Fiscal Policy for Growth and Equity

Public Finance Review
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OVERVIEW

This Third Programmatic Public Finance Review (PFR-3) supports Ukraine in reorienting fiscal policy towards supporting inclusive and sustained economic growth after the COVID-19 crisis. Fiscal policy is an important instrument for improving living standards, especially through its impacts on macroeconomic stability, resource allocation, and income distribution. However, Ukraine’s fiscal performance has been relatively poor vis-a-vis the first two outcomes; although Ukraine has done relatively better in terms of the equity of fiscal policy, over 60 percent of the population relies on social transfers. This is of concern, given that sustained improvements in welfare can only be achieved through higher economic growth and better job creation. Going forward, in the “new normal” of post-COVID-19 Ukraine, successful policies will not only need to protect the most vulnerable but also need to focus on allowing capital, labor, skills, and innovation to shift to new purposes in order to build a stronger economy and generate sufficient private sector employment opportunities for citizens.

This PFR combines the main findings of recent public finance analyses into the fiscal policy framework and analyzes tax and state-owned enterprises (SOEs) policy aspects that would help to support investment and better use of productive resources. This PFR is the third in a series in which the first focused on macroeconomic stabilization and identification of policy measures to reduce the fiscal deficit and public debt. The second focused on the equity aspects and improvement of the quality of public services in a fiscally sustainable manner. This PFR focuses predominantly on how fiscal policy instruments—namely aggregate spending, tax policy, and asset ownership—could be strengthened to support economic growth. It will be followed by a full report.

The key findings of this report are the following:

1. Fiscal policy can contribute to a robust and lasting post-COVID economic recovery. Over the last two decades, economic growth in Ukraine has consistently lagged peers due to the low capital investment, with fiscal policy (alongside other factors) playing an important role. More recently, while lower fiscal deficits have helped in anchoring macroeconomic sustainability and provided some buffers during the COVID-19 shock, the track record of fiscal policy in boosting long-term growth, in particular capital deepening, has been less impressive. Much of this is due to the boost in domestic demand, particularly through increases in current expenditure can only provide temporary support to growth in the absence of a supply-side response, and there may be other adverse impacts on macro and price stability and long-term competitiveness (occurring for example through exchange rate movements). Fiscal policy changes that encourage capital deepening would help to accelerate growth. This requires a rebalancing of the fiscal policy from the focus on social expenditures to include growth-enhancing investment. Tax policy adjustments could also help remove competition distortions that restrict investments. Through the SOEs, the
government directly participates in value added creation but also indirectly impacts the development of the private sector and incentives for private investment.

2. **Strengthening tax policy incentives to reduce a large and deep-rooted shadow economy should help to increase investment**. Ukraine is currently an outlier in the region in terms of high tax collection. Still, taking into account a large shadow economy, this suggests that the burden on tax obeying economic agents is extremely high. Going forward, the focus of tax policy should be shifted from revenue mobilization to restoring the fairness of the tax system for all economic agents. This requires strengthening incentives for formalization. The government’s initiative to introduce a prescribed tax obligation in agriculture can help ensure equity in taxation of income from agricultural land use in Ukraine (but should be designed in a way that does not undermine small farmers).

3. **Tightening eligibility criteria and eliminating concessional features of the single tax system (STS) will help to reduce competitiveness distortions and impediments for investment**. The STS coverage is now too large, amounting to around 1.6 million payers. It has, thus, almost become a parallel system to the normal tax system. The turnover cap for the STS is too high. So, it effectively overrides the VAT threshold, and it offers important tax and SSC incentives for employees to reclassify as independent entrepreneurs – a practice that is very difficult to combat. Tightening eligibility criteria and eliminating concessional features of the STS should help to level the playing field and remove impediments for investment.

4. Although Ukraine has a large number of SOEs, only the four largest – which are also natural monopolies – currently matter in terms of fiscal and economic outcomes. Thus, better governance of the key SOEs is important. However, state regulatory policy has underpinned their financial inefficiencies in recent years. Naftogaz, Ukrzaliznytsa, Ukrenergo, and Energoatom are providers of critical public services, and as such, are subject to heavy state regulation. They are also the largest taxpayers in the country and potentially major sources of fiscal risk because implicit arrears accumulated by SOEs to private sector companies may increase fiscal pressures significantly. Historically, the largest operational losses or inefficiencies seen in the largest SOEs were due to tariff regulation by the state, not because of formal dividend policies. The direct fiscal cost of such losses can reach up to 5 percent of GDP – much larger than the losses from other channels; the overall negative impact on public net worth could be even larger.

5. A balanced and predictable dividend policy is important to allow SOEs to properly plan their investments and to channel their profits into much-needed infrastructure modernization. SOEs in Ukraine have complicated and non-formalized relationships with the central budget, which undermine the companies’ operational efficiency. When fiscal pressures are low, SOEs are held less accountable for their financial inefficiency; but during times of fiscal stress, they are usually requested to transfer more profits to the budget. Allowing SOEs to retain a stable and healthy portion of their earnings would enable more funds to flow into critical infrastructure and grow Ukraine’s public assets value, rather than maximizing SOEs’ dividends towards short-term consumption via budget redistribution.
6. **Fiscal risks posed by SOEs could be lower if the government focuses more on the public sector balance sheet (PSBS) and net worth.** Many of the vulnerabilities associated with the SOEs are not seen in the budget before they materialize. But there could be earlier recognition (and remedial measures) if a PSBS approach, reflecting all assets and liabilities, is constructed. Analyzing PSBS, along with the government’s net worth and what causes it to change, would lead to a better understanding of policies needed to manage fiscal risks. For example, setting tariffs for SOEs is always a tradeoff between social obligation and fiscal costs. If tariffs are set below cost recovery and/or the social obligation is not fully compensated, it will lead to a higher debt burden for the SOE and reduce the net public worth. At the same time, an increase in public investment (including by SOEs) would increase debt, but it could positively affect the net worth because it would also add to the public asset stock and may strengthen future public revenues.

<table>
<thead>
<tr>
<th>Table 0.1: Fiscal Policy Framework for Growth and Equity</th>
</tr>
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<tbody>
<tr>
<td><strong>WHAT</strong></td>
</tr>
<tr>
<td>Macroeconomic stabilization / demand side management</td>
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<tr>
<td>Maintain aggregate fiscal discipline</td>
</tr>
<tr>
<td><strong>WHY</strong></td>
</tr>
<tr>
<td>Quality of economic policy—both monetary and fiscal—is an important element of sustainable economic recovery. Reducing the risk of a disorderly unwinding of external imbalances</td>
</tr>
<tr>
<td><strong>HOW</strong></td>
</tr>
<tr>
<td>Broaden the focus of fiscal policy away from control over the public deficit and debt, and monitor policy impact on aggregate demand and external imbalances Broaden the scope of fiscal monitoring to include the key SOEs performance Implement a Public Sector Balance Sheet approach, including SOE, to monitor both the fiscal flows and stock of assets and liabilities Reduce the remaining loopholes in the tax base</td>
</tr>
</tbody>
</table>
1. HOW CAN FISCAL POLICY HELP ECONOMIC RECOVERY?

Before COVID-19, Ukraine’s track record of using fiscal policy to achieve sustainable, inclusive, and lasting growth had been mixed. During 2015–19, Ukraine’s policymakers, faced with the need to service the growing government debt, implemented several reforms to consolidate the budget and curb budget deficits. The fiscal deficit was maintained at below 2.5 percent GDP over these four years, which helped to reduce the public and publicly guaranteed debt from 80 percent of GDP in 2016 to 50 percent in 2019. At the same time, after a 16 percent cumulative economic decline in 2014–2015, the economic recovery was not vigorous enough to fuel a sustainable increase in living standards and catch up with regional peers. Inflation and the cost of public borrowings remained high up until 2019. The government’s reliance on the domestic bond market has negatively impacted lending to the private sector by pushing up lending costs and limiting the supply of credit to nongovernment borrowers. Between 2009 and 2018, net claims on the government increased from 2.5 percent of GDP to 24.0 percent (Figure 0.1).

Thus, even during periods of tight control over the fiscal deficit, fiscal policy had an overall negative impact on potential growth. This happened because the fiscal stimulus was directed toward supporting domestic consumption, while supply responses lagged because of low investment. The low fiscal deficit was achieved because of the recovery in revenue (tax policy was focused on broadening the tax base), while high current expenditures continued to boost domestic consumption. Meanwhile, investment remained low because of the institutional weakness and uneven playing field, undermined by tax policy flaws and a large public footprint. As a result, the public sector remained the key contributor to the savings-investment gap (Figure 0.2).

Figure 0.1: Net Claims on the Central Government and Other Sectors, percent of GDP

![Figure 0.1](image1)

Source: National Bank of Ukraine

Figure 0.2: The Savings-Investment Gap, percent of GDP

![Figure 0.2](image2)

Source: National Bank of Ukraine
While macroeconomic stabilization is a necessary condition for Ukraine to grow, it is not sufficient. In part, this is because Ukraine has made insufficient progress in adjusting resource allocation to support the accumulation of physical and human capital. Over the last two decades, Ukraine’s economic growth has consistently lagged behind its peers. The World Bank’s Growth Study for Ukraine concluded that the key impediment to growth had been the low investment that undermined capital accumulation and resulted in low productivity. One of the main reasons why Ukraine has failed to accumulate sufficient investment has been the low domestic savings, undermined by elevated consumption that also resulted in a high cost of capital for government and private borrowers.

Going forward, fiscal policy changes that encourage capital deepening would help to accelerate growth. Building fiscal space for more productive expenditures is critical to supporting economic growth. This requires a rebalancing of the fiscal policy from the predominant focus on social expenditures to include growth-enhancing investment. A sustainable optimization of social expenditure should be underpinned by structural reforms in health and education sectors (which would also lead to higher productivity) and by reducing universal subsidies provided by key SOEs. Tax policy adjustments could also help remove competition distortions that restrict investments. In addition, Ukraine’s tax policy could be strengthened to provide incentives for more efficient use of the key productive resources in the economy. Through the SOEs, the government directly participates in value added creation but also indirectly impacts the development of the private sector and incentives for private investment.

2. HOW CAN TAX POLICY IMPROVE INVESTMENT PROSPECTS?

Ukraine is currently an outlier in the region in terms of high tax collection. But taking into account Ukraine’s large shadow economy, this suggests that the burden on tax-compliant economic agents is extremely high. Major tax reform done in 2015 helped to streamline the tax regime, broaden the tax base, and realign tax rates with those of regional peers. Despite tax rates that are similar to its regional peers, Ukraine collects significantly more taxes: the total annual tax collection in Ukraine averaged 35 percent of GDP over the last five years, compared to a regional average of around 22 percent. This high tax collection happened despite the fact that Ukraine’s shadow economy is estimated at around 40 percent of GDP. Strong tax revenue performance could therefore be a sign of an excessively high burden on tax-compliant economic agents.
The already high tax burden and large informality undermine a level playing field and investment through several channels. According to a number of investors’ surveys, one of the main restrictions for FDI in Ukraine is the lack of a level playing field, largely due to high informality. In addition, informality reduces access to capital because financial institutions tend to avoid lending to unregistered firms and borrowers without official jobs or declared income. The single tax system (STS) has also contributed to tax base erosion by creating large arbitrage opportunities and an uneven playing field for taxpayers. Originally designed for small entrepreneurs, it currently has become very porous to others and has been instrumental in escalating informality. STS also imposes horizontal and vertical inequality since tax liabilities under the general versus the simplified regime differ considerably.

Going forward, the focus of the tax policy should be shifted from just revenue mobilization to restoring the fairness of the tax system for all economic agents.

Potential options for effective reduction of informality in Ukraine while mobilizing sufficient revenue and removing the impediments for investment are the following:

- **Reducing cash transactions.** This, a frequently used measure internationally in recent times, could be particularly effective in Ukraine. The VAT system is generally working well, but at the same time, the widespread use of unregistered cash transactions creates room for VAT optimization schemes. This enables transfers of the VAT credit from imported goods (sold domestically in cash). The broader use of cash machines and use of bank-issued cards at the point of sale may be bolstered through a combination of incentives (e.g., a value-added tax cut) and legal obligations (e.g., requiring card acceptance by merchants over a certain size).

- **Strengthening incentives for formalization.** All countries face the problem of taxing small and micro enterprises. Such sectors as agriculture, IT, and other services are difficult to tax across the board. Financial and other positive incentives for moving into the formal sector – such as the provision of
institutional finance – could be successfully used. In addition, the government’s initiative to introduce a prescribed tax obligation in agriculture can help to ensure equity in the taxation of income from the use of agricultural land in Ukraine. It does not affect companies that operate officially and pay taxes but creates an incentive for the formalization of land contracts, helping to restore fair competition for all market players. However, the introduction of this tax needs to be done in a way that does not hurt small farmers.

- **Reforming the STS.** The turnover cap for the STS is too high, effectively overriding the VAT threshold. The STS offers important tax and SSC incentives for employees to reclassify as independent entrepreneurs – a practice that is very difficult to combat due to poor rules and weak enforcement. To address this problem, some countries have successfully tried using an annual lump sum tax or a single business permit; this is applied to all businesses and allows a separate client-oriented administration of taxes, mostly by local governments. The tax rate is scaled to location, market size, sector, and business size (small, medium, and large) using simple size criteria such as floor space, number of hotel rooms/beds, restaurant capacity, etc.

While Ukraine has one of the highest levels of CO2 emissions per capita of GDP in the world, it also has the lowest carbon tax (among countries that have such a tax). There is a clear need to increase the carbon tax in Ukraine because the net social and economic impact of its carbon-intensive economy, including spillovers such as pollution, undermines long-term growth trends. One of the risks of introducing carbon pricing instruments is an increase in the cost of production. At the same time, international experience suggests that carbon taxes are economically neutral or beneficial – provided revenues from the carbon tax are recycled.

The current tax system is fairly equitable, but at the same time, there is room to improve the progressivity of personal income taxation. A recent World Bank fiscal incidence analysis indicates that the tax benefit system in Ukraine is quite pro-poor. However, indirect taxes contribute to higher inequality. An introduction of two additional rates of 20 and 25 percent for PIT on higher incomes could be a beneficial option for Ukraine. However, the income brackets should be defined properly so that they target only high-net-worth individuals. The higher progressivity of PIT should be done in a way that does not undermine the incentive to disclose incomes honestly.

### 3. WHY DOES THE PUBLIC NET WORTH APPROACH MATTER FOR BETTER MANAGEMENT OF SOEs?

Although Ukraine has a large number of SOEs, most are not operational. But the four largest companies – providers of critical public services – are the largest taxpayers in the country and could be a major source of fiscal risks. As of 2019, there were 3,682 centrally-owned SOEs, most of which are not operational. The top 100 SOEs generated revenues equivalent to 13 percent of GDP in 2019 and are responsible for employing around 600,000 people. Such companies as Naftogaz, Ukrzaliznytsia, Ukrenergo, and Energoatom not only account for the largest portion of assets and employment but are critical taxpayers to the budget, contributing around 15 percent
of total revenues from taxes paid by corporates (or up to 4 percent of GDP) over the last decade. Although indirect SOE fiscal costs from explicit debt guarantees are relatively small, implicit arrears accumulated by SOEs to private sector companies may increase fiscal pressures significantly.

SOEs in Ukraine have complicated and non-formalized relationships with the central budget, which undermines the companies’ ability to undertake much-needed capital investment. When fiscal pressures are low, SOEs are less accountable for their financial inefficiency, while during times of fiscal stress, they are requested to transfer more profits to the budget. Such an approach has undermined their effectiveness in delivering public services and complicated or undermined their longer-term financial sustainability; they cannot properly plan their investments or expand/diversify, which results in productivity losses and negatively contributes to the overall economic growth of the country.

Better governance of the key SOEs is important. But in recent years, state regulatory policy has been the major driver of SOE financial inefficiencies. Historically, the largest operational losses or inefficiencies were in Naftogaz, Ukrzaliznytsia, and Ukrenergo—which are subject to state tariff regulation. Prior to its unbundling, Naftogaz was obliged for decades to supply gas to households at a regulated tariff that led to fiscal losses of over 5 percent of GDP in 2014; the move to market pricing accompanied by targeted social transfers reduced the fiscal cost of the gas supply to households to only 2 percent of GDP in 2019. The unfinished tariff reforms agenda in the electricity and railways sectors leads to operational and productivity losses at the related SOEs and inevitably results in fiscal pressures. For example, arrears to the private sector accumulated by Ukrenergo have added 1 percent of GDP to already high fiscal financing needs in 2021. The current tariff setting policy for Ukrzaliznytsia does not allow the company to invest in much-needed infrastructure; as a result of this, the company has accumulated large debts that are not directly accounted for in the budget but could become a source of fiscal risks going forwards.

**Figure 0.5: Tax proceeds from the largest SOEs, UAHbn**

<table>
<thead>
<tr>
<th>Year</th>
<th>Naftogaz-AMO</th>
<th>Ukrzaliznytsia</th>
<th>Energogas</th>
<th>Ukrenergo</th>
<th>Share in total taxes paid by corporates, percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>10.3</td>
<td>5.7</td>
<td>16.6</td>
<td>31.9</td>
<td>14.5</td>
</tr>
<tr>
<td>2020</td>
<td>10</td>
<td>31.5</td>
<td>23.5</td>
<td>25</td>
<td>11.6</td>
</tr>
</tbody>
</table>

Source: Ukrainian State Fiscal Service, World Bank staff estimates

**Figure 0.6: Net Financial Result of top 100 SOEs**

Source: Ukrainian Statistical Service, SOE Data Portal, Haver, World Bank staff estimates

Going forward, to reduce fiscal risks and support economic growth, the formalization of the government SOE relationships should be done by (i) setting operational efficiency targets (based on the benchmarking approach) to right-size employment.
and unify compensation policy; (ii) ensuring that SOEs investment plans are accountable and properly financed; (iii) recognizing SOE Public Service Obligations (PSOs) in fiscal accounts to accurately budget for implicit subsidies in a timely manner and to account for their impact on public net worth.

PSOs should constitute part of the policy agreement between individual SOEs and government, be medium-term in nature, and their compensation from the budget guaranteed by the law. OECD guidelines recommend that special responsibilities and obligations be clearly mandated, legislated, and publicly disclosed. Ukraine has started implementing PSOs for its largest SOEs, yet their implementation remains ad hoc and lacks a systematized approach and effectiveness monitoring. Under such obligations, SOEs are requested to adhere to regulated tariffs that may from time to time be below cost. Good international practice suggests that once PSOs are defined and costed, they can be compensated directly from the budget. This process, however, was not systematized in Ukraine. While SOEs account for their PSO costs, their compensation from the budget is not guaranteed and remains subject to the government’s decisions, preventing SOEs from being able to forecast their revenues, profit levels, and cash flows, and this should be fixed.

The fiscal risks posed by SOEs could be lower if the government focuses more on the public sector balance sheet and net worth. Although Ukraine has a sufficient focus on the SOEs’ impact on the budget, limited attention has been paid to the more comprehensive public sector balance sheet (PSBS) approach. Analyses of the operational performance of the key SOEs show that state policy rather than governance failures is the key reason for the fiscal losses. Many of the vulnerabilities associated with the SOEs are not seen in the budget before they materialize. But they could be clearly seen if a public sector balance sheet reflecting all assets and liabilities is constructed.

Analyzing the PSBS, along with the government’s net worth and what causes it to change, could lead to a better understanding of how to craft improved policies. In Ukraine, the policies that have led to operational losses by key SOEs could have been adjusted if the government had focused more on the stock of assets and liabilities (the PSBS approach) rather than on flows. Prior to Naftogaz’s unbundling, Ukraine’s own gas production for years was undermined by low prices and a lack of investment, while the government provided a universal subsidy to the population through very low gas tariffs. This was not initially seen in the budget, and the large Naftogaz imbalances did not materialize right away, but gradually the state-owned gas reserves (assets) were depleted. In the electricity sector, similarly, the impact of the SOE’s growing imbalances was not immediately seen in the budget. But since mid-2019, Ukrenergo and other SOEs in the sector have had to buy more expensive renewable energy generated by private power stations while not being allowed to pass these costs to consumers through increased tariffs. Only when Ukrenergo accumulated over 1 percent of GDP in arrears was the growing imbalance reflected in the state budget. At the time, had the government used the balance sheet approach (not a flow, but a stock concept), the accumulation of arrears in the electricity sector would have been seen much earlier on. The growing debts on the SOE’s balance sheets would have impacted the consolidated public sector balance and reduced net public worth. The government would then have been able to react to the problem proactively.
The SOE policy approach in Ukraine could be revised by looking into both stock and flow aspects of the consolidated budget and the four largest enterprises. If the scope of the regular fiscal monitoring were to be broadened to include the asset position of the government, including the four largest SOEs, the fiscal impacts of state policy regarding providing social services through the SOEs, investment into infrastructure, or other aspects of the SOE regulation would be clearer and more quantifiable.