German Advisory Group

Institute for Economic Research and Policy Consulting

Policy Brief Series [PB/01/2010]

Reforming the Simplified Taxation for Individual Entrepreneurs in Ukraine

Summary of key recommendations

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Berlin/Kyiv, June 2010

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The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry of Economics and Technology under the TRANSFORM programme and its successor.

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Reforming the Simplified Taxation for Individual Entrepreneurs in Ukraine: Summary of key recommendations

1. Strategic considerations

The simplified taxation system was introduced in 1998 in order to promote legalisation and development of individual entrepreneurs' activity and small business. It is comprised of unified tax for physical persons and legal entities and fixed tax for physical persons. However, there is strong evidence for a massive misuse of the current system of taxation of individual entrepreneurs to reduce the tax burden of companies. Besides, there is a contradiction between the regulation on simplified taxation and compulsory pension insurance, which raises concerns about future pension provision of individuals working under simplified taxation. At the same time, the simplified taxation is important for many people, as it provides them with opportunities to work and earn income.

Table 1 presents the main advantages and disadvantages for maintaining, abolishing, or reforming the system in a structured form. We believe that a reform of the system (option 3) should be the priority option for Ukraine, since abolishing the system is neither economically sensible nor politically feasible.

Table 1: Strategic reform options

Reform options	Pros	Cons	Decision
Option 1: Maintain the current system			**NO**
	Operation of small business under stable rules of game	Not reasonable from a fiscal point of view partially due to fraudulent behaviour of many taxpayers	
Option 2: Abolish the current system			**NO**
	Lower fraud and, as a result, potentially higher fiscal revenues	Lower incentives for entrepreneurship activity	
		Possible increase in fraction of shadow economy	
		Higher unemployment	
		Decline in the fraction of middle class	
Option 3: Reform current system of simplified taxation			**YES**
	Lower opportunities for fraud and, as a result, potentially higher fiscal revenues	Lower incentives for some types of entrepreneurship activities, though the impact will be limited	

2. Discussion of concrete measures

Table 2 summarises the concrete measures which should be taken within the reform of the current system of simplified taxation. The measures are structured in several directions: fields of activities, turnover and tax level, participation in social security system, control, etc. In the table we have also included several points under discussion, which the Government should according to our opinion not introduce in the Tax Code.

Table 2: Concrete reform measures

Measures	Pros	Cons	Decision
1. Limit the field of activities for individual entrepreneurs			
a. Exclude from the system starting 2011: - marketing and advertisement, - consulting, - financial and insurance services, - entertainment, - gambling, - owners of markets and trading centers, - manufactures and retail trade of excise goods, - real estate *<u>Explanation:</u> These are the types of activities, which are characterized by the highest fraud. Besides, some of them should not be subject to simplified accounting and reporting by their nature.*	Lower fraud Higher potential fiscal revenues		YES
b. Exclude from the system IT services starting 2014 *Therefore, transition period of 3 years is proposed: IT services could work under simplified taxation between 2011 and 2013, and then starting 2014 they should switch to general taxation.* *<u>Explanation:</u> IT services are only now starting developing in Ukraine. The transition period will allow them to develop more and prepare to work under general taxation regulation.*	Exclusion of some fraud Potential for higher fiscal revenues	Most IT services developing software are outsourced. The change will reduce significantly the incentives for developing IT services in Ukraine Higher prices / costs of IT services	YES
c. Exclude from the system B2B services not envisaged in point 1.a. (the exception could be	Exclusion of some fraud	Higher prices / costs of consulting activities	YES

Measures	Pros	Cons	Decision
done for research services) starting 2014 *Therefore, transition period of 3 years is proposed: other B2B services could work under simplified taxation between 2011 and 2013, and then starting 2014 they should switch to general taxation.* *Explanation: This is done to support SMEs (especially small companies), which at the moment outsource entrepreneurs – physical persons to provide them services. These are primarily accounting, bookkeeping, lawyers, IT services, cleaning, etc. They are doing this as they do not have large enough business to have staff bookkeepers, lawyers, and other specialists or to higher another company. If such B2B services will be excluded from using simplified taxation right away, then small companies will face increase in prices for respective services, as they will have to higher other small companies for providing them. The transition period of 3 years will help these companies to prepare for the change.*	Potential for higher fiscal revenues		
d. Starting 2014, individuals providing B2B services could: - organize small companies for providing the services, - register as professionals paying PIT and social security contributions However, in such case they should be eligible for paying fixed contributions at least at minimum level. ***THEREFORE:*** Simplified taxation will be applicable to all B2C services, production of non-excisable goods, retail trade *(including Internet stores)*. For 3 years IT services and some B2B services (not envisaged in point 1.a.) will be eligible for simplified taxation scheme. Afterwards, they	Exclusion of some fraud Potential for higher fiscal revenues	Reduced incentives for development of such services Increase in shadow payments Some will run out the business Higher costs of business, necessity to hire bookkeeper	YES

Measures	Pros	Cons	Decision
should switch to general taxation.			
2. Make invoices from individual entrepreneurs non-tax deductible for companies under general taxation			
Explanation: not necessary as starting 2014 all B2B services will be provided under general taxation.	Higher potential fiscal revenues Lower potential fraud	Lower incentives for entrepreneurs activity	NO
3. Maximum turnover			
a. Maximum turnover level should remain the same	Stable rules of the game	The turnover level seems to be justified according to today's reality Inclusion of higher turnover group, who will otherwise pay taxes on general taxation or apply for simplified taxation for legal entities	YES
b. Indexation of maximum turnover	Automatic adjustment of the tax level	No gradual phasing out Difficulties in planning Implementation problems	NO
4. Tax level			
a. Increase in tax level	Potential for higher fiscal revenues	Some private entrepreneurs will decide to leave business	YES
b. The unified tax for physical persons should be a local tax. 100% is transferred to the local budgets. Social security contributions should be paid on the top	Potential for higher fiscal revenues Potential for higher revenues of Pension Fund	Higher tax burden	YES
c. Indexation of tax level	Automatic adjustment of the tax level	Difficulties in planning	NO
5. Number of employees			
a. Set maximum number of employees at 5			YES
6. Tax holidays			
a. Tax holidays for certain individuals under		Increase in potential fraud	NO

Measures	Pros	Cons	Decision
simplified taxation		Decline in fiscal revenues Market distortions	
7. Social security contributions			
a. Entrepreneurs physical persons - on the simplified should pay at least minimum pension insurance contribution	Potentially higher revenues of the Pension Fund Pension provision of such people in the future	Lower profits of such individuals	YES
b. Entrepreneurs physical persons - on the simplified should pay social security contributions for their employees at standard rates	Potentially higher revenues of the Pension Fund Pension provision of employees in the future	Lower profits of such individuals	YES
8. Registering as payers of unified tax			
a. Probation period for participating in Simplified taxation – 1 year of operation under general taxation (article from the draft Tax code)	Potentially higher fiscal revenues Potentially lower fraud	Lower entrepreneurs activity Hampers small start-ups	NO
9. Control and monitoring			
a. Retail trade as well as persons providing other B2C services should have cash machines and provide customers with checks	Improved monitoring of turnover Decline in potential fraud Higher potential revenues Better basis/support for improving own accounting	Slightly higher costs of doing business	YES
10. Market duty			
a. Retain the market duty for irregular small trade (primarily farming) on the markets			YES

3. Concluding remarks

The successful reform of the simplified taxation should be combined with reforms in other spheres. In particular, pension reform and regulatory reform are necessary. The pension reform should ensure higher incentives to participate in the system and fair pension provision. At the same time, regulatory reform should result in easier procedures for starting a business, lower level of bureaucracy and licensing, and facilitate accounting. Otherwise, the reform of simplified taxation will not reach its objectives but result in higher unemployment, higher shadow economy and higher poverty.

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