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Tax Reform in Agriculture: At the Expense of Effectiveness?

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The Ministry of Incomes and Levies of Ukraine proposed to reform the system of agricultural taxation with regard to two major sources of state support for agriculture: preferential regime on value added tax (agroVAT) and fixed agricultural tax (FAT). Two options for implementation of the reform have been introduced. The first option is to abolish agroVAT preferences and introduce 7% VAT for agricultural producers. At the same time, reimbursement of VAT at exports of cereals and industrial crops shall be restored while taxation through FAT shall be kept in force. The second option is to abolish FAT and introduce the so-called Single Tax on the level of 7%.

According to our analysis, abolition of preferential tax regimes and restoration of conventional VAT reimbursement at export operations will have negative effects on producers and the state. It will reduce producer profits which are reinvested in further development of production. Additionally, it will hamper the investment climate and external trade.

It is commonplace that tax preferences for agriculture are among the most powerful tools of state support for the sector. However, tax preferences are put into question and challenged in light of general state budget deficits and relatively high profitability of agriculture. Thus, in 2013 agripolitical environment of Ukraine is characterized by fierce debate on the revision of the agricultural taxation system, in particular with regard to the FAT and agroVAT.

FAT is a tax, which is estimated and collected in relation to a unit of land area as a percent of normative monetary value of land. FAT replaces the following taxes, levies and contributions:

- tax on profit of enterprises, including advance payment at disbursement of dividends;
- land tax (for land used for agricultural production);
- contribution for special use of water resources;
- contribution for undertaking of some types of entrepreneurial activities (several trade activities).

The FAT rates depend on the type of land use, e.g. for arable land, hay-fields and pastures the rate is 0.15% or 0.5-0.6 EURct/ha per year.

Additionally, any enterprise operating in the fields of agriculture, forestry or fisheries may choose **special regime of taxation by VAT** provided that:

- main activity of an enterprise is the supply of own agricultural output (goods or/and services) produced at its own or leased production facilities, including tolling schemes;
- the share of agricultural output (goods and/or services) makes up at least 75% of the total value of all goods and/or services produced and/or provided during 12 preceding consecutive reporting periods in aggregate.

In case this special regime is chosen, an enterprise shall transfer the due amount of VAT not to the budget, but to a special bank account. This sum may be used by the enterprise as a tax credit according to a general procedure; the remaining sum, if any, is not transferred to the budget and may be used for other production purposes.

From macroeconomic point of view, the analysis of effectiveness of tax preferences is viable only in the context of changes of preferential regimes that have been taking place over time. In *nominal* terms, the volume of producer benefits from VAT and FAT preferential regimes grew from UAH 1.5 billion in 2001 up to over UAH 18 billion in 2012 (based on the data of State Statistics Service of Ukraine).

These benefits provided one of the main bases for technological modernization and significant increase of productivity in agriculture. For example, average grain productivity grew up from 2.7 t/ha to 3.1 t/ha between 2001 and 2012. In the same period, according to the State Statistics Service of Ukraine, productivity of sunflower seed and sugar beet production increased from 0.9 t/ha to 1.7 t/ha and from 18.3 t/ha to 41.1 t/ha, respectively.

At the same time, there were other changes in taxation in the same period which even significantly reduced *real* tax benefits for the sector.

Firstly, estimations show that non-reimbursement of VAT at export leads to decrease of purchase (procurement) prices amounting to over UAH 9 billion in total; this means that the balance of tax benefits (including VAT exemptions and FAT) in

2012 made up about UAH 8.5 billion only (see also [Doing Agribusiness in Ukraine 2012](#)).

Secondly, another significant change that took place in the specified period was exemption of mandatory contributions to the State Pension Fund from the list of taxes, levies and contributions replaced by FAT (the latter, in particular, exempts agricultural producers from paying profit tax). Starting from 2010, agricultural producers made contributions to the State Pension Fund, later on replaced by a unified social contribution. In 2012, estimated tax burden related to labor cost made up over UAH 5 billion, and this made the volume of tax benefits for agrarians decrease down to UAH 3.4 billion (in equivalent of preferential regime effective at the beginning of the 2000-s).

Thus, while *nominal* value of tax preferences is looking very impressive, *real* benefits and preferences decreased remarkably between 2001 and 2012. The share of tax benefits in the gross agricultural output decreased from 6% in 2001 down to 3% in 2012. This implies that ongoing growth of agricultural production in Ukraine is taking place against the background of shrinking tax incentives. Therefore, preferential taxation in agriculture can be considered as effective.

Besides supporting profitability of agricultural producers, preferential taxation also plays an important role in balancing economic incentives in different subsectors of agricultural production. For example, FAT which is calculated based on normative monetary value of farmland in use seems to be more beneficial for livestock farming. Despite application of FAT, the average profitability of livestock sector over the last 12 years has been lower than the same in crop production (based on data of State Statistics Service of Ukraine). This implies that the number of farmers which exit from livestock production could be much higher if there was no preferential regime through FAT. Therefore, application of FAT is partly eliminating imbalances in profitability of crop production and livestock farming.

Thus, in case of abolition (or revision) of tax preferences, the sector may find itself in bad fiscal conditions. Already today some specific conditions of taxation to a certain extent reduce and dilute the effect of tax preferences for agriculture. For instance, the Tax Code of Ukraine (point 15 of Sub-section 2 of Section XX) provides for tempo-

rary, till January 1, 2014, exemption from VAT of cereals delivery operations within the customs territory of Ukraine. According to this provision, only direct purchase of grain and industrial crops from producers (without intermediaries) is subject to VAT credit accrual (as opposed to VAT liability accrual). At the same time, the share of intermediaries on the market is high, which, in combination with the above provision, implies reduction of prices and increase of transaction costs in the supply chain.

Among other things, abolition of preferential regime of taxation and restoration of reimbursement of VAT at export of cereals and industrial crops implies losses for the state – budgetary revenues will be remarkably lower than expected. For example, if livestock sector immediately loses support through FAT, the majority of producers will become unprofitable and exit the market. The mid-term effect of additional budgetary revenues will be, thus, considerably lower than that of budgetary losses due to reduction of production volumes and, consequently, producer incomes as a taxable base.

The effects of the proposed tax reform on investment climate and external trade may be also detrimental. Capital investments in agriculture were slightly above the volumes of state support through tax preferences in the last years (UAH 20 billion vs. UAH 18 billion in 2012, according to the State Statistics Service of Ukraine). This implies that, apart from direct effects on producer incomes, preferential taxation has an indirect effect on investments. In this context, abolition of tax benefits might entail reduction of investment activity and suspension of productivity improvements in the sector. Furthermore, opportunities for improvement of positive balance of trade with agricultural commodities might be lost because of reduction of production volumes.

Additionally, abolition of preferential taxation regime presupposes introduction of “normal” profit tax or turnover tax. However, taxation regimes that make the volumes of taxes paid depend on operational results always require higher administration costs. This will especially affect small and medium-size agricultural producers. Another potential outcome (that has already been experienced in 1990-ies) may be intentional misrepresentation of data in financial reports by the pro-

ducers. This may distort market information necessary to implement adequate agricultural policy measures.

The aforementioned issues lead to some conclusions. Firstly, specific provisions with regard to VAT credit accrual of the Tax Code should be changed if the intention to restore VAT reimbursement at export of cereals and industrial crops is still in focus. However, at the same time, "rules of the game" for market participants should be kept clear and stable.

Secondly, tax reform that aims to establish equal taxation conditions for agriculture and other sectors should consider peculiarities of structural development and subsectoral disparities in agriculture and subsequently propose a stepwise approach to transformation of the taxation regime. Mechanisms for compensation of the diminished

efficiency and productivity incentives should be developed.

German and European experiences show the importance of specific state support to agriculture. In light of the special public services and environmental values provided by agriculture, recent adoption of the new Common Agricultural Policy (CAP) of the EU for the period 2014-2020 prolongs this approach. Ukrainian agriculture provides similar services and values not only with domestic, but also international impacts. Thus, there is a good reason to use a corresponding approach of public support to the development of sustainable agriculture in Ukraine.