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Proposals to De-shadow Ukraine's Economy

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Proposals to De-shadow Ukraine's Economy

Executive Summary

In Ukraine, a considerable degree of economic activity takes place in the "shadow", i.e. outside the formal economy. While precise estimates are difficult to obtain and thus vary widely, national experts put this number at around 30% of official GDP. This poses major economic problems: A lack of funds for the state and no level playing field for companies.

Attempts to formalise such activities are thus well-grounded. In this paper, we focus on the unreported economy, i.e. on activities that are legal in principle, but are not properly documented by economic agents in order to reduce the tax burden. This includes the wide-spread practice of underreporting employees' incomes - paying partly officially, partly by "envelopes".

In order to assess specific measures for reducing underreporting, one needs first a deeper understanding of its causes. In this paper, we identify three broad reasons for such underreporting. First, high social security contributions (especially pensions) provide an incentive for underreporting, which outweighs any positive effects resulting from low personal income tax rates. Second, serious administrative barriers often create an extra burden on taxpayers and lead to avoidance schemes (including corruption). Third, taxpayers often get the impression that their tax payments are poorly managed by the state, thus creating a permissive culture of tax evasion.

The causes identified above set the broad framework for improving the situation. In order to formalise economic activities previously conducted in the shadow, a sensibly designed system of economic incentives (and counterincentives) needs to be created. Simply speaking, policy makers need to strike the right balance between "sticks and carrots" to minimise shadow activities.

Regarding concrete policy recommendations, we take the following positions:

1. We support the reform of the pension system that has recently passed the first reading in parliament. This reform will stabilise the first pillar of the system in the medium-term, creating room for a reduction of contributions later on. Furthermore, the link between contributions and expected benefits has to be strengthened.
2. Establishing an economy-wide "indicative wage scale" is in our view not the right instrument, as a number of associated problems will likely outweigh its potential benefits. We thus do not support such plans.
3. Reform of tax administration has to keep pace with the recently adopted legislative improvements as seen in the Tax Code. As long as paying taxes is a complicated and burdensome process, this overshadows improvements made in other areas.
4. Boosting "tax morale" is a "soft", albeit important issue in public revenue collection, especially in the long term. Once people get a better and direct understanding of the value of their contributions, they will be more willing to participate in the system.

While Ukraine can gain much by moving along the lines sketched above, it has to be emphasized that no quick victory over the shadow economy is possible. Policymakers can realistically expect only a gradual reduction of the problem. But given the enormous dimension of the problem, also gradual improvements count a lot.

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1. Introduction

In Ukraine, a considerable degree of economic activity takes place in the "shadow", i.e. outside the formal economy. While precise estimates are difficult to obtain and thus vary considerably, national experts put this number at around 30% of official GDP. International studies report an even higher share of more than 50%. Regardless of the true number, it can be said with certainty that the shadow economy poses a big economic problem for Ukraine's policymakers. As a large part of activity escapes taxation and social security contributions, less revenue is collected in the public sector. This implies a corresponding low level of provision of public goods and social security for its citizens. A vicious circle is the result.

Thus, we view the objective to de-shadow such activities and bring them into the formal economy as a legitimate goal for the authorities. At the same time, to be effective, the right mix of instruments has to be used. Otherwise, the state risks that even more activity drifts into the shadow, with even more negative implications for public coffers.

This paper addresses the issue of de-shadowing Ukraine's economy and provides related policy recommendations. While it is not intended to develop a comprehensive and broad-based strategy, it focuses instead on a number of relevant aspects that are currently in the public discussion and has thus a more narrowly defined scope.

The paper is structured as follows: In chapter 2, we will examine the "shadow economy" in general terms. This includes some necessary definitions and implications for the public and the private sector. Chapter 3 will deal with Ukraine's shadow economy. Here, we will provide an overview of statistical estimates, including some international comparisons, as well as an analysis of the causes for moving such activities into the shadow in Ukraine. Our policy recommendations can be found in chapter 4. Finally, we provide some concluding remarks in chapter 5.

2. What is the "shadow economy"?

2.1 Definition

What is the "shadow economy"? – The term is (maybe unsurprisingly) almost as difficult to pin down as the activities it refers to. There have been attempts, though, to establish concepts that are more specific and clearly defined, at the expense of not necessarily capturing all the activities that we'd expect to be part of a precise definition (or, to the contrary, more than that). All these concepts have in common that they refer to economic activity that is not carried out fully along the lines or within the boundaries of the legal provision of the jurisdiction in question. (This implies, of course, that an activity that is part of the shadow economy in one country or region may not be in another – the definition of the "shadow economy" is therefore also country-specific.) Generally, it is distinguished between the concepts of the illegal economy, the unreported economy, and the unrecorded economy.

The "**illegal economy**" refers to activities that by themselves violate the law and, therefore, cannot be carried out in a legal way. Obvious examples are abound: trafficking in human beings, drugs and arms, and other activities usually attributed to organized crime, but also trading in stolen goods, selling forged documents, and any other way of getting paid for an illegal activity. Here, it is not in question to "formalizing" or even tax the activities, but rather how to eliminate them.

To the contrary, the concept of the "**unreported economy**" focuses on activities that are legal in principle (although it also includes the illegal economy), but are not documented properly by the agents, often to avoid taxation. Examples range from large-scale smuggling or underreporting of profits and incomes by large corporations to corner shops not issuing

receipts or private households not registering their cleaning lady. The size of the unreported economy is given by the difference between the amount of income that should, under full compliance with the tax code, be reported to the authorities, and income actually reported[1]. The size of the unreported economy therefore also determines the size of the "tax gap", the income (inclusive of payroll taxes) lost to the government because of tax fraud.

Closely related is the "**unrecorded economy**". Here, it is not the tax authorities, but the statistics agencies that don't get proper documentation, usually because businesses (especially small ones) don't keep proper records, or because they fear that their data might also end up with the taxman[2].

In a transition country like Ukraine, all the examples just given are present, and to "formalize" the economy (at least to an extent that has been achieved by the country's Western neighbours) long-run efforts have to be taken in different sectors and on all levels. In the following, this paper will not address all these issues, but focus when talking about the shadow economy on the **unreported economy**, especially on the wide-spread practice of underreporting employees' incomes - paying them partly officially, partly by "envelope"[3].

2.2 Implications for public and private sector

A large shadow economy primarily, of course, hurts the public sector. So, at first sight it might look like an easy way out to shift activities from the public sector to the private sector. And to some extent, that has worked in the past – with the transition from a state-owned, socialist economy to a market system with private property, a huge black market for almost everything was replaced by legal businesses.

Ever reducing the size of government though is not the solution. Many government functions differ substantially from goods that are traded in the market, as people can't directly be charged a price for them. That is the case either because these functions are directly redistributive in character (e.g., public welfare, minimum pensions, etc), or because they are "public goods", of which citizens can't be excluded once somebody has provided them (such as security, rule of law, environmental protection, certain infrastructure, etc).

As these functions can only be performed by the government if it collects substantial revenue from citizens – revenue that is not directly linked to how many government services they "consume" –, a large shadow economy undermines that basic functions of society can be performed at all. And in the long run, these are also indispensable foundations of economic prosperity: data of countries worldwide shows a clear adverse correlation between the size of the shadow economy and economic performance[4].

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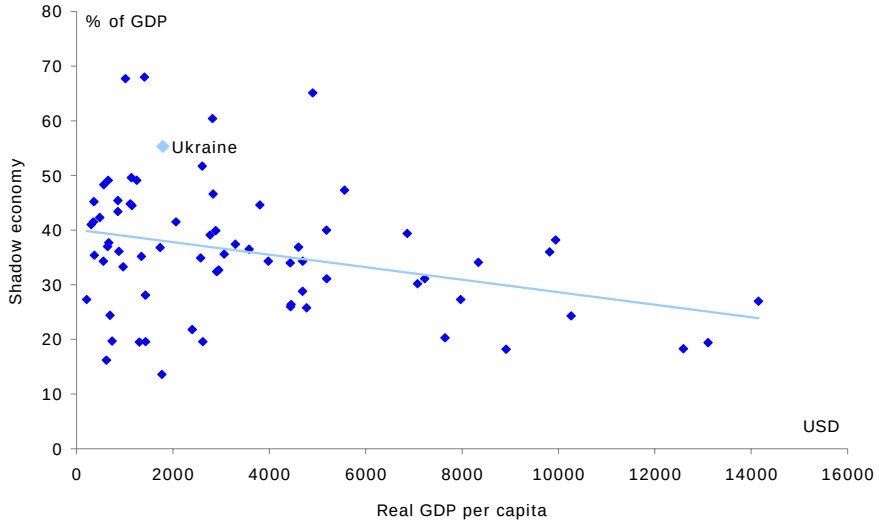
1 Cf Feige/Cebula (2011), p 4.

2 The term "informal economy" is often used as a synonym for the whole shadow economy. However, it looks from a slightly different angle. Its characteristics are non-compliance with, circumvention of or exclusion from the protection of the rules governing legal economic activity (not only referring to taxation, but also to contracts, working conditions, credit, etc). As our focus here is on taxation, though, we will use the term as a synonym for the unreported economy.

3 Officially reported average wages in Ukraine are among the lowest in Europe. According to the United Nations, in 2009, the country rivaled Moldova for last place in its statistics – cf United Nations Economic Commission for Europe (UNECE), http://w3.unece.org/pxweb/dialog/varval.asp?ma=60_MECCWagesY_r&path=../database/STAT/20-ME/3-MELF/&lang=1&ti=Gross+Average+Monthly+Wages+by+Country+and+Year.

4 Cf Schneider/Buehn (2009).

Figure 1: Size of shadow economy and economic performance worldwide (2005)



Source: Own compilation, using data from Schneider/Buehn (2009), pp 15-16, 24, and USDA Economic Research Service, http://www.ers.usda.gov/data/macroeconomics/data/historicalrealgdpvalues.xls

Given the fact that to function properly, any government needs some minimal revenue, the problem of a large shadow economy can become self-aggravating. Where the government tries to generate the necessary revenue from relatively few taxpayers, the burden of taxation on the individual can become rather high, even with an underfinanced public sector. That increases the individuals' incentive to go informal themselves – and with every potential taxpayer disappearing into the shadows, the burden placed on the those remaining gets heavier, thus further increasing their incentives to leave the system themselves. Finally, taxes end up being paid by a small fraction of the economy, often especially by foreign investors (who are highly visible, usually aren't very well connected with the local power structure, are controlled also by authorities in their home countries, etc).

In consequence, a structure emerges where many players can avoid taxation more or less, while those which are still included in the system face comparatively very high tax rates (having to compensate also the loss from their competitors' fraud). Instead of a level playing field, which is a pre-condition for a functioning market economy, this provides a substantial competitive advantage for those in the informal sector and a huge disincentive to formal, legal investment.

And things can play out even worse, when people in the administration actively apply the tax legislation selectively, to put pressure on certain businesses, while favouring others. The resulting structure of powerful, politically intertwined monopolies is a far cry from an efficient market outcome and a blow to growth and prosperity.

Therefore, fighting the shadow economy and finding ways to integrate more of the revenue and income generated by the economy into the tax system is not just a tool to generate more government revenue, but also an essential precondition for long-run economic success.

3. Ukraine's Shadow Economy

3.1 Size, structure and international comparison

As by definition the shadow economy is not recorded, its size cannot be measured by referring to the usual sources of economic data (especially, the government statistics offices), but only roughly estimated. All these estimates are highly dependent on the methodology being applied and – as there is no generally accepted precise definition of the term – on the specific concept of "shadow economy" that is being used. As a consequence, assessments vary substantially and usually should not be compared directly.

Estimation techniques use all kinds of available indicators. "Direct" approaches either simply take surveys or use the statistics of tax fraud discovered by the authorities. "Indirect" approaches use data on expenditure or production inputs, or they rely on indicators as diverse as, e.g. the amount of cash in circulation or the amount of electricity being consumed. In each case, the subtraction of what is presumably needed for the reported economy leaves an "unexplained" residual giving an indication of the size of the shadow economy[5].

Size

In the case of Ukraine, in spite of varying estimates there can be no doubt that the shadow economy is large, at least by European standards. According to estimates carried out by the Ministry of Economy using a combined indicator[6], it is estimated to have fluctuated between 26% and 32% of official GDP during the years 2001 to 2008[7]. The National Institute for Strategic Studies, which provides the most up-to-date estimates, gives figures of 37% in 2009 and 33% in 2010[8].

With all due caveats that apply to these estimates, they still point to a slow decline of the shadow economy in the years before the global economic crisis hit in 2008[9]. That took place against the background of an improved economic environment and measures to close free economic zones and fighting smuggling at the borders. Similarly, the latest decline in shadow activity recorded since 2010 might be attributed to the improved macroeconomic situation and an upturn in business expectations[10].

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5 A third approach uses models assuming that the shadow economy is determined by some measurable factors (i.e. the tax rate) and affects other indicators (i.e. employment). All these techniques have in common, though, that it's almost impossible to plausibly specify a relationship between the indicator used and the actual size of the shadow economy (let alone one that would be remotely constant over space and time), which adds to the vagueness of the estimates they provide. – For a more comprehensive critique of the methods usually used in estimating the shadow economy cf Thomas (1999).

6 The indicator combines, among others, estimates based on retail turnover, cash circulation, and electricity consumption. The estimates used in the indicator are weighted with respect to parameter stability over a five year period // the Order of the Ministry of Economy, No.123, February 18, 2009.

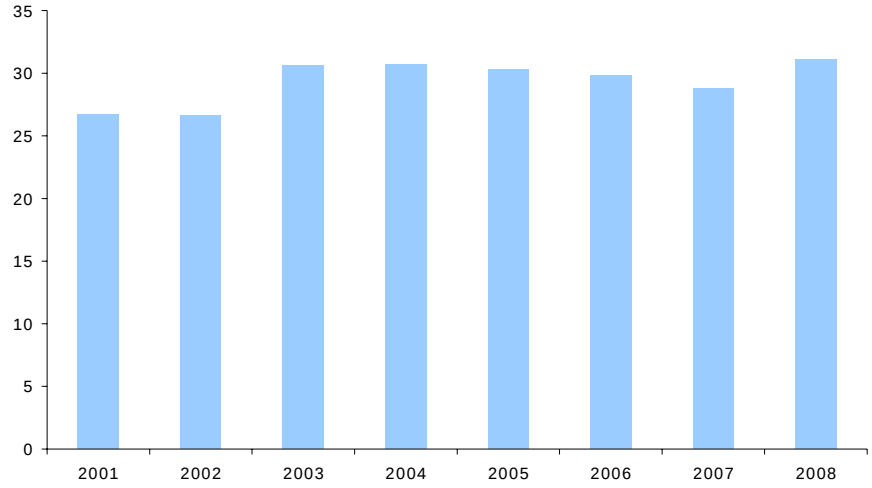
7 Source: "The trends in shadow economy 2008", Ministry of Economy.

8 These estimates by the National Institute for Strategic Studies were presented in the Presidential Address to the Parliament, 2011. However, the methodology used remains unclear, so no statement can be made comparing these data with the estimates by the Ministry of Economy (or by Schneider et al. [2009]).

9 Schneider et al. (2009), p 23, also find no increase at least in Ukraine's shadow economy over that period.

10 Presidential Address to the Verkhovna Rada, Kyiv, 2011.

Figure 2: Shadow economy in Ukraine (% of official GDP)

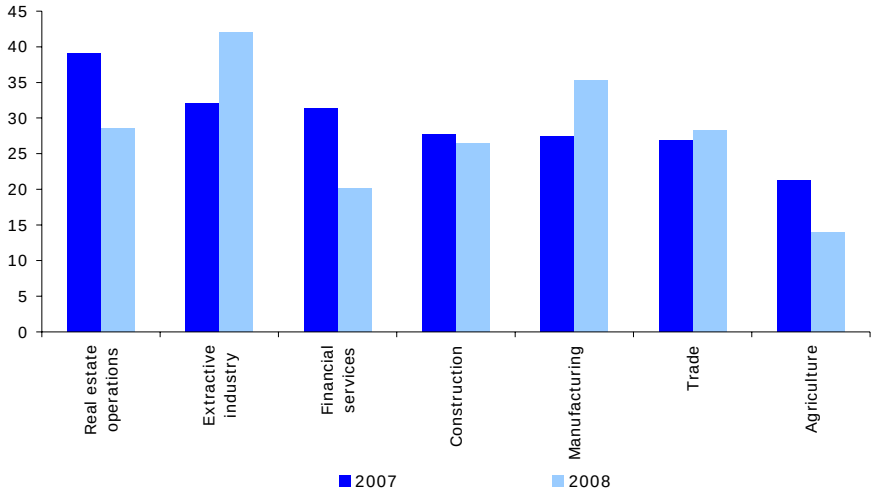


Source: "The trends in shadow economy 2008", Ministry of Economy

Structure

Traditionally, trade, real estate, construction and financial services had the highest shares of underground activity[11]. In 2008, however, the ranking of sectors has changed against the background of the global economic crisis. In particular, shadow activities declined in the sectors of real estate and financial services, which were especially affected by the crisis. At the same time, the share of underground activity increased in extractive industries and manufacturing.

Figure 3: Shadow economy in Ukraine by sectors (% of gross value added)



Source: "The trends in shadow economy 2008", the Ministry of Economy

[11] According to: *Trends in the shadow economy in 2008*, the Ministry of Economy

International comparison

The discussion so far focused on Ukraine's shadow economy, using national sources. It is also interesting to know how Ukraine compares to other countries. The international estimates of shadow economies by Schneider et al. (2009) shown below (see Table 1) use a model based on cash circulation, labor market participation, and the development of the official economy (GDP; labor market participation) as indicators. There results imply that the shadow economy in Ukraine as a share of GDP remains one of the largest among transition economies.

Table 1: Shadow economy in transition economies (% of official GDP)

No.	*Country*	*Years*								*Country Average*
		1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	
1	Czech Republic	18.7	19.1	18.7	18.4	18.2	18.5	19.1	19.3	18.7
2	Slovak Republic	18.7	18.9	19.1	19.2	19.4	19.6	20.3	20.5	19.5
3	Hungary	24.9	25.1	25.1	24.8	24.7	25.0	25.3	25.3	25.0
4	Slovenia	27.0	27.1	26.8	27.0	27.2	27.5	28.2	28.0	27.4
5	Poland	27.4	27.6	27.7	27.4	27.4	27.8	27.9	28.1	27.7
6	Lithuania	30.0	30.3	30.9	31.4	31.9	32.0	32.6	32.9	31.5
7	Turkey	31.5	32.1	31.4	31.3	31.6	32.2	32.7	32.9	32.0
8	Croatia	33.2	33.4	33.9	34.5	34.2	33.9	35.0	35.1	34.2
9	Macedonia, FYR	-	-	34.1	33.9	34.9	35.2	35.7	36.7	35.1
10	Romania	34.8	34.4	35.0	35.4	34.5	35.9	36.2	36.7	35.4
11	Albania	34.7	35.3	35.3	36.1	36.4	36.4	36.8	37.9	36.1
12	Bulgaria	36.7	36.9	37.2	37.1	37.7	38.2	39.1	39.4	37.8
13	Estonia	36.6	38.4	38.3	38.8	38.9	38.4	39.0	39.6	38.5
14	Latvia	39.6	39.9	40.1	40.3	41.6	41.9	42.6	42.8	41.1
15	Tajikistan	-	43.2	42.2	42.2	42.1	42.4	41.9	42.6	42.4
16	Kyrgyz Republic	-	-	-	41.2	42.7	42.8	44.1	44.6	43.1
17	Kazakhstan	43.1	43.2	42.5	43.4	43.3	44.1	44.8	45.2	43.7
18	Moldova	44.6	45.1	46.1	45.8	45.7	46.2	46.8	46.0	45.8
19	Russian Federation	46.4	46.1	46.0	46.3	46.6	46.6	47.3	46.4	46.5
20	Ukraine	51.2	52.2	51.6	52.4	52.5	53.6	53.3	52.8	52.5
21	Georgia	64.8	67.3	65.5	65.7	66.3	65.1	66.4	66.4	65.9
	Time Average	35.8	36.6	36.4	36.8	37.0	37.3	37.9	38.1	

Source: Schneider et al. (2009), p 23.

It has to be mentioned that their method has been criticized to substantially overestimate the size of the shadow economy[12]. This can be also seen when comparing the estimates to those obtained from national sources (Ministry of Economy and National Institute for Strategic Studies) mentioned earlier. However, as they have applied it to a large number of countries in the same way, it allows at least for an international comparison/ranking of the size of the respective shadow economies.

3.2 Causes: What drives economic activity into the shadows?

The basic reason for the existence of a shadow economy is, of course, the difference between the amount of money people are paying for an economic activity, and the actual payoff for the person carrying out that activity – in other words: government intervention, usually through taxation. As, however, government needs to generate revenue from citizens and corporations to fulfil its functions, there is no way around substantial intervention in the economy.

[12] Friedrich Schneider of Linz University is Europe's leading researcher on the issue. For a critique of his approach (especially his use of cash circulation as an indicator) cf Petersen et al. (2010).

Therefore, the solution can't be to remove the "root causes" for the existence of a shadow economy, but to find a system of sensibly designed incentives (and counterincentives) that reduces the shadow economy to a minimum.

We can distinguish between "hard" incentives and "soft" incentives. While "hard" incentives directly affect the payoffs for citizens and businesses, "soft" incentives affect their attitude to paying taxes and government activity in general. Hard incentives involve the set-up of the tax system as well as social security contributions, penalties for non-compliance, and the administrative cost involved in paying taxes.

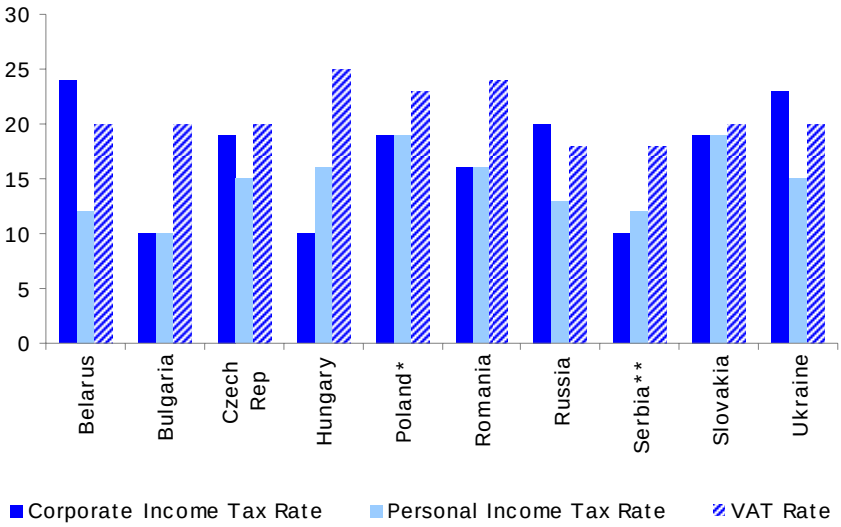
The tax system (here broadly defined, to include also payroll taxes) consists of two elements: the tax legislation, stipulating tax rates and assessment bases, and the implementation of the law by the tax administration.

Legislation: Tax base, tax rate, and social security contributions

As far as tax rates are concerned, over the last years Ukraine has "done its homework" and made substantial progress.

The flat tax on personal income introduced some years ago is easy to apply and leads to relatively little distortion of economic activities. Few possible deductions from personal income lead to only few distortions (as they are inherent in complex progressive systems, e.g. in Germany), and the tax rate of 15% (17% for incomes above a certain threshold since January 2011) is not high by international comparison. The fact that income tax is withheld before salaries are paid follows the widely accepted principle to tax as closely as possible to the source.

Figure 4: Flat rate taxes in CEE (%)



Source: National regulations; compilation by authors
* Flat income tax only for certain incomes, otherwise progressive rate up to 32% at the margin
**12% income tax for wage income. For other types of income, rates between 10% and 20% apply.

The corporate tax rate is still higher than in neighbouring countries, but if the decline over the coming years envisioned in the Tax Code is enacted as planned, it will soon reach a level comparable to that in, e.g., Romania, Hungary, or Slovakia. One should be aware that also creates incentives to join the formal economy, thus bringing additional revenue. At the same time, it is essential that expenses, especially wages paid to employees, are fully deductible – that's not only a matter of efficiency, but also an incentive to go formal. Tax breaks and exemptions for specific sectors should be handled with care and reluctance (especially as

long as it cannot be ensured that these special regulations are not used as loopholes for completely different businesses).

The fully-fledged VAT, as it is in place in Ukraine, is another asset, as by design it does not discriminate against certain kinds of economic activities (as opposed to, e.g., a non-refundable sales tax). However, high VAT refund arrears in Ukraine create problems for exporters making their products and services less competitive on the world market.[13]

At the same time, there are persistent loopholes and "easy ways" out of the system, resulting e.g. from special treatment for certain taxpayers, lump sum taxation of small businesses, or weaknesses of bankruptcy laws and law enforcement. In addition, starting from 2011, certain sectors have been exempt from profit taxes – a move that creates further incentives to shift profits into these sectors to avoid taxation.

Additionally, payroll taxes (primarily pension system contributions) constitute a major problem in Ukraine[14]. The very high pension fund contribution (over 30% of income) more than outweighs the positive incentives generated by the low income tax rate. The Unified Social Contribution (USC) rate paid by the employer varies from 36.76% to 49.7%, depending on the class of occupational risk; the employee pays an additional 3.6%[15]. On average, about 90% of USC payments are transferred to the Pension Fund.

Table 2: Payroll tax in 2010

	Employer's contribution (%)	Employee's contribution (%))	Total contribution (%)
Social insurance contributions *(rate depends on the class of occupational risk)*	36.76-49.7	3.1-3.6	39.86-53.3
Pension insurance	33.2	2	35.2
Social insurance against temporary working disability and expenses associated with birth and funeral	1.4	0.5-1.0	1.9-2.4
Social insurance against working accidents and occupational disease *(rate depends on the class of occupational risk)*	0.56-13.5	0	0.56-13.5
Social insurance against unemployment	1.6	0.6	2.2
Personal Income Tax		15	15

As most people expect to receive the minimum pension after retirement (currently 65% of pensioners), there also is no strong relationship between the levels of contribution and expected benefits. Therefore, there is no personal advantage for those who pay substantial contributions (as compared to those who cheat).

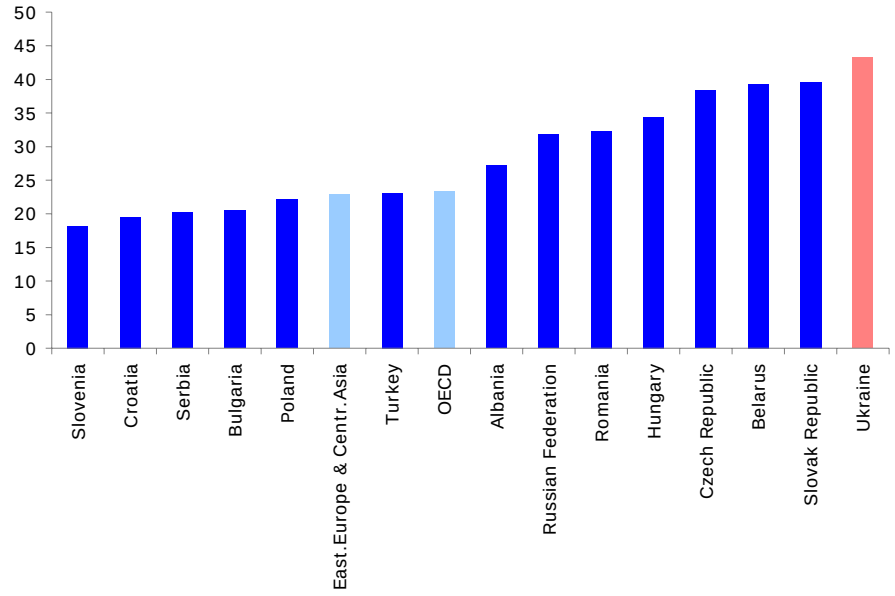
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[13] See: *VAT Refund Arrears in Ukraine: Analysis and Recommendations on How to Solve the Problem, With a Special Focus on Agriculture*, Policy Paper, Berlin Economics, 2010

[14] While issues of the tax system have been addressed, major problems of the social insurance system in Ukraine have remained untackled over the last years. The German Advisory Group and the Institute for Economic Research and Policy Consulting have jointly provided a number of policy papers in this area.

[15] The "Unified Social Contribution" was introduced in 2011. It combines contributions paid to the Pension Fund and three national social insurance funds. – Wages on which contributions are based are capped at 15 times the subsistence level.

Figure 5: Labour tax and contributions (%, 2009)



Source: World Bank, Doing Business, http://www.doingbusiness.org/data/exploretopics/paying-taxes

So, to sum up, it might be said that in terms of legislation, Ukraine has moved into the right direction towards creating an efficient, incentive-oriented taxation, although loop-holes still remain. At the same time, with respect to social security contributions, there's still a long way to go.

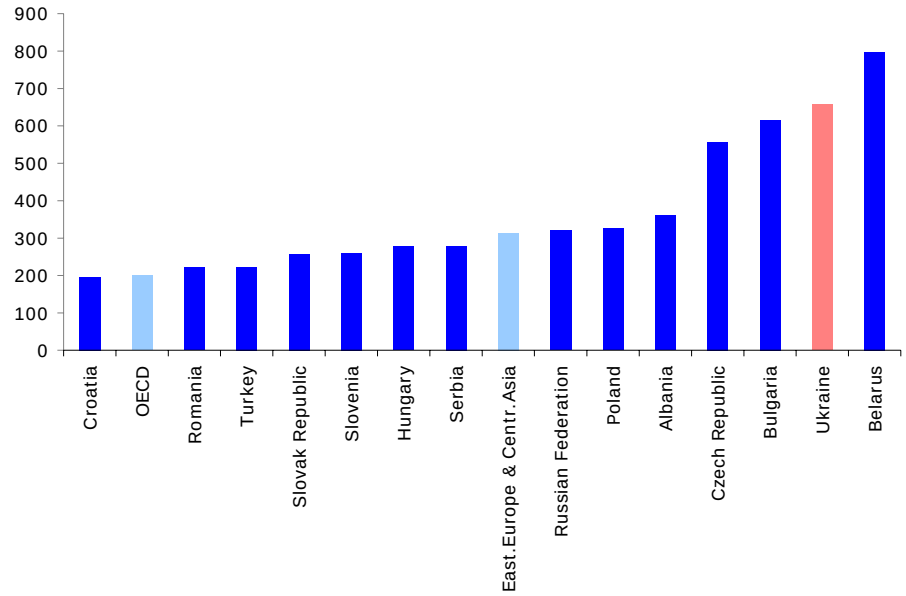
Tax administration and the issue of simplified taxation

An additional cost of being taxed, beyond the actual amount of taxes due, is the administrative burden of reporting and dealing with authorities, and the corruption that sometimes comes along with it. The effort associated with paying taxes differs substantially across countries, and it is especially high in Ukraine. According to World Bank data, in the category "paying taxes" Ukraine ranks third from bottom, right between the Republic of Congo and the Central African Republic.

The high administrative burden argument, though important for a broader perspective on the shadow economy, is less essential for our narrow focus here. This is a reason to forgo reporting and keep activities completely outside the official sector. It is no explanation, though, for underreporting, as employees who receive part of their salary "in the envelope" are registered, so the administrative burden is born by the employer anyway.

That doesn't imply, though, that the quality of the administration is irrelevant for our topic. Certain levels of corruption in the administration (facilitating tax evasion) and in the judicial system (making it very difficult to, e.g., claim refunds, which are a key element of any efficient tax system) both create incentives to underreport incomes and thus save on income tax due.

Figure 6: Hours per year spent on paying taxes (2009)



Source: World Bank, Doing Business, http://www.doingbusiness.org/data/exploretopics/paying-taxes

One way out, at least with respect to a certain share of economic activity, might be a system of simplified taxation for smaller businesses, as it was installed in Ukraine in 1998. The stimulus for start-up investment such a system can create has been widely discussed, along with ways to ensure that it generates sufficient revenue[16]. At the same time, though, there are also advantages when it comes to mitigating problems in the tax administration.

If paying taxes is simple, there aren't many administrative barriers that create extra costs and might even have to be removed by paying bribes. If taxes due are uniform (or, at least, very easy to calculate), oversight and the detection of fraud becomes much easier. And, above all, if rates are low, there's not much incentive left to pay bribes or avoid paying taxes – especially where there's a real risk to be fined substantially in case of non-compliance.

There is, however, also a flip side to the coin. First, simplified taxation forgoes the advantages of (and good reasons for) a set of rules designed to keep the distorting effects of the tax system as small as possible. Turnover taxation (without deductions), for example, or lump-sum taxes are easy to administer, but they can create bizarre incentives for the set-up of business activities, which in turn hamper production and employment.

Second, two sets of rules (general vs simplified taxation) automatically create spaces which are filled by avoidance schemes, some of them probably even legal. But not only will businesses respond by, e.g., introducing as much as possible of their profit into the simplified system (while they'll try to keep their losses deductible under general taxation), they might also start to bribe administration officials to reach that goal. So, while doing away with certain incentives for corruption, simplified taxation immediately creates others, that aren't necessarily less problematic.

Third, low rates lead to low revenues. If tax (and payroll tax) rates are low in the simplified system, as it is the case in Ukraine, the system can't fulfil the major purpose of any tax system: to fund the government's budget (and, e.g., the expenses of the pension fund). But by increasing rates, incentives for corruption and tax fraud return.

[16] Cf for example the discussion of Ukraine's approach in German Advisory Group policy paper PP/05/2010. – While that paper broadly addresses issues of designing proper rules of the game in a system with simplified taxation, the focus here is on implications of such a system for the tax administration.

The bottom line here is that simplified taxation can serve as a tool to reduce problems caused by "too much" administration. It doesn't remove, though, the need for a sensible compromise between low rates and substantial revenue, and the demand for well-educated, properly paid officials that are capable of applying the rules properly and enforcing the system and that are sufficiently immune to the temptations of cutting deals under the table.

Box 1: Ukraine's simplified taxation system

The simplified taxation system (STS) was introduced in 1998, when Ukraine faced economic problems, large unemployment, lack of state funding for job creation and a rampant shadow economy. Therefore it was aimed at promoting legalisation and further development of individual entrepreneurs and small businesses. The STS is comprised of unified taxes for physical persons and legal entities and a fixed tax for physical persons.

Table: The eligibility criteria for simplified taxation scheme

	Maximum annual turnover ('000 UAH)	Maximum number of employees	Monthly tax
Fixed tax for physical persons	119	5	UAH 20-100
Unified tax for physical persons	500	10	UAH 20-200
Unified tax for legal entities	1000	50	6% of turnover + VAT 10% of turnover incl. VAT

Source: Decree of the President of Ukraine "On the Simplified System of Taxation, Accounting and Reporting of the Entities of Small Entrepreneurship"; Decree of the Cabinet of Ministers "On the personal income tax".

The introduction of STS allowed for developing micro businesses and reducing the shadow economy. Its benefit for taxpayers was not only lower taxes, but, even more importantly, simpler accounting, which allowed entrepreneurs to escape from corruption in the tax administration. Currently, the STS provides opportunities and incentives to work and earn income for many Ukrainians.

However, there is also strong evidence for a massive abuse of the current system of simplified taxation of individual entrepreneurs, in order to reduce the tax burden of companies.

Source: Based on German Advisory Group Policy Paper PP/05/2010 *Reforming the Simplified Taxation for Individual Entrepreneurs in Ukraine*, Ricardo Giucci, Robert Kirchner, Oleksandra Betliy, Thomas Otten, August 2010

In general, it is of high importance to ensure that avoiding taxation comes at a cost. If penalties aren't high enough or the risk of being discovered and penalized is too low, there'll always be a strong incentive for fraud, even if the tax law is full of best intentions. Ukraine currently has quite high penalties for companies not withholding the full income tax of their employees, but enforcement is still weak.

But how about other, soft incentives to pay taxes? To create a certain readiness among people to contribute to the common good, it is essential for them to get the perception that their money is not wasted and, as a community at least, they get something in return for their sacrifice. In Ukraine, however, people experience public projects to be few, of bad quality, and, on top of that, in many cases way more expensive than in other countries, which poses questions of corruption and abuse of public funds. As citizens don't see any examples of higher tax receipts leading to better government performance, for most of them, there's no point in paying taxes, where they can avoid it. That, in turn, leads to a permissive culture of tax evasion: Cheating the taxman is not being perceived as immoral, rather as an act of legitimate resistance against a kleptocratic state.

To sum up, tax legislation has partly improved; however, in practice Ukraine's system of public revenue still is an extraordinary impediment to economic development, even by the standards of transition countries. Among others, one key problem is the widespread readiness of employers and employees alike to report only minimal wages to the administration, while paying the bulk of salaries[17] "in an envelope". This phenomenon is

[17] It should be born in mind that paying undeclared wages only makes much sense as long as there are undeclared profits, too (otherwise, the undeclared expenses would be taxed as profits instead). Therefore,

especially striking, as by definition it affects legal, formal employment, and it does so on a large scale.

4. Policy Recommendations

In the following chapter, in order to develop policy recommendations, we focus on three broad causes for the practice of under-reporting wages actually paid:

1. Social security contributions/payroll taxes: High pension contributions outweigh all positive effects of the low personal income tax.
2. Tax administration: Problems in the administration (incl. cases of corruption) and insufficient enforcement of penalties prevent that benefits from recent reforms can materialize.
3. "Tax morale": Given the commonly perceived low level of quality of public goods, citizens lack motivation to contribute to public sector activities.

The different ideas and proposals discussed in the following to help Ukraine's economy to come out of the shadows can be divided in measures that make it easier and more attractive to follow the rules, and measures that make it more difficult and expensive to cheat – in other words, in "carrots" and "sticks". This also applies to any of the three major causes for income and payroll tax evasion.

4.1 Social security contributions

As the high burden of pensions creates a huge gap between wages paid and wages received (a gap that dwarfs any positive incentive created by, e.g., the recent improvements in the tax system), we assess a reform of the pension system to be key to achieve a sustainable increase in personal income tax receipts. A reform should comprise the following elements as „carrots" and to create incentives for full participation in the system:

- As immediate action, stabilise and reform the pension system's first pillar, as is currently planned. Specifically, increase the contribution period, especially the retirement age for women, place restrictions on early-retirement-schemes and special pensions, and put a cap on pensions in general[18]. As soon as these first steps have been implemented successfully, there'll be room for a reduction in contributions to give incentives to "de-shadow"[19].
- Strengthen the link between the amount of contributions and expected pension payments. If people know that higher contributions today will guarantee them considerably higher pensions in the future, they'll become more ready to pay into the system while they are still working. Credibility is a major issue here, though. Only if people trust the government to deliver on its commitment, there's a chance of success.
- Moreover, reduce the burden of pensions on incomes also by streamlining the Social Security Funds' functions and by reducing their administrative costs. Consider possibilities for increasing the retirement age above 60 years for men and women in the longer run.

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bringing a larger share of wages into the legal sphere also, as a secondary effect, reduces the "necessity" to generate profits elsewhere in the shadow economy.

[18] This issue has been addressed at length by a related paper. For details see German Advisory Group Policy Paper PP/01/2011 *Pension reform in Ukraine. Comments on the main features of the current Draft Law*, by Oleksandra Betliy and Ricardo Giucci, February 2011.

[19] A similar path has been followed in Kazakhstan, where contribution rates were decreased. Apparently, this contributed to de-shadowing according to some observers.

At the same time, though, reform must also address the problem that those who cheat today go mostly unpunished and are still eligible for benefits.

- Consider reducing minimum pensions and introducing waiting years for those who have cheated. If retirement age goes up for those haven't fully participated in the system, that's an incentive to go legal, and at the same time it reduces the cost of the system.

The following two boxes discuss further proposals that are currently in the public discussion. This concerns a change in the distribution of payroll taxes between employers and employees (box 2) and on "indicative wages (box 3).

Box 2: Redistribution of payroll taxes between employers and employees?

Certain stakeholders, in particular, employers' representatives, suggest to change the distribution of pension fund contributions and make workers pay a much larger share, while at the same time reducing the contribution of their employers.

From a formal point of view, however, this wouldn't make any substantial difference. For the business, what matters is costs, in other words: the sum of salary and all (payroll-)taxes. For the employee, what matters is how much money finally ends up in his pocket. Therefore, if under the current regime employees have had the bargaining power to achieve their current net wages (implying certain gross wages for their employers), then there's every reason to assume that sooner or later they'd manage to roll over the burden of pension contributions to the extent necessary to return to their net wages to the previous level (and, thus, also the gross wages paid by the employer).

During the transition period, though, shifting the burden of pension contributions (if only partly) on employees simply amounts to a drastic cut in their wages. This would not only provide them with further incentives to evade payment altogether, but might also lead to unrest and instability.

For these reasons, we assess such a move not to be very promising, and we don't recommend it.

Box 3: Introducing "indicative wages"?

A draft law published by the Ministry of Social Policy in March 2011 suggests the introduction of „indicative wages". These presumed individual incomes shall become the base for the calculation of social security contributions and PIT, apparently following a model that has been earlier established in Bulgaria. Specifically, it is suggested to assign every professional qualification to one out of eight major groups, for which different indicative wages will be defined. According to official estimates, this way the gross wage bill could be expected to go up by 20-25%, increasing tax receipts accordingly.

Although the motivation of the authorities to propose such legislation is understandable, and their concern with the substantial tax avoidance through underreporting of income is fully justified, we see mostly negative implications of this instrument. Assuming certain income levels to be associated with certain professional functions is fine as long as they just determine down payments, and the taxpayer has the possibility to prove it easily (and get his money back) if he actually earned less than the assumption. (Given the current state of Ukraine's legal system, though, such a system would hardly stand a chance of success.)

To the contrary, though, the scheme proposed here basically gives up on income taxation and taxes professional affiliation instead. This would lead to a highly questionable incentive structure, very likely leading to even more distortions and losses of meaningful economic activity. If it pays to have fewer managers and more support staff, businesses likely would reorganize, giving up on efficient internal structures in attempts to save taxes. Implicitly, minimum wages for individual professions would arise (as people would have to afford high taxes in jobs which are assumed to pay well), taking flexibility out of the labour market. And on top of it all, very likely bribes would be paid by the really affluent to achieve a downgrading of their professional occupation. This is a price way too high for limited additional revenue potential, and we don't recommend it.

4.2 Tax administration

The improvements in the Tax Code that have been discussed above make it easier for citizens and businesses to pay taxes. They have to continue. Implementation of the Tax Code, though, still needs to be strengthened, to make tax fraud more risky and costly. Currently, severe implementation problems in the tax administration and the judiciary constitute a major problem.

- Emphasize the role of recently established "Large Taxpayer Offices", focusing on big employers with many people on their payroll. These offices should be well equipped and staffed with officials of high professionalism, who face incentives (like, e.g. performance premiums) and receive salaries that allow them to forgo bribes and corruption.
- Carry on with the discussion about introducing higher fines and penalties for paying „envelope wages". The Ministry of Social Policy recently published three draft laws related to the issues of wage and employment legalisation. The proposals envisage that the Inspection of Labour would be authorized to conduct checks of any company on issues related to employment[20]. This idea is worth considering – but when thinking about higher penalties for tax fraud, make sure that they are properly applied. A "blackmail state" that applies the tax law selectively and uses it to keep potentially powerful businesspeople under control is a severe deterrent to investment!
- Work on the ability (and willingness) of courts to handle complaints and demands for refunds properly and timely. Develop an understanding of refunds paid out (where they are due) not as a loss, but as an incentive to pay taxes in the first place!

Moreover, as an additional incentive to "formalize" personal income, we suggest to consider special requirements for bank loans (e.g. to allow as justification of income only properly declared and taxed income and profit).

4.3 Tax morale

Albeit being a "soft" issue, the frustration of citizens about the perceived squandering of their taxes paid should not be overlooked as an important impediment to more successful public revenue collection. Taxpayer education to achieve a better "tax culture" therefore constitutes an essential part of any strategy to improve public revenue. The effort should go beyond mere PR campaigns, though, and comprise the following elements:

- Visibly and sustainably fight corruption and wastage in public spending. Where public funds have been squandered, prevent cover-ups and make sure that these cases are investigated properly, impartially and in public.
- Create visible examples of successful, cost efficient public projects and communicate how they were made possible through the contributions of taxpayers.
- Make it more difficult for big income earners to resort to tax havens. Especially the double taxation treaty with Cyprus is widely seen as an invitation to avoid Ukrainian taxes. Closing this escape door would not only generate additional revenue, but also be likely to give a boost to tax morale among smaller taxpayers. However, such actions should be still accompanied by an improvement of the investment climate.
- "Reward" especially law-abiding taxpayers (at least by, e.g., publicly announcing which companies have contributed to the public good) – this can be an issue especially at the local level, where there is a clearer link between local taxes paid and local public goods provided.

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[20] Cf http://www.mlsp.gov.ua/control/uk/publish/article?art_id=127000&cat_id=107177. – If the company were to be found to have informal employees or to pay wages in envelopes, the employer would be penalized. In case of having informal employees, the company's head would lose the right of being a top-manager for the following 10 years. Underreporting of wages would result in a fine of 500 up to 700 times the subsistence income, and even a higher punishment in case of recurrence.

While the measures just listed mainly stir positive sentiments and, therefore, fall in the category of “carrots”, there are also “sticks”:

- Inform extensively about the consequences of individual fraud (low-quality public services, low pensions, etc) and convey the message that tax evasion by well-to-do citizens especially hurts those most in need.
- Communicate to the public also proven cases of large-scale tax fraud by businesses. Again, this measure can be especially effective at the local level.

5. Conclusions

The present paper attempted to shed some light on Ukraine’s considerable shadow economy. Having discussed some empirical estimates, the paper proceeded on an analysis of likely causes, and discussed a number of policy recommendations.

It became clear that there is no “silver bullet” for solving this severe economic problem, which has plagued the country ever since the start of its transition period. Rather, the problem is multi-faceted, and rests mainly in the fields of social security contributions, tax administration, and tax morale. Thus, it needs to be combated by a mix of appropriate instruments. These measures could be described as a combination of “carrots and sticks”: Measures to make it easier and more attractive to follow the rules (“carrots”), and measures that make it more difficult and expensive to cheat (“sticks”). The authorities need to strive a delicate balance between these two broad instruments. Any misbalance between them, e.g. by putting too much emphasis on any one of them will likely be counterproductive and not yield the desired results.

At the same time it should be emphasised once more that any success in fighting the shadow economy will likely realise only in the long-term. Quick results can’t and won’t be expected in this area.

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