

Monetizing a barterized economy Withering away of nonmonetary transactions with the budget in Ukraine

Janusz Szyrmer

4 June 2000

Nonmonetary transactions, including the so-called mutual settlements, between state budget and economic actors are a fundamental building bloc of the “virtuality” in a post-soviet economy.¹ Together with nonpayments, arrears, bad credits, barter, in-kind wages and pensions, shadow, corruption, etc., they belong to a large “Potiemkin village” family of activities that hinder economic growth. They look efficient and reasonable from outside. More often than not they are nasty and disastrous from inside. Officially, fiscal mutual settlements are common-sense financial clearing operations between the budget, budget sphere organizations, and tax paying enterprises. In real world many of these transactions are nontransparent shadowy operations that promote tax evasion, corruption, and confusion.

The mutual settlements provide an opportunity for the bureaucrats to continue their micro-management of the economy. These operations enable the bureaucrats to decide about who is and who is not allowed to settle tax liabilities by means of different, sometimes quite sophisticated, nonmonetary transactions.² Often these decisions involve mil-

¹ This new economy is called virtual, because “... it is based on illusion, or pretense, about almost every important parameter of the economy: prices, sales, wages, taxes, and budgets. ... It is this pretense that allows for larger government, and larger expenditures, than Russia can afford” (Clifford G. Gaddy and Barry W. Ickes, “Beyond a Bailout: Time to Face Reality About Russia’s ‘Virtual Economy’”, The Brookings Institution, June 1998). Ukraine is struggling with a similar economic virtuality. Nonmonetary transactions emerge as a main pillar for this virtuality.

² Monetary transactions support economic freedom of producers and consumers. They are the core of a modern market economy. “Adam Smith spoke of money as the ‘obvious system of

lions of hryvnas. They pick winners and losers. They enable some loss making enterprises to successfully continue their activities, even to invest and expand, while pushing others into indebtedness and shadow. These decisions are poorly regulated and highly idiosyncratic. It is not clear why some enterprises are allowed to participate in this scheme and others are not. Consequently, old explicit controls of the soviet era are replaced by new "shadow" controls. These controls are supported by vibrant informal networks among government officials, enterprise managers, and other influential individuals. They consist of telephone calls, requests and deals behind closed doors, intractable contracts, price manipulations, etc., and enable leakages of cash outside the apparently cashless economy.³ As a result, the old soviet system, when compared with this kind of a "centrally decentralized" shadow command economy, may look like a quite clean, orderly and economically efficient alternative, indeed.

While the direct damage that is inflicted by shadow controls on the public finance is significant and expensive to the economy, their indirect effect may be even worse. They aggravate the lack of transparency at the level of central government, where the "technology" of nontransparent operations is used, perfected, and supported. By tolerating or sponsoring these transactions the central government stimulates the development of a demonetized economy. The demonetization trickles down to local governments, budget sphere organizations, state-owned and privatized enterprises, and so on.

In fact, a serious problem is not only the nonmonetary transactions per se, but, even more importantly, their perception. The lack of transparency inherent in these transactions undermines the confidence of people into their government. It reinforces an image of Ukraine as a highly corrupted country, both among its residents and abroad. The "psychological" damage inflicted on the economy by the lack of transparency in the budget sphere is very significant. Even if they happen to be orderly and clean, they are widely believed to be corrupted and dishonest. This perception would operate as a self-fulfilling prophecy. It promotes a culture of rent seeking, non-payments, and arrears.

The fact that in 1999 about 30 percent of revenues and expenditures of the consolidated budget were nonmonetary must affect the behavior of taxpayers. As long as noncash taxes are allowed for some companies, there is a precedent that promotes efforts to seek in-kind

natural liberty" (James Buchanan, *Frozen Desire*; see: "The cash don't work", *The Economist*, December 19, 1998).

³ This leakage of cash results in "... a huge implicit transfer of resources from productive to non-productive activities, which reduces incentives to produce and undermines growth." (Kateryna Fonkych, "Rent-seeking and interest groups in Ukrainian Transition", *Ukrainian Journal Economist*, March 2000, pp.54-63.

payments and various nonmonetary settlements since there is an expectation (right or wrong) that these transactions are profitable for enterprises. Seeking a license from the authorities for noncash tax payments is expected to be a more profitable activity than competing at the open market. The lack of an efficient market for managers enables many old nomenklatura members to stay on the job. Their rent seeking skills tend to be much stronger than the skills to operate at a tough competitive market. The most successful managers are still those who are able to develop good relationships with the authorities and through tax manipulations save a lot of cash for their companies and themselves.

So far, no government has been successful in combating the demonetization dragon. The consecutive governments came and went promising the abolishment of wage arrears, nonpayment, and barter. None of these governments have succeeded.⁴ All of them have kept struggling with (short-term) symptoms of economic problems and failed to address real institutional and structural causes of the economic collapse such as: pervasive incompetent micro-management of the economy by the government, weak property rights, and soft budget constraints.

If policy measures do not reach deep enough – to the root of the problem – they would keep producing superficially positive effects while substituting one problem for another. Doubtful accomplishments in combating demonetization in the energy sector last year may be used as a good illustration for these substitutions. While the rate of barter in total sales in electric power industry declined by 19 percentage points, from 48 percent in 1998 to 29 percent in 1999, cash payments increased only by 4 points, from 17 percent in 1998 to 21 percent in 1999.⁵ Thus, while certain indicators improved – what is eagerly used by the populist official propaganda – some other indicators got worse. In most cases, the net result of these shifts remains difficult to figure out.

Low effectiveness of the efforts to combat poverty and abolish wage and pension arrears is another cause of concern. During 1999, the stock of wage and pension arrears was reduced by UAH 770 million. At the same time, the monetary base increased by UAH 3.4 billion. A major official justification for this increase was the need to reduce these

⁴ In his book on Russian transition David M. Woodruff (*Money Unmade: Barter and the Fate of Russian Capitalism*, Cornell University Press, 1999) argues that as long as the policies in Russia are not implementable, the content of these policies is of less importance. Similarly, in Ukraine the enforcement capacity is the main binding constraint. There is little use of good policies if the government lacks the capacity to implement them. Policy effectiveness is more important than policy efficiency. Demonetization significantly reduces the effectiveness of monetary, fiscal and other policies.

⁵ Source: HIIID data base.

arrears. Yet, this policy led to a significant increase in the “inflation tax”. The annual consumer price index was 23 percent in 1999, as compared to 11 percent in 1998. The inflation tax is highly regressive: the poorer you are the more you pay. This tax is paid mostly by low-income households whose revenue and expenditures are predominantly in hryvnas. Most of income, expenditures, and savings of the high-income segment of the population are in hard currency. The high-income households contribute little to inflation tax collections. The sudden deep devaluation of the hryvna in the fall 1998 made the rich richer and the poor poorer. In 1999, large repayments of wage and pension arrears failed to increase real household consumption expenditures, which declined by several percentage points. Ukraine ended up with less arrears and more inflation. In 2000, so far, inflation has remained high while arrears began growing again. During the first quarter the total wage and pension arrears increased by UAH 102 million.⁶ Their true cause is not the shortage of money but the shortage of good institutional reforms. The government should focus on the latter, not on the former. We know from economics that significant increases in the nominal money supply tend to reduce the real money supply. Paradoxically more money means less money. The more banknotes you print the greater shortage of money you create.

There is a long list of examples of confused policies aimed at increasing budget revenue and reducing fiscal deficit while helping out the enterprises in need. Nonmonetary transactions with the budget occupy a top position on this list. There is plenty of evidence that the efforts to increase budget income through enabling the mutual settlements fail to help bridge deficit gap while reducing transparency of the budget sector.⁷

Similarly, by supporting enterprises with credit lines and various forms of directed bank credits the government promotes soft budget constraint expectations and at the same time it undermines banking and hinders the development of a healthy credit market and strong financial system.⁸ Those banks are better off that co-operate with the

⁶ Source: HIID data base.

⁷ Georg Simmel argued that an important role of money in society is to support people’s action based on “cognitive rather than normative expectations”. Monetization of the economy helps realism and discourages decisions based on wishful thinking (see: “The cash don’t work”, op. cit.). Consistently unrealistic budgets, voted in every year by the Ukrainian Parliament as “budget laws”, supported by a scheme of mutual settlements, illustrate the perils of wishful thinking at work.

⁸ The strength of banking and the financial system is shown to be good predictors for economic growth (Ross Levine, “Financial Development and Economic Growth: Views and Agenda”, *Journal of Economic Literature*, June 1997, 688-726). The stronger the banking, the higher economic growth can be expected. Hungary is an example of a transition economy, in which the strengthening of the banking sector stimulated investment, both domestic and foreign, and economic growth.

authorities and follow their orders and advice as to foreign exchange operations, credits, purchase of treasury bills, etc. The banks that seek profits through active market operations but fail to develop good (informal) relationships with the central and local authorities are not likely to be successful. This policy results in high interest rates, low credit availability, and of course more financial problems for the Ukrainian enterprises and less tax payments. The need for special deals, such as the mutual settlements with the budget, becomes necessary.

A simple numerical analysis of the officially published statistics demonstrates some of these policy-introduced distortions. For instance, the data on performance of main industries show that their profitability is negatively correlated with investment and growth and at the same time it correlates positively with barter activities. The greatest loss makers in 1999 (in cash terms) were the electric power industry and the nonferrous metals industry. At the same time, these two industries managed to absorb large investment allocations (about $\frac{1}{4}$ of total investments in industry in 1998) and to accomplish fast growth (7 and 9 percent in 1999, respectively).⁹ More detailed figures help explain these findings. It has been shown that bank credits continue to be negatively correlated with performance of industries – the less profitable you are the more credits you get. Yet, barter appears not to be affected by the financial liquidity of enterprises. There is no evidence for barter transactions to be related to enterprise cash balances. Providing credits to enterprises does not help their performance and fails to reduce barter.¹⁰

The lack of efficient and effective bankruptcy procedures led to an impossible situation in which half of companies are loss making. Protecting these enterprises against bankruptcy leads to weak contract enforcement and rent seeking. The policies against bankruptcies promote bankruptcies. They result in a growing number of effectively bankrupt enterprises that are allowed to operate despite of their loss making status. These enterprises of course would not pay due taxes and some nonmonetary arrangements become necessary.

The eagerness with which tax authorities seek tax revenues by focusing on the few still profitable enterprises (including those who somehow manage to export their output) stimulate the firms to avoid foreign trade, generate losses rather than profits, and move the bulk of their activities into the shadow. In such a way, many firms turn into good clients of those bureaucrats who decide which loss making firms

⁹ Source: HIID data base.

¹⁰ Olena Besedina, "Nature of Barter: Case of Ukraine", Kyiv-Mohyla Academy, 2000, manuscript.

be allowed to continue their operations and to use nonmonetary methods of tax payments. Efforts to collect more tax income result in less tax income, in more barter, and more arrears.

There are many other examples of perverse institutions and policies that produce effects opposite to those intended by their makers. Enterprises are often better off when they scale down their production and worse off when they expand their activities. Land, buildings, and other assets are not taxed. There is no cost in keeping them idle. There is no mechanism that would allocate privatized land and enterprises to those investors who are willing and able to use them. Investors may purchase a property at a low price and keep it unused. At the same time, any profitable use of these assets that would involve hiring labor and generating income results in high tax payments. The existing tax system effectively promotes staying idle. Efforts to secure tax forgiveness and various deals with the authorities are more profitable than improving the quality of output.

The tax system promotes old socialist capital intensive enterprises and discriminates against new market-oriented labor intensive small firms, the latter operating predominantly in consumer good industry and the service sector. Employing capital is tax-free, no matter how inefficient it is and how much energy it uses.¹¹ Employing labor involves high taxes and may cause a lot of problems. Nonmonetary tax payments are basically additional subsidies generously provided by the state – predominantly to the old big enterprises. These subsidies are rarely available to new market-oriented companies. Only very few of them manage to secure an active support from a powerful bureaucrat.

The regulations and various impediments to foreign trade instead of “supporting the domestic producer” are harassing this producer. As a result the Ukrainian producer can hardly compete at international markets with producers from other countries who are less “supported” by their governments. Tax authorities tend to be lenient for loss-making giants but are merciless for those small and medium-size firms that make efforts to export and generate income. Many enterprises do not export because they fear tax inspectors.

The decline of GDP, investment, and foreign trade in Ukraine during the last several years is just an aggregate reflection of the systemic inefficiency of this kind of economy. This is a *par excellence* negative sum game. There are a few winners and large masses of losers.

State budget is a loser. The total annual income of the consolidated budget amounts to about \$10 billion, or \$20 per capita, per month (including about \$6 of nonmonetary tax settlements), compar-

¹¹ The large enterprises also enjoy softer budget constraints. Capital intensity and tax arrears tend to be positively correlated (Vladimir Dubrovsky, “Soft Budget Constraints and Industry Structure in Transitional Ukraine, HIID, 2000, manuscript).

ing to \$150-\$200 in Central Europe and about \$1,000 in Western Europe. It is obvious that the Ukrainian state is not able to perform well with this level of income.

The Ukrainian enterprise is a loser. The inefficient tax system results in a situation in which only a small number of profitable enterprises are paying high taxes.¹² Enterprises are becoming gradually less profitable. This process is reflected in the amount of enterprise profit taxes collected by the budget: 13.2 percent of GDP in 1994, 6.7 percent in 1998, and 5.8 percent in 1999. In real terms, between 1994 and 1999, these taxes declined by 63 percent.¹³

Ukrainian people are losers. About $\frac{3}{4}$ of them live below the World Bank poverty line (income of \$1 per person per day), at least in terms of their official incomes.¹⁴

Fortunately the situation is changing. The “critical mass” interested in reforms is growing. The new government of Ukraine, established in December 1999, has initiated fundamental reforms. It is determined to wipe out demonetization of the economy. The efforts of the government are respectable and deserve a lot of support and help. This time the main problem is not the lack of commitment of the government, but rather the feasibility of the reforms it undertakes. There are many good reasons for which it becomes very difficult to abolish mutual settlements, barter, and arrears. Powerful interests are involved in these operations. They include a small number of influential “oligarchs” as well as a large number of enterprise managers, petit bureaucrats, and entrepreneurial middlemen who find these transactions highly profitable.

As argued above, the main causes of nonmonetary transactions lie “outside” of these transactions. Thus far, the governments have been struggling with demonetization with little success because their focus has been on the nonmonetary transactions themselves rather than on their causes. Superficial short-term administrative measures “by brute force” will not work. Simply forbidding the nonmonetary transactions will not produce sustainable positive results.

What to do? First, let’s agree that the problem of demonetization is complex and difficult. No quick fixes are possible. The principle *tishe yedesh dalshe budiesh* seems to fully apply in this case. A large-scale effort to study this problem is necessary. Intuitive solutions that follow somebody’s thoughts and perceptions are not likely to work. A well

¹² See: David Snelbecker, “Prospects for economic security and growth in Ukraine”, *Ukrainian Journal Economist*, March 2000, pp. 26-32.

¹³ Ukrainian Economic Trends, TACIS, December 1999, p. 60.

¹⁴ In 1999 Ukrainian households spent on the purchase of consumer goods and services UAH 42 billion, or UAH 2.32 (\$0.57) per capita per day (Ukrainian Economic Trends, op. cit.).

designed monitoring system should be created that would enable the collection of detailed relevant data. Currently, it is difficult, if possible at all, to formulate responsible policy recommendations and to evaluate the effects of undertaken policy measures. Here, in turn, a popular in many countries bumper sticker can be quoted: *If you think knowledge is expensive try ignorance*. Unfortunately, in transition economies, for many years, ignorance has been happily used in both policy analysis and policy making with doubtful successes.

The true causes of the nonmonetary settlements must be traced. They are the result of fundamental systemic flaws. As long as the various grave institutional deficiencies exist the demonetized economy will thrive, no matter what actions the government undertakes. In fact, immature radicalism aimed at simply quickly exterminating nonmonetary transactions, without the necessary institutional reforms, may inflict more damage than the current permissiveness, which tolerates these transactions. The main problem of Ukraine is not its current fiscal policy and the behavior of taxpayers, but the institutional environment in which both the policymakers and economic actors operate. It is impossible to impose a good behavior on these “players” as long as “the rules of the game” remain corrupted.¹⁵

This monograph is a collection of studies on mutual settlements and other nonmonetary transactions with the budget sector. By their very nature, the nonmonetary transactions are nontransparent. Thus, what we are able to address is only the proverbial tip of an iceberg. And, even this tip, so far, has been poorly known and gravely misunderstood. The intention and hope of the authors of this monograph is that their efforts will help bridge this unfortunate and expensive gap in our knowledge.

¹⁵ According to Mancur Olson, improvements in policies cannot help economic growth (can not help a nation to become prosperous), at least not significantly, unless fundamental institutional changes are made. The crucial institution that enables growth is the enforcement of transactions – not only those simple direct transactions, but more importantly those “advanced” transactions which are a main source of prosperity. (Mancur Olson, *Power and Prosperity; Outgrowing Communist and Capitalist Dictatorships*, 2000.

BUDGET PERFORMANCE AND FISCAL DISCIPLINE IN UKRAINE

Khwaja Sultan and Liliana Paseka

Introduction

In a democracy, the passing of the Budget law is a manifestation of public will. The government, with an elected leadership (in Ukraine, the President) guides the preparation and the formulation of the budget based on its policy programs. Thereupon, the people's representatives (in Ukraine, the Verkhovna Rada) discuss it, sometimes modify it, and then vote on it. In effect, the budget process is a demonstration of the "division of power" between the Executive and the Legislature, and indicates the level of understanding and co-operation between the two branches of government. It is a product of their joint labor.

The budget spells out government's priorities in economic (and indeed social) policy and shows the course of government actions. In doing so, it is necessary to match realistically determined outlays with revenues: to balance the budget or at least reduce the budget deficit. A government must live within its means. Every hryvna spent has to be earned somehow. Deficits mean that the government spends more money than it receives. This can be justified only where (as in some cases of capital borrowing) this brings about a benefit of an enduring nature that significantly increases future revenues.

The government can meet the deficit either by printing money or by incurring debt. In Ukraine, the government often finances the deficit by running arrears, i.e. by not making payments for its expenditure obligations. Ukrainian citizens are already well acquainted with the traumatic consequences of printing money, and its destructive nature. As far as debts are concerned, accumulating debt has limits. Ukraine's external debt has reached USD 12 billion, i.e. about UAH 65 billion. The domestic debt is about UAH 10.5 billion. The stock of budget arrears in the social sector is around UAH 6 billion. Together they equal to about 55 percent of GDP). This is a disturbing trend. Incurring debt merely postpones taxes to a future date, since debts have to be serviced from future taxes. Moreover, public debt in

Ukraine is expensive. The terms on which creditors may agree directly depends on the creditworthiness of the country. If a country pursues an unreasonable and financially dangerous budget policy, the terms become more costly since creditors take higher risks. In fact, Ukraine has had tremendous problems in servicing its external and domestic debts recently. It had to resort to “restructuring” starting from autumn 1998. In early 2000, USD 2.6 billion worth of eurobonds had to be restructured to the year 2007. Also, commercial banks and foreign investors have left the T-bill market, the NBU being the only buyer of primary T-bill issues.

As priority, there must be budgetary discipline. This is particularly essential, as it is the main fulcrum by which the Government can directly leverage the economy. Budget balance is also a highly visible sign of commitment to reform and stability. Transparency in the Budget law and in the implementation of the budget revenues and expenditures is equally important for building credibility. This paper discusses several practices that greatly reduce transparency in the budget. The use of non-monetary settlements instead of cash, and of extra-budgetary funds, are among the examples we have used. In addition, we have shown how inaccurate and unrealistic revenue and expenditure targets make the budget less reliable than it ought to be.

The Revenue Performance in the last two budgets

Every year, unrealistic forecasts of revenues are made. Here, we give examples of the years 1998 and 1999 only, but the same argument is true for earlier years also. In 1998, the original budget was very unrealistic and the government had to later present a revised budget. The financial crisis and the drying up of the T-bill market influenced the budget performance for 1998. It forced the government to make the much needed budget corrections in the middle of the year. Even at the time of formulation, experts had pointed out that the original 1998 Budget, especially the estimate for revenues at UAH 29.8 billion was unrealistic. The budget deficit was also high at UAH 3.4 billion. The revised Budget of July 1998 (UAH 26.4 billion) was more realistic in terms of the aggregate revenue expectations, though not so much in details. The budget deficit was reduced to UAH 2.34 billion. Reduction in expenditure in the revised Budget was of UAH 4.4 billion (down from UAH 33.1 billion to 28.8 billion), mainly due to reduction in Chernobyl Fund spending, but also due to other smaller items (Table 1).

The actual performance was well short of the original budget estimates. It is, however, creditable that the performance is fairly close to the revised budget estimates made by the government in July 1998. In 1999 also, the revenue forecasts were unrealistic, though to a much lesser extent, about 5 percent lower than the targeted figure.

Table 1

	1998 Budget	1998 Revised Budget	Actual perform- ance 1998	1999 Budget	Actual perform- ance 1999
Total revenues	29,763	26,448	28,441	34,252	32,340
Total expenditure	33,142	28,786	30,506	35,492	34,266
Budget deficit	3,380	2,340	2,065	1,240	1,926

Data source: the Ministry of Finance of Ukraine

As in previous years, the major portions of budget revenues in 1998 and 1999 were from the four main taxes (value-added tax, enterprise profit tax, personal income tax, and excise tax), that contributed 63 percent of total revenues in 1998 and 64 percent in 1999. However, the government had projected revenues from these taxes to be only 54 percent and 57 percent of total revenues respectively in 1998 and 1999 (Table 2).

In enterprise profit tax (EPT), year after year, revenues have been underestimated. Having set UAH 2.3 billion as its target for 1998, the government has collected almost UAH 5.6 billion, 2.4 times the target. In 1999, the government collected 36 percent more revenue than was estimated. However, a big portion of EPT revenues comes not in cash, which is not as much possible in the case of VAT.

It was primarily due to unrealistic projection of revenues from sources other than the four main taxes that overall revenues were about 10 percent short of the budget target in 1998 and 5 percent short in 1999. Actual overall collection of revenues from four main taxes exceeded the targeted amount by almost UAH 2 billion in both 1998 and 1999.

For the non-tax revenues, the budget for 1999 had projected UAH 5.6 billion but could collect only UAH 3.2 billion. This year, for 2000, despite the history of poor performance, the budget has projected UAH 9.5 billion for non-tax revenues. It is virtually impossible for the government to collect this level of revenue. Such unrealistic projections will lead either to a large revenue shortfall, which will mean either a much higher budget deficit or to an increase in budget arrears.

Table 2

Consolidated revenues performance: 1998-99					
<i>Million hryvnas</i>	1998 Approved	1998 Revised	1998 Actual	1999 Approved	1999 Actual
TOTAL REVENUES	29,763	26,448	28,441	34,252	32,340
Percentage of GDP	29.4	26.2	27.9	26.9	25.4
MAIN TAXES	15,942	15,411	17,888	19,706	20,688
Value Added Tax	8,756	7,460	7,238	8,303	8,130
Enterprise Profits Tax	2,328	2,912	5,840	4,700	6,371
Personal Income Tax	3,528	3,528	3,561	3,940	4,434
Excise taxes	1,330	1,511	1,249	2,763	1,753
Main taxes as % of total revenues	53.6	58.3	62.9	57.4	64.0
Other taxes and non-tax revenues as % of total revenues	46.4	41.7	37.1	42.6	36.0

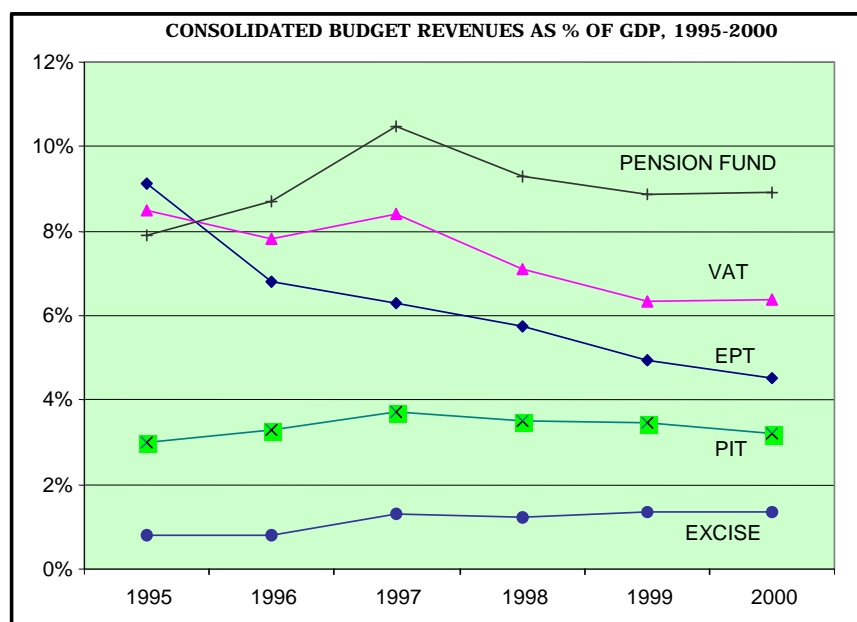
Data source: Budget laws of 1998 and 1999, the Ministry of Finance of Ukraine

Dynamics of the main taxes

Figure 1 shows the dynamics of the main revenue sources during the period 1995 to 2000. It is interesting to note the sharp decline in revenues from VAT and enterprise profits tax. If this change had happened as a result of lowering the tax rate and widening of the tax base, this would have been a significance move towards lowering the overall tax burden in the economy. Unfortunately, that is not the case. Although VAT rate has remained constant at 20 percent and EPT rate at 30 percent, there has been a sharp decline in revenue receipts from these taxes. The constant attempts to change the provisions of value added tax, to dilute its tax base, has already resulted in severe erosion of VAT revenues. A wide base for VAT is essential for the fiscal stability of Ukraine and for its transformation to a market-driven economy. VAT played an important role in the stabilization in Hungary, Poland, Slovakia and the Czech Republic because they kept the tax base as wide as possible. Likewise, creation of a large number of tax-free zones has eroded EPT revenues despite the fact that there is no reduction in the tax rate. Excise tax revenues have remained stable at about 1.4 percent of GDP since 1997. The average level of excise tax revenues in Central and Eastern Europe is about 4 percent of GDP, and Ukraine is lagging far behind its neighbors in this regard. Taxing energy encourages compliance in downstream activities. By gradually raising further the rate of excise duty on petroleum products and luxury

goods, the proportion of excise taxes to GDP should gradually be raised to about 4 percent. This could help reduce the burden from direct taxes.

Figure 1. DYNAMICS OF THE MAIN REVENUES 1995-2000



Data source: Ministry of Finance

N.B. Data for the year 2000 are based on Budget 2000 estimates and for other years on actuals

'Pension Fund' includes Social Insurance Fund

Non-observation of expenditure limits set in the budget.

A persistent feature of the fiscal performance in Ukraine is the non-observance of the expenditure limits set by the parliament. The budget loses its sanctity as the official financial statement of the government, if spending are not done strictly according to the amounts authorized by the parliament. In many cases, there is overspending by significant amounts and in many other, there is underspending. Such actions of not following the budget allocation have become more a routine rather than an exception.

Actual budget expenditures in 1998 were UAH 30.5 billion (30 percent of GDP), falling short of the original target by about 10 percent. There are several examples of budget expenditures differing significantly from the targeted amount. Given the planned UAH 0.5 billion of construction expenditures, government's actual spending reached about UAH 2 billion, exceeding the target by 4 times. Actual consolidated budget expenditures for communal services have exceeded the targeted amount by 2.8 times. At the same time, Chernobyl fund expenses have been financed only to the extent of 55

percent of the target. In 1999, housing and communal services overspent by 4 times the allocated figure and public administration spent about 30 percent above the allocation. Road and transport spent about 70 percent in excess of the allocated amount. On the other hand, several items of expenditure, such as international affairs, fundamental research and environment protection activities spent significantly lower than was allocated by the parliament.

Budget deficit

In the original 1998 Budget, consolidated budget deficit¹ was set at UAH 3.4 billion, or about 3.4 percent of GDP. However, after revision in July, the deficit was brought down to UAH 2.3 billion. The actual budget deficit reached very close to the revised estimate, and was UAH 3.0 billion (3 percent of GDP). In 1999, budget deficit was set at UAH 1.2 billion. The year ended with a deficit of UAH 1.9 billion (1.5 percent of GDP). This is a significant improvement. However, figures of budget deficit do not tell the whole story. They do not include huge amounts of arrears accumulated by Ukrainian government in recent years. In fact, these arrears are additional claims on the government. As we can see from Tables 3, the estimated increase in budget arrears in 1998 was around UAH 2.4 billion². This includes arrears in wages, pensions and other social benefits, and various payments (e.g., for energy, communal services, medicine). Together with the budget deficit, these amounts constitute overall indebtedness, or effective budget deficit. The effective budget deficit has come down significantly in 1999, mainly because of the reduction in the stock of budget arrears in that year.

Table 3

Effective Budget Deficit					
<i>million hryvnas</i>	1995	1996	1997	1998	1999
Budget deficit	4,043	3,617	6,196	2,065	1,926
Increase in budget arrears	1,756	3,195	1,954	2,435	-781
Effective budget deficit	5,799	6,812	8,150	4,500	1,145
Primary budget balance (-) deficit, (+) surplus	-3,078	-2,135	-4,045	359	1135

The primary budget balance, shown in the above tables, indicates the budget balance excluding debt servicing (payment of interests on

¹ For deficit figures we have used Ukrainian methodology (privatization receipts are included in revenues. The deficit using IMF methodology will be slightly higher; we need to exclude privatization receipts.

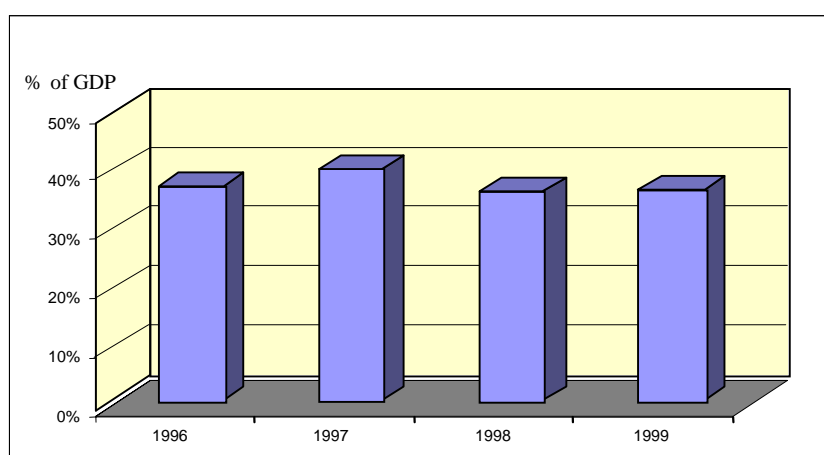
² No reliable data on the change in total budget sphere arrears are available. While data on arrears in pensions and wages are published, data on changes in other arrears (social payments, payments for suppliers to the budget sector, VAT credit repayments etc.) can only be guessed. During 1998, wage arrears in the budget sector increased by UAH 200 million and pension arrears increased by UAH 560 million. We have estimated the increase of all other budget arrears at about UAH 1.64 billion.

government debt). In 1998 and 1999, there are primary budget surpluses, although prior to that, there were deficits. This indicates high level of interest payments, which is leading to a squeeze on other essential expenditures. It implies that the entire budget deficit financing and the primary surplus are used up for interest payments. Interest payments have grown substantially in the last few years because of government borrowing at high interest rates. In 1998, actual interest payments were UAH 2.4 billion, and in 1999 UAH 3.1 billion.

Fiscal Burden

Unfortunately, there has been little change in the fiscal burden. in the last four years, as can be seen in figure 2. In the figure below, we have included in the fiscal burden total budget revenues, pension fund revenues and social insurance fund revenues. Effective fiscal burden is actually higher than shown in the chart, and should also include other non-budgetary levies of various ministries and local bodies. Information on many of these is not transparent, and total amount for these levies are difficult to estimate accurately.

Figure 2. FISCAL BURDEN (budget + extra budget)



Source: Ministry of Finance

** Extra budget includes the Pension Fund and a few other smaller social funds*

Extra-budgetary funds in Ukraine.

One important non-transparent component of the Ukrainian fiscal system is the existence of about 7,150 extra-budgetary funds³. These amount to about UAH 10 billion or approximately a 40 percent addition to the size of the budget. Because of this, size of the state's involvement in the economy as measured in terms of the size of the

³ "Tenevoy Budget" (Shadow Budget) in *Gazeta Business*, No. 42 (353), 18 October 1999 (Ukrainian)

budget becomes misleading, since public expenditures, covered from extra-budgetary funds are not recorded in the state budget. Levies raised for these funds (including those owned and created by different ministries, state committees, and local authorities) contribute to enlarging the unofficial, or shadow part, of the Ukrainian public sector. They expose enterprises to additional tax burden since authorities at different levels (state, regional and local) exercise the right to introduce taxes, penalties, fines to replenish their own extra-budgetary funds. The non-transparency, lack of monitoring and control over their usage cause numerous abuses committed by state and local officials and contribute to increased corruption. Non-budgetary funds also undermine taxation discipline in the economy. They create “loopholes” in tax legislation for tax avoidance.

In the budget for the year 2000, many extra-budgetary funds have been included in the state budget. This should enhance the transparency of the budget and make budget spending more effective. It is hoped that new extra-budgetary funds will not be created when the old ones are incorporated into the budget.

Cash Revenues and Mutual Cancellation

One disturbing factor in the Ukrainian tax system is the use of barter or mutual cancellation as a means of paying taxes. Several reasons, including the absence of liquidity in enterprises, and the discouragement to cash operations due to kartoteka-2, results in enterprises paying taxes in goods rather than in cash.

There are three major problems with this method. Firstly, the value of goods, given instead of cash, is not easily determined. Most of the enterprises are insolvent or bankrupt because they are producing goods that cannot be sold in the market. In effect these goods have very little market value. This can lead to over-valuation, cheating and corruption. Secondly, it increases the administrative cost of the tax administration, which then has to find suitable buyers for these unmarketable goods. Thirdly, government has to meet most of its expenditure obligations with cash. Goods are of little use for this. For instance, goods cannot be used to service debt.

In 1998, total non-cash revenues, in the form of mutual cancellation, was UAH 6.8 billion of which UAH 2.8 billion was in the State budget and UAH 4 billion in the local budget. In 1998, the State budget received UAH 15.4 billion in revenues. Of this, UAH 3.3 billion was for targeted funds. Of the balance UAH 12.1 billion, only UAH 9.8 billion was in cash (i.e., approximately 65 percent of total State revenues).

Mutual cancellation continued in 1999 and was about 30 percent of total revenue collection. The Law on the State Budget 2000 does not give any direct instructions as regards the non-monetary settlements. This, however, did not help to stop the practice of non-monetary

settlements. According to the Ministry of Economy, the non-monetary settlements amounted to 9.1% of the entire revenues of consolidated budget during the first quarter.

Concluding Remarks

More than 50 percent of Ukrainian enterprises are loss making (value-subtracting, instead of value-adding). This has lead to problems of barter, non-payments, and tax arrears. In 1998, tax arrears increased from UAH 2 billion in January to UAH 9 billion in December. In 1999, it reached more than UAH 12 billion. Only if we have healthy, profit-making enterprises will tax collection be good. Hence economic restructuring and deregulation assume great importance.

The importance of the Budget law as the main policy statement of the government and the parliament depends, to a large extent, on its authenticity. People within the country, as well as international institutions, experts and foreign investors, take the budget seriously if it is based on realistic assumptions. Past record also matters. If it is found that year after year, revenue projections are overstated, or that actual public spending is not in accordance with expenditure allocations in the budget, the importance of the budget is undermined. This also destroys the credibility of both the parliament and the government.

Sound fiscal health, with almost zero budget deficit, efficient and transparent fiscal management, where expenses are incurred strictly according to budget allocation, and low fiscal burden, are important ingredients for economic growth in Ukraine.

NON-MONETARY SETTLEMENTS OF THE BUDGET

by Igor B. Zhyliaiev and Veronika Orlova

1. Introduction

In the second half of the 1990s, non-monetary forms of settlement became especially widespread in Ukraine, testifying to the gradual demonetization of the economy, where non-monetary settlements prevail over monetary ones. By definition, the main features of demonetization of an economy are settlements by barter, mutual settlements [*vzaiemozaliky*], clearing, promissory notes [*vekseli*], and pervasive indebtedness.

The evolution of non-monetary settlements of the budget progresses in several stages. At first, mutual settlements with the budget were used, registered as "mutual settlement records (protocols)". These were partially replaced by settlements using treasury promissory notes [*kaznacheiski vekseli*], which were accepted as tax payments and used to finance budget expenditures. Still later, Ukrspetsfin was created to handle treasury promissory note record-keeping, which was used for practically all non-monetary settlements of the budget. A further step was to introduce exchange transactions for bills of exchange [*perekazni vekseli*] and treasury promissory notes used to cover payable and receivable arrears of the state. Recently, a decision was taken to close Ukrspetsfin and to halt non-monetary settlements of the budget. Nevertheless, non-monetary settlements did not disappear, and in the first quarter of the year 2000 they represented approximately 9% of the total consolidated budget revenues.

2. Non-monetary settlements in the economy

Non-monetary settlements of the budget are considered a part of a specific system of relations – the demonetized economy where monetary settlements cannot prevail over non-monetary forms of payments. One of the reasons for demonetization of the economy is a misunderstanding with regard to the real meaning and role of money in a func-

tioning economic system. The dominance of the “real bill doctrine” and the principle of “production credits” has led to significant distortions in the concept of price and value in the FSU.

The existence centralized management of enterprises and soft budget constraints meant that entrepreneurs did not orient themselves on consumer demand and profit maximization. In the first years of independence, inefficient management was hidden by hyperinflation and disorganization of the market. After the stabilization of the local (domestic) currency, entrepreneurs were forced to either change their behavior or to seek new ways to apply said behavior. The flourishing of non-monetary settlements is to a certain extent a preservation of old stereotypes.

Another reason for non-monetary settlements of the budget is the inability of the government to create a realistic and transparent budget. Accumulation of budget arrears, lack of budget discipline, the absence of real will and commitment by the government in “banning” non-monetary settlements, all stimulate “non-monetary” expectations of other economic agents and, as a next step, actual non-monetary settlements.

3. Definition of non-monetary payments

In general, it is possible to identify four basic elements of non-monetary settlements. There are mutual settlements, promissory note settlements, barter, and clearing. However, in settlements with the budget, mutual settlements and promissory notes have been dominant. Therefore these elements are defined in greater detail.

- definition of mutual settlements:

There are several different definitions of mutual settlements in Ukrainian legislation. For instance, “a mutual settlement is a conduct of non-monetary settlement under which mutual claims or obligations (liabilities) of debtors and creditors are discontinued in equivalent sums”.

- properties of mutual settlements

There are several important properties of mutual settlements: (a) existence of liabilities (obligations); (b) mutual character of claims; (c) time frame; (d) equivalence of claims.

- definition of promissory notes

A promissory note [*vekseľ*] is a security that testifies to an unconditional obligation of the issuer of the promissory note to pay a defined sum of money to an owner of the promissory note at the specified date. In this paper, special attention is paid to treasury promissory notes that are issued and paid by the Treasury of Ukraine. These promissory notes are primarily used to finance budget expenditures, on the one hand, and to pay taxes, on the other.

- classification of non-monetary settlements
It is possible to produce several classifications of non-monetary settlements. The main criteria are (a) economic agents; (b) number of participants; (c) instruments used to register a settlement (provides an insight into one of the basic difference of non-monetary settlements); (d) time constraints of claims.

4. Negative consequences of non-monetary settlements

Several important negative effects of non-monetary settlements within the budget are clear to see:

- (a) price distortion (mutual settlement and treasury promissory note prices often sharply differ from market prices, and stimulate misallocation of resources);
- (b) budget deformation (non-monetary settlements during budget execution distorts the "real" indicators of revenues and expenditures indicated by the budget);
- (c) violation of the principle of transparent operations (controlling interrelationships and establishing real debt amounts in non-monetary settlement chains is quite complicated complicated, and conditions are created for abuse and highly profitable illegal financial schemes);
- (d) changes in budget priorities (while cash funds can be distributed or allocated to several priority recipients, the "revenues" from mutual settlements or promissory notes have predetermined participants, which may not correspond to established priorities);
- (e) activated rent-seeking (subjective factors become more important in the system of non-monetary settlements, leading to the activation of rent-seeking);
- (f) distortion of demand for goods and services (the budget is forced to accept a certain range of goods and services, which might not be selected if there were cash on hand under similar conditions);
- (g) "non-monetary settlements expectations" (once businesses understand that mutual settlements and promissory note transactions are profitable, and that the government cannot effectively stick to its threats to ban non-monetary settlements, this leads to increased volumes of transactions of this kind and also the formation of expectations that such will continue);
- (h) deformation of the role of the financial system (the financial system is incapable of fulfilling its functions in the economy due to the existence of great volumes of non-monetary settlements, which do not require channeling of funds through bank accounts);

- (i) losses (losses connected to the distortion of prices in the process of carrying out non-monetary transactions are increased);
- (j) transaction costs (the mechanism of non-monetary settlements encourages the establishment of a large number of intermediaries, which reduces the efficiency of budget expenditures yet more).

5. Equivalence of exchange in non-monetary settlements

One of the main features and consequences of non-monetary settlements is a non-equivalence of exchange. In other words, the value of goods supplied through non-monetary settlements differs from the value of these goods through monetary payment. One of the main factors in such distortions is the existence of non-transparent settlement chains with goods of varying liquidity. In addition, non-monetary settlements create inequalities in the tax burden for different enterprises.

- range of prices in non-monetary settlements
Several case studies have shown that prices in mutual settlements differ significantly from the market-clearing price (i.e., cash price). In the example considered in greater detail, the price of goods under mutual settlement agreement is 47 % higher than the market price.

6. Factors that accompany and support non-monetary settlements in the budgetary sphere

Among the factors that accompany and support non-monetary performance of the budget are:

- (a) the general payments crisis characterized by the rather small share (less than 50%) of monetary payments in volumes of shipments;
- (b) widespread use of barter in industry and agriculture;
- (c) tax arrears (including overdue tax arrears) of enterprises that have steadily increased and reached 13.5% of the total tax revenues of consolidated budget revenues in 1999;
- (d) growing accounts payable and receivable arrears in settlements with the budget;
- (e) direction of monetary receipts of the budget towards social welfare needs and debt servicing and redemption that leaves other budget expenditures in the non-monetary settlements sphere.

7. Motives of economic agents

All economic agents enter an “economic game” with their motives and expectations. We may consider various motives for enterprises, government, households, and financial organizations.

- enterprises
The existence of overdue payable arrears and large receivable arrears (plus the generally low level of enterprises' efficiency) stimulates producers to seek additional paths of settlement. Moreover, low liquidity of producers' products, high discount in non-monetary settlements (profit opportunity), and tax evasion are real incentives for entrepreneurs. The negative effects of non-monetary settlements for enterprises include higher risk and transaction costs.
- government
The government appears to base its decision to use non-monetary settlements on higher "statistical" performance of the budget, a lower budget deficit, and hidden subsidization of selected industries.
- budgetary organizations and households
These groups of economic agents enter non-monetary settlements to receive at least some compensation for their work in a payments crisis.
- financial organizations and intermediaries
The main incentives for financial organizations to enter into non-monetary settlements are to profit from differences in debt sales and purchases, receive service fees, and help their clients.

8. Statistics of non-monetary settlements in the budgetary sphere

Statistics of non-monetary settlements in the budgetary sphere are non-uniform, sporadic and inconsistent. There is no single agency that monitors all aspects of this phenomena. In addition, there is no single methodology for data collection. In different years non-monetary settlements with the budget have had different components, a different nature and varying characteristics. Furthermore, non-monetary settlements between budgets of different levels are not usually included in these non-monetary settlements, further distorting the comprehension of this phenomena, which is non-transparent statistically by its very nature.

- revenues in the budget
Non-monetary settlements represented about one-fourth of all revenues of the consolidated budget of Ukraine. During 1995–1998 they increased nearly eight times, and at the end of 1998 they were valued at nearly 6.8 billion UAH. This represents about 24 percent of the budget actually executed for 1998. Preliminary data indicate that in 1999, 424 million UAH worth of mutual settlements were carried out, as well as 5.97 billion UAH worth of promissory notes transactions. However, about half of this amount was not included in the budget revenues.

- expenditures in the budget
On average, about one-fifth of expenditures are not financed in monetary form. During 1996–1998, the percentage of expenditures financed in monetary form was an average of 80 percent of total expenditures. According to preliminary calculations, in 1999 some 15 per cent of consolidated budget expenditures were in non-monetary form. In addition, nearly 5 billion UAH of non-monetary settlements in the budgetary sphere was not included in budget expenditures.
- between budgets
There are various channels of non-monetary settlements between budgets. They include subventions to the local budgets (only 46 percent in monetary form in 1999), state subsidies to local budgets, and inter-budget “transfers” of tax receipts in non-monetary forms.

9. Legal basis for non-monetary settlements

The legal framework for non-monetary settlements of the budget is created both by the Parliament in the budget laws and the executive through numerous normative documents. Although non-monetary settlements of the budget generally contradict the principles of the budgetary system declared in the Law On the Budgetary System of Ukraine, there is a loophole in this Law: “their [revenues and expenditures of the budget] mutual settlements and compensations are forbidden excluding exemptions introduced in laws of Ukraine”.

Until 1998 the main acts regulating non-monetary settlements in the budget sphere were the Decrees of the Ministry of Finance of Ukraine and the National Bank of Ukraine on Temporary Methodological Instructions for Mutual Settlements with the Budget. Although treasury promissory notes were introduced in 1996, only in October 1998 did the creation of Ukrspetzfin enforce their circulation as the main instrument of non-monetary settlements with the budget. The special feature of these transactions were a 5 percent cash fee paid by entrepreneurs. In the middle of 1999, stock market trades of treasury promissory notes were introduced, with Ukrspetzfin as the monopoly trader. In 1999 an alternative mechanism of non-monetary settlements with the budget was adopted, namely, settlements with treasury bills.

In December 1999 Ukrspetzfin was closed, and all non-monetary settlements with budget were forbidden. However, in January 2000 a Decree of the Cabinet of Ministers was issued that allowed settlements with the State Security Service via treasury promissory notes. Moreover, in the budget-2000 there is the possibility of conducting mutual settlements with the budget in the fourth quarter of the year.

10. Use of promissory notes in settlements with budget

The introduction of treasury promissory notes was in 1996, however, only in 1998, after the creation of the state enterprise Ukrspetzfin were treasury promissory notes actually substituted for mutual settlements in the non-monetary part of budget transactions. Use of treasury promissory notes took place in three stages: (a) without Ukrspetzfin; (b) with Ukrspetzfin and a 5 percent fee on transactions with treasury promissory notes (this fee had to be paid in cash from profit); (c) with Ukrspetzfin and stock market sales of treasury promissory notes (characterized by a 15 – 20 percent discount and actual monetary flows). In the end of December 1999 Ukrspetzfin was closed.

Although the use of treasury promissory notes carries the negative consequences of non-monetary settlements, the introduction of stock market trades of treasury promissory notes made these settlements more transparent and unified, thus reducing resource losses. It may be said that stock market trades led to a reduction of non-monetary features of this mechanism.

In addition, existence of the 5 percent fee and, later, huge discounts, was actually a tax that should have deterred enterprises from using non-monetary settlements. The effectiveness of this mechanism seems to have been hampered by great opportunities for rent seeking.

11. Policymaking vis a vis non-monetary settlements in the budgetary sphere: what the government can and must do

The premise of this paper is primarily based on the severity of consequences of non-monetary settlements in the budgetary sphere for the Ukrainian economy as a whole. We have to define both the strategy and tactics of the government in resolving this problem.

- premises and components of development of efficient economic strategy towards non-monetary settlements in the budgetary sphere

One of the important steps toward solution is to identify the balance between different sets of budget values/goals. The government has to optimize the efficiency of budget flows and support the social welfare network of the country at the same time. The main criteria of this strategy for Ukraine should be a maximization of social welfare, minimizing costs for society, and creation of clear market-oriented rules for all economic agents.

- national experience in regulation of non-monetary settlements in the budget sphere

recognizing the existence of the phenomena, the government has tried different remedies including partial or full bans on

such transactions, limitation of types of non-monetary expenditures, administrative regulations, and introduction of new mechanisms of settlements. However, this phenomena continues its steady growth.

- the road to a solution

Despite numerous obstacles on the way to a resolution of this problem, we would say that the ideal recommendation would be to ban these settlements. However, without significant changes in the economy as a whole, an administrative prohibition of non-monetary settlements may not result in its actual abolishment. Therefore, we have to stop accumulation of arrears, budget encouragement of non-market behavior, and develop competitive and transparent economic environment in order to achieve efficient outcomes.