Budget Report: 3rd Quarter 2014

In the 3rd quarter 2014, the consolidated fiscal revenue's increase was barely noticeable. In particular, the consolidated fiscal revenues for this period reached UAH 115.6 billion, which is only 0.7% more than the income received in the 3rd quarter 2013. As shown by the results of the first two months after the budget's revision (September–October 2014), the increased taxes and the new taxes introduced had an insignificant impact on the raising revenues. The revenues could have been significantly lower but for the non-refundable financial aid received from the EU.

The ATO's (anti-terrorist operation) expenditures were growing rapidly, increasing by a factor of 1.5 as compared to 2nd quarter 2014, and by a factor of 2 year-over-year. However, the consolidated fiscal expenditures in the 3rd quarter 2014 increased by as little as UAH 0.1 billion year-over-year, and amounted to UAH 119.8 billion. This became possible due to budget amendments, the manual restriction of capital expenditures, and the inability to execute budget expenditures in the occupied territories in the Eastern Ukraine. The slow growth of expenditures helped maintain the consolidated fiscal deficit in the 3rd quarter 2014 at a level of UAH 12.1 billion, or 3.3% of the GDP. As a result, the cumulative consolidated fiscal deficit from January through August amounted to 3.1% of the GDP, which is less than the 5.8% ceiling approved by the IMF. However, the expenditures' underperformance in fact hides the deficit and increases the expenditures for the future.

A pause was seen in the 2015 budgetary process due to the early parliamentary elections. The government had even prepared two draft laws "On the 2015 State Budget". However, these drafts are yet to be seen. At the moment, the government claims that the budget is "waiting on the shelf". It is anticipated that the 2015 budget will be up for a vote in a package together with the decentralization reform, which has not yet been approved, and the new tax law amendments.

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CURRENT TRENDS: Budget Cuts on the Agenda

After the budget amendments were passed in August and another tranche was received from the IMF (see Budget Report No. 2), four topics were prioritized in the fiscal sector: 1) the impact of increased taxes on the revenue section of the budget, 2) drafting the budget for 2015, 3) budget relations with the occupied territories in Donbas, and 4)the impact of fiscal policy on the national currency's destabilization.

Tax Increase Failed

As evidenced by the results of the first two months after the previous revision of the budget (September–October 2014), increased taxes and royalties on mineral resources has had an insignificant impact on the raising revenues. In August, the state budget revenue made a 16.2% leap to UAH 32.5 billion, however, the simple reason for this jump was an injection of UAH 4.7 billion in aid received from the EU. As early as September, revenues dropped (-8.1% year-over-year) to UAH 30.3 billion, and demonstrated insignificant growth in October (+2.1% year-over-year). It had been anticipated that the increased tax rates would offset the fiscal gap (an 11.4% revenue increase had been planned for 2014). However, by the end of October, the state budget revenues totaled UAH 295.8 billion, and were only 6.2% higher than the same figure in 2013. This clearly evidences the failed attempts to remedy the situation made in July. Therefore, in order to execute the fiscal plan, the budget revenues would have to start growing at a rate of at least 30% year-over-year in November and December, which is obviously not happening. Thus, in fact it is important to speak of the central fiscal revenues underperformance to a tune of UAH 20–30 billion in the current year.

Major Budget Events, 3Q2014

July	04 – Amendments to the Tax Code of Ukraine regarding the taxation of passive income 31 – Cancellation of tax allowances, introduction of the war tax 31 – Amendments to the 2014 State Budget
August	
September	04 – 2nd IMF installment received by Kyiv 15 – The Government in fact failed to submit the budget to the Verkhovna Rada

Source: CASE Ukraine

2015 Budget Expected by the New Year's Eve

Due to the elections process in the Autumn 2015, the budget's preparation is taking longer than expected. Yatseniuk's government claims to have already drafted the budget by September 15. Moreover, according to the Prime Minister, two drafts were prepared: one using the old tax base, and another with the anticipation of substantial reforms. However, the document was never submitted to the parliament or publicly published.

This course of events made sense, since the parliamentary elections were set to take place on October 26, and the 2015 budget was nevertheless to be determined by a new coalition and a new government. So to speak, it was unreasonable to do the same work twice. Under such circumstances, and considering the time it took to form the coalition, we can once again expect the next year's budget by New Year's eve at best.

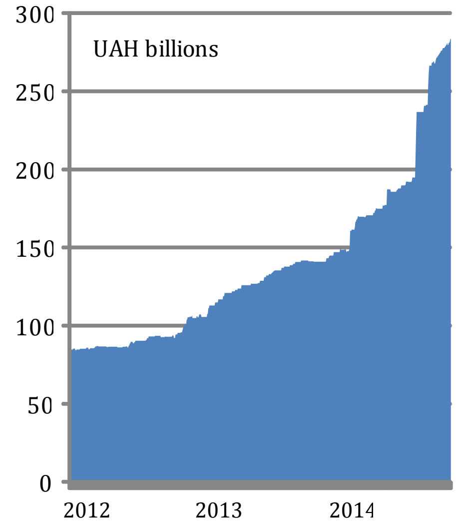
Donbas Disconnected

One of the key subjects on the agenda starting from August 2014 (after the eastern oblasts of Ukraine were occupied by the Russian army) has been the occupied territories being disconnected from the budget's funding. This necessary move stirred up many emotions among the public (especially those with family ties in the East) due to the significant humanitarian problems these measures would cause in the region. As a point of reference, according to various estimates, Donetsk and Luhansk regions "cost" the 2014 budget UAH 30 to 40 billion in net subsidies per year (including about UAH 15 billion that is generated by the pension fund deficit in both oblasts). Under the conditions of war and partial occupation, this amount could have significantly increased, as the region ceased paying taxes to the budget, while the social needs remained the same. Considering the problematic condition of the economy and low-level of budget revenues, maintaining the occupied region would result in the deficit's rapid growth with corresponding consequences for the country's solvency. In other words, the decision to "disconnect" the Donbas was simply a matter of time. As anticipated, this decision was made right after parliamentary elections.

Budget Deficit as a Factor in Devaluation

Although the emission funding of the budget deficit and the deficit of Naftogaz of the Ukraine National Joint-Stock Company had been approved by the IMF, starting in August this practice proved to be devastating to the national currency. The Russian attack on the eastern oblasts of Ukraine was followed by a panic on the currency market, which was caused by the intensifying military actions on the one hand, and by the realization of the loss of territory responsible for producing about 25% of the total currency revenue on the other hand. As it later turned out, the occupation of the Donbas itself did not have such a radical impact on the currency market (the imports dropped as severely as the exports), whereas the active emission of hryvnia for the needs of the budget was creating significant problems against the backdrop of the general wave of panic. Certainly, a large part of the emitted funds went to the accounts of Naftogaz, however, they were later automatically converted into currency in order to pay foreign debts. In fact, it must be pointed out that the active funding of budget expenditures through emissions became one of the key cause for the currency fluctuations in Autumn 2014.

Government Bonds in the Portfolio of the National Bank of Ukraine, UAH billions



Source: NBU

REVENUE: The Budget Revenues Are Tight

The revenues of Ukraine's consolidated budget over the 3rd quarter 2014 amounted to UAH 115.6 billion, which is 0.7% more than in 3Q2013 (see table). But for the non-refundable aid received from the EU received in August, the revenue could have been smaller than in the 3rd quarter 2013[1]. The trends observed in the 1st half of the current year continued on into the 3rd quarter: the collection of indirect taxes (value added tax (VAT) and excise tax) were influenced by the dropping demand and the hryvnia's devaluation at the same time, while the collection of direct taxes (personal income tax (PIT) and enterprise profit tax (EPT)) suffered from a decreasing level of business activity. The introduction of the interest income tax and the war tax, as well as the increased royalties for minerals, were of

Consolidated Fiscal Revenue

	3Q 2013	3Q 2014	Change, %
Total	**114.8**	**115.6***	**+0.7**
PIT	18.5	18.7	+1.1
EP	11.9	8.3	-30.5
VAT (collection)	47.7	50.4	+5.7
VAT (refund in cash)	-15.4	-13.7*	-10.8
Excise taxes (domestic)	6.9	8.2	+18.0
Excise taxes (import)	2.3	5.2	+130.4
Mineral royalties	3.8	4.6	+21.5
Land Fee	3.4	3.2	-6.4
Import Duty	3.6	3.3	-6.6
National Bank of Ukraine	9.7	0.8	-91.7
Own Revenue of Budget Entities	11.6	8.8	-24.6

Source: Ministry of Finance
*Excluding the VAT recovery through issue of domestic bonds in 2014

[1] In 3Q2013, the NBU transferred UAH 9.7 billion to the budget, whereas in 2014 all the funds were received from the NBU in advance in the 1st year half, which influences the data comparability.

smaller help than expected.

Non-Refundable Aid from the EU

In August, the EU granted Ukraine EUR 250.0 million (UAH 4.7 billion) in non-refundable aid. The payment is the first of the two possible installments, and mainly reflects the EU's positive evaluation of the new Public Procurement Law. The second installment of EUR 105.0 million may be received in 2015 depending on the achievements made with the anti-corruption enforcement and public service reforms. This aid was the reason for the 10.1% increase in the consolidated fiscal revenues as compared to August 2013. Without the UAH 4.7 billion received from the EU, the actual revenues would have shown a 2.6% reduction.

New Taxes in Action

In the 3rd quarter 2014, UAH 18.7 billion of personal income tax (PIT) was collected, which is 1.1 less than in 3Q2013. From July through September 2014, the PIT revenue from salaries was 6.4% lower than the same figure last year, and the PIT revenues from the miners' salaries was 26.0% lower. On the other hand, the amount of PIT revenues from the salaries of military personnel increased 26.3% at the same time, which reflects the current affairs within the country. In 3Q2014, UAH 0.6 billion was received in PIT from net interest income, and UAH 0.8 billion from the war tax. These two taxes were introduced in August, however, for technical reasons, they started to properly function only in September. They were expected to produce a monthly revenue of UAH 0.7 billion and 0.6 billion, respectively.

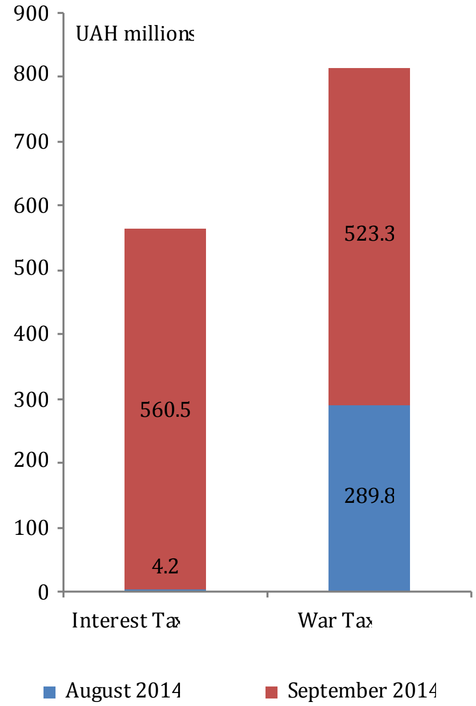
Mineral Royalties - Collection Problems

In 3Q2014, the revenue from mineral royalties amounted to UAH 4.6 billion, which is 21.5% more than in 3Q2013. In 2014, the mineral royalties rates have been increased twice: in March and in July, which was supposed to produce about UAH 3.4 billion in additional revenue in the 3rd quarter. The actual results were much more modest, mainly due to the debt of Ukrnafta, the nation's main petroleum producer, to the budget. The State Fiscal Service estimated the amount of this debt to be UAH 1.5 billion over August and September 2014.

Improvement in VAT Recovery Refunds

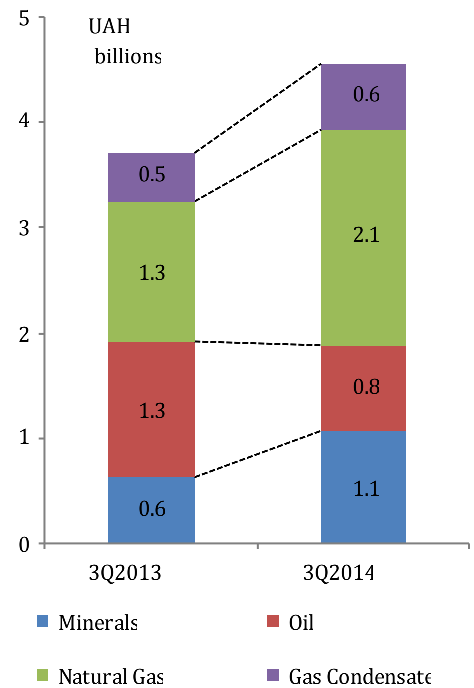
In the 3rd quarter 2014, the VAT refunds in cash amounted to UAH 13.7 billion, which is 10.8% less than in 3Q2013. Cancelling the VAT refund for grain exporters was supposed to save UAH 1.9 billion. With this factor accounted for, the VAT refunds from July through September 2014 reached the level from the previous year. Therefore, the 3rd quarter 2014 showed an improvement in the situation with VAT refunds (in cash). In the 1st and 2nd quarters of this year, significant problems were observed in this area (in 1Q2014, the amount of VAT refunded was 34.7% less year-over-year, and 17.3% less in 2Q2014). Additionally, UAH 6.7 billion in VAT declared for refund by January 1, 2014, was refunded with domestic bonds.

Revenue from the New Taxes



Source: State Treasury Service

Revenues from Mineral Royalties



Source: State Treasury Service

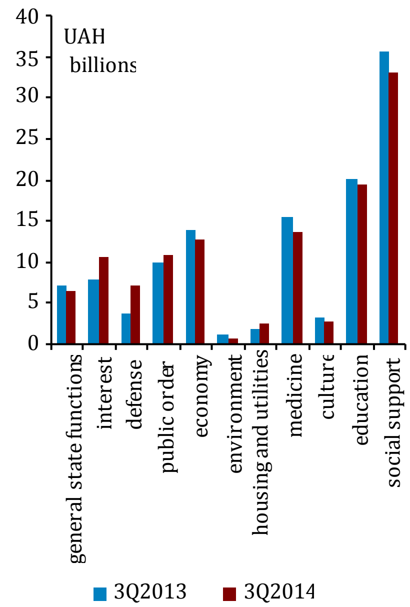
Forecast: Budget Underperformance in Revenue

The revenue part of the 2014 budget will definitely not be 100% executed. Achieving this would require an impossible 30.0% year-over-year increase in revenue in the 4th quarter. Save any radical changes or developments, the underperformance will likely amount to UAH 20–30 billion. The government has too little time for any new developments, which is why it is most likely to focus on improving the administration of the new taxes, as well as focus on resolving the problems surrounding Ukrnafta.

EXPENDITURES: The War Requires Increasingly More Resources

The consolidated fiscal expenditures in the 3rd quarter 2014 amounted to UAH 119.8 billion and increased by as little as UAH 0.1 billion as compared to 3Q2013. The factors contributing to such a reduction in expenditures can be divided into 3 groups: 1) the impossibility of executing the expenditures in the occupied territories in Eastern Ukraine, as well as the annexation of Crimea; 2) budget amendments with cuts in expenditures in several areas; and 3) the manual limitation of expenditures in anticipation of the approval of revisions to the budget. The resources saved this way were redirected for defense funding.

Consolidated Fiscal Expenditures by Functions



Source: State Treasury Service

Administrative Expenditures Finally Start to Decrease Significantly

In the 3rd quarter 2014, the administrative expenditures were not only limited but saw a reduction. For instance, the labor expenditures decreased by 13.3% year-over-year, and amounted to UAH 20.7 billion over July-September 2014. The consolidated fiscal expenditures for general public services (excluding debt servicing) was reduced by 9.9% to UAH 6.5 billion. The anti-crisis measures for reducing budget expenditures should not be underestimated: the administration and management expenditures were reduced in almost every ministry and agency. At the same time, a large portion of the expenditures were reduced not through governmental measures but due to the limited capabilities to execute the expenditures in the occupied territories in Eastern Ukraine. It should also be kept in mind that a year ago, Crimea was a part of Ukraine. The same factors determined the evolution of medical, educational, and social expenditures. To show the scale of expenditure reduction through the accumulation of arrears: the inter-budget transfers alone over the 9 months were UAH 3.6 billion less than planned for the period.

The situation is absolutely different with capital expenditures. Along with the budget revisions, manual control became a defining factor here. For instance, in anticipation of the approval of the budget revisions due in July, the government suspended capital expenditures in the beginning of the quarter. Although later on, in August through September, the disbursement of such expenditures increased, the total amount of capital expenditures performed as of the end of September was UAH 11.5

billion, or less than one-third of the already adjusted year's plan.

War Expenditures Rapidly Increasing

As it has become customary this year, the savings were redirected for funding the ATO (Anti-Terrorist Operation), which requires increasingly more and more fiscal resources. The defense expenditures increased by a factor of two as compared to 3Q2013, or by a factor of 1.5 as compared to 2Q2014-- amounting to UAH 7.1 billion. All this is happening against the backdrop of general claims of insufficient equipment and material supplies.

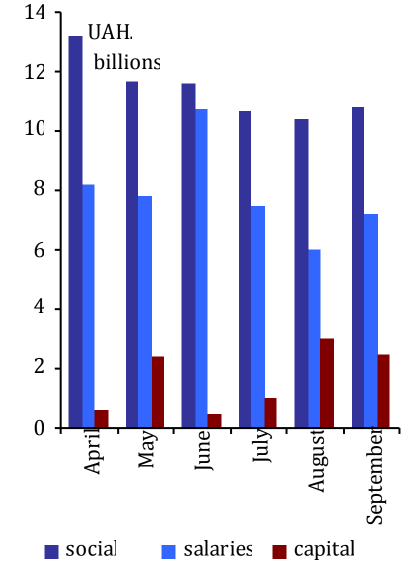
Pension Fund Reduced the Expenditures

Unfortunately, the budget's execution reports have been provided by the Pension Fund with a significant delay. Moreover, the monthly information provided by the Pension Fund is neither standardized nor complete. In September, the Pension Fund even forgot to, or chose not to (?), report on the execution of Pension Fund's budget. One should notice an increase of the Pension Fund's own revenues by 2.7%, to UAH 26.7 billion, in July through August 2014. Set against the annexation of the Crimea, this is a positive result. It is consistent with the growing PIT revenue and was partially achieved by intensifying work with debtors. Despite the suspension of an increase in social standards, the representatives of the Pension Fund have pointed out that carrying out the 2014 budget is challenging. However, some "help" in this regard has been found in the incomplete payment of pensions for the pensioners in the eastern oblasts of Ukraine. The Pension Fund does not provide any regular reports about the amount of debt. Some figures surface in the press from time to time: for instance, an UAH 3.7 billion debt for pensioners in the region of the ATO was mentioned at the beginning of November. Most likely, this is not far from the truth. For example, as compared to the funding of pensions in April 2014, when the pensions were being paid in full, the pension funding was only UAH 1 billion lower in July and UAH 0.7 billion lower in August. This debt is a concealed deficit in the state's funds. It is currently unknown when the pension obligations will have to be carried out in full; this depends on the situation in the ATO area and on how active the pensioners from the East register in other parts of Ukraine.

Forecast: Expenditures Will Not Be Executed According to Plan

The government will be able to save some funds on payments not performed in the occupied territories in the Eastern Ukraine. However, these social payments will become liabilities in the future. Most likely, the capital expenditures will not be fully executed this year. At the same time, at the end of 2014 the debt service expenditures may be expected to rise: even without consideration being given to recent wave of devaluation, UAH 15.8 billion remain to be paid in the 4th quarter 2014. Moreover, the military actions require increasingly more fiscal resources.

Consolidated Budget Expenditures, UAH billions



Source: State Treasury Service, CASE Ukraine

DEFICIT AND DEBT: Devaluation Increases the Debt More than New Borrowing

The consolidated fiscal expenditures in the 3rd quarters 2014 exceeded the revenues by UAH 12.1 billion, or by 3.3% of the GDP[2], which is approximately two times larger than the same figure last year. This level is acceptable: based on the results of January through September 2014, the consolidated fiscal deficit amounted to 3.1% of the GDP, which is less than planned for the year and does not exceed the ceiling set by the IMF (5.8% of the GDP). Maintaining the deficit at the level allowed, among other things, reducing the expenditures and receiving international aid. Despite this, in July through September of the current year, the national debt in UAH increased by 17.1% to UAH 962.1 billion, or 64.8% of the GDP. The crucial catalyst for this rise in the level of debt, half of which is denominated in foreign currency, was made by the further devaluation of the hryvnia: in the 3rd quarter, the debt in US dollars increased by 6.9% and reached USD 74.3 billion.

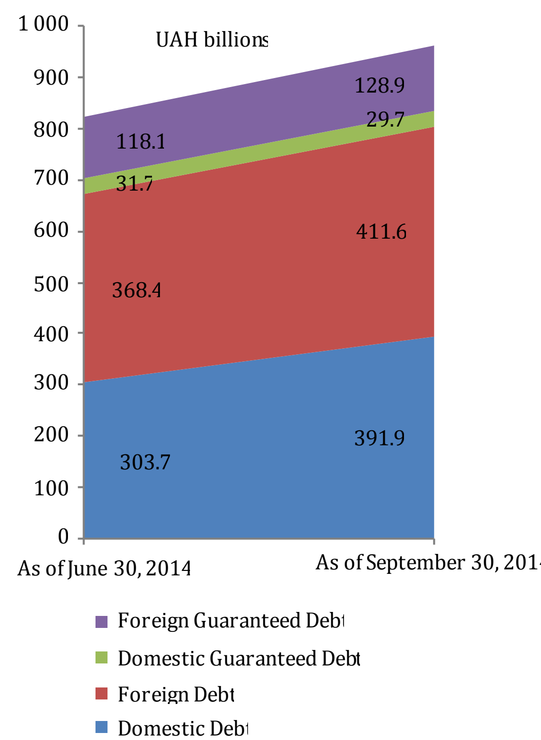
Internal Borrowings, or 'Expensive Cheap' Gas

The internal borrowings in 3Q2014 amounted to UAH 94.6 billion, which is about four times more than in 3Q2013. The main cause for this level of growth was tied to the issue of domestic government bonds totaling UAH 73.7 billion in order to cover the deficit of Naftogaz of Ukraine (the issue peaked in August). The bonds that have been issued since the beginning of 2014 total UAH 96.6 billion. Over July and August of the current year, the Ministry of Finance also issued domestic bonds for a refund of VAT for UAH 6.7 billion. According to the arrangement with the IMF, Ukraine may issue bonds to an additional amount of UAH 10 billion until the end of 2014 for the same purpose. The placement of domestic bonds generated fiscal resources to the tune of UAH 11.7 billion and USD 0.3 billion in the 3rd quarter this year.

Second IMF Trance and Other Foreign Credit

Foreign borrowings in 3Q2014 amounted to USD 1.7 billion, which is about two times more than in the same period last year. In September 2014, Ukraine received its second installment from the IMF for USD 1.4 billion. The total borrowings from the IMF since the beginning of 2014 have amounted to USD 4.6 billion, and an additional USD 12.4 billion may be received from the fund in the coming year and a half (on the condition that the agreed arrangements for reforms are complied with). The majority of the second installment (USD 1 billion) was used to support the budget. In addition to the funds from the IMF, Ukraine has received USD 0.3 billion from the World Bank for bolstering its social safety nets, USD 0.5 billion from the World Bank for financial sector reforms, USD 0.2 billion from Canada aimed towards budget funding and USD 0.1 billion from Japan for economic reforms.

Ukraine's National Debt, UAH



Source: Ministry of Finance

[2] CASE estimate.

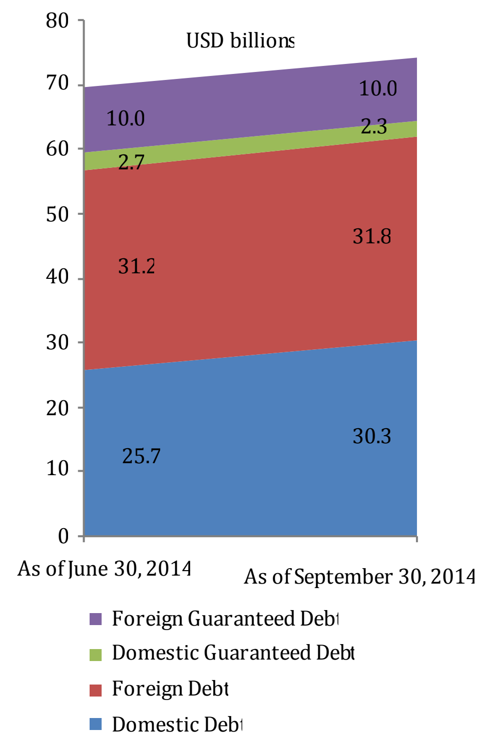
Timely Debt Repayment

In the 3rd quarter 2014, Ukraine was repaying its domestic and foreign obligations on time and in full. From July through September, Ukraine redeemed domestic bonds for UAH 13.5 billion and repaid USD 0.7 billion in foreign debt.[3] Redemption of foreign bonds issued by Naftogaz for USD 1.6 billion was planned for September 30, 2014, however, the actual payment took place on October 1, 2014.

Forecast: Deficit and Debt Under the IMF Control

Despite the very challenging budget revenue situation, the deficit is unlikely to exceed 5.8% of the GDP. Maintaining the deficit at this level is one of the main requirements of the IMF, and receiving further installments depends on whether it is complied with. Most likely, the third and fourth installments (USD 2.8 billion total) will be received simultaneously at the beginning of next year. Since no privatization took place in Ukraine, borrowings (totaling UAH 17.0 billion) will be made. The hryvnia's exchange rate will continue to influence the amount of debt. According to an IMF forecast, the debt will amount to 67.6% of the GDP by the end of the year.

Ukraine's National Debt, USD



Source: Ministry of Finance

[3] Exchange rate as of the last date in the reporting period.

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