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Sustainability of the budget and macroeconomic implications

Introduction

Economic development in Ukraine over the last half of the year shows significant loss in macroeconomic stability and reduction of the speed in economic growth. Such sudden change in the economic development of the country is partly attributed to the changes in the budget and tax policies that were introduced during the presidential election campaign and later by the new government of Ukraine. This paper discusses possible outcomes of the new budget and tax policies in the short and medium run, analyses the risks, and suggests some policy continuations to ensure the stable economic growth in the long-run.

The major risks of the budget sector

First, we would like to stress that the new budget and tax policies always introduce new short-term risks to economic development of the country. These risks may influence business decisions (especially investment decisions), and may develop into long-term economic problems if are not countered by careful government policy. In order to minimize the risks, any change in the tax or budget policy should be made in very transparent and predictable manner, which allows economic subjects to predict the risks, and adjust their economic strategies. Since predictable risks may be incorporated into investment strategies (contrary to the unpredictable), the predictable risks will have smaller influence on the investment decisions, and, therefore, are less harmful for the long-term economic growth. Below we list and discuss the major risks created by the recent changes in the budget policy, and the table at the end of this section summarizes the risks and possible consequences of these risks. Our believe is that if the government admits these risks publicly and talks about policies counterfeiting these risks, it can decrease the uncertainty for the business and induce investment in the country. Following are the major risks for the macroeconomic stability in the country, resulting from the new budget policy.

Budget revenues plan failure

The failure to fulfill the planned level of budget revenues could occur due to inability of the economy to maintain the new level of taxation burden. Moreover, the business-climate in the country was markedly damaged by the re-privatization declarations and contradictory actions of the authorities.

In 1H05 the growth rates of GDP decelerated to 4% yoy while the authorities expect that in 2005 the economy will grew not less than 8% (the latest week forecast) - this growth rates could be achieved in case in 2H05 the real sector will develop with about 10-11% yoy.

So there exist significant hazard that the revenue side of the budget will be lower than initially expected. According to CASE Ukraine estimations the deficit of consolidated budget will be larger than the actual plan by about 4 billion UAH what is about 1% of GDP.

A related consequence of the unexpected budget deficit enlargement is public debt growth. Obviously, in case of shallow privatization revenues (the situation we observed in 1H05) the government will have to loan resources for covering the gap between revenues and obligations.

Table 1. The hazard of the overestimated economy possibilities

		2005	2006	2007
GDP (CASE Ukraine estimates)	billion UAH	416.2	488.4	582.6
GDP (official plan)	billion UAH	436	524.9	-
Revenues of consolidated budget (official plan)	billion UAH	133.4	-	-
	% of GDP (CASE estimate)	32.0	-	-
Revenues of consolidated budget (CASE Ukraine estimates)	billion UAH	129.4	153.2	184.6
	% of GDP (CASE estimate)	31.1	31.4	31.7
Expenditure of consolidated budget (official plan)	billion UAH	136.8	-	-
	% of GDP (CASE estimate)	32.9	-	-
Consolidated budget deficit (official plan)	% of GDP (CASE estimate)	0.8	-	-
Consolidated budget deficit (CASE Ukraine estimate)	% of GDP (CASE estimate)	1.8	-	-

Source: Ministry of Finance of Ukraine, CASE Ukraine estimates

Investments "crowding out"

Growth of the tax burden, increase in the level of minimum wages and minimum pensions created significant pressure on investment activity besides the uncertainty in the country related with the property rights and drastic changes in general "rules of game".

At the beginning of the year the majority of sector privileges and privileges for the territories of priority development were abolished and, as a consequence, the tax burden for the whole economy increase approximately 5 p.p.

In 2004 the Ukrainian economy had rather moderate fiscal burden, which was lower than in most EU countries.

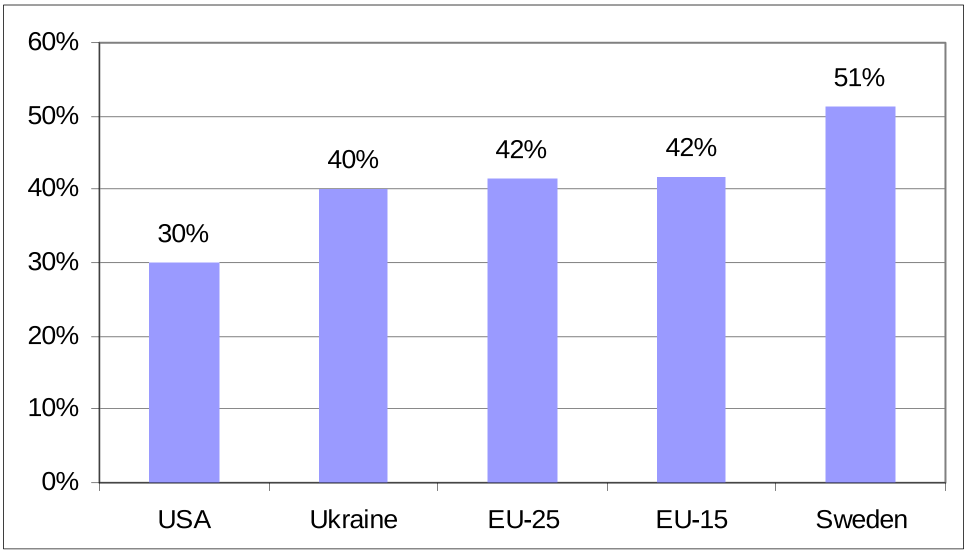
At the same time during 5 months of 2005 over 33.5% of GDP were redistributed only through the budget. Such a sharp rise was possible, first of all, due to abolishment of tax privileges for producers.

These changes (uncertainty with property rights, fiscal pressure rise and increase in social payments) created replacement of investments. According to CASE Ukraine estimations about 1% of GDP was taken off from the investments and was allocated to the social need (from investment to consumption). As a consequence investment demand and sustainability of the economy growth in the future were significantly damaged.

Although the revenues of the consolidated budget were enlarged markedly the share of the government consumption in the budget expenditures seems to be decreasing (on the basis of the available information for 5M05). Thus the other point of the crowding out effect is that the resources that were in previous periods allocated at the government consumption at the current situation are defined to be "eaten up".

The growth of the values of minimum wages also creates additional pressure on producers since the volume of the payroll taxes outlays were simultaneously enlarged. In addition, the revenues of the state enterprises under the new rules are transferred to the budget while again no resources for investment were left.

Picture 1. GDP redistribution through taxes and social payments in countries (groups of countries)*



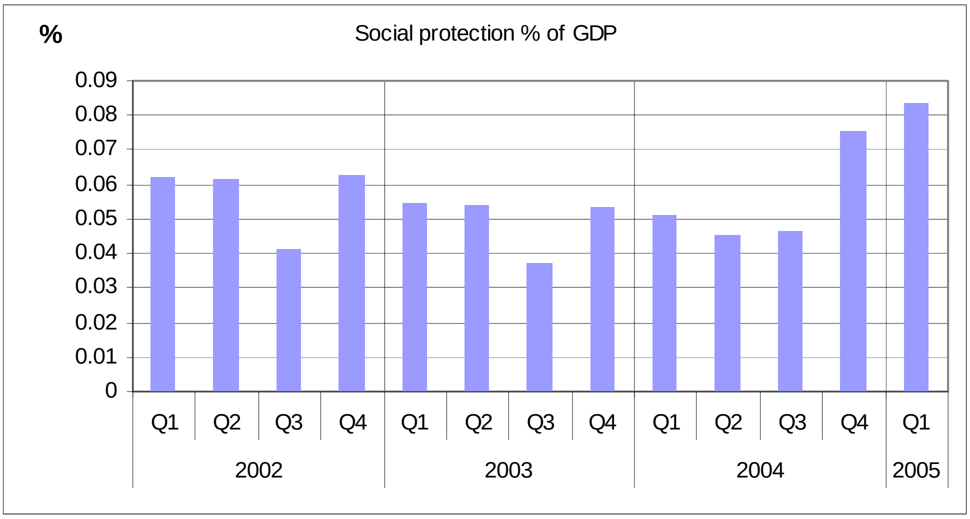
- it is worth noting that the share of shadow economy in Ukraine is much higher than in other countries represented in the graph. That is why the relative fiscal pressure on the Ukrainian economy is somewhat lower.
- Statistics for Ukraine is for 2004, statistics for other countries is for 2001/

Source: OECD taxation policy review, CASE Ukraine calculations.

Social expenditures pressure on the price level

Outstanding expansion of social expenditures of the budget at the end of 2004 –2005 definitely has negative impact on price level in Ukraine. Furthermore, continuation of rapid social expenditures growth could contribute to preservation of high inflation in the following years.

Picture 2. Social protection expenditures in Ukraine

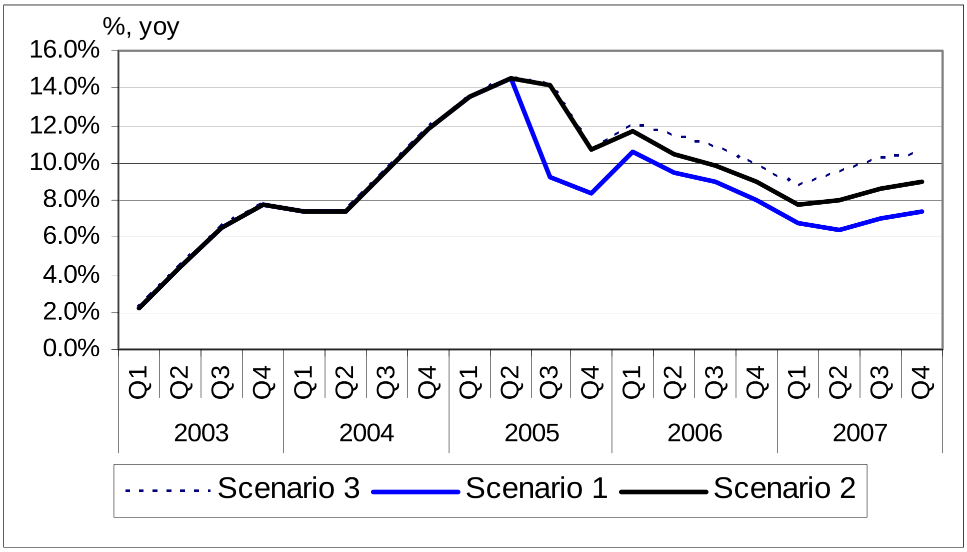


Source: Budget Committee of Verkhovna Rada, CASE Ukraine estimates

The data for the last five and half years suggest strong correlation (more than 60%) between social expenditures of the budget and CPI in Ukraine. Prices of some food stuff (like meat, milk) and nonfood goods are most prone to increase in social payments and subsequent surge in incomes. Climbing in social spending and surge in people's incomes entails rise in internal demand. As a result, one could observe reinforcement of demand-side pressure on prices.

For estimation of the effect of the enlarged social outlays on the price dynamics we developed three major scenarios where under scenario 1 the social spending in 2005-2007 is almost unchanged. For scenario 2 we take the current situation (large social spending growth in 2005) with further increase of this kind of expenditures although with slower growth rates. And the third scenario considers robust social expenditures during the next three years.

Picture 3. CPI growth rates according to the scenarios of social spending growth



Source: CASE Ukraine estimates

The outcome of the estimations is roughly the following: scenario 1 (moderate social spending behavior) – CPI growth about 1.4 p.p. lower than in scenario 2 (generous spending) and by 2.1 p.p. lower than in scenario 3 (robust social outlays growth).

Slow pace of personal income (salaries and wages) de-shadowing

Despite significant decrease in the rate of personal income tax a substantial part of salaries and wages is still in shadow. The consolidated budget in January-May received only by 26% more revenues from personal income tax against the background of 40% rise in nominal incomes of people. A partial explanation of this tendency is that poor layers of population, which have lower tax obligation, benefited mostly from employees' compensation and pension increase. However, the major reason for slow pace of income de-shadowing is that income legalization measures are not quite efficient. One of the explanations for such poor results is high rates of payments to four social funds. Actually the fiscal burden on employees' compensation remains too high. Further success in legalizing incomes is possible only in case of reduction of social payments rates in the purpose of broadening the taxable base. One possible scenario of reforms is 10% reduction in social payments rates during 3 years with subsequent monitoring of the social funds receipts dynamics.

Pressure on pension system

In 2005 about UAH 12 billion will be transferred from the state budget to the Pension Fund for covering the deficit. This measure has certainly a number of positive effects like increase in well being of poor layers of population. Obviously in 2006 the necessity in state budget transfers to the Pension Fund will persist since government plans to provide generous pensions to population with further real increase of its size. However, from macroeconomic point of view, provision of pensions from the budget is not acceptable in long run. Pension, in nature, is delayed consumption of what a person earned during working age. Provision of pensions from the state budget violates this principle, which may endanger macroeconomic financial stability in the long run. That is why it is important that such measures were purely temporary in nature. In view of this it is necessary to set a maximum share of budget transfers in Pension Fund revenues (for instance, at the level of year 2005) and constantly reduce it. For example, one possible scenario is to reach zero share of state budget transfers in PF revenues in 5 years.

Pressure on accidence social security funds system

Financing of aid for baby caring (one time aid following birth of a baby) from the social security Disability Fund may lead (and actually leads) to deficit of the Fund. In this case the deficit is covered from the state budget. Since April 1st the expenditures of accidence social security fund went up by over UAH 3 billion yearly. Initially, the projected Fund proceeds are significantly lower than projected expenditures. The Fund financial system is misbalanced. It is preferable to finance one time aid for baby caring directly from the state budget without involving social security fund as intermediary. Such kind of aid is not an insurance compensation in nature but an element of state social policy reflecting the state priorities.

Table 2. Summary of the current budget policy risks and its consequences

risks	reasons	consequences
budget revenues plan failure	a) the economic growth for year 2005 was overestimated (increase in the level of tax burden for the economy and uncertainty with the property rights (re-privarization) played the key role for the economy deceleration), thus the potential budget revenues were also possibly overestimated;	a) growth of budget deficit with subsequent public debt enlargement b) inability to fulfill the declared obligations
investments "crowding out"	a) increase in the level of tax burden due to abolition of the tax privileges; b) large-scale changes in the taxation rules; c) talks about re-privatization and contradictory high governmental officials statements on the issue of large enterprises' ownership status; d) transfer to the budget of most dividends earned by state-owned enterprises (like Ukrnafta) with very limited resources left for companies' investments;	a) slump in investment activity of foreigners; b) decrease of investment demand; c) further weakening of the economy performance due to outstanding consumption in the current period
inflation growth	b) increase of social spending of the budget; c) growth of the minimum wages level; d) unsustainable growth of the minimum pensions;	a) weakening of the real consumption possibility; b) stimulation of further inflationary expectations; c) damage to the credibility of national currency;
slow pace of personal income (salaries and wages) deshadowing	a) despite sharp decrease in personal income tax rates, contributions to social insurance funds (and overall fiscal pressure on employees' compensation) remain too high;	a) lower than expected consolidated budget receipts of personal income tax;
pressure on pension system	a) the increase in minimum pensions created huge deficit in Pension Fund which is financed from the budget;	a) there is possibility of lock-in effect when the larger part of potential investments will be

	b) the population becomes older and there will be no possibility to decrease the misbalance in Pension Fund in further periods;	eaten up by the outlays on Pension Fund deficit financing;
pressure on accidence social security fund system	a) increase in aid for baby caring (one time aid following birth of baby);	a) one time increase in accidence social fund expenditures by over UAH 3 billion yearly;

Simulations of scenarios of the economy development depending on the changes in the fiscal policy[1]

In order to illustrate the consequences of the major macroeconomic risks in the country, we developed forecast according to three different policy options that might be executed by the government. The baseline for our comparison is the scenario in which we assume that the government policy continued the way it was before the election (before the revolution). This scenario is chosen because it reflects the "stable policy". As you know, most national and international investors complaint that the major hazard for their business in not the bad policy, but the frequent changes in the policies. The baseline scenario, therefore, assumes that the policy changes did not happen. The second scenario assumes that the government continues its present policies in budget sphere. The third scenario provides insight on the effects of alternative budget policies, introduced in 2006.

Scenario 1: hypothetical "status quo" – no changes took place at the beginning of 2005

In this scenario we consider hypothetical situation assuming that no major changes in the economic policy of Ukraine took place after the end of election process. In other words, the estimations are based only on the liaisons at the economy at the beginning of 2005 and on the general macroeconomic tendencies (i. e. no shocks with re-privatization notions, changes in taxation rules etc).

The major assumptions in the scenario are:

- level of taxation in 2005 remains on the level of 2004;
- share of government consumption in the total volume of budget is fixed on the average level of 2003-2004;
- social expenditures increase only by the value of CPI growth (indexation is present);
- external demand is estimated without corrections accounting for unfavorable changes to internal business climate for exporting enterprises;
- consumers' prices growth was considered to be the same as actual for 1H05 (the major factors of the price acceleration evolved in 2004) while the CPI dynamics for the further periods was estimated given moderate social outlays enlargement;
- budget deficit is roughly assumed to be equal to about 2% of GDP during 2005-2007;

Table 3. Some projected macroeconomic indicators for scenario 1

		2005	2006	2007
GDP	change, %	6.2	5.9	5.9
Domestic demand	change, %	4.0	4.8	4.3
Private consumption	change, %	11.1	10.3	10.5
Gross capital accumulation	change, %	5.6	5.1	5.0
Industry (value-added)	change, %	6.6	6.0	5.8
Market services (value-added)	change, %	9.2	8.8	9.1
CPI	aop., %	11.3	9.2	6.9

[1] CASE Ukraine macroeconomic model is employed for simulation of scenarios

Current account balance	% of GDP	12	13	14

Source: CASE Ukraine estimations

The results of the scenario 1 will serve as a benchmark for comparison with other scenarios. However, the results should be considered critical since estimations of the exports development do not account for possible changes in the share of Ukrainian products on foreign markets (only the growth of the markets is modeled) while producers of such products as metals and machinery will lose their markets in long-run without modernization.

The major reason for such calculations is just to show what effect the manipulations in fiscal sector will have in the nearest future.

Scenario 2: estimation of the consequences of the actual actions of the government

In the second scenario we consider the development of the economy as it was in 1H05 and how it is expected to be in 2H05 and in 2006-2007. The major points that will distinguish the scenario 2 from the first one are:

- level of tax burden is increased by about 5 p.p. (of GDP);
- social expenditures continue to increase although with slower paces than in 1H05 – by about 20% yoy during 2H05-2007 on average;
- development of consumers' prices is corrected accounting for the inflationary effect of social spending;
- increase of the tax burden is estimated to have "crowding out" effect on investment; in case of enlargement of the tax burden by 5 p.p. (of GDP) the share of investments in GDP structure will decrease by 1p.p.
- in the 2nd scenario correction coefficient is introduced for 1H05 in order to account for the tendencies which already took place in the economy;
- in the 2nd scenario we also consider some loses of the external markets by Ukrainian producers due to low competitiveness of production which is likely to persist if no modernization takes place (possible consequence of the investment "crowding out");

Table 4. Some projected macroeconomic indicators for scenario 2

		2005	2006	2007
GDP	change, %	4.6	5.0	5.8
Domestic demand	change, %	7.6	8.3	8.5
Private consumption	change, %	12.2	9.5	8.8
Gross capital accumulation	change, %	-6.4	-3.4	-2.1
Industry (value-added)	change, %	2.9	0.2	1.3
Market services (value-added)	change, %	4.1	8.2	7.9
CPI	aop., %	13.2	10.2	8.3
Currant account balance	% of GDP	8	6	5

Source: CASE Ukraine estimations

This scenario clearly shows that in 2005 we observe the process of investment crowding out due to the enlargement of taxation level. As a consequence of the social outlays growth the inflation accelerates with a lag of one quarter (estimations of the effect were made on the basis of the historical data for Ukraine). The redistribution of the resources through the budget seems to have positive effect on the dynamics of private consumption – we observe stronger dynamics in scenario 2 compared to the growth rates in scenario 1. However, the enlargement of the household demand has positive effect on the imports dynamic rather than domestic production.

The increase in the taxation level, growth of wage-bill expenditures, and inflation stimulation has negative effect not only in 2005 but also in the next periods. Estimations show that the effect of investment deterrence has chain reaction in long-run. Unfortunately, the model could not catch the effect of uncertainty at the economy. Thus the negative effect of uncertainty was considered only for the current year due to the statistics available at the mid of 2005.

So at the moment we can state that the current development in the Ukrainian economy related to reallocation of resources for current consumption make Ukrainians to sacrifice about 0.9 p.p. of growth for the next three years.

Scenario 3: consequences of enterprise profit tax rate and payroll tax rate reduction

The major feature of the scenario 3 is the possibility of the tax burden reduction at the expense of payroll tax decrease to about 20% and some enterprise profit tax decrease. Other conditions remain the same as in scenario 2.

- roughly we assume that the reduction of the enterprise profit tax (EPT) rate will be compensated to full extent by the deshadowing effect thus major consequence will be that the enterprises will receive spare resources; in other words, in 2006 the revenues of the consolidated budget in nominal terms (given tax rate 20%) will be of the same volume in case the tax rate is 25%;
- for estimations we presume that every year the EPT tax rate will be reduced by 5 p.p. in 2006-2007 thus the volume of declared incomes will be by 25% higher in 2006 compared to 2005 and by 33% higher in 2007 compared with 2006;
- we also assume that about half of the spare resources the enterprises receive from the tax rate reduction will be allocated at the investments;
- thus the investments will be larger in nominal terms by the value of 2% of GDP in 2007 (compared to the scenario 2) – the reduction of tax rate in 2006 will create spare resources for investment only in 2007;
- the decrease of the payroll tax to the level of 20% will reduce the burden of this kind of taxation by 45%;
- similarly to the decrease in the enterprise profit tax rate the reduction of the payroll tax will create some spare resources for enterprises;
- for the last three years wage-bill was on the level of 14% of GDP that is in case of reduction of the payments by 10 p.p. the enterprises will receive about 1.4% of GDP of free resources;
- assuming that about one-half of the money are invested it means that approximately 3.5p.p. of additional growth of investments will take place in 2006;
- similarly to EPT rate reduction we assume that decrease in payroll tax will be compensated for budget by deshadowing of wages;

Table 5. Some projected macroeconomic indicators for scenario 3

		2005	2006	2007
GDP	change, %	4.6	5.9	8.9
Domestic demand	change, %	7.6	9.4	12.4
Private consumption	change, %	12.2	9.7	9.4
Gross capital accumulation	change, %	-6.4	2.7	18.1
Industry (value-added)	change, %	2.9	2.2	9.3
Market services (value-added)	change, %	4.1	8.3	8.3
CPI	aop., %	13.2	10.2	8.3
Currant account balance	% of GDP	8	6	5

Source: CASE Ukraine estimations

The results of the third scenario shows that in case of reduction of tax burden the economy perform much better thanks to recovery of investment demand. Specifically, in case of reduction of the EPT and payroll taxes, GDP growth improves by 2 p.p. in 2006-2007 (no changes in taxation is reasonable in 2005).

Necessary to note that in case of successful reformation of EPT and payroll tax the average growth of economy will exceed by 0.5 p.p. growth rates of GDP in scenario 1 (hypothetical "status quo"). Such result is logical since the suggested reduction of the taxation level is much stronger (-6.4% of GDP in 2006 and – 8% of GDP in 2007) than the actual taxation burden enlargement that took place at the beginning of 2005 (+5% of GDP).

Importantly, we made a strong assumption that the reduction in the tax rate will be compensated by the economy deshadowing; however, there exist a necessity of additional investigation of the perspectives of deshadowing .and possible scale of the process (depending on improvement of business and investment climate in other regulatory spheres than taxation).

Policy recommendations

The analysis shows that there are significant risks to macroeconomic stability of Ukraine. These risks to large extend are related to the extended social spending and budget obligations introduced with the changes to budget 2005. Sudden increase of tax pressure on economy and expectations of continuing such policy in the future decreases official business activity of economic subjects and decreases investment.

The scenario analysis shows that economic growth in 2005-2007 would be higher if there were no change in policy since 2004 compare to the situation when government implemented budget reforms. It is natural result, usually change in economic policy creates shock to the economy and result in short-term decrease in growth rate of economy. However, it is important to ensure that this shock do not lead to the long-term decrease of the growth. Unfortunately, analysis shows that continuation of current budget policy may result in slowdown of economic growth in medium-term. In order to avoid such slowdown, careful change on budget policy has to be introduced starting 2006.

Here we provide some suggestions for policy changes and the way these changes are introduced:

- Any change to budget policy has to be introduced in transparent and predictable manner, and start with the next tax cycle. It means that any tax law has to take effect at least in three months after its adoption, and it has to start at the beginning of month, quarter, or year (whatever is the tax cycle). Therefore, all the changes to taxes or budget that planned for 2006 have to be introduced not later than end of September 2005. There should not be retroactive tax legislation.
- Any changes to the tax laws have to be carefully evaluated with respect to the impact on budget revenues before introduction. If there is a chance that the budget revenues will be decreased as the result of the changes to the tax law, proper reduction of budget expenditures should be made before the changes to tax law are introduced.
- Significant risk to the execution of the budget and pressure for inflation in 2005 was created by increased social expenditures. We recommend considering any further increase in social spending very carefully, and, if possible, avoid increases of social spending (including pensions) in 2006. Continued policy of increasing social expenditures will add about 1-2% to the annual inflation in 2006 or 2007
- Significant decrease in the payroll taxes together with keeping flat personal income tax rate and progress in deregulation can stimulate de-shadowization of wages, which might significantly increase tax base for payroll and income taxes in the long run. Such decrease can result in up to one percent additional GDP growth in 2006 and up to 3% in 2007. However, the decrease in the payroll taxes will have positive effect only if the

budget remains balanced. The decrease of payroll taxes from 37% to 20% in 2006 will require decrease another budget expenditures by 3.5-4% of GDP, which will have to be directed to additional financing of existing social funds. In the longer run, the balance of the funds can be achieved by decrease in the funds obligations and increase in the tax base. However, it is impossible in the short (one or two years) perspective. Therefore, it is better do not reduce payroll taxes in 2006 if the matching decrease of other expenditures is not feasible.

- If considered, the decrease in the enterprise profit tax rate (up to the level of the personal income tax) might have significant effect on de-shadowization of the enterprise profits. In the best case the expansion of the tax base might compensate the losses from decreased tax rate. However, the expectation of the increase in tax base should not be counted for at the first year of the enterprise profit tax reform. It is better to use gradual approach, and decrease the tax rate gradually by 3-5% a year, and make another decreased conditional on the expansion of the tax base.
- Finally, we recommend making the 2006 budget on very conservative assumptions, expecting the growth rate in 2006 only about 5% and inflation rate at the level of 9%. Most budget risks for the economy in 2005 are associated with the possibility of the significant budget misbalance either from incorrectly estimated macroeconomic indicators for the budget 2005 or from underestimated impact of changes to the taxes and social obligations. These risks can be eliminated by conservative budget estimates (and significant expenditure reduction) in the budget for 2006.