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Ukraine: managing war-time public finances responsibly

The recent fiscal, macroeconomic and then political debacle in the UK has implications for Ukraine. Despite the war and horrendous budget deficit, financed first by its National Bank, then by foreign allies, Ukraine had its own tax-busting campaign during the last couple of months. Initiated by a group led by an economic advisor to the Head of the President's Office, the proposal included halving the VAT, a significant reduction of the profit and income taxes and abolishment of the social contribution tax. The proposal champions recognised that this would decrease tax revenues at least in the short-term, but claimed that the proposal would reduce corruption and spur economic development in the mid-term future.

How to finance an already ballooning government budget deficit? With global financial markets being closed for Ukraine, the only non-inflationary choice is a foreign support. Proposal initiators were somehow sure that foreign governments and international finance institutions would support their wild fiscal dream, pretty much like UK PM Liz Truss and her Chancellor Kwasi Kwarteng expected global financial markets to support their "mini-budget".

Well, there are at least four reasons, why the Ukrainian government has not employed such ideas into its Budget 2023. First of all, the claim that the lower taxes spur economic growth in an unfree economy is dubious. Ukraine's economy was rated as mostly unfree by the Heritage Foundation even before the war. One cannot expect much freedom during the existential fight amid military mobilisation and severe restrictions on the movement of males aged 18-60. Even more generally, the link between lower taxes and GDP growth is weak, as Martin Wolf writes in the FT.[1] And talking of economic freedom, neither the Heritage Foundation, not foreign investors rate high taxes as the main problem in Ukraine. Tax administration, VAT refund in particular, and rule of law in general, have been of much greater concern.

The Ukrainian liberals are right in their aim to reduce government's share in the economy (that is after the war, of course). But the state's size is defined by the level of government expenditures, not taxes. "Prewar, Ukraine was a middle-income country with a poor track record of growth. But it was also a post-Soviet society with an unusually large welfare network," writes Adam Tooze from Columbia University.[2] For a comparable level of GDP Bosnia had 3% of social protection expenditure as share of GDP, Armenia and Georgia - 6%, Moldova - 8%, Albania - 9% and Ukraine - 16%, according to the World Bank. Of course, there is a brutal way to reduce expenditures by cutting taxes drastically and thus depriving the national budget of money. But one better not tries this during the time of war when not only national budget, but the statehood is at stake.

Ukraine's spending needs to be better targeted, argues a recent report by the Centre for Economic Policy Research. "Some measures—such as price caps on gas and district heating — are wasteful. Aid to displaced people takes the form of a basic income, which goes to all regardless of need. The CEPR report advises taking a leaf out of America's playbook from the 2nd world war. During the conflict, the number of American households paying income tax grew tenfold, and the federal tax take more than doubled. Ukraine's flat-tax system, designed to make the country an attractive place to invest in normal times, is ill-suited to supporting a war economy," argues The Economist.[3]

Third, in general, tax reduction is inflationary. With inflation 10% in the UK and 25% in Ukraine, lowering taxes is not a prudent macroeconomic idea. Liberals might want to remember that their role

1 The economic consequences of Liz Truss. https://www.ft.com/content/a9be9db6-a91e-48e4-8d69-4bbfff7e0f5f
2 https://adamtooze.substack.com/p/chartbook-149-success-on-the-battlefield
3 https://www.economist.com/finance-and-economics/2022/10/18/ukraines-economy-seems-to-be-growing-again

model Margaret Thatcher raised, not lowered taxes in 1981 to fight inflation and finance the future Falkland war.

Last but not least, the expectation of the foreign allies and international financial institutions to finance ever larger budget deficit caused by tax reduction, is not liberalism. It is irresponsibility and infantilism. During the 8 months of the war foreign governments and IFIs granted or loaned Ukraine $28bn.[4] By the end of the year this amount is expected to be at $42bn. Ukraine's GDP is expected to be at the level of $130bn, 33% lower than in 2021. That means that the foreign support will amount to one-third of Ukraine's GDP, which is an order of magnitude higher the legendary Marshall Plan's size for its 15 beneficiaries (2.6% of GDP on average).

Simply saying, this foreign fiscal support is already huge, even before accounting for the military aid (more than $20bn delivered out of $36bn pledged for 2022). Ukraine's survival without all of this support would be very difficult.

But it is crucial to remember that the Western public supports aid to Ukraine to help to fight its existential war for freedom and rule-based global order, not to help the Ukrainian business to be more profitable in the times of war through lower taxes. "The authorities are encouraged to refrain from measures that erode tax revenues, as they strive to align expenditure with available financing," - says the IMF Statement at the Conclusion of an its Ukraine's Mission on October 21, 2022[5] after delivering $1.3bn in Emergency Financing Support to the country.

Summarising, Ukraine's government made a right decision not to heed to the populist proposals to cut taxes in the times war. But some tougher fiscal decisions may be needed in the future inn both Ukraine and the UK.

4 https://www.mof.gov.ua/en/news/ukraines_state_budget_financing_since_the_beginning_of_the_full-scale_war-3435
5 https://www.imf.org/en/News/Articles/2022/10/21/pr22359-ukraine-statement-at-the-conclusion-of-an-imf-mission