



Tax Revenue Outlook for Ukraine

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- The revenues from enterprise profits tax are estimated by UAH 2.9 bn above the official plan in 2007, totaling UAH 31.8 bn.
- The revenues from value added tax grow thanks to higher private consumption and imports, and will reach UAH 64.5 bn in 2007.
- The revenues from personal income tax in 2007 are expected to reach UAH 35.5 bn that is UAH 3.0 bn higher than official plan.
- For 2008 the revenues from enterprise profits tax are forecast to reach UAH 41.2 bn or 4.7% of GDP backed by continued growth of profits.
- The expected continuation of consumption and import patterns allowed forecasting revenues from value added tax for 2008 at UAH 84.1 or 9.5% of GDP.
- The revenues from personal income are forecast to reach UAH 47.8 bn in 2008.

Forecast Period:
2007 and 2008

Forecast Variables:
EPT, VAT and PIT revenues

Basis for comparison: the State Budget Law for 2007, as amended on May 30, 2007; the Draft State Budget Law for 2008 submitted by the Cabinet of Ministers to the Verkhovna Rada on November 28, 2008.

EPT forecast: The government underestimated revenues from the EPT by nearly UAH 3.1 bn in 2007

Enterprise profits tax (EPT) is the second most important source of consolidated fiscal revenues after the VAT. Between January and October 2007 the EPT revenues amounted to UAH 22.1 bn being over-executed by 13.4% of plan. This follows the Institute forecast concerning the underestimation by the Government of EPT revenues in 2007. The over-execution of EPT collections is mainly attributed to stronger than officially projected nominal GDP growth and improved economic performance of enterprises supported by further growth of prices at the main export markets for Ukraine. The IER upgrades its previous forecast of the EPT revenues in 2007 that are now estimated at UAH 31.8 bn (4.5% of GDP). Thus, the government underestimates the EPT revenues by UAH 3.1 bn.

The IER forecast of the EPT revenues for 2008 is UAH 41.2 bn or 4.7% of GDP. It is by UAH 0.6 bn higher than the Government plan due to assumption of higher inflation rates as compared to the official forecast. The EPT revenues are expected to increase as a share of GDP thanks to continuation of the world commodities prices growth that is expected to lead to higher enterprises' profits.

The forecast of the EPT collections in 2008 is based on the assumption of no major changes in the EPT legislation. It is assumed that the proposed introduction of tax privileges for "innovation and investment" to stimulate the investment activity will not take place. The provision of such privileges could lead to non-transparency and to the misuse of public funds. Besides, it would distort competition, since some enterprises would receive tax privileges, while other not.

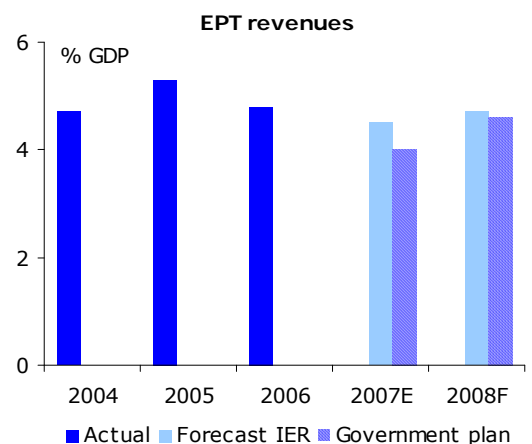
The risks for the EPT forecast for 2007 and 2008 are comprised with different than assumed economic development. An additional risk for the 2008 forecast relates to possible changes in the EPT legislation, including the re-establishment of sector privileges and special economic zones, and change in the tax rate.

EPT revenue forecast assumptions:

- The EPT revenue forecast is based on macroeconomic indicators for 2007 and 2008 according to the IER Macroeconomic Forecast of Ukraine №2 (12), December 2007.
- The EPT legislation remains unchanged in 2007 and 2008, in particular, the EPT rate stays at 25%.
- The EPT privileges in the restored special economic zones and for specific sectors will not be introduced in 2008.
- The world prices for chemical and metal products remain high in 2007, with a slight slowdown in 2008.

Fiscal indicators 2006:

Consolidated fiscal revenues/GDP: 32.0%
EPT/Consolidated fiscal revenues: 14.9%
VAT/Consolidated fiscal revenues: 27.6%
PIT/Consolidated fiscal revenues: 13.3%
Consolidated fiscal expenditures/GDP: 32.6%
Central fiscal deficit/GDP: 0.7%
Public debt/GDP: 15.1%
GDP: UAH 537.7 bn



Source: State Treasury Reports, IER forecast, the Draft State Budget for 2008
E - estimate, F - forecast

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VAT forecast: VAT revenues in 2007 will be under-executed by approximately UAH 0.6 bn

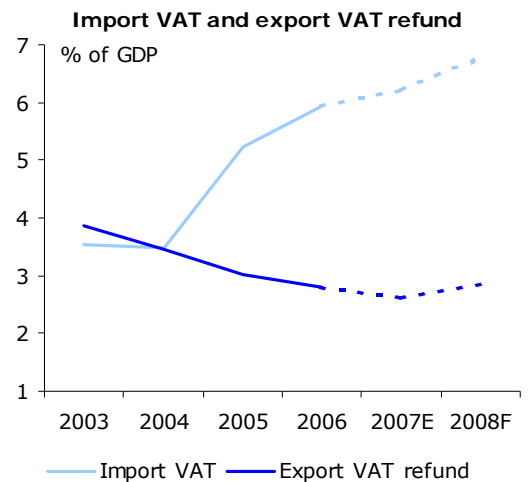
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The value added tax (VAT) remains the largest tax source of the consolidated fiscal revenues. Between January and October 2007 the VAT revenues amounted to UAH 48.3 bn being under-executed by 3.6% due to the underperformed VAT collections on domestically produced goods. The revenues from VAT on imports were slightly over-executed. At the same time, during first nine months of year the VAT refund arrears (both overdue and non-overdue) increased by UAH 1.5 bn to UAH 8.3 bn. It is the consequence of delays in VAT reimbursement caused by growing number of tax inspections of exporters. It seems that a principle of "selective" repayment is still used creating an extremely conducive environment for abuse and corruption.

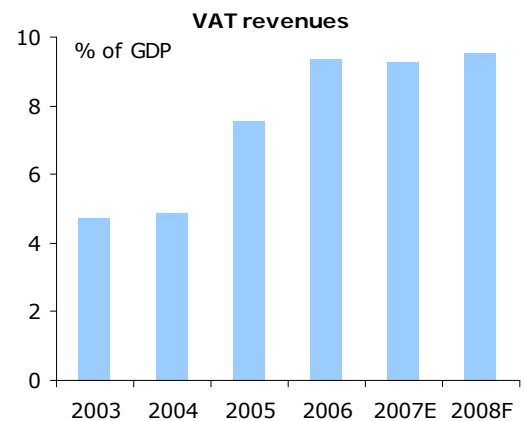
The IER revised upward its forecast of the VAT revenues in 2007 by UAH 0.5 bn to UAH 64.5 bn. One of the major reasons for the revision is higher than previously expected VAT revenues from imports. They are mainly attributed to very high nominal import growth rates stimulated by the strong domestic demand in the country. According to the Institute estimates, the revenues from the VAT on imports would not be sufficient to compensate the under-executed VAT collections on domestically produced goods, and the increased tax evasion via the issue of VAT promissory notes on imports, and the losses due to VAT privileges. In particular, there is a tax credit provided to the National JCK 'Naftogaz of Ukraine' for the one-year period, starting from July 2007. On the other hand, we revised downward our estimate of VAT refunds, taking into account accumulated VAT refund arrears. As a result if all these factors, the share of the VAT revenues in GDP is expected to reduce to 9.3%. The fiscal plan of VAT receipts envisaged in the Budget-2007 is UAH 65.1 bn. Thus, we estimate that the VAT fiscal plan for 2007 will be under-executed by UAH 0.6 bn.

In 2008 the VAT revenues are forecast at UAH 84.1 bn or 9.5% of GDP. The forecast is based on the assumption that the growth of domestic demand and imports will continue in 2008, though at a lower rate than in 2007. The legislation is assumed to remain unchanged. In particular, the zero VAT rate for the agricultural sector will be kept. Additionally, it is supposed that the measures taken in 2006-2007 to enhance VAT administration will be strengthened, thus contributing to an increase in VAT collections. The IER forecast is higher than the government plan for 2008 by UAH 0.3 bn due to the difference in the forecast of major macroeconomic parameters.

The major risks for the VAT revenue forecast for 2008 are associated with the change in macroeconomic parameters that could have both upside and downside effects on the VAT revenues. As of downside risks, there is a risk of amending VAT legislation, in particular, granting new privileges to selected sectors and zones after coming to power of a new government. As of upside risks, there is a likelihood of further accumulation of VAT refund arrears that would increase current revenues and future liabilities. Also, Ukraine's WTO membership might force the Ukrainian Parliament to change the tax regime for the agriculture, introducing the regular VAT rate for the sector.



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



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

VAT revenue forecast assumptions:

- The VAT revenue forecast is based on macroeconomic indicators for 2007 and 2008 according to the IER Macroeconomic forecast of Ukraine №2 (12), December 2007.
- The VAT legislation remains unchanged in 2007 and 2008.
- In particular, the VAT rate remains at 20% in the forecast period.
- VAT refund arrears will not be further accumulated in 2008.
- VAT privileges for special economic zones are not changed.



PIT forecast: The PIT revenues for 2007 and 2008 are revised upwards

The personal income tax (PIT) remains the third major revenue source that generates nearly one fifth of consolidated tax revenues. For ten months of 2007 the PIT collections reached UAH 27.4 bn or 4.9% of GDP, which is 0.7 percentage points higher than in 2006. The increase is explained by several factors. First, the major engine of the PIT collections remains gradual increase in the minimum wage that pushed all wages upwards. Another reason is higher wages paid in public sectors due to implementation of the second stage of the Unified Tariff Scale for employees of budget sectors in the second half of the year. During this period the PIT brought around 59.3% of local budget revenues (not accounting for transfers) and was streamlined for financing delegated responsibilities of local government, primarily health care and education.

The IER revised upwards its forecast of the PIT revenues for 2007 to UAH 35.5 bn (5.1% of GDP) due to higher than previously expected PIT collections during the first ten months of the year. This trend is attributed to higher than earlier estimated increase in the nominal wage bill, which coincides with higher nominal GDP. Thus, the PIT revenue forecast for 2007 is by UAH 3.0 bn higher than the official plan. The additional revenues will enable the local governments to finance delegated responsibilities, for instance wages in health care and education.

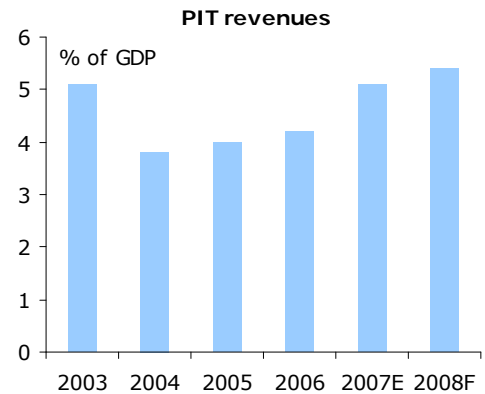
The PIT revenue forecast for 2008 is UAH 46.8 or 5.3% of GDP. It was also revised upwards due to higher than previously expected nominal wage bill in 2007, and thus in 2008. It is forecasted that gross wages will grow rapidly in 2008 due to several factors. First, the growth rate of minimum wage is planned to be higher than in 2006 and 2007. Besides, the implementation of the third and last stage of the Unified Tariff Scale will result in a higher wage bill in the public sector. According to our assumptions, it will take place in the second half of the year. Among the factors that could push wage growth downwards is the necessity to invest into energy-saving technologies. The legislation basis is presumed to remain rather stable. The introduction of 5-years PIT exemption, as suggested by the government, for physical individual entrepreneurs that do not have employees is assumed not to have significant impact on the PIT collections.

The risks inherent in the PIT revenue forecasts for 2007 and 2008 are associated with different than assumed wage growth. In addition, the forecast for 2008 could be challenged if the government introduces more rapid increases of minimum wage and subsistence minimum growth, which will increase the level of the social privilege and affect the wage bill.

Parameters of PIT forecast:

	2006	2007E	2008F
PIT rate, %	13	15	15
Gross wages, UAH bn	162	215	287
M Deleted: , the beginning of the year, UAH	350	400	520
Subsistence minimum for			
P Deleted: , at the beginning of the year, UAH	483	525	635
Social Privilege, UAH	175	200	255

E - estimate, F - forecast
Source: legislation of Ukraine, IER estimates

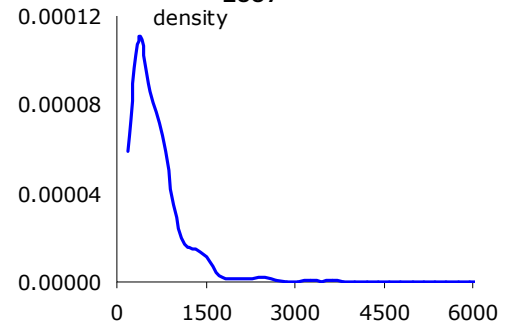


Source: State Treasury reports, IER forecast
E - estimate, F - forecast

PIT revenue forecast assumptions:

- The PIT rate remains flat at the level of 15%, as it has been since 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 50% of the minimum wage in 2007 and 2008.
- The minimum wage is expected to be raised to UAH 520 on January 1, 2008.
- The subsistence minimum for individuals able to work will be increased to UAH 635, on January 1, 2008.
- The wage distribution remains the same as in 2006.

Distribution of monthly wages, 2007*



Source: Household Survey (Derzhkomstat), own calculation
* Kernel density function of monthly wage

