Tax Revenue Outlook for Ukraine

- The enterprise profits tax (EPT) revenues for 2005 will be UAH 0.5 bn higher than budgeted, totalling UAH 20.0 bn.
- In 2006 the EPT revenues will be UAH 0.9 bn lower than planned by the Ministry of Finance, totalling UAH 24.6 bn.
- The value added tax (VAT) revenues for 2005 will amount to UAH 28.0 bn, which is below budget.
- VAT revenues will continue to rise in 2005 and 2006 relative to GDP (to 6.7% and 7.4% respectively).
- Personal income tax (PIT) revenues in 2005 are expected to reach UAH 17.1 bn, exceeding the Ministry of Finance's plan.
- PIT revenues are forecast to reach UAH 20.4 bn in 2006.

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Forecast Period:
2005 and 2006

Forecast Variables:
EPT, VAT and PIT revenues

Fiscal indicators 2004:
Consolidated fiscal revenues/GDP: 26.5%
EPT/Consolidated fiscal revenues: 4.7%
VAT/Consolidated fiscal revenues: 18.3%
PIT/Consolidated fiscal revenues: 14.4%
Consolidated fiscal expenditures/GDP: 29.4%
Central fiscal deficit/GDP: 2.9%
Public debt/GDP: 24.8%
GDP: UAH 344.8 bn

In this 'Tax Revenue Outlook' issue, we compare our forecasts for 2006 with the figures given in the Draft State Budget Law for 2006, which the government submitted to the Verkhovna Rada on September 15, 2005.

EPT forecast: The EPT revenues will be UAH 0.5 bn higher in 2005 than budgeted

In the first eight months of 2005 the consolidated fiscal revenues from EPT reached UAH 14.7 bn (5.8% of GDP) on a cash basis. Compared to the previous year, the weight of EPT revenues as a percentage of GDP has increased by 1.7 percentage points. The increase is due to an improved tax administration and to a substantial broadening of the tax base. To whit, in March 2005 Parliament approved amendments to the Budget Law 2005 that eliminated both privileges of enterprises belonging to numerous special economic zones and sector-specific EPT preferences. The Ministry of Finance estimated that changes in the tax legislation should bring in an additional UAH 1.8 bn of EPT revenues in 2005. Also, the government's advance EPT payment scheme continues, which - according to the Ministry of Finance's report on the execution of Budget-2005 for the first seven months - has accumulated UAH 2.4 bn or 1.1% of GDP as of September 1, 2005.

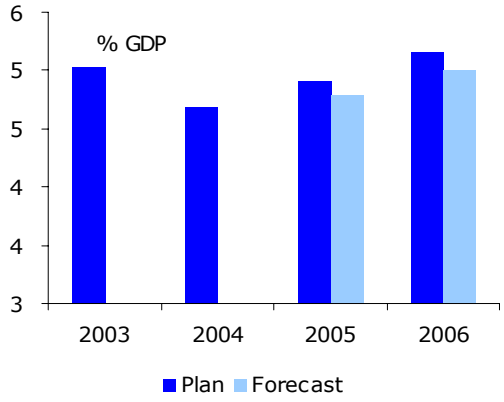
Our forecast of EPT revenues for 2005 is UAH 20.0 bn (4.8% of GDP), which is UAH 3.9 bn higher than the consolidated fiscal EPT revenues collected in 2004. This differs from the plan envisaged in the consolidated budget for 2005 (UAH 19.0 bn or 4.4% of GDP). The difference in the estimates for 2005 might be explained by the fact that our forecast is based on an assumption that the advance EPT payment will remain by the end of the year. This factor overcompensates lower EPT revenues that the government would collect otherwise due to lower slower economic growth..

Our forecast of EPT revenues for 2006 is UAH 24.6 bn (5.0% of GDP), while the government projection for EPT consolidated fiscal revenues is UAH 25.5 bn. The difference between our and the Ministry of Finance's forecasts for 2006 can be explained by two major factors. Firstly, we expect that the advanced EPT payments will be eliminated after the parliamentary elections next March, and secondly, our tax forecast is based on a more conservative macroeconomic scenario.

EPT revenue forecast assumptions:

- The EPT revenue forecast is based on macroeconomic indicators for 2005 and 2006 according to MEFU №2 (8), September 2005.
- The EPT legislation will stay unchanged in 2006.
- The EPT rate remains at 25%.
- All accumulated advanced EPT payments will be repaid in 2006.

EPT revenues to Consolidated budget



For 2003 and 2004 actual revenues are presented
Source: State Treasury, Ministry of Finance, Insitute

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Risks associated with our EPT forecast arise from different economic growth trends than we assumed, and from legislative changes associated with the approval of the State Budget Law for 2006.

VAT forecast: VAT revenues in 2005 will total UAH 28.0 bn, which is below budget

The value added tax (VAT) is traditionally the largest tax source of the consolidated fiscal revenues. The VAT collection on a cash basis for the first eight months of 2005 was UAH 21.5 bn (8.5% of GDP). However, during the same time period the VAT refund arrears grew from nearly zero to UAH 2.6 bn. Thus, the actual amount collected during the first eights month excluding the VAT refund arrears was a mere UAH 18.9 bn (7.5% of GDP).

Institute forecasts that VAT revenues in 2005 will amount to UAH 28.0 bn (6.7% of GDP), which is UAH 11.2 bn higher than in 2004. The important assumption behind this projection is the repayment of all VAT refund arrears in 2005. The VAT revenue forecast is driven mainly by a favourable consumption outlook. As a result, we anticipate that the share of VAT in the consolidated revenues will increase. This trend will benefit the economy, since VAT, as an indirect tax, is less harmful to investment than are income taxes.

We have slightly revised our forecast for the 2005 VAT revenues since May (from UAH 27.9 bn to UAH 28.0 bn) to reflect our updated macroeconomic forecast, as well as the dynamics of VAT revenue and VAT refund claims. The downward revision of exports of goods and services implies smaller refunds, while the lower than expected nominal imports of goods and services will result in a reduction of VAT from imports. Also, the stronger than expected household consumption will generate more VAT revenue from domestic sales. Finally, the actual trends of VAT refund claims have been taken into account.

According to our calculations, the government overestimated the net VAT revenues for 2005 by UAH 2.1 bn. One of the reasons is that the Ministry of Finance foresees a lower requirement for VAT refunds (Ministry of Finance: UAH 13.2 bn vs. Institute: UAH 14.7 bn). Another reason is the optimistic nominal GDP forecast assumed in the State Budget Law for 2005 (UAH 436.0 bn as compared to the UAH 417.5 bn forecast by the Institute).

Our forecast of VAT revenues for 2006 is UAH 36.4 bn, which equates to 7.4% of GDP, thus continuing the upward trend of 2005. As in 2005 the driving force for the revenue increase will be higher domestic consumption. Also, some additional VAT revenues are attributable to the introduction of a 10% VAT rate in the agricultural sector, replacing the present 0% VAT rate. Finally, we anticipate further policies aimed at improving the VAT administration. The government plan for VAT collection in 2006 is UAH 39.0 bn.

The risks inherent in the VAT revenue forecasts for 2005 and 2006 are associated with an economic development different from what we now expect. Also, there is always the danger that the complete repayment of VAT refund arrears will be postponed, which, would temporarily boost the cash VAT revenue at the expense of future revenues.

VAT revenue forecast assumptions:

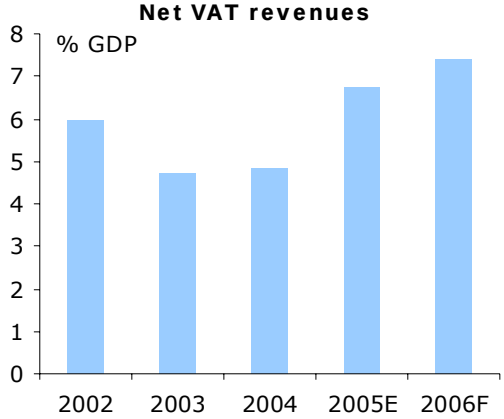
- The VAT revenue forecast is based on macroeconomic indicators for 2005 and 2006 according to MEFU №2 (8), September 2005.
- The VAT rate remains at 20%.
- The administration for collecting VAT will be improved.
- VAT refund arrears accumulated in 2005 will be repaid in 2005.
- A VAT rate at the level of 10% will be introduced in 2006 for the agricultural sector.

Parameters of EPT and VAT forecast:

	2004	2005E	2006F
GDP, UAH bn	344.8	417.5	491.1
GDP real growth, % yoy	12.1	3.5	4.4
Industrial output growth, % yoy	12.5	6.3	6.9
Household consumption, UAH bn	185.5	248.1	298.3
Exports of goods and services, USD bn	39.6	42.4	47.5
Imports of goods and services, USD bn	34.8	41.7	49.2
CPI inflation, % yoy aop	9.0	14.2	10.0
PPI inflation, % yoy aop	20.4	10.7	9.6

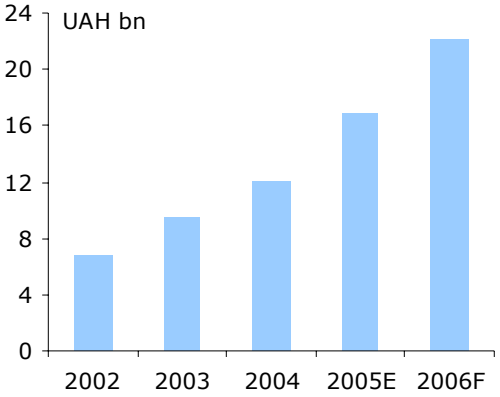
E - estimate, F - forecast
Source: Macroeconomic Forecast Ukraine №2 (8), September 2005, IER

Net VAT revenues



Source: State Treasury Reports, IER forecast
E - estimate, F - forecast

VAT on imports



Source: State Treasury Reports, IER forecast
E - estimate, F - forecast

PIT forecast: The government underestimated the PIT revenues for 2005

PIT revenues remain the third largest source of the consolidated fiscal revenues. It is also the major revenue source funding local governments, from which they have to finance the responsibilities delegated to them, such as health care and secondary education.

Our forecast of PIT revenues for 2005 is UAH 17.1 bn, thus, their share in GDP increases to 4.1%. The previous PIT revenue forecast was revised upwards thanks to higher personal income tax collections during the first eight months of the year. Wage increases were the major determinant for the increased PIT revenues. In 2005 the driving force for wage growth in the economy is the minimum wage, which was gradually increased from UAH 262 in January to UAH 332 by September 2005.

Due to adjustments to the actual pattern of PIT collections, the Institute has forecast PIT revenues for 2005 to be UAH 0.2 bn higher than the government had planned for 2005.

For the year 2006 we have revised the forecast of PIT revenues from UAH 15.0 bn to UAH 20.4 bn. The major factor influencing this sharp upward revision is explained by the reduction in the Social Privilege. The Parliament decreased its level from 80% to 50% of the minimum wage by amendments to the PIT Law, which were approved on July 7, 2005. Other factors that will influence PIT revenues in 2006 are expected to be the same as in 2005: increases in the minimum wage and in the subsistence minimum for individuals able to work, as defined in the draft Budget Law for 2006. In particular, it is foreseen that as of January 1, 2006 the minimum wage will reach UAH 350 and the subsistence minimum for individuals able to work will be UAH 483. The increases in the minimum wage and the level of subsistence minimum for individuals able to work will decrease PIT revenues due to the concurrent increase in the Social Privilege. The reduction in PIT revenues caused by the higher minimum wage and subsistence minimum will be partially offset by continued wage growth in the economy, based on further economic growth.

Our PIT forecast is UAH 0.4 bn lower than the foreseen amount in the Draft State Budget for 2006. Therefore, the local authorities, which already face problems to finance their obligations in 2005, might face more serious problems in 2006.

The risks inherent in the PIT revenue forecasts for 2005 and 2006 are associated with lower wage growths than assumed. In addition, the forecast for 2006 could be challenged if the government introduces a yet higher minimum wage and subsistence minimum growth, which would increase the level of the Social Privilege yet further.

PIT revenue forecast assumptions:

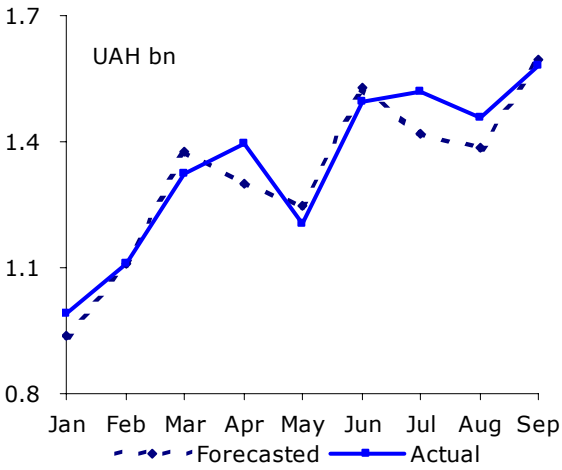
- The gross nominal wages in the economy in 2005 are equal to UAH 130 bn (a 40% increase as compared to 2004).
- The PIT rate remains flat at the level of 13%.
- People, whose wages are lower than 1.4 subsistence minimums for persons able to work, are eligible for the Social Privilege set at 50% of the minimum wage.
- The minimum wage is expected to be raised to UAH 350 on January 1, 2006.
- The subsistence minimum for individuals able to work will be equal to UAH 483, on January 1, 2006.
- Gross nominal wages will increase by 22% in 2006.
- The distribution of wages remains constant over time.
- Employment levels will remain the same in 2005 and 2006.

Parameters of PIT forecast:

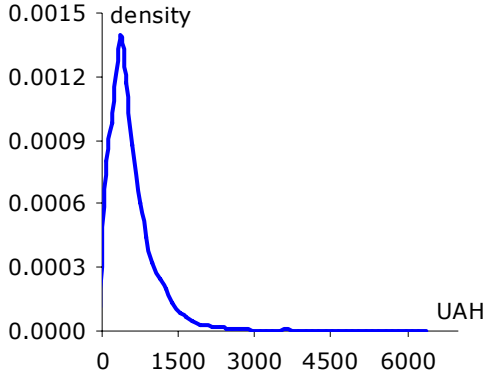
	2004	2005	2006F
PIT rate, %	13	13	13
Gross wages, UAH bn	94	130	159
Minimum wage, at the beginning of the year, UAH	205	262	350
Subsistence minimum for persons able to work, UAH	386	409	483
Social Privilege, UAH	61	131	175

Source: legislation of Ukraine, IER estimates
F - forecast

PIT collections



Distribution of monthly wages, 2005*



Source: Household Survey (Derzhkomstat), own calculations
* Kernel density function of monthly wage

Table 1. Tax revenues (UAH bn)*

	2002	2003	2004	2005E	2006F
EPT	9.4	13.2	16.16	20.0	24.6
VAT	13.5	12.6	16.7	28.0	36.4
PIT	10.8	13.5	13.2	17.1	20.4

Note: E – estimate; F – forecast

Table 2. Tax revenues (% GDP)*

	2002	2003	2004	2005E	2006F
EPT	4.3	5.0	4.7	4.8	5.0
VAT	6.0	4.7	4.9	6.7	7.4
PIT	4.8	5.1	3.8	4.1	4.2

Note: E – estimate; F – forecast

Table 3. Distribution of tax revenues by quarters in 2005 (UAH bn)*

	QI	QII	QIII	QIV
EPT				
Collected	3.8	5.5		
VAT				
Collected (cash basis)	6.8	8.7	-	-
Collected minus arrears to be refunded	5.2	7.2	-	-
PIT				
Collected	3.4	4.1	-	-

** Source: State Treasury Reports, IER estimations*

Technical notes

1) EPT forecast

For EPT forecast purposes, we applied an econometric method based on buoyancy. The econometric estimates are based on Derzkomstat statistics. The estimated EPT revenues were adjusted to the actual EPT collections and were then corrected for changes in the legislation. The actual EPT revenues were taken from State Treasury reports.

2) VAT forecast

For forecasting VAT we adopted an iterative-analytical technique and used the Ukrainian legislation. The forecast is built on a system of build-in indicators (proportions), which are adjusted to reflect past dynamics and changes in the legislation.

The methodology of VAT revenue forecasting is very similar to the official VAT forecasting methodology of the Ukrainian government. The official methodology has been adjusted to use IER macroeconomic forecasts as input. Also, our VAT model uses different sets of empirical data. The official methodology was approved by joint Order #543/315/502/637 dated August 31, 2004 of the Ministry of Finance, the Ministry of Economy, the State Tax Administration and the State Customs Service.

VAT revenue is forecast on the basis of macroeconomic indicators and the effective tax rates. The total VAT revenue is decomposed into VAT from imported goods, VAT from domestically produced goods, and VAT refunds. The evolution of each component is forecast on the basis of historical data as well as macroeconomic forecasts by the Institute. The forecast for VAT from domestically produced goods is done with a simplified demand method, using household consumption as the leading indicator. VAT from imports is forecast via the dynamics of imports of goods and services and the exchange rate. VAT refunds are forecast using the dynamics of exports of goods and services, the exchange rate, PPI and the growth of industrial output. Additionally, the contribution of the reduction of VAT privileges is taken into account. The value of cancelled VAT privileges was taken from the Explanatory Note to the Draft State Budget 2005.

When making the VAT forecast for 2005, we disregarded the UAH 3.6 bn of VAT revenues due to the state, which are based on a non-transparent and non-cash scheme.

3) PIT forecast

The PIT forecast is based on a detailed household survey (HS), produced by Derzhkomstat. This survey includes information describing the distribution of the after-tax income of individual households for the year 2003. Therefore, for our forecast purposes we extrapolated the data for the following years (2004-2006), assuming that the income distribution would remain constant throughout.

The actual PIT revenues collected by the government were taken from the yearly State Treasury reports. This allowed us to check our estimates of PIT revenues in 2004 with the actual amounts collected. Our estimate for 2004 differs from the actual by 2%. Thus, for the forecasts of 2005 and 2006 we made adjustments of the same magnitude.

The forecasts are based on PIT paid on the wages of employees, which is the major source of the total PIT revenues. However, PIT revenues also include the fixed and unified taxes paid by small entrepreneurs, taxes from lotteries, taxes on dividends, etc. In 2004 wage-based PIT amounted to 96% of the total PIT collected. We corrected the wage-based PIT revenue estimates to account for the other PIT revenues.

Note: **yoy** **year-on-year** **aop** **average of period**
VAT **value added tax** **EPT** **enterprise profit tax**
PIT **personal income tax**