Child-Focused PFM Monitoring: Observations for January-September 2010

This report is a monthly PFM update for UNICEF Ukraine. It is part of on-going technical support which FISCO is providing to UNICEF in the area of public finance during 2010, to facilitate more effective redistribution of resources to enhance children's wellbeing and protect their rights.

Key features:

- Highlights of macroeconomic performance, emphasising the increased inflation rate and the fact that the real GDP growth in the second quarter of 2010 is registered in comparisons to very low base, both in year-over-year comparisons (with the bottom of recession in 2009) and with the first quarter of 2010, when the GDP was still falling;
- Baseline revenue comparisons which reveal continued underperformance of most taxes. A striking feature of this month was dramatic fall in receipts of the Value Added Tax, since in August the Government refunded more VAT than it has collected, and as a result the overall cumulative amount of VAT collected to the budget during the year actually decrease;
- Comparisons of real expenditures to spending in same period of last year, which show that overall spending is growing given the increased social payments and transfers throughout the year, while investment-intensive programmes remain far below 2009 levels.

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Acronyms and Abbreviations

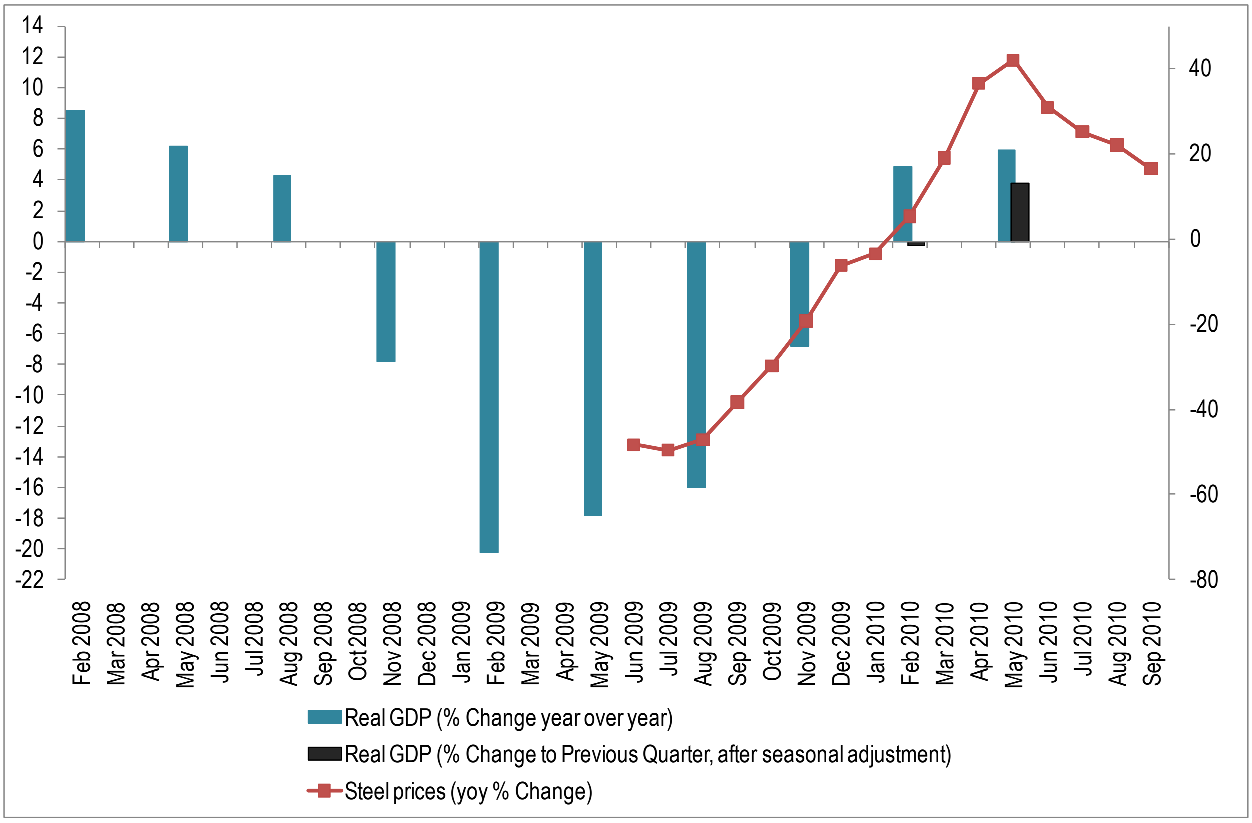
CMU	Cabinet of Ministers of Ukraine
CPI	Consumer Price Index
EPT	Enterprise Profits Tax
GDP	Gross Domestic Product
IMF	International Monetary Fund
MEFP	Memorandum of Economic and Financial Policies
PFM	Public Financial Management
PIT	Personal Income Tax
PM	Prime Minister
SDR	Special Drawing Rights
TIC	Trade and Investment Council
UAH	Ukrainian Hryvnia
UNICEF	United Nations Children's Fund
USD	United States Dollar
VAT	Value Added Tax
VPM	Vice Prime Minister
VR	Verkhovna Rada
WTO	World Trade Organization

Budget results through August 2010

Macroeconomic developments (some highlights)

In the second quarter of 2010, Ukraine's real GDP grew, but compared to a low base in both last year and in previous quarter). Official statistics on Ukraine's GDP performance released by the Government showed that Ukraine's real GDP continued to grow in the second quarter of 2010 over same period of last year (by 5.9%), and also increased by 3.8% compared to the previous quarter, after seasonal adjustment[i] (see Figure 1). However, as shown in the Figure 1, this growth is registered in comparison to the 2009 months when the recession had bottomed, and to the previous quarter when the GDP was still continuing to fall. It is also notable that these results take place at the background of almost a year of consecutive growth in global steel prices (which strongly influence Ukraine's economy and have historically boosted export-oriented sectors). Moreover, later developments in terms of external trade throughout 2010 were less favourable, although official statistics on GDP performance in these quarters is not yet available.

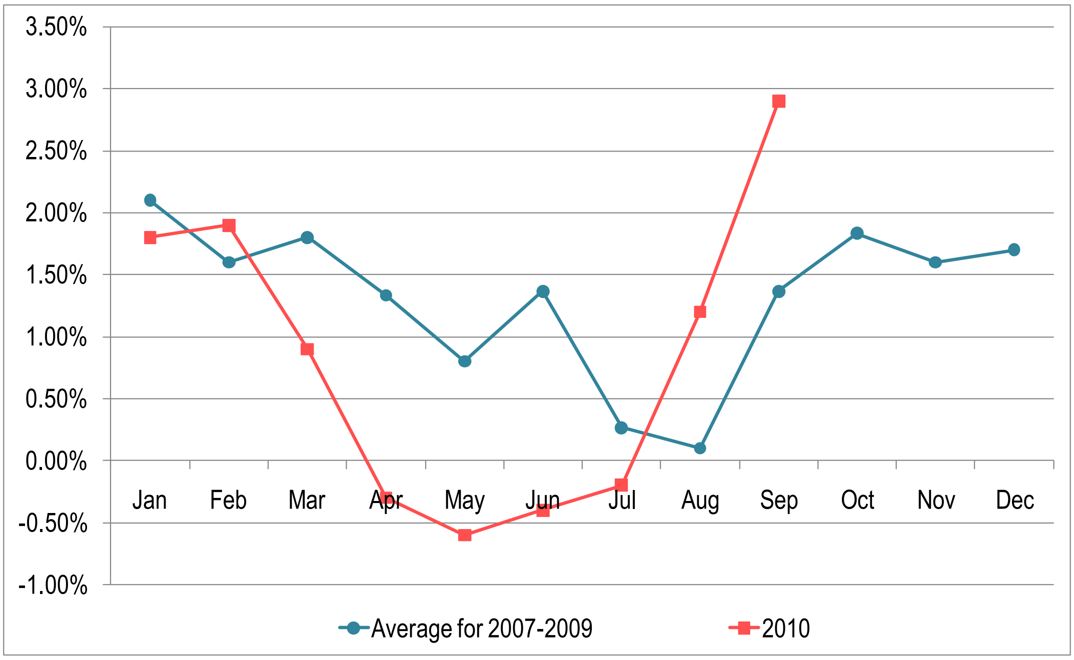
Figure 1. Ukraine's Real GDP and International Steel Prices



Consumer inflation accelerated to levels above historical seasonal averages. During August and September 2010, consumer inflation accelerated to levels significantly higher, in monthly comparisons, than in respective periods throughout 2007-2009 (see Figure 2). As noted by SigmaBleyzer, in part this was explained by growing world food prices, natural gas tariff increases[ii] and domestic supply shortages (1). Growing inflation was mentioned as a problematic aspect in the President's comments on macroeconomic situation, although the President assured that the CPI growth will ultimately be insignificant (2).

[i] Source: State Statistics Committee of Ukraine.
[ii] Discussed in detail in earlier reports, in particular in (27)

Figure 2. Monthly CPI Change: 2010 compared to 2007-2009 Average



Consolidated budget receipts

Total revenues are falling in real terms compared to last year and underperform compared to period baseline projections. Overall total revenues of consolidated budget (general and special funds combined) in January-August 2010 were 1.31% lower in real terms than in respective period of last year (see Table 1). Moreover, consolidated receipts were also almost 4% below baseline projections for the period[iii], as illustrated in the same Table.

Table 1. Consolidated Revenue Execution in January-August 2010 (UAH Millions)

		Comparisons to plan		Comparisons to baseline		Comparisons to same period of 2009	
	Nominal actual revenues in Jan-Aug 2010	Annual plan (for Jan-Dec 2010)	Actual revenues as % of annual plan	Baseline projection (Jan-Aug 2010)	% Difference of actual over baseline	Nominal actual revenues in Jan-Aug 2009	% Change in real terms
Total Revenues	**189,628.58**	**313,897.42**	**60.41%**	**197,216.43**	**-3.85%**	**175,971.03**	**-1.31%**
Value Added Tax	47,870.59	88,292.50	54.22%	58,165.40	-17.70%	52,985.98	-17.15%
Personal Income Tax	31,699.54	51,656.22	61.37%	33,086.07	-4.19%	28,522.65	1.88%
Enterprise Profit Tax	24,923.08	40,490.39	61.55%	24,793.41	0.52%	21,199.10	7.54%
Excise Taxes	17,889.52	30,366.00	58.91%	18,995.42	-5.82%	12,675.95	29.70%
Land Tax	6,245.78	10,054.67	62.12%	6,465.57	-3.40%	5,447.40	5.09%
Import Duty	5,026.84	8,290.00	60.64%	5,439.08	-7.58%	3,968.89	16.00%

Source: Treasury Budget Exectuion Report.

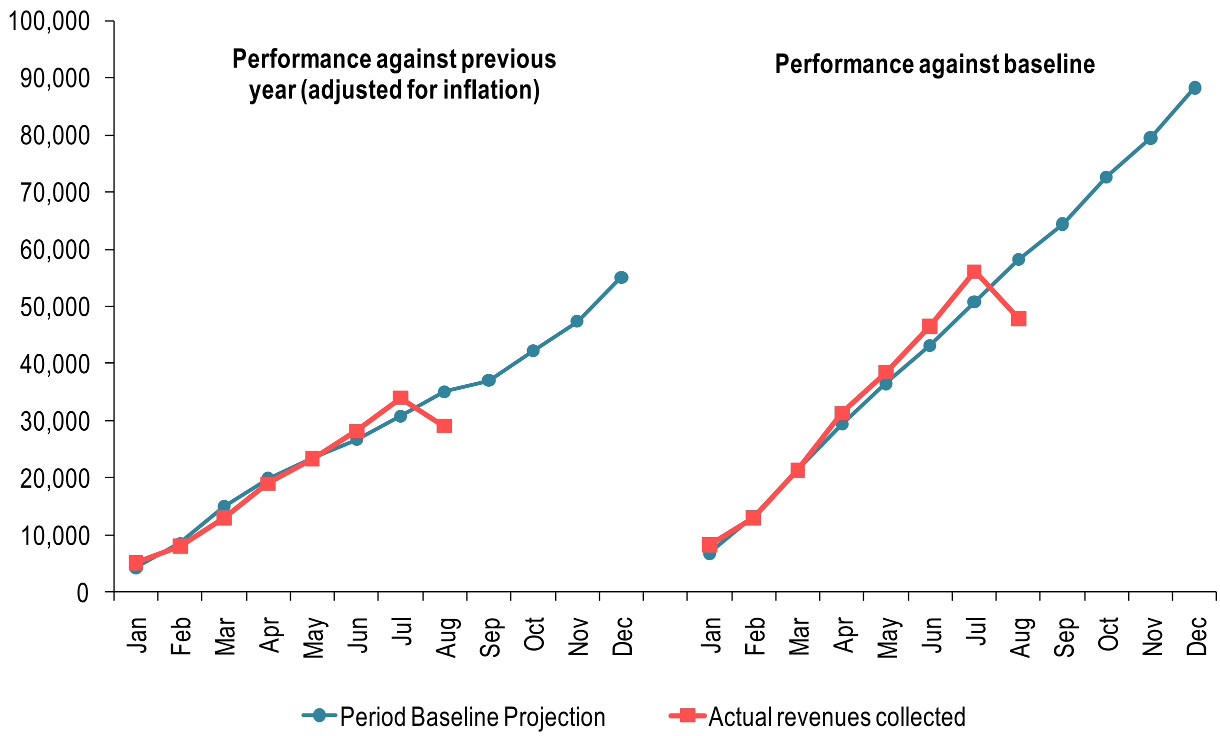
[iii] As explained in technical footnotes and in the detailed section in previous monthly updates [(1)], comparisons of revenue collections to period baselines in this text operate with period projections calculated by FISCO id, given that official revenue baselines – the “budget rozpys” – has been persistently restricted from public access. In the absence of rozpys, percentages of execution of annual plans are relatively poor indicators since they do not take into account various cyclical patterns such as tax collection schedules or seasonal fluctuations.

In August, the Government had refunded higher amounts of VAT than it collected. VAT performance was the most striking aspect of budget execution in August. As shown in Table 1, overall collection of this tax fell dramatically during this one month, taking cumulative VAT result for January-August to become more than 17% lower than in the same period of 2009 (in real terms), and almost 18% lower than baseline projection for the period. The fact that this development occurred during August is illustrated by Figure 3. It shows that in August specifically collections were both lower than last year for the first time since January, and also lower than planned. But it also shows that – as a result of developments in August – overall cumulative amount of VAT collected to the budget during the year actually decreased: in other words, the Government received less of VAT during that month than it had refunded.

A ceiling on VAT refund arrears is one of the conditions for access to the agreed IMF stand-by loan, but some analysts question whether current reduction of arrears is credible and sufficient. A ceiling on VAT refund arrears for the remainder of 2010 was a specific commitment signed by the Government as a condition to a SDR10 billion (about USD 15.15 billion) agreed with the IMF in July 2010 (within the Fiscal Policy reform agenda of the MEFP [(3)]). Under the MEFP, the Government committed to "ensuring the payment of all VAT refunds accruing in the remainder of the year in full & on time and not accumulate any arrears during 2010" (with an operational ceiling at UAH 2 billion), which would be one of the prerequisites for release of further tranches of the loan. At the end of September, the Government stated that it actively pursues this goal, including via decreasing VAT refund arrears by UAH 15 billion during September only (no information was released on repayments during August) [(4)]. However:

- **Unofficial statistics on existing refunds quoted by the media indicate that the overall amount of arrears is still growing:** according to Dzerkalo Tyzhnya, it reached UAH 40 billion by end of August, with more than half of this amount being not eligible for restructuring with newly introduced VAT T-Bills; and forecasted to grow to UAH 50 billion by end of this year [(5)]. Current levels of VAT refund arrears were also assessed as "problematic" and "representing a risk to execution of the 2010 budget" by Ukraine's Accounting Chamber in mid-September [(6)].
- **Procedures for selection of enterprises eligible to actual refund are not transparent.** Some of the quoted analysis claims that actually refunded amounts represent about a quarter of existing liabilities, leading to highly opaque selection of eligible enterprises [(5)].

Figure 3. Value Added Tax Performance during 2010 (UAH Millions)



VAT performance seems to be overrated by varying numbers of annual VAT plan in State Treasury Reports. Annual forecasts of collections of each tax are part of the annual Budget Law voted and approved by the Parliament. During 2010, this part of the 2010 Budget Law was amended several times, in particular within the Budget Sequestration in July attempting to acknowledge for underperformance of some revenues including VAT, whose forecast was decreased (in response to the IMF requirement prior to agreement of the stand-by loan). The figures of annual VAT plan are featured in the Budget Law and quoted in each monthly budget execution report generated by the State Treasure. It is notable, however, that throughout 2010 the VAT annual plan figures quoted in the Treasury reports (and thus used in official estimates of annual plan execution) have varied significantly between months, including those when the Budget Law was not amended. Moreover, each monthly report by the Treasury has decreased the quoted annual VAT plan, including by a strikingly high amount in August 2010: although the most recent voted change was approved by Parliament in July (at UAH 105 billion), Treasury report for August is based on an annual plan figure of UAH 88 billion (down by almost 16%) (see Table 2). Unfortunately, this inconsistency in official quotes of the annual revenue plans is also affecting the calculation of period baseline projections within this report, since our methodology is based on revenue plans reported in official Treasury reports – which means that our baselines are also changing and decreasing. However, even with these understated annual plan figures, VAT performance is still visibly poor.

Table 2. Annual Revenue Plans Quoted in the Monthly Budget Execution Reports by the State Treasury

	May '10	Jun '10	Jul '10	Aug '10	% difference between August and July
Total	**311,448,852,068**	**342,170,009,432**	**329,446,571,489**	**313,897,415,140**	**-4.72%**
PIT	33,725,764,938	51,487,892,849	51,542,360,842	51,656,215,420	0.22%
EPT	40,739,351,718	40,903,539,534	40,454,227,771	40,490,385,585	0.09%
VAT	119,034,191,300	117,684,191,300	104,735,191,300	88,292,502,300	-15.70%
Excise on domestic goods	25,610,789,600	25,992,000,000	25,992,000,000	25,992,000,000	0.00%
Excise on imported goods	4,359,000,000	4,359,000,000	4,374,000,000	4,374,000,000	0.00%
Land tax	6,422,059,358	9,970,964,117	10,014,271,693	10,054,671,516	0.40%
Import duty	8,290,000,000	8,290,000,000	8,290,000,000	8,290,000,000	0.00%

Most other taxes are also behind schedule, apart from EPT whose collections are in line with baseline[iv]. As shown in Table 1, cumulative receipts for January-August from most of the key taxes were below period baselines, even though they are higher than last year in real terms. In particular, PIT revenues were 4.19% below period projection (though 1.88% higher than in 2009), Excises – by 5.82% (even though considerably – 29.7% - higher than last year because of increased rates), Land Tax – by 3.4%, and Import duties – by 7.58%.

Import duties grow compared to last year, although Ukraine's trade partners suspect that customs value of imported goods is often overstated with the help of opaque procedures. Import duties have been an exceptionally buoyant revenue source in 2010, growing by 16% in real terms in January-September compared to same period of last year (even though they remained below period projection). However, this growth is registered at the background of complains from Ukraine's major trade partners over opaque procedures for defining customs value of imported goods, which – they claim – results in significantly overvalued amounts of chargeable import duties. In particular, this concern was voiced by the US delegation to the third meeting of the Trade and Investment Council (TIC), established by the United States-Ukraine Trade and Investment Cooperation Agreement, held on 13 October 2010. The US delegation leader, Deputy United States Trade Representative Miriam Sapiro, stated that while

[iv] More detailed analysis of the extraordinary resilience of EPT in 2010 was provided in the previous monthly update, page 4 [31]. In particular, it drew attention to the fact that throughout this year EPT was collected above its historical seasonal baselines specifically in the months when the tax is officially due, which seems to indicate that in these specific months the government exerted, ad hoc, extra administrative effort to collect this tax.

Ukraine had decreased customs tariffs after acceding WTO, it had also started to use lack of clear regulatory procedures to raise the customs value of imported goods by extreme amounts, nullifying the initial tariff decrease. In one quoted example, one US pharmaceutical company found that the customs value of the anti-cancer medications was increased from $16 to hundreds of dollars, leading to a 1600% increase, without transparent explanation [7].

Consolidated budget spending

Real cumulative expenditures remain higher than last year, given the increased social payments and transfers to Pension Fund throughout 2010. August had brought almost no change to the pattern of expenditure results accumulated during the previous months. Budget expenditures over January-August 2010 remained at a considerably higher level compared to same period of last year (by 10.71% in real terms), mostly due to the growing transfers to cover Pension Fund deficit coupled with increasing public wages and social assistance payments, hiking in May and June. As illustrated in Table 3, real cumulative spending on Social Protection in the first seven months of 2010 remains 33.52% higher than in 2009. Because of the growth in public wages above inflation rate, expenditures in Healthcare and Education were also higher than last year (by 8.62% and 6.10%, respectively).

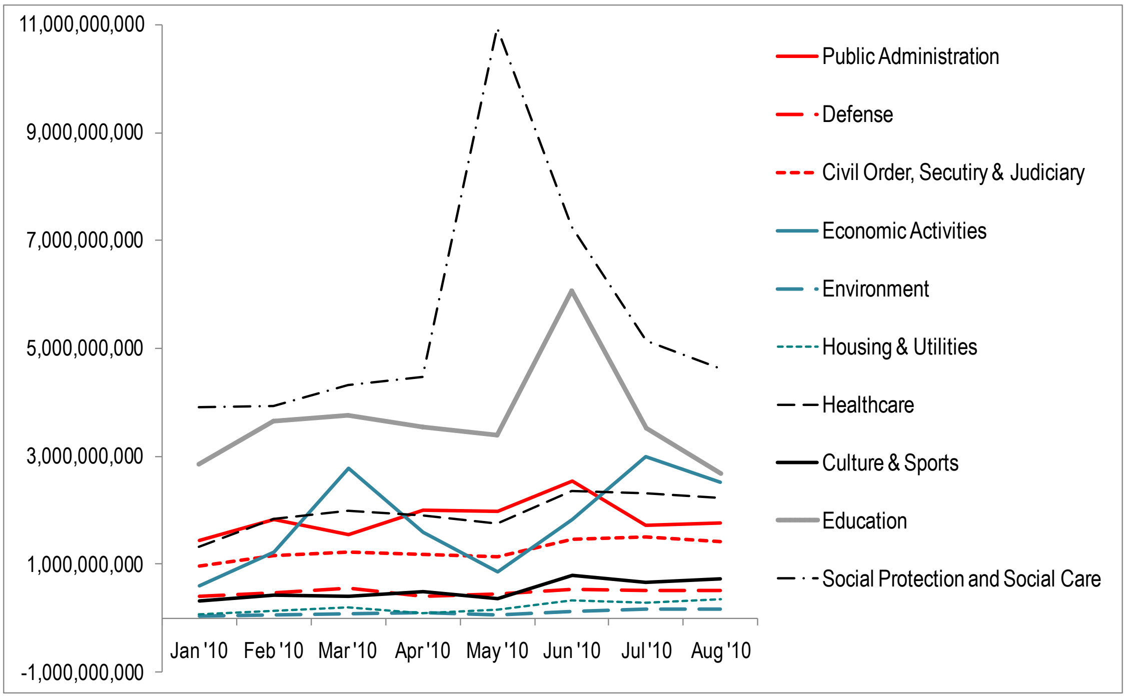
Investment-intensive spenidng continues to be much lower than in 2009. Unlike current spending items, investment-intensive programmes were funded at consistently lower rates in 2010 compared to same period of last year. Over January-August 2010, real expenditures on Economic Activities, Housing and Utilities, and Environment decreased in real terms compared to same period of 2009 by 16.57%, 39.99%, and 5.03%, respectively. Figure 4 illustrates that monthly expenditures on Economic Activities had a cyclical pattern over the year, and were higher in June and July compared to earlier months. These monthly increases in Economic Activities programme were explained by higher spending on Agriculture and on Roads. But, as already mentioned, despite these monthly fluctuations, overall cumulative spending on these programmes remains lower than last year (in real terms).

Table 3. Consolidated Expenditure Execution in January-August 2010 (UAH Millions)

		Comparisons to plan		Comparisons to same period of 2009	
	Nominal actual expenditures in Jan-Aug 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-Aug 2009	% Change in real terms
Total Expenditures	**230,322.94**	**390,546.17**	**58.97%**	**190,798.24**	**10.71%**
Public Administration	24,497.91	50,490.47	48.52%	19,199.41	17.23%
Defence	6,359.04	12,239.14	51.96%	5,843.18	-0.10%
Civil Order, Security & Judiciary	16,628.70	27,549.57	60.36%	15,206.42	0.39%
Economic Activities	23,776.42	45,017.46	52.82%	26,063.17	-16.57%
Environment Protection	1,249.26	6,770.98	18.45%	1,212.56	-5.03%
Housing and Utilities	2,681.15	5,270.29	50.87%	4,109.92	-39.99%
Healthcare	25,992.92	43,557.21	59.68%	21,941.81	8.62%
Culture and Sports	6,931.92	11,371.15	60.96%	4,676.73	36.10%
Education	48,600.05	79,843.75	60.87%	41,988.96	6.10%
Social Protection & Social Care	73,605.57	108,436.14	67.88%	50,556.09	33.52%

Source: Treasury Budget Exectuion Report.

Figure 4. Monthly real expenditures on key functions in consolidated budget in January-August 2010 (UAH)



The (poor) rate of performance of Environment expenditures is explained, in part, by a two-fold increase of the annual plan figure in the Treasury Report for August. As in the case of revenues, the amounts of annual expenditure plans quoted in the monthly Treasury reports for individual functions was not stable throughout the year. But while variations in these figures was not significant for most functions, one of the lines – annual plan for Environment Protection – was increased twofold between July and August, from UAH 3.4 billion to UAH 6.8 billion (see Table 4). As a result of this increase of quoted annual plan, the official rate of execution of the annual plan for Environment is the poorest across all functions (18.45% over 8 months of the year, as shown in Table 3). The reason and the implications of this statistical issue are not clear.

Table 4. Annual Expenditure Plans Quoted in the Monthly Budget Execution Reports by the State Treasury

	Jun '10	Jul '10	Aug '10	% difference between August and July
Total Expenditures	**400,335,991,350**	**385,115,398,315**	**390,546,168,594**	**1.41%**
Public Administration	65,566,382,638	53,107,934,648	50,490,474,909	-4.93%
Defence	13,728,670,174	12,181,865,155	12,239,144,347	0.47%
Civil Order, Security and Judiciary	27,220,212,045	27,141,975,272	27,549,568,986	1.50%
Economic Activities	41,455,150,546	43,107,892,676	45,017,460,083	4.43%
Environment Protection	3,240,318,729	3,379,176,909	6,770,980,346	100.37%
Housing and Utilities	4,890,148,343	5,090,260,742	5,270,294,493	3.54%
HealthCare	43,170,348,933	42,789,324,843	43,557,206,064	1.79%
Culture and Sports	10,288,006,484	11,123,012,620	11,371,154,560	2.23%
Education	79,317,855,291	79,265,875,503	79,843,749,503	0.73%
Social Protection and Social Care	111,458,898,167	107,928,079,946	108,436,135,304	0.47%

Key PFM-related policy initiatives

Development of a Tax Code

Key principles of the current draft Tax Code were presented by PM Azarov, but the actual document is not yet publicly presented. As we described in the previous updates, throughout the summer the Government repeatedly attempted to finalise development of a draft Tax Code (8) (9). Parliamentary consideration of a draft Tax Code on 17 June raised acute public debates since the voted edition appeared extremely draconian and significantly different from earlier officially submitted Governmental draft. Consequent attempts to incorporate numerous critical comments and amendments were complicated by lack of clarity about the policy process and the composition of the team involved. In early September, PM Azarov had announced the key principles of the new Draft Tax Code, although the actual text was not yet presented for public debates. Given the lack of certainty over the ultimate content of the document, it is not yet analysed in detail in this report.

Pension Reform still in the making

Proposals on Pension Reform were not yet submitted or clearly presented. Considerable reformation of the Pension system was among explicit commitments taken by the Government within the Fiscal Policy reform agenda of the MEFP (3) agreed with the IMF, with key legislation to be submitted for Parliamentary consideration by end of September (the details of this commitment discussed in the previous update (10)). During September, the legislation was not either submitted or presented for public discussion, but VPM Tigipko shared some of the plans on next steps for this reform, such as introduction of a second pillar of the pension system in 2012. Given the lack of certainty over the ultimate content of this reform package, it is not yet analysed in detail in this report.

2011 Budget

Aligning the 2011 Budget with new Tax Code: in time and in substance

The Budget Code does not allow to amend legislation which affects next year's revenues after 15 August. According to Ukraine's Budget Code, the Cabinet of Ministers should submit a draft budget for the next year for Parliamentary consideration by the 15 September (Article 37-2) (8). Moreover, the currently effective Budget Code requires that all new legislation which affects budget revenues or expenditures should be made public by 15 August of the year before the one on which the budget is being developed (Article 27-3) (8). While the Budget Code was amended in July 2010 with changes to be effective next year, this article was preserved and strengthened: and will require that such legislation is approved by 15 July (Article 27-3) (9).

With parliamentary support, the Government intends to base the 2011 Budget on new, not yet approved or clearly communicated, tax legislation – which will delay submission of the draft Budget to the Parliament. In early September the CMU stated that it is working on the draft 2011 Budget and plans to align it with the new Tax Code (10). Initially (on 6 September), parliamentary opinion – voiced by the Speaker V. Lytvyn – was that it was hardly feasible given that approving the Tax Code would take much longer time than is available for submitting the draft Budget (11). However, when the CMU did submit a draft 2011 Budget to the VR on the 13 September, the Speaker decided to return it back to CMU without registering it for consideration in the committees, with a requirement that the new Tax Code does have to be incorporated. The arguments given by the Speaker included (11):

- that this decision is in line with the view of the President;
- that this decision is in line with the view of the Council of Regions held on 9 September 2010;
- that the Parliament decided in July to send the Tax Code to public debate;
- that the Parliament had discussed the Tax Code on 7 September, with the conclusion that it has to influence the next year's budget.

As a result, by end of September the 2011 Draft Budget was not yet available.

National Programme for Social and Economic Development for 2011

The annual Programme of Social and Economic Development is not yet released. The country's annual programme for social and economic development is traditionally presented by the Government for Parliamentary approval as part of the package submitted along with the draft budget for the next year. Given the delayed schedule of the budget process this year, the document has not yet been released. On 15 September the CMU considered a draft Programme for Social and Economic Development for 2011 (12), but no document was approved.

Other relevant developments

Preparing for the IMF Quarterly Review

In November, the IMF will conduct the first quarterly review of Ukraine's progress against agreed reform programme in order to decide upon release of the next tranche of the stand-by loan. As discussed in detail in the previous monthly update (10), in July this year the IMF approved a decision to allocate SDR10 billion (about USD 15.15 billion) loan to support Ukraine's economic adjustment and reform programme. In response, the Government agreed to a series of reform objectives, including a list of "prior actions" which were implemented in July, before the agreement was approved. Access to these funds will be phased into ten tranches: while the initial amount of SDR 1.25 bln was available to Ukrainian Government upon Board's approval of the arrangement, the nine subsequent tranches will equal SDR 8.75 billion and are contingent upon completion of quarterly reviews, starting from November 2010.

In September the Government stated that it remains committed and optimistic about reform agenda, although concrete steps are still uncertain. Throughout September, the Government made several statements on its progress and plans with regard to the upcoming review, emphasising that it remains committed to the signed agreement and hopes that the review in November will be favourable. In particular, it emphasises progress in repayment of VAT refund arrears (4). However, as was explained in previous sections of this update, concrete plans on many of the agreed measures (such as Pension Reform or sustainable resolution of the problem with the VAT refund arrears) remain to be uncertain.

World Bank Country Economic Memorandum

A newly released country analysis by the WB was focused on strategic importance of major fiscal and structural reforms. At the end of September, the World Bank presented its new Country Economic Memorandum (CEM) for Ukraine (16), a periodic in-depth study of the progress, drivers and barriers in the economic development of the country. The 2010 CEM was titled "Strategic Choices to Accelerate and Sustain Growth in Ukraine", and focused on reasons why Ukraine has systemically underperformed in the recent decades compared to its potential, and how this could change. The analysis concluded that unleashing the growth potential will not be possible without deep fiscal and structural reforms. In particular, these should include:

- Significant fiscal reforms to ensure macroeconomic stability, return of investors, and repayment of VAT refund arrears to revitalise the export sector, and to create fiscal space for investing into appropriate state infrastructure for private sector development;
- Fundamental changes in the investment climate and business environment, removing barriers for new businesses, strengthening competition and helping to diversify exports;
- In-depth reforms in the public administration, aimed at changing the relations between the state and the taxpayers, including judiciary reforms and streamlining state bureaucracy.

The report emphasised that Ukraine's response to these challenges represents a long-term strategic choice "between a low-growth, muddle-through scenario and a scenario of rapid modernization, turning Ukraine into a powerhouse in Eastern Europe."

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