necessary to turn the budget process into an effective instrument of the macroeconomic policy. Adoption of program budgeting and steps towards the reform of some taxes are just a few examples. In spite of this progress, there are still serious structural fiscal problems remaining in Ukraine. Tax arrears of enterprises, government refund arrears and pervasive tax privileges deteriorate the tax base and reduce the budget revenue. Subsidies to the loss-making enterprises and disproportionably large spending on defense and police siphon the government's resources away from the under funded education and healthcare. Local budgets lack own adequate sources of revenue that would allow them to take responsibility for the social and economic development of their regions.

To secure the stable economic growth and social development of Ukraine will require deep systemic changes. Such changes cannot be implemented quickly, but delaying them would be dangerous. The necessary legislative and institutional reforms will span a medium-run period of several years but the process of structural fiscal reforms outlined above needs to start now.

N.L., R.C. Lector: R.G.

Kiev, April 2003

[17] Personal income tax is the main source of revenue for local budgets. With he minimum non-taxed income of UAH 17 per month and the income brackets unchanged in years, the inflation period of 1990's left households with a continuously increasing real taxation of personal incomes.

## Appendix: International comparison of public expenditure

In order to put the structure of the proposed budget in prospective, we compared the relative size of selected spending items of the Ukrainian budget to those in advanced transition countries (see Table 1). The comparison yields the following conclusions:

The Ukrainian budget features relatively high defense and law enforcement expenditures, while investment in education and healthcare spending are relatively low.

International experience confirms the need for substantial government spending of healthcare programs, particularly the ones that have significant positive externalities and provide access to medical assistance for the low-income households.[18]

Budget for 2003 projects the healthcare spending from the Consolidated budget in the amount of 3.47% of GDP. In contrast, public healthcare spending in Poland and Hungary is 4.2%, in Slovenia 5.8%, in Czech Republic 6.8%, and in Slovakia 7.1% of GDP.

When we consider the amount of healthcare spending relative to the total budget expenditures, the differences are even more obvious. The share of total expenditure allocated on healthcare is 12.15% in Ukraine, 8.4% in Poland, 12.8% in Slovenia, 14.5% in Czech Republic and 16.7% in Slovakia. Only in Hungary the healthcare spending is as low as in Ukraine (see table 1).

Budget envisions defense expenditures to reach UAH 4.5 bn which is 1.9% of GDP. Hence, Ukraine is in line with - Czech Republic and Slovakia (1.9% of GDP)[19] that have the highest level of defense expenditures among the advanced transition countries. In other countries the defense expenditures have been significantly smaller and amounted to 0.9% of GDP in Hungary, 1.1% in Slovenia and 1.4% in Poland.

Relative to the total budget expenditures, Ukraine spend one of the biggest share of the Consolidated budget on military programs. Budget plans to allocate 6.6% of public expenditures on military purposes. In Hungary the share of defense expenditures is 1.6% of the total expenditures, in Slovenia 2.5%, in Poland 2.8%, in Czech Republic 4% and in Slovakia 4.4%.

In 2003, the budget envisages expenditures on civil order, security and justice to reach UAH 5.17 bn or 2.15% of GDP. Among transition countries the expenditures on these items have been so high only in Czech Republic.[20] In Hungary and Slovakia the spending on civil order, security and justice was 1.6%, in Slovenia 1.7%, and in Poland 1.8% of GDP.

Once again, the contrast becomes even starker when we focus on the share of expenditures on civil order, security and justice in total budget spending. In Ukraine, in 2003 7.5% of budgetary funds are to be allocated

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[18] World Bank Discussion Paper. Evaluating Public Spending: a Framework for Public Expenditures Reviews // Washington DC, 1996.
[19] Data for 2000. Source: Government Finance Statistics.
[20] Data for 2000. Source: Government Finance Statistics.

for civil order, security and justice, while in Hungary 2.8%, in Slovenia and Poland 3.7%, Slovakia 3.9%, and the Czech Republic 4.6%.

Table 1: Expenditures on health care, defense and civil order in transition economies*

| | Health care | Defence | Civil order and security |
|---|---|---|---|
| Amount of expenditures as a % of GDP | | | |
| **Ukraine** | 3.5 | 1.9 | 2.2 |
| Poland | 4.2 | 1.4 | 1.8 |
| Hungary | 4.2 | 0.9 | 1.6 |
| Czech Republic | 6.8 | 1.9 | 2.1 |
| Slovakia | 7.1 | 1.9 | 1.7 |
| Slovenia | 5.8 | 1.1 | 1.6 |
| Share of expenditure as a % of total expenditures | | | |
| **Ukraine** | 12.2 | 6.6 | 7.5 |
| Poland | 8.4 | 2.8 | 3.7 |
| Hungary | 7.5 | 1.6 | 2.8 |
| Czech Republic | 14.5 | 4.0 | 4.6 |
| Slovakia | 16.7 | 4.4 | 3.9 |
| Slovenia | 12.8 | 2.5 | 3.7 |

Source: Own calculations based on of Government Finance Statistics and IMF data.

* 2000 data for advanced transition countries, 2003 planned indicators for Ukraine.