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Tackling the dilemma of agricultural taxation: Moving towards a comprehensive and transparent approach

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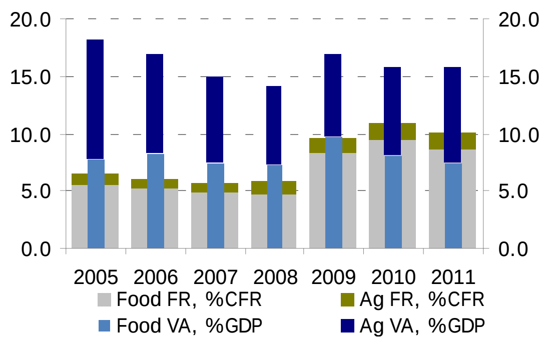
The current agricultural taxation system in Ukraine (AgTS) neither provides adequate revenue to the state budget nor stimulates economic growth. At the same time significant tax benefits to farmers create problems down the supply chain (e.g. export VAT refunds arrears) that ultimately reduce farms' revenues. Recent attempts to increase agricultural tax revenues via increasing the fixed agricultural tax (FAT) rates, amending the special value added tax (AgVAT) regime in agriculture, and introducing an additional land duty for farmers, however, do not tackle this dilemma but burden further the farmers. The government would better initiate a comprehensive, open and transparent reform of agricultural taxation, rather than challenge the sector with ad-hoc initiatives.

The contribution of agriculture to consolidated fiscal revenues (CFR) has been by far inadequate compared to its contribution to the country's GDP (1.1% vs. 8% on average over the last 6 years, see Fig. 1). The food industry, on the contrary, demonstrated much better performance and its contribution to CFR even surpassed the contribution to GDP over the last two years.

Figure 1. The share of Agriculture and Food sectors in GDP and in CFR



Source: Own presentation using data from the State Treasury and Input-output tables from Ukrstat.
Notes: CFR – consolidated fiscal revenues; FR – fiscal revenues; VA – value added; Food – food-processing sector; Ag – primary agriculture.

Two pillars of the AgTS, - the FAT and the AgVAT, - leave agriculture largely untaxed. The FAT is a flat rate tax that replaces a number of taxes and duties, including profit and land taxes. Its rate varies from 0.09 to 1% of the normative value of farmland, depending on farmland's type and location. In 2010, the FAT resulted in an average tax payment of only roughly 6 UAH/ha (0.75 USD/ha) of arable land that leaves farm profits in Ukraine essentially untaxed. This encourages the formation of vertically integrated enterprises that combine agricultural and highly profitable non-agricultural activities to effectively reduce taxation liabilities (as long as agriculture accounts for at least 75% of gross revenue). The simplicity of the FAT without the need to maintain detailed bookkeeping systems is attractive. This reduces, however, ultimately their productivity and creditworthiness, because it is not possible to efficiently manage a modern agricultural enterprise or get a loan without detailed and accurate accounting.

According to the AgVAT regime, farmers are entitled to retain the VAT received from their sales to recover VAT on inputs and for other production purposes at the discretion of farmers. In 2010, the benefits from the AgVAT accrued to UAH 11.1 bn (USD 1.39 bn). The AgVAT, however, is one of the main reasons for VAT refunds arrears to exporters that pass this on the farmers in the form of reduced farm gate prices (by 10% on average).

These apparent farms' benefits from the FAT and AgVAT, however, are to a great extend offset by excessive post-harvest regulations and ad-hoc trade restrictions that ultimately reduce farm-gate prices. For example, the estimates of the forgone farms' revenues during the export restriction episode in 2010/11 vary from USD 0.9 to 2.6 bn.

This dilemma requires a careful and comprehensive solution. Instead, the recent tax initiatives in agriculture look clumsy and ad-hoc. Draft Law #10500 suggested increasing the FAT rate for arable land and pastures from 0.15 to 1.15% to farms cultivating more than 100 ha. The Draft Law #10051 suggested levying on farmers an additional land duty at 1% of the normative value, for rural areas development. The Draft Law #10731 suggested using the accumulated AgVAT only according to the Cabinet of Ministers of Ukraine directives. These draft laws will likely to increase agricultural fiscal revenues and worsen financial liquidity of farms. The underlying dilemma, however, will remain unsolved.

A first-best and comprehensive solution to this dilemma should include **simultaneous** realization of the following components: i) ensure smooth functioning of the VAT refund system; ii) terminating the AgVAT system; iii) replace the FAT by a profit based taxation and leave the FAT only for small farmers; iv) at least 5-year commitment of refraining from interventions (incl. trade restrictions) on agricultural markets and in taxation system.