

# **ALTERNATIVE MECHANISMS FOR THE SOCIO-ECONOMIC DEVELOPMENT OF UKRAINE**

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**Alternative Mechanisms for the Socio-Economic Development of Ukraine /**

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The study is dedicated to researching the social and economic processes happening in Ukraine and producing alternative mechanisms of government regulation of these processes. The authors focus on the search for resources for Ukraine's economic development. In order to do that, they propose to introduce changes into the state's tax and debt policy, some methods of fighting against the outflow of Ukrainian capital abroad.

The book provides evidence for the pointlessness of using neoliberal methods in governing social and economic processes. Instead, the authors propose a number of instruments that could become the basis for providing social welfare and creating the basis for the innovative and sustainable development of Ukraine.

The book is targeted at scientists, graduate and postgraduate students, the heads of scientific and educational institutions, professors and students, as well as public officials who deal with the issues of social and economic development of Ukraine.

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# INTRODUCTION

For almost a quarter of a century, Ukraine has been undergoing transformation of its planned economy into a market economy. During this period, radical transformations have happened in its socioeconomic life. Through a range of acute crises that happened throughout Ukraine's history since 1991, the new structure of Ukrainian economy has taken shape — a structure dominated by export-oriented industries and low-tech production.

The short-term stabilization of the mid-2000s became a period of missed opportunities. In this period, instead of taking advantage of the circumstances favorable for Ukrainian products, and of whatever was left of the Soviet industrial potential, to shape innovative development, local elites exploited the decrepit fixed assets and tried to integrate into the global market as resource providers. Ukraine became hostage to this position in the global economic system.

This situation resulted in one of the greatest economic downfalls in the world, after another round of financial and economic crisis had unfolded in 2008. Today, the acceleration of such tendencies can be observed, as foreign players actively divide Ukraine into zones of influence. The country's financial and economic policies are subjugated to the will of creditors and international organizations who demand to accelerate neoliberal reforms. Their final goals are total deregulation and the weakening role of government institutions in all economic and social processes; as well as funding cuts for education, healthcare, science, welfare. If these tendencies continue, they will lead to irreversible consequences, and any opportunities for a breakthrough from the peripheral model of development will be lost.

This kind of policy is presented as the only option for contemporary Ukraine. However, in our opinion, there is an alternative, and it lies in the critical reconsideration of neoliberal ideology as the ideology that has demonstrated its inefficiency for satisfying the needs of the majority and creating conditions for the country's balanced development.

In relation to this, contemporary methods of governing the socio-economic processes in Ukraine need to be scientifically evaluated, and suggestions for their improvement or replacement must be offered. That is why, in this book, we focused on the overview of the basis of fiscal and debt policies, as well as on the phenomenon of mass outflow of capital from Ukraine to foreign jurisdictions. A balanced approach to the realization of these instruments determines who will benefit from using the country's resources.

Research in these directions could serve as a basis for developing an independent balanced view of the country's future and for creating real alternatives, in order to raise Ukraine out of the crisis, provide social welfare, and accumulate resources for sustainable innovative development.

# **CHAPTER 1**

## **OVERCOMING UKRAINE'S DEBT DEPENDENCE**

Contemporary global economic system is increasingly characterized by the dependence on financial capital, which has been becoming dominant and determinant in the global resource distribution system. At the same time, global financial flows are based on disproportionate economic development and uneven balances of payment. Within this framework, the development of indebted “Third World” countries is subject to the displacement of financial capital from the borrower countries to the countries of the “core.” Ukraine has been consistently integrated into this global market chain as a provider of raw materials [Асоціація з ЄС: наслідки для економічного розвитку та ринку праці в Україні, ЦСТД, 2015].

Today, instead of looking for internal resources for development, Ukrainian government adopts the course of a rapid buildup of external loans. However, the efficiency of such a method raises serious doubts, since loans will have to be paid back with interest; so the country is pushed towards the Greek scenario, in which financial “aid” will be provided in exchange for harsh austerity measures, and the country will end up not only in an unprecedented socio-economic crisis, but also with a portfolio of multi-billion-dollar debts.

Given these circumstances, we think that it is time to examine the sensibility of such policies for the country's development. We will test the well-known claim that accumulating debt is the only option, and assess the consequences of a possible default in Ukraine in economic, legal, and social terms. We will attempt to sketch some possible alternatives to the debt policy. In order to do that, we will review Ukraine's debt policy in the recent years, assess the impact of external loans on the state budget, overview the international experience of defaulting, and define the possible social consequences of default in Ukraine.

## 1.1 The origins of Ukraine's debt dependence

The history of Ukraine's credit relations since the moment it declared independence has been rather complicated. Its public debt was managed using a combination of administrative methods. That is why it is appropriate to divide the history of external loans up into several stages, and to study the characteristics of each stage.

Entering the international loan market in 1991-2000. Forming the system of public debt management.

This stage was characterized by unsystematic accumulation of public debt. External loans at this stage outweighed internal loans, and public loans outweighed private loans. The experience of credit resource management started to accumulate at this stage, and some attempts to design independent debt policies were made. When the USSR collapsed, Ukraine had no external debt, based on the "zero option" in the distribution of the liabilities and assets of the former USSR.

The country's financial system in the early 1990s was characterized by chronic budget deficit. Its depended on imported energy, and the responsibility for the overdue debt for energy resources was transferred from the private to the public sector. Hyperinflation was managed by money emission. The government lacked experience in international credit relations, and there was no regulatory framework for those relations.

The introduction of the market, which broke the links within the single economic complex of Soviet republics, and the resulting decline in production led to diminished tax revenues and caused an acute budget deficit. As a result, welfare budget shrank, the amount of unpaid wages in the public sector accumulated on a catastrophic scale, and so on. In that situation, in order to balance the budget deficit, Ukrainian government asked external creditors for financial help, and its public debt started to accumulate rapidly (Figure 1.1).

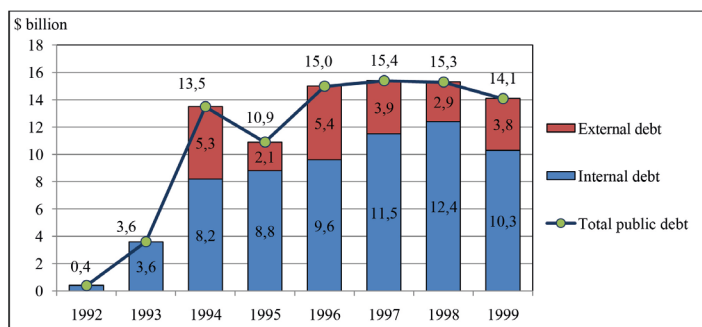


Figure 1.1. The dynamics of public debt accumulation (as of the end of each year) for both internal and external crediting [based on the data provided by the Ministry of Finance, the National Bank of Ukraine, and the Accounting Chamber]

At the first stages, creditors from specific countries were involved, primarily from former Soviet republics. In the first three years, Ukraine's external debt had already reached \$3.6 billion, more than \$2.7 billion of which was made of the loans that were officially attributed to the adjustment of the overdue debt to Russia. Since 1992, loans by the National Bank of Ukraine and public guarantees for international loans to Ukrainian companies had been issued. However, there was no clear mechanism for evaluating credit projects, which led to arbitrariness and corruption schemes. Decisions about giving loans were made by a small group of officials in the Currency and Monetary Board of the Cabinet of Ministers of Ukraine, without any competitive procedure or developed methodology; so the decisions were based on subjective methods of evaluation.

It is no less important that the state budget's capacity to service the emerging government obligations in the agreed time was not assessed. For seven years, 1992 through 1999, public guarantees for loans totalling \$2.4 billion were issued in these circumstances [Рахункова палата України, 2003]. Company debts, in their turn, were hardly ever paid back, and got transferred to the state balance, pushing the country into a financial crisis in the future.

The evidence for the unsystematic nature of external debt accumulation in the first years of independence is provided by the fact that the Decree by the Cabinet of Ministers "On the priority directions for foreign loans", which limited the practice of chaotic public guarantees and at least started the process of ordering the external credit relations and creating the tools for a reasonable debt policy, was only passed in the early 1995 [Постанова КМУ № 234, 1995]. At the same time, the internal market for government loans was barely developed, and the fraction of external debt reached 80 percent of the total structure of Ukraine's public debt by 1996.

The desire to reach out to new markets of loan capital turned a new page in Ukraine's external relations — its history of borrowing from international financial institutions (IFIs), including the World Bank, the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD), and the European Bank for Reconstruction and Development (EBRD). Because of loans from these organizations, Ukraine's external debt increased by \$3.2 billion in 1995 only.

It is important to note that cooperation with the IMF has certain special features. The borrower country receives loans based not only on the general condition that it pays back its debt, but also on the condition that it introduces some changes in its internal policies. According to the established policy of the IMF, the country that takes its loan has to implement neoliberal reforms; crucial outcomes of these reforms are that the social function of the state is reduced and all processes are abandoned to market "self-regulation." In theory, such measures are supposed to

improve the country's solvency for international lenders, to stabilize its balance of payments and its budget deficit. However, global practice demonstrates that these relations are basically a tool to control a country's development and impose the "dependent development" model on it, subordinating it to the countries of the "core."

Thus, the condition for receiving the first IMF loan was that Ukrainian government signed the Memorandum on Economic Policy and Strategy in September 1994; this document launched the accelerated implementation of market relations in Ukraine. The Memorandum essentially limited Ukrainian government's independence in internal policy making and determined the directions of development for Ukrainian society [Економічна безпека України, НІСД, 1997].

Among other things, the IMF demanded:

- to liberalize the foreign trade system;
- to liberalize the currency exchange rate and the pricing policy, particularly to reduce price controls;
- to cut subsidies and introduce a targeted welfare system;
- to accelerate the privatization of companies in the public sector;
- to restructure natural monopolies and particular companies;
- to reduce the budget deficit;
- to start deregulation and an administrative reform.

Therefore, we can deduce that the implementation of the Memorandum was intended to integrate Ukrainian economy into the global market as a country with developed raw material industries and a consumer of imported goods (to cancel indicative export prices, to cancel the requirements for certifying the quality of imported goods produced abroad, to organize wholesale privatization of export-oriented companies), and, simultaneously, to reduce the state's social responsibility (to cut subsidies, to increase utilities tariffs and administrative fees to make them profitable).

However, in practice, not all the conditions were met on the Ukrainian side, since the government realized that their full implementation would further exacerbate the socio-economic situation and threaten the very course of transition to the capitalist development track, as well as the ruling status of the elites. This was reflected in the fragmentary nature of the relations with the IMF: the Ukrainian side regularly interrupted and slowed down the implementation of the loan conditions, and, in return, the international credit institutions limited the amounts of funding.

As Ukraine entered international financial markets, the internal policy of its National Bank changed. Instead of large-scale money emissions, it began to attract credit funds using government bonds. In March 1995, the first auctions for placing internal government loan bonds (IGLBs) were organized; non-

residents got access to these auctions via Ukrainian banks, and they bought out more than a half of the bonds [Рахункова плата України, 2001]. However, even if this instrument solved the problem of budget deficit in short term, the high profitability of the bonds (40 to 65 percent annual interest) led to multiple overpayment of interest, and created the need to borrow again because of the increase of the budget deficit in the future, when those loans were to be repaid. The situation was further complicated by the growth of the “commodity loan” debt to post-Soviet countries, primarily for gas and fuel; by 1995, Ukraine had accumulated \$732 million of gas debt to Turkmenistan, and \$1.4 billion gas debt to Russian state company Gazprom.

In these circumstances, a new stage in the country’s financial system development started: the government introduced the national currency, hryvnia, in 1996. Although this move stabilized the situation to some extent, Ukraine’s public debt management policies did not contribute to debt reduction (Fig. 1.2).

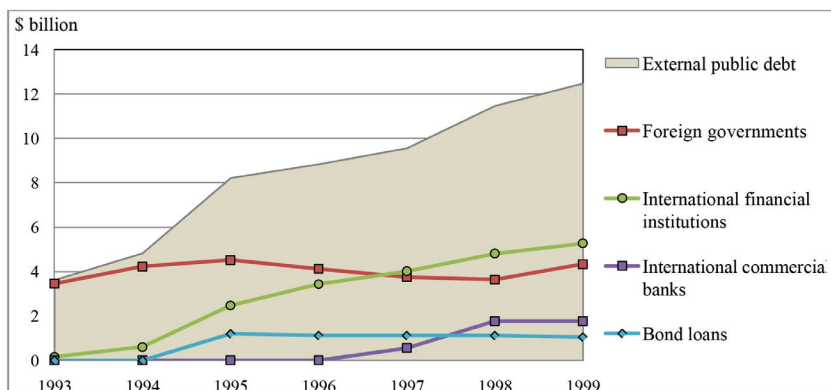


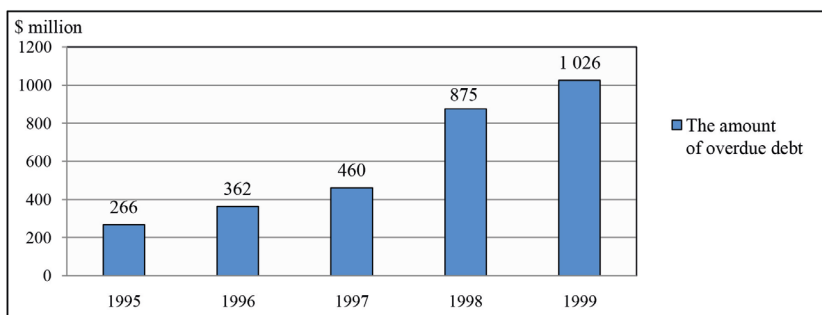
Figure 1.2. The dynamics of accumulation of Ukraine’s external debt in 1993-99, by key credit sources [based on the data by the Ministry of Finances of Ukraine]

As we can see in the Figure 2, the introduction of national currency provided an opportunity to expand the list of credit sources. Ukraine started to take loans in the international financial markets by issuing Eurobonds, to take loans from foreign commercial banks, and to issue external government loans bonds (EGLBs). Even as the IMF slowed down its lending due to another violation of the Fund’s economic policy conditions, Ukraine managed to bring in more than \$0.5 billion from foreign commercial banks. And although these loans were more expensive (10 to 17 percent of annual interest) and had shorter repayment terms (1 to 3 years) because of the country’s low credit rating, the advantage was that this money could be used without any additional conditions.

However, adding new sources of funding did not change the fact that new loans were taken to pay back the previously accumulated debt.

In 1997, the first place in the list of lenders to Ukraine was taken by international financial institutions, to whom Ukraine owed 42.3 percent of its external debt; 91.3 percent of these 42.3 percent were owed to the IMF and the World Bank. Another chunk of debt burden was still owed to foreign governments — 34.8 percent, or \$4.34 billion in 1999; more than \$3 billion of this fraction were owed to Russian Federation. At the same time, the burden which the service of internal debt bonds placed on the state budget increased rapidly and started to dangerously resemble a financial pyramid, threatening the economy.

The situation with publicly guaranteed debt (foreign loans to various Ukrainian companies and organizations, including private ones, which were guaranteed by the government) also got out of control by the late 1990s. The cost of servicing (paying the interest) and repayment of the publicly guaranteed loans increased to 31 percent of the state's total debt payments, including internal debt. Overdue debt, for which the government was held responsible, rapidly accumulated (Fig. 1.3).



*Figure 1.3. The amount of overdue corporate debt guaranteed by the government in 1995-99 [based on the data by the Accounting Chamber of Ukraine]*

According to the data provided by the Accounting Chamber of Ukraine, less than 15 percent of the companies that borrowed from foreign lenders paid their fees properly; about a third of them did not even try to pay back the loans they received. It is interesting that the overwhelming majority of this debt consisted of the obligations of Ukrainian companies to pay for the goods they imported from abroad. Therefore, the state budget ended up subsidizing foreign manufacturers instead of helping to develop domestic production.

In general, the annual cost of servicing and paying back foreign loans, which constituted a lion's share of Ukraine's public debt, outweighed the new loan income already in 1995. Loans were taken to cover the budget deficit that was caused, among other things, by the need to pay for external debt service. The short-sighted debt policy in the situation of a global financial crisis led to a significant reduction of loan resources from both external and internal sources in 1998.



## **1999-2007. Restructuring and transition to a balanced public debt management policy**

As a result of irresponsible financial management, by 1999, Ukraine's public debt reached \$15.3 billion, which exceeded the critically acceptable level of 60 percent of the GDP. The government proved unable to pay the accumulated debt. In 2000, the total amount of the required payments to the IMF alone exceeded all the currency reserves of the National Bank of Ukraine. The total payments for foreign public debt in 2000 were twice as high as the year before, reaching UAH 3.7 billion. The question of restructuring the foreign and the domestic debt, as well as of a fundamental changes in debt policies, became rather urgent.

The first problem to be solved was the question of foreign and domestic debt to commercial lenders. In October 1999, the parliament, despite the Cabinet's resistance, initiated a prohibition of taking new foreign loans under public guarantees [Про інформацію КМУ про структуру і динаміку державного боргу України]. The internal government loan bonds payments were "voluntarily" transferred to new documents that had to be repaid in 2001-4.

Special Eurobonds were issued for foreign holders of IGLBs. The obligation to pay back the external commercial debt was replaced with Eurobonds with 10 or 11 percent annual interest rates, that had to be repaid by 2007. International financial institutions had every reason to treat these steps as a sovereign default declaration, which caused the country's credit rating to fall.

This raised a possibility that lenders would demand that Ukraine paid back the total amount of its external debt earlier. The central problem of external debt to foreign governments and the IMF had to be solved immediately. The negotiations with the Paris Club of creditors (19 developed economies that got together to regulate the debt owed to them by borrower countries) lasted until the summer of 2002. Ukraine managed to arrange the restructuring of \$580 million of its debt, out of \$980 million. To wrap it up, a 12-year delay of debt repayment was arranged, with a three-year grace period and repayment in 18 equal portions. The restructuring program also covered the foreign loan bonds of 1995, issued to pay for Russia's gas. In general, Ukraine managed to reduce the debt burden on its budget in the short term; the total amount of Ukraine's foreign debt was reduced by 17.1 percent in 2000.

In the case of the debt to Russia, an agreement was reached that the debt will be reduced by \$1.13 billion. According to the treaty titled "On mutual payments related to dividing the Black Sea Fleet and the presence of Russia's Black Sea Fleet in the Ukrainian territory," the compensation for the ships, vessels and watercraft received from Ukraine was to reach \$526.5 million. Based on the same document, Russia reduced Ukraine's debt for the supply of nuclear fuel for its nuclear power plants and petroleum products by a total of \$450 million, because

of the tactical nuclear weapons exported from Ukraine in 1992 [Про ратифікацію Угоди між Урядом України та РФ].

In addition, since January 1, 1998, a significant part of Ukraine's debt to the Russian Federation was repaid by counting in the fee for the use of land plots, shore infrastructure, and bay waters by the Russian Black Sea Fleet, as well as the compensation for the environmental harm caused by its operations, and so on. It was agreed that the debt for Russian gas, which, at that point, was consumed by Ukraine without prepayment, covered by external public debt stocks, would be paid back by June 21, 2007 [Лісовенко, 2000].

It is worth noting that restructuring did not at all mean that Ukraine refused to pay its debts or that a part of the debt was written off. Basically, restructuring simply eased the debt burden at the time and redistributed it over the future periods. Moreover, it led to additional expenses on public debt service (according to the Accounting Chamber's assessment, the additional expenses amounted to \$209 million). However, we must admit that Ukrainian government won some time to make its move and attempt to develop a more balanced debt policy, as well as the time to review the principles of its relations with international creditors. For example, from 2000 on, the government's refusal to implement the IMF's demands to accelerate market reforms minimized Ukraine's borrowing from the IMF (only \$0.5 billion of the envisaged \$1.8 billion were received in 2001-3); in 2002, Ukraine stopped taking the IMF loans altogether; and from 2004, the cooperation between Ukraine and the IMF was limited to consulting and technical services; no new loan programs were opened until 2008.

For similar reasons (demands to privatize energy companies, to increase energy fees for the general population, to "optimize" the system of benefits and subsidies), Ukraine's cooperation with the World Bank group, particularly with the International Bank for Reconstruction and Development, was also limited.

The Concept of the State Debt Policy for 2001-4 was developed and approved; it defined the preferred sources of funding, prioritizing internal resources, and declared the need to reduce the debt burden, to prevent the further increase of foreign debt and create an efficient system of public debt management, to stop the uncontrolled accumulation of public debt, and to facilitate the coordination of executive government bodies, institutions and organizations in order to achieve these goals [Постанова КМУ № 1483, 2000]. The indicated goals served as a basis for Ukraine's debt policy in the following years.

As a consequence of the economic restoration, international distrust for Ukrainian financial market disappeared. In 2004, a number of leading rating agencies raised Ukraine's credit rating to B or B+ with a stable and positive forecast. It gave the government access to international stock markets and allowed it to place Ukraine's Eurobonds with record low annual rates of 6.9 percent. All of this led to reducing the debt pressure on the country's economy (Fig. 1.4).

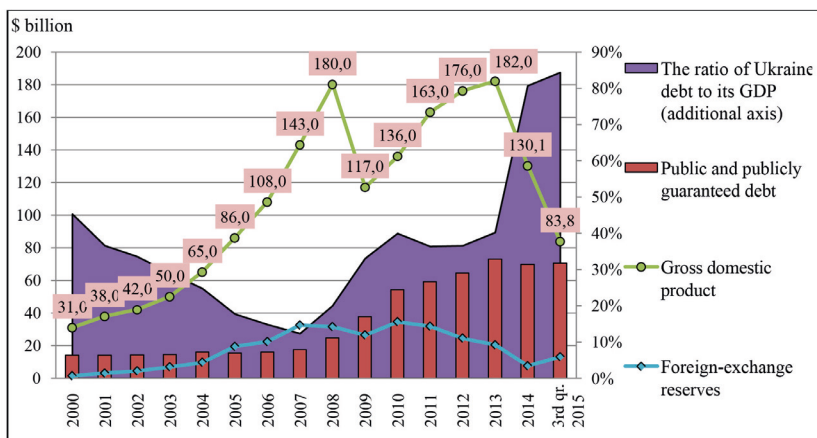


Figure 1.4. The ratio of Ukraine's debt, its foreign-exchange reserves and its GDP in 2000-15, as of the end of the year [based on the data provided by the Ministry of Finance of Ukraine and the National Bank of Ukraine].

As we can see, the ratio of public debt to GDP fell consistently after the restructuring and the change in financial policy priorities, from 61 percent in 1999 to the lowest point of 12 percent in 2007. The question is, how did Ukraine manage to achieve this change? What could cause its economic growth, apart from the change in the policy of dealing with international financial institutions? Maybe there was a radical rearrangement of the economy? Were any prospects of an economic breakthrough in high-tech industries created? Or did the country succeed in implementing a new model of social development based on improving the access to knowledge, innovative development and the increase of investment into human capital? Unfortunately, this was not the case.

The answer lies primarily in the world market conjuncture favorable for the raw materials exported by Ukrainian companies. For example, a fraction of exports in the total volume of the sold products of iron and steel industry reached 79 percent, and in the mechanical engineering industry the exports reached 74 percent [Кравчук, 2014].

The revival of industrial engineering industry was also extensive in nature and happened without the proper upgrade of manufacturing facilities; the rate of investment in these facilities lagged far behind the investment in trade and other industries that bring quick profits.

Therefore, Ukraine's mostly restorative economic growth was based on the remnants of the industrial potential created in the Soviet years (iron and steel, chemical industry, heavy mechanical engineering industry), which ended up in the hands of oligarchic groups after the privatization. True, that part of the product

created within this model which was not sent offshore did increase the taxable base; it allowed to limit external lending and even to gradually improve the living standard for the population. However, the increase in social transfers to the population (from 12 percent of all budget payments in 1999 to 22-28 percent in 2005-8) was not supported by any programs that would encourage the development of promising industries, and did not promote the supply of consumer goods by national manufacturers [Геєць, 2009].

Development without a general technical upgrade (the level of depreciation of fixed assets reached 61 percent in 2008) was limited by definition [Держкомстат]. The principles of attracting credit funds also did not change. For example, in 2005, the fraction of loans taken to fund investment projects in the total amount of external borrowing (UAH 7.2 billion) was less than 15 percent, and the rest went to cover current payments and refinance the existing public debt.

It is important to understand how the factors that influenced the country's financial stability changed. If during the transformation of the late 1990s the main cause of the crisis was the accumulation of public debt and public guarantees for questionable projects, since the mid-2000s, this role was played by the private sector. The situation in the global market helped speculative private capital to come to Ukraine. In particular, considerable funds were invested in the real estate market by foreign bank branches, and mostly in foreign currencies.

In general, in four years from 2005 to September 2008, the total amount of loans in foreign currencies increased twofold and reached a third of the country's GDP [Шевчук, 2009]. In the end of 2006, Ukrainian real estate market was valued as 400 percent of the country's GDP, while even in the "bloated" US market this indicator was only 160 percent [Гриджук, 2006]. The fall of credit rates stimulated private individuals to accumulate consumer loans.

Meanwhile, the National Bank's policy was not to interfere in these dangerous processes. It all led to increasing import dependence; the economy started to depend on foreign currency, the balance of payments became negative, and capital started to flow out of the country; all this laid the foundation for the future crisis. An "overheated growth bubble" emerged, and it was bound to burst sooner or later. The transition of the world financial crisis into an active phase in 2008 caused a sudden halt; that is, private capital started to flee the Ukrainian market en masse, and both domestic and foreign demand for Ukrainian product was reduced. Once again, Ukraine faced the issue of aid from international financial institutions.

Thus, in the mid-2000s, the commercial sector played the same destructive role for the financial and economic stability of the country as the public sector in the 1990s, once again pushing Ukraine to curtail its economic independence and to engage in another round of foreign debt accumulation.

### 2008-13. Resuming active cooperation with international financial institutions under conditions of a financial crisis and the deepening debt dependence of Ukraine

After this, debt policies were based on the previously accumulated disproportions in the economy and, at the same time, on the attempts to maintain the pre-crisis level of individual consumption. All of this was a part of carrying on with neoliberal policies that did not involve any alternative economic instruments for changing the model of socioeconomic development.

The economic crisis left limited sources for funding the budget deficit in the situation of a decrease in production and, therefore, shrinking taxable base. The first source of funding was to use the accumulated foreign exchange reserves which, by 2007, reached a considerable amount of \$31.5 billion. In 2008-13, the forex reserves were reduced by 37 percent, down to \$20.4 billion. As for the second source, already in 2008, the government asked international financial institutions for large-scale aid packages.

The newly resumes IMF loans were based on a “standby” program, according to which Ukraine received \$14.4 billion in 2008-10. In 2008, it received an urgent loan of \$0.8 billion from the World Bank to cover the budget deficit. These tranches were traditionally aimed not to facilitate development, but to cover current expenses, and already in 2012-13 they led to peak external debt payments: \$3.7 billion in 2012 and \$5.7 billion in 2013 [Міністерство фінансів, НБУ] (table 1.1).

**Table 1.1 The trends in public and publicly guaranteed debt and the fraction of the IMF debt in it (\$ billion)**

Indicators	2007	2008	2009	2010	2011	2012	2013	2014	09.2015
Total amount of public and publicly guaranteed debt	17.6	24.6	37.8	54.3	59.2	64.5	73.2	69.8	70.7
Public debt:	14.1	17.0	26.5	40.6	44.7	49.9	60.1	60.1	58.5
- internal debt	3.5	5.8	11.4	17.8	20.2	23.8	32.1	29.2	23.0
- external debt	10.6	11.2	15.1	22.8	24.5	26.1	27.9	30.8	35.5
<i>including debt to international financial organizations</i>	2.5	3.2	8.5	10.4	10.6	10.0	7.7	10.7	16.1
Publicly guaranteed debt	3.5	7.6	11.3	13.7	14.5	14.5	13.1	9.8	12.2

*[based on the data provided by the Ministry of Finance of Ukraine]*

As the table demonstrates, by the end of 2009, the IMF debt reached \$8.5 billion. Trying to diversify the sources of funding, the government also took domestic loans on an equally large scale: internal debt increased from \$5.8 billion in 2008 to \$17.8 billion in a year from that point. We must also note that a considerable part of the internal public debt stocks is still in the hands of non-Ukrainian residents. It means that not including them into the count of external debt distorts the actual scale of Ukraine's dependence on creditors.

When the financial and economic situation stabilized and the global demand for Ukrainian product recovered, attempts were made to develop strategies with the aim to reduce external funding [Середньострокова стратегія управління державним боргом на 2013-2015 роки]. In particular, the program included reducing the fraction of foreign debt to 50 percent; accelerating the repayment of public loans; and setting the limits for public debt refinancing and its maximum limit of 31 percent of Ukrainian GDP. However, despite these attempts, the program could not be effective without a radical restructuring of the economic system, without preventing the capital from flowing out and investing it into economic development, without using loans as intended, to fund innovative development.

Going back to the analysis of the debt burden, let us analyze the balance of payments and revenues for foreign loans in the recent years (Fig. 1.5).

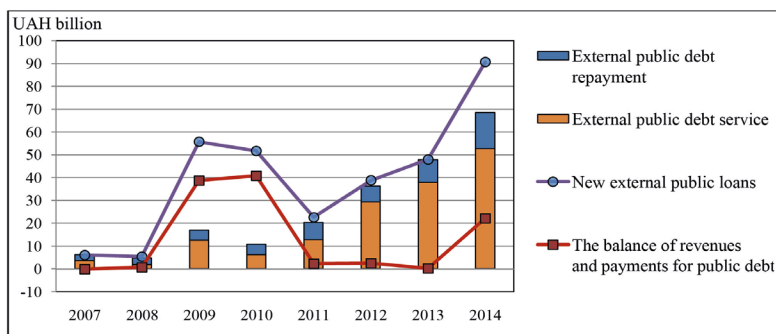


Figure 1.5. The balance of payments and revenues for Ukraine's public debt in 2007-14 [based on the data provided by the State Treasury of Ukraine]

Therefore, as the figure demonstrates, the debt accumulated in 2009-10 led to a threatening situation in 2011, and new external loans were more or less equal to the payments for older loans. If we take into account internal debt payments, we can conclude that this version of budget funding is excessively burdensome, because internal resources are diverted from their possible use for socioeconomic development to service the debt burden.

In this situation, Ukraine approaches a sharp turn in its economic policy, including the financial policy, after its government changed after the tragic events of winter 2014.

## 2014-20xx? From Ukraine's own debt policy to total dependence on the IMF's orders. Debt burden becomes heavier, and a default situation is taking shape

Since the beginning of 2014, the new government has radically changed the principles of public debt management. The role of foreign consultants becomes more important, the IMF consultants are introduced into the administrative structures of the National Bank, foreign experts are invited to join the government, and they have become responsible, among other things, for Ukraine's debt discipline in relation to international financial institutions. The military conflict in the east of Ukraine and the increase in military spending caused by it, the dubious regulatory policy of the National Bank, the mass capital flight from Ukraine — all of these together led to a large-scale financial and economic crisis, and the National Bank's foreign exchange reserves declined in 2014 from \$20.4 to \$7.5 billion. Once again, Ukraine asked international institutions for a considerable financial aid package. As a result, the external debt of government bodies and the National Bank in 2014 reached \$35.1 billion because of the loans from the EU (€1.6 billion), Canada (US\$0.2 billion) and Japan (\$0.1 billion). In addition, as a part of the Standby program, Ukraine received \$4.6 billion in 2014, \$3.7 billion of which were paid back to the IMF for Ukraine's old debt; in addition, Ukraine received \$1.3 billion from the World Bank [звіт НБУ 2014 рік].

The size of the debt burden can be assessed using the data provided by the Ministry of Finance of Ukraine, calculated in the beginning of 2014 with the exchange rate of UAH 7.99 for one US dollar (Fig. 1.6).

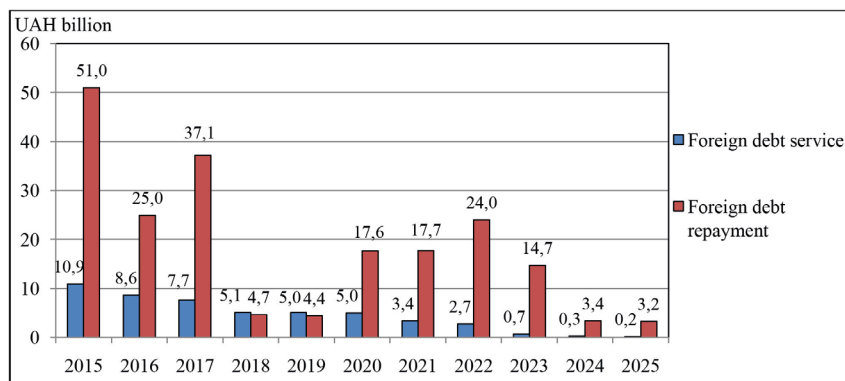
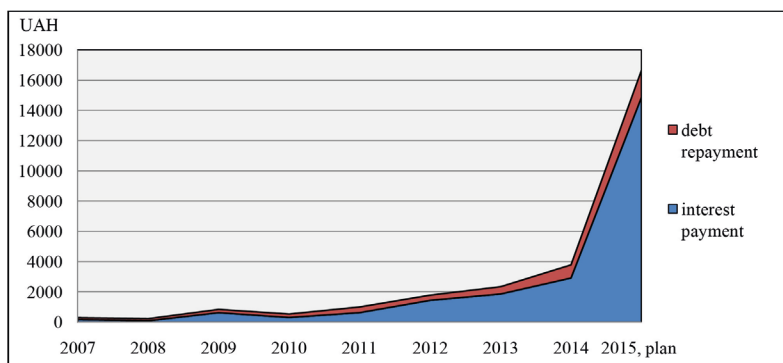


Figure 1.6. The predicted amount of payments for foreign public debt repayment and service in 2015-25, as of the beginning of February, 2014 [based on the data provided by the Ministry of Finance]

The total amount of payments for all of Ukraine's foreign credit agreements was estimated to reach \$30 billion, with peak payments in the current year and in 2017. By now, this number has increased in the hryvnia equivalent after the devaluation and has been supplemented by new debt obligations. If we compare the borrowing in 2014 with the experience of 2009-10, we can argue that the situation would not have become uncontrollable, if not for the triple devaluation of hryvnia. And, since about 55 percent of the public debt was concentrated in foreign currency, its re-assessment led to the situation when, in 2015, Ukraine's public debt, including new loans, is set to reach UAH 1,394,430,819,300, which will be equal to the predicted level of the country's gross domestic product [Бюджет України, 2015].

The payments for public debt service in 2015 reached UAH 92.7 billion (UAH 46.3 billion more than the 2014 plan). This number is equal to 16 percent of budget expenditures, and it is too high a price for the "borrowed life," since the payment of public debt interest alone became the largest item of budget expenditure in 2015. The direct debt burden on Ukraine's population of working age also increased (Fig. 1.7).



*Fig. 1.7. The dynamics of external debt burden per one employed person in Ukrainian economy [based on the data provided by the State Statistics Service and the State Treasury Department of Ukraine]*

Therefore, in 2014, about UAH 3,300 was paid for foreign debt per one working person, and in 2015, almost UAH 16,600 was paid per person; thus, it reached 56 times (!) the amount of 2007, and more than 7 times the amount of 2013.

The logical consequence of this is that all of Ukraine's credit ratings fell, and its debt obligations were assessed as default or pre-default in 2015. In practical terms, this means that Ukraine will have limited access to commercial borrowing abroad or, at best, that commercial foreign loans will be given with high interest rates. In these circumstances, if the current policy is further pursued, the government can only count on the financial support from the IMF. In order to secure it, the



government agrees to nearly all of the IMF's requirements about its internal economic policy.

If earlier Ukrainian leaders tried to maneuver between geopolitical blocs and implemented austerity policies only selectively, the current government have declared their full surrender and are determined to implement the harshest requirements of international institutions. As a result, in March 2015, Ukraine received the first tranche of \$5 billion as a part of the new Extended Fund Facility program, which provides \$17.5 billion of funding.

In the fall of 2015, the agreement was reached about postponing some of the payments to commercial lenders for three years and writing off 20 percent of the principal. Of course, it allowed to stabilize the situation in the financial market and to ease the debt burden, to some extent. But what is the price of these measures? For, according to them, Ukraine de facto loses its capacity to independently make its own financial and economic policies and commits itself to implementing a harsh agenda of cuts in the social sphere. The basis for such a claim are the requirements listed among the latest obligations to the IMF which the government is going to undertake [меморандуми з МВФ від 11 березня 2015 року та 31 липня 2015 року]. According to the Memorandum, the IMF will exercise close oversight of all the processes that Ukraine will implement in its fiscal, tax, and monetary policies; this will, among other things, lead to all-encompassing welfare cuts, in order to be able to pay the IMF.

The restructuring of Ukrainian debt, which the government has to organize now, primarily benefits the lenders whose chances for returns on their investment are held up. Just as in with the previous restructurings, such actions only postpone the country's bankruptcy, limiting its independence with a debt yoke, without raising the key question of a complete refusal to pay for illegal and unmanageable debts accumulated by all the previous "elites." Furthermore, the conditions for the restructuring include linking future payments to creditors to the rate of Ukrainian economy's growth. Thus, if the growth rate of Ukrainian GDP will be from 3 to 4 percent, Ukraine will have to pay 15 percent of its GDP increase over 3 percent, and 40 percent of each percent of the GDP increase over 4 percent [Ключові факти щодо угоди зі Спеціальним комітетом кредиторів].

However, in this case, there is the question of the role of the "people's" government, if the citizens' interests are secondary to the dictates of international capital. We have overviewed the history of Ukraine's debt dependence, and now we will move on to the analysis of the consequences of Ukraine's contemporary debt policy in terms of the central financial plan of the country, the state budget as one of the instruments for distributing the national wealth. We will investigate how the budget has been formed in the recent years, and evaluate the role of the debt burden for the way the budget performs its key functions.

## 1.2 The interrelation between Ukraine's budget and its debt policy

### The dynamics of Ukrainian budget's revenues and expenses in 2012-15

Government budget is an important tool for regulating socio-economic processes in a country, since the direction of economic development, the financial situation, the quality of social welfare, among other things, depend on the budget size and structure. Budget deficit, when budget expenses exceed the revenues, characterizes most countries, including countries with developed market economies (in 2013, budget deficit in Australia was 1.3 percent, in the USA 4 percent, and in Japan 8.2 percent). The scope of the deficit is between 1 and 17 percent of the GDP, and its global average amount in 2013 was \$2.2 billion, or 3.1 percent of the global GDP [Central Intelligence Agency]. Ukrainian budget is no exception, as it is chronically deficient (see Fig. 1.8).

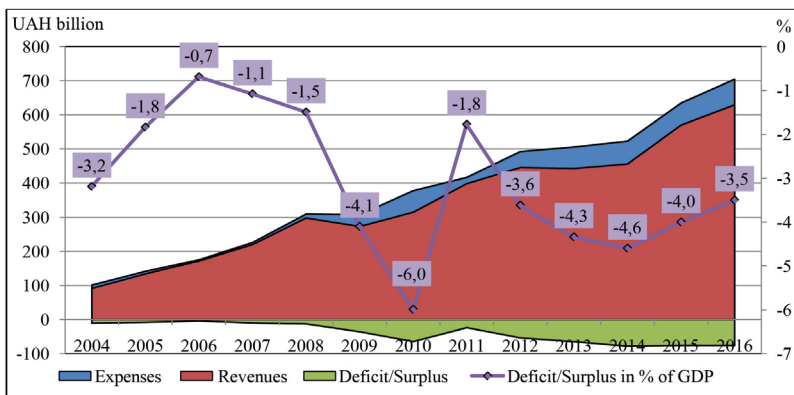


Figure 1.8. The dynamics of revenues and expenses of the consolidated Ukrainian budget [based on the data provided by the National Bank of Ukraine, the Ministry of Finance of Ukraine]

However, this is not critical for economic development. Much more important are the directions and the amounts of public expenses, that is, the ways in which the accumulated funds are spent — the balance between the social support of the population and investment into various industries. In the situation in which Ukraine finds itself today, these two aspects are joined by another, third factor, and just as important one: namely, public debt payments.

In general, according to Ukrainian budget for 2015, the total planned revenue in that year was UAH 502.3 billion, and the planned expenses were UAH 566.5 billion; the repayment of loans to the budget should bring UAH 4.8 billion, UAH 16 billion are assigned to government lending, and the deficit limit is set at UAH 75.8 billion.

Due to the permanently unbalanced budget, the government has to constantly look for sources to fund the deficit; the most popular sources are external borrowing and money emission. The rapid devaluation of hryvnia in 2014-15, caused by the aggregated effect of such factors as deposits flowing out of the banking system, foreign currency reserves shrinking to a critical level, and active speculation on the financial market, caused Ukraine's public debt to grow very rapidly (from UAH 480 billion on December 31, 2013, to UAH 1,185 billion on April 30, 2015). Correspondingly, it increased the budget spending on debt service [Мінфін, 2015].

Of course, international financial institutions take into account the fact that, in the situation of economic crisis, it will be difficult for Ukraine to repay its previous debts; thus, when they review its applications for refinancing or new loans, they issue certain requirements for the way the budget should be formed. Moreover, although we cannot say for certain what motivates the institutions to do so, there are grounds for believing that the desired policy changes are the prime causes. That is, countries are intentionally forced to take up credit burden in order to create pressure on local governments to make them reduce social expenses on the needs of local workforces, which are embedded in the international division of labor.

According to the National Bank's predictions in March 2015, public and publicly guaranteed debt will reach 93 percent of the GDP in 2015 (mostly because of the re-assessment of Ukraine's foreign currency debt because of the exchange rates). The external part of Ukraine's public and publicly guaranteed debt should, according to the National Bank's optimistic scenario, reach 59 percent of the GDP by the end of the year [НБУ, 2015].

### **The discrepancy between the planned budget and the prospects of its implementation**

In order to evaluate the adequacy of the government budget plan for 2015, let us compare its figures and the dynamics of the actual implementation of budgets in the recent years (Table 1.2). It is worth noting here that the consolidated budget (the total of all budgets on all levels) is somewhat different from the government budget, but all tendencies and directions for change in specific items are essentially the same.

**Table 1.2 The indicators of the Government  
Budget of Ukraine implementation in 2012-5 (UAH billion)**

Indicators	2012		2013		2014		2015		
	Plan	Fact	Plan	Fact	Plan	Fact	Plan	Fact	
								Jan-Apr	Growth rate compared to 2014
Revenues	383	346	360	339	378	357	502	163	35%
Individual income tax	7	7	8	8	14	13	42	13	430%
Corporate profit tax	58	55	58	54	40	40	36	17	-7%
Subsoil use fees	16	13	13	13	20	18	42	5	5%
Value-added tax	212	185	195	182	202	189	230	75	40%
VAT reimbursement from the budget	-48	-46	-60	-53	-59	-50	-58	-17	25%
Excise tax on the excisable goods produced in Ukraine	31	27	31	26	32	28	37	11	45%
Import duties	13	13	15	13	16	12	34	10	178%
Funds transferred by the National Bank	13	24	23	28	23	23	61	15	-24%
Public institutions' own income	25	25	30	29	27	22	19	7	1%
Expenses	427	396	433	404	461	430	567	153	20%
General government functioning	46	44	53	50	69	66	115	30	74%
<i>including debt service:</i>	25	24	33	32	48	48	93	25	108%
Defence	17	15	16	15	29	27	44	12	166%
Public order, security and justice	38	37	41	39	47	45	49	13	17%
Economic activities	60	49	50	41	39	34	40	9	-12%
Environmental protection	8	4	8	5	4	3	3	1	48%
Housing and community utilities	1	0	0	0	0	0	1	0	-98%
Healthcare	13	11	14	13	11	11	12	2	-17%
Mental and physical development	6	6	6	5	6	5	7	2	41%
Education	33	30	34	31	32	29	30	9	-3%

See the beginning of the table on the previous page

Indicators	2012		2013		2014		2015		
	Plan	Fact	Plan	Fact	Plan	Fact	Plan	Fact	
								Jan-Apr	Growth rate compared to 2014
Social security and welfare	77	75	89	89	87	81	87	29	-2%
Transfers between budgets	128	125	122	116	138	131	179	48	14%
Deficit (-) / Surplus (+)*	-44	-50	-73	-64	-84	-73	-64	8	-

*\* without taking into account lending and loans repayments*

*[based on the data provided by the State Treasury of Ukraine and the Ministry of Finance of Ukraine]*

From 2012 until 2014, the difference between the planned and the actual revenues was between UAH 21 billion and UAH 37 billion, while the deviation of expenses from the planned level was between UAH 29.5 and UAH 31.4 billion. This indicates that the government adjusts some expenses to the actual revenue collected as taxes, rent fees, excise fees, etc.

The main beneficiary of the decrease in revenues is the uncollected VAT: from UAH -27 billion in 2012 to UAH -12 billion in 2014. The plan was exceeded only a couple of times, and those cases were attributed to the National Bank of Ukraine: UAH +10.4 billion in 2012 and UAH +6.1 billion in 2013. In 2012-4, the lack of funds affected the following expense items the most: economic activities (from UAH -5 to -10.1 billion), defence (from UAH -1.3 to -2.9 billion), education (from UAH -2.3 to -3.6 billion), social security and welfare (from UAH -0.8 to -6.8 billion).

Therefore, the state budget has not been fully implemented for the last 3 years. The results of the first four months of 2015 indicate that the revenue part of the budget is unlikely to be implemented in 2015 as well: even though all goods and services have become more expensive, and therefore the taxable base has increased, budget revenues have only increased by 35 percent (although the annual inflation, even in official records, reached 60.9 percent by April 2015), while budget expenses have increased by 20 percent.

As the spreadsheet demonstrates, all of the government's social functions, such as healthcare, educational services, housing maintenance, or culture, have become secondary. In contrast, spendings on debt service, as well as defence and repressive functions (the Ministry of Interior's and Security Service's structure, Prosecutor's Offices, and so on) has increased.

Thus, the social "reforms" are intended to redirect budget funds to other areas which are currently among the government's priorities. The logical implication of

this is that the burden placed on disadvantaged populations, which will gradually include more and more social groups, is increasing.

Debt service spending only rose to 4.8 percent of the GDP. The deficit limit of Ukrainian government budget is set at UAH 75.8 billion, and for the most part it will be, once again, funded via external borrowing. The National Bank's income of UAH 60.5 billion was supposed to compensate for the slow increase of revenues from core taxes, but after the first two months of 2015, this turned out to be a rather difficult task (the revenues are 38 percent lower than in the same period of 2014).

At the same time, there is a tendency to transfer the tax burden from companies to individuals. If the revenues from the corporate profit tax are planned to be even lower than last year (UAH 35.9 billion vs. UAH 39.9 billion), the income tax revenues are supposed to increase by 235 (sic!) percent. In January-February 2015, UAH 5.9 billion of individual income taxes were collected for the government budget (4.3 more than in 2014), and only UAH 4.8 billion of corporate profit tax (36 percent less than in 2014).

It should be taken into account that 39 percent of the collected income taxes are made of the military tax and the income tax obtained as percentage of bank deposits; these numbers will become smaller over time because of the outflow of deposits from the banking system and unchanging salary funds. The processes of stagnation in the country's economy, a considerable reduction in its exports as one of the key sources of financial revenues, the loss of spending power of the population and, consequently, the decrease of imports — all of these factors reduced the liquidity of most companies to critical levels and forced some of them to launch bankruptcy procedures. At the same time, inflation (two- or threefold increase of prices for most goods and services) and a significant increase of spending on defence and on energy resources, create the need to increase budget spending on all levels.

The government sees privatization as one of the sources of budget revenues in 2015. In 2013, only 14 percent of the planned amount of revenues from this source were actually obtained (UAH 1.5 billion of 10.9 billion), and in 2014, only 2.7 percent (UAH 466.9 million of the planned 17 billion) (Держказначейство 2015). However, at present, using the need to save the budget and hand public companies over to "efficient owners" as justifications, the plans for sweeping privatization of any attractive facilities still owned by the state have been announced.

We think that, in the long term, these innovations will end up having opposite effects; that is, the revenue from profitable public companies which could have been controlled by the government will be lost. The less attractive companies will be pushed to go bankrupt, with all the negative social consequences it can have in the future.

## The possibilities of fulfilling internal and external debt obligations (given the current level of inflation)

There are two possible ways to fund the budget deficit: by money emission or by external and internal borrowing, as the accumulated credit sums essentially form the public debt (the latter is preferable, according to the dominant monetarist approach). Ukrainian government tries to combine both ways, while the position of the IMF, adopted also by the new National Bank management, is to strictly limit money emission.

In recent years, the main source for covering the budget deficit was external borrowing in foreign currencies; the government did not make any attempts to insure itself against currency rate risks. Because of the 250-300% devaluation of hryvnia in 2014-15, and the corresponding nearly threefold increase of Ukraine's public debt in foreign currencies, fulfilling debt obligations has become practically impossible in the long term. By the end of February 2015 (see Fig. 1.9), Ukraine's public debt was almost two times bigger than the amount of state budget revenues planned for 2015 (UAH 1,372 billion vs. 502 billion).

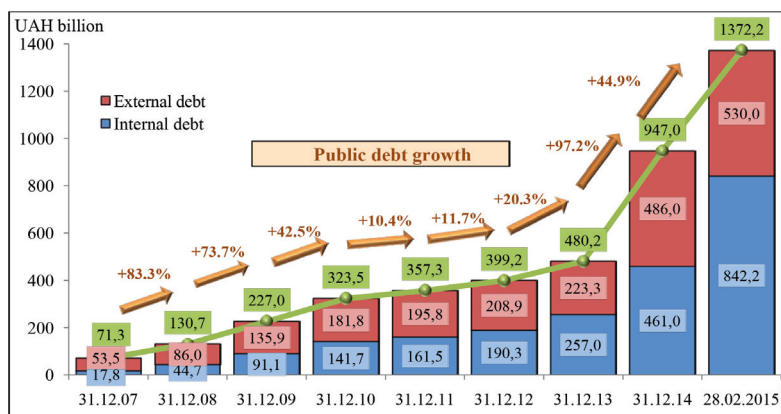


Figure 1.9. The dynamics of Ukraine's public debt increase  
[based on the data provided by the Ministry of Finance of Ukraine]

This entails a logical conclusion: without strengthening the national currency (at least to the economically justified level), public debt service is unlikely to be successful as early as in 2016.

On the one hand, the growth of Ukraine's public debt (to the IMF and to other international financial institutions) helps to balance the country's budget and contributes to the stability of hryvnia exchange rate (the government and the National Bank receive certain funds which they use according to their functional responsibilities). On the other hand, while the government received considerable

amounts of loan money in the previous years to fund the budget deficit, it did not manage to invest it in a way that would bring profits and strengthen the economy. Instead, most of the money was channeled out into oligarchic structures via procurement tenders; another part of the money was spent on maintaining the exchange rate and rescuing banks (refinancing and other measures), so it was not spend in completely rationally either.

For example, according to the State Procurement Herald (Visnyk derzhavnykh zakupivel), data about tenders for UAH 520 billion were published in 2012, and about tenders for UAH 204 billion in 2013; in in 2014, the number fell to UAH 155 billion due to the lack of money for construction, road repairs and other capital spending in the government budget (Українська правда, 2015). That is, in 2012 only, funding for public companies which were artificially made to look unprofitable consumed about \$63 billion (with the average exchange rate of UAH 8.27 per one US dollar).

According to an analysis conducted by the Ministry of Finance, the average period until public debts are repaid is 4.8 years; however, this forecast too optimistic given the current state of the economy. In addition, if creditors do not provide new loans to refinance the old ones, Ukraine will, most probably, face a default situation.

The government can choose one of the three ways which allow to repay its external public debt and avoid defaults (or it can combine all three):

- 1) to strengthen hryvnia's exchange rate considerably (so that budget revenues become sufficient to cover the debt service);
- 2) to accelerate inflation by turning on the printing press and inject cash into the market (to increase budget revenues), while maintaining a stable exchange rate;
- 3) to spend the IMF money on developing the economy, which would cause the rate of budget revenue growth to exceed budget spending, and would allow to compensate for the expansion of the government budget due to rate differences (an unlikely scenario).

In the international debt management practice (including developed countries), defaulting is a rare occasion. Therefore, we can assume that the global community, and Ukraine's creditors above all, will not allow Ukraine to default unilaterally, and will help it to restructure its public debt, so that it can repay its past debts. On the other hand, given the steep decline of the population's welfare due to the devaluation of national currency, defaulting would probably be better for Ukraine; since, if the government defaulted on its debts, that part of the budget which used to be spent on debt service would be redirected to solve internal problems that suffer from underfunding (social payments would increase, capital would be injected into poorly developed industries, and so on).



## The dynamics of spending on debt repayment and service compared to social spending

The budget for 2015 presupposes that its deficit will be funded via borrowing (Table 1.3).

**Table 1.3 Funding of the consolidated Ukrainian budget by debt type**

	2012		2013		2014		2015*
	Plan	Fact	Plan	Fact	Plan	Fact	Plan
Funding by debt transactions	47.6	44.7	82.9	80.5	209.0	200.9	145.3
Loans	119.5	115.4	165.0	160.9	336.0	325.0	396.9
incl. internal loans	75.5	72.5	110.9	109.0	237.3	230.0	110.2
incl. external loans	44.0	43.0	54.2	51.9	98.7	95.0	286.7
Repayment	-71.9	-70.7	-82.1	-80.4	-127.0	-124.1	-251.6
incl. internal debt	-38.8	-38.4	-44.0	-42.4	-72.2	-71.2	-128.0
incl. external debt	-33.1	-32.3	-38.1	-38.0	-54.8	-52.9	-123.6
Revenue from the privatization of state property	7.0	6.8	1.5	1.5	0.5	0.5	17.0
Funding by active transactions	-1.5	-0.7	2.1	-18.4	-106.8	-129.4	-86.5
incl. purchasing securities	-7.5	-7.0	-15.0	-14.7	-123.6	-123.3	-88.5
Total	53.1	50.8	86.5	63.6	102.7	72.0	75.8

*\* government budget funding*

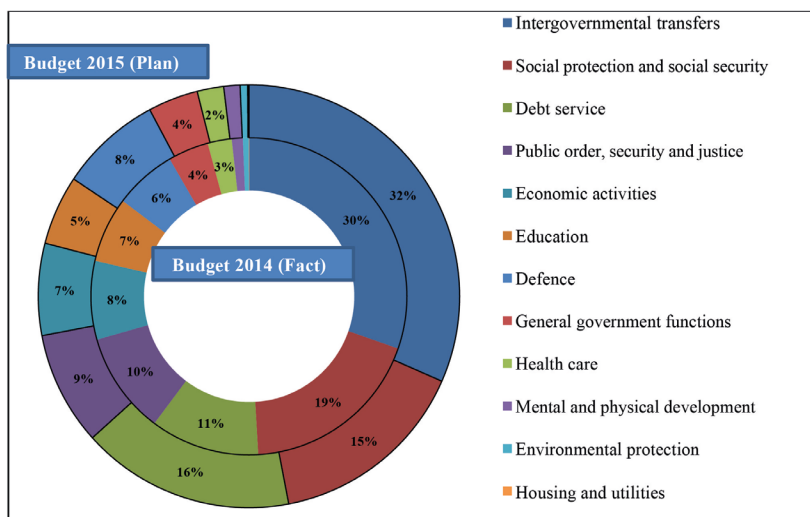
*[based on the data provided by the State Treasury and the Ministry of Finance of Ukraine]*

In particular, funding from external loans will increase by 202 percent and reach UAH 287 billion; while funding from external loans will fall by 52 percent to UAH 110 billion. Debt repayment will require to spend UAH 252 billion, and a considerable part of this amount will be drawn from new loans.

According to the plan, no more than UAH 128 billion, or 51 percent of the total sum, will be spent on internal debt repayment; it is one of the IMF's requirements for receiving a loan. And this is a dangerous tendency, since the IMF pressure makes the government more dependent on external institutions. As a result, the IMF can control budget policies and force the government to implement "unpopular" reforms, which essentially limits Ukraine's independence as a sovereign state. The plan for revenues from the privatization of state property is also significant, reaching UAH 17 billion. Although this process has already

been happening for a long time, and it has been rather politically charged, the recent government's actions, aimed to simplify the privatization procedure and expand the list of facilities that are to be privatized, indicate that the government is determined to hand the sectors that are still run publicly over to private companies [Економічна правда, 2015].

One of the conditions for a balanced budget policy is the principle of balance between spending on social stability and funding the development of promising economic branches. In 2015, the principle was de facto ignored, since the government chose to pursue the policy of austerity, justifying its moves by the military operations in the east and the crimes of the previous government. In particular, the fraction of funding dedicated to social security and welfare was reduced by 4 percent (down to 15 percent), the fraction of education was reduced by 2 percent (down to 7 percent), the fraction of healthcare was reduced by 1 percent (down to 3 percent) (Fig. 1.10).



*Figure 1.10. The dynamics of revenues and expenses of the consolidated budget of Ukraine [based on the data provided by the National Bank and the Ministry of Finance of Ukraine]*

The negative trends can be compensated by increasing transfers between budgets (from 2 to 32 percent) and increasing the size of local budgets, since they also include education and healthcare expenses.

In 2015, defence expenses were planned to increase by 62 percent, up to UAH 44.4 billion, or 8 percent of the total budget expenditure (to compare, Japan dedicated 5.2 percent of its budget to defence in 2015, and for the USA the number was 13 percent) [US Govspending, MinFin of Japan 2015]. The Ministry

of Defence will receive UAH 39.7 billion of funding in 2015, while in 2014 it received UAH 26.5 billion, and in 2013, only 13.9 billion.

This amount does not include additional transfers to fund the Anti-Terrorist Operation, which the Parliament assigns through special decrees. The 2015 budget also gives UAH 49.3 billion of funding to the Ministry of Education, and UAH 43.6 billion to the Ministry of Health Care (spending on the national level); both of them combined are less than the spending on public debt service, which is UAH 93 billion in 2015. The policy of permanently increasing the gross public debt without any structural changes in the economy leads to the disproportionate growth of the debt burden for future generations.

### **Alternative ways of budget management with a balanced structure of revenues and spending on the social sphere and investment projects**

It is typical for Ukraine to have a passive budget distribution; that is, the budget funds are used to cover current expenses (social transfers, wages for public sector workers, etc.). Meanwhile, in developed countries, the budget distribution is typically active, meaning that budget funds are invested in the economy, which facilitates the GDP growth, allows to push the economic development forward and accelerate the growth of capital. As a result, the gradual increase of Ukraine's budget deficit is mostly caused by its low economic development and, therefore, small individual and corporate incomes. In order to radically change the existing tendency, we need to follow the principle, "Do not save more, but make more."

The debt situation in which Ukraine has found itself is not the most critical in the international practice (examples of Greece, Argentina and other Latin American countries are quite telling). In addition, some developed European countries are experiencing a period of hidden economic crisis and stagnation (Hungary, Spain, etc.), which creates the need to optimize the EU budget. For example, Janusz Lewandowski proposed a budget forming system in which, by 2020, about 58 percent of the EU budget has to be spent on social projects and welfare (the total amount of spending was €141 billion in 2015). It is suggested that 15 percent of this amount should be spent on innovation, 38 percent on sustaining the rational use of resources, 12 percent on developing new professions and creating new jobs [Lewandowski 2014]. That is, the emphasis is shifted from stable development using the old economic system, to the active use of the achievements of scientific progress.

The existence of a budget deficit stimulates to constantly search for ways of closing it up; the specific steps made by governments in this direction can vary, but, in the end, they all boil down to creating possibilities to increase budget revenues and reduce budget spending. In order to reach this goal, the tax system needs to be

improved; the responsibility of economic agents and their managers, particularly their liability and criminal responsibility for adhering to tax regulations, needs to be increased; the ways to involve personal savings into the investment market must be improved; budget funding must be replaced with a system for subsidies, subventions, and investment loans to economic agents; a scientifically grounded system must be introduced for predicting the indicators which would serve as the basis for forming the list of budget revenues and expenses; the standards of budget sufficiency must be used in budget planning; an effective program must finally be launched to develop the remaining potential of Ukraine's competitive high-tech industries, which can provide the government budget with increasing revenues in the future.

We would like to highlight the efficiency of the way both budget and external credit funds are used. Let us have a look at a specific example. In October 2005, as a result of privatization competition, Mittal Steel Germany GmbH bought 93 percent of the shares of the largest metal processing company of Ukraine, the Kryvorizhstal, for UAH 24.2 billion (\$4.8 billion). After the government received the money, payments to the population for their Soviet savings books (UAH 1000 for each deposit) intensified; student stipends and retirement pensions increased; and budget deficit was partially covered. Setting aside the question of the sensibility of this privatization, we should point at the following problem: a major part of consumer goods (textiles, clothes, household appliances) in Ukraine are imported. In this case, most of the money that came to Ukraine as potential investment funds were in short time transferred abroad as payments for imported goods, which strengthened other countries' economies. The method of intensifying the rate of the country's social and economic development by increasing the money supply, which was used here, is acceptable only in cases when all industries of a particular economy are well developed, not when most industries are in decline. At the moment, a key part of Ukraine's commodity GDP and of its exports comes from the food industry, agriculture, and the iron and steel industry, which are all industries that produce raw materials.

Was there any alternative at that moment? Yes, the alternative was to distribute the money from privatizations using the profitability principle. For example, every Ukrainian region could have received about UAH 1 billion of proceeds as targeted funding (as loans or loan interest compensation), depending on the region's specialization — e.g., steel and iron in the case of Donetsk Region, or agriculture in the case of Vinnytsia Region. Each region could have built 40 new grain elevators capable of storing about 2 million tons of grain. Or they could have planted 2,177 intensive fruit gardens (in 2014 prices), which would provide jobs for 1,100-1,300 citizens and allow to avoid importing fruit and increase the exports of concentrated juice [Маркет Сад]. And in each of these examples, the population (engineers, construction workers, farmers, etc.) would also have received some money from

selling the Kryvorizhstal, only in a different form, as wages. But, as a result, some manufacturing facilities would remain competitive and would not only satisfy the needs of the population, but also allow Ukraine to reach global markets. But, most importantly, due to the improved balance of payments, we could have reduced the country's debt burden and avoid borrowing again.

Thus, in order to structure the Ukrainian budget in a rational way, the following steps must be taken. First of all, the government must clearly understand our competitive advantages in the international division of labor and strengthen them by developing complex programs for developing those industries. Second, the received loans must be used more efficiently, so that the relatively cheap borrowed money work for the country's economy; new loans should not be used to service the ever increasing public debt. Third, it is necessary to define the budget expenditures (healthcare, welfare, education and science, etc.) that must be funded with fixed percentages of the total budget expenses and protected on the constitutional level.

The issues of rationality and priorities in budget spending are inseparable from resolving the problem of defaulting on Ukraine's foreign debt, which is often used to scare Ukrainian society into quietness. Let us try to produce an objective scientific evaluation of this phenomenon, study defaults in the international practice, define the types of defaults and their differences from the partial debt restructuring option, which is currently proposed to Ukraine; based on this, let us define the possible consequences of defaulting for Ukraine's socio-economic development.

### **1.3 The imperfection of the international system of public debt restructuring on international and Ukrainian levels**

We would like to point out that default is not something unique or extraordinary in the global financial relations. Some countries — not only in Latin America, but also in Europe — have spent more than half of their financial history in the state of default. Since 1820 until today, 248 cases of defaulting have been recorded in 107 sovereign states. Most often, defaults occur in South America — Ecuador, Mexico, Uruguay and Venezuela; each of these countries has defaulted at least 8 times, and they often demonstrated the phenomenon of “serial defaults.” Ecuador and Honduras have spent more than 120 years each in the state of default, and Greece was in this state for more than 90 years.

At the same time, defaults in different countries had different impact on the global financial system. Until the early 2000s, the biggest default in human history

was declared in 1918 by the Russian Soviet Federative Socialist Republic when Lenin was its prime minister. At the turn of the millennium, the leading position was first overtaken by Argentina, which, in 2001, defaulted on a larger sum (about \$100 billion), and then by Greece with its €220 billion default in 2012. Today, the Greek default remains the biggest in the world, and its consequences can still be felt in global as well as European financial system. The consequences of defaults for debtor countries also varied widely. For example, the Argentinian case of 2001 and the Russian case of 1998 are considered successful defaults that, despite the considerable amounts of written-off debt and the unilateral defaulting, led to quick recoveries of economic growth in these countries. At the same time, in such countries as Ireland (2010) and Greece (2012), default and restructuring did not lead to economic revivals, but, on the contrary, deepened the crisis.

### **Comparing the Argentinian and the Irish versions of default**

If we examine the consequences of defaults in terms of social and economic development of the countries that dared to make that step, we can say that the Argentinian case was the most successful. Between 1998 and 2002, there was a serious recession in Argentina, caused by the implementation of neoliberal policies approved by the IMF [Blustein 2004]. The destructive effect of those policies is confirmed even by an independent audit that was commissioned by the IMF shortly afterwards [IEO, 2004].

On December 26, 2001, Argentina unilaterally defaulted on its external debt, which, at that point, was estimated to reach about \$93 billion. Of the \$82 billion which were defaulted on, 51 percent were borrowed in the three years between 1998 and 2001. The flow of foreign investment, which was rather wide in the years before the default, almost completely ceased between 2001 and 2003 (after which it soon resumed on the same scale as before). The Argentinian peso, which used to be tied to the dollar with a 1 to 1 rate, was devalued to the rate of 4 to 1, which meant that inflation was more than 40 percent per year and the real GDP fell by 11 percent in 2002 [Hornbeck 2013]. It is interesting that, for five years after the default, Argentina did not pay anything at all, neither the principal nor the interest on its old debt. In addition, the country completely refused to cooperate with the IMF, at least for that period.

The process of partial debt restructuring (which is not completed yet) started only on December 19, 2005, and payments on the debt of \$82 billion partially resumed. At the second stage of debt restructuring in 2010, the service of 93 percent of bonds was resumed, under condition that only 30 percent of their nominal cost would be paid and that the payments would be postponed. After the agreement was reached, regular payments on these bonds resumed. Thus, we can say that Argentina managed to have more than a half of its debt relieved (70

percent of more than 90 percent of the bonds were written off). Thanks to the moratorium on debt service in the first five years after the default, the country managed to accumulate considerable resources and carry out efficient economic policies which facilitated the country's quick economic recovery.

For more than ten years, Argentina consistently implemented economic policies aimed to develop domestic production and markets, which were quickly nicknamed kirchnerismo, after Néstor Kirchner, the president of Argentina in 2003-7. The economic policies of Kirchnerism were directly opposite to neoliberal policies and involved protectionist measures to promote Argentinian industry and provide employment in the country. In particular, the policy of import substitution was implemented, and the import of goods similar to the ones produced within the country by Argentinian manufacturers in sufficient quantities was prohibited. Therefore, the government of Argentina has been fundamentally opposed to any kind of multilateral or bilateral free trade zones. In particular, in 2005, despite the insistence of Bush's administration, Argentina refused to sign the FTAA agreement.

By promoting neo-Keynesian policies, Argentina managed to overcome an economic crisis, to achieve a substantial increase in tax revenues, a positive balance of trade, and a significant GDP increase. At the same time, the country managed to considerably improve its human rights record. In particular, the laws of the junta period, which limited human rights, were finally canceled. Law enforcement agencies were cleared of people who had been involved in human rights violations (Epstein 2006).

Another important component of the Argentinian economic wonder is the unprecedented development of industrial cooperatives. After the crisis of 2001, factories and plants started to close down en masse; Argentinian workers responded with a mass movement under the slogan, "Occupy, protect, produce!" Workers occupied factories abandoned by their owners and resumed production, but now it was organized on cooperative principles — that is, they introduced new rules: the factory belongs to all workers, the profits are distributed equally, and crucial decisions are made at general assemblies of all the workers of the factory. Between 2001 and 2004, 290 such cooperatives were organized in Buenos Aires only. Usually, cooperatives had no more than 100 members, but among the self-organized enterprises, there also were a few relatively large ones, with 450 workers. In general, there are about 170-200 occupied or otherwise revived enterprises in Argentina today, and about 10,000 workers work at such enterprises. In 2004, a law was passed to legalize the nationalization of factories and hand them over to the collectives of workers after the nationalization [Ждановская 2015: 240–241].

In contrast to the Argentinian experience, one of the most dramatic and unsuccessful cases of default is the restructuring of Ireland's debt in 2010. The country used to be called a new "Celtic tiger" in the first decade of the century

and demonstrated high economic growth rates (in contrast to numerous countries of Africa and Latin America that constantly suffer from crises, depressions and serial defaults which only deepen the crises).

In the early 2000s, Ireland pursued the policy of deregulation and reduction of corporate taxes. In particular, the corporate profit tax was reduced to 12.5 percent, a low rate unprecedented in Europe, and the de facto tax rate for transnational corporations who located their branches in Ireland was 3–4 percent, a dream of any CEO. In 2007, Ireland had zero budget deficit, and in 2008, it had zero unemployment rate. It seemed that in this paradise on earth everybody won. Workers had jobs (even if they were often precarious), their families were busy consuming, and local and foreign business made extraordinarily high profits.

Financial deregulation provoked a mortgage and consumer credit boom. The total household debt before the crisis was about 190 percent of the GDP. Of course, it promoted the quick expansion of construction industry, and the banking industry experienced exponential growth. Thus, a mortgage and stock market bubble started to grow, since the total capitalization of stock market, bonds and bank assets became 14 times larger than the GDP (similar tendencies, by the way, existed in the Ukrainian market as well [Кравчук, 2015]).

In September–October 2008, the economy collapsed, companies were closing down and leaving the country, unemployment grew from zero percent in 2008 to 14 percent in 2010. Since many families were no longer able to pay their mortgages, and the banking system as a whole was on the brink of bankruptcy, the government had to guarantee bank deposits for a total of €480 billion (about three times the GDP of Ireland, which is €168 billion). The Allied Irish Bank, which was the key mortgage provider and had a portfolio of €48.5 billion loans (about 30 percent of the country's GDP), was nationalized. Exports fell, the state budget revenues slumped. The budget deficit increased from 14 percent of the GDP in 2009 to 32 percent in 2010 (more than half of the increase was due to a large-scale aid package provided to banks: €46 billion for investment in authorised capital and €31 billion for purchasing toxic assets).

At the end of 2010, the large-scale European plan for credit aid of €85 billion (€22.5 billion from the IMF) to Ireland was approved, which was provided in exchange for the obligation to implement austerity measures, and which led to a drastic decline in household purchasing power and a decrease in consumption. Government spending on welfare, wages in the public sector, and investment in infrastructure also decreased, as well as the tax revenues.

As a result of the austerity plan implementation:

- 24,750 public sector workers were laid off (8 percent of the total workforce);
- those who got re-employed were paid 10 percent less;
- the reduction of social transfers led to a steep decline in health care availability and to the freezing of retirement benefits;



- the tax burden increased for the majority of citizens who were already victims of the crisis: VAT was increased from 21 to 23 percent in 2014; a new residential property tax was introduced; the minimum hourly wage was reduced from €8.65 to €7.65.

The interest on Ireland's loans was rather high. The IMF loan had 5.7 percent interest, and the EU loan had 6.05 percent [Toussaint 2012:163-164]. No wonder that Ireland's economy has still not recovered, and today, more than six years after the crisis, the country's GDP remains 8 percent lower than before the crisis. Five years after the crisis, Ireland's GDP was still more than 15 percent lower than before the crisis (84.76 percent of the 2008 GDP). To compare, Argentina's GDP in 5 years after the crisis and the default recovered almost completely (98.43 percent of the pre-crisis GDP), and now it is more than two times bigger than before the crisis.

At the same time, Ireland, just as Ukraine, never explicitly announced a unilateral default, but always received international aid and negotiated debt restructuring with its creditors. However, the country's obvious inability to meet its debt obligations did in the end create the need for restructuring, which was carried out, with the approval of the creditors, in 2013, whereupon Ireland committed to carry on with the destructive neoliberal austerity policies. The agreement with the European Central Bank included restructuring of €85 billion of debt. Due to the prolongation of the loan program until 2053, the amount of payments in the nearest ten years will be reduced by €20 billion, but there is no plan to write off any part of the debt.

As we can see from the dynamics of Ireland's GDP in particular (Fig. 1.11), the neoliberal austerity policy practically froze the country's economic growth; the debt burden, as well as the so-called "aid," is used by global financial institutions as a means to force countries to carry out such policies.

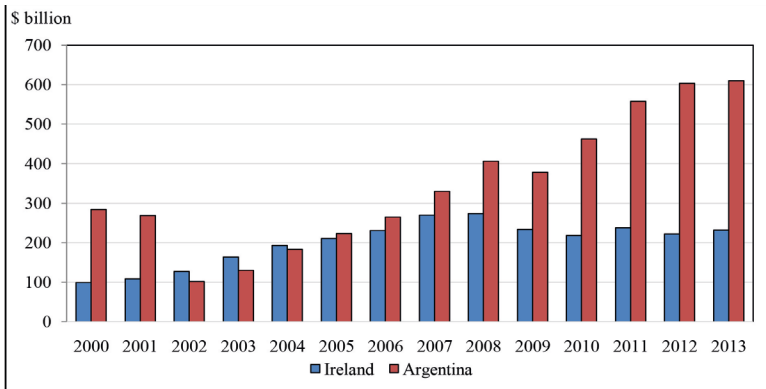


Figure 1.11. The trends in the GDP of Ireland and Argentina, in current prices  
[based on UN data]

This policy naturally led to bankruptcy, but, instead of defaulting in time, back in 2009-10, Ireland decided to rescue private banks at all costs, by paying them at the expense of lowering living standards and halting economic growth.

Therefore, we can argue that a unilateral default, in certain circumstances and with a certain economic strategy, can be better for the quick recovery of economic growth, and even for ensuring a quicker return to global financial loan markets, than some versions of restructuring preliminarily approved by creditors. This situation can be explained primarily by the imperfection of the international public debt restructuring system.

The example of Ireland demonstrates that it is quite risky to try to follow the letter of the existing agreements and all the procedures that make up the existing international public debt restructuring system (if we can say that it actually exists). The shortcomings of the system can be explained to a large extent by the history of its creation and the priorities of its architects.

Earlier, when developing countries resorted to extensive lending, the USA and European countries simply sent their armies to force those countries to repay their debts. In the mid-19th century, France sent its troops to Mexico; in 1882, Britain invaded Egypt; in 1902, a coalition of European countries bombed Caracas; and, until recently, the US practiced such methods of influence in the Caribbean. Of course, in the late 20th century, such methods became outdated, and today military intervention is usually not directly justified by the need to collect debts. At the same time, any other generally accepted international procedure for regulating sovereign defaults is *de facto* missing.

A sovereign country, by definition, cannot be forced to pay its debts if it does not agree to pay them of its own accord [Borensztein, 2010]. Of course, in practice, sovereign governments face immense pressure by creditors and the governments of industrially developed countries. However, the regulations of the UN Charter (Article 2), which prohibit member countries to use force, to threaten debtor countries with wars or military interventions because of their inability to repay debts, or to take assets under control by force in order to satisfy the creditors' demands, are still officially recognized.

## **The mechanisms of public debt restructuring and their consequences**

At present, any government that defaults can be deprived of any opportunity to borrow again, as well as lose some assets located abroad via confiscation requested by its creditors [Reinhart, 2009]. Governments also often face political pressure within the country from the holders of domestic government bonds. Therefore, countries rarely choose to default completely; instead, they initiate negotiations

with bondholders in order to reach an agreement about postponing (restructuring) or partially relieving their debt.

The IMF often provides “sovereign countries” with loans to restructure their previous debt. In theory, it is one of the key functions of this institution. In order to ensure that the loans are repaid, the IMF provides them under the condition that certain “reforms” will be implemented in the country, which usually include austerity measures, such as public sector cuts, welfare cuts, subsidy cancellations and tax increases for individuals (primarily VAT increases). In recent years, the IMF has especially emphasized the cancellation of “fuel subsidies,” which implies fee increases for all kinds of transportation, heating, and utilities in general. All this usually has a very negative effect on the internal market in the countries that receive such aid (not to mention that it spreads poverty and social injustice). However, even in this case, fulfilling the IMF’s demands remains “voluntary,” and the only way the IMF can influence it is the possibility that it will withdraw from any further credit provision.

At the same time, at least since the end of the 1980s, leading economists have pointed at the need to develop an international bankruptcy code, similar to the one that exists in the USA. According to the Nobel Prize winner Joseph Stiglitz, that need became absolutely obvious during the crises of the 1990s. However, government structures of the leading creditor countries (particularly the US Treasury Department) do not seem to be interested in establishing transparent and clear rules [Стиглиц, 2005: 278].

The crises of the first decade of the 21st century only confirmed that the current public debt restructuring system is inefficient, and that creditor countries are not interested in improving the transparency of debt restructuring processes. In the report by the UN Commission on the international monetary and financial system, also known as the Stiglitz Report (after the name of the expert group’s chair) unambiguously states that public debt crises have been the main obstacle to the attempts to achieve stable growth and development in developing countries at least since the 1980s [Стиглиц 2010: 287]. According to the authors of the report, public debt crises were the causes of long periods of income losses, unemployment, spreading poverty, and, in some cases, sharp polarization of income. At the same time, in Latin America in the 1980s, the so-called “nationalization” of external debts of the private sector was widespread; that is, governments undertook the service of the debts of private banks and corporations which were “too big to fail.” In the recent decades, the practice became typical for debt crises in developing countries. Meanwhile, just as it was earlier, countries with large debt are unable to accelerate their growth and thus reduce their debt burden [Байер, 2002: 222].

The problem of contemporary debt restructuring is not so much that the process is very long and expensive, as that the amounts of relieved debt are obviously

not sufficient to actually strengthen any country's "immunity to the debt virus." Excessive indebtedness suppresses economic growth, spreads poverty and significantly limits the provision of services which are important for the society. Quite often, when the relieved fraction of the debt turns out to be insufficient, it soon leads to another crisis [Стиглиц, 2010].

The best way to resolve the debt problem is allegedly not to postpone it but to actually cancel the excess debt by writing it off. The excess here is the part of the debt which, if written off, would allow to sell the rest of the debt close to its parity price on secondary markets. Indeed, excess debt in and of itself limits economic growth: heavy debt burden diminishes the motivation to invest, since, even if exports grow due to more investment, most profits will go to the creditors, not to the country itself. Thus, a "debt fatigue" can occur. That is why cutting down the debt would be more effective than new loans. There is a belief that debt relief can even result in higher expected payment, that what was expected to become less, can become more [Байєр, 2002: 225].

Interestingly, even such free market advocates as the architect of Poland's shock therapy Jeffrey Sachs, in their time, demanded to implement programs aimed to drastically reduce debts [Sachs, 1989]. According to Sachs, the US Treasury has to actively demand "coordinated action" and "mandatory" participation of all banks and private creditors to reduce debt, and take measures to punish "free riders." All banks, according to Sachs, have to agree to an equivalent reduction of their debt. Obviously, such measures required to create a new, more effective international system of public debt regulation and restructuring, which has never actually been created. Although it was discussed, in particular, in the USA, both under the Bush administration (the Secretary of Treasury Brady's plan) and under Clinton (Stiglitz's initiatives).

One of the key conclusions in the Stiglitz Report was that, due to unfavorable consequences and high expenses related to financial restructuring, developing countries are not ready to default at a proper point in time. The current system of resolving public debt issues proposes a procedure that is too lengthy and serves the creditors' interests, and not the public good; it is far from the interests of the poor and the disadvantaged in debtor countries [Стиглиц, 2010].

The obvious injustice of the current semi-formal system of public debt restructuring, which is once again being imposed on Ukraine in 2015, also lies in the fact that, in contrast to national bankruptcy procedures (including bankruptcies of municipal and government structures), it does not even try to provide any guarantees to ordinary citizens, employees, local communities, etc. National bankruptcy procedures at least ensure that a balance is maintained between the interests of creditors and of regular citizens who suffer from a private corporation's bankruptcy (including social insurance for the bankrupt company's employees in terms of free education and re-qualifying, health care,

benefits for the retired), not to mention providing the bankrupt organization with an opportunity to restructure and resume production, make a fresh start with a clean slate.

For example, Chapter 9 of the US Bankruptcy Code, applied in the cases involving municipal and other low-level government structures, distinguishes a separate plaintiff category of pensioners (former civil servants who were promised a government pension). This category's claims to receive a fraction of the public revenue are prioritized. Obviously, in the process of public debt restructuring in Ukraine in the early 2000s, pensioners and other disadvantaged categories were not only not allowed to participate in negotiations as priority plaintiffs, but, on the contrary, ended up as the priority victims of canceling the government's duties to them without any warning. Indeed, according to the Memorandum signed by Ukraine and the IMF and the laws passed to implement the Memorandum, pension payments and other guarantees to pensioners were reduced without any prior public discussion. According to American domestic laws, such practice could be considered a crime.

Most cases of debt restructuring in specific countries in times of crisis were based on voluntary agreements about cooperation with bondholders, since adhering to the norms of the international law, particularly the regulations about the payment of foreign debt, is formally "voluntary." But in fact the restructuring agreements barely made the debts smaller, and the debtor countries were pressured by creditor countries and international financial institutions. Most of the time, restructuring turned out to be an instrument for saving creditors rather than debtors, although the former, apparently, were not careful enough when they provided loans.

Thus, the mechanism of regulating public debt crises does not ensure equality between partners. State creditors always complain that private creditors do not adhere to the principles of restructuring that were agreed upon in the Paris Club. At the same time, the size of restructuring and the fraction of the debt that gets relieved are negotiated in an opaque manner and, apparently, depend on the power of the debtor country in any given case and on the negotiating skills of its representatives; that is, these parameters are determined without any clear procedure or criteria, by means of secret diplomacy [Стиглиц, 2010].

The debtor country finds itself in negotiations based on informal, opaque and faulty IMF's coordination of the efforts of the debtor country and its creditors, under the auspices of leading industrialized countries, members of the G7. These are the countries that provide general guidelines to the IMF and other institutions involved in the process, such as the Paris Club, which works with public debt restructuring.

It is a telling fact that negotiations are coordinated not by any independent institution (such as courts specializing in bankruptcies that exist in many

countries), but by the IMF, which is itself a creditor and is de facto governed by creditor countries. In this system, the debtor country is supposed to accept the approved macroeconomic adaptation program that has to be effective and provide economic growth. Therefore, all the creditors (international, public and private) are supposed to cooperate in order to agree upon the general amount that will be relieved, and to provide the debtor country with the necessary financial aid to implement the program according to the IMF documents.

In practice, the amount that actually gets relieved turns out to be extremely small, so it all boils down to debt restructuring, and the size of debt reduction is calculated using very optimistic growth predictions which hardly ever come true [Стиглиц, 2010].

Although unilateral default and restructuring approved by creditors are two different scenarios of resolving an insolvency crisis, in terms of finance theory, default and restructuring are synonymous, they basically signify the same thing, namely refusal to fulfill one's financial obligations which, in the end, results in relieving a fraction of the debt, approved by creditors. Cases of complete and final refusal to pay debts are scarce (Argentina in 2001 is one of them). Therefore, from this perspective, independent Ukraine experienced numerous defaults in 1998-2000; however, they did not have any significant negative consequences and did not stop the growth of the country's economy.

If we take the definitions of default and restructuring which are used in contemporary Ukrainian financial theory, the difference between the two terms will lie precisely in the unilateral nature of defaulting, in contrast to restructuring as an agreement between all the parties involved. So we need to distinguish between restructuring approved by creditors, which often requires lengthy and complicated negotiations, and unilateral defaulting, which bears the risks of shock effects for the country's banking system, but, at the same time, provides the country with an opportunity to choose the optimal time for defaulting independently, and, surprisingly, in many cases strengthens the country's position in negotiations with its creditors.

At the same time, researchers worldwide include any cases of rejecting or postponing debt obligations in the definition of a default, regardless of whether the rejections and postponements were approved by creditors, or were unilateral. Given that most borrowing is done by openly placing government bonds on the stock exchange, it is obvious that any restructuring is approved only by some of the major creditors, and not consensually by all bondholders. This approach also gives us an opportunity to compare the economic dynamics of various countries after insolvency crises, particularly to evaluate the consequences of their defaults (restructurings) depending on the percentage of the debt that was relieved. We will distinguish between defaults and systemic crises in the banking and credit systems of those countries, which are sometimes caused by defaults (or, vice

versa, which can cause the default). Because defaulting, that is, refusing to pay a part of the debt and restructuring the debt, can be carried out in a completely civilized way, without disrupting the normal functioning of the country's banking system, and does not necessarily cause shock in the economy, but sometimes even has some positive effects.

Formally, from the perspective of a sovereign borrower, the question of the expediency of defaulting can be solved by comparing the relative advantages of defaulting and continuing to service the debt (e.g., in terms of current pure value of cash flows, taking into account their predicted increase due to economic growth). That is, by comparing the advantages of additional, more expensive loans to pay for the existing debt, and the advantages of stopping the payments, taking into account the losses caused by the country's exclusion from the loan market for a while (the impossibility to receive new loans during that time), as well as the higher price of future loans taken by the country in the periods after it re-enters the loan market.

Assuming that the government of any sovereign country represents all its citizens, the key criterion for deciding if default is advisable must not be the question of improvement of the government's financial situation, but rather the prospects of economic growth and, first of all, the question of whether this step will bring more wealth to the population and reduce its poverty. Defaulting (declaring a moratorium on external debt payments) can free the funds that were previously directed to external debt service, and target those cash flows at improving the social and economic situation in the country, use them to stimulate investment and economic growth. However, the possible negative consequences of defaulting for the country's economy in general must be considered, in particular, worse borrowing conditions for private companies, that is, problems with attracting additional funds for investment projects; this, of course, would have a negative effect on economic growth.

However, a number of studies prove that, in most cases, a country's exclusion after it defaults and writes off a part of its debt does not last for long, and new loans usually do not become significantly more expensive. In particular, Stiglitz himself, in a collective monograph on the issues of overcoming the debt crisis in developing countries, argues that the dangers of a pause in borrowing in the period after the default are exaggerated [Herman, 2010]. According to Stiglitz, the examples of Russia in 1998 and Argentina in 2000 prove that a unilateral decision to stop debt payments can have quite positive consequences for debtor countries [Стиглиц 2010].

A famous French economist and the speaker for CADTM Eric Toussaint also argued that "[w]hen a country succeeds in enforcing debt relief on its creditors and uses funds that were formerly meant for repayment in order to finance an expansionist tax policy, this yields positive results" [Toussaint 2012].

Findings of debt crisis research provide grounds for a conclusion that solving a crisis by a unilateral default promotes the recovery of the economic system as a whole; in particular, the number of company bankruptcies falls rapidly, both as a result of lowering the interest rate, and because of the general increase in productivity throughout the economy. Since production volumes increase, collected tax revenues also increase; the government's financial situation improves, which, in turn, makes it easier to draw in new loans, if needed. Herman writes that there is little empirical evidence to prove that defaulting entails lengthy market exclusions; for example, Russia returned to global financial markets within two years after it defaulted, although it did not consult its creditors before doing it [Herman 2010: 49].

Of course, we do not think that defaults are the panacea for economic growth. Some of more than a hundred cases of defaulting on sovereign debt clearly had negative effects on the economies of the debtor countries. Statistical studies of defaults on sovereign debt point at a significant correlation between such indicators as the percentage of the haircut, the length of the period of exclusion from financial markets, and the price of future loans. These studies indicate that more than 60 percent of the countries that wrote off less than 30 percent of their debt got access to the global loan market within two years since the default. At the same time, only 30 percent of the countries that wrote off more than 60 percent of their debt returned to the global market within two years. For the countries that refused to repay more than 60 percent of their debt, the chance to return to financial markets even within 10 years since their default is only around 50 percent.

It should be noted, however, that very few countries did not return to the global market in 10 years, and, apparently, we should look for reasons for this not only in the fraction of their debt that was relieved ten years ago. As a rule, these are the poorest countries which are experiencing long-term depression and whose economy is ruined, not only unable to generate the revenue required for debt payments, but also lacking any signs of growth prospects. Often, countries end up in this state precisely because loans were imposed on them under the condition of implementing the macroeconomic reforms approved by the IMF, which, in the end, created the circumstances that ruined their economies. The problems of these countries are actually caused by their attempts to repay old debts using new loans, and by their long negotiations with creditors about debt restructuring to avoid unilateral defaulting.

Thus, we can argue that there are no studies that would prove that debt relief will definitely have a long-term negative effect on the exclusion of countries from global financial markets. At least if we are talking about countries with relatively powerful economies, and if they relieve no more than 50-60 percent of their debt. It should be noted that the most successful cases of defaulting are



often characterized by a relatively high percentage of the relieved debt (e.g., after the 1998 default, Russia's debt was reduced by 50 percent). As for Argentina's successful default in 2001, the agreement with creditors has not been reached yet. Research indicates that "default episode[s] seem to mark the beginning of the economic recovery" [Levy-Yeyati, 2006].

According to Stiglitz, whose opinion is also shared by Toussaint, in the process of determining a just percentage of debt to be relieved, it must be taken into account that creditors lend to countries without properly checking their ability to repay their debt. The creditors, who are aware of a high risk that a country will default, but still lend money to it, must bear responsibility for the risks they take. Because, if we admit that high interest rates are risk bonuses, then creditors must be ready to accept a high percentage of debt relief in case of default [Toussaint 2012:168]. Researchers also point out that bankers often provide overtly "raiding" loans to countries who are clearly in a pre-default situation (that is, consciously provide loans at unreasonably high interest to push countries towards defaulting, and then snatch a piece during the restructuring) [Herman 2010:55].

In this context, writing off 20 to 35 percent of Eurobond debt looks quite moderate and delicate [Економічна правда, 2015, Інсайдер, 2015], and the advice for creditors from the US Department of Treasury to agree to such debt relief sounds totally reasonable [УНІАН, 2015]. It is possible that the greed of Ukraine's private creditors now make them lose much more money later.

We must also note that whether the access to international financial markets will be resumed after defaulting depends on the seriousness of the reasons for defaulting and the losses suffered by creditors. For example, countries that defaulted because of a natural disaster usually get access to financial markets sooner (more than half of them get it within three years) [Tonz 2013:19]. It should be mentioned that Ukraine nowadays is in a force majeure situation, to say the least: it lost control over a considerable part of its territory, many of its factories and other enterprises were physically destroyed, and it is engaged in a war.

Researchers highlight the importance of public debt audits, with a wide involvement of representatives of the public, for determining whether a default is advisable and what the best moment to default is. The Stiglitz Report directly concludes that "[p]ublic debt audits for transparent and fair restructuring and eventual cancellations of debts should be encouraged. Norway and in Ecuador provide examples" [Стиглиц 2010: 296]; Eric Toussaint, in support of Stiglitz, proposes an even more specific set of measures to overcome the debt crisis, approved by the CADTM in August 2010, particularly:

- unilateral moratorium on debt service payments (on both the principal and the interest) until the public external debt audit with public participation is completed;
- expropriation of all the country's banks under public control;

- prohibition to use tax havens (offshore jurisdictions); introducing a tax on financial transactions;
- fighting tax evasion by big business;
- ensuring regulation and transparency of financial markets;
- legislative reduction of work hours in order to create jobs; increasing wages and pensions;
- re-socialization of companies privatized in the last thirty years;
- constituent assembly of European peoples for a new Europe [Toussaint 2012, CADTM 2010].

This set of measures is primarily aimed to overcome the debt crisis within the EU, but it can also be used to overcome the current debt crisis in Ukraine. It is true that, until recently, sovereign defaults were not legally regulated in any way. In addition, based on the Ukrainian Law “On Ukraine’s international treaties,” one could assume that it is impossible for Ukraine to declare a sovereign default.

However, when Ukraine generally adopted the bill on the special characteristics of legal transactions with public and publicly guaranteed debt, as well as local debt, it was an important step towards the legal regulation of unilateral sovereign default in Ukraine. Of course, the draft only concerns a part of the government’s external debt to private creditors and only allows to declare a moratorium on debt service, but not to reject it completely. However, it is a very important precedent which clearly demonstrates that it is Ukrainian government (and nobody else) who has the right to make decisions about a unilateral refusal to repay debts. Moratorium, as we have already said, is no different from defaulting: for example, Argentina had a moratorium on its bonds for ten years since 2001 (and still has it on some of its debt obligations), and no-one tries to claim that “it’s not about defaulting,” as Ukrainian media do [Калачова, Лямец, 2015]. It is also important that the USA and the EU have officially confirmed that they acknowledge Ukraine’s right to make such steps, and called on its creditors to engage in a more constructive dialogue (УНІАН 2015а, Інтерфакс 2015).

Therefore, public audit, moratorium on payments on all external debts until the audit is completed, and, later, declaring a sovereign default is, in our opinion, a more balanced strategy for the country’s debt policy than the one carried out by the current government in order to ensure that the country is able to pay its debts at any cost.

However, before we can recommend these radical measures, the social consequences of defaults in different countries must be investigated in detail, and we shall try to extrapolate them onto the Ukrainian situation.

## **1.4 The social consequences of a potential default**

The conventional indicators of economic growth, such as the GDP, have an impact on people's lives, but this impact is often rather indirect. The GDP growth in and of itself does not necessarily improve the lives of the majority of the country's population, since, in the situation of considerable social inequality and capital concentration, additional wealth nearly always ends up on the bank accounts of the richest 10 percent. Below, we will analyze the social consequences of a potential default for the wider population of Ukraine. We will derive our conclusions from the analysis of the trends in the key indicators of social welfare in the countries that defaulted in the past. We will attempt to extrapolate these conclusions to Ukraine, predicting the possible short- and long-term social changes in case of a default.

### **The consequences of defaults in Mexico, Argentina, Russia**

To analyze the consequences of default, we selected three countries. These are Mexico, which defaulted in 1992; the Russian Federation, which defaulted in 1998; and Argentina, which defaulted in the early 2002. Our selection can be explained by a couple of reasons. First of all, these are some of the few countries that defaulted in recent decades. In addition, various information about social indicators and their change over time in these countries in this period is available, although even for Mexico, unfortunately, we do not have all of the data that are available for the other two countries. The second reason is also related to timing, although not in terms of data, but in terms of the general economic stage of neoliberal transformations which started around 1973. This ongoing period is characterized by the expansion of a certain economic paradigm and the dominant methods of economic policy-making.

The principles on which the neoliberal economic paradigm and politics is based include: the idea of the free market which is capable of self-regulation; minimization of government intervention; liberalization of pricing and financial flows; privatization; and so on. Since this stage is characterized by certain economic instruments and special economic policies (of course, there is some variation, but there are also some general tendencies), it is logical to analyze our cases within this timeframe, with its characteristic tendencies which can be directly related to the current situation in Ukraine, as well as its possible courses of development. And the last reason that justifies the geography of case selection is the semi-peripheral position of these three countries at the moment of defaulting,

which is also close to Ukraine's position. This thesis can be contested by arguing that the selected countries were better positioned than Ukraine today, as well as by claiming that each historical situation is unique. But, in general, we think that it is much more reasonable to make predictions based on systematic data from these particular countries.

Some researchers of the consequences of defaults [Levy-Yeyati and Panizza, 2006] arrived at an interesting conclusion that the destructive impact on the economy, on its short- and long-term trends, is made not so much by the default itself as by expectations of it. Instead of analyzing annual trends, the researchers looked at the data by quarters and demonstrated that default is not the reason for downward trends in economic indicators, at least because the economy usually starts to recover immediately after defaulting. We will try to test this hypothesis using the three case studies of the selected countries, primarily by interpreting them in terms of social and economic well-being of the population, rather than the generalized economic growth. Before we interpret some of the indicators, we must note that the selection of indicators depends in part on the availability of data about the countries that concern us in the required timeframe. The data have been obtained from the World Bank statistics, unless otherwise indicated.

One of the indicators which can be used to interpret the social consequences of defaulting is the moderate poverty index (Table 1.4).

**Table 1.4 Comparison of poverty, unemployment and labor productivity in Argentina in 1998-2011 [World Bank]**

Indicator	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Poverty index (less than \$2 per day), %	3.5	3.8	4.5	7.1	9.8	7.6	5.3	3.9	3.1	2.8	2.4	2.3	1.6	1.3
Unemployment, % of workforce	12.8	14.1	15	18.3	17.9	16.1	12.6	10.6	10.1	8.5	7.8	8.6	7.7	7.2
GDP per person employed, \$ thousand, in 1990	25.6	24.7	24.3	22.9	22.9	23.2	23.3	23.6	24.4	26.2	26.6	26.2	27.9	28.4

In this index, that part of the population who live on less than \$2 per day (adjusted for the purchasing power parity) are considered to live in moderate poverty. We think that it is more appropriate to take this universal indicator rather than the local poverty line, which varies from country to country, which

makes data from different countries difficult to compare. Moreover, for many countries, including Mexico and Argentina, the data about the local poverty line and the population who live below it are lacking. As the table demonstrates, the percentage of the population living in poverty significantly increased in Argentina before the default, reaching 2.8 times the number of 1998, and peaked at the moment when a default was declared. After that moment, the poverty indicator started to fall: by 2006, it was already less than it had been in 1998, and in the long run, in nine years, the moderate poverty index became 2.7 times less than in the best years before the default.

Unfortunately, the data on the moderate poverty index in Mexico are incomplete (see Table 1.5).

**Table 1.5 Comparison of poverty levels, unemployment and labor productivity in Mexico in 1981-94 [World Bank]**

Indicator	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Poverty index (less than \$2 per day), %				9.6					6.7			4.3		3.6
Unemployment, % of workforce	4.2	4.2	6.9	6.0	4.4	4.3	3.9	3.6	3.0	2.8	2.6	2.8	3.4	3.6
GDP per person employed, \$ thousand, in 1990	21.0	20.2	19.2	19.1	18.7	17.5	17.2	16.8	16.9	17.1	17.3	17.5	17.6	17.8

The first available data are from 1984, and since then, they have been only occasional. However, the conclusions drawn from the Argentinian case are confirmed by the Mexican case. The index was the highest in 1984, two years after the default, and since then, the percentage of the poor in the total population gradually decreases. In ten years after the default, the poverty index was 2.2 times lower than in two years after the default, and in two more years it was 2.7 times lower than in 1984. Unfortunately, there are no data about this index before and at the moment of defaulting. However, we can assume that, just as in the case of Argentina, the number of people living in poverty increased for a couple of years before the default, peaked at the moment of default, and started to gradually decrease right after it.

As for the changes in this indicator in the Russian Federation, we can observe a somewhat different tendency here (Table 1.6). The key characteristic that differs

Russia from the other two countries in a much lower fraction of its population living in moderate poverty. However, the general conclusion is confirmed. The data from the default period are also only occasionally available, but we can assume that the general tendency was preserved here: the poverty index grew before the default, peaked in the year of defaulting, and started to fall right after it. The available data do not contradict this interpretation. If it is true, then the percentage of population living in poverty fell to the pre-default level almost immediately after the default (in 1999) and kept falling to reach zero in 2008, ten years after the country defaulted.

**Table 1.6 Comparison of poverty levels, unemployment and labor productivity in the Russian Federation in 1996-2009 [World Bank]**

Indicator	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Poverty index (less than \$2 per day), %	2.5			2.6		1.2	0.7	0.5	0.8	0.3	0.3	0.1	0.0	0.1
Unemployment, % of workforce	9.7	11.8	13.3	13.0	10.6	9.0	7.9	8.2	7.8	7.1	7.1	6.0	6.2	8.3
GDP per person employed, \$ thousand, in 1990	10.5	10.8	10.4	11.0	12.0	12.5	13.0	13.8	14.7	15.6	16.8	18.0	18.8	17.6

Therefore, the moderate poverty index data for Argentina, Mexico and Russia point at the tendency for this index to become worse — that is, for poverty to spread — before defaulting, to peak in the year of defaulting, and to decrease right after defaulting. In the short term, the percentage of the poor returns to the pre-default level, and in the long term, it becomes significantly lower, decreasing by at least 2.7 percent literally within a decade.

Another indicator that allows to interpret the dynamics of social well-being is the unemployment level. Since official government data are often far from the truth, in order to assess the actual levels of unemployment, we will use the data collected by the International Labor Organization (ILO) which take into account other indicators in addition to the fraction of the population who are officially registered at employment centers.

As the Table 1.4 demonstrates, unemployment in Argentina gradually rose until 2001, and then it started to fall. As early as in two years after the default, unemployment reached its pre-default level and continued to fall, with a minor

increase in 2009 — which happened, undoubtedly, due to the economic crisis that affected many countries. In nine years after the default, unemployment in Argentina was 1.8 times lower than a couple of years before the default. Unfortunately, the ILO data on unemployment are available only since 1991, so it is impossible to use these data to analyze the dynamics of unemployment in Mexico before and after the default.

As the Table 1.6 demonstrates, unemployment in Russia also increased before the default, peaked in the year of defaulting, and gradually started to fall. As early as in three years after the default, the number of unemployed became lower than before the default. In ten years after declaring the default, this number was 1.6 times lower than before the default. Just as in Argentina, there is a certain increase of the fraction of the unemployed in the general population in the year of the global economic crisis.

Therefore, the available data on unemployment in Argentina and the Russian Federation confirm the tendency that the situation deteriorates before defaulting, unemployment peaks in the years of defaulting, and the first positive tendencies can be observed right after defaulting and continue in the long run. Unlike the previous moderate poverty indicator, the unemployment index demonstrates some fluctuation during the economic crisis of 2009. The difference from the previous indicator allows to make a cautious conclusion that unemployment levels, unlike poverty levels, depend not only on the local processes, but also on the fluctuations in the global economy.

Another indicator which we propose to consider in order to evaluate the consequences of defaults in the selected countries is the GDP per person employed. This index essentially indicates productivity, namely, what fraction of the country's GDP is accounted for by one employed person.

As the Table 1.4 demonstrates, the GDP per person employed in Argentina fell before the default, was at its lowest in the years of the default, and started to grow in the following year, reaching the pre-default level in five years after the default, and has continued to grow since then. A certain fluctuation towards a fall in productivity can be observed in 2009, apparently because of the global economic crisis.

In Mexico, as the Table 1.5 demonstrates, the situation is significantly different than in Argentina. The GDP per person employed index here falls before the default and continues to fall with a considerable rate for the next six years. Only in 1990, in seven years after defaulting, labor productivity in Mexico started to grow, although it has never returned to its pre-default maximum. We can add to the data provided in the table that the level of \$21,000 per one worker has never been reached (as of 2012).

The data from the Russian Federation, demonstrated in the Table 1.6, confirm the tendency which we saw in Argentina only to some extent. In particular, it

is apparent that labor productivity in Russia did not fall before the default as significantly as in Argentina — it even grew a little right before the default. Later, the index did fall to its lowest point in the year of the default and started to grow right after the default was declared. Unlike in Argentina, labor productivity exceeded its pre-default levels basically in a year. Just as in Argentina, the growth tendency continued in the long term, deviating from the positive course in the first year of the global economic crisis.

Therefore, we can conclude that labor productivity (based on the GDP per person employed) follows a more complex pattern than the two other indicators. Although the cases of Argentina and Russia confirm the negative dynamics of productivity before the default and the positive dynamics after the default, the case of Mexico points at somewhat different tendencies. We can draw a cautious conclusion that productivity is characterized by a stronger dependency on local specificities and domestic trends than unemployment and poverty levels. At the same time, just as unemployment, productivity is also affected by global economic fluctuations.

Another double indicator which we would like to use to investigate the impact of defaults on social welfare is the distribution of income among the country's population; to be specific, we are interested in the fraction of income that goes to the richest 10 percent and to the poorest 10 percent. Of course, we could have used the Gini coefficient, which demonstrates the relation between those two indicators, but we consider it important to look at the patterns in each of the indicators separately (Table 1.7).

**Table 1.7 Argentina: the distribution of income between the richest and the poorest 10 percent of the population, % of the total income [World Bank]**

Category	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Richest 10%	38.1	37.1	37.7	39.5	40.5	39.9	36.7	36.3	35.4	34.9	33.7	32.6	32.4	31.8
Poorest 10%	1.1	1.1	1	0.7	0.9	0.8	1	1.1	1.1	1.2	1.3	1.2	1.5	1.6

As the table demonstrates, the relative wealth of the richest people in Argentina grew before the default, peaked at the moment of defaulting, and started to decline right after it. The tendency for this indicator to fall continued in the long run. The situation with the fraction of income that goes to the poorest population



is basically reverse, that is, it falls, with some fluctuation, before the default and starts to grow after it was declared. The growth tendency for this fraction also continues in the long run.

Unfortunately, the data on this indicator in Mexico are only occasionally available since 1984 (Table 1.8).

**Table 1.8 Mexico: the distribution of income between the richest and the poorest 10 percent of the population, % of the total income [World Bank]**

Population category	1984	1989	1992	1994
Richest 10 percent	35.1	41.4	40.3	41.5
Poorest 10 percent	1.9	1.1	1.6	1.7

It is impossible to draw any conclusions about the pre-default trends in Mexico from the data available; however, it is clear that the general picture is different from the Argentinian pattern. In the long run (with some fluctuation), the fraction of income received by the richest grew, and the fraction of the poorest fell. However, the occasional nature of the data only allows to draw the most general conclusion that the situation in Mexico is different from the situation in Argentina.

Table 1.9 demonstrates that the dynamics of income distribution in Russia does not follow any clear tendency and is not linked to the default. There are wave-like rises and falls of the fraction of income of both the richest and the poorest citizens.

Some conclusions can be made about the distribution of income between population categories. First of all, these indicators and their dynamics in the period under consideration vary the most between countries, compared to other indicators.

**Table 1.9 The Russian Federation:  
the distribution of income between the richest and the poorest  
10 percent of the population, % of the total income [World Bank]**

Population category	1996	1999	2001	2002	2003	2004	2005	2006	2007	2008	2009
Richest 10%	35.5	27.7	30.4	28.2	29.1	30.8	28.9	29	30.5	27.9	31
Poorest 10%	1.5	2.4	2.5	2.6	2.5	2.3	2.5	2.4	2.5	3.5	2.6

The most relatively positive tendency in income redistribution can be seen in Argentina, and it clearly correlates with the moment of defaulting.

We can observe that income was concentrated in the hands of the richest before the default and became less concentrated after the default. There is also a corresponding opposite tendency of the fraction of income that goes to the poorest citizens of Argentina to increase.

However, the data from Mexico and Russia point at more complex, wave-like fluctuations of income concentration, which are not visibly linked to the moment of defaulting. In general, we can cautiously conclude that social equality and income redistribution is the least related with the moment of default among all the indicators considered here, and depends the most on local circumstances. We can assume that inequality in this case mostly depends on the post-crisis economic policy in each country.

Therefore, default in the contemporary world can, in fact, be not as dangerous as it seems to be. Our analysis of the available data on the indicators of social welfare does not reveal any long-term crises that are supposed to follow after defaults according to conventional views. Moreover, after defaulting, some key indicators, such as unemployment or moderate poverty, actually start to improve, and they return to the pre-default levels even in the short term. However, we must emphasize that the data do not show that defaults were the reason for the improvement in Mexico, Argentina or Russia. Default is just one of the possible strategies of behavior in the situation of economic crisis.

The data on moderate poverty, especially from Argentina, confirm the hypothesis that the expectations of default are one of the possible factors of a default situation that are detrimental for the economy and the social welfare of the population. The moment of defaulting in itself is more of a marker, while the economic decisions that can make the economic situation worse (factory shutdowns, investment flight, mass panicked purchase of foreign currency) are usually made and implemented before the default, in expectations of it, as the economy goes down [Levy-Yeyati and Panizza 2006]. Researchers underscore that, in that case, any efforts to avoid a default can be ill-advised: they do not improve the situation, but only consume resources. The general positive impact of defaults on the population's welfare can be interpreted with confidence in these terms only, since any other factors can depend too heavily on local policies.

Therefore, the conclusion is that other social welfare indicators, such as income distribution, can demonstrate the importance of local political decisions and strategies for ending the default situation and the economic crisis that caused it. Local political decisions also predominantly determine what population categories will feel the consequences of the crisis the most heavily.

We would also like to emphasize once again that default is not the end of the world, but only one of the possible strategies in a situation of crisis. Moreover,

as historic studies of debt crises demonstrate, negative correlation between economic indicators and defaults is surprisingly low [Tomz and Wright 2007]. In other words, not all countries default when their economy is in a grave crisis. Although most countries do make this step in very critical situations, there are many cases when countries defaulted in a relatively stable economic situation, even during periods of economic prosperity, while others did not dare to do it even in the worst of economic situations.

This only supports the claim that a default is just one of the possibilities, a political move. The consequences of such a decision, as our statistical analysis demonstrates, can heavily depend on further socioeconomic policies. This conclusion makes our task somewhat more complex, since our goal was to predict the possible consequences of defaulting for the social welfare of Ukraine's population. However, in the next section, we will try to formulate some key theses in this respect.

Below, we will analyze the dynamics of the selected indicators of social welfare in Ukraine and attempt to assess the situation, in terms of possible defaulting among other aspects.

### **Possible social consequences of defaulting for Ukraine**

Our interpretations are also complicated by the quick changes of the socio-economic situation in Ukraine since the late 2013, which are not recorded in the data. However, it is possible to make some estimates (Table 1.10).

**Table 1.10 Comparison of poverty, unemployment and labor productivity in Ukraine in 1996-2013 [World Bank]**

Indicator	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Poverty index (less than \$2 per day), %	2.8			0.6	0.2	0.2	0.1	0.2	0.1	0.0	0.1	0.0			
Unemployment, % of workforce	11.6	11.6	10.9	9.6	9.1	8.6	7.2	6.8	6.4	6.4	8.8	8.1	7.9	7.5	7.9
GDP per person employed, \$ thousand, in 1990	5.8	6.3	7.0	7.2	7.9	8.9	8.9	9.6	10.2	10.4	9.2	9.6	10.2	10.6	

As the table demonstrates, the percentage of the population living in moderate poverty in Ukraine is rather low. Moreover, it is even lower than in the United

Kingdom. However, we must remember that the index is adjusted for purchasing power parity, which can change significantly in a very short period of time with high inflation, increasing utility fees, commercialization of healthcare and education.

Therefore, in the current situation, the percentage of the population living in poverty in Ukraine can increase considerably; this is caused in part by the demands of international financial institutions.

As for unemployment, its level has remained rather low in Ukraine since it emerged from the crisis of the 1990s. It was also comparable to the level of unemployment in, say, the UK. However, we must remember the heavy consequences of the conflict in Eastern Ukraine in two aspects. First, it ruined the industry, manufacturing and infrastructure, both as a result of military operations and as a result of the economic crisis. Second, we must mind one major problem that will influence the Ukrainian situation for years after the conflict is settled, namely the internally displaced persons. Their employment is another issue of the welfare of Ukrainian population if Ukraine defaults (or does not default).

However, the most critical role in the issue of social welfare, not only if the government chooses to default but also if it does not, can be played by the low labor productivity in Ukraine. The GDP per person employed has always been low in Ukraine, unlike the indicators mentioned above. In this respect, Ukraine falls far behind not only the UK, but also most post-Soviet countries (Belarus, Azerbaijan, Georgia, the Russian Federation).

Even though our research is about the consequences of defaulting, the consequences of public debt restructuring in Ukraine in 1999 are also worth considering. At least because the data confirm the previous conclusion about the consequences of a full-fledged default. Poverty in Ukraine increased before the restructuring, peaked (according to the available data) in the year of restructuring, and started to fall after it. As early as three years after the restructuring, poverty was more than three times lower than in the years before the restructuring.

The picture is similar for unemployment. It increased before the restructuring, peaked in 1999-2000, and then started to fall, with further fluctuations in the years of the global economic crisis. Labor productivity fell a little before the restructuring and started to increase after it. In general, we can claim that restructuring had similar consequences for Ukraine's social welfare as defaulting in the other countries we analyzed.

Let us look at the recent patterns of social inequality in Ukraine (Table 1.11).

As demonstrated in the table, income distribution in Ukraine is much more equal than in Mexico and Argentina (in the period under our consideration) and somewhat more equal than in Russia. Moreover, there is a positive tendency for income concentration to reduce over time, and for income distribution to become more equal. We can also notice that the year of restructuring became the year when income was redistributed to some extent in favor of the poorest, not the richest.

**Table 1.11 The distribution of income between the richest and the poorest 10 percent of the population of Ukraine, % of the total income [World Bank]**

Population category	1996	1999	2002	2003	2004	2005	2006	2007	2008	2009	2010
Richest 10%	27.7	23.2	23.2	23.4	23.1	23.2	23.9	23.9	21.9	22	21
Poorest 10%	2.9	3.7	3.6	3.8	3.6	3.7	3.7	3.8	4.1	4.2	4.4

In general, we can assume that the consequences of a default for the social welfare of Ukrainian population can be no different than the consequences for Mexico, Argentina, Russia. This conclusion can be backed in the local context by the data on the dynamics of socioeconomic indicators in Ukraine during the debt restructuring. Therefore, chances are that defaulting will not increase poverty or unemployment to any critical level, but instead they will shortly return to the pre-default levels; and that positive tendencies in social welfare can continue in the long run. However, to make this, at least the situation in the East must be stabilized, and systematic efforts must be made to solve social and economic problems caused by the armed conflict.

In addition, default or no default, systematic efforts must be made to increase labor productivity in the country. In addition, everything possible must be done to preserve the positive tendency of income distribution to become more equal; at the very least, capital flight to offshore must be prevented, tax evasion must be overcome, and progressive taxation systems must be developed. If labor productivity does not increase, profits that could be distributed more equally will not increase either; and if profits are not distributed more equally, labor productivity will only improve the situation of oligarchic elites.

Therefore, in the next chapter of this essay, we will try to answer the question of what the tax policy in Ukraine should and could look like, in order to distribute national wealth fairly among those who create it; and look at the way tax policies can efficiently ensure sustainable innovative development of the country.

## **CHAPTER 2**

# **OPTIMIZING UKRAINE'S TAX POLICY**

As another round of the economic crisis developed, aggravating the situation in Ukraine since the early 2014, the problem of searching for the tools to ensure the country's sustainable development became urgent. It became particularly important after the loss of the resource base in the industrially developed eastern regions which provided a major part of tax revenues and currency flows. In our consideration of the probability of significant economic change, it is impossible to ignore the system of national income redistribution. One of its key instruments is the tax system.

## **2.1 Ukraine's Tax System in the Process of Reforming**

### **The philosophy of the Ukrainian tax system**

Unfortunately, members of the current government often cannot formulate their view of the country's tax system without reproducing Milton Friedman's 1962 superstitions: "The philosophy goes like this: the introduction of lower tax rates will stimulate economic activity and, in the end, will lead to increasing budget revenues," explains her vision of the Ukrainian tax reform the deputy minister of finance Olena Makeyeva.

Reluctantly admitting that this "philosophy" "punishes the low-income part of the population and benefits the richer part," and that "tax rates [in Ukraine] are not the highest compared to the EU countries with which we share the Soviet history," Makeyeva still claims that Ukraine "does not deviate from the general European trend in taxation." In particular, the partial rejection of the flat tax

rate and the increase of the tax burden since 2015 are seen by experts as forced measures [Касперович].

At the same time, Makeyeva's final conclusion is still in the spirit of Milton Friedman. In her opinion, the strategic direction of the tax system's development lies in "the search for an optimal taxation system that would involve shifting the emphasis in taxation from direct taxes to indirect ones." Therefore, the government emphasizes the increasing weight of indirect taxes, such as the VAT (which is de facto a flat rate taxation of the consumer), rather than taxation of the oligarchs' profits (that would be direct taxation). Thus, in Makeyeva's own words, the "optimal taxation system" is to "punish the poor" [Макеева, 2015].

As we can see, the obvious fact that flat rates and indirect taxes increase social inequality is not questioned even by the architects of tax reforms. The injustice of tax leveling is apparent even from the perspective of the marginal utility theory, since you must admit that the last UAH 1000 have very different value for a retired elderly person and for an oligarch. Indeed, it is not so difficult to understand that 15 percent of the income of a person whose earnings are just a bit above the subsistence level will significantly reduce their opportunities to buy even the most basic goods, while paying even 20 percent of a personal income that can reach a couple of billion hryvnias will, most likely, have absolutely no effect on personal consumption (especially given that the 20 percent are only paid on that part of the profit which the oligarch decided to legalize for personal use, since everybody knows that big business hardly pays the direct corporate tax anyway).

In most European countries, the maximum income tax is much higher than 50 percent and often reaches 75-80 percent, because it motivates entrepreneurs to reinvest their profits, and not to extract them from the business to satisfy their own needs for consuming luxurious cars and yachts.

As for the VATs and excise taxes, the injustice of taxation appears even more striking in these cases. Obviously, these consumer taxes primarily limit the affordability of the cheapest goods for the poorest populations. Even UAH 12 of tax on an extra square meter of an apartment can bite away a considerable fraction of income of a lonely pensioner, and the same UAH 12 even for a middle-class IT industry employee (not to mention entrepreneurs) will make about 0 percent of their income (accurate to many decimal places).

In the Strategic Plan for the Ministry of Finance, "the punishment of the poor" is declared even more clearly. For example, "Further liberalization of the tax and duty systems, promoting the simplification of business activities in Ukraine" (p. 5) is explained as "shifting the emphasis from the direct taxes to the indirect ones... Intensifying the negotiations to sign double taxation treaties" [Стратегічний план діяльності Міністерства фінансів України, дод. 1, с. 3]. The illustration for the way the emphasis shifts can be found in the more technical

plans for the State Fiscal Service. For example, the Plan of Measures of the State Fiscal Service (SFS) to Implement the Government Agenda and the Coalition Agreement contains a whole chapter on implementing a new system of VAT administration, but mentions the income tax only once in a paragraph about a new tax declaration form [План заходів ДФС України]. As for the current SFS plans, they create an impression that the service has long given up on the income tax. Numerous methods to collect VAT and other indirect taxes are listed in those plans, while the income tax is not even mentioned [План роботи ДФС України].

Although, according to the Nobel Prize recipient Joseph Stiglitz, the myth that lower taxes will increase savings and stimulate hard work seems to contradict facts [Стиглиц Дж., 2005, с. 329], government officials apparently believe that it is so much the worse for the facts. In general, officials prefer to misinform the society rather than to reject their neoliberal ideology and mythology, which is obviously aimed to further enrich the richest at the expense of “punishing the low-income part of the population.”

The strategy of “lowering corporate taxes” has already proved ineffective during Yanukovych’s rule, but the government keeps making the same mistake. According to a conclusion by experts from the National Institute for Strategic Research, “lowering corporate tax rates in 2011-14 (from 25 to 18 percent)... was followed by a decrease in revenues... Therefore, it has not proven possible to claim that tax revenues will multiply if tax rates in Ukraine are lowered, , as the classic economic doctrines claim” [Касперович, с.6].

In fact, the architects of the “tax reform” themselves do not really believe in Milton Friedman’s mythology and likely treat his claims as slogans for the plebs, aimed to maintain among the barely literate lower classes (including the BAs and MBAs of most Ukrainian universities and business schools) the faith in the efficiency and the uncontested position of the free market. The actual goals of the reform, which are not concealed too carefully (think of Sasha Borovyk), is to hand the remainders of the public property over to private hands and generally to reduce the role of the state in the economy — that is, to reduce the scope of redistribution and to lower social standards. Once again, it is the policy of enriching the richest at the expense of the poorest and those who will become poor as a result of this policy [Боровик С.].

As Stiglitz rightly points out, lowering taxes help to create to artificial budget deficits, which, in turn, force governments to cut their expenses and limit their role in the economy. Stiglitz claims that tax reforms of this kind were implemented regardless of the outcomes of the tax reduction experiments [Стиглиц Дж., 2005, с.223]. In general, the strategy of the Ukrainian tax reform can be characterized precisely as the lack of desire or plans for systemic change; the current government continues Yanukovych’s policy to increase the tax burden on employees and small



businesses — the policy that was, in fact, one of the reasons for Euromaidan. In addition, there are reasons to believe that this pro-oligarch policy is implemented in a much more radical way today [Одосій].

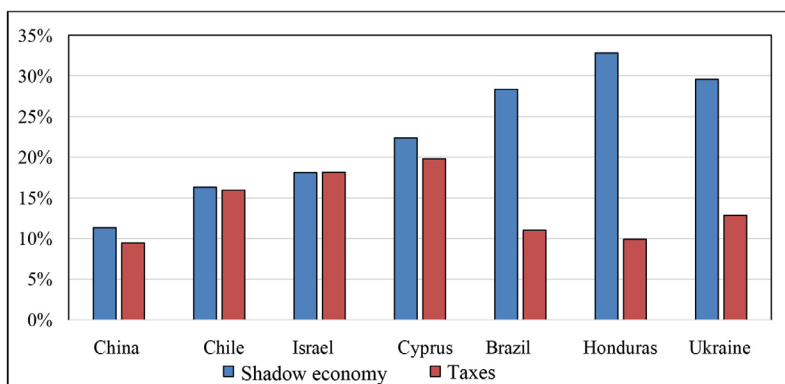
Unfortunately, the situation is not unique, since similar tax reforms are imposed on many countries worldwide in the recent decades. Fifteen years ago, George Soros already pointed out that, after 1980, in most western countries, corporate taxes and contributions to unemployment insurance funds fell, while consumer taxes keep increasing; that, in other words, the tax burden was shifted from capitalists to citizens. The billionaire believed that this tendency is one of the signs of the crisis of the global capitalism which emerged because of the reduction of real democracy even in the leading capitalist countries and which pushes the capitalist system towards self-destruction [Сорос Дж, с.123]. However, the tendency has not changed in any significant way until now. As Zhdanovska emphasized in her recently published book, “using the creation of favorable ‘investment climate’ as an excuse,” the goal is “to redistribute income from working people to capitalists” [Ждановская, с. 170].

### **The real weight of the tax burden**

We must note that, despite the widespread belief that the tax burden is too heavy for business in Ukraine, despite the active propaganda for lowering taxes, the general weight of the tax burden in Ukraine is in fact not high. Even the official data on the tax burden are rather moderate (even by the Ministry of Finance admits this). However, the real tax burden on big business is much lower than the official statistics.

Let us explain why this is the case. According to the World Bank, in 2012 (the latest available data), the tax burden indicator as the ratio of tax revenues to the GDP in Ukraine was 18.2 percent. Even though this number is slightly higher than the global average (14.3 percent), it is still lower than the average in Europe and Central Asia (18.6 percent) [World Bank].

However, it should be noted that the indicator takes the ratio of tax revenues to the official GDP, which is calculated based on the official reports of companies and institutions. Since, according to the Ministry of Economic Development, shadow economy in Ukraine reached about 42 percent of the GDP in 2014 (compared to the global average of 22 percent, 18 percent for developed countries [Elgin]), the real tax burden can be about 12.8 percent, which is much lower than the global average [Тенденції тіньової економіки в Україні у 2014 році]. Therefore, if we assess the weight of the tax burden in relation to the GDP including the shadow economy, Ukraine will be among the countries with a very low real tax burden, but a very high percentage of the shadow economy. Figure 2.1 provides a relevant comparison of Ukraine with some developing countries.



*Figure 2.1. Shadow economy and the real tax burden in percentage of the GDP, including the shadow sector [based on the data by the World Bank, Poverty and Inequality Team & Europe and Central Asia Region research]*

As for the developed countries, they are characterized by much smaller shadow economies, but also much higher weight of the tax burden. Ukraine is special because its shadow economy includes not only small businesses, but also primarily big exporter companies. This system emerged during the economic recovery in the early 2000s, when the government facilitated the creation of powerful financial and industrial groups aimed to develop raw material exports from the country. According to Marko Bojcun, the conspiracy of bureaucrats and business owners consolidated regional political powers around the most powerful firms that served as a counterbalance to the center's influence and competed for the access to central institutions; but their success in tax minimization increased the tax burden for small businesses [Бойцун].

Production volumes and the profits from mining and metal processing plants kept growing, but accounting papers always reported losses. For example, in 2010, the steel giant Azovstal increased its profits by 14.2 percent compared to the previous year, up to UAH 35.8 billion, but, at the same time, just as in the previous year, the company reported losses of about UAH 200 million. The artificial losses happened at the majority of the economically active companies that clearly increased production and brought profits to their owners [Семенов].

According to the most conservative estimates of the analysts at the president Yanukovych's administration in 2011-2, five largest oligarch holdings alone avoided paying approximately UAH 15.5 billion of taxes — that is, of course, without taking into account the legal schemes for “optimizing” taxation which could have allowed them to “save” much more. The most prevalent violations of tax laws at that time were artificial losses and transfer pricing [Вышинский].

It is remarkable that the proportion of shadow activities in 2014 was the highest in the mining industry, which is operated almost exclusively by big exporter

companies that belong to the country's major oligarchs. As a study by the Ministry of Economy points out, "the scope of the shadow operations in the mining industry has reached 52 percent;" at the same time, characteristically, "even though the mining industry is highly profitable, many companies demonstrate losses as the outcome of their activities" [Міністерство економічного розвитку і торгівлі 2015, с. 15]. The third chapter of this book will be dedicated to these issues.

During the Euromaidan, Viktor Pynzenyk, a former Minister of Finance of Ukraine and the leading economic expert of the then-oppositional UDAR party characterized this tax system and the Tax Code innovations as "exempting oligarchs from paying the income tax" [Пинзенік]. Unfortunately, there has been no significant change in the tax system, despite all the claims. On the contrary, the tax burden somewhat increased, weighting down consumers, employees and small businesses; accordingly, the tax burden on oligarchs became relatively lighter. At the same time, in some industries (such as the mining industry), oligarchs carry out more than a half of their activities in the shadow; and in some other industries (such as the agribusiness) they are legally exempt from paying taxes. In both cases, the actual weight of the tax burden on the businesses of oligarchs is extremely light.

No wonder that the revenues from taxes on income, profits and capital gains in Ukraine make up a much smaller fraction of the total tax revenues (24.2 percent in 2012) than in most neighboring countries, except for Russia (Fig. 2.2).

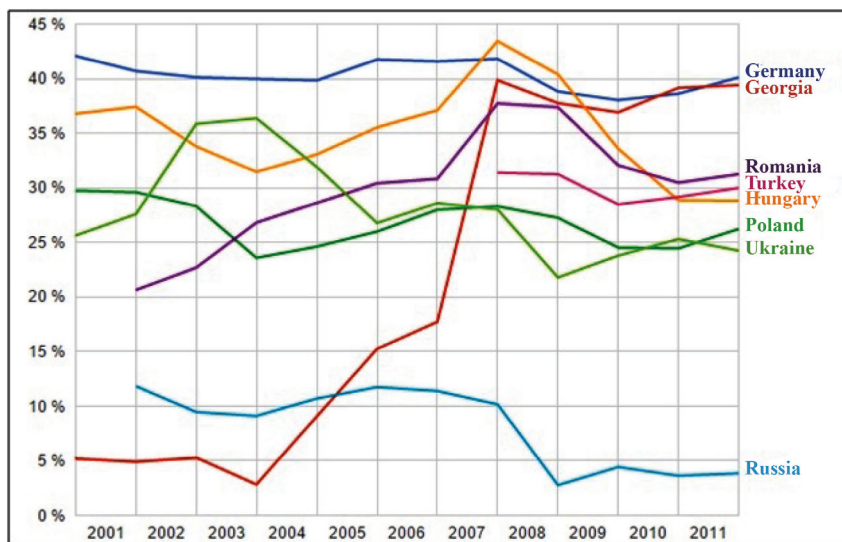


Figure 2.2. Taxes on income, profits and capital gains (% of budget revenues)  
[World Bank Data]

It means that most of the tax burden is placed on consumers (primarily on employees, self-employed workers and small businesses) [Шемаєва, Корень]. It should also be noted that the data reflect both corporate profit taxes and personal income taxes (primarily on working people's income). And as for the seemingly high (in relation to the profits in the official balance) corporate tax rates (52.9 percent in 2014), this statistical aberration is mostly linked to the fact that big corporations almost always report artificially diminished profits, often even losses [World Bank Open Data].

The budget-forming taxes in the structure of the consolidated budget revenues of 2014 were the VAT (41.1 percent), the income tax (16.2 percent), the excise tax (10.4 percent) and the corporate tax (8.7 percent). Therefore, indirect consumer taxes already make up more than half of the revenues. However, in complete accordance with the government's "philosophy" and plans, in 2015, we could notice the tendency to further shift the tax burden from businesses to individuals.

The National Institute for Strategic Research mentions this as one of the key tendencies: "[The] income tax starts to play an ever greater role compared to the corporate tax (4.5-4.9 percent of the GDP vs. 2.6-4.1 percent of the GDP in 2009-14)" [Касперович]. Today, the tendency has become stronger: "If the planned corporate profit tax revenues are even lower than last year (UAH 35.9 billion vs. 39.9 billion), the income tax revenues in 2015 are supposed to increase by 235 percent" [Одосій].

Therefore, the government's inability and unwillingness to solve the problem of taxing the big oligarchic business is the reason for the systemic problems with filling up the country's budget; the government tries to solve these problems by increasing the tax burden on individuals, centralizing the budget system, extracting money from local budgets and redistributing it. The evidence for the increased centralization of the budget system can be found, in particular, in the constant increase of the fraction of transfers in local budget revenues [Шемаєва, Корень].

### **Local budget revenues and their cuts under the banner of "decentralization"**

The banner of decentralization, raised by the government, actually has nothing to do with the facts, at least in the budget sphere. The most cynical part of it is that local budget revenues started to include a new source, 10 percent of the corporate tax mentioned above. That is, of the tax which is bringing less and less revenues, and on which the government does not really rely anyway, as we have seen. On the other hand, it gives local communities a reason to demand that the enterprises registered on their territories bring their transactions out of the shadow. In particular, communities can demand that local enterprises implement open accounting systems [Про внесення змін до Бюджетного кодексу України].

However, the biggest source of revenue for local budgets in Ukraine is the income tax. Textbooks on local finances traditionally characterize it as “the most important source of local budget revenues in terms of volumes” [Власюк, с. 48]. And, indeed, in 2005-9, the fraction of the income tax in local budget revenues reached 70-78 percent (стор. 315).

In 2015, despite the significant reduction of the fraction of the income tax that goes to local budgets, this tax still was the key source of local budget revenues. Thus, according to the data by the Ministry of Finance, the fraction of the income tax in local budget revenues in January through June 2015 was 52.8 percent [Довідка щодо стану виконання місцевих бюджетів]. The considerable reduction of the fraction of the income tax in local budget structures was caused by the centralization of Ukraine’s budget system. In 2015, only 60 percent of the collected income taxes went to local budgets (except for Kyiv), instead of 75 percent. Kyiv’s local budget of Kyiv kept only 40 percent of the income taxes collected on its territory, instead of the 50 percent it had kept before [Бюджетний кодекс України].

Of course, this is not the worst option: in summer 2014, some proposals for even bigger cuts for local budgets were considered; for example, it was suggested that Kyiv’s local budget should keep only 20 percent of the income tax [Зміни до Бюджетного кодексу]. The distribution of the Kyiv residents’ income taxes was the key intrigue in the process of forming the Kyiv budget in 2015. The negotiations between, figuratively speaking, Klychko and Yatsenyuk were precisely about the percentage of the income tax which the capital could keep for its own budget. Klychko insisted on the classic formula from the 1990s, 50/50, but the center managed to squeeze another 10 percent out of him in exchange for 10 percent of the corporate profit tax.

Based on the data from the Ministry of Finance on the implementation of the consolidated state budget in the first quarter of 2015, the fraction of the corporate tax in local budget revenues can be estimated as 7.5 percent, which is a rather big portion [Показники виконання Зведеного бюджету України]. However, for some reason, the corporate tax is ignored by the Ministry of Finance in its reports about the implementation of local budgets. Instead, the Ministry’s analysis of the first half of 2015 mentioned some taxes that provide an even smaller percentage of the revenue, such as the excise tax (7.2 percent) and the property tax (0.6 percent), as well as the second biggest source of revenue for local budgets, the land tax (14.9 percent). The fraction of income from the land tax has traditionally been high (7-15 percent) for at least a decade; in addition, since 2007, it tends to grow steadily [Аналіз надходжень плати за землю в Україні].

The heightened attention paid by the Ministry of Finance to the excise tax and the property tax can probably be explained by their novelty. The fact that local budgets can collect revenues from licensing the sales of excisable goods is viewed

as an incentive for them to fight the illegal circulation of alcohol and tobacco. The property tax this year ceased to be a tax on luxury, and it will be paid by all owners of apartments with the area of more than 60 sq. m [Карелін].

The vehicle tax and the single tax for small entrepreneurs also traditionally play an important role in the structure of local budgets. The fraction provided by any of these taxes is usually between 2 and 3 percent of all tax revenues. Local taxes and fees make up less than 1.5 percent.

Thus, there is something like a vicious circle here. The country is in a debt yoke, experiences a budget crisis, while the real corporate tax rates in Ukraine are among the lowest in the world and falling, which aggravates the budget crisis. And the main source of local budget revenues is the income tax, whose amounts directly depend on the success of bringing companies out of the shadow and on the government's ability to guarantee the rule of law. Therefore, the situation of expanding shadow employment and the lack of implementation of labor laws will soon lead to bankruptcy for most local budgets.

This reform will hardly promote economic growth and will undoubtedly increase the disproportion between the country's regions; the poor citizens from poor regions will be punished twice. However, it will be completely in the spirit of the economic philosophy of the ruling oligarchy, who treat the tax reform as an acceptable way to make even more money by redistributing social wealth in favor of their own private pockets.

We have described the general characteristics of the Ukrainian tax system, and now we shall move on to defining the industries which, as we have pointed out, are potentially undertaxed, abuse the tax minimisation and income concealment schemes most heavily, and can potentially be turned into sources of revenues for the country's budget.

## **2.2 Study of the actual level of taxation in specific industries of Ukrainian economy**

As another round of the economic crisis unravels, aggravating the situation in Ukraine, the question of finding the instruments to ensure the country's sustainable development becomes very urgent. It became especially true after the loss of the resource base of the industrially developed eastern regions, which used to provide a major part of tax and currency revenues. It is impossible to leave the national income redistribution system out of the consideration of the possibilities for significant economic change. One of the key instruments here is the taxation system. In this sense, it is important to study new industries that create added value in Ukraine, and of the weight of the tax burden on companies in those industries.

Therefore, we will attempt to study those segments of the national economy which potentially create superprofits and possibly evade taxation by employing various minimization schemes, offshores, etc. Of course, we also aim to use the analysis to propose some possible changes in the contemporary tax policies in order to establish a fairer (from the social point of view) taxation system.

For this end, we will look at the structural changes in production volumes by industries, compare these tendencies with the amounts of tax revenue from each industry, and consider the possibility for changing the tax pressure on export-oriented “raw material” sectors of the economy, which play an ever greater role in Ukraine’s economy.

Let us first analyse the industrial composition of Ukrainian economy in the recent years (Table 2.1).

**Table 2.1 Production and distribution  
of the GDP by types of economic activity in 2001-13, %**

Type of economic activity / years	2001	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Agriculture, forest keeping, fisheries	15.9	11.4	9.6	7.1	8.1	8.5	7.6	9.5	9.0	10.0	11.8
Mining and quarrying	4.8	3.9	4.5	4.1	4.8	6.4	4.8	6.7	7.3	6.3	5.8
Processing	20.3	19.1	21.3	21.6	19.4	16.6	16.4	14.5	13.2	12.7	13.1
Electricity, gas, steam and conditioned air supply	6.2	3.6	3.2	3.2	3.0	3.3	3.5	3.2	3.5	3.5	3.4
Construction	3.9	4.2	4.1	4.9	3.7	2.7	2.9	3.5	3.2	2.8	2.6
Trade and repairs	12.4	11.7	15.2	14.7	14.3	14.4	16.0	16.5	17.3	16.6	16.4
Transportation, storage keeping, mail and courier services	9.8	11.2	9.4	9.0	9.0	8.6	9.0	9.3	8.5	8.3	8.0
Finance and insurance	2.5	6.0	5.3	5.8	6.1	5.2	7.2	5.6	5.2	5.3	5.1
Real estate operations	4.4	5.5	4.9	5.5	6.6	6.7	6.4	5.9	6.5	7.3	7.5

*See the beginning of the table on the previous page*

Type of economic activity / years	2001	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Government and defence; mandatory social insurance	4.1	4.4	4.3	5.1	5.0	6.4	5.6	5.0	5.0	5.2	5.5
Education	4.5	5.0	4.9	4.8	4.8	5.9	5.6	5.4	5.6	6.0	5.7
Health care and social aid	2.7	3.3	3.3	3.3	3.3	4.1	4.0	4.0	4.1	4.1	4.1
Other services	8.5	10.7	10.0	10.9	11.9	11.2	11.0	10.9	11.6	11.9	11.0

*[calculations based on the data by the State Statistics Service and the National Bank of Ukraine]*

The table demonstrates the tendency of the recent years to switch from industries with high added value (the fraction of the processing industry in the GDP reduced from 19.1 percent to 13.1 percent in the last 10 years) to such spheres as agriculture or the service sector (trade, maintenance and repairs, real estate operations, etc.); the role of the real economy diminishes. Interestingly, the fraction of the construction industry has shrunk after the end of the investment boom in Ukraine in 2007 (no more than 4.9 percent of the GDP); it will probably keep shrinking because of the reduction in crediting (mostly in foreign currencies), which used to be a factor of high growth rates in this industry [Кравчук, 2015].

In general, such tendencies agree with the general logic of incorporating Ukraine into the global market as a provider of raw materials, which has been followed for the last two decades [Кравчук 2015]. Without going into a detailed analysis of the reasons for these processes, we will only note that they happened as capitalism was being restored in its “wild” form. The unwillingness of local elites to build a viable state, even within the model imposed from the outside, has limited the independence of today’s domestic and foreign policy making, and caused some businesses of local oligarchs to shut down or be redistributed.

However, we must work with what we have, and we should understand what exactly we can make of this distorted economic structure given the available resources; we should understand which of these resources can be redirected from bloated private pockets to social goals. Thus, having defined the structural changes in the country’s GDP (the gross sums of the added value of industries), let us ask how each particular industry provides revenues for the government budget.

Let us compare taxation levels by industry, which will allow us to draw conclusions about inadequate taxation in some industries (Table 2.2).



**Table 2.2 The comparison of industries by tax revenues and the GDP they produced in 2012-14 (UAH million)**

Activity	Corporate tax	VAT	Subsoil use fee	VAT refund	Revenue balance	Fraction in the tax revenues in 2012-14	Fraction of the GDP in 2014
Agriculture, forest keeping, fisheries	933	1,866	10	-1,303	1,505	0.6%	11.8%
Mining and quarrying	26,005	15,506	26,652	-20,551	47,612	19.8%	5.8%
Processing	27,088	38,979	532	-77,642	-11,044	-4.6%	13.1%
Electricity gas, steam and conditioned air supply	9,707	24,417	110	-1,239	32,995	13.7%	3.4%
Water supply, sewerage, waste management	458	2,926	82	-45	3,422	1.4%	0.5%
Construction	3,212	10,812	770	-561	14,234	5.9%	2.6%
Wholesale and retail trade; vehicle repairs	27,393	44,629	1,481	-23,513	49,991	20.8%	16.4%
Transportation, storage keeping, mail and courier services	9,797	17,395	4	-2,880	24,315	10.1%	8.0%
Temporary accommodation and catering	501	1,503	0	-128	1,876	0.8%	0.7%
Information and telecommunications	6,166	14,873	0	-91	20,948	8.7%	3.5%
Finance and insurance	8,881	1,840	0	-51	10,671	4.4%	4.1%
Real estate operations	1,573	5,471	1	-1,132	5,914	2.5%	7.5%
Professional, scientific and technical activities	5,600	23,557	85	-661	28,582	11.9%	3.2%
Administration and support services	958	5,031	1	-2,010	3,981	1.7%	1.3%
Government and defence; mandatory social insurance	140	1,988	3	-5	2,125	0.9%	5.5%
Education	83	530	1	-1	612	0.3%	5.7%
Health care and social aid	317	1,009	10	-2	1,334	0.6%	4.1%
Arts, sports, entertainment and leisure	93	553	0	-84	562	0.2%	1.0%

*See the beginning of the table on the previous page*

Activity	Corporate tax	VAT	Subsoil use fee	VAT refund	Revenue balance	Fraction in the tax revenues in 2012-14	Fraction of the GDP in 2014
Other activities	123	411	0	-9	525	0.2%	1.8%
TOTAL:	129,028	213,294	29,741	-131,906	240,157	100%	100%

*[calculations based on replies to public requests from the State Fiscal Service of Ukraine]*

Therefore, according to the analyzed data, we can distinguish a number of features. First, the agricultural companies, which produce a growing fraction of the country's GDP, paid only a miniscule 0.6 percent of the "net tax revenues" from all types of economic activities. It is 20 times less than the fraction of the GDP produced by the industry. Thus, the government's reliance on agriculture as "one of the most promising sectors that ensure the growth of our economy" (according to the prime minister Arseniy Yatsenyuk) does not look so bright.

We must note that this kind of dependence is typical not only for Ukraine, but also for other peripheral countries. A tax policy researcher Indira Rajaraman argues that the greater the fraction of agriculture in the structure of a particular economy, the less taxes the government accumulates; in general, the sector, despite its profitability, is particularly difficult for tax collection [Indira Rajaraman].

Generally, one must understand that foreign investment in and of itself (including the privatization of the remnants of public infrastructure in agriculture), which is so actively invited to Ukraine [Дорожня карта реформ агросектору], will not lead to any positive change without changing the tax redistribution system, because this kind of growth, if it ends up in monetary form in the hands of the select few, will not contribute anything good to the country's development.

Another characteristic is the high portion of tax revenues from the real economy, where the state either keeps a considerable part of companies, or still, by inertia, reserves the right to use the important instrument of tax redistribution: energy (13.7 percent), transportation (10.1 percent), mining (19.8 percent). These three industries together provide more than a half of all tax revenues to the state budget. Note that, if the policy of large-scale privatization of the remnants of state monopolies is implemented, a corresponding reduction in tax revenues can be predicted (because the special tax treatment for public companies will be canceled, minimization schemes will be used by private owners, etc.); therefore, the funding of social and investment projects on the macrolevel will be reduced.

Third, the sectors which are also controlled by the government to a large extent, but perform social functions (public administration, education, healthcare,

sports), are not heavily taxed, which looks completely logical, since these sectors are subsidized from the country's budget.

And the last point concerns the situation in the processing industry. As we can see, the scope of VAT refunds to companies in this industry in the last three years exceed the total sum of all the taxes paid by them. The trend can be observed every year within the timeframe of our research. In this situation, almost 21.8 percent of the net tax revenues are collected from companies in the trade and repairs sector, and most of those revenues are made of the same indirect value-added tax, which, in the end, is shouldered by ordinary consumers.

Let us move on to the analysis of the export potential. Since Ukraine keeps following the tendency of reorientation towards external markets (the proportion of both exports and imports in 2014 reached more than half of the country's GDP each, which is significantly higher than the global average of 30 percent [Держстат, World Bank]), it is interesting to look at the situation with taxation in exporting industries.

Of course, one can argue that probably we should increase the tax burden for the processing industry, which basically does not bring any revenues to the budget. Surely, we do not deny the need for revealing the tax minimization schemes in the processing industry as well, but we should remember that these companies will feel more and more pressure of competition due to further opening of Ukrainian markets for EU products, and they will need some support to survive, including fiscal support [Асоціація з ЄС: наслідки для економічного розвитку та ринку праці в Україні]. In our opinion, the development of processing industries, especially the high-tech spheres, such as mechanical engineering, instrument making, etc., has to be a priority in the government policies. That is why the next criterion for selecting the economic sectors that could bring additional tax revenues for the state budget is their export potential.

Unfortunately, the structure of Ukrainian exports is still low-tech (Fig. 2.3).

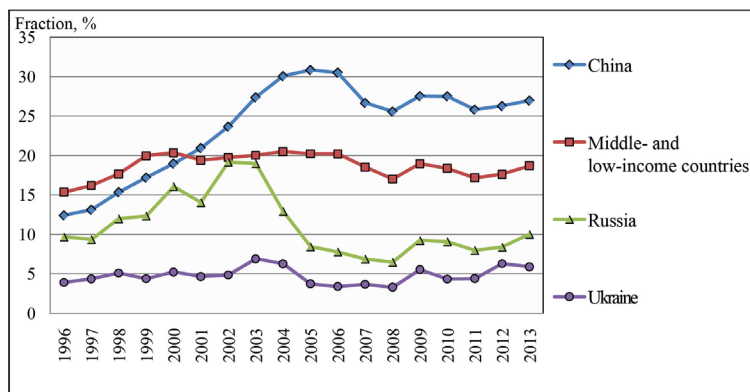


Figure 2.3. The fraction of high-tech exports in the total exports of countries [World Bank data]

If we distribute the changes in these, so to say, “backward” sectors by industries, we will see that, in the last decade, the structure of their exports has experienced major shifts. Thus, in 2005, the leading place in Ukraine’s exports belonged to the products of ferrous metallurgy, which made up 45 percent of the exports; transportation, instrument making and mechanical engineering with 13 percent of the exports; chemical industry with 10 percent; and agriculture with only 13 percent of the exports. This made Ukraine’s exports somewhat monocultural. However, since 2008, the fraction of agricultural products in exports has been gradually increasing and reached 19 percent in 2011, while the fall of global prices and of the demand for ferrous metals caused their fraction in Ukraine’s exports to fall to 27 percent. In 2012, the leading place was already taken by agriculture and food industry, which are the key sources of foreign currency earnings for Ukraine.

Assuming that the undertaxed industries are also the ones that export the most, let us analyze which of the existing industrial companies are oriented to selling their products abroad. Figure 2.4 reflects a selection of industries in which the fraction of exports is higher than 40 percent of the total output and which produce more than 1 percent of the total industrial product sales.

As the figure demonstrates, this list includes 6 industries which together make up 41.9 percent of the total value of the goods sold by industry. More than half of these products (54.3 percent) are exported. The only exception so far is oil and fat production.

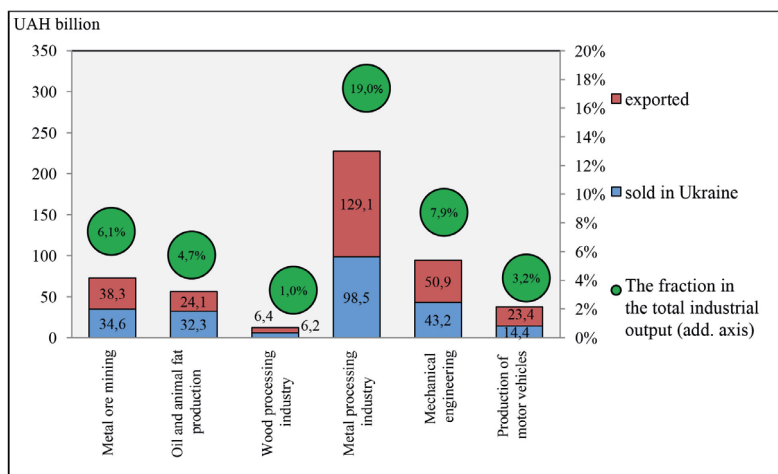


Figure 2.4. The fraction of exports in the production of specific industries in 2014  
[data by the State Statistics Service of Ukraine]

It should be noted that, according to the Association Agreement signed by Ukraine and the EU [Угода про асоціацію], exports of sunflowers are expected to

rise after the relevant trade restrictions are lifted, and the production of oil at local factories is expected to fall. Therefore, this industrial segment will shrink, while the fraction of exports from the factories that will remain competitive compared to importers are likely to increase [Асоціація з ЄС, ЦСТД, 2015].

Today, we can observe the tendency for establishing a new, “agrarian” monoculture in Ukrainian exports (Table 2.3). And, given the considerable investment into technological upgrades in agricultural production (development of storage infrastructure, transportation and port loading) in the last 5-7 years, the sector is likely to become the leader already in the next decade.

Interestingly, in 2014, agricultural and food exports fell only slightly compared to 2013, only by 2 percent, while destructive processes in other sectors, as well as the general aggravation of the geopolitical and financial crisis in the country, led to a 10 percent fall in exports of the products of the metal processing industry, 30 percent fall in the chemical industry exports, and 57 percent in transportation exports.

Given that some factories in these sectors are either destroyed by fighting in the east of the country, or located on the territories not currently controlled by Ukrainian government, the probability of raising the tax revenues from these industries in the nearest future is quite low. In addition, due to a partial loss of markets in post-Soviet countries, industries such as instrument making, glass production, or light industry are basically in the survival mode now. Therefore, increasing the tax burden on them will only exacerbate their stagnation.

**Table 2.3 The dynamics of exports and the trade balance of Ukraine by industry, 2013-15**

Group's export rating		Product group	Export, \$ million				Balance (export - import), \$ million			
2013	2014		2013	2014	Jan-Mar 2015	Δ Jan-Mar 2015/2014, %	2013	2014	Jan-Mar 2015	Δ Jan-Mar 2015/2014, \$ million
1	1	Agricultural products	17,024	16,671	3,437	-15	8,840	10,619	2,393	300
2	2	Products of ferrous metallurgy	14,319	12,907	2,210	-36	12,089	11,609	2,070	-1,079
4	3	Raw minerals	4,629	4,092	694	-39	3,494	3,141	497	-389
3	4	Chemical products	4,864	3,385	673	-30	-5,065	-4,556	-868	151
6	5	Instrument making	3,492	2,973	508	-34	-3,701	-2,011	-298	74
5	6	Mechanical engineering	3,522	2,715	357	-50	-1,562	-593	-96	51

See the beginning of the table on the previous page

Group's export rating		Product group	Export, \$ million				Balance (export - import), \$ million			
2013	2014		2013	2014	Jan-Mar 2015	Δ Jan-Mar 2015/2014, %	2013	2014	Jan-Mar 2015	Δ Jan-Mar 2015/2014, \$ million
8	7	Energy resources	2,878	2,031	118	-84	-18,968	-13,738	-2,689	404
9	8	Ferrous and non-precious metal processing products	2,770	1,845	271	-35	1,045	597	90	-12
7	9	Transportation	3,292	1,426	130	-68	-2,183	-998	-180	202
11	10	Wood processing products	1,144	1,263	255	-13	728	968	219	-3
12	11	Light industry products	1,083	1,067	198	-30	-2,038	-1,140	-199	108
10	12	Paper products and publishing	1,247	986	152	-37	-655	-304	-49	32
14	13	Nonferrous metal products	482	483	97	-14	-566	-294	-8	64
13	14	Rock, glass, ceramics	583	479	71	-33	-558	-321	-36	54
15	15	Pharmaceutical goods	252	256	37	-37	-2,848	-2,217	-271	377
		Selected industries	61,581	52,578	9,207	-33	-11,947	763	574	334
		Total:	63,312	53,914	9,424	-33	-13,652	-468	384	556

*[calculations based on the data by the State Statistics Service of Ukraine]*

The high demand for raw materials in the global market, coupled with the curtailment of high-tech industries, de facto makes agriculture, mining and processing industries (low technology sectors) the priorities in Ukrainian exports.

In general, if we analyze the reasons for the persistent foreign trade deficit (the balance was positive only in the three industries mentioned above, and in the wood processing industry), they are rooted in the systemic disproportions of the development of Ukrainian economy which have affected it for a rather long time and shaped its present structure.

The change of the industrial composition of the GDP and the exports causes an objective need to shift the tax burden from some economic sectors to others. In our case this undoubtedly concerns the agricultural industry, as argued above. It is also interesting to study the situation in the mining industry, since, despite a rather high portion of tax revenue coming from companies in this industry,

the claim about undertaxed superprofits and large-scale capital outflow from the country needs to be tested. There are reasons to claim that these profits, which usually escape taxation through offshore schemes, keep growing due to the rapid devaluation of hryvnia and the corresponding reduction of the cost of producing the exported goods in foreign currencies.

In the next section of this book, we will try to provide a more detailed account of taxation specifically in the agricultural industry, and to suggest some possible changes in fiscal policies that would promote a more just distribution of the profits created within the country, as well as replace the raw material orientation of Ukraine's economic development.

## **2.3 The actual level of taxation in Ukrainian agricultural industry**

The key that should be taken into account when changing the tax pressure on any economic sector are the sector's actual profitability (including the shadow economy) and the priority of its development. Let us investigate the situation in Ukrainian agricultural industry in these respects.

The thesis that agribusiness has become "the economy's locomotive" is rather widespread these days, since its portion in the GDP rose to 11.8 percent in 2014; the net currency earnings from foreign trade with the products of this sector reached \$10.6 billion in the same year; the industry has demonstrated persistently high output growth rates. However, as in any country in the world, agriculture is one of the most vulnerable economic sectors because of the seasonal nature of its production, its strong dependence on weather, and the situation with prices in global markets. That is why in many countries (even in the EU and the USA) agriculture is subsidized or has other privileges (production and export subsidies, preferential tax treatment, direct payments per hectare of arable land, etc.). In this respect, we will try to analyze in detail the system of taxation of agriculture in Ukraine and prove or, on the contrary, debunk the myth about its high vulnerability to increased tax pressure.

### **Profitability of production**

As recently as ten years ago agriculture was an unprofitable sector with low production growth rates, and it actually needed both tax reliefs and major subsidies. In the last few years, however, the situation changed radically, and the profitability of agricultural production has been high, which should mean that its tax preferences should be changed.

According to the State Statistics Service of Ukraine, in 2014, the profitability of the core activities of agricultural companies reached 26.3 percent, which is 2.3 times higher than the same indicator in 2013. In addition, agricultural companies demonstrated profits of UAH 34.5 billion in 2014, compared to UAH 12.3 billion in 2013. Profits from plant and animal farming were made by 81.5 percent of companies. The average level of profitability in plant farming increased in 2014 to 29.2 percent, compared to 11.1 percent in 2013. However, even this high rate is actually lower than the real profits made by agricultural businesses. According to reports by the Statistics Service, the cost of producing, say, one ton of sunflower seeds in 2014 was UAH 2,422, while its selling price was UAH 3,842.7 per ton; that is, its profitability rate was 59 percent [«Економічні результати с/г виробництва», «Реалізація продукції с/г підприємствами» за 2014 рік]. And if we base our calculations on the actual market indexes rather than prices from company reports, then real, not fictional profitability can reach up to 300 percent. As the Figure 2.5 demonstrates, profits also depend on the moment when the product is sold.

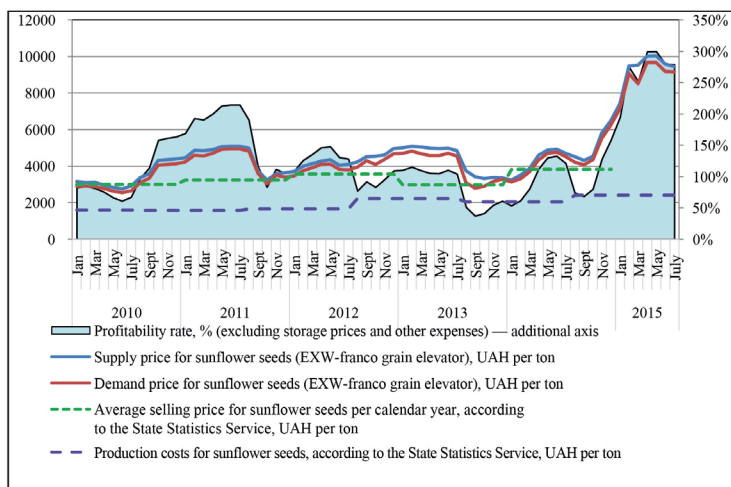


Figure 2.5. Profitability dynamics for sunflower seed farming in 2010-15  
[based on the data from the State Statistics Service and the APK-Inform website]

The increase of profitability rates for agricultural products was facilitated primarily by the devaluation of hryvnia, since, despite the falling export prices, agricultural businesses got two or three times more revenue than in the previous. Due to the cyclic nature of production, agriculture benefited from hryvnia devaluation the most. Of course, in the following periods, profitability will fall, since a part of profits will be spent to purchase factors which have also become more expensive (fuel and lubricants, plant protecting agents, fertilizers, etc.).



## **The tax system.**

The key tax preferences for agriculture, which determine its low tax revenues, are the single tax (ST) for the fourth group of taxpayers and the special VAT treatment.

### **Corporate profit tax**

Budget revenues from corporate taxes in all sectors have been falling for years. If in 2012 the budget received about UAH 55 billion (16 percent of all revenues) from the corporate tax, in 2014 it was only UAH 39.9 billion (11.2 percent). In 2015, the expected amount is even smaller, UAH 36 billion, or only 7.2 percent of budget revenues. The decrease was caused by both objective causes of falling industrial output, loss of powerful companies in the east, shrinking markets for selling products in post-Soviet countries; and by speculative factors (mass tax evasion, the government's transfer of the tax burden from companies to individuals). The structure of the corporate profit tax in 2012-14 was mostly made of revenues from wholesale trade and processing industry (21 percent each), mining (20 percent each), electricity and transportation services (8 percent each). Meanwhile, the supposedly profitable agriculture has only provided to the budget 0.7 percent of its total revenues, or UAH 0.9 billion, for three years.

Until 2015, the profits of agricultural companies were taxed using the fixed agricultural tax (FAT). As a result of the tax reform of 2014, the FAT was formally included into the single tax (ST). The key factors that determine its size are the tax rate and the normative monetary valuation of one hectare of farmland [Єрובה 2015].

The basic rate of the SP (former FAT) for arable land was set only three times:

- when it was introduced in 1999, it was 0.5 percent of the monetary valuation of farmlands;
- after social contributions were excluded from the FAT in 2005, it was reduced to 0.15 percent;
- since January 1, 2013, the single tax rate for the fourth group was increased threefold, from 0.15 to 0.45 percent for arable land and from 0.45 to 1.35 percent for land with water resources.

Given that the rate has always been relatively low, the central role in the tax charges belonged to the normative monetary valuation of arable land. It is ironic that the valuation was actually done in Ukraine only in 1995, that is, 20 years ago, and after that it was just indexed. It is important to note that the rate of indexation is based on the general inflation rate in Ukraine, so it does not fully reflect the tendencies in the sector. In addition, the basis for calculating the normative monetary valuation of arable land in 1995 was the rental income, created by

producing grains and based on the economic valuation of lands carried out back in 1988. Only since January 1, 2012, the normative monetary valuation of lands was increased by introducing an additional coefficient of 1.756.

Therefore, inflation processes, the devaluation of national currency and the unchanging tax base led to the loss of any economic grounds for this particular tax rate [Тяпуш 2015]. As a result, its fiscal value became significantly lower, the tax ceased to accomplish both its fiscal and regulatory goals, and the taxation of the profits of agricultural companies has become purely formal. Apparently, by this means, the government proposed a kind of compromise for the sector: “In most countries of the world agriculture is subsidized, but since our funds are limited, we offer you preferential tax treatment.”

The fact that the budget did not get enough revenue from this tax until 2015 is also confirmed by the calculations carried out by specialists of the Institute of Agrarian Economy, according to which the average amount of the single tax from a hectare of farmland in 2005 was UAH 7 (\$1.4), and in 2014 it was UAH 5.9 (\$0.35). For the sake of comparison: just from selling corn, a farmer made UAH 10,747 per hectare (according to the State Statistics Service, the average harvest of corn in 2014 was 6.16 tons per hectare, and the price was UAH 1,744.7 per ton).

## **Land tax**

The land tax, which duplicates the function of the single tax, also cannot be ignored, because the basic principle for calculating it is similar. The predicted rate of the land tax in 2015 is no more than 1 percent of the normative monetary valuation of farmland plots (it used to be 0.1 percent, about UAH 21 per hectare), and no more than 3 percent for other land plots (1 percent before 2015) [ІІКУ 2015]. This means that some categories of landowners and land users will be discriminated against. In particular, the single tax rate of 0.45 percent for the fourth group is more than two times smaller than the land tax rate, which motivates the transition to the simplified system and creates incentives for tax evasion. Another factor contributing to it is that the ratio of the single tax to the land tax has fallen in the recent decade from 60.8 percent to 27.6 percent [Тяпуш 2015]. And since the single tax replaces the payment of the land tax and other fees (corporate tax, subsoil use fee, etc.), more and more companies move to the simplified system in order to reduce their taxes.

What could be done to fix the situation and make the taxation of companies more fair? The rates of the ST for the fourth group and the land tax rates for farmland should be adjusted to correspond to each other. And, given that in 2015 the land fee was included in the list of local taxes, local governments must be given the right to set the single tax rates for the fourth group of taxpayers, as they do in the case of the first and the second groups.

To sum up all of the above, we can conclude that the key arguments against the simplified single tax system in its current form are the following:

- Large and middle-sized companies split into smaller ones (one apparent example is the use of this system in commercial chains, where each checkout desk in a large supermarket is represented by a different individual entrepreneur).
- The single tax is used by businesses in very profitable sectors.
- The number of employees is often reduced (in order to reduce the income tax payments).
- The sector has become highly profitable in the recent years.

## **Value-added tax**

The highest fraction of the government budget revenues is still provided by the VAT. In 2015, the net VAT revenues are predicted to make up 34 percent of the budget revenue, or UAH 172 billion. At the same time, in 2015, the VAT on imported goods is supposed to increase by only 26 percent, although, due to hryvnia devaluation, the tax basis is now more than two or three times larger. Of course, there is the factor of reduced volumes of import both in terms of value and in terms of natural volumes (in January-May 2015, there were 39 percent less imported goods than in the same period of 2014), but the abovementioned 26 percent increase is disproportionate.

In general, we should consider the possibility of rejecting the VAT and the corporate profit tax for some industries (the issue is contested and requires some special research), with a simultaneous introduction of a circulation tax on the sales of goods or services to the consumer. This would prevent the use of various tax base minimisation schemes. In addition, some economic sectors that have preferential tax treatment, particularly agriculture, should be taxed according to the rules of the general tax system. Although the government tries to support the sector by preferential tax treatment, it also simultaneously creates the conditions for abuse by agricultural companies and public servants who either “allow” the companies to accumulate money on their special accounts, or do not allow it.

Admittedly, the first steps in this direction were made in spring 2015, when the Cabinet of Ministers published a draft for the budget policy in 2016. According to this document, in 2016, all agricultural companies should be transferred to the general VAT collecting system [Ілюстр. 2015]. Messages claiming that this was one of the obligations undertaken by Ukraine when it signed the Memorandum with the IMF appeared in the media and during public discussions. In addition, the representative of the IMF in Ukraine emphasized that various tax preferences for agricultural businesses cost the budget UAH 30 billion every year [YHIAH 2015], and this claim is more or less correct (in 2014, the net revenue from the

sales of agricultural products reached UAH 165.6 billion; the VAT on this sum was about UAH 27.6 billion). The initiative was met with hostility by agricultural companies and NGOs in the field, who responded with organizing a strike committee and started a national agricultural forum demanding to bring the preferential tax treatment back. Here is a brief outline of the story of the struggle for agricultural tax preferences.

Back in July 2011, changes were introduced into the Tax Code to cancel the refund of export VAT for key export-oriented cultures, including wheat, barley, corn, sunflower and rapeseed. The reason was that, given the billions earned from exported agricultural goods and the de facto lack of any VAT revenues from the sector, the government's debt to the exporters kept growing, reaching UAH 2.5 billion in the early 2011 [YAK 2011]. After a long silence, the struggle for the export VAT between the oligarchic business (which is its primary benefactors) and the government resumed in 2014.

That year, large agricultural holdings (some former managers of which are now represented in the parliament—such companies as the Myronivsky Khliboprodukt, Ukrlandfarming, Kernel, etc.) lobbied for VAT refunds to agricultural producers and first intermediaries from October 2014. However, according to the Ukrainian Grain Association and the American Chamber of Commerce, from October to December 2014, only about 500 companies exported grains under the official status of agricultural producers, which is only 0.8 percent of the actual number of agricultural producers in Ukraine. Thus, the government support of domestic production was in fact just support of specific companies in the sector.

On December 28, 2014, a number of changes were introduced into the Tax Code of Ukraine to remove discriminatory rules for collecting VAT on grain and industrial crops transactions. After this, during 2015, lobbyist organizations (agricultural holdings seemed to enjoy the experience of October-December 2014) and some members of the relevant workgroups in the parliament started to actively promote the claim that VAT refunds supposedly are the basis for the revival of rural areas. As a result, on May 14, 2015, the bill “On introducing changes into the Tax Code of Ukraine to create fair conditions for selling agricultural products and directly support producers of goods in agriculture” passed the first reading; it would bring back the selective VAT refunds to particular economic entities.

We believe that the compromise in the issue of VAT administration in agriculture lies in the middle: preferential VAT tax system should be cancelled, but VAT refunds on exports should be brought back. The VAT rate can be differentiated, as in some other countries (for example, in Russia the VAT on agricultural products is 10 percent, while for most consumer goods it is 18 percent).

Based on all these facts, we can make the following conclusions about the tax system in Ukrainian agriculture and the ways to improve it:

- The lack of proper control over pricing in agriculture and a large proportion of “grey and black” market (that is, unaccountable trade) distorts the actual profitability rate of agricultural production; therefore, the thesis about undertaxing in this sector is confirmed. The potential amount of VAT that could be received by the state budget in 2014 (and used for social and investment programs) from plant farming only is around UAH 35-36 billion.
- The practice of the single tax and the land tax administration in agriculture is faulty and creates conditions for abuse and for the use of various tax minimization schemes. The most effective way to increase budget revenues is to unify the single tax and the land tax, and to gradually increase the tax rate, taking into account the increasing profitability of the sector due to hryvnia devaluation.
- Agricultural companies should be transferred to the general VAT taxing system by establishing equal conditions for economic activities regardless of the industry or the type of a company. However, it should be acknowledged that this step can reduce the sector’s profitability (since the preferential VAT treatment was the key premise for the technical upgrading and the economic development of agriculture). That is why one of the compensatory mechanisms can be to resume the practice of VAT refunds for exports (the argument for this is that the electronic system of automatic VAT refunds was introduced in 2015), which will allow to support the export-oriented sectors, maintain the positive rates of production and allow the export volumes to grow. And the general increase in tax revenues can be used to develop some other sectors of the country’s economy in addition to the raw material industries.

The proposed changes in tax policies will have the intended effect if they are also simultaneously introduced on the local level. That is why the special characteristics of taxation and local budget revenues should be studied. Let us use the example of Kyiv for this, and give some recommendations for increasing tax revenues to the city’s budget.

## **2.4 The opportunities for obtaining revenues for local budgets: the case of Kyiv city budget**

It became commonplace for the Kyiv city government to complain about the lack of money in the capital’s budget; this was cited as the reason for raising transportation and administrative service fees, and for all kinds of austerity measures aimed to curb the social security of low-income residents. However, it turned out that in 2015 Kyiv budget had much higher revenues than planned; and the revenues could have been even higher if the government pursued the policy of fair taxation of big corporations, rather than trying to solve all its problems by

increasing the tax burden on low-income population groups. The real prospects of decentralization and self-government by local communities are contingent, first and foremost, on the possibility of providing the local government with real funds. Therefore, the research of the opportunities for increasing local budget revenues is the crucial question for local government development and grassroots participation in the management of the citizens' interests. It will be possible to introduce participatory budgets only when those budgets have actual money which could be spent on community development. In our study of Kyiv budget revenues, we aim to generalize the existing experience and to find some opportunities for increasing revenues not only for the capital, but for all local budgets in the country.

According to the data published by the Kyiv City State Administration (KCSA), the revenues of the Kyiv city budget's general fund in 2015 totalled UAH 24,946 million, which was 20.4 percent more than predicted in the plan approved by the Kyiv Council on January 28, 2015 [Київрада, 2015]. Interestingly, the revenues for the previous year, 2014, were below the plan by about 8 percent, primarily due to the fact that 10 percent of the planned tax revenues were not collected [КМДА, 2015d]. The plan for 2015 was also exceeded mostly due to tax revenues which make up more than 60 percent of the budget's general fund, although we also should not forget that non-tax revenues were also 75 percent above the planned level [КМДА, 2015c]; more than 80 percent of the non-tax revenues are administration fees, that is, straightforward extortion by increasing fees for administrative services, rent fees for public facilities, and so on. However, this article is about a more narrow issue of the patterns and structure of tax revenues of the Kyiv city budget, in which, despite the fact that the general plan was exceeded, we can observe a number of tendencies which indicate that the city government is reluctant to burden the big business with fair taxation, but, at the same time, readily increases the tax burden for individuals, first of all for workers and poor citizens.

As the Table 2.4 demonstrates, for some of the taxes, the planned amount was exceeded by 3.5 times, and for others, not even half of the plan was implemented. In particular, the income tax, the single tax and the real estate tax were all significantly below the plan. That is, the taxes which are mostly paid by employees, the self-employed and small entrepreneurs, and homeowners, including retirees, respectively.

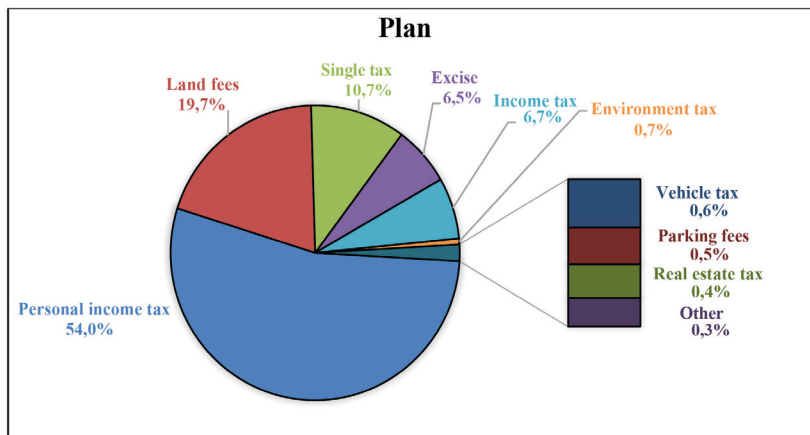
At the same time, the plans for some other taxes were failed, particularly for the environment tax and for parking fees. However, the amount and the fraction of the corporate taxes in Kyiv increased. We will attempt to explain these phenomena later, when we consider each source of tax revenues for Kyiv city budget separately.

The planned and the actual structure of the tax revenues for Kyiv city budget in 2015, distributed by the key sources, are shown on the diagrams below (Fig. 2.6, 2.7).

**Table 2.4 Planned and actual tax revenues  
to the general fund of the Kyiv city budget in 2015, UAH thousand**

Tax	Plan	Fact (as of 19.12.15)	Implementation
Personal income tax	6,586,559	7,557,767	114.8%
Land fee	2,400,000	2,446,390	101.9%
Single tax	1,300,000	1,885,288	145.0%
Excise tax	796,000	896,045	112.6%
Corporate profit tax	820,200	1,560,379	190.2%
Environment tax	80,000	29,686	37.1%
Vehicle tax	72,000	119,538	166.0%
Parking fees	55,000	22,480	40.9%
Real estate tax	50,000	175,937	351.9%
Other	42,621	55,420	130.0%
TOTAL	12,202,379	14,748,928	120.9%

*(Sources: Planned numbers based on the Kyiv City Council's Decision of January 28, 2015, #60/925 "On the budget of the city of Kyiv for 2015" [Куїєпада, 2015]; the actual amounts based on the KCSA Report on Kyiv City Budget Revenues, according to the current data, of December 19, 2015 [КМДА, 2015c])*



*Figure 2.6. The planned structure of tax revenues for Kyiv city budget in 2015  
[Куїєпада, 2015]*

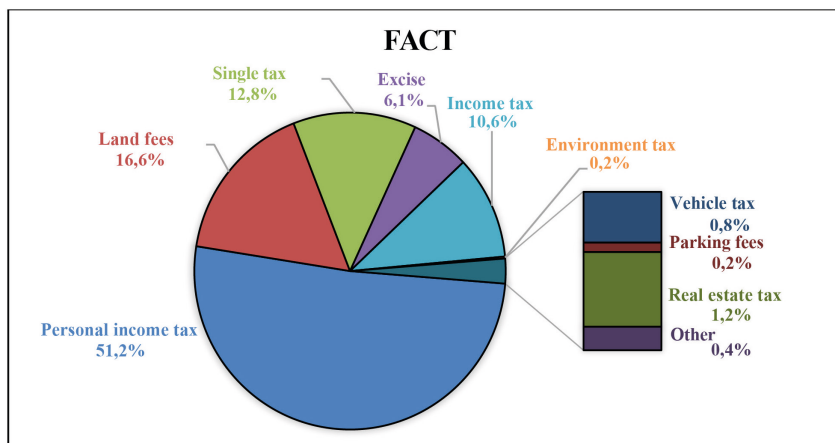


Figure 2.7. The actual structure of tax revenues for Kyiv city budget in 2015, as of December 22, 2015 [КМДА, 2015c]

## Personal income tax

As we have indicated above, both the “philosophy” and the practice of contemporary tax reforms involve shifting the tax burden from big business to consumers, and first of all to employees [Попович З., 2015]. Even though the percentage of the personal income tax (PIT) that stays in the local budget was lowered, it was still the main revenue source for local budgets in 2015.

In Ukraine in general, the revenues from the PIT in 2014 amounted to UAH 75,203 million, of which local budgets kept UAH 62,557 million, and the central government budget took UAH 12,646 million. The former sum corresponds to 71.6 percent of the total amount of tax revenues to local budgets (UAH 87,334 million) [Ціна держави, 2015]. Kyiv city budget received UAH 7,985 from the income tax in 2014, and the same amount went to the central government budget, since in 2014, only 50 percent of the PIT had to be sent to the central budget [КМДА, 2015d]. Thus, more than 20 percent of the total income tax revenues were collected in Kyiv. For the first 11 months of 2015, the total amount of the income tax collected all over Ukraine was about UAH 90,403 million, of which local budgets received UAH 47,811 million [Ціна держави, 2015].

According to the Ministry of Finance, the fraction of the income tax in the revenues of the local budgets’ general funds in January-November was 52.5 percent [Мінфін, 2015a]. The income tax also made up approximately the same fraction (about 54 percent) of the planned budget of the City of Kyiv (even though only 40 percent of the PIT collected in Kyiv was kept by the local budget in 2015). However, the actual collected amounts of this tax in Kyiv fell behind the planned



numbers; in the first 11 months of 2015, UAH 7,085 million were collected in Kyiv — that is, 7.8 percent of the total PIT collected in Ukraine.

Despite all the debates around the proportions for distributing the personal income tax among the local and the central budgets, and despite the potential change in the procedure of PIT payments by companies, this tax remains and will probably remain the biggest source of city budget revenues.

The reason is that, as we have already mentioned, the general direction of the tax reform which is currently being implemented in Ukraine is, unfortunately, to reduce the already low taxes for big companies and to place the tax burden mostly on the working population and on low-income population groups in general [Попович З., 2015]. This kind of policy is certainly unfair towards the majority of citizens (even the IMF representative in Ukraine Jerome Vacher admits it [Баузе Ж., 2015]), and it is unlikely to promote sustainable economic growth; in any case, local councils cannot change national tax policies.

Therefore, transparent and consistent policies for taxing personal income are particularly important for forming local budgets and planning the financial activities of local communities in general. It is possible that, when the PIT will begin to be paid at workplaces, the revenues from this tax to Kyiv city budget will fall, which makes the analysis of additional revenue reserves, particularly bringing business out of the shadow and progressive taxation, even more important.

Bringing the shadow economy out to the light and actual reduction of the number of salaries paid “in an envelope” (that is, bypassing official records and taxes) can provide a significant increase of revenues from the personal income tax. As estimated by Ihor Bilous, the head of the State Fiscal Service, monthly unofficial payments in 2014 reached between UAH 20 and UAH 50 billion per month, which makes UAH 240-600 billion per year [Дзеркало тижня, 2014]. According to a more conservative estimate by the Ministry of Social Policy, the shadow wage market in Ukraine also exceeds UAH 200 billion per year [Мінсоцполітики, 2015]. Thus, experts estimate the potential losses for the budget to be around UAH 46 billion, and the unreceived social contributions as more than UAH 97 billion per year [Форбс, 2014].

Clearly, these numbers follow from the assessment of the amount of taxes and other payments that could have been paid if the wage funds, estimated at around UAH 240-600 billion, were legalized. In case of the PIT, if we base our calculation on its 2015 rate of 15 percent, this would mean a potential reduction by UAH 36-90 billion, UAH 3-7 billion of which would be lost in Kyiv (where approximately 7.8 percent of the total Ukrainian personal income tax is collected).

Let us assess the potential losses for the Kyiv city budget because of the black labor market from another perspective, based on the number of the illegally employed. While there are about 5 million of unofficial employees in Ukraine in general [Укррудпром, 2012], Kyiv could have about 390,000 of them. At

the same time, according to the UN data, about 100,000 of internally displaced persons permanently live in Kyiv, and about a half of them are of working age [UN, 2015] (according to the State Migration Service of Ukraine, there are less IDPs: around 39,000 in Kyiv and 46,000 in the Kyiv region [ДМС, 2015a., p.11]; however, not all the IDPs who are de facto based in Kyiv are registered in the capital). Most of these people work in Kyiv, and experts argue that the war caused an unprecedented rise in the scale of the illegal labor market [Укррудпром, 2015].

Therefore, there is no doubt that Kyiv hosts between a couple of hundred thousand and half a million illegal employees. Let us base our calculation on our estimation of  $390,000 + 50,000 = 440,000$ . The average wage in Kyiv in November 2015, according to the government statistics, was UAH 7,089 per month [Київстат, 2015], which is not very different from the estimates by employment services (the average wage for vacancies in the first week of 2015 was UAH 6,644, according to Work.UA [Work.UA., 2015]).

If these 440,000 illegal employees earn at least UAH 7,000 on average, it already makes for a wage fund of more than UAH 3 billion per month, that is, about UAH 37 billion per year. With the 20 percent tax rate, it would make more than UAH 7 billion of the income tax revenue per year, and Kyiv city budget could keep around UAH 3 billion of that sum. This calculation is, of course, very rough, but it allows us to perceive the scope of the problem.

It should also be taken into account that, in addition to the officially unemployed, there are also numerous people who are employed half-officially, that is, employees who officially earn the minimum salary, but in fact receive a much higher wage, most of which is paid in black cash. According to some estimates, up to 80 percent of the working population are employed in this manner [Дзєркало тижня, 2014]. Given that the unofficial part of the pay is usually bigger than the official part, the amount of the personal income tax that has not been collected because of this phenomenon can be estimated as at least 40 percent of the current revenues, that is, about UAH 3 billion per year.

Therefore, the total reserve of uncollected income tax can be estimated to reach about UAH 5-6 billion, which corresponds to the range estimated by the State Fiscal Service (UAH 2-5 billion). That is, income tax revenues can be increased by 70 percent and used to cover all the losses of communal companies (for example, to provide free public transportation for Kyiv). Moreover, we leave out of this study the PIT reserves that could be harnessed by introducing progressive taxation and fighting the substitution of civil contracts for employment contracts.

Apparently, the State Fiscal Service is currently not very successful in collecting the income tax, despite all the declarations and calls to pay it [ДФС, 2015e, 2015c, 2015d].

The most troubling aspect of this situation is that the Department of Finance of the KSCA does not consider pushing employment out of the shadow a priority

in its work. Their logic is that the “efficiency” of working in this direction is not too high, since making hundreds of jobs official provides relatively less funding than, say, collecting the land fee for one land plot in the city center. Unfortunately, we cannot say that there is any systematic policy of bringing employment in the capital out of the shadow.

## **Corporate income tax**

The corporate income tax is a new source of local budget revenues, which also provides considerable sums and possibly has the highest potential to increase its efficiency. Starting with 2015, Kyiv city budget can keep 10 percent of the corporate tax on the profits of all companies that are registered in the capital and pay taxes there. If before 2015 Kyiv city budget received only the taxes on the profits of communal companies, and those revenues provided about UAH 40-100 million per year in the last decade, the planned corporate tax revenues in 2015 were UAH 820 million (about 7 percent of the total planned revenue) [Київрада, 2015]. Moreover, the actual amount of revenue exceeded the plan almost twofold and, according to the preliminary data, provided UAH 1,616 million to the budget (almost 12 percent of the total revenues). The prospect of receiving the amount of taxes two times higher than planned was noticeable early in the year, since, in contrast to the rest of the national taxes, the plan for corporate tax revenues was already completed in the first half of 2015.

However, the cause of this considerable increase in corporate tax revenues is, unfortunately, quite sad. Most probably, the reason is that companies which are de facto located and operate in the occupied territories of Donbas and, possibly, Crimea simply re-registered in Kyiv. These companies usually operate semi-legally, paying taxes both to Ukrainian budget and to the so-called “DPR” and “LPR.” From time to time, messages about the total blockade of Donbas and shutdown of these companies emerge, but they are soon disproved by the government’s announcements of its intention to simplify cargo transportation across the division line to meet the needs of Ukrainian companies that operate in the “DLPR” territories, but pay taxes to Ukrainian budget [ДФС, 2015f].

Usually the functioning of such companies is impossible without some smuggling and illegal movement of considerable amounts of cash, at least across the division line. Thus, the corporate tax which we can see in the Kyiv city budget is in fact, so to speak, the semi-official “legalization fee” for cash flows of much greater volumes and for the profits linked to them.

When the war ends and the situation in Donbas normalizes, it is logical for Kyiv to expect a reduction in corporate tax revenues from companies of this kind. However, in fact, the reserves for increasing corporate tax revenues are vast. If the fight against corporate tax evasion and offshore schemes succeeds,

it is possible to significantly increase the revenues, especially from taxes on oligarchic businesses. The potential increase of revenues can be estimated using the fact that the scope of purely corrupt (with legal violations) corporate profit tax evasion by the largest oligarch holdings was assessed in 2012 as 15 percent of the revenue; at the same time, the legal offshore tax evasion schemes helped your typical oligarchic holding to pay 80-90 percent of its corporate taxes abroad. It should be noted that we mostly speak here about raw material exporters who barely operate any actual manufacturing facilities and who cannot create added value abroad, so it is all about accumulating a lion's share of profits by fictitious offshore intermediaries [Економічна правда, 2013, Остро, 2012].

Similar estimations of the corrupt corporate tax evasion can be derived from the analysis of the unequal distribution of tax revenues among industries [Український тиждень, 2013]. Therefore, the reduction in the use of corrupt schemes alone can provide a 15 percent increase in corporate tax revenues, at the very least.

As the recent research by the CSLR [Небора М., 2015.] demonstrates, neither the war in Donbas nor the war on corruption declared by the government have not brought any significant changes in offshore business practices. Only in the first 9 months of 2015, Ukraine's budget did not receive more than \$500 million of corporate taxes which it was supposed to receive (in 2014, this number was \$950 million, which is not much less than in 2013 or 2012). The reason for these major losses is the persistence of the practice of transiting most of the exports from Ukraine through offshores and the use of transfer pricing — artificially lowered prices for specific intermediaries — which allows to artificially reduce profits in Ukraine and to “create” profits for the offshore intermediary, that is, allows to avoid taxation in Ukraine.

Nearly half of all exports of grain from Ukraine are sold to Switzerland, which means that Ukrainian agricultural holdings mostly provide food for Swiss welfare benefit receivers. Food here, of course, is used figuratively, since the whole population of Switzerland could not eat that much grain; we mean that profits are sent out of Ukraine and taxed by Switzerland. The total annual revenue from grain exports from Ukraine is more than \$13 billion, and the price reduction for exports is usually 15-30 percent, which means that every year up to \$4 billion are offshored. Meanwhile, the actual profitability of production in agriculture (for example, in the case of sunflower seed production) reaches 300 percent [Одосій О., Кравчук О. 2015].

The situation is also similar in ferrous metal exports. The only difference is that some of the oligarchs, just as in agriculture, export via Swiss intermediaries, and others use the Russian Federation instead of Switzerland [Ляхович О., 2015]. (Of course, unlike Switzerland, Russia is not only a transit country, but also a consumer of Ukrainian metal. In fact, the consumed volumes are even

higher than the transit volumes.) Thus, some of the profits evade taxation in Ukraine not only via the classic offshore zones and countries with extremely low tax rates, but also via such countries as the Russian Federation, providing revenues for its budget. The annual sum for ferrous metal exports is about \$14 billion.

No wonder, then, that the annual amount of due corporate profit tax revenues which Ukraine does not receive is estimated to reach up to \$1 billion, and the net profits of exporters that are kept abroad are estimated at up to \$5 billion [Heбopa M., 2015], which, in particular, means that these funds are not invested in Ukraine as they could have been. That is why fair taxation of profits, particularly full implementation of the laws on transfer pricing (with the possibility to control all operations, etc.) would increase not only tax revenues, but also investment into Ukrainian economy.

The total corporate tax revenues collected in Ukraine in the first 11 months of 2015 equalled UAH 40,639 million [Ціна держави, 2015]; in the same period, the general fund of Kyiv city budget received UAH 1,474.7 million [КМДА, 2015a], which means that about 3.6 percent of the corporate tax goes to Kyiv budget. Therefore, due to the offshore trade described above, Kyiv budget loses at least UAH 900 million annually — which, let us remind you, is more than the original plan for 2015 (UAH 820 million). Given that the plan for 2015 was clearly exceeded, it can be predicted that the reserves would allow to increase the revenues by 50 percent, if not to double them.

And if the legislation about avoiding double taxation with offshore zones is actually revised, it is possible to achieve a four-times increase of revenues simply by changing the balance of taxation, without increasing the tax burden on the business of oligarchs. In this case, the revenues solely for Kyiv budget could reach UAH 3-8 billion per year. Not to mention that the actual tax burden on big business could be increased to the level of developed European countries.

## **Land fees**

Land fees have traditionally been an important source of revenues for local budgets. The total fraction of land fees in the general funds of local budgets in 2005-9 was 9 to 14 percent. In the first half of 2015, local budgets received a total of UAH 6.64 billion from land fees [Мінфін, 2015b], and in the first 11 months of 2015 they received UAH 13,181.9 million from the same source [Мінфін, 2015a]. Thus, in 2015, land fees made up around 15 percent of all local budget revenues in Ukraine (without taking transfers into account).

Nationwide, the growth rate of the actually collected land fees in the first 11 months of 2015 compared to the same period (January-November) of 2014 was 130.1 percent [Мінфін, 2015a].

According to the budget plan, in 2015, land fees in the city of Kyiv were supposed to provide UAH 2.4 billion [Київрада, 2015], which was around 20 percent of the total tax revenues to the general fund of the capital's budget. In 2014, the sum was about UAH 1.89 billion, a little less than 19 percent [КМДА, 2015d]. The actual revenues to Kyiv city budget, as of December 19, 2015, reached 2.446 billion, which is 102 percent of the plan and 16.59 percent of the total tax revenues [КМДА, 2015c]. Formally, the plan was completed. However, let us recall that the plans for other taxes were considerably exceeded. In total, the actual tax revenues to Kyiv city budget, according to the preliminary data, reached 127 percent of the planned revenues. So the land fees were lagging behind, to say the least.

Even the approved "Program for Kyiv city land use and protection" [КМДА, 2015g] mentions that the budget received too little money from this source. As the Program's authors note, proper administration and prevention of commercial structures from evading land fee payments could lead to the increase in "the annual city budget revenues from land use fees from UAH 2.3 billion in 2010 to UAH 3.4 billion in 2015."

The reasons why plans are not fully implemented mostly lie in the field of systemic corruption in the administration of the tax, and in the lack of leverage to actually collect it.

The opaque system of allocating and using land plots has existed for many years, and the local government and companies seem to be totally fine with it, since the allocation of land plots and manipulations with them are one of the most profitable and secretive businesses in Kyiv; most "developers," including the current mayor, are involved in it. So it is no wonder that, as the Program states, "it was not possible to complete the work of revising the land registry and official registration of the land use rights." Therefore, the issue of increasing land fee revenues is simply an issue of improving the transparency of the land registry and carrying out an independent assessment of lands under public control. We want to add that an introduction of a differentiated approach and a progressive tax scale for land fees, and property taxes in general, could not only increase revenues, but also serve to reduce social tensions and restore social justice.

In addition to national taxes and land fees, there are also local taxes that should provide revenues to local budgets. However, even though these local taxes are quite numerous, only a few of them actually make significant contributions to budget revenues. In addition to the income tax, which has been discussed above, other important sources of Kyiv budget revenues are the excise tax and the single tax (Fig. 2.8).

In addition to these two types of taxes, we will also briefly discuss the new property taxes and the parking fees, because they concern a considerable number of citizens and are of great social importance.

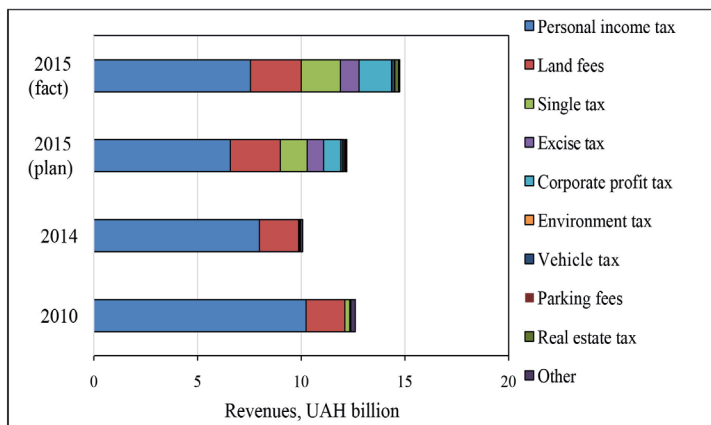


Figure 2.8. The changes in the structure of tax revenues to Kyiv city budget in 2010-15  
[Київрада, 2015, КМДА, 2015c, 2015b]

### Excise tax for retail trade

The planned annual revenues to the Kyiv city budget from the new excise tax, which was introduced on January 1, 2015, were expected to reach UAH 796 million, which was about 6.5 percent of the total tax revenues [Київрада, 2015]. The actual amount collected in the first half of 2015 was about UAH 333 million, which is 5.4 percent [Мінфін, 2015b]. During the whole 2015, about UAH 970 million of excise taxes were collected, which is about 6.3 percent of the total tax revenues. This means that the actual amount collected was 122 percent of the planned amount.

As of December 1, 2015, the actual revenues from the excise tax were UAH 7,011 million, which makes UAH 179.2 per capita [Мінфін, 2015a]. In the same period, the general fund of the Kyiv city budget received UAH 885.14 million, which was 12.6 percent of the total excise taxes collected in Ukraine [КМДА, 2015a]; of course, it was less than the 20 percent of the personal income tax, but it was more than the fraction of the corporate profit tax, 3.6 percent. Revenues from excise taxes per capita in Kyiv were UAH 306.5, 1.7 times higher than the average for Ukraine and 2.5 times higher than in the neighboring Chernihiv region [Мінфін, 2015a].

The excise tax is paid directly to the local budget by retail trade agents who sell excisable goods (alcohol, tobacco, petroleum products), and its rate is 5 percent on the retail price. This tax certainly is a relevantly stable source of income for local budgets. Our only concern is that the introduction of this tax is another step towards shifting the tax burden from companies to citizens, primarily to the poor populations who are the key consumers of excisable goods. So far, we do not have any data on the impact of increasing excise rates on alcohol and tobacco consumption, but the issue certainly needs to be examined.

## Single tax

The single tax has traditionally been an important source of revenue for local budgets, and in 2005-9 it provided 3-7 percent of local budget general funds, and this fraction tended to decrease [Щербина І, 2009]. Between 2011 and 2014, the single tax was included into the special funds of local budgets.

The planned amount of revenues from the single tax in Kyiv in 2015 was set at UAH 1.3 billion, more than 10 percent of the total tax revenues. In fact, in 2015, about UAH 1,914 million were collected, which is about 12.4 percent of the total budget revenues. This means that 147 percent of the planned amount was actually collected.

The fact that the plan was exceeded can be explained by the inflow of taxpayers who transferred from other forms of taxation to the single tax. We mentioned earlier that the actual fraction of the personal income tax in the tax revenues fell to the 51 percent, compared to the 54 percent that were planned [Київрада, 2015, КМДА, 2015с].

The increase of the fraction of the single tax in the budget revenues can signify that the capital's economy is descending into the shadow, that the substitution of labor relations with civil contracts is spreading, and the scope of tax evasion using the payers of the single tax is expanding, since we cannot see any sign of rapid multiplication of small companies in the capital.

## New property taxes

The capital's budget also includes revenues from two other property taxes: the real estate tax and the vehicle tax. Both taxes were introduced in 2015, and their success could already be evaluated at the end of the year.

The plan for **the real estate tax** is UAH 50 million per year, which would make 0.4 percent of the tax revenues to Kyiv city budget [Київрада, 2015]. However, the plan was already exceeded in the first half of 2015, and by December 19, 2015, the amount of revenues from this tax reached almost UAH 176 million; that is, the collected amount of this tax was 3.5 times higher than the planned number. Nevertheless, despite the success, the fraction of the real estate tax in the total tax revenues was only slightly more than 1 percent [КМДА, 2015с], which means that it is not very significant for the budget.

This tax is controversial, because it is mostly paid by relatively poor citizens who own apartments of more than 60 sq. m, to whom the same principles apply as to the individuals who own a lot of property. So this tax is not progressive, and it contributes to transferring the tax burden on to the poor citizens. The fact that the plan was exceeded can be explained by the easiness of administering the tax and the lack of opportunities to evade it for most people who live in the apartments which they own.



One can compare the Ukrainian real estate tax to the taxes paid per capita in the feudal times of Kyiv Rus, when a so-called “smoke tax” was collected.

The plan for the **vehicle tax** in 2015 was UAH 72 million, which was about 0.5 percent of the total planned tax revenues [Київрада, 2015]. In the first half of 2015, the actually collected amount of this tax fell somewhat behind the plan, but as of December 19, 2015, its amount was almost UAH 120 million, 0.8 percent of the total tax revenues [КМДА, 2015c]. The municipality collected 116 percent of the amount planned.

The vehicle tax is probably the only luxury tax in Ukraine, because it is imposed on the cars which have been in use for less than 5 years and whose engine capacity is more than 3000 cubic centimeters — that is, the cars that are a luxury even for most Ukrainian MPs [ДФС, 2015].

## Parking fees

The planned amount of revenues from parking fees in Kyiv in 2015 was UAH 5 million (0.4 percent of the total tax revenue) [Київрада, 2015].

The actual amount collected by December 19, 2015, was a little less than UAH 22.5 million, which corresponds to 0.15 percent of the total tax revenues [КМДА, 2015c] (we are talking here about fees for parking spots, not about profits from paid parking lots that belong to the communal company Kyivtransparkservice and are not included in tax revenues). So by December 19, 2015, only 40.87 percent of the planned amount was collected. In the last 10 days, another UAH 675,000 were received, which allowed the amount to reach 42.1 percent. Thus, despite all the effort, even half of the plan was not implemented. The dynamics of the revenues of the general fund of the Kyiv city budget from parking fees in 2007-15 is demonstrated in Figure 2.9.

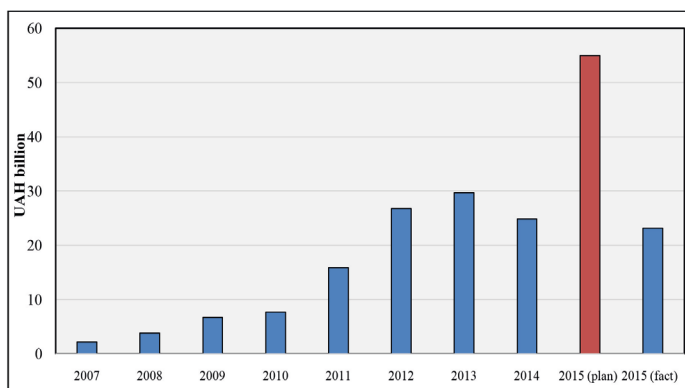


Figure 2.9. The dynamics of the revenues of the general fund of Kyiv city budget from parking fees in 2007-15 [КМДА].

So it is a failure which is comparable only to the fiasco of the attempts to collect the environment tax. This situation is probably linked to the fact that most parking lots function in a semi-legal and opaque manner, so taxing their owners turned out to be a difficult task.

The direct cause of this situation is, as we have already noted, the opaque and corrupt administration of land use in the capital. At the same time, the systematic improvement in parking tax collection can be expected if the problem of parkings is approached comprehensively, particularly by expanding the network of cheap communal parking spots and overcoming corruption in the Kyivtransparkservice company (for example, a complete rejection of cash payments to parking attendants) [KMДА, 2015e].

## **Conclusion**

We should not be too happy about the considerable excess of the actual revenues compared to the plans for the Kyiv city budget. First, the numbers could have been impacted by an incorrect adjustment for inflation. And second, the excess existed only for some of the revenue sources. And, last but not least, increasing revenues in our circumstances do not necessarily mean increasing funding for social programs and generally for the issues that concern most of the residents of Kyiv. The extra funding will be spent on the projects that are in the financial interests of the developer lobbyists who currently head both the KCSA and the Kyiv Council. If, at some point, no such projects are taking place, the city management will rather accumulate the surplus on the city's accounts than spend it on the actual needs of the city. By the way, while the revenues of the general fund of the city budget were exceeded in 2015 by more than 20 percent, the spendings were exceeded only by 11.6 percent. We do not aim to review the spendings in this article, but there can be no doubt that the Kyiv government will still lack the funds to improve public transportation, education, healthcare or social welfare.

The main potential for increasing tax revenues to Kyiv city budget lies not in raising taxes for citizens, but in systematic pushing businesses out of the shadow economy. Any further increase of personal property taxes without introducing a steep progressive scale will bring very little revenue and will disproportionately hit the poor, particularly the owners of small apartments.

Of course, any progressive tax scale will work only insofar as the government is able to ensure the proper administration of progressive taxes. For example, simple introduction of a progressive income tax without forcing taxpayers to legalize their income often does not increase the tax revenues [Гладун А., Дутчак О., 2015], since the agents of the shadow economy know how to conceal the actual size of their income.

At the same time, progressive taxation on real estate property and elite cars is much easier to administrate. The existence of the relevant registers in Ukraine makes this administration completely realistic. And if the car registry maintained by the Ministry of Internal Affairs [MBC, 2015] is opened to public, it will be possible to make the administration transparent and enable the public control over progressive taxation of these properties. Thus, the potential for progressive taxation exists, and it should be exploited not only for the sake of social justice, but also in order to actually provide revenues for the budget.

However, the potential for increasing revenues from flat rate consumer taxes, namely the revenues from excise and other indirect taxes, is almost exhausted. Any further increase of these tax rates will lead to poverty and “punishment of the poor,” but will also have a limited effect in terms of budget revenues.

Meanwhile, the reserves for increasing revenues from the corporate profit tax are very broad. If the shadow economy is systematically exposed and offshore schemes are systematically attacked (of course, central government policies are needed to do this), income tax revenues could double, triple or even quadruple, reaching UAH 3-8 billion per year. In that case, the personal income tax could become the central source of tax revenues and provide Kyiv with enough funds to modernize the infrastructure and implement the necessary social programs [КМДА, 2015f].

Another source for increasing budget revenues, with even higher potential, is the legalization of labor relations, primarily in large and middle-sized companies. The reserves for increasing the **personal income tax**, especially if a fair progressive tax rate is introduced, can reach UAH 2 to 5 billion. Kyiv city government is completely capable of systematic employment monitoring. In particular, it would be useful to produce an account of the actual number of employed people. The monitoring can be carried out without interrupting the production process. If it is found out that an employer has more employees than they have stated in their tax report, they should be offered an opportunity to legalize the actual number of employees without paying any fines. Fines and other sanctions should be used only against repeated offenders. It is also advisable to increase the personal responsibility of CEOs and the persons who are to blame for avoiding employee registration, up to introducing a criminal punishment similar to the responsibility for not paying wages.

The estimated reserves for increasing tax revenues to Kyiv city budget from the sources with the highest potential are listed in Table 2.5.

It would also be reasonable to expand the supervision rights of unions and NGOs, as well as employees' power to control the activities of the companies they work for. In particular, it is advisable to publish complete and detailed information about the cash flows of, at least, all the communal companies, including the actual wages of all employees, especially the managers (what is there to hide, if they work for the community?).

**Table 2.5 The key sources for increasing tax revenues to Kyiv city budget**

<b>Tax</b>	<b>Potential revenue increase</b>
Personal income tax	UAH 3-6 billion
Corporate profit tax	UAH 1-2 billion
Land fees	UAH 1-2 billion
<b>TOTAL</b>	<b>UAH 5-10 billion</b>

*(according to the author's estimates)*

As the instruments for controlling employers are introduced, it would also be useful to increase the incentives for employees to demand to officially register their labor relations. In particular, we tend to agree with the suggestion that all personal income should be reported and that the list of the types of taxable income should be expanded [Фролова, 2014].

In general, these measures would promote the economic development of the capital, lead to the concentration of enterprises that produce goods with higher added-value in Kiev, and provide additional the incentives to upgrade technology and equipment.

## **Prospects**

Bringing labor, and business in general, out of the shadow would also promote transparency in companies, particularly the publications of their accounting records as open data. The majority of the abuses related to illegal labor compensation, tax evasion, and plain theft of money and property are possible precisely because the information about financial and economic activities of companies is closed. Even tax reports and statistical reports are not public, although they are generalized enough to allow to conceal specific operations and tax optimization schemes. Even tax authorities need to carry out a lengthy and costly investigation to clearly establish which tax evasion schemes are used by a particular company, if any.

Therefore, the introduction of open accounting systems with open data at the companies that pay taxes would allow, on the one hand, to see and analyse specific transactions if there is any suspicion (for example, about a particular contractor); and, on the other hand, to compare and analyse the big data to explore patterns — for example, to discover recurring characteristics of suspicious transactions.

The first in the line to adopt open accounting systems should be the government, communal companies and large natural monopolies regardless of their ownership status. For example, open accounting at the facilities of the DTEK corporation would not hinder its functioning in any way and would not bring any commercial risks (especially given that the company is a monopoly); at the same time, it would

allow the company to earn trust (including the trust of the potential investors) and improve its efficiency due to public and worker control.

Some steps towards making budgets and accounting of government bodies and companies more open have already been made in Ukraine; they confirm that it is possible to use these tools under public pressure and control. In Kyiv, in particular, the Open Budget system, based on the SAP software, has been introduced for a test run; it is available online at <http://new.kievcity.gov.ua/>. At the moment, it is not stable enough, and the data it provides are not sufficiently detailed in terms of budget spendings. However, it publishes daily updates about cash flows for the general and the special funds of the Kyiv city budget, albeit in a generalized form (under second-level budget categorization codes). Unfortunately, it is yet impossible to download the data in a structured form.

The bills about opening public financial data, which were passed lately, are, of course, a major step forward in this direction. However, they do not demand to publish full primary data, although they do not prohibit it either [BP, 2015a, 2015b].

According to these new laws, the data on the use of public funds and budget indicators will be published in a generalized form with a delay of a couple of months. In contrast to raw data publishing, this form will require additional efforts to process and will create opportunities to conceal some economic operations in the generalized “melting pot.”

Therefore, we think that, in addition to the generalized information, it is reasonable to demand that the raw accounting data are published, both by the managers of public funds and directly by companies. The pilot project aimed to implement this model was run in 2014 at the central apparatus of the Ministry of Education and Science of Ukraine, and the author of this research participated in the test run [Попович З., 2014, Потапов Д., 2015].

The decision to use this system is still valid. The data are available at the old Ministry website, at [http://old.mon.gov.ua/ua/public\\_information/vidkr\\_buch/](http://old.mon.gov.ua/ua/public_information/vidkr_buch/). Unfortunately, despite the remarkable simplicity and the exceptionally low cost of the implementation of this decision, the practice did not become widespread. An important factor that could accelerate the introduction of this system in other government branches is the citizen and NGO pressure on the government, demanding to make its functioning more open and to publish detailed information (listing every transaction) about the flows of public money in the form of open data.

At the same time, openness in and of itself, without providing citizens and worker collectives with real means to participate in planning and distributing the budget funds, does not automatically improve the efficiency with which public money are used. International practice proves that, in order to introduce real participatory budgeting, it will be necessary to create institutions for it and to

implement the relevant processes systematically within annual budget cycles. In particular, citizens, both on the neighborhood and on the city level, should be given the opportunity not only to discuss, but also to systematically (at least annually) make decisions about the distribution and the allocation of funds, to closely control the implementation of those decisions and make new decisions for the next budget cycle, taking into account their previous experience [Sintomer, 2013]. The introduction of participant budgeting in Kyiv and in Ukraine in general is a very important strategic goal, and to achieve it, joint efforts of both the academic and the activist communities, as well as constant political pressure by grassroots movements, will be required.

Having reviewed the tax system on the different levels of Ukrainian economy, let us examine how various versions of tax policies affect individuals.

## **2.5 Predicting the consequences of introducing a progressive tax system in Ukraine**

The question of progressive taxation is one of the cornerstones of the political agenda of the left; however, it has barely been discussed in the Ukrainian political discourse. Currently, there are a couple of different versions of the way individuals will be taxed after the tax reform, and one of the versions involves a progressive personal income tax with 15 and 20 percent rates (for the income higher than 10 minimum wages). However, the progressivity here is insignificant compared to the tax scales in many European countries.

In general, there are arguments in favor of progressive taxation on various levels of the socioeconomic reality. On the macrolevel, progressive taxation can be supported by the positive effect it has on the historical dynamics of the economic system. This argument is discussed by a French economist Thomas Piketty in his bestselling book *Capital in the Twenty-First Century* [2014]. Based on a vast array of statistical historical data, Piketty examines economic dynamics in different countries. He reaches the conclusion that the capitalist system is characterised by a constant tendency to concentrate capital in the hands of the richest few, and, therefore, to increase inequality. According to Piketty, this tendency can lead to devastating consequences for the society, if we do not try to stop it. Piketty believes that one of the means to overcome this tendency and its negative consequences is progressive taxation, which would reduce the concentration of capital and inequality, thus helping to avoid the catastrophic consequences.

The key argument in favor of progressive taxation on the level of particular social systems is that income has diminishing marginal utility. In other words,

each subsequent dollar is less useful for an individual than the previous one. Individual exceptions are possible, but generally for a person with a UAH 2000 (\$80) wage, an extra thousand of hryvnias will have a greater effect than for a person with a UAH 10,000 (\$400) wage. In addition, increasing income among upper classes starts to resemble a zero-sum game, since they engage in conspicuous consumption. This phenomenon was described by Thorstein Veblen in his book *The Theory of the Leisure Class* [1899]; in essence, conspicuous consumption means that the goal of such consumption is no longer to make use of the utility of particular goods, but to confirm one's social status. Therefore, the accessibility of certain goods for many people will immediately reduce their value for some of them, since these goods will no longer be able to serve as status symbols. Thus, increasing income does not increase subjective well-being, but only leads to competitive consumption. Based on this phenomenon, it makes sense to redistribute some wealth among those who will benefit more from it.

As for the macrolevel, progressive taxation generally has a positive effect on subjective well-being. In their article titled *Progressive Taxation and the Subjective Well-being of Nations* [Oishi et al, 2012] the authors find a positive correlation between progressive taxation and subjective well-being in 54 countries. The researchers included not only the direct answers to the question about life satisfaction, but also the question about the positive or negative nature of people's everyday experiences. Progressive taxation, which was expressed as a difference between the maximum and the minimum tax rate, or as the difference between the taxes paid by individuals whose income is 167 or 67 percent of the average, was linked both to increased subjective well-being and to positive everyday experiences, as well as to a reduction in negative everyday experiences. The researchers point at the intermediate link between positive experiences and progressive taxation — the public goods, such as public transportation, education and health care. The accessibility of these services improves due to progressive taxation, which, in turn, affects subjective well-being and the daily experiences of citizens. The authors conclude that progressive taxation or the wealth of any particular country do not necessarily lead to a happy society. However, the proper use of that wealth, which can be redistributed, for example, via progressive taxation, and then invested into public goods, increases the well-being and happiness of a society.

There are also some more extreme cases. For example, the authors of the article titled *Happy Taxpayers? Income Taxation and Well-Being* [Akay et al. 2012], based on the data from the German Socio-Economic Panel, conclude that the amount of income taxes paid by an individual has a considerable positive effect on their own subjective well-being. The authors explain this effect by three factors. First of all, higher taxes paid by an individual can correspond to better accessibility and quality of public goods (public transportation, education, health

care). Thus, taxpayers feel that they fund these goods. Second, higher taxes can mean better income redistribution and a stronger safety net of the social security system (such as unemployment benefits). Therefore, by paying taxes, individuals improve their subjective well-being because it corresponds to their personal views or because it provides them with an “insurance” in case of adversities in the future. And, third, higher taxes can affect subjective well-being through “tax morality” (the moral duty to pay taxes) or civic feelings of belonging to a society or of making a meaningful contribution to its development.

### **Does progressive taxation make public goods more accessible?**

Based on the assumption that public goods are the link between progressive taxation and subjective well-being, we decided to test whether progressive taxation is indeed related to higher government spending in this sphere. To do this, we chose two indicators, government spending on education and on health care as percentages of the GDP, according to the World Bank data. We assume that the level of spendings on public goods is related to the accessibility and quality of those goods, which are difficult to assess directly.

A large part of the research about progressive taxation uses imperfect indicators and relies on the changes in the Gini coefficient before and after the taxation, or on the difference in tax rates for specific population categories. In our case, the progressivity indicator was taken from the World Tax Indicators database, which is the most complete database that includes taxation-related indices. Our goal was not only to have the best indicator of progressive taxation, but also to collect data on as many countries as possible, including developing countries, since many studies focus on the relatively homogenous OECD countries for which detailed statistical data are available. The drawback of using this database is that it only includes data until 2005; that is why we used the data for the last available year.

For our analysis, we used the Average Rate of Progressivity (ARP) variable, determined by calculating 100 income tax rates for incomes from 4 to 400 percent of the GDP per capita in local currency. These rates include all the major preferential tax treatments, important local taxes, etc. They do not take into account the changes in taxation that depend on the personal characteristics of the taxpayer (children, marital status, etc.). After this, the regression coefficient  $b$  is calculated, for which the tax rate is the dependent variable, and the logarithm of income is the independent variable. The regression coefficient is the measure of progressivity. If its value is positive, we are dealing with a progressive tax system; if it is negative, it is a regressive system; and if it equals 0, the system is proportional. The higher the value of the coefficient, the more progressive the taxation.

Our hypothesis is that the level of taxation system’s progressivity has a positive effect on the fraction of the GDP which the government spends on health care and



education. These indicators were chosen as the ones that reflect some of the most important social goods. In addition, statistical data about government spending in these areas are available, allowing us to make an international comparison. As a control variable, we used the natural logarithm of the gross national income, in order to account for the fraction of variation in spending on public goods, which can be explained by the increase in the gross national income in a particular country (Table 2.6).

**Table 2.6 The impact of tax  
progressivity on government spending on public goods**

	Only high-income countries		Excluding high-income countries		All countries	
Indicator	Spending on healthcare, fraction of the GDP	Spending on education, fraction of the GDP	Spending on healthcare, fraction of the GDP	Spending on education, fraction of the GDP	Spending on healthcare, fraction of the GDP	Spending on education, fraction of the GDP
ln GNI	-0.016	0.109	0.423	0.122	0.383	0.218
(stand. beta)	0.913	0.602	0.001	0.485	0.000	0.137
Significance	0.684	0.304	0.150	0.061	0.465	0.215
(p-value)	0.000	0.157	0.206	0.725	0.000	0.142
Tax progressivity	0.429	0.027	0.202	0.00	0.545	0.114
(stand. beta)	28	24	62	36	90	60
Significance	0.000	0.157	0.206	0.725	0.000	0.142
(p-value)	0.000	0.157	0.206	0.725	0.000	0.142
Adjusted R <sup>2</sup>	0.429	0.027	0.202	0.00	0.545	0.114
N	28	24	62	36	90	60

In order to measure the effect of progressivity on government spending, we used linear regression. Since the progressivity indicator is impossible to interpret literally, the table lists the standardized beta regression coefficients. They do not include units of measurement and allow to compare the impact of specific variables.

The Table 2.6 demonstrates that the progressivity of taxation has a positive effect on government spending on health care and education as a fraction of the GDP, although the effect is not statistically significant in the case of education (p-value > 0.05). At the same time, the effect of tax progressivity on health care

spending is significant even after controlling for gross national income in all countries. As for the spending on education, the data about this indicator were available for fewer countries.

If more data were available, we would probably be able to obtain statistically significant coefficients; however, the effect of progressivity in this case is still much smaller than its impact on health care spending.

This difference can be related to the variability of education funding models, since higher education institutions can be mostly privately funded, or use their revenue from selling their own research and engineering products, or there can be many private education institutions. The situation in health care is different, because even mandatory health insurance requires government spending.

Since many studies of the effect of tax progressivity analyse the relatively homogenous developed countries, we decided to consider different countries in groups according to the World Bank categorization by their GNI. For two groups of countries, one with high GNI, and another containing the rest of the countries, the tendencies turned out to be opposite. Thus, for the relatively homogenous high-income countries, progressive taxation had the highest effect on government spending on health care, and their GNI indicator was not significant. For the rest of the countries, higher gross national income meant higher government spending on health care, while the impact of progressive taxation was not statistically significant. The diagram below demonstrates the dispersion with regression lines for groups of countries by income (Fig. 2.10).

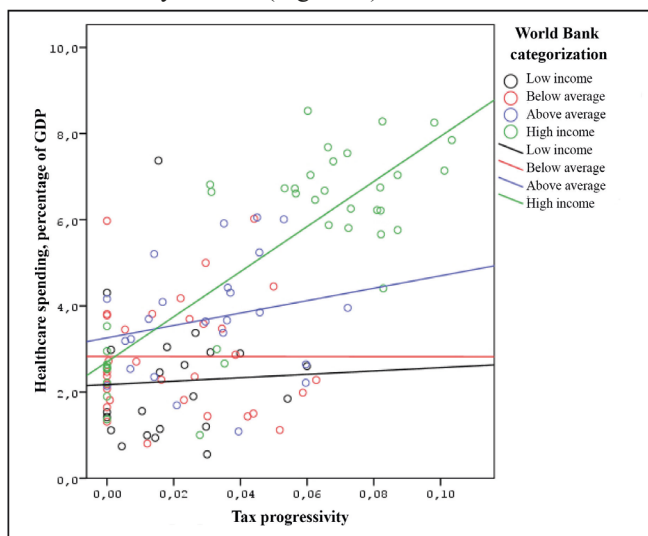


Figure 2.10. The relation between progressive taxation and the ratio of government spending on health care to the GDP [calculations based on the World Tax Indicators and World Bank data]

As we can see, the strong impact of progressivity on healthcare spending is more typical for high-income countries. For the group of countries whose gross national income is lower than average, including Ukraine, the regression coefficient even has a slightly negative value. Therefore, progressive taxation has different effects in developed and developing countries.

### **Special characteristics of progressive taxation in developing countries**

In general, there are few reasons to doubt that higher quality of public goods leads to higher level of personal well-being. However, in some countries, progressive taxation does not mean higher funding for public goods. We are not aware of any research that would specifically consider different effects of progressive taxation on the quality of public goods in different countries. However, there is a constant problem with using progressive taxation in developing countries, namely the tax evasion.

For example, different effect of progressive taxation on the observed and the actual inequality is studied in the article titled *Unequal Inequalities: Do Progressive Taxes Reduce Income Inequality?* [Denvil and Peter, 2012]. The researchers conclude that increasing the progressivity of the income tax reduces the observed inequality more than the actual inequality; it is assessed by consumption levels. However, the effect of progressive taxation on the actual inequality is smaller in the countries with weak democratic institutions and prevalent civil rights violations. In the same way, for the countries with widespread tax evasion, the effect of progressive taxation on the actual inequality is statistically insignificant.

Not only increases in tax progressivity can lead to tax evasion; however, reduction in progressivity leads to increased levels of voluntary tax payment. The article titled *Myth and reality of flat tax reform: Micro estimates of tax evasion and productivity response in Russia* [Gorodnichenko et al. 2009] is a study of the experience of introducing flat tax rates in Russia in 2001. The reform was generally lauded as a flat tax rate success story, because tax revenues in Russia increased by 25 percent in one year, while the economy grew by 5 percent; many transition economies, including Ukraine, adopted flat tax rates shortly after that.

At the same time, it was difficult to define what exactly caused the revenue increase — reduced tax evasion or higher household productivity (more work hours, more effort, etc.) after the taxes became lower. Analysing household survey data, the researchers point at a considerable narrowing of the gap between the declared and the actual consumption for households that experienced lowering of the marginal tax rates (for each subsequent unit of income), from 9 to 12 percent more than for other households. In general, according to the researchers' calculations, tax revenues increased by 10-11 percent due to reduced tax evasion,

and by 0 to 4 percent due to increased productivity. Higher tax revenues in Ukraine are linked to voluntary income reporting and reduced tax evasion more than to increased productivity. High tax evasion levels are the reason why proportional tax rates became popular among post-Soviet countries in particular.

Therefore, progressive taxation will have the desired effect only if governments are capable of enforcing the actual payment of taxes and fight tax evasion effectively. On the other hand, progressive taxation can be introduced not only with a higher income tax, but also using other taxes which are more difficult to evade. These can include, for example, taxes on luxury items or corporate profit taxes.

To sum up, what do these results mean for the current Ukrainian situation? They mean that increasing tax progressivity in and of itself will not provide higher tax revenues and higher quality of public goods for countries like Ukraine. There are a number of reasons for this: the undeveloped system of tax administration; widespread tax evasion schemes with further outflow of money to offshore zones or into the shadow economy; and the interest of the ruling class in preserving such schemes. That is why the introduction of progressive taxation, whether in the limited version proposed by the current government or in the forms proposed by other political parties, has to be accompanied by systemic changes in fiscal policies, as well as radical restructuring of the current economic system, so that Ukraine's resources do not only serve the small groups of oligarchs, but also enable the development of the society as a whole.

To make our analysis complete, after characterising the Ukrainian tax system, we should move on to the study of that part of the wealth produced in Ukraine which escapes taxation. That is why, in the next chapter, we will examine the phenomenon of capital outflow from Ukraine to offshore zones; if this problem is not solved, it is impossible to ensure the country's development.

## **CHAPTER 3**

# **FIGHTING THE OUTFLOW OF CAPITAL FROM UKRAINE**

A country's development has to be based on the efficient use of the available resources and on creating conditions for expanding those resources. In order to do this, the economic policies must aim to fairly distribute the goods created in the country, rather than to let them be used by a small group of people. One of the effective instruments to achieve it can be a successful fight against the outflow of capital to offshore zones, which has become rampant in Ukraine.

Many contemporary economists often claim that capitalism, whose cornerstone is profit maximization, has reached its final stage of development in the form of globalization. One integral part of this process of integration of different countries' economies into one unified and liberalized system is the existence of offshore finance and trade centers.

According to the estimates by OxFam International (a confederation that deals with poverty and poverty-related injustice worldwide), in may 2013, about \$18.5 trillion were hidden by oligarchs in tax havens all over the world. According to the OxFam calculations, the budgets of all the countries of the world lost more than \$156 billion, which is twice as much as is needed to end poverty [OXFAM 2013]. In Ukraine, the amount of potentially lost taxes is much smaller, but they could also be enough to solve the socio-economic problems of the country.

Below, we will study the origins of offshore schemes in Ukraine, calculate the socio-economic consequences of their use, and try to develop recommendations about how to minimize them.

### 3.1 The origins of the offshore model of Ukrainian economy

According to the expert evaluation, Ukraine is one of the top ten countries with the most massive outflow of capital abroad. As the Tax Justice Network estimated, in 1991-2012 only, this sum was \$167 billion, which is comparable to the annual GDP of Ukraine [Бєдров, 2013]. Globally, offshores contain sums that are equivalent to 30-45 percent of the global GDP.

In the first section of the chapter dedicated to this issue, we will investigate the historical origins of the “offshore” model of Ukrainian economy. We will trace the dynamics of the reorientation of Ukrainian producers to global markets and the proliferation of the country’s financial-industrial groups based on this model; we will also outline the scope of the total losses of Ukrainian economy due to the use of such “optimization” schemes.

We will start with a brief review of terminology. In the most general sense, offshores are the financial centers which are located in the territories that offer preferential treatment to foreign companies. According to the OECD guidelines [Harmful tax cooperation], these centers are characterized by:

- zero or minimal corporate tax rate;
- inefficient exchange of information about contractors with other states (for example, between tax authorities);
- opaque legislative, legal and administrative procedures;
- lack of requirements to actually carry out economic activities (allows to avoid doing anything but the operations related to the management of the offshored capital).

Depending on the extent to which these financial centers have the above characteristics, they are placed at a certain point in the range from classic offshores with zero tax rates and maximum secrecy in information handling (such as the British Virgin Islands or Seychelles), to “countries with favorable taxation” (such as the contemporary Cyprus or Ireland).

Another method of tax minimization, which is less discussed in the media, is the use of onshores, which, in turn, are closely linked with offshores. Onshore countries include “high-tax” countries that offer preferential treatment only for some activities (such as asset management) and are useful for constructing agent schemes or registering holding structures. They even include such large and respectable partners of Ukraine as the UK, Switzerland and the Netherlands (every fifth dollar of foreign investment came to Ukraine from these countries). Such activities are less profitable in terms of saving on taxes, but they are more reliable if you need to prove the “respectability” of the owners or to legalize your capital, which was sent out of your home country and accumulated in

offshore havens. Indeed, you can rarely hear complaints about capital brought out to or from Switzerland (in contrast to Cyprus), although the origins of such assets are often also dubious. Anyway, such complaints would be hopeless, since Switzerland is the world leader in the financial secrecy index [Financial Secrecy Index, 2015].

Historically speaking, offshores emerged in response to the desire to escape the regulations of the authorities of specific countries, to reduce the fraction of the added value that gets redistributed through national budgets through taxation, and thus to maximize the profits which remained in the hands of the owners. The problem existed even in the Ancient World, when Romans in the Mediterranean area competed for trade routes through their islands by minimizing taxes on those islands [Гамбаров, 2013]. However, offshores really started to flourish in the international economy in the second half of the 20th century. In this period, financial capital, thanks to the accelerated development of communication technologies, acquired the ability to travel between different parts of the world very quickly in search for profitability. The revolution in information technology allowed offshore centers to manage assets and function at a distance. However, let us focus on Ukrainian realities.

### **The beginning of offshore proliferation and establishment of financial and industrial groups**

The restoration of the market brought about the revival of the market logic in economic activities. That is why the real offshores came to Ukraine after 1991 as a response to the desire of the new market players to minimize their expenses within the country. But the first legal basis for offshore schemes was laid in the last years of the USSR. For example, the Double Taxation Treaty with Cyprus was signed back in 1982. At that time, it was necessary to sign this treaty to begin foreign trade between the Socialist Bloc and the West; but quite soon, after Ukraine declared independence, Cyprus became one of the central channels for moving money out of the country. The negotiations about changing the Soviet treaty, promoted as part of the fight against capital outflow, started in 1997, but the new Convention about Avoiding Double Taxation with Cyprus was only signed in 2012 and implemented in 2014. The delay can only be explained by the mutual benefits that the highest authorities of both sides received from these relations. It must be noted that the conditions for offshore transactions with Cyprus have now become worse for post-Soviet entrepreneurs: the increase of the profit tax rate and the harmonization of tax administration were among the conditions for Cyprus to join the EU.

Since the early 1990s, many companies have emerged in Ukraine to provide the services of registering and accompanying capital in tax havens, such as the offshore Cyprus. The mechanism has not changed in any significant way in the

twenty years that have passed, and the price of such services is relatively low, within the range of a couple of thousand dollars per year, including service. So even a middle-sized company owner can afford to keep their money in offshore zones, saving much greater amounts thanks to undertaxation.

The establishment of schemes for moving capital out of the country is closely linked to the change of the economic system, the transition from state planning to market methods and privatization, which created the material preconditions for the new system. In 1991, Ukraine had the highest centralization and concentration of industrial production, the major part of which produced products which were competitive in the global market [Падалка, 2012]. For example, many machine and instrument making factories in Ukraine in the 1990s disproved the claim that they were “backward” by exporting more than a third of their produce to neighboring and other countries (the Kramatorsk Heavy Machine Building Factory, the Odessa Radial Drilling Machine Factory, the Poltava Artificial Diamond Factory, etc.). Ukraine also inherited a powerful space potential, which is among the few sectors that still preserve some of the knowledge-intensive production. 140 facilities in this sector employed 200,000 workers who produced a third of the output of the whole space sector of the Soviet Union. A total of 40,000 mid-sized and 6,000 large state-run facilities in Ukraine were estimated to be worth hundreds of billions of dollars. Their de-socialization marked the beginning of the emergence of Ukrainian economic model and the establishment of schemes for moving capitals created in Ukraine out of the country.

### **The special characteristics of capital accumulation during the 1990s privatization**

In 1992, a number of laws were passed that launched the so-called “small privatization,” that is, the privatization of small companies (with up to 100 employees, small sales and not enough capital to create stock companies). At the beginning, there were some attempts by worker collectives to privatize the enterprises that were rented before, especially the “closed joint-stock companies.” However, at the following stages of privatization, these attempts were supplanted by other schemes, which we can now call fraudulent. In 1993, the process of de-socializing industrial giants and strategic facilities began. At the same time, the Decree “On liberalization of external economic activities” was issued, which allowed to create incentives for exporting Ukrainian products and tried to control foreign trade and bring it out of the shadow.

The stalling process of privatization, the danger to lose any control over chaotic economic processes forced the government to pause privatization with a moratorium from July 1994 until March 3, 1995. On that day, “The list of companies not subject to privatization” was approved (including energy and fuel,

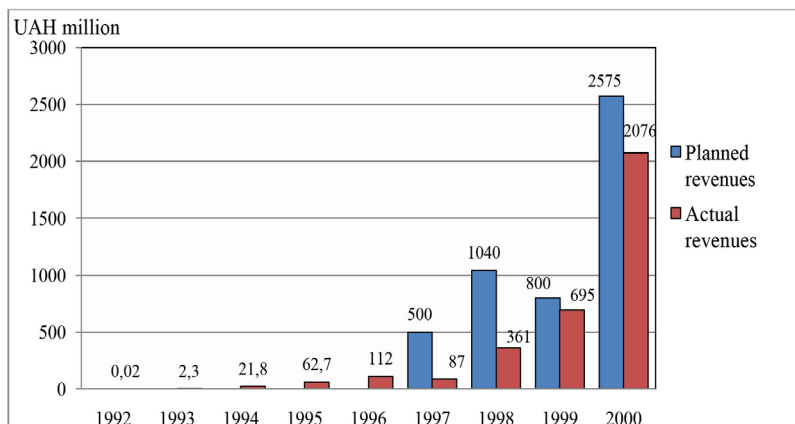


shipbuilding, petroleum processing and other facilities), and so another round of “mass privatization” started. Ukrainians remember this period by privatization certificates [Завершальний етап приватизації в Україні]; this option aimed to legitimize the process, since, in theory, every citizen became an owner of the same number of certificates that provided him with the right to own a fraction of public property. However, in fact, due to the lack of experience with markets and mass poverty, their price was artificially devalued and then sold by financial speculators on the black market. As a result, by the turn of the millennium, 30 million of citizens had lost their property rights, and the new actual owners were now former directors of public companies, speculators, and bureaucratic elites, who concentrated 47 percent of big and middle-sized companies just by buying those certificates. In 1999, the last stage begins, called “the big privatization,” that is, the selling of major public companies, but this time at auctions involving “strategic investors” with certain social and investment guarantees.

The attempts to privatize the agrarian sector were confronted by mass social resistance. As a result, a moratorium on free sales of land resources was introduced, and it is still valid today. In the 1990s, collective farms still existed, but in 1996 they were gradually divided into land plots for the members of their collectives. However, at the time when whole plant and animal farming complexes were ruined, and alternative capital investment was missing, this led to major adverse consequences for the economy and to further degradation of rural areas, up to the replacement of monetary relations by barter and natural exchange of the products of one’s labor in order to survive. In 2000, the situation starts to improve after mass contracting was allowed for agricultural companies producing industrial crops (sunflower, corn, rapeseed, soya). It attracted domestic and foreign investment into agriculture and laid the basis for the agricultural recovery in the 2000s. However, the recovery was not unambiguous, because it led to the degradation of agricultural product market (and the influx of imported goods), to irrational use of land resources. The newly established agricultural corporations soon also joined the offshore trade schemes and, moreover, they manage to pay very few taxes to the government budget [Кравчук О., Одосій О. 2015].

It must be noted that this accelerated market transformation was a response to a direct demand from western creditors, detailed in the numerous memorandums signed with the IMF and other organizations that started to provide loans to Ukrainian government in that period [Кравчук, 2015]. Even the infrastructure for privatization was funded by international organizations (USAID funded and supported the privatization bills, created networks of privatization auctions in every region). This indicates that western “partners” were interested and involved in the emergence of contemporary peripheral economic model in Ukraine. It is telling that today, in 2015, the USAID sponsors the technical side of the sales of energy companies which are still publicly owned [USAID, 2015].

In contrast to, say, the neighboring Poland, where privatization processes were based on international market assessments of property and transparency of procedures (although their efficiency after privatization is questionable), assets in Ukraine were sold at minimum prices and hardly provided anything for the country's budget (Fig. 3.1).



*Figure 3.1. The planned and the actual amounts of revenues received by Ukrainian budget from the privatization of public assets in 1992-2000 [based on the data by the Public Property Fund of Ukraine]*

Therefore, by the late 1990s, the economic transformation created large financial and industrial groups (FIGs) that acquired control over the most profitable industries: electricity production, metallurgy, chemical industry, etc.

The Ukrainian situation was characterized by the prevalence of financial/banking capital, which formed earlier than industrial capital. Private banks claimed and often obtained the right to privatize industrial giants (that was what happened to Aton, the Energy Systems of Ukraine). Later, these financial-industrial groups would start to fight for power in the government and distribute government bodies among themselves using resources in favor of various FIGs.

The issue of privatization of the rest of strategic companies (Odessa Port Factory, energy generating and distributing facilities, Kryvorizhstal, Azovstal) will become one of the key reasons of a number of political crises in the country. There is even a special law "On financial and industrial groups," aimed to lobby their interests, but also involving greater control over them. However, it was cancelled in 2005 (only one financial and industrial group called Titan was registered, although a couple of financial and industrial groups de facto controlled and still control whole economic sectors).

However, despite the explosive emergence of the new class of owners on the ruins of the old industry, the processes of offshorization had not yet reached

alarming proportions by the end of the 1990s. It is proven by the data on investment into offshore zones (Fig. 3.2).

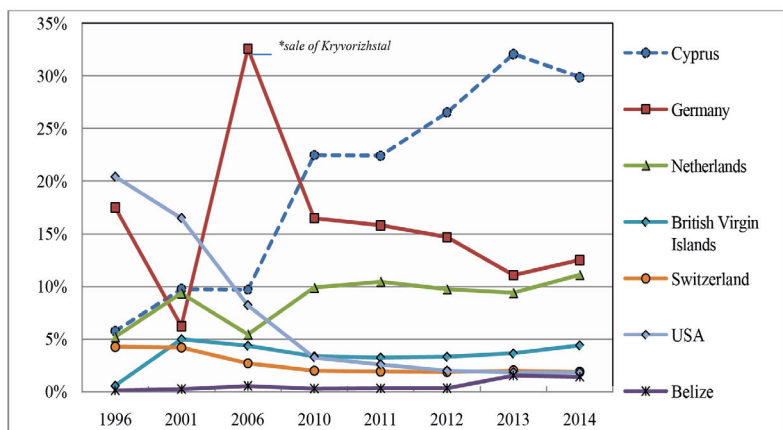


Figure 3.2. The dynamics of foreign direct investment from various countries into Ukraine in 1996-2014, cumulative total [based on the data by the State Statistics Service]

As the figure demonstrates, offshore (primarily Cyprus) started to rapidly become more important after 2006. In the case of the key offshore partner of Ukraine, Cyprus, the fraction of investment there increased to 22 percent in 2006-10, in the years when Ukrainian companies increased their exports.

But, of course, oligarchic business, which grew up closely related to and protected by the state, looked for other ways. How could they hide their superprofits from exploiting the assets they bought for garbage prices, and the workers that were forced to work for miniscule compensation? The ways to do that were soon discovered.

### Free economic zones as an alternative means for hiding profits

In 1998, free economic zones (FEZs) and priority development areas (PDAs) started to become widespread in Ukraine. In the same year, a number of laws were passed to provide broad tax preferences. Companies located in these zones were relieved of duty fees for their imports, and were relieved of or had preferences in paying income taxes and the VAT, could choose not to sell their foreign currency revenues from exports, excise fees, land fees, and so on.

These zones were created on the national level and were justified by higher goals of attracting investment into depressed regions, developing the productive forces of the country and introducing high-tech manufacturing. In the end, 12 free economic zones and 464 priority development areas were created. These zones

covered more than 20 percent of the country's territory (10.5 percent under the FEZs, and 10.3 percent under the PDAs). Most investment into these zones was imported into Ukraine from offshores. For example, 41 percent of investment into Donetsk FEZ and PDA were drawn from Cyprus, and another 6.4 percent from offshore Virgin Islands [Національний інститут стратегічних досліджень, 2007].

This meant that the Ukrainian capitals previously sent out to offshores were brought back without any import duties or taxes, which is one of the ways to minimize taxation. Even though some of these projects actually aimed to create new jobs and modernize industries (the construction of the petroleum processing plant in Mariupol funded by investment from Cyprus, the modernization of metal processing complex Isteel funded by investment from Virgin Islands, etc.), this kind of investment in the situation when any balanced government policy was lacking usually happened in low-tech processing industries.

As a result, Ukrainian economy was fixed in the position of an exporter of raw materials, while other options for social development and social security lacked funding. Therefore, in practice, these companies served as “tax-free openings” and allowed to abuse Ukrainian resources for profit. The data of our analysis also prove this (Fig. 3.3).

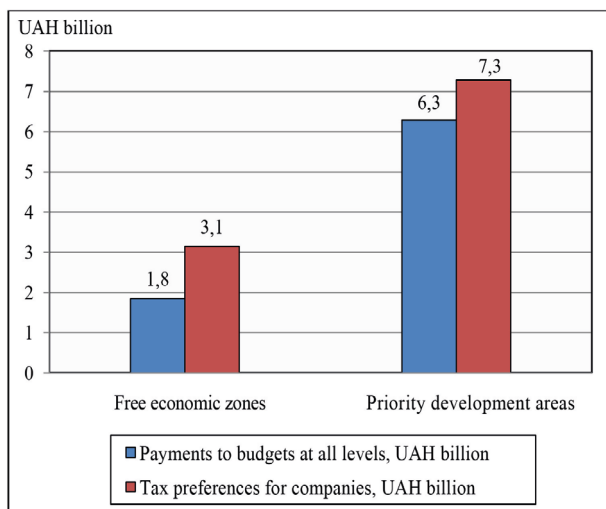


Figure 3.3. The relation of tax preferences provided to FEZs and PDAs in Ukraine to tax revenues, as of 2007 [based on the data from NISR]

The figure demonstrates that free economic zones and priority development areas received a total of UAH 10.43 billion from tax preferences, and provided only UAH 8.14 billion to the government budget. The index of budget efficiency

for FEZs was UAH 0.59 per one hryvnia of benefits; PDAs fared a little better, UAH 0.86 per one hryvnia; together, they provided UAH 0.78 per each hryvnia of tax benefits. For example, one hryvnia of tax benefits for the Donetsk FEZ brought the government only 0.06 of a hryvnia in tax revenue. The growth rate of the output of these zones and areas was only slightly higher than the average growth rate in their regions in 2000-6 (145.5 percent vs. 131.3 percent). Major violations of the procedures of quality testing and the national standards have been found in these zones. The fraction of investment into free economic zones, despite the expectations, was only 10 percent of all foreign investment into the country.

Many companies limited their activities to the duty free trade of imported goods, which means that they existed only to avoid payments to the government budget. That is why in 2005 the conditions of operation of FEZs and PDAs were radically changed, and benefits and preferences for such companies were limited.

In 2005, tax evasion via offshore zones started to gather momentum. Offshore zones are just another type of free economic zones, but they are located in other countries.

### **Entrenchment of the offshore model of big business in Ukraine**

As the Table 3.1 demonstrates, since 2007, major capital investments by Ukrainian companies have been recorded in Cyprus, which has accumulated more than 90% of the total investment from Ukraine.

**Table 3.1 Direct investment from Ukraine  
into particular economies, \$ million (as of the end of the period)**

Country/Years	2006	2007	2008	2009	2010	2011	2012	2013	2014	3rd quarter 2015
Total	220	6 196	6 199	6 223	6 226	6 868	6 900	6 483	6 352	6 232
Russian Federation	103	149	100	166	166	190	237	293	197	135
British Virgin Islands	-	11	14	21	26	26	26	26	26	52
Cyprus	2	5 826	5 826	5 779	5 779	6 343	6 342	5 811	5 819	5 818
Direct investment from Cyprus to Ukraine (for information)	3 012	5 942	7 683	8 593	9 915	12 646	17 275	19 036	13 711	12 188
Other countries	85	211	258	259	90	63	56	97	311	228

*[according to the State Statistics Service]*

If we go back to Figure 3.2, we will see that in the same period the capital that flowed out to Cyprus was partially brought back to Ukraine. The fifth line in the Table 3.1 demonstrates that investment from Cyprus was more than two times higher than the recorded capital transferred from Ukraine to that country. The probable reasons are that offshore flows are redistributed between many zones, and that some money was sent out of Ukraine not as investment but as exports for lowered prices and as imported fictitious services (royalties, dividends, etc.), which are some of the most popular schemes for pumping resources out of the country. We will discuss the analysis of these phenomena in the next sections of this book.

The table also demonstrates a downward trend in foreign investment from Ukraine: \$6.2 billion of assets by the end of September 2015, which is 10 percent less than the sum in 2012. The trend of foreign investment into Ukraine is even more typical; it has turned into a true capital flight. Thus, by the end of the 3rd quarter of 2015, foreign direct investment into Ukraine shrunk to \$43.95 billion, which is a quarter less than the \$58.16 billion invested into Ukrainian companies in 2013 [Держкомстат]. Of course, what else we can expect in an unstable economic situation and during a military conflict.

It is reasonable to analyse the structure of investment into Ukrainian economy and compare it to the offshores (Cyprus and the British Virgin Islands, which invested \$14 billion, 32 percent of all foreign investment into Ukraine) and other countries (Fig. 3.4-3.5).

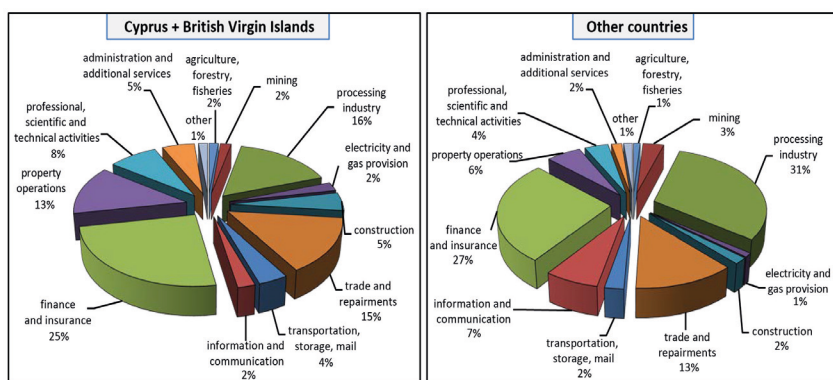


Figure 3.2. The dynamics of foreign direct investment from various countries into Ukraine in 1996-2014, cumulative total [based on the data by the State Statistics Service]

The analysis demonstrates considerable differences in investment:

- Offshores invest three times less into the processing industry, and even two times less into the mining industry, than the average for the rest of investor countries.

- The fraction of investment into professional, technical and scientific activities (\$1.1 billion) from offshores is twice as big as from other countries, which can indicate abuse of fictitious services.
- Construction in Ukraine is mostly funded by offshore investment (the fraction of this kind of investment is almost three times higher).
- Interestingly, almost a half, 48 percent, of investment from the Virgin Islands (\$883 billion) is investment into trade and repairments.

Ukraine's trade, which we do not cover in this book for the reasons of space, has been going through offshore centers and countries with favorable tax treatment, at least until recently. It is also confirmed by the State Fiscal Service. According to the Service, about 52 percent of exports from Ukraine went through intermediaries, and 13.8 percent of those through offshore zones. This means that a major part of surplus value produced by Ukrainian companies flows out of Ukraine, that is, escapes its tax authorities, and then is re-sold to the countries that actually consume these products [Собуцький, 2012]. For example, in metal processing industry, more than 75 percent (UAH 64.7 billion) of operations are carried out through intermediaries. The situation in the grain market is even more threatening: according to the tax authorities, more than 98 percent of exports in this sphere use intermediary companies which are often connected to each other (see the analysis for specific industries below in Sections 3.2 and 3.3).

### **Contemporary use of offshores by Ukrainian companies**

Since 2014, Ukrainian exports and imports have been actively diverting from traditional offshores. For example, the total value of all goods exported to Cyprus in this period is less than \$50 million, which is five times less than in the same period of 2014; the trade through Belize and British Virgin Islands has practically come to a halt (while as recently as in 2013, \$175 and \$385 million worth of goods, respectively, were exported to these countries). The trend in the service sector is similar, albeit less abrupt; for the first 9 months of 2015, the exports of services to Cyprus and the British Virgin Islands fell by 43 percent, and the imports from these countries fell by 36.4 percent. All of this happens as the volumes of Ukrainian foreign trade are shrinking rapidly. By the end of the 3rd quarter of 2015, the total export of goods from Ukraine fell by 32.7 percent (to \$28.1 billion), and the total import by 33.6 percent (to \$26.4 billion). The export and import of services fell by 20 percent in the first nine months of 2015. Even though this is not the key factor of reduced offshore trade, it undoubtedly impacted the use of offshore zones as intermediaries. In any case, without a systematic solution, the problem of capital outflow will remain a threat to the country's further development.

Ukrainian government plans to fill its budget by denouncing the Treaty with Cyprus [YHIAH, 2014] (actually, this is one of the IMF demands); however, after

the adoption of the new Convention, which is more strict about tax minimization, and after the recent bank crisis in this country, Ukrainian capital is looking for safer and more profitable tax havens anyway. This logically entails the question, Are offshores an invincible evil, and can the struggle against them be effective?

### **Fighting offshores: international and Ukrainian experience**

First of all, we must mention that we believe that the problem of capital hiding is impossible to solve without replacing the whole system of commodity and money economy with a more progressive method of distributing resources. However, even today, even within the contemporary market system, the problem can be considerably reduced, if not eradicated.

At the turn of the 1980s and the 1990s, when the process of unchecked capital accumulation was rampant in Ukraine, developed countries started to fight against offshores. In 1989, the Financial Action Task Force (FATF) was created, which focuses on capital outflow to offshore havens. This organization, which operates on the international level, successfully demanded that Ukraine signed a law on implementing the famous 40 recommendations to fight money laundering [Financial Action Task Force, Закон України «Про запобігання та протидію легалізації доходів»]. In 1998, the abovementioned Report by the most developed OECD countries was published; the Report brought the fight against offshores to a new level. Today, much attention is paid to implementing international agreements about tax information exchange. In 2010, the USA signed the unilateral Foreign Account Tax Compliance Act [FATCA], which introduced financial sanctions for banks that refuse to reveal information about the accounts of US residents. In 2014, OECD countries agreed to a similar exchange of tax information since 2017, which is promoted as an opportunity to fight illegal capital outflow from these countries [OECD, 2014]. It should be noted that less developed countries have to comply with fewer demands of this kind. The reason might be that the key offshore centers are created on the territories directly or indirectly controlled by these countries, and, in addition to loans, they are one of the instruments of global resource redistribution. As a result, offshores contain 17-20 percent of capital from developed countries, which is two times less than from developing countries (about 40 percent).

As for Ukraine, it has also passed some legislation since 2000 that introduced serious responsibility and control over foreign trade. In particular, currency control was strengthened, the right of offshore companies to privatize Ukrainian companies was limited, the rules for fighting unfair pricing of imported goods were detailed, and fines for capital repatriation into offshores were introduced, etc. [Гаркуша В.]. However, since stopping these flows of capital would endanger a whole class of beneficiaries who directly influence political processes, these



attempts were negated, or other, more elegant methods of surpassing the law were invented. Even the story of Cyprus, which was included into and excluded from the list of offshore zones a couple of times, proves this point. In 2015, Ukrainian government expanded the list of countries (territories) under control to include 75 items [Розпорядження КМУ від 14 травня 2015]. There were attempts to implement the Law on Transfer Pricing, which is strongly resisted by major importers and exporters and has not started to work properly (see Section 3.4).

Thus, as we can see, the issue of capital outflow from Ukrainian economy is one of the most urgent issues to resolve in order to provide the country with growth opportunities. This topic has to be investigated in detail, and the appropriate mechanisms of fighting the resource outflow should be implemented. In the next sections, we will try to assess the scale of capital outflow from Ukraine, list the main schemes by which it happens, and to evaluate the legal possibilities for stopping this process.

## **3.2 Calculating the total losses caused by the capital outflow from Ukraine in 2012-15**

Nearly all major companies use offshores to optimize their expenses, regardless of the country they work in. In particular, according to the Offshore Shell Games 2015 study, 500 biggest American companies keep about \$2.1 trillion in offshores to reduce the taxes they pay; the US budget loses an estimated sum of \$620 billion due to this practice [Економічна правда, 28.10.2015].

This phenomenon is impossible to eradicate completely, but it can be taken under control, and its impact on the economy can be minimized using certain mechanisms. These mechanisms include tax legislation about the control over transfer pricing, customs legislation, laws on money laundering, etc. Some steps in this direction have already been taken by passing the law on transfer pricing. However, its practical implementation faces many problems.

According to Taras Kuzmych, the transfer pricing law that is in effect in Ukraine today is its fourth version; however, it still has many blind spots. For example, the rules for calculating profitability, grouping of operations, or price corrections are not clearly defined. There is no detailed manual on how to apply the transfer pricing method to financial transactions, e.g. to loans and deposits, currency exchange, stocks, official papers, etc. There still exist many opportunities to avoid the transfer pricing control. One of them is to sell your products to the end user via an intermediary who is registered in a respectable country which is not listed in the Cabinet of Ministers' list of offshores, such as Germany or the UK [Кузьмич, 205]. These countries also offer some opportunities for tax optimization. The list of offshores was approved by the Decree No. 143-r by the Cabinet of

Ministers on February 23, 2011. However, it contains only 36 countries, including such exotic countries as Antigua and Barbuda, the British Virgin Islands, Vanuatu, the Isle of Man and others. Even though this Decree is still valid today, it is hardly ever used in tax legislation.

A much larger chunk of trade transactions is made of partial offshores which offer preferential tax treatment and require financial reporting, in particular the UK, Cyprus and Hong Kong. Because of this, in 2013, according to the Tax Code, the Cabinet of Ministers issued the official list of countries with preferential tax treatment (the decrees No. 1042-r of December 25, 2013; No. 449-r of May 14, 2015; and No. 977-r of June 16, 2015), which includes those countries (or territories) where the general corporate tax is 5 or more percentage points lower than in Ukraine, as well as countries which have not signed information exchange agreements with Ukraine. On January 1, 2015, there were 73 such countries, including 29 countries which are officially recognized as offshores in Ukraine. If Ukrainian companies trade with these countries, additional export control measures are used.

These are not the only countries that are used by companies who want to minimize expenses and maximize profits. It is important to control trade transactions with countries which have signed double taxation treaties with Ukraine. Some of them have higher corporate tax rates than Ukraine, but under certain circumstances they can be considerably reduced. These countries can also offer much more attractive conditions for taxation of capital, and specific tax rates and the methods of payment are written in agreements, so the regulations of the Tax Code do not apply to them. On January 1, 2015, there were 71 such countries, 14 of which were also on the preferential taxation list.

The most popular methods of using countries with preferential tax treatment are:

- selling goods for artificially reduced prices;
- paying for consulting services and copyright fees;
- buying shares from non-residents.

These schemes are often on the edge of legality or just plainly illegal.

For example, according to the typology of illegal income laundering, provided by the State Financial Monitoring Service, the spheres that carry the highest risk of money laundering are foreign trade, credit and finance, energy sector, and metal and mineral market [Типології легалізації (відмивання) доходів]. The leader among them is foreign trade, particularly trade in high-liquidity goods, such as non-ferrous metals, chemicals, specific agricultural products, etc. According to the State Financial Monitoring Service, the following methods are used to organize capital outflows:

- artificially reduced export prices;
- artificially increased import prices;
- fake import contracts, fake loan contracts, etc.

In addition, according to our study research, some of the most popular mechanisms used to achieve illegal goals via conversion and sending money out of the country include:

- selling stocks issued in Ukraine by non-resident individuals to residents;
- paying for promissory notes by Ukrainian issuers which are submitted for payment by non-residents;
- paying dividends on investment by non-resident companies which de facto belong to Ukrainian citizens.

We will study the statistical data on exports and imports of goods and services, in order to determine the extent to which these schemes are used by Ukrainian economic agents.

## Export of goods

Ukrainian exporters do not shy away from opportunities to reduce their tax burden, and use countries with lower tax rates as intermediaries for further sales. According to the State Statistics Service, in 2014, 43 percent of goods exported from Ukraine went through 8 countries which consume only 2.41 percent of Ukrainian goods all together (Table 3.2).

**Table 3.2 Key intermediary countries for Ukrainian exports, \$ million**

Countries	Export of goods in 2014		Ratio of transit goods to consumed goods (≤50%), %
	destination country	intermediary country	
Export	53,902	53,846	100
British Virgin Islands	110.71	267.61	41.0
Cyprus	283.73	1,537.41	18.5
Lebanon	272.32	950.0	28.7
Luxembourg	16.18	375.23	4.3
Marshall Islands	2.94	30.29	9.7
United Arab Emirates	394.94	2,568.11	15.4
Panama	31.53	311.54	10.1
Switzerland	187.43	17,096.60	1.1
Total:	1,299.78	23,136.79	
% of exported goods	2.41	42.97	

*[Calculation based on the data by the State Statistics Service]*

**Table 3.3 Key destination countries  
for goods exported from Ukraine, \$ million**

Countries	Export		Ratio of transit goods to consumed goods	Key export goods		
	Destination country	Intermediary country		Code	Value	Fraction, %
Total (all countries)	53,902	53,846	%			
Indonesia	168.25	0.84	19,938	grains	68.93	41.0
				ferrous metals	80.97	48.1
Kenya	126.43	0.11	110,807	grains	79.75	63.1
				ferrous metals	30.93	24.5
				fertilizers	14.15	11.2
Libya	219.06	0.49	44,880	grains	199.68	91.2
				ferrous metals	16.24	7.4
Morocco	294.77	0.30	99,417	grains	123.64	41.9
				food industry waste	54.88	18.6
				fossil fuels; oil and petroleum products	45.33	15.4
Mexico	152.46	1.80	8,493	ferrous metals	107.29	70.4
				fertilizers	27.55	18.1
Nigeria	314.94	4.45	7,073	ferrous metals	220.98	70.2
				fertilizers	41.28	13.1
Syrian Arab Republic	162.99	2.13	7,649	grains	70.3	43.1
				ferrous metals	34.08	20.9
				vegetable and animal fats and oils	25.24	15.5
Tunisia	329.31	3.45	9,548	grains	212.18	64.4
				ferrous metals	87.45	26.6
Total (top destinations):	1,768.21	13.57				

*[Calculation based on the data by the State Statistics Service]*

The corporate tax rates in all these countries are 5 or more percentage points lower than in Ukraine, and when Ukrainian companies have transactions with entities connected to them and registered in these countries, and when they sell goods through non-resident commissioners in these countries, such transactions are controlled. However, the rule about connectedness with the non-resident is quite easy to bypass by registering the company under the name of a person or

entity who, according to the registration papers, is not connected to the Ukrainian exporter.

Therefore, given the lack of balance between the consumption in and the trade with these countries, we can conclude that, by selling goods via connected non-residents or commissioners, Ukrainian exporters concentrate profits outside Ukraine. The goods that, on paper, are transported through these countries, do not in fact even cross their borders, but are transported directly to the destination country. For example, the countries listed in Table 3.3 receive only 0.03 percent of the goods in monetary form according to direct agreements, while in fact they consume more than a hundred times more, namely 3.3 percent of Ukrainian exports.

This export scheme is used most often for grains, ferrous metals, fertilizers, oil and petroleum products, — that is, raw materials. Thus, according to our analysis of exports, the use of countries with preferential tax treatment as trading partners that accumulate the bulk of profits is a popular practice among Ukrainian exporters.

Let us determine the scale of the use of low-tax territories for Ukrainian exports of goods. In total, Ukraine exports about 80 groups of goods that are defined by the Categorization of Foreign Trade. However, the volumes of export of many kinds of goods are insignificant. That is why we will focus on the analysis of the key 15 groups of export goods (Table 3.4) which comprised 81 percent of all Ukrainian exports in 2012-14.

**Table 3.4 Exported amounts of the main categories of goods, \$ million**

Goods	2012		2013		2014	
	67,780	%	62,306	%	53,902	%
grains	6,970	10.3	6,352	10.2	6,544	12.1
seeds and fruit of oil plants	1,752	2.6	2,045	3.3	1,688	3.1
animal or vegetable fats and oils	4,185	6.2	3,497	5.6	3,822	7.1
food industry waste	877	1.3	921	1.5	1,108	2.1
ore, slag and ash	3,198	4.7	3,797	6.1	3,472	6.4
fossil fuels; oil and petroleum products	3,595	5.3	2,689	4.3	2,012	3.7
ferrous metals	15,322	22.6	14,315	23.0	12,905	23.9
ferrous metal products	2,802	4.1	2,557	4.1	1,691	3.1

See the beginning of the table on the previous page

Goods	2012		2013		2014	
	67,780	%	62,306	%	53,902	%
non-organic chemicals	1,586	2.3	1,645	2.6	1,178	2.2
fertilizers	1,789	2.6	1,171	1.9	694	1.3
wood and wooden products	1,059	1.6	1,143	1.8	1,262	2.3
paper and cardboard	1,006	1.5	1,080	1.7	851	1.6
nuclear reactors, boilers, machines	3,700	5.5	3,732	6.0	2,977	5.5
electrical machines	3,172	4.7	3,094	5.0	2,680	5.0
railway locomotives	4,092	6.0	2,449	3.9	839	1.6
Total:	55,106	81.3	50,487	81.0	43,726	81.1

*[Calculations based on the data by the State Statistics Service]*

The selection included the groups of goods that were exported for more than \$630 million, which is more than 1 percent of the annual exports in 2012-14. As we can see, most of these goods are natural resources or goods on a low processing stage, such as metal processing products, agricultural products and chemicals.

The total fraction of these goods in Ukrainian exports is 67.5 percent. Of the 15 groups, such products with high surplus value as machines and instruments make up only 12 percent of exports, which indicates that raw materials dominate the country's exports.

The key intermediary countries for the exports of these groups of goods are listed in Table 3.5.

**Table 3.5 The amount of exports  
of the main categories of goods by country, \$ million**

Countries	Trade amounts						Consumption	
	2012	2013	2014	Jan-Sep 2015	Total 2012-15*	% in exports	price	% consumption to trade
Austria	630	432	445	291	1,797	1.0	268	14.9
Belarus	1,225	988	710	215	3,137	1.8	3,135	99.9
Great Britain	2,809	1,989	2,305	1,913	9,016	5.2	356	4.0

See the beginning of the table on the previous page

Countries	Trade amounts						Consumption	
	2012	2013	2014	Jan-Sep 2015	Total 2012-15*	% in exports	price	% consumption to trade
Hungary	780	584	1,021	407	2,793	1.6	2,590	92.7
British Virgin Islands	4,680	2,549	258	477	7,965	4.6	807	10.1
Germany	1,797	1,731	1,469	627	5,624	3.2	1,632	29.0
Hong Kong	44	815	850	466	2,175	1.3	19	0.9
Kazakhstan	1,526	957	409	190	3,082	1.8	2,868	93.0
Cyprus	1,113	1,052	1,260	658	4,083	2.4	528	12.9
Lebanon	854	802	943	509	3,107	1.8	747	24.0
Netherlands	1,004	1,154	1,053	374	3,584	2.1	660	18.4
UAE	2,957	2,658	2,491	1,602	9,710	5.6	265	2.7
Poland	816	1,043	1,519	780	4,159	2.4	2,985	71.8
Russian Federation	11,868	10,384	6,336	2,236	30,824	17.8	27,911	90.6
Switzerland	16,262	16,991	16,611	8,367	58,231	33.6	218	0.4
Total exports of the main groups of goods:	55,530	51,120	43,737	22 838	173 224	86.2	44 991	26.0

*[Calculations based on the data by the State Statistics Service and the State Fiscal Service]*

86 percent of Ukrainian exports are sold to these countries, but they consume only 26 percent of them. Therefore, 60 percent of goods transit through these countries, and the profits from selling them are accumulated in these transit countries.

Let us pick countries with low percentage of consumption of the goods they receive and with small taxes, particularly the countries where corporate taxes are 5 or more percentage points lower than in Ukraine. These countries are the British Virgin Islands, Cyprus, the United Arab Emirates, Switzerland and Lebanon; of all these, only the British Virgin Islands do not have a double taxation agreement with Ukraine.

In order to determine the scope of profits that stay in these countries, let us analyze the prices for specific goods if they are sold directly to the consumer country and if they are sold to an intermediary country (Table 3.6).

**Table 3.6 Export prices when goods are sold directly  
to the consumer country and to an intermediary country,  
\$ thousands [according to the data by the State Statistics Service]**

Goods	Period	Destination	Intermediary	Weight, tons	Value	Price	Comparison of transit and final prices, %
Grains	2012	Great Britain	Great Britain	48,137	14,159	0.29	100
		Portugal	Great Britain	73,917	16,668	0.23	76.66
		Japan		17,194	3,635	0.21	71.88
		Turkey		48,122	11,210	0.23	79.19
Total transit				139,233	31,513	0.23	76.95
Animal or vegetable fats and oils	2013	Great Britain	Great Britain	88	126	1.43	100
		Albania	Great Britain	3,158	3,106	0.98	68.69
		Egypt		14,210	13,525	0.95	66.46
		Tajikistan		66	62	0.93	65.21
Total transit				17,433	16,693	0.96	66.86
Animal or vegetable fats and oils	2012	Switzerland	Switzerland	0	0	3.82	100
		Sudan	Switzerland	7,736	8,359	1.08	28.27
		Syria		2,090	2,265	1.08	28.35
		Turkey		45,114	50,509	1.12	29.29
Total transit				54,940	61,133	1.11	29.11
Ferrous metals	2014	Switzerland	Switzerland	973	1,719	1.77	100
		Brazil	Switzerland	28,369	15,716	0.55	31.36
		Syria		26,685	12,996	0.49	27.57
		UAE		251,456	129,873	0.52	29.24
Total transit				306,510	158,584	0.52	29.29
Seeds and fruit of oil plants	2012	Cyprus	Cyprus	2	4	1.98	100
		France	Cyprus	5,291	3,157	0.60	30.16
		Greece		3,016	1,164	0.39	19.51
		Italy		7,391	3,209	0.43	21.94
Total transit				15,699	7,529	0.48	24.24
Paper and cardboard	Jan- Sept 2015	Cyprus	Cyprus	0.03	296	11,270	100
		Lithuania	Cyprus	0.00	28	6,019	53.46
		Russian Federation		0.03	231	7,460	66.26
Total transit				0.04	260	7,271	64.57



See the beginning of the table on the previous page

Goods	Period	Destination	Intermediary	Weight, tons	Value	Price	Comparison of transit and final prices, %
Wood and wooden products, charcoal	2013	UAE	UAE	13,617	2,314	0.17	100
		Netherlands	UAE	22	2	0.10	59.69
		Syria		77	6	0.08	48.07
		Turkey		342	47	0.14	80.18
Total transit				441	55	0.12	73.53
Energy sources; oil and petroleum processing products	2013	British Virgin Islands	British Virgin Islands	590,349	324,382	0.55	100
		Czech Republic	British Virgin Islands	48,334	18,198	0.38	68.52
		France		31,383	1,772	0.06	10.27
		Georgia		3,455	562	0.16	29.60
Total transit				83,172	20,532	0.25	44.93
Ferrous metals	2014	Lebanon	Lebanon	4.22	22	5.2	100
		Bangladesh	Lebanon	42,407	19,879	0.47	9.01
		Nigeria		24,898	11,941	0.48	9.22
		Saudi Arabia		540,688	254,898	0.47	9.07
Total transit				607,992	286,718	0.47	9.07

Thus, according to our analysis, the price for sales via a transit country is generally 20-90 percent lower. Of course, these calculations do not take into account such characteristics as the kind of goods, the conditions of delivery, or transportation, but we can say with confidence that at least 25 percent of profits escape taxation in Ukraine.

Given the scale of the escaped profits and the corporate profit rates in Ukraine, we can calculate how much money from these taxes failed to reach the Ukrainian budget. In addition, if we take into account the corporate tax rates in intermediary countries, we can calculate the size of additional capital of Ukrainian exporters which is accumulated abroad and partially returns to Ukraine as direct investment. These calculations are demonstrated in Table 3.7.

The amount of unreceived corporate taxes is just an estimate and certainly does not take into account all the special characteristics of taxation in different countries in terms of the size of profits of an economic entity or the structure of its ownership. However, the amount of unreceived taxes for only five countries allows us to understand that one considerable potential source of budget revenues is the implementation of the mechanisms of control over transfer pricing.

**Table 3.7 The calculation of taxes on the profits from exports via intermediary countries which did not reach the Ukrainian budget, \$ million**

Period	Countries	British Virgin Islands	Cyprus	UAE	Switzerland	Lebanon	Total
	Corporate tax rates, %	0	12.5	0	8.5*	0*	
2012	Cost of re-sold products	4,357	993	2,903	16,228	174	24,655
	Profits outside Ukraine (25%)	1,089	248	726	4,057	43	6,164
	Net profits of exporters accumulated abroad	1,089	217	726	3,712	43	5,787
	Corporate taxes not received by Ukrainian budget (21%)	229	52	152	852	9	1,294
2013	Cost of re-sold products	2,178	919	2,551	16,861	762	23,272
	Profits outside Ukraine	544	230	638	4,215	191	5,818
	Net profits of exporters accumulated abroad	544	201	638	3,857	191	5,431
	Corporate taxes not received by Ukrainian budget (19%)	103	44	121	801	36	1,105
2014	Cost of re-sold products	150	1,019	2,429	16,588	927	21,113
	Profits outside Ukraine	37	255	607	4,147	232	5,278
	Net profits of exporters accumulated abroad	37	223	607	3,795	232	4,894
	Corporate taxes not received by Ukrainian budget (18%)	7	46	109	746	42	950
Jan-Sep 2015	Cost of re-sold products	473	624	1,561	8,336	498	11,491
	Profits outside Ukraine	118	156	390	2,084	124	2,873
	Net profits of exporters accumulated abroad	118	137	390	1,907	124	2,675
	Corporate taxes not received by Ukrainian budget (18%)	21	28	70	375	22	517
Net profits of exporters accumulated abroad in 2012-14 and the first 9 months of 2015:							18,787
Total corporate tax not received by the budget in 2012-14 and the first 9 months of 2015:							3,867

*\*For specific types of companies, specific activities, specific industries, specific territories, etc  
[Calculations based on the data by the State Fiscal Service]*

The amount of unreceived corporate taxes is just an estimate and certainly does not take into account all the special characteristics of taxation in different countries in terms of the size of profits of an economic entity or the structure of its ownership. However, the amount of unreceived taxes for only five countries allows us to understand that one considerable potential source of budget revenues is the implementation of the mechanisms of control over transfer pricing.

The average annual loss for Ukraine from the exports of the goods in the 15 groups to these 5 countries for artificially reduced prices and via intermediaries is \$9-1.2 billion of corporate taxes, which, given the current exchange rates, is more than a half of all budget revenues from the corporate tax in 2014, which was UAH 39.56 billion.

An even larger reserve of budget revenues and investment into the economy are the assets of exporters accumulated outside Ukraine, which, according to our estimates for 15 groups of goods, reach \$18.7 billion. Our analysis demonstrates that simply by introducing effective mechanisms of control over transfer pricing Ukraine could considerably increase its tax revenues and investment in its economy.

The following example is the evidence that tax minimization schemes and the accumulation of capital in countries with more favorable tax treatment are practiced not only by private companies, but also by public ones. According to a study by Schemes, the Kharkiv public factory Elektrovazhmash does almost 70 percent of its exports of goods, works and services via indirect contracts, almost 90% of which are contracts with two British companies, while most consumers of its products are Russian residents. The study points out that, in January 2015, Elektrovazhmash sold the equivalent of \$260,000 to one British company. In the same months, those products were resold to the Russian company Elmash-LTO for more than \$320,000, which is a quarter more expensive [Схеми, 2015].

## **Import of services**

The central ways to send money out of the country as a part of import flows is to pay for consulting services, copyright fees, and loans. The reason is that, say, a fake license agreement allows to transfer large sums of money between parties, and, since it is rather difficult to assess an immaterial asset (copyrighted materials), and the price of such assessment is often high, it is difficult to apply to them the transfer pricing methods used for regular prices. At the same time, some copyrighted materials do not have to be officially registered. It is sufficient to sign a license or franchise agreement and regularly transfer payments to an account of an individual or a legal entity that owns an idea or an invention.

According to the data by the State Statistics Service, demonstrated in the Table 3.8, on average, Ukraine imports \$2.6 billion worth of such services annually,

and their fraction in the total import of services is 35-43 percent. This is income earned by non-residents, which originated in Ukraine; types of such income are listed in paragraph 141.4.1 of the Tax Code of Ukraine:

- interest, discount income paid to a non-resident, including interest on loans and bonds issued by a resident;
- dividends paid by a resident;
- royalties;
- leasing/rent paid by residents or permanent representatives to a non-resident, a lessor or renter, based on an operational leasing/rent agreement;
- income from selling property located in Ukraine and belonging to a non-resident, including property of a permanent representative of the non-resident;
- profit from selling or otherwise alienating stocks, derivatives or other corporate rights;
- broker, commissioner or agent's compensation received from residents or permanent representatives of other non-residents for broker, commissioner or agent's services provided by a non-resident or their permanent representative in Ukraine to residents;
- contributions and bonuses for insurance or reinsurance of risks in Ukraine (including risks to life) or insurance of residents for risks outside Ukraine, etc.

**Table 3.8 Import of professional and financial services, \$ million**

Import of services	2012		2013		2014	
	6,639.22	%	7,523.03	%	6,373.13	%
Services related to financial activities	951.66	14	1,009.8	13	800.35	13
Royalties and other copyright-related services	417.62	6	839.29	11	450.48	7
Business services	1,083.55	16	1,415.90	19	993.92	16
Total:	2,452.83	37	3,264.99	43	2,244.75	35

*[Calculations based on the data by the State Statistics Service]*

According to the Tax Code of Ukraine, these types of income are taxed with the so-called “repatriation tax,” and for most of them the rate is 15% paid by the resident. However, if there is a double taxation convention between Ukraine and the non-resident's country, the regulations of the convention apply, which can include income tax reliefs, reduced tax rates or returning the difference between the paid tax and the sum that the non-resident has to pay, according to Ukraine's international convention.

Since only 14 of the 73 countries with preferential taxation have double taxation agreements with Ukraine, it is mostly these countries that are used to arrange capital escape from Ukraine. This allows companies to pay taxes either on the territory where activities take place, or in the country where they are registered. The available data show that, of the 59 countries which do not have such agreements, 95-99 percent of services are imported from the 10 countries listed below. These countries provided only 2.2-3.6 percent of all imported services, 40 percent of which were imports of professional, financial and business activities (Table 3.9).

Let us assess the scale of capital outflow through import of services using the case of royalty import. According to the Tax Code, royalties are any fees paid for using copyrighted materials, namely creations of literature, art or science, software, films, any patented rights, any registered trademarks, copyrighted information about industrial, commercial or scientific experience (know-how), etc.

**Table 3.9 Import of services from countries  
that do not have double taxation agreements with Ukraine, \$ million**

№	Countries	2012		2013		2014	
		6,639.22	%	7,523.1	%	6,373.13	%
1	Belize	11.26	0.2	19.11	0.3	19.97	0.3
2	British Virgin Islands	59.92	0.9	66.08	0.9	45.57	0.7
3	Ireland	32.41	0.5	34.01	0.5	28.46	0.4
4	Lichtenstein	0.63	0.0	0.58	0.0	2.55	0.0
5	Luxembourg	9.25	0.1	8.33	0.1	8.86	0.1
6	Maldives	2.18	0.0	2.56	0.0	3.99	0.1
7	Malta	2.19	0.0	3.51	0.0	88.72	1.4
8	Marshall Islands	1.07	0.0	0.89	0.0	1.14	0.0
9	Panama	25.43	0.4	52.49	0.7	27.08	0.4
10	Seychelles	1.18	0.0	1.15	0.0	1.14	0.0
	Total:	145.52	2.2	188.71	2.5	227.49	3.6
	of which:						
	services related to financial activities	26.99	18.6	52.15	27.6	45.51	20.0
	royalties and other copyright-related services	0.67	0.5	10.1	5.4	11.22	4.9
	business-related services	59.18	40.7	56.62	30.0	32.57	14.3

*[Calculations based on the data by the State Statistics Service]*

Of course, some of the royalties paid by Ukrainian residents are actually aimed to obtain software, films, and trademark rights. However, a major part of this money is paid to buy copyrighted materials which are not used in Ukraine in practice, and the goal here is to send money out of the country.

In this context, the trends in the import of royalties from Cyprus is telling. In particular, before the new Double Taxation Treaty with Cyprus, which increased royalty tax rates from 0 to 5 percent, became valid on January 1, 2014, in 2013, royalties imported from Cyprus were worth \$408.62 million, which was 2.4 times as much as in 2012; however, in 2014, only \$58.17 million of royalties were imported from Cyprus, which is 14 times less. Therefore, Ukrainian “importers” of royalty tried to make the most of the last chance to use the preferential taxation in this country. We can conclude from this that countries where tax rates for royalties are more than 0 percent are less attractive for money outflow via fake agreements, and even if the tax increases to 5 percent, it will make this mechanism significantly more expensive.

For example, according to double taxation agreements, royalty tax rates in Belarus, Brazil, Egypt, Syria and Thailand are from 12 to 18 percent; so no wonder that, in 2014, of all these countries, royalties worth \$849,700 (0.2 percent of all imported royalties) were imported into Ukraine only from Belarus and Brazil. However, in most countries, royalty tax rates are much lower than in Ukraine, and, according to international convention, this type of income is taxed in the importer country. In particular, 20 countries have the maximum royalty tax rate of 5 percent, provided that the ownership structure is of a certain type. Generally it is from these countries that Ukraine imported about 80 percent of its royalties in 2013-14 (Table 3.10).

**Table 3.10 Taxes on royalties in the countries  
that signed double taxation treaties with Ukraine, %**

Tax rate, %	0	0/5*	0/5/10*	0/10*	5/10*	5
Country	Armenia, Great Britain	Germany, Austria, Spain	Finland	Belgium, Denmark, Canada, Netherlands, UAE, France, Switzerland	Cyprus (from Apr. 1, 2014), Norway, Slovenia	Hungary, South Korea

*\* Depending on the type of royalties.*

*[According to Ukraine's double taxation treaties]*

Given the popularity of buying royalties in countries where the tax rates on them is low, in order to prevent capital outflow through this channel, it is necessary to establish a certain tax rate for two countries that participate in transactions. Generally, it can be the 10 percent rate, and if royalties are imported, say, to Armenia or Great Britain, the royalties will be taxed in Ukraine using the full 10 percent rate; if they are imported to Hungary, then the rate will be 5 percent. This rate will not significantly affect the final price of royalties, but it will make it unprofitable to use this method to channel capital out of its home country.

The calculation of additional budget revenues if royalties are taxed with a 10 percent rate in Ukraine and the importer country is provided in Table 3.11. In general, if the 10 percent tax on royalties is introduced in both countries, its main effect will be not the additional budget revenues, which will reach up to UAH 1 billion if the level of royalty import is preserved, but the fact that hundreds of millions of dollars will stay in Ukraine and be invested in its economy.

Given the considerable amounts of imported services related to financial and business activities, some of which are also used to have higher profit rates by avoiding taxes, the system of taxing and controlling these services must be reviewed.

**Table 3.11 Budget revenues from introducing  
the general 10% tax rate for royalties, \$ thousand**

	2012			2013			2014		
	Import	Ukrainian rate	Tax, \$ thousand	Import	Ukrainian rate	Tax, \$ thousand	Import	Ukrainian rate	Tax, \$ thousand
Armenia	42	10	4.2	2	10	0.2	109	10	10.9
Austria	6,193	10	619.3	9,676	10	967.6	9,291	10	929.1
Belgium	17,919	10	1,791.9	22,603	10	2,260.3	6,515	10	651.5
Great Britain	36,529	10	3,652.9	64,900	10	6,490.0	83,111	10	8,311.1
Denmark	11,918	10	1,191.8	4,761	10	476.1	2,168	10	216.8
Spain	2,944	10	294.4	5,130	10	513.0	123	10	12.3
Netherlands	4,343	10	434.3	10,074	10	1,007.4	16,191	10	1,619.1
Germany	39,284	10	3,928.4	30,904	10	3,090.4	27,228	10	2,722.8
Norway	173	5	8.7	283	5	14.1	76	5	3.8
Slovenia	0	5	0.0	97	5	4.9	227	5	11.4
Hungary	58	10	5.8	1,294	10	129.4	2,822	10	282.2
Finland	87	10	8.7	353	10	35.3	658	10	65.8
France	9,270	10	927.0	20,316	10	2,032.6	18,139	10	1,813.9
Switzerland	35,266	10	3,526.6	109,433	10	10,943.3	122,679	10	12,267.9
Sweden	5,012	10	501.2	3,035	10	303.5	5,378	10	537.8
Cyprus	169,990	10	16,999.0	408,616	10	40,861.6	58,170	10	5,817.0
South Korea	2,352	5	117.6	1,155	5	57.8	447	5	22.3
UAE	10	10	1.0	1	10	0.1	5,086	10	508.6
Canada	269	10	26.9	404	10	40.4	160	10	16.0
Japan	0	10	0.0	0	10	0.0	488.6	10	48.9
Total:	341,659		34,040	693,038		69,227	359,067		35,869

In general, although Ukraine buys technology, innovation, professional services for \$6-7 billion per year, its key export goods are raw materials and products on early processing stages.

To sum up the data, Ukrainian exports only to such intermediary countries as the British Virgin Islands, Cyprus, the UAE, Switzerland and Lebanon in 2012-14 and the first 9 months of 2015 reached UAH 83.1 billion, which is 50 percent of all exports of goods, of which only the equivalent of \$2.57 billion (1.5 percent) were consumed in these countries. Given that these are not the only transit countries for Ukrainian exports, we can say with confidence that more than a half of the exports of goods from Ukraine go through low-tax territories, and most of the profits of Ukrainian exporters accumulate on their accounts in these countries' banks; meanwhile, the budget loses considerable sums in corporate taxes.

Given these outcomes, the decision No. 977-r by the Cabinet of Ministers on September 16, 2015, to exclude Switzerland and the United Arab Emirates from the list of countries where the corporate tax rate is 5 or more percentage points lower than the same tax rate in Ukraine becomes even more dangerous; the timing of this decision coincided with the start of the fall season of business activities, including growing grain exports.

The consequence of this decision will be the lack of control over transfer pricing for exports into these countries, and even more massive outflow of profits to offshore zones; the government budget of Ukraine for 2015 will not be implemented, which is confirmed by the fact that the actual revenues from the corporate tax as of November 1, 2015, were 81 percent of the total amount planned for 2015 [Звіт про виконання Держбюджету за січень-жовтень 2015 року].

Simply if the effective mechanisms of control over transfer transactions are implement, Ukraine can have at least an additional \$1 billion of corporate tax revenues per year, which will increase this source of revenue by 60 percent compared to 2015.

In addition, given the considerable imports of financial and business services into Ukraine, some of which may be fake, the system of taxing them when they are imported from countries which have double taxation treaties with Ukraine needs to be revised; this will both increase tax revenues, especially from taxing royalties for \$30-40 million per year, and prevent illegal capital outflow.

After we have defined the general losses from capital outflow in foreign trade, let us move on to a more detailed analysis of such consequences for specific industries, particularly for agriculture and mining industry which are the core industries for Ukrainian manufacturing sector and exports.



### **3.3 Analysis of the consequences of trade through offshores and tax havens in specific industries**

Prem Sikka of the University of Essex writes in his report that “the amount of tax avoided by major corporations in developing countries is roughly equivalent to foreign aid received by them. As a condition of financial support/loans, the World Bank and the International Monetary Fund demand that developing countries engage in ‘structural adjustments’, devalue their currencies and curtail subsidies for farming, food and other essentials. Yet these institutions have failed to examine the impact of tax havens and major corporations in stifling economic development of emerging economies” [Sikka 2003].

The evolutionary development of different countries created different kinds of offshore zones (which are, in essence, a type of free economic zones): industrial zones, science and technology zones, storage and trade zones, special economic zones in ports, zones with Anglo-American (oriented to information requests from investors and creditors) and continental (with close relationship between banks which are usually the ones who satisfy the needs of financial companies) accounting models; classic offshores (the companies registered there have no right to any activities within the country and only pay a fixed annual fee to its budget) and tax havens (whose legislature does not relieve businesses of paying taxes, but offers preferential treatment if some conditions are met) [Ko-map 2014].

In our analysis of Ukrainian offshore flows, we should pay the most attention to the latter two groups, since a lion’s share of Ukraine’s external trade gets transited through these zones. And if the presence of some financial centers in the chain from the provider to the consumer is really necessary in the contemporary system of resource distribution, Ukraine can easily reject some other services.

The analysis of exported and imported goods and services allows us to understand how it happens and what the main channels of capital outflow are.

#### **Reducing taxation base by foreign trade via offshore zones in agriculture, mining, fossil fuel industry and metal processing industry**

Every country in the world has its own unique system of government and financial administration, so cases of offshore trade basically happen in all countries. In this situation, a small country with practically nonexistent export potential can earn huge money by setting a zero or low corporate tax rate (3 to 10 percent). First, in this way, the financial system attracts a lot of money

flows. Second, if the country re-exports big volumes of products, even a small corporate tax provides enough budget revenues to cover government expenses. That is why, back in 2013, the Cabinet of Ministers of Ukraine issued a list of countries (territories) where corporate tax rates are 5 or more percentage points lower than in Ukraine, in order to facilitate transfer pricing. The list includes 73 countries; the key trade partners of Ukraine that are on this list are Cyprus, the Virgin Islands, Liechtenstein, Saint Vincent and the Grenadines, Switzerland and others [Урядовий кур'єр, 2014]. It should be noted that, unlike other countries on the list, Switzerland offers additional benefits for those who register their companies in the country; it is easier for a local trade structure to take cheap loans in European banks, it is more convenient to present to international partners, and so on.

In Cyprus, which is so familiar to Ukrainians, all the tax residents of the country have to pay a corporate tax on the taxable sources in Cyprus and outside it; the tax rate is fixed at 12.5 percent for all companies. In addition to the corporate tax on profits, companies in Cyprus have to pay a number of other mandatory fees, including the so-called annual registration fee. In Germany, the unified national corporate tax is fixed at 15 percent of the taxable corporate profits, with an additional 5.5 percent of the amount of taxes to support solidarity. Therefore, the cumulative corporate tax rate in Germany is 15.825 percent [Кучерявенко, 2015]. The nominal federal corporate tax rate in Switzerland is only 8.5 percent, but in some cases it can reach up to 24 percent. However, each canton has its own tax legislation and local taxes, and if, for example, a company is a holding, its actual tax rate in a canton can be reduced to 5 percent or even to zero. In addition, in some cantons, foreign companies can expect generous tax preferences. What exactly the preferences will be is decided by local tax authorities in every particular case. The maximum period during which a preference can be valid is ten years. That is why dozens of companies affiliated with Ukrainian metal and agricultural holdings are registered in Switzerland: Metinvest International SA, Kernel Holding S.A., MAKO Trading SA, Nibulon SA, Ferrexpo PLC, Rosukrenergo, Interpipe Europe SA, etc. In most cases, Ukrainian companies open their headquarters or trading structures which manage the trade with the consumer country [Фінанси, 2013]. So there are barely any direct exports; in the customs papers, the importer is the company located in any of the abovementioned offshore countries (although the customs declaration also mentions the country of destination).

As the Table 3.12 demonstrates, the major flows of exports of grains, oil cultures and the products of their processing (groups 10, 11, 12, 15 and 23 of the Ukrainian categorization of foreign trade goods, UCFTD, which together made up 76 to 81 percent of agricultural exports in 2012-15) transit through countries where corporate tax rates are much lower than in Ukraine.

**Table 3.12 Export of grains, oil cultures and the products of their processing (groups 10-12, 15, 23 UCFTD) by intermediary country (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Switzerland	5,639	5,519	6,538	4,801	3,387	21,083	43%
2	British Virgin Islands	2,208	1,318	77	10	406	4,008	8%
3	Great Britain	698	656	1,184	800	1,226	3,763	8%
4	Netherlands	953	1,095	1,002	718	345	3,395	7%
5	Germany	1,151	1,053	761	570	163	3,129	6%
6	Cyprus	384	432	663	450	479	1,959	4%
7	Hong Kong	9	198	383	235	419	1,009	2%
8	Malaysia	285	256	244	193	147	932	2%
9	Panama	399	101	131	56	185	816	2%
10	Russian Federation	192	272	186	156	85	735	2%
11	United Arab Emirates	71	201	237	130	219	728	2%
12	Poland	255	139	181	131	97	673	1%
13	France	220	179	93	75	46	537	1%
14	Lithuania	38	102	241	199	149	530	1%
15	Belarus	136	133	136	105	64	468	1%
	Total for top 15	12,638	11,653	12,057	8,628	7,416	43,765	90%
	Total	13,948	12,987	13,288	9,479	8,282	48,506	100%

*\* data for January-September 2015*

*[calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

The uncontested leadership in this list belongs to Switzerland with its 43 percent of Ukrainian exports in the period from 2012 to September 2015. Massive flows also travel through the Virgin Islands (8 percent), Great Britain (8 percent), Cyprus (4 percent), Panama and Hong Kong (2 percent each). The list of top 20 reseller countries does not include any actual importer.

The Table 3.13 demonstrates the top 15 countries that import Ukrainian agricultural products (the list does not include any actual offshore zone), whose fractions are relatively small and evenly distributed.

**Table 3.13 Export of grains, oil cultures and the products of their processing (groups 10-12, 15, 23 UCFTD) by consumer country (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Egypt	2,070	1,517	1,338	948	667	5,591	12%
2	India	1,227	1,072	1,374	995	757	4,429	9%
3	Spain	1,361	753	913	648	474	3,500	7%
4	Turkey	703	655	643	388	465	2,465	5%
5	China	74	474	755	431	1,046	2,348	5%
6	Italy	690	588	611	479	339	2,227	5%
7	Iran	734	514	578	408	370	2,197	5%
8	Netherlands	502	664	688	571	320	2,175	4%
9	Saudi Arabia	579	425	626	513	357	1,987	4%
10	Israel	498	428	361	252	269	1,555	3%
11	France	366	479	350	254	251	1,447	3%
12	Poland	526	293	278	217	139	1,237	3%
13	South Korea	241	266	327	152	248	1,082	2%
14	Belarus	271	285	285	215	174	1,015	2%
15	Portugal	322	223	211	183	166	922	2%
	Total for top 15	10,163	8,636	9,337	6,657	6,042	34,179	70%
	Total	13,948	12,987	13,288	9,479	8,282	48,506	100%

*\* data for January-September 2015*

*[calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

So the top three importers of Ukrainian agricultural products are shared by Egypt (12 percent), India (9 percent) and Spain (7 percent). The foreign consumers buy almost all of Ukrainian products from Swiss, Cypriot or Spanish companies for much higher prices than they could pay if they bought directly from Ukraine. For example, in January-September of 2015, the average price for exported vegetable oils (group 15 of the UCFTD) directly into Egypt was \$1,175 per ton, while the price of reselling via Switzerland was \$806 per ton (31 percent lower); the direct price for Spain was \$927 per ton, and \$773 per ton via Switzerland (17 percent lower). If the export price of goods listed in Tables 3.12 and 3.13 is artificially lowered by 15 percent, then in 2012-15, about \$8.56 billion of profits escaped the corporate tax in Ukraine. The picture is similar for other export-oriented goods — ferrous metals and ferrous metal products, ore and energy resources — although the fraction of offshore trade is somewhat lower in these cases (Tables 3.14, 3.15)

**Table 3.14 Export of ferrous metals and ferrous metal products (groups 72 and 73 of UCFTD) from Ukraine by *intermediary country* (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Switzerland	6,289	6,338	5,984	4,840	2,918	21,529	38%
2	Russian Federation	4,044	4,066	2,347	1,941	811	11,267	20%
3	United Arab Emirates	2,187	1,815	1,724	1,325	1,087	6,814	12%
4	Lebanon	844	788	926	690	496	3,054	5%
5	Poland	234	488	825	639	365	1,912	3%
6	British Virgin Islands	1,239	445	46	24	41	1,771	3%
7	Great Britain	575	395	335	276	210	1,515	3%
8	Kazakhstan	440	278	78	59	33	829	1%
9	Belarus	284	271	154	130	53	763	1%
10	Saint Vincent and the Grenadines	300	309	81	81		689	1%
11	Hong Kong	8	342	283	273	14	646	1%
12	Bulgaria	150	190	179	159	99	617	1%
13	Belize	305	139	0	0	27	471	1%
14	Hungary	90	33	331	314	3	457	1%
15	Azerbaijan	172	154	68	58	24	418	1%
	Total for top 15	17,161	16,050	13,362	10,809	6,180	52,753	93%
	Total	18,178	16,909	14,603	11,730	7,096	56,785	100%

*\* data for January-September 2015*

*[calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

**Table 3.15 Export of ferrous metals and ferrous metal products (groups 72 and 73 of UCFTD) from Ukraine by *consumer country* (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Russian Federation	3,439	3,006	2,059	1,709	751	9,255	16%
2	Turkey	2,017	2,136	2,106	1,676	1,109	7,368	13%
3	Italy	1,198	1,317	1,408	1,093	766	4,689	8%
4	Egypt	707	1,077	1,349	996	761	3,895	7%
5	Poland	650	668	665	542	301	2,284	4%

*See the beginning of the table on the previous page*

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
6	Iraq	658	613	568	404	253	2,092	4%
7	Lebanon	1,223	241	104	81	69	1,637	3%
8	USA	423	402	434	334	203	1,462	3%
9	Bulgaria	349	414	407	331	260	1,431	3%
10	Kazakhstan	492	660	129	88	61	1,342	2%
11	Saudi Arabia	328	343	373	302	237	1,281	2%
12	Hungary	276	567	389	366	26	1,258	2%
13	Belarus	466	415	250	212	90	1,222	2%
14	Germany	366	307	205	161	130	1,009	2%
15	Azerbaijan	343	369	206	173	64	983	2%
	Total for top 15	12,937	12,537	10,653	8,467	5,080	41,208	73%
	Total	18,178	16,909	14,603	11,730	7,096	56,785	100%
	Total	13,948	12,987	13,288	9,479	8,282	48,506	100%

*\* data for January-September 2015 [*

*calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

Better transparency in these industries is an illusion, since a lion's share of trade in these products is with Russia, which has many affiliated companies in Ukraine and therefore taxes some of the profits in Russia. As the Tables 3.14 and 3.15 demonstrate, the amounts of export make the Russian Federation a net intermediary, because it resells a lot of goods further to post-Soviet countries (Kazakhstan, Azerbaijan, etc.).

It is interesting that Turkey, which is the second largest buyer of Ukrainian metal industry after Russia with 13 percent of exports, is not even in the top 15 of intermediaries, despite its geographical proximity to Ukraine and relatively low freight costs. Just as in the case of agriculture, the price for direct sales to consumers is much higher: in January-September 2015, the average price of exported ferrous metals (group 72) directly to Turkey was \$388 per ton, while for trade via the Virgin Islands the price was \$241 per ton, and via Switzerland it was \$356 per ton. Even compared to Switzerland the difference is \$32 per ton, or 8 percent, some of which is spent on taxes and the maintenance of an office in this country.

The situation in ore and petroleum trade is practically the same as in grains and vegetable oils: in 2012-15, the same 43 percent for trade via Switzerland as an intermediary, and 5 to 8 percent via the UAE, the Virgin Islands, and Cyprus (Table 3.16).

**Table 3.16 Export of ore and energy sources (groups 26 and 27 of UCFTD) from Ukraine by *intermediary country* (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Switzerland	2,300	2,836	2,656	2,109	1,265	9,057	43%
2	UAE	503	517	461	378	249	1,729	8%
3	British Virgin Islands	741	574	109	108	1	1,424	7%
4	Cyprus	551	416	332	312	73	1,372	6%
5	Russian Federation	826	224	144	126	45	1,238	6%
6	Great Britain	354	352	339	299	76	1,121	5%
7	Slovakia	345	355	295	228	115	1,110	5%
8	Luxembourg	176	224	189	159	78	667	3%
9	Belarus	218	208	176	159	3	606	3%
10	Czech Republic	133	151	178	155	53	515	2%
11	Belize	231	185	0	0	0	417	2%
12	Hong Kong	7	218	145	141	8	378	2%
13	Moldova	56	135	60	48	2	253	1%
14	Hungary	26	56	83	68	36	201	1%
15	Singapore	6	85	50	50	9	151	1%
	Total for top 15	6,473	6,536	5,217	4,340	2,013	20,239	95%
	Total	6821	6783	5485	4570	2120	21209	100%

\* data for January-September 2015

*[calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

The presence of the Virgin Islands, Cyprus and Belize among the net importers of ore, oil and other goods of groups 26 and 27 of UCFTD (Table 3.17) can be explained only by the fact that customs declarations do not necessarily include the country of destination.

**Table 3.17 Export of ore and energy sources (groups 26 and 27 of UCFTD) from Ukraine by *consumer countries* (top 15), \$ million**

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012-15*	Fraction in 2012-15*
1	Switzerland	2,300	2,836	2,656	2,109	1,265	9,057	43%
2	UAE	503	517	461	378	249	1,729	8%

See the beginning of the table on the previous page

No	Country/Years	2012	2013	2014	Jan-Sep 2014	Jan-Sep 2015	Total 2012- 15*	Fraction in 2012- 15*
3	British Virgin Islands	741	574	109	108	1	1,424	7%
4	Cyprus	551	416	332	312	73	1,372	6%
5	Russian Federation	826	224	144	126	45	1,238	6%
6	Great Britain	354	352	339	299	76	1,121	5%
7	Slovakia	345	355	295	228	115	1,110	5%
8	Luxembourg	176	224	189	159	78	667	3%
9	Belarus	218	208	176	159	3	606	3%
10	Czech Republic	133	151	178	155	53	515	2%
11	Belize	231	185	0	0	0	417	2%
12	Hong Kong	7	218	145	141	8	378	2%
13	Moldova	56	135	60	48	2	253	1%
14	Hungary	26	56	83	68	36	201	1%
15	Singapore	6	85	50	50	9	151	1%
	Total for top 15	6,473	6,536	5,217	4,340	2,013	20,239	95%
	Total	6821	6783	5485	4570	2120	21209	100%

*\* data for January-September 2015*

*[calculations based on the data by the State Statistics Service and the State Fiscal Service of Ukraine]*

It is because of the rapid increase in the number of multinational corporations that the need for control over transfer pricing has emerged; today, the control is supervised by the OECD. One of the key principles of transfer pricing is the so-called arm's length principle, which means that if two independent companies cooperate, the conditions of their commercial and financial relationship is as close to the market as possible; meanwhile, if associated companies interact, external market factors do not necessarily affect their trade and financial relations (in particular, a "transfer of profits" to that one of the companies which is located in a country with smaller taxes may occur). It happens because associated companies act in accord, "hand in hand," while independent companies act "at arm's length" [Жукова, 2015].

In general, there is nothing illegal in such practices, if the distribution of profits in the chain from a supplier to the consumer is even (and not in the cases when only the minimum profit of \$1-2 per ton is taxed in Ukraine, and \$10-15 are



sent out to offshores). Some countries use this principle in their tax audits of companies, and if companies are able to provide the relevant papers (price of transportation, funding rates, etc.), the foreign trade transaction is deemed legal and no additional fines or charges apply. The audit of such transactions is carried out by major audit companies.

In Ukraine, it has become a custom that companies end up with losses year after year, even though it runs counter to the laws of economic theory, and send the bulk of their profits to offshores in order to minimise the taxable base. Both private and public companies do this; moreover, they do not even try to conceal the fact that they engage in such practices.

For example, according to the financial report of the private company Interpipe (deals with metal product trade) for 2012, all the branches of this group worldwide paid \$16.3 million in taxes; however, only \$1.99 million were paid in Ukraine, which is 9 times less than the previous year, \$18 million (84 percent). In 2011, this company contributed \$3 million to the budget of Switzerland, and \$1.1 million to the budget of Cyprus, even though the effective tax rate for this company in those countries was 11 and 10 percent, respectively. Indeed, this way, the company saved almost half of the sum of potential tax it could have paid in Ukraine. But we should keep in mind that through these schemes we fund the economies other countries, all the while looking for new creditors to pay for the existing public debt and to cover budget deficits.

While the companies of oligarchs demonstrate constant losses, sending most of their profits to offshores, the government tries to compensate for reduced tax revenues by increasing the tax burden on industries where companies do not usually belong to oligarchs. Thus, by expert estimates, corporate tax revenues from food industry in 2012 increased by 33 percent, from construction industry by 27 percent, etc. In addition, oligarchs have political leverage to obtain full refund of VAT both on the products they actually export and, possibly, on fictitious exports. For example, in 2012, the amount of VAT refunded by the government to the exporters was much higher than a half of all the VAT paid by Ukrainian producers (UAH 46 and 83 billion, respectively) [Кравчук, Одосій, 2015].

As for the public sector, there are 1,829 functioning public companies in Ukraine, and most of them operate under general economic regulations and are supposed to pay taxes. However, their efficiency is extremely low: in 2014, their total revenues from selling their produce was UAH 377 billion; but their total net losses were \$115 billion. Out of the top 100 largest public companies, only 57 are profitable, and their net profit rates are miniscule.

An example of “successful” trade via offshores is presented by the Public Food Grain Corporation, which is one of the top five public companies with highest revenues. The company owns more than 10 percent of grain storage facilities and two large port terminals. And while this kind of business is profitable for

all private companies, the PFGC officially suffered losses of UAH 3.5 billion in 2014 [Івченко, 2015]. The public corporation sold grains to questionable offshore companies, and they did not pay for it. It all happened in 2013-14. The wheat, barley and corn that the corporation sold to these companies were bought using the money from a Chinese loan (let us remind you that the PFGC received a \$1.5 billion loan from China, which was guaranteed by the government). Cargo ships delivered the goods to importers, the buyers paid to the offshore companies, but not a single dollar was transferred to the PFGC's account [Каплюк, Дєнков, 2015]. This led the public corporation to accumulate billions in losses which will, in the end, be covered from the pockets of Ukrainian citizens.

To sum up all of the above, we can make the following conclusions:

- Every year the problem of offshore zones is becoming more and more critical. As of May 2013, according to Oxfam, the total potential tax revenues lost by public budgets of countries all over the world reached \$156 billion, which is twice as much as the sum required to end poverty.
- Ukrainian companies practically do not trade by direct contracts with the actual importers of Ukrainian products, but use offshore zones to transfer their profits out of the country. In 2012-15, only four key trade partners with low tax rates (Switzerland, the Virgin Islands, Great Britain and Cyprus) together received about 64 percent of exports of grains and oil plants from Ukraine, 44 percent of exports of ferrous metals and ferrous metal products, and 61 percent of exports of ore and energy sources.
- The amount of potentially lost taxes in the grain and vegetable oil trade only from 2012 to September 2015 is estimated to reach \$1.5-1.7 billion; this money could have been used to improve the social and economic situation in Ukraine and to ensure its innovative development.

After we have studied the economic consequences of capital outflow, we also have to determine what specific legal action can be taken to stop this practice. We need to find out how offshores are fought at the international level, and which of the means of fighting them could be useful and effective in the Ukrainian situation.

## **3.4 Opportunities for fighting tax minimization in offshore zones: the legal aspect**

### **3.4.1 The possibility to terminate double taxation agreements (DTAs)**

#### **Regulating the termination of double taxation agreements**

The issue of counteracting aggressive tax minimization is raised by nearly all political groups, because the society is naturally unhappy with this phenomenon. However, we must keep in mind that politicians often manipulate the public

opinion and offer vague incorrect solutions. In particular, it is important to define how the termination of DTAs is regulated.

Is it possible to terminate bilateral double taxation agreements between Ukraine and other countries?

By September 16, 2015, Ukraine had signed 9 agreements with countries which are categorized as offshores. The list of the countries that signed DTAs with Ukraine was included in the decree No. 977 by the Cabinet of Ministers of Ukraine on September 16, 2015. The analysis of the agreements between Ukraine and offshore countries leads to the following conclusions. Today, the list includes 65 countries, and only nine of them have signed DTAs with Ukraine.

The procedure of termination written in all of these conventions is practically identical: a party must inform about its intention to terminate an agreement before June 30, 6 months before the end of the year. It is possible to do this on the fifth year of the convention's validity (only some agreements allowed to terminate them in any year of their validity, namely the agreements with Lithuania, Latvia, Switzerland). By now, it is possible to terminate any double taxation agreement signed by Ukraine, except for the agreements with Cyprus and Ireland, which were signed relatively recently. It will be possible to terminate the agreement with Cyprus no sooner than 2018 (it took effect in 2013), and the agreement with Ireland only in 2020 (it took effect in 2015). It should be noted that the UN Model Double Taxation Convention has a paragraph stating that the convention can be terminated 6 month before the end of the year, while the condition that a certain period of time (e.g., 5 years) has to pass since the agreement was signed is not mandatory.

The Vienna Convention on the Law of Treaties (1986) uses such concepts as invalidity, termination and suspension of treaties, which are applied to treaties as a whole, and not to their specific paragraphs. The most widespread way to terminate an agreement is to denounce it, that is, to unilaterally reject it with a warning. A party has to warn about the denunciation a year before it, unless otherwise specified in the agreement. DTA conventions include a different termination procedure, so this procedure has a priority [Віденська конвенція ООН].

At the same time, the Vienna Convention provides a right to cancel a treaty; that is, a country can unilaterally withdraw from a treaty it signed. The legitimacy of such an act has to be based on fundamental political and legal foundation, and the procedure should be in accordance with international practices. In particular, a treaty can be cancelled in the following cases: 1) if it is invalid (if they were signed under the influence of deceit, bribe, threat, mistake); 2) one of the sides seriously has violated the treaty; 3) the treaty is impossible to implement (the entity required to implement the agreement has disappeared irretrievably); 4) radical change of circumstances.

## **Additional reasons for premature termination of DTAs**

It is difficult to say if Ukraine can refer to any of these circumstances. If it wants to cancel an agreement without adhering to the dates indicated in it, that step must be justified. The list of reasons for terminating an agreement in the Vienna convention is not exhaustive. In practice, there were cases when treaties lost their validity and different reasons were cited. An economist Eric Toussaint considers legal arguments for canceling external public debts. In general, these international law doctrines can also be applied to termination of any DTA. In addition to a force majeure or a fundamental change of circumstances, the researcher also mentions, in particular, the state of necessity, odious debt, and illegal debt [Toussaint, Millet, 2010]. Based on international experience, we can review some reasons for terminating agreements which could theoretically apply.

**Force majeure.** Force majeure often refers to a military conflict: a treaty was designed to function in peaceful times, but a war started (for this, a country defines which specific paragraphs of the agreement it can no longer adhere to, but an approval of the other party is required in this case). The fact of a military operation in Ukrainian territory can be considered a circumstance that emerged against the government's will and that complicates the implementation of international agreements. Let us remind you that on January 27, 2015, the Parliament of Ukraine issued a decree that approved an Address in which it recognizes that Ukraine is a target of military aggression on the part of the Russian Federation.

**The “odious agreement” doctrine.** Some agreements (such as the DTA with Cyprus) were signed back in the Soviet times, and were supported by old political regimes. It is also possible to say that some agreements were signed under pressure from certain financial and industrial groups close to the government elites, whose interests those agreements pursued. In addition, nearly all of the agreements signed by independent Ukraine do not meet the UN and the OECD standards, which is an indirect evidence that they were designed to benefit oligarchs.

**The state of necessity or causing harm to the country's interests.** According to the Charter of Economic Rights and Duties of States (1976), “Every state has the primary responsibility to promote the economic, social and cultural development of its people” (Article 7). The state can use the argument that adhering to the DTA Convention causes losses for its budget, which is why it cannot fulfill its basic duties to its citizens (the right to dignified standard of living, health care, education, etc.) [Хартія економічних прав та обов'язків держав].

**Declare the double trade agreement unconstitutional.** According to the Article 86 of the Ukrainian Law “On the Constitutional Court of Ukraine,” the Constitutional Court reviews Ukraine's active international agreements and decides whether they are unconstitutional. A document can be submitted for review to the Constitutional Court either by the Government, or by the President.

In addition, the Constitutional Court can consider whether the law about the ratification of any particular agreement is constitutional. Such laws can be submitted to the Constitutional Court by members of parliament (45 or more people), by the ombudsman, or by the Supreme Court of Ukraine. A decision that an international agreement does not agree with the Constitution of Ukraine can result in terminating the agreement.

History knows cases when the Constitutional Court of Ukraine (CCU) decided that ratification laws were unconstitutional. In the Court Decision on July 12, 2000, about the case No/ 1-34/2000 the Constitutional Court deemed the Law “On ratification of the European Charter for Regional or Minority Languages, 1992” unconstitutional. The process of considering and passing this law violated some requirements of the Constitution: Article 94 (not submitted for a presidential signature), Article 94 (signed and officially published not by the President but by the Speaker of Ukrainian Parliament), Article 93 (violated the President’s right of legislative initiative).

Thus, the submission to the CCU can mention both discrepancies between the paragraphs of an international agreement and the Constitution, and procedural violations.

### **Examples of initiatives to terminate double taxation agreements in Ukraine**

Numerous bills aimed to denounce the double taxation agreement with Cyprus, signed in 2012 (No. 0001-1; No. 001-2; No. 001-3), or to renegotiate the agreement (No. 1668) have been submitted to the current 8th convocation of Verkhovna Rada. However, nearly all those bills were purely populist and did not include any legal justification for the early termination of the agreement. According to the Law “On Ukraine’s international treaties,” propositions to terminate or suspend Ukraine’s international treaties can be submitted by the Ministry of Foreign Affairs, by other central government bodies and state collegial bodies, but not by members of parliament.

The most developed bill was submitted by the Cabinet of Ministers of Ukraine under the number **0001-3** (on December 22, 2014). The project suggested that the 2012 double taxation agreement with Cyprus should be denounced, and that the Cabinet should sign another one. It looks a little absurd that the Cabinet wrote a piece of legislation that orders the Cabinet to do something.

Denunciation bills were imperfect. However, some ratification laws also raise questions. For example, in spite of the Law on international treaties, a number of bills were not accompanied by an approval note. We are talking about the bills on the ratification of double taxation agreements between Ukraine and Saudi Arabia (June 26, 2012), Cyprus (May 16, 2013) and other countries.

None of the bills about denunciation or changing the terms of a convention was approved, but the government still initiated the procedure for reviewing this document. As the press service of the Ministry of Finance of Ukraine announced [Урядовий Портал 2015], on July 2, 2015, the leadership of the Ministry of Finance reached an agreement with the representatives of Cyprus about reconsidering the offshore agreement. The plan is that the paragraphs about higher taxes on particular types of passive income will take power in 2019.

### **Negative consequences of terminating double taxation agreements**

Would it be a useful step to terminate the double taxation agreement with Cyprus, for example? There is no clear answer to this question.

If the termination procedure is violated, the Republic of Cyprus can sue Ukraine in the International Court of Justice. In addition, “Cypriot” investors can also seek international arbitration (the investments are owned by Ukrainian oligarchs).

In case the convention is terminated, even if the termination is in accordance with legal regulation, it can be perceived as a hostile act against Cyprus and the EU in general, which Ukraine is trying to integrate with.

Terminating the agreement only with Cyprus will not solve all problems. Business owners themselves admit that, should the Cyprus agreement be terminated, they will use other territories, particularly in Europe [Серветник, 2014]. Countries like Austria, Switzerland, and the Netherlands are not considered offshores, so capital outflow transactions with them are much safer. According to an estimate by the Belgian economist Eric Toussaint, 70 percent of offshore money is concentrated in the EU countries. We should be prepared for a “capital strike,” that is, investors can transfer their wealth to the countries that provide more suitable conditions. Only a state that has a clear strategy of recovering its control over the economy can stand against this kind of blackmailing.

There is a risk that companies will use territories that do not have any tax information exchange agreements with Ukraine to evade taxes. If today Ukrainian companies use for tax planning the “transit offshores” located in Europe, if these schemes are shut down, and if the government is not able to limit the capital movement, they will redirect their capital to exotic island countries.

### **3.4.2. International cooperation as an alternative to denunciation of double taxation agreements**

#### **Reconsidering the terms of double taxation agreements**

Although terminating bilateral double taxation agreements seems to be the most basic step towards deoffshorization, in practice, we do not know of any examples

when countries dared to do it. Loud claims along those lines were made, for example, by Russia. In the times of the Cyprus crisis of 2013, the prime minister Dmitry Medvedev announced that Russia may denounce its agreement with Cyprus [Газета.Ru, 2013]. Later, the Russian president's advisor Sergey Glazyev included the demand to terminate Russia's current double-taxation agreements in his Report [Глазьев, 2015]. These political declarations were of absolutely no legal consequence, even if the words of Kremlin leaders are seemingly easy to implement.

The experience of deoffshorization in developed countries, such as the USA, was not about denouncing double-taxation agreements, but about implementing internal policies and renegotiating the terms of those agreements. The latest version of the agreement between Ukraine and Cyprus is generally closer to the UN and the OECD standards. Which cannot be said about many other current agreements.

The UN and the OECD emphasize that double taxation agreements include some useful clauses and potentially can be used against tax minimization. According to the Introduction to the UN Model Double Taxation Convention between Developed and Developing Countries (2011), "the treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes." Although these agreements allow to minimize taxes, they also include paragraphs that serve as a legal basis for international counteraction against tax fraud.

Compared to the Decree by the Cabinet of Ministers of May 14, 2015, the list of offshore countries shortened from 20 to 9 countries; thus, transactions with such countries, popular for tax structuring, as the Netherlands, Austria, Switzerland and the United Arab Emirates are not subject to the transfer pricing law. This makes report submission unnecessary. These countries partially adjusted their laws to meet the OECD standards: reduced the scope of banking secrecy, simplified the procedure of revealing owners, and increased corporate tax rates. On the other hand, conventions between Ukraine and these countries include paragraphs about preferential tax rates on interest, dividends and royalties. By the way, the assets of well-known Ukrainian oligarchs are located precisely in these countries. Therefore, the question of introducing changes to these conventions is urgent.

**Rate increases.** A number of countries established less favorable conditions for business in the Ukraine. For example, Article 13 of the tax convention between the USA and Cyprus (1986) sets the tax rate on interest at 10 percent, and not 2 percent, as the agreement between Ukraine and Cyprus [Tax Convention With The Republic Of Cyprus]. Article 10 of the taxation convention between the US and Austria (1999) sets the royalty rate at 10 percent, and not 5 percent, as the agreement between Ukraine and Austria [Taxation Convention With Austria].

The minimum tax rate on dividends in the UK/Netherlands Double Taxation Convention (2010) is 10 percent, while the convention between Ukraine and the Netherlands sets the rate at only 5 percent [UK/Netherlands Double Taxation Convention And Protocol].

**Preventing abuses.** In addition, the commentaries on the UN Model Double Taxation Convention between Developed and Developing countries mention the possibility to include “general anti-abuse rules.” Rules of this kind are included in the double taxation convention between the Russian Federation and the State of Israel (2000) [Конвенция между Правительством Российской Федерации и Правительством Государства Израиль]. According to Article 24 of the convention, the competent authority can refuse preferences to any person or transaction, “if it thinks these preferences will lead to abuse of the regulations of the convention.” It is important to spell out in double taxation conventions that transactions “without reasonable economic purpose” shall lead to the loss of preferences. It is important to spell out the regulations that define the concept of “conduit companies,” which also cannot be treated according to preferential tax rates.

**Recommendations within the framework of the BEPS plan.** Attention should also be paid to the suggestions prepared as a part of the OECD BEPS (Base Erosion Profit Shifting) plan. Action 6 of the Plan is about counteraction abuses of double taxation agreements [BEPS Action].

Among other things, the Plan includes rather general clauses: first of all, it recommends to include in the preamble of tax treaties a clear indication that the sides aim to prevent tax evasion and avoid creating opportunities for so-called “treaty shopping” (selecting the more profitable conventions). It will allow to accuse companies of actions that go against the convention’s aims. In particular, the following anti-abuse changes are suggested:

- limitations on benefits, included in the US tax conventions;
- clear criteria for the main purpose of transactions, reflected in the UK tax conventions.

Ukraine’s reconsideration of its treaties is not only a desirable step in terms of social justice, but also a demand by the country’s partners, including the OECD.

## **Tax information exchange agreements**

Ukraine has to demand the improvement of coordination with tax havens in order to strengthen its control over capital flows. For this goal, it should sign tax information exchange agreements, as the USA did. The United States signed these agreements with the following countries which Ukraine recognizes as offshores: Barbados, Bermuda, Guernsey, Hong Kong, Jersey, the Isle of Man, the Cayman Islands and the Republic of Panama [Treaties and TIEAs]. The exchange



should involve the information on financial accounts, dividends, interest, account balances, payments for accounts, etc. Most double taxation agreements ratified by Ukraine in the 1990s-2000s do not take into account the contemporary standards of information exchange, as representatives of an audit company point out [Ernst & Young, 2015].

Ukraine managed to sign a tax information exchange agreement only with Belize (at the same time, negotiations with such countries as Panama and the Cayman Islands still have not succeeded). Under the pressure of the international community, even small island countries more and more often reject banking secrecy. If the government knew for sure what sums are located there, it could demand taxation or demand fines from the property located in Ukraine. Ukraine's persistency in this respect would be its contribution to the pressure on offshores by the international community.

It should be acknowledged that information exchange agreements will not demonstrate quick effects; in addition, it requires high professionalism on the part of tax authorities.

### **3.4.3. Internal deoffshorization policies in different countries**

#### **Overview of deoffshorization instruments in the US legislation**

The development of anti-offshore legislation was strongly affected by the US policies. The most powerful corporations which employ complicated tax evasion schemes are located in the USA. The US government had to find the response to these challenges by developing highly professional tax authorities. The inevitability and severity of punishment is the key characteristics of the American legal system, which is somewhat contradictory to the image of the United States as the stronghold of liberalism.

In 2010, the USA passed the Foreign Account Tax Compliance Act (FATCA). According to this law, foreign banks were obliged to inform the US tax authorities about all of their clients who can be connected to the USA, to reveal information about their transactions and account balance. Since then, banks, brokers and investment funds have been made to sign agreements with the US tax authorities and to become the tax agents of American taxpayers. Otherwise they have to pay a 30 percent fee on any transaction that passes through the United States. In order to implement this law, bilateral agreements have been signed with tax authorities of different countries. From the legal perspective, the Act is questionable, since it uses the concept "Persons of the United States", which includes not only US citizens.

The law is extraterritorial, that is, if the US security is threatened by financial transactions of companies and individuals outside the United States, these persons can be held responsible.

If an illegal offshore account is found, its owner should pay a fine of up to 150 percent of the sum on the account.

At the same time, we should not think that the strict regulations in the United States allowed to quickly collect large amounts of money; from 2011 until 2015, the tax authorities enforced the payment of \$5.5 billion as additional tax payments and fines. At the same time, American corporations are hiding about \$127.5 billion of taxes in offshores [Lenta.Ru, 2013], which is the world record. However, the principled approach of the US tax authorities is changing the legal field.

The success of the United States is linked to a number of factors, such as the special global position of the USA and the vulnerability of American corporations to publicity.

Undoubtedly, the FATCA mechanisms question both the owner's right to confidentiality and the state sovereignty (which is what the Russian Parliament appeals to). However, it seems that the problem of offshores has grown to such a scale that the existing mechanisms turned out to be insufficient.

#### **3.4.4. The reasons for the confiscation of offshore-related assets in Ukraine and abroad**

From the perspective of budget revenues and budget spending on social development, we should consider the idea of seizing the offshore-related assets located in Ukraine until the owners do not prove that their money is legal. Ukraine can also address other countries with the demand to assist in returning assets that belong to Ukrainian oligarchs. The countries that play the role of offshore centers bear extra responsibility, since it is a widely known fact that their banks are used for illegitimate purposes.

#### **General principles recognized by the international community**

International law emphasizes the return of the assets owned by officials linked to corruption. However, in Ukraine, nearly every corporation has connections with the government, and the property was obtained via privatization involving violations of the law. Corruption includes activities carried out not only by officials, but also in the private sector (bribe, corporate policy violations, etc.). The seizure of the assets of whole corporations for the crimes of their management seems reasonable.

Anti-laundering conventions can also apply, since nearly all of the money belonging to major companies in Ukraine can be considered "dirty." Since the early 2000s, the consensus has been established that money is laundered in offshore centers.

The current unsatisfactory situation with asset returns is related to the fact that the crimes of big capital are investigated using the same approach as for regular

citizens. The sabotage of returning the assets of Yanukovych's regime can be explained both by the favorable attitude of the government leadership to the concept of inviolability of private property, and by the fear of creating unpleasant precedents. In fact, international standards allow to derogate from such principles as the presumption of innocence. There are numerous cases when the procedure of proving the fact of fraud can be simplified. International standards are based on the recognition of the fact that "persons related to politics" will abuse their power for their own illegal enrichment. This group can include former public servants, such as "leading public figures." The reason for preliminary asset seizure does not have to be a court decision; the fact that criminal investigation has been started is sufficient.

The fact that an official who fled the country owns great wealth allows to assume that it was obtained by illegal means.

One of the most important means for recognizing the necessity of decisive steps against fraud is the UN document titled "International cooperation for crime prevention and criminal justice in the context of development." We would like to highlight the sections on expropriating corporations and the burden of proof.

The section on expropriation, reinforced by transferring the burden of proving the origin of suspicious property to the owner, can be a powerful tool to keep government officials from misconduct. However, if this rule is applied only to government officials, it will mean that a great potential that lies in it will be ignored. The document acknowledges that corporations, trusts and many contemporary business structures exist in order to avoid personal responsibility. It states that contemporary forms of private corporations are used to avoid punishment by eroding responsibility and intentionally complicating this issue, as well as by using all kinds of methods that allow CEOs to convincingly deny their involvement. Long-term imprisonment of officials that take bribes is deemed insufficient: it is the risk of "catastrophic consequences," namely confiscation of all corporate property, that should prevent them from accepting bribes. Practically every major company in Ukraine is linked to bribery, for example, during government tender competitions.

The section on the burden of proof provides a pragmatic idea of professional work in fighting corruption. The recommendations ambiguously points out that, in terms of strategy, transferring the burden of explaining the origins of assets to the official that owns them is akin to psychological and tactical war against corruption.

The general legal basis for asset seizure and return is provided by the United Nations Convention against Corruption (2003). In the context of offshore, it is important that countries cannot deny extradition based on the fact that a crime is thought to be related to tax issues.

### 3.4.5. Analysis of international legislation

*Directive 2014/42/EU of the European Parliament and of the Council on the freezing and confiscation of instrumentalities and proceeds of crime in the European Union (2014):*

The central idea of this document is that some severe crimes committed by officials can entail preliminary freezing of assets as a part of criminal proceedings. Presumption of guilt is applied in this case. In absentia sentence can also be the reason for asset seizure (Article 4). Conviction can be based on a court decision “where a court, on the basis of the circumstances of the case, including the specific facts and available evidence, such as that the value of the property is disproportionate to the lawful income of the convicted person, is satisfied that the property in question is derived from criminal conduct” (Article 5). Member states must take immediate action to freeze the property with the goal of possible further confiscation.

Some European countries have introduced tougher measures. In particular, we mean such mechanisms as presumption of criminality (testing for “criminal lifestyle”), which puts the burden of proof on the perpetrators to make them provide evidence that their assets have legal origins and thus protect their property from confiscation (regulations of this kind exist in Finland, France, Italy, Lithuania, the Netherlands, the United Kingdom) [представництво ЄС в Україні, 2015].

*Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism (1990):*

States have to grant requests for confiscation of income or means, or of equivalent sums (Article 7). Requests for confiscation can be sanctioned by courts or prosecutors. If a state receives a request for property confiscation on its territory, it should ensure that the decision about confiscation, made by a court of the party that submitted the request, is implemented, or passes the request on to its government bodies to receive a resolution. At the same time, Article 18 lists the cases in which a state can refuse to satisfy the request: if it contradicts the principles of the legal system of the responding party or damages its sovereignty, security or other substantial interests; if the importance of the case does not justify such measures; if a crime is political or financial. All these reasons for denying such requests must be properly justified. Bank secrecy cannot be the reason for denying cooperation. It is possible to implement a decision about confiscation even after an owner dies or after a legal entity is liquidated. All costs are usually covered by the requested party.

*The prevention and control of organised crime: an EU strategy for the beginning of the new millennium (2000):*

It is reasonable to equate “negligent behavior” to money laundering (it is easier to prove negligence than criminal intent). The document emphasizes the

implementation of a simplified procedure for confiscation and seizure of illegally obtained assets, since these measures have often been hampered “by the slowness of the exchange of information, the differences in legislation and the cumbersome nature of bureaucratic procedures.” Offshore centers and “fiscal paradises” are treated as territories that can provide a safe haven to criminal elements and be used for further criminal purposes. The burden of proof should be mitigated in case of proving the origins of property held by a person accused of crime, related to organized crime, within criminal, civil and financial law.

#### **3.4.6. Suggested measures for Ukraine**

**Limiting the freedoms of offshore businesses.** The possibility of discriminatory treatment of companies affiliated with offshore territories should be justified in legislation. The following ideas about limiting the rights of offshore companies can be considered: preventing them from getting access to tenders, loans, mining and activities in strategic industries, prohibiting VAT refunds to them.

**Substantial presence.** Offshore companies that work in Ukraine should be required to have substantial presence in the offshore territory; for example, a 2004 US law states that 25 percent of company staff must work in the offshore zone (business presence requirements). This makes it impossible for companies to have virtual presence in the country of registration but use its tax benefits.

**Presumption of dishonesty.** The experience of Nordic countries might be useful. In these countries, the burden of proof of innocence lies on taxpayers, not on tax authorities; that is, there is a presumption of guilt of a taxpayer when they sign a contract with a blacklisted offshore company. The presumption of dishonesty of taxpayers exists in some form in Australia, China, Ireland, Russia, the USA, Singapore, South Korea, and Sweden [Nexus Financial Consulting, 2014]. Even the extremely liberal Singapore has the presumption of taxpayer’s dishonesty. If a taxpayer is found guilty, they can be punished with a fine of up to 400 percent of the total sum of the unpaid tax, as well as with prison time.

The Supreme Court of Switzerland maintains that a company can be suspected of tax evasion when the schemes used by it look “unusual” from the economic perspective. Of course, in Ukraine, such conclusion would be treated by lawyers as a value judgement. “The active implementation of the General Anti-Avoidance Rule brings a lot of uncertainty for business,” Ukrainian lawyers claim. Nevertheless, it has become a usual practice in constitutional states and is dictated by social interests.

**Transparency of property.** The implementation of procedures to reveal the final beneficiary owners of various assets should be brought to its logical conclusion. Today, as the experts in the area of government registration explain, nobody demands the submission of a full set of papers that reveal the corporate

chain on the stage of registering legal entities, since it would not correspond to the principle of simplifying the procedure for opening a business. The key role in the deoffshorization process should be played by the public, but for that to happen, public registers of ownership must be created. As a lawyer Oleksandr Hubin points out, fiscal authorities have two main sources of information as to which Ukrainian companies that use tax havens: open databases of company owners and banks, and “the former is available only in a limited number of countries, for example, in Cyprus” [Губін, 2015].

**Differentiation of fines.** Fines should be higher for companies affiliated with classic offshorees which do not have automatic tax information exchange agreements with Ukraine. Such a scale functions in the UK [Art Business Group, 2011]. British tax authorities have the right to collect a fine of 200 percent of the unpaid taxes if a perpetrator used “wild” jurisdictions that allow to use aggressive tax optimisation schemes.

Changing the business environment culture. Tax evasion via offshorees must be treated as an act against the social interest. The formation of proper behavior will be facilitated both by the self-control of the business circles and by risks that outweigh the potential benefits. It does not mean that the role of tax consultants will be reduced. Experts admit that the time of aggressive tax planning based on simple decisions is inevitably becoming a phenomenon of the past [Nexus Financial Consulting, 2014], so lawyers will start to deal with more complex issues. It must be acknowledged that the arguments in favor of tax optimization are unconvincing, in particular the argument about the heavy tax burden: the corporate tax rate in Ukraine is only 18 percent, while in the USA it is 35 percent [Попович, 2015]. Ukrainian companies have claimed many times that they do not pay taxes because the government is corrupt. However, capital flees even from the USA which Ukrainian establishment treats as a social ideal.

## CONCLUSION

The current stage of Ukrainian history is characterized by the crisis of government institutions in managing the socio-economic life of the country. The long-term inability of the ruling elites to offer a vision of viable development that could unite the society, the prevalence of the interests of big business over the common goals, the restoration of archaic forms of capitalism with the flaws inherent in it — all these factors have led to a structural systemic crisis in the economy and, in the end, to rapid loss of independence in financial and economic policy.

The corrupt administrative methods were succeeded by the even less acceptable versions of market methods of regulating socio-economic relation. As a result, the funding for socially important programs in education and health care was cut, and fundamental and applied scientific research has become underfunded.

All these factors throw Ukraine many steps back and prevent the possible development in the future.

The analysis of the contemporary system of socio-economic policies carried out in this book, as well as the development of alternative suggestions about governance that aim to provide the basis for sustainable innovative development, allow to formulate the following conclusions.

1. The impact of Ukraine's system of debt relations on its loss of independence in financial, economic and social policy making is proved to be quite considerable. In the 1990s, the key role in this was played by the increase in the number of public and publicly guaranteed loans that funded the imports of foreign products and transferred the debt burden to the public budget balance. It aggravated the crisis and led to the first default in 1999. In the next period until 2008, there were attempts to develop a balanced debt policy and reduce the dependence on international financial institutions which used to impose neoliberal reforms among other conditions for their loans. The evidence has been provided that uncontrolled admission of international banking and speculative capital into Ukrainian markets

caused the severe crisis of 2008. It has been proved that if Ukraine's current debt policy is maintained, it will threaten the development, because the debt burden is impossible to carry if the strategy for the country's economic development is to be constructed.

2. The example of the 2015 budget has demonstrated the consequences of the redistribution of public funds to pay for public and publicly guaranteed debt. In the situation when resources are limited, these funds are taken by force out of social spending and investment spending on Ukraine's development. The influence of the International Monetary Fund on the priority of external public debt payments, which increases the government's dependence on external institutions, has been investigated. As an alternative, it has been proposed to replace the principle of passive budget distribution (money are spent to cover current expenses) with the so-called active budget distribution, where the money are spent on investment into economic growth.

3. Based on international experience, the authors prove that a unilateral announcement of sovereign default is preferable to a series of public debt restructuring, the option currently imposed on Ukraine. The example of Argentina disproves the thesis which is popular in Ukraine that after a default a country inevitably faces the deterioration of the socio-economic situation and limited access to international financial capital markets. The situation can have an opposite effect if a new economic policy is introduced. At the same time, the Irish case points at the possible negative consequences of debt restructuring following the scenario provided by the foreign creditors. Proof has been provided for the legitimacy of the demand for writing off illegal debts by the country's citizens. The question was raised about the need for introducing transparent public procedures in the international credit relations.

4. The social consequences of the latest defaults in Mexico, Russia and Argentina have been studied. It has been proven that such indicators as unemployment levels and the fraction of people living below the poverty line have a tendency to become worse before defaulting, unemployment peaks in the years of default, and the first positive tendencies can be observed right after defaulting and continue in the long term. Our finding is that the indicator of labor productivity has less correlation with defaulting and depends more on local conditions and the economic dynamics within the country. As for the indicator of income inequality, it also depends more on the post-crisis (post-default) economic policies in every particular country. The analysis of the 1999-2000 default in Ukraine shows that default has become one of the possibilities for improving social well-being and reducing economic inequality under conditions of developing a balanced economic policy.

5. It has been demonstrated that the philosophy of Ukrainian tax system serves the interests of a small minority of the population. It happens because of the tendency to redistribute the tax burden from big business to individuals. We



can observe the tendency for the fraction of the corporate tax in the total budget revenue to decrease, and the fraction of indirect taxes (VAT, excise tax), paid by the majority of already impoverished population, to increase. In spite of the dominant discourse of “high taxes,” it has been shown that the actual effective tax rate in Ukraine is one of the lowest in the region. The work on local budget decentralization has been proven ineffective, and the possible ways to provide local budgets with revenues have been outlined.

6. Based on the statistical analysis, the degradation of Ukraine’s economic structure and its reorientation to raw material exports (agriculture, mining and metal processing, etc.) has been described. Based on the data provided by the State Fiscal Service, the structure of actual taxation by economic sectors has been studied. The finding is that agriculture, “the new locomotive,” pays 20 times less total taxes than its fraction in the GDP (0.6 percent vs. 11.8 percent). This proves that the tax policy aimed to subsidize major agricultural companies at the expense of other industries and social spheres is unjustified. As of 2014, about a half of tax revenue is provided by the sectors of the real economy, where many companies are still public, or where the government still has effective means of tax redistribution, namely by the energy sector, transportation, and the mining industry.

7. It has been proven that agriculture is undertaxed because of fictitious official data about profitability of production and a large fraction of shadow market for its products. The calculation of profitability of growing sunflowers was provided as an example; officially, sunflower farming has the profitability of 59 percent, but in fact it brings up to 300 percent profit to agricultural companies. Arguments were provided for the need to replace the existing system of preferential VAT compensation to agricultural companies, which concentrates on a small number of holdings. We have proposed methods to improve the tax policy for agriculture, which would facilitate fairer redistribution of superprofits produced by this industry, while preserving profitability sufficient for development.

8. Based on the analysis of Kyiv city budget, the reorientation of the tax pressure from corporations to individuals was described. Further increase of tax rates on personal property without the introduction of a steep progressive scale will strongly hit the poorer citizens, particularly the owners of small apartments. We calculated the possible reserves for increasing tax revenues by systematically bringing business out of the shadow and introducing official employment. We also provided arguments for the need to involve communities and worker collectives in the planning and distribution of budget funds by introducing participative budgeting and its transparent administration.

9. Based in the statistical economic modelling, we studied the effect of introducing progressive taxation in different economies on several social indicators, particularly on increasing government spending on healthcare and

education, which should improve the population's access to these services. We proved that this effect varies depending on the type of the country we study. For example, for the countries with relatively high income per capita, progressive taxation affects the increase in healthcare spending. For other countries, this relation has not been observed due to poorly developed tax administration systems, widespread tax evasion and capital outflow to offshores, and the shadow economy. For Ukraine, this can mean that introducing progressive taxation modelled after European systems will not bring higher tax revenues or improve the quality of public goods in and of itself. Therefore, such measures must be combined with systemic changes in administration, improvement in transparency and effectiveness of control over the fiscal policy.

10. We studied the origins of contemporary Ukrainian economy based on the use of various tax minimization schemes. We provided evidence that, after the predatory privatization of public companies in the 1990s, the new owners mostly used free economic zones to avoid paying import duties, corporate taxes, VAT, and other taxes. Since 2005, capital outflow to offshores, especially to Cyprus, has become a priority. In particular, in 2015, more than 94 percent of foreign investment from Ukraine is concentrated in countries and territories of this kind. Some of the capital that escaped taxation in Ukraine later returns to Ukraine as foreign investment. We have demonstrated that the structure of offshore investment is distorted towards speculative capital and the financial sector.

11. We have calculated economic losses from Ukrainian companies' foreign trade with offshore territories. The analysis comprised 15 key export groups of goods that provide 80 percent of all exports from Ukraine. It found that more than 60 percent of goods have been sold via intermediary companies in order to minimize the corporate profit tax which could have been paid to Ukrainian budget. The reported price for the sold goods is artificially lowered by 20 to 90 percent, depending on the type of goods. The total estimated losses due to undertaxed exports from 2012 until September 2015 are about \$3.9 billion. Additional \$140 billion were lost in 2012-14 due to fictitious royalty imports. Excluding Switzerland and the United Arab Emirates from the list of controlled offshores in 2015 will intensify the capital outflow and looks unreasonable, given the simultaneous plans to reduce funding for social programs within the country.

12. We have studied the structure of offshore flows in the key export segments of Ukrainian economy, including plant farming and ore and metal industries. We found that, from 2012 until September 2015, only four key low-tax trade partners (Switzerland, the Virgin Islands, the UK and Cyprus) received about 64 percent of exported grains, oil plants and the products of their processing; 44 percent of exported ferrous metals and ferrous metal products; and 61 percent of exported ore and energy sources. The analysis of foreign trade proves that these countries are mere resellers, and the actual consumers are companies located in

other countries. The artificial reduction of prices in this trade scheme allows a major part of surplus value to evade taxation in Ukraine. The estimated losses in tax revenues due to offshore trade in grains and oil plants alone from 2012 until September 2015 is \$1.5-1.7 billion; this money could have been spent on improving the socio-economic situation and innovative development of Ukraine.

13. We analyzed in detail the international anti-offshore legal practices. We have studied the possibilities of implementing the relevant legal regulations in Ukraine. Based on this, a series of recommendations were developed to minimize the resource outflow from Ukraine to offshore. These include limiting the freedoms of offshore businesses (legal discriminative treatment of companies affiliated with offshore); introducing the presumption of dishonesty for foreign trade with offshore partners; improving ownership transparency (revealing the final beneficiary owners of various assets); introducing the principle of “substantial presence” (a part of company staff must work in the offshore); differentiation of fines for companies registered in offshore and tax havens.

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