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NOTES ON UKRAINIAN DRAFT BUDGET FOR YEAR 2001

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GENERAL OVERVIEW

On June 22, 2000 the Parliament approved the 2001 budget resolution. According to the resolution next year state budget entails no deficit and should be drafted on the basis of the new Tax Code, which provides for reducing the number of existing taxes and lowering tax rates, among others. In mid August, the Ministry of Finance presented 2001 draft budget proposition. It provides for balanced budget with consolidated revenues and expenditures each totaling about UAH 47 billion. With the assumption of zero deficit 2001 draft budget represents further continuation in the efforts to reform fiscal sector initiated in year 2000. In 2000 for the first time in the history Ukrainian authorities try to implement balanced budget (according to the Ukrainian methodology). However, taking into account a half year experience in difficulties with balanced budget execution, the doubts may arise whether such a commitment can be met next year. Moreover, 2001 draft budget appears to be balanced only according to the Ukrainian methodology as privatization receipts are included into budget revenues. Inclusion of one time privatization receipts into budget revenues is considered artificial measure and does not create sufficient pressure for further fiscal adjustment. Thus, draft budget should be regarded as deficit one according to the international standards. Draft budget foreseeing a surplus (preferably according to the international accounting standards) would facilitate possibility of at least balanced budget execution. It would provide some space for traditional expenditures sequester practices if the government faced the lack of sufficient revenue. Although the debt burden on next year's budget remains high, Ministry of Finance does not plan to pass a budget with a surplus since it hopes to receive renewed foreign financing after reaching final agreement with the IMF. The government should submit 2001 draft budget to the Parliament by September 15, 2000.

MAIN MACROECONOMIC ASSUMPTIONS

Ministry of Finance proposed 2001 draft budget with zero deficit. The size of revenues and expenditures of the consolidated budget is estimated at UAH 46 889 million. The budget is to be shared between the state budget and extra-budgetary fund in the following proportion: UAH 39 100 million and UAH 7 789 million respectively.

The budget is based on the following assumptions regarding the main macroeconomic indicators, which were provided by the Ministry of Economy:

1. real GDP will grow by 4 per cent
2. CPI will increase by 19.5 % on average
3. average exchange rate will be 6.6 UAH/USD

Consolidated budget is to constitute about 25 % of GDP. The share of revenues in GDP appears to remain almost the same as in the previous years but it may not be sufficient enough taking into account the fact that Ukraine needs to finance complex economic reforms. Related share of budget expenditures may reflect a measure towards the restructuring of the government spending providing that a package of

necessary reforms is successfully implemented. On the other hand, reform process poses on the government very high financing constraint. Relatively limited possibility to further restrict government spending should be recognized and took into account while projecting budget expenditures.

SOME MAJOR WEAKNESSES AND RISKS

1. **Unrealistic macroeconomic indicators projection**.

Evaluation of successful budget execution possibilities was based on the forecast of nominal GDP, inflation and budget revenues prepared by the CASE modeling group. CASE experts forecast following results regarding the main macroeconomic indicators for year 2001:

1. real GDP growth will account for 1.6 %
2. by the end of the year monetary base will increase by 25 %
3. CPI will increase by 19.5 % on average
4. exchange rate will be 6.7 UAH/USD at the end of December 2001

Above assumptions substantially differ from macroeconomic assumptions applied by the government in the process of budget formulation in relation to one important indicator: the real GDP growth rate. It appears that **4 % real GDP growth estimated by the Ministry of Economy** and applied by the Ministry of Finance in draft budget **seems to be too optimistic,** and therefore, **unrealistic**. Next year some deterioration of current favorable external factors (which substantially contribute to high GDP growth in 2000) is expected to take place. It relates to slower rate of growth of external demand for Ukrainian export. What concerns domestic demand, we forecast substantial increase of investment demand, moderate increase of private consumption and decrease of government consumption reflecting fiscal consolidation effort. In addition, there will not be the effect of low statistical base present next year. Therefore, GDP growth for 2001 is forecasted to be lower than in the current year and will account for about 1.6 %. Thus, presented discrepancies in the rate of real GDP growth forecast (and respectively in nominal GDP value) will influence the nominal revenues projections, which is overestimated for this reason. It poses a threat that balanced budget will not be achieved in year 2001. Regrettably, year after year, Ukrainian authorities appear unable to apply credible budget planning. Ukraine has not been able to overcome these problems and as a consequence actual revenues are consistently lower than plan.

2. **Uncertain budget revenues base**.

Discussed 2001 draft budget has been prepared on the base of tax system currently prevailing in Ukraine. However, almost parallel to the adoption of 2001 budget Parliament is to approve a new Tax Code. Thus, **budget revenues forecast relies on tax regulations, which probably will not be in force during budget implementation**. The draft Tax Code that was submitted to the Verhovna Rada by the Cabinet of Ministers for the first reading contains many provisions that if enacted would considerably change the tax system. Unfortunately, the final shape of tax legislation may substantially differ from currently discussed version due to political

process. Furthermore, according to foreign advisory experts (CASE, HIID, Barents Group) although draft Tax Code provides, to some extent, improvement in the Ukrainian tax system, it still fails to address several significant issues. Among others, the following shortcomings should be mentioned: the strengthening of inappropriate proportions between direct and indirect taxation, too fast pace of tax rates reduction, limited reduction in number of taxes, insufficient repealing of tax privileges and exemptions in PIT, EPT and VAT. As a result implementation of a new Tax Code according to the proposed draft law would lead to a major fiscal crisis and would not have expected positive effects on the economy. In order to address these important issues it is recommended that improving actions should be taken as soon as possible so that a revised draft Tax Code could be substituted for the current draft before the Parliament considers second reading in September.

According to the Barents Group experts the **adoption of the draft Tax Code would reduce total tax revenues by UAH 3.2 billion in 2001 and by UAH 5.0 billion in 2002**. Such decrease represents 14 % of expected tax revenues for 2002. Even if it is assumed that the tax reductions will generate additional economic activity or reduce the size of the shadow economy, the revenue decrease will remain significant. Assuming the most favorable effects, the economic impact of the tax reductions may generate additional revenue of between UAH 0.5 to 0.8 billion, still leaving a financial gap. So far, no alternative measures have been identified to compensate for the loss of revenue. The government should consider major expenditure reductions in order to compensate revenue shortfall or alternative scenarios of tax reform that are less costly to the budget.

Furthermore, in short run perspective proposed changes in the tax system will probably not bring considerable expected positive influence on a GDP growth rate. CASE forecast of 1.6 % GDP growth in 2001 is based on the assumption that old Tax Code prevails.

All these factors negatively influence the process of budget planning. **Indicated results show that the government** (lacking knowledge about the final shape of revenue base and about the prospect influence of tax reform on economic growth) **should be very cautious while projecting GDP growth and budget revenues**. There is absolutely no room for unrealistic overvaluation of these basic indicators.

3. **Expenditures**.

There is a serious threat that **overestimation of macroeconomic and fiscal indicators** at the budget formulation stage **may lead to** the repetition of tendency to **overestimate potential for expenditures**. Consolidated budget expenditures have been constantly unfounded and not executed as provided by law over all recent years. Funded expenditures range between 84 % to 96.5 % of approved appropriations during 1995-1999. Year 2000 may also face the same problem. The Finance Ministry on several occasions during this year has repeated that there exists the possibility of sequestering the state budget. However, consideration of the issue has been postponed several times. During the first half of the year, state and local budget revenues amounted to UAH 19 429 million or 45.9 % of the amount the Ministry of Finance projected for the entire year. In mid August, the authorities confirmed necessity to restrict government expenditures in 2000. The underfunding of approved budget

appropriations is a direct consequence of unreliable budget forecast and difficulties with revenue collections. **There are good reasons to expect that next year the same well known practice of sequester will be used if budget revenue problems emerge.** This contradicts the idea of budget process transparency. Credibility of government's responsibility for proper budget planning is undermined when the burden of weak budget procedures is transferred to the economy and society.

4. **Debt servicing and privatization**.

According to the Ministry of Finance, in the next year **the expenditures for debt servicing** will amount to **one fifth of the total budget spending**. In April 2000, the Ministry of Finance carried out a large-scale restructurization of its external obligations due for settlement in 2000 – 2007 and exchanged them for new Eurobonds. The repayment of these Eurobonds should begin in March 2001. Taking into account the lack of foreign financing during almost whole year 2000 and uncertain prospects in this field for next year the government should be especially interested in the adoption of realistic balanced or preferably surplus budget next year (according to the IMF standards).

Next year the government foresees privatization receipts be one of the key financing sources for debt servicing expenditures. The Ministry of Finance projects to earn about USD 1 billion from the sale of state enterprises. For the current year privatization plans were planned at the half of this ambitious level. During the first half of year 2000 privatization process proceeded according to the schedule. But the process is expected to substantially slow down next months. There is even a possibility that some tenders will be shifted to the next year. It raises a **question about the probability of successful collection of assumed privatization revenues in 2001 unless the privatization process in the key sectors such as electricity distribution and generation, telecommunication, metallurgy and chemical industry will be really accelerated.** And this is strictly connected to the progress in deregulation of the infrastructure sectors and removing the existing political obstacles in this sphere.

CONCLUSIONS

In order to avoid budget implementation difficulties in 2001 the Ministry of Finance should **formulate draft budget on properly forecast macroeconomic indicators**. To address these important issue it is recommended that improvements in the Ministry of Economy projections should take place as soon as possible so that a revised draft budget could be substituted for the current one before submission to the Parliament by September 15. **Realistic budget for year 2001 is an economic necessity and one of the IMF major requirements**. According to the IMF experts one of the main issues facing Ukraine is a realistic budget for the next year.