

Strengthening the VAT in Ukraine

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EXECUTIVE SUMMARY

The paper evaluates the past and current performance of the VAT in Ukraine. Main findings and messages include:

VAT and the 2006 budget:

- VAT collections went up sharply during 2005 after a declining trend observed from 1999 to 2004. This increase was driven by a variety of factors including the commendable action of cutting exemptions taken by the government at the beginning of 2005, and the new leadership in both collection agencies (Customs and Tax Administration).
- The VAT revenues have become heavily dependent on VAT collections from imports. Despite the growth in collections in 2005, that dependency persists. As of September 2005, two-thirds of the net VAT revenue was via imports. This trend underscores weaknesses on domestic VAT administration.
- The sharp VAT revenue increase in 2005 may be a one time effect. Because of the nature of the factors that drove collections up, another sharp increase in collections for 2006 is not likely to occur, and thus, the budget 2006 forecast for VAT revenue seems overly optimistic. Setting recurrent expenditure increases for 2006 on the basis of this revenue forecast would not be prudent. In this context, substantial strengthening of tax policy and particularly of tax administration needs to take place.

Selected VAT policy issues:

- Replacing the VAT with a turnover tax is not a solution. In fact, a turnover tax would generate more problems to the Ukraine's tax system, as it would bring more distortions, and a cascading effect of taxation that would harm economic activity and growth.
- There are no solid grounds for reducing the VAT rate in Ukraine at the moment. The current rate of 20 percent is not high compared regionally. A policy in that direction could cause serious losses to the budget. Only structural improvements in tax administration would open the way to discuss this possibility in the future.
- The energy sector (particularly the gas sector) has generated serious problems to the VAT system, but this issue goes beyond a tax policy and administration discussion in Ukraine.

This large subsidy and its operation belong to a broader and urgent discussion on energy policy.

- The VAT in agriculture also requires revamping. The present VAT system for agriculture complicates tax administration and produces little revenue. Given the current conditions and political constraints, this note supports the IMF's report (2005) recommendation regarding the prompt implementation (starting in 2006) of the amendment to the VAT law (on Art. 8.1), that establishes rates of 9 percent for agriculture and 6 percent for forestry and fishing activities, and moves closer to the EU sixth VAT directive.
- There are good reasons for having a special system for small taxpayers in Ukraine. However, the regulation of the current simplified tax system has led to an erosion of the VAT base, as it is allowing medium size businesses to migrate to this system. A reasonable step for resolving this issue is lowering the upper limit of turnover for legal entities in the simplified tax system (currently at 1,000,000 Hrv) to the level of the VAT threshold (currently at 300,000 Hrv.).

Strengthening the VAT administration:

- The level of refund claims, fraudulent refund claims, and refund arrears are just symptoms of underlying administrative weaknesses. Thus, it is necessary to shift the focus of discussion from these specific issues and work on the structural administrative problems behind them.
- The State Tax Administration Agency needs to strengthen core tasks of tax administration. The attached paper proposes the strengthening of six basic areas as a priority, but also argues that this collection agency needs political support in order to undertake the necessary steps to enhance their capabilities in these tasks:
 - i. Improving the registration process: Ukraine needs a registration system that is fast, client friendly, but able to reject potential evaders. This is not taking place, the single window of business and tax registration has no screening processes for applicants that register to the VAT.
 - ii. Reducing compliance costs: the time spent by firms following the procedures to comply with core taxes, such as VAT (and other taxes) continues to be excessively high. Efforts need to be exerted to facilitate reporting and payment mechanisms without additional burdens.
 - iii. Improving monitoring tools: a new and comprehensive monitoring system is critical for Ukraine and needs to be implemented as soon as possible. Tax administration requires a variety of benchmarks of collection and fraud (e.g., VAT gaps) by sectors of the economy, by type of tax payers, and by geographical regions (the attached note provides guidance on the construction and implementation of those monitoring benchmarks). The strengthening of this task also implies better and more fluid

channels of communication and information sharing between the Ministry of Finance, the State Tax Administration, and the State Customs Administration.

- iv. Allocating resources more efficiently: Analytically based monitoring would help substantially in allocating tax administration resources. International experience suggests that monitoring on this basis can be very efficient in terms of revenue recovery vis-a-vis administrative costs incurred.
- v. Improving audit practices: As monitoring tools become more sophisticated, audits need to be better targeted, and avoid extra hassle to good tax payers. This is also critical for the improvement of the business environment in Ukraine.
- vi. Improving the enforcement of penalties and re-thinking its structure: Criminal prosecutions for VAT fraud are costly and lengthy, and do not produce much revenue in Ukraine. Administrative penalties maybe more effective (including deregistration, fines, temporary closures of business, and the like—the attached note provides guidance in how to set a structure for this type of penalties). Thus, the system of penalties needs a better balance between administrative penalties and criminal prosecutions. A vigorous enforcement of penalties is always necessary but it should be accompanied by further curtailment of corrupt practices, a transparent system of administrative penalties, and the enhancement of current mechanisms for listening taxpayers' complaints and appeal processes.

(*) This paper draws on the report elaborated by Prof. Richard Bird during a mission to Kyiv on September 2005.

I. INTRODUCTION

1. Since its full implementation in 1997, the VAT has been the backbone of the tax revenue system in Ukraine.¹ However, during recent years this tax has performed poorly in collections, it has created additional burdens for businesses, and its administration has experienced difficulties, particularly tackling fraud. For these reasons, the VAT has been heavily criticized, and proposals for its replacement by a turnover tax have been under discussion.² This paper evaluates the past and current performance of the VAT in Ukraine. It examines the underlying factors behind that performance and the VAT's current weaknesses. This paper argues for the strengthening of the VAT administration as a priority and provides specific measures that could be implemented for that purpose. Selected policy issues concerning this tax are also discussed.

Table 1: Revenue sources as percent of total revenues (2002-2005)

	2002	2003	2004	2005(Jan-Sept)
Social insurance contributions (labor taxes)	26.21	25.94	28.81	26.22
VAT	19.69	15.42	14.69	23.84
CIT	13.73	16.20	16.03	15.00
Other taxes on goods and services	12.87	13.42	14.84	12.44
Personal income tax	15.82	16.55	13.11	11.67
Taxes on international trade	3.46	4.64	5.03	4.86
Other taxes	5.59	5.35	5.23	4.04
Land tax	2.64	2.49	2.27	1.92

Sources: Ministry of Finance; IMF data; Bank staff calculations.

2. Indeed, the VAT has experienced difficulties as a revenue raiser, with declining collection efficiency during the period 1998-2004. Despite the fact that this year is expected to be marked by a sharp increase in VAT collections, problematic issues on the overall performance and administration of this tax persist. It is also true that refunds to exporters had (and still have) delays. This situation has caused damage to the business environment and has created structural problems for the normal functioning of the VAT. But this problem stems from the administrative inability to manage this tax and it is not caused by the VAT itself or its refund system.

3. Improving the performance and administration of the VAT is an urgent concern for Ukraine, especially regarding the prospects for rate reductions in other revenue sources in the tax system, as envisaged by the government. Lowering the marginal tax burden in the country is important, but it needs to be accompanied by a broadening of the tax base, better compliance rates, and better overall administrative capabilities on the part of the revenue authorities.

4. The paper is organized as follows: Section II evaluates the VAT trends and performance for the period 1998-2004 and the prospects for 2005-06. It provides an analysis of collection efficiency and examines the changes in VAT collection composition (i.e., VAT on imports vis-a-

¹ Although a value-added tax was first introduced in 1991 it was only in 1997 that a "modern" type of VAT, allowing in principle for freeing both investment and exports from tax, was introduced.

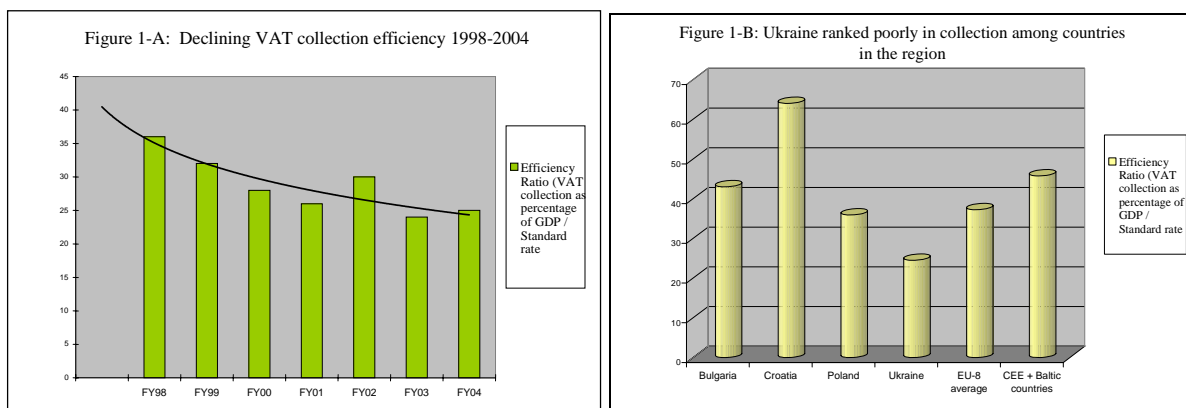
² As is argued later in this paper, the potential outcomes of such a measure are unambiguously negative, and may result in losses of efficiency in the economy, distortions, and even potential revenue losses for the budget.

vis VAT on domestic consumption). Section III aims at examining the underlying administrative factors that contribute to the problems of the VAT. This section also identifies opportunities to tackle VAT administrative weaknesses in Ukraine, and provides concrete alternatives for their implementation. The measures and alternatives for VAT improvement provided in this section are easily applicable to tax administration in general. Finally, Section IV examines selected policy issues in the VAT system, focusing particularly on VAT issues in the energy and agriculture sectors, and also looking at the inter-relation between the VAT and the simplified tax system.

II. VAT TRENDS AND PERFORMANCE

The 1998-2004 Period

5. **From 1998 to 2004, VAT collection performance in Ukraine declined significantly.** As shown in Figure 1-A, the revenue yield of VAT as a share of GDP declined more or less steadily after the tax came into full effect in the late 1990s. Although fluctuations in revenue yield are hardly unique to Ukraine, such a prolonged decline in VAT yields is both unusual and disturbing. In general, VAT yields rise with both GDP growth and import growth.³ In Ukraine, however, although real GDP rose by 49 percent in the 1998-2004 period, VAT as a share of GDP actually fell by 33 percent.⁴ If we analyze a simple measure of performance, collection efficiency, also called VAT productivity, Ukraine ranks poorly in the international context as of 2004 (see Figure 1B).⁵



Sources: GFS; World Economic Outlook; Ukraine State Tax Administration; Bank staff calculations (Data for Ukraine are for 2004; data for the rest of the countries are for 2002).

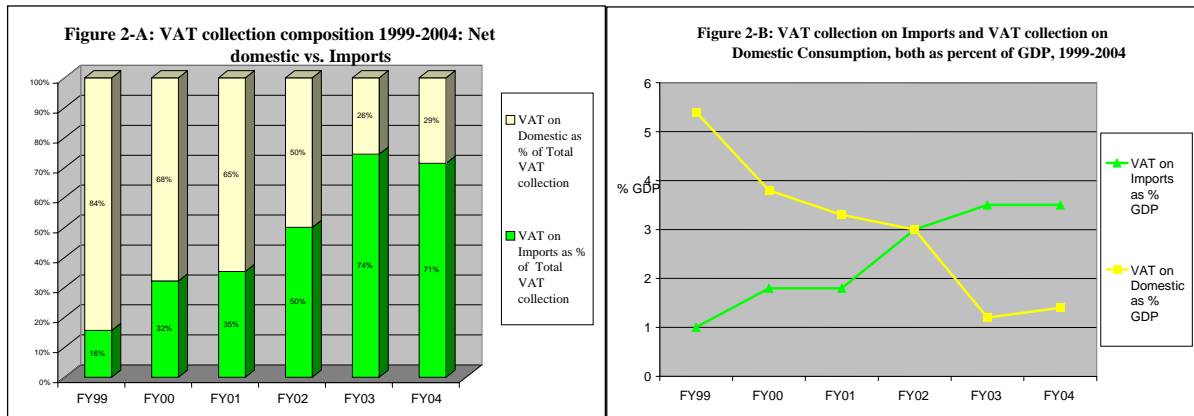
6. **Concurrent with a poor collection performance, a sharp change in VAT collection composition took place.** In 1999, the collection on net domestic VAT was 84 percent of total

³ See for example, the econometric analysis in T. Baunsgaard and M. Keen, IMF Working Paper No. WP/05/11, June 2005.

⁴ Commonly, a general consumption tax such as VAT would exhibit a (nominal) GDP elasticity on the order of 1 over a period of years. In Ukraine, however, the arc GDP-elasticity of VAT from 1999 to 2004 was an incredibly low 0.38.

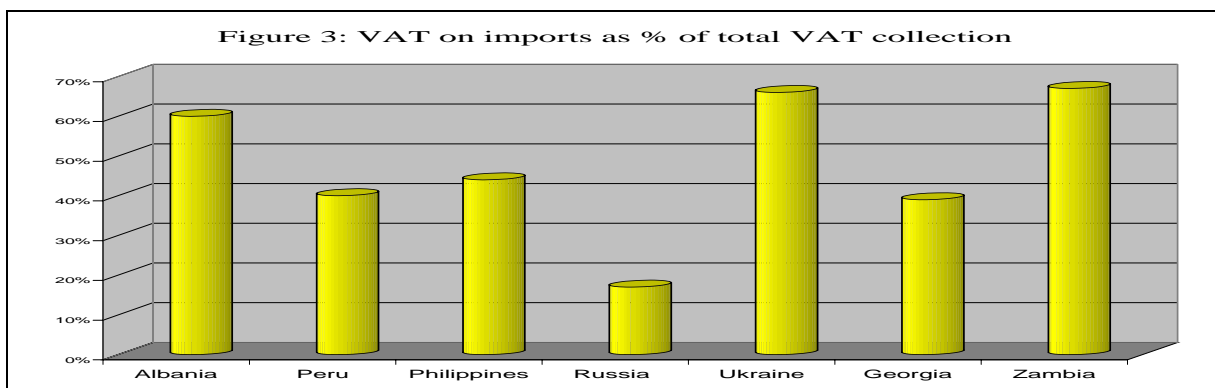
⁵ Collection efficiency or VAT productivity is the actual collection as a ratio of GDP, divided by the standard rate of the VAT in the country. Technical Annex 1 contains a discussion of this and other VAT performance indicators.

VAT collection, while VAT on imports was 16 percent. By 2004 this relationship was almost inverted: net domestic VAT collection dropped to just 28 percent, while VAT on imports became 72 percent of the total VAT collection. Net VAT collected on domestic consumption fell gradually but steadily, from an average of 5.6 percent of GDP in 1998-99 to 3.4 percent in 2000-02, and to only 1.3 percent in 2003-04. Of course, it is important to consider that a large amount of refunds (discounted from domestic gross collection) may be generated because of claims for refund on VAT paid on the import of inputs for the production of goods that were later exported (e.g., equipment).



Sources: Data from MoF; Bank staff calculations

7. **In any case, the change towards the dependence of VAT collections on imports is noteworthy.** While the growth in imports experienced in Ukraine during the last few years is likely to be reflected in an increase in the share of VAT collected from imports, it is difficult to point to any other country with such a marked and rapid change toward dependence on imports for VAT revenue. This type of proportion is not unusual in small developing countries, but it is uncommon in economies as large as Ukraine's.



Sources: Ebrill et al. (2001); MoF; Bank staff calculations (data for Ukraine are for 2005, January-August).

8. **Changes in the economic structure explain only part of the trends in collection performance and composition.** A rise in GDP attributable to an export-driven expansion, as happened in 2003-04, would not necessarily mean that VAT collection should grow, since VAT does not tax exports. In fact, even a small decline, rather than an increase in VAT revenues could

be expected as input credits may build up more quickly than output taxes, thus resulting in a fall in net VAT receipts. But, at the same time, one may expect a positive offsetting effect due to the growth in imports and the VAT collection on that front.

9. **The same applies to changes in the tax structure.** There was clearly some base “erosion” in the form of increased exemptions and the like previous to the 2002 decline of VAT-to-GDP ratio. But the level of exemptions decreased in the period of 2003-2004, and yet the decline continued. There has been, however, a different type of base erosion taking place during the last years. This erosion has been essentially driven by medium size companies migrating to the simplified tax system, using a variety of schemes in order to fit that system’s regulation (this issue is discussed later in this paper).

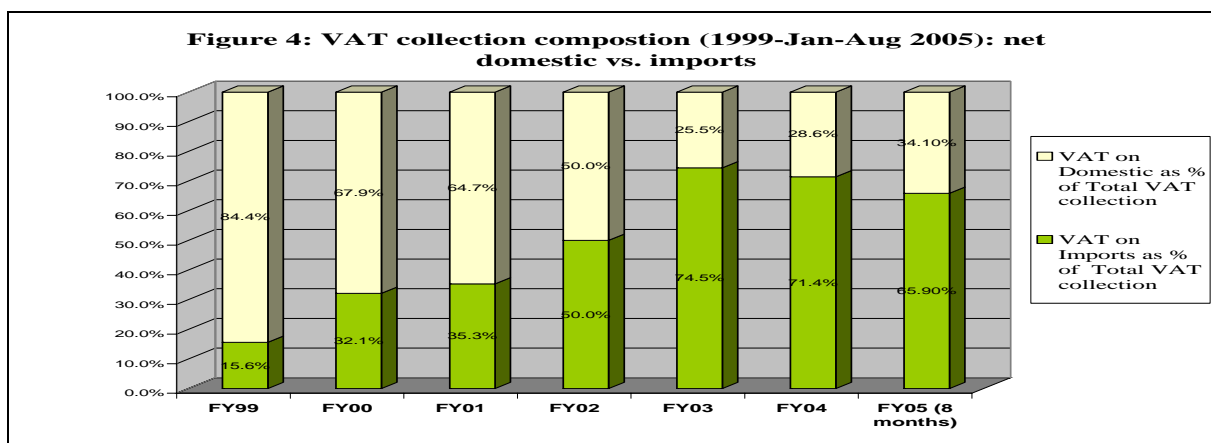
10. **This leaves tax administration as a feasible explanatory factor for the poor performance of the VAT.** The IMF report (2005) uses accounting identities to decompose the magnitude of the effect of VAT exemptions, exogenous macroeconomic factors, and administration on the changes in VAT collection as a percent of GDP.⁶ The results of that report suggest that exogenous macroeconomic developments did not play a role in the poor performance of the VAT in the period 1999-2004. VAT exemptions and administration, on the other hand, are found to be significant factors affecting VAT collection performance. This report will return to the central issue of VAT administration in Section III.

The 2005-06 Period

11. **VAT collection will rise substantially in 2005.** The actual VAT net collection as of August 2005 was 21.46 billion Hrv., which represented around 8.5 percent of GDP (January-August). In the context of other revenues, the VAT collection for this eight-month period represented 24 percent of total tax revenues. The government forecasts a total net VAT collection for 2005 in the order of 33.7 billion Hrv. This 2005 forecast is feasible given the collection performance as of August.

12. **But dependence on the VAT collection from imports persists.** From January to August of 2005 the amount collected through VAT on imports represented two-thirds of the total VAT collection, while the remaining one-third was VAT on domestic consumption. It is of concern that collection remains heavily reliant on VAT on imports despite substantial growth in overall collections in 2005. Moreover, according to the draft budget figures for 2006, the VAT’s revenue dependence on VAT from imports is expected to continue. This collection composition highlights the weaknesses in the domestic VAT administration, even considering the fact that overall collection is up.

⁶ See IMF report “Proposals to Reform the Tax System” (October 2005), Appendix I, for a discussion of the decomposition of the change in the VAT/GDP ratio between administration, exemptions, and exogenous factors.



Sources: STA; Bank staff calculations.

13. **This year's increase in collections was driven mainly by three factors**, namely: cuts in VAT exemptions, the introduction of VAT collection on imports of oil from Russia, and the leadership change in collection agencies. The legislative changes that curtailed a significant portion of VAT exemptions at the beginning of 2005 were important in improving the VAT revenue base. This was a commendable action on the part of the new government. VAT revenues on imports of oil from Russia also had a positive effect on VAT collections. Prior to this year, Russia charged VAT on its oil exports to Ukraine; however, Russia ceased this practice for 2005, allowing the Ukrainian government to charge VAT on these imports.⁷ Finally, the changes in leadership and personnel in key areas of the STA and Customs was a determinant factor in increasing VAT collections.

14. **But the sharp increase in 2005 may be a one-time effect.** Because of the nature of the factors that drove collections up, another sharp increase in collections for 2006 is not likely to occur. This is particularly evident if substantial reforms on several fronts including tax administration and taxation of energy do not take place.

15. **In this context, the government forecast for VAT collection in the 2006 budget seems overly optimistic.** Continuing the trend of 2005, the growth rate of revenues is set to exceed the nominal GDP growth. Moreover, the VAT increase in collection is forecast to be 29 percent higher than in 2005.⁸ The 2005 collection is likely to be a high base to measure future increases, and thus the growth expected by the government for 2006 would be difficult to reach.

⁷ Roughly 89 percent of Ukraine's oil imports come from Russia (Bank estimation based on 2002 WITS figures). If we assume this is the current share of oil imports to Ukraine from that country, and we apply the standard VAT rate to imports for the period of January-September 2005, VAT revenues on these imports would reach just above 3,2 billion Hrv. This amount represents around 13 percent of net VAT collection for that 9 month period (January-September). Of course, this is not the amount of revenue gained as a result of the discussed policy change, since VAT was being charged at later stages of product value added before 2005 (without a credit for the import VAT). However, the loss may still be significant as the first stage of VAT collection (possibly the most effective in revenue collection) was being forgone.

⁸ This number was calculated on the basis of the first draft of the Budget for 2006.

16. **Thus, setting recurrent expenditure increases for 2006 on the basis of these revenue forecasts would not be prudent.** The increase in revenues estimated only for the VAT in 2006 is approximately 5.2 billion Hrv., which is more than 1 percent of GDP. But the overestimation of revenues is not limited to this source. Personal Income Tax and social insurance contributions, for example, may be potentially overestimated as well. The real wage growth forecast (of 11 percent) is set to be below the current figures. However, owing to the lagged/inertial effect of the 2005 growth slowdown and inflation acceleration, it may well decelerate into single digits in 2006. If that occurs, revenues for these sources may not reach the government's forecast figures.

III. THE UNDERLYING PROBLEM OF TAX (AND VAT) ADMINISTRATION.⁹

17. This section discusses the administrative problems that the VAT system faces in Ukraine, arguing that the current focus of the debate is too narrow, as the VAT problems cannot be attributed solely to such issues as the level of refund claims, fraudulent refund claims, or the refund system. This paper argues that these issues are merely "symptoms" of broader and more structural administrative weaknesses in such core tasks of tax administration as improving registration processes, reducing compliance costs, enhancing monitoring, and improving auditing and enforcement. This section proceeds by identifying opportunities for addressing the weaknesses in those core tasks, and providing concrete alternatives for their strengthening. The measures and alternatives for the improvement of VAT administration articulated here can be applied to tax administration in general.

The level of refund claims and fraudulent refund claims: Symptoms of administrative weaknesses

18. **The refund arrears, and the fraudulent refund claims are only symptoms of underlying administrative weaknesses.** Thus, it is necessary to shift the focus of discussion from these issues and concentrate on those underlying weaknesses. Unavoidably, we must return to the operation and capabilities of the administration of collection agencies. As noted earlier, the rise in overall VAT collection in 2005 was mainly generated by legislative changes that expanded the base and by a new leadership in collection agencies, but that increase was not necessarily a sign of better Customs or Tax administration. In fact, apart from cosmetic arrangements, the operation of these institutions has not changed significantly in recent years. This implies that the same issues may worsen or even that new problems may appear, if structural enhancements of the basic core tasks of tax administration do not take place.

19. **Many observers have suggested that the problems with the VAT in Ukraine arise from the level of refund claims; but this is only partly true.** Refund levels for a given year in Ukraine appear to be within an "expected" range. In 2004, new refund claims amounted to 41.3 percent of collections. A recent (unpublished) study of 28 countries for the 1998-2001 period, for example, found that nine countries had ratios in excess of 40 percent, with an average for the

⁹ While VAT revenues are collected through both Customs and the STA, in this paper we concentrate primarily on STA functions. However, some of the lessons that emerge from this discussion are also applicable to the management and operations of Customs administration.

seven transition economies included in the study of 36.8 percent. Based on these data, that study estimated a regression equation of “expected” refund levels taking into account a variety of macroeconomic conditions and other factors, such as the level of exports.¹⁰ Using 2004 data for Ukraine, this equation predicts that the refund level observed would have been 46.5 percent, which is more than the actual level observed.¹¹ Now, “expected” levels means only that they are comparable (i.e., at a similar level) to other countries with similar characteristics. In other words, this does not mean that refund claims at those expected levels do not include fraudulent claims, as most countries have some level of fraud. Furthermore, the exports variable already may be distorted (i.e., over-reporting of exports, as explained below)

20. While fraudulent claims raise the overall level of refund claims, the government needs to look at the source of that problem. Many argue, with good reason, that a significant share of refund claims, past and present, are fraudulent. That is, the value of exports may be inflated, the exports may never have occurred, or the input taxes claimed on exports may be inflated. In fact, a recent World Bank report provides evidence that Ukrainian export and import statistics are distorted, showing an over-reporting of exports and an under-reporting of imports.¹² Moreover, it is well known that, over the years, fraud in refund claims has become increasingly sophisticated in Ukraine.¹³ But while fraud exists, the problem is not with refunds per se but with the administration of the VAT in general, which is unable to tackle fraud throughout the system. In fact, there are many ways to cheat on any tax, but in practice, with good tax administration, it is harder to cheat with a VAT than with other forms of sales taxes.¹⁴

21. Nevertheless, there have been refund arrears generated by weak administration. While this issue is not acute at the present time, it is important to examine its causes in order to avoid the same mistakes in the future. The large amount of refund arrears accumulated in earlier years (particularly during 2000-03) has been an obstacle to the normal operation of the VAT’s refund system. One of the causes for these accumulated refunds arrears was the overall poor collection efficiency exerted by the revenue agencies (both the STA and Customs) and their inability to tackle fraud. Corruption played a role as well, as some dishonest officials allowed fraudulent claims to be processed for refunds while leaving in stand-by legitimate claims.

22. Another cause of this issue was that wrong incentives were imposed on the tax administration office. This was a self-imposed predicament. The government decided to set VAT “net collection targets”, the achievement of which was rewarded with bonuses and other incentives. The problem started when the targets were about to be missed by the tax administration owing to increasing refund levels, which were in principle normal for a period of export-driven growth. Because of the incentives, the revenue authority began to stop the due payment of refunds. As would be expected, this situation was accompanied by fraudulent refund

¹⁰ These data, like the equation mentioned below, come from G. Harrison and R. Krelove, “VAT Refunds: A Review of Country Experience,” April 2005.

¹¹ The estimated equation (adjusted R squared = 0.8826) is $\text{Refunds} = 0.16 * \text{Exports} + 0.75 * \text{Growth} + 0.19 * \text{Literacy} + 0.90 * \text{Range}$, where exports is the share of exports in GDP, growth is average GDP growth in the period, literacy is the literacy rate, and range is the difference between the lowest (non-zero) and highest VAT rates. (A number of dummy variables are included in the original equation, but none are applicable for Ukraine.)

¹² See Ukraine Trade Policy Study- World Bank, 2005 (pp. 32-33).

¹³ See World Bank (2004), note on VAT special accounts in Ukraine.

¹⁴ Later this report shows a brief comparison of pros and cons between VAT and a Turnover Tax.

claims, carried out under increasingly sophisticated schemes, which the administration was unable to tackle. While there are several other reasons for this problem, the roots lie primarily in administrative weaknesses that are structural in nature.

23. The refund issue has also been exacerbated by factors beyond the administration of the VAT. Many of the refund arrears accumulated in the past arose from inter-enterprise arrears connected largely with the energy sector and arising, in part at least, from the persistent underpricing of energy. The solution to such problems would lie in sensible energy policy, and not in playing with the VAT refund system. Further discussion on this issue will be found in section IV.

24. But if one focuses only on fraudulent refund claims or some other narrow issue, the underlying problems will remain and will soon manifest themselves again. However, it is important to emphasize that attributing the problem to administrative weaknesses does not imply that the tax administration is incompetent. The creation and development of a modern tax administration is always a difficult and time-consuming task. Ukraine began to take this path only a decade or so ago. The process began with an unpromising legacy of state-private relations, with no trained officials, and within a very difficult political and economic setting. Under these circumstances, while progress has been achieved, it is not surprising that there is still much to do.

25. The problem is not so much that VAT administration has deteriorated as that it has never been strong. Moreover, the task facing tax administration has been made incredibly difficult by many developments in the last few years, particularly the following: a) lack of consistent support from political leaders; b) frequent changes in tax legislation; c) problems with the legal and judicial system; d) weak corporate governance legislation and practices; e) low level of accounting standards; and f) rapidly changing structure of private activity. On top of that, the tax administration agency has not enhanced its capabilities in order to face those challenges.

26. Despite improvements, many of the preconditions for an effective self-assessed and a well administrated VAT are not in place in Ukraine. Historically, the tax administration in Ukraine has concentrated efforts on temporary pressing issues while ignoring the bigger picture. Thus, little has been done to provide the proper tools for the core tasks of tax administration. Moreover, little has been done to provide taxpayers with an encouraging environment for self-compliance.

Box 1: Pre-conditions for Effective Self-Assessment

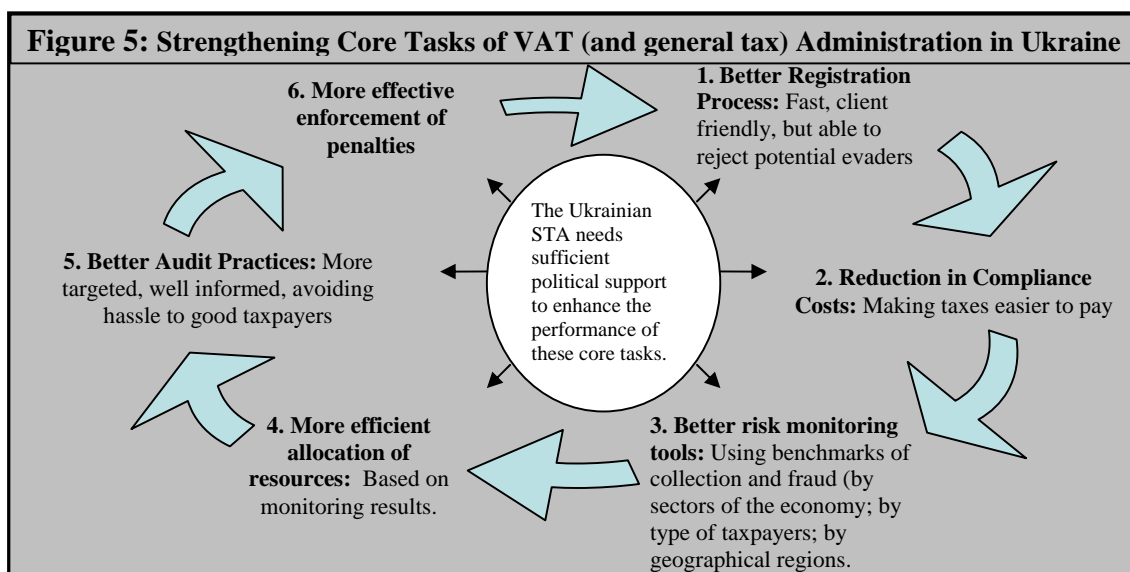
- Simple, clear, stable tax laws
- Adequate service and support to taxpayers in complying with tax obligations
- Simple procedures for registration, filing, payment, and refund
- Effective collection enforcement
- Reasonable audit coverage
- Strict application of penalties
- Provision for independent review

Source: Ebrill et. al., (2001). "The Modern VAT"

27. **The current administration lacks the essential analytical capabilities to perform core tasks.** These capabilities span on a range of areas of tax administration, from tools to execute a rapid and quality controlled registration process, to the tools to perform a proper monitoring of collections and taxpayers. There is no “magic formula” to good tax administration, but there are many established, analytical, and workable ways to better perform this function.¹⁵

Opportunities for addressing VAT administrative weaknesses

28. **This paper proposes the strengthening of 6 basic core tasks of tax administration.** These tasks are the following: registration processes, reduction of compliance costs, comprehensive monitoring, more efficient allocation of resources, audits, and enforcement of penalties.¹⁶ In addition, this paper argues that the collections agencies need political support in order to undertake the necessary steps to enhance their capabilities in these tasks. The tasks discussed here do not represent the full spectrum of tax administration activities. Rather, this selection showcases prioritization for strengthening VAT administration in Ukraine (see Figure 5). The recommendations that emerge for this discussion can be applied to tax administration tasks in general. In fact, tax administration should consider all these issues within a comprehensive-functional framework.



1. Better Registration Process

29. **A better registration process is critical for the business environment.** A fast, client friendly registration system is very important for improving the country’s business environment. While some steps have been taken, like the recently established single window for business

¹⁵ For a recent review, see R. Bird, “Administrative Dimensions of Tax Reform,” March 2004.

¹⁶ These are some specific priorities in the same line of the basic preconditions for a self-assessed VAT as presented by Ebrill et al, (2001) (see Box 1).

registration, there is as yet no evidence of sweeping improvements. Based on data from the Doing Business Survey (2005), we find that the registration process for a business in Ukraine takes, on average, 34 days, almost double of the OECD country average.

30. But a reliable and fast screening of registrants is also important for improving VAT compliance. This is not taking place in Ukraine: the single window for business and tax registration has no screening processes for applicants that register (including the shareholders of new firms). Thus, individuals and shareholders of companies that have committed tax fraud in the past, and may be prone to fraudulent activity in the future, are not identified at this important early stage. Thorough, but rapid, screening of new VAT registrants (including shareholders of registrant companies) is a common and fruitful practice in most developed countries and certainly in developing countries that are tackling fraud successfully (e.g., Chile). At the time of registration, an information system should be able to quickly elicit data on past compliance for any applicant. In many countries, interconnected systems with customs and other government agencies have helped to facilitate this process (e.g., Australia) (See Box 2).

Box 2: Strong government-wide commitment to the success of the Australian Business Register

While single registration windows for business, tax identifier numbers, and the like have been implemented in many countries around the world, the Australian Business Register (ABR) offers interesting lessons on how strong government commitment to these schemes has helped to improve the business environment and to facilitate government control and flows of information. The ABR is a comprehensive registry system that serves as contact registration point for business. The government uses this registration system for a variety of functions including tax administration. The ABR provides businesses with the Australian Business Number (ABN), a unique 11-digit identification that makes it easier for businesses and all levels of government to interact. The ABR has been central to the Australian government's commitment to reduce the administrative burdens on the business community.

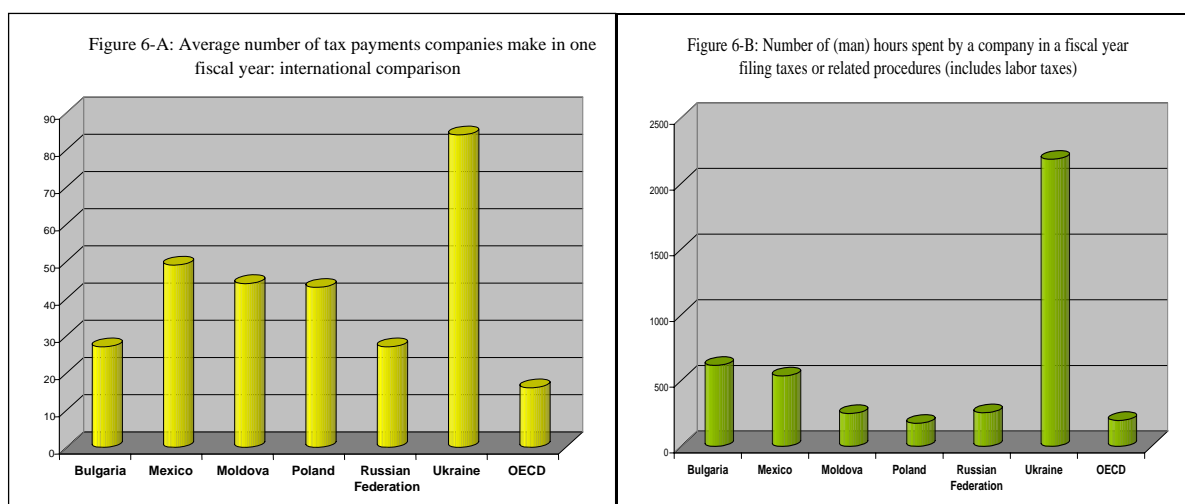
A key factor for the success of this system is that the Tax Office recognized early that benefits for business could not be derived from the ABR without strong and wide government commitment to the project. Thus, it lobbied the project (through an established task force) across agencies and levels of government in order to connect ABR data with multiple agencies. Currently, registration can be undertaken on-line through the internet. Moreover, the ABR designed a system to allow businesses to update their information online as well. The changes are transmitted to all government agencies that have a business use and legal right to the information. The aim is to cut down on time-consuming, duplicative paperwork and processing. The ABR was envisaged as source to integrated registration with other services provided by all levels of government. Some of the ABR's achievements are the following: a) it make possible a fast and efficient registration process, generating a reduction in transaction costs of registration and information update to the tax administration office (and other agencies); b) it facilitated a supervised e-commerce in the country; improving the screening process of registrants making it faster and more reliable; c) it improved data quality for compliance; d) it facilitated government integration; e) it facilitated a higher and seamless government service to business; and e) it facilitated the targeting of business clients based on industry code.

Source: Australian Tax Office at www.ato.gov.au.

2. Reduction of Compliance Costs

31. Ukraine has high tax compliance costs. Although some progress has been made in the last decade, the costs and difficulties generated by tax compliance procedures remain high. The filling of tax forms for the VAT continues to be complicated. Payment and tax reporting procedures are costly owing to their frequency and the complexity imposed by ever-changing

legislation.¹⁷ The Doing Business survey published in 2005 shows that Ukraine ranks poorly internationally in this regard. Figures 6-A and 6-B present worryingly evidence of this situation. The time spent by firms following the procedures needed to comply with core taxes, such as VAT, Corporate Income Tax, and payroll taxes (withholding) continues to be excessively high. Moreover, the number of payments made by a company to the tax administration (even without considering labor taxes) highlights the need for major streamlining in tax compliance procedures.



Source: Doing Business Survey 2005.

32. At the moment, new compliance procedures aimed to have a better handle on VAT activity are being discussed by the government.¹⁸ The MoF and the STA are proposing the implementation of software in which VAT registrants will input their sales and purchases records (subject to VAT). The registrants will then have to transmit these data through e-mail to the STA. This record-keeping and reporting process will run in parallel to the current paper-invoice record keeping and reporting. There are some positive aspects to this system. For instance, an easier cross-control of both purchases and sales among taxpayers can be expected. Currently, most of the controls are run through the credits (purchases) claimed by VAT registrants. Thus, the new system would allow the STA to quickly cross-check and determine VAT liability. However, despite some advantages, the government needs to evaluate the potential gains in collection through the implementation of this new procedure vis-a-vis an increase in the administrative compliance costs, which are already quite high in the country (See Box 3). The implementation of this system from the point of view of the taxpayer (i.e., having the adequate IT requirements, and IT literacy, and the double record keeping for VAT transactions) and from the STA perspective (i.e., the management of large amount of data) could prove difficult and administratively costly under the current conditions.¹⁹ In addition, since taxpayers still need to keep the paper trail system, this is an additional burden on them.

¹⁷ The IFC survey on the Business Environment in Ukraine found that the VAT was among the most difficult taxes to file due to the complexity posed by the large number of amendments this tax suffers each year.

¹⁸ These procedures are being proposed as amendments to the Law on Value Added Tax—November 2005

¹⁹ Universal access to IT and internet does not exist in Ukraine. There are regions of the country that are still far from being able to operate under this system. Thus, the cross controls envisaged may not be accomplished for a large number of VAT transactions.

33. **Ukraine must continue to simplify the procedures for tax compliance.** It is critical for the STA to design and articulate a plan for reducing compliance costs. Most developed countries during the last 10 years have established clear strategies for tackling this issue. For example, in 2004, France launched a program aimed at “making taxes easier to pay”, which contained a list of 30 measures to achieve that goal. Following international trends, this program further moves the system to direct debit and payments through the Internet, makes it easier to file forms, facilitates "real-time tax accounts" consultation via the Internet or by telephone, and gives taxpayers easy access to the tax administration for queries about compliance. While measures to reduce compliance costs have to be tailored to country conditions and characteristics, some aspects, such as those listed in Box 3 below, should be considered in order to avoid extra and cost-inefficient burdens on taxpayers.

Box 3: General recommendations to consider before implementing new compliance procedures

- Implement a process for assessing the cost-effectiveness of tax compliance procedures through evaluation of revenue potential, compliance costs, and uncertainties resulting from compliance measures (and continue re-evaluating periodically).
- Root out and transform bureaucratic requirements that have grown up as a part of the tax compliance system but that are not essential to obtaining necessary information or to discouraging corruption within the tax authority.
- Embrace new technology to streamline compliance procedures when possible, through techniques such as electronic filing, while avoiding extra burdens that can result from thoughtless implementation of new technology.
- Choose carefully the issues to address in tax reform efforts and the design of tax compliance rules. An overly ambitious agenda can drive the process toward careless implementation characterized by unnecessary extra burdens on taxpayers.
- Avoid over-reacting to perceived abuses with broad-based measures that impose extra administrative burdens and uncertainty on a range of taxpayers, or a range of transactions, that is out of proportion to the abuse in question.
- Eliminate the practice of financing the government through unreasonable and unprincipled limitations or delays in paying tax refunds to which taxpayers are entitled under the law. This is a particularly shortsighted practice. Not only does it impose huge administrative burdens on taxpayers but it also encourages them to adopt aggressive or even unjustified tax positions.

Source: Extracted from Inter-American Development Bank (2002).

3. Better Monitoring Tools

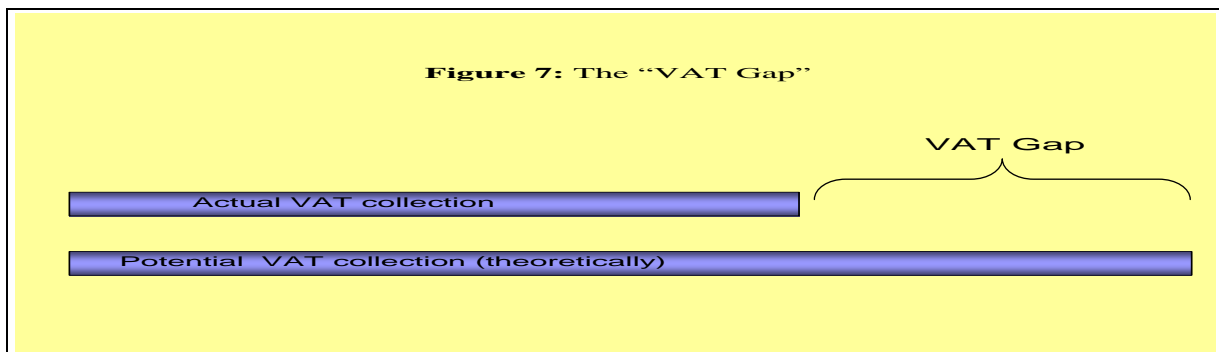
34. **Enhancing monitoring tools is essential to improving collection efficiency.** Currently, the STA lacks the analytical basis to carry out proper monitoring and risk profiling. If the current capabilities are not enhanced, the task of curtailing fraud on all taxes, but particularly on VAT, could prove to be costly and unrewarding. Moreover, the cost of tackling fraud without the adequate analytical capabilities can be costly, not only in terms of the loss of efficiency in the resource assignment of the tax administration, but also in terms of further deterioration of this agency’s image, especially if good taxpayers continue to be targeted (i.e., the current situation regarding refund arrears to exporters in Ukraine is evidence of this situation).

35. **Monitoring needs to be comprehensive, throughout the system.** Thus, risk profiling can work only in the framework of a broader monitoring strategy. As discussed earlier, tackling the

symptoms (i.e., coping with higher refund claims through the refund system) does not resolve the underlying problem. While it seems reasonable to have some system in place to better handle specific areas, the need for better and comprehensive monitoring has to be central to the strategy for better VAT administration in Ukraine.

36. **The former risk profiling system of “traffic light corridors” for VAT refunds had a very limited coverage.** This system was based on the assignment of exporters to risk categories (e.g., green for good taxpayers and expedited refund, and red for problematic taxpayers). While the principle may be appropriate, the profiling was to some extent arbitrary. Consequently, similar systems under consideration at the moment (at Customs and the STA) may fail again if analytical basis for the categorization are not strengthened. Moreover, as stressed earlier, monitoring must be a comprehensive.

37. **Benchmarks for VAT collection should be established for proper monitoring.** Such benchmarks are indicators of activity, compliance, fraud, collection, and potential collection by industrial sectors of the economy, by types of taxpayers, by specific taxpayers, and by geographical location. In the case of VAT, a basic benchmark to be established is the “VAT Gap”, which is the difference between the VAT actually collected and that potentially realizable (or theoretically feasible) given the level of economic activity in the country (or a specific sector), and the VAT regulations (See Figure 7).



38. **Moreover, “VAT gaps” are useful benchmarks that can be estimated by sector of the economy, by type or groups of taxpayers, and by geographical location.** Once they are calculated and established, they can become a key tool for monitoring compliance. Basically they serve as standards (i.e., benchmarks), from which considerable deviations raise red flags about behavior and compliance. These benchmarks (e.g., VAT gaps) inform the tax administration (and customs), so that these institutions can address problems in a more targeted and efficient manner. This type of benchmarks, could prove extremely valuable to VAT administration and the administration of other major sources of tax revenue.

39. **The beginning step in the construction of those benchmarks is to identify the size of the problems.** There are a variety of ways to estimate the “VAT gaps”, and they can be broadly classified in two groups: indirect methodologies (also called top-down approaches) and direct methodologies (also called bottom-up approaches). Indirect methods are based on information/data gathered from disaggregated national accounts. Direct methods are based on information gathered by the tax administration through audits and other internal data. Technical

Annex 2 of this report provides a detailed explanation of how to apply these methodologies in order to produce different benchmarks for monitoring VAT collection.

40. Other benchmarks have to be constructed to identify the nature of the problems. While the daily operation of tax administration provides its managers with some idea of the nature of such collection problems as non-registration, false registration, non-filing, under-reporting of sales, over-reporting of purchases, and non-payment, constant monitoring is needed to cope with the ever-changing environment and new avenues for fraud. The benchmarks obtained through direct methods can provide critical information in this regard.²⁰ While building these indicators may take some time and intensive analytical work, they can provide the tax administration with insightful information regarding fraud and can help to set the basis for a stronger monitoring apparatus in the medium term.²¹

41. The Customs Administration and the MoF can also build up benchmarks for VAT on imports, based on targeted audits (by industry) and on the evaluation of the prices of imported merchandise. Moreover, they can support the construction of these benchmarks using methodologies such as “mirror statistics”; that is, by comparing imports registered in Ukraine to exports to Ukraine declared by other countries.²² As mentioned earlier, not surprisingly, a recent World Bank study found that under-reporting of imports is taking place in Ukraine.²³

42. In this context, we recommend the implementation of a tax analysis unit in the MoF, and a revenue intelligence unit in the STA, with Customs participation. This is necessary in Ukraine because a) technical analysis on tax policy always lags to the pressure of the writing and passing of new legislation; and b) the tax administration is always burdened by its unsuccessful efforts to cope with fraudulent practices. The approach suggested here is not new. Intelligence units that monitor VAT (and other taxes), and units that analyze tax policy have been implemented within ministries of finance, tax administrations and customs agencies in most OECD countries and in many developing countries facing VAT problems similar to those in Ukraine. The customs administration should also enhance its analytical capabilities either by creating its own unit, or even better, by having representatives within the units proposed for the MoF and STA.

43. However, implementation requires close coordination. The implementation of separate small units in the MoF and STA follows a straightforward rationale: both institutions need to develop their own analytical capabilities. But the key issue here is that of close coordination in order to maximize the results through information sharing. Coordination and information sharing are currently a problem among the MoF, the STA, and the Customs administration. The current

²⁰ See Technical Annex 2.

²¹ For additional discussions of how to carry out such studies, see for example, U.K. National Audit Office, *Tackling VAT Fraud* (London, 2004), and A. Gebauer, C.W. Nam, and R. Parsche, “Is the Completion of EU Single Market Hindered by VAT Evasion?” Paper presented to the International Institute of Public Finance, Prague, 2003. As these studies show, every country in the EU has some degree of VAT evasion, ranging from relatively low estimates in the United Kingdom and the Netherlands to substantial evasion in Italy and Greece.

²² Data on exports from other countries to Ukraine can be gathered using databases such as WITS and COMTRADE. The obvious disadvantage is the delay in the availability of these data. However, pilot exercises could be implemented mirroring statistics gathered directly for one or two countries.

²³ See Ukraine’s Trade Policy Study – World Bank 2005

formal channels for information sharing are weak and informal channels of communication barely exist. Thus, the existing channels need to be strengthened radically for a successful implementation of the proposed units.

44. **A clear division of functions for these units is important.** The assignment of functions should also strive for complementarities. The MoF could establish a small tax analysis unit comprising a small number of highly qualified specialists to support the development of new tax policy proposals. In addition, perhaps in conjunction with the office charged with revenue estimates, this unit might undertake the systematic analysis of the revenue and economic aspects of the tax system, in part to determine where there appear to be problems and how they might best be resolved. The natural house for this type of unit is the Tax and Customs Policy Department in the MoF. In fact, this department is already carrying out most of these functions but requires more resources to address the variety of pressing issues in tax policy that Ukraine is currently facing, particularly as the new tax code is being formulated.

45. **The STA (in coordination with Customs) could establish a revenue intelligence unit to create monitoring collection benchmarks and to track them.** As mentioned above, such a unit has the task of creating the analytical basis for smart monitoring of VAT and other taxes. This implies the creation, establishment, and maintenance of adequate collection monitoring benchmarks that look at the size, the location (i.e., sector of the economy, or geographical), and the nature of the problems for each type of tax. Some benchmarks (e.g., those produced through indirect methods-see Annex 2) can be quickly established. The establishment of other benchmarks (e.g., obtained through direct methods) would take more time, as survey audits would need to be implemented and their results would have to be analyzed. In any case, this can be done within the first year of operation of a unit such as that proposed. This revenue intelligence unit could start with few well trained economists and accountants, and grow in time as benchmarks become more sophisticated and as results are observed as a consequence of a better monitoring.

4. More Effective Allocation of Resources

46. **Analytically based monitoring can help substantially in allocating tax administration resources more efficiently.** Experience in several European countries, particularly in the United Kingdom and Latin American countries, shows that monitoring based on analytical information can be very efficient in terms of revenue recovery vis-a-vis the administrative costs incurred.²⁴ Moreover, having this type of systemic and comprehensive monitoring could be critical in allocating and re-allocating STA resources for auditing (e.g., pre-refund and post-refund in the case of the VAT), in tackling the issue of fraudulent claims, and in other basic administrative tasks. This is valid not only for the VAT but for tax administration in general in Ukraine. In time, overhead costs could be reduced (or coverage could be expanded) thanks to an informed and smart monitoring system.

5. Better and More Targeted Audits

²⁴ In the UK tax administration, the “shadow economy team for VAT registrations” alone has an annual return of half million pounds per officer.

47. **Better audit planning is necessary in Ukraine.** The first step is to take stock of the results of past audits, that is, to look at the percentage of audits by sectors, recovery by audit, recovery by officer, cost by audit, and lessons learned. Such a stocktaking exercise is important to planning any strategy for improvement. Preparing collection and fraud benchmarks (through direct methodologies) (see Technical Annex 2) using audit surveys is also a key part of this exercise. These tasks would be typical for a revenue intelligence unit like that proposed in this report. Once some initial (quicker to establish) benchmarks are in place, audits can be directed to sectors of the economy (or groups of taxpayers, or geographical areas) that deviate from historic behavior (i.e., that show greater VAT gaps than in previous periods of time). Setting priorities is the basis for stating an audit strategy for the following months. Results of future audits would feed into the proposed intelligence unit to further develop more sophisticated benchmarks, so that a portion of the future audits would be further targeted and better informed.²⁵

48. **Better targeting of audits leads to a more efficient tax administration and to a better business environment.** As monitoring tools become more sophisticated, audits will tend to be more appropriately targeted, that is, they will reach a larger percentage of fraudulent taxpayers than previously. At the same time, the inertia of this situation will ease the burden and hassle of audits for good taxpayers. While such a change requires time and effort, it is important for improving the business climate in Ukraine. In the past, one of the major complaints of taxpayers has been the hassle of audits and the corruption sometimes present in this process. While progress has been achieved during the last year, improvement on this front needs to continue. It is clear that well informed and targeted audits are an important step in this direction.

Box 4: Keeping an eye on the ball: Continued efforts to improve audits in Canada

Canada is generally considered to have a good tax administration. Indeed, a comparative study of administrations in a number of developed countries, for example, concluded that in many ways Canada's administration was a 'north star' on which other countries might benchmark. It is interesting, however, to note that over a decade after Canada adopted a VAT, the country's Auditor-General, in a review of the VAT system, still found it necessary to stress the need for the revenue agency to do more and better VAT (GST) audits. Achieving a satisfactory level of tax administration is not a "once-and-for-all task". Hence, every country must continually strive to maintain its performance at a satisfactory level in the face of the constantly changing real world in which the tax system operates.

Sources: Auditor-General of Canada, Revenue Canada—Goods and Services Tax: Returns Processing and Audit, Ottawa, 1999; Vazquez-Caro, "Benchmarking Complex Tax Systems: In the Search for a North Star," March 2005.

6. More Effective Enforcement of Penalties

49. **Vigorous enforcement should be applied when violations are found.** Once fraud and the violation of regulations have been adequately and fairly proven, penalties should be applied as swiftly as possible. Vigorous enforcement action is critical when irregularities are detected. However, careful examination of the procedures in this regard has to be undertaken. The processes need to be fair and transparent.

²⁵ It is important to mention that a portion of the audits needs to be made (remain) on random basis. In fact, random audits are the ones that feed the samples through which analysis is made to create collection /fraud benchmarks (see Technical Annex 2)

50. **Criminal prosecutions for VAT fraud are costly and lengthy, and may not produce results in terms of cost recovery.** This seems to be happening in Ukraine. Thus, the system of penalties needs a better balance between administrative penalties and criminal prosecutions. Currently, most of the efforts rely on the latter. A criminal prosecution should be pursued only as a last resort, for large and egregious fraud.²⁶ Moreover, in these cases of fraud, publicizing convictions (carried out through a fair process at the courts) may help to reinforce compliance.

Box 5: Publicizing conviction as a tool to reinforce compliance in Canada.

Publicizing convictions for the evasion of taxes helps to send a strong message to the community that non-compliance is not acceptable. Moreover, it leverages the impact of tax prosecutions to deter non-compliance and encourages voluntarily compliance. This strategy also helps to reassure honest citizens that the government is applying the law fairly and equitably. Information on tax convictions is generally released to the media (print, radio, and TV) upon sentencing. Releases are also posted on the tax collection agency website. The effects of this strategy are difficult to measure. However, taxpayers who make voluntary disclosures regarding their tax non-compliance often cite publicity as a factor in their decision to come forward.

Source: Centre for Tax Policy and Administration, OECD

51. **Administrative penalties maybe more effective.** Thus, a well thought out structure of “quicker” and easily enforceable penalties that includes deregistration, fines, temporary closures of business, and other administrative penalties should be established and pursued actively. The implementation of such a system should be accompanied by at least the following actions: a) further curtailment of corrupt practices; b) transparency (including wide public dissemination) in the system of administrative penalties; and c) the strengthening of current mechanisms for listening taxpayers’ complaints and appeal processes.

Box 6: Basic criteria for setting an adequate structure of penalties

Based on lessons learned from international experience, an adequate and equitable structure of penalties should consider, at least, the following elements:

- Penalties should increase with higher potential revenue loss due to the tax offence/fraud.
- Penalties should increase together with the difficulty and administrative cost of detecting the tax offence.
- Penalties should increase with the effects of the tax offence on other taxpayers.
- Penalties should be applied considering the motive of the tax offence, that is, higher penalties if the offence is deliberate and planned.
- Penalties should consider the difficulties and costs encountered by the taxpayers to comply with the tax.

Source: Extracted from Bird (2004).

Political support is needed to enable the work of the tax administration

52. **The STA needs sufficient political support from the higher executive and legislative authorities to enable it to perform its job.** It should be emphasized that good tax administration is not simply a matter of more and better directed efforts on the part of the tax

²⁶ In the UK, with 1.4 million registrants, only a few hundred cases a year go to prosecution. On average, it takes three-five years of detailed investigative work (and considerable resources) to bring a case to trial.

administration. It is also critical, for example, not to burden the tax administration with constantly changing and more complicated laws. On this issue, it is urgent and necessary to put together a well thought through tax code. Moreover, tax authorities need adequate resources and sufficient political support to enable them to carry out their essential tasks of processing taxpayer information, detecting significant deviations from “benchmark” patterns, investigating such discrepancies, and, where appropriate, applying adequate penalties. It is also essential to provide the tax administration with data and information in a timely and usable fashion. In all these respects, the situation in Ukraine remains far from ideal, thus substantially complicating the task facing even the best-intentioned tax administration.

IV. SELECTED VAT POLICY ISSUES

53. This section examines six policy issues on the VAT that have been under debate in the country, namely: a) the benefits of the VAT over a turnover tax; b) tax exemptions on VAT; c) arguments for maintaining the standard VAT rate at the current level; d) VAT treatment in the energy sector; e) VAT treatment in the agriculture sector; and f) the problematic links between the VAT and the simplified tax system.

The VAT versus a turnover tax

54. **Replacing VAT with a turnover tax is not a solution.** In fact, a turnover tax would bring more problems than solutions to Ukraine’s tax system. A turnover tax carries out distortions to the economy, as the market may shift its choices of production to less efficient ones based on the incentives generated by this tax. Moreover, this type of tax would bring a cascading effect of taxation that would harm economic activity and could prove to be extremely negative for the business environment. Evasion schemes are easier to undertake under this tax, and thus potentially gains from easier administration are dubious. Finally, a turnover tax has uncertain distributional effects, so that equity implications are difficult to foresee. In short, the VAT stands as a better tax compared to the turnover tax for Ukraine. Thus, rather than stepping away from the VAT, Ukraine should place its efforts on strengthening its administration, bringing it even closer to European standards and international best practices.

Figure 8: The VAT stands as a better tax compared to a turnover tax

Issue	VAT	Turnover tax
Distortions	<ul style="list-style-type: none"> • Less distortion on economic choices with respect to production technology by crediting taxes on inputs, and avoids taxing exports by crediting taxes paid at prior stages. 	<ul style="list-style-type: none"> • High distortion. This is the most distorting type of sales tax. • Cascading taxation effect (double taxation +) • Exports are taxed. • Creates incentives for vertical integration of firms (as “within firm” sales are not taxed) • High marginal tax on lower margin business.
Issues of evasion (detection of fraud)	<ul style="list-style-type: none"> • Fraud detection is easier as it takes two to evade (buyer and seller). • Buyers and sellers (in theory) have conflicting interests-buyers want to overstate their purchases and sellers want to understate their sales. 	<ul style="list-style-type: none"> • It only takes one to evade. • Under-reporting of sales is common and more difficult to verify.
Administration	<ul style="list-style-type: none"> • It requires a more sophisticated tax administration to monitor and tackle fraud. 	<ul style="list-style-type: none"> • Easier to administrate—BUT the administrative costs could rise with audits-as verification of reported turnover is difficult.

Equity	Many argue that, in general, consumption taxes are regressive, but to discuss equity impact it is necessary to look also at the incidence of expenditures.	
	<ul style="list-style-type: none"> • Clearer distributional effect as VAT collects what is economically equivalent to a single-stage sales tax by withholding tax at each stage of production. By doing so it achieves the goal of only taxing consumption. 	<ul style="list-style-type: none"> • Unclear distributional impact.

VAT exemptions

55. **A large portion of VAT exemptions have been curtailed but some remain.** The curtailment of VAT exemptions in early 2005 was an important improvement credited to the new government of Ukraine. This situation made it possible to raise collections and to cut distortions in the tax system. Nevertheless, many exemptions remain. Apart from agriculture, which is treated separately in this report, there are considerable large exemptions in health services and prescription drugs, manufacturing (particularly car manufacturing), and educational services. Some of these categories might be considered proper to deserve exemptions because of their equity implications (e.g., education and health services), and in fact they follow similar precepts of the EU sixth VAT directive. However, in other cases (i.e., manufacturing, transfer of assets among legal entities) these exemptions are arguably adequate.

VAT rate reduction

56. **There are no solid grounds for reducing the VAT rate in Ukraine at the moment.** The 20 percent rate in Ukraine is not high by regional comparisons. Several countries in the EU are within the same range. Moreover, in some countries (for example Germany) there are proposals to raise VAT rates to cope with fiscal deficits. In fact, one lesson from international experience is that lowering taxes is easy but raising them later on is extremely difficult and it is politically costly. In the case of Ukraine, rate reduction in VAT is not a pressing issue, and at the moment a policy in that direction could cause serious losses to the budget.

57. **Only structural improvements in the tax administration would open the way to discuss this possibility in the future.** Instead, and from a broader perspective, Ukraine should prepare the terrain to reduce tax rates in labor taxes by enhancing the overall tax administration and collection of labor taxes, and by pursuing policies to broaden the tax base.

VAT in the energy sector

58. **The energy sector has generated serious problems for the VAT system.** In past years, many of the accumulated refund arrears arose from inter-enterprise arrears connected largely with the energy sector and arising in part from the persistent under-pricing of energy. Paying refund arrears inflated by subsidies and quasi-fiscal activities in the energy sector has been extremely costly for the VAT system and has jeopardized its sustainability.

59. **The gas sector continues to be a problem for the VAT.** Since March 2005, gas imports are not charged with VAT at the border. Moreover, domestic purchases of gas from NaftoGaz

continue to be zero-rated if the purchaser is a VAT registrant.²⁷ That is, after the pass-through at the border (with no VAT charge made to Naftogaz), NaftoGaz does not charge VAT to its direct customers, if they are VAT registrants. VAT is charged only at the third stage when those Naftogaz customers (e.g., metallurgy companies, large gas distributors) sell their products.²⁸ On the other hand, NaftoGaz does charge VAT to municipal gas companies and other non-VAT registrants. This policy has important and problematic implications, including the following: a) it represents a large subsidy; b) it may be generating revenue loss for the government since VAT revenues are losing two stages of collection, and VAT administration, is in a way, left to NaftoGaz direct customers; c) it may be subject to abuse and evasion when claiming refunds, as the control of having to pay VAT at earlier stages is not present and, consequently, revenue leakage may be taking place; d) and it has equity implications for households across Ukraine that purchase from municipal companies paying VAT.

60. But VAT on gas and on other sources of energy must be treated within the context of a broader energy policy discussion. VAT on energy goes well beyond a simple tax policy and administration discussion in Ukraine. This large subsidy and its operation belong to a broad and urgent discussion of energy policy and its implications.

VAT in agriculture

61. VAT in Agriculture also requires revamping. As in a number of other transitional countries, agriculture in Ukraine is subject to VAT. In principle, there is no reason why this should not be the case. In fact, important agricultural countries such as New Zealand also do this. However, the regulation of the VAT for this sector in Ukraine is causing revenue losses to the budget as a result of a combination of factors, including the following: a) a reduced rate; b) the retention of VAT collected by agricultural taxpayers; c) purchasers of agricultural products having the right to claim VAT credit for their purchases; and d) meat and milk processing factories that charge VAT but do not remit VAT collection to the budget, instead, they submit these resources to a special account earmarked for the sector.

62. The present VAT system for agriculture complicates tax administration and produces little revenue. The administration costs of VAT in this sector are high compared to the net revenue generated. Marginal changes to the current system are unlikely to raise net revenues considerably from VAT in agriculture. But given the current conditions and political constraints, this report supports the recommendation in the IMF's report (2005) regarding the prompt implementation (starting in 2006) of the amendment to the VAT law (on Art. 8.1), that establishes rates of 9 percent for agriculture and 6 percent for forestry and fishing activities, and moves closer to the EU sixth VAT.²⁹

VAT and the simplified tax system

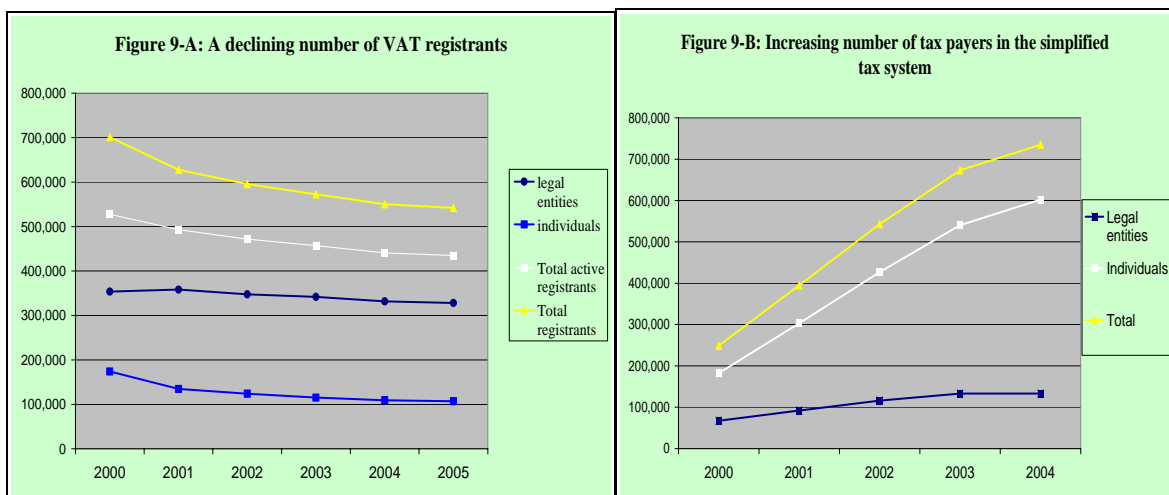
²⁷ This information is based on the analysis of the 2005 budget and the 2006 draft budget (as of November 2005).

²⁸ Companies, direct customers of NaftoGaz cannot claim credit for inputs of gas as their purchase is zero rated

²⁹ The PER will have a separate report on agriculture issues that will revisit the VAT issue in more detail. It will analyze other tax privileges, subsidies, and expenditures for the sector financed through the budget.

63. **There are good reasons for having a simplified system in Ukraine, but the current system has led to an erosion of the VAT base.** There are several well-known efficiency and administrative reasons for keeping small taxpayers out of the VAT.³⁰ Both the compliance costs (those borne by taxpayers) and the administrative costs (those borne by the tax administration) of dealing with such taxpayers are high compared to the potential revenue yield. Moreover, the idea of having such a system in Ukraine was to bring to light the small business operating in the shadow economy. However, the current structure of the simplified system is allowing medium businesses to migrate to this system which is causing erosion in the VAT base.³¹

64. **There are an increasing number of medium size firms migrating to this presumptive system.** The behavior of taxpayers is obviously tied to the opportunities to significantly lowering the tax burden offered by the existing system for small businesses and individual entrepreneurs. Anecdotal evidence suggests that businesses dismember their operation into pieces and use other schemes in order to fit the requirements of this system, which allows them to avoid the regular system of taxation.



Source: STA.

65. **No one who can pay VAT should be in the simplified system; and no one in that system should be expected to pay VAT.** It is odd to have legal entities with the option of paying VAT within the simplified system, as in Ukraine. In fact, no legal entities above the VAT threshold should be allowed to hide in the simplified system. If a business has taken on legal form and with it the obligation to maintain books and records at a certain level, there is absolutely no reason why it should not be a registered VAT payer (again, if it is above a reasonable threshold).

³⁰ This paper limits itself to discussing some of the most pressing issues between the VAT and the simplified system for legal entities. However, the PER under preparation will provide a deeper discussion regarding the simplified system and its relation to other important sources of revenue, such as the payroll taxes.

³¹ The PER will make a similar argument regarding the relationship between payroll taxes and the simplified tax system. In fact, the relationship between these two (payroll taxes and the simplified taxation) is much more complex and is generating large revenue losses for the government.

66. **A critical step in resolving this issue to have a matching threshold for both VAT registrants and for subjects of the simplified tax system.** Currently, there is a mismatch of thresholds between the VAT and the simplified tax system. Lowering the threshold for legal entities in the simplified system from the current 1,000,000 Hrv. to the VAT threshold (300,000 Hrv.) is a reasonable option.³² One advantage of doing so would be that the entry level to the VAT system and the maximum level for firms in the simplified system would then be identical.

67. **Having matching thresholds at 300,000 Hrv. would also be a barrier to medium firms' migration to this system.** There are two reasons for this. The first, and the obvious one, is that in theory only small business (below the VAT threshold) would be accepted in this system. The second is that dismembering a business into pieces would be more costly with a lower threshold. That is, the transaction costs of dismembering a business are lower if the turnover of every piece had to be below a larger figure (e.g., the current threshold). But a lower threshold (e.g., 300,000 Hrv) would increase these transaction costs, making the dismembering of businesses and the migration more costly.

68. **This is a politically difficult reform, but a necessary one.** In fact, little can be done to expand the base of VAT and the base of other important taxes, including social insurance taxes (payroll taxes), if incentives and regulations of the simplified system are not changed. A different section of the Public Expenditure Review deals in more detail with the simplified tax system in general, and with the simplified system for individuals in particular.

³² This applies to legal entities.

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TECHNICAL ANNEX 1: Collection efficiency measures

A crude indicator of VAT ‘collection efficiency’ – also called ‘VAT Productivity’ – measures what percent of GDP each percentage point of the standard VAT rate collects. In other words this measure is the actual collection as ratio of GDP divided by the standard rate. In principle, ‘VAT productivity’ may be misleading measure, since VAT essentially is a tax on consumption, not production, and GDP measures production, not consumption. For this reason, somewhat more refined calculations (so-called ‘VAT efficiency’ or ‘C-efficiency’), relating VAT yield to trends in consumption, or in private (household) consumption, which is closer to the theoretical VAT base) are common. Since all these measures are highly correlated, however, such refinements would add little information.³³

Many questions may be raised about all these measures. For example, while differences between countries may be interpreted as reflecting differences in both base ‘erosion’ (through reduced rates, zero-rating and exemptions) and tax evasion, the measured differences may be affected if e.g. input credits are limited (thus taxing some intermediate as well as final consumption) or differentiated rates are imposed.³⁴ Moreover, not only may single-year calculations be misleading but quite different numbers may often be produced for the same country and year from different data sources.

Despite such problems, however, measures of VAT ‘efficiency’ have now begun to appear sufficiently frequently that they are beginning to enter into econometric analyses. For example, one recent study estimates that 41 percent of the variability (adjusted R^2) in the ratio of VAT revenues to consumption is explained when regressed against the standard rate of VAT, a measure of the openness of the economy, the level of illiteracy, and indexes of government capacity to control corruption and the cost of registering a new business, with all independent variables except the last being statistically significant.³⁵ Using a smaller sample of transitional countries, the same study also found that an index related to the prevalence of bribery was a significant (negative) explanatory factor. The implication drawn from this analysis is that there is clearly substantial room to improve VAT efficiency in many countries by improving governmental institutions and tax administration. This inference seems clearly applicable to Ukraine.

Another recent study, using an unbalanced panel of 45 countries for the 1970-99 period, find that VAT collection efficiency increases with urbanization, trade openness, real GDP per capita, and measures of both political stability and the ‘fluidity’ of political

³³ Bird and Gendron (2005) found the two consumption-based measures to be almost perfectly correlated (correlation coefficient is equal to 0.98) for their sample and the simple GDP (‘productivity’) measure used in Table 1 to be strongly correlated to the private consumption measure (correlation coefficient is equal to 0.91).

³⁴ Bird and Gendron (2005) find that using standard versus weighted average rates does not make much difference quantitatively or in the ranking.

³⁵ W. McCarten, “The Role of Organizational Design in the Revenue Strategies of Developing Countries,” World Bank Institute, March 2005.

participation, but is negatively related to the agricultural share of GDP.³⁶ For different specifications, from 55 to 67 percent of the variance was explained. The most important explanatory variables were urbanization and real GDP per capita, and all results were found to be relatively robust. The only inference that emerges for Ukraine is simply to underline the apparent perversity of recent experience, when rising income and openness levels resulted not in increases in measured VAT efficiency, but in declines.

³⁶ J. Aizenman, and Y. Jinjark, "The Collection Efficiency of the Value Added Tax: Theory and International Evidence," July 2005.