

OSTEUROPA-INSTITUT MÜNCHEN



Kurzanalysen und Informationen

Scheinerstr. 11
81679 München
Telefon: 089/99 83 96-0
Telefax: 089/98 10 110
E-Mail: oei@oei-muenchen.de
Internet: www.oei-muenchen.de

Nr. 16 April 2004

Wirtschaftswissenschaftliche Abteilung

Comment on the Expenditure Side of the Draft Budget of Ukraine for 2004¹

Richard FRENCH, Arnim KUHN, Nikolay KASTIOUKEVITCH, Natalie LESCHENKO, Sasha BETLYI

The paper comments on the composition of the expenditure side of the central state budget of Ukraine for 2004. It takes a closer look at possible expenditure risks contained, the priorities which are reflected in the expenditure changes for individual items, and the transparency and accountability of the budget.

Risks on the expenditure side

A previous paper on the *revenue* side of the budget has identified possible risks of revenue shortfalls of UAH 5.2 to 6.6 bn.² The following *expenditure* risks have been identified:

- The minimum wage increase, uncertainties related to the introduction of a Unified Tariff Scale (*nicht übersetzen: Tarifsysteem für den Öff. Dienst*), and the questionable success of attempts to reduce public employment might require **more funds for the salaries of civil servants**. The related expenditure increases might reach between UAH 2 bn and 4 bn.
- **Other risks** are related to additional expenditures in the area of disaster relief in agriculture (UAH 0.5-1 bn), the coal sector (UAH 0.8 bn), and additional transfers to local budgets (UAH 0.8 bn).
- **Total risks** thus amount to roughly UAH 4.8 bn.
- **Thus, additional budget expenditures based on more optimistic growth expectations should be avoided.**

Priorities set by the Central Budget

- State support for **specific industries**: The **agricultural sector** is supposed to get more funds for direct subsidies. The subsidisation of the **coal sector** is continued, even though Ukrainian coal is half as expensive as comparable energy sources.

¹ Originally published as Policy Paper A9, German Advisory Group / Institute for Economic Research and Policy Consulting, Kyiv, October 2003.

² Paper A5/2003 "Comments on the revenue side of the 1st Draft of the Law 'On the State Budget of Ukraine for 2004'", IER/German Advisory Group, Kyiv, September 2003.

- The **social expenditures have increased**, which is in line with the intention to focus more on social issues. Attention should be paid to the quality of social services, especially health care and education.

Transparency and accountability

- A provision **prohibiting non-cash operations** with the budget has been rightly introduced into the budget law.
- **Social security funds** are sometimes cross-subsidising tasks which are supposed to be financed from tax funds.
- The share of **earmarked tax revenues** in the special funds is increasing. An ever-greater part of budget revenues is thus not available for parliamentary debate and decisions.
- **Inter-governmental relations:** The regions of Ukraine are threatened by an underestimation of the revenues from the Personal Income Tax. To avoid even stronger under-funding of regional budgets, transfers from the centre to the regions would have to be increased, which entails a great potential for inter-governmental conflict.

1. Introduction

This paper comments the revenue side of the draft central state budget for 2004. Overall, the draft budget for 2004 which has been presented by the government is well-planned³, and does not stipulate major deficits from the start. Nevertheless, we would like to discuss critical points in three areas:

1. Risks related to unforeseen additional budgetary deficits, originating from revenue shortfalls and additional expenditures.
2. Spending priorities through the state which are revealed by the draft budget.
3. Issues of accountability and transparency of the budget.

The paper starts with a general overview on the central budget expenditures as they have been planned by the government and submitted to the Verkhovna Rada in September 2003.

2. Overview on the Budget Expenditures 2004

The share of central budget expenditures in total GDP will amount to roughly 22%. Compared to 2003, this share will be almost unchanged. This means that the central budget expenditures are planned to increase only by 7.5% in real terms

(assuming 6% inflation in 2004), compared to more than 19% in real terms in 2003.⁴ Debt service (+17%), education and culture (+6.1), social spending (+13.5%) and intergovernmental transfers (+3.9%) gain at the cost of economic activity programs (-13.6%) and general public services (-7.2%, without debt service), where overall expenditures are cut. For details of the budget, see table 1.

The draft budget 2004 aims at being both a social budget as well as being future-oriented in terms of channelling a higher share of expenditure to investment purposes. While wages and salaries are to rise by 8.1%, capital expenditures for public investments increase by 18.3% compared to the 2003 budget.⁴

Table 2 gives an overview on the financing of the budget deficit. The net debt is planned to decrease compared to last year, but taking into account Ukraine's swiftly growing economy, it would be desirable to have no net debts at all. As long as there are net debts, total public debts will increase, which should not be necessary during an economic boom period. Even though Ukraine's public debt as share of GDP is still relatively small compared to other countries, debt service accounts for more than 6% of central budget expenditures. During a growth period, the opportunity should be taken to reduce the amount of total public debts.

³ Nevertheless, the budget contains some risks on the revenue side as summarized in Table 4 in the annex. For details refer to the IER Comments on the Revenue Side of the 1st Draft of the Law "On the State Budget of Ukraine for 2004".

⁴ It has to be taken into account that the overall execution rate of the budget expenditures for 2002 was only 89%. According to preliminary information, the execution rate for 2003 will almost reach 100%.

Table 1: Composition of Central Budget expenditures.
Draft 2004 versus budget 2003 and budget 2002

	2002	2003	2004	2004 vs		
	executed	planned *	draft **	2003		
	<i>UAH m</i>	<i>UAH m</i>	<i>UAH m</i>	<i>Structure in % of total expenditure in 2004</i>	<i>Change in the structure in percentage points</i>	<i>Expenditure growth in real terms</i>
General public services (w/o interest payments)	4,002	5,477	5,388	8.93%	-0.9	-7.2%
Defense	3,536	5,059	5,563	9.22%	0.2	3.7%
Public order & Safety	4,677	5,176	5,857	9.71%	0.4	6.8%
Economic activity	5,581	9,862	9,034	14.98%	-2.7	-13.6%
Agriculture	1,251	2,670	2,300	3.81%	-1.0	-18.7%
The program "Ukrainian coal"	2,135	2,686	2,796	4.63%	-0.2	-1.8%
Electricity sector	7	926	708	1.17%	-0.5	-27.9%
Transport	1,100	1,774	2,090	3.46%	0.3	11.1%
Research & Development	443	577	637	1.06%	0.1	4.1%
Communal services	51	70	67	0.11%	-0.0	-9.7%
Health	1,582	2,214	2,373	3.93%	0.0	1.1%
Education and Culture	5,414	6,159	6,927	11.48%	0.5	6.1%
Social security & welfare	7,273	6,752	8,123	13.47%	1.4	13.5%
Intergovernmental transfers	8,818	11,354	12,505	20.73%	0.4	3.9%
Subsidy with a predefined social privileges content	3,934	4,778	4,923	8.16%	0.0	-2.8%
Debt service	2,870	3,038	3,769	6.25%	0.0	17.0%
Interest on domestic debt **	630	353	923	1.53%	0.9	146.7%
Interest on foreign debt	2,240	2,684	2,846	4.72%	-0.1	0.0%
Total expenditures	44,348	55,863	60,328	100.00%		7.5%

* Source: Law on the Central budget 2003 with amendments (09.07.03).

** UAH 142m of domestic debt service are on overdue VAT repayment debt.

Table 2: Financing of the central state budget, 2002-2004, UAH m

	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>In % of expenditures, 2004</i>
Total expenditures	44,348	55,863	60,328	100.00%
Total revenues	45,467	53,229	57,959	96.07%
Financing state deficit	(1,119)	2,635	2,369	3.93%
New gross debts	5,169	9,083	9,931	16.46%
Debt redemption	(5,774)	(8,074)	(9,587)	15.89%
Net debt	(605)	1,008	344	0.57%
Privatisation receipts	603	2,153	2,137	3.54%
Liquidity operations	(418)	(526)	(111)	0.18%

Note: Negative numbers in parentheses ().

⁵ 2003 figures in this document always refer to the latest available amendment to the 2003 budget from July 2003.

One way to reduce long-term debt is to use privatisation receipts as a debt-financing item. Indeed, a considerable part of the planned debt financing (UAH 2,369 bn) consists of privatisation receipts (UAH 2,137 bn). **It is completely appropriate that these privatisation receipts are not accounted as current revenues.** Privatisation receipts are nothing on which the government can count on in the long run, because they are unstable and bound to decrease, the more state property will have been sold. It is much more sound to use these receipts to lower the long-term debt burden of the state. Thus, attempts to shift these receipts to the revenue part of the budget should be resisted.

3. Risks on the Expenditure Side of the Budget

The risks involved with the budget 2004 originate, on the one hand, from the revenue side of the budget, as many tax rates have been reduced, and thus revenues may be below expected levels (see table 4 in the annex). However, some expenditure items could exceed planned levels as well. In our view, this applies to salaries in the public sector.

3.1. Public Salaries

Salaries account for UAH 12.1 bn or 23.3% of central budget expenditures. There are several budgetary risks involved with this figure, which are connected with a change in the minimum wage, the likely introduction of a unified tariff scale, and difficulties in conducting planned cuts in public employment.

Increase of the Minimum Wage

The minimum wage in Ukraine will be increased from UAH 185 per month to UAH 237 on December 1, 2003, and is foreseen to remain at this level throughout 2004. Minimum wage increases in the budget sphere will be paid on the principle of *additional payments*: employees receiving wages below the minimum wage will simply obtain additional payments to cover the gap. This will leave other nominal wages in the public sector unchanged. In order to finance the minimum wage increase on the additional payments principle, the respective consolidated budget expenditures are increased by UAH 2.3 bn (including a 1.5 bn revenue increase of local budgets) as compared to 2003. Thus, the minimum wage increase does not pose a threat to the budget balance as long as the Unified Tariff Scale is not introduced.

Introduction of the Unified Tariffs Scale

Previously, it was planned to introduce the Unified Tariff Scale (UTS) in the budget sector from January 1, 2004. This UTS would have the effect that an increase in the minimum wage would be effective for the whole tariff scale to the same percentage. According to the estimates of the Ministry of Finance, this would necessitate additional expenditures, based on the current level of the minimum wage (UAH 185), roughly UAH 4.6 bn.⁶ Thus, due to scarce budget resources, the Cabinet of Ministers postponed its introduction one more time to January 2005. Should the Unified Tariff Scale be introduced earlier, there is definitely the **risk of additional UAH 384 m budget expenditure per month** which would have to be financed. If, for instance, the UTS were introduced in July 2004, additional expenditures of UAH 2.3 bn could be necessary.

Reduction of Employment at Central Executive Bodies

On the other hand, wages and salary payments in the 2004 draft budget are contingent upon the Draft Budget Law 2004, which supposes that employment in central executive bodies (220.000 employees in central ministries, committees, and other central state institutions) will be reduced by 10%. However, no exact provisions for the decrease of employment limits have been decided so far. Even though a reduction of administrative employment is probably desirable for Ukraine, international experience shows that the achievement of such a task is very difficult, particularly in the run-up to presidential elections. The risk to the expenditure side of the 2004 budget is UAH 221 m,⁷ provided that no limitation will be achieved at all.

3.2. Other Expenditure Risks

There are risks which might emerge during 2004, but also risks that expenditures increase during the budget negotiations in the Verkhovna Rada:

- In the area of agriculture, Ukraine has experienced a bad wheat harvest in 2003. The harvest was so low that imports of food wheat in the magnitude of 4 m tons will probably be necessary. If the Ukrainian government is not willing to allow imports by private traders at higher prices (in order to avoid bread price increases), **subsidies of wheat imports or**

⁶ The Explanatory Note to the Budget Law 2004.

⁷ The figure has been calculated assuming an average monthly salary of UAH 840.

other disaster relief would be necessary. If these subsidies amount to 30-40 USD/ton, UAH 640-850 m would have to be spent from public funds.

- Expenditures on the coal sector have increased during the budget negotiations by about 30% compared to the 1st draft in the previous years. If this year's negotiations follow a similar pattern, expenditures will be UAH 0.8 bn higher than in the current draft budget.
- A failure of the reformed Personal Income Tax (PIT) to yield the desired revenues could result in additional compensatory transfers to local budgets (the lion's share of the PIT is earmarked to finance local governments). These additional transfers would almost equal the possible revenue losses from the PIT, i.e. UAH 0.8 bn (see Table 4).

3.3. Conclusion

Due to the uncertainties connected with the introduction of the UTS, the more important part of the risk to the budget expenditures cannot be exactly quantified. Taking the arithmetic means of all possible risks to expenditures and summing up, we arrive at UAH 4.8 bn.

We must emphasise that the resulting fiscal gap is only the result of summing up various risks - most of which are not related to each other - which represent a "worst-case" scenario only.

Nevertheless, Ukraine should be prepared to face a higher budget deficit than initially planned. Thus, **it is important that the Verkhovna Rada does not further expand the expenditure part of the budget**, for instance based on optimistic growth estimations of GDP of 8% instead of 5%, as long as revenues are not increased by the same amount in a sound manner.

4. Spending Priorities: Support to Special Sectors

4.1. Agriculture

The total amount of agriculture programs in government spending is stated to decline somewhat between the 2003 and 2004 budgets, accounting for 4.3% of total budget expenditures in 2004 as compared to 4.7% in 2003.⁸ Regarding Ukraine's

⁸ There has been a recent amendment to the 2003 budget enabling the Rada to channel 716m UAH to purchase grain to the state reserve and compensate the sowing campaign. *Interfax-Ukraine*, September 26, 2003.

WTO-accession, the agricultural budget should be checked for items which contradict future WTO obligations.⁹ Subsidies that can bias the international agricultural trade relations of Ukraine are mostly ruled out, whereas trade-neutral support measures ("Green Box" measures) may be rendered without limitations.

As can be seen from Table 3 there is planned a significant increase of 237.7% in subsidies and financial support to agricultural producers ("Blue Box" measures). This support is supposed to be rendered through partial compensation of the cost of purchased machinery, through interest compensation schemes, through direct payments per animal head to sheep producers, to hop, flax and hemp producers and subsidies to animal, poultry and crop producers. In total, the financial support including income support measures envisaged by the "Green Box" accounts for 27% (or UAH 805.5 m¹⁰) of agricultural spending in 2004. Even though this figure is lower than that of 31% in 2003, there seems to be a shift from income support measures undertaken to alleviate the hardship of the bad 2003 harvest to subsidization of agricultural production. Furthermore, the share of expenditures consistent with sustainable agricultural growth ("Green Box") is stated to be reduced by 35%.

Thus, the recent grain crisis seems to have contributed to a shift in the agricultural policy: a shift from productivity-enhancing investments such as investments into agricultural research and extension, land reform implementation toward inefficient measures such as financial support to agricultural producers. It is questionable whether a one-time weather calamity justifies increasing support for agricultural producers for years to come, particularly given the intention of the government to prolong the validity of the existing tax privileges for agriculture until December 2009. The abolition of the agricultural tax privileges would represent the most straightforward way to compensate farms that have suffered harvest losses. They would not have to pay taxes, and could perhaps even carry forward their losses, while successful farms would be taxed in the same way as other businesses.

⁹ This check is necessary due to the standstill agreement that Ukraine has agreed to during the negotiations for WTO accession. It should be applied to all sectoral spending, and not only to agriculture.

¹⁰ This item does not include quasi-social expenditures.

Table 3: The agricultural budget¹ in 2004 in UAH m

	2003 (planned)	2004 (planned)	2004 in % of 2003
Total agricultural expenditures	3451.8	3026.4	87.7
"Amber Box" measures* (intervention purchases of grain)	70.0	0.0	-
"Blue Box" measures** (General subsidies to the farm sector)	330.1	781.5	237.7
"Green Box" measures***, of which:	2146.2	1404.5	65.0
Agricultural research	184.3	172.5	93.6
Pest and disease control	57.5	75.7	132.6
Inspection services	314.0	364.1	116.0
Agricultural training & education	501.2	545.8	108.9
Land reform implementation	238.6	77.0	32.2
Rural infrastructure development	21.0	22.0	104.8
Environment protection	45.1	38.3	84.9
Direct financial support	763.5	24.0	3.1

* Amber Box measures are measures that are not in line with the WTO requirements and are subject to reduction commitments (intervention purchases).

** Blue Box measures are measures that should be reduced in the long run (payments to producers located in zones with unfavourable climatic conditions, interest rate compensations, holding seeds stocks, partial compensation of the cost of agricultural machinery, subsidies to agricultural producers that are not connected with prices or production).

*** Green Box measures are exempted from reduction commitments and are in line with the WTO requirements.

¹ The figures comprise the total agricultural budget and therefore exceed the figures for agricultural support under "economic activity" in Table 2.

4.2. Coal Mining

The program "Ukrainian Coal", approved in the year 1996 and to be terminated by 2010, envisages state financing from the budget. For the year 2004, the "Ukrainian Coal" program is planned to receive UAH 2.9 bn from the state budget, which is UAH 0.16 bn more than planned for the year 2003. The following points should be considered when assessing the expenditure for coal:

- The huge amounts of scarce budget money spent on coal subsidies has to be questioned generally. Ukrainian production costs for coal (USD 29/ton) are lower than the world market price (USD 35/ton). Ukrainian coal is thus competitive on the Ukrainian energy market. There is no reason to further subsidize coal prices down to USD 25/ton.
- There are various complaints from the management of coal extraction companies that only a fraction of the funds spent on coal actually arrive where they are targeted. Similar complaints come from the Independent Trade Union of Coal Miners in the Donetsk region. Miners whose income is intended to be supported at a level of USD 100 per month receive only UAH 150-200.

Budget money spent to support economic activities which are profitable anyway is a major waste of national resources. These funds would have a more beneficial impact if they were redirected into investments such as infrastructure projects or education. We recommend a phasing of the support to the coal sector during the next ten years.

4.3. Is this a "Social Budget"?

One of the explicit aims of the new budget draft has been to pay attention to the issue of social security and welfare in Ukraine. Increasing expenditures for social protection make the highest contribution to state budget expenditure growth of all items listed in Table 1. Central budget expenditures for social security and welfare are raised by nearly UAH 1.4 bn, 71% of which are due to increased budget transfer to the Pension Fund (see Part 5.2), and 20% to increased expenditures for social protection. Increases in health care expenditures and especially in education are partially due to higher wages in these areas. In addition, it is planned to increase stipends by 10% comparing with 2003. The promises of the government and the provisions of the budget resolution to make the budget socially oriented thus had a positive effect. If we look at the com-

position of consolidated budget expenditures, the weight of social expenditures, defined as health care, education, social protection and welfare, recreation, culture and religious affairs,¹¹ is 52.1%.

Thus, the budget can be called more social than the previous ones. However, a huge social budget is by no means an end in itself, and social expenditures definitely cannot be judged solely according to the amount of money spent. It is also important on *what* and *how* the funds are spent, and whether they are suited not only to cushion hardship, but also include incentives for the beneficiaries to overcome the reasons of social neediness. While income transfers like pensions should be unconditional and do not have a quality aspect, expenditures on health definitely have. We therefore recommend to carefully consider this **quality aspect of social expenditures**, and to emphasize incentive creating rather than merely re-distributive measures.

4.4. Concluding Remarks on Priorities

The growing debt service, higher minimum wage, growing pensions, and transfers to local governments necessitate only small increases or even shrinking of other transfers and/or other purchases of goods and services. This conclusion fits into the pattern revealed in Table 1 that already indicated a shrinking weight of state support programs under the "economic activity" cover.

To the extent that state support to industries will be replaced by social transfers, this may be seen as an improvement. However, increases in social transfers have – from international experience – the tendency to be "locked in". Redistribution through new programs in health, education etc. might be preferable. Moreover, from a macro-economic perspective, most social security expenditures are **consumptive** expenditures in contrast to **investment** expenditures like infrastructure, education and preventive health programmes. If the state is willing to play an active role in fostering economic growth, public expenditures on investment should not decrease vis-à-vis consumptive expenditures. Instead, subsidies on coal, agriculture and other direct support for businesses should be cut, and tax exemptions abolished.

¹¹ This is done according to the methodology of the Ministry of Finance.

5. Budget Transparency and Accountability

The draft budget 2004 contains a provision prohibiting settlements with the budget in non-monetary form. This is a vital provision mentioned in the budget law from year to year in terms of transparency and it helps to prevent such negative events as the further accumulation of tax arrears. Other aspects of transparency touch upon the relations with the social security funds, the increasing importance of the "special funds", and the relations with local governments.

5.1. Relations with social security funds

In the draft budget 2004, it is foreseen to increase transfers to the Pension Fund by UAH 1.5 bn, as compared to the 2003 budget, thus, constituting UAH 2.8 bn. This increase mainly relates to divisions of financing sources between the State Budget and own revenues of the Pension Fund, as it is defined in the pension legislation, and to the increase of average pensions approximately by 20%. Moreover, according to the Law "On Compulsory Pension Insurance", any deficit of the Pension Fund has to be covered from the State Budget. The following features and potential problems are related with this practice:

- The increase is partly due to – rightly – shifting the general responsibility for administering pensions to the Pension Fund and transferring program money hitherto directly paid out of the state budget to the Pension Fund.
- The increase also includes a budget transfer to fully compensate the pension contribution payments of the agricultural enterprises using fixed agricultural tax (UAH 165 m).¹² The underlying tax privileges of the agricultural sector are not justifiable from a fiscal point of view.
- The transfer to the Pension Fund to finance increases of existing and additional state pension programs of about UAH 840 m is financed by increasing the duty on foreign currency non-cash transactions from 1 to 2%. The choice to tax this particular economic activity is arbitrary, and it is increasing the likelihood of shadow transactions.
- The expectations regarding the deshadowing of salaries as a consequence of the income tax reform might be overly optimistic. If the sum of declared wages will be lower, the transfers of budget funds to the

¹² According to new Pension Law, such enterprises have to pay pension contributions on general basis.

Pension Fund will have to increase further (in order to avoid pension arrears) and will continue to give rise to specially funded additional budget burdens.

Relations between budget transactions and state social insurance funds in the 2004 draft budget are characterised by cross-subsidisation to an increasing extent. A prominent example is the financing of measures for miners from social insurance funds. For instance, it is foreseen that the Fund of Compulsory State Social Insurance against working accidents will transfer UAH 200 m for eliminating regressive payments arrears to miners that were created by the State before the Fund was created, in 2001. Thus, the arrears are paid at the expense of contributions paid by other sectors of the economy.

- Our proposal is to clearly differentiate budgetary and extra-budgetary functions.
- If additional benefits and programs are desirable, they should be funded from budget revenues and not from extra-budgetary funds.

The demographic problems that Ukraine will face in the 21st century will most likely make an increasing share of tax-based social security financing inevitable. The consequences for the sustainability of the current pay-as-you-go pension system as the most important pillar of the Ukrainian pension system have to be carefully considered in the days already.

5.2. Generally versus specially funded expenditures

As a heritage of having incorporated many past extra-budgetary funds, the Ukrainian budget still makes a distinction between special and general funds. Revenues for the special fund are earmarked and cannot be spent for other purposes. In connection with the Ukrainian budget practice to designate a list of protected generally-funded expenditure items, the government effectively protects some expenditures. The volume of the special fund (without accounting for own revenues of budget entities) in the draft budget 2004 increased in comparison to the 2003 budget by UAH 1.4 bn¹³, or from 13.4% to 14.6% of the central budget expenditures.¹⁴

¹³ Taking into account net crediting.

¹⁴ For the year 2003, the sum of explicitly protected expenditures and the special fund spending constituted around 75%. If we assume that the spending on such items as provision of nutrition, transfers to population, purchase of medicines and dressing material in 2004 remains constant, the weight of protected items in the general fund will reach 70%, and about 78% if we will not take into account net crediting.

Our proposal is to reduce the weight of the special fund from year to year. Otherwise, the Government and Parliament of Ukraine ever more constrict their capacity to decide on the use of tax revenues, and thus undermine their fiscal sovereignty. The current structure and handling of protected budget items seems like 'mistrust of the legislature in itself'.

5.3. Inter-governmental relations

Transfers to the regional governments from the central budget constitute more than 20% of the total central budget expenditures, and even 39% of all local budget revenues. Moreover, the most important local tax revenues originate from the Personal Income Tax (PIT), which is decided upon by the National Parliament. The regional and municipal governments are therefore heavily dependent on the centre. Nevertheless, they have to carry out important tasks, particularly in the area of social services and education.

In the draft Law on the Central budget 2004, the amount of equalisation transfers from the central budget is increased by UAH 1.25 bn. The calculation of intergovernmental equalisation transfers has been subject to some amendments including updated regional distribution parameters. Moreover, a reimbursement of losses which originate from the centrally imposed social privileges in the Personal Income Tax (PIT) is foreseen, but it may not be sufficient (see Section 3 on expenditure risks). As a step into the right direction, the 2004 draft budget also foresees the elimination of the coefficient denoting 'depressed regions' (struggling with particularly hard economic problems) in the formula of intergovernmental transfers, as this coefficient provided a negative incentive for local authorities to fund their own budgets.

The current existence of a gap between delegated tasks and financing abilities on the local level may create serious local budget imbalances. We would again like to stress that the transfers of the centre to the regions are crucially dependent on the PIT revenues. The complex way this tax is administered and how possible underestimated revenues have to be reimbursed is rather complex and implies the risk of budget shortfalls at the local level, which is, of course, difficult to determine in detail. In the long run, there is a definite need for administrative reform that includes more fiscal autonomy for the regions.

In latter assumptions, the weight of protected items and the special fund expenditures will climb to 83%.

6. Overall Assessment

Positive aspects:

- In view of the sweeping tax reforms which are going to be implemented in 2004, the cautious approach to budgetary planning (increase in real terms by only 7.5% to 2003) is reasonable and should not be watered down during the parliamentary readings.
- Decreased spending on "economic activity" (-13.6%) is positive.
- Nevertheless, increased investment in transport infrastructure (+11.1%) is regarded as necessary for Ukraine in order to decrease the high costs of internal and international shipments of goods.
- Increased spending on education and culture (+6.1%) is welcome, as Ukraine needs to invest in human capital.
- The intention to spend more on social security issues (+13.5%) is positive, depending on what the funds are actually spent for.
- The resolution that prohibits non-monetary settlements with the budget is an important step towards more budgetary transparency

Critical aspects:

- The spending on the coal sector is unlikely to decrease.
- Spending in the agricultural sector is more oriented towards measures which might delay the Ukraine's WTO accession.
- Redistribution for education (mostly investment expenditures) and social (mostly consumptive expenditures) should be more balanced, meaning that expenditure increases on both should be the same.

- Debt service is increasing (+17%), even though the economy is growing. The chance to decrease long-term debt should be taken.
- Risks of additional expenditures exist in the area of salaries for public employees, the coal sector, disaster relief for agriculture, and transfers to local governments.
- The share of tax revenues reserved for pre-defined expenditure items seems to be further increasing.

7. Annex

In table 4, a summary of possible risks the revenue side of the budget are repeated from an earlier comment on the revenue side of the budget in September 2003.¹⁵

We must emphasise that the resulting fiscal gap is only the result of summing up various risks - most of which are not related to each other - which represent a "worst-case" scenario only.

Most risks are due to the sweeping tax cuts foreseen for 2004, in particular the reduced Personal Income Tax and Value-Added Tax rates. We estimate the losses to the government forecast as UAH 790 m and 1342 m, respectively¹⁶. The gas transit fee is another major problematic item with a possible shortage of the expected revenues of more than UAH 1 bn.

The resulting fiscal gap of UAH 4.2 bn would add to the deficit of UAH 2.37 bn already estimated by the Government. The overall deficit of then roughly UAH 6.6 bn would represent 2.4 percent of GDP (5.3bn when assuming unchanged VAT, or 1.9 percent of GDP).¹⁷ Thanks to efforts to broaden the tax base and eliminate privileges, the gross revenue loss was made smaller than it would have been without such cuts.

¹⁵ For details please refer to the IER Comments on the Revenue Side of the 1st Draft of the Law "On the State Budget of Ukraine for 2004".

¹⁶ The recent second veto of the President on the VAT Law will probably diminish the amount of the estimated loss due to this tax, as the 20 % rate will stay in place.

¹⁷ In the EURO area, a deficit of 3 % of GDP is considered to threaten fiscal and macro-economic stability.

Table 4: Summary of possible revenue risks for the consolidated 2004 budget (UAH m)

	<i>Government</i>	<i>Our "worst case" scenario</i>	<i>Difference</i>
Personal Income Tax	12500	11710	-790
Value-Added Tax	17070	15728	-1342
Excise taxes	6034	5748	-286
National Bank profits	500	0	-500
Dividends	300	100	-200
Gas transit fee	2243	1120	-1123
Total fiscal gap			-4241
plus planned deficit			-2369
Total deficit estimated			-6610
Total deficit when assuming no change of VAT			-5268