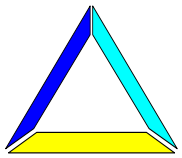
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T32

The Struggle over VAT Refunds for Grain Exports

Executive Summary

The situation with VAT refunds for grain exporters (wheat, rye, barley) is characterised by considerable uncertainty at the moment. Since the approval of the state budget for 2004, numerous legislative projects have been launched. Among other things, they aimed at restricting the general rule that grain exporters get a full VAT refund when they export grain. Law 4467, for instance, declared that only grain producers and processors should be eligible for VAT refunds in the case of exports. However, the internationally accepted practice to refund VAT of exports is crucially important for both exporters and farmers, as its abandonment would mean a **double taxation of grain by both the exporting country (Ukraine) and the country of destination**. The analysis of the attempts to use VAT regulations as a means to influence market outcomes has shown that this often results in a **taxation of agricultural producers**.

We recommend the following:

1. The indirect taxation of Ukrainian agriculture should be acknowledged and reduced, and direct taxation should be started instead. Indirect taxation inflicts pain to both successful and less successful farms, while direct taxation of profits will put the burden predominantly on the strong performers.
2. The VAT is supposed to collect state revenues, and must **not** be misused for other political purposes. Any manipulation of the VAT will drive private business into the shadow economy, or lead to economic structures which are not conducive to competition and efficiency in agricultural trade.
3. Thus, the proper refunding of VAT to all exporters of all agricultural products is vital to ensure functioning markets, fair prices to producers, and a flourishing, export-oriented agricultural sector. The Law No 4467 should not remain in force in its current form. Instead, Ukraine should follow internationally accepted practices and not tax its exports via VAT.
4. Any struggle on VAT regulations should be finished as soon as possible in order to bring back stability to the markets.

1 Introduction

The new Law No 4467 (March 2004) involves suggestions on refunding VAT for grain exports which may have a major influence on farm prices and incomes. This paper summarises the relevant legislative proposals regarding their impact on grain exports, and discusses and quantifies their possible consequences.

Several special provisions exist regarding VAT rates for agricultural enterprises. But the legislation on exports of agricultural products did not differ from that of other goods. This does not mean that there have not been problems with export refunds: The State Tax Administration (STA) reports that there are still considerable VAT refund arrears to business entities (roughly UAH 6 bn in the end of 2003). As Ukraine is highly dependent on foreign trade, with exports constituting about 50% of total GDP, the refund arrear problem has far-reaching consequences for Ukraine's international competitiveness.

It seems that the proposals regarding the VAT refunds for grain exports which are included in Law No 4467 have to some extent been motivated by the shortage on the market for food wheat in the marketing year 2003/2004.[1] Many policymakers would like to get markets better under control. For that purpose, there seem to be intentions to support quasi-state companies and organisations in their competition with private or foreign trade companies. The relevant provision in Law 4467 regarding VAT refunds for grain exporters might be interpreted as implicitly discriminating against 'pure' grain traders in favour of producers and processors.

The paper is organised as follows: In chapter 2 we give an overview on functioning of the VAT. Chapter 3 contains the most recent legislative acts on VAT related to agricultural exports. Chapter 4 discusses the consequences of the changes to VAT legislation regarding grain exports, including a quantitative assessment. Conclusions and recommendations will be given in the end.

2 How does the VAT Work in Agriculture and Grain Trade?

The importance of the VAT as a revenue source for public budgets as well as the problems related to the proper handling of the VAT by both taxpayers and the STA justify efforts of the Government of Ukraine to improve the administration of the VAT.[2] It is questionable, however, whether this requires legal adjustments in the first place. Improvements in the procedures of VAT administration would probably be more urgent, for which the STA would be the right target. But as documented in chapter three, legal reforms of the VAT are discussed in the Parliament and the media; laws

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[1] This topic has been extensively discussed in various policy paper by the IER and German Advisory Group, see http://www.ier.kiev.ua/Ukraine/papers/papers_ukr.phtml (Ukrainian), or http://www.ier.kiev.ua/English/papers/papers_eng.phtml (English).

[2] The VAT is one of the most important taxes in Ukraine, accounting for roughly 29.3 percent of the Central Government revenues, and 22.6 percent of the consolidated public budgets. The current tax rate is 20 percent, with plans to reduce this rate to 15 percent from 2006 onwards.

and decrees are drafted which claim to address the problems at hand, vetos are wielded. It is our impression that some of the legal changes such as Law No 4467 are not targeted at improving the functioning of the VAT, but are rather driven by motivations which have their background in trade policy. This broad discussion of legal changes – particularly when it seeds uncertainty among exporters and other market participants about the effective level of VAT – is harmful to the functioning of agricultural and other product markets, even when actually nothing will have changed after the storm has calmed. Although we believe that this will be the most likely result, we would like to contribute to the public debate by explaining the economics of the VAT a bit more in detail.

What is the economic result of a proper VAT regulation?

The current VAT regulation on grain exports may be described as follows: farmers sell grain to elevators who dry and clean it. The elevator then sells the grain further on to a grain trader who either sells it to a mill domestically, or exports it beyond the national border. In case that the grain trader also possesses an elevator, the second transaction in the chain will not take place, and no VAT transaction is paid to and later refunded by the STA.

The VAT mechanism works as follows: The farmer sells grain to the elevator, and assuming that he is using the special VAT regime, he will charge 9% VAT on his invoice. Under normal circumstances, he would have to transfer this money to the STA. But he is exempted by the special VAT legislation for agriculture, which means that Under the special regime for agriculture, he may simply retain this amount of VAT regardless of the amount of VAT he has paid for VAT in farm inputs.[3]

When the elevator sells the grain to a trader, he claims 20% VAT on the invoice, and will reclaim the 9% he has paid to the farmer as refund from the STA. In contrast to the farmer, the elevator is not exempted and has to transfer the 20% VAT he charged from the trader to the STA.

When the trader sells the grain to a domestic mill, and the mill sells flour to a bakery, the same procedure is repeated: VAT on procured inputs (grain and flour) will be re-claimed by the enterprises from the STA, while those who sold the goods have to transfer the 20% VAT written on the invoice to the STA. This insures that the economic incentive prices on the basis of which businesses are dealing with each other are always on a net base, i.e. net of VAT.

The mechanism works differently when the bakery sells bread to the final consumer. Consumer prices also contain VAT (even though this mostly not mentioned a cash receipts for consumer goods), and the bakery has to transfer this money to the STA. However, and this is the big difference to the transaction between business entities – the final consumers cannot re-claim the VAT he has paid at the shop counter, unless he can prove that he will further process the bread instead of directly consuming it. The salient point is: the STA will have to pay back all the VAT for intermediate products. From a **financial** point of view, only the final consumer is taxed. But this

[3] As a rule, farmers manage to realise a surplus on their VAT account.

can only work when the VAT is properly administered and not manipulated to introduce taxation before the final consumer.

In **economic** terms, not only consumers are affected by a VAT: as the consumer price level is higher than without VAT, overall private consumption will be somewhat lower, thus driving the sales and profits of private businesses down. Thus, the burden of the VAT is shared between consumers and producers, the ratio of the shares depending on the elasticities of supply and demand for individual products. On the other hand, the production and consumption of public services will be higher due to higher tax revenues from the VAT.

VAT exemptions for farmers

If the farmer is VAT exempt, this means that he charges VAT from the trader, but he does not have to transfer the money amount to the STA, but may keep it for his own purposes. Usually, VAT payments on inputs are lower than VAT payments on outputs, so the farmer manages to make a small profit through this practice. Economically spoken, the VAT exemption lowers the fixed costs of the farmer, thus allowing him to offer his products at a lower price. As all farmers are confronted with the same situation and compete with each other, market supply will expand to some extent.[4] In **financial** terms, only the farmer benefits from the exemption which is financed by lower tax revenues, i.e. the tax payers. In **economic** terms, this benefits the farmer, whereas taxpayers have to pay higher taxes to the amount which farmers do not have to pay. In case of an autarky situation, also consumers benefit to a minor extent due to decreased price levels (see footnote 4).

VAT at zero rate for exports

If the grain trader decides to export the grain instead of marketing it domestically, most governments have decided to apply a VAT rate of zero to the value of these exports. This zero rate is implemented by refunding the trader with the VAT he has paid to the farmer or elevator if he can prove that he has really exported the grain. This common international practice is applied in order to avoid double taxation, as almost all countries charge VAT on imports. As such, the zero rating of exports is neutral in both financial and economic terms. If it were not applied, traders would have to pay VAT without the chance to reclaim it somewhere else. They would try to transmit these costs to farmers. Thus, cancelling the refunds for VAT in the case of export operations is equivalent to an ad-valorem export tax.

Mismanaged VAT: refunds do not work

What is the result of a VAT administration that does not properly work? The most common feature is the failure to transfer refunds to business which reclaim VAT paid on inputs. If we have a production process with many stages, a failure to refund VAT

[4] Prices will only decrease (due to increased supply) when Ukraine is in an autarky situation, i.e. not participating in world trade. Otherwise, price levels are determined by world market prices plus/minus transport and tariffs.

increases the tax burden very quickly. Technically, a failure of refunding VAT for means of production means that the VAT is changed into a turnover tax for all businesses at a much too high rate. The immediate economic results are: reduced economic activity due to reduced consumer demand as a result of high consumer prices; and increased tax revenues. But the latter requires that the refunds which have not been repaid do not end up in the pockets of corrupt officials.

The longer term results of such a mismanaged VAT are immense: many businesses will be driven into the shadow economy, with the result of decreasing VAT revenues by the STA. This partly explains the large estimated VAT arrears which the STA reports every year. Another effect is the establishment of large holdings which vertically integrate the production and marketing chain. This allows the holdings avoid declaring VAT on invoices for other businesses. A widespread shadow economy as well as large vertical holdings are still common features of the Ukrainian economy. The final economic results are high transaction costs in the shadow economy, a lack of competition in sectors where vertically integrated holdings dominate, and a low effective VAT rate compared to other countries.[5]

3 The Current Legislative Framework

Current Value-Added Taxation of export-import operations

According to article 6.2 of the Law on VAT (168/97, April 1997), exported goods are not VA-taxed in order to avoid double taxation in the importing country. The exporter has the right to get a VAT refund within 30 days from the day when the application for export refunding has been submitted. Even though this refunding for exporters does not properly work and is a source of continuous complaints from exporters of all economic sectors, agricultural (and grain) exporters at least have the formal right to receive a VAT refund.

However, the state budget law for 2004 interferes with this standard procedure. According to the article 83 of The Law of Ukraine "On the State Budget of Ukraine for 2004" (N 1344-IV), by July 1, 2004, exports of goods under The Foreign Trade Goods Code, 1001 (wheat), 1002 (rye), and 1003 (barley) are zero-rated. This article applies to agricultural producers and processors starting on January 1, 2004. However, there is a problem with the interpretation of article 83. The previous version of article 83 established that the groups of goods 1-24 under The Foreign Trade Goods Code to be zero-rated. Thus, under the current version, signed by President of Ukraine on 30.03.04, the questions arises whether exporters (traders) who are not producers of processors of grain are still eligible for VAT refunds.

[5] See also the Legeida/Sologoub, "Modelling VAT Revenues in an Transition Economy: The Case of Ukraine", IER Working Paper No 22. According to the estimations of the VAT tax base (final sales to consumers) from national accounts, only half of the VAT which *should* be due is actually collected.

Law No 4467: A proposal to change VAT regulations for export operations

Concerns of market participants that this provision was aimed at specialised grain traders were confirmed by the Rada's approval of Law No 4467. According to Ukragrokonsult[6], in early March the Verkhovna Rada approved this law which stipulates that VAT will be zero-rated for exports of wheat, rye and barley, but this law applies only to agricultural producers and processors. Law No 4467 consists of two parts (both amendments to the law on state budget 2004). The first part concerns only wheat and rye, allowing importers of wheat and rye to offset import VAT with export VAT through tax bills. The second part stipulates that wheat, rye, and barley exports are VAT zero-rated. This law will be analysed in detail in chapter four.

The draft law No 5353

Law No 4467 encountered criticism for the fact that it was restricting the eligibility for export refunds to producers and processors. In order to correct this, Draft law No 5353 is currently discussed in the Rada ("On amending part II of the Law of Ukraine "On amending the Law of Ukraine 'On the State Budget of Ukraine for 2004'" (regarding the field of the law's application)" was registered in Ukraine's Parliament. According to the authors of the law (Deputy K. Vashchuk), it will contribute to stable prices for bread and other bakery items in Ukraine, prevent the discrimination of certain categories of trading enterprises, and promote agricultural exports.[7]

The law stipulates that "... that the sentence "operations by agricultural producers and processors" in Chapter II of the Law of Ukraine [No 4467] as of March 4, 2004 "On amendments to the state budget" be replaced by the following sentence "regarding Value-Added Taxation on operations (deals) mentioned in Chapter 1 of the Law (including operations by enterprises with foreign investments regardless of when these investments were made) starting [from January 1, 2004.]" (text in brackets by the authors of this policy paper).

Summing up, it seems that the handling of the export VAT in Ukraine is not characterised by as much reliability as it should be. First, the deputies still cannot bring themselves to abstaining from special regulations for agricultural exports. Second, the series of laws dealing with the topic does not create the impression that the matter will soon be settled.

4 The Economic Impact of Restricted VAT Refunds on Grain Exports

In this chapter, a scenario is discussed which might become true for VAT refunds if the law 4467 would really come into force. The draft law stipulates that grain exporters are eligible for VAT refunds only if they are producers or processors of grain. The law contains this provision for the purpose of driving out middlemen (i.e. specialised grain traders) out of the market, as a member of parliament allegedly disclosed to

[6] Agrinews Kyiv, 11 (396), March 16 - 22, 2004.
[7] Agrinews Kyiv, 14 (399), April 06 - 13, 2004.

Ukragrokonsult (see footnote 6). The traders would effectively be forced to pay an export tax in the magnitude of the VAT rate (i.e. 20 %) which would make them non-competitive on the Ukrainian market. The following points are flawed about this approach:

- The implicit provision on traders in the law probably derives from the widespread belief that traders exploit producers, processors and consumers. By paying farmers very low prices and selling the grain for high prices elsewhere, traders are blamed to realise huge profits. This opinion ignores that traders are incurring real costs (costs of gathering information, concluding contracts, transport costs, dealing with widespread bureaucracy and corruption in Ukraine) which have to be covered by the price margin they receive from moving grain from areas with low prices to higher priced locations. This is not to say that traders are not making profits, but it is fair to assume that these profits are not excessive. The market for trade services in grains and oilseeds is very competitive, as the Anti-Monopoly-Commission has confirmed last year. If there were such huge profits to realise, why have enterprises such as Khlib Ukrainy not already become major players in grain trade? It is because of their lack of expertise in international grain trade, not because of their 'brotherly' approach towards pricing.
- Another motivation for the provision could be that the outflow of grain from Ukraine in surplus years shall be curbed. From conversations with officials dealing with the issue, it became clear that Ukrainian traders are believed to prefer selling grain on the domestic market. Thereby they allegedly help to keep consumer prices down, making the build-up of national reserves affordable, which in turn would facilitate price stabilising intervention measures by the Government. There might be some truth in this expectation, but the question is whether it would actually materialise, and at whose costs. The main problems with this approach are:
  1. Many traders also operate elevators, mills, and crushing plants. The provision in the law is thus only driving out specialised traders. The few 'pure' traders left will probably try to acquire the status of processors.
  2. The law once more favours the establishment of large vertically integrated holdings, who will exercise monopoly power on the farmers and retailers. If there are considerable surpluses in the country, the holdings will still export grains, but from a better position to exploit farmers.[8]

[8] See also policy paper T2 on establishing a "Strong National Grain Trader", IER/GAG, July 2003, http://www.ier.kiev.ua/Ukraine/papers/t2_ur.pdf (Ukrainian) http://www.ier.kiev.ua/English/papers/t2_en.pdf (English)

The likely outcome of the Draft Law 4467 and similar proposals

If the Law 4467 really came into effect, what would be the most likely outcomes?

1. Trade will be left to those traders who have the right status to receive refunds (producers or processors, or – according to law 5353 – companies with foreign investments). But at the moment it is uncertain who will actually receive this status.
2. Grain traders not eligible for VAT refunds will be forced to offer lower prices to farmers, as they would be threatened to effectively pay an export tax. This will drive them out of the market.
3. Consequently, there will be a lot of legal struggle about the status of exporters, creating a lot of uncertainty and additional bureaucratic costs in grain trade, which makes traders charge risk discounts from farmers. Moreover, if those exporters eligible for refunds do not have the capacities or skills to export the same amount of grain as all traders together without the law, the market will suffer from a bottleneck effect which will drive farm prices down.
4. Farmers are very unlikely to enter the grain trading business, as this requires skills beyond their expertise. Moreover, farmers do not have the financial capacity and international network to carry out export operations.
5. All these results will lead to lower farm prices for grains in Ukraine, mainly as a result of uncertainty and bottleneck effects. As world market prices will most likely not be influenced by the decisions of the Ukrainian Parliament, the margin between world and domestic prices will be widened at the cost of **farmers**.
6. Consumers will benefit from the proposed provision, as domestic prices for bread will decrease.

Failed VAT refunds for grain exports: Results of a simulation exercise

The IER and the German Advisory Group have developed a numerical simulation model[9] to analyse the impact of external factors and policy measures on the Ukrainian food economy.

In order to quantify the impact of non-refunded VAT, it is assumed that the law will effectively tax grain exports through withheld VAT refunds. Moreover, export margins increase due to the uncertainty during the legal process and the increased market share of entities which do not have the skills of long-established traders. The resulting effective export tax is assumed to be lower than the VAT rate, because some traders will not be affected, as they can prove that they are involved in processing. Without being able to exactly determine the extent to which the struggle about export VAT will drive up effective export taxation, the model simulation has been carried out assuming an effective export tax on wheat, rye and barley of 10 %. The model's baseline assumption represents an average year for Ukraine's agricultural production, with moderate export surpluses for most crops. The impact of the effective export tax

[9] The model is called RASMU (Regionalised Agricultural Sector Model for Ukraine)

enters the model in the price equation linking domestic prices in Ukraine with f.o.b. world market prices. The condition for profitable exports is that the domestic price plus transport costs to the border has to be lower than or equal to the f.o.b. world border price times 1 minus the effective export tax:

Price (Wheat, EXW Ukraine) + Transport and other trade costs (Wheat, EXW to Odessa)
=
Price (Wheat, f.o.b. Odessa) x (1 - **Export tax (Wheat, Ukraine)**)

The higher the effective export tax, the lower the EXW price has to be to make exports profitable, and the lower has to be the price farmers receive.[10]

The following table displays results for the affected products.

Table 1: Simulation results for selected crops [a]

			Baseline	*Simulation*	*Change in %*
Wheat	Producer price	USD/MT	108	96	-10.9
	Production	1000 MT	15313	15024	-1.9
	Producer revenues	1000 USD	1655	1447	-12.6
	Net trade	1000 MT	2671	1638	-38.6
	Feed use	1000 MT	4834	5494	13.6
	Total demand	1000 MT	12642	13386	5.9
Barley	Producer price	USD/MT	91	84	-8.2
	Production	1000 MT	8770	8718	-0.6
	Producer revenues	1000 USD	801	731	-8.7
	Net trade	1000 MT	2184	1734	-20.6
	Feed use	1000 MT	5453	5822	6.8
	Total demand	1000 MT	6586	6984	6.0
Rye	Producer price	USD/MT	87	85	-2.6
	Production	1000 MT	1396	1388	-0.6
	Producer revenues	1000 USD	122	118	-3.2
	Net trade	1000 MT	13		-100.0
	Feed use	1000 MT	473	468	-1.1
	Total demand	1000 MT	1383	1388	0.3

a. It is assumed that the failure to refund VAT to grain exporters leads to an effective export tax of 10 % for wheat, barley and rye.

As the table shows, the exports of the commodities affected by the new VAT refund regulations will decrease tremendously, with rye exports becoming unprofitable. Producer prices for all affected crops decrease between -2.6 % (rye) and -10.9 % (wheat). For wheat this means a reduced production of -1.9 %, while barley and rye production remain largely unchanged. As wheat and barley have become cheaper, their feed use goes up by 6.8 % (barley) and 13.6 % (wheat).

The next table shows the changes for the profits of the farm and processing sector, and real incomes of consumers ("welfare changes").

[10] In the baseline solution of the model, no effective export tax is assumed, even though the problems with non-refunded VAT exists already. This means that farmers could get better prices already today, if VAT refunds were better administered.

Table 2: Changes of producer profits and real incomes of consumers in USD m

	Producer surplus [a]	*Consumer surplus* [b]	*Central budget*	*Overall effect*
North	-70	42		-28
West	-38	29		-9
Center	-126	59		-66
South	-175	81		-94
Ukraine	-408	211	25	-173

a. Producer surplus is the change in profits (= surplus to cover capital costs of producers).
b. Consumer surplus is the income equivalent of the policy change at unchanged prices.

The table shows that the damage done to the producers is much larger than the benefits that consumers enjoy through reduced prices. Overall, the Ukrainian economy experiences a damage of around USD 173 m. The greatest harm is done to the central and southern regions where most of the grain is produced.

5 Conclusions

The analysis of the attempts to use VAT regulations as a means to influence markets has shown that this results in a **taxation of agricultural producers**. This is logical, as traders, particularly international ones, can simply trade something else, or leave the country. They are more mobile than farmers and can therefore better adjust to changes in the regulatory environment. Farmers often have few alternatives, and thus sometimes produce crops even though they incur losses. The whole process shows that the claims of politicians to support agriculture are not reflecting the reality: agriculture may not be directly taxed, but indirectly through measures which were initially aimed at traders.

We recommend the following:

5. The indirect taxation of Ukrainian agriculture should be acknowledged and reduced, and direct taxation should be started instead. Indirect taxation inflicts pain to both successful and less successful farms, while direct taxation of profits will put the burden predominantly on the strong performers.
6. The VAT is supposed to collect state revenues, and must **not** be misused for other political purposes. Any manipulation of the VAT will drive private business into the shadow economy, or lead to economic structures which are not conducive to competition and efficiency in agricultural trade.
7. Thus, the proper refunding of VAT to all exporters of all agricultural products is vital to ensure functioning markets, fair prices to producers, and a flourishing, export-oriented agricultural sector. The Law No 4467 should not remain in force in its current form. Instead, Ukraine should follow internationally accepted practices and not tax its exports via VAT.
8. Any struggle on VAT regulations should be finished as soon as possible in order to bring back stability to the markets.

A.K., O.N., Lector S.v.C., April 2004