Analyses OSW

CENTRE FOR EASTERN STUDIES 15.10.2024 www.osw.waw.pl

Ukraine increases taxes amid mounting budgetary pressures

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On 10 October, the Ukrainian parliament (Verkhovna Rada) enacted a law amending Ukraine's tax code during the period of martial law, which raises taxes for individuals and sole proprietors, while also increasing the tax on bank profits. This marks the first tax increase since the onset of the full-scale war and is a response to the widening budget deficit in defence spending, amounting to approximately 500 billion hryvnias ($12 billion), which cannot be covered by foreign aid.

The previous day, the EU Council agreed to provide Ukraine with a new package of macro-financial assistance totalling €35 billion. This loan, granted under the G7 mechanism, will be repaid using profits generated from frozen Russian assets. The tax increases, which were delayed for several months due to political reasons, will have minimal impact on this year's budget. However, next year, when combined with funds from the G7, they should ensure Ukraine's financial stability, particularly in the defence sector.

The budget gap

The growing difficulties in covering defence expenditures in this year's budget had been publicly acknowledged for several months. In late May, Danylo Hetmantsev, head of the Verkhovna Rada's finance committee, conceded that a tax increase was inevitable, as the 2024 defence budget faced a shortfall of 300 billion hryvnias (approximately $7.3 billion). The deficit partly stemmed from a six-month deadlock that delayed the US Congress's approval of financial support for Ukraine (see '*The new US supplemental bill on Ukraine and the threat to confiscate Russian assets*'), which was intended for military aid. Consequently, Ukraine was forced to purchase weapons using its own funds.

In addition to this, the defence allocation in this year's budget proved inadequate, given the intensity of the ongoing war. According to Finance Minister Serhiy Marchenko, by July, the shortfall in defence funding had already reached 500 billion hryvnias ($12.1 billion). A draft bill to increase budgetary spending was submitted to the Verkhovna Rada on 18 July, but it was only passed two months later. It should be noted that expenditure for this purpose cannot come from funds directly transferred to Ukraine's budget by foreign donors due to their domestic legal constraints; therefore, the deficit must be financed from Ukraine's own resources.

The tax increase

The widening budget gap sparked a debate on how to secure funds for additional defence-related expenditures. On one hand, it was evident that the government needed to raise taxes in some form. On the other hand, the President's Office sought to distance itself from

socially unpopular decisions (a similar situation occurred with the mobilisation law; see '*Ukraine adjusts its mobilisation policy*'), which significantly delayed the entire process.

The amendments to the tax code were initially expected to pass by the end of August, but this was delayed until October. The proposed solutions included raising VAT, increasing the military tax (an additional 1.5% levy on personal income introduced in 2014), or a combination of both options. Many economists and businesspeople supported a VAT increase, as it is easier to administer and fairer, distributing the burden evenly across all taxpayers, including those earning income in the shadow economy.

Ultimately, however, due to concerns over rising inflation, the government decided not to raise VAT, but only to increase the military tax. This decision drew criticism from the business community, which argued that the increase would primarily affect fully transparent companies, rather than those that employ workers off the books or pay most wages under the table. Business representatives also called for a significant reduction in budgetary spending and a crackdown on the shadow economy, which would increase state revenues.

The legislation raises the military tax on wages of individuals (excluding those serving in the military, for whom the rate remains unchanged) and on all other types of income from 1.5% to 5%. It also introduces a military tax of 10% on the minimum wage for sole proprietors and individual entrepreneurs paying a lump-sum tax. Additionally, entrepreneurs in the so-called third group (with an income limit of 8.2 million hryvnias, paying 3% tax) will now be subject to a 1% military tax on their income.

Moreover, the tax on bank profits was raised from 25% to 50%; this increase will apply to the entirety of 2024 rather than from the date when the law takes effect. Starting next year, non-bank financial institutions, such as insurance companies, will also pay a 25% tax. During the vote, MPs rejected a key amendment that would have raised the military tax rate for individuals starting on 1 October. Although the proposal to implement the tax increase retroactively raised legal concerns, it would have bolstered budget revenues this year.

After the first reading of the bill, it was estimated that the tax increases would generate an additional 58 billion hryvnias (approximately $1.4 billion) this year and 137 billion hryvnias (approximately $3.3 billion) next year. However, it is currently difficult to assess how much revenue will flow into the state coffers by the end of the year, as it remains unclear when the president will sign the bill into law.

Closer to G7 support

On 9 October, progress was also made in the G7's efforts to develop a mechanism for allocating funds from interest generated by frozen Russian assets (see '*The G7 Summit: $50 billion has been promised to Ukraine*'). The ambassadors of the EU's member states approved the European Commission's proposal to grant Ukraine a new package of macro-financial assistance (MFA) worth up to €35 billion, which will form the EU's contribution to the €45 billion ($50 billion) aid package promised by the G7.

Previously, the process was stalled by a US demand that the EU extend its freeze on Russian assets from six to 36 months, a measure Hungary has vowed to block until the US presidential election on 5 November. The European Commission opted for the MFA formula, as it can be approved by a qualified majority, thus bypassing Hungary's objections. The European Parliament must still approve the decision, which it is expected to do on 22

October.

The MFA funds will be tied to the implementation of various economic and institutional reforms, aligned with the requirements for receiving assistance under the Ukraine Facility, with the specifics to be outlined in a separate memorandum. According to the EU Council's statement, the funds are expected to be disbursed in 2025. Unofficial media reports from 10 October suggest that the World Bank has established a special fund to manage the G7's financial support for Ukraine, although it remains unclear how the contributions will be divided among the US, Japan, and Canada.

The outlook for Ukraine's budget

The tax increases will only slightly alleviate this year's budgetary challenges. A deal reached last August to defer payments and partially restructure Ukraine's Eurobonds, for which 115 billion hryvnias (approximately $2.8 billion) were allocated in the budget, will enable the government to cover part of the deficit. An additional 100 billion hryvnias (approximately $2.4 billion) is expected from higher-than-anticipated tax revenues. However, the largest portion of the required sum, over 200 billion hryvnias, is to be raised through additional domestic bonds; the remaining gap will be filled through cuts to various budget items.

An additional 137 billion hryvnias, which the Ukrainian government expects to receive next year from the tax increases, will provide a significant boost. However, if the war continues with its current intensity, this sum will likely fall short of covering all the defence-related needs (the 2025 draft budget allocates 2.2 trillion hryvnias for this purpose).

A further increase in domestic debt may pose another problem in the coming year. The 2025 draft budget anticipates 579.2 billion hryvnias (approximately $14 billion) from bond issuance, the vast majority of which (561.9 billion hryvnias, or $13.6 billion) will be used to repay previous obligations.

Another challenge arises from the fact that foreign donors have only confirmed $15 billion in support so far, which falls significantly below the $38.4 billion anticipated in the draft budget. Given this shortfall, securing funds from the G7 will be crucial for the country's financial stability next year, particularly if they can also be allocated for defence.