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Ukraine 2019 budget

Make it good and fast

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In recent weeks, Ukraine's 2019 draft budget has turned out to be the document of highest importance for the country's economic stability and fiscal sustainability through the end of 2018 and in 2019. The IMF has reportedly delayed its decision to extend its next loan tranche to Ukraine until its government demonstrates its commitment to sound fiscal principles. Receiving IMF assistance before the year end is critical, as much of Ukraine's 2H18 foreign currency proceeds and international sources of budget financing are linked to the loan's approval.

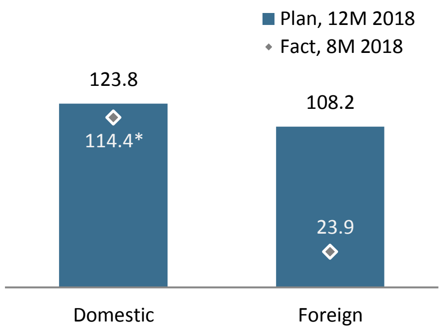
With a planned deficit at 2.3% of GDP and no changes in the tax code and key tax rates, the 2019 draft budget looks as though it has a solid foundation. However, some serious adjustments are also in order. The government's initial plan to cut utility-related subsidies by 22% is likely to be revised, as this expense needs to be adjusted for the IMF-required hikes in natural gas prices for households (which have yet to be approved).

State budget stats, UAH bln

	2018 plan	2019 draft	yoy
Revenues	917.9	1,008.4	9.9%
Spending	991.7	1,094.4	10.4%
Deficit	80.6	90.0	11.6%
% of GDP	2.3%	2.3%	0.0pp

Source: Verkhovna Rada, Concorde Capital research

Attracted government debt financing, UAH bln



** Including short-term debt that has been already redeemed or will be redeemed (refinanced) by year-end.*
Source: Verkhovna Rada, State Treasury

Budget must be approved as quickly as never before

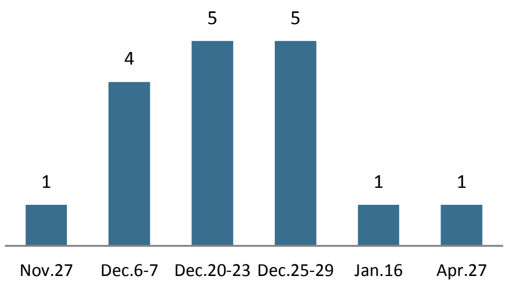
Given that the critical IMF loan tranche is dependent on the budget, parliament should be approving it in the quickest tempo. Practically all foreign currency proceeds Ukraine plans to receive through the end of 2018 are linked to the IMF program's approval.

Receiving an IMF loan would pave the way to about USD 1.4 bln in loans from the EU and the World Bank. In addition, Ukraine is not likely to gain access to other affordable financial resources on the global markets until it secures the IMF tranche. In 8M18, Ukraine's external borrowing totalled UAH 23.9 bln, or just 22% of the annual plan. Amid the waning ability of the domestic market to generate debt resources for MinFin, the government needs to borrow at the external markets to finance the budget deficit.

In addition, without foreign currency receipts, Ukraine's end-2018 foreign currency reserves could be USD 4.8 bln below the National Bank's plan and significantly below the key threshold of three months of imports. Securing much foreign financing this year is critical for getting through 2019, when payments on the state foreign debt will amount to USD 6.9 bln while access to new borrowing may be impeded because of the presidential and parliamentary elections that are scheduled.

It's worth noting that the budget was approved by parliament earlier than December only once since 2000. That doesn't mean it can't happen much earlier this year.

Distribution of state budget approval dates in 2000-2017



Source: Verkhovna Rada, Concorde Capital research

Remaining 2018 Rada session days

Oct. 2 - 5

Oct. 16 - 19

Nov. 6 - 9

Nov. 20 - 23

Dec. 4 - 7

Dec. 18 - 21

In the best-case scenario, it will approve the budget's first reading on Oct. 2-5. Once it's approved, the government should submit all amendments in the shortest period for the second reading's approval. If no major obstacles emerge, the second reading could be adopted on Oct. 16-19 or Nov. 6-9, which we consider to be the latest deadline to approve legislation for the IMF loan tranche. In which case, Ukraine could secure IMF financing by the end of November.

Projected inflation not in line with central bank target

The 2019 draft budget is based on forecasts of GDP growth of 3.0% yoy, consumer inflation of 7.4% yoy and producer inflation of 10.1% yoy. Notably, the CPI projection substantially exceeds the central bank's target of 5.8% for 2019. The government also is more optimistic on Ukraine's GDP growth next year (vs. 2.5% in the NBU's latest projection).

Should its projections for inflation and economic growth turn out to be overstated (particularly with nominal GDP), the government will experience difficulties meeting budget targets. By stating this, we highlight that the previous years' budgets were also designed based on more optimistic nominal GDP as compared to NBU forecasts, but the actual budget numbers were even better than assumed.

No surprises on the revenue side

The Finance Ministry projects state budget revenue rising 9.9% to UAH 1,008 bln, meaning GDP redistribution through the budget will decline to 25.6% of GDP from 26.5% GDP in the 2018 budget. At the same time, the overall structure of expected budget revenues didn't undergo significant changes. VAT receipts are expected to increase 12.9%, remaining the major revenue source. Fuelled by the minimum wage rising to UAH 4,173 (from UAH 3,723 in 2018) and average monthly wage to UAH 10,129 (6.9% yoy growth in real terms), receipts from personal income tax are expected to increase 16.5%. Enterprise profit tax receipts are expected to increase 12.5%. Apparently, the government is anticipating a significant improvement in the management of state assets, projecting revenue will improve 22.6%.

The potential risks on the budget revenue side are low as no changes in major tax rates are planned. The minor changes include lowered rental payments on natural gas extraction and adjusting rent paid to a fixed amount on an annual basis.

Expenditures as a subject for revision

Budget expenditures are likely to undergo significant adjustments. The current plan to cut utility-related subsidies by 22.4% yoy to UAH 55.1 bln is unrealistic, particularly since it doesn't take into account the planned price hike for natural gas for households, which has yet to be announced by the government. The eligibility criteria for subsidy recipients are likely to be tightened this year, and the number of subsidy recipients should decrease. However, this will not likely result in reduced budget outlays for utility-related subsidies. We expect natural gas prices for households to rise 30-40% by the year end. Rates for central heating and hot water will be adjusted correspondingly. These increases will carry over into utility rate hikes next year, prompting higher subsidies for eligible households.

In 8M18, government spending for utility-related subsidies amounted to UAH 57.6 bln. To avoid the risk of underfinancing subsidies in 2019, budget outlays should be at least UAH 10-15 bln higher than the initial plan. This adjustment will need a new source of budget revenue and/or spending cuts in order to meet the IMF requirement for the state budget deficit not exceeding 2.5% of GDP. We don't see much room for boosting revenue, and the IMF is not likely to accept such attempts. Meanwhile, attempts to cut spending will encounter resistance as most state bodies will argue they need costs for undergoing reforms. So the government is faced with very difficult challenges in the coming weeks, but we believe success is more likely than not.

Key budget stats

State budget revenues and expenditures, UAH bln

	Target 2018	Target 2019	Target 2019 / 2018
State budget revenues	**917.9**	**1008.4**	**9.9%**
% of GDP	**26.54%**	**25.55%**	**-1.00pp**
State budget spending	**991.7**	**1094.4**	**10.4%**
% of GDP	**28.68%**	**27.73%**	**-0.95pp**
State budget deficit	**80.6**	**90.0**	**11.6%**
% of GDP	**2.33%**	**2.28%**	**-0.05pp**
Tax revenues	759.9	849.1	11.7%
% of GDP	21.98%	21.51%	-0.46pp
Personal income tax	91.1	106.2	16.5%
% of GDP	2.64%	2.69%	0.05pp
Enterprise profit tax	82.3	92.6	12.5%
% of GDP	2.38%	2.35%	-0.03pp
VAT	384.3	434.0	12.9%
% of GDP	11.11%	11.00%	-0.12pp
Rent on mineral extraction	46.5	48.6	4.5%
% of GDP	1.35%	1.23%	-0.11pp
Import duties	28.0	30.5	8.9%
% of GDP	0.81%	0.77%	-0.04pp
Excise duties	124.1	133.7	7.7%
% of GDP	3.59%	3.39%	-0.20pp
Non-tax revenues	145.0	149.2	2.9%
% of GDP	4.19%	3.78%	-0.41pp
Transfer from the NBU	50.5	45.6	-9.8%
% of GDP	1.46%	1.16%	-0.31pp
Revenues from state ownership	36.3	44.5	22.6%
% of GDP	1.05%	1.13%	0.08pp
Defense Ministry	86.6	101.4	17.2%
% of GDP	2.50%	2.57%	0.07pp
Internal affairs (police)	66.0	82.3	24.8%
% of GDP	1.91%	2.09%	0.18pp
Ministry of education	95.5	110.7	15.9%
% of GDP	2.76%	2.80%	0.04pp
Ministry of healthcare	87.0	95.8	10.2%
% of GDP	2.51%	2.43%	-0.09pp
Ministry of social policy	152.3	179.6	18.0%
% of GDP	4.40%	4.55%	0.15pp
- Incl. pension fund subsidy	139.3	166.5	19.5%
% of GDP	4.03%	4.22%	0.19pp
State road agency	28.4	30.5	7.6%
% of GDP	0.82%	0.77%	-0.05pp
Finance Ministry	312.9	310.1	-0.9%
% of GDP	9.05%	7.86%	-1.19pp
- Incl. housing subsidies	71.0	55.1	-22.4%
% of GDP	2.05%	1.40%	-0.66pp
- Incl. debt servicing	130.2	145.2	11.5%
% of GDP	3.77%	3.68%	-0.09pp
- Incl. social assistance	59.9	63.0	5.2%
% of GDP	1.73%	1.60%	-0.14pp

Source: Verkhovna Rada, MinFin, UkrStat, Concorde Capital research

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