



Tax Revenue Outlook for Ukraine

- The revenues from enterprise profits and personal income taxes are overestimated by the government in 2006. The additional to the planned consolidated fiscal deficit is significant and forecasted at UAH 2.6 bn (0.5% of GDP).
- In 2006, the enterprise profit tax (EPT) revenues will be UAH 1.9 bn below the government target, totaling UAH 23.4 bn.
- The value added tax (VAT) revenues for 2006 will continue to rise; and will be close to the government plan amounting to UAH 41.0 bn.
- Personal income tax (PIT) revenues in 2006 are expected to reach UAH 20.6 bn, or UAH 0.7 bn below the government plan.
- The EPT revenues, for 2007 will reach UAH 30.5 bn (5.0% of GDP).
- The VAT revenues will amount UAH 51.3 bn in 2006 (8.4% of GDP) due to high imports growth.
- The PIT revenues are forecast to reach UAH 24.3 bn (4.0% of GDP) in 2007.

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Forecast Period:
2006 and 2007

Forecast Variables:
EPT, VAT and PIT revenues

In this issue of TRO, we present forecast and budget for the VAT and EPT not taking into account clearing operation that nets compensation of Oschadbank deposits, tax arrears of utility sector, and non-payments of population. The fiscal plan of the State budget from 20.12.2005 with amendments from 16.03.2006 is taken into account.

Fiscal indicators 2005:

Consolidated fiscal revenues/GDP: 31.6%
EPT/Consolidated fiscal revenues: 17.3%
VAT/Consolidated fiscal revenues: 25.0%
PIT/Consolidated fiscal revenues: 12.9%
Consolidated fiscal expenditures/GDP: 33.3%
Central fiscal deficit/GDP: 1.8%
Public debt/GDP: 17.7%
GDP: UAH 424.7 bn

EPT forecast: The government overestimates revenues by nearly UAH 1.9 bn

Enterprise profits tax revenues is the second most important source of consolidated fiscal revenues after the VAT. In 2005, the EPT revenues reached UAH 23.2 bn or 5.5% of GDP, accounting for 17% of consolidated fiscal revenues. The EPT execution was above the initial government plan by UAH 1.4 bn (0.3% of GDP). Such a high performance is explained by tax administration strengthening and the tax base broadening via elimination of sector privileges and special economic zones.

In 2006, according to the IER forecast, the EPT revenues will reach UAH 23.4 bn (4.6% of GDP), returning to the 2004 level in terms of the GDP. The October forecast was revised downwards taking into account the higher than previously forecast production price index growth and the negative effect on economic growth by recent gas price shock. The increased gas prices will mostly affect profits of metallurgical and chemical enterprises, which weight in the total profits of profitable industry enterprises was nearly 40% in 2005.

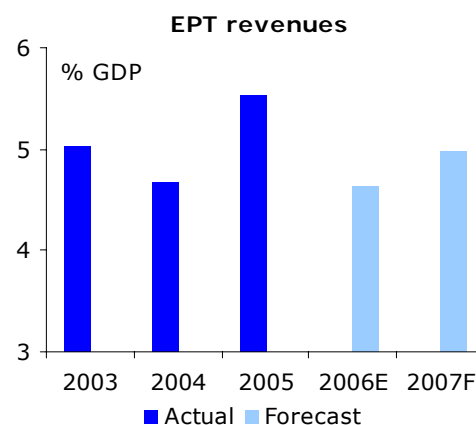
The government plans to get UAH 25.3 bn (5.0% of GDP) from EPT in 2006. The difference between the IER forecast and the government fiscal plan is partially explained by overly optimistic macroeconomic scenario used while drafting State budget figures for 2006: real GDP growth was expected to reach 7%. Thus, according to our forecast, there is a high risk that the revenues from EPT will be underexecuted in 2006 by UAH 1.9 bn (0.4% of GDP).

Our forecast of EPT revenues for 2007 constitutes UAH 30.5 bn or 5.0% of GDP. While forecasting we assume lower real GDP growth rates than the government does. Besides, we do not expect change in legislation.

The risks of the EPT forecast are comprised with further increase in the energy prices and changes in the legislation including reestablishment of the sector privileges and special economic zones.

EPT revenue forecast assumptions:

- The EPT revenue forecast is based on macroeconomic indicators for 2006 and 2007 according to MEFU №1 (9), May 2006.
- The EPT legislation remains unchanged in 2006 and 2007.
- The EPT rate remains at 25%.
- The amount of EPT paid in advance will be small in 2006-2007



Source: State Treasury Reports, IER forecast
E - estimate, F - forecast

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VAT forecast: Revenues in 2006 will total UAH 40.2 bn, which coincides with the government fiscal plan

The value added tax is traditionally the largest tax source of the consolidated fiscal revenues. Currently the VAT rate is set at 20%. In 2005, VAT revenues constituted 25.2% of total consolidated fiscal revenues. The VAT collection on a cash basis was UAH 33.5 bn (7.9% of GDP), which is UAH 1.5 bn above the initial fiscal plan. The boost in fiscal revenues was attributed to two major factors: tax administration and overall macroeconomic trends. In particular, during 2005 VAT collections were enhanced by tax administration strengthening (e.g. "Kontrabanda Stop" campaign). However, the major contribution to the increased VAT revenues is explained by the strong consumption growth caused by the continuous increase in disposable income of population, decline in investment activity (which is credited), and strong import growth in nominal terms. In 2005 the growth rate of imports surpassed the growth rate of exports. This caused increase in the weight of VAT collections from imports in GDP and simultaneous reduction of export-related claims for VAT refund as a share of GDP. Despite these positive for the VAT collection trends, the VAT refund arrears increased from almost nil at the beginning of 2005 to UAH 0.6 bn (0.1% of GDP) at the beginning of 2006.

The IER forecasts that VAT revenues in 2006 will amount to UAH 41.0 bn (8.1% of GDP), which is UAH 7.5 bn higher than in 2005. Thus, we expect that the VAT revenues in relation to GDP will go up. We revised our October forecast for nominal VAT revenues in 2006 upwards in order to take into account the effect of the gas price shock and continuation of macroeconomic trends of 2005 including dominance of imports and favorable consumption outlook. The current VAT forecast also assumes that the privileges for agricultural sector were prolonged till the end of 2006.

The fiscal plan of VAT collection envisaged in the budget-2006 is UAH 41.0 bn. Thus, according to our estimation, the government fiscal target is realistic.

Our forecast of VAT revenues for 2007 is UAH 51.3 bn, which equals to 8.4% of GDP. The driving force for the revenue increase will be robust domestic consumption and continued dominance of imports in foreign trade. Also, we assume the introduction of a 10% VAT rate in the agricultural sector, replacing the present 0% VAT rate.

The risks inherent in the VAT revenue forecasts for 2006 and 2007 are associated with an economic development different from what we now expect. The other risks are comprised with the changes in the legislation, first of all reduction in the tax rate. Also, 10% VAT rate in agriculture may not be introduced in 2007, thus reducing the potential VAT tax base. Finally, there is a risk that VAT refunds are not paid in time in 2006-2007, which would temporarily boost the cash VAT revenue at the expense of future revenues.

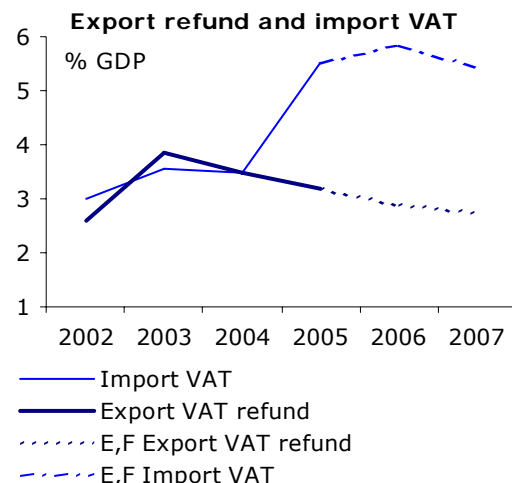
VAT revenue forecast assumptions:

- The VAT revenue forecast is based on macroeconomic indicators for 2006 and 2007 according to MEFU №1 (9), May 2006.
- The VAT rate remains at 20%.
- The measures taken in 2005 to enhance VAT administration on customs will be continued in 2006 and 2007.
- VAT refund arrears are not accumulated in 2006 and 2007.
- A VAT rate at the level of 10% will be introduced in 2007 for the agricultural sector.

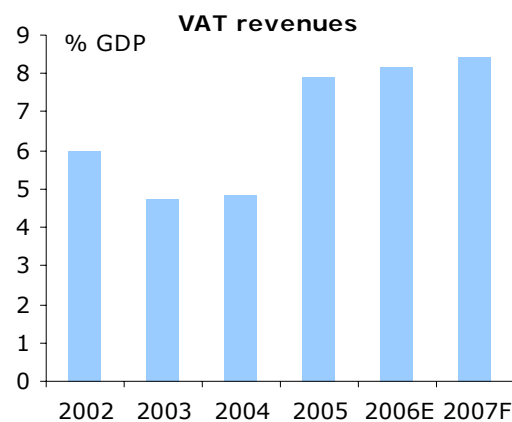
Parameters of EPT and VAT forecast:

	2005	2006E	2007F
GDP, UAH bn	424.7	503.7	613.6
GDP real growth, % yoy	2.6	2.2	3.7
Industrial output growth, % yoy	0.8	0.0	1.5
Household consumption, UAH bn	239.0	294.5	354.7
Exports of goods and services, USD bn	44.4	46.3	52.5
Imports of goods and services, USD bn	43.7	52.9	63.1
CPI inflation, % yoy aop	13.5	12.0	12.0
PPI inflation, % yoy aop	16.8	10.0	17.4

E - estimate, F - forecast
Source: Macroeconomic Forecast Ukraine №1 (9), May 2006, IER



Source: State Treasury, IER forecast, E-estimate, F-forecast



Source: State Treasury Reports, IER forecast
E - estimate, F - forecast



PIT forecast: The government overestimated revenues for 2006

The personal income tax remains the third major revenue source that generates about one fifth of consolidated tax revenues. PIT also brings more than half of local budget revenues (not accounting for transfers) and is streamlined for financing delegated responsibilities of local government, primarily health care and education.

The PIT collections in 2005 reached UAH 17.3 bn (4.1% of GDP) slightly surpassing adjusted government plan by UAH 0.1 bn. The major engine of the PIT collections was sharp phased increase in the minimum wage.

The IER forecasts PIT revenues for 2006 at UAH 20.6 bn (4.1% of GDP). Our previous PIT revenue forecast for 2006 was revised downwards due to lower expected economic growth. We expect that the slowdown in economic growth caused by gas price shock and political uncertainty somewhat suppresses the PIT base that is wage bill. At the same time, in 2006 the minimum wage is to be increased gradually again, which will push gross wages up even at the background of unfavorable economic development.

Our PIT revenues forecast for 2006 is UAH 0.7 bn lower than the government projection. The possible gap in the local budgets revenues should be compensated by the increase in transfers from the Center.

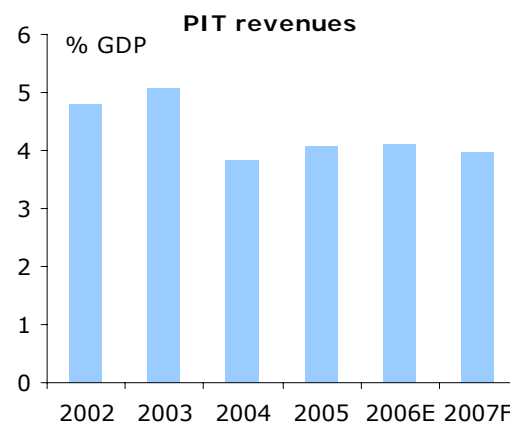
The PIT revenues forecast for 2007 is based on two major legislative preconditions, which have opposite impacts on PIT revenues. On the one hand, starting from 2007 the legislation, which is currently in force, envisages increase in the PIT rate from 13% to 15%. On the other hand, according to the current legislation social privilege for people with earned incomes lower than 1.4 of subsistence minimum will be increased to 100% of the minimum wage in 2007 (UAH 450). In 2006 the amount of social privilege constituted only 50% of minimum wage (UAH 175). As a result, our PIT revenues forecast for 2007 is UAH 24.3 bn (4.0% of GDP).

The risks inherent in the PIT revenue forecasts for 2006 and 2007 are associated with lower than assumed wage growth. In addition, the forecast for 2006 could be challenged if the government introduces a higher minimum wage and subsistence minimum growth than planned before, which will increase the level of the social privilege even further and affects the wage bill.

Parameters of PIT forecast:

	2005	2006	2007F
PIT rate, %	13	13	15
Gross wages, UAH bn	130	150	180
Minimum wage, at the beginning of the year, UAH	262	350	450
Subsistence minimum for persons able to work, UAH	409	483	540
Social Privilege, UAH	131	175	450

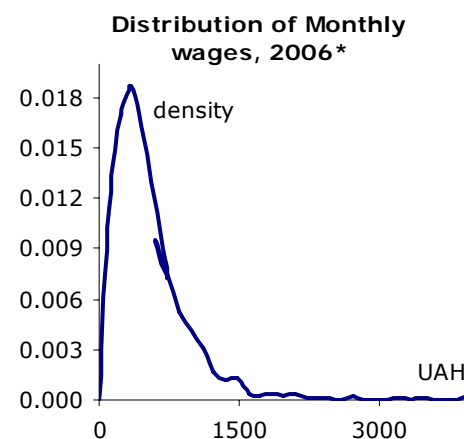
Source: legislation of Ukraine, IER estimates
F - forecast



Source: State Treasury Reports, IER forecast
E - estimate, F - forecast

PIT revenue forecast assumptions:

- The nominal wage bill in the economy in 2006 is equal to UAH 150 bn (a 40% increase as compared to 2004).
- The PIT rate remains flat at the level of 15% starting from January 1, 2007.
- People, whose wages are lower than 1.4 subsistence minimums for persons able to work, are eligible for the social privilege set at 100% of the minimum wage in 2007.
- The minimum wage is expected to be raised to UAH 450 on January 1, 2007.
- The subsistence minimum for individuals able to work will be equal to UAH 540, on January 1, 2007.
- Nominal wage bill will increase by 20% in 2007 and reach UAH 180 bn.
- The distribution of wages remains constant as in 2004.
- Employment levels will remain the same in 2006 and 2007.



Source: Household Survey (Derzhkomstat), wn calculations
* Kernel density function of monthly wage

