German Advisory Group Ukraine

NEWSLETTER

Issue No. 86 | December 2015

No alternatives to the continuation of the IMF programme

In the attempt to tackle its economic and financial crisis, Ukraine cooperates closely with the IMF. Thus, it is a point of major concern that there has been a delay of several months in the release of the next credit tranche. Recently achieved macroeconomic stability is at risk without additional funding.

Issues of fiscal policy are largely at fault in the delay as no budget has yet been adopted for 2016. Due to two competing tax reform proposals, published by the Ministry of Finance and the Parliament's tax committee, respectively, no consensus on the necessary fundamental tax reform has been reached. Thus, the urgently needed IMF agreement has been blocked ever since.

Certainly, Ukraine is running out of time, and it is highly important that an IMF-compliant budget is soon adopted that will keep Ukraine on its consolidation path. The compromise proposal on the tax reform recently announced by the President could remove hurdles to an agreement.

The IMF programme in brief

On 30 April 2014, the IMF approved a 2-year Stand-By Agreement (SBA) for Ukraine. The total loan amounted to USD 17 bn of which USD 3.2 bn were made available for immediate disbursement. The loan was approved under the Fund´s exceptional access policy which therefore allowed Ukraine to draw 800% of the IMF quota instead of the cumulative limit of 600%.

However, the SBA is a short-term programme and many of the necessary structural reforms are of long-term nature. For this reason, the government decided to officially end the SBA, and the IMF approved the replacement of the programme by an Extended Fund Facility (EFF). The EFF programme, which came into force in March 2015, has a term of 4 years and a total volume of USD 17.5 bn (900% of the IMF quota), of which USD 5 bn were made available for immediate disbursement. Additional funding from other sources (such as the EU and World Bank) as well as targeted debt restructuring brought the total amount of the financing package to USD 40 bn. Further IMF disbursements were to be subsequently approved in the course of quarterly reviews and certain performance criteria over the next four years. The main objectives of the EFF programme are to restore external and financial stability and to strengthen potential growth drivers. Reforms to the National Bank will lead to a more flexible exchange rate and to a strengthening of the banking sector. In the long run, public finances will be strengthened through a restructuring of expenditures, in order to achieve fiscal consolidation. Furthermore, in addition to reforms in the energy sector, the business and investment climate will be improved through the reduction of administrative barriers, a comprehensive tax reform, and reforms to fight corruption.

Recent developments

The first IMF review took place on 31 July 2015. After a successful IMF mission, the disbursement of USD 1.7 bn was approved. Thus, the total amount of disbursements under the EFF programme has reached USD 6.7 bn so far. The following missions, which took place in September and November 2015 and were supposed to ensure compliance with the arrangement in order to approve the release of the second tranche, failed to reach an agreement. Accordingly, the third review mission, scheduled for December 2015, did not take place at all. The initial timetable for the provision of financial means has thus lapsed given this enormous delay of the next scheduled funding of USD 1.7 bn which will probably be released, at the earliest, in the first quarter of 2016. In addition, the financial support of other international donors is tied to the IMF agreement. For this reason, Ukraine is currently missing funds from these sources as well. Over USD 2.3 bn from international donors are coupled to the next tranche of funding from the IMF.

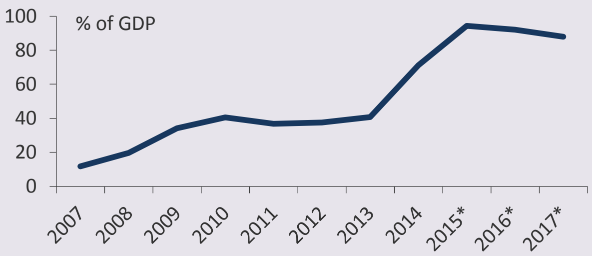
The National Bank via its foreign exchange reserves is bearing the brunt of the lack of progress in IMF negotiations. Although these have gradually recovered from their low point in spring 2015 and are currently at USD 13.1 bn, they are still underperforming the programme´s objectives. Since October, the political uncertainty ahead of the regional elections in Ukraine had put the Hryvnia again under downward pressure, of course with corresponding negative consequences for the accumulation of reserves. And this state of limbo in which the EFF funding is currently situated creates additional uncertainties that could further destabilize the exchange rate.

The central point of contention is that the Ukrainian parliament has not yet passed a budget compliant with the requirements of the EFF programme. The programme requires a reduction of the budget deficit to 3.7% of GDP, which is supposed to be achieved by restructuring expenditures and reforming the tax system. In particular, the programme calls for the reduction of expenditures to 40% in 2016, which outstandingly amounted to the above-average sum of about 48% of GDP in 2015.

Main focus: the budget and tax reforms

There is consensus in Ukraine that a fundamental tax reform is necessary. The country has a large shadow economy and suffers from massive tax evasion. However, two competing reform proposals have been submitted by the Ministry of Finance and Parliament's tax committee, respectively. The Ministry of Finance published its draft budget for 2016 together with its tax reform proposal. The budget deficit in this proposal complies with IMF requirements through various sufficient counter-financing measures. In general, this set of tax reforms would lower rates but broaden the tax base by closing loopholes. The reform proposal submitted by the tax committee, which had been considered as populist move by many, however, does not include an analysis of its impact on revenues. It includes massive tax breaks and relies on self-financing through growth. In the short term, however, it would lead to a loss of revenue totalling approximately USD 9 bn, or 9% of GDP. This would be a complete departure from the intended consolidation path set forth by the IMF programme. Despite the successful restructuring, government debt has risen sharply to over 90% of GDP, making further, gradual fiscal consolidation inevitable and any experiments in this regard misguided.

Development of public debt



*Source: IMF, *estimation/forecast*

Tax cuts vs. reform of the tax administration

There is no doubt that the existence of a sizeable shadow economy is a great fiscal and economic problem for Ukraine. Therefore, it is certainly comprehensible to consider if this shadow economy can be shrunk by taking steps to cut tax rates. However, the question also arises as to whether it is high tax rates that are responsible for the existence of the shadow economy. Indeed, the discontent with the tax system can be traced primarily to great dissatisfaction with the tax administration that quite often appears to act arbitrarily. Tax rates (except for the very high contributions to the social security system) seem to be the minor problem. For this reason, reforming the tax administration should be the highest priority, rather than changing tax rates. The question also arises as to whether it is the right time for extensive tax cuts. Fiscal consolidation is absolutely necessary, especially as Ukraine is currently being kept afloat by financial support from the IMF and other donors. Since the international community's appetite for further increases of the financial support, which it has committed to Ukraine, is limited, the Parliament should not challenge the donors' patience. Also, it is of particular importance to abolish unfair tax breaks for certain economic sectors.

Conclusion

Since last year, Ukraine has cooperated with the IMF in exemplary fashion. This had not always been the case in the past, as a series of uncompleted programmes can demonstrate. For this reason, delays seen in recent months are particularly concerning.

From our perspective, there are, despite improved macroeconomic stability, no alternatives to the cooperation with the IMF. The situation remains fragile, and it may slip out of control again at any time. It is incomprehensible that certain actors in Parliament would actually play with fire in this situation.

One way out of the situation would be to immediately adopt the budget recently proposed by the President as a compromise between the two competing tax proposals. This compromise has much more in common with the one made by the Ministry of Finance and, including additional counter-financing measures, would most certainly yield an acceptable budget deficit.

Authors

Robert Kirchner, kirchner@berlin-economics.com
Ricardo Giucci, giucci@berlin-economics.com
Katharina Kolb, kolb@berlin-economics.com

German Advisory Group

The German Advisory Group advises since 1994 the Government of Ukraine on a wide range of economic policy issues. The group is financed by the German Federal Ministry for Economic Affairs and Energy under the TRANSFORM programme and its successor.

Editors

Dr Ricardo Giucci, Robert Kirchner

Contact

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel. +49 30/20 61 34 64 0
Fax +49 30/20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de