PLAN B: TAX POLICY

General needs of Ukraine for additional financing and proposals for increasing revenues from tax revenues

Throughout 2023, domestic experts and analysts from international financial institutions, including the World Bank and the IMF, revised their forecasts several times regarding Ukraine's economic development, changing them for the better. For example, in the April World Economic Outlook, the International Monetary Fund predicted a 3% drop in our GDP, while the recent decision of the Fund's Board of Directors to revise the EFF program for the second time was based on a 4.5% economic growth forecast.

The inflation rate, according to preliminary estimates, was supposed to exceed **21%**

but now it is only at

4,3%

The situation in the foreign exchange market, international reserves, and other indicators are also relatively stable, indicating that macrofinancial stability is being maintained[1].

The key task of domestic policy was to put the national economy on a war footing, create an effective model of mobilization and redistribution of economic resources (financial, labor, material) in order to meet the needs of the military-industrial complex and the armed forces to the maximum extent possible.

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[1] How the Ukrainian economy survived the war's second year
https://www.ukrinform.ua/rubric-economy/3803794-ak-ukrainska-ekonomika-perezila-drugij-voennij-rik.html

Main achievements of 2023[2]:

1 **Ukraine has preserved its independence and state sovereignty.**

2 **An unprecedented amount of military and economic assistance from external allies has been received.**

Between February 2022 and November 2023, allied countries announced military, financial, and humanitarian assistance worth €255 billion, almost €100 billion of which was military aid. Total aid amounted to about 85% of the annual GDP. During 2022-2023, aid was delivered in a rhythmic and timely manner. In fact, as of 2023, the state budget had received $70.6 billion in grants and loans.

3 **Successful cooperation with the IMF.**

In 2023, Ukraine agreed with the IMF on an EFF program financing package totaling $15.6 billion, $4.5 billion of which has been received this year. Ukraine is fulfilling the structural benchmarks and indicative targets set out in its program commitments.

4 **Ukraine's economy is gradually recovering from the initial military shock**

The decline in production has been halted, new technological processes are being established, and the real sector is being transformed. According to preliminary data from the State Statistics Service, Ukraine's real GDP will increase by 5.3% in 2023, but the decline compared to the pre-war period is significant and amounts to about 25%.

5 **Stability of the banking system has been maintained.**

The banking system remains stable, well capitalized, liquid, and profitable. The war has not had a negative impact on the banking system in general. Capital adequacy and liquidity ratios are many times higher than the regulatory requirements, and net profit will amount to about UAH 150 billion in 2023. Thus, the banking system has significant potential to expand lending, which is an important factor in economic recovery.

[2] Економічні підсумки 2023 року та завдання на 2024 рік https://www.epravda.com.ua/columns/2024/01/1/708280/

6 Currency stability has been ensured.

Thanks to sufficient international assistance, the timely introduction of a fixed exchange rate and currency restrictions, the NBU has managed to maintain currency stability and even replenish foreign exchange reserves to a record level of more than 5 months of imports, or almost $39 billion as of December 1, 2023. However, the state of currency equilibrium remains unstable. The main risk is a huge negative trade balance of $31 billion in the first 10 months of 2023, primarily due to the economy's growing import needs, Ukrainian exports being blocked, and problems with the return of foreign exchange earnings.

7 Systematic support for business and households through the channel of state grants, loans, and guarantees has been implemented.

The government introduced grants for starting small businesses, expanded the functionality of the "Affordable Loans 5-7-9%" loan program, launched a state portfolio guarantee program, and introduced new mortgage support programs, "Affordable Mortgage at 7%" and "eOselya." For the period of martial law, the possibility of obtaining loans at 0% per annum with a guarantee of up to 80% of the loan amount was introduced, the maximum loan amount was increased to UAH 60 million, loan terms were extended to 3-5 years, and collateral requirements were eliminated. During martial law, more than 40 thousand soft loans worth almost UAH 170 billion have been issued under the 5-7-9% program. The implementation of these programs have allowed streamlining national savings redistribution in supporting the economy's functionality through the banking system.

8 The budget system is operating smoothly

The budget system is operating smoothly, but with a significant fiscal deficit of more than 30% of GDP (excluding grants as part of revenues). International financial support has amounted to more than $70 billion since Russia's invasion in 2022, making up 1/3 of all state financial resources received in 2022-2023. Stable financing of the fiscal deficit made it possible to meet the critical financial needs of the defense sector. However, the public debt already amounts to around 80% of GDP, and is likely to cross 100% of GDP next year, signaling high risks to the debt sustainability of public finances.

9 The Ukrainian government has begun the transition of the domestic industry to a military mode.

In 2023, the capacity of the domestic defense industry increased by 4 times relative to 2022, and in 2024 it will increase by another 6 times.

10 By the end of 2023, inflation had decreased to 5% annually

while a year prior it was at almost 30%. The current inflation rate is within the NBU's target range (5 +/- 1%), but does not meet the NBU's forecasts from last year (21%). The decline in inflation was driven by both structural shocks (reduced aggregate demand, problems with agricultural exports) and policy decisions (exchange rate stability, tight monetary policy, and a moratorium on utility tariffs). Low inflation has strengthened financial stability. However, the rapid drop in inflation below the level of interest rates has caused additional losses to the economy and public finances from rising real interest costs.

What was not done in 2023[3]:

1 Military production remains insufficient to meet the needs of the Armed Forces.

2 The potential of domestic savings is hardly used for the development and restructuring of the country's economy.

The banking system has more than UAH 2.1 trillion in deposits of legal entities and individuals. Banks' free liquid funds amount to almost UAH 1 trillion. In addition, there is over $118 billion of cash foreign currency in circulation outside the banking system. However, the redistribution of these funds to support economic development or finance the fiscal deficit remains extremely weak. Thus, the level of lending to the economy is constantly decreasing, despite large-scale government support programs, and the Government's attraction of funds from the domestic debt market remains scarce.

[3] Economic results of 2023 and tasks for 2024 https://www.epravda.com.ua/columns/2024/01/1/708280

3 High and growing dependence of the economy on imports.

Ukraine has not managed to sufficiently establish domestic production to reduce the economy's need for imports. The foreign trade deficit significantly exceeded expectations and amounted to $31.3 billion in 10 months of 2023, while the IMF expected the annual value of this indicator to be $22.4 billion. The structural deficit in financing the balance of payments (excluding foreign aid) is about $30 billion a year.

In the war's second year, the Ukrainian economy did better than in the first. Unemployment has decreased, small businesses have resumed operations, the number of registered entrepreneurs is growing, and surveys show an improvement in business activity and consumer sentiment.

UAH 3.3 trillion of revenues that the Ukrainian economy can provide next year have been approved for UAH 1.8 trillion of expenditures. **The budget deficit in 2023** is a quarter of the total GDP, and **in 2024 it is planned to be reduced to 20%**. For comparison, in the pre-war period, the budget deficit was 2-3%, while during the fight against COVID-19 it rose to a maximum of 6%. Since Russia's invasion in February 2022, half of budget expenditures have been spent on the military. **In the 2024 budget, defense spending will amount to UAH 1.6 trillion, which is 50.5% of expenditures.** The other half is to be spent on salaries for public sector employees and civil servants, social expenditures, and pensions. The funds generated by the economy are only enough for the first half: the army. The rest is to be financed by international partners.

According to the Ministry of Finance

almost **32** billion USD / in **2022** — the country received from international partners [4]

42,6 billion USD / in **2023** — the state budget in external financing *(Table 1).*

[4] A war for survival. What will happen to Ukraine without western money https://www.bbc.com/ukrainian/articles/cn4p6pjjq91o

Grants provided on a non-refundable basis **amounted to $11.5 billion, about 27%** of the total amount of funding. **At the same time, Ukraine received all loans on favorable terms.**

The largest donors of financial assistance in 2023 were:

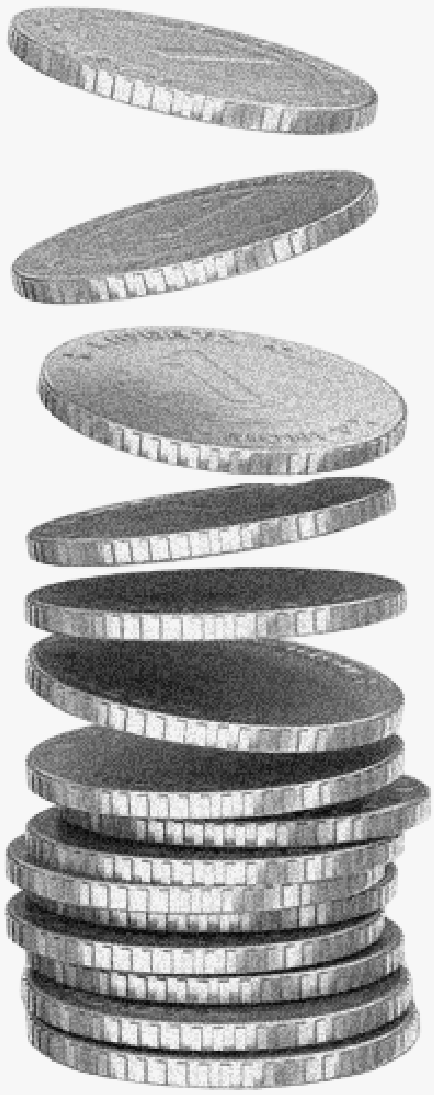
European Union	**$19,7 BILLION** (concessional financing);
United States of America	**$11 BILLION** (grants);
International Monetary Fund	**$4,5 BILLION** (concessional financing);
Japan	**$3,6 BILLION** (concessional financing and grants);
Canada	**$1,8 BILLION** (concessional financing);
United Kingdom	**$1,0 BILLION** (guarantee);
World Bank	**$652 MILLION** (concessional financing);

All funds from international partners were used for priority state budget expenditures. The Ministry of Finance works closely with donors to ensure that every dollar of financial aid is used for its intended purpose. The trust of our partners is a key asset for continued cooperation. In total, since the beginning of the full-scale war in February 2022, international partners have provided $73.7 billion to Ukraine[5].

Sources of financing of the general fund of the state budget[6]

Table 1

millions of dollars USA



Sources of financing	2022	2023
EU	7 961	19 530
USA	11 980	10 950
IMF	2 693	4 475
Japan	581	3 626
Canada	1 889	1 757
World Bank	1 385	660
UK	1 040	998
Germany	1 584	105
EIB	720	-
France	437	-
Italy	330	-
Netherlands	318	-
Norway	21	190
Spain	-	96
Denmark	51	-
Sweden	49	-
Finland	-	36
Switzerland	-	30
Lithuania	22	-
Ireland	-	21
Latvia	16	-
Austria	11	-
Belgium	5	3
Iceland	0,5	2
Albania	1	-
Estonia	-	0,1
Total	**31 095**	**42 479**

[5] In 2023, the Ministry of Finance of Ukraine attracted $42.6 billion in concessional and grant financing from international partners
https://www.mof.gov.ua/uk/news/ministry_of_finance_of_ukraine_attracted_usd_426_billion_of_concessional_and_grant_financing_from_international_partners_in_2023-4370

[6] In 2023, the Ministry of Finance of Ukraine attracted $42.6 billion in concessional and grant financing from international partners
https://www.mof.gov.ua/uk/news/ministry_of_finance_of_ukraine_attracted_usd_426_billion_of_concessional_and_grant_financing_from_international_partners_in_2023-4370

The country **is expected** to receive about the same amount of international aid next year as in 2023, but there are no firm guarantees to date that the full amount of the budget deficit will be covered by grants or loans. The issue of international assistance from the United States is particularly acute as the presidential election approaches and it becomes increasingly difficult for the main political players to reach compromises.

Among the possible theoretical options to cover the budget deficit in the event that international partners do not provide the full amount of international support is domestic fundraising through government bonds. **The best option** is if the buyers are banks and legal entities. However, in a critical situation, the NBU could also buy government bonds, but in the medium term this could have negative consequences in the form of high inflation and hryvnia devaluation.

The second way is the adjustment of the NBU's policy on the discount rate and the national currency exchange rate, which we analyzed in another analytical paper, summarizing the following conclusions: a slight hryvnia devaluation by 10% will have a positive impact on domestic production, increase customs revenues to the budget, and enable the Ministry of Finance to receive a larger hryvnia equivalent of international financial assistance.

The third way that the Ministry of Finance is working on, which should provide additional revenues of UAH 44 billion, is the change in tax policy, which we will discuss in more detail below and suggest alternative steps that will have less negative impact on the Ukrainian economy.

In order to assess possible scenarios for covering the budget deficit in 2024, we will identify THE MAIN RISKS that directly affect the economic situation and macroeconomic stability:

The main risk in 2024 is the effect of war.

It is virtually impossible to predict the effects of war on the economy with reliable accuracy. The escalation of hostilities may result in an additional reduction in the country's production potential and loss of labor resources. This will destroy the productive forces of the economy and undermine the possibilities for its recovery.

Foreign policy risks.

A decrease in the volume and disruption of the rhythm of international support for Ukraine due to political processes in partner countries could cause significant damage to both financial stability and defense capabilities of the country.

Transportation route blockades of exports and imports.

Continued blockades of freight transportation on the western border and restrictions on sea transportation routes will negatively affect the foreign trade balance, which will generate risks to currency stability.

Man-made disasters.

As a result of the Russian attacks on critical civilian infrastructure, the risks of accidents are increasing, which will require additional budgetary expenditures and reduce economic productivity.

Possible aggravation of protest in society

Possible aggravation of protest in society as a result of the enemy's informational warfare, increased military mobilization, reduction of social benefits, etc.

The key task in 2024 is to build a wartime economy, which should involve mobilizing material, financial, and human resources and directing them to meet the army's needs to the fullest extent possible. This implies an increase in state orders for defense enterprises and industries capable of manufacturing products for the needs of the army, while giving preference to domestic enterprises in the fulfillment of state orders, etc. In other words, the **military economy** is primarily an economy of state demand and state incentives. Military production potential should be strengthened through government procurements. An important aspect of business support is the launch of a state investment insurance system against war risks involving funds from international donors. State stabilization programs for business support should focus on job creation projects in the areas of production localization.

All in all, Ukraine faces serious challenges related to the war, but careful planning and implementation of strategies can ensure economic sustainability and social support. International cooperation and diplomatic efforts play an important role in the situation stabilization and support receipt.

Analysis of tax policy for 2024

On December 27, the Government adopted the National Revenue Strategy for 2024-2030, which is a roadmap for reforming Ukraine's tax and customs system. It provides for the adaptation of tax and customs legislation to the standards of the European Union and is also one of the structural benchmarks envisaged by the IMF's Extended Fund Facility (EFF) program.

The National Revenue Strategy sets out the general direction of reforms. At the same time, it is a flexible document that allows for adjustments to the sequence of measures and content, depending on the circumstances, including the results of additional research and discussions of the practical aspects of the relevant reforms with stakeholders.

In the context of the prospects for reforming the tax system of Ukraine, as outlined in the National Revenue Strategy for 2024-2030, the following key areas of action are identified:

Key action areas:

1. Prohibition of the simplified taxation system for legal entities and gradually increase tax rates to 18% for legal entities that previously used this system.

2. Increase in the simplified taxation system rates for individual entrepreneurs, with the introduction of diversified rates depending on the type of activity.

3. Reduction of the scope of activities covered by the simplified taxation system and revision of the rates for agricultural producers.

4. Mandatory use of cash registers and keeping records of the origin of goods for all business entities using the simplified system.

5. Introduction of a progressive personal income tax scale for individuals, although specific rates and income limits have not yet been determined.

6. Reform of the system of tax privileges and discounts, including the introduction of tax refunds based on the costs of improving housing, business, medicine, and education.

7. Introduction of European corporate taxation rules and harmonization of VAT legislation with EU directives.

8. Increase in excise taxes on fuel, alcohol, and tobacco products to the minimum level of EU rates and consideration of the possibility of excise tax introduction on sugary drinks.

9. Increase in the rate of the environmental tax on carbon emissions after the end of the war.

10. Change in the property tax base to the assessed value of real estate.

11. Provision of more autonomy to local authorities in the area of local taxes and fees and systematic assessment of tax privileges with their subsequent review.

These areas should determine the country's tax policy strategy for the coming years.

The main provisions of the tax initiatives in 2024 were announced by Danylo Hetmantsev, Chairman of the Tax Committee of the Verkhovna Rada, during the United News marathon: the introduction of a military fee for individual entrepreneurs and legal single taxpayers, as well as an increase in taxation of certain types of real estate and jewelry transactions, which should provide additional revenues to the state budget in the amount of UAH 44 billion.

Increasing the tax burden on entrepreneurs in wartime, complicating logistics, mobilizing workers, reducing incomes, etc. may have the following negative consequences:

1 Increase in production costs:

Increased tax pressure leads to higher costs of goods production or services provision. This can lead to a decrease in the profitability of the enterprise and make it less competitive in the market.

2 Reduced investment:

Increased domestic taxes may force enterprises to reduce their investments in the development and modernization of production. This may have a negative impact on the enterprise's future innovation and competitiveness.

3 Decrease in employment:

As a result of the increased tax burden, enterprises may be forced to reduce the number of employees or delay plans to expand their staff. This may lead to an increase in unemployment and a decrease in the income level of the population.

4 Reduced profitability:

High taxes can lead to a decrease in the enterprise profitability, as most of the profit will be directed to paying taxes rather than developing the business.

5 Reduced competitiveness of local producers:

An increase in the tax burden may lead to higher production costs for local products, which may make them less competitive with imported alternatives on the market. This may lead to a decrease in demand for local goods and an increase in imports, which threatens domestic producers.

Thus, an increase in the tax burden on enterprises can lead to a wide range of negative consequences that threaten their financial condition and economic viability.

Therefore, increasing state budget revenues by increasing the tax burden on domestic producers is considered inappropriate and will threaten macroeconomic stability.

An alternative option to increase tax revenues is increasing taxes on imported products by increasing import duties.

The advantages for the country's economy from increasing taxes on imported products are as follows:

However, there are also disadvantages of increasing taxes on imported goods, namely a possible increase in consumer goods prices. However, given that inflation is at its lowest in recent years, this is not critical.

It should be noted that the negative trade balance in 2023 amounted to $27.5 billion, and accordingly, the increase in import duties is fully in line with the rules of the World Trade Organization, namely Article XII Restrictions to Safeguard the Balance of Payments of the General Agreement on Tariffs and Trade.

Trade of Ukraine

At the end of **2023,** Ukraine's trade turnover amounted to

$99,4 BILLON

imported goods for **$63,5 BILLION**

exported goods for **$36 BILLION**

Taxed imports amounted to

$52,6 BILLION

which is 83% of total imported goods.

The tax burden per 1 kg of taxable imports in January-December 2023 amounted to $0.49/kg, which is 38% more than in 2022.[7]

Thus, the additional revenues from the additional import duty will amount to $2.6 billion, or almost UAH 100 billion.

[7] https://www.facebook.com/UkraineCustoms/posts/pfbid034TuVXS9tfsPSexRYPqLBaBK9j597i5D8bMm3WEFP2QsS9vDW693FqhQnYu9TaDpVl