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Are the budget plans compatible with an acceleration of structural reforms? Proposals for strategic budget reforms

Summary

The many achievements since 2000 include a dramatic improvement of the solvency of the government, which resulted in a much lower interest burden than anticipated. The regained freedom of action on the part of the government could be used to accelerate structural reforms including, for instance, the elimination of any remaining payment arrears so as to contribute to break the cycle of non-payments and inter-enterprise arrears. An acceleration of structural reforms should be visible on both the revenue and expenditure side of the budget and in changes of the underlying administrative rules. When examining budget developments and budget plans this expectation is indeed to some extent met. There are many changes that may be expected to have substantial beneficial effects, perhaps most importantly the introduction of a so-called "program-targeted approach to government expenditures". But there are also many areas where stronger signs of structural change and structural reforms initiated by the government could be visible in the budget. To show this is one goal of this paper. Another goal is to provide proposals for government decisions in areas where reform progress was very difficult to achieve, not considering here tax reform[1], and whose adoption would make structural reforms more visible in the budget. These strategic decisions concern particularly the coordination of budget planning with lower levels of government and budget control, a new organization of the relationship between the government and energy enterprises, especially Naftogas Ukraine, and development of the social support system so that, among others, the income criteria of eligibility would be substituted for the many other criteria of eligibility currently employed.

[1] Please see our proposal for a comprehensive tax reform: "Tax reform: An important step ahead". German Advisory Group on Economic Reform to the Government of Ukraine, August 2001.

1. Introduction

The goal of this paper is to contribute to compatibility of the budget plans with the policies of structural reform. The discussion begins with a brief review of the underlying main medium-term macroeconomic assumptions and the use of potential "windfall gains" during the current year as a result of some better than expected developments, mainly concerning lower than expected interest expenditures. The question is then asked to what extent the budget plans for revenues and expenditures are compatible with the expectation of accelerated structural reforms. Finally, further reform proposals are made, that could be expected to improve this compatibility.

2. Underlying basic macroeconomic assumptions

Due to the improvement of the economic development during 2001 the government adjusted its basic macroeconomic forecasts for 2001 and 2002 concerning real economic growth, inflation and the Hrivnia/US-Dollar exchange rate:

Official forecasts of major economic indicators for 2001 and 2002:

Indicator	Earlier official foreca 2001	Revised official fo for 2001	Official forecast for 2
GDP real growth	4%	7.3%	6.0%
CPI year on year	13.6%	12.3%	9.8%
PPI year on year	-	7.0%	6.5%
Exchange rate, UAH/ average	5.7	5.46	5.75

For both years the real growth assumption was considerably raised, expected inflation was lowered and the expected average exchange rate for 2002 was recently somewhat raised.
It is clear that due to the significantly more favorable than expected economic development during the first 8 months of 2001 the basic macroeconomic assumptions for 2001 had to be revised. However, there has been a substantial downward revision of forecasts for the economic development during 2001 and 2002 of major Western and Asian trading partner countries of Ukraine and for growth of world trade. The only exception is Russia, whose importance for Ukraine's exports rose considerably since 2000. However, the growth of Ukrainian exports to Russia is unfortunately severely inhibited by voluntary export restraints concerning important steel goods, and Russia's economic growth and its imports from Ukraine may be adversely affected should the oil price remain relatively low.
Moreover, Ukraine's important exports of agricultural goods during 2001 are restraint by a lack of competition and effective restrictions[2]. Evidence for these restrictions is the current domestic price level for major agricultural export goods that is substantially below the price level on international markets for these goods. This price decline may have adverse consequences for the production and supply of agricultural goods during 2002. The price decline below international market prices may be interpreted as one example of lagging progress of structural reforms that could inhibit economic growth in Ukraine. Other examples of lagging structural reforms may concern the energy sector (improvement of the regulatory policies concerning electricity tariffs and transport, transparent privatization of energy distribution companies, implementation of coal sector restructuring), banking system

[2] See German Advisory Group on Economic Reform, "Ernstfall Rekordernte: Was läuft schief auf den ukrainischen Getreidemärkten?, September 2001. (Record harvest in 2001: What went wrong on Ukraine's markets for grain?)

reform (implementation of an improved deposit insurance system, strengthened restructuring of banks with foreign banks as advisors, simplification of payments in the banking system), promotion of foreign investment through improvements of the legal system and not through tax privileges and additional special economic zones, promotion of competition through lowering entry and exit barriers, and also importantly the fiscal area (implementation of a tax reform that broadens and simplifies the tax base and reduces several tax rates).
In light of

- the downward revision of expected growth in major trading partners of Ukraine,
- the uncertainty concerning exports to Russia,
- the necessity to maintaining export competitiveness, which may require some moderate nominal devaluation vis-à-vis the US-Dollar and the Euro, and
- in order to prevent downward adjustments of government expenditures during 2002,

it may be important to plan the budget 2002 on the basis of conservative growth and exchange rate estimates. Hence, the growth estimate of 6% for 2002 could be rather optimistic. However, the upward adjustment of the expected exchange rate vis-à-vis the US-Dollar for 2002 from 5.6 to 5.75 is in our view a reasonable and adequate policy assumption. Together with the inflation forecasts it implies that the real currency appreciation vis-à-vis the US-Dollar during 2002 would amount to merely about 0.5-3% vis-à-vis the US-Dollar during 2002 so that the considerable real currency appreciation during 2000 and 2001 would not continue. Such a small real currency appreciation is likely to prevent a loss of Ukraine´s external competitiveness. This assumes that average productivity in Ukraine´s industry will increase somewhat more than in the major western and Eastern trading partner countries so as to compensate a small real currency appreciation. Thus, in order to facilitate a sustainable growth performance it appears very reasonable to accelerate structural reforms and productivity growth and simultaneously to attempt to prevent a real currency appreciation in excess of the difference between Ukraine's expected productivity growth rate and the productivity growth rate in major trading partner countries by way of continued accumulation of foreign currency reserves.[3]

3. "Windfall gains" during 2001

During 2001 the exchange rate depreciated less and growth was higher than expected causing especially debt service payments to be less than planned (by 1.5 billion Hrivnias) and some tax revenues to be higher than planned (especially PIT and "own revenues of budgetary agencies"). Thus, despite the large shortfall of privatization revenues, overall government revenues are only slightly below plan as are total expenditures.
To the extent that these "windfall gains" in the form of lower than expected budget expenditures cause a higher than expected budget surplus, it could be considered to use them as a priority to reduce faster than planned the still remaining wage and other arrears of the government. This could increase the governments` credibility and contribute to stop the cycle of non-payments.

[3] Currently, market forces may even wish a considerably higher real appreciation than the NBU is allowing. The NBU pursues, in our view, a very good policy of dampening the real appreciation of the Hrivnia through its buying of foreign currency while sterilizing the concomitant increase in the money supply. However, the real currency appreciation that might occur if the NBU would not buy US-Dollars could be too strong in the sense of damaging Ukraine's export competitiveness. This could cause overvaluation and later increasing instability as had occurred during 1998.

4. Compatibility of planned budget policies with structural reforms

a) Basic assumptions and tax reform

Given the uncertainties and risks for growth described above, we propose to apply conservative plans for revenues[4] and thus also for expenditures. Since prior to the upcoming elections an agreement on the crucially important broadening of the tax base may not be possible, we agree that it may be preferable to plan the budget 2002 on the basis of the existing legislation without any tax changes. We see the danger that if substantial tax rate cuts are implemented without simultaneously reducing the long list of tax privileges, not only will the further improvement of the budget balance be jeopardized but also a unique opportunity of broadening the tax base in return for tax cuts would be forgone. Since tax rates cannot be lowered indefinitely, such an opportunity would not appear again. However, the assumption of a fully implemented tax reform by 2003 and corresponding preparation of the medium term-budgets as well as the distribution of these medium-term budgets in parliament could appear important so as to promote the discussion of a broad based tax reform with parliament.

b) Revenues

The revenue plan 2002 incorporates several very commendable technical improvements, most importantly the elimination of privatization revenues from the normal government revenues and showing them as a financing item of the budget balance, and the complete elimination of the social insurance system from the budget. However, there are significant problems on the revenue side, which would need to be addressed by particular fiscal and economic policies:

- The decline of VAT and excise revenues as a share of GDP continues. With regard to VAT the main reason for the relatively low share of these very important revenues appears to be the existing exemptions. There may also be a significant problem of tax avoidance or fraud. With regard to excises a problem may be seen in tax rates, which are relatively low by international comparison.[5]
- Non-tax revenues from property and entrepreneurial activity have been persistently and substantially below their expected amounts and dividend revenues from the still large holdings by the government of commercial enterprises have been very low: For instance, regarding 2002 dividend revenues in the amount of only 480 million Hrivnias are planned. For 2001 about the same amount was planned but actual revenues during the first 8 months of 2001 were even much lower than expected and amounted to less than 70 million Hrivnias. This points to the necessity to further improve both the control of government owned enterprises and of the management of share holdings.
- The planned and actual revenues from transit of oil and gas have substantially risen during recent years but they still appear to be lower than plausible calculations would suggest. Such calculations make two main assumptions: First, the gas, which is received as a transit fee, would be sold at market prices. This has been an explicit policy goal

[4] This refers especially concerning privatization revenues, which have been consistently overestimated in the past.

[5] However, it is true that simply raising these relatively low rates could even worsen the significant problem of smuggle to the detriment of domestic production. Therefore, increases in these rates should be decided upon after consultation of the domestic producers of the goods in question because these producers made technical proposals on how to improve the excise tax system and border controls.

since some time. Second, there are no mutual settlements between energy companies, other enterprises and the government, so that the subsidies for energy consumption of households are paid for by the government in cash or by vouchers only to households eligible for support. These costs would fully appear on the expenditure side of the budget. Under these assumptions and applying a market price of about 50 US-Dollars per 1000 cm^3 natural gas (which is substantially below an average world market price) one could expect net revenues from the transit (after deducting costs incurred and taxes paid by Naftogas Ukraine) of about 550 million US-Dollars, which would amount to 3.16 billion Hrivnias when using the official expected average exchange rate of 5.75 for 2002. This would be 920 million Hrivnias more than foreseen in the budget 2002 (only concerning gas transit revenue). Of course, it is not possible to plan unrealistically high revenues. Actual receipts from Naftogas Ukraine have always been substantially lower than planned ones. Therefore the revenue discrepancy discussed here may underline the importance of adjusting government policies so that the assumptions made in the above calculation could be fulfilled. An additional problem concerning the revenues from the transit fee is that a substantial part of these revenues is not received in cash by the government. Instead this claim by the government is used as a basis for mutual settlements to cancel the government's debt to enterprises that supply consumers with gas and electricity at subsidized prices on account of the income support program for private households. However, these mutual settlements may not be consistent with the policy of prohibiting mutual settlements in general (article 6 and article 39 of the budgets 2001 and 2002, respectively). This prohibition is crucial because of the many disadvantages of mutual settlements for budget revenues and for transparent and consistent government policies.

- During 2001 additional mutual settlements, which may not be consistent with their general prohibition given in article 6, occurred by an order of the Cabinet of Ministers: Debt of the government to metallurgical enterprises (VAT reimbursement payments) was canceled by simultaneously also canceling debt of these enterprises to energy supplying enterprises and tax debt of the latter to the government.
- The "State Committee on Material Reserves", which had been planned in 1999 to gradually reduce its activities and be phased out, is now planned to increase very substantially its activities with a balanced budget of about 660 million Hrivnias. The major problematic aspect of this fund is its potential for interfering in markets and their functioning and in influencing decision making on the part of enterprises, so that they may be distracted from concentrating on improving productivity and product quality. Hence, even if the budget of the State Reserve would be very small, detrimental effects of this institution on the functioning of markets could be significant.
- The so-called "own funds of budgetary agencies" are planned for 2002 to have substantially higher revenues. They are to a large extent fees charged by the education and health sector. Of course, the system of these fees is a complicated question, which cannot be discussed here, and it also true that in the past the government had been asked to include all off-budget funds into the consolidated budget. However, since the government does not manage these own funds of budgetary agencies and has relatively little control over them, it may be questionable whether these revenues should be included in the consolidated budget. This question arises also for another important reason: If higher own funds for health and educational institutions are planned, then the financing of increases in health and education expenditures could be seen in these higher own funds. But preventing low-income households from paying higher fees for

education and health should be a policy goal.[6] But also in case the own funds of budgetary agencies would in the future not any more be included in the consolidated budget, the necessity of making the social support programs for low income households effective, i.e. shielding the households from too high fees for basic needs such as education and health care, may be seen as an important task for the government. This could be an explicit part of the development budget.

c) Expenditures

Crucial reforms have been initiated to improve the expenditure side of the budget: The introduction of a so-called "program-targeted approach to government expenditures"[7] is likely to improve the effectiveness of all government expenditures, particularly if it can be achieved to clearly define responsibilities. The classification of expenditures was further adjusted to Western standards and an improved development budget was formulated, which singles out and presents those expenditures that may be particularly important for economic development (it comprises about 12% of total government expenditures). However, despite these important reforms, there are several questions concerning important expenditure policies:

- The development budget defines many social and investment spending programs in all spheres of the economy, including investments in the health and education sectors and in environmental protection. However, those expenditures in the conventional consolidated budget, which are investment spending in a narrow sense, such as road maintenance, communications, transport, and construction, are reduced even in nominal terms and thus substantially in real terms. Their planned aggregate share in GDP declines below 1 percent and this during a time when many tax incentives exist whose goal is to attract private investment. There is thus the question whether those programs for industry, health, and education, which foresee rising fixed investment spending, can make up for the planned reduction in the investment spending on roads, transport, communications and construction. But even if total public fixed investment spending is rising, the importance of particularly investment in roads and transport for economic growth is undisputed and urgent in Ukraine[8]. Another important question concerns the efficiency of the planned investment spending. All investment expenditures should be based on prior cost-benefit analyses so that they are concentrated there, where they are expected to

[6] Total spending for social support programs will be substantially increased. However, the social programs that aim at achieving the particular objective of protecting low-income households and granting them support for education and health care may be relatively small. For instance, regarding education the program that grants loans for university education is planned to amount to 15 million UAH in 2002. Regarding health treatment there is the promise of medical care free of charge, but payments for medicine and additional voluntary payments are common, that pose a problem for low-income households. A reform of the health sector is called for to introduce competition at all levels and a program to provide reasonable health insurance to low-income households.

[7] This approach implements earlier recommendations concerning the improvement of budget transparency, responsibility, and effectiveness of expenditures. It is planned to develop criteria, which allow assessing the results of a particular budget program. In the future all expenditures should be connected to a so-called "budget distributor", which can be a ministry or other agency, and which is responsible for fulfilling the respective budget program. Indicators for assessing the results, effectiveness and quality of the budget program should be monitored by the budget distributor and regularly reported to the Ministry of Finance. Also the process of control is planned to be changed such that not only the Ministry of Finance performs financial audits but also the National Accounting Chamber.

[8] See: Dodonov, von Hirschhausen, Opitz, and Sugolov, Infrastructure Monitoring for Ukraine, Institute of Economic Research and Policy Consulting, Working Paper No. 8, Kiev, June 2001

have the largest beneficial effects. Therefore, it could be important to prepare in addition to the consolidated budget and the so-called development budget a medium-term plan for fixed investment spending of the government. This could also serve as a means to demonstrate to investors (domestic and foreign) the seriousness of the government to improve successively Ukraine's public infrastructure. Using scarce public funds for carefully planned public infrastructure investment could be more beneficial for long run economic growth than tax exemptions for an increasing number of special economic zones. Finally, after carefully reviewing the development budget, we did not find social programs that protect low-income households from fees charged in the health and education sectors (with the exception of the already mentioned 15 million UAH student loan program). Such programs may, however, be important in promoting broad based economic development.

- A recurring issue concerns significant deviations of several actual expenditure categories versus planned expenditures in the consolidated budget. In some cases the deviations were the result of developments, which could not be foreseen. But another important reason for such deviations is that expenditures of especially regional governments deviate persistently and significantly from the plans. This may suggest that the coordination at the planning stage of the budgets of the central and regional governments should still be further improved. This particular issue does not appear to be explicitly addressed in the "program-targeted approach to government expenditures" planned to be introduced in 2002.
- Regarding particular expenditures planned for 2002 several questions may arise:
  - The planned very substantial increases of real expenditures for defense, police and national security are substantially larger than those for education, health and social protection.
  - The planned substantial increase in expenditures for the coal sector could be an important contribution to economic development and beneficial structural change in the economy if these expenditures would primarily be used for restructuring of the coal sector so that this sector will eventually become independent from government support. But the part of these expenditures, which concerns subsidies and not support for restructuring is significantly raised and amounts to half of the total support to the coal sector. This raises the question whether inefficient mines will be able to use the funds to raise their output.
  - Spending for agricultural programs rises by 40% and to above 0.6% of GDP. When assessing these spending programs it needs to be considered that the agricultural sector is already largely tax exempt. In view of the massive social and employment problems confronting agriculture and rural areas in Ukraine (over 20% of the population are employed in agriculture, but this sector generates less than 15% of GDP), net payments to agriculture from the rest of the economy can be justified. However, such payments must be directed at accelerating structural change and creating a sound social net for those who lose employment in the process of restructuring, rather than perpetuating inequity by propping up inefficient farms and state institutions.
  - The current budget plan does not show expenditures for the elimination of government wage arrears.
- Although mutual settlements are prohibited, the expenditures for the subsidization of communal services and electricity consumed by eligible private households are largely not paid in cash but through mutual settlements between the enterprises that deliver those services, the government, and Naftogas Ukraine.

- The overwhelming part of social support granted by the government (including tax privileges) is still provided to certain groups of the population (several groups of civil servants, certain pensioners, persons affected by the Tchernobyl accident, military employees etc.). The main point is that it is unclear whether these households would be eligible for social support if means testing would be applied. In addition, non-payment for communal services implies further social support from the government. This is because the government covers at least to some extent losses of energy, gas and heating companies incurred due to non-paying households. (The payments are often made in the form of tax write-offs, tax exemptions, and mutual settlements). Hence, the question arises whether the development of the social system from one, which grants support on the basis of many criteria unrelated to income to one, which is fully concentrated on providing support to low-income households, could be accelerated.

5. Three basic strategic decisions that could increase the compatibility of the budget with structural reforms

Considering that the introduction of the "program-targeted approach to government expenditures" in 2002 may be an important new instrument to improve the efficiency of government spending and thus may contribute to reduce the above discussed problems, we concentrate our conclusions on three groups of policies, where the experience shows that reform progress is very difficult to achieve and where reforms may not be implemented soon despite this new approach. This concerns, firstly, reforms of budget planning, implementation, and control, secondly, reforms, which aim at preventing mutual settlements, and thirdly, reforms of social support policies.

- Regarding the policies of budget planning, implementation, and control, the new "program-targeted approach to government expenditures" is likely to accomplish substantial improvements, especially if responsibilities will be clearly defined, and control rights of the court of auditors extended. But the approach should also include measures to improve the coordination process of budget planning between the central government and lower government levels. The reason for this is that a lack of understanding between the different levels of government at the stage of budget planning is a major explanation not only for the recurring large deviations of actual from planned government expenditures but also for debt incurred by budgetary agencies. This debt is later then paid off by the central government and often in the form of mutual settlements. A better ex-post evaluation of government spending, as foreseen in the new "program-targeted approach to government spending", will probably contribute to improve the budget planning process, because the additional information produced will facilitate planning decisions on spending. But improved coordination between the government levels does not only require better information, regular meetings, and medium-term plans instead of annual budgets and one year time horizons, but also a stable and reliable system of revenues for lower levels of government so that they have no incentives to behave "tactically", provide inaccurate information or withhold information etc. In this particular regard, the "program-targeted approach to government expenditures" may not help, because it does not address the questions of revenues of lower levels of government. In addition, the way information on government revenues and expenditures is collected and summarized at the "State Treasury" would need to be changed so that

this information becomes easier to understand and use.[9] On the budget implementation level, better definition of responsibilities will probably be decisive, and this is one major goal of the new envisaged mechanisms. On the budget control level, the reforms envisaged call for extended tasks of the court of auditors. However, this control can be effective only if the auditors can control oblast budgets and are independent of the ministries. Hence elementary necessary strategic decisions could be,

- to improve the classification of revenues and expenditures as a joint exercise of all government levels together with the State Treasury,
- to define a stable and reliable system of revenues for lower levels of government as one important means to improve the coordination of budget planning of the different government levels, and
- to extend the tasks of the court of auditors and simultaneously make it financially independent of the government.

- Reforms to effectively prevent mutual settlements between all levels of the government and enterprises would not only require the already mentioned better coordination between the different levels of government so that, for instance, budgetary agencies cannot incur any longer unauthorized debt. It would also require that the government receives all of its revenues in cash and that it pays for all expenditure programs in cash (including especially all social support programs). Since the largest entities with debt to the government, which either do not service their debt properly or use as payment the non-cash form, are energy enterprises and the government owned Naftogas Ukraine company, the unavoidable necessary strategic decision for the government to take is
  - to newly define and organize its relationship with all of these enterprises so that cash payments would be enforced.

  Since another important reason for mutual settlements has been debt of the government concerning particularly VAT reimbursements, an additional decision necessary to be taken would be
  - to improve the administration of this particular tax also with a view to reduce fraud activity (e.g. the granting of the tax credit concerning VAT could be made dependent upon proof of actual sales by the enterprise that claims the VAT tax credit).
- Reforms of the social support granted by the government would be most effective, if it there were direct cash or voucher payments to eligible low-income households only. Households above the low-income threshold would be excluded from receiving subsidies. Dependent on the granting of transitory support payments for groups who loose support, the government could realize net savings. Without such transitory support the net savings could exceed 1 percent of GDP. They could be larger in the long run, because the whole economy may become more efficient and productive, particularly because current social support subsidizes to some extent energy consumption. Necessary strategic decisions to achieve this objective concern three areas.

[9] In the opinion of many observers, the treasury, which was established several years ago to improve transparency of the budget, has not fully yielded the expected results and improvements. A major reason for this disappointment may be that the information collected by the treasury on government revenues and expenditures is not classified and organized in such a way that a user can easily understand it. For instance, a user might want to use the system to find out for what exact purpose expenditures were incurred. But often this question cannot be answered because each oblast may have own definitions of revenues and expenditures or has some freedom to classify revenues and expenditures and the treasury also has own definitions and classification numbers for revenues and expenditures.

- The criteria, which define eligibility of social support, would have to be changed so that only the income criteria would remain.[10]
- Means testing of eligible households would need to become efficient.[11]
- The government would need to improve the capacity of local governments to pay out cash or vouchers to eligible households and the funds needed by the local governments would have to arrive there on time. Hence, the ministry responsible for administering the social programs must have sufficient funds and some reserves for unexpected increases in claims.
- These changes may become feasible only if the other reforms discussed above are also fulfilled, because otherwise the central government would not have the required cash funds and it may continue to be under pressure from enterprises that did not receive full payment for their delivery of energy or other sensitive goods and services to households to engage in mutual settlements, write-off of tax arrears and tax privileges.

N.L., T.V., U.T., October 2001
Lektor: I.A., L.H.

[10] Income losses for many households that result from such changes could be dampened through raising salaries and pensions where possible and appropriate. (This would, however, reduce the short run net savings realized by the government).

[11] This could be accomplished with the help of the envisaged introduction of so-called "social inspectors" who would perform random checks of fulfillment of eligibility criteria. However, since the goal of social support is to grant it to all eligible households, social inspectors should also inform all potentially eligible households about the support programs. Perhaps also non-government institutions that are specialized on these questions, could participate in these improvements.