

# Tax Revenue Outlook for Ukraine

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- In 2006 the under-execution of enterprise profit tax (EPT) revenues will be compensated by higher value added tax (VAT) revenues. That allows keeping the central fiscal deficit in limits foreseen in budget plan for 2006.
- The EPT revenues will be UAH 1.1 bn below the government target in 2006, totalling UAH 24.4 bn.
- The VAT revenues will continue to rise thanks to higher private consumption and imports, and reach UAH 43.6 bn in 2006.
- Personal income tax (PIT) revenues in 2006 are expected to reach UAH 23.0 bn that exceeds the government plan.
- The government plan of tax revenues for 2007 is realistic.
- The EPT revenues for 2007 are forecast to reach UAH 25.0 bn or 4.2% of GDP, coinciding with the government plan.
- The VAT revenues will continue to rise in 2007 reaching UAH 54.7 bn due to final consumption and imports growth.
- The PIT revenues are forecast to reach UAH 28.8 bn in 2007.

For the comparison of the tax revenues forecast of the Institute for Economic Research, we use the parameters of the State budget law for 2006 and the draft of the State budget law for 2007, submitted to the Verkhovna Rada on 15 September 2006.

## EPT forecast: The government overestimates revenues by nearly UAH 1.1 bn for 2006

Between January and September the government has received UAH 16.3 bn from the EPT that is 87% of projected value for the period. The weight of EPT revenue in GDP has declined to 4.8%, which is lower than in the same period of 2005. It follows the IER forecast concerning the EPT revenues under-execution in 2006. Lower profits of enterprises and, thus, the EPT revenues in 2006 are to the large extent explained by increased gas prices and the continued wages growth backed by administrative rises in minimum wages.

At the same time, the drop in enterprises' profits appeared to be smaller than it was previously expected, first of all due to smaller effect on overall economic growth from the gas price hike. In particular, the profits of metallurgical and chemical enterprises, expected to be the most hampered by the gas price shock, were partially preserved thanks to the growth of world prices on metals and chemical products. That allowed the IER to revise the EPT estimate for 2006 upwards. It is estimated that the nominal revenues from EPT will reach UAH 24.4 bn (4.7% of GDP) in 2006. Thus, likely under-execution of the government plan of the EPT revenues will be at UAH 1.1 bn or 0.2% of GDP, compared to the UAH 1.6 bn under-execution projected in May.

### EPT revenue forecast assumptions:

- The EPT revenue forecast is based on macroeconomic indicators for 2006 and 2007 according to IER Macroeconomic forecast of Ukraine №2 (10), October 2006.
- The EPT legislation remains unchanged in 2006.
- The EPT investment tax credit (ITC) privileges are introduced in the restored SEZ in 2007.
- The world prices for chemical and metal products remain high.
- The EPT rate remains at 25%.

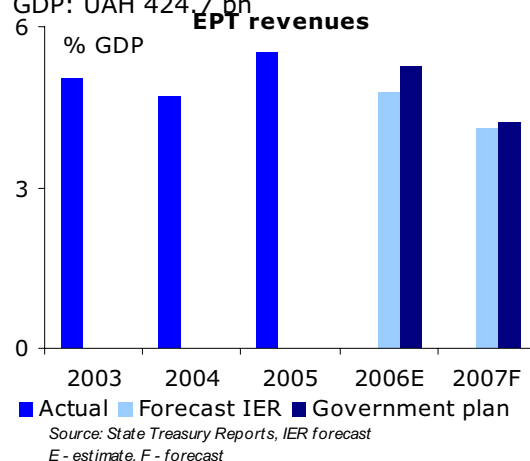
**Forecast Period:**  
2006 and 2007

**Forecast Variables:**  
EPT, VAT and PIT revenues

### 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



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*In this issue of TRO, we present forecast and budget plan for the VAT and EPT for 2006 not taking into account clearing operation that nets compensation of Oschadbank deposits, tax arrears of utility sector, and non-payments of population.*



The IER forecast of EPT revenues for 2007 is UAH 25.0 bn or 4.1% of GDP, which is consistent with the government plan. The forecast is based on assumption of slightly slower real GDP growth rates and higher inflation rates as compared to the government forecast. The further growth of gas prices and the introduction of the EPT investment tax credit privileges in the restored SEZ will keep the EPT share as the percentage of GDP lower than in 2002-2006.

**VAT forecast: VAT revenues are driven by growth of consumption**

The VAT revenues account for more than a quarter of consolidated fiscal inflows. In 2005 the weight of VAT revenues in GDP increased to 7.9% thanks to tax base broadening, strengthening tax administration, and high import growth that overpass export growth rates. Between January and August 2006 VAT revenues reached UAH 29.4 bn or 9.8% of GDP, thus further expanding as a share of the GDP. The revenues were 16% or UAH 4.0 bn above the target.

The IER revised upward its forecast of VAT revenues in 2006 by UAH 2.5 bn to UAH 43.6 bn. It is expected that VAT revenues as a ratio to GDP will increase and reach 8.5%. One of the major reasons for revision is much higher than expected growth of households final consumption, that contributed to higher revenues from the VAT on domestic products. Besides, rates of import growth continued surpassing exports that led to higher VAT revenues from imports. Both these factors caused significant over-execution of the VAT revenues, even though recovery of exports since May resulted in marginally higher than initially estimated VAT refunds. As expected, the over-execution of VAT revenues will be maintained till the end of the year, allowing the government to cover gap caused by the under-execution of EPT revenues.

The VAT revenues for 2007 are forecast by the IER at UAH 54.7 bn, which equals to 9.0% 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 12% VAT rate in the agricultural sector, replacing the present 0% VAT rate. These factors will compensate the losses from introduction of VAT privileges in special economic zones. The IER forecast is lower than the figure foreseen in the draft of the State budget for 2007 by UAH 0.5 bn due to the difference in forecast of major macroeconomic indicators.

The risks inherent in the VAT revenues forecast for 2007 are associated with unexpected change in macroeconomic parameters and the changes in the legislation. Also, as the State budget law for 2007 is not approved yet, a 12% VAT rate in agriculture may not be introduced in 2007, thus reducing the potential VAT tax base. Finally, there is a risk that VAT will not be refunded in 2007, which would temporarily boost the cash VAT revenue at the expense of future revenues.

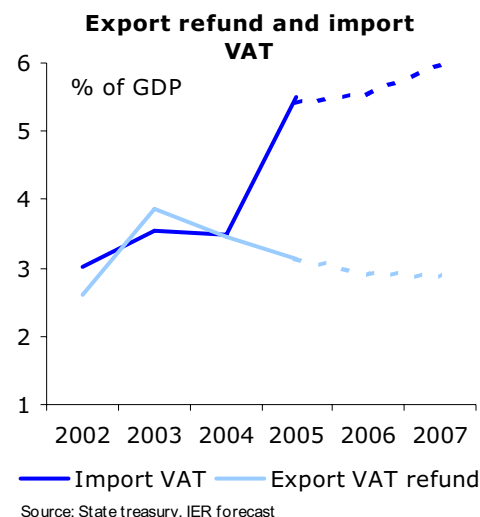
**VAT revenue forecast assumptions:**

- The VAT revenue forecast is based on macroeconomic indicators for 2006 and 2007 according to IER Macroeconomic forecast of Ukraine №2 (10), October 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 12% will be introduced in 2007 for the agricultural sector.

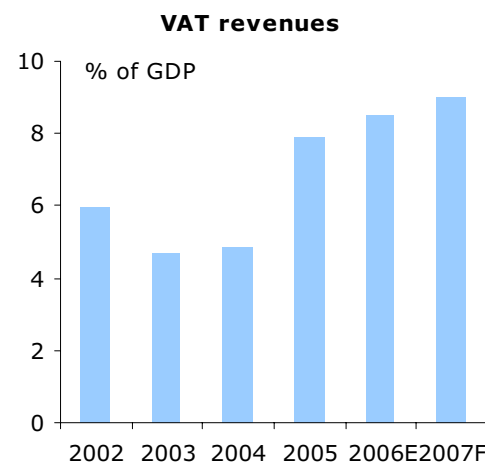
**Parameters of EPT and VAT forecast:**

	2005	2006E	2007F
GDP, UAH bn	424.7	512.9	608.3
GDP real growth, % yoy	2.6	6.3	5.9
Household consumption, UAH bn	238.0	306.2	360.1
Exports of goods and services, UAH bn	227.3	249.1	293.7
Imports of goods and services, UAH bn	223.6	255.1	305.2
CPI inflation, % yoy aop	13.5	8.0	8.5
PPI inflation, % yoy aop	16.8	8.6	9.3

E - estimate, F - forecast  
Source: Macroeconomic Forecast Ukraine №2 (10), October 2006, IER



Source: State treasury, IER forecast



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

## PIT forecast: Local government entities will get more resources in 2006

The personal income tax (PIT) remains one of the major revenue sources that generates nearly 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.

Between January and August 2006 the revenues from PIT reached UAH 14.3 bn or 4.8% of GDP, that is by 0.6% of GDP higher than before. The increase is explained by strong growth of wages backed by administrative rise in minimum wage and expanding demand for labour.

The IER revised upwards its forecast of PIT revenues for 2006. It is expected that they will amount to UAH 23.0 bn (4.5% of GDP). The revision was made due to higher than previously forecasted growth of the wage bill thanks to stronger than forecasted economic development. In 2006 enterprises seem to come over the gas price shock better than it was expected, and higher real GDP growth is accompanied by raising wages. Thus, the PIT forecast for 2006 is UAH 1.6 bn higher than the government plan. The additional revenues will enable the local government to finance its delegated responsibilities, for instance wages in health care and education.

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. In 2006 the amount of social privilege constituted only 50% of minimum wage (UAH 175). The PIT revenues forecast for 2007 was also revised since the government abstained from sharp minimum wage growth and plans to leave it for January 2007 at the level of UAH 400, effective from December 2006. As a result, the PIT revenues forecast for 2007 is UAH 28.8 bn (4.7% of GDP). This figure is consistent with the government plan.

The risks inherent in the PIT revenue forecasts for 2006 and 2007 are associated with lower than assumed wage bill growth. In addition, the forecast for 2007 could be challenged if the Parliament approves higher minimum wage and subsistence minimum growth than foreseen in the draft of the State budget for 2007. Such policy would increase the level of the social privilege even further, while the growth of the overall wage bill in the economy is likely to be slower, thus hampering revenues from the PIT.

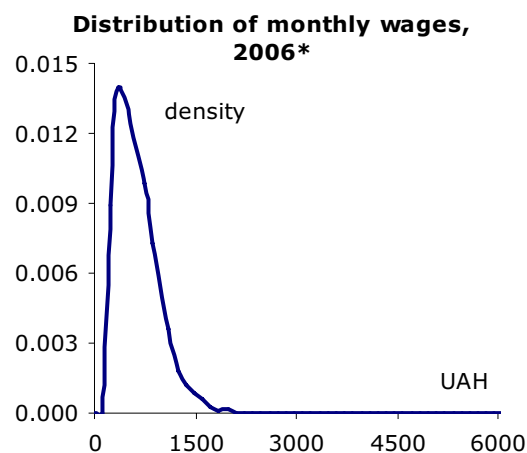
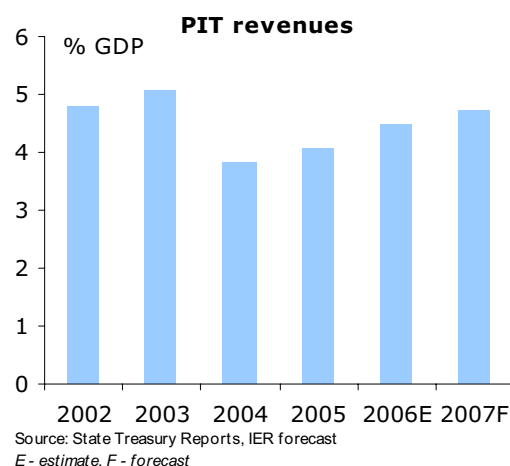
### PIT revenue forecast assumptions:

- The nominal wage bill in the economy is equal to UAH 160 bn and UAH 190 bn in 2006 and 2007 respectively.
- The PIT rate remains 13% flat till the end of 2006.
- The PIT rate increases to 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 at the level of UAH 400 on January 1, 2007.
- The subsistence minimum for individuals able to work will be equal to UAH 525 on January 1, 2007.
- The distribution of wages remains constant as in 2005.
- Employment levels will remain the same in 2006 and 2007.

### Parameters of PIT forecast:

	2005	2006	2007F
PIT rate, %	13	13	15
Gross wages, UAH bn	130	160	190
Minimum wage, at the beginning of the year, UAH	262	350	400
Subsistence minimum for persons able to work, UAH	409	483	525
Social Privilege, UAH	131	175	400

Source: legislation of Ukraine, IER estimates  
F - forecast



**Table 1. Tax revenues (UAH bn)\***

	2002	2003	2004	2005	2006E	2007F
EPT	9.4	13.2	16.16	23.2	24.4	25.0
VAT	13.5	12.6	16.7	33.5	43.6	54.7
PIT	10.8	13.5	13.2	17.3	23.0	28.8

Note: E – estimate; F – forecast

**Table 2. Tax revenues (% GDP)\***

	2002	2003	2004	2005	2006E	2007F
EPT	4.3	5.0	4.7	5.6	4.7	4.1
VAT	6.0	4.7	4.9	8.0	8.5	9.0
PIT	4.8	5.1	3.8	4.1	4.5	4.7

Note: E – estimate; F – forecast

**Table 3. Distribution of tax revenues by quarters in 2006 (UAH bn)\***

	QI	QII	QIII	QIV
<b>EPT</b>				
Collected	3.6	9.2	15.1	
<b>VAT</b>				
Collected (cash basis)	9.6	21.1	34.1	-
Collected minus arrears to be refunded	9.1	n/a	n/a	-
<b>PIT</b>				
Collected	4.6	10.2	16.3	-

\* Source: State Treasury Reports, IER estimations

#### Technical notes

##### 1) EPT forecast

For EPT forecast purposes, we applied an econometric method based on buoyancy. The econometric estimates are based on Derzhkomstat statistics. The estimated EPT revenues were adjusted to the actual EPT collections and were then corrected for changes in the legislation. The actual EPT revenues were taken from State Treasury reports.

##### 2) VAT forecast

For forecasting VAT we adopted an iterative-analytical technique and used the Ukrainian legislation. The forecast is built on a system of build-in indicators (proportions), which are adjusted to reflect past dynamics and changes in the legislation.

The methodology of VAT revenue forecasting is very similar to the official VAT forecasting methodology of the Ukrainian government. The official methodology has been adjusted to use IER macroeconomic forecasts as input. Also, our VAT model uses different sets of empirical data. The official methodology was approved by joint Order #543/315/502/637 dated August 31, 2004 of the Ministry of Finance, the Ministry of Economy, the State Tax Administration and the State Customs Service.

VAT revenue is forecast on the basis of macroeconomic indicators and the effective tax rates. The total VAT revenue is decomposed into VAT from imported goods, VAT from domestically produced goods, and VAT refunds. The evolution of each component is forecast on the basis of historical data as well as macroeconomic forecasts by the Institute. The forecast for VAT from domestically produced goods is done with a simplified demand method, using household consumption as the leading indicator. VAT from imports is forecast via the dynamics of imports of goods and services and the exchange rate. VAT refunds are forecast using the dynamics of exports of goods and services, the exchange rate, PPI and the growth of industrial output.

##### 3) PIT forecast

The PIT forecast is based on a detailed household survey (HS), produced by Derzhkomstat. This survey includes information describing the distribution of the after-tax income of individual households for the year 2004. Therefore, for our forecast purposes we extrapolated the data for the following years (2005-2007), assuming that the income distribution would remain constant throughout.

The actual PIT revenues collected by the government were taken from the yearly State Treasury reports. This allowed us to check our estimates of PIT revenues in 2005 with the actual amounts collected. Our estimate for 2004 differs from the actual by 3%. Thus, for the forecasts of 2006 and 2007 we made adjustments of the same magnitude.

The forecasts are based on PIT paid on the wages of employees, which is the major source of the total PIT revenues. However, PIT revenues also include the fixed and unified taxes paid by small entrepreneurs, taxes from lotteries, taxes on dividends, etc. In 2005 wage-based PIT amounted to 96% of the total PIT collected. We corrected the wage-based PIT revenue estimates to account for the other PIT revenues.

**Note:** **yoy** year-on-year **aop** average of period  
**VAT** value added tax **EPT** enterprise profit tax  
**PIT** personal income tax