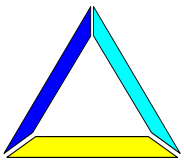
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VAT Refund Crisis In Ukraine: Causes, Risks, and Solutions

Conclusions and policy recommendations

The analysis of the current situation in the VAT taxation showed that

- The VAT problems lie not only within VAT legislation and administration, but touch a broad range of fiscal and economic issues.
- The current VAT system leads to non-transparent public finance, where the government is loosing scarce resources in non-cash schemes and settlements.
- Numerous preferences (exemptions and 0-rated operations) erode VAT tax base and result in fraud and corruption. Lack of the efficient collection mechanism leads to the accumulation of VAT arrears.
- Unpaid refunds cause cash-flow problems and prevent expansion of the business sector.

The major risks arising in the present situation are erosion of the tax system, increasing budget deficit, erosion of social consensus, external imbalance and devaluation of the currency, unemployment and slower economic growth, and political instability.

We propose the following recommendations:

- The VAT system needs to be reformed quickly to restore transparency of public finance and to safeguard the future economic growth.
- The legislation regulating VAT needs to be reviewed and unified. Tax treatment of different sectors and localities needs to be unified as much as possible in order to restore the VAT tax base.
- Direct income support, instead of tax exemptions, needs to be used as an instrument of social policy.
- Efficient mechanism of VAT collection in sectors that have the largest arrears needs to be worked out.
- The overdue refund debt needs to be paid off, first to exporters, then the rest. Increased collections, resulting from reduction of tax exemptions and improved VAT payment mechanism, should be the primary source of the funds.

1. Introduction

Since 1998, the performance of the Value Added Tax (VAT) system in Ukraine has been deteriorating. The business sector has accumulated large arrears it owes to the government, firms are unable to recover VAT refunds, and the whole situation is obscured by rampant fraud and corruption. While the scale of the problem in Ukraine is unique, the causes can be identified clearly. Because similar problems have occurred in other countries, a considerable international experience with proper solutions exists.

The VAT problem damages the Ukrainian economy in many ways. It interferes with cash flows firms use to finance their daily operations, and it undermines the competitive edge of exports on which economic growth in Ukraine depends. It also reduces government's revenues, and it deters foreign investors from doing business in Ukraine. But perhaps the greatest and most serious damage is done to Ukraine's price system. The practice of complicated tax privileges, write-offs, offsets, schemes and wechsels is a step back to the mechanism in which non-transparent, non-cash transactions enabled massive redistribution of funds that drain public finance and evade scrutiny by the government and by the public. What's more, such practices make tracking the true debt position of firms impossible, introducing bias into the privatization process, bankruptcy proceedings, etc.

That is why this problem deserves immediate attention of Ukraine's leadership. The VAT refund debt is de facto a loan the government borrowed from businesses and used it to finance its spending. It is therefore crucial that the government restores the transparency of VAT. Unfortunately, there are no quick and easy solutions for these problems. The purpose of this paper is to provide a concise overview of the causes that led to this crisis, the risks that this crisis brings, and, most importantly, the steps that will solve these problems.

As the following paragraphs show, the VAT problem presents the political leadership of Ukraine with a difficult challenge, but also with a unique opportunity. Implementing the steps leading to the solution of this problem will provide a clear signal to the Ukrainian society, as well as to the international community, that the government of Ukraine is committed to economic reform.

2. The extent of the problem

Currently, the amount of VAT refunds claims stands at UAH 5.8 bn. Refunds of approximately UAH 2.1 bn are overdue. These overdue claims represent about 4% of the Ukraine's budget, or almost 1% of GDP. The problem of this scale therefore calls for systemic solutions in legislation, administration, and public finance. The structure of the VAT refund debt is described in the following table:

Claims	UAH bn
Claims verified and should be paid - overdue	2.0
Claims overdue but not audited	0.1
Claims in process, not due for payment (exporters, 30 days have not passed)	1.8
Claims in process, not due for payment (others, 90 days carry forward period)	1.9
Total	*5.8*

According to the STA, 56% of the collected VAT was refunded in 2001, compared to 49% in 2000. This proportion is far higher than in other countries.

Currently, the estimated amount of VAT arrears that firms owe the government is UAH 3.8 bn.

3. International experience

Currently, 120 countries around the world use VAT as an important component of budget revenues. As a result, a significant amount of international experience with VAT administration has been accumulated over time.

VAT system that contains multiple rates and complicated exemptions invariably lead to deteriorating VAT collection and delays in VAT refunds. For this reason, the European Union moved towards a VAT harmonization and the VAT administration has improved.

The extensive analysis of international experience showed that tax exemptions (for example on food) are the least effective instrument to help the economically disadvantaged segment of population. The greatest beneficiaries are the wealthy families, while the biggest looser is the government budget. Ultimately, exemptions severely limit the scarce resources the government uses to meet the needs of poor citizens. The best way to meet the social needs is to replace tax exemptions by direct income assistance.

Because of the sheer volume of the VAT refunds claims, tax administrations audit individual firms selectively. For example, in Belgium only 10% of claims are being audited. Tax administrations develop and maintain taxpayer profiles on all firms and select for audit only the ones with insufficient history, past tax problems, or uncharacteristic claims.

The analysis of tax amnesties in different countries shows that they do not improve the compliance. In fact, the effectiveness of collection may decrease because future amnesties are justifiably expected.

The strict application of the interest payment on the overdue refunds by the government showed to be an effective instrument bringing discipline to processing the claims.

Well functioning VAT systems can be found not only in advanced market economies of Western Europe, but also in Central and Eastern European transition countries. For example, in the Slovak Republic VAT revenue consistently meets or exceeds the revenue targets. This shows that VAT is a useful component of a tax system also in countries facing similar challenges as Ukraine.

4. Causes of the problem

4.1. VAT Legislation

In April 1997, the new Law # 168/97 "On Value-Added Tax" substituted the # 1114-92 Decree of the Cabinet of Ministers of Ukraine "On Value-Added Tax". Since 1998, however, the application of the law was substantially modified by hundreds of exemptions granted by Verkhovna Rada to specific industries and localities. A number of legislative documents adopted by different executive power bodies (President, STA, Cabinet of Ministers, State Treasury) regulate specific aspects of VAT administration. For example, the VAT refund procedure is subject to 3 legislative documents: the VAT Law, Order of the VAT refund by the STA and State Treasury of 02.07.1997, and the President's Decree on Some Taxation Issues of 07.08.1999.

The VAT administration is particularly complicated by the mutual settlements or offsets, regulated by the Cabinet of Ministers Acts (e.g., 1270 and 2215). Other acts (e.g., 2210) regulate such settlements in the energy, metallurgy, and other sectors with a high degree of state ownership. The resulting benefits amount to hidden subsidies, which are impossible to track.

In sharp contrast to the situation in other countries, the Ministry of Finance in Ukraine has no power to veto the legislation that interferes with the revenue collection of the current year. This makes meeting the revenue targets impossible and the execution of the current budget is subject to manipulation by special interests.

As a result of numerous exemptions, the VAT tax base was severely eroded, and the effectiveness of the Law on VAT has been undermined. While the VAT refunds in West-European countries do not exceed 30% of total VAT revenue, in Ukraine the refunds reached 56% of the collected VAT.

The tax amnesty, introduced by the Law "On Settling Taxpayers' Obligations before the Budget and State-targeted Funds" of December 21, 2000, has cost the government much needed revenue and further deepened the refund problem. According to STA, around UAH 6 bn of VAT arrears have been written off as of 31.12.1999. The amnesty did not improve the compliance and massive VAT arrears, estimated at UAH 3.8 bn as of 01.01.2002, continue to accumulate.

The collection of VAT is further complicated by the provision according to which the unpaid amount of tax is written off after three years. This makes the enforcement even less efficient.

4.2. VAT Administration

Excessive number of exemptions introduced into the VAT legislation in the last three years led to serious problems in tax administration. On the one hand, the

increased potential for fraud places a disproportional burden on the STA and the tax police. On the other hand, the complicated and often contradicting legislation lends itself to a subjective interpretation and gives the STA an unacceptable degree of discretion. This inevitably leads to corruption.

Since 1998, consolidated budget tax revenues have declined from about 21% of GDP in 1998 to 18% in 2001. This decline can be explained by the eroding VAT tax base combined with the inefficient administration, which lead to the decrease in the VAT revenues from 7.3% in 1998 to 4.9% of GDP in 2001. In the same period, Enterprise Profit Tax (EPT) revenues decreased from 5.6% in 1998 to 3.9% in 2001. Not even the increase in the Personal Income Tax revenues from 3.5% in 1998 to 4.2% of GDP in 2001 could offset this negative trend. Consequently, VAT and EPT revenues have also decreased their shares in the structure of the consolidated budget tax revenues.

The government, facing the pressure to balance the budget with lower than expected revenues, used the collected VAT to finance its expenditures before the refund obligations were met. This misuse of funds, which contradicts the existing law (Article 7.7.5), amounts to taking an illegitimate loan from the business sector to finance public expenditures. The result is the current refund debt.

The overdue VAT refunds are routinely paid without the interest that should be added by law. This represents another hidden tax imposed on businesses. The only recourse for businesses is a costly and lengthy litigation and most firms prefer to avoid it.

5. Risks for Ukraine

The VAT refund problem undermines the credibility of the Ukrainian government. The problem creates threats to both the system of public finance, as well as economic growth in general. Here are the most important consequences of the problem:

- **Erosion of the tax system**. The continuing problem of VAT collection and refunds creates expectations of future failure of the government's ability to raise taxes effectively. This will lead to decreased compliance in the future. Today's problem will cost the government future revenues.
- **Increasing budget deficit**. The trend of decreasing VAT revenues will undermine the government's effort to keep the balanced budget.
- **External imbalance and devaluation of the currency**. The VAT refunds problem changes behavior of firms. Since the most disadvantaged firms are exporters, the VAT problem will undermine Ukraine's strong export performance, leading to current account deficits and a weakening currency.
- **Unemployment and slower economic growth**. The unpaid refunds cause exporters serious cash-flow problems and undermine their profitability. This will lead to the outflow of capital, increasing unemployment and slower economic growth. At the same time, valuable resources are wasted unproductively in schemes that help exporters at least partially recoup their losses.

- **Erosion of social consensus**. Problems with balancing the budget will negatively influence the economically most vulnerable segment of population and undermine the public support for government policies.
- **Political instability**. With the budget deteriorating, the inability of the government to maintain and improve the standard of living of some groups of population may lead to political unrest.

These risks fundamentally contradict the national interests of Ukraine, as well as the interests of the international organizations and other countries of the region. The solution of this crisis must therefore begin immediately.

6. Evaluation of recent government measures concerning VAT

On 27 February 2002 the Government approved 7 legislative acts aimed at solving the current VAT refund problems. They address the following issues:

- Better control over the export operations to prevent export frauds. The taxpayer will receive the VAT refund only when the goods leave the territory of Ukraine.
- The VAT administration in the gas, coal and electricity industries envisions the creation of separate accounts to deal with VAT payments. They will be introduced in April 2002.
- VAT treatment of agricultural producers introduces stricter controls and registration of firms that receive tax privileges. Special accounts for privileged funds are to be used. If the enterprise does not open an account, it will have to transfer the funds to its revenues and pay the tax. This will also apply to the producers whose sales amount of agricultural products is more than 50% of the gross revenue of the enterprise.
- Regulation of the issuance of wechsels, with the intention to strengthen the payment discipline of enterprises with the state's share of more than 50%.
- The VAT refund debt of those enterprises will be written off or restructured whose tax arrears were written off or restructured in 2001, as permitted by the Article 56 of the Law of Ukraine "On Central Budget of Ukraine for 2002".

The introduction of these acts is expected to reduce the refund debt by UAH 200 m by the end of March 2002, and to bring UAH 50 m of additional revenues each month.

While the proposed changes show the willingness of the government to deal with the problem, we think that they will not significantly expand the VAT tax base. With the differential VAT treatment of different industries and localities preserved, it is difficult to expect these measures to improve the effectiveness of tax collection or to curb rent seeking and fraud seriously. More substantial changes will be needed.

7. Recommended solutions

The problem with VAT has two aspects. On the one hand, the overdue refund claims need to be paid in order to restore the credibility of the government, the functioning of the price system, and to ensure future economic growth. On the other hand, the VAT legislation and administration need to be reviewed and changed in order to bring the efficiency of the system to the internationally comparable level.

7.1. Improvement of the VAT system

As shown above, numerous exemptions to tax obligations defined by the Law on VAT eroded the tax base. We recommend:

- That the government undertakes a fundamental review of all exemptions to restore the functional law from before 1998. Namely, the implicit subsidy in agriculture needs to be abandoned and replaced by a reduced VAT rate, if such is deemed politically desirable. The tax treatment of industries and regions must be unified to the greatest extent possible. The code needs to be simplified so that its application leaves no discretion to STA. Socially motivated tax exemptions need to be replaced by direct income assistance.
- To reform the status of the Ministry of Finance and achieve harmonization with the EU legislation. Consistently with international standards, Ministry of Finance needs to have the right to veto the budget-related legislation interfering with the execution of the current-year budget.
- To reform the tax collection legislation. The effectiveness of the auditing process needs to be improved by generating the risk profiles of firms applying for refunds. Established firms that have been audited in the past and have a good history of meeting their tax obligations pose a smaller fraud risk than the firms with no or bad history.
- To publish all the relevant statistical data regarding VAT. Most of the data on VAT in Ukraine is not publicly available. That obscures the seriousness of the problem and leads to speculation. Making data available to the public will make it easier for the government to gain the public support for the proposed measures.

7.2. Refund debt

The most important step is to legitimize the existing refund debt. The government needs to design and publish a plan of paying off the debt, together with the interest, in order to prepare the business sector for this process. Ukraine will need to mobilize a substantial amount of resources to pay the overdue refunds. Because the issue of treasury notes is unlikely to raise sufficient funds in the current situation, the Ukrainian government will need to move fast in the VAT reform to generate additional revenue that may serve as a source of refunds. The use of the funds must then be accompanied by the system of administrative measures to ensure the future performance of the VAT system.

In order to preserve the competitiveness of Ukrainian exports, the overdue refunds owed to exporters need to be repaid first. The following measures need to be considered:

- Establishing a special account as a separate chapter of the budget under the supervision of the Ministry of Finance.
- The use of the funds on this account is limited by law exclusively for the purpose of the refund payment (misuse would constitute a criminal offence resulting in severe penalties).
- After the law comes into effect, transfer the funds to the above account.
- Prepare the list of exporters who get the refund strictly according to the date the claim occurred. We recommend that alternative criteria of relative importance will not be used to determine the order of firms receiving refunds, because they will be subject to abuse and corruption.

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