



2015 Budget: an “Empty” Version

On December 29, 2014, the Verkhovna Rada of Ukraine adopted the Law On State Budget 2015. The bill introduced to the parliament several days before the voting offered a too ambitious income plan (with an anticipated growth of over 30%), included a very wide fiscal gap (8.8% of GDP, including 3.7% GDP of the central budget deficit), and was too reliant on the money issue by the National Bank (the budget required to issue about UAH 200 billion). The government stated that the budget was realistic, and implementation only requires change to 49 legislative instruments offered by the “budget package”. The budget offered by the government faced a furious reaction by the members of parliament due to its poor conformity with the Ukrainian economic reality and clearly jeopardized the negotiations with the IMF (the Fund insisted on a fiscal deficit not exceeding 5.8% of the GDP).

Nevertheless, the Government aggressively insisted on passing the bill without significant change and necessarily (!) before the end of 2014. The voting took place in the night from 28th to 29th of December and only after the Prime Minister promised to revise the budget by February 15, 2015, according to the IMF mission recommendations. Considering the fact that the IMF will certainly oppose such an optimistic budget, it can be safely said that the adopted budget is in fact “empty” and most likely will have entirely different content in just a few weeks.

However, despite the anticipated large revisions to the national budget, we analyzed the “empty” version of the 2015 budget for the understanding of the direction in which the Ukrainian budget policy is going.

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TRENDS: New Year's Eve Budget with Surprises

The draft budget 2014 was introduced to the Verkhovna Rada with a significant delay on December 22, 2014, due to parliamentary elections. The 2015 budget was developed against the backdrop of military actions, declining GDP, unstable energy (gas and coal) supplies, complete dependence of foreign credits on IMF program compliance, and unreformed budget sector.

Considering the critical value of external funding, when drafting the budget the government had to comply with the budget deficit ceiling set by the IMF memorandum. In particular, the Fund limits the fiscal deficit at 5.8% of GDP, which includes the deficit of Naftogaz of Ukraine NJSC and 3.9% of GDP for the consolidated budget. From the formal standpoint, the draft budget met the budget deficit requirement (excluding quasi-fiscal needs) at 3.7% of GDP. However, the specified deficit is based on an incredibly optimistic assumption of over 30% of budget revenue growth (to UAH 475.2 billion), whereas the nominal GDP (tax base) growth, according to the government forecasts, will only increase by 11% to UAH 1,712 billion (real GDP forecast -4.3% year-to-year, +13% inflation).

The government plans to meet the ambitious revenue plan and deficit level through large scale revisions of the tax law. Indeed, before voting on the budget, the people's deputies hastily amended tax and budget legislation, which are supposed to ensure an impressive increase in the budget revenue and reduce the budget costs. However, for some reason the government will not consider the fact that, by increasing the tax burden in the conditions of declining economic activity, they guaranteed a large underperformance on tax revenue.

Under such circumstances, the only hope for the 2015 budget process is the Prime Minister's promise to radically revise the budget by February 15 after the IMF mission visit.

Forecast: Prospects of 2015 Budget Process

The draft budget was adopted by the parliament "by ear" and "on the record" around 4 a.m. in the night from Sunday to Monday. These circumstances clearly outline the quality of the document that was adopted. Perhaps for the first time in our history, the parliament members adopted the draft budget without even realizing what exactly they are voting for (when passing the budget, the Cabinet of Ministers was instructed to balance the figures to account for the amendments made "by ear" and the results of voting on related bills). It appears that the most important part in the adopted budget are the final provisions, according to which the government undertakes to revise and amend the budget by February 15, 2015.

REVENUE: an Inflated Revenue Plan

Considering the need to receive financial aid from the IMF, the government had been expected to make a realistic income plan in

State Budget Revenue

		2014 plan	2015 plan
Revenues	UAH billions	377.8	475.9
	% GDP	24.8%	27.6%
Expenditures	UAH billions	441.6	527.9
	% GDP	29.0%	30.6%
Deficit	UAH billions	68.6	63.7
	% GDP	4.5%	3.7%

Source: State Treasury Service, Law On 2015 State Budget

Concealed Deficit Amount

		2014	2015
NJSC «Naftogaz of Ukraine»	UAH billions	96.9	31.5
	% GDP	6.4%	1.8%
Bank support	UAH billions	-	36.5
	% GDP	-	2.1%
Deposit insurance fund	UAH billions	10.1	20.0
	% GDP	0.7%	1.2%
Total	UAH billions	107.0	88.0
	% GDP	7.0%	5.1%

Source: Ministry of Finances, Law On 2015 State Budget

the draft 2015 budget. However, in reality it was directly the opposite. The government set the revenue plan of the 2015 state budget at UAH 475.2 billion, which is 30% more than expected in 2014.

Overstated Budget Revenue

The government proposed to set the revenue plan of the 2015 state budget at UAH 475.2 billion, which is 30% more than the actual result expected in 2014 (the forecast is UAH 475.9 billion). To a certain extent such increase is explained by the transfer of the personal income tax (PIT) from the local budgets to the central budget. However, even excluding the PIT factor, we see that the government has planned an increase of tax revenue by 26% (!), which is beyond our economic capabilities. For instance, the Minister of Finance presenting the 2015 budget underscored that the budget is based on the macro forecast of a real GDP reduction up to 4.3% and +13% inflation. The nominal GDP growth is planned at 11% to UAH 1,721 billion. Considering such a moderate growth of the tax base, achieving the ambitious revenue growth under the given circumstances is practically impossible.

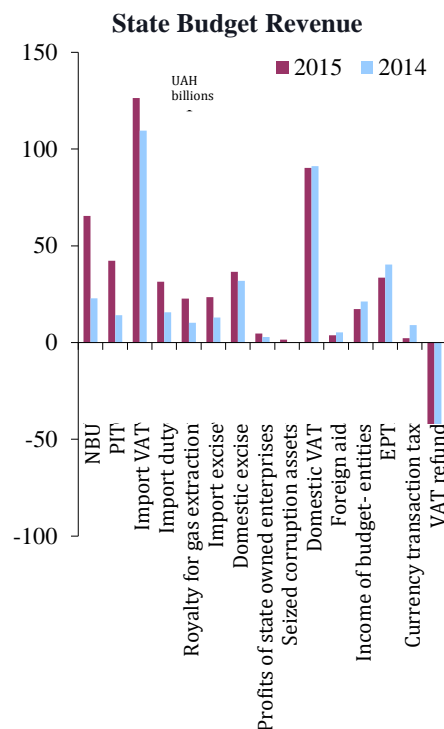
The government certainly counts on the tax increase and tax base expansion. However, as demonstrated by the 2014 practice, introduction of additional taxes does not have a sufficient revenue potential. Therefore, the version of the budget proposed by the government entails an underperformance of the revenue plan at the level of UAH 30–40 billion at the year end.

Interestingly, the revenue plan is highly dependent on the support of the National Bank. The NBU has to transfer UAH 65.4 billion of difference between the revenue and expenditures anticipated in 2015 to the treasury. This figure is almost three times higher than the UAH 22.8 billion transferred in 2014.

At least UAH 40 billion of the planned budget revenue is based on unfinished legislation

The draft 2015 budget requires several new legislative provisions. Presenting the amendments to the Tax Code, the Government underscored the reduction of the number of taxes from 22 to 9. However, in addition to these purely technical amendments, the government made many other important and less popular proposals. An incomplete list of such amendments includes:

- increase of the existing taxes and introduction of new ones: increasing personal income tax rate to 20% for income in excess of 10 times the minimum wage, cancelling the discounted PIT rate for miners, increasing the passive income tax from 15% to 20%, introducing a tax on new cars with large engine capacity, import and jewelry taxes, increased subsurface resources management fee for gas production, taxation of pensions over 3 times the minimum wage (UAH 3,654), and increasing the currency exchange fee from 0.5% to 2%;



Source: State Treasury Service, Draft 2015 Budget

- increased fiscal component in administration of taxes and tax loopholes elimination: introducing electronic VAT administration, restricting the outflow of large company income from the country: denunciation of the Cyprus Agreement, and increased fiscal provisions of the transfer pricing law;
- stimulation of shadow economy reduction through tax rates cut: law on reduction of the unified social contribution rate from 37% to 16.4% (not for everyone, however) and tax compromise.

According to the government's assessment, the resource added by the tax innovations is UAH 40 billion. Some of these bills were passed mere hours before the adoption of the 2015 budget. However, almost all bills in the package differ from the version proposed by the government.

Forecast: Budget Underperformance in Revenue Guaranteed

The version of the budget proposed by the government entails an underperformance of the revenue plan at the level of UAH 30–40 billion at the year end. The government expects to receive this amount through legislative changes. However, the struggling economy will hardly allow “producing” the anticipated income and once again respond by a growing shadow sector.

EXPENDITURES: Expenditure Cuts? What's That?

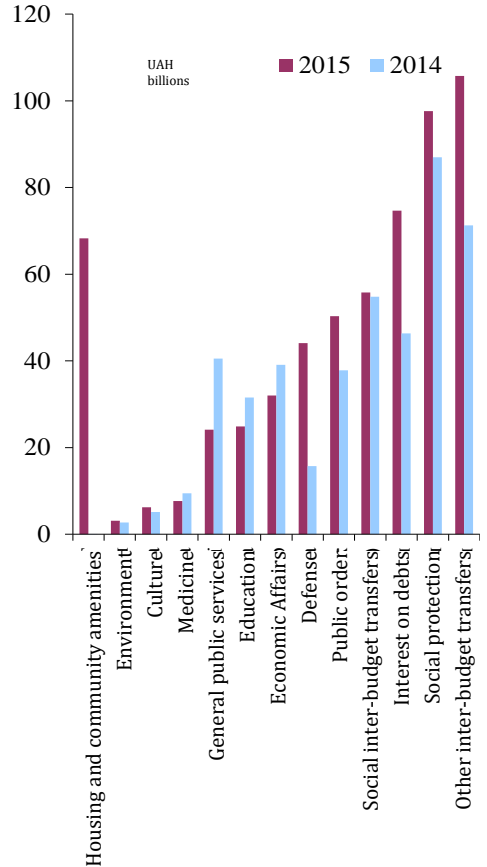
The state budget expenditures are planned at the level of UAH 527.2 billion (UAH 527.9 billion according to the budget), which is 19.4%, or UAH 85.6 billion, higher than planned for 2014. According to the government's draft budget, 2/3 of these expenditures are allocated to defense programs (16.2%), debt service (18.4%), social inter-budget transfers, and financing the Pension Fund deficit (27.8%). The source of real savings are cut in state aid (primarily the support of the coal industry). The reduction of other items is mostly technical: classification particularities and transfer of responsibility to the local level. There are no cuts of unreformed social expenditures, despite numerous restrictions and “suspensions”. Additionally, the government even hopes to increase them after the planned budget revision in February and based on the results of the 1st year half.

Military and Law Enforcement Expenditures Will Exceed 5.3% of GDP

The Minister of Finance announced an increase of defense and law enforcement expenditures to UAH 82.9 billion in 2015 (UAH 63 billion in 2014) according to the resolution of the National Security and Defense Council. Of that, UAH 44.1 billion (UAH +15.6 billion) is the defense expenditures, the rest being allocated to the National Guard, Security Service of Ukraine, and the Ministry of Internal Affairs. Additionally, UAH 6.0 billion in state guarantees are planned for the purchase of military vehicles and weapons.

Additionally, there is an increase in the expenditures which may not be directly classified as military expenditures, but are closely related to the

State Budget Expenditures by Functions



Source: State Treasury Service, Draft 2015 Budget

military actions. For instance, the 2015 budget allocates UAH 2.6 billion for support of military personnel and refugees. Half of that is the reimbursement of salary to people drafted for service, UAH 0.5 billion is allocated to the refugees issue, and UAH 1.5 billion is allocated to restoration of infrastructure in the Eastern Ukraine. Generally, such expenditures in 2015 should amount to 5.3% of the GDP, or over UAH 250 million every day. Additionally, the expenditures on other programs (such as Cabinet of Ministers's capital investments, reserve fund, etc.) may be partly used for the anti-terrorist operation related purposes.

Reduction of Administrative Expenditures is Doubtful

The Government announces a reduction of costs almost in all ministries and agencies. In reality, however, the cuts in different ministries and agencies are incomparable.

The expenditures for general public functions are reduced almost by half to UAH 24.1 billion due to reserve fund reduction (in 2014 these were actually defense expenditures) and reduction of the capital investments of the Cabinet of Ministers (which have to be redistributed to other functions over the year). Excluding this factor, the general public expenditures are planned at the 2014 level. Despite the government's attempts to save money on some programs, the costs of participation in UN and other international activities have increased (due to devaluation of hryvnia).

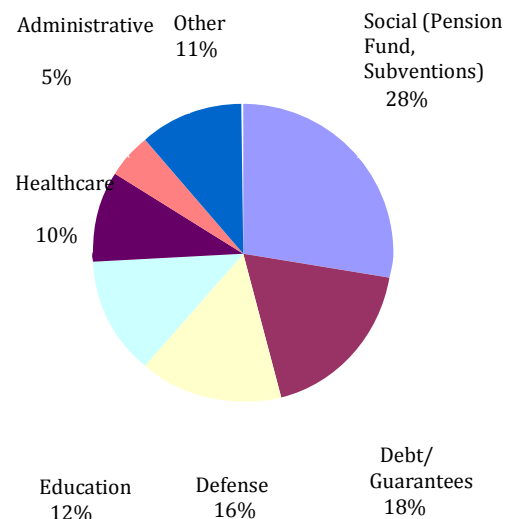
The expenditures from the state budget on wages and salaries are to be increased by 1/5 to UAH 58.4 billion. This is primarily due to rise in salaries in defense and law enforcement. The other part remains very close to the level of 2014. The labor expenditures in the general public programs will amount to UAH 7.1 billion, which is only UAH 0.1 billion less than planned for 2014. Besides, it appears that some government staff expenditures have become concealed. For example, in 2015, over UAH 1 billion of the labor costs for implementation of reforms at the Cabinet of Ministers secretariat is, for unknown reasons, indicated economic activity allocations instead of expenditures for general public tasks. As it is widely known, any attempt to reduce the number of state officials in Ukraine typically results in their being transferred from one agency to another.

Ineffective Social Expenditures Replaced by Equally Ineffective Ones

The government has announced an ambitious plan to limit the growth of social expenditures and conduct an austerity policy. According to the adopted budget revision, the increase of social standards and guarantees (social benefits, minimum pension, and minimum wage) will be "suspended" throughout 2015 at the 2014 level; they will only be increased in December. Moreover, the draft budget 2015 involves suspending several dozens of provisions regulating social benefits provided based on social and professional status.

At the same time, despite the "social expenditures freeze", the 2015 state

Structure of 2015 State Budget Expenditures by Purpose



Source: State Treasury Service, Draft 2015 Budget, own calculations.

budget plan for social security expenditures rised by 12.3% to UAH 97.7 billion due to the enlarged Pension Fund deficit and the housing provision program for the military personnel. The inter-budget transfers for the social benefits will also increase by UAH 0.9 billion to UAH 55.8 billion, in particular due to the need to support the refugees.

In other words, even despite the announced economy measures, there has been no reduction in social expenditures. Some social expenditures areas were “frozen”, but even these measures should be viewed as temporary: as soon as possible these expenditures will undergo “indexation” and inflate the budget expenditures. Even the budget revision in February may not result in a reduction of expenditures (as currently anticipated). Moreover, people often recourse to court in case of reduction of their social guarantees and successfully receive the “cancelled” benefits and guarantees.

Pension Fund Deficit is Increasing

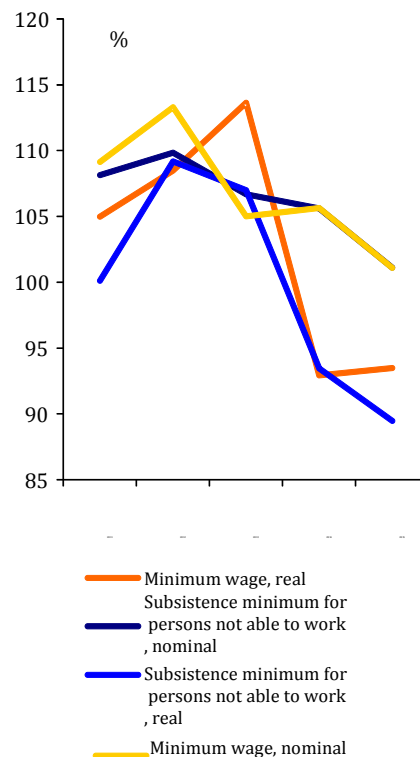
The Pension Fund deficit 2015 was increased by almost 1/3 year over year to UAH 28.8 billion. Another UAH 61.9 billion will be spent on special pensions, or preferential pensions (including the pensions of deputies, state officials, military personnel, judges, etc.), in the amount exceeding ordinary age pensions.

For the funding of the Pension Fund transfers, the government hopes to increase special taxes used to cover the Pension Fund deficit. However, it is very improbable that the additional funds will suffice. First, sooner or later the pensioners from the ATO zone will return for their pensions (Ukraine has not refused from its obligations) and will demand being paid not only the pensions accrued in 2015, but also the pensions accrued in 2014 (the “price of the matter” may be about UAH 6 to 7 billion). Second, along with the budget, the government proposes passing a bill according to which the unified social fee (USF) rate in 2015 is reduced by more than a half to 16.4% (currently about 37%). The implementation of this plan is unlikely, because the reduced rate will only be applied to companies increasing the salaries by 30% during the crisis year, those with labor costs 2.5 times more than average, and those that can provide a salary not lower than 3 times the minimum wage. However, when calculating the revenue, the government included the additional revenue due to reduction of the shadow sector. Third, when the 2015 budget was adopted, agreements were made regarding the possibility of indexation of pensions based on the results of the 1st half of 2015.

Government Continues Reducing the State Aid

A significant saving of funds is still maintained due to the government’s refusal to support certain economy sectors: the respective expenditures decreased by 18.1% to UAH 32.0 billion. In particular, this relates to the support for the agriculture and coal industry. The coal industry support expenditures, which have recently amounted to 1% of GDP each year, were reduced to UAH 1.2 billion (UAH 11 billion in 2014), 0.3 billion of which was made the responsibility of local government. These

Dynamics of Social Standards and Guarantees



Source: State Treasury Service, Draft 2015 Budget

expenditures are allocated to preparation of these companies for liquidation instead of direct support of their costs. The real sector support expenditures could have been lower but for the obligations under state guarantees, which amount to 59.8% of the respective expenditures.

There is almost no room for actual development costs. Although the 2015 development expenditures are planned at the level of UAH 39.5 billion, half of them are for the army and offenses, and UAH 4 billion are allocated for highly doubtful research and design activities.

Forecast: the Expenditures Will Increase

The military expenditures and the debt service costs are rapidly increasing, while the government's social obligations are inflexible. Even in the need for stringent economy, the government has failed to secure the adoption of several provisions restricting social expenditures (for instance, restriction of public transport discounts for school students, refusal from indexation of salaries and pensions, and change in the procedure of salary payment to public sector employees). As a result, there hardly remains any fiscal resources for more productive expenditures, such as infrastructure construction.

Instead of reforms, which will require time for reduction of social burden, the government performs ad hoc cuts. This entails several risks related both to the effectiveness of expenditures and the possibility of unforeseen expansion of the budget in the nearest future.

The adopted budget envisages funding for several reform programs including the public finance modernization project, medical reform, and implementation of the administrative reform. Let us hope that Ukraine finally makes these reforms, if not due to fiscal restrictions, then due to pressure from the international community.

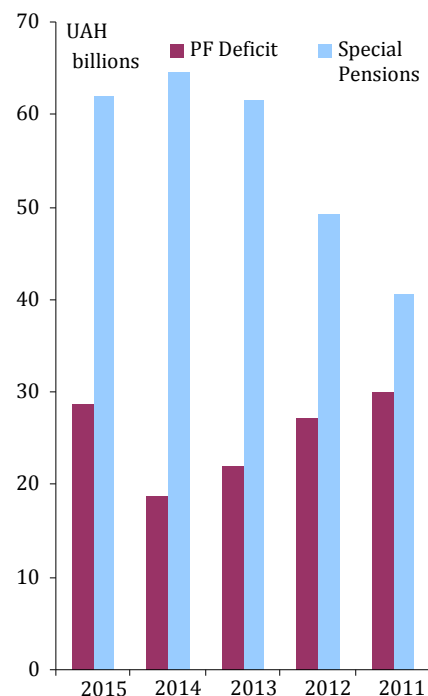
INTER-BUDGET RELATIONS: Reform in Action?

When calculating the figures for local budgets, the Budget relied on adoption of changes to the Budget Code. The 2015 budget specifies that the resource of local budgets has to increase to UAH 262.1 billion as compared to UAH 250.1 billion in 2014.

Several Costs Transferred to the Local Level

The main changes expected in the inter-budget relations are the redistribution of new taxes and fees (UAH +5.9 billion in excise on retail sales of alcohol and tobacco products, UAH +0.9 billion in administrative service fees, UAH +3.1 billion in 10% corporate income tax, expansion of the real estate tax base, and increase of the share of environmental fee transferred to the local budgets to 80%) in favor of the local budgets. Another positive thing is that the Ministry of Finances will not determine the indicative revenue figures and will not communicate them to the local budgets. Instead, a series of special subventions for the funding of education and healthcare will be created,

Transfers from the State Budget to the Pension Fund



Source: State Treasury Service, Draft 2015 Budget

and the local governments will autonomously undertake decision on redistribution of all local tax received. The total resource of the local budgets in 2015 has to increase from UAH 250.1 billion to UAH 262.1 billion.

As regards the risks, first, the local budgets become more dependent on transfers from the state budget. It is expected that the local budgets' own revenue in 2015 will reach UAH 104.2 billion, whereas subventions and grants will amount to UAH 161.5 billion. Therefore, the proportion of transfers in the budget revenue will increase from 54.9% in 2014 to 61.6% in 2015. Since there are no provisions allowing the saving of subvention and grant funds at the local level, the local budgets do not have any incentives to improve the efficiency of their expenditures. On the other hand, the capabilities for effective use of funds by local budgets are limited by the absence of sector reforms.

Second, the increase of 2015 local budget resources is based on optimistic revenue forecasts. In particular, the personal income tax revenue is expected to increase in 2015 by 18% year-over-year, against the backdrop of growing unemployment and moderate increase in nominal salaries. This does not even account for the anticipated underperformance on PIT in 2014. The increase in corporate income tax revenue is expected at 10%, and excise revenue is expected to increase by 5 times (in spite of smuggling of goods subject to excise).

Third, besides the additional revenue, the government plans to expand the authority of local budgets by assigning 800–900 social and public sector institutions to them and establishing local police. This is in addition to the significant powers already possessed by them, such as, for example, maintenance and development of local roads. The very fact of transfer is justified from the standpoint of authority distribution, and has been planned for a long time already. At the same time, the comparison of the transferred responsibilities and financial resources by value is disturbing. The funding of education can be demonstrated as an example of this disparity. For instance, the state budget allocations to vocational and higher education institutions of the I and II levels of accreditation should amount to UAH 6.3 billion, whereas the respective subvention to the local budgets for 2015 is only UAH 5.7 billion. We welcome the increase of required number of students per class and teacher workload, however, in absence of reforms it is not clear how exactly the required expenditures are determined.

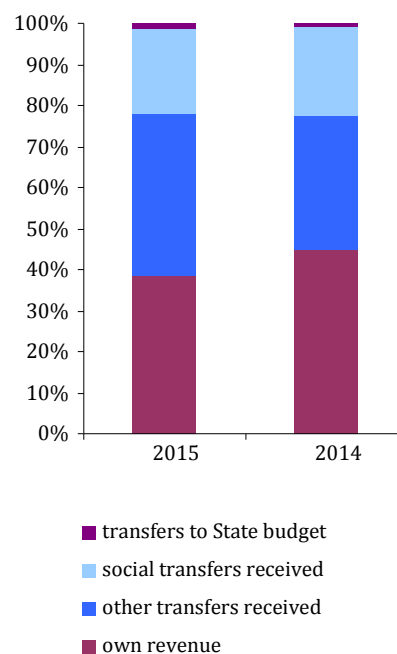
Forecast: at the local level, the expenditures will be funded on a residual basis

In the absence of funds, the central government is most likely to shift the fiscal deficit to the local level. The new medical and education subventions should guarantee a certain minimum for payment of salaries and utility services, which, however, falls short even of the 2014 level.

DEFICIT: Concealed Deficit at 10% of the GDP

The draft 2015 budget plans a state budget deficit at

Structure of the Local Budgets Resource



Source: Executive Summary to Draft 2015 Budget, own calculations, State Treasury Service.

UAH 63.7 billion, which formally meets the limit set by the IMF. However, high risk of underperformance on the revenue, as well as extrabudgetary and concealed expenditures, indicate that the actual deficit may exceed 10% of the GDP at the end of 2015.

State Budget Deficit Plan Understated

Considering the need for new credits from the IMF, the planned deficit at UAH 63.7 billion (3.7% of the GDP) is an important parameter. This deficit size meets the limits set by the IMF (3.9% of the GDP for the consolidated budget according to the updated 2015 program). However, as already said, this figure (even excluding the extra-budget expenditures) is understated. The factors of such understatement include:

- probability of underperformance on revenue (up to UAH 30 to 40 billion);
- part of the government's "frozen" social expenditures may be deemed unconstitutional and increase the budget liabilities through court procedures.

Significant Quasi-Fiscal Deficit Exists

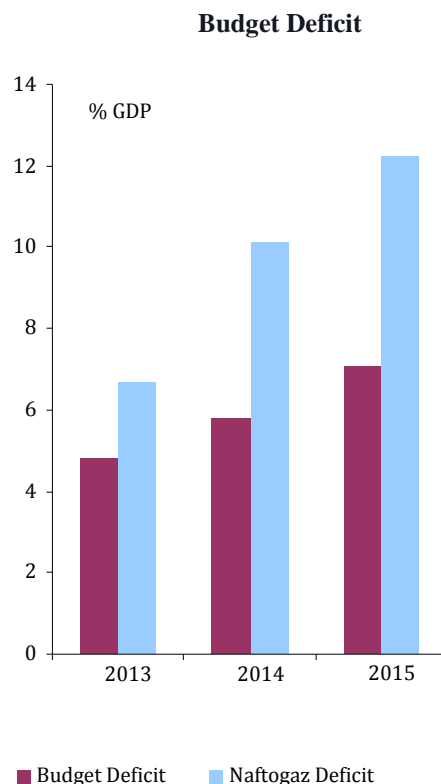
The consciously planned quasi-fiscal deficit plan amounts to about UAH 100 billion and involves the support of *Naftogaz of Ukraine* (UAH 31.5 billion), redemption of bankrupt banks (UAH 36.5 billion), funding of the Deposits Guarantee Fund (UAH 20 billion) and state guarantees (up to UAH 25 billion).¹

Deficit Funding Not Supported by Sufficient Resources

The planned state deficit, as well as quasi-fiscal liabilities, will be funded through the issue of sovereign bonds, which, traditionally for Ukraine, are repurchased by the National Bank... Thus it means the issue of hryvnia. Moreover, even the planned deficit is not supported by realistic funding sources. For instance, the government has planned UAH 17 billion in revenue from privatization, however, the current economic and geopolitical situation barely gives a chance to receive revenue from the sale of public assets successfully. As a result, according to the adopted budget, UAH 151 billion (8.8% of the GDP) will have to be printed in 2015, considering (a) the IMF requirement to keep the total fiscal deficit at or under 5.8% GDP, and (b) very small currency reserve (about UAH 7 billion), which are the first thing to suffer from the significant creation of money.

Forecast: Deficit Must Be Reduced for the IMF Program

Even excluding the potential underperformance of the 2015 budget and the need for additional expenditures (expenditures concealed as state guarantees to the amount of UAH 25 billion, and UAH 7.5 billion in



Source: Executive Summary to Draft 2015 Budget, own calculations, State Treasury Service.

¹In 2015, the government plans state guarantees to the amount of UAH 25 billion. The purposes for which these guarantees are provided are very broadly defined. However, it is already safe to say that the UAH 6 billion in guarantees for purchase of weapons is actually a budget expenditure, and the guarantee liabilities should be included in the national debt.

debts payable), the public finance deficit may significantly exceed 10% of the GDP in 2015 (including the support of Naftogaz of Ukraine, redemption of bankrupt banks, and support of the Deposit Guarantee Fund). As a reminder, the IMF program limits the acceptable public sector deficit to 5.8% of the GDP (including the Naftogaz of Ukraine). Certainly, a lot has changed since September, when the memorandum was signed, and the military conflict, which had been expected to decline, continues. However, the IMF has to see the progress at least in the reduction of the budget deficit, which is yet to be seen in the adopted 2015 state budget. This leads to disappointing conclusion that, if the budget is not sequestered in February (as promised), there will be no cooperation with the IMF in 2015.

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