

MEMU Supplement

Private investment and growth implications of the revenue side of the First Draft Budget 2005

The draft budget law for 2005 has recently been submitted to Parliament by the Cabinet of Ministers. The Minister of Finance refers to this draft as a budget for development, i.e. as stimulating investment and thus future growth. Meeting this claim on the revenue side requires minimising distortions on private investment.

The nominal revenues of the consolidated budget 2005 are to be increased by 30% yoy in comparison to Budget Law 2004 figures, and this revenue increase appears to be based on attainable macroeconomic parameters. The resulting revenue-to-GDP ratio will remain comparable to those of other transition economies. *In addition, the impression is that indeed the general tax policies underlying the 2005 draft budget seem to be compatible with pro-investment strategy of the government.*

In terms of the composition of the tax revenues, the share of the cash collections for the value-added (VAT) and excise taxes (ET) in the total consolidated tax revenues is to be increased by 2 percentage points in 2005 over the 2004 budget figures. Since consumption taxes are considered to be relatively neutral to decisions to save and invest, this increasing reliance on VAT and ET will help fostering enterprise capital accumulation.

Tax administration also matter for private investment decisions. Things in this area look better too, due to the government's attempt at solving the VAT refund arrears problem through the issue of state bonds (OVDPs) in 2004, thus acknowledging VAT refund arrears as state debt, and improving financial state of enterprises. The credibility of this approach to solve the VAT arrears problem, and thus the positive impact on private investment, will depend on the government's handling of the VAT arrears flows: disincentives to invest may result if the government should try strictly to target short-term revenues and fail to refund VAT in money form in 2005.

Moreover, the draft budget 2005 revenues are based on broadening the tax base in two major ways. First, the legislative provisions that impose personal income tax (PIT) on income categories (including capital gains, heritage, and gifts) that were previously exempt become effective in 2005. While the tax base extension is vital, one of the current PIT exemptions, namely the exemption of interest paid on deposits, can still be justified by transition arguments: taxation could negatively affect the amount of funds available for crediting the real sector. Second, the draft budget provisions envisage further reductions of tax privileges specifically targeted at selected industries. Draft budget revenues are calculated based on the assumption that the tax privileges eliminated in 2004 will not become effective again in 2005. However, the revenue calculations have so far not been supplemented by a law that removes these tax privileges in 2005, hence imposing fiscal risks.

Finally the draft budget is based on the assumption that depreciation allowances on the enterprise profits tax (EPT) will be increased. This is conducive to enterprise investment, as own funds are many enterprises' major sources of investment. However, this might turn out to mostly benefit older enterprises that have accumulated excess fixed capital, while new investors could find themselves in a less advantageous position.

To sum up, the revenue side of the draft budget 2005 envisages improvements in terms of investment incentives with respect to the composition of tax revenues, tax administration, and broadening the tax base. More detailed inspection, however, reveals certain half-heartedness in some of these improvements. Thus it remains unclear, whether the current political good-will can be maintained in the medium term.

Parameters of the consolidated Draft Budget for 2005:

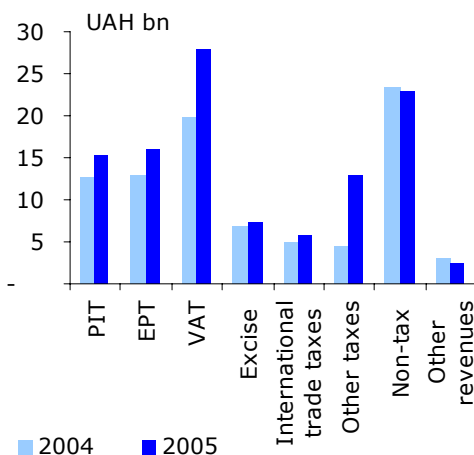
Revenues:	UAH 110.5 bn (28.5% of GDP)
Expenditures*:	UAH 115.5 bn (30.5% of GDP)
Deficit:	UAH 5.0 bn (1.2% of GDP)

* including repaid credits

Major macroeconomic assumptions of the consolidated Draft Budget 2005:

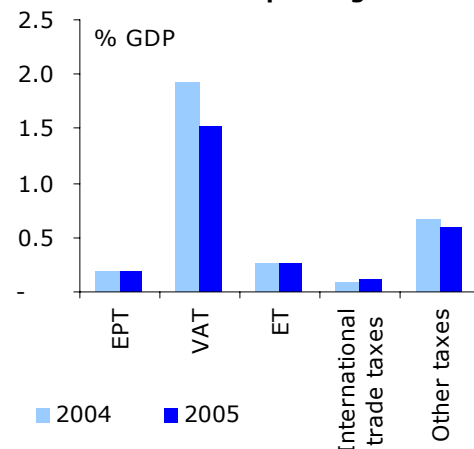
GDP growth:	8.6%
CPI inflation:	7.0%
Min. wage:	UAH 262

Consolidated fiscal revenues



Source: Budget Law for 2004, Draft Budget Law for 2005

State tax privileges



Source: Ministry of Finance

Author:
Natalia Leschenko,
Institute for Economic Research and
Policy Consulting



Quarterly Trends

National accounts		Q2 02	Q3 02	Q4 02	Q1 03	Q2 03	Q3 03	Q4 03	Q1 04	Q2 04
GDP	UAH bn	49.9*	64.1*	63.3*	51.5*	60.0*	75.6*	77.1*	64.1*	78.6*
GDP (real)	% yoy	4.7*	4.3*	6.1*	8.4*	10.0*	6.8*	12.1*	12.3*	13.2*
Households consumption (real)	% yoy	2.0*	8.9*	11.2*	10.2*	14.4*	11.2*	13.6*	15.5*	16.0*
State consumption (real)	% yoy	5.4*	-18.8*	2.9*	15.0*	17.8*	19.2*	9.0*	-3.6*	-2.0*
Gross fixed capital formation (real)	% yoy	7.8*	3.8*	5.7*	9.0*	20.4*	24.3*	9.0*	23.3*	4.3*
Exports of goods and services (real)	% yoy	2.5*	15.3*	17.0*	9.9*	9.8*	9.8*	11.6*	16.5*	15.2*
Imports of goods and services (real)	% yoy	1.4*	10.4*	6.7*	13.8*	16.2*	17.4*	17.7*	14.5*	7.0*
Agriculture, hunting, forestry (real)*	% yoy	12.1*	2.1*	1.3*	4.0*	-13.7*	-22.5*	6.7*	-4.2*	1.2*
Manufacturing industry (real)*	% yoy	10.6*	8.0*	11.5*	12.0*	15.4*	23.0*	20.1*	22.7*	15.5*
Construction (real)*	% yoy	-7.9*	-1.2*	2.7*	18.2*	24.8*	30.9*	16.9*	29.8*	30.6*
Trade, repair services (real)*	% yoy	5.3*	8.8*	3.5*	7.2*	15.1*	22.6*	29.6*	23.5*	35.1*
Transport (real)*	% yoy	0.5*	7.9*	11.0*	10.0*	11.5*	15.9*	11.7*	11.0*	8.9*
Balance of payments										
Current account balance	USD bn	0.6	0.8	1.0	1.1	0.7	0.7	0.4	1.7	2.3
Current account balance	% of GDP	6.7	6.4	7.9	11.2	7.0	5.0	3.0	14.3	16.5
Trade balance in goods	USD m	87	155	225	309	-42	-155	-381	767	1460
Trade balance in services	USD m	244	247	382	387	399	362	409	542	307
Current transfers	USD m	441	517	520	500	526	574	584	465	746
Direct investment (FDI)	USD m	119	156	300	238	454	390	329	310	574
Portfolio investments	USD m	-311	-592	-520	-825	640	-444	-293	60	-409
Gross international reserves	USD bn	3.4	4.1	4.4	4.6	6.2	6.7	6.9	7.9	9.6
Fiscal indicators										
Consolidated fiscal revenues	% of GDP	29.9	28.2	28.1	31.6	31.7	30.1	28.6	28.1	27.9
Personal income tax	% of GDP	5.2	4.9	4.9	5.7	5.7	5.3	5.1	4.5	4.3
Enterprise profit tax	% of GDP	4.3	4.1	4.3	5.7	5.1	4.8	5.0	4.0	4.1
Value-added tax	% of GDP	6.6	6.4	6.1	6.2	6.3	5.8	4.8	6.4	5.9
Excise tax	% of GDP	1.9	1.9	1.9	2.1	2.2	2.1	2.0	2.2	2.2
Consolidated fiscal expenditures	% of GDP	28.4	26.4	27.3	27.7	29.2	27.9	28.8	26.1	27.5
Current expenditures	% of GDP	na	na	na	na	26.3	24.2	24.3	23.1	23.6
Capital expenditures	% of GDP	na	na	na	na	3.0	3.7	4.4	3.0	3.9
Consolidated fiscal balance	% of GDP	1.5	1.7	0.7	3.8	2.5	2.2	-0.2	2.0	0.4
Privatization receipts	% of GDP	0.4	0.3	0.3	0.6	1.0	1.0	0.8	1.5	3.9
Labour market										
Average wage (real)	% yoy	20,0	21,2	17,7	12,3	19,1	19,9	14,9	23,0	17,8
Household income (real)	% yoy	61,3	100,8	65,6	-1,18	8,57	9,96	8,66	15,7	13,0
Unemployment rate (ILO methodology)	%	9,7	9,2	11,1	9,4	8,8	9,2	9,0	9,0	9,6
Banking system										
Monetary aggregate M0	% yoy	48.0	46.0	35.8	32.4	37.0	30.5	25.3	29.1	25.6
Monetary aggregate M2	% yoy	39.5	46.5	42.2	47.8	54.6	49.9	47.6	45.4	44.8
Household deposits in national currency	% yoy	90.1	103.6	72.5	73.4	74.7	65.0	66.1	69.4	67.3
Household deposits in foreign currency	% yoy	47.4	55.1	59.3	71.2	70.2	70.4	77.5	67.0	61.7
Commercial bank credits	% of GDP	65.4	56.7	66.4	89.4	87.8	80.0	88.0	114.6	103.0
Com. Bank credits in national currency	% yoy	34.5	42.3	54.4	63.7	71.2	73.0	61.7	56.8	52.1
Com. Bank credits in foreign currency	% yoy	32.1	37.3	40.3	44.1	48.4	57.7	60.9	63.6	56.2
Long-term com. bank credits	% yoy	70.6	85.8	92.5	110.6	156.4	164.0	157.9	141.7	102.7
Long-term com. bank credits	% of total	23.5	25.3	28.2	31.3	37.4	40.1	45.0	47.4	49.3
Average lending rate on national cur. credits	% p.a.	25.0	23.5	21.8	18.0	17.2	17.2	17.7	17.2	16.6
Average lending rate on foreign cur. credits	% p.a.	12.9	11.9	11.3	12.5	12.6	11.7	10.9	12.2	12.1

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

* preliminary

Notes:

yoy year on year change

p.a. per annum