Child-Focused PFM Monitoring: Observations for January-November 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:

- Baseline revenue comparisons, which reveal that overall revenues in January-October 2010 were about 3% below schedule, with most taxes continuing to significantly underperform (the poorest performer being still VAT, which was 10.5% below baseline projection and 7.5% lower than last year, in real terms);
- Analysis of collection patterns of EPT, which confirm that the tax is likely to have benefited from ad-hoc administrative pressures, but that its buoyancy has been recently deteriorating. Overview of statements by the STA which show that some of the biggest non-payers of EPT are big enterprises in metal, chemical production, energy generation and water supply, construction, and financial services, while the biggest current contributors are businesses in food and agricultural processing, tobacco producers and oil extraction industry;
- 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;
- Analysis of resulting difficulties with balancing Ukraine's consolidated budget;
- Overview of the results of the IMF quarterly mission to review Ukraine's progress against reform measures in the agreed Stand-By Arrangement, which highlights the still conditional nature of the mission's conclusions and the need for Ukraine to comply with a list of prior measures before the 2nd tranche of the loan will become available.

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Acronyms and Abbreviations

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

Budget results through October 2010

Consolidated budget deficit and financing

General budget's deficit was in the focus of policy discussions throughout November as the Government hosted the IMF monitoring mission attending Ukraine with the Quarterly Review under the Loan Agreement with the view to decide on the release of the second tranche at SDR1 billion (around USD 1,6 billion) (1). Keeping annual consolidated deficit within 5.5% in 2010 is one of the core conditions agreed within the IMF stand-by support programme. General government balance, defined by the IMF as including central government, local governments and social funds, at a level below 5.5% of GDP for 2010, was one of the core benchmarks accepted 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 (1)). In particular, as a prior action for the stand-by agreement, the Government approved a supplementary budget which reduced annual target for general government deficit (not including Naftogaz) to 5.14% of GDP. Maintaining the deficit within this annual target is therefore critical for accessing further tranches of the loan.

Although quarterly figure for deficit as %of GDP is available for Q2 only (5.39%), nominal deficit expanded considerably since the time, as revenue and expenditure trends remain unchanged. Based on publicly available data, it is impossible to say what is the current level of Ukraine's deficit as a % of GDP, since GDP data for the third quarter will be released at the end of December, and the IMF's mission report based on Government's internal statistics was not yet publicly released (although some media claimed that had access to leaked copies). The latest available figure for deficit as % of GDP remains to be only the one for the 2nd Quarter of 2010 (5.39%). Since that time, trends in revenues and expenditures did not change, and the cumulative nominal consolidated deficit continued to increase, as illustrated in Figure 1. Overall deficit of the consolidated budget in January-October 2010 reached UAH 48.2 billion (see Table 1); the State / Central budget deficit (whose annual figures are approved within the annual budget law) for the same period was UAH 56,6 billion.

Statements from the Government acknowledge growing problems with the deficit. The Ministry of Finance acknowledged that cumulative deficit of the central budget for the first ten months of 2010 exceeded the annual plan for the whole year by 4.6% (2). Moreover, as Figure 1 also illustrates, cumulative deficit has increased at a faster rate in the recent months than was observed in respective months of 2009. At the same time, preliminary figures of GDP growth point at signs of deceleration in the rate of recovery: based on the preliminary data for the 3rd quarter on the SSC's website, real GDP growth was 3.5% over last year, compared to 5.9% in the 1st Quarter. In his statements around the IMF visit, PM Azarov admitted that the Government had revised the expected annual deficit figure - allegedly, up from 4.5% to 5.5%, - so it would still remain within the agreed target.

Table 1. Consolidated Budget Totals through September 2010

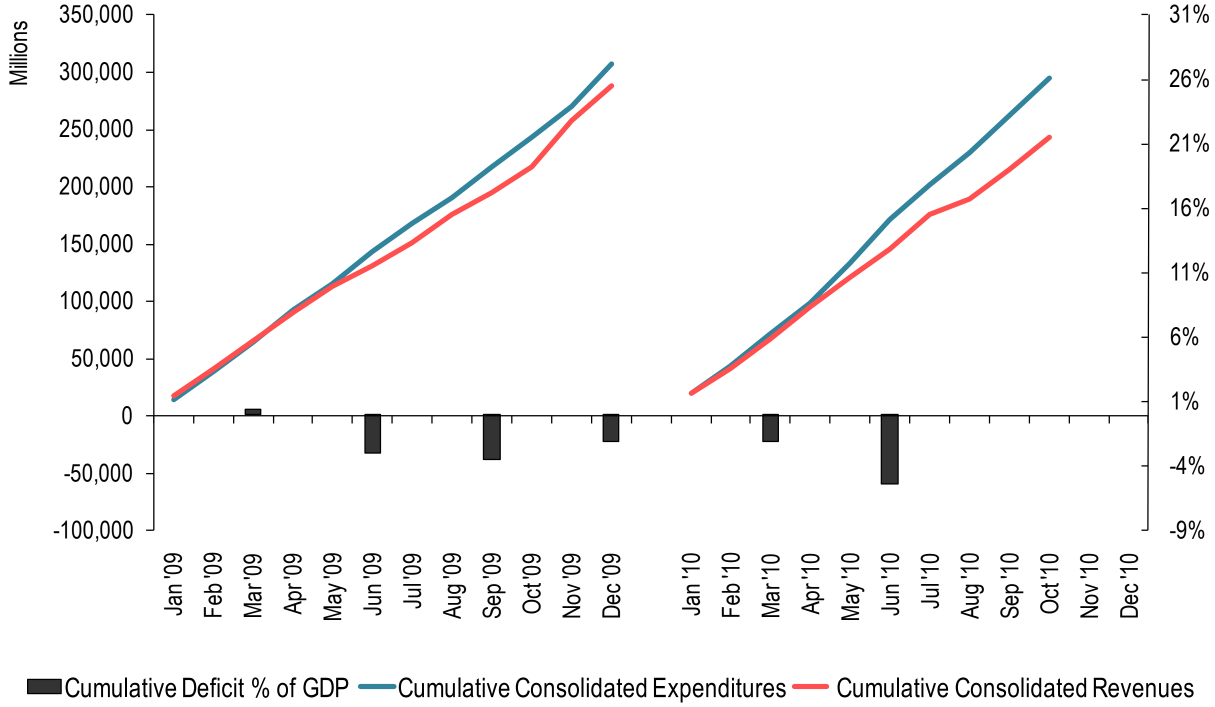
	Annual budget plan*	Actual budget totals	
	2010	2010	2009
Latest monthly comparisons		Jan-Oct 2010	Jan-Oct 2009
Expenditures	397,822,267,810	250,999,933,632	268,248,574,131
Revenues	318,536,519,881	202,767,837,525	247,552,724,817
Deficit	-79,285,747,929	-48,232,096,108	-20,695,849,314
% of GDP**	-7.32%	n/a	n/a
Latest quarterly comparisons		Q2 2010	Q2 2009
% of GDP		-5.39%	-3.04%

* Based on the latest Treasury Report

** Annual consolidated budget plan based on latest Treasury Report; GDP forecast based on IMF projection in Country Report No. 10/262

State Treasury budget execution reports continue to be based on changing annual plan totals, which is difficult to explain and interpret. It also remains disturbing that the official Treasury reports contain revenue and expenditure totals which are presented against changed numbers of annual plan, as compared to the 2010 Budget Law figures, taking into account amendments voted during the year. The annual plan figures in the Treasury report currently presume annual deficit at the level of about 7.32% of GDP (up from 7.19% based on the report of the previous month and different from 5.14% in the actual budget voted in July). The nature and implications of these discrepancies are difficult to explain, although lower figures of annual revenue plans obviously improve reported indicators of current revenue performance.

Figure 1. Consolidated Budget Totals through October 2010



Source: State Treasury of Ukraine; calculations by FISCO id

The IMF staff-level agreement over release of the second tranche of the stand-by loan remains conditional on prior actions, which some sources believe include the sales of Ukrtelecom to cover the deficit by end of year. As we discuss in detail in respective section, the IMF's decision on the 2nd tranche was agreed at staff-level, but actual release of funds remains conditional on the Government's progress in implementing a list of prior actions, whose list is not publicly released at the moment [3]. PM Azarov stated to the media, that discussions with the IMF on the prospects for maintaining the agreed deficit target for 2010 were difficult and included a possibility of expenditure sequestration, which the Government managed to rebut. However, he said the alternative agreed plan was privatisation of Ukrtelecom by end of year (at around UAH 11-12 Billion), which should be sufficient to cover the emerging budget gap and avoid sequestration [4]. Media sources who claim to have access to the text of the staff-level agreement report that another option unsuccessfully proposed by the Government at the negotiations was a new release of VAT-bonds to continue restructuring of the defaulted liabilities on VAT refunds in the amount of around UAH 10 Billion [5], [6]. At the very least, the IMF's public press release regarding the November mission's findings stated that the new Tax Code is not expected to generate additional revenues during 2010-2011, so it could not be viewed as a source of potential coverage for the currently developing deficit [3].

Consolidated budget receipts

Revenues continue to fall behind schedule, with most taxes underperforming, VAT falling even in comparison to 2009, and EPT overexecution potential exhausted. The trends in revenue execution have been almost identical to those observed during the previous month. Total consolidated revenues collected during January-October 2010 were somewhat higher in real terms than last year (by 2.29%), but remained below period baselines (by 2.73%), as shown in Table 2. As in previous months, the most dramatic decline is still in the most significant tax – VAT, which is both severely behind the schedule (by 10.49%) and much lower than last year in real terms (by 7.48%). All other taxes also underperform, albeit at less dramatic scale (and with a rather thin-stretched exception of EPT which was just in line with our period projections, although its monthly collection patterns were on the downward trend, as discussed further).

Table 2. Consolidated Revenue Execution in January-October 2010 (UAH Millions)

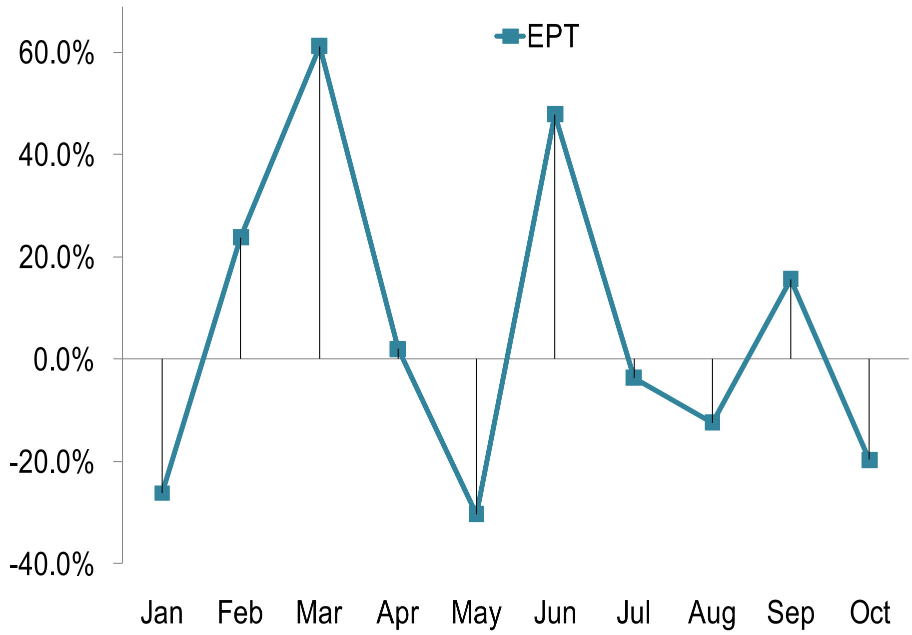
		Comparisons to plan		Comparisons to baseline		Comparisons to same period of 2009	
	Nominal actual revenues in Jan-Oct 2010	Annual plan (for Jan-Dec 2010)	Actual revenues as % of annual plan	Baseline projection (Jan-Oct 2010)	% Difference of actual over baseline	Nominal actual revenues in Jan-Oct 2009	% Change in real terms
Total Revenues	**243,548.34**	**318,536.52**	**76.46%**	**250,391.84**	**-2.73%**	**217,403.20**	**2.29%**
Value Added Tax	65,004.34	88,292.50	73.62%	72,620.64	-10.49%	64,091.42	-7.48%
Personal Income Tax	40,642.24	52,130.24	77.96%	42,248.33	-3.80%	35,991.52	3.24%
Enterprise Profit Tax	29,398.83	40,462.99	72.66%	29,381.70	0.06%	26,024.74	3.29%
Excise Taxes	23,085.30	30,404.29	75.93%	24,793.78	-6.89%	17,041.83	24.21%
Land Tax	7,848.40	10,118.92	77.56%	8,277.37	-5.18%	6,886.61	4.24%
Import Duty	6,709.04	8,290.00	80.93%	6,897.06	-2.73%	5,194.42	17.95%

Source: Treasury Budget Exectuion Report.

EPT collection continue to raise concerns about the possibility of applying ad hoc administrative measures to extract reveneus from businesses. October continued to confirm an alarming pattern in collection of the EPT which we have first noted in the July update: namely, that it tends to exceed monthly period baseline projections (adjusted for seasonality and other historical monthly variations) by extraordinary amounts exactly once in a quarter when the EPT returns are due, as illustrated in in Figure 2. As we wrote earlier, in theory the quarterly cycle of EPT collection should not affect the pattern of overperformance represented by the % difference over period baselines: the period baseline projects are specifically calculated to take into account specific cyclical patterns of each tax. In other words, if EPT were overperforming because of factors such as economic growth or overall improvement in administrative procedures, changes in monthly percentage of overexecution should have been distributed evenly across all months. The fact that EPT was collected above its historical seasonal baselines specifically in the months when the tax is officially due seems to indicate that in these specific months the government exerted, ad hoc, extra administrative effort to collect this tax. Unfortunately, these calculations are supported by quotes of complains from businesses in the media, which claim that they face various administrative measures directed at extracting additional taxes, such as, e.g., refusal of the state tax authorities to accept tax return with low tax liabilities (5). Moreover, multiple sources refer to evidence of significant amounts of advance payments of taxes and fees have already accumulated on the government's accounts, reaching UAH 14.5 billion by end of September (7), (8).

STA revealed that EPT is already below targets and will underperform by UAH 4.7 billion, with biggest non-payers being energy distribution companies, metal and chemical producers, and best performing payments from agricultural, food and tobacco processing industries. Moreover, October confirmed that despite the exceptional resilience of EPT throughout 2010 (it was the only tax whose cumulative collection managed to remain above baseline projections), overall trend in the behaviour of this tax is also alarmingly downward, and extra revenues raised each quarter tend to diminish, as illustrated in Figure 2. On 18 November, declining EPT was recognised by the State Tax Administration in an official letter on the matter, submitted to PM Azarov, projecting that by the end of year EPT is likely to underperform by UAH 4.7 Billion, and explaining that based on the Government's own baseline projections for January-October, cumulative EPT collections were actually UAH 1.7 Billion below schedule (which makes our own calculations relatively more optimistic) [9]. In this letter, STA Head Mr. O.Papaika listed specific sectors and state-owned enterprises whose EPT payments were decreasing, asking the PM to influence the management of these enterprises via respective line ministries. The sectors include: mail and communication; financial services; energy generation and distribution; machine building; construction; chemical and metal producers; oil refineries; as well as light industries. The STA is especially concerned about falling revenues from metal producers and oil refineries, given that their output increased by 50% recently with the economic recovery. On top of this, it refers to significant decreases in EPT payments from major state monopolists such as Ukraine's Naftogas, National Nuclear Energy Company "Energoatom", and National Joint Stock Company "Ukraine's Energy Company". It also reports almost complete avoidance of any EPT payments by the Ukrtelecom. On the other hand, the biggest current EPT payers are businesses in agricultural processing, food processing, tobacco producers, and oil extraction.

Figure 2. Difference of monthly actual collections of EPT over period baselines in January-October 2010 (%)



Consolidated budget spending

Real cumulative expenditures remain higher than last year, given the increased social payments and transfers to Pension Fund throughout 2010. October was the fourth month is a raw which brought no change to the previously accumulated pattern of expenditure results. Budget expenditures over January-October 2010 remained at a considerably higher level compared to same period of last year (by 10.58% 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. Because of the growth in public wages above inflation rate, expenditures in Healthcare and Education were also higher than last year (by 11.13% and 7.77%, respectively).

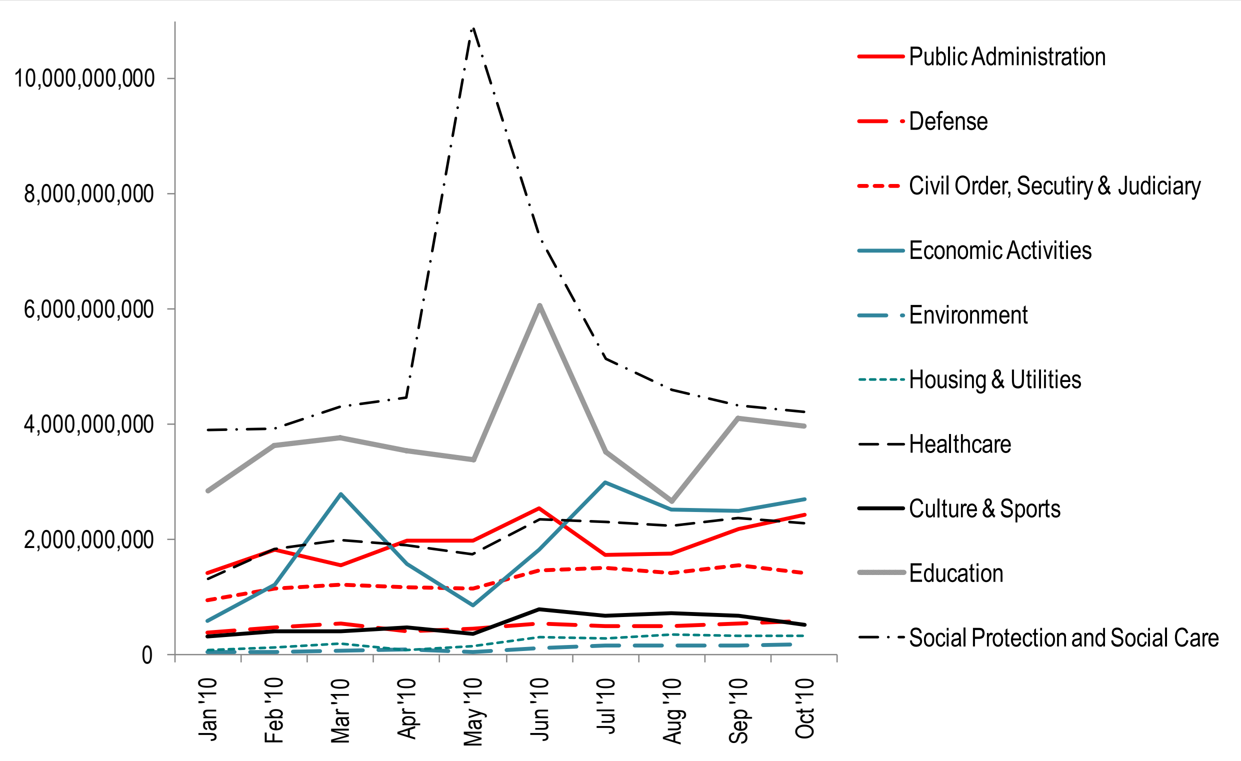
Investment-intensive spenidng continues to be much lower than in 2009. Unlike current spending items, investment-intensive programmes were funded at consistently lower rates in 2010 compared to same period of last year. Over January-October 2010, real expenditures on Economic Activities, Housing and Utilities, and Environment decreased in real terms compared to same period of 2009 by 8.59%, 39.13%, and 4.04%, respectively. Figure 3 illustrates that monthly real amounts of spending on key functions continued the trends of the previous months without exception.

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

		Comparisons to plan		Comparisons to same period of 2009	
	Nominal actual expenditures in Jan-Oct 2010	Annual plan (for Jan-Dec 2010)	Actual expenditures as % of annual plan	Nominal actual expenditures in Jan-Oct 2009	% Change in real terms
Total Expenditures	**294,600.15**	**397,822.27**	**74.05%**	**243,720.99**	**10.58%**
Public Administration	32,435.04	46,705.83	69.45%	25,381.51	17.04%
Defence	8,322.10	12,665.14	65.71%	7,629.72	-0.16%
Civil Order, Security & Judiciary	21,724.77	28,615.32	75.92%	19,486.13	2.01%
Economic Activities	32,724.88	49,330.03	66.34%	32,594.65	-8.59%
Environment Protection	1,833.65	6,903.77	26.56%	1,751.76	-4.04%
Housing and Utilities	3,828.11	8,060.28	47.49%	5,760.06	-39.13%
Healthcare	33,981.05	44,025.11	77.19%	27,948.45	11.13%
Culture and Sports	9,021.48	11,811.51	76.38%	6,412.00	28.96%
Education	62,462.70	81,206.08	76.92%	52,985.26	7.77%
Social Protection & Social Care	88,266.36	108,499.21	81.35%	63,771.46	26.84%

Source: Treasury Budget Exectuion Report.

Figure 3. Monthly real expenditures on key functions in consolidated budget in January-October 2010 (UAH)



IMF Quarterly Review for 2nd Tranche of the Stand-By Arrangement

Background

On 28 July 2010, Ukraine entered into a Stand-By Arrangement (SBA) with the IMF over a loan available in a total size of SDR10 billion (about USD 15.15 billion at the time of agreement) to support Ukraine's economic adjustment and reform programme. The loan is available in ten tranches: one was received immediately after the agreement was approved, and others would be phased in nine subsequent tranches upon completion of quarterly reviews, starting from November 2010 (see Table 4). The initial agreement was described in a package of materials including a Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding (1), which outlined key measures to be reviewed by quarterly missions and open access to further tranches of the loan (described in detail in our PFM update for January-August 2010 (10).

Table 4. IMF Stand-By Agreement: Proposed Access and Phasing of the Loan

			Percent of quota	
Availability	Date 1/	SDR mn	Purchase	Cumulative
2010	July (approval)	1,250.0	91.1	91.1
	November	1,000.0	72.9	164.0
2011	March	1,000.0	72.9	236.9
	June	1,000.0	72.9	309.8
	September	1,000.0	72.9	382.7
	December	1,000.0	72.9	455.5
2012	March	1,000.0	72.9	528.4
	June	1,000.0	72.9	601.3
	September	1,000.0	72.9	674.2
	December	750.0	54.7	728.9
	Total	10,000.0	728.9	728.9

Source: IMF, CMU (1)

The first quarterly monitoring mission visited Ukraine during 3-15 November to discuss progress over agreed reforms with Ukrainian authorities. The mission reached a staff-level agreement with Ukraine's Government on the conclusion of the first review, outlining a list of prior actions which will have to be undertaken by Ukraine for the funds to be released. The Executive Board of the Fund will consider Ukraine's "Letter of Intent" after these prior actions are completed, which is expected by the end of this year.

Details of the IMF's findings with regard to Ukraine's progress against reform objectives were described in an updated Memorandum, which is not yet publicly available, although some media sources claim to have access to a leaked copy, described below (6). The IMF made only one official statement via a press-release, which acknowledges that:

- Performance under the SBA has been broadly in line with program objectives. All end-September quantitative performance criteria were met and steady progress was made on structural reforms;
- The government remains committed to fiscal consolidation aiming to bring public debt down over the medium term. This includes the following expected measures:
  - General government deficit at 3.5% of GDP in 2011 (achieved via streamlined expenditures, since the new Tax Code is expected to be "revenue neutral";
  - Reforms in the energy sector which already in 2011 will allow Naftogaz to balance its finances;
  - Reforms to strengthen the finances of the pension system; and
  - Public administration reforms.

Based on the statements of Ukraine's top officials, the negotiations have focused on several key issues, described below, and cantered on difficulties with the current budget execution, including difficulties in balancing the financial position of Ukraine's Naftogas and Pension Fund.

Issues related to budget balancing

As already discussed, the key open question is whether Ukraine's budget deficit is sustainable and could be maintained within the agreed 5.5% target, especially given considerable quasi-fiscal deficits in the energy sector. Based on the IMF's press-release, if Ukraine does comply with its commitments through the outlined prior measures, one USD billion out of the new tranche could be spent on budget support. Based on the statements in the press, particular issues included:

- Ukraine's consideration of the possibility of another round of restructuring Government's defaulted liabilities on VAT refunds via issuing of VAT bonds: which, allegedly, was not supported by the IMF; and Ukraine's request to release the current benchmark on (zero) VAT refunds by end of year (increasing it by UAH 2 billion).
- The possibility of budget sequestration, which as not supported by Ukraine;
- The second 50% increase in gas prices to households to be undertaken in April 2011; followed by half-yearly further increases in tariffs;
- Legal action on Pension reform to be undertaken by end of year and implemented by 1 January 2011. Government states that the IMF insisted on increased pension age for women but, allegedly, acknowledged the importance of alternative measures such as introduction of individual savings accounts.
- Discussion over the newly approved Tax Code, which was assessed by the IMF as revenue neutral (not leading to increases in Budget revenues in 2010 or 2011).

Key PFM-related policy initiatives

Tax Code Approved

Detailed coverage of this theme will be provided in a separate material.

Pension Reform: status still unclear

At the background of negotiations with the IMF which focused closely on plans for Pension Reform, several initiatives were announced and discussed, but without actual measures implemented into practice:

- Active promotion by the Government of information about the growing deficit of the Pension Fund, presumably in preparation to unpopular measures. In particular, the VPM Tigipko announced a projection about the possibility of the Pension Fund's deficit reaching UAH 50 billion this year, and then, in middle November, PM Azarov stated that Pension Fund's deficit increased to UAH 60 billion [(11)]. One of the official exchanges presented by the media included a public reprimand from President Yanukovych towards PM Azarov for allegedly concealing from the public actual problems with the Pension Fund Budget [(12)].

- At the same time, a 1.8 times increase in the Pension Fund's deficit was registered by Ukraine's Accounting Chamber, which estimated its size at UAH 25,3 billion [(13)]. According to the Accounting Chamber, the Pension Fund currently relies on pension insurance contributions only by 72.5%, with the rest covered by the state budget.

- Statements by the Government about its intentions to avoid increases in the pension age for women requested by the IMF through an alternative policy of urgent introduction of individual pension savings accounts.

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