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# The VAT refund problem:
# Towards a sustainable solution for the future

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# Structure

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# 1. Key facts on the VAT refund problem

- Since 2008: Companies face massive problems for receiving legitimate VAT refunds from the government
- Result: Huge accumulation of VAT refund arrears
- May 2010: UAH 27.3 bn
  - Equivalent to 2.5% of GDP and 8.4% of consolidated state budget
- Strongest hit sectors (April 2010):
  - Agriculture (UAH 7.1 bn)
  - Metallurgy (UAH 7.1 bn)
- Furthermore: Very unequal treatment of companies

→ No level playing field


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# 2. Two aspects: Stock vs. flows

- Analytical distinction: 2 different aspects of the VAT refund problem
- Aspect 1: Regular VAT refunding does not work properly

  → Flow problem
- Aspect 2: As a consequence of the malfunctioning of the system, the government accumulated large liabilities/debt in the form VAT refund arrears

  → Stock problem
- Current focus in politics and public: Resolving the stock problem
- But at least equally important in economic terms: Solving the flow problem
- Thus: Both aspects have to be dealt with


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# 3. Economic implications of refund problem

„Export tax“:

- Weakening of export sector/impediment for recovery
- Strong barrier for investment and FDI in exporting sectors

Unequal treatment:

- Incentive for companies to engage in rent seeking, disincentive for innovation and investment
- Strong link to corruption

Structural distortions:

- Favouring of inefficient big conglomerates as opposed to modern, highly-specialised and efficient companies

Business climate:

- If government doesn’t comply with legislation, why should the private sector do so?
- Very bad press/reputation of UKR
- Serious impediment for investment, incl. FDI


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# Who bears the cost?

- Common view: Cost is only beard by big business/exporters
- But: When deciding how much to pay for inputs, exporters price-in the additional VAT costs (i.e. non-reimbursed VAT)
- Result: Lower input prices ("price effect") and lower income for workers
- Thus: Substantial part of the cost is beard by small/medium-sized business and by the working population

  → Not only big business, but also common people suffer!
- Example: Agriculture
  - Firms with massive VAT refund arrears are forced to decrease their input prices by roughly the non-reimbursed VAT in order to remain competitive
  - Thus, prices and income received by farmers dropped by approximately this amount
- **Conclusions:**
  - VAT reimbursement problem has negative effects on employment, wages and income
  - In agriculture: Huge setback towards regional development and poverty reduction ambitions of the government


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# 4. Solving the stock problem: VAT bonds

- 2010: Very difficult for the government to repay the accumulated stock of VAT refund arrears in cash
- Thus: Issuing of VAT bonds is in principle a reasonable and practicable solution
- However:
  - Reasonable solution only if details and handling appropriate
  - In particular: Recognition of outstanding debt by STA and the concrete conditions of bonds (“market-conditions”)
  - Most importantly: This must be strictly considered an one-off solution, not a recipe for the future
  - Attempts to use this instrument in the future again will damage the credibility of the government and lead to very negative economic effects
  - Thus: In addition to issuing of VAT bonds, a sustainable solution to the problem has to be found for the future


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# 5. Sustainable solution for the future

- For a long-term solution: Several policy areas have to be tackled at the same time
  i. Fiscal consolidation
  ii. Improvement of tax administration
  iii. Fighting corruption

- Crucial: Long-term solution can only be found, if all areas are simultaneously tackled

  → Combined approach is needed ("policy mix")


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# i. Fiscal consolidation

- Strictly speaking: VAT refunds are legal obligations of state that have to be reimbursed independently from fiscal situation
- However reality UKR: If serious fiscal problems, then reimbursement problems are rather likely
- Thus: Without fiscal consolidation problems will remain
- **Conclusion**: Fiscal consolidation is a necessary part of the solution


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# Implementing fiscal consolidation

- How to implement fiscal consolidation in the short- to medium-term?
- Regarding the pace of consolidation:
  - "Economic Reform Program" by the President foresees a yearly decrease of the budget deficit of 1 percentage point of GDP
  - Our view: Right direction, but plans not ambitions enough
  - More adequate: around 3 percentage points of GDP per year
- Regarding the main areas for fiscal consolidation:
  - Pensions
  - Naftogaz/Energy tariffs
- **Conclusion**: Fiscal consolidation is feasible and should be implemented at a faster pace


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# ii. Improvement of tax administration

- Necessary to combat fraud in the VAT chain decisively, but without punishing honest taxpayers for the violations of others
- Reforming VAT administration in several areas can help to combat such behaviour:
  - Registration of new companies: Real identity checks of owners/managers, tax history checks
  - Monitoring: Use of risk-profiling and audits based on this
  - Automatic refund procedure for low risk profiles based in order of appearance
  - Centralised refund system


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# iii. Fighting corruption

- Corruption within government/tax administration:
  - Not the only cause of the problem
  - But: Very important factor
- Thus: Corruption needs to be tackled
- Approach to combat corruption
  - Obligation for provision of data to the public or to interested parties (such as competitors)
  - Example: Publication of share of VAT refunding for different companies in one sector
  - Numbers to be checked by independent auditor
- Additional measure to fight corruption and discipline the government: Payment of interest on VAT refund arrears


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# 6. Concluding remarks

- VAT refunding: Major economic problem of UKR today → Solution is needed
- VAT bonds:
  - Appropriate for solving the stock problem
  - But definitely no solution of the flow problem
- Needed for sustainable solution of flow problem:
  - Fiscal consolidation
  - Tax administration
  - Fighting corruption
- Only a combination of measures will work


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