



# MEMU Supplement No. 03-2005

## New social liabilities: A fiscal gap of UAH 13.5 bn

The government announced its intention to substantially revise the State budget for 2005. One of the essential reasons for the revision is the necessity to finance the social liabilities, unforeseen in the current version of the budget, primarily the increase in minimum pensions and in the level of the subsistence minimum (SM), which were approved after the adoption of the budget law.

In December 2004 Parliament passed the amendments to *The Law on Compulsory State Pension Insurance*, according to which the minimum pension was increased to the level of the subsistence minimum. In addition, Parliament overcame the veto of the President and approved *the Law on the Subsistence Minimum for 2005* that sets the SM level on average by 11% higher than foreseen in the Budget Law. If this Law were implemented, the minimum pension would be UAH 332 instead of UAH 300 as foreseen in the Budget Law. Therefore, at the moment there exist two levels of the SM and it is not clear which of them should be taken into account when calculating the minimum pensions. Since financing of neither of these laws was foreseen in the budget, the February minimum pension payment was set at UAH 295, the level set in September and indexed for inflation.

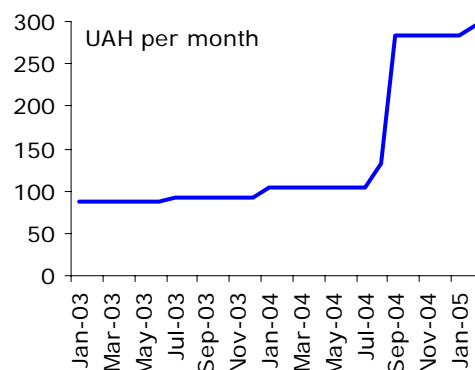
The validity of either law is very questionable, since their adoption processes contradicted the Budget Code. Both laws were adopted after the approval of the State Budget Law for 2005, and neither of them was supplemented by a calculation suggesting a source for covering the resulting fiscal gap that is estimated at UAH 13.5 bn.

In fact, the laws simply continued the practice of budget ballooning started last year. In 2004 the minimum pension payment was increased several times. The highest increase was in September 2004 and meant that 80% of pensioners received the same pension of UAH 284, i.e. the level of the SM set for 2004. This was achieved by paying the targeted social aid to those pensioners that had pensions lower than the SM. This equalization of pensions resulted in breaking one of the main principles of the pension reform, which began in 2004, namely the principle of diversification. Equalising pensions reduces the incentives for the working population to participate in the state pension insurance system, thus discouraging them from wage de-shadowing. The increase in the minimum pension to the level of the SM defined for 2005 means a continuation of this policy.

More importantly, sharp pension increases endanger fiscal sustainability and macroeconomic stability. Pension payments are recurrent expenditures that should be financed from stable sources of revenues. However, this was not the case last year when the UAH 5 bn fiscal gap was covered by privatisation receipts. Besides, it is questionable that stable sources for financing the increased social liabilities will be found this year. In addition, rapid pension increases create inflationary pressure. According to IER estimates, the sharp increase in pension payments in 2004 brought about an additional 2 to 3% increase in CPI during last quarter of the year. The increase of social payments in 2005 is two and a half times higher than that of last year. Thus, it is likely that additional social payments will add at least 4 to 6% to inflation. In addition, the high rate of inflation and the political instability observed at the end of 2004 has spurred inflationary expectations that will also add to inflation in 2005.

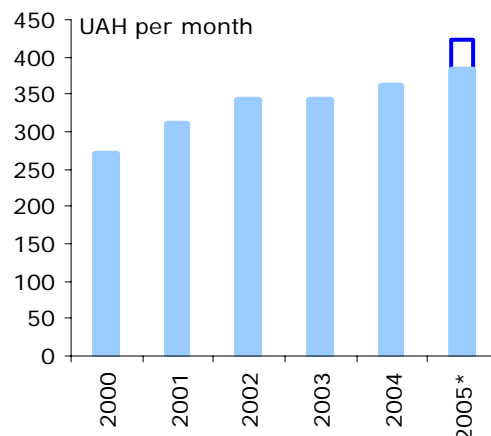
Increasing the welfare of the poorest groups of population is a commendable effort by the government. But, to avoid adverse consequences for the economy the government should look for stable sources of financing the resulting fiscal gap and refrain from one-shot payments.

### Minimum pension payments



Source: Legislation of Ukraine

### Average SM for all demographic groups



Source: Legislative acts of Ukraine

\* Lower figure denotes the SM set by the Law on State Budget for 2005, higher figure denotes the SM set by separate law

### Monthly SM for 2005 (UAH)

	The State Budget Law 2005	The Law on SM for 2005
Average SM for all demographic groups	382	423
SM set for:		
children up to 6 years	335	376
children of 6-18 years	422	468
working able people	409	453
working unable people	300	332

Sources: the state budget law for 2005, the law on the SM for 2005.

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**Quarterly Trends**

<b>National accounts **</b>		<b>Q2 02</b>	<b>Q3 02</b>	<b>Q4 02</b>	<b>Q1 03</b>	<b>Q2 03</b>	<b>Q3 03</b>	<b>Q4 03</b>	<b>Q1 04</b>	<b>Q2 04</b>	<b>Q3 04</b>
GDP	UAH bn	49.9	64.1	63.3	51.5	60.0	75.6	77.1	64.1	78.6	101.0
GDP (real)	% yoy	4.7	4.3	6.1	8.4	10.0	6.8	12.1	12.3	13.2	14.2
Households consumption (real)	% yoy	2.0	8.9	11.2	10.2	14.4	11.2	13.6	15.5	16.0	15.6
State consumption (real)	% yoy	5.4	-18.8	2.9	15.0	17.8	19.2	9.0	-3.6	-2.0	-3.0
Gross fixed capital formation (real)	% yoy	7.8	3.8	5.7	9.0	20.4	24.3	9.0	23.3	4.3	6.1
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	6.2
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	4.3
Agriculture, hunting, forestry (real)*	% yoy	12.1	2.1	1.3	4.0	-13.7	-22.5	6.7	-4.2	1.2	36.2
Manufacturing industry (real)*	% yoy	10.6	8.0	11.5	12.0	15.4	23.0	20.1	22.7	15.5	13.8
Construction (real)*	% yoy	-7.9	-1.2	2.7	18.2	24.8	30.9	16.9	29.8	30.6	17.2
Trade, repair services (real)*	% yoy	5.3	8.8	3.5	7.2	15.1	22.6	29.6	23.5	35.1	3.0
Transport (real)*	% yoy	0.5	7.9	11.0	10.0	11.5	15.9	11.7	11.0	8.9	11.1
<b>Balance of payments</b>											
Current account balance	USD bn	0.6	0.8	1.0	1.1	0.7	0.7	0.4	1.7	2.3	1.7
Current account balance	% of GDP	6.7	6.4	7.9	11.2	7.0	5.0	3.0	14.3	16.5	9.7
Trade balance in goods	USD m	87	155	225	309	-42	-155	-381	767	1460	683
Trade balance in services	USD m	244	247	382	387	399	362	409	542	307	549
Current transfers	USD m	441	517	520	500	526	574	584	465	746	703
Direct investment (FDI)	USD m	119	156	300	238	454	390	329	310	574	388
Portfolio investments	USD m	-311	-592	-520	-825	640	-444	-293	60	-409	779
Gross international reserves	USD bn	3.4	4.1	4.4	4.6	6.2	6.7	6.9	7.9	9.6	12.1
<b>Fiscal indicators</b>											
Consolidated fiscal revenues	% of GDP	29.9	28.2	28.1	31.6	31.7	30.1	28.6	27.2	26.9	26.3
Personal income tax	% of GDP	5.2	4.9	4.9	5.7	5.7	5.3	5.1	4.4	4.1	3.8
Enterprise profits tax	% of GDP	4.3	4.1	4.3	5.7	5.1	4.8	5.0	3.9	4.0	4.1
Value-added tax	% of GDP	6.6	6.4	6.1	6.2	6.3	5.8	4.8	6.2	5.7	5.1
Excise tax	% of GDP	1.9	1.9	1.9	2.1	2.2	2.1	2.0	2.1	2.1	2.0
Consolidated fiscal expenditures	% of GDP	28.4	26.4	27.3	27.7	29.2	27.9	28.8	25.3	26.5	26.8
Current expenditures	% of GDP	na	na	na	na	26.3	24.2	24.3	22.4	22.7	21.7
Capital expenditures	% of GDP	na	na	na	na	3.0	3.7	4.4	2.9	3.8	5.1
Consolidated fiscal balance	% of GDP	1.5	1.7	0.7	3.8	2.5	2.2	-0.2	1.9	0.4	-0.5
Privatisation receipts	% of GDP	0.4	0.3	0.3	0.6	1.0	1.0	0.8	1.5	3.7	3.5
<b>Labour market</b>											
Average wage (real)	% yoy	20.0	21.2	17.7	12.3	19.1	19.9	14.9	23.0	17.8	13.2
Household income (real)	% yoy	61.3	100.8	65.6	-1.2	8.6	10.0	8.7	15.7	13.0	9.9
Unemployment rate (ILO methodology)	%	9.7	9.2	11.1	9.4	8.8	9.2	9.0	9.7	7.9	6.1
<b>Banking system</b>											
Monetary aggregate M0	% yoy	48.0	46.0	35.8	32.4	37.0	30.5	25.3	29.1	25.6	37.1
Monetary aggregate M2	% yoy	39.5	46.5	42.2	47.8	54.6	49.9	47.6	45.4	44.8	51.5
Household deposits in national currency	% yoy	90.1	103.6	72.5	73.4	74.7	65.0	66.1	69.4	67.3	67.9
Household deposits in foreign currency	% yoy	47.4	55.1	59.3	71.2	70.2	70.4	77.5	67.0	61.7	55.2
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	44.3
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	43.5
Long-term com. bank credits	% yoy	70.6	85.8	92.5	110.6	156.4	164.0	157.9	141.7	102.7	82.7
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	50.9
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	17.0
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	12.6

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