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Ukraine Special Focus Note: Fiscal Reforms for Stability and Growth

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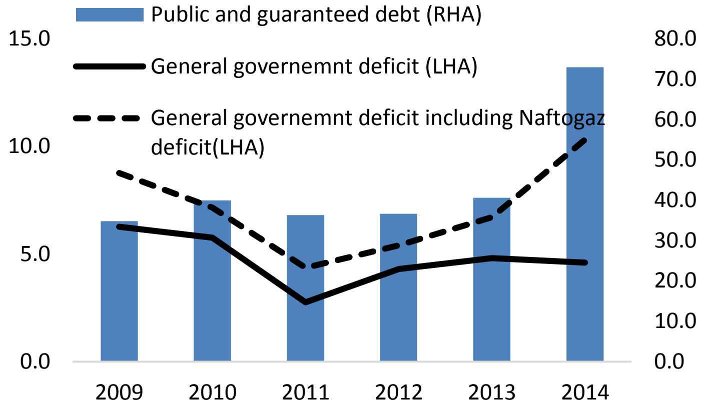
- ***Ukraine's public finances remain under pressure due to large accumulated imbalances which are compounded by the economic contraction.***
- ***A credible deficit reduction strategy is needed to complete the ongoing macroeconomic adjustment, to stabilize and then gradually reduce public debt, rebuild investor confidence and restore Ukraine's access to international capital markets.***
- ***The need for budget discipline has to be balanced with reforms to create fiscal space for targeted investments in critical infrastructure and public services to support the weak real sector, spur employment, protect the vulnerable and lay the foundation for future growth.***

Why fiscal reforms are needed?

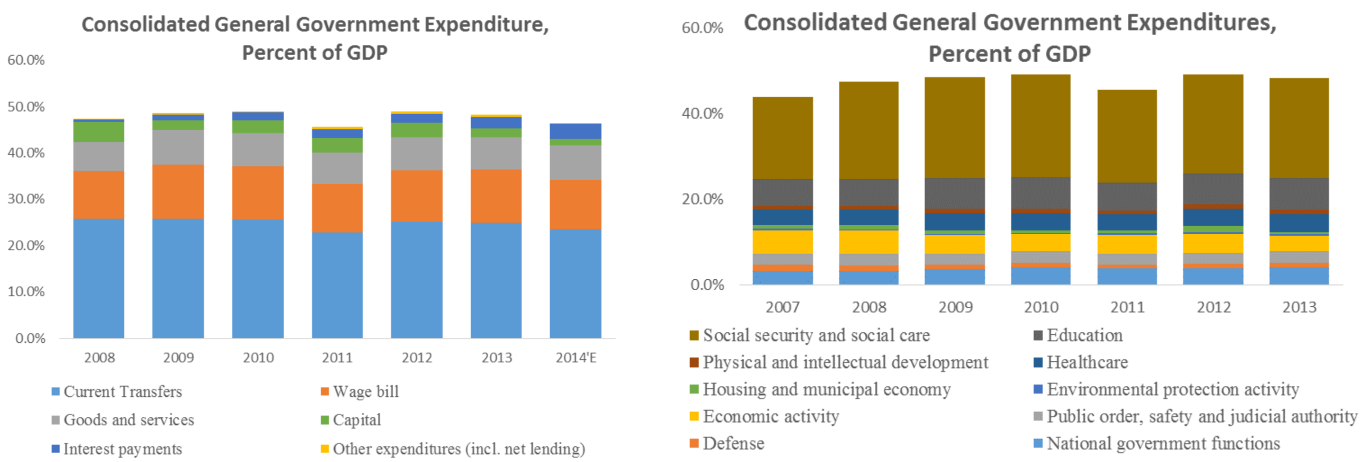
Restoring sustainable public finances is a key challenge for Ukraine. Ukraine has been running general government deficits over the last 20 years. The fiscal position deteriorated considerably since 2009 as a consequence of the financial crises and remained elevated over the last 5 years. Despite fiscal tightening in 2014, the fiscal deficit remained high at 4.6 percent of GDP due to weak revenue collection, increased security spending and the Naftogaz deficit. Additional financing needs to recapitalize the domestic gas utility company (Naftogaz) brought the overall consolidated fiscal deficit (including Naftogaz) to 10.1 percent of GDP in 2014. Banking sector capitalization added 1.9 percent of GDP to these fiscal financing needs. Currency depreciation, accumulated fiscal imbalances, large quasi-fiscal losses of Naftogaz, and bank recapitalization needs have led to a rapid expansion of public and publicly guaranteed debt, which exceeded 70 percent of GDP in 2014 (up from 40.6 percent of GDP a year ago – see Figure 1).

Figure 1 Large Deficits and Rising Public Debt



Source: World Bank Staff calculations based on official data.

Figure 2: Large Budget Footprint, Dominated by Government Consumption and Transfers



Source: World Bank Staff calculations based on official data.

Moreover, public spending in Ukraine is high and skewed towards government consumption, social transfers and subsidies that crowd out government investment. Ukraine is taxing and spending more than countries at similar levels of income and in the region. At 48.5 percent of GDP in 2013 general government expenditures are about 7 percentage points higher than the regional average and about 9 percentage points above countries with similar per capita income. The composition of public expenditures is dominated by current expenditures, crowding out government investment. Social expenditures absorb a large and growing share of available resources. Spending on social benefits including, most importantly, pensions, expanded from an already high 19.6 percent of GDP in 2007 to 23.4 percent in 2013. This increase was driven both by increasing benefits (many of which are indexed to wages) and larger number of beneficiaries which is rising due to demographic developments. Despite falling student numbers, expenditures on education also increased from 6.2 percent of GDP in 2007 to 7.2 percent of GDP in 2013, mainly due to increases in teacher salaries. Health care expenditures also increased, albeit from a relatively low 3.7 percent of GDP in 2007 to 4.2 percent of GDP in 2013. Wage increases pushed up spending on the public sector wage bill from 10.1 percent of GDP in 2007 to about 11.5 percent in 2013. Interest payments have also picked up reaching 2.5 percent of GDP in 2013 driven by greater debt issuances during the crisis period. On the other hand, capital spending contracted most sharply over the same period, down from 5.4 percent of GDP in 2007 to 2 percent of GDP in 2013.

The resulting size and structure of the tax burden undercut the business environment and competitiveness of the economy and encourage widespread informal activity. Ukraine's tax system is based on consumption and income taxes and payroll contributions, which make up 31.1 percent and 18.2 percent of 2014 consolidated general government revenues, respectively. The standard VAT rate is 20 percent and the profit tax rate is 18 percent. Personal income tax is levied at two tax brackets with 15 percent and 17 percent applied to wage income, profits of self-employed and capital income accruing to individuals. In addition, social security contributions, accounting for 28.6 percent of consolidated general government revenues, are levied with top marginal rates at above 50 percent. As such, Ukraine has some of the highest marginal tax rates on labor (especially high payroll taxes to finance social security spending and pensions). Yet, tax collections are undermined by narrow tax bases that are eroded by exemptions, low compliance and loopholes that have allowed widespread tax avoidance and evasion.

A fiscal reform agenda

Addressing fiscal challenges will require comprehensive and deep fiscal reforms. Reforms should aim to balance the budget and gradually, but durably, reduce the size of the government whilst ensuring sustainability of public services and social insurance. The brunt of the adjustment will need to fall on expenditures, given the already heavy tax burden. In addition to reducing the overall size of the expenditure envelope, the government needs to create sufficient fiscal space to finance productive investments and its reform program (e.g., pension reform, public sector modernization), and this must be carried out within a consistent macroeconomic framework. To achieve this, the government should change the consumption (and current transfers) orientation of its budget, which is hampering future growth, and move towards more productive and efficient spending, with emphasis on needed investments. Short-term expenditure retrenchment may be achieved through spending freezes and across-the-board cuts of discretionary spending (goods and services and capital), but these measures should be temporary and replaced with more targeted cuts and efficiency gains. Building on recent fiscal consolidation measures, this would require:

- Reductions of subsidies, starting with most inefficient ones on energy, agriculture, and coal;
- Comprehensive reforms of social transfers through full implementation of the new pension reform and better targeted social assistance programs;
- Right-sizing of public administration and public sector wage bill (which also implies deep reforms in service delivery in sectors such as education and health);
- Gradual increase (as it becomes fiscally affordable) of capital spending on priority infrastructure;
- On the revenue side, tax reforms that aim to expand the tax base for major taxes (VAT, CIT and PIT) by reducing tax exemptions and privileges to create space for lowering high marginal rates on direct taxes (which heavily tax labor and capital).

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