VAT Refund Arrears in Ukraine

Analysis and Recommendations on How to Solve the Problem, With a Special Focus on Agriculture

Policy Paper on behalf of the American Chamber of Commerce in Ukraine (ACC)



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Executive Summary

Ukraine makes international headlines with an enormous accumulation of VAT refund arrears to domestic and foreign-owned companies. According to public information, the amount of VAT subject to refund was as of 1 April 2010 equal to UAH 28.4 bn, which corresponds to 2.6% of GDP. Primarily affected are export-oriented companies, which can claim VAT paid on inputs, while their exports are zero-rated. Within the export sectors, agriculture is hardest hit in both absolute and relative terms: While its share in the economy is 8.2%, it represents 28% of outstanding claims. At the same time, the present system of taxation in agriculture leads to heavy budgetary losses, estimated at UAH 10.5 bn for crop production in the current marketing season.

Negative impact on profitability, investment and rural development

The lack of VAT refunds is implicitly taxing and thus depressing prices for Ukrainian export goods. As a result, the profitability of numerous companies is drastically curtailed. For example, agricultural producers of grains and oilseeds will lose in 2010 alone an estimated UAH 11.7 bn in revenues. But depressed prices also work as a major obstacle for investments and for long-term economic growth. Many profitable investment projects become unprofitable due to depressed prices and are thus not implemented.

The negative effect on prices has also an impact on income and wages. This impact is especially high in agriculture, where commodity prices received by farmers are about 15% lower than would be otherwise. Thus, the VAT problem hurts the rural population and is a major impediment for rural development and poverty reduction.

<u>Unequal treatment of companies and negative structural effects</u>

There is clear evidence about a very unequal treatment of companies concerning legitimate VAT refunds. This unequal handling makes the problem even more serious, since it sets the wrong incentives to companies. Instead of spending time and money on capital goods and in adopting modern management technologies, companies might be tempted to engage in rent seeking activities, with negative economic effects for Ukraine and its people.

Furthermore, the fact that horizontally and vertically integrated companies can deal better with the VAT problem, implies the existence of negative structural effects on the economy.

Three causes for VAT refund arrears

The timely payment of VAT refunds to companies is a legal obligation of the state. Thus, there is no excuse for delaying or for not refunding VAT. Despite this, we identify three main factors that contributed to the present accumulation of VAT arrears.

The first cause is the weak fiscal position. When public expenditures are much higher then revenues, there is a tendency for using VAT funds owed to companies to pay bills such as wages and pensions, even though the former represent equally legitimate claims. The second cause is the fraudulent behaviour of some companies in the private sector. Such behaviour complicates the refund process and can partly explain the VAT refund arrears. Third, corruption within the public sector is a major cause for the refunding problem and especially for the unequal treatment of companies. Thus, corruption is the key element in distorting fair competition and preventing a level playing field for all companies.

The problem can be solved: General recommendations

The government will soon issue bonds in order to pay off existing VAT arrears. Thus, a solution to the stock aspect of the problem seems imminent. But it is also crucial to avoid VAT refund arrears reappearing in the future. In order to solve this flow aspect of the VAT refund problem, we put forwards recommendations in three areas.

- 1. Ukraine must return to fiscal stability and balance the budget in the medium term. While this is politically not an easy task, there is vast potential for reducing state expenditures as well as for increasing state revenues. Thus, the task is manageable.
- 2. VAT administration should be improved to reduce fraud, but without hurting lawabiding companies. In this respect, improvements in the registration process of new companies, a better strategy for monitoring the VAT chain, the consistent use of risk profiles and a centralised refund system would be of crucial importance.
- 3. Corruption within the public sector should be combated decisively. An important step would be the timely dissemination of comprehensive and reliable data by the State Tax Authority (STA). For monitoring the general situation, economy-wide and sectoral data on the development of VAT arrears are needed. In order to assess whether companies are treated equally, the STA should provide reliable and audited data on the ratio of VAT refunds to VAT claims at a company level.

Specific recommendations for agriculture

A special taxation system is currently in place to subsidise agricultural producers. Actual tax payments in the sector are very low. Furthermore, the system features a positive correlation between production and subsidies: If agricultural production goes up, so do the implicit subsidies. Since this taxation system is seen as a major reason for the VAT refunding problem in the sector, we elaborate proposals to reform it.

- 1. Most importantly, the current practice of charging, but not transferring VAT to the state budget should be changed, while maintaining the current rate of 20%. As a compensation for introducing this pay-in/pay-out system, agricultural companies should receive direct transfers from the state, as practiced in other countries.
- 2. In case a full implementation of this recommendation is politically not feasible, we believe that the introduction of a special VAT rate for agriculture of e.g. 10% would be a pragmatic second-best solution. The state budget would systematically receive VAT from agricultural producers and thus lower fiscal risks. From the farmers point of view there would be strong incentives to invest and to purchase inputs, as VAT payables may be deducted from VAT receivables to lower the tax burden.

A great chance for sending a strong signal to investors

Finding a long-term solution to the VAT refund problem should be a major aim of the new government. Ukraine would make a decisive move to support exports, which are essential to pull the economy out of recession and to stabilise the economy and its currency. Besides, it would increase investments and thus lay the foundations for future economic growth and for higher standards of living. At the same time, the new leadership would send a strong signal to domestic and foreign investors that Ukraine is not just concerned with reinstalling "stability", but also means business when it comes to "reforms".

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1. Introduction

Currently, Ukraine makes negative international headlines with an enormous accumulation of VAT refund arrears to domestic and foreign-owned companies. According to information published in the explanatory notes to the Draft State Budget Law for 2010¹, the amount of VAT subject to refund was equal to UAH 21.8 bn as of 1 January 2010. Information provided by the Presidential Administration showed that these arrears grew to UAH 28.4 bn as of 1 April 2010, which amounts to 2.6% of the expected GDP for this year.

While delays and other inconsistencies in VAT refunds have been a problem for many years in Ukraine, VAT refund arrears grew considerably in the last year, as refunds practically stopped for many companies. Primarily concerned are export-oriented companies, which can claim VAT paid on inputs, while their exports are zero-rated. A special focus among the exporting sectors is agriculture, which is the sector hardest hit in both absolute and relative terms: While its share in the economy is 8.2%², it represents 28% of outstanding claims. In addition, no level playing field exists among companies— some firms apparently receive (some) money back, while others do not.

This report analyses the quantitative importance of the VAT refund problem, looks at its underlying causes and economic implications, and derives policy recommendations for improving the system of VAT refunding – both for the overall economy and for agriculture. The focus is hereby on making sure that future "flows" of VAT refunds will be reimbursed in a timely manner. The clearance of the existing "stock" of VAT refund arrears will not be touched, since a solution for this problem seems imminent.³

2. Value Added Tax in Ukraine – Is there an Alternative?

The VAT is a consumption tax, i.e. borne (paid) ultimately by the final consumer. It is collected at each stage of the production and distribution chain as a fixed proportion of value added and then partially reimbursed as the good is sold⁴. Most countries apply the destination principle, i.e. VAT is collected in the country where final consumption of the good takes place. This implies VAT to be removed from exports (i.e. applying a rate of zero to export sales), allowing the exporting firm to reclaim VAT paid on inputs. This practice avoids a double taxation, as VAT is usually charged on imports, and puts exports internationally on an equal basis with domestically produced goods.

¹ Submitted to Parliament on 23 April 2010.

² We use as an indicator the share of value added in agriculture (UAH 65.52 bn) in total value added (UAH 797 bn) in Ukraine for 2009. Alternatively, the share of agriculture could be expressed in relation to GDP (UAH 915 bn). In this case the share amounts to 7.2%.

³ See the relevant information provided in the Budget Law for 2010 and the recent Draft Resolution of the Cabinet of Ministers on Issuing State Domestic Bonds for Value Added Tax Refund.

⁴ See Frensch/Bigdai/Leschenko (2004): VAT replacement or better administration?, IER/German Advisory Group Policy Paper T36.

VAT is a key component of tax systems in over 130 countries (including Ukraine), which are at very different stages of economic development, and raises about 25% of world tax revenue⁵.

In Ukraine however, VAT administration has been frequently criticised for its low efficiency. The main problems of the current system mentioned are the accumulation of VAT refund arrears as well as a low level of tax compliance. Despite attempts to improve administration, these problems have persisted, leading to proposals on the political level to replace the current VAT system with a different fiscal instrument.

While a consistent conceptual approach as an alternative to VAT is currently lacking in the political discussion, a turnover tax (TT)⁶ is often mentioned. A TT can be defined as a cumulative (or cascade) multistage sales tax, which is imposed at all levels of production and distribution, without the right to deduct the taxes paid at previous stages. The specific features of this tax in comparison with VAT have a number of economic implications, which are summarised in the following Table 1:

Table 1: Comparison of VAT versus TT

	VAT	TT
Tax base	Value added (VA)	Turnover (VA plus inputs)
Deduction of taxes previously paid	Yes	No (cumulative taxation effect)
Impact on relative prices of goods and services	No	Yes
Taxation of investments	No	Yes
Neutrality in terms of exports/imports	Yes	No
Neutrality in terms of business organisation	Yes	No (creates incentives for vertical integration of firms)
Tax compliance	High (fraud easier to detect)	Low (fraud difficult to verify)
Administration	Requires sophisticated tax administration	Easier to administrate (but administrative costs could rise with audits, as verification of reported turnover is difficult)

Sources: Burakovsky/Vakhnenko (2005): To change or not to change? Economic and Fiscal Implications of Turnover Taxation, IER/German Advisory Group Policy Paper U7; and World Bank (2006): Ukraine. Creating Fiscal Space for Growth: A Public Finance Review, Report No. 36671-UA, Poverty Reduction and Economic Management Unit (ECSPE)

To sum up Table 1, a TT would exhibit negative economic effects in a number of areas, while the impact from a fiscal point of view (tax compliance, administration) would be more than uncertain. In addition, a TT would be also contradicting the long-term European integration ambitions of Ukraine, as all EU-accession candidates are required to have a VAT system, which is in line with the EU's harmonised VAT legislation⁷.

⁵ See Harrison/Krelove (2005): VAT Refunds: A Review of Country Experience, IMF Working Paper WP/05/218.

⁶ There are other alternatives, including the introduction of a general sales tax (GST). While a GST does not share all the negative features of a turnover tax mentioned below, it remains nevertheless an inferior alternative to VAT. See Frensch/Bigdai/Leschenko (2004): VAT replacement or better administration?, IER/German Advisory Group Policy Paper T36.

⁷ See VAT Directive (Directive 2006/112/EC).

Conclusion 1: A turnover tax (TT) is an economically inferior alternative to the current VAT system, and thus should not be introduced. The obvious shortcomings of the VAT system in Ukraine in terms of administration, and here specifically VAT refunding, should be addressed by improving the system, rather than abolishing it in favor of a TT.

3. VAT Refund Arrears in Ukraine: Quantitative Assessment

A first step of a thorough analysis of VAT refund arrears consists of a quantitative assessment of the problem within the framework of public finances. The following Table 2 shows different aspects of VAT collections during the last years:

Table 2: Dynamics of VAT collections, 2005 - 2009

Indicator	Unit	2005	2006	2007	2008	2009
Gross VAT collection	UAH bn	46.8	65.4	78.3	126.5	119.1
Actual VAT refunds	UAH bn	13.3	15.0	18.9	34.4	34.5
Net VAT collection (gross – actual)	UAH bn	33.5	50.4	59.4	92.1	84.6
VAT refund arrears (end of the year)	UAH bn	4.2	6.8	8.6	12.8	21.8
Central fiscal revenues	UAH bn	105.3	133.5	165.9	231.7	225.3
Nominal GDP	UAH bn	438.7	544.2	720.7	948.1	914.7
Share of VAT refund arrears in total VAT collections	%	9.0	10.4	11.0	10.1	18.3
Share of VAT refund arrears in total central revenues	%	4.0	5.1	5.2	5.5	9.7
Share of VAT refund arrears in GDP	%	1.0	1.2	1.2	1.4	2.4

Sources: STA reports, Derzhkomstat, Presidential Administration, own calculations

Table 2 clearly demonstrates that the VAT refund arrears have grown considerably in 2009. While the share of VAT refund arrears to different fiscal indicators has always fluctuated in a relatively narrow range (last three rows of Table 2), the respective ratios almost doubled in 2009 (see figures highlighted in bold). A very interesting point to note is that the data on VAT arrears is not provided by the STA, although this institution is the natural source of such information. Instead, the data are provided by the Presidential Administration.

This is the reason why a more detailed analysis of the recent dynamics of VAT refund arrears is based on the regular updates published by the Presidential Administration, given in Table 3 below:

Table 3: Recent development of VAT refund arrears, including overdue VAT

As of	VAT refund arrears	Growth	Overdue VAT refunds arrears*	Growth
	UAH bn	%, yoy	UAH bn	%, yoy
01.01.2002	5.8	-	1.9	-
01.01.2003	7.5	29	3.9	105
01.01.2004	7.4	-1	2.4	-38
01.01.2005	3.5	-53	n/a	-
01.01.2006	4.2	20	1.5	-
01.01.2007	6.8	62	3.2	113
01.01.2008	8.6	26	4.1	29
01.01.2009	12.8	49	3.0	-28
01.02.2009	13.2	-	3.9	-
01.03.2009	13.6	-	3.9	-
01.04.2009	13.6	63	3.7	5
01.05.2009	13.7	-	3.9	-
01.06.2009	14.7	-	4.1	-
01.07.2009	16.1	96	4.4	20
01.08.2009	17.4	-	4.5	-
01.09.2009	19.2	-	4.9	-
01.10.2009	16.2	59	5.1	98
01.11.2009	18.2	-	5.5	-
01.12.2009	19.4	-	5.4	-
01.01.2010	21.8	71	6.2	109
01.02.2010	24.9	88	7.3	86
01.03.2010	25.6	89	7.6	98
01.04.2010	28.4	108	8.6	132

Source: Presidential Administration, own calculations

Notes: * No information on how overdue arrears are calculated are provided n/a represents missing information

Beginning in 2009, VAT refund arrears started to accumulate at an alarming rate, with annual growth rates at times exceeding 100%! Recently, an explosive growth of such claims has been recorded, and arrears grew up to <u>UAH 28.54 bn</u> (1 April 2010). While the share of VAT refund arrears that is considered as overdue is much less than the total amount, it is nevertheless increasing at roughly the same alarming rate as total arrears. Furthermore, there are hints that the declaration of overdue refunds is administratively delayed. The STA has a number of instruments at hand to delay this recognition.

Given a lack of consistent and regularly published data, it is very difficult to monitor the sectoral distribution of VAT refund arrears. Table 4 below exhibits the only available official data from the office of the Prosecutor General⁸. No historical development of sectoral VAT refunds is available, only a one-off snapshot of selected sectors.

⁸ While official data are scarce, there is no shortage of numbers mentioned in the public discussion. However, most often these numbers are rather confusing and not consistent with each other, and thus no substitute whatsoever for official data. Furthermore, there are no official data at company level.

Table 4: Split between selected sectors of the Ukrainian economy (UAH m)

Sector (Selection)	VAT refund arrears (01 March 2010)	VAT actually refunded in 2009
Agricultural industry (including grain traders)	7,117	3,572
Mining and metallurgical complex (mining and smelting)	7,114	11,424
Machinery construction	1,027	2,057
Chemical industry	1,466	2,007
Food industry	524	383
Trade	407	358
JSC "Naftogaz"	n/a	8,000

Source: Prosecutor General of Ukraine

Note: The information above includes only selected sectors of the economy and is based on a different source than Table 3

Table 4 clearly shows that in absolute terms, the agricultural sector suffers most from the problem of unreturned VAT, with <u>UAH 7.1 bn</u> in claims as of 1 March 2010, representing 28% of total claims in the economy. Taking into account that agriculture represents only 8.2% of the economy (2009) the situation is even more severe in relative terms.

Our research conducted for the quantitative assessment of VAT refund arrears has led to a further major insight: There are huge problems in data availability. This involves different aspects:

- The responsible institution for taxation in Ukraine, the STA, provides very little
 information on VAT refunds arrears to the public. Obviously, it does neither
 consider this as an obligation nor as an important task
- As a result, information has to be gathered from other sources, both public (e.g. Presidential Administration, Prosecutor General, citations of state officials in the press) and private (press releases from business associations and companies).
 Needless to say, the multiplicity of secondary sources does not always provide a clear picture of the situation
- Public data are disseminated at a very aggregate level, which makes an analysis of the implications for different sectors and companies very difficult. In particular, there are no public data at sectoral and at company level

Conclusion 2: According to public information VAT refund arrears amount currently to UAH 28.4 bn (2.6% of GDP). Thus, the problem has reached an economy-wide, systemic importance. The agricultural sector is most affected, both in absolute and relative terms.

Conclusion 3: There are severe shortcomings in terms of public dissemination, swift availability and extent of coverage of reliable data. This is a major impediment for a thorough analysis and for a close monitoring of the problem.

4. VAT Refund Arrears: General Causes and Consequences

In order to effectively combat the problem of VAT refund arrears, one needs a thorough general understanding of their underlying roots and the negative consequences for Ukraine's economy. In the following sections, we deal with the causes of the VAT refund crisis and their economic consequences.

4.1 Causes

We identify <u>three</u> main causes for the explosion in VAT refund arrears: the strained fiscal situation, the fraud in the VAT chain and the widespread corruption in the public administration.

Cause 1: Strained fiscal situation

While there have been frequent problems with VAT refund arrears in the past (delays, etc.), the systematic non-reimbursement of such claims takes only place in periods of high stress to public finances. This view finds support in the recent past, where crisis-related factors led to a big loss in revenues, while expenditures were not adjusted accordingly. This lack of fiscal discipline resulted in a huge increase in the budget deficit. In 2009, the budget deficit of the general government amounted to 9.0% of GDP⁹, while the corresponding figure for 2008 was only 3.2%. Specifically, during election campaigns, policy makers set spending priorities¹⁰ in such a way that puts companies with legitimate VAT refund claims at a disadvantage to other recipients of public funds such as pensioners and public officials. As a result, companies are forced to crediting the Ukrainian state at zero interest rates, for an undetermined period of time, and with high uncertainty regarding the full reimbursement of claims.

Cause 2: Fraud in the VAT chain

As in many other countries, Ukraine faces the problem of fraudulent behaviour of private companies regarding VAT. In particular, some companies charge VAT when "selling" their goods, only to become bankrupt soon afterwards, without transferring the charged VAT to the tax authorities. In many cases, is it not possible to track the managing director of the fraudulent company due to legislative and administrative weaknesses in Ukraine. Thus, the VAT chain is often broken, and the tax authorities need to investigate the situation in order to avoid large revenues losses. Since such investigations need time, the process of VAT refunding can be delayed as a consequence. While it is difficult to assess the quantitative importance of this fraudulent behaviour, the problem seems to be quite serious. According to the State Tax Authority, this fraudulent behaviour is a major reason for delays and refund arrears.

Cause 3: Corruption in the public sector

Companies and business associations complain about severe corruption in the public administration. In particular, receiving VAT refunds seems only possible after the payment

⁹ This includes the central and local budgets, the Pension fund and also the deficit of Naftogaz, but excludes recapitalisation.

¹⁰ It has to be stressed that such a political prioritisation of social commitments over VAT refunds is not in accordance with existing legislation, as VAT refunds are a legal obligation of the state.

of large kick-backs in the realm of 20 - 50% of the amount to be refunded, as state officials admit¹¹. The existence of such corruptive schemes is a major cause for the accumulation of VAT refund arrears. Furthermore, the use of corruptive schemes implies as a rule large differences in the treatment of companies and is currently one of the main reasons for the lack of a level playing field in some sectors of the economy.

Conclusion 4: The underlying roots for the existence of VAT refund arrears are several-fold. Thus, a strategy to deal with this problem needs to tackle it from several angles.

4.2 Consequences

The existence of large VAT refund arrears has several negative consequences on the Ukrainian economy. The export sectors are weakened, thus discouraging new investment. Besides, there are negative implications on the structure of companies and on the general business climate.

Consequence 1: Weakening of export sectors

The exact impact of the VAT refund problem at the company level depends on a numbers of factors, such as on whether the VAT arrears are eventually reimbursed or not, the size of the implicit discount to receive VAT refunds (either through kick-backs or other schemes) and the duration of delays. But without doubt, the current problems regarding VAT refunds have a strong negative impact on the liquidity situation as well as the profitability and solvency of companies in the exporting sector. Regarding liquidity and working capital, this is a huge problem especially in the context of a credit-constrained environment. Concerning profitability, the current problems put many companies under threat, thus jeopardizing thousands of jobs in the export industries.

This weakening of the export sector is particular damaging under the current macroeconomic conditions. Fiscal and monetary policies cannot become more expansionary, since this would put the stability of the economy and the domestic currency under threat. The only hope for recovery lies in the export sector. But by taxing this sector with up to 20%¹², it is doubtful whether it will be able to function to its full capacity. Besides, not only exports suffer as a result of such an extra tax, but also domestic prices for the whole product range suffer accordingly. Thus, the VAT problem has to be considered as a major impediment for the short-term stabilisation and recovery of the Ukrainian economy.

Consequence 2: Discouragement of new investments in export sectors

The VAT refund crisis has also major <u>long-term</u> implications on the exporting sector. Any potential investor in this sector needs to take the de-facto export tax in form of VAT non-reimbursement into account, especially now that the problem is perceived as being of a permanent nature. Under such circumstances, a large amount of otherwise profitable investment projects become non-profitable and will thus not be conducted.

¹¹ Prime Minister Azarov mentioned these figures during a press conference briefing on 24 March 2010.

¹² Actually, the burden is even higher, since the losses due to non-refunded VAT are not accepted as a "cost deductible item". As a result, corporate profits and the corresponding tax burden are artificially inflated.

The detrimental impact on investment in the export sector has negative consequences on the productivity of labour and thus on the level of wages of the Ukrainian population. Also, it hinders the diversification of the structure of exports in Ukraine and makes the country more vulnerable to external shocks. The economic policy objective of creating dynamically growing and well-diversified exports is hardly achievable in such an adverse environment.

Consequence 3: Negative structural implications

As stated above, some companies apparently find it much easier to receive VAT refunds than others. This unequal treatment creates severe structural problems.

First, illegal bribes and corruption support rent-seeking activities rather than the quest for economic efficiency gains. As a result, competition is distorted and there is no level playing field among companies.

Second, big, vertically and horizontally integrated holdings are put in a competitive advantage simply due to the fact that they are able to offset VAT payable and receivable internally, without asking the STA for refunds. This –legal– artificial advantage, which lacks any underlying economic rationale, leads in effect to an inefficient sector structure.

Third, there are legal schemes available, where companies with VAT payables buy e.g. grain/oilseeds and export, thus being themselves eligible for the offsetting. The number of market transactions carried out under such offsetting schemes grows considerably, thus increasing transaction costs and reducing transparency. This is also diametrically opposed to the international trend towards smaller, specialised firms.

Ultimately, the overall result of these negative structural implications is that competitiveness, productivity and economic growth will suffer, including income and wage growth.

Consequence 4: Negative impact on general business climate

The whole story of VAT refunds is a major negative marketing event for Ukraine. Domestic and international investors have doubts about the reliability of government policy and the predictability of the country's taxation system. In such a way, the business climate of the country becomes much worse. While the exact magnitude of such effects is practically impossible to measure, based on extensive conversations with private companies, we are convinced that the damage so far is huge.

Conclusion 5: The economic consequences of the VAT problem are extremely serious. Ultimately, all factors mentioned above reduce economic activity and investments, create structural distortions, increase uncertainty and have thus a negative impact on employment, income and wages.

5. VAT Refund Arrears in Agriculture: Special Considerations

The data on VAT refund arrears show that agriculture suffers most among the sectors concerned, both in absolute and in relative terms. At the same time, agriculture is with respect to taxation and subsidisation quite different from the rest of the economy. This special treatment is perceived both by market participants and by state officials as a specific cause of the VAT refund problems within the sector, i.e. a direct link between these issues is accepted as a fact.

5.1 Causes

Domestic producer support to the agriculture and food sector in Ukraine is mainly channeled through i) fiscal support measures, and ii) foregone tax revenues from agriculture and the food industry. Fiscal support to agriculture is comparatively low compared with producer support in the US or EU, but increased constantly till the year 2008. Due to the impact of the financial crisis it decreased in 2009. The state budget for agriculture increased again in 2010.

Table 5: Total agricultural public expenditures 2007 to 2010 (UAH bn)

2007	2008	2009	2010
executed	executed	adopted	adopted
8.45	10.45	7.46	11.07

Source: Own display

Major producer support is provided through special tax regimes comprising the following major elements:

Fixed Agricultural Tax:

Agricultural enterprises receiving more than 75% of their gross revenues from sales of agricultural commodities are eligible for this tax based on the official nominal value of the land. As this tax is based on land values of the year 1995, the actual value of the land tax is very low. The total sum of paid taxes in 2009 was UAH 122.9 m or about UAH 5 per ha of arable land, according to the Ministry of Agrarian Policy.

Special VAT scheme for meat and dairy producers:

Dairies or meat processors receiving VAT from consumers may put this money on a special account for producers of milk and meat to finance investments in the sector. VAT is not paid to the state budget. Currently, a draft law is under review to revise this system to ensure VAT payment to the state budget. Producers would be compensated by direct investment subsidies.

Special VAT scheme for agricultural producers:

Agricultural producers may choose to pay VAT to the state budget or to put this money on special accounts to be used for investments. In the second option VAT is not paid to the budget. The total sum of paid VAT from agricultural producers in 2009 was according to Ministry of Agrarian Policy UAH 326.5 m. So, the vast majority of producers prefer the second option. The budget losses for crop production alone are estimated at about UAH 10.5 bn (see below).

Zero-VAT and VAT refund for exporters:

Traded agricultural commodities are zero rated for export purposes. Exporters have to pay VAT paid for inputs and commodity purchases to the state budget. The difference between VAT receivables and VAT payables may be claimed back from the tax administration. The current system leads to constant arrears of payment. Payment arrears to agricultural companies at the beginning of March 2010 are estimated at UAH 7.1 bn.

Conclusion 6: Support to agricultural producers is mainly based on special tax regimes and tax exemptions. This system is based on the wrong conclusion that agricultural production cannot be fully taxed because of its disadvantages compared to other sectors in the economy. With growing processing and export shares the current system comes under pressure.

5.2 Consequences

Agricultural enterprises sell their products to traders and receive VAT. They are also buying inputs and pay VAT. Usually, they are receiving more VAT than they pay. If the agricultural producer is choosing the special VAT regime he may keep the received VAT on his accounts. Table 6 illustrates the current mechanism for wheat production.

Table 6: VAT payments from the farmers point of view, model calculation, (ha)

Wheat production		VAT Receivables	VAT Payables
Yield (t/ha)	3.1		
		received from	
Net Revenue (Price = 1000 UAH/t)	3,100	processors or traders	
VAT 20 % (UAH/ha)	620	620	
Gross Revenue (UAH/ha)	3,720		
<u>Variable costs</u> :			paid to input suppliers
Seed (UAH/ha)	200		40
Fertilizer (UAH/ha)	400		80
Agro-chemicals (UAH/ha)	350		70
Other costs (UAH/ha)	240		48
Fuel (UAH/ha)	250		50
Variable Labor Costs (UAH/ha)	150	non-VAT item	
Fixed Agricultural Tax (UAH/ha)	6	non-VAT item	
Land Lease (UAH/ha)	250	non-VAT item	
Amortization (UAH/ha)	400	non-VAT item	
Administration (UAH/ha)	200	non-VAT item	
Capital costs (UAH/ha)	160	non-VAT item	
Variable costs (UAH/ha)	2,606		
Gross Margin before VAT (UAH/ha)	1,114		
Gross Margin after 20 % VAT (UAH/ha)	494		

Source: Own display

Note: This is a model calculation based on the IER data of agricultural enterprises.

Yields as well as input and output prices in Table 6 are based on realistic assumptions. However, actual calculations for a farm may differ from this model calculation. The producer receives the net price plus 20% VAT from the processor or trader. He may keep this money on a special account. At the same time he pays net input prices for VAT items and pays 20% VAT. The balance is positive and is increasing his gross margin of wheat production. In other

sectors the producers balance VAT receivables and payables and transfer the balance to the state budget.

This support to farmers is pro-cyclical. The higher the performance of the sector the higher will be the foregone tax revenues for the state budget. With increasing production, processing and exports the foregone state budget revenues are increasing. From the state budget point of view this is the core problem. In the years 2008 and 2009 with good harvests VAT outflow to processors and traders from the state budget had to be increased without adequate VAT inflow from agricultural producers. Consequently, the system collapsed.

Table 7: VAT payments from the point of view of the state budget (ha)

Wheat production		
VAT Inflow	(UAH/ha)	VAT Outflow (UAH/ha)
no inflow from w	heat producer	refund to exporter or processor
		620
Inflow from inj	out suppliers	
Seed	40	
Fertilizer	80	
Agro-chemicals	70	
Other costs	48	
Fuel	50	
Sum	288	620
State budget loss	332	

Source: Own display

It is evident that the current VAT tax regime is not a viable long-term solution. A widening gap between VAT outflow to processors and exporters and stagnating VAT inflow from agricultural producers would lead to ever increasing problems for the state budget to refund VAT timely and fully. It also gives wrong incentives to agricultural producers. The agricultural production intensity and investments remain lower in a system where the input is taxed but the output is not.

Table 8: State budget losses through non-payment of VAT in the crop production season 2009/2010, model calculation

				Total yield	Budget loss
Crop	Loss/ha	m ha	Yield/ha	m t	UAH m
Wheat	332	6.7	3.1	20.77	2,224
Barley	224	5	2.4	12	1,120
Corn	610	2	5	10	1,220
Sunseeds	676	4.2	1.6	6.72	2,839
Rapeseeds	732	1	1.8	1.8	732
Other grains	300	0.5	2.5	1.25	150
Other oilseeds	600	0.6	1.4	0.84	360
Sugar beet	400	0.3	33	9.9	120
Vegetables	5,000	0.2	20	4	1,000
Potatoes	4,000	0.2	13	2.6	800
Total		20.7			10,566

Source: Own display

Notes: The production figures are based on official data partially adjusted to reflect our own and views of market participants. The loss/ha has been calculated based on gross margin calculations for each individual crop. For vegetables rough-cut estimates have been made. The total crop area is about 27 m ha. The above calculation comprises 20.7 m ha. Therefore, calculations are without feed production and perennial crops; without livestock production; without on-farm processing. The losses would be higher if those sectors were included in the calculations.

As shown in Table 8, the total loss in crop production for the state budget in the current marketing season is estimated at about UAH 10.5 bn. The Ukrainian state budget is not benefiting from increasing grain and oilseeds production. It is the opposite: Through higher processing and export shares the necessary state budget needs for VAT refunding are steadily increasing. It is evident that this system is not viable. A good harvest leads to increasing state expenditures through VAT refunds to processors and exporters with tax revenues from agricultural producers remaining at the same low levels as before. State budget control becomes impossible in such a system.

Processors and traders facing high risks of delayed or non-payment of VAT refunds will not bear that risk. They will instead roll over higher risks and capital costs to farmers by offering lower prices. Usually, their VAT refund calculation includes corruption risks, capital costs and risks of non-payment. In the past, many of them assumed a rate of about 10% losses due to payment delays, corruption and higher administration costs. Currently, due to the long and uncertain non-payment of VAT they are anticipating almost 20% losses. Therefore, farmgate prices for farmers are about 15 to 20% lower than they would be with timely and fully VAT refunding. As a consequence, farmers lose about the same amount of money that they earn by VAT exemption. As they cannot deduct VAT paid to input suppliers from their VAT receivables those farmers who are investing in improved technology lose. The combined impact for farmers is negative. The more producers are investing the higher is this impact. The VAT system gives wrong incentives to investors. The order of magnitude of this "price effect" cannot be neglected any longer. Ukraine is producing this season about 48 m t of grains and 10 m t of oilseeds. The value of this production at current prices of about USD 130/t grain and USD 350/t oilseeds is USD 9,740 m or UAH 77,920 m. Assuming a price loss of 15 % at farm-gate the total loss for Ukrainian farmers is about USD 1,461 m or UAH 11,688 m in this season. This sum is higher than the state budget for agriculture in 2009, and is equal to 1.3% of GDP. There is no other agricultural policy measure with a similar impact of this huge order of magnitude.

Conclusion 7: The consequences of the current VAT system in agriculture lead to increasing state budget problems, and hence problems with VAT refunding, in years with good harvest and high processing and export shares. Therefore, state budget expenditures increase procyclically. Control of state expenditures will become more difficult in future with rising investments, production and export shares. The current system gives also wrong incentives to farmers. Investing farmers cannot deduct VAT payables from their tax bill. The overall impact for farmers is negative. Thus, investments and efficiency gains in the sector will be lower than in a system comparable with practices in other sectors.

6. How to Solve the Problem: Policy Recommendations

The development of VAT refund arrears has reached a critical stage, and a long-term solution is needed so that the present situation will not appear again in the future. The causes for VAT refund arrears that we identified above serve as starting points for our general policy recommendations. Since the agricultural sector is a special focus of this report, specific recommendations for agriculture will be presented afterwards.

6.1 General Recommendations

Recommendation 1: Stabilise and consolidate public finances

A prudent and sustainable fiscal policy is clearly needed, with a clear objective of balancing the budget in a medium-term perspective. Otherwise, the arbitrary withholding of legitimate VAT refunds will likely happen again in case of budgetary needs.

Concrete measures¹³ for stabilising public finances can be identified both on the expenditure and the revenue side. Cutting public expenditures should focus on pensions (by implementing a broad-based pension reform), price subsidies (mainly in the energy sector, where cost-recovery by raising tariffs needs to be achieved) and enterprise subsidies. It is important to note that such measures can be done in a way that does not hurt the poor.

Also the revenue side has room for improvement, as the tax base could be broadened by closing loopholes and reducing tax exemptions/privileges. Here, simplified taxation has to be mentioned, where the focus must be on curtailing the massive abuse of the current system, even though the system should continue for truly small businesses and entrepreneurs.

Recommendation 2: Reform of VAT administration

Fraudulent schemes in connection with VAT refunds should not be seen as an excuse to stop refunding for all companies. "Good" companies should not be punished for tax crimes that "bad" companies may commit, i.e. a "joint responsibility" of all companies operating in the VAT chain for individual violations of the law is not justified. Rather, it is the obligation of the STA to identify and sanction any VAT fraud, and thereby keeping the VAT chain free from such criminal behavior. Companies in the VAT chain should be considered as acting in "good faith", unless proven otherwise. In order to effectively combat fraud, a general reform of VAT administration is essential:

Registration of new companies

The process of the registration of new companies needs to be better screened, in order to prevent fraudulent companies from entering the VAT system. It should be make much harder to create bogus firms, e.g. by checking the real identity of owners and managers more thoroughly, and by creating and using a tax history of companies and their owners and managers. Checks and controls at this stage of the process are critically important for identifying potential fraudsters.

¹³ We draw here heavily on concrete recommendations that have been made by a number of institutions recently. For an overview, see World Bank (2010): Making Ukraine Stronger Post-Crisis; and Independent International Experts Commission (2010): Proposals for Ukraine: 2010 – Time for Reforms.

Monitoring (risk profiling and audits)

Improvements in the monitoring strategy are an essential part of a more effective VAT refund processing system. One approach which has been used internationally with some success is the preferential treatment of taxpayers with a sound compliance history in terms of accelerated VAT refunds¹⁴. As a first step, the STA needs to create risk-profiles (with respect to non-compliance) of VAT-registered companies. For companies with a sound history of compliance, i.e. companies who have a good risk-profile, the refund procedure should be automatic. Selective post-refund audits for such companies can take place in addition to cross-check above procedures. Such risk profiling eases the burden of compliance for good taxpayers, but also helps STA to better target resource allocation to audits in areas where fraud is more likely. For high-risk refund claims, i.e. originating from companies with poor or unknown compliance history, or for uncharacteristic claims, extensive pre-refund audits should take place.

Centralised refund system

Right now, there is a system of allocating money for refunds on a regional ("oblast") basis, so companies may be advantaged or disadvantaged, depending on their domicile. In order to ensure equal treatment of companies across all regions of Ukraine, a central system of refunds "in order of appearance" should be established. Under such a central system, once a claim is made and checked, or the limit of 42 days have expired without claims being checked, the refund request is sent from the local tax office to the STA register. The local tax office is legally obliged to do it in 42 days since the claim was presented. Refund payments are then made by the State Treasury through the STA register "in order of appearance". This straight and simple system would eliminate the possibility of unequal treatment or arbitrary decision by officials.

Finally, the state should pay interest rates on delayed but legitimate VAT refunds, in order to compensate companies for the period of time in which they are deprived of parts of their working capital.

<u>Recommendation 3: Better dissemination of data and increase in transparency</u>

In the chapter dealing with the quantitative assessment (chapter 3) we highlight the severe shortcomings regarding public data on VAT refund arrears. But the availability of reliable public data is of paramount importance for at least two reasons. First, reliable and up-to-date data are needed to monitor the general situation regarding VAT refunding. Second, sectoral and company level data are crucial to avoid or at least combat corruption. In particular, companies should be able to compare their success/failure in receiving VAT refunds with the success/failures of direct competitors. As shown by international experience, increasing transparency by providing proper data makes the conducting of corruptive schemes much more difficult. In such a way, a level playing field could be re-installed. Here it is important to note that the provision of reliable and up-to-date data does practically not cost anything. Thus, the question here is not the ability, but the willingness to provide information.

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 $^{^{14}}$ See for more details, including country experience, Harrison/Krelove (2005): VAT Refunds: A Review of Country Experience, IMF Working Paper WP/05/218.

Behind this background, we make following recommendations. First of all, the responsible institution, i.e. the STA, must be obliged to provide reliable, audited and up-to-date data to the general public through a widely accessible channel such as the internet. In case the STA fails to do so, then the PM and/or the President should take personal responsibility to solve the data problem. As to which information should be provided, we suggest the inclusion of general, sectoral and company level data according to the details explained below.

Data on the development of aggregate VAT refund arrears (economy-wide and sectoral)

The objective of publishing aggregate VAT refund arrears is to allow a timely public monitoring of such arrears in the economy, and in traditional export sectors (e.g. agriculture, metals, chemical sector).

Consequently, the STA as the responsible agency and ultimate source of data should report on its website on a monthly basis and in a timely manner the following data:

Table 9: Illustrative development of VAT refund arrears, fictive data

	01.03. 2010	01.02. 2010	01.01. 2010	01.01. 2009	01.01. 2008	01.01. 2007
Total arrears	100	90	80	60	20	10
Historic origin of total arrears	100	80	70	50	20	0
Verified arrears	40	45	48	42	16	9
Ratio of verified to total arrears	40%	50%	60%	70%	80%	90%

Source: Own display

The total stock of VAT refund arrears on the beginning of a particular month is shown in the first row. In this example using fictive data, claims of 100 were outstanding on 1 March 2010. Equally important is the historical origin of these arrears, i.e. how long these claims date back in time. To stick to above example, 20 units of the total amount of 100 outstanding dates from the time before 1 January 2008 (i.e. are already more than 2 years old), 50 dates from before 1 January 2009, and so on. The arrears already checked and accepted by STA are shown in the next row as verified arrears. The ratio of verified to total arrears (last row) is also very important for monitoring purposes. In the example above, a gradual worsening of this ratio is shown, i.e. the verification does not hold pace with the accumulation of arrears.

Data on VAT refund claims and actual refunds at company level

The objective of publishing data on VAT refund claims and actual refunds of individual companies is to allow an assessment of equal treatment with respect to their claims and refunds. Each company would have an opportunity to cross-check its own refund situation against those of its competitors and the sectoral average. Consequently, the STA should regularly publish¹⁵ the following table, which includes each company above a certain size threshold in a specified sector:

¹⁵ The dissemination of this information could be restricted to a specific user circle (i.e. online-access of VAT payers).

Table 10: Illustrative development of VAT refund claims and refunds, fictive data

	Mar 2010	Feb 2010	Jan 2010	2009	2008	2007
Company A						_
Refund claims	10	10	10	120	120	120
Actual refunds	3	4	5	84	96	120
Pro-rata actual refunds to refund claims	30%	40%	50%	70%	80%	100%
Company B						
Refund claims	10	10	10	120	120	120
Actual refunds	7	7	7	84	96	120
Pro-rata actual refunds to refund claims	70%	70%	70%	70%	80%	100%
Company C						
			•••			
Sectoral Average						
	•••	•••	•••	•••	•••	•••

Source: Own display

Table 10 is relatively straightforward to interpret: Following the claims and refunds for two fictive companies (A, B) in a certain sector (e.g. agriculture) over time, one can clearly see that the pro-rata share of returned VAT develops quite differently as time passes. While over 2007-2009, both companies seemed to be treated in an equal manner in terms of refunds, company A experiences severe problems in 2010, as only 30% of their monthly VAT claims are being refunded, while this ratio stays much higher at a constant 70% for company B. The possibility to cross-check this with further companies or the sector average (not shown) adds further credibility to this information.

While a reporting of refund claims and actual refunds at company-level might be difficult from a legal and administrative point of view, there are other options available. One alternative would be the reporting of the implied pro-rata share (third row for each company and the sector in Table 10) by the STA. However, this information should be verified by an internationally reputable auditor, who has unlimited access to the raw data.

6.2. Specific Recommendations for Agriculture

It is common sense that future growth of agriculture in Ukraine will be mainly driven by export markets and investments. In this view, VAT reform is a necessary pre-condition for future growth. Without reforms Ukrainian producers will continuously receive lower prices than their competitors in the US and the EU undermining Ukrainian competitiveness.

There is a wide consensus that all sectors of the economy should be treated equally to allow for optimal allocation of scarce capital. This implies that agricultural producers should pay VAT. There is no example in the world that big agricultural exporting countries can afford a system of zero VAT rates for producers in a sustainable way.

Two options are possible:

Option 1: Enforce strict payment of VAT for inputs and outputs at 20% for all agricultural producers ("pay-in/pay-out")

Advantage: Tax revenues from agriculture would increase with increasing production and exports. Tax revenues would facilitate public investments in market infrastructure to enhance marketing and transport infrastructure. With strict law enforcement processors and traders would include full VAT refunding in their price calculations. Farm-gate prices would go up accordingly and immediately. Competitiveness of Ukrainian grain and oilseeds production would increase.

Small farmers below 50 or 100 ha may be allowed to choose a simplified tax regime.

Direct payments to farmers and investments in market infrastructure and rural development should replace the old VAT system to support priority areas of agricultural development so that the net impact for the sector would be positive.

Under this scenario the fixed agricultural tax based on nominal land values of the year 1995 should be adapted to current nominal or real values. Nominal values are not reflecting the real value of the land. Nominal values should immediately be adapted to 2010 levels. After lifting of the moratorium for sales and purchases of agricultural land real values should be calculated to create incentives for productive land use and to minimise land speculation.

Conclusion 8: Under option 1, where VAT from sales is paid by farms but reimbursed to exporters, the farming sector would be the main beneficiary, as the price gains are higher than the losses. On top, the government is free to provide a better targeted subsidy to farmers.

Option 2: Special reduced VAT rate for agriculture

In many EU countries with important agricultural production and strong agrarian lobby groups special VAT systems evolved. Farmers charge VAT at lower rates.

Table 11: Special vs. basic VAT rates

Country	Special VAT rate	Basic VAT rate	
France	5.5%	19.6%	
Germany	7%	19%	
Italy	4%	20%	
Poland	3%	22%	

Source: Own display

In the above countries, farmers charge VAT in such a way that the VAT sum received through output sales at special rates is usually lower than the VAT sum paid through input purchases at basic rates. The state budgets receive VAT from agricultural producers, however, less than from producers in other sectors. From the farmers point of view there is a strong incentive to invest and to purchase inputs as VAT payables may be deducted from VAT receivables to lower the tax bill. It stimulates agricultural growth. It also minimises fraud sales.

What if Ukraine had such a reduced rate? The following table summarises the results of a model calculation for the major cash crops. The left column shows the current state budget loss, i.e. the foregone tax revenues at 20% VAT. The right column shows the losses assuming a special agricultural VAT rate of 10%. In the first case the state budget would receive only VAT from input suppliers, whereas in the second case the state budget would receive VAT from input suppliers at the basic rate and VAT from agricultural producers at a special rate. This model calculation does not show the actual cash flow of the state budget, but the budget loss compared to the reference situation of complete VAT payment. The actual agricultural VAT cash flow for the state budget may well be positive in the second scenario.

Table 12: Impact of reduced agricultural VAT payments on the state budget in the 2009/2010 season, model calculation (UAH m)

Crop	Current state budget loss	State budget loss at 10% VAT
Wheat	2,224	147
Barley	1,120	40
Corn	1,220	180
Sunseeds	2,839	958
Rapeseeds	732	192
Other grains	150	100
Other oilseeds	360	300
Sugar beet	120	10
Vegetables	1,000	120
Potatoes	800	100
Total	10,566	2,147

Source: Own display

Notes: The current state budget loss is from Table 8. The state budget loss at 10 % VAT has been calculated based on gross margin calculations for each individual crop assuming that the farmer may deduct VAT payable (20 %) from VAT receivables (10 %). For vegetables rough-cut estimates have been made. The actual total crop area is about 27 m ha. The above calculation comprises only 20.7 m ha. Calculations are without feed production and perennial crops; without livestock production; without on-farm processing. The losses would be higher if those sectors were included in the calculations.

The model calculation for crop production shows a significant leverage. Even with a special VAT rate of 10% instead of the basic rate of 20% the budget risk for the state would be considerably decreasing. The state budget would receive a high share of VAT from both agricultural input suppliers and agricultural producers to refund processors and exporters. Farmers would be able to deduct VAT paid for inputs from the VAT bill to the state budget.

Conclusion 9: A special VAT rate for agriculture would be a pragmatic second-best solution with ample experience in many EU countries. The state budget would systematically receive VAT from agricultural producers, thus lowering budget risks in a volatile sector. From the farmers point of view there would be strong incentives to invest and to purchase inputs as VAT payables may be deducted from VAT receivables to lower the tax burden. Farmers need to finance inputs and pay VAT early in the production cycle. To avoid liquidity problems agricultural producers should therefore be allowed to claim VAT payables earlier. After the harvest sales VAT receivables and VAT payables would be balanced.