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Achieving Financial Stability and Sustainability

One of the main objectives of the tax reform is to eliminate the shadow economy.
—Ihor Bilous, head of the State Fiscal Service[1]

Ukraine's fiscal policy is the nexus of everything that is wrong with the Ukrainian state and economy. The government collects too much money from the economy, but it spends far more. It uses the funds not only inefficiently but corruptly, redistributing incomes to the criminal and powerful, while depressing economic growth. The tax administration is a major cause of corruption and poor business climate. Ukraine's fiscal system does not fulfill any of its basic aims and needs thorough reform.

In 2014, Ukraine was in a rampant financial crisis of falling output, causing a rising budget deficit, leading to a fast depreciation of the currency, which in turn boosted inflation. As a consequence, half the banking system was collapsing and public debt rose ruthlessly. The underlying reason was years of financial mismanagement, but since April Russian military aggression has caused most of the output fall, rendering the financial crisis acute. It has to be dealt with swiftly and firmly.

Ukraine's public expenditures have persistently been much too high by any standard, depressing economic growth. A large share of the public expenditures consists of subsidies to the wealthiest or outright corrupt. The excessive expenditures cannot be financed, resulting in steady budget deficits and a substantial public debt. The public expenditures must be cut significantly. In the next few years the budget needs to be brought to balance if Ukraine is to be financially sustainable, and the public debt should gradually be reduced through small budget surpluses in the medium term.

The total tax revenues are surprisingly stable and have persistently been

1. "Ihor Bilous: Ne mogu skazat', chto sokrashchu vdvoye kolichestvo nalogovikov" ["Ihor Bilous: I cannot say that I will cut the number of taxmen by half"], *Zerkalo nedeli*, August 29, 2014.

high. The tax burden and the number of taxes should be reduced as expenditures are slashed. Taxes on labor, especially the payroll tax, are far too high and should be cut to reduce the shadow economy. Tax rates should be low and flat. The Ukrainian tax administration is not only cumbersome but also lawless. The tax system should be simplified, the tax police abolished, and taxation decriminalized. As political and state powers are being decentralized, so should the management of both revenues and expenditures. The banking system is in shambles and the front of the financial crisis. Many failing banks should be closed down because the government can no longer afford much recapitalization.

In the current crisis, Ukraine can hardly avoid default. The public debt is not very large by international comparisons, but it is skyrocketing. The best approach seems to be an agreed prolongation of the existing debt in the framework of a new International Monetary Fund (IMF) program.

The fiscal reforms should aim not only at resolving the current economic crisis but also at building the institutional foundation for sustainable long-term growth. This involves a major rethinking of the role of the state in the economy and the appropriate form and degree of state regulation.

Rampant Financial Crisis

By the summer of 2014 Ukraine had fallen victim to a serious financial crisis. According to the IMF, the 2014 budget deficit was set to reach 10.1 percent of GDP, which was based on the assumption that output would decline by 6.5 percent (IMF 2014d, 39).[2]

The main driver of the financial crisis was the contraction of output, which largely depended on the intensity of the warfare. In the first quarter of 2014, before Russian aggression hit the economy, Ukrainian GDP contracted by only 1.1 percent. In the second quarter, as Russian military aggression started in the south and east, GDP fell by 4.6 percent. In the third quarter, GDP declined by 5.1 percent year over year,[3] and in the fourth by 15.2 percent.

These numbers reflect two contradictory trends. Ukraine's annualized industrial production plunged because of fighting in Donbas—at most in August by 21.4 percent and 10.7 percent for 2014 as a whole. The war damages seem to have peaked in the third quarter, and the fourth quarter saw some recovery. The decline was driven by the fall in coal production by as much as 66 percent in October in annualized terms and steel production by one-third. At the same time, Ukraine's agriculture was growing, compensating somewhat for the industrial decline.

The second driver was the depreciation of the exchange rate. The hryvnia lost half its dollar value in a year, falling from 8 hryvnia per US dollar in November 2013, when Euromaidan started, to 16 hryvnia per dollar in mid-November 2014. In early 2014, the National Bank of Ukraine (NBU) had no choice

2. "Ukraine Needs More Financial Help, IIF Says," Reuters, September 23, 2014.

3. UniCredit Bank, "Banking Flash," Kyiv, November 3, 2014.

but to let the exchange rate float. In September–October, the NBU maintained an actual peg of 12.95 hryvnia per dollar. In early November that peg collapsed as international reserves fell below the critical level of $12.6 billion. At the end of 2014, reserves had shrunk to $7.5 billion. In spite of severe currency regulations, the economy appeared to have entered a devaluation-inflation cycle, as year-end inflation reached 25 percent. Inflation could easily rise to triple digits within a year as happened in Belarus in 2011. An advantage of the sharp depreciation of the hryvnia is that Ukraine's sizable current account deficit turned into a surplus in 2014, as imports fell far more than exports.

Banks have incurred large losses because of the depreciation of the hryvnia. The government has been caught in a hopeless conundrum. Only the Ukrainian government can bail out the banks. Ukraine has been shut out of the international debt market for two years. Since the government had no financing, it had no choice but to sell bonds to the NBU and related state banks financed by the NBU, which together hold 60 percent of Ukraine's public debt. Any announcement of recapitalization of the banks leads to new depreciation.

After the fall of Yanukovych, the new Yatsenyuk government quickly appealed to the IMF, and as early as March 2014 the IMF concluded a two-year Stand-By Arrangement with total international financial support of $33 billion for two years, of which the IMF itself would contribute $17 billion. The rest of the funding would come from the World Bank, the European Union, the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), and various bilateral creditors. The program was based on benign assumptions of no further Russian military aggression but rightly emphasized the geopolitical risks.

With increased war damage, preconditions changed substantially, and the program had become unrealistic by April 2014. All indicators turned out far worse than the IMF expected. Former IMF official Susan Schadler (2014, 7) noted with understatement that the "report gives the impression that IMF staff and management find the program scenario as skewed toward optimism as markets do." This IMF program was not credible and had to be redone.

In December 2014, Ukraine's financial situation was desperate but not hopeless. Without a substantial change in the country's economic policies, a financial meltdown within three months or so appeared imminent (see chapter 2). A government had been formed and it had adopted a radical program for fiscal adjustment and structural reform. Even so, Ukraine needed substantial new financing, not only credits to replenish its international reserves but also grants to cover the substantial war damage, as argued in chapter 3.

Cut Public Expenditures

In the 1950s and 1960s, the dominant Western view was that the level of public expenditures did not matter as long as a country had its budget deficit under control. The United States had a marginal income tax exceeding 90 percent (Tanzi 2011). Even today, the IMF tends to be neutral on this issue. Axiomatically, the European Union considers the EU average ideal, without considering its economic effects.

Yet, multiple econometric studies show that low public expenditures are better than large, but of course they must be properly financed so that the public deficit does not become excessive (Barro and Sala-i-Martín 2004). The post-communist country that has persisted with high public expenditures, large budget deficits, and big public debt is Hungary—and Ukraine comes close to it. Both have public expenditures over 50 percent of GDP. While Estonia more than doubled its GDP from 1990 to 2012 in real terms, Hungary's grew by a miserable 24 percent (World Bank 2014a). The cause in Hungary as in Ukraine was that politicians refused to heed the insights of sensible economists who warned about its "premature social welfare society" (Kornai 1992, Bokros 2014). Ukraine is doing even worse, with lower GDP today than in 1990, according to the World Bank (2014a). Moreover, the less developed and the more corrupt the state is, the less public redistribution of revenue is morally justified, because it is likely to be done more inefficiently than in an honest and well-developed state (Milanovic 1998).

Ukraine's public expenditures are deeply problematic in three regards. They are far too large, misallocated, and inefficient. All along, Ukraine has had excessively large public expenditures—both budgeted and executed. In 2013 the IMF (2014b, 34) assessed Ukraine's public expenditure at 51.2 percent of GDP (table 9.1), which is high by any standard. The current average of the far more developed European Union is 49 percent of GDP.[4] By July 2014, the IMF (2014d, 41) had raised Ukraine's forecast expenditures for 2014 to 52.7 percent of GDP.

Lack of data and public awareness are major concerns. The Ukrainian government does not publish the composite state budget. The best source is the IMF, which is not focused on public education. As a consequence, hardly any Ukrainians know the size of the country's public expenditures or the budget deficit. The numbers used by the government are only the central state budget, excluding the vast pension fund and regional and local budgets as well as Naftogaz subsidization and bank recapitalizations. The government needs to come clean with the population and publish elementary budget data.

According to Wagner's law, public expenditures rise with GDP, but Ukraine remains quite a poor country, so by that token it should have low public expenditures. Moreover, high public expenditures are neither inevitable nor beneficial, and depress economic growth (Tanzi and Schuknecht 2000). The three fast-growing Baltic countries have public expenditure ratios of 34 to 38 percent of GDP. Lithuania, Europe's fastest growing country, appears a suitable standard for Ukraine. Its public expenditures are only 34 percent of GDP, and its social indicators are much better than Ukraine's (Eurostat 2014).

4. Eurostat, Total Government Expenditures, Percent of GDP, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00023 (accessed on August 8, 2014).

Table 9.1 General government expenditure in Ukraine, 2010–14
(percent of GDP)

Component	2010	2011	2012	2013[a]	2014[a]
Total expenditure	49.0	45.6	49.0	51.2	52.7[b]
Current	46.0	42.2	45.7	48.1	48.7
Compensation of employees	11.4	10.4	11.2	11.7	11.7
Goods and services	7.3	6.8	7.4	8.0	7.9
Interest	1.6	2.0	1.9	2.3	3.3
Subsidies to corporations and enterprises	2.4	1.9	3.1	2.3	2.2
Social benefits	23.2	21.2	22.0	23.8	23.6
Social programs (on budget)	3.4	3.2	3.9	4.0	3.7
Pensions	17.9	16.2	16.6	17.8	17.9
Unemployment, disability, and accident insurance	1.9	1.8	1.6	2.0	2.0
Other current expenditures	0.0	0.0	0.0	0.0	0.0
Capital	2.8	3.0	3.1	1.7	1.7
Net lending	0.1	0.4	0.3	0.1	0.1
Naftogaz deficit	1.7	1.6	1.1	2.0	2.0

a. IMF Staff projections.
b. Includes Naftogaz balance from Ukraine's September 2014 IMF Stand-By Arrangement.

Source: IMF (2014b, 34).

Ideally Ukraine should aim at cutting its public expenditures by 18 percent of GDP over the next few years for sustainable growth and financial development.

Usually, the best way to make big fiscal adjustments is to eliminate the categories of public expenditures that cause direct harm. Cutting expenditures across the board makes people unhappy and does not propel structural reforms (Balcerowicz 1992). Three kinds of public expenditures stand out in Ukraine, namely energy and other enterprise subsidies, excessive pensions, and unwarranted expenditures on public administration.

First, the government should abolish enterprise subsidies. According to the IMF (2014b, 87), the Ukrainian government spent 7.6 percent of GDP on energy subsidies to gas, electricity, and coal in 2012. Of these only 1.3 percent of GDP was recorded in the budget, with the rest being either below-the-line operations, such as recapitalization bonds for Naftogaz, or off-the-budget writeoffs of arrears. Other enterprise subsidies in the budget accounted for 0.9 percent of GDP, bringing total enterprise subsidies to 8.5 percent of GDP. By July 2014, the IMF (2014d, 21) had raised Naftogaz's need for financial support from the state in 2014 from 4 to 7.6 percent of GDP. This increase would raise total energy subsidies to 10 percent of GDP in 2014. A country in crisis should not be doling out subsidies of such magnitude. They should be eliminated instantly (see chapter 10). Table 9.2 offers a different division of

Table 9.2 Outlays by function of Ukraine's government, 2010–12 (percent of GDP)

Function	2010	2011	2012
Total outlays	48.4	45.3	48.3
General public services	4.3	11.4	12.7
Public debt transactions	1.6	2.0	1.9
Defense	1.0	1.0	1.0
Public order and safety	2.7	2.5	2.6
Economic affairs	4.1	4.4	4.4
Agriculture, forestry, fishing, and hunting	0.7	0.6	0.5
Fuel and energy	1.1	0.8	1.2
Transport	1.3	1.3	1.1
Communication	0.0	0.0	0.0
Environmental protection	0.3	0.3	0.4
Housing and community amenities	0.5	0.7	1.4
Health	4.3	3.8	4.3
Recreation, culture, and religion	1.1	0.8	1.0
Education	7.4	6.6	7.2
Social protection	22.8	13.6	13.3

Source: IMF, *Government Finance Statistics*, 2013.

public expenditures from table 9.1.[5] For 2012, it shows "economic affairs" (4.4 percent of GDP) and "housing and community services" (1.4 percent) as subsidies to be eliminated. Even if the government gave 2 percent of GDP in cash compensation to the poorest half of the population, it could save 8 percent of GDP on energy and enterprise subsidies.

The most outlandish public expenditures are pensions. The IMF (2014d, 41) assessed their cost at 16.3 percent of GDP in 2014, whereas 8 percent of GDP is a reasonable level internationally. Ukraine carried out a pension reform in 2011, which did not make even a dent in pension expenditures. The country has maintained a large number of old Soviet nomenklatura benefits, largely paid from the pension fund. Many of them are labeled "special pensions," which have amounted to almost 4 percent of GDP (Betliy and Giucci 2011). The government has started cutting nomenklatura benefits, but much remains to be done.[6] The very low retirement age needs to be raised faster, and

5. The lower total public expenditures are explained by the exclusion of the Naftogaz deficit in this table.

6. "Poroshenko otmenil l'goty Yushchenko, Litvina, Azarova i drugikh" ["Poroshenko canceled benefits of Yushchenko, Lytvyn, Azarov and others"], *Ukrainskaya pravda*, August 4, 2014; "President lishyl l'got generalov v otstavke" ["President deprived benefits of retired generals"], *Ukrainskaya pravda*, August 4, 2014.

the loose standards for early retirement and disability pensions need to be tightened. The country needs to carry out a full-fledged pension reform with mandatory private pension savings (see chapter 11). Ukraine should aim at cutting pension expenditures by 4 percent of GDP in one year.

The Ukrainian public sector has far too many institutions, functions, and employees. As a consequence, too many public employees are not very competent because they earn too little. The obvious solution that the Yatsenyuk government has started is to cut the number of public employees sharply, while keeping the wage funds for the remaining workers. It would make sense to cut the public labor force by half and double the salaries for the rest as discussed in chapter 8. At least 1 percent of GDP can be economized on such cuts. Ukraine spends 2.6 percent of GDP on maintaining public order and safety, which is too high, and should reduce it by 1 percent of GDP (table 9.2).

At the same time public expenditure should be made more efficient, especially state procurement, which must be competitive. The Ukrainian government's total purchases of goods and services on the budget account for 8 percent of GDP; adding 1.7 percent of GDP in public capital expenditures takes the amount to almost 10 percent of GDP (IMF 2014b, 34). Under Yanukovych, kickbacks of 50 percent were considered normal from major infrastructure projects (see examples in chapter 5). One of the new government officials claimed that the total amount embezzled through procurements amounted to only one-fifth.[7] Even so, 2 percent of GDP could be saved through better procurement.

In the spring of 2014, Ukraine adopted a new law on state procurement once again to satisfy an IMF precondition.[8] Alas, within four months of the adoption of the law, deputies lobbying various business interests submitted more than 50 draft laws for exceptions (Blinov 2014). For procurement to be open and competitive, just reducing looting would yield a gain of 2 percent of GDP. The government suggests that 20 percent of total procurement could be saved through the introduction of electronic state procurement.[9]

Summing up the proposed cuts yields a reduction in public expenditures of 20 percent of GDP: elimination of enterprise subsidies (8 percent of GDP), reduction in pension expenditures (8 percent), downsizing staff (1 percent),

7. "Pervy zamministr kabmina Parakuda: Na goszakupkakh vorovalas' kazhdaya pyataya grivna" ["First Deputy Minister of the Cabinet of Ministers Parakuda: In State Procurement Every Fifth Hryvnia Was Stolen"], *Focus*, October 20, 2014.

8. IMF, "IMF Executive Board Approves 2-Year US$17.01 Billion Stand-By Arrangement for Ukraine, US$3.19 Billion for Immediate Disbursement," press release no. 14/189, April 30, 2014, www.imf.org/external/np/sec/pr/2014/pr14189.htm; Law of Ukraine, "Pro zdiysnennya derzhavnykh zakupivel'" ["On Public Procurement"], No. 1197-VII, April 10, 2014, http://zakon3.rada.gov.ua/laws/show/1197-18/print1383857428710001.

9. "Perekhod no elektronnye goszakupki pozvolit sekonomit' do 40 milliardov" ["Transition to Electronic State Procurement Allows the Economizing of up to 40 billion [hryvnia]"], *Ekonomichna pravda*, October 16, 2014.

cuts in law enforcement spending (1 percent), and normalization of public procurement (2 percent). While pension cuts will not be instant, these proposed changes would free up funds to spend on important, more desirable items, including social compensation.

Although Ukraine's overall public expenditures are too large, spending on some items is quite small. Most strikingly, defense expenditure of 1 percent of GDP was minuscule and needs to be increased in view of Russian military aggression. The government's goal is to raise it from 1.6 percent of GDP in 2014 to 5 percent of GDP in 2015. But a Ministry of Defense representative complained that about 90 percent of the defense budget is spent on "food, utilities and the salary of military personnel."[10] The defense sector should also lay off superfluous staff and sell unnecessary real estate. Family and unemployment benefits, which are too low, should be raised.

Some Ukrainian government representatives use the need for more military expenditures as an excuse for not cutting public expenditures in general and instead call for "financial mobilization." This makes no sense. The desired increase in defense expenditure is merely 3.4 percent of GDP, while the preferred cut in public expenditures is 20 percent of GDP. Moreover, an expansion of one kind of public expenditures is a reason to economize on other expenditures. Furthermore, Ukrainians are not likely to be more appreciative of a parasitic and corrupt state because of the war.

Slashing public expenditures urgently is all the more crucial because Ukraine is in the midst of a major financial crisis. Else, the crisis could become as ferocious as the Russian financial crash of August 1998. At the time the Russian government could not obtain any financing and had no choice but to cut its public expenditures by 14 percent of GDP from 1997 to 2000, which led to a steady economic growth of 7 percent a year for a decade. The cuts in enterprise subsidies of 16 percent of GDP leveled the playing field, opening up the marketplace for new entrepreneurs (Åslund 2007). When Moldova faced a financial crisis combined with devaluation, it also sharply cut public expenditure by 15 percent of GDP from 1997 to 1999 (Åslund 2002, 226), which led to sustained economic growth. If high public expenditures render a country financially unsustainable, sharp cuts in those expenditures do not harm the economy but instead imbue confidence and kickstart economic growth.

Similarly, in the two crisis years 2009–10, Latvia carried out a fiscal adjustment of 13.6 percent of GDP (Åslund and Dombrovskis 2011, 107). Two years of strict fiscal policy led Latvia to enjoy the highest economic growth in Europe in 2011 and Prime Minister Valdis Dombrovskis was reelected twice. Estonia and Lithuania had similar experiences in 2009–10.

All these countries carried out major fiscal adjustments by primarily cutting public expenditures fast, which cleansed the market of subsidies and

10. Oleksandr Lashchenko, "2012 roku finansuvannia ukrainskoi armii bude rekordno nyz'kym" ["In 2012, the financing of Ukrainian army will be at the record low level"], *Radio Liberty*, May 19, 2011, www.radiosvoboda.org/content/article/24179169.html.

barriers and spurred beneficial structural reforms, leading to rapid economic growth. Unlike Russia and Moldova, the Baltic countries did not carry out devaluation, but even so they achieved impressive growth spurts. A large budget deficit in the midst of a financial crisis does not stimulate growth but impedes it, as the Ukrainian and Russian experiences of the 1990s show (Åslund, Boone, and Johnson 2001), not to mention Greece in 2008–13. These examples run contrary to the Blanchard and Leigh (2013) argument for developed European economies that fiscal multipliers are big and positive, which are short term for one year and clearly do not apply to emerging economies.

Unlike the IMF program for Latvia in 2008, the March 2014 IMF Stand-By Arrangement for Ukraine was amazingly relaxed. It did not foresee a reduction of very large public expenditures of more than 2 percent of GDP in 2014, and "a gradual expenditure-oriented fiscal adjustment—proceeding at a pace commensurate with the economy's speed of recovery—aiming at reducing the structural fiscal deficit by around 2 percent of GDP by 2016." It anticipated enterprise subsidies—a major source of corruption—to shrink by a marginal 0.1 percent of GDP (IMF 2014a, 19, 62–63). This program was far too cautious and not commensurate with the severity of Ukraine's fiscal crisis. It is difficult to see how it could have salvaged Ukraine from default. Even after it cut Ukraine's GDP forecast for 2014 from a contraction of 5 to 6.5 percent, the IMF (2014d, 41) demanded an additional fiscal tightening of only 1 percent of GDP to a total of 3 percent of GDP. Seldom has an IMF program been so inadequate. It did not offer Ukraine any chance of economic success.[11]

In a relaxed fashion, the IMF stated that "a schedule should be adopted to raise [gas] tariffs to the cost recovery level over the next three years through semiannual increases of 20 percent until mid-2016" (IMF 2014a, 89). This pace was far too slow, giving one big and powerful businessman enough time to capture the gas arbitrage and buy Ukraine's politics. Public expenditures must be cut much faster, and the prices of natural gas and other forms of energy should be increased to the market level immediately, while those affected by high energy prices should be compensated with cash transfers.

The IMF designed such an unsustainable program for Ukraine presumably because Western governments wanted to finance Ukraine but not from their own budgets. They treat the IMF as their international reserve fund, caring little about the organization's conditionality and even less about a client country's financial sustainability.

Lower Taxes and Close Loopholes

Ukraine's state revenues are large and remarkably stable at about 45 percent of official GDP. The main concerns about Ukraine's tax system are instead a vast underground economy created by massive tax evasion, cumbersome taxation practices, and outright criminalization of the tax administration.

11. Dabrowski (2014) expresses similar views.

Table 9.3 Ukraine's general government revenue, 2010–14 (percent of GDP)

Tax	2010	2011	2012	2013[a]	2014[a]
Total revenue	43.3	42.9	44.5	45.5	45.3
Tax revenue	37.5	38.4	38.9	39.8	39.7
Tax on income, profits, and capital gains	8.4	8.9	8.8	9.2	8.8
Personal income tax	4.7	4.6	4.8	5.2	5.2
Corporate profit tax	3.7	4.2	4.0	4.0	3.6
Payroll tax	11.6	12.4	13.0	13.9	14.0
Property tax	0.9	0.8	0.9	0.9	0.9
Tax on goods and services	13.3	13.5	13.5	13.0	13.0
Value-added tax	9.5	10.0	9.9	9.3	9.3
Excise	2.6	2.6	2.7	2.8	2.8
Other	1.1	0.9	0.9	0.9	0.9
Tax on international trade	0.8	0.9	0.9	0.9	0.9
Other tax	2.5	1.9	1.8	1.9	2.0
Nontax revenue	5.7	4.5	5.6	5.6	5.6

a. IMF Staff projections.

Source: IMF (2014b, 34).

If Ukraine would cut its public expenditures to Lithuania's level of 34 percent of GDP in the medium term, state revenues should decline to 36 percent of GDP to allow for an annual budget surplus of 2 percent of GDP to reduce the public debt. That offers a lot of room for tax cuts, 9 percent of GDP, but public expenditures must be slashed before taxes are reduced.

Two taxes dominate Ukraine's state revenues, the payroll tax and the value-added tax (VAT). The "unified social security contribution" or payroll tax of 41 percent contributes 13 percent of GDP. In the European Union, the corresponding average rate is 36 percent of the payroll, and in the United States 15 percent. The VAT together with excise taxes yield 13 percent of GDP. The nearly flat personal income tax yields 5 percent of GDP, and the corporate profit tax 4 percent of GDP. Foreign trade taxes contribute barely 1 percent of GDP. Nontax revenues, mainly dividends from state companies and privatization revenues, add 5.5 percent of GDP (table 9.3) (IMF 2014b, 34; Yatsenyuk 2014a).

In July 2014, the Yatsenyuk government presented a Concept for Reform of the Tax System (Cabinet of Ministers 2014b). In mid-September, the government submitted its tax proposals to parliament, which refused to consider them before the elections. The reform plan focused on three problems: the shadow economy, the budget deficit, and the public debt. The government assessed the shadow economy at 34 percent of the official GDP, which seems low. Out of Ukraine's total labor force of 27 million, only 17 million are acknowledged as members of the active workforce, and many of them reveal only half of their real incomes to secure a minimum pension.[12]

The concept's first objective was to create beneficial conditions for economic growth and to bring the shadow economy into the official economy. Its second aim was transparency. The third was to develop mutual trust between taxpayers and state. The fourth objective was to reduce the time and costs of tax administration. The goal of maintaining sufficiently large state revenues came toward the end. An additional aim was decentralization (Cabinet of Ministers 2014b). Tax revenues have always been high in Ukraine regardless of the economy's performance, indicating that consecutive governments had focused on state revenues rather than economic growth. When state revenues fell short, the state tax administration unlawfully raided companies or demanded advance payments of taxes.

A large number of small nuisance taxes have characterized Ukraine's tax system. The Tax Code of 2010 reduced the number of state taxes from 29 to 18 and the local taxes from 14 to 5 (Shevchenko and Otten 2014, 2). Prime Minister Arseniy Yatsenyuk (2014a) wanted to cut the number of taxes from 22 to 9, which is the average number in Western countries. The 13 taxes Yatsenyuk wanted to abolish are sectoral taxes yielding only 2 percent of budget revenues. They cost more to administer than they yield in revenue, and they distort competition, benefiting only their collectors. These taxes are typically minor fees (Cabinet of Ministers 2014b).

The remaining taxes are sensible: personal income tax, unified social contribution, corporate profit tax, value added tax, excise tax, agricultural tax, real estate tax, import tariffs, and natural resource taxes. Ukraine has no wealth tax and no inheritance tax on residents. Capital gains are essentially taxed as income (Deloitte 2014). The proposed tax reform would give Ukraine the right tax structure by international standards.

Big corporations should be dissuaded from indulging in transfer pricing and be compelled to disclose their profits in Ukraine for taxation. Loopholes for the rich and powerful should be closed. Most importantly, all enterprises must reveal their real owners to stay registered in Ukraine and should be prevented from importing goods without paying VAT and obtaining VAT refunds when exporting.

The general trend in taxation is to move it from production, that is, labor and capital, to consumption (Tanzi and Schuknecht 2000). A VAT of 20 percent and high excise taxes on tobacco, alcohol, and some luxury products make sense, and these indirect taxes yield large revenues. Yanukovych legislated to reduce the VAT to 17 percent starting in 2015, and the IMF (2014a, 30) rightly insisted on keeping it at 20 percent. The VAT and excise taxes should be kept at their current high level.

VAT has always been controversial in Ukraine because it is riddled with

12. "AP: okolo poloviny ukraintsev rabotayut nelegal'no" ["Presidential Administration: About Half of the Ukrainians Work Illegally"], *Ukrainskaya pravda,* October 17, 2014.

massive evasion and fraud. Prime Minister Yatsenyuk has stated: "The most corrupt tax in the country is the value-added tax."[13] Many problems plague VAT, but they mainly concern VAT refunds for exporters. On the one hand, VAT fraud is common, with people obtaining refunds for goods not exported but sold inside Ukraine. Yatsenyuk claimed that the losses from such fraudulent VAT refund demands amounted to 20 billion hryvnia per year (Dovgan 2014). The State Fiscal Service claims that one of Yanukyvoch's loyalists arranged a scheme to smuggle petrol into Ukraine without paying VAT or custom tariffs, adding 7.6 billion hryvnia to the state revenues in six months in 2014.[14]

On the other hand, many exporters do not receive their legitimate refunds for exports, which means that their exports are subject to an informal penalty tax of 20 percent. Foreign investors in Ukraine have persistently complained about this problem. The tax authorities charge "commissions" on VAT refunds for exporters, usually 20 to 30 percent of the refund. These informal commissions peaked at 40 to 50 percent after Yanukovych became president in 2010 (Stecklow, Piper, and Akymenko 2014; Vyshynsky 2014b). In September 2014, a financial investigation of the State Fiscal Service reportedly revealed that a group of former tax inspectors had embezzled VAT refunds of 2.2 billion hryvnia.[15]

Many Ukrainians favor replacing VAT with a general sales tax, but the government's revenues from VAT are substantial. While the EU average revenues from VAT are 7 percent of GDP, Ukraine obtains 10 percent of GDP. Within the European Union, only Denmark collects as large VAT revenues. Therefore there is no realistic alternative to VAT. A sales tax could hardly be higher than 10 percent because of the distortions it causes by not taxing the whole production chain but only retail sales, and it would generate far smaller revenues (Betliy, Giucci, and Kirchner 2013). The tax authorities explain that VAT revenue is large because much of it is collected through customs. Another reason is that the government does not budget for all legitimate VAT refunds, which are thus not paid. The Ukrainian government recognizes this shortcoming and is focusing on improving the administration of VAT amid calls from the opposition parties to replace it with a sales tax. A great advantage of VAT is that even politically influential enterprises are forced to pay it.

Ukraine introduced a real estate tax of up to 1 percent of the assessed value in January 2013. Its level corresponds to Western standards, and it makes

13. "Arseniy Yatsenyuk rasskazal o pravitel'svennykh initsiativakh stimulirovania i detenizatsii ekonomiki" ["Arseniy Yatsenyuk Told about Government Initiatives to Stimulate the Economy and Reduce the Shadow Economy"], *Pravitel'stvenny portal*, July 31, 2014.

14. "Byudzhet Ukrainy poluchil 7,6 milliarda ot detenizatsii vvoza nefteproduktov" ["Ukraine's Budget Received 7.6 Billion from De-Shadowing of Imports of Oil Products"], *Ekonomichna pravda*, September 9, 2014.

15. "Moshenniki vmeste s eks-nalogovkiama obokrali gosudarstvo na 2,2 milliarda" ["Fraudsters Together with Former Taxmen Stole 2.2 Billion from the State"], *Ekonomichna pravda*, September 16, 2014.

perfect sense. It offers owners an incentive to utilize land and property. Yet, actual real estate taxes remain minimal and should be hiked.

The most problematic Ukrainian tax is the "unified social contribution," which is a payroll tax for pension, health care, and unemployment benefits. It is unsustainably high at 41 percent of the payroll and is a major cause of the small official labor force and the sizable shadow economy. Many workers hide in the informal economy, which deprives them of social benefits deriving from the payroll tax. The collection of the payroll tax was traditionally ineffective because it was carried out by various social funds, but since October 2013 the Ministry of Revenues and Charges (Shevchenko and Otten 2014, 2)—renamed the State Fiscal Service—has been collecting it.

Yatsenyuk's (2014a, 2014b) main idea was to keep the payroll tax at the current 41 percent for two minimum incomes and decrease it to 15 percent for higher incomes. It might appear strange to have a regressive payroll tax, but it must be seen in the light of incentives and taxation practices. The two main objectives of the unified social tax are to generate revenues and bring labor from the shadow economy into the official economy. "In the private sector, many Ukrainian businesses pay their employees partly in cash—known as 'black' salaries—to avoid social-security contributions.... Tax authorities estimate that cash payments for salaries total about $17 billion a year, resulting in at least two million workers not appearing on tax rolls" (Stecklow, Piper, and Akymenko 2014).

Most workers want payroll tax to be paid on the minimum wage so they are entitled to public pension, but neither employees nor employers have any incentive to pay more social taxes, which do not result in significantly higher pensions. Therefore, additional earnings have been paid in cash, but cash is expensive. The State Fiscal Service assessed that cash payments cost 15 percent of the turnover. To begin with, it costs about 10 percent of the payroll to generate the cash through VAT fraud and then some 5 percent of the payroll to transport and handle the cash. Knowing this, the State Fiscal Service proposed a payroll tax of 15 percent for higher incomes, which would be equal to the cost of black cash.[16] The same principle determined the level of the flat income tax in Russia in 2001 at 13 percent.

The proposed cut in payroll tax would improve both VAT and payroll tax collection. The State Fiscal Service does not think that it will have any significant impact on overall tax revenues, given the current massive tax evasion. If Ukraine carried out a pension reform with personal savings accounts, or at least tied pensions to contributions, the incentives to pay would improve dramatically.

With his 2010 tax code, Yanukovych had abandoned Ukraine's previous flat personal income tax of 15 percent for a higher rate of 17 percent, which made no sense. Yatsenyuk (2014a) proposed the reintroduction of a progressive personal income tax with three rates: 15, 20, and 25 percent. But if the government cannot collect a payroll tax of more than 15 percent, it definitely

16. Interview with Ihor Bilous, head of the State Fiscal Service, in Kyiv, September 17, 2014.

cannot collect an income tax of more than 15 percent, which offers no tangible benefit to the taxpayer. Moreover, most countries in this region have low, flat personal income taxes, for example, 10 percent in Bulgaria, 13 percent in Russia, 15 percent in Lithuania, and 16 percent in Romania. Being significantly poorer than these neighboring countries, Ukraine needs to have competitive taxation with a low, flat personal income tax. Reverting to the rate of 15 percent appears the natural choice.

About half of the postcommunist countries have flat personal income taxes, and as one of the more corrupt countries Ukraine needs such a tax until it has successfully reduced corruption. In Russia, the introduction of a flat income tax in 2001 led to a sharp increase in those tax revenues, as has generally been the case. Yuriy Gorodnichenko, Jorge Martinez-Vazquez, and Klara Sabirianova Peter (2009) concluded their econometric assessment that in connection with Russia's flat tax reform "large and significant changes in tax evasion" were "associated with changes in voluntary compliance." The IMF opposes flat taxes for ideological rather than economic reasons. Even so it acknowledged that "there is evidence for Russia that compliance did improve; the distributional effects of the flat taxes are not unambiguously regressive, and in some cases they may have increased progressivity, including through the impact of compliance" (Keen, Kim, and Varsano 2006; cf. Ivanova, Keen, and Klemm 2005).

Since 2009, Georgia has gone even further. It has abolished its payroll tax, introducing a single flat income tax of 20 percent (Bendukidze and Saakashvili 2014). Ukraine should follow Georgia's lead in due course.

The Tax Code of 2010 legislated a gradual reduction of the tax rate on corporate profits from 25 to 16 percent, with a rate of 18 percent in 2014 (Shevchenko and Otten 2014, 3). Few countries collect as large a share of GDP in corporate profit taxes as Ukraine, 4 percent of GDP in 2013, while the EU countries get barely 3 percent of GDP in corporate profit taxes (table 9.3, Eurostat 2014). The largest private Ukrainian companies have minimized profit taxes through transfer pricing to lower profits in Ukraine and accumulate profits in offshore tax havens. The profit taxes are therefore most burdensome for medium-sized companies, which have borne the brunt of Ukraine's severe tax collection practices. The corporate profit tax should be reduced further and all loopholes should be eliminated. Many countries in the neighborhood have adopted for equally low personal income taxes and corporate profit taxes, because small entrepreneurs can easily transform one form of income into the other. Ukraine should opt for a flat income tax of 15 percent for both individuals and corporations, as Lithuania has done; in Bulgaria it is 10 percent and Romania 16 percent.

Yatsenyuk also proposed to simplify taxation of small entrepreneurs. From 1998 to 2010, single entrepreneurs in Ukraine enjoyed a favorable simplified tax. They paid either a small lump-sum tax or a low turnover tax. This sector of microenterprises expanded rapidly to millions of people (Thiessen 2001). In 2010, the Yanukovych tax code sharply restricted this simplified tax, forcing many to close down and driving many into the underground economy. Unfortunately, official statistics of the microenterprise sector are too contradictory to allow any clear assessment of the consequences. It will be several years before Ukraine successfully manages a reasonable tax system for millions of taxpayers. Until then small entrepreneurs need a simplified tax as a shield against government arbitrariness. Fortunately, the draft tax law proposes a substantial expansion of lump-sum taxation of small entrepreneurs with limited turnover and up to 10 employees and a turnover tax of only 4 percent without VAT obligations for small entrepreneurs with a maximum of 20 employees. Moreover, small enterprises with a turnover of less than 20 million hryvnia a year, about $1.2 million, will not be subject to inspections for two years.[17]

Ukraine's agricultural sector benefits from very mild taxation, which has rightly aroused considerable controversy at the IMF. All agricultural enterprises regardless of size have been subject to a land tax of up to 1 percent of the assessed value of the land, but usually this tax has been minimal. For Ukraine's millions of poor agricultural producers this tax makes sense because they have small family plots, which enable them to survive during hard times through subsistence farming. But Ukraine's many large agroholdings of up to 500,000 hectares are in a different league. These holdings are often large integrated companies with nonagricultural enterprises as well, but they pay the very low agricultural tax for all their activities, and are also exempt from VAT. These entities should be subject to regular taxation with full bookkeeping. Conversely, the current government proposal is that such taxation should apply to agricultural companies with sales of more than 20 million hryvnia, about $1.2 million.[18]

Privatization can yield substantial additional revenues for Ukraine. Although most state-owned enterprises have been sold, 3,300 remain in state hands. The Yatsenyuk government proposes to privatize 1,251 enterprises,[19] although they may not fetch a meaningful price in the midst of the rampant financial crisis. If done through open tenders, privatization of enterprises should contribute a few percent of GDP each year for the next few years. An even larger source of income could be the sale of unused or underutilized public real estate, which could bring at least 2 percent of GDP a year.

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17. "Vlast' khochet zapretit' proverki biznesa s oborotom do 20 millionov" ["The Government Wants to Prohibit Inspections of Businesses with a Turnover up to 20 Million [hryvnia]"], *Ekonomichna pravda*, September 9, 2014.

18. "Arseniy Yatsenyuk pro uriadovu reformu podatkovoi systemy v Ukraini" ["Arseniy Yatsenyuk on Government's Reform of the Tax System in Ukraine"], *Uriadovyi portal*, August 6, 2014.

19. "Pravitel'stvo obrashchaetsya k Parlamentu bezotlagatel'no prinyat's zakon o privatizatsii" ["The Government Turns to the Parliament and Demands that it Adopts a Law on privatization"], *Pravitel'stvenny portal*, September 3, 2014.

Simplify and Decriminalize Tax Administration

The Ukrainian tax administration is fraught with corruption, extortion, red tape, arbitrary police actions, and other illegalities. Collecting revenues is the least of the problems; the main concern is protecting the business community from lawless tax inspectors. Tax officials extort bribes from taxpayers, part of which is passed on to superiors in the tax administration. Under Yanukovych, the extorted funds seem to have been concentrated at the top level of the government.

Tax inspectors have also indiscriminately imposed penalties. The Tax Code of 2010 stipulates that the maximum tax penalty should not exceed 50 percent of the withheld amount (Shevchenko and Otten 2014, 2). But tax officials have routinely charged penalties that were five times larger than the amount of income being penalized, in accordance with a temporary presidential decree of June 1995. Ukraine's Supreme Court has ignored the tax code on this matter (Koval 2014).

The government's new Concept of Reform of the Tax System emphasizes building "a partner relationship between the tax authorities and the taxpayers." The rights and duties of both parties are to be strictly regulated in law. Mediation is expected to replace an administrative procedure (Cabinet of Ministers 2014b). The government should go one step further and decriminalize taxation. Competing tax collection agencies extract money from the same companies, causing what Andrei Shleifer and Daniel Treisman (2000) have called "overgrazing." These agencies do not care about the survival of the taxpayers, only how much their agency can extract.

In his tax reform speech on August 6, 2014, Prime Minister Yatsenyuk attacked the three "monsters" that pursue criminal tax inspections: two departments of the State Fiscal Service, two departments of the Ministry of Interior, and the State Security Service. He proposed abolishing all these police functions in these institutions and instead creating a Service of Financial Investigation. "On average, only officially, these three monsters carry out 61,000 inspections; 61,000 criminal cases are opened each year. Every hour 30 enterprises are investigated and subjected to criminal cases. They have no time to work. They only deal with prosecutors, policemen and investigators" (Yatsenyuk 2014a). Yatsenyuk prohibited inspections of enterprises until December 31, 2015, through amendments to the Budget Law, passed by parliament on July 31, 2014.[20] But the inspections have continued. This step was inspired by President Mikheil Saakashvili's reforms in Georgia.

The old tax administration is rotten. In the 1990s, Mykola Azarov built it from scratch. He was one of Yanukovych's closest collaborators. His overt concern was collecting sufficient taxes, not how it was done. He developed a vast tax administration with 70,000 inspectors, who became extortionists running

20. Law of Ukraine "On Amending the Law of Ukraine "On State Budget of Ukraine for 2014," No. 1622-VII, July 31, 2014, http://zakon4.rada.gov.ua/laws/show/1622-18/paran32#n32.

a repressive tax regime. In the early 2000s, Azarov's state racket competed with the Ministry of Interior and the State Security Service in extortion (Åslund 2009). The new head of the State Fiscal Service, Ihor Bilous, started with more than 60,000 employees, first laying off 10 percent, and then another 7 percent.[21] If taxation is decriminalized and automated, more could be cut.

Ukraine has 6,000 tax policemen,[22] who are the greatest scourge to enterprise. As policemen they are entitled to enter any firm at will and even stop its activities without showing any proof of grounded suspicion of wrongdoing. The government proposes to transform the tax police into a new Service of Financial Investigation, but that would just preserve the problem. The tax police should instead be abolished, and taxation should be decriminalized. No tax inspector should have the right to visit an enterprise without a court order. Contacts between taxpayers and the tax authority should be minimized

The long-running problems with VAT refunds for exporters should be resolved by making VAT refunds automatic, as demanded by the IMF. The new government has promised to do so by changing the whole VAT administration beginning in January 2015, claiming to make it transparent (Dovgan 2014). Businessmen remain skeptical, fearing that the government just tries to keep their funds longer in special VAT accounts.

Decentralize the Fiscal System

Ukraine maintains an excessive Soviet centralization of public finance, with both revenues and expenditures going through the central treasury in Kyiv. This overcentralization makes it impossible for state agencies to obey formal rules and breeds corruption. Fiscal decentralization should enhance the transparency and efficiency of public finance and improve incentives at all levels of government.

All state authorities are compelled to deliver virtually all revenues to the central treasury, which discourages them from collecting revenues. In effect, they are subject to confiscatory marginal taxation. Often, local authorities can retain funds collected through penalties and fines, which has led to the proliferation of such highly inefficient—and corrupt—forms of taxation (Kravchuk 1999). The natural reaction has been that each institution has established a black or gray account for additional revenues so that they control some funds themselves.

The same overcentralization applies to public expenditures. Until the recent adoption of a new law on reform of higher education, a local university had to not only seek the central treasury's permission to buy pencils but also

21. "Bilous: Umen'shenie chisla nalogov ne povlechet za soboi znachitel'nogo sokrashcheniya nalognikov" ["Bilous: A Reduction of the Number of Taxes Does Not Lead to a Substantial Cut in the Number of Taxmen"], *Ekonomichna pravda*, August 30, 2014.

22. Information from Bilous, September 17, 2014.

follow its stipulation on the kind of pencils to purchase and at what prices. In 2012–13, the State Treasury blocked local authorities' accounts, arguing their paperwork was not done properly, when it was clear to many that someone higher up wanted to seize these funds. Even though local authorities had money in their accounts they could not spend it.

Decentralization of political power is being widely discussed in Ukraine and is the focus of the constitutional amendments proposed by Deputy Prime Minister Volodymyr Groisman (see chapter 7). Political decentralization needs to be accompanied by fiscal decentralization. The constitution should explicitly state that both regional and local authorities are entitled to their own independent budgets formed by those authorities within the framework of Ukrainian laws.

Ideally, revenues from different taxes should be divided between central, regional, and local authorities depending on their nature. Expenditure mandates should also be divided between the central and local government. The clearer and more transparent these divisions are the better the incentives are for government at all levels to economize on public resources.

In international practice, foreign trade taxes, VAT, social taxes, and natural resource taxes go to the central government because VAT and foreign trade taxes are by necessity national. Social taxes finance social benefits, regardless of where the beneficiary lives in the country. Natural resource royalties can be huge, and they are usually national, not regional, assets. Otherwise some regions would reap windfall gains. Land, property, and small enterprise taxes, on the contrary, are naturally local. Such revenues motivate local authorities to nurture their entrepreneurs and take care of their region. Accordingly, the Yatsenyuk government's tax reform concept argued for land and property taxes to be kept with the local authorities. Corporate profit taxes and personal income taxes can be shared among the central, state, regional, and local authorities (Shleifer and Treisman 2000, 118–20).

The central government is typically responsible for expenditures on foreign policy and defense, pensions, unemployment benefits, higher education, and national infrastructure, while regional and local authorities cover local infrastructure and primary and secondary education. The financing of health care varies. In addition, the central government usually transfers funds to poor regions, and since it is difficult not to make them distortive, they should be kept relatively small.

Improve the Budget Process

Budgeting in Ukraine has traditionally been disorderly. The budget has often been adopted long after the budget year has started. The Ministry of Finance has played only a limited role in the creation of the budget, which has been formed through horse trading in the parliament's budget committee. Often revenues have fallen short after the adoption of a budget, necessitating sequestration, as occurred in 2014. Usually sequestration has meant not only cuts but also a redistribution of state funding, typically from social programs to enterprise subsidies and state administration (Åslund 2009).

The Western countries that suffered financial crises around 1990, notably New Zealand, Australia, Sweden, and Finland, established more orderly budget processes, giving their ministries of finance greater authority (Honkapohja 2009, Iwulska 2012, Kirchner 2013).[23] These reforms involved many steps.

To begin with, the budget process had to be strictly controlled by the Ministry of Finance, in a timely, transparent, and orderly fashion. The Ministry of Finance managed the budget process centrally, which strengthened it in relation to other "demanding" ministries and made it easier to pursue national financial objectives, such as a balanced budget and limited public debt. The discretionary powers of the parliament's budget committee and the parliament in general were curtailed. A rising view is that the parliament should receive the budget only to vote it up or down. All these measures aim at minimizing opportunities for lobbyism and corruption.

The Ukrainian Parliament is notorious for its impulsive lobbyism. Businessmen-parliamentarians suddenly propose legal amendments to divert budget funds to their favored interests, and before anyone figures out what is going on, they have already had the funds legally allocated. Legislative initiative by the Ukrainian Parliament needs to be limited. Former finance minister Viktor Pynzenyk has proposed that the parliament not accept legislative proposals with fewer than 50 signatures of parliamentarians.[24] The time needed to allocate additional budget funds should also be regulated.

Ukraine can considerably improve the quality of the budget process by allowing more time for budget planning. Policymakers would then concentrate on the outcomes of budget spending and make economic policies more result-oriented. This aim can be achieved by implementing a medium-term expenditure framework. Such a multiyear budgetary approach links policy objectives, expenditure policies, and tax policy in the medium term. It allows policymakers to balance short-term policy achievements against long-term needs for the country's development and increase the efficiency of the allocated public funds. The Ukrainian government could prepare a medium-term expenditure framework for 2015–17 after the crisis has faded.

The European Union has budgetary rules that Ukraine should consider adopting. In its Maastricht Treaty on the formation of the Economic and Monetary Union (EMU), the European Union adopted the "Maastricht criteria," which stipulate that the budget deficit must not exceed 3 percent of GDP and the public debt not more than 60 percent of GDP. Several EU countries, notably Germany and Poland, have adopted such public debt limitations in their constitutions. Also, supplementary budgets for unexpected expenses, such as for wars and disasters, have been restricted. A standard demand is "pay as you

23. Needless to say, the United States does not belong on this list.

24. Interview with Viktor Pynzenyk in Kyiv, September 15, 2014.

go," that is, any additional expenditures should be covered by additional revenues or compensated for with cuts in other public expenses.

Keep Banking Clean and Simple

Ukraine has a rudimentary financial system, with little but banking. Its banking system looked promising before the global financial crisis in 2008, being sophisticated, large, and diversified with many reputable foreign banks, but it has fallen deep into disrepair. The stock market never took off, and it is doubtful that it ever will, given that it is so backward. Ukrainian companies prefer to go abroad to sell their stocks mainly on the Warsaw Stock Exchange.

In September 2014, the National Bank of Ukraine (NBU) estimated that about half the country's banks are in such a dire state that they need to be closed. In October, it carried out a stress test of the 15 biggest banks and found that ten of them needed recapitalization, but who would do so after repeated, failed recapitalizations?[25] The main cause of the banks' losses is the big devaluation, which is ongoing, but embezzlement by owners is a major concern.

The Ukrainian banking system has been persistently convulsing for the last decade. In 2006–08, Ukrainian banks rapidly expanded lending and made extraordinary profits. Commercial banks with access to funding from the euro market could borrow short-term funds at low interest rates, while issuing consumer loans in hryvnia at interest rates of up to 50 percent a year. The artificial peg of the hryvnia to the US dollar caused this large interest gap, and the credit boom unleashed a real estate boom. The Ukrainian owners boosted the banks' assets by issuing overly large and risky loans just before they sold their shares. Many Ukrainian businessmen sold their banks because banking requires a lot of capital, which they did not have.

The overheating was extreme. West European banks purchased Ukrainian banks at crazy prices of up to five times the book value, when multiples of one or two are normal. By July 2008, 17 West European banks' share of Ukrainian banking assets peaked at 40 percent. In October, the banking system collapsed, as Ukraine experienced a sudden stop in international funding in the wake of the Lehman Brothers bankruptcy on September 15. The Ukrainian banks faced a severe currency mismatch, having taken large short-term loans in euros, dollars, or Swiss francs, while issuing loans in hryvnia, which were sharply devalued during the crisis. About one-third of the 30 biggest Ukrainian banks, all owned by Ukrainians, collapsed because of currency mismatches. Foreigners recapitalized their banks at great losses.

The IMF praised the Ukrainian authorities for their work to clean up the banking system, and all the Western banks stuck it out, until Yanukovych came

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25. The five banks that had sufficient capital were the two big privately owned banks, PrivatBank (Kolomoisky and Boholyubov) and PUMB (Akhmetov), Austrian-owned Raiffeisen Bank Aval, and the two Russian banks, Alfa Bank and Sberbank (*Komsomolskaya Pravda v Ukraine*, September 26, 2014).

to power. Foreign and unrelated private banks could no longer work profitably in Ukraine.

Four trends became evident in Ukrainian bank ownership. First, most West European banks withdrew. Only two of Ukraine's ten biggest banks, Raiffeisen Bank Aval and Ukrsotsbank, are still owned by West European banks, Raiffeisen and Unicredit, respectively. Two or three other smaller Western-owned banks may survive, but most of the Western owners have decided to sell and leave. Second, the two traditional state banks, Ukreximbank and Oshchadbank (Savings Bank), sharply raised their share of banking assets during the crisis. The government used these banks to buy state bonds for indirect state financing and let the NBU refinance them. The number of state banks increased as private banks collapsed and were taken over by the state. Third, Russian state banks had increased their share of banking assets to 16 percent by September 2014. Fourth, businessmen close to President Yanukovych greatly advanced in the banking sector, in particular, by imposing restrictive business practices on banks owned by West Europeans.

The Yanukovych administration's hostility toward foreign presence and rigorous banking standards profoundly weakened the country's banking system. Hopefully, the biggest and seemingly best run West European banks, Raiffeisen Bank Aval and Ukrsotsbank, will survive. By contrast, in the 10 new eastern members of the European Union, West European banks remain dominant and their share of banking assets shrank only marginally during the crisis.[26]

In 2014, the Ukrainian banks were hit with a double whammy. The new Yanukovych bank owners either did not know how to run banks or did not even try; they either wanted to simply steal banking assets or were truly ignorant. In at least one big bank, more than 80 percent of the lending went to the owner.

With depreciation, Ukrainian banks incurred ever greater losses because of currency mismatches. When the government announced that it would recapitalize the banks by issuing more bonds, which the NBU would buy either directly or indirectly by providing financing to the big state banks, the market rightly identified this as monetary emission, sending the exchange rate down.[27] Intermittently, Ukraine has seen both bank runs and currency runs, in response to which the NBU has reinforced the already very strict currency regulations. The situation is so bad that Ukraine is best advised to keep its banking sector small, clean, and simple.

The government should close the many obviously corrupt banks, which might account for most of the banking system, and demand recapitalization of the banks deemed viable—presumably the two traditional state banks, Os-

26. The two exceptions are Slovenia, where substandard state banks remain dominant, and Hungary, where the Viktor Orban government is trying to tax foreign banks out of existence.

27. Dragon Capital, "NBU Plans to Recapitalize State-Owned Oschadbank, Ukreximbank and Ukrgazbank," *Dragon Daily*, September 22, 2014.

hchadbank and Ukreximbank, the Western banks, and the Russian banks. In 2014, the NBU closed 32 banks, but the remaining 150 are still excessive. The government must not recapitalize corrupt and dysfunctional banks but close them. Fortunately, the NBU has limited the number of systemic banks that need to be recapitalized to only eight, which seems like the right number. Credit is expected to be tight in 2015 and 2016 in any case.

Can and Should Ukraine Avoid Default?

If the Ukrainian government does not undertake a major financial tightening and mobilize new international financing in early 2015, default is likely. Yet it would offer little relief, because the public debt that can be subject to a haircut is rather small. For Ukraine, it is more important to establish a sensible economic policy and maintain good relations with its Western donors, but some debt restructuring appears more or less inevitable.

At the end of 2013, Ukraine's public debt was merely 41 percent of GDP, but it is skyrocketing. In its July 2014 public debt sustainability analysis, the IMF (2014d, 48–50) presented rather ominous numbers. Its baseline scenario was that "debt will reach 67.6 percent of GDP at end-2014, a jump of over 26 percentage points from 2013, driven by large financing needs under past unsustainable policies as well as significant exchange rate depreciation. This ratio is about 10 percent of GDP higher than at the time" of the Stand-By Arrangement. But that was an unrealistically optimistic prospect.

The IMF offered two worse scenarios (IMF 2014d, 49). "Under a growth shock, entailing a cumulative growth decline of over 9 percent in 2015–16 in addition to the projected 2014 decline of 6.5 percent, the debt-to-GDP ratio reaches 99 percent in 2016." In a "combined macro-fiscal shock" the IMF foresaw public debt going to 134 percent of GDP in 2016. Ukraine would default long before.

Public debt is not only a fiscal cost. It also reduces growth. An empirical IMF paper found that "on average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2 percentage points per year, with the impact being somewhat smaller in advanced economies" (Kumar and Woo 2010). Already in its Stand-By Arrangement of March 2014, the IMF (2014b, 34) projected that Ukraine's interest payments would rise from 3.3 percent of GDP in 2014 to 4.8 percent of GDP in 2018, but it is set to rise far higher much earlier. The IMF (2014d, 41) foresaw an interest cost of 4.6 percent of GDP in 2015.

Ukraine's financial situation does not look sustainable. In December 2014, the consensus prediction is a 2014 output decline of 7 percent, more than what the IMF stress scenario projected, because of Russian aggression. Furthermore, the NBU is pursuing straightforward monetary financing, which boosts inflation and depresses the exchange rate. The falling exchange rate undermines the banks, which inevitably suffer from currency mismatches. Ukraine's public expenditures and budget deficit are far too large and rising fast.

Ukraine's public debt consists of three large chunks (table 9.4). Half of the debt is domestic, virtually all held by the NBU and state banks. The NBU holds an additional 10 percent of the debt through international bonds. In September 2014, the NBU and state banks with NBU financing held 60 percent of the country's public debt. Eurobonds account for just $16.3 billion, one-fifth of the total public debt, of which Russia holds $3 billion.[28] In addition to the data in this table, Gazprom has filed a lawsuit with the Stockholm arbitration court insisting that Ukraine repay gas arrears of $1.4 billion ($2.2 billion including penalties). Ukraine has countered with a demand for $6 billion in alleged overpayments for gas since 2010. At present, Ukraine is increasing its share of loans from international financial institutions, mainly the IMF and the World Bank.

Of these debt obligations, only the eurobonds and the debt to Russia could be partially written off. Even a substantial haircut would do little to ease Ukraine's desperate financial situation. The benefits from a debt writeoff are quite small (see chapter 3).

If Ukraine is successful in fending off Russian aggression, it should demand substantial compensation and reparations from Russia for assets taken from Ukraine, such as Crimea, gas reserves of 2 billion cubic meters held in storage in Crimea, the oil and gas company Chornomornaftogaz, companies in Crimea, monetary holdings in Crimea, and reparations for war damage, but this depends on the settlement of the war. Russia's claims on Ukraine may be put into question.

My Peterson Institute colleague Anna Gelpern (2014, 1) has argued that Ukraine should repudiate part of Russia's claims on Ukraine. This bond issue is subject to British law, which is not supposed to be used for international suppression:

> A single measure can free up $3 billion for Ukraine and send a powerful message to Russia: The United Kingdom can refuse to enforce English-law contracts for the money Russia lent former Ukrainian president Viktor Yanukovych in a failed attempt to keep him in power late last year. Ukraine would then have the option to walk away from this debt without the usual legal and market consequences of repudiation.

Given the financial situation of December 2014, the natural trajectory is default caused by a depreciation-inflation cycle. Then the government would be well advised to opt for an orderly debt reprofiling or prolongation of debt maturities in the framework of a new IMF program. A better option would be for the government to drastically cut public expenditures, link the reductions to major structural reforms, and ask for Western assistance. To cover the cost of war damages Ukraine should request humanitarian assistance from friendly

28. Vadim Khramov, "Ukraine: Ten Reasons Why We Think that Sovereign Debt Restructuring Is Unlikely," Morgan Stanley, September 24, 2014.

Table 9.4 Ukraine's public debt structure, 2010–13

Component	2010 Millions of US dollars	2010 Percent of GDP	2011 Millions of US dollars	2011 Percent of GDP	2012 Millions of US dollars	2012 Percent of GDP	2013 Millions of US dollars	2013 Percent of GDP
Total debt	54,300	39.80	59,220	36.24	64,500	36.52	73,110	40.47
State direct debt	40,630	29.78	44,720	27.36	49,950	28.28	60,080	33.26
Domestic debt	17,790	13.04	20,210	12.37	23,810	13.48	32,150	17.80
Obligations under treasury bills	17,381	12.74	19,811	12.12	23,436	13.27	31,796	17.60
Obligations to the National Bank of Ukraine	409	0.30	399	0.24	374	0.21	354	0.20
External debt	22,936	16.81	24,507.1	15.00	26,137.7	14.80	27,931.8	15.46
IFO loans	10,432.3	7.65	10,556.5	6.46	10,020.9	5.67	7,744.7	4.29
European Bank for Reconstruction and Development	331.3	0.24	444.7	0.27	533.8	0.30	596.3	0.33
European Investment Bank	196.5	0.14	257.8	0.16	400.8	0.23	535.9	0.30
International Monetary Fund	6,860.9	5.03	6,839.6	4.19	6,054.5	3.43	3,542.4	1.96
World Bank	3,043.6	2.23	3,014.4	1.84	3,031.8	1.72	3,070.1	1.70
Bilateral borrowings	1,415.7	1.04	1,341.8	0.82	1,138.4	0.64	910.7	0.50
Russia	996.9	0.73	899.1	0.55	801.4	0.45	703.6	0.39
Other bilaterals	418.8	0.31	442.7	0.27	337.1	0.19	207.1	0.11
Loans from foreign banks	2,000.1	1.47	2,000.1	1.22	0.1	0.00	0.1	0.00
Other external debt	1,891.2	1.39	1,885.3	1.15	1,887.3	1.07	1,897.5	1.05
SDR allocations received to the state budget	1,891.2	1.39	1,885.3	1.15	1,887.3	1.07	1,897.5	1.05
State external bonds, 2003-13	7097	5.20	8,723	5.34	13091	7.41	17379	9.62

State-guaranteed debt	13,670	10.02	14,500	8.87	14,550	8.24	13,030	7.21
Domestic debt	1,750	1.28	1,530	0.94	2,030	1.15	3,390	1.88
External debt	11,923.5	8.74	12,967.5	7.93	12,521.1	7.09	9,636.2	5.33
IFO loans	7,740.6	5.67	7,701.5	4.71	5,074.2	2.87	2,030.0	1.12
European Atomic Energy Community	65.3	0.05	55.5	0.03	47.5	0.03	39.8	0.02
European Bank for Reconstruction and Development	148.6	0.11	126.4	0.08	113.1	0.06	97.9	0.05
International Monetary Fund	7,384.5	5.41	7,361.6	4.50	4,727.9	2.68	1,648.6	0.91
World Bank	142.3	0.10	158.1	0.10	185.6	0.11	243.7	0.13
Bilateral borrowings	190.6	0.14	190.6	0.12	247.8	0.14	247.8	0.14
Loans from foreign banks	1,001.1	0.73	1,580.6	0.97	3,224.9	1.83	3,454.9	1.91
Other external debt	2,991.2	2.19	3,494.9	2.14	3,974.1	2.25	3,903.5	2.16
Total public external debt	34,759.5	25.48	37,474.5	22.93	38,658.8	21.89	37,568.0	20.80
Total public domestic debt	19,540.5	14.32	21,745.5	13.31	25,841.2	14.63	35,542.0	19.67

IFO = international financial organization; SDR = special drawing rights

Source: Ministry of Finance of Ukraine, Ukraine Bond Prospectus, February 17, 2014.

states. It is universally provided as grants, unlike financial stabilization support, which primarily consists of credits.

A common view among international financial experts is that excessive public debt should be written off early on, but what is excessive varies greatly and is a matter of opinion and policy (Reinhart and Rogoff 2009). Bulgaria and Poland reached agreements with their official creditors on substantial and conditional reductions of their foreign public debt. The first postcommunist Polish government sensibly claimed that its inherited public debt was too large and asked for a writeoff of 50 percent. After long negotiations, its creditors agreed to write off the debt in two rounds, in 1991 and 1994. In return Poland was required to pursue a strict fiscal and monetary policy and far-reaching structural reforms so that it could service the rest of the debt (Das, Papaioannou, and Trebesch 2012; Pirian 2003).

Russia defaulted on its domestic public debt in 1998. Its main regret was that default did not take place earlier and in a more orderly fashion. Hungary, by contrast, never restructured its large public debt. It has managed to service its public debt, with the intermittent assistance of the IMF, but it has not succeeded in breaking out of the fiscal trap of excessive public expenditures and public debt, forcing it to maintain higher taxes than all other countries in the region and leaving it with the lowest growth in the whole region since 2000 (Åslund and Djankov 2014).

If Ukraine desires a general debt restructuring, it should do so early, before it runs out of reserves and becomes overly burdened with IMF credits, because IMF and World Bank credits cannot be written off, as Argentina has experienced so bitterly. At the end of 2014, its international reserves were as low as $7.5 billion, which might be a reason to call for a voluntary standstill in its foreign debt service.

For long, the Ukrainian government denied the need for debt restructuring, but all governments do so until they actually do it. While visiting the United States in late September 2014, Prime Minister Yatsenyuk stated: "We strongly believe and we are confident that Ukraine will not default." But he also said Ukraine's current program with the IMF may need to be "readjusted."[29] On January 21, 2015, Finance Minister Natalie Jaresko publicly raised the need for some debt restructuring: "We'll reach out to our sovereign creditors and talk to them about their vision, our vision, how we can work together to improve the debt sustainability in the medium-term."[30]

At the same time, IMF Managing director Christine Lagarde issued this statement: "President Poroshenko informed me today that the Ukrainian authorities have requested a multi-year arrangement with the Fund, supported by the Extended Fund Facility, to replace the existing Stand-By Arrangement.

29. Dragon Capital, "Government Officials Rule Out Debt Restructuring," *Dragon Daily*, September 25, 2014.

30. Olga Tanas, Andrew Mayeda, and Stefan Riecher, "Ukraine to Consult Bondholders on Debt Terms After IMF Loan," Bloomberg, January 22, 2015.

The new arrangement would support immediate macroeconomic stabilization measures as well as broad and deep economic reforms over several years to ensure economic and financial stability and restore sustainable growth."[31]

The IMF had decided to redesign its program with Ukraine demanding more structural reform and a debt restructuring was presumed.

Recommendations

1. Publish the consolidated state budget in a comprehensible form on the web.
2. Cut public expenditures from 53 to 34 percent of GDP over the next few years with a first-year cut on the order of one-tenth of GDP.
3. Abolish all enterprise subsidies instantly, first and foremost energy subsidies, but offer social cash compensation.
4. Reduce spending on public pensions gradually from 16 to 8 percent of GDP.
5. Cut half of the civil servants and double the salaries for those who remain.
6. Implement transparent and competitive procurement procedures.
7. Cut tax revenues by 9 percent of GDP after public expenditures have been slashed.
8. Demand disclosure of final beneficiaries of any firm registered in Ukraine.
9. Combat transfer pricing and minimize multiple tax loopholes.
10. Decrease the number of taxes from 22 to 9.
11. Keep the VAT and excise taxes at their current levels.
12. Reduce the unified social contribution to 15 percent for incomes more than double the minimum wage.
13. Adopt a flat income tax of 15 percent for individuals and corporations.
14. Expand the simplified taxation system for individual entrepreneurs.
15. Impose ordinary taxation (corporate profit tax and VAT) on large agroholdings.
16. Decriminalize taxation by abolishing all forms of tax police. Tax inspectors should have no right to enter an enterprise or visit an individual without a court order.
17. Simplify tax administration and further develop electronic taxation.
18. Decentralize the extremely centralized fiscal system with regard to both revenues and expenditures.
19. Divide revenues from different taxes between central versus regional and local levels.
20. Adopt a medium-range budgeting process for three years.

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31. IMF, Statement by IMF Managing Director Christine Lagarde on Ukraine, press release no. 15/11, January 21, 2015.