

Does Ukrainian agriculture need tax privileges?

(The results of round table discussion on “Taxation in Ukrainian agriculture in 2004”)

Due to the necessity to make political decisions (which will come into force in 2004) concerning the taxation system in Ukrainian agriculture the German Advisory Group on Economic Reforms and the Institute for Economic Research and Policy Consulting have prepared the scientific material on “Taxation and Agriculture after 2004” (October, 2002). The Ministry of Agrarian Policy and the Institute for Economic Research and Policy Consulting have arranged the round table discussion on “Taxation in Ukrainian Agriculture in 2004” on November 20, 2002. The representatives of the following organizations participated in the discussion: Ministry of Agrarian Policy, Institute for Economic Research and Policy Consulting, German Advisory Group, Presidential Administration, the Ministry of Finances of Ukraine, Secretariat of Government Agrarian Policy Coordination Council, Institute of Agrarian Economics UAAS, National Agricultural University, Kiev National Economics University, Project of International Financial Corporation “Agribusiness Development in Ukraine”, Project of improving welfare of rural population, Department of International Development of Great Britain, U.S. Department of Agriculture, Information agency “APK-Inform” and the magazine “Propoziziya”.

The purpose of the round table was to determine the directions for further development of the tax system in Ukrainian agriculture to be introduced in 2004. The following goals were set for this round table :

- To discuss the existing tax system in Ukrainian agriculture and to determine its role in the state budget formation
- To assess the effects of certain taxes on efficiency of agricultural enterprises
- To consider the tax systems in agriculture of developed and transition economies
- To formulate the major ‘stones’ of the future tax system in Ukrainian agriculture after 2004.

The issue of the existence of the tax privileges in agriculture lied at the heart of the discussion. All the participants may be divided into two groups. Some of the participants had no particular opinion in this respect. The first group supported the continuation of granted tax privileges in the future, but the second one insisted on the elimination of any tax benefits. The first group consisted of the representatives of the Ministry of Agrarian Policy, Presidential Administration, Secretariat of Government Agrarian Policy Coordination Council, the Institute of Agrarian Economics UAAS, and Kiev Economics University. The representatives of the Institute for Economic Research and Policy Consulting, German Advisory Group on Economic Reforms, the project of International Financial Corporation “Agribusiness

Development in Ukraine”, the Ministry of Finances and information agency “APK-Inform” had the opposite opinion.

The arguments put forward by the **supporters** of tax privileges are the following. Agriculture is pivotal for the development of other sectors of Ukrainian economy. One agricultural worker provides the jobs for 8 workers in the non-agriculture. Agriculture is at the core of the food security. However, it has inherent peculiarities that are seen through the interrelation between production and weather conditions, through low speed of capital turnover and low elasticity of demand for food products. Thus, the conditions under which agricultural sector develops differ substantially from those under which other sectors do. This results in the non-profitability of agricultural enterprises and poor financial conditions. It also leads to an increase in prices for industrial products and a decline in prices for agricultural commodities. As a result of such conditions, 70% of the fixed assets available in the agricultural sector is fully depleted.

An introduction of the fixed agricultural tax (1999) and exemption from the VAT payments along with an introduction of a zero rate value added tax for some commodities enabled to improve the financial condition of agrarian enterprises and to increase tax revenues to the budget. In words of the first deputy of the State Secretary of the Ministry of Agrarian Policy in Ukraine Yuriy Luzan agro-industrial complex is the second largest source of tax revenues (the first is fuel complex). Another advantage of introduction of fixed tax is that it discourages “wrong” financial accounting with a view to evade taxes. Nevertheless, the shortcoming of the fixed tax is that agricultural enterprises are no longer encouraged to do book-keeping in a proper(?) way.

Furthermore, as was calculated by the researchers of the Institute of Agrarian Economics during 1991-1999 agricultural sector has lost about 99 bln. UAH as a result of price disparities. That is why Ukrainian agriculture needs to be supported.

Arguments in favor of the tax privileges in Ukrainian agriculture are donation systems aimed at supporting agriculture in EU countries, United States and other countries of OECD. For example, half of the EU budget is spent to support farmers, in the United States in 2003 \$76 bln. will be used for this purpose. In the nearest future Russian authorities are going to introduce fixed agricultural tax.

Moreover, in developed countries agricultural budget is used mainly to support farmers and prices rather than to foster the development of rural areas. That is why the supporters of tax privileges think that Ukraine has to take over the experience of developed countries and support production. If production develops then rural areas will develop as well.

Hence, the main proposals of the tax privileges’ supporters are:

- To retain the special regime of taxation of agricultural enterprises

- Keep the fixed agricultural tax for the next 5 years without changes
- Not to increase tax burden for agricultural enterprises
- To switch to a special regime of VAT payments or reduce the rate of VAT on the agricultural products.

Non-supporters of tax privileges put forward the following arguments. When elaborating new tax system in Ukrainian agriculture one should in the first place think of adequate tax revenues received by the budget. Agricultural sector accounts for about 15% in Ukrainian GDP, 23% of population work in agriculture, and, despite this, tax revenues from agriculture are only 1.5% of total tax revenues. Thus, tax system in agriculture should reflect real macroeconomic situation in Ukraine. Over 1999-2001 tax benefits to agriculture amounted to 2.6 bln. UAH. If one looks at the figures themselves then agricultural support seems not to be huge compared to that in Western countries. But if one looks at relative numbers then one can see that **2%** of GDP is directed to support agriculture. In the OECD countries this number is less than 1.3% of GDP. At the same time, around **2%** of Ukrainian GDP is directed to financing education and medical care, which are essential for economic development.

Furthermore, if agricultural sector pays no taxes, but the total budget expenditures are not cut, the tax burden on the non-agriculture is automatically increased. and budget spends money Exemption from the VAT leads to the large extent to the non-repayment of the export VAT. This aggravates the overall macroeconomic conditions in Ukraine. To provide an example, let us consider the case when export VAT is not paid back. As a result, exports as well as the number of traders decline, which directly effects procurement prices. For example, since domestic grains prices are linked to export prices and export costs, the decline in exports reduces the domestic price. **Non-repayment of VAT to exporters increases export costs.** Moreover, since VAT exemptions effected the abilities to pay export VAT back, the benefits from tax privileges are reduced due to lower grains prices.

Along with macroeconomic aspects, the impact of taxation on agriculture itself is also important.

Tax revenues and expenditures on agriculture are interrelated. However, it is rural development that must be paid lots of attention. As a result of agricultural reforms there emerged enterprises of private and other forms of ownership. The development of social infrastructure becomes the responsibility of the local authorities rather than agricultural enterprises. Many former CAE members have lost their jobs as a result of re-organizations and the problem of unemployment in rural areas is very actual. Furthermore, rural areas have poor infrastructure, low level of education and medical care . Because of the lack of small enterprises, the opportunities of the rural people to find an alternative job have dramatically shrunk. Thus, budget money should be spent on these purposes.

From our point of view all agents must pay taxes. A market economy requires substantial finances to settle the problems. It is financing of education, medical care, unemployment, military forces, police, etc. If the government wants to finance the development of rural areas then it should finance infrastructure rather than private production. And if the government is concerned with under financing of agriculture by commercial banks then it should direct its policy to creating efficient agricultural producers who would be able to compete to get credits from commercial banks. Subsidizing agriculture only prevents from enhancing efficiency of the agricultural enterprises.

One should be cautious considering the argument that Western countries spend a substantial amount of money to support agriculture. Economists of these countries have found this practice extremely harmful for the economic growth as a whole. Moreover, subsidizing agriculture is not beneficial to competitiveness of producers. Their products are not competitive in the markets of those countries where agricultural support is much lower. As an example one can mention such countries as Argentina, Australia, New Zealand, former socialist countries including Ukraine whose products are highly competitive. As for Ukraine this is in the first place true for grains.

Furthermore, in developed countries budget money suffices both to support farmers and to support the development of country-side. In Ukraine this is not feasible taking into account the current financial condition. If money is spent to support production then there is hardly anything left to be spent on the development of the country-side.

However, when the decisions should be expedient from both economic and political point of view. So far, in the developed countries political reasons for subsidizing agriculture have been prevailing. Nevertheless, the decisions recently made by the EU concerning CAP indicate a new trend to gradually reduce farm support.

Some people also think that recommendations to eliminate tax privileges are someone's desire to destroy Ukrainian agriculture and to keep agricultural producers as strong competitors out from the world market. Above we have explained how support effects competitiveness. What must be added here is that orientation to agriculture as a prior sector of Ukrainian economy would be a fallacious policy to follow, which will keep Ukraine far behind developed countries. Budget money should be spent on informational technologies, service sector, science and education, in a word, on the sectors that would spread innovations and, ultimately, enhance economic activity in Ukraine. Ukraine has the large agricultural potential for natural reasons, and benefits and subsidies will not convert agriculture into the most prospering sector. There is a threat for Ukraine to become the main source of raw materials for developed countries.

The main recommendations of non-supporters of tax privileges are:

- In terms of taxation agriculture must be in equal conditions with the rest of Ukrainian economy. It is not expedient to provide special tax benefits to agriculture. This distorts the economy and negatively effect overall macroeconomic stability.
- Tax system in agriculture should be considered as an element of the general reform in Ukrainian tax system where one of the most important points is the transition from taxing enterprises to taxing individual incomes. Relieving tax burden would encourage a reduction in the share of shadow economy. This means that individual incomes must increase at a high rate and they must be both a base for taxation and the main source of budget revenues. For example, individual income taxes account for 70-80% in total revenues in the Western countries, meanwhile those amounts to only 20-30% in Ukraine. State can be rich only if its population is rich.
- New tax system in agriculture should be based on taxing enterprises' incomes and incomes of other agents of economic activity. It would be expedient if the fixed tax were retained only for small farms and also levied on private subsidiary house holdings of those who are engaged in agricultural production with a view to selling their products in the market.
- VAT rate must be the same for all sectors of the economy. Agriculture must not enjoy the benefits from a special regime of VAT payments. It is worthwhile reducing VAT rate for all sectors.
- Land tax yield should not be transferred to the state budget and it is more expedient to retain it in the budget of local authorities

Summarizing, there are two distinct points of view concerning further development of tax system in Ukrainian agriculture. At this stage it is policy makers and legislators who are to make the ultimate decision. This decision must be well founded, it must allow for internal and external factors and ensure economic efficiency when introduced into life.

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