

ICPS newsletter

How to unravel the problem of VAT refunds in Ukraine

The problem of VAT refunds in Ukraine is swelling. It originates from the government's failure to fulfil obligations in this sphere and the accumulation of outstanding government debts towards taxpayers. Consequently, the VAT has actually turned into an additional tax on exports sapping their resources. The lack of an equitable mechanism to pay off the state's debts on VAT refunds results in inequality among taxpayers. Possible solutions to the VAT refunds problem were discussed at the roundtable on "VAT refunds in Ukraine: Problems and Solutions" held last week at the International Centre for Policy Studies. The roundtable aimed at initiating a public discussion of possible solutions

The VAT has a number of features which make it an attractive instrument of fiscal policy, among them the following:

- one of the most neutral taxes; hence, it assures sustainable proceeds to the budget with minimum changes in consumers and business behaviour;
- it is a tax on consumption and is neutral on investments; that is, it does not affect investment decisions;

VAT refunds to exporters is a widespread international practice, supported by the WTO; this allows to avoid double taxation, and thus, spurs international trade.

Problem

The major problem that Ukraine has to tackle in the sphere of VAT refunds to exporters is the government's failure to fulfil its obligations. Since Ukraine has seen export growth (in 2001, exports amounted to 55% of GDP), the government's reimbursement obligations have increased. The problem is aggravated by the accumulated outstanding debts on VAT refunds (according to some estimates, it amounts to 2 billion UAH).

As a consequence, enterprises seek to avoid paying VAT, which will adversely affect budget revenues. And since Ukrainian legislation envisages VAT refunds to exporters at the expense of VAT proceeds, this makes the circle exclusive. On the one hand, the

government does not reimburse VAT, on the other hand, due to the lack of trust to the government, enterprises avoid paying VAT, which will further obstruct abilities to perform reimbursement. Moreover, the budget resources are limited due to the write-offs of taxpayer debts in 2001 in the amount of 15.4 billion UAH.

Implications of accumulated debts

The paramount implications of the VAT non-reimbursement problem are the following:

- VAT has actually turned into an export tax and restricts exporters' resources, which in turn reduces the volume of foreign trade;
- The lack of an equitable mechanism of paying off debts makes Ukrainian taxpayers unequal. Decisions on reimbursement are frequently adopted "manually" (arbitrarily); coupled with the lack of criteria for reimbursement, this presents huge opportunities for rent-seeking and corruption;
- Budget revenues become less regular or predictable, because they depend on political decisions to pay off the debts on VAT refunds.

Reasons

- Structural distortions in the economy. The biggest exporters have raw material and energy intensive production, which in effect translate to hefty tax credits.

This week's events

This week, the ICPS will host the next in a regular series of events carried out under the framework of the "Network for Policy Development in the Government of Ukraine" project.

On Tuesday, a roundtable on "Principles for the functioning of a professional public service: Forms of NGOs for public servants: Canada's experience" will take place. This event will be managed by Andrew Graham, President of the Public Servants Association of Canada.

For over thirty years, Mr. Graham has been in the public service, during most of which he has been involved in policymaking and planning in the Correction Service of Canada.

Additionally, he was Assistant Deputy Minister on Agricultural Policy of Canada, as well as Co-Chairman of the Committee of the Assistant Deputy Minister on Information and Financial Management Strategy. Mr. Graham teaches a course in "Public Management" at the Queens University of Kingston, Ontario.

On Wednesday, a seminar on "Change management" will be chaired by Katherine Graham, Professor of Public Management at Carleton University of Canada, Ottawa, Ontario. Ms. Graham has authored a number of books, publications, and articles on various aspects of public management.

The project on "Network for Policy Development in the Government of Ukraine" is a joint initiative of the Cabinet of Ministers of Ukraine's Secretariat and the ICPS, and is carried out under the framework of the Policy Advice for Reforms (PAR) project of the Canadian Bureau for International Education (CBIE), funded by the Canadian International Development Agency (CIDA).

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Comparison of alternative solutions to the problem of VAT refunds

Option	Exporters' behaviour	Fairness	Budget balance	Indebtedness
Budget + VAT payers	Neutral impact	Not for all enterprises	Neutral impact	Half-way solution
Budget + VAT payers + creditors	Increased operational costs	Not for all enterprises	Probable abuses	Half-way solution
Postponing for future periods	Reduces exporters' liquidity	Ensures equality	Complicates forecasting	Virtually solves
Write-offs	Worsened expectations and decreased confidence in politicians	Will partially adjust unfairness resulting from tax debt write-offs	Diminishes budget indebtedness	Solves, however, debt accumulation is possible in future
Payments	Bolsters exporters' liquidity	Ensures equality	Increased deficit	Solves the problem, however new pile-ups are likely

- Distortions in the taxation system:
 - Energy enterprises have the most sizable debts on VAT payments, thus, the budget lacks those VAT receipts, which would equal the amount of exporters' tax credits.
 - Agriculture does not pay VAT to the budget, which diminishes the tax base together with fewer VAT proceeds.
 - Debt write-offs for taxpayers reduce budget revenues, and, consequently, the opportunity to pay off the budget debt on VAT refunds.
- The shadow infrastructure handles faked export transactions.
- Ineffectiveness of the tax reimbursement mechanism:
 - Reimbursement is made at the expense of VAT proceeds, other tax proceeds cannot be used for this purpose;
 - There is no mechanism for VAT refunds in one oblast at the expense of VAT proceeds in another oblast. Therefore, the reimbursement issue is the most burning for those oblasts where export enterprises are amassed. These oblasts have a negative balance of VAT proceeds and are unable to execute their obligations on VAT payments at the expense of their own money.

Solution alternatives

There are several alternatives to solve the problem of VAT non-reimbursement in Ukraine, the key ones being:

- Reciprocal write-offs of VAT refunds obligations against the tax obligations of VAT payers;
 - Reciprocal write-offs of VAT refunds obligations against the tax obligations of creditors of VAT payers;
 - Write-offs and restructuring of the government debt on VAT refunds, proportionately to write-offs and restructuring of taxpayers' debts towards the budget;
 - Paying off budget debts towards taxpayers at the expense of budget money.
- International experience offers the following alternatives:
- Chile: if the amount of the VAT refunds exceeds the tax obligations of VAT payers, then per taxpayer's statement the surplus can be transferred to future tax periods and offset future tax obligations.
 - Canada: if sales transactions of enterprises are exempt from VAT, the amount of the tax credit can be either allotted to operation costs or included in the cost of capital assets.
- In order to choose the most effective solution, we set a number of criteria to assess each alternative:
- Impact on taxpayers' behaviour;
 - Observing taxpayers' equitability;
 - Influencing budget revenues and balance;
 - Resolving outstanding budget debts and eliminating chances for their popping up in future.

The table reflects our assessment of the alternatives discussed in Ukraine by the mentioned criteria.

Topics for discussion

As we can see from the comparison of alternative solutions (see Table), each alternative has its own advantages and disadvantages. In order to find an optimum solution for VAT refunds, we should answer the following questions:

- How to avoid debt accumulation on VAT refunds in future?
- What mechanisms can ensure that tax obligations are executed?
- What mechanisms can distinguish between real and forged export transactions?
- What changes are necessary in the administration of VAT refunds?
- What tax reform measures will allow to find a solution to the VAT refunds problem?

In the nearest future, the ICPS plans to generalise the results of the public discussion on VAT refunds, and define ways to unravel this problem. If this topic is of interest to you and you have some proposals or remarks regarding the possible solutions, please send your comments by email to tsytnyk@icps.kiev.ua. All remarks and proposals will be summarised and presented in the next issue of the *Quarterly Predictions* journal. ■

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