

September 25, 2017

# 2018 Budget: Plan for a Recovering Economy

## Deficit satisfies IMF requirement

Ukraine's 2018 draft budget is a much less controversial spending plan than previous years, as it does not assume any changes in the tax code and key tax rates. That allows us to expect that the budget will be approved easier this year, and the process of its approval won't bring surprises to business. The best news to come from it is that the budget deficit is at 2.4% of GDP, or in line with a 2.5% limit agreed upon with the IMF. Also, the revenue target does not look overly optimistic as it reflects economic tendencies that are in line with our projections. Importantly, the budget envisages cuts in utility-related subsidies and no increase in subsidies to the Pension Fund, instead planning more infrastructure spending, especially on roads. Finally, the Finance Ministry budgeted costs to cover many important reforms in the judiciary, education and healthcare.

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### State budget stats, UAH bln

	2017 plan	2018 plan	yoy
Revenues	771.0	877.0	13.8%
Spending	841.1	948.1	12.7%
Deficit	77.6	77.9	0.4%
% of GDP	2.7%	2.4%	-0.3pp

Source: Verkhovna Rada, Concorde Capital estimates

### Macro forecast foresees depreciation

Our 2018 nominal GDP forecast of UAH 3,225 bln almost perfectly fits the official projection of UAH 3,247.7 bln. We have slightly different views on other macro parameters. In particular, the Finance Ministry anticipates 3.0% yoy GDP growth (we project 3.5%) and 7% consumer price inflation (we project 6.6%). Also we are much more optimistic about hryvnia prospects, anticipating UAH 28.5/USD on average in 2018 compared to UAH 29.3/USD envisaged by MinFin in its spending plan.

### Budget revenue to grow on import VAT

The Finance Ministry projects state budget revenue rising 13.8% to UAH 877 bln. In relative terms, budget revenue remains almost unchanged at 27.0% of GDP vs. 27.1% of GDP in 2017. The main source of rising budget collections will be VAT on imports, which is responsible for three-quarters of 2018 revenue growth. All other revenue items demonstrate quite modest increases, or even drops like rent on mineral extraction and revenue from state enterprises. A solid part (near one-third) of swelling VAT revenue on imports is due to projected hryvnia devaluation. However, the main part of that increase (near two-thirds) is owing to anticipated fast import growth. We are sticking to our view of less dramatic hryvnia depreciation next year. At the same time, imports should swell in the double digits owing to a recovering economy, as well as strengthening investments and private consumption.

### Spending more on roads and defense, less subsidies for housing and pensions

The 2018 budget will concentrate more on those areas that desperately need financing, like improving roads and beefing up defense amid ongoing attacks from Russian-backed forces occupying the Donbas region. Spending will rise modestly compared to the revenue side. In particular, public outlays will grow 12.7% yoy to UAH 948 bln. In relative terms, state budget spending will drop to 29.2% of GDP from 29.6% of GDP in 2017. We see noticeable increases in spending on defense (21.1% yoy growth) and police (20.3% yoy). Spending on the State Road Agency more than doubled to UAH 37.5 bln from UAH 17.4 bln in 2017. Also rising are costs of debt servicing (14.9% yoy growth) and healthcare (15.3%). In the meantime, utility-related subsidies have been cut by 9.2% and Pension Fund subsidies have been left unchanged from 2017.

**Deficit target satisfies IMF requirements**

For 2018, the deficit target has been narrowed to 2.4% of GDP from 2.7% of GDP in 2017, satisfying IMF requirements that set the limit at 2.5% of GDP. Remarkably, the initial 2017 deficit target was 3.0% of GDP but GDP grew faster than expected. The deficit of UAH 77.9 bln will be covered at the expense of UAH 46.5 bln (USD 1.59 bln) in net external loans, UAH 22.5 bln in privatization proceeds and UAH 9.7 bln in net domestic loans.

**Education, judicial and healthcare reforms are budgeted**

Large-scale reforms are budgeted in the proposed spending plan. For instance, a 56% rise in spending is earmarked for the State Judicial Administration, meaning that an increase in salaries for judges (who are drastically underpaid) is indeed on its way. Complaints remain about the selection process of judges, as many with dubious reputations have been approved. But at least remuneration is undergoing progress.

The budget openly envisages the transfer of vocational schools to local budgets (previously financed by the central budget). This step is an essential part of decentralization reform in which local authorities become responsible for financing local education institutions. As of 2018, they will decide how many vocational schools every community needs, and what funds they receive.

The draft budget also partially reflects healthcare reform. Funding for primary healthcare will increase by 23.2%, according to the Health Ministry, with the key idea to pay doctors for the quality of their services, not simply for showing up for work, as is currently.

**No changes in tax rates assumed**

Unlike previous budget drafts, the 2018 plan does not imply any changes in the rates of the most important taxes (only a 20% hike in the excise duties for tobacco, as well as additional inflation adjustments for existing excise duties for tobacco and alcohol). That should make it much easier to approve the plan.

The finance minister recently said that he might consider incorporating a cut in the natural gas extraction tax for new wells in 2018 (not incorporated in existing draft). Cabinet officials discussed a proposal to cut the gas extraction tax to 12% for new wells in 2017 (from the current level of 29% and 14% for deep wells) in late 2016 but it was rejected in last-minute voting by parliament in late December. Theoretically, parliament could reconsider the proposal this year.

## Key budget stats

### State budget revenues and expenditures, UAH bln

	Target 2017	Target 2018	Change
<b>State budget revenues</b>	<b>771.0</b>	<b>877.0</b>	<b>13.8%</b>
% of GDP	27.09%	27.01%	-0.08pp
<b>State budget spending</b>	<b>841.1</b>	<b>948.1</b>	<b>12.7%</b>
% of GDP	29.56%	29.19%	-0.37pp
<b>State budget deficit</b>	<b>77.6</b>	<b>77.9</b>	<b>0.4%</b>
% of GDP	2.73%	2.40%	-0.33pp
<b>Tax revenues</b>	<b>630.1</b>	<b>747.6</b>	<b>18.6%</b>
% of GDP	22.14%	23.02%	0.88pp
<b>Personal income tax</b>	<b>77.2</b>	<b>90.8</b>	<b>17.6%</b>
% of GDP	2.71%	2.80%	0.09pp
<b>Enterprise profit tax</b>	<b>67.1</b>	<b>72.3</b>	<b>7.8%</b>
% of GDP	2.36%	2.23%	-0.13pp
<b>VAT</b>	<b>302.9</b>	<b>383.7</b>	<b>26.7%</b>
% of GDP	10.64%	11.81%	1.17pp
<b>Rent on mineral extraction</b>	<b>49.6</b>	<b>46.5</b>	<b>-6.2%</b>
% of GDP	1.74%	1.43%	-0.31pp
<b>Import duties</b>	<b>23.1</b>	<b>26.3</b>	<b>13.8%</b>
% of GDP	0.81%	0.81%	0.0pp
<b>Excise duties</b>	<b>113.3</b>	<b>125.6</b>	<b>10.9%</b>
% of GDP	3.98%	3.87%	-0.11pp
<b>Non-tax revenues</b>	<b>112.1</b>	<b>117.9</b>	<b>5.2%</b>
% of GDP	3.94%	3.63%	-0.31pp
<b>Transfer from the NBU</b>	<b>45.0</b>	<b>47.8</b>	<b>6.3%</b>
% of GDP	1.58%	1.47%	-0.11pp
<b>Revenues from state ownership</b>	<b>25.2</b>	<b>21.0</b>	<b>-16.7%</b>
% of GDP	0.89%	0.65%	-0.24pp
<b>Defense Ministry</b>	<b>68.8</b>	<b>83.3</b>	<b>21.1%</b>
% of GDP	2.42%	2.57%	0.15pp
<b>Internal affairs (police)</b>	<b>53.1</b>	<b>63.9</b>	<b>20.3%</b>
% of GDP	1.87%	1.97%	0.10pp
<b>Ministry of education</b>	<b>85.4</b>	<b>94.0</b>	<b>10.1%</b>
% of GDP	3.00%	2.90%	-0.10pp
<b>Ministry of healthcare</b>	<b>74.6</b>	<b>86.0</b>	<b>15.3%</b>
% of GDP	2.62%	2.65%	0.03pp
<b>Ministry of social policy</b>	<b>153.5</b>	<b>153.6</b>	<b>0.1%</b>
% of GDP	5.39%	4.73%	-0.66pp
- Incl. pension fund subsidy	<b>141.3</b>	<b>141.3</b>	<b>0.0%</b>
- % of GDP	4.97%	4.35%	-0.62pp
<b>State road agency</b>	<b>17.4</b>	<b>37.5</b>	<b>115.6%</b>
% of GDP	0.61%	1.16%	0.55pp
<b>Finance Ministry</b>	<b>273.5</b>	<b>291.0</b>	<b>6.4%</b>
% of GDP	9.61%	8.96%	-0.65pp
- Incl. utility subsidies	<b>63.7</b>	<b>57.8</b>	<b>-9.2%</b>
- % of GDP	2.24%	1.78%	-0.46pp
- Incl. debt servicing	<b>113.3</b>	<b>130.2</b>	<b>14.9%</b>
- % of GDP	3.98%	4.01%	0.03pp
- Incl. social assistance	<b>53.9</b>	<b>57.9</b>	<b>7.3%</b>
- % of GDP	1.90%	1.78%	-0.12pp

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

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