

# ICPS newsletter

## Radical Fiscal Reform Will Save Ukraine from Economic Collapse

*The economic crisis in Ukraine was aggravated at the end of 1998 and did not ease up at all in the first quarter of 1999. Experts from the Ministry of Economy of Ukraine made this conclusion during the macroeconomic seminar at the International Centre for Policy Studies on 27 March. Adopting an unrealistic budget led to an increase in debts payable to the budget, shortage of funds to finance government expenditure and a surge in debts by government agencies and organisations payable to non-state economic entities. This situation threatens to undermine state finances over the course of the year. Sequestration of budget expenditure is becoming inevitable. Absence of external lending during the first quarter of 1999 has led to a catastrophic depletion in the National Bank's foreign exchange reserves which makes intervention to support the hryvnia absolutely impossible. Together with the government's destabilised fiscal position, this compromises the hryvnia's stability and poses a threat of debacle on Ukrainian currency.*

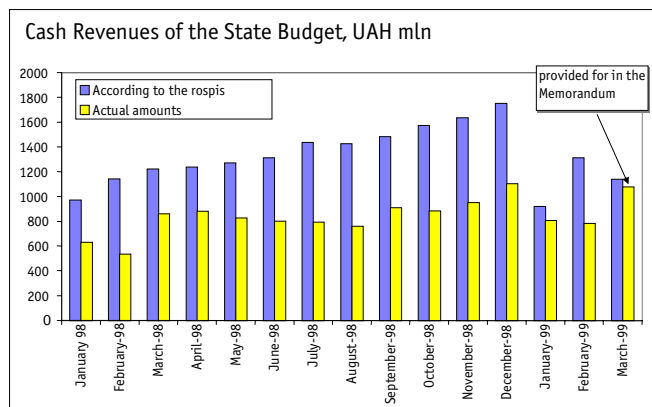
*In order to revive the Ukrainian economy, radical tax reform must be implemented. There must be a substantial cut in the level of taxes which entrepreneurs are unable to pay. This step will not induce a sharp decline in budget revenues and increased fiscal deficit because it will pull a large share of the Ukrainian economy out of the shadow, considers member of the Supreme Rada Mr. Hennady Balashov.*

### Ministry of Economy Reports on the Results of the First Quarter

The Ukrainian economy is still suffering from the consequences of the autumn crisis, which resulted in sharp increases in prices for raw materials and commodities, credit shortages and increased interest rates, and a drop in the demand for domestically produced goods. These developments caused Ukraine's GDP to fall in real terms by 4.2% during January-February 1999 compared with the same period of 1998. Production output decreased 2.1% YOY during the same period.

During the first two months of 1999, Ukraine's nominal GDP was UAH 16 billion. This figure allows for forecasting nominal GDP for the entire first quarter at UAH 25 billion, as presented by experts of the Ministry of Economy of Ukraine Tamara Lebedeva and Ivanna Nevidomska.

The first two months of 1999 saw a decline in output in all branches of the Ukrainian economy, with few exceptions being the energy sector and woodworking industry. The biggest fall in output was recorded in the chemical and petrochemical industry at 16.7% YOY to the same period of 1998, construction materials manufacturing industry at 11%, and machine-building and metalworking industry at 8%.



The rate of growth in consumer prices fell in December. Considering the consequences of the financial crisis, this indicator can be judged satisfactory. In January-February

### Last Week

#### Young Economists Inquire into the Ukrainian Banking System.

The second stage of the Young Economists Contest "Economic Reforms in Ukraine: Attitude of the Youth" saw the discussion of the young researchers' projects on the subject "Development of the Banking System". This stage of the Contest took place from 31 March to 2 April. The Contest is cosponsored by the National Bank of Ukraine, Taras Shevchenko University and the International Centre for Policy Studies.

16 young economists participated in the Contest at this stage. First prize went to Olexiy Kutsenko for his research work "Provisions of Commercial Banks". The winner will be awarded an internship abroad. Second prize was divided between Ihor Doroshenko ("Commercial Banks' Operations with Credit Cards: Perspectives of Development in Ukraine") and Andriy Dudnik ("Analysis of the Contemporary Financial Crisis"). These economists were awarded UAH 1,000 each. The UAH 1,000 prize went to Lubov

Ledomaska and Alexander Naumenko for their joint research "Alternative Approach to Determining and Forming Provisions of a Commercial Bank".

The winners in two remaining nominations within the second stage of the Contest will be announced later. For further information contact Andriy Kaminsky, ICPS project coordinator (AKaminsky@icps.kiev.ua).

## ***This Week***

**The Ukrainian Economy in the Year of the Presidential Elections.** The following macroeconomic seminar at the International Centre for Policy Studies on 6 April will be devoted to discussion of the subject "Presidential Elections: Possible Consequences for the Economy in 1999 and 2000". The speakers will be ICPS Publications Director Hlib Vyshlinsky, Head of the Quarterly Predictions team Serhiy Ilchuk, and Director of the Institute for Politics Mykola Tomenko.

The following questions will be discussed:

1. Two scenarios of economic policy before the presidential elections: underlying measures of optimistic and pessimistic scenarios.
2. Impact of government activities under these two scenarios on different sectors of the Ukrainian economy: state budget, monetary system, balance of payments, business, investments, privatisation, stock market, agriculture, labour market, and households.
3. Probability of each scenario under the current political situation.

If you would like to participate in the seminar, contact Larisa Romanenko (LRomanenko@icps.kiev.ua). Number of participants is limited.

## ***Next Week***

**How to Conduct Tax Reform?** The macroeconomic seminar at the International Centre for Policy Studies on 13 April will be devoted to the subject "Tax Reform Process". The speaker will be Richard Laliberte, Chief of Party Fiscal Reform Project, Barents Group.

Questions for discussion:

1. Factors for success.
2. Obstacles of tax reform.
3. Strategy for tax reform.
4. Measurement of progress.

1999, the consumer price index rose by 2.5%. Wholesale prices increased by 1.9% during the same period. During the next 2-3 months, changes in consumer prices will be determined by the increase in tariffs for public utilities and seasonal growth in prices for foodstuffs. The arrested monetary expansion is likely to counteract the above mentioned inflationary factors.

Budget revenues continued to decline in real terms. A substantial increase in revenues from value added tax, which accounted for 1/3 of the whole amount of state revenues in January-February (and 1/2 of cash revenues), saved the situation from collapse. According to preliminary data, the Ukrainian consolidated budget received UAH 3.552 billion in revenues, or 10.4% of the annual amount. Compared to the corresponding period of the previous year, nominal budget revenues grew by UAH 226 million, or 6.8%. Revenues were down by 11% in real terms.

Despite the nominal growth in budget revenues, it is already possible to forecast the shortfall in revenues amounting to UAH 3 billion in FY 1999. The issue of sequestering budget expenditures has already arisen.

The government's ability to finance current expenses is limited not only by low state income, but also by a large portion of fiscal revenues going to extra-budgetary funds. In January-February, the share of these funds constituted 20% and 6% of revenues from the central and local budgets correspondingly.

Unrealistic approved amounts of budget revenue lead to an accumulation of budget indebtedness. Wage arrears grew by UAH 36 million in January-February.

The Ukrainian government has developed a set of economic measures to regain control over the situation. The first set of government measures encompasses the period of April-July 1999.

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## **MP Hennady Balashov Proposes Radical Steps**

In order to overcome the current crisis, fast and bold reforms in the fiscal system need to be implemented. The main theme of these measures should be to decrease the tax burden on economic agents to 10% of GDP. Member of the Supreme Rada Mr. Hennady Balashov expressed this idea.

Mr. Balashov emphasised that the Ukrainian government does not control the economy. Most entrepreneurs are shutting down their activity in the formal economy. According to Mr. Balashov, there is a ration of 1:3 between Ukraine's formal and informal economies. If the official nominal GDP of Ukraine is about UAH 100 billion, then "shadow" GDP reaches UAH 300 billion. Thus Ukraine's total GDP is UAH 400 billion.

The tax reform proposed by Mr. Balashov envisages sharp tax cuts for enterprises and individuals. He proposes to implement 10% tax on profits and individual income.

This reform, according to Mr. Balashov, will encourage a large share of entrepreneurs who are currently working in the shadow economy to return to the formal economy. These entrepreneurs will start paying taxes, which will protect the government's fiscal position from catastrophic deterioration.

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*Macroeconomic seminar at the International Centre for Policy Studies "First Quarter of 1999 s Macroeconomic Review. Lessons and Expectations", 30 March 1999*

*Speakers: Tamara Lebedeva, Head of the Main Department of Macroeconomic Forecasting of the Ministry of Economy of Ukraine, Ivana Nevidomska, Head of the Department of Updated Monitoring, Main Department of Macroeconomic Forecasting of the Ministry of Economy of Ukraine and Hennady Balashov, Member of the Supreme Rada*

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The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the development process of Ukrainian policy. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of policy. Director of ICPS Vira Naniivska. Address: 8/5 Voloska Street, 254070, Kyiv, Ukraine Phone (38044) 462 4937/38/58 Fax (38044) 463 5970 E-mail Office@icps.kiev.ua