Budget Report: 2nd Quarter 2014

In the 2nd quarter of 2014, the performance of the budget, which has already sustained some cuts, will be strained. Unfortunately, the government has failed to show significant results in countering the tax evasion schemes. Instead, the revenue on the major taxes (VAT and income tax) has continued to fall at an increasing rate against the backdrop of the escalating anti-terrorist operation (ATO). So far the government has managed to compensate this by ad-hoc measures (national currency devaluation, delay of VAT recovery, National Bank's emission) and increase the revenue part of the consolidated budget of 2Q2014 by 7.8% as compared to the same period of 2013 to UAH 112.3 billion. However, as early as in June, for instance, the National Bank’s limit for the funding of the budget was nearly depleted. At the same time, the debt service costs and social security costs were increasing, while the military needs became a priority. In order to meet the budget restrictions, the government had to postpone many expenditure programs. The expenditures of Ukraine’s consolidated budget over the 2nd quarter 2014 were UAH 132.6 billion, which is 4.4% more than the same in 2Q2013.

The plummeting revenue, military costs, as well as the need to meet the IMF fiscal balance requirements, became the grounds for a new budget revision. The goal of such measure was to fill the budget by new revenue sources (deposit tax, military tax), increased excise rate, rent, and accounting for the EU grants. Besides, the old revenue plan was adjusted to the new economic situation. As regards the expenditures, it was proposed to redirect the majority of resources to the funding of military action. Although the motto of both the first budget cuts (made this March) and the July budget amendments (July) was saving at the expense of administrative costs, significant savings off the state officials were not achieved. A real source for the government’s savings were the subsidies for various sectors, social expenditures, and local budget expenditures. In the aggregate, these measures allowed almost doubling the funding of the army to a record figure of 2% of the GDP, and improved the changes of performing the revenue part of the budget. Additionally, the budget amendments increased the national debt through funding of the deficit of Naftogaz of Ukraine national joint-stock company, which amounts to UAH 960.0 (over 60% of the GDP).

The second quarter was also marked by the commencement of high-profile reform concepts, namely the tax reform and decentralization. However, the majority of the government’s proposals provoke many questions to be discussed. Another problem is that it is unclear how such fiscal reforms are going to be implemented given the problems with the collection of the budget revenue. Therefore, we can hardly expect any actual reform in the nearest future.

TABLE OF CONTENTS

CURRENT TRENDS: The Government Reshapes the Budget for the Sake of the ATO

In late July, the government made a radical revision of the state budget for the second time this year. Despite the resources that became available due to cuts of several programs, the state expenditures plan had to be increased in order to continue the ATO. The funding of such increase was at the expense of both the citizens (income tax on interest income and defence tax) and companies (increased mineral royalties). The national debt level was also increased to 64% of the GDP. In the 2nd quarter 2014, the Verkhovna Rada proclaimed the Autonomous Republic of Crimea a temporarily occupied territory, isolating it from Ukraine's budget system. Prime Minister Yatseniuk presented a tax reform project.

Parliament Adopts the Budget Revision on the Second Attempt

The second budget revision in the current year, made on July 31, became another important event. After a 4-week visit of the IMF Mission to Ukraine, the Cabinet of Ministers submitted draft laws on amendment of the Law of Ukraine "On the State Budget of Ukraine for 2014 " and of the Tax Code. However, the parliament members refused to vote for the amendments, and the parliamentary majority fell apart, with UDAR and Svoboda factions withdrawing from it. As a result, Prime Minister Yatseniuk immediately announced his resignation. The Parliament's refusal to amend the budget and the tax law could undermine the cooperation with the IMF. However, over the weak the parliamentary storm subsided; the deputies voted for the new revisions of the state budget and the Tax Code, and Arsenii Yatseniuk remained in his position of the Prime Minister. The budget revenue, on the one hand, and the expenditures and credit provision, on the other hand, were increased by UAH 4.9 billion. The marginal deficit amount remained unchanged.

Revenue Increase at the Expense of both Citizens and Companies

The 2014 budget revision increased the revenue plan by UAH 4.9 billion to UAH 375.8 billion. This is the net result of the revision. On the one hand, the plan for several items of budget revenue was reduced by a total amount of UAH 13.0 billion. For instance, due to the unfavorable macroeconomic situation and the military action in the Eastern Ukraine, the planned revenue on VAT and corporate income tax revenue was reduced by UAH 7.95 billion and UAH 2.8 billion, respectively.

On the other hand, in order to offset the tax losses, the government found additional sources of revenue in the amount of UAH 18.0 billion (of which the tax revenue is UAH 13.5 billion, non-tax revenue is UAH 0.5 billion, and the EU assistance is UAH 4 billion). The increase of the tax revenue is mostly to be performed through temporary increase of the subsurface resources management fee (UAH +4.8 billion), taxation of interest from deposits (UAH +3.3 billion), defence tax (UAH +2.9 billion), and excise tax (UAH +0.3 billion). Additionally, the VAT exemption of grain exporters in the last quarter of this year will save about UAH 2.0 for the State budget.

Major Budget Events, 2Q2014

April	15 – Anti-Terrorist Operation commenced in the Eastern Ukraine 15 - The Autonomous Republic of Crimea proclaimed a temporarily occupied territory and isolated it from Ukraine's budget system 30 – IMF decides to grant Ukraine a stand-by credit
May	6 – IMF transfers the first credit installment 25 – Extraordinary presidential elections 27 – State Fiscal Service established
June	24 – IMF mission begins working in Kyiv

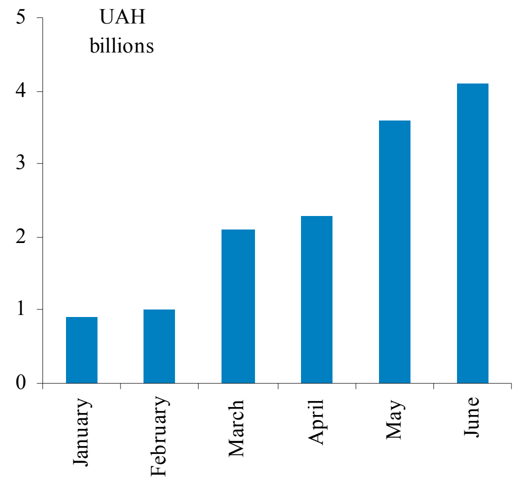
Source: CASE Ukraine

Largest Expenditures Allocated to the Reserve Fund

At the same time, the planned expenditures were increased by UAH 4.9 billion. By reducing the expenditures in some areas the government increased the expenditures in the others. The largest amount of additional funding was allocated to the reserve fund. These funds were allocated for the following purposes: ATO: UAH 9.1 billion, restoring the infrastructure in the Eastern Ukraine: UAH 1.9 billion. An UAH 1.8 billion subvention was also allocated to the city budget of Kyiv.

Interestingly, Yatseniuk's widely publicized initiative for reduction of expenditures to several central executive government agencies (mainly various government committees) promises only about UAH 0.6 billion of savings. Instead, the majority of savings is anticipated from the reduction of (a) transfers to the Pension Fund (UAH -2.1 million), (b) real sector support programs (UAH -2.9 billion), and (c) environmental protection expenditures (UAH -2.2). Importantly, the government plans to offset the reduced allocations to the Pension Fund by withdrawing the same amount from the Temporary Disability Insurance Fund and the Unemployment Insurance Fund.

Defense Costs of the General Fund of the State Budget in the 1st Half of 2014



Source: Ministry of Finances, CASE Ukraine

Increased National debt due to Devaluation and Additional Capitalization of Naftogaz of Ukraine

The "ceiling" of the state debt has been increased by UAH 143 billion to UAH 960.0 billion (including the state guarantees), which is more than 60% of GDP. According to the Ministry of Finance, the national debt including the state guarantees reached 56.8% of GDP (UAH 821.8 billion) by the end of June. The Cabinet of Ministers explains the need to increase the state debt limit by the devaluation of the national currency and the respective increase in the UAH value of debt denominated in foreign currency. The state debt will additionally increase due to the further capitalization of the NJSC Naftogaz of Ukraine through the issue of sovereign bonds to the amount of UAH 63.3 billion and contribution of securities to the company's authorized capital.

Crimea Isolated from Ukraine's Budget System

In April, the Verkhovna Rada proclaimed the Autonomous Republic of Crimea and the city of Sevastopol temporarily occupied territories. Additionally, it passed the amendments to the Budget Code, thus isolating the Crimea from Ukraine's budget system. The taxes payable in the territory of the Crimea were excluded from the state budget revenue; they are now to be fully paid to the respective local budgets. The costs and credits of the local budgets in the Autonomous Republic of Crimea have to be performed only at the expense of, and within the amount of, the revenue of the local budgets of Crimea without the equalization mechanism applied. As a result, the local budgets of the Autonomous Republic of Crimea no longer receive transfers from the State Budget of Ukraine.

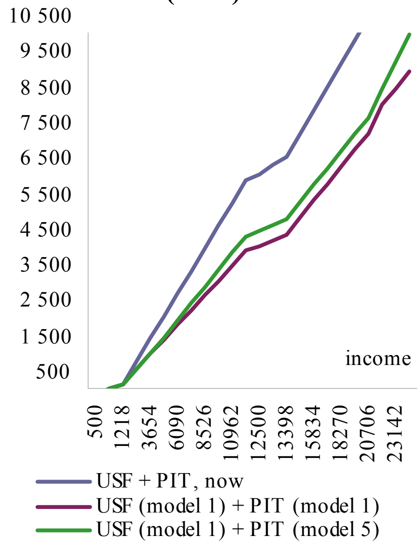
Government Presents the Tax Reform

The tax reform concept has been under development since this spring. Besides the Ministry of Economy, non-governmental organizations have been working on the reform. The main proposals included: (1) an idea to implement differentiated VAT rates, (2) an idea of significant reduction of the unified social contribution rate, (3) and a proposal to reduce the number of taxes and duties from 22 to 8. However, the Ministry of Finances remained unsatisfied with the draft reform proposed by the Ministry of Economy and the community activists. According to the official estimated, the revenue may drop by 2.3% of the GDP. The Ministry of Finances officials could not agree to such underexecution of revenues, and developed an alternative concept jointly with the State Fiscal Service. In early August, Arsenii Yatseniuk presented a new version of the tax reform at the Cabinet of Ministers meeting. The areas of the tax reform may be outlined as follows:

- *Tax base broadening.* It is proposed to switch the agricultural enterprises with annual revenue over UAH 20 million and area of agricultural land over 3 thousand hectares to the general VAT system. According to the government calculations, about 10% of agriculture enterprises will switch to the general system.
- *Simplifying the tax system and reporting.* The number of taxes is reduced from 22 to 9 by removing several duties and rent for transportation of oil, oil products, natural gas, and ammonia. The excise, environmental, unified, and real estate taxes, as well as the rent, will be transformed. The reporting for tax and accounting purposes in relation to corporate income tax will be made more similar.
- *Strengthening revenue autonomy of local budgets.* The real estate tax and fixed agricultural fee will be reclassified as local taxes.
- *Countering shadow salaries.* It is proposed to change the rates and brackets of unified social contribution (USC) and personal income tax (PIT). At the moment, the USC is accrued at a rate from 36.76% to 49.7%, depending on the company risk class. The government proposes implementing a fixed USC rate of 37% (option I) or 41% (option II) of the minimal wage. The amount of the employee's salary exceeding the minimum wage will be subject to either 19% USC in option I or 15% in option II. The reduction of budget revenues would be partially offset by the progressive PIT rate. The reform authors propose 5 options of PIT brackets with rates from 10% to 25%.

The Prime Minister underscored that the state budget for 2015 has to be drafted with due consideration of the innovations in the tax area. However, complete implementation of all tax reform initiatives in the coming year is doubtful due to the fiscal problems. In particular, excluding the reduction of the shadow economy, the USC revenue is expected to drop by UAH 45.5–47.9 billion, whereas the maximum proposed offset option does not exceed UAH 15 billion. The other measures can hardly be called a reform, as they are of more declarative

Tax Reform: Change in the USF and the PIT (UAH)



Source: State Fiscal Service, CASE Ukraine

Transformed Taxes

1. Excise tax. 2. First vehicle registration fee 3. Environmental tax (on the fuel). 4. Targeted markup on the current electric and heat supply rates.
Excise Tax
1. Environmental tax (except for fuel) 2. Forest resources use fee.
Environmental tax
1. Subsurface resources management fee. 2. Radiofrequency resources use fee. 3. Special water use fee.
Rent
1. Real estate tax (except land) 2. Land fee.
Real estate tax
1. Single Tax 2. Fixed Agricultural Tax
Single Tax

Source: Ministry of Finance

nature than practical value for a taxpayer.

Cabinet of Ministers Approves the Draft Law on Fiscal Decentralization

In early August, the government approved amendments to the Budget Code involving the introduction of a new model of inter-budget relations. The reform authors underscore the extension of local budget revenue sources. For instance, the following taxes and duties will fund the general fund of the local budgets: administrative services fee, state duty, 10% of the private company income tax, excise goods retail sales fee, and single tax. The following taxes and duties will fund the special fund of the local budgets: 45% of the environmental tax, and the commercial real estate tax. Additionally, the administrators of local budget funds will be able to choose to receive services from the treasury service or a bank. The equalizing intergovernmental transfers will be replaces by several subventions.

However, the positive impact of the proposed initiatives for the local budgets is doubtful. For instance, the additional resources of local budgets are estimated at UAH 21.1 billion. At the same time, the draft law proposes to change the PIT distribution and withdraw 25% of the amount of this tax to the state budget. In 2014, the respective estimated loss of local budgets is about UAH 19.4 billion. Thus the net increase in the revenues is not so large and amounts to UAH 3 billion. Additionally, it is proposed to expand the responsibilities of the local councils. However, the government has not presented a value estimation of such expansion. Transferring the service of the local budget funds to the banks restricts the local budgets' capabilities to use the loans from the State Treasury Service. Replacement of the equalization transfers with separate subventions for education, healthcare, roads, and training of working personnel additionally limits the local government's capabilities to make decisions on the efficient use of funds.

Expenditures Transferred to the Local Budgets

Ministry of Health
1. Medical activities support costs. 2. Specialized medical and sanitary units. 3. State Sanitation and Epidemiology Service Laboratory Centers.
Ministry of Education and Science
1. Specialized schools. 2. Extracurricular facilities.
Ministry of Social Policy
1. Social security for Chornobyl victims. 2. One-time financial aid to the disabled and poor unemployed individuals.
Ministry of Culture
Several nature reserve areas.
Ministry of Youth and Sports, Ministry of Agricultural Policy, Ministry of Internal Affairs
Maintenance of sports communities and sports camps

Source: Ministry of Finance

REVENUE: Military Action Complicates the Budget Revenue Collection

The revenues of the consolidated budget of Ukraine over the 2nd quarter 2014 is UAH 112.3 billion, which is 7.8% more than in the same period of the previous year. Thus the fiscal revenues collected over the 1st half of the current year amounted to UAH 224.5 billion, which is 6.4% more compared with the same period last year. Considering the military action in the east of the country, which caused production shutdown and closure of customs offices, such rates of revenue execution can be viewed as an achievement. However, this success is not comprised with systemic actions, and was most likely caused by ad hoc factors such as advance profit transfer of National Bank (NBU) to the budget, delayed value added tax refund, and hryvnia devaluation. Without these factors, the low tax collections would not have allowed the government to boast of an increased revenues.

Consolidated Budget Income, UAH billions

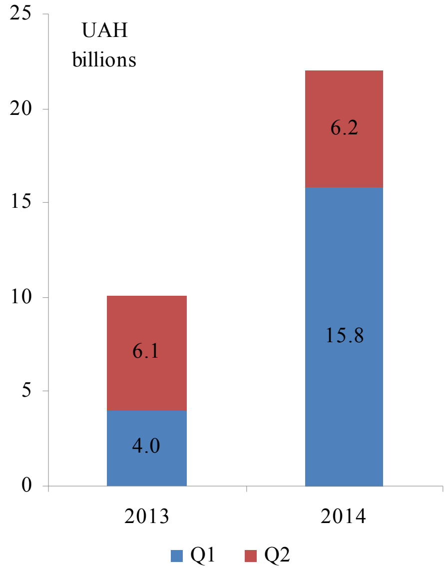
	2Q 2013	*2Q 2014*	*Change, %*
Total	**104.2**	**112.3**	**+7.8**
Tax Revenue	***86.6***	***90.5***	***+4.5***
VAT	32.1	36.3	+13.2
fee	*45.9*	*47.7*	*+4.0*
reimbursement	*-13.8*	*-11.4*	*-17.3*
PIT	18.0	17.9	-0.2
Excise Tax	9.1	11.4	+24.2
Corporate Income Tax	12.2	9.4	-22.6
Non-Tax Revenue	***17.0***	***21.1***	***+24.0***
NBU Funds	6.1	6.2	+2.2

Source: State Treasury Service

NBU Stops Supporting the Budget Only in June

Over the 2nd quarter 2014, the NBU transferred UAH 6.2 billion to the budget, which is almost at the level of the same period last year (UAH 6.1 billion). Importantly, all of this amount was transferred before the first of June. Therefore, over the 5 months the NBU transferred UAH 22.0 billion to the budget, which is two times more than in the 1st half of 2013 (UAH 10.1 billion) and makes up 96.5% of the amount planned for 2014 (UAH 22.8 billion). The NBU had to ,ake advanced profit transfer to the budget in order to offset the budget problems with tax revenue. Predictably, such practice was disapproved of by the IMF, so that the government hurried to take the most out of it and refuse from it only after signing a memorandum with the Fund.

Funds Transferred by the National Bank of Ukraine



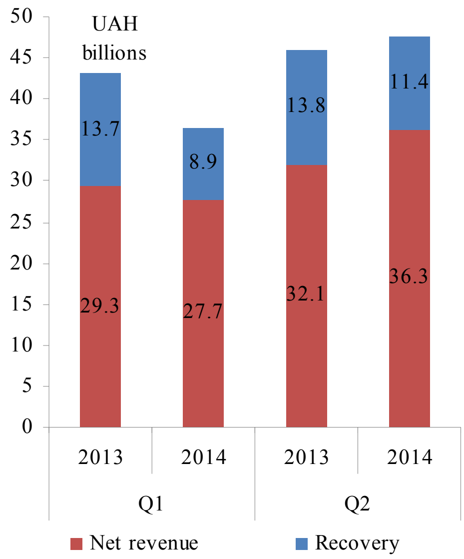
Source: State Treasury Service

Government Attempts to Fix the VAT Administration

Over the 2nd quarter 2014, UAH 47.7 billion of VAT was collected, which is 4.0% more than in the 2nd quarter 2013 (the VAT revenue from domiestic products increased by 0.8%, and from the imported goods by 6.9%). In the 1st quarter this year, the VAT collection dropped by 14.9% against 1Q2013. Most probably, the increase in VAT revenue is the result of the increase in prices, especially for the imported goods. The additional resources obtained by cancelling the VAT exemptions for medications and medical products (about UAH 0.4 billion per quarter) played a secondary role. The VAT revenue situation was the best in April (+16.2% as compared to April 2013), but deteriorated in May and June (-5.2% and +2.2%, respectively).

At the same time, the VAT refunded to the exporters in the 2nd quarter 2014 amounted to UAH 11.4 billion, which is 17.3% less than last year. In the 1st quarter this year, the VAT refund was 34.7% less than in the 1st quarter 2013. Since April 1, grain producers are not entitled for VAT refund, which should have saved the government about UAH 2.0 billion per quarter. Considering the reduction of VAT refund amounts, we may assume that the government has managed to eliminate some cases of falsified VAT refund from the budget. However, the government still has problems with the refund of legitimate amounts as well: from January to May 2014, the VAT refund arrears increased by UAH 9.0 billion. Interestingly, the VAT refund situation somewhat improved after the end of the revolutionary events. In particular, the rates of VAT refund cut in April and May decreased to -12.5% and -3.8%, respectively. However, in June the situation deteriorated again (VAT refund amounts dropped by 39.5% year-over-year), which was obviously caused by the intensifying ATO.

VAT Collection and Recovery



Source: State Treasury Service

Along with the refund of this year's VAT, the government also has the problem of the old VAT refund arrears. According to the Ministry of Finances' estimate, the VAT refund arrears was UAH 14.9 billion. In order to resolve this problem, the government commenced the issue of VAT bonds in July (the value of bonds issued so far is UAH 6.7 billion, with the IMF approved maximum for 2014 of UAH 16.7 billion). The initial bond yield is 9.5% p. a., with coupon payment twice per year in 2015–2019. The VAT bonds were generally well received by the

Ukrainian and foreign investors due to the 20.0% discount on these securities, which allows making a good profit.

Drop in the PIT Revenue Insignificant Against Other Taxes

In the 2nd quarter 2014, UAH 17.9 billion of personal income tax (PIT) was collected, which is 0.2% less than in 2Q2013. Considering the circumstances, the reduction in the PIT revenue could have been much larger. First, the annexation of the Crimea reduced the economically active population of Ukraine by 1.5 million, or 7%. Second, there are problems with the payment of salaries in the ATO zone. Finally, the unemployment is on the rise: the unemployment rate of 8.0% in 1Q2013 increased to 8.8% in 1Q2014. The revenue of the tax paid from income other than salaries is increasing, however, these amounts make up a small share of the total revenues.

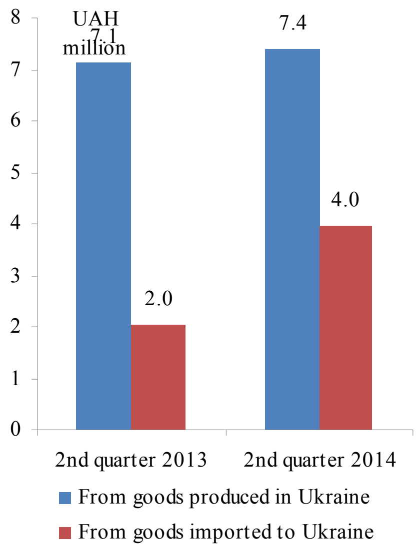
The Government Traditionally Uses the Excise Tax for Easy Budget Revenue Collection

In the 2nd quarter 2014, the revenue of the excise tax was UAH 11.4 billion, which is 24.2% more than in 2nd quarter 2013 (the revenue of excise tax on the goods produced in Ukraine increased by 3.7%, and almost doubled on the imported goods). The significant increase in the excise tax revenue on imported goods was due to the oil products and liquefied natural gas tax, the income from which increased 2.5 times against 2Q2013, reaching UAH 3.3 billion (4/5 of all excise revenue). The main cause of such result was the price increase due to devaluation of hryvnia. Multiple increase of excise rate on several categories of goods in the current year and the termination of Serhii Kurchenko's corruption scheme involving duty-free import of oil products also helped collect the budget revenue.

Reduction of Company Business Activity Has a Negative Impact on the Budget

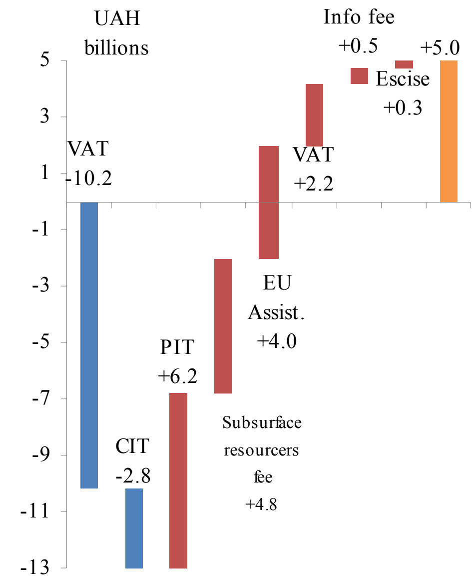
In the 2nd quarter 2014, UAH 9.4 billion of corporate income tax was collected, which is 22.6% lower as compared to the same period last year. The financial condition of the Ukrainian companies deteriorated significantly in 2014. The military action in the eastern Ukraine caused a significant reduction, or even suspension, of business activities of many enterprises situated there. Whereas in 2013 65.9% of Ukrainian companies made a profit, in the 1st quarter 204 only 50.0% had a positive financial result. The negative trends persist even despite the fact that companies are currently paying the tax in advance based on 2013 returns (the advance payments amount to 2/3 of all revenue). Besides, the Tax Code exempts the taxpayers that ended the 1st quarter 2014 with a loss from the advance payments, even if a positive financial result was achieved in 2013.

Excise Tax Revenue



Source: State Treasury Service

Amendments to the Income Part of the State Budget

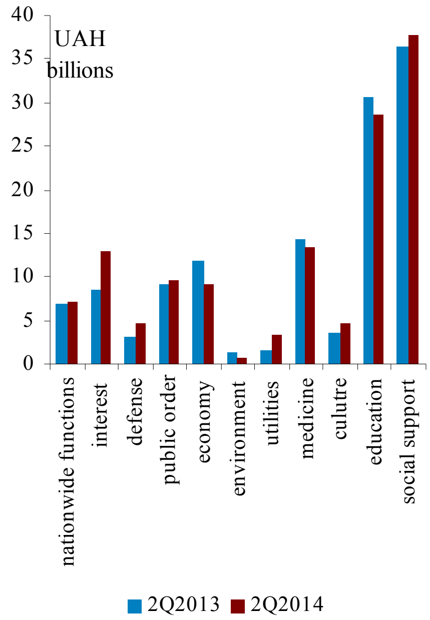


Source: Executive Summary to Draft Law No. 4308a of July 21, 2014

Forecast: New Taxes to Offset the Arrears in the 2nd Half 2014

Therefore, although the government managed to show a 7.8% increase of the budget income in 2nd quarter 2014 despite the military action in the Eastern Ukraine, this was achieved through ad-hoc measures. For this reason, amendments to the budget were proposed in July in order to offset the arrears on the major taxes and find UAH 5.0 billion to cover the increasing expenses. In particular, a temporary (until January 1, 2015, although prolongation is being discussed) defense tax from individuals at the rate of 1.5% of income will be introduced, and the mineral royalties for extraction of oil, gas, and iron ore will be increased. Additional resources should also be acquired from the interest income tax introduced earlier. The amendments significantly increase the government's chances of meeting the income part of the budget in 2014.

Consolidated Budget Expenses



Source: State Treasury Service, CASE Ukraine

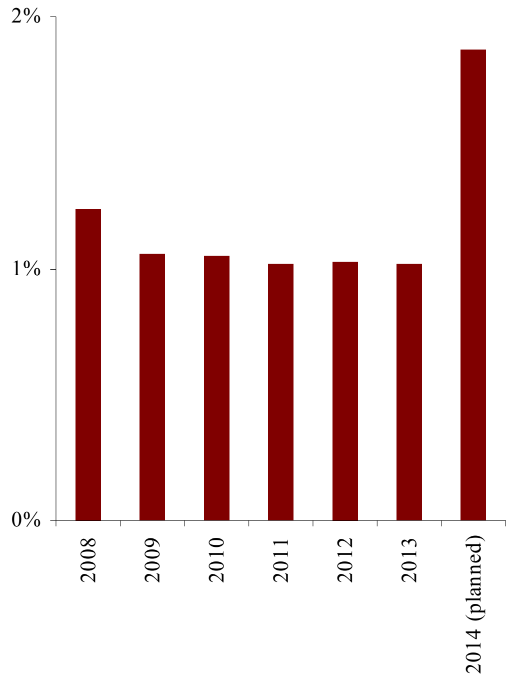
EXPENDITURES: All for the War…

The expenditures of Ukraine's consolidated budget over the 2nd quarter 2014 were UAH 132.6 billion, which is 4.4% more than the same in 2Q2013. From April to June, the government allocated larger amounts to the state debt service, defense, housing and utilities, and social security. The compliance with the IMF program, need to fund the military action, and the annexation of the Crimea caused the reduction of costs for support of the real sector, education, and healthcare. In July, the government proposed a new saving plan to the benefit of the war costs.

Army and Debt are the Priorities

The expenditures of Ukraine's consolidated budget over the 2nd quarter 2014 were UAH 132.6 billion, which is 4.4% more than the same in the 2nd quarter 2013. The increase was primarily caused by the increase in the funding of defense and debt service. In April through June 2014, the defense costs increased 45% year-to-year to UAH 4.6 billion. The majority of such costs was financed through the reserve fund. This mechanism is often criticized due to its vulnerability to abuse. However, considering the military action, the expenditures through the reserve fund may be justified, as it allows the Cabinet of Ministers to react promptly to the changing needs without waiting for amendments to the budget law. The reserve fund is used for the payment of additional cash allowance for the military personnel, modernization of weapons and military equipment, purchase of food, etc. The July amendments to the budget increased the funding of the army by an additional UAH 9.1 billion. The total amount of army funding at the year end has to reach 1.8% of the GDP. This should suffice till the end of the year, if the cost of the ATO does not exceed UAH 1.5 billion per month.

Defense Costs (% of the GDP)



Source: State Treasury Service, CASE Ukraine

In 2nd quarter 2014, UAH 13.0 billion was spent on state debt service, which is 55% more than in 2nd quarter 2013. In the structure of the consolidated budget from April through June, the share of debt service expenditures reached almost 10%. UAH 26.3 billion remains to be paid to the end of the year.

Social Security: a Frozen Priority

Despite the announced policy of saving in the 2nd quarter 2014, it can be said that the measures taken helped only to limit the rate of increase of pensions and social assistance. As a result, the funding of social protection expenditures increased to UAH 36.8 billion, which is 3.6% more than in the 2nd quarter 2013. Such increase is explained by the fact that in the absence of reforms the government is neither able to reduce the amount of payments nor restrict the range of recipients. The additional budget load caused the government decision regarding the performance of the provisions on adjustment of the citizens' income to the inflation.

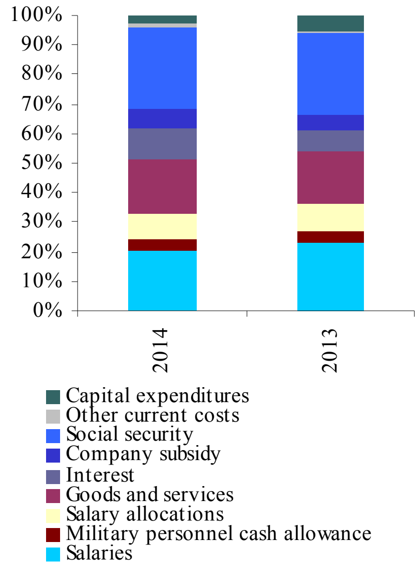
Largest Amounts of "Administrative" Savings Achieved Locally

The main factor determining the reduction of the expense part of the consolidated budget in April through June 2014 was the compliance with the IMF conditions and further delay of financing of non-urgent programs. Another important factor in the reduction of expenditures was the annexation of the Crimea. To give an idea of the scale of this factor: in 2013, the state budget expenditures related to the Autonomous Republic of Crimea amounted to UAH 9.8 billion for the central government agencies located in Crimea, and the expenditures of the local budgets in the Crimea amounted to UAH 10.5 billion.

Despite the "austerity" measures, the government has failed to make a significant reduction in theist wage bill . The wage bill of the state budget in the 2nd quarter 2014 amounted to UAH 6.7 billion, as compared to UAH 6.9 billion in 2Q2013. This can be partly explained by the need to comply with the provisions on dismissal pay. The requirement to notify the employee 2 months in advance of dismissal makes it impossible to perform the reduction of staff and the respective labor costs quickly. Moreover, the total amount of state budget expenditures for general public services increased by 15.5% to UAH 4.8 billion. This increase can be explained by the presidential elections (UAH 0.6 billion) and increase of expenditures for foreign affairs (UAH +0.2 billion) dependent on the foreign exchange rate. However, the central government reduced the capital expenditures by half to UAH 3.6 billion, research and development costs by one-fourth to UAH 2.1 billion, and current subsidies to enterprises by another 1/10.

The reduction of wage bill and expenditures for publicly funded entities did take place at the local level. This success probably resulted from the habit of "transferring the deficit" to the local level. The wage bill here reduced by 10.9% to UAH 19.9 billion, and the expenditures for utility services by 25.3% to UAH 1.9 billion. The expenditures for general public services at the local level reduced by 8.6% to UAH 2.4 billion. It should be mentioned that over one half of the local budgets expenditures are for education and healthcare.

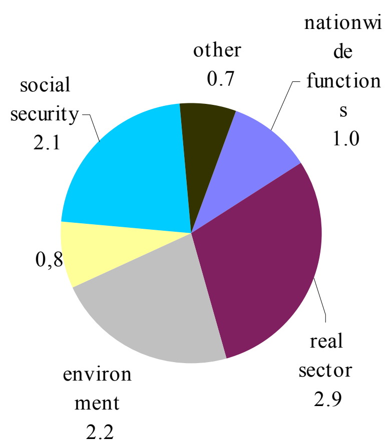
Consolidated Budget Costs Structure



Source: State Treasury Service, CASE Ukraine

Expenditure Saving Areas

(July changes to the budget, UAH billions)



Source: 2014 Budget Amendments, CASE Ukraine

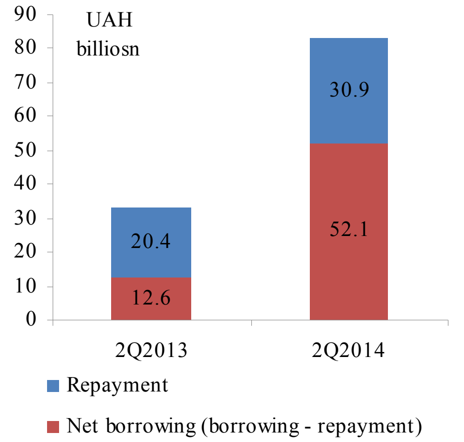
Forecast: Expenses May Be Revised This Autumn

In July, the government proposed to adopt substantial budget amendments . The changes in the expenditure part of the state budget comprise redistribution of UAH 9.8 billion between the programs and increase of the total amount of expenses by UAH 4.9 billion to finance the military actions.

If Ukraine complies with all arrangements made as a result of the negotiations with the IMF, it will receive the second installment in the amount of USD 1.4 billion in the beginning of September. Some time later, the IMF mission will return to Ukraine in order to evaluate the results of the Ukrainian government's efforts. One of the assumptions of the IMF program is the phasing out of the military action in the eastern Ukraine in the nearest months. Otherwise Ukraine will require larger amounts of assistance. The government has mentioned a latent reserve for budget savings of UAH 9.8 billion.

By the end of the year, the government may face the need to increase the social security funding. In particular, in July the funding of pensions in the Autonomous Republic of Crimea was restored. Additionally, it will be necessary to increase the expenses on reimbursement of the utility services provided to the citizens against the backdrop of increasing utility prices.

Deficit Financing Using Borrowed Funds



Source: State Treasury Service

DEFICIT AND DEBT: State Loans Performed According to Plan

The deficit of the consolidated budget in the 2nd quarter 2014 was UAH 21.3 billion, or 6.3% of the GDP[1]. On one hand, this is quite a high figure, however, on the other hand, even despite the more complicated conditions than expected, the government has managed to keep the deficit in check. The prudence allowed Ukraine to receive the 2nd installment of the IMF loan. Ukraine's debt as of the end of June reached UAH 821.8 billion, or 56.8% of the GDP[2]. In addition to the borrowings, its change was also affected by the devaluation of hryvnia.

Government Keeps Deficit under Control

The deficit of the consolidated budget in the 2nd quarter 2014 was UAH 21.3 billion, or 6.3% of the GDP, which is not different from the same figure last year. The deficit financing was performed using the borrowed funds. Same as in the 1st quarter this year, almost no revenues were received from privatization, despite the annual plan approved at the level of UAH 17.0 billion. Although the government promises a large-scale privatization in the nearest future, it is vey unlikely that it will be possible to engage efficient investors and receive a good price for the

National and Government-Backed Debt, UAH billions

	As of March 31, 2014	*As of June 30, 2014*	*Change, %*
Total	**721.8**	**821.8**	**+13.9**
Public internal debt	285.8	303.7	+6.3
Public foreign debt	304.4	368.4	+21.0
Guaranteed internal debt	31.2	31.7	+1.7
Guaranteed foreign debt	100.5	118.1	+17.5

Source: Ministry of Finance

[1] Compared to the GDP for the 2nd quarter of 2014
[2] Compared to the GDP over the 2nd half 2013 – 1 half 2014

properties while there is military action going on.

Ukraine Receives First Credits under the New Arrangements

From April through June 2014, the national and government-backed debt increased by UAH 100.0 billion to UAH 821.8 billion, or 56.8% of the GDP. As a percentage, the increase of the debt over the 2nd quarter this year was 13.9% in UAH and 5.5% in USD. Over this time, Ukraine borrowed UAH 83.1 billion, which is 3 times more than over the 2nd quarter 2013, and repaid UAH 30.9 billion, which is 50% more than the same figure last year. The rest is the result of the devaluation of hryvnia by 8.6% over the 2nd quarter 2014.

From May to June this year, Ukraine started to receive loans from international organizations, including the IMF (USD 3.2 billion), World Bank (USD 0.8 billion), and the EU (USD 0.8 billion). Ukraine also issued Eurobonds to the amount of USD 1.0 billion. At the same time, it managed to fully repay some old loans, for example, Eurobonds to the amount of USD 1.0 billion and a part of the earlier IMF loans (USD 1.2 billion).

In the 2nd quarter 2014, Ukraine placed internal bonds to the amount of UAH 25.8 billion in hryvnia and USD 0.3 billion in US Dollars. Of them, bonds to the amount of UAH 11.8 billion were issued to increase the authorized capital of Naftogaz of Ukraine, supporting which has an extremely negative impact on the evolution of the national debt in general. The retirement of bonds was performed on time and fully, amounting to UAH 15.9 billion over the 2nd quarter 2014.

National and Government-Backed Debt, USD billions

	As of March 31, 2014	*As of June 30, 2014*	*Change, %*
Total	**65.9**	**69.5**	**+5.5**
Public internal debt	26.1	25.7	-1.5
Public foreign debt	27.8	31.2	+12.1
Guaranteed internal debt	2.8	2.7	-5.8
Guaranteed foreign debt	9.2	10.0	+8.8

Source: Ministry of Finance

Forecast: the Deficit Will Not Change, and the Debt Will Increase

Despite the government's intent to maintain the budget deficit unchanged, the debt will be rapidly growing in the 2nd half of 2014. Due to the latest amendments to the budget, the debt may exceed UAH 960.0 billion, which is over 60% of the GDP. In particular, Ukraine has already received the second installment from the IMF (USD 1.4 billion), and expects the additional USD 2.8 billion by the end of the year. Besides, Ukraine has already increased the authorized capital of Naftogaz of Ukraine by an additional UAH 63.3 billion.

CASE UKRAINE
Poltavska Str., 10,
Office 34
Kyiv, 01135

Tel.: +38 044 227-53-17

Project Manager:
Dmytro Boiarchuk
boyarchuk@case-ukraine.kiev.ua

Project prepared with the support from the Open Society Institute and the European Union

This publication was prepared with the support from the European Union under the "Price of the State" project implemented jointly by the Eastern Europe Foundation and CASE Ukraine. The contents of the publication are the exclusive responsibility of CASE Ukraine and cannot be interpreted as the opinions of the European Union.