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Institute for Economic Research and Policy Consulting

Policy Paper Series [PP/03/2013]

Fiscal consolidation in Ukraine: Why it is needed and how to do it

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Berlin/Kyiv, December 2013

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Fiscal consolidation in Ukraine: Why it is needed and how to do it

Executive Summary

The consolidation of public finances is a major topic in many countries around the globe in the aftermath of the global financial crisis 2008/09. Rapidly increasing fiscal deficits during the crisis put significant upward pressure on the public debt stock, which resulted in public debt crises in some economies. Ukraine was also hit hard during the crisis, and saw a widening of its fiscal balances, leading to a steep increase in its public debt level to almost 43% of GDP at the end of 2013 (from 12% in 2007). In a wide definition (i.e. including the operational deficit of state-owned Naftogaz) the overall general government deficit is expected to reach almost 8% of GDP this year, up from 4.3% in 2011.

It is obvious that this situation is not sustainable, and the current financing difficulties of the government (e.g. no access to international capital markets, limited liquidity at domestic capital markets, rating downgrades and negative outlooks by all three major rating agencies) are proof of that. Thus, the authorities need to re-embark on a path of fiscal consolidation in order to firmly anchor the sustainability of public debt. This is a challenging, but nevertheless manageable task, as the government has demonstrated during the recent past: Over the years 2010-2011, the authorities achieved some initial success in stabilizing public finances, as the deficit was significantly reduced.

In terms of how to achieve fiscal consolidation, our recommendations can be broadly separated into four categories. First, we think that the authorities should aim for a positive primary balance of 0.7% of GDP, which would stabilize public debt at current levels. This is a value that should be achieved gradually over the next few years. Second, in terms of ensuring enough revenues, the foreseen reductions in EPT and VAT rates in 2014 should not be enacted. A reduction in existing tax privileges (e.g. in agriculture) should be undertaken, while at the same time no new privileges should be introduced. Fair, stable and transparent rules of taxation would help to improve revenue collection in the medium term. Third, on the expenditure side, there is also significant room for improvement. A reduction in energy subsidies plays a key role here, as well as the topic of corporate subsidies. Regarding the latter, the adoption of the law on state aid, as well as streamlining public procurement would ensure higher efficiency of spending and larger returns from subsidies provided. With a view of the Presidential elections in 2015, a clear restraint in terms of the public wage bill and social assistance payments is warranted, especially in the current period of price level stability. Finally, the financing of the remaining deficit should be conducted in a transparent manner, and with a clear view towards reducing borrowing risks (e.g. FX risks).

Finally, it should be stressed that fiscal consolidation is only one cornerstone of a wider strategy to stabilize Ukraine’s economy, which is running some of the highest twin deficits in the world. Reducing these imbalances requires a new policy mix, which includes also fundamental changes in the conduct of monetary and exchange rate policy. Allowing gradually more exchange rate flexibility would be another major component of this policy mix, which could help to decrease external deficits, and support sustainable economic growth.

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Acknowledgements

The authors would like to express their gratitude to Woldemar Walter for providing excellent research assistance. The usual disclaimer applies.

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1. Introduction

After the global financial crisis in 2008/09, fiscal policy issues are currently in the spotlight in many economies around the world. The crisis led to a significant increase in budget deficits in virtually all countries affected, which in turn increased the public debt stock to much higher levels. A small number of countries, including developed ones, experienced public debt crises as a result, in which the sustainability of the public debt stock became a crucial issue.

Against this international background, Ukraine's experience with its fiscal situation is no exception. The crisis 2008/09 hit the country's public finances hard, and led to a rapid build-up in public debt. Furthermore, there are currently a number of signs that the fiscal situation in Ukraine has deteriorated significantly over the recent past, as the country's economy is facing a protracted period of stagnation, with an increased risk of recession as of late.

This challenging situation warrants a closer look at the state of public finances in Ukraine, with a specific focus on the budgetary situation. The overall aim of this policy paper is to provide some recommendations on how the necessary process of fiscal consolidation can be brought back on track.

The paper is structured as follows: In the next chapter, we will provide a comprehensive analysis and assessment of the overall state budget, taking into account its different components. Based on this analysis, the following chapter entails concrete policy recommendations on how the authorities should react to the challenges. In the last chapter we deliver some concluding remarks.

2. State budget: Analysis and Assessment

Ukraine was hit exceptionally hard during the global financial crisis, with real output dropping by almost 15% in 2009. In order to stabilize the situation, the authorities arranged a Stand-by Arrangement (SBA) with the IMF at the end of 2008. A second SBA was agreed in 2010, and fiscal sustainability was defined as a major goal of this agreement. Since then, it has been one of the ongoing major policy issues in the discussions between the IMF and the Ukrainian government made in the framework of Article IV negotiations in 2012 and 2013, as well as in all meetings related to the possibilities to negotiate a new, third IMF program.

Table 1, which summarises the main fiscal indicators, clearly shows the background of this continued focus on fiscal developments, as the numbers signal severe vulnerabilities and risks coming from the fiscal side. Undermined by weak economic performance, the share of revenues in GDP increased in 2012 only slightly to 44.5%, while expenditures increased rapidly and reached 49.0% of GDP. Here, one should note that in 2012 parliamentary elections were held, which had an impact on the growth in entitlements.[1] The general government deficit reached 4.5% of GDP in 2012, which does not include the operational deficit of state-owned Naftogaz Ukraine, which is estimated at an additional 1.6% of GDP. This together makes a deficit of more than 6% of GDP, an increase of almost 2 p.p. in comparison to the previous year (2011: 4.3%).

Fiscal pressure remained high in 2013, as the Government is confronted with a prolonged economic stagnation, while restricted access to domestic and international capital markets limits the possibilities to finance the deficit. The Government has decided to use promissory notes to pay some obligations, including VAT refunds in the end of the year.

According to the Tax Code EPT and VAT rates are to decline in 2014, which is likely to result in a decline in consolidated fiscal revenues in relation to GDP.

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1 In March 2012 the President initiated additional increases in social payments, including pensions. See: *Social initiatives - New social initiatives on the eve of parliament elections*, MEMU, №4 (138) April 2012, IER Kiev.

Table 1

Main Fiscal indicators (% of GDP)

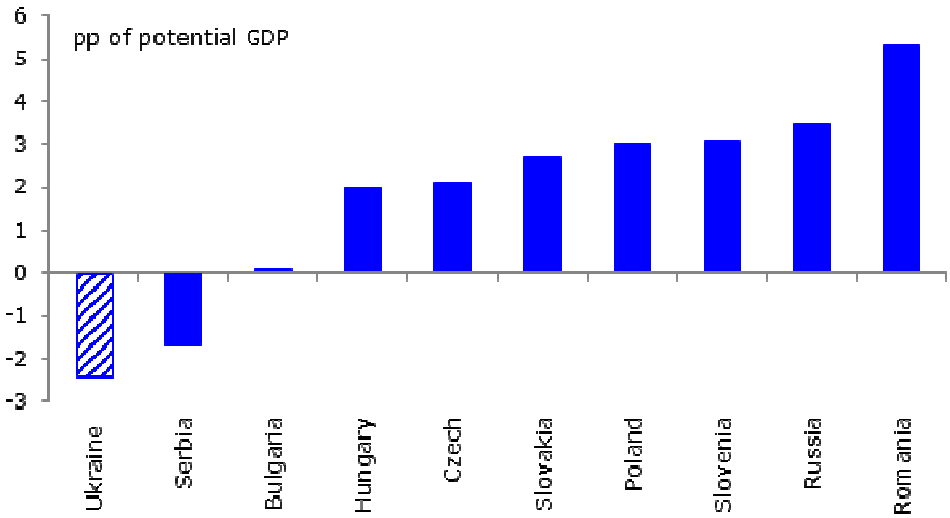
	2007	2008	2009	2010	2011	2012	2013E	2014E
General government revenues[1]	41.8	44.3	42.3	43.2	42.9	44.5	45.2	44.5
General government expenditures[1]	43.8	47.4	48.6	49.0	45.6	49.0	49.5	49.6
General government balance[1]	-2.0	-3.2	-6.3	-5.8	-2.8	-4.5	-5.8[3]	-5.1
Naftogaz' operational deficit[3]	n/a	n/a	-2.4	-1.6	-1.5	-1.6	-2.0	-2.0
Overall balance, including Naftogaz' operational deficit	n/a	n/a	-8.7	-7.4	-4.3	-6.1	-7.8	-7.1

Note: E – estimate
[1] *General government includes central and local governments and the social funds*
[2] *IMF estimates, Country Report 2012*
[3] *General government deficit for 2013 is estimated at 5.8% of GDP, including 1.3% of GDP in recognized VAT refund and expenditure arrears to be covered by recently approved promissory notes (IMF estimate).*
Source: IMF

Another indicator for the dire state of public finances in Ukraine is the development of the cyclically adjusted fiscal balance. [2] In a regional perspective, Ukraine clearly underperformed other countries in Central and Eastern Europe, most of which showed significant consolidation successes during the period 2009-2012. The most impressive adjustment has been delivered by Romania, whose balance improved by around 5 percentage points (pp) of potential GDP during that period. In comparison, Ukraine's balance deteriorated by more than 2 pp, putting it last among our sample.

Figure 1

Change in cyclically adjusted budget balance between 2009 and 2012



Source: IMF Fiscal Monitor Oct 2013, WEO for Serbia

In order to gain more insights into fiscal developments in Ukraine over the last years, we will briefly analyse revenues, expenditures and the financing of the resulting fiscal balance in separate sections below.

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[2] The cyclically adjusted fiscal balance adjusts the overall balance for the output gap, and thus gives a better view of the underlying fiscal position of the country. Further adjustment by transitory factors like commodity price shocks, asset price effects, etc. yields the structural fiscal balance.

Revenue side

The major source of consolidated fiscal revenues is taxes. The share of tax revenues grew by 4.7 p.p. to 80.9% between 2008 and 2012 due to changes in the structure of the economy, differences in the methodology of fiscal revenues, increases in the rates of excise duties and rent payments, and increased efforts in tax administration.

VAT revenues remain the major tax revenue source (equal to 10% of GDP in 2012). They increased due to larger consumption of both domestically produced and imported goods. At the same time, the issue of VAT refund arrears was not solved, regardless of the introduction of automatic VAT refunds for companies, which comply with specified criteria on wage levels and tax credits. This supported higher net VAT revenues. Overall, according to the Ministry of Revenues and Duties, VAT refunds due by November 1, 2013 were estimated at UAH 12 bn.

Another important source of tax revenues was traditionally EPT, but whose importance declined over recent years. In particular, the EPT rate was gradually decreased from 25% in 2010 to 19% in 2013, which, against the background of weak corporate profits, undermined fiscal revenues. At the same time, increased collection efforts by the tax administration and advance EPT payments supported this revenue item, at least for the time being. As a result, EPT revenues were at 4% of GDP in 2012. Higher revenues from excise duties were ensured by a gradual increase in rates, while wage growth ensured higher PIT revenues (2.6% of GDP and 4.8% of GDP, respectively).

In 2013, the revenue side stood under high pressure, as fiscal indictors were based on the assumption of real GDP growth at 3.4%, while it declined by 1.3% yoy in first nine months of the year. Consolidated tax revenues declined by 0.7% yoy between January and October due to lower net VAT revenues and smaller excise duties collections. At the same time, non-tax expenditures increased by 18.6% yoy, primarily due to larger transfer of the NBU profits (by 63.0% yoy).

A negative structural feature of revenue side of the budget is losses of fiscal revenues due to tax privileges. In particular, according to estimates of the tax authorities, the losses to the consolidated budget totalled around 11.8% of total revenues in 2012, as the following table shows:

Table 2

Estimated losses due to tax privileges

	2012E		**2013E**	
	UAH bn	**% of total tax revenues***	**UAH bn**	**% of total tax revenues****
EPT	16.84	4.67	16.31	4.28
VAT	22.86	6.34	22.32	5.86
Excise	2.42	0.67	2.40	0.63
Other	0.34	0.09	0.44	0.11
Total	***42.45***	***11.77***	***41.46***	***10.89***

Note: E – estimate of the STS
** of actual revenues*
*** of estimated IER fiscal revenues*
Source: Explanatory note to the State Budget Law of 2013

At the same time, the highest losses of EPT revenues are attributed to loss-carry-forward (65% of total losses of EPT revenues) and operations exempted from taxation according to international agreements (17.5%). Privileges to different sectors of the economy and companies that implement government investment projects are estimated to account for UAH 2.4 bn in 2013.

47.3% of VAT revenues losses are attributed to the special VAT regime for agriculture and agricultural exports. In particular, producers are entitled to retain the VAT received from their sales, to transfer it to special bank accounts and to use it for VAT refund on inputs and for other production purposes. Agriculture benefits from this taxation regime, but overall it makes negative contribution to fiscal revenues.[3]

13.0% of VAT revenues losses are attributed to exemption of pharmaceuticals sales from value added taxation. Overall, in Ukraine only two VAT rates are applied: statutory at 20% or reduced rate at 0%, which differs from most EU countries, where reduced but higher than 0% VAT rate is applied for some (e.g. socially important) goods.

According to the Tax Code, VAT and ETP rates are to be reduced in 2014 to 17% and 16%, respectively, which would increase fiscal pressure next year. However, the State Budget Law for 2014 is likely to terminate this reduction to ensure higher revenues next year, which was state by the Minister of Finance in the beginning of November.[4]

Expenditure side

The State Budget Laws for 2012 and 2013 envisaged further increases in social standards, including minimum pensions and minimum wages. The wage for public employees as defined in the Single tariff scale was also increased, bringing the wage of the first tariff rate to 76.2% of the minimum wage as of December 2013 as compared to 74.0% a year earlier. In 2012, wage payments and spending for subsidies each accounted for about 11% of GDP. The increase in state debt over the last years resulted in higher expenditures on interest payments, which grew to more than 5% of total expenditures (2.0% of GDP), as compared to only 1.6% in 2008 (0.5% of GDP). One should keep in mind that this increase happened despite a period of globally low interest rates, which will not last forever. This will likely put further upward pressure on interest payments in the future.

As a result, the share of current expenditures was at 91.7% of total consolidated fiscal expenditures in 2012 and was the major contributor to expenditure growth over last years. The Government allocates less than 10% of expenditures (3% of GDP) on capital outlays, while on average in transition countries this spending item accounts to almost 14% of public spending (4.4% of GDP). This results in a further deterioration in the infrastructure sectors, which are predominantly financed either by central or local governments, with negative implications for economic growth and development.

Despite the lack of financing, in the first ten months of 2013 subsidies and current transfers to the population increased by 17.2% yoy, primarily due to higher transfers to the Pension Fund (see Box 1). Spending on debt service increased by 32.1% yoy due to a larger debt stock as well as higher weighted average yields. At the same time, capital spending dropped by 33.1% yoy, following its negative trend described above.

Box 1: *Recent Developments at the Pension Fund*

In the first nine months of 2013, the Pension Fund's expenditures increased by 8.5% yoy to UAH 187 bn due to increases in pension payments, predominantly explained by higher minimum pensions. Pensions were financed at the expense of higher revenues from pension insurance contributions (by 6.3% yoy) and a larger central fiscal transfer. The share of expenditures, which is financed by revenues from pension insurance contribution, declined to 65.4%, which is by 1.4 p.p. lower than in the same period of last year.

At the same time, loans of the State Treasury to the Pension Fund were much lower this year (estimated at about UAH 1.5 bn as compared to an estimated UAH 13.5 bn last year). This could be partially explained by the higher central fiscal transfer, which surged

3 See for more details*: Turning Ukrainian Agriculture into an Engine of Growth: A Strategy for the Development of the Grains and Oilseeds Sector*, Berlin Economics, Study for EBA/ACC, 2012.

4 In particular, according to estimates by Minister of Finance, Yuriy Kolobov, the reduction in tax rates would result in revenue loss of UAH 25 bn.

by 31.8% yoy, with a larger increase of deficit financing transfer (by 51.3% yoy).[5] Another reason of low State Treasury loans is the low balance of the Single Treasury Account, which does not allow such operations. The Government even acknowledged some delays in social payments, which were widely reported over the last few months.

Source: MEMU, Social policy: The Pension Fund's deficit remains high, #11 (157), November 2013, IER Kiev

The pressure for 2014 might increase taking into account Presidential elections in March 2015. In particular, social entitlements traditionally increase in the pre-election and elections years in real terms.

Financing the fiscal balance

Even though the consolidated fiscal deficit was in the first ten months of the year lower than planned (e.g. due to lower than planned borrowings), it increased by 27.1% yoy to UAH 37.1 bn (accounting for 59.0% of annual plan). Also, the numbers do not include Naftogaz' operational deficit, which is a further debt-creating item.

The financing of the deficit, as well as the amortization of government debt due, was quite challenging, as Ukraine lost access to international capital markets in May, due to a number of domestic and external reasons (e.g. the tapering debate in the US, and increased concerns on the external vulnerability of the country and the lack of policies aimed at domestic fiscal consolidation). To some extent, the deficit was financed at the expense of placement of domestic government bonds denominated in USD, which further increased the exposure of state debt to exchange rate risks.

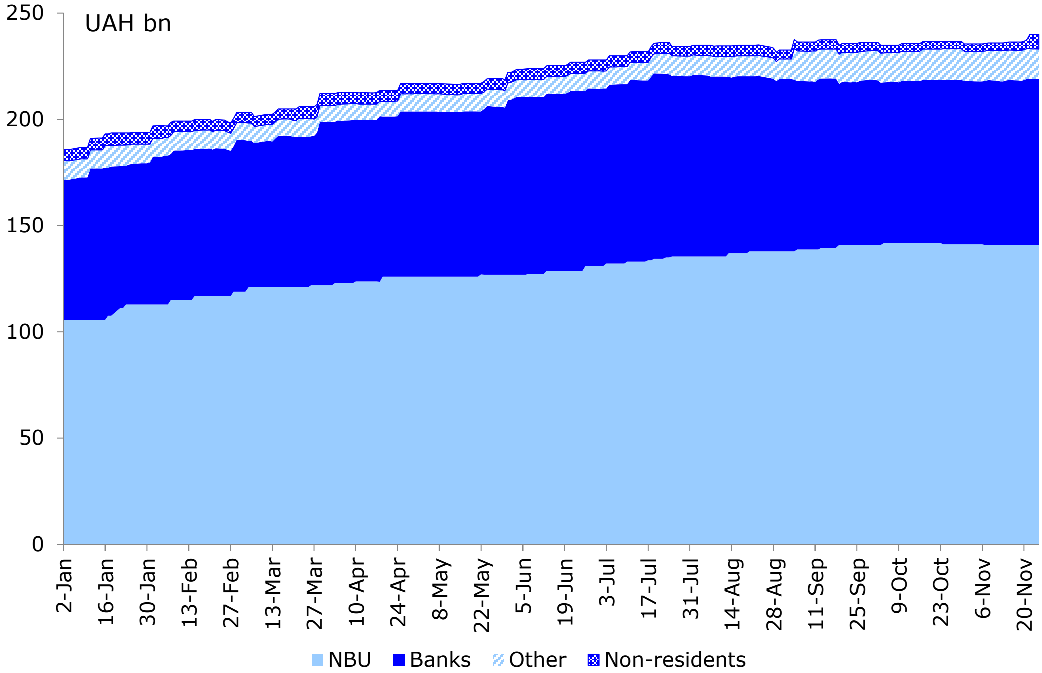
Since the beginning of 2013, the stock of domestic government bonds increased by 29.1% (as of November 25). Most new bonds appeared in the portfolio of the NBU, which now holds 58.7% of all domestic government bonds. Also state-owned banks have been purchased government bonds to a significant degree.

Privatisation receipts were executed at only 8.4% of the annual plan due to the lack of large scale transactions, and thus did not play a significant role.

5 The Pension Fund receives two transfers from the Central budget. The first one is directed to the Pension Fund to ensure payment of pensions according to different state pension programs (e.g. higher pensions to civil servants, judges, etc.) including co-payment to pensions to minimum level for those retired individuals, whose pensions are to be lower than the minimum level if calculated according to the general pension formula. Another transfer is a deficit financing transfer, as this is the only source of financing the Fund's deficit.

Figure 2

Domestic government bond holdings



Source: National Bank of Ukraine

Overall, by the end of this year, the Government will be able to secure the gross financing requirements only if the NBU will continue playing its active role at the bond market, or the Government attracts external loans from other sources. According to IMF estimates, the general government deficit will increase to 5.8% of GDP, which includes 1.3% of GDP in recognized VAT refunds and expenditure arrears to be covered by recently approved promissory notes.[6] Moreover, Naftogaz's operational deficit might reach 2.0% of GDP (including trade credits and advanced payments for gas transit by Gazprom).

Thus, the fiscal deficit in Ukraine is not explained primarily by the business cycle, but by an unsustainable fiscal policy stance, as Figure 1 clearly showed. This urges the need for fiscal consolidation, which is also required taking into account very low government's cash balance, which declined to UAH 0.4 bn as of November 1, the lowest level for the last ten years. Otherwise, the risk is that public debt will be on explosive path during the next years.

Implications

What implications can be drawn from the above analysis? We would like to highlight three particular aspects of fiscal situation, which deserve in our view closer attention.

i. Increase in public debt

Increased expenditures against the background of a lack of corresponding revenues resulted in an increase in the state debt by 2.8 times in US dollar terms between 2008 and September 2013. Pressure on the Government increased as it requires significantly more financial resources for servicing the public debt stock, in addition to covering any new budget gap. In particular, public debt surged from 12.3% of GDP at the end of 2007 to an estimated 41% of GDP by the end of 2013. One of the reasons was the devaluation of the Hryvnia in the end of 2008, as around 60% of the debt stock is in foreign currency, but also the loose fiscal policy with a high share of quasi-fiscal operations and contingent

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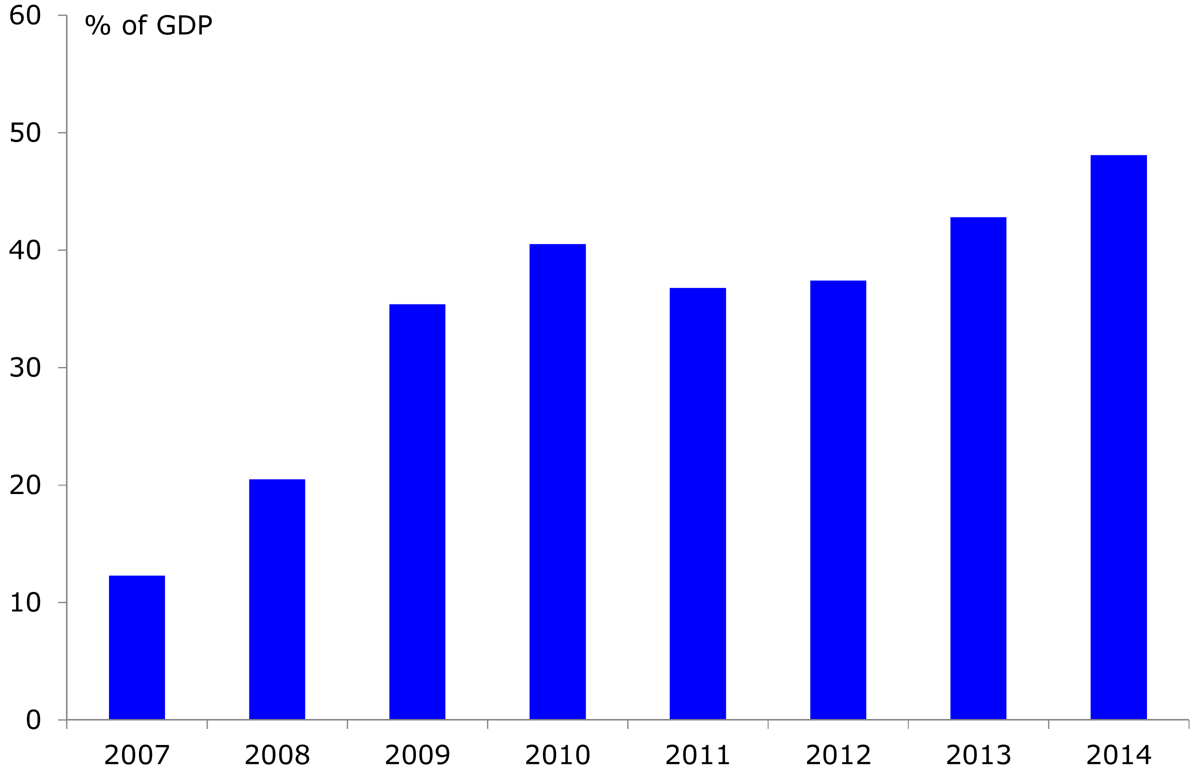
[6] Statement by IMF Mission to Ukraine, Press Release No. 13/419, October 31, 2013, http://www.imf.org/external/np/sec/pr/2013/pr13419.htm

liabilities. It should be highlighted that over the period 2006-2013, Ukraine always had a negative primary fiscal balance[7], which contributed to negative debt dynamics.

Figure 3

State debt (direct and guaranteed)



Source: IMF

The high fiscal pressure was among the major reasons for the downgrade of Ukraine's sovereign rating by all three major international rating agencies during September-November 2013. As a result, yields on Ukrainian sovereign Eurobonds jumped on average to 10% p.a., thus closing effectively the access of the Government for new borrowings at international capital markets.

ii. Problems with the business climate

Increased pressure on companies due to attempts by the fiscal authorities to ensure higher fiscal revenues clearly deteriorates the business climate in Ukraine. In particular, according to the IER Quarterly Enterprise Survey, 54.9% of managers named excessive taxation (which is comprised of high taxes and extensive tax administration) as one of the biggest impediments to business development in the first quarter of 2013. For comparison, this share was at 37.9% and 48.0% in the third and fourth quarters of 2012.

Besides, meetings of businesses conducted by business associations (e.g. ACC, EBA) claim that the issue of VAT refunds is not solved, which makes running a business more expensive. Frequent requirements to make advance EPT payments are also a problem at a time of shrinking profits due to the economic stagnation. Additionally, such strategies provide only a temporary relieve to the state coffers, as this money is missing at a future point in time.

Also due to the unfavorable investment climate in the country, investment remains at depressed levels and a number international companies, both working in real and financial sectors, are currently discussing possibilities to exit their operations in Ukraine.

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[7] The primary balance excludes interest payments on government debt.

In turn, the negative business climate negatively impacts the medium and long-term economic growth potential, further hampering the fiscal situation.

iii. Lack of transparency

The discussed lack of financing makes the Government more "creative" in generating corresponding financing schemes. One of the recent decisions taken relates to the introduction of the promissory notes, which are to be used for covering budget arrears. Promissory notes are to circulate as state domestic bonds, but are likely to be excluded from reported state debt. Therefore, it would reduce fiscal transparency, which is required by international fiscal standards.

In particular, UAH 12.0 bn of promissory notes are to be proposed to companies that claimed VAT refunds. Near UAH 4 bn of promissory notes will be provided to cover budget arrears. In addition, the Parliament allowed the Government to restructure debts of heating generating companies through provision them with promissory notes. These promissory notes are likely then to be paid to Naftogaz and then refinanced by banks, even though the procedure is not defined yet. As a result, total amount of promissory notes might be at a level of 1.3% of GDP by the end of 2013.

Therefore, promissory notes might increase further the amount of quasi-fiscal operations, which are already high. In particular, state banks support Naftogaz through several schemes. On the one hand, they purchase state domestic bonds, which are provided by the Government to the statutory capital of company. In turn, the NBU then either purchases these bonds or provides refinancing against these bonds. On the other hand, state banks provide "directed lending" to Naftogaz at lower than market yields. In particular, loans to Naftogaz accounted for 33% of the loan portfolio of Oschadbank by the end of 2012, while 69% of these loans were pledged as collateral for NBU refinancing.

Therefore, the exposure of state banks to the financial situation of one particular company (Naftogaz) is already very high. Moreover, it means also higher contingent liabilities for the Government, which endangers substantially fiscal sustainability.

3. How to reduce and finance the budget deficit: Policy Recommendations

In this chapter, we provide some recommendations on how the process of fiscal consolidation should be brought back on track. We separate our proposals into four sections: First, we look at the level of the fiscal balance that the authorities should aim for in its consolidation efforts, as this is the key variable in stabilizing public debt dynamics. Second, we look at measures on the revenue side that will support consolidation. Third, we look at the expenditure side for corresponding measures. Fourth, we provide some thoughts on financing the budget deficit in a transparent manner.

3.1 Target level of fiscal balance

Taking into account the currently high fiscal pressure, including the growing state debt, the Government must introduce fiscal consolidation measures that will reduce the large financing needs. In order to anchor the sustainability of public firmly, it should put its main priority on the stabilization of public debt, which has increased rapidly over the last few years (Figure 3). While the level in relation to GDP is not very high in international comparison[8], a number of features, including the large part denominated in foreign currency, make it very vulnerable to different sources of risks.

- To stabilize the debt at the current level in relation to GDP (ca. 43% of GDP at the end of 2013) an average primary fiscal surplus of at least at 0.7% of GDP during

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[8] Putting the current debt level into perspective, one should not forget that in the year prior to Ukraine's default in 1998-2000, the public debt ratio was 34.7%, according to an analysis by Moody's.

the next years is needed[9]. This contrasts with a negative primary balance of 2.8% of GDP on average between 2007 and 2012. In 2013, a negative primary balance of 1.8% of GDP is expected. In case no consolidation efforts are undertaken and the balance would remain unchanged over time, this would have extremely negative implications for public debt dynamics: Under an unchanged primary deficit at 1.8% of GDP, a steady increase of state debt to 60% of GDP by 2020 would be the result, clearly threatening the sovereign's solvency.

Thus, a significant and lasting consolidation effort is needed, whose impact will likely have to be spread over a number of years. For this, the Government has several options: Increase revenues and restrict spending growth. Besides, it should increase the efficiency and effectiveness of public spending.

3.2 Revenue side measures

The Government should enact a number of measures to strengthen the revenue side, which we discuss in more detail below:

- The foreseen EPT and VAT rate cuts should be put on hold until the fiscal situation becomes sustainable. We support recent respective statements by the Minister of Finance, and think they are an important cornerstone of consolidation efforts.
- Tax privileges should be reduced. In particular, sectoral tax privileges should be eliminated as they often create room for fraudulent behavior. In particular, agriculture profits and income should be taxed on the basis of the general taxation system. Moreover, the simplified taxation system should be streamlined, as recent changes in it created more fraud. In particular, certain medium-sized companies apparently abuse the simplified schemes for tax minimization purposes.
- Third, new privileges should not be introduced. In particular, the law on transfer pricing was approved in 2013, and according to official estimates could generate up to UAH 20 bn per year. However, the law granted exemptions for those sectors that could ensure such revenues, which will result in lack of positive impact on fiscal stance.
- The Government should ensure fair, stable and transparent rules of taxation, which are an important part of the business climate. In this respect, there is still a lot of work to do, as Ukraine's 164th position in the World Bank's sub-indicator "Paying Taxes" is significantly below the overall rank of Doing Business (112th position). The continuation of reforms of the regulatory environment and the protection of property rights would further contribute to an improved investment climate. As a result, in the medium term, fiscal revenues will be strengthened.

3.3 Expenditure side measures

On the expenditure side, a number of concrete measures would contribute to a decrease in the overall fiscal deficit:

- Energy subsidies should be reduced, in particular through increase in gas tariffs for the population and heating generating companies.[10] This would reduce transfers from the central budget to Naftogaz, which equaled about 1% of GDP in 2012, and improve its financial position.
- At the same time, social assistance to families should become means-tested and the provision of housing and utility subsidies should be streamlined. Social privileges provided to different categories of the population should be gradually

[9] Own estimate based on a standard (IMF) approach of debt sustainability. Real interest rates are assumed close to current levels (5.4%), while real GDP is assumed to grow at 3.5%.

[10] Jörg Radeke, Ricardo Giucci, Dmytro Naumenko. *Adjusting gas prices to unlock Ukraine's economic potential*, Policy Paper PP/02/2012, German Advisory Group/IER; Oleksandra Betliy, Jörg Radeke. *The Socio-Economic Impact of Rising Gas Tariffs*, Policy Briefing Series PB/02/2012, German Advisory Group/ IER

phased out. Besides, the Government should introduce anti-fraud procedures while providing social assistance.

- The provision of subsidies should be streamlined. In particular, Ukraine still lacks a law on state aid, which would ensure higher efficiency of spending and larger returns from subsidies provided. Moreover, the Government would benefit from streamlining public procurement, which is characterized by the low efficiency of fiscal spending.
- Taking into account the comparatively low wages in the public sector, an outright reduction seems not feasible. At the same time, the Government should continue its administrative reform, with a view of improving the efficiency of the public administration. This could result in a lower number of civil servants, thus, restricting the growth of the wage bill.
- International experience proves that the best policy to increase the living standards of the population is to ensure sustainable economic growth, rather than escalating social payments, which then have to be financed through increased tax pressure on working individuals and companies. Therefore, the Government should limit increases in social expenditure in the run-up of presidential elections in 2015. It should also take in mind that in the current phase of price level stability, a nominal expenditure restraint would equate to a real one.

<u>3.4 Transparent deficit financing</u>

The recent past shows the difficulties of financing a high and growing fiscal deficit. In this regard, a number of issues can help to improve deficit financing, lowering the risks associated with borrowing, and ultimately also the borrowing costs:

- The Government should clearly recognize its entitlements and liabilities and finance them in a transparent way. During this year, a preferred strategy would have been to sequester the budget, taking into account the inadequate available amount of financing. Instead of following this approach, the authorities introduced the non-transparent instrument of promissory notes (for financing liabilities of nearly 1.3% of GDP). This had a negative economic impact, as it reduces the liquidity of companies (who operate in an environment of very high interest rates), decreases fiscal transparency and increases fiscal risks for the future[11].
- The Government should also reduce the quasi-fiscal operations of state-owned banks, which support state institutions. This relates e.g. on the provision of loans to Naftogaz in order to finance its quasi-fiscal deficit at lower than market rates. In this context, also the National Bank should concentrate in its liquidity provision on monetary, rather than indirect fiscal targets.
- Taking into account the risks associated with the high share of foreign currency debt, the Government should take measures to further develop the local bond market. While certain steps in this direction have been taken in the past (e.g. the introduction of a primary dealer system), a full-fledged financing of the deficit from the capital markets in local currency is still far away.

4. Concluding Remarks

Ukraine is currently running some of the highest twin deficits globally, that is simultaneous deficits in the current account balance and in the fiscal balance.[12] The situation is aggravated by very low buffers against any negative shocks, as FX reserves as well as fiscal reserves are at multi-year lows, and continue to show a declining trend.

[11] The last issue of VAT Bonds, which were used to clear VAT refund arrears, was in 2010, and meant to be an extraordinary and non-recurring event.

[12] The current account deficit was at 8.4% of GDP in 2012 and is estimated to exceed 8% of GDP in 2013.

On top of that, Ukraine's economy is undergoing a prolonged phase of economic stagnation, with no clear light at the end of the tunnel.

While the reasons for these adverse developments are complex, and can be blamed on a number of external and internal factors, there is a clear-cut case for the immediate macroeconomic stabilization of the country. The reduction of the mentioned macroeconomic imbalances must be the main objective for policy makers in the near future, as otherwise there is no realistic chance for achieving sustainable economic growth.

As we argue throughout the paper, fiscal consolidation must be one of the cornerstones of this new policy mix, as the challenges are significant. Faced with a high and growing fiscal deficit, as well as quasi-fiscal deficits in other sectors of the economy, a clear commitment to a gradual reduction of these deficits is needed. This will help to stabilize public debt dynamics, which have been on an unfavorable trend over the last few years, and also ease short-term financing constraints. Furthermore, the problem of crowding out private borrowers (e.g. companies borrowing for investment purposes) can be (at least partially) solved through such a strategy[13]. The authorities should remember their initial success in stabilizing public finances over the years 2010/2011, when a deficit reduction was achieved, and the increase in public debt temporarily reversed. While right now the challenges are of similar, if not higher order, there is still time to act, and shape the situation in a controlled manner.

Fiscal consolidation is only one part the overall macroeconomic policy mix that is needed to stabilize the economy. The other key ingredient consists of measures in the field of monetary and exchange rate policies that have a direct impact on external imbalances. Here, we would like to repeat our long-standing call for allowing gradually more exchange rate flexibility[14], while targeting monetary policy more towards domestic objectives, i.e. achieving a low level of inflation. This would contribute towards a reduction of the current account deficit, and help to ease the current constraints on investments and net exports. An economic recovery would be the likely result of such actions, which could in turn help to improve the fiscal situation.

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[13] This often concerns especially small and medium-sized companies (SMEs), as large corporations have usually better access to off-shore funding for their operations.

[14] See our Policy Paper "Towards a sustainable and growth supportive FX policy in Ukraine", by Robert Kirchner, Ricardo Giucci and Vitaliy Kravchuk, Policy Paper 05, December 2012.

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