

## Draft State Budget Law – 2007: Change of policy direction

- Macroeconomic forecast, on which the draft budget for 2007 is grounded, is rather realistic.
- The plan of central fiscal revenues for 2007 contains numerous changes to the tax legislation.
- There is a high probability of underexecution of planned privatization receipts in 2007.
- The Draft Budget foresees restrictions and limitations of social payments.
- Part of development expenditures, the amount of which increased as compared to 2006, has doubtful economic grounding.

### Parameters of the State Budget Law - 2007

Revenues/GDP: 23,6%  
 Expenditures/GDP: 25.8%  
 Deficit/GDP: 2.5%  
 Debt/GDP: 12.5%

In this work we consider the Draft budget Law for 2007 submitted by the Cabinet of Ministers to the Parliament on 15<sup>th</sup> of September 2006.

### Macroeconomic forecast

1. According to the forecast of the Institute for Economic Research and Policy Consulting, in 2007 the real GDP will increase by 5.9%<sup>1</sup>. This figure is lower than the official forecast (6.5%). Consumer price inflation will remain below the two-digit threshold at the level of 9.0% in December-on-December terms. It is somewhat higher than the official forecast of 7.5%.

2. The IER estimate of the nominal GDP is UAH 608.3 bn that is UAH 14.2 bn above the figure, on which the draft of Central Budget for 2006 is grounded. The discrepancy is explained by several factors. First, it is a statistical base effect, as by the IER estimate, nominal GDP figure for 2006 will be higher than it is envisaged in draft Budget. Also, the IER estimate grounded on somewhat higher expected inflation that counterweights the slower real growth.

3. Domestic demand will remain the key contributor for the economic growth in the country. According to the IER estimates, in 2007 the final consumption of households will increase by 8.9%, thus returning to its trend growth pace after the several years of the two-digit growth. The slowdown is attributed to the increase in the personal income tax rate by 2 percentage points to 15%, slower growth in minimum pensions and wages, and the redirection of the funds of enterprises from wage bills to investment activities.

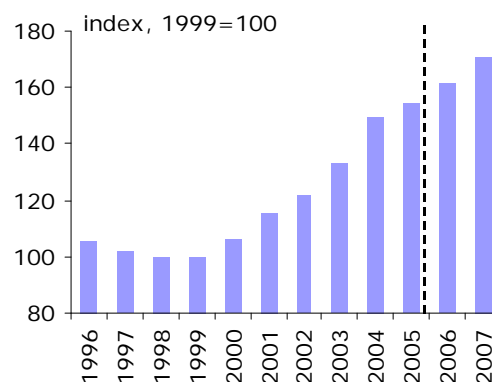
4. Investments, as expected, will significantly accelerate returning to the high growth pace. It is forecast that gross fixed capital formation will augment by 15.1% in 2007. The obsolete equipment, the need to enhance energy-efficiency against the background of high world energy prices, and the need to increase the competitiveness on the eve of the WTO accession will stimulate investment activity in the country.

5. The increase in domestic demand will be satisfied both by further expansion of domestic production and by imports. It is expected that the growth of investment-oriented production and imports will dominate.

6. Both the official and IER forecasts are based on assumption that the import gas price at the border of Ukraine will become USD 130-140 per thousand cubic meters (tcm) range in 2007. The import gas price at the border is maintained at USD 95 per tcm till the end of 2006.

7. The Institute forecasts that the growth rate of imports of goods and services will surpass the growth rates of exports. In particular,

### Gross Domestic Product



Source: Derzhkomstat, own calculations

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<sup>1</sup> According to the Macroeconomic Forecast Ukraine No. 2(10), 2006, produced by the IER.

real exports will increase by 5.3%, while imports will grow by 11.8%. That will result in negative balance of trade in goods and services. The IER forecast is based on assumption that Ukraine will complete negotiations with the WTO in 2006-early 2007 and become the member of this organisation by the mid-2007. The membership will cause the further liberalization of trade in goods and services, especially the reduction of import tariffs on agricultural and food products, which are the most protected at present. At the same time, Ukraine get better access to world markets, for instance, the quantitative barriers on metal trade will be eliminated. Also, it is assumed that the world price for commodities like metals and chemicals will remain high supporting Ukrainian exports.

8. Summing up, the macroeconomic forecast built in the draft budget 2007 seems rather realistic. The risks of the forecast are predominantly external, including higher than currently expected gas price growth and significant reduction of world prices of commodity that Ukraine exports.

### Central fiscal revenues: General overview

9. The central fiscal revenues are to decline from 25.2% of GDP planned for 2006 to 23.6% in 2007. According to the IER tax forecast,<sup>2</sup> this revenues plan is realistic. However, it is prone to risks of unfulfilled macroeconomic assumptions, introduction of import restrictions, and abuse of revenues caused by privileges granted.

10. Revenues were planned at the lower level as a share of GDP mainly due to cancellation of clearing operations in EPT and VAT (0.5% of GDP) and renovation of privileges for special economic zones (SEZ) (0.2% of GDP). Also, cut in the excise duties for oil products and reduction in the share of profits of state owned enterprises due to the budget contributed to lower fiscal revenues. The revenue decline is expected to be to a some degree offset by tax base broadening, the ad-hoc increase in rates of some obligatory payment to the budget, and changes in the tax calendar, which artificially boost tax revenues.

#### Tax privileges to SEZ

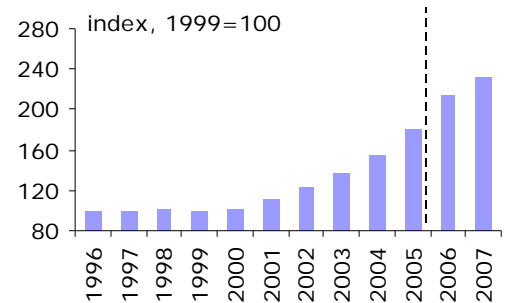
11. The draft Budget reintroduces privileges to the SEZ. The SEZ are to be granted EPT investment tax credit (ITC) privileges, import duty exemption, and allowed to use VAT promissory notes that are likely to taxpayers' abuse. The ITC design is to be defined by the Cabinet of Ministers. This grants extraordinary power to the executives and hampers transparency, as tax administration rules must be defined by legislation. The effect of the ITC on budget revenues and investment will depend on its design. International experience and research show that the gain from the investment increase net of revenue loss due to privileges is greater in case the ITC is set for incremental investment.

12. The privileges will be restored for new investment projects as well as to those that were registered prior to April 2005, not taking into account their efficiency and compliance with the investment contracts. This nullifies all the gains of tax base broadening of 2005 and is not likely to improve investment climate. The previous experience of the SEZ in Ukraine showed that they were inefficient in attractive large investments and/or facilitating considerable exports growth. It is more efficient to improve investment climate in the country as a whole via development of infrastructure and support of legislative and political stability.

#### Tax base broadening

13. The important innovation of the draft of the State Budget is the change in the VAT regime for agricultural producers, namely the

### Households' Consumption



Source: Derzhkomstat, own calculations

### Central budget revenues (% GDP)

	2006	2007*	Difference
EPT	5.2	4.2	-1.05
VAT	8.6	9.3	0.69
Excises	2.1	1.7	-0.44
International trade	1.5	1.4	-0.09
Other taxes	4.2	3.6	-0.60
Profits of state-owned enterprises	0.7	0.2	-0.49
NBU profits	0.3	0.3	0.06
Rent payments	1.4	1.4	0.02
Other revenues	5.6	4.9	-0.70
Total revenues	25.2	23.6	-1.62

Source: Law "On State budget for the year 2006", Draft law "On State Budget for 2007" (submitted by the Cabinet of Ministers on 15 September 2006)

\* do not take into account mutual settlements

### Indicators of SEZ activity 2004

		SEZ Ukrain Share of SEZ		
Export	UAH bn	6.9	194	3.5
Output	UAH bn	20.2	484.2	4.2
Employment/Economically active population	m	0.14	22	0.6
Privileges/Consolidated expenditures	UAH bn	2.0	101	2.0
FDI	USD m	131.6	1559	8.4

Source: Ministry of Economy, own calculations

<sup>2</sup> Tax revenue outlook for Ukraine No. 2(4) October 2006

planned introduction of 12% VAT rate in this sector since 2007. It is a positive step in terms of raising overall fiscal revenues, balancing spending on the agriculture and revenues from the sector, widening tax base, and equating tax burden among economic agents. However, this step will limit cash flows for farms, toughing financial constrains without supplementing them by other reforms like the development of the land market.

Changes aimed at ensuring enough revenues

14. In addition to tax base broadening, the government expects positive effect on revenues from increase in excise rate for alcoholic products, rent payments, additional restrictions on loss carry-forward, depreciation deduction, and revision of tax calendar for EPT purposes.

15. The draft Budget introduces several important amendments to the EPT calculation and payment schedule. In particular, the amounts of loss carry-forward are to be restricted further. This contradicting the provisions of current legislation that allows the loss carry-forward up to 2 years. Also, the tax on profits received in 2007 is to be paid at the end of 2007. This again amends the current legislation, artificially boosting revenues for the next fiscal year.

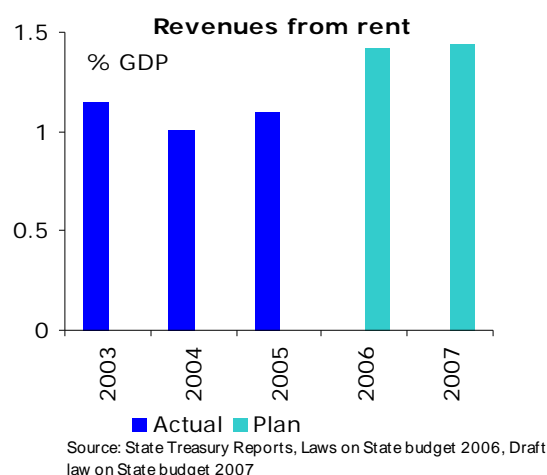
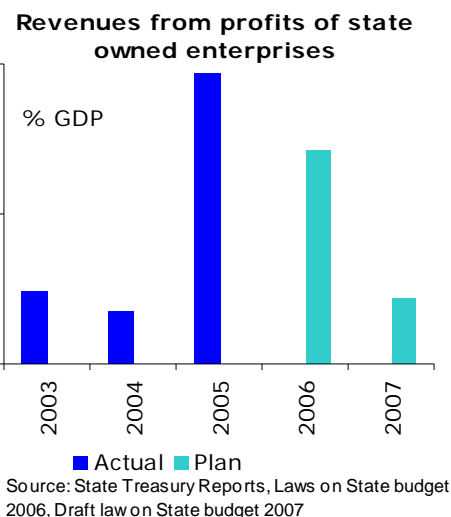
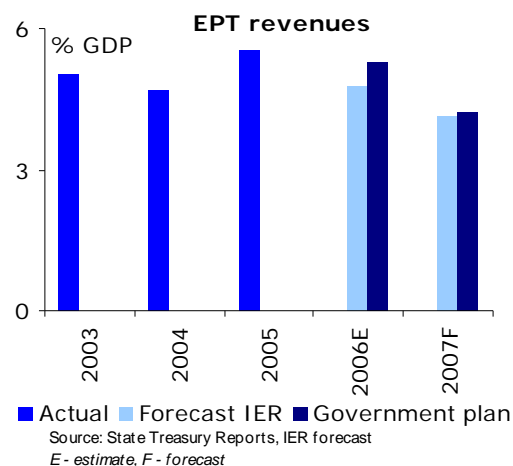
16. The rules of depreciation deduction for the EPT purposes changed in draft budget. In 2007 the worth of any improvement of fixed assets is to be deducted in the limits of 10% of the worth of respective group of fixed assets, while at the moment the cap is defined by the 10% overall residual value of fixed assets. On the one hand, the deduction allowance cap limits fiscal revenue losses. Furthermore, the cap in tandem with highly restrictive loss carry-forward provision favors profit-making enterprises against loss-makers, being a positive stimulus for enhancing enterprises efficiency. On the other, the proposed design of deduction allowance does not prevent the windfall gains to taxpayers and subsidizes investments that are likely to be made anyway. The proposed design may also discourage firms entering to the market. Furthermore, targeting the cap to the fixed asset group introduces rigidity, and distorts investment decision and the structure of fixed assets of enterprises.

17. The share of profits of state owned enterprises due to the budget is to be reduced from 50% to 15% for completely state owned enterprises and to 30% for enterprises with state-owned share. Frequent changes and adjustment of such rates to the fiscal needs introduces uncertainty and hampers the enterprises' activity.

18. The rates of rent payments for the extraction of natural resources (including oil and gas) are to be raised. The increase is driven by first of all fiscal purposes, increasing uncertainty for the enterprises. In order to improve the situation, the government should establish formula that would define rent for extraction of natural resources.

19. The Draft also foresees differentiation of rates for the natural gas extraction depending on gas final user, de-facto subsidizing the provision of gas to population. This measure enhances non-transparent quasi-fiscal activity in the economy and worsens the state of gas extraction enterprises. Provision of gas to population at privileged prices should be replaced with targeted subsidies to low-income people. The current mechanism of social aid provision is not efficient since first of all benefits richer people.

20. As shown, the government returns to the practice of changing tax legislation in the text of the Budget Law as a way to ensure sufficient revenues. Such policy harms fiscal transparency in the country. Also, the Government restores the SEZ tax privileges that shrinks the tax base and stimulates further rent seeking activities. Thus, although the revenues figures are realistic, the approach to



getting these figures doesn't correspond to fiscal stability and transparency principles.

### Central fiscal expenditures: General overview

21. The central fiscal expenditures are to be reduced from 27.7% to 25.8% of GDP. The major reduction of expenditures as a share of GDP is caused by the cut in spending on social policy, slower growth rates of wage bill of some budget sectors, and the absence of clearing operations. The share of development expenditures<sup>3</sup> in central fiscal expenditures remains at the level of 2006.

22. As in 2006, the draft budget 2007 defines the stabilization fund at the amount of UAH 3 bn. However, the rules of funds' use are still not in place. That contributes to non-transparency, provides lucrative opportunity to expand back social payments, and grants executives excessive power.

#### Sector support

23. The government reverts to the practice of substantial state support of commercial sectors. Support of coal and agricultural sectors remain de-facto fiscal expenditure priorities. The large share of these funds is spent in the form of direct transfers to enterprises, what in the long term is not economically justified. To ensure the efficiency of the state support and limit rent seeking activity, general rules on the state support should be approved. Furthermore, the analysis of state aid effectiveness should be conducted in Ukraine.

24. The major article of fiscal expenditures for the energy sector is still associated with the execution of "Ukrainian Coal" program (2001)<sup>4</sup>. In 2007 it is planned to allocate UAH 5.1 bn to the coal sector. The structure of expenditures becomes more biased towards direct subsidies. About 80% of the funds are to be streamlined to state support of cost recovering and capital transfers. The residual funds should finance coal sector restructuring<sup>5</sup>, R&D, and other expenditures.

25. The Draft Law envisages UAH 8.9 bn for agricultural programs, which is UAH 1.6 bn more than in 2006. The 'green' box expenditures – state support measures not restricted by the WTO rules – decreased by 4.5% to UAH 4.5 bn UAH. However this decrease is rather technical, since financing of the National Agrarian University were moved out from the functions of the Ministry of Agrarian Policy. On the other side, the spending on 'amber' box measures, limited by the WTO rules, is to increase by 71% to UAH 4.4 bn. Although Ukraine stays in the limits of its possible aggregate measure of support ceiling, the increase in the 'amber' box shows that reforms of agricultural support mechanisms are still postponed.

26. The state traditionally provides support to agriculture and coal sector. Unfortunately, the increase in state sector support proposed in the draft budget 2007 is associated with the most costly and least efficient subsidies and postpones the reforms.

### Social policy and social expenditures

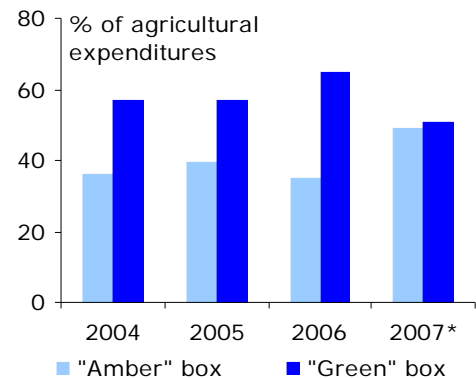
27. The Draft law foresees further gradual increases in social standards, including minimum wages, subsistence minimum, minimum pensions, and other social payments in 2007. However, the growth rates of social standards will be lower than in 2004-2006. Some of them will even decline in real terms. This points out the reversion of the government from the populist social policy of previous years and an attempt to challenge its consequences.

<sup>3</sup> According to the budget classification, the development expenditures include outlays for scientific, investment, and innovative activity.

<sup>4</sup> Resolution of the CMU "On approving the program "Ukrainian Coal" #1205 from 19 September 2001

<sup>5</sup> Resolution of the CMU "On the guidelines for financing coal mines meant to be prepared for liquidation" #223 from 28 February define the Guidelines for distribution of restructuring funds are approved by the CMU.

**Agricultural expenditures of the central budget according to WTO framework**



\* Draft budget figures  
Source: IER estimations

### Coal sector fiscal support

	2002	2003	2004	2005	2006 (plan)	2007 (draft)
Cost covering, capital transfers	0.9	1.9	2.9	2.3	3.1	3.6
Restructuring	0.5	0.6	0.7	0.8	0.8	0.9
Other	-	-	-	-	0.2	0.4
<b>Total</b>	<b>1.5</b>	<b>2.6</b>	<b>3.6</b>	<b>3.1</b>	<b>4.3</b>	<b>5.1</b>

Source: State Treasury, own calculations

### Subsistence minimum in 2007 (UAH)

	from January	from April	from October
General level	492	501	510
For children less than 6 years old	434	442	450
For children of 6-18 years old	558	568	579
For working able individuals	525	535	548
For individuals that lost ability to work*	380	387	395

Source: Draft State Budget for 2007 (submitted by the Cabinet of Ministers in September 15, 2006)

\* minimum pension level

28. The provision of social privileges, social assistance and other social payments are to become targeted, which is a positive feature of the draft. The targeting has several features. First, the groups of eligible individuals is limited by the income level at 1.4 times subsistence minimum set for working able individuals. Second, maximum amount of assistance is capped by the defined guaranteed subsistence minimum level. However, the draft law grants the Cabinet of Ministers excessive power to set the sizes of social payments and privileges already stated in effective legislation.

Balancing budget of the Pension Fund

29. In order to balance the budget of the Pension Fund and still finance previously increased pension benefits, the government plans to undertake several ad-hoc steps that include increase in the contribution paid by employers to 33.2% of the wage bill (from 31.8% in 2006); limiting the size of pension benefits for working pensioners by two subsistence minimum levels; and the cap on the pensions paid according to some state pension programs, like pensions to civil servants and judges, at 12 minimum pensions. At the same time, it is planned to reduce harmful for investments pension duty paid on non-cash currency exchange purchase-sale operations by 0.3 p.p. to 1.0%.<sup>6</sup>

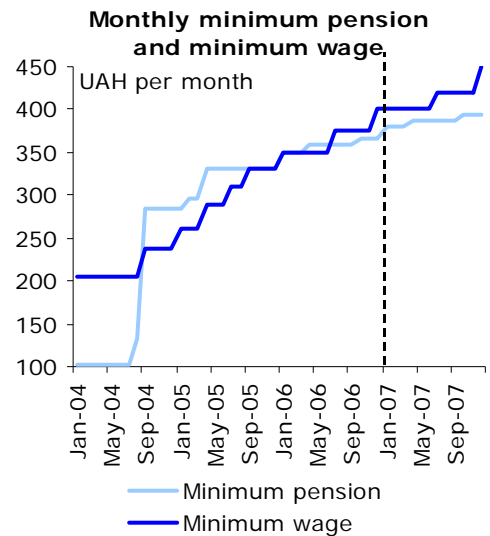
30. The draft budget law envisages increased transfer to the Pension Fund at UAH 20.9 bn (13.6% of total central fiscal expenditures). Such increase is explained by assignment of additional functions to the Pension Fund: payment of pensions to military pensioners and retired judges. For this, the Fund should receive additional UAH 10.3 bn. Another part of the transfer is envisaged for financing pensions paid according to different state pension programs. Besides, as in previous year, the Pension Fund is to be compensated the losses caused by lower contributions envisaged by fixed agricultural tax scheme (UAH 1.4 bn). All these factors make the transfer to the Pension Fund high, though it is not caused by the deficit of the Pension Fund.

31. To ensure higher revenues of social insurance funds and of the Pension Fund, it is planned to increase maximum amount of wages, from which social and pension insurance contributions are paid from 10 to 15 subsistence minimum levels defined for working able individuals. However, it is not likely that the result of such increase will generate significant amount of money inflow.

32. Thus, the draft law foresees measures for balancing the budget of the Pension Fund. However, use of some measures is rather questionable. The increase of the insurance contribution to the Pension Fund, which accounts for more than 80% of total payroll tax, sends wrong signals to the business. Such policy does not coincide with government's announcements to reduce tax pressure. The cap on pensions paid according to different state pension programs is still high as compared to average pension in Ukraine. The reduction of the pension duty paid on currency exchange operations is a positive step, though it is not sufficient for reducing the investment barriers. Therefore, measures conducted for balancing the budget of the Pension Fund seem rather inefficient in the long run.

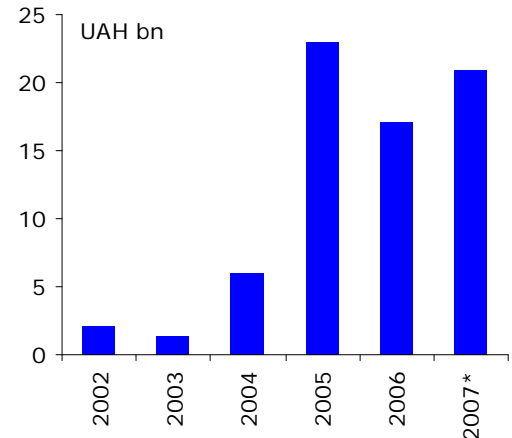
The reduction of expenditures of social insurance funds

33. In order to avoid rise in shadow economy and excessive burden of payroll taxes due to increase of the pension insurance contribution rate, the latter will be compensated by cut in the contributions to other social insurance funds and restricting their expenditures.



Source: Legislation of Ukraine

**Central fiscal transfer to the Pension Fund**



Source: State Budget Laws for 2002-2006, Draft of the State budget for 2007

<sup>6</sup> See IER policy paper V7 The pension funds tax on purchases of non-cash foreign currency: Time to go by R. Giucci, V. Bigdai.



34. The contribution for the insurance in case of temporary loss of ability to work is planned to be reduced by 1.4 p.p. to 1.5%. At the same time, the responsibilities of the Fund of Social Insurance in Case of Temporary Loss of Ability to Work are to be cut. First, the Fund will not be responsible for paying birth grants in 2007. Instead, the payments are to be paid to all eligible individuals at the expense of respective subvention from the central budget to local budgets. Second, it is envisaged that in 2007 the duration of the sickness leave payments will be cut from current 75 to 30 days. However, the resulting reduction in expenditure needs may not be sufficient to compensate drop in revenues caused by sharp cut of the insurance contribution, thus causing unplanned deficit or unfulfilled liabilities.

35. The draft also contains ad-hoc measures aimed at cutting expenditures of the Unemployment Insurance Fund, while not enhancing efficiency of active labour market policies. Firstly, unemployment benefits are to be paid during 9 months in 2007, while the Law on Employment stipulates 12 months term, which coincides with international practice. Secondly, the payment of pensions to persons that retired 1.5 year earlier according to early-retirement schemes is to be stopped in the case these persons return to work.<sup>7</sup> This step might be considered as positive one, since it can reduce spending of the Fund. On the other hand, this change breaks provisions of Ukrainian legislation.

36. It is planned to reintroduce an old practice according to which the Unemployment Insurance Fund should finance a program of job creations for miners that lost their work due to mining restructuring. In 2007 it is planned to spend on this program UAH 130 m in 2007. The problem is that the execution of this program is not transparent. According to international practice such payments should be rather tax financed than covered by insurance contribution.

37. Thus, in order to ensure the balanced budget of the Pension Fund, as well as to finance some additional state programs, the government tries to cut some social assistance paid through state insurance funds. Such policy does not seem to be well-organized, since does not contain measures on enhancing efficiency of the funds' activity.

**Intergovernmental relations: towards decentralization?**

38. Local fiscal revenues, net of transfer, are expected to decline in 2007 both as a share of GDP and of consolidated budget. This reduction is explained by several factors. First of all, local revenues have low revenue elasticity, frequently being attached to fixed parameters. For instance, land tax liability is often defined by the physical area of the land plots instead of land value. Furthermore, local revenues are used below their full potential. Besides, it is planned to shorten the list of genuine local taxes abolishing taxes with low revenue capacity.

39. At the same time, the planned revenues from PIT – key tax for local budgets - increase from 4.4% to 4.7% of GDP. It is explained by the tax rate change from 13% to 15% as it is envisaged by current legislation. Higher PIT revenues partially compensates the decline in other local revenues and supports financial ability of local units to execute delegated tasks. However, this does not solve the problem of low revenue autonomy of local government units and low efficiency of own tasks execution.

40. The local units to a great extent depend on the central fiscal transfers. The amount of transfers constitutes 6.5% of GDP or 45% of local expenditures. However, the mechanism of redistribution of investment and additional equalization transfers among the local

**Payroll tax and deductions from wages, 2007**

	The contribution made by employer (%)	The contribution made by employee (%)	Total contribution (%)
<i>Social insurance contributions (without contrib. for the working accidents insurance)</i>	36	2.0-3.5	39.5
Pension Fund	33.2	0.5 – 2.0*	33.7-35.2
Social insurance in case temporary working disability	1.5	0.5-1.0*	2.5
Social unemployment insurance	1.3	0.5	1.8
Social insurance in case of working accidents	0.66-13.6**	0.0	0.66-13.6**

\* the lower rate is paid by employees with wages below the subsistence minimum set for working able individuals, and higher rate is paid by those with wages above the subsistence minimum.

\*\* the rate depends on the class of risk

Source: The Law On the size of contribution to compulsory types of insurance, the Draft of the State budget for 2007.

**Local fiscal indicators % of GDP**

	2005	2006	2007
Revenues	7.1	7.6	7.3
Revenues net of transfers	6.8	7.4	6.6
Total transfers to local level	5.5	6.6	6.5
Expenditures	12.6	14.5	14.4

Source: IER calculations, State treasury reports, Draft law on State budget 2007

**Local fiscal indicator % of consolidated budget**

	2005	2006	2007
Local revenues including transfers/Consolidated revenues	22.6	23.1	24.1
Local revenues net of transfers/Consolidated revenues	21.5	22.2	21.8
Total local expenditures/Consolidated expenditures	37.8	40.5	43.5

Source: IER calculations, State treasury reports, Draft law on State budget 2007

<sup>7</sup> According to the Law, pensions to these people are paid by the Pension Fund with further compensation from the Unemployment Insurance Fund.

units is not stipulated. This makes the allocation of funds non-transparent and increases uncertainty, hence hampering efficiency of local expenditures.

41. Despite the planned reduction of central fiscal expenditures as a share of GDP, the weight of local expenditures in GDP is to remain at 14.4%, which is close to parameters of 2006. This definitely appraises the role of local budgets. However, this is not related to the increased decentralization. The share of local expenditures, which is to be covered by own and assigned revenues and equalization transfers, declines from 72% in 2006 to 64%. The high weight of local expenditures is caused to a great extent by increase in targeted transfers for social payment.

42. Summing up, the increase in PIT rate envisaged by the legislation helps to compensate for decline in other local taxes. However, central fiscal transfers remain the very important source of funds for financing local fiscal spending. The relative increase in the share of local fiscal expenditures in consolidated expenditures is associated with the increase of targeted transfers and not with fiscal decentralization. Furthermore, the existing redistribution of large transfers is not transparent and requires design and enforcement of additional legislative provisions.

**State debt and deficit financing**

43. The central fiscal deficit is planned at UAH 15.1 bn that constitutes 2.6% of GDP. Nearly UAH 5 bn or one third of this amount is planned to be financed at the expense of borrowing. By the end of 2007, the state debt should reach UAH 76.0 bn of 12.8% of GDP. The expected ratio of debt to GDP is at safe level for the economy. At the same time, nearly two thirds of the debt is foreign borrowing, making the structure of debt prone to exchange rate risks.

**Privatisation in 2007**

44. According to the draft budget 2007, it is planned to get UAH 10 bn privatisation receipts. For the time being there are about 500 state companies that are planned to be privatized in 2007. The list of these enterprises includes agricultural, printing, tinned food factories and other small companies. Thus privatisation plan is potentially risky, as the preparation of the large number of tenders require time, while the sale price of enterprises not quoted at stock market remains unclear until the end of the tender.

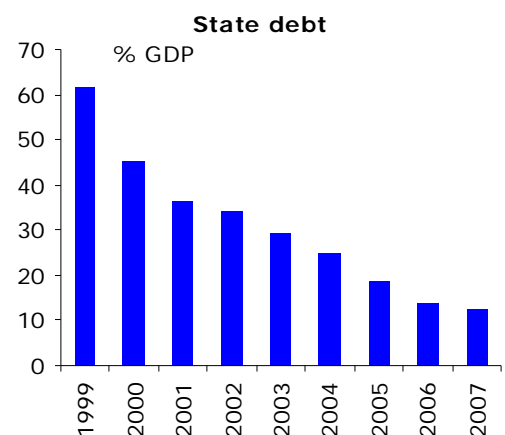
45. The alternative way of receiving UAH 10 bn is through selling several big stakes, so called ‘blue chips’ in telecommunication, machinery, energy, metallurgy, and chemistry sectors. One of the options to accomplish the plan of privatization receipts in 2007 is to sell Ukrtelecom. Privatisation of this company has been postponed several times. Currently the market value of the company is evaluated at USD 3.5 bn or UAH 17.7 bn that is almost twice higher than privatization plan for 2007. It should be noted that the final amount of receipts greatly depends on the transparency of a tender.

46. Traditionally privatization process is highly politicized. Therefore, its speed and efficiency will to a large extent depend on the decisions of the Government. The strategy on the current Cabinet of Ministers promises to intensify the property transformation process.

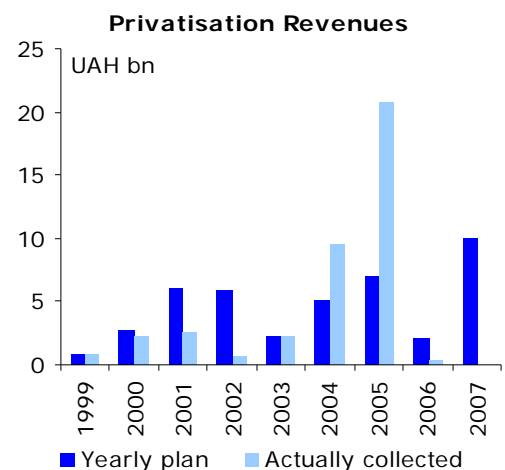
**State borrowings and debt repayment in the Draft Budget for 2007**

	UAH bn.	% GDP
<b>Borrowing</b>	11.6	1.9
Domestic	3.8	0.6
External	7.8	1.3
<b>Repayment</b>	6.7	1.1
Domestic	2.5	0.4
External	4.2	0.7

Source: Draft law on the State Budget for 2007 (submitted by the Cabinet of Ministers on September 15, 2006)



Source: State Treasury, Draft budget law



Source: State Treasury

**Conclusions**

47. The draft law on state budget 2007 represents an attempt to cope with consequences of the populist policy of the previous years in ad-hoc manner, thus worsening fiscal transparency and endangering future economic growth.

48. On revenue side, the positive feature of the draft budget is its reliance on realistic macroeconomic assumption and an attempt to broaden the tax base introducing 12% VAT rate in agriculture.

49. However, this positive impression is spoiled by the tax base shrinks due to reincarnation of privileged tax regime to the SEZ. Moreover, the latter create backgrounds for tax avoidance and low efficiency of funds use. In addition the government continues to replace the financing of reforms in the coal and agricultural sectors with provisions of subsidies – policy inconsistent with the goal of increase in competitiveness in these sectors.

50. Also, the need to finance the expanded social obligations and slow path of reforms resulted into ad-hoc and numerous changes in the tax legislation that contradicts the goal of fiscal stability and predictability.

51. On expenditure side, the positive feature of the draft Budget is an introduction of targeting of provision of social assistance payments and privileges that enhances efficiency of state social support programs. At the same time, the draft budget envisages limitations on some types of social payments, including unemployment benefits, sickness leave payment and pensions, making it hard to estimate net effect of changes in social standards in 2007. Moreover, such limitations contradict economic principles and international standards.

52. The budget execution in 2007 is prone to several risks. First, the external shocks may change economic situation, thus questioning the macroeconomic figures, on which the budget is built. Also, fiscal revenues may be abused due to reincarnation of privileges. On expenditure side, the increase in social standards – e.g. the change of birth grants eligibility criteria – during the discussion of the draft budget in the Verkhovna Rada may misbalance the budget.

**Note:**

**VAT** value added tax  
**PIT** personal income tax  
**EPT** enterprise profit tax

**Central fiscal parameteres**  
(% GDP)

Total revenues								
	2005 % GDP	2005 structure	2006 % GDP	2006 structure	2007 % GDP	2007 structure	Difference % GDP	Difference in structure
Tax revenues	14.94	70.80	15.10	71.34	0.79	72.2	-14.31	0.84
Non tax revenues	5.64	26.71	5.41	25.55	0.26	23.6	-5.15	-1.94
Other revenues	0.53	2.49	0.66	3.11	0.05	4.2	-0.61	1.10
Central fiscal expenditures								
	2005 % GDP	2005 structure	2006 % GDP	2006 structure	2007 % GDP	2007 structure	Difference % GDP	Difference in structure
General public services	3.1	11.8	9.8	35.5	9.8	37.9	-0.05	2.39
Defense	1.4	5.3	1.5	5.4	1.4	5.6	-0.06	0.17
Public order	2.3	8.8	2.5	9.0	2.6	9.9	0.06	0.89
Economic activity	3.2	12.2	3.9	14.2	3.8	14.8	-0.13	0.55
Health care	0.7	2.7	0.8	2.9	0.9	3.3	0.06	0.44
Culture and Education	2.6	9.9	2.7	9.7	2.6	10.1	-0.08	0.39
Social welfare	6.5	24.8	6.1	22.1	4.4	17.1	-1.73	-5.07
Transfers to local budgets	6.1	23.3	6.6	23.9	6.5	25.0	-0.14	1.19
<b>Total expenditures</b>	<b>26.2</b>	<b>100.0</b>	<b>27.7</b>	<b>100.0</b>	<b>25.8</b>	<b>100.0</b>	<b>-1.89</b>	

Source: Law "On State budget for the year 2006", Draft law "On State Budget for the year 2007" (submitted by CMU 15<sup>th</sup> of September 2006)