Ukraine:
Tax Policy and Tax Administration

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Ukraine

Currency Equivalents
(Exchange Rate Effective June 29, 2001)
Currency Unit=Hrivnya
US$1=5.37UAH

Government Fiscal Year
January 1-December 31

Weights and Measures
Metric System

ABBREVIATIONS AND ACRONYMS

ATF Alcohol, Tobacco and Fuel
EPT Enterprise Profit Tax
FZ Free Zone
GDP Gross Domestic Product
LTO Large Taxpayer’s Office
NPO Non Profit Organization
NTI Non Taxable Income
PIT Personal Income Tax
SCA State Customs Authority
STA State Tax Administration
STAMP State Tax Administration
          Modernization Program
TI Transparency International
TPD Territories of Priority Development
UAH Ukrainian Hrivnya
VAT Value Added Tax

Vice President: Johannes F. Linn
Country Director & Team Leader Luca Barbone
Sector Manager Deborah Wetzel
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1. **SUMMARY AND KEY RECOMMENDATIONS**

1. This report presents an analysis of the evolution, current status, and reform prospects of tax policy and its administration in Ukraine. Tax matters have been and still are at the center of the political and economic debate in the country. This study hopes to contribute to that debate, and specifically to the creation of a tax system that is fair, equitable, and easy to implement. Gains in the quality of the tax design and in the efficiency of its implementation will contribute to forestalling fiscal imbalances and to providing a propitious ground for the development of a sound modern market economy. The Office of the President and the Cabinet of Ministers have assigned a great priority to the reform of the tax system. Indeed, during the past parliamentary section, a Tax Code was presented to the consideration of Parliament. This review takes account the existing tax legislation, the proposed Tax Code, revenue performance, and some topical tax policy and administration issues.

2. Since February 2002 when the basic analysis for this report was undertaken, there have been important developments related to some of the issues discussed here. In particular, the proposed Tax Code was not approved by the last Parliament. The new strategy of the government temporarily set aside consideration of a Tax Code. New draft proposals have been introduced for parliamentary consideration to reform the value-added tax (VAT), the enterprise profits tax (EPT), the personal income tax (PIT), and the system of excise taxes. Discussions have continued with the IMF and the Bank about the ongoing problems with tax arrears and VAT refunds. The review attempts to take some of these recent developments into account where relevant, but we do not provide here an article-by-article detailed evaluation of the various draft laws now under consideration. Our focus in this report is not on such details. Rather, we set out what seem to us to be the most important immediate and longer-term problems with Ukraine’s tax system and outline the most promising solutions to those problems. There is of course considerable overlap between these problems and the issues that are currently the focus of attention, but the overlap is by no means perfect.

**Arrears and Refunds**

3. Tax arrears and VAT refunds have surfaced as critical issues today, and their consideration serves to illustrate the core of the tax problems in Ukraine. The arrears and VAT refund issues must be resolved, and soon, and some reforms in tax policy and administration are necessary for this purpose. Nonetheless, since neither of these problems fundamentally originates in defects of the tax system, they cannot be resolved solely by manipulating the structure or administration of that system. Indeed, previous attempts to solve these essentially non-fiscal problems through fiscal means have, we suggest, substantially damaged the capacity of Ukraine’s tax system to generate the needed revenues in an efficient and fair manner. Tax policy has been severely affected by the failure to pay refunds in a timely fashion, and tax administration has been weakened both by repeated amnesties and by the continued use of heavy-handed administrative techniques.

4. The core problem underlying the arrears-refund issue, however, lies not in the tax system per se but rather in more basic public management issues related to energy
pricing, state enterprises, and regional employment problems. The arrears problem will not disappear until these more basic issues, which clearly have deep political roots, are resolved. To attempt to rectify the underlying situation by forgiving tax debts leads, in particular, to delays in VAT refunds caused by insufficient positive cash flows to the budget. Obviously, this practice that cannot last for long. As we discuss in Chapter 10, it is important both to deal with arrears and to ensure that refunds are paid in accordance with law, if Ukraine’s tax system is to function both effectively and in an economically efficient manner. Nonetheless, even the most thorough revision of tax policy and tax administration will not in itself suffice to correct the basic public sector management problems underlying the current difficulties. Indeed, until that problem is faced and resolved, the reform of both tax policy and tax administration is likely to continue to be hindered by recurrent crises arising from these underlying issues.

Rates, Bases, and Administration

5. Something similar may be said about the current focus of the reform proposals on the need for rate reductions, like in the PIT and the VAT. Some rate reductions may indeed be desirable, as we note below in Chapter 6. For the most part, however, to focus on rate changes is again to deal with symptoms rather than with the real problems facing Ukraine’s tax system. In our view, those problems largely arise from the combination of unduly narrow tax bases and certain features of current tax administration practices. In turn, these two factors to a considerable extent appear to reflect more basic difficulties arising from the continuing effect of the command-economy heritage on one hand and the current interplay of political forces and institutions in Ukraine.

6. One result of the interaction of such basic political economy factors is the proliferation of tax concessions, exemptions, and incentives that narrow the tax base and require a higher tax burden from those who do pay taxes to meet revenue targets. A higher tax burden and the complex tax structure make life in the huge “shadow economy” even more attractive to many. This exacerbates the task facing the relatively young and insufficiently experienced tax administration and strengthens the natural tendency to fall back upon the heavy-handed techniques of the old system in an effort to make up the resulting revenue deficiency. Structural reform of the tax system, and especially broadening of the tax base, thus must accompany—and in all likelihood, given Ukraine’s revenue needs, precede—any significant tax rate reductions. The current draft proposals for reforming the principal taxes clearly recognize the need for structural reform of the tax base to some extent but they do not go as far in the direction of reducing tax concessions as seems necessary. Similarly, the State Tax Administration Modernization Program (STAMP) moves in most of the right directions, but this long-term effort has to be complemented with strategically selected actions to improve tax administration in Ukraine now. We elaborate both these comments later in this report.

The Tax Policy Process

7. Understandably, the focus of current reform discussions has been on issues of substance, such as rates and bases. Much of the present report is of course also concerned with these issues on a tax-by-tax basis. An unduly neglected but important dimension of tax reform, however, relates to the process by which tax policy is
formulated and administered. Three key aspects of this process appear to require more attention in Ukraine.

8. First, the tax legislative process needs to be carefully reconsidered if there is to be any real long-term hope of reducing the proliferation of special treatments currently characterizing the tax system. Some suggestions for certain reforms in legislative and administrative procedures are therefore presented later in this report (see Chapter 2). Of course, we recognize that changes in fundamental political institutions are rather unlikely to be easily or quickly achieved. But we nonetheless think it important that the issue at least be recognized and public discussion of it launched.

9. Secondly, given the importance of reducing and keeping under close observation tax concessions, we suggest in Chapter 7 that Ukraine should introduce and meticulously implement a formal “tax expenditure budget.” This approach is consistent with the more fundamental changes in how tax law is made mentioned in the preceding paragraph, but it can also be undertaken separately, and is perhaps more easily achievable.

10. Thirdly, no matter what the tax law says, its real effects on citizens and the economy will to a large extent depend upon how it is administered. It is therefore critical to ensure that the process of tax administration is kept as open, transparent, and accountable as possible. This report therefore contains a number of suggestions in Chapter 10 as to how to achieve this desirable state of affairs as soon as possible.

Issues For Immediate Action

11. As already mentioned, much of this report inevitably focuses on a number of specific problems and suggested solutions. The matters discussed range from the treatment of VAT at the border to the administration of excises, the relation of PIT and EPT bases and rates, the analysis of particular tax concessions, reforms in penalty structures and other administrative matters, and local taxation. Some of the key recommendations on such substantive issues, as well as on a few of the broader issues discussed earlier, with respect to which immediate action seems possible and desirable are summarized below.

12. **Simplify the Simplified System.** One particular substantive issue deserves to be highlighted because it interacts with so many aspects of the tax system as a whole. That issue is the treatment of small taxpayers. The present “simplified” system (coupled with other “small taxpayer” features found throughout the tax structure) complicates administration, creates perverse incentives, has the potential to distort much of the tax base in the long run, and does not effectively deal with the real problems facing truly small taxpayers. The so-called “simplified” tax system thus needs serious examination and—though we hesitate to say so—real simplification (see Chapter 8).

13. **Review and Reduce Tax Concessions and Introduce a Tax Expenditure Budget.** Listing and costing all tax “expenditures” – and then eliminating all those that do have very strong arguments in their favor—is an important step to reforming the tax base. Ukraine already has many of the elements of such a tax expenditure budget. What it needs to do is to establish a formal annual reporting system with respect to all “expenditure” elements of the tax system, to require that proposed new measures be
properly costed, and that such “tax expenditures” be formally recognized as outlays in the budget framework and hence properly financed (see Chapter 7).

14. **Change most Tax Expenditures into Credits.** Tax expenditure items should not be confused with deductions and exclusions that are more properly part of the process of determining the tax base. It is thus critical to the integrity of the tax system that any such concessions should, to the extent feasible, come only at the end of the base determination process. To ensure proper accountability, all taxpayers should be required to report their tax bases fully in accordance with law. Those who benefit from special tax relief can then take such relief in the form of an explicit credit against the tax liability otherwise due.

15. **No More Amnesties.** If taxes are properly due in accordance with law, they should be paid. If they are not paid, appropriate collection action should be taken. In limited circumstances, and within a clearly established framework, individual payment arrangements, in a few instances including the forgiveness of tax debts, may be negotiated, but in no circumstances should there be any further recourse to general forgiveness of such debts. No tax system can be administered effectively if future amnesties are anticipated, and every amnesty increases the expectation of still more forgiveness in the future. The line should be drawn now: no more amnesties.

16. **Pay the Refunds.** The other side of the rule just announced is that the government must play the game fairly also. If the law says that refunds are due, then refunds should be paid. Not to do so calls the credibility of both the law and the government into account. In particular, one of the key economic rationales for the VAT is to remove tax barriers to export and investment. Ukraine clearly wants to encourage both exports and investment. It is completely inappropriate to play games with VAT refunds to offset arrears that should have been collected: in this case, two wrongs make an even bigger wrong. VAT refunds should be paid.

17. **Reform Tax Administration – Now!** The Tax Administration Reform Project (STAMP) currently discussed between the Government and the Bank sets a framework for long-term administrative reform. But some administrative reforms are needed right now, for example, to enable the STA to deal adequately with some of the issues that in part underlie its obvious reluctance to pay VAT refunds in many cases. Four such reforms may be singled out:

- In conjunction with the State Customs Administration (SCA), immediately begin to administer both VAT and excises correctly at the border (see Chapters 3 and 4);

- Reform the penalty structure and apply it;

- Reform organizational structure on a functional basis, beginning with the Large Taxpayer Offices (LTO);

- Become much more publicly transparent and accountable.

- These (and other) recommended administrative reforms are discussed in detail in Chapter 10.
18. **Other Recommendations.** In addition, a number of other changes in tax structure are also discussed and recommended throughout this report. Among the more important such changes that might be considered for immediate action, in addition to reducing concessions in all major taxes, are the following:

- Do not allow legal entities to use the (revised) “simplified” tax system;
- Set the top marginal PIT rate equal to the EPT rate;
- Apply the EPT base determination rules to all PIT taxpayers reporting business income;
- Raise certain excise tax rates (as discussed in detail later in the report);
- Establish a simple local property tax, to be administered locally with some local rate discretion;
- Simplify taxation of wages, taking into account the various payroll taxes as well as the PIT.

2. **The Setting for Reform**

19. Ukraine has in many ways done a commendable job with its tax system. In only a few years the country has managed to accomplish the major tasks of putting into place most major taxes and creating a tax administration to implement them.

20. Unfortunately, although progress has continued to be made on a number of important fronts, several critical problems, including base erosion and discretionary tax administration, have not completely disappeared in recent years. The declining tax revenue performance over the last few years is especially disturbing in view of the improved macro environment. The recent performance of the revenue system suggests that tax policy and tax administration in Ukraine still leave much to be desired.

21. In the past, many unfortunate features have been introduced in the tax system in response to pressing immediate revenue needs. The time for such temporary fixes and reactive policies is past, however. It is time for a different approach to tax policy and tax administration in Ukraine.

22. Although the tax system is not yet in full-blown crisis, one may loom ahead in the not too distant future unless significant changes are made soon in both tax policy and tax administration. Revenues are not expanding as they should given the rate of economic growth. The decline in privatization revenues not offset by tax revenues to the budget reveals the underlying structural problem with the tax system. The tax system is both economically distorting (allocatively inefficient) and, in all likelihood, highly inequitable. Both public perception of the tax system and the reality of how it works leave much to be desired.
The Structure and Performance of the Revenue System

23. Ukraine’s public sector has kept a relatively stable level of revenues as a percentage of GDP during the last four years, up to 2001. In fact, budgetary and extra-budgetary revenues in Ukraine have decreased only marginally from 37.7 percent of GDP in 1998 to 36.4 percent in 2001. These figures do not include quasi-fiscal revenues, of which precise estimates are not available. But, since energy prices are still below long-term marginal costs, quasi-fiscal revenues are not likely to be marginal. All combined, this means that the public sector in Ukraine continues to absorb a substantial amount of resources from the economy.

24. While the overall level of revenues and contributions has been roughly maintained up to 2001, their composition has changed significantly. Revenues from taxes and earmarked funds have decreased as a share of GDP from 35.2 percent in 1998 to 28.3 percent in 2001. Other revenues, mainly privatization receipts, have filled the gap. Indeed, non-tax/contribution revenues reached 8.1 percent of GDP in 2001. Since, it will be difficult for the country to maintain the current level of non-tax revenue performance, the fiscal strategy followed during last years has effectively postponed the actions necessary to streamline expenditure and protect the revenue flow.

25. The drop in tax/contributions revenues by about 7.2 percentage points of GDP between 1998 and 2001 is accounted for to a great extent by the performance of the state earmarked funds, both on and off-budget. Their revenues went from 13.9 percent to 9.8 percent of GDP during this period, partly as a result of the elimination of several earmarked funds within the budgetary reform process. This was the case of the Chernobyl Fund, targeted to support the victims of the nuclear disaster. However, the revenues of the pension fund also came down, from 8.5 percent of GDP in 1998 to 7.8 percent in 2001. This development is surprising and contrary to that of the PIT, as is shown below. This development has been a cause of concern for the authorities, who have targeted some excise revenues to buttress the finances of the pension fund (see Chapter 6).

26. The drop in tax revenues proper, from 21.3 percent of GDP in 1998 to 18.2 percent in 2001, has been smaller but still significant. Interestingly, revenues from income taxes, at 8.4 percent of GDP in 2001, contribute the most to overall tax revenues and have dropped only by 0.8 percent of GDP from 1998 to 2001. The personal income tax has remained steady at about 4.4 percent of GDP, while the enterprise profit tax, at 4.1 percent of GDP in 2001, continues to be a strong performer.

27. The strength and buoyancy of the PIT reminds us that despite all of the current problems with the Ukrainian economy, a good part of the workforce continues to employed in the formal sector and paying taxes, despite partial participation in the informal sector, through second jobs. This continues to be so despite the tremendous burden that taxes and contributions impose on wages and the lack of proper indexation of tax brackets to inflation. Indeed, PIT, pension contributions and other contributions based

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1 The reader is referred here to Annex Tables 2 and 3 in the Annex. Annex Table 2 presents a comprehensive overview of public revenue performance from 1998 to 2001 including budgetary and non-budgetary resources. The latter corresponds to the four social insurance related funds: the Pension Fund, the Social Insurance Fund, the Unemployment Fund, and the Job-related Accident Fund. Table 3 excludes the revenues from these funds. The information for the first semester of 2002 is preliminary and not comprehensive.
on salaries accounted for 13.6 percent of GDP in 2001. This performance level is not likely to be sustainable over the medium term, given the present structure of incentives (see Chapter 6).

28. The current level of the EPT revenues, high for transition and developing countries, mostly reflects the continued importance of the public enterprise sectors as revenue generators for the treasury, as well as inadequacies in accounting for tax purposes. On the other hand, the fact that exemptions are estimated to be significant means that the EPT burden is unevenly distributed throughout the economy (see Chapter 5).

29. Indirect taxes on goods and services yielded 7.2 percent \(^2\) of GDP in 2001, down from 9 percent in 2001. The limited relevance of indirect taxation in Ukraine is surprising, since the VAT tax rate is high at 20 percent. The drop in VAT collection from 7.3 percent from 1998 to 5.1 percent in 2001 is troubling and a reflection of the problems that beset and continue to beset revenue performance in Ukraine. This report emphasizes the need to strengthen the collection of indirect taxes, by improving the collection methods for VAT and excises, and possibly increasing the rates for the latter. Doing so, will allow to reduce somewhat the burden of taxation on wages and deal with any uncertainties in the revenues from EPT (see Chapter 3). The level of excise collections, 1.3 percent of GDP in 2001 is comparatively low, and still represents a unexploited revenue potential in the Ukraine (see Chapter 4).

30. Revenue from other taxes are less important. In 2001, taxes on international trade represented around 1 percent of GDP in 2001, property taxes 0.3 percent, and royalties for the use of natural resources, mostly land tax, 1.1 percent (see Chapter 9). Other taxes accounted for 0.64 percent. It is noteworthy that local taxes and charges only account for 0.25 percent of GDP. Lastly, there is still in Ukraine a number of nuisance taxes and contributions that burden the taxpayer and contribute little to the budget.

31. The weakening tax revenue/contribution performance of the last four years contracts with the renewal of economic growth. Indeed, the economy grew by above 5.8 percent in 2000 and 9.1 percent in 2001. The low elasticity of revenue performance illustrates that current effective tax bases in Ukraine are not linked to the expanding and dynamic sectors of the economy. A good example of this is agriculture, which so far is practically untaxed.

The Eroding Tax Base and its Consequences

32. The erosion of the bases of major taxes through concessions at many levels and in many ways has been one of the major problems in Ukraine recently. This has been a result of a political environment in which both the government, the parliament and the public look at the tax system as one more instrument to distribute favors and gains. There is no clear and credible social pact around taxation. With rising erosion, the government has been driven in its search for revenues not only to discretionary and unpredictable enforcement efforts but also to repeated attempts to close through still more legislative

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\(^2\) Annex Table 2 presents a value of 6.74 percent for VAT and excises. However, this figure excludes .5 % of excises earmarked for the Pension Fund (see Chapter 4).
changes the gaps arising from political and administrative decisions that were taken without adequate attention to their systemic effects.

33. As a result of the continuing changes in the effective tax structure, the resulting erosion of the tax base, and the consequent pressure on the tax administration to meet revenue targets, those taxpayers who remain subject to the full rigor of the formal system have faced uncertain tax burdens, and in some instances burdens have increased substantially. All too often, these taxes have been applied in an unduly discretionary fashion.

34. The result is that no one in Ukraine can say with certainty how any transaction will be taxed today, let alone tomorrow. The relatively few taxpayers – mainly wage-earners in the formal sector of the economy and some less favored enterprises – subjected to the full rigor of the formal tax system face increasing and often arbitrary burdens. Savings and investment are both deterred and misallocated. The shadow economy is expanded. Indeed, potential taxpayers have many routes of escape in Ukraine:

- They (or at least their tax base) may flee abroad;
- They may remain but hide in the huge “shadow economy;”
- They may secure favorable treatment through legal means by having changes made in the law or its interpretation;
- They may, if trapped within the taxation system, seek relief by forgiveness of arrears through amnesty laws;
- Or they may, and in some cases do, combine all of these methods of avoiding taxation.

35. As revenues fall, the tax pressure is again increased on those who cannot escape, and the vicious cycle continues. Not only is this situation clearly not conducive to the development of a modern economy, but fiscal implosion – the effective destruction of the tax system – may lie in the not too distant future. This dismal prospect may not yet be a specter looming over Ukraine, but it is definitely more than a small rain-cloud on the distant horizon.

The Tax Code Experience

36. Broadly, there are two ways to approach fiscal reform. One is to proceed in piecemeal fashion, analyzing each problem in turn and then fixing it as necessary. Another approach to the present situation is to tackle everything at once, and impose a new and comprehensive Tax Code. The latter approach was, until recently, that chosen in Ukraine. This attempt, it seems fair to say, has been put aside, although the government has begun to revisit it. Nonetheless, this experience has some important lessons for the future.

37. The proposed Code was largely focused on two problems—the high nominal (and effective) tax rates imposed on certain taxpayers and activities and the chaotic and hard to understand nature of the present tax system, based as it is on hundreds, if not thousands,
of different laws, decrees, and decisions by authorities at every level from the Presidential office to the local tax office.

38. The second aspect of the proposed Code, although less discussed, was the most important. The attempt to introduce some order and principle into both tax legislation and the administrative structure of taxation did not go as far as it should, but the adoption of the Code would have clearly represented an improvement in these respects compared to the existing situation. Two important lessons may be derived from this experience. First, if Ukraine is to have a coherent and sustainable tax system, it is essential to reduce the many levels at which tax “law” is now, in effect, made. We shall return to this point. Second, although it is certainly not essential to include all substantive tax legislation in a single law (“the Code”), it is essential that there is clear and uniform procedural code encompassing, for example, penalties, collections, audit, and appeals procedures. There also have to be proper review mechanisms in place to assure legislative consistency.

39. The most-discussed aspect of the Code, however, was not such mundane though important matters but rather reductions of the rates of all the major taxes. While understandable, this focus is unfortunate because it diverts attention from what is in fact the major tax problem facing Ukraine, namely, the effective erosion of tax bases. The central lesson suggested by our analysis of the Code discussion is that the high nominal (and sometimes effective) rates that some taxpayers in Ukraine today face are again a symptom and not the real problem. That problem is base erosion. The most recent version of the proposed Tax Code, like the current package of tax-by-tax reform proposals, attempts to redress the immediate negative impact on revenues from rate reduction by eliminating some existing concessions. Unfortunately, experience suggests that such trade-offs, even if they finally become law, will not be long sustainable in the absence of more fundamental change. What is needed is a change in the political economy setting which tax decisions are made in Ukraine. As long as power interests continue the game of seeking special treatments and exemptions, the vicious circle described earlier will continue. While it is unlikely that significant changes may occur any time soon, given the continued fiscal difficulties, this may well the time for the government to lead an effort to change the direction in how tax policy is made in Ukraine.

40. On balance, although the proposed Tax Code in some respects represented an improvement over the present situation, it did not really deal with the central problems of taxation in Ukraine. Since even the prompt passage of the Code would not have sufficed to avert the looming fiscal crisis, and since the political and administration efforts required to secure its passage could likely be better used elsewhere, the recent decision to put the Code proposal aside, at least for the present, and to revise the major taxes one by one, is not in itself a bad thing.

41. Unfortunately, it seems unlikely that the current reform package will do the job either. What seems needed instead is to deal more directly with at least some of the

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4 See, for example, the detailed analysis of the legislative history of tax changes in Gorbachuk, “Political Economy of Tax Reform in Ukraine, 1998-2001,” April 2002.
deeply-rooted institutional factors that have led to the present situation. One approach along these lines, to which the present report is intended to be a contribution and a stimulus, is simply to refocus official and public concerns on the real central issues of Ukraine’s tax system – base erosion and administration. Tax rates, important as they are, follow from and are determined to a considerable extent by these factors (although there is of course a certain degree of simultaneity in this equation). Rate reform alone is not enough, and indeed rate reform in the absence of more basic reform is all too likely to exacerbate rather than relieve the problems. Until public discussion of tax matters incorporates and accepts this reality, substantial and sustainable improvement in Ukraine’s tax system seems unlikely.

Improve Tax Policy Information and Procedures

42. Another lesson we derive from the extensive recent discussion of tax reform in Ukraine is that a critical but unduly neglected path to reform is to improve and make more transparent the process of formulating and implementing tax policy. Three ways to do so are as follows:

43. First, group all remaining tax concessions in one place. More importantly, require full annual reporting of the estimated revenue forgone as a result of such concessions, as well as periodic, and public, evaluation of the benefits secured as a result of these expenditures. Within Parliament, committees other than the financial committee should be prohibited from promoting tax reforms independently. Such limitations are normal in most legislatures.

44. Second, require estimates of the revenue cost – indeed, ideally also of the incidence and effects of all new proposals—to be attached to all proposals to introduce tax concessions or to decrease tax revenues. At the same time, introduce all tax concessions only for a limited period of time and as much as possible in the form of “credits” (reductions of tax) rather than at prior stages of tax calculation. Ideally, such concessions would not only be costed but also included in the budget of the appropriate spending department. Although this desirable change may prove too much to hope for, at the very least much tighter procedures than now exist for introducing new reliefs are needed. Where tax concessions remain, they should be clearly limited in scope and duration and subject to verifiable and publicly reported monitoring. Certain types of concessions – in particular tax holidays – are always and everywhere a bad idea and should be avoided. New concessions, if any, should be granted only by legislation conforming to these rules, and not by discretionary actions at any level of government. (See Chapter 7 for further discussion.)

45. Third, develop a better statistical basis for both revenue-estimating and analytical purposes. The capacity to carry out such analyses needs to be strengthened in both the executive and legislative branches of government. In addition, adequate fiscal data – on bases, not just revenues—should also be made publicly and promptly available to outside analysts. Information on taxes and tax bases needs to be more systematically collected and made available. The present situation, with, for example, different estimates of the revenue costs of exemptions from different agencies, is not satisfactory.

46. Accurate information is the lifeblood of effective democracy, however uncomfortable it may sometimes make those in power. Neither the legislative nor
executive branches of government seem to be as aware as they should be of the fiscal problems they are engendering through their decision processes. Properly presented, data are nonpartisan and have no political agenda. Numbers do not lobby for a point of view but rather provide a useful picture of reality and hence an opportunity for officials—and the public—to understand the issues better and to make better policy decisions.

47. Of course, information alone is not enough. But in the absence of both better public information and more enlightened discussion of critical issues it is unlikely that Ukraine will ever be able to find its way out of the present situation. To illustrate, at present no one can possibly have a clear idea of the complex way in which rates, bases, and administration interact to determine the outcomes of tax policy – whether on revenue, on resource allocation, or on the distribution of income and wealth. Similarly, there appears to be substantial confusion on many points of policy ranging from the interaction of taxation and regional policy to the role of capital cost allowances (tax depreciation) in financing investment and the sectoral impact of VAT. Many of these confusions can and should be cleared up by clearer presentation and analysis of data.

48. At the broadest level, for example, the interdependence between expenditures, revenues, intergovernmental finance, and tax administration needs to be explicitly recognized and taken into account both in formulating tax policy and in improving tax administration. The revenue-expenditure linkage is critical from the perspective of both macroeconomic and microeconomic management. At the macro level, as mentioned above, it is important to attempt to introduce more rationality into the budgetary process by attaching sound revenue cost estimates to proposals for increasing expenditures or (the budgetary equivalent of) reducing taxes through tax concessions. At a more micro level, earmarked revenues such as those going to the social insurance funds or for other purposes may sometimes make sense, but they are nonetheless taxes from both an economic and administrative perspective, and it is important that they both be understood as such and taken into account when evaluating those taxes formally labeled as such in the budget.

**Tax Administration Reform is Critical**

49. Yet another lesson from recent experience is that tax administration reform is a critical component of tax policy reform. Although Ukrainian tax administration, which is really still only in its infancy, has performed fairly well, it needs considerable further change if the tax system is to become a credible and productive cornerstone of government. Tax policy, tax law, and tax administration need to work together. To achieve this goal in the context of Ukraine today, not only should tax policies be altered along the line suggested in this report, but also tax laws need to be simplified and tax administration transformed from its present “command-based” mode of operation to a more open and publicly accountable system. Tax administration is a difficult enough task without weakening it through repeated amnesties and, perversely, at the same time “strengthening” it by recourse to methods more suitable to a command than a market economy.

50. As we discuss in detail in Chapter 10, tax administration management at all levels needs to develop a more coherent strategy for maximizing compliance with the law, the collection of revenue, and the support and development of its staff. The tax administration also needs to upgrade its business processes and its infrastructure support
in order to undertake successfully such urgent tasks as developing large taxpayer offices, where the greatest impact and revenue benefit is to be gained. Moreover, tax administrative procedures should be codified and adhered to uniformly throughout the country. Not only should the penalty system should be revised as indicated later in this report, but in addition the present system of requiring specific and peculiar tax accounting procedures needs to be reviewed and eliminated as much as possible.

**Intergovernmental Fiscal Reform and Tax Reform**

51. Finally, we suggest that the system of local finance also needs to be rethought, if efforts at national tax reform are not to be sabotaged by the demands of intergovernmental finance. At present, there are essentially no significant taxes for which local governments are politically accountable, while at the same time such governments can through their actions adversely impact on national collections. The intertwining of intergovernmental finance with national tax policy has adversely impacted on both.

52. Given the dependence of local budgets on sharing arrangements with national taxes, the variance in those shares from tax to tax, and the frequent changes in those arrangements in the past, the need to consider the intergovernmental implications of tax policy changes is obvious. Under current arrangements, for example, PIT rate reductions would immediately impact on local budgets in a manner that varies widely from region to region. Similarly, EPT reductions would significantly impact on the Kyiv city budget. On the other hand, to the extent local tax administrations are responsive to local wishes, they may in some instances exert greater efforts to collect taxes that accrue to local budgets than to national budgets. This problem, together with the apparently increasing divergence of local tax systems, combined with the need to strengthen and improve the STA, may suggest that separate local tax administrations for local taxes in at least the larger regions should perhaps be considered.

53. While these complex issues cannot be fully explored in the present report, we outline in Chapter 9 a suggested simplified tax on real property that could serve as the basis for a sound reformulation of local finance. It is important to emphasize, however, that no “quick fix” lies in property taxation for either local or national revenue problems.

**Taxation and Equity**

54. An important aspect of tax reform in any country is its effect on the distribution of income and wealth. Equity is always and everywhere a central issue in taxation. Indeed, from one perspective, the principal rationale for taxes in the first place may to a considerable extent be thought of as an attempt to secure equity. After all, governments do not need taxes to secure money, because they print the money in the first place. The role of the tax system is instead to take money away from the private sector in as efficient, equitable, and administratively least costly fashion as possible. Equity, with efficiency and administration, is thus one of the three principal objectives of any tax system. Of course, exactly what is considered to be “equitable” or fair by any particular person may differ from the conceptions held by others. In the end, only through the political institutions by which it reconciles conflicting views and interests can any country define and implement its view of what is an equitable tax system.
55. Nonetheless, it is seldom correct to assume that “what is” in terms of the effects of any tax system on the distribution of income and wealth reflects the carefully considered outcome of the political process. Such an assumption is especially implausible in a situation like that in Ukraine, with continual changes in tax legislation and administration. It is thus important to consider carefully what can be said about the equity of the present tax system, and what can and should be done to improve matters in terms of removing some of the tax burden from the poorest segments of society and increasing effective taxation on the richest.

56. The equity issue may be approached at two different levels. First, one can consider the details of the relative treatment, in law and in practice, of the tax burdens imposed on taxpayers in the same and different economic circumstances. Secondly, one may instead focus on the overall effects of taxation on people’s income and level of well-being. Economists tend to take the second approach, while much popular discussion of taxation instead takes the first approach.

57. The policy implications of these two different ways of approaching the equity of taxation may be quite different. Focusing on the implications for equity of details of particular taxes tends to result in proposals to alter the rates and structures of particular taxes. Such proposals, while they may improve horizontal and vertical equity within the limited group who are actually subject to the full legal burden of the tax in question, may at the same time actually exacerbate inequity more broadly considered. From the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income.

58. Viewed from this perspective, a critical factor in evaluating Ukraine’s tax system is the great importance of the “shadow economy.” A common estimate, for example, is that the “shadow” share of economic activity may be as large as the above-ground share known to the authorities. Whatever its precise size, what is clear is that the existence of a large sector of the economy that is effectively not subject to direct taxation substantially affects how one assesses the effects of different fiscal instruments on equity. For example, the value of a nominally progressive PIT which impacts mainly on wage-earners and which many high-income recipients seem largely to escape is far from evident. In Ukrainian conditions, it is even possible such indirect taxes as the VAT and taxes on motor vehicles may be more progressive than a tax such as the PIT that essentially burdens only a limited group of wage-earners. The name of a tax does not tell us what its effects are. We shall return to this point later in the next few chapters on specific taxes.

3. The Value Added Tax

59. In Ukraine, as in many countries, the VAT has become the workhorse of the revenue system. In 2001, for example, 47.1 percent of state budget revenues came from VAT, which accounted for 18.8 percent of all consolidated budgetary revenues and 5.1

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percent of GDP. VAT is the largest, most important, tax in Ukraine. The design and implementation of the VAT is thus a critical determinant of the performance of the entire fiscal system.

### Revenue Performance

60. It is thus disconcerting to find that VAT collections have declined in relative terms in recent years – from 7.3 percent of GDP in 1998 to 6.4 percent of GDP in 1999 to 5.6 percent in 2000, and to 5.1 percent in 2001. Indeed, if one goes back as far as 1994, at that time the so-called VAT – then really a turnover tax—accounted for 10.8 percent of GDP!\(^6\) When the rate of this “pre-VAT” was lowered from 28 percent to 20 percent in 1995, the “VAT” share unsurprisingly fell (from 10.8% to 8.3% of GDP). What is much more surprising, even disconcerting, however, is that even after the adoption of a “real” VAT in 1997, revenues have continued to fall. Since the GDP-elasticity of a VAT is generally close to unity, VAT revenues would normally be expected to expand at about the same rate as the economy, and the (measured) Ukrainian economy has been expanding in recent years. Nonetheless, the GDP elasticity of VAT in the 1999-2001 period was an astonishingly low 0.35. To put it another way, for every 1000 UAH increase in nominal GDP, only 23 UAH more was collected in VAT. For a VAT that was recently estimated to cover perhaps 62 percent of all household expenditure,\(^7\) this is an astoundingly poor performance. What accounts for it? And how can the VAT be fixed? These questions are considered in this section of the report.

61. A first observation is that matters may not be as bad as just suggested for two reasons. First, since (in principle, if not always in Ukrainian practice) VATs do not tax exports, to the extent the recent expansion was export-led, some relative decline in the VAT/GDP ratio was perhaps only to be expected, at least in the short run. Closer examination, however, does not show any clear correlation between the drop in VAT revenues and the rise of exports. From 1998 to 1999, for example, exports as a share of GDP rose by 29.7 percent, and VAT fell by 11.3 percent. From 1999 to 2000, although exports rose only by 14.9 percent, VAT fell even more, by 13.9 percent. And from 2000 to 2001 (first 9 months), although exports actually declined by 10.1 percent, VAT continued to decline, by 8.3 percent. So the explanation cannot lie in exports.

62. Secondly, since VATs in principle also do not tax capital goods, to the extent the expansion was investment-driven, again some relative decline might be expected in the short run. However, although this factor may indeed have been at play in Ukraine to a limited extent, the observed decline is much too large and too sharp to be attributed solely to this cause.

63. Two other possible explanations for VAT’s poor revenue performance, to some extent related, come to mind. First, there are a number of features of the VAT in place in Ukraine that weaken its ability to capture rising incomes and consumption, in particular the large and growing number of exemptions. The effect of such structural defects on revenue is exacerbated by the peculiar way in which VAT for the most part continues to

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\(^6\) A “value-added tax” was introduced in 1991, but it was not until 1997 that a “modern” VAT, allowing in principle for appropriate treatment of trade and business inputs, was adopted.

be collected in Ukraine (see below), as indicated also by the excessive accrual of VAT arrears in recent years. This point is discussed further below. Secondly, there are many problems with normal VAT administration in addition to the fundamental accounting problem just mentioned. Although neither the arrears nor the administrative issue is dealt with at length here, since they have recently been the subjects of separate reports by the IMF, these matters are considered briefly below.

**VAT Administration**

64. As of the end of 2000, there were 424,611 VAT registrants, of whom 83.3 percent (353,730) were actively reporting. These numbers were considerably lower than those a few years earlier. In 1997, for example, 581,874 taxpayers were registered for VAT and 440,884 (75.8 percent) were active. This reduction did not represent simply the desirable elimination of dead wood. Actual VAT collections also peaked in 1997, before beginning the downward trend already noted. What happened?

65. First, the introduction of (an earlier version of) the “simplified” tax system in 1998 appears not only to have reduced the number of VAT taxpayers but also, more importantly, to have reduced VAT collections as well. VAT revenues fell from 29.3 percent of total revenues in 1997 to 25.8 percent in 1998 and continued to fall to 18.8 percent in 2001. Since total tax revenues also fell over this period, from 21.3 percent of GDP in 1998 to only 17.4 percent in 2001, the reduction in VAT revenues was clearly not made up by new revenues collected through the simplified system.

66. Second, VAT arrears accumulated rapidly during this period. Although there were a number of reasons for this development – some of which are discussed elsewhere—the result was that cumulative VAT arrears rose from only 10 percent of VAT collections in 1997 to an astonishing 55 percent in 1998, and peaked at 66 percent in 1999, before declining, largely as a result of write-offs, to 47 percent in 2000 and 36 percent at the end of 2001.

67. Although VAT administration is not examined in detail in this report, it is clear that the legislation remains complex and ad hoc. The system is full of privileges and exemptions that minimize its revenue impact and make it difficult to manage. Arrears remain high and continue to accumulate (despite a significant write off in 2001). Refunds often accumulate to meet budgetary needs. Very little is offered in the way of taxpayer services. Similarly, at least until very recently, VAT audit processes were limited to simple checking and have only recently started to embrace risk assessment.

68. In these circumstances, it is not surprising that in terms of revenue efficiency, Ukraine’s VAT does not appear to rank very high. Its “efficiency ratio” (VAT as percent of GDP/standard rate of VAT) in 2001 was only 24, compared to 36 for transition countries more generally – and to 36 for Ukraine itself in 1998 before the precipitous decline of the VAT in the last few years. A more meaningful measure might be “C-efficiency,” or the ratio of the share of VAT revenues to consumption to the standard rate. A VAT that applied uniformly to all consumption would obviously have a C-efficiency ratio of 100. This measure for all transition countries is 62; in EU countries it

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8 See L. Ebrill et al., The Modern VAT (IMF, 2001), for discussion of this and other measures of VAT efficiency.
is 71. Recent estimates suggest a steady decline in C-efficiency of VAT in Ukraine from 87 in 1994 and 81 in 1997, to 64 in 1998, 59 in 2000, and 45 for the first 9 months of 2001.9

69. A serious, indeed almost incomprehensible, problem with VAT administration in Ukraine concerns its application at the border. In principle, imports should be taxed, which means that VAT should be paid before goods clear customs. Similarly, the accumulated VAT on exports should be refunded once the exports have left the country. In practice, neither side of this system has worked properly.

70. The problem was recently recognized by a Cabinet decision at the end of February 2002 that refunds should not be paid until the export of goods is confirmed by the State Customs Authority. It is equally important to ensure that imported goods pay. A country that does not collect VAT properly on imports is unlikely to do much better with the more difficult application of the tax in the domestic economy. An accountability issue also arises where Customs clear goods at the border on the basis of a promissory note, which is subsequently supposed to be collected by the tax administration. To ensure control, it is desirable that only one agency be responsible for collecting a tax and ensuring the validity of claims for exemption or refund.

71. Many studies have shown that VAT evasion, the size of the underground economy, and corruption are closely linked. A study carried out recently by the Argentine tax agency, for example, recently found a correlation of 0.66 between the estimated level of evasion and the Transparency International index of perception of corruption.10 New Zealand, for example, with a very low TI index of 9.411 has an estimated evasion level of about 10 percent, and Mexico with a high index of 3.7 has a 32 percent evasion level. This correlation is of course far from perfect: for example, although the corruption index is about the same in the U.S. and Chile, evasion is more than twice as great in the latter. Similarly, although corruption is much greater in South Africa than in New Zealand, the reported level of tax evasion is about the same in the two countries. When the perceived level of corruption is as high as it is in Ukraine (2.1) a high level of tax evasion – about 38 percent, if one simply extrapolated the regression just mentioned – is perhaps only to be expected. This does not reduce the importance of fighting evasion but simply underlines that it reflects systemic problems.

72. An interesting feature of the Argentine study is that it attempts to relate the proportion of potential collection evaded by sector, finding the highest level of VAT evasion (70 percent) in the construction sector, followed by retail trades and services. Interestingly, by far the best taxpayers in Argentina, according to this study, were the energy companies. The contrast with Ukraine is striking.12 While sectoral data on evasion are not available, the data on arrears make it clear that the largest cumulated arrears (for all taxes combined) are in energy companies and energy-using heavy industries. At the end of 2001, even after the substantial write-offs of arrears (up to end-

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9 Calculations by I. Lunina.
10 Available at www.afip.gov.ar.
11 The TI index goes from 10 (lowest level of perceived corruption) to 1 (highest level). See the discussion at www.gwdg.de/~uwvw/2001.html.
12 Of course, the Argentine and Ukrainian economies differ in many respects – energy companies in Argentina are mainly in the private sector, for example – so the sectoral data cited are only illustrative.
1999) earlier that year, 20 percent of all arrears were in the fuel industry, and another 19 percent in the electric power industry. In other words, these two sectors, although together they accounted for about 15 percent of taxes collected, accounted for almost 40 percent of taxes not collected.

73. To a considerable extent, VAT arrears arise from inter-enterprise arrears that in turn arise in large part from low cash collection levels and the under-pricing of energy. The result is that energy (and some other) enterprises under similar policy restraints cannot pay their bills from their sales proceeds. To some extent, these firms compensate by also not paying the VAT due on these bills. On the other hand, since these enterprises are entitled to deduct VAT on inputs when it becomes chargeable (the shipment rule), even if they do not pay it, they can and do claim the deduction, thus either receiving a refund, if an exporter, or decreasing their tax debts. This situation is clearly wrong.

74. The 1997 VAT law was, as is normal world-wide practice, based on an accrual system, but this was soon changed to a cash system, perhaps largely because of the strong institutional inertia of the long-existing previous settlement system, under which enterprises were not liable to pay taxes (out of their bank accounts) until payments were made into these accounts by those to whom the goods were shipped. The cash system led to obvious fraud, as taxpayers claimed non-payment (bad debts) but still claimed their deductions. Although the accrual system was re-instituted in 1998, its application to the critical energy sector was postponed to 2001, so that there remained a substantial structural loophole in Ukraine’s VAT structure conducive to fraud. At present, however, only the “communal services” sector (gas, heating, water, etc.) remains on the cash system of tax accounting.

75. Such basic administrative problems are not confined to the energy sector. In 2001, VAT refunds claimed by the mining and smelting sector with respect to exports (UAH 17.2 billion) were 40 percent higher than in 2000 although of their reported exports did not increase in terms of GDP. Equally odd is the fact that in 2001, wholesale and retail trade – as noted above a notoriously difficult sector to tax – claimed UAH 652 million in refunds, even though these sectors report no exports. It is difficult to understand such figures except as reflecting serious underlying administrative problems.

76. Many specific administrative problems with VAT may be noted. For example, since it appears that every VAT registrant qualifies for the threshold (currently UAH 62,000), there is obviously an incentive to “income split” by registering branches, affiliates, and other detached units separately. Although this incentive is perhaps not too important, given the low VAT threshold, it is still essential to control registration centrally to limit the number of entities having the right to claim refunds. Similarly, taxpayers who produce both exempt and taxable products may attribute most inputs to the taxable activity. These and other simple rearrangements may noticeably reduce VAT liabilities. Few of these possibilities seem to be eliminated in the current reforms.

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13 Cash collection in the energy sector has been increasing since early 2000, when they reached levels between 10 to 20 percent. The current levels are now closer to 90 percent. Now, that collections in cash have increased, alignment of tariffs with economic costs is a priority. For a recent analysis of the extent of energy mispricing in Ukraine, see Martin Petri, Gunther Taube, and Aleh Tsyvinski, “Energy Sector Quasi-Fiscal Activities in the Countries of the Former Soviet Union,” IMF Working Paper QP/02/60, March 2002.

should be closely examined and rectified as part of the serious VAT tax reform that seems clearly needed in Ukraine.

**VAT Structure**

77. The single rate of the VAT (20 percent) is a good and commendable feature. As already noted, however, there are many exemptions from the base to which this rate is applied. In 1999, for example, 60,588 enterprises were exempted. The associated estimated revenue loss was greater than actual VAT collections and reached an incredible 7.6 percent of GDP.\(^{15}\) VAT exemptions were reduced sharply in 2000 and 2001, however, and amounted to only 2.9 percent of GDP in the latter year. Still, there remain too many exemptions and considerable room for improvement in this respect.

78. As an illustration, Table 1 contains a list of VAT concessions existing in 2000, with estimated revenue costs for that year. In total, the listed concessions amount to 27.4 percent of collections in that year. To put it another way, 21 percent of potential VAT revenue was forgone for these purposes. Some of these concessions might be considered normal in the sense that they are found in many countries, such as those for educational and medical services. Others, however, seem much more questionable.

79. The treatment of agriculture, for example, clearly deserves reconsideration. The revenue forgone by the present VAT treatment of agriculture—which is actually taxed but then in effect allowed to keep the tax—accounts for 37.8 percent of all privileges. In effect, VAT is used as a means of channeling subsidies to agriculture. In principle, there is no good reason for this treatment. Political considerations may obviously make it difficult to act in this area, as is indeed suggested by recent discussion of reform proposals, but action there must be in Ukraine is to build a sound tax system.

80. Even less defensible is the treatment of housing construction, which should normally be taxed as a proxy for taxing housing services. Although the exemption of so-called “critical imports”—as determined, apparently to a considerable extent on an ad hoc basis, by the Cabinet—was officially eliminated in May 2000, other, equally questionable, exemptions—such as of imports of cars and parts—remain. Such exemptions appear to represent inappropriate industrial policies and have no place in a good VAT system. Other items that may be questioned include the treatment of sales by enterprises where a certain proportion of employees are deaf or disabled, the treatment of health resorts, and the treatment of passenger transport. It is most unlikely that any conceivable social gains from such provisions will offset the damage they do to good VAT administration. In total, about three-quarters of the exemptions listed could advantageously be eliminated with little cost in equity and considerable gains in efficiency and administration.

\(^{15}\) This figure may be exaggerated since the data seem to treat components of a “normal” VAT (refunds to exports, for example) as equivalent to exemptions. Like some of the other figures cited in this report, there appears to be a fair amount of “rubber” in the exemption numbers, in the sense that they bounce around from source to source and from year to year in ways that are not always very clear.
<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero rating of sales by Society of Deaf</td>
<td>2,334</td>
</tr>
<tr>
<td>Zero rating of domestic car sales</td>
<td>36,182</td>
</tr>
<tr>
<td>Books, periodicals, etc.</td>
<td>20,516</td>
</tr>
<tr>
<td>Educational services</td>
<td>69,710</td>
</tr>
<tr>
<td>Goods for disabled</td>
<td>10,665</td>
</tr>
<tr>
<td>Services re delivery of pensions, etc.</td>
<td>25,925</td>
</tr>
<tr>
<td>Medicines and medical goods</td>
<td>400,029</td>
</tr>
<tr>
<td>Health care services</td>
<td>6,206</td>
</tr>
<tr>
<td>Health resorts and children’s recreational facilities</td>
<td>39,164</td>
</tr>
<tr>
<td>Preschools, boarding schools, etc.</td>
<td>20,271</td>
</tr>
<tr>
<td>Meals for school children and patients</td>
<td>4,043</td>
</tr>
<tr>
<td>Services within penitentiary system</td>
<td>12,457</td>
</tr>
<tr>
<td>Passenger transport</td>
<td>87,764</td>
</tr>
<tr>
<td>Religious organizations</td>
<td>220</td>
</tr>
<tr>
<td>Burial services</td>
<td>5,404</td>
</tr>
<tr>
<td>Housing construction</td>
<td>180,000</td>
</tr>
<tr>
<td>Charitable aid</td>
<td>43,890</td>
</tr>
<tr>
<td>Sales by organizations of disabled</td>
<td>4,913</td>
</tr>
<tr>
<td>Housing for veterans</td>
<td>8,621</td>
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<tr>
<td>Diplomatic missions</td>
<td>5,944</td>
</tr>
<tr>
<td>Critical imports for domestic production</td>
<td>319,321</td>
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<td>Home-made agricultural products</td>
<td>55,700</td>
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<tr>
<td>Imports of cars and parts</td>
<td>118,379</td>
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<tr>
<td>Processing of milk and meat</td>
<td>279,851</td>
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<tr>
<td>Health resorts in Crimea</td>
<td>92,470</td>
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<tr>
<td>Agricultural products</td>
<td>700,000</td>
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<tr>
<td>Goods from Russian Federation</td>
<td>36,100</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,586,696</strong></td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance*

**VAT Reform**

81. Although there have been many proposals to reduce the VAT rate in Ukraine to e.g. 17 percent or 15 percent, there seems to be no good case on equity grounds for reducing VAT rates in Ukraine. As discussed in Chapter 2, the VAT is unlikely to be much if any more regressive than other taxes in Ukraine. Nor is there a good case for
such a reduction on efficiency or administrative grounds, since, viewed from either perspective, the VAT is (or could be) one of the best taxes in Ukraine. One study, for example, found that the “shadow” economy paid perhaps 7 percent of its value added in indirect (VAT and excise) taxes, compared to perhaps 25 percent in the so-called “soft” sector of the official economy ¹⁶ – agriculture, energy, and many state enterprises – and up to 50 percent in the less fortunate private official economy.¹⁷ A broader VAT base and better administration extending the reach of the system increasingly into both the “soft” and the “shadow” economies would enable the same revenues to be obtained with lower rates, thus reducing distortion further. But simply reducing the tax rate would have no effects on the undesirable allocative effects of such an effective rate structure. Market-based activities would continue either to migrate into the shadow sector or to join the lengthening queue of those seeking relief from the oppressive taxation of non-favored enterprises

82. In the case of Ukraine, it would thus seem to be a fatal error to cut VAT rates before broadening bases and tightening administration. Rate cuts may result from, or perhaps, in the best circumstances, accompany base broadening and administrative measures. But they cannot precede them without great danger to the revenue. To a considerable extent the future of the Ukrainian tax system lies with the VAT. It is therefore especially important that nothing be done to weaken this tax, and that every effort be made to strengthen and improve it. The VAT administration procedures are carried out within the legislative norms, therefore, in order to improve the administration procedures, it is necessary, first of all, to improve the current legislation.

4. **Excise Taxes**

83. Excises are taxes imposed on specific products or services. The conventional wisdom of fiscal economics is that such taxes, when properly designed and applied, are good ways to raise revenue in the sense that they are economically efficient and relatively easy to administer. Good excise taxes are a way to impose differential rates on certain products in a way that provides a useful complement to a good VAT. The major concern usually expressed about good excises relates to their equity, since their distributive effects may not be particularly desirable.

84. The key word in the preceding paragraph is “good.” Essentially, a good excise tax system is one that: (1) taxes few products, (2) taxes those products correctly, and (3) is administered well. In reality, excise systems in many countries fall short of this standard. Excises are imposed on too many products; the rate structure is not logical; and excise administration leaves much to be desired. The result is all too often a complex structure that produces less revenue and more distortions than it should and is not well administered.

¹⁶ The “soft” sector is that part of the economy that is not subject to a “hard” budget constraint, for example, because it can be (and frequently has been) bailed out by the government, as in the case of the energy sector discussed earlier.
¹⁷ Sultan, op. cit.
The present excise system in Ukraine is neither wholly good nor wholly bad in these terms. Some features, such as the reliance on specific rates and the relatively few products subject to tax, are generally good. Other features, such as the level and structure of rates and the efficiency of administration, leave something to be desired. We shall first describe the present system and then present some suggestions for improvement.  

The Current System

86. At present, excise taxes are imposed on four groups of products in Ukraine – alcoholic beverages, tobacco, petroleum products, and jewelry. In addition, vehicles are subject to a range of special taxes which may also be considered under this heading, and there are number of additional special “duties” (quasi-excise) taxes that have been imposed recently for various purposes. We shall consider each of these groups separately, with most emphasis on the first three – the ATF (alcohol, tobacco, fuel) products – that invariably account for most excise revenues in most countries.

87. As Table 2 shows, Ukraine is no exception to this rule. In 2001, when excises accounted for 5.0 percent of consolidated budgetary revenue (6.0 percent of state budget revenue) and 1.3 percent of GDP, 99 percent of STA excise revenue came from the ATF group, with 61.8 percent from alcoholic products, 26.9 percent from tobacco products, and 9.8 percent from petroleum products. The single most important revenue producer was distilled spirits, followed by cigarettes, with beer, wine, and motor fuel accounting for most of the rest. This pattern seems fairly constant in recent years. The 2002 budget, for example, estimated that total excise collections would be UAH 3478.2 million, with 22.3 percent coming from imports and the balance from domestic goods. Spirits accounted for 24.4 percent of excise revenues, tobacco for 17.8 percent, gasoline for 12.9 percent, other oil products and beer for 7 percent each, wine for 4.3 percent, and jewelry for only 0.6 percent.

88. Table 3 sets out a selection of excise tax rates prevailing in 2002. Many of these rates were increased in 2000 or 2001, although the rate on unfiltered cigarettes was actually lowered by 50 percent in 2001. There are actually 57 different (non-zero) rate categories specified in the law, compared to the 12 shown in Table 3, although many specified rates on different commodities are identical. Three characteristics of this rate structure deserve notice: first, most rates of excise tax are specific in nature; second, some rates are stated in foreign currency (Euros); and, third, there are considerable variations in rate by type of specific product within broad groups of products. Each of these features may or may not make sense, depending upon exactly what is done.

89. Specific rates, for example, have two principal advantages: they are easier to administer and, to the extent taxes are rationalized on non-fiscal grounds, they are easier to target (e.g., to alcohol content or pollution). Their principal disadvantage is in terms of equity: if, for example, cheap local cigarettes are consumed mainly by low-income

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18 The Law of Ukraine No.195 of October 24, 2002 On Introducing Amendments to Some Laws of Ukraine on Taxation, Production and Turnover of Excisable Goods takes into account some of the points discussed below. In particular, the excise duty has been raised for denatured ethyl alcohol, malt beer, engine gasoline, and diesel fuel. The excise duty on jewelry items has been abolished. This law also bans refunds of excise duty or a part of it to payers (or granting subsidies from a local budget, or in another manner) located on the territory of a respective territorial community.
smokers and expensive foreign cigarettes mainly by high-income smokers, the effective rate of a specific tax on cigarettes will be much higher on the cheaper brand. Primarily for administrative reasons, in 1996 Ukraine changed most of its previous ad valorem rates to specific rates. On the other hand, specific rates are obviously vulnerable to erosion through inflation and hence need periodic adjustment if effective rates are to be maintained. It is presumably for this reason that most specific rates were increased in 2000 or 2001.

Table 2. Excise Taxes in Ukraine, 1999-2001

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>1787.6</td>
<td>2239.7***</td>
<td>2654.2***</td>
</tr>
<tr>
<td>Total collected by STA, which:</td>
<td>1695.6</td>
<td>1947.8</td>
<td>2243.2</td>
</tr>
<tr>
<td>Alcohol</td>
<td>103.5</td>
<td>53.0</td>
<td>74.3</td>
</tr>
<tr>
<td>Spirits</td>
<td>541.6</td>
<td>778.4</td>
<td>917.7</td>
</tr>
<tr>
<td>Wine</td>
<td>81.7</td>
<td>101.1</td>
<td>160.1</td>
</tr>
<tr>
<td>Beer</td>
<td>84.2</td>
<td>136.8</td>
<td>236.3</td>
</tr>
<tr>
<td>Tobacco</td>
<td>524.5</td>
<td>453.6</td>
<td>603.0</td>
</tr>
<tr>
<td>Vehicles*</td>
<td>1.9</td>
<td>4.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Petrol</td>
<td>202.6</td>
<td>308.1</td>
<td>159.4</td>
</tr>
<tr>
<td>Oil products</td>
<td>90.6</td>
<td>79.5</td>
<td>61.0</td>
</tr>
<tr>
<td>Jewelry</td>
<td>n.a.</td>
<td>20.2**</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

* Excludes motorcycles and bicycles

** This figure is taken from Table 4. It is not included in the total for STA shown for 2000 in part because the other revenue figures shown in Table 4, although close to those provided in this table, are, with the exception of the figure for beer, not identical.

*** These figures exclude UAH 1,030.6 million in excise taxes earmarked to the Pension Fund of Ukraine in 2000. See text discussion. Source: State Tax Administration.

90. An alternative way to deal with this problem is to state the rates not in national currency but in some (presumably more stable) foreign currency. This procedure, used in Ukraine for petroleum and vehicle taxes, adjusts for inflation to the extent that exchange rates do. In the long run, this is perhaps not a bad approximation although it may not always work very well in the short run.

91. Finally, rate variations may reflect “targeting” considerations, as mentioned above, or they may, on the contrary, be used to provide protection for domestic production (as seems to be the case with respect to unfiltered cigarettes) or to attempt to achieve some distributional goal, as is perhaps in part true with respect to automobiles. In addition to the excise tax imposed on the purchase of vehicles, an annual tax is also

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19 With respect to filter cigarettes, for example, a 40% ad valorem excise was replaced by a specific levy of 2 ECU/1000.
levied – for example, on passenger cars of from UAH 3 to UAH 40 per 100 cc. of engine
displacement, depending on engine size, and on cargo vehicles at rates of UAH 10 to 12
per 100 cc.

Table 3. Selected Excise Tax Rates, 2002

<table>
<thead>
<tr>
<th>Product</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cigarettes without filter</td>
<td>5UAH/1000 units</td>
</tr>
<tr>
<td>Cigarettes with filter</td>
<td>10UAH/1000 units</td>
</tr>
<tr>
<td>Natural grape wines</td>
<td>0.8UAH/liter</td>
</tr>
<tr>
<td>Sparkling wines</td>
<td>1.6UAH/liter</td>
</tr>
<tr>
<td>Vermouths</td>
<td>2.6UAH/liter</td>
</tr>
<tr>
<td>Ethyl alcohol</td>
<td>17.4UAH/liter</td>
</tr>
<tr>
<td>Beer</td>
<td>0.23UAH/liter</td>
</tr>
<tr>
<td>Petrol</td>
<td>Euro 30/1000 kg.</td>
</tr>
<tr>
<td>Vehicles, new, engine less than 1000 cc</td>
<td>Euro 0.2/cc</td>
</tr>
<tr>
<td>Used less than 5 years, engine less than 1500 cc</td>
<td>Euro 0.4/cc</td>
</tr>
<tr>
<td>Used, more than 5 years, engine less than 1500 cc</td>
<td>Euro 0.6cc</td>
</tr>
<tr>
<td>Jewelry</td>
<td>Na</td>
</tr>
</tbody>
</table>

92. From time to time different excises, or “quasi-excises,” have been imposed on a
variety of products, usually to meet specific revenue needs. In 1998, for example, a
variety of small excise taxes were imposed on such items as caviar, leather clothes,
microwave ovens, CDs, color TVs, and so on in an attempt to boost revenues. These
minor excises were abolished in 2000.

93. However, the much more important set of excises established to fund “pension”
arrears in 1998 continue to exist. A 1 percent levy is imposed on the purchase or sale of
foreign currency, on sales of domestically-produced automobiles, on jewelry (except
wedding rings) containing gold, platinum, and precious stones, on cellular phones, on the
sale of cars, on the production and import of tobacco products, and on real estate
transactions to fund the payment of pension arrears. These taxes are now earmarked
(Art. 8 (11) of 2002 State Budget Law) simply for “payment of pensions.” In 2000, UAH
1,030.6 million, or 7.4 percent of the revenues of the Pension Fund came from this
source, compared to only UAH 701.1 million from the employees’ portion of the payroll
tax and 11,415.5 million UAH from the employers. Since total excises reported in
budgetary accounts for that year were only UAH 2,239 million, the “pension” excises are
far from insignificant, amounting to an additional 0.5 percent of GDP or, if these
revenues are added to excise taxes, a total from excises of 7.9 percent of budgetary
revenue and 1.8 percent of GDP.

20 Taking into consideration Law of Ukraine No.195 of October 24, 2002 On Introducing Amendments to
Some Laws of Ukraine on Taxation, Production and Turnover of Excisable Goods.
21 PADCO/USAID, Analysis of the Financial Statements of the Pension Fund of Ukraine for Calendar Year
2000.
94. There are a good many exemptions from excise taxes other than exports, including:

- Special purpose vehicles such as militia and ambulances;
- Agricultural products (e.g. tobacco) when exchanged for products of other sectors;
- Enterprises in Free Economic Zones and Special Investment Regimes;
- Alcohol used by domestic producers in the medical sector or for manufacturing purposes;
- Domestically produced vehicles.
- Under the vehicle tax, in addition to vehicles used by public transport enterprises, and other organizations funded by the national budget, veterans, the elderly, and disabled persons are exempted.

95. As suggested by some of these items, as well as by certain aspects of the rate structure, at least to some extent excise taxes appear to have been used as an instrument for industrial and sectoral policy.

96. Finally, it should be noted that the picture is further complicated because the yearly budget laws have often targeted some excise taxes to finance specific expenditures or levels of government, in the context of inter-governmental finance. In particular, 50 percent of the excise on domestic goods (other than on oil products and transportation means) paid by taxpayers located in the Autonomous Republic of Crimea goes to the budget of that entity. In addition, 50 percent of the excises on both imported and domestically-produced oil products and transportation means are earmarked for development and maintenance of the road network (Art. 32 (3), 2002 State Budget Law) The annual vehicle taxes mentioned earlier are also earmarked, with Kyiv City keeping all such taxes collected there, Crimea, Simferpol City and oblast capital cities keeping 50 percent, with 20 percent of these amounts being in turn passed on to the relevant cities, towns and villages in which the taxed vehicles are registered.

Reform of Excise Taxes

97. While information on tax bases and effective tax rates is hard to find for excises, fortunately this question has recently been studied carefully for Ukraine, as shown in Table 4. As shown there, the effective rate of excise tax varies considerably within product groups (alcohol) and also between products (compare tobacco and petroleum products). It is unlikely this situation has altered much since 2000. Two observations may be made about these effective excise rates.

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22 Crimea has, it might be argued, seriously abused this provision by exempting local distilleries from “its” excise, hence distorting competitive conditions.

23 Note that these calculations do not take into account the substantial excises that are allocated to the payment of pension obligations, which were eliminated only at the beginning of 2003.
Table 4. Effective Excise Tax Rates, 2000

<table>
<thead>
<tr>
<th>Revenues (millions)</th>
<th>Rate</th>
<th>Estimated Base (millions)</th>
<th>Effective Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spirits</td>
<td>778.4</td>
<td>16UAH/liter</td>
<td>48.6 liters</td>
</tr>
<tr>
<td>Wine</td>
<td>101.1</td>
<td>0.8UAH/liter</td>
<td>126.3 liters</td>
</tr>
<tr>
<td>Beer</td>
<td>136.8</td>
<td>0.14UAH/liter</td>
<td>977.1 liters</td>
</tr>
<tr>
<td>Alcoholic beverages</td>
<td>1016.3</td>
<td>0.88UAH/liter</td>
<td>1152.2 liters</td>
</tr>
<tr>
<td>Tobacco</td>
<td>453.6</td>
<td>10UAH/1000</td>
<td>44.7</td>
</tr>
<tr>
<td>Jewelry</td>
<td>20.2</td>
<td>55%</td>
<td>36.8 UAH</td>
</tr>
<tr>
<td>Petroleum</td>
<td>362.4</td>
<td></td>
<td>4.4 tons</td>
</tr>
<tr>
<td>Gasoline</td>
<td></td>
<td>218UAH/liter</td>
<td></td>
</tr>
<tr>
<td>Diesel</td>
<td></td>
<td>54.4UAH/liter</td>
<td></td>
</tr>
<tr>
<td>Other oil products</td>
<td></td>
<td>109UAH/liter</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

(1) Tax bases are estimated as the ratio of collections to tax rate. For petroleum, a weighted average rate of 81.6UAH/liter is used, with weights reflecting percentage of consumption attributable to different products. It should be noted that this method of estimation does not allow for non-compliance (or any legal exemptions). It is thus the actual, not the potential, base that is estimated.

(2) Effective tax rates are calculated as percent of producers’ prices by taking ratio of consumption value to that value net of excise tax and subtracting from one.

(3) In 2000, average exchange rate was 5.44 UAH = 1.00 USD.


98. First, excise taxes in Ukraine appear to be relatively low in international terms. Gasoline taxes, for instance, were reported to be four times greater in Russia and six times greater in Poland. On the other hand, Ukrainian taxes on cigarettes appear to be closer to those in neighboring countries: in Latvia and Estonia, for example, cigarette excise taxes are estimated to be about 40 percent of the retail price. In Poland, the specific excise on cigarettes is Euro 13.14/1000 plus a 20 percent ad valorem excise. In Lithuania, however, the rate is only Euro 7.99/1000. All of these rates seem very low compared to the average rate prevailing in the European Union of 75 percent of retail price. 

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24 W. Thirsk, “Social Welfare and Indirect Tax Reform in Ukraine,” Kyiv, March 2002, p. 7. As indicated in the notes to Table 4, the effective rates calculated are those applying to products that are actually taxed and not the “average” rate applied to the product. For example, if 50 percent of cigarettes are smuggled and sold tax-free, the average rate on cigarettes (neglecting the costs of smuggling) would be half that shown in the table.

25 S. Cnossen, “How Should Tobacco be Taxed in EU-Accession Countries?” CES ifo Working Paper No. 539, August 2001, Table 3. Although this comparison is not too meaningful, since obviously incomes are much higher in the EU, the “real” effective excises applied in Ukraine (and perhaps the other transition countries mentioned) are of course even lower than they seem for the reason mentioned in the preceding note.
99. Second, to the extent one can believe the effective tax rates shown in Table 4, the marginal cost of raising additional funds from excises appears to be highest with respect to tobacco products and lowest with respect to petroleum products, which seem to be the most under-taxed items in Ukraine. Since survey data suggest that these two groups of products are surprisingly similar in terms of their income elasticity of demand, raising taxes on petroleum products and reducing them on tobacco products would thus seem to produce the same revenue, with roughly the same distributional consequences, and considerably less deadweight loss. Of course, this calculation leaves out of account externalities, tax evasion, administrative costs, and many other relevant factors, and hence perhaps should not be taken too seriously.

100. For example, externality considerations might lead the government to consider increasing taxes even on tobacco products, the most highly taxed excise sector in Ukraine, as has recently been recommended by the World Bank and the World Health Organization. For much the same reasons, consideration might perhaps be given to altering the taxes on alcohol to be based solely on alcohol content, as in Russia and many other countries. The present exemption of domestically-produced vehicles seems particularly undesirable. Not only are vehicle taxes usually the most progressive of all excises in their incidence and the most elastic in terms of revenue, but this exemption clearly has undesirable allocative effects, providing a high effective rate of protection and reducing the revenue base. As in the case of the VAT, a thorough review and revision of excise tax policy seems in order.

Excise Administration

101. As with all taxes, issues of excise tax reform require a careful balancing of efficiency, equity, and administrative considerations. As just discussed, there may be a case on both efficiency and equity grounds for higher excises in at least some sectors in Ukraine. What about administration? Ukrainian authorities have strongly resisted raising excise rates on the grounds that higher rates would encourage evasion and, in the end, weaken collections. In other words, their view seems to be that Ukraine is, if not already on the wrong side of the Laffer curve, then already at the revenue-maximizing point. This seems unlikely. Even where tax rates are (relatively) high, as with respect to tobacco, demand is relatively price inelastic (-0.4). Given the high importance of diesel (estimated to be 60 percent of all petroleum products) in Ukraine, a relatively low price elasticity also seems plausible in this low-taxed sector.

102. There do seem to be problems in raising excises in Ukraine, but they appear to be largely problems of administration, not of tax structure. As a recent study of tobacco taxes has shown, it is likely true that when smuggling provides 20 percent or more of domestic consumption, higher taxes are not enforceable. But, as the same study shows, where smuggling is this high, it is usually closely associated with a high level of

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26 See Thirsk, op. cit., for a detailed analysis.
perceived corruption. In other words, it may be true that the present Ukrainian tax administration is not capable of enforcing higher excise taxes. If so, however, this simply underlines the importance, stressed elsewhere in this report, of improving tax administration in general. Excise taxes are in principle and indeed in practice among the simplest of all taxes to enforce effectively. If a country cannot enforce reasonable levels of excise taxation on a few key products – essentially the ATF group – there is little hope that it can do much at all.

103. Specifically, Ukraine must change the archaic system, carried over from the previous regime, under which excise taxes only need to be paid when those who buy them from the producer or importer transfer payment to the bank account of the seller. It is this system that has led to the incredible situation of excise arrears with which Ukraine continues to struggle. In principle, excise taxes, like customs duties (and VAT and excises due on imports) should be paid before goods are released, and there should never be any arrears. Even though UAH 624.2 million in excise arrears were written off at the end of 2000 – an amount equal to 30 percent of excise collections in that year – and payment of another UAH 233 million was deferred—by the end of 2001 another UAH 217.5 million of excise arrears had accrued on the books of STA. To put this another way, about 8 percent of excises due in 2001 were not in fact collected. By general Ukrainian standards, this proportion may not appear that bad. But for excise taxes, which in principle should be collected before they leave the factory or the customs point, it is incredibly high. The need to adopt a good “warehouse” enforcement system for the critical excise products – and to simplify the system to concentrate on those products – seems clear.

104. If Ukraine needs revenue in the near future, it should definitely consider significantly increasing taxes on petroleum products and perhaps also on beer and wine. If it is considered that significant externalities exist with respect to tobacco usage, consideration might also be given to increases in that area. For all excise taxes, regular adjustments should be made in specific tax rates to ensure that effective rates do not decrease. Minor excise taxes such as those on jewelry and the various “excises” that flow to the Pension Fund should be abolished. Finally, a careful review should be made of existing excise administration to ensure it accords with international standards. In addition to establishing a standard excise “warehouse” system of control, other changes also seem required in this respect. For example, Ukraine, like some other countries, uses “strip stamps” (a paper seal covering the neck and cap) as a means of ensuring that excises are paid on distilled spirits. As a recent study observes, however, in practice this is a costly and ineffective way to enforce excises. Gadgets such as this can easily be

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29 D. Merriman et al., «How Big is the Worldwide Cigarette Smuggling Problem?» in P.Jha and F. Chaloupka, eds., *Tobacco Control in Developing Countries* (London: Oxford University Press, 2000). A recent study of smuggling in Ukraine estimates that smuggled tobacco constituted 12 percent of domestic consumption in 2002, compared to 30 percent in 2000. Some analysts attribute this decline to the decrease in excise rates, but this seems improbable unless the cost of smuggling has also risen in this time period for some reason or, alternatively, competitive pressure in the smuggling industry had already driven smuggling profits down to “normal” levels.

30 UAH 1.5 billion in excises on imported products were not collected in 2001. UAH 4.9 million of imports was written off earlier that year, and payment of another UAH 1.0 million was deferred.
circumvented if the administration is not vigilant, and they are not needed if it is.\textsuperscript{31} With excises, as with other taxes, there are no magic substitutes for good tax administration.

5. **ENTERPRISE PROFITS TAX**

105. Ukraine enacted the current Enterprise Profits Tax (EPT) in 1997.\textsuperscript{32} This tax was on the whole a quite broad based and relatively standard tax in terms of accepted Western practice. Since then, however, the tax design has been severely undermined by legislated breaks, and the simple forgiveness of tax debts. As Figure 1 shows, the EPT revenue performance as a percentage of GDP has been decreasing, although it still is around 4 percent of GDP. It is troublesome that base erosion is on the increase and that, reportedly, so are evasion and avoidance schemes.\textsuperscript{33} Given these circumstances and the recent tax amnesty, the future performance of the EPT is likely to deteriorate.

![Figure 1. Basic Parameters of EPT Collection (1997-2001)](image)

Change in arrears not available for 2001

106. The statutory EPT rate is a flat 30 percent today, but the average effective rate varies widely owing to the tax breaks and benefits that are targeted to specific sectors. As

\textsuperscript{31} International Tax and Investment Center, *Guidebook for the Taxation of Distilled Spirits* (n.d.).

\textsuperscript{32} This form of tax was first introduced by a decree of the Cabinet of Ministers in 1992, followed in 1994 by a law, which in turn was amended several times until the present law was adopted in 1997.

\textsuperscript{33} For example, to minimize their tax liabilities through transfer pricing, many Ukrainian companies began to work as offshore companies.
an example, the metallurgical sector was initially granted a tax rate of 9 percent, and subsequently raised to a rate of 15 percent. Many other sectors have also received special treatments to the point that the current EPT by sector (Figure 2) shows wide variance in terms of effective tax rates.

Figure 2. Effective Rates on Profits by Sectors

Source: Volodymyr Riaboshpyk, Cash flow statement as a tool for analysis of overall impact of tax burden, defaults and other factors upon production

107. Table 5 shows that EPT taxes paid by private enterprises were close to forty percent of total payments in 1998 and 1999, while those paid by public enterprises were 43 percent and 50 percent in 1998 and 1999, respectively. However, of these taxes, the part actually paid in cash came largely from private enterprises. Most payments by public enterprises (56 and 69 percent of this line item) took the form of tax offsets of claims (and other non-monetary settlements). The combined effect of tax offsets and arrears in the case of public enterprises signals a severe problem of public sector noncompliance.

108. To a considerable extent, this problem was concentrated in the energy and fuel sectors and, as noted earlier, appears to reflect more basic problems with public enterprise management, payments discipline, and pricing in Ukraine’s transitional economy. State-owned public enterprises and budget-dependent activities have a different profile and nature than enterprises working for profit. To a large extent, their losses reflect, in the best of cases, their key role as providers of jobs in important regions of the country. This is a public sector management problem with tax and fiscal repercussions.
Such problems cannot be solved from the tax side and require a wider more comprehensive approach. Unfortunately for the tax system, however, the legislative and administrative responses to these problems to date have resulted in serious fiscal distortions. Specifically, several laws were enacted to forgive tax arrears and special regimes were introduced that in effect exclude from EPT a number of enterprises.

Table 5. Breakdown of EPT Collection by Type of Taxpayers

<table>
<thead>
<tr>
<th></th>
<th>Total EPT Collected</th>
<th>Cash Payments</th>
<th>Offsetting Claims</th>
<th>Arrears</th>
<th>Over Payment Arrears</th>
<th>Net Arrears</th>
<th>Increase in Net Arrears</th>
<th>Estimation of EPT Accrued</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>1998</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-owned enterprises</td>
<td>42.7</td>
<td>29.1</td>
<td>55.7</td>
<td>61.4</td>
<td>30.6</td>
<td>91.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private enterprises</td>
<td>39.0</td>
<td>39.8</td>
<td>38.2</td>
<td>18.9</td>
<td>43.9</td>
<td>-5.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indefinite type of ownership</td>
<td>18.3</td>
<td>31.1</td>
<td>6.1</td>
<td>19.7</td>
<td>25.7</td>
<td>13.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>1999</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State-owned enterprises</td>
<td>50.6</td>
<td>36.3</td>
<td>68.8</td>
<td>62.9</td>
<td>23.1</td>
<td>78.5</td>
<td>51.0</td>
<td>50.7</td>
</tr>
<tr>
<td>Private enterprises</td>
<td>38.1</td>
<td>48.2</td>
<td>25.3</td>
<td>23.9</td>
<td>56.5</td>
<td>11.0</td>
<td>36.1</td>
<td>37.7</td>
</tr>
<tr>
<td>Indefinite type of ownership</td>
<td>11.3</td>
<td>15.6</td>
<td>5.8</td>
<td>13.2</td>
<td>20.4</td>
<td>10.4</td>
<td>12.9</td>
<td>11.6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Share by type of taxpayer (in percent)

|                  | 1998                |               |                   |         |                      |             |                        |                           |
|                  |                     |               |                   |         |                      |             |                        |                           |
| **State-owned enterprises** | 42.7               | 29.1          | 55.7              | 61.4    | 30.6                 | 91.3        |                        |                           |
| **Private enterprises**     | 39.0               | 39.8          | 38.2              | 18.9    | 43.9                 | -5.3        |                        |                           |
| **Indefinite type of ownership** | 18.3             | 31.1          | 6.1               | 19.7    | 25.7                 | 13.9        |                        |                           |
| **TOTAL**          | **100.0**           | **100.0**     | **100.0**         | **100.0**      | **100.0**       | **100.0**   |                        |                           |

Share of payment concept (in percent)

|                  | 1998                |               |                   |         |                      |             |                        |                           |
|                  |                     |               |                   |         |                      |             |                        |                           |
| **State-owned enterprises** | 10.0               | 33.2          | 66.8              | 34.6    | 8.5                  | 26.2        |                        |                           |
| **Private enterprises**     | 100.0              | 49.8          | 50.2              | 11.7    | 13.3                 | -1.7        |                        |                           |
| **Indefinite type of ownership** | 100.0           | 82.9          | 17.1              | 26.0    | 16.7                 | 9.3         |                        |                           |
| **TOTAL**          | **100.0**           | **48.8**      | **51.2**          | **24.1** | **11.9**            | **12.3**    |                        |                           |

|                  | 1999                |               |                   |         |                      |             |                        |                           |
|                  |                     |               |                   |         |                      |             |                        |                           |
| **State-owned enterprises** | 100.0              | 40.1          | 59.9              | 47.9    | 5.0                  | 42.9        | 27.3                   | 127.3                     |
| **Private enterprises**     | 100.0              | 70.7          | 29.3              | 24.1    | 16.1                 | 8.0         | 25.7                   | 125.7                     |
| **Indefinite type of ownership** | 100.0            | 77.2          | 22.8              | 45.2    | 19.6                 | 25.6        | 31.1                   | 131.1                     |
| **TOTAL**          | **100.0**           | **55.9**      | **44.1**          | **38.5** | **10.9**            | **27.7**    | **27.1**               | **127.10**                |

109. Ukraine’s EPT has been in such a state of flux that it is hard to analyze. What is clear, however, is that it now diverges substantially from general standards defining
profits taxes around the world. As a consequence of the fragmented legal changes that it has undergone, the current EPT has a relatively low level of generality and a high level of complexity, arising largely from explicit exclusions of tax base and taxpayers. As noted in Chapter 8, the recently enacted special regime that allows relatively small taxpayers to choose between the normal EPT and a simplified tax may make matters worse.

Structure and Problems

110. In principle, EPT is a global income tax for residents and a source income tax for non-residents. The EPT definition of taxpayers includes all legal entities doing business for profit including affiliate offices and representative branches and non-governmental enterprises funded from the budget. The definition of business taxpayers does not include physical persons engaged in business activities—entrepreneurs not registered as legal persons. An important direction for reform in Ukraine is to apply the same rules for determining profits regardless of the legal classification of taxpayers. We shall return to this point in Chapter 6.

111. EPT taxpayers can opt to pay a consolidated tax or maintain a branch-based payment. An important and complicating feature of the EPT is that it is a quarterly, not an annual, tax thus multiplying by a factor of four the compliance and administrative burden. For example, there is a quarterly loss carry forward. The current proposals to eliminate this feature of the tax are thus to be applauded.

112. Until recently, EPT was essentially a national tax. The implementation of the special simplified regime, however, has not only transferred to local governments the amounts paid by those entering the system but also allowed these governments to set business tax rates (admittedly, only for individuals). Who gets how much from business taxation thus now depends upon how many taxpayers qualify and opt for the new system.

113. Among the special tax bases singled out in EPT are incomes from transactions that include barter, insurance, foreign exchange operations, operations with affiliated persons, securities and derivative trading operations, joint operations on Ukraine's territory without forming legal entities, dividends, operations with debt claims and liabilities, income resulting from the performance of long-term contractual obligations, non-profit institutions and organizations, enterprises belonging to volunteer disabled persons' organizations, and innovation centers entered in the National Register.

114. Some of these cases indeed merit special treatment in terms of the proper definition of a tax base. Insurance, for example, is an instance in which the special nature—multi-year—activity of insurance justifies ways to estimate bases in ways that report very low income bases contradicting the long-term reality of insurance activities. Others, however, such as the “disabled” enterprises and the provisions for non-profits are clearly simply tax incentives (tax expenditures) and inevitably tempt taxpayers to artificially create situations that fit the softened tax base concept.

115. Agricultural producers have a separate inflation adjustment procedure: Gross revenues and costs of agricultural manufacturers are adjusted monthly based on the official inflation index until the end of the taxable year. Moreover, the income tax accrued is reduced by the amount of land tax paid on agricultural production turnover. The first of these provisions substantially complicates administration. The second makes
no logical sense: land tax is properly a deduction in computing net income, but it is not an appropriate deduction from income tax. This treatment does not apply to enterprises specializing in the output and/or sales of certain products.\textsuperscript{34}

116. As with special incomes, deductible costs include many elements that distort the notion of cost and hence the measurement of the tax base for EPT. An important example is the deduction of up to 4 percent for contributions to non-profit organizations. To avoid abuse, any desired degree of fiscal favoritism to charitable contributions should not be part of the definition of the tax base but should rather take the form of a limited tax credit, as discussed later with respect to tax expenditures in general. On the other hand, some expenses that represent the ordinary course of business are currently subject to detailed and sometimes inappropriate limitations.

117. Deductions follow the general pattern of Western models. However, depreciation rules seem to be arbitrary in the case of accelerated depreciation. Depreciation rules are set for fixed assets (that is, those with useful life above a year) as a way to impute the cost of the use of capital.\textsuperscript{35} The rules are straightforward and quite standard. They contemplate an inflation adjustment of the asset value. In addition, however, they provide, at the taxpayer's option, accelerated depreciation of 80 percent of the asset value in the first four years. This latter feature seems unwarranted given the provision to adjust for inflation, and it may generate substantial fiscal losses that will then have to be carried forward and reduce future revenues.

118. According to the law, "if a resident taxpayer registers a negative value of the taxation object, such book losses may be carried forward to subsequent accounting periods within five tax years from the year of their occurrence and the object of taxation shall be reduced accordingly over these five years." In addition, the rules provide quarterly inflation adjustments to losses being carried forward. This approach is understandable in a system that contemplates (although partially), inflation adjustments to tax bases. Given the enormous amount of losses in the recent past, however, this provision may become a very costly feature of EPT and should be monitored closely. Table 6 presents an estimate of the yearly profits and the losses that remain in the system.

\textsuperscript{34} Ornamental gardening, wild plants, wild animals and birds, fish (except fish caught in rivers and isolated reservoirs), furs and fur garments, wines and spirits, beer, material for wine production (except such material meant for further treatment), which enterprises shall be taxed according to the general regime. Most agricultural producers are in fact subject to a fixed tax in lieu of EPT and other taxes, as discussed in Chapter 8.

\textsuperscript{35} Some have criticized the present depreciation deductions as inadequate to “replace” capital investment. The purpose of these deductions is simply to write-off (as an offset to current income) an appropriate proportion of the costs of assets used to produce that income. It may be appropriate – especially when inflation is significant – to adjust that cost for changes in current price levels to ensure that the write-off is approximately of the right amount in current price terms, but this is a very different matter indeed from so-called “replacement cost depreciation” which attempts to adjust not for general price-level movements but for specific asset-price changes. Such adjustments cannot realistically be made.
Table 6. Profits and Losses as Percent of GDP

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<tbody>
<tr>
<td>Base</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit of Profitable Enterprises</td>
<td>21</td>
<td>19</td>
<td>21</td>
<td>18</td>
<td>n/a</td>
</tr>
<tr>
<td>Losses of Loss-making Enterprises</td>
<td>-9</td>
<td>-17</td>
<td>-19</td>
<td>-11</td>
<td>n/a</td>
</tr>
</tbody>
</table>

n/a: not available

119. As has already been noted several times, arrears have been a major problem in the recent history of Ukrainian public finances, and their recurrent forgiveness and rescheduling (Table 7) has likely done much to create a culture of nonpayment in Ukraine.

Table 7. EPT Tax Arrears, Forgiveness and Rescheduling 1997-2001

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<tbody>
<tr>
<td>Arrears forgiveness</td>
<td>2.1</td>
<td>0.3</td>
<td>0.6</td>
<td>2.4</td>
<td>7.2</td>
</tr>
<tr>
<td>Arrears rescheduling</td>
<td>3.5</td>
<td>0.9</td>
<td>0.9</td>
<td>0.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Change in arrears</td>
<td>0.0</td>
<td>1.1</td>
<td>0.8</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Stock of arrears</td>
<td>0.4</td>
<td>1.4</td>
<td>1.9</td>
<td>1.9</td>
<td></td>
</tr>
</tbody>
</table>

120. An important problem with the EPT is that its establishment preceded the adoption of normal financial accounting standards. The socialist accounting system was based in a different set of values whereby the only value was produced through labor in material goods. All other activities were not productive and therefore, "valueless". In addition, the concept of accrual was not understood in the application of tax accounting. Cash was the dominant basis of accounting both by taxpayers and tax officials.

121. In this historical context, STA fiscal controls used audit techniques that were not in line with financial accounting audit techniques but more the reflection of a "police state" harassing citizens on the basis of presumed obligations. The emphasis was more on matters related to bookkeeping than on accounting principles that were largely unknown to the new group of auditors in charge of monitoring evasion. With the subsequent enactment of financial accounting, taxpayers started keeping two sets of books to comply with the law. Indeed, if they were foreign companies, they usually have to keep three sets of books. With such a system, compliance costs are high, and non-compliance is difficult to detect.

Some Possible Reforms

122. The basic level of technical quality of the original EPT was good, but it has been damaged by the large quantity of partial reforms that respond to pressures from particular
interest groups. The task now is to reconstruct the tax as an orderly and self-contained system. To keep it that way, it is important to avoid regulatory delegation as much as possible. The administrative environment for the improved legal mandate also needs to be improved. A better policy framework and legal design would make administration relatively easier, but close attention to administration per se is nonetheless necessary for better results and improved compliance.

123. An important change that might be considered is to exclude legal persons from the definition of small taxpayers. As discussed in Chapter 8, the coexistence of two separate business tax regimes is unnecessary and leads to confusion and undesirable misclassification. In addition, entrepreneurial income should generally be determined as in the EPT law. There is no need for separate rules in the PIT law (which at present permits no “business” deductions). If the base of the two taxes is more unified, the EPT rate should logically be set at a level close to the top PIT rate. Costs/expenses that are not business related should of course not be deducted as part of netting the tax base. At present, allowable gross expenses include items (charitable contributions, sums transferred to the budget) that do not fit the general rules of necessity or “relation of causality” and proportionality between expense and income. Such items, if included at all, should be treated as discussed in Chapter 7 below. On the other hand, some expenses, such as on public relations and marketing, that are necessary are now disallowed. Such expenses should be allowable, though perhaps within predetermined limits. The general rule should be that all income and expenditure transactions are on the basis of accrual unless expressly established otherwise. A general comprehensive rule on valuing barter situations is also needed, as is an appropriate framework for dealing with transfer pricing issues in general. In addition, to reduce compliance costs (and the enormous misunderstanding that seems at present to prevail on all sides about accounting issues and procedures), both the law and STA practice should move closer to financial accounting as the way to measure profits. Special “tax accounting” (as the term is now used in Ukraine) should be restricted to establishing limits for those cases in which there is uncontrollable risk of evasion and fraud. Along the same lines, the period for the EPT should be annual, not quarterly. Quarterly payments should be based on estimated income, subject to (inflation-adjusted) minimums set by the previous year.

124. At present, there is strong pressure to open the tax system to promote nonprofit organizations (NPOs). While understandable in terms of encouraging the development of civil society, the problem with such a blanket approach is that the whole EPT may be put at risk, since it would be all too easy for enterprises to recharacterize themselves as NPOs. It is thus critical that any NPO rules should establish clear limits, impose formal reporting obligations, and ensure transparent fiscal accounting. NPO’s must have a clear exempt purpose, specified in the law. Entities that produce profits in their economic cycle but are legally created not for profit, (that is, are exempt for policy reasons) should have an ordinary base netting process to get to net income like all other taxpayers.\textsuperscript{36} Income related to non-exempt activities should be taxed.

\textsuperscript{36} In December 2002 the Supreme Council of Ukraine adopted the Law of Ukraine “On Introducing Amendments to the Law of Ukraine “On the Taxation of Enterprise Profit”, which introduces number of changes that improve the current legislation. Some provisions became effective January 2003 (revision of the term “normal price” to taxpayers’ benefit; deduction of losses accumulated in the previous periods from taxable income in the following periods until entirely paid off, etc.) while the others are to become effective
6. PERSONAL INCOME TAX

125. The personal income tax (PIT) was established in 1993. Since then, 11 changes have occurred, 5 of them during the year 2000. As with other taxes, base erosion appears to be the main structural problem. The recent introduction (see Chapter 8) of a simplified regime permitting taxpayers with incomes below UAH 500,000 to exit the general system may allow a great number of taxpayers to opt out of the general income tax. Nonetheless, most current public discussion about personal income tax continues to focus on the alleged convenience of a flat rate rather than the much more critical issue of the potential disappearance of much of the tax base.

126. This issue is especially important because PIT is not only an important source of revenue for Ukraine's budget but also the only major tax that has demonstrated any income elasticity in recent years. Admittedly, this buoyancy may largely reflect the non-indexation of brackets (since the “non-taxable minimum” has not been changed since 1998). Nonetheless, the question remains: should PIT take a leading role in the revenue structure? In 1997 Ukraine appeared to have opted for a strong VAT as the main revenue engine, but developments since then have placed more emphasis on the revenue role of the PIT. If designed properly, i.e., taxing personal income at the right rate and base, PIT could indeed prove a useful instrument to provide inter-personal equity in addition to being a major revenue source without the distorting impact of the EPT on business decisions.

PIT Rates

127. Of course, the right level of a tax rate, particularly one as visible as the PIT, is a political decision that varies from country to country and from time to time within a country. If the rate is perceived to be “right” in a fundamental political sense, an important collateral effect should be to reduce pressures to decrease the tax base. In Ukraine, eroding the tax base seems to have been the main defense of taxpayers against PIT.

128. Incomes Received at the Place of Regular Work. Incomes received at the place of regular (main) work are payments received by individuals from enterprises, institutions, and organizations under all forms of ownership, as well as from natural persons acting as business entities, in respect to which these citizens act as employees. Aggregate taxable income also includes material and social benefits in cash and in kind, granted by employers, except for certain specific items not included in the aggregate taxable income. Those subject to this tax must be on an employer's official payroll, and all required deductions must be made to the social insurance fund.

129. Income tax brackets for the income received at the regular work place are defined in terms of “non-taxable income” (NTI, currently 17 UAH per month) as follows:

January 2004 (reduction of income tax rate from 30% to 25%; quarterly payments of EPT; simplification of tax reporting, some changes in depreciation policy, etc.).

On the other hand, perhaps a few persons who are now “off the books” may choose to reveal themselves to the authorities now that they can avoid the rigors of the regular tax system.
These rates are very high on what are really quite low incomes. The minimum wage (July 2002) was only 165 UAH a month, or 9.7 NTI, so even a minimum wage earner was taxed at 15 percent. Wage-earners receiving as little as 21,000 UAH a year (less than $US4,000) are subject to the maximum rate. The effective rate most probably is 12-13 percent.

130. **Incomes received from other sources** include payments for non-recurrent and other works done under contracts and other civil legal agreements, and revenues of natural persons from business activities. “Other” incomes (and incomes received by citizens without permanent residence in Ukraine) are initially taxed at a 20 percent rate and then included in the aggregate base to be taxed according to the progressive rates set out above. An odd feature is that royalties paid to heirs are taxed at twice the normal rates, although not above 70 percent.

131. The present PIT rates seem to be too high in the fundamental sense that the political and administrative structure of Ukraine appears to unwilling or unable to support them. One reason may be that in the case of salary income, PIT shares the base with a host of payroll related contributions including the Social Protection Fund, the Unemployment Fund, the Social Insurance Fund, and the fund for insurance of work injury and occupational diseases. Taxes on salary income already imposed by these social insurance agencies are substantial. The Pension Fund alone levies a tax of 33-37 percent on payrolls (32 percent on employers and 1-5 percent on employees, depending on sector and level. The total payroll tax can be higher than 40 percent. Moreover, the structure of these taxes – as is common with payroll taxes for social security around the world – is fundamentally regressive, since the maximum level subject to these rates is UAH 2200 per month. Given that PIT is also levied on payrolls for the most part, it seems essential to take the existence of these heavy additional taxes levied on much the same base into account in assessing the effects, whether on labor markets or in equity terms, of changes in the structure of the PIT. In 2000, for example, the Pension Fund alone received UAH 12.6 billion from contributions (11.4 billion from employers, 0.7

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38 Self-employed persons may receive benefits if they choose to pay premiums: the rates are 32% for the Pension Fund (PF), 3% for the Unemployment Fund, and 3% to the Social Insurance (Protection) Fund, or a total of 36%, which is not only less than the combined rate on payrolls but even less than the employer’s share. Natural persons who are under the simplified tax system may also join. It appears, although this is not clear, that they would be charged a “set tax” related to the single tax, the fixed agricultural tax, or the patent, as the case may be – which would seem to be even more favorable. The tax paid is divided between the Pension and Social Funds by the Treasury. As the pension fund data cited below suggest, there appear to be a not insignificant number of payments from the self-employed under these various regimes.

39 The law on a single insurance contribution (Art. 9.4) says that this maximum cannot exceed 5 times the average wage in the “national economy sectors” over the previous year and shall be indexed annually to the average wage. Note that the highest PIT rate takes effect at 1700UAH a month: there seems no reason to have these different cut-off levels.
from employees, 0.2 from fixed agricultural tax, and 0.3 from other flat taxes) compared to total reported PIT collections for the year of only UAH 6.4 billion.

132. As noted above, rate setting is to a considerable extent a political decision. From a technical perspective, it seems sensible to ensure that the minimum effective rate on the first bracket of taxable income is set high enough so that at least the marginal cost of processing the required paper is covered. Given how low the threshold is in Ukraine, this condition is not satisfied. Equally, there are clear administrative advantages in setting the top PIT rate equal (or close to) the EPT rate, both to reduce obvious opportunities for tax avoidance through sheltering income in enterprises and to simplify dividend taxation, if desired. (Dividends can be exempted since they have already been taxed at the top marginal rate.) Beyond that, revenue considerations and politics rule and little more can usefully be said here. It seems unlikely, however, that simply cutting the top marginal rate, as appears to be envisaged in the PIT reform currently under consideration, will do much. There seems little reason to reduce the top PIT rate much if at all below the EPT rate. At the same time, it would seem to be essential in the interests of restoring some minimal equity to this tax to allow for a larger non-taxable minimum. Doing so, for example, might reduce some of the pressure to reduce the rates of other taxes, such as the VAT.

PIT Base

133. PIT is, on paper, a global income tax for Ukrainian residents and a source tax for non-residents. Residents are those who lived in Ukraine for at least 183 calendar days during the taxable period. The definition of PIT payers includes private entrepreneurs.

134. The number of PIT taxpayers has grown to about 20 million in 2001, but only 1.7 million filed returns. Every year the Cabinet of Ministers sets a threshold for filing PIT returns in order to reduce the workload of STA: for example, those with aggregate income of less than 933UAH (three subsistence levels) were not required to file in 2002. As already mentioned, it seems clear that the threshold to enter the system (1 minimum wage) is too low. More and more minimum income persons are forced to declare in spite of the indexation of the income tax brackets (expressed in terms of minimum wage multiples).

135. The base of the PIT follows standard rules. Permanent residents in Ukraine pay on their aggregate taxable income received from any source in a calendar year, within and outside Ukraine. Nonresidents pay on incomes received from sources within Ukraine. Income includes incomes received in monetary form and in kind. Income in monetary form includes national and foreign currencies. Income in kind, in principle, is valued at market prices. Incomes received in foreign currencies are converted into Ukrainian UAH at the effective exchange rate of the National Bank of Ukraine on the date of income receipt. Income received by permanent residents outside Ukraine is included as part of the aggregate income taxable in Ukraine, with credit for taxes paid

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40 “Analysis of the Financial Statements of the Pension Fund of Ukraine for Calendar Year 2000” (PADCO/USAID). This draft report also estimated the number of contributors as at least 13.7 million, while noting that the Fund reported it was “much higher.” Current information is that there may be 16-18 million contributors, or approximately the same number as those registered as PIT payers.
abroad to prevent double taxation. If international treaties establish taxation rules other than those provided by the laws of Ukraine, the rules of the treaty have precedence.

136. With taxes as with many other things, however, the devil is in the details and the details are sometimes devilish. The details of the Ukrainian PIT start with a long list of itemized exclusions from income as shown in Table 8. The list contains many questionable items and some uncontrollable ones. The level of specificity is so detailed that administration becomes very difficult if not impossible. It is all too easy to mask one form of income as another that is excluded, and all too difficult to uncover such frauds.

137. In addition to excluding many items from income, the PIT law provides various itemized reductions of income. These reductions can be extended to other beneficiaries under a permanent authorization to the Cabinet of Ministers and to local governments. Local governments are also authorized to exempt individuals from the income tax within the calendar year. Reductions include lump sums up to a tax-free minimum NTI for over each complete month throughout the taxable period. An additional legally determined tax-free NTI is provided for the parents (guardians) of a child aged under 16, if the parent's monthly aggregate taxable income does exceed 10 NTI. Taxpayers affected by misfortune (war, Chernobyl tragedy, disabled individuals\(^{41}\)) can reduce their tax base by up to 5 tax-free NTI or in some cases up to 10 NTI in conjunction with other exclusions. Given the small size and un-indexed nature of the NTI, all these are very minor.

138. After the end of the calendar year taxpayers other than those receiving regular salary income are supposed to submit a tax declaration reporting aggregate income received from both regular work and other sources. The tax return is to be submitted by March 1 of the following year.

139. Records of income and expenses involved in generating these incomes have to be kept using the forms and following procedures established by tax authorities.\(^{42}\)

**Conclusions**

140. First, as noted earlier with respect to the EPT, the profits tax embedded in PIT should be determined in accordance with the general rules on profits in the enterprise profits tax – which themselves will, as noted in Chapter 5, have to be revised to accord more closely with business accounting. This will bring private entrepreneurs into the general business tax rather than either adapting special definitions or cross-referencing.

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41 Participants in the Great Patriotic war and other military operations in defense of the former USSR
* Servicemen/reservists with records of service in Soviet troops in Afghanistan and other countries
* People crippled since childhood and Group 1 and 2 invalids
* Citizens affected by the Chernobyl nuclear disaster and falling under Category 3 and 4
* Parents and surviving spouses of military servicemen killed in action, dead or missing in action;
* Citizens rehabilitated under the Law on the Rehabilitation of Victims of Political Purges in Ukraine

42 This requirement was recently removed for the “patent” taxpayers (see later discussion).
### Table 8. Exclusions from Income for Tax Purposes

- State social insurance indemnities and state social allowances, except temporary disability payments including: sick-child-care allowances; pregnancy and labor allowances; childbirth gratuity; child-care allowance; payments to mothers (fathers) with three and more children aged under 16; crippled child-care allowance; allowances for children under 16 (under 18, if enrolled in school); child-care allowances for single mothers; allowances for military servicemen children under trusteeship; temporary allowances for minors whose parents evade alimony; funeral expenses relief including legal assistance

- Alimonies paid

- Government pensions and additional voluntary pensions

- Most monetary compensations and reimbursements in kind

- Allowances, premiums, and other payments received by men and officers of the in the line of duty

- Sales of produce grown on personal plots, including honey, livestock, rabbits, nutria, and poultry, by both live and dead-weight

- Sums received by inheritance and as gifts, except royalties repeatedly received by legal successors to authors

- Interest, discount incomes and prizes under government bonds, monetary deposits, bearer savings certificates, wins at state lotteries, and Treasury bonds

- Revenues from the alienation of shares and other corporate rights acquired by citizens in the course of privatization, in return for privatization or compensation certificates, and when such shares and rights are acquired at cut rates and with their own money by workers of enterprises being privatized in line with Law of Ukraine 'On the Privatization of Property of State Enterprises'

- Sums received by citizens as per compulsory and voluntary insurance policies (except when premiums under accumulation insurance policies are made at the expense of enterprises, institutions, and organizations)

- Value of the charitable aid, including humanitarian aid received in the form of funds or property (work performed or service rendered free of charge) to the benefit of persons

- Sums received by citizens after placing their savings on current accounts at Ukraine's banks, including foreign currencies

- Sums of revenues directed to the sources of these incomes, in order to purchase stocks, and sums invested in reconstruction and production expansion projects being carried out by business entities;

- Limited to 4 per cent of the amount of declared taxable income, sums sent by taxpayers to charitable institutions and organizations

- Compensations received by workers/employees for crippling physical damage or other damage to their health incurred in the line of duty, as well as in the event of loss of the breadwinner

- Sums received by citizens as blood, breast milk, and other donors

- Cost of medical treatment, health resort and children's summer camp accommodations—except tourist-international arrangements

- Sums received by citizens from statistics authorities for keeping family budget records

- Sums of revenues received by persons engaged in agricultural and construction works in the countryside, either on temporary or seasonal basis, as well as by student construction teams working in the countryside

- Revenues received by workers of agricultural enterprises and fish farms, irrespective of the form of ownership and system of management, and collective fish farms [kolkhozes], provided revenues are in kind (e.g., as fish and products therefrom, except products listed by the Cabinet of Ministers of Ukraine).

- Payments for maintenance and education of children in nursery, general secondary and vocational schools and higher educational establishments in the territory of Ukraine at the expense of natural or legal persons

- Dividends taxable when being paid according to the Law of Ukraine "On Taxation of Incomes of Enterprises"

- Sums received by citizens in return for secondary raw materials (scrap paper and rags)

- Funds paid by individuals and legal entities to pension accounts opened in banks authorized by Kyivmiskbud holding company according to the Law of Ukraine "On Holding Experiment in Housing Construction on the Basis of Kyivmiskbud Holding Company"

- Funds paid to individuals according to the same law "On Holding Experiment in Housing Construction..." under pension deposit contracts concluded during the period of the said experiment

- Scholarships of the President of Ukraine received by promising talented sportsmen of Ukraine, champions of Olympic and Paralympic Games and scholarships of the International Olympic Committee, as well as the value of the movable and immovable property, and gifts transferred under their ownership

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141. **EPT definitions.** If profits presently part of PIT are made part of EPT they would be taxed proportionally, which is the correct way to tax business without penalizing efficiency with increasing marginal rates. Even if this is not done, as suggested earlier,
the top rate of the PIT should be kept close to the rate of the EPT and the results will be similar.

142. Secondly, as discussed in more detail in Chapter 8, the various special simplified regimes should be phased out before major damage to the level of collection and equity of PIT is done and the system collapses. At the very least, record-keeping for those that choose the patent system should be re-instated if only to check the thresholds.

143. Thirdly, as is discussed further in Chapter 7, all tax preferences should be grouped in one chapter of the law and, to the extent possible, defined as tax credits only.

144. Fourthly, if policy is that those who make more should pay more than proportionally, the tax should be progressive and all incomes consolidated into a global tax base. Only if incomes are to be taxed proportionately ("flat tax") would consolidation not be necessary. To avoid overloading the STA – and perhaps overtaxing the sophistication of taxpayers – it would likely be desirable in the immediate future to maintain the current system, under which only those who have income (above some threshold) from more than one source would be required to file returns.

**PIT and Payroll Taxes**

145. In addition to the STA, several other “controlling organs” exist in Ukraine with respect to tax matters. One is the State Customs Authority, as discussed briefly elsewhere with respect to VAT and excises. Two others are the Pension Fund and the Social Insurance Fund. In fact, there are at present three social insurance funds in addition to the Pension Fund: the Unemployment Fund, the Social Insurance Fund, and the fund for insurance of work injury and occupational diseases. Although there is a law for a single insurance contribution to mandatory state social insurance, which is apparently to take effect in 2003, at present it seems that all four of these funds collect their contributions/taxes separately. In addition, a proposal for a new system of state medical insurance, also to be funded by payroll taxes although with no precise rates yet specified, has also been floated recently, although it is perhaps unlikely to become law in the near future.

146. As noted above, the taxes already imposed by these social insurance agencies are substantial. In the circumstances, it might be advisable to consider the possibility of adopting a unified system for registering employers and persons for purposes of both social insurance and taxation. In addition, all these taxes, no matter what their earmarked destination, might be collected in the same way and at the same time. At present, it appears that an employer has to deal with up to four separate state agencies, all taxing payrolls in slightly different ways. With respect to Unemployment Insurance, for example, the basis for the contribution is defined precisely to be equal, for both employers and employees, to payment of labor remuneration “subject to the individual income tax” (Art. 19, Law on Compulsory State Unemployment Insurance, March 2, 1999). It should be noted that, unsurprisingly, social insurance contributions are usually clearly distinguished from taxes: for example, Art. 1 of the law on the single insurance contribution says explicitly that “the said contribution shall not be included in the taxation system, and the tax legislation shall not be applied to it (except for cases stipulated in this Law).” Nonetheless, if it looks like a payroll tax and it acts like a payroll tax, then in economic terms it is clearly a payroll tax, which is how it is treated here.
Surely, a simpler, less costly, system of administering this set of payroll taxes can be designed. We understand a pilot scheme is currently under way in several oblasts to determine if the Pension Fund can act as a sole collection agency, but it is not clear why these levies cannot, as in many countries, equally well be collected by the STA.

147. In this connection, it is perhaps worth noting also exactly how the payroll contributions are in fact collected. Essentially, these contributions are simply directed to the various funds by banks as part of the normal payroll process. An employer, for example, owes, say, UAH 1000 to an employee for a particular month. He will in fact pay UAH 1372 to the bank with respect to this amount, UAH 372 of which is to cover his contribution to the various funds. The bank will then pay (approximately) UAH 970, less PIT, to the employee after deducting his share of the contributions and remit 402 to the various funds. Two provisions with respect to this system are noteworthy (see Art.17 of the previously cited law, for example). [1] If the employer does not have funds sufficient to pay both salary and insurance premiums, they are charged on the salary and "transferred to the Fund on a pro rata basis." [2] If the bank does not remit contributions simultaneously with salary payment, "such banking institutions shall pay the amount of insurance premiums due to the Fund at their expense." Should these obligations not be met interest and penalties are chargeable for the Fund (Art. 38).

148. As noted in Chapter 4, the Pension Fund also at present receives substantial revenue from a set of miscellaneous excise taxes. These levies should clearly be eliminated, and doing so might provide an appropriate occasion to consider more carefully the design and administration of the various social insurance fund taxes as part of the general tax system. In this connection, finally, it should perhaps be noted that these high payroll taxes would seem to add to the general desirability of reducing direct taxes on labor in the official sector of the economy to reduce the stimulus to expand instead in the shadow economy. As noted in Chapter 3 a broader based and better functioning VAT is the key to tax reform in Ukraine: it will enable the rationalization of excises, the elimination of the PF excises, and the reduction of the high tax rates currently imposed on workers and businesses whose activities are not hidden or officially favoured in one way or another. By doing so, it will also reduce both the incentives to expand "shadow" activities and to seek ever more official favors.

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44 Art. 10.5 of the single contribution law says "while making a request for funds for remuneration of labor, employers shall submit to the bank orders for transferring the insurance contribution, without which the funds for the remuneration of labor shall not be issued."

45 Of course, evasion of these provisions is still simple: just pay one minimum salary to employee and attached pension and then pay another salary (without tax) under the table. Since the benefits received are essentially unrelated to the amount paid or the length of service, such practices are obviously attractive to both sides.
7. TAX EXPENDITURES

149. As has already been discussed, base erosion through tax expenditures is the single most important structural problem of the Ukrainian tax system. Despite the sharp decline in the official estimates of the share of tax exemptions, from 11.8 percent of GDP in 1998 to 4.1 percent in 2001, unless some fundamental changes are made in the tax policy process, they may soon rise in importance again, owing to both parliamentary and executive initiatives.

150. Five types of “tax expenditure” may be distinguished:

- Exempt or partially exempt bases, such as the income of servicemen under certain conditions;
- Exempt or partially exempt taxpayers such as agricultural producers, victims of the Chernobyl disaster;
- Exempt or partially exempt sectors such as construction, milk and meat related processing activities;
- Exempt or partially exempt geographical spaces such as special tax free economic zones;
- Reduced tax rates, special exemptions, deductions, etc.

In some instances, some of these options are combined, as in the case of the special regime created for small taxpayers discussed below.

151. New exemptions are usually introduced at the beginning of the budget period but have sometimes been created for the budget year even after the approval of the budget. Once established, exemptions tend to become permanent, and indeed in Ukraine they are often open-ended. Spatial exemptions, like free zones, are long-term “tax heavens” within the country created for 20 or 30 years. Almost invariably, tax expenditures, when as broadly drawn and loosely administered as in Ukraine, will reduce budget revenues.

152. In 1997, Ukraine revised both EPT and VAT, in general following standard European practices with few tax expenditures. Unfortunately, the process of base erosion started almost at once, with 10 amendments to the VAT law, 9 amendments to the EPT law, and various amendments related to other taxes in 1998. According to Ministry of Finance estimates, the budget lost about UAH 0.5 billion as a result. In 1999, 4 laws introduced after budget approval accounted for budget losses close to UAH 2 billion.\footnote{46 - Law (December 11, 1998) “On amendments to some Laws of Ukraine on excise and customs duties and procedures of excise payments” – losses: 500 million
2000, of the 45 laws on taxation introduced, 26 included tax expenditures. One law alone (April 20, 2000 “On the temporary regulation of taxation for production and sale of crude oil and combustibles and lubricant”) reduced budget revenues by UAH 1.5 billion.47

153. The lack of coherence characteristic of the tax policy process was well illustrated in 2001. Two weeks after approving the budget law (which prohibited the write-off and restructuring of tax arrears accumulated after January 1, 2000), the Verkhovna Rada adopted the Law “On procedure for payments of tax obligations to the budget and state earmarked funds.” Article 18 of this law has been estimated to result in losses to the budget of UAH 14 billion (including penalties and fees forgone), because it allows the write-off and restructuring tax arrears for the period January 1, 1999 to January 1, 2001.

154. The Ministry of Finance made a very first approach to calculate tax expenditures (Table 9).48 Calculations for VAT, EPT, Excise and Land tax were done based on the statistical form 13-pp that is initial form used by enterprises to report on tax exemptions in accordance with the budget classification. As far as PIT is concerned, there is no reliable data on the lowest level that could be aggregated in the way similar to the 13-pp form. Elaboration of such filing procedure is being designed and is to envisage further obligatory reporting. Hence, calculation for PIT was done based on budget statistics.

Table 9. Tax Expenditures, 1998-2002

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002 (est.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT</td>
<td>3.78</td>
<td>5.25</td>
<td>3.50</td>
<td>4.39</td>
<td>5.46</td>
</tr>
<tr>
<td>Enterprise Profit Tax</td>
<td>0.82</td>
<td>1.26</td>
<td>2.70</td>
<td>2.50</td>
<td>1.69</td>
</tr>
<tr>
<td>Excises</td>
<td>0.06</td>
<td>0.08</td>
<td>0.15</td>
<td>0.08</td>
<td>0.08</td>
</tr>
<tr>
<td>Land tax</td>
<td>0.93</td>
<td>1.00</td>
<td>0.87</td>
<td>1.03</td>
<td>1.24</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>n/a</td>
<td>n/a</td>
<td>0.45</td>
<td>0.58</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Tax Expenditures total</strong></td>
<td>5.86</td>
<td>7.79</td>
<td>7.46</td>
<td>8.11</td>
<td>8.48</td>
</tr>
<tr>
<td><strong>Tax Expenditures total as % of GDP</strong></td>
<td>5.71</td>
<td>6.00</td>
<td>4.40</td>
<td>4.00</td>
<td>3.90</td>
</tr>
<tr>
<td>GDP actual, billion UAH</td>
<td>102.59</td>
<td>130.42</td>
<td>170.07</td>
<td>204.19</td>
<td>218*</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

155. Estimates of tax expenditures fiscal cost necessarily involve some subjectivity in classification. That is, it is necessary to separate technical exclusions (like zero rated

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47 As of February 2002, there had been 81 amendments to the VAT law and 65 to the EPT law, although not all created tax expenditures.

48 It should be noted, however, that these estimates are a first cut and may include some items that would not really be considered “tax expenditures.” Other items, disguised preferential treatments hidden in the “netting” process, for example, are not included. Exemptions of intermediate goods in VAT may well end up increasing revenue through cascading. As work on this progresses, such issues will be addressed to allow an improved assessment of tax expenditures.
VAT on exports) from tax expenditures (like exemptions to agricultural producers). Some categories may fall in a middle ground. For instance, many countries around the world offer some tax exemptions to NGOs; whether this should be considered a tax expenditure remains a matter of considerable debate among experts. Also, there are double counting problems with databases like form 13-pp, which can only be solved by hard work, estimation, educated guesses and ultimately improvement of data collection and tax policy. In spite of imperfect calculations, the fact that the problem of tax expenditures is now being recognized is an important step towards clarifying their extent and reducing them. At the same time, there are still some improvements to be made in terms of implementing a proper methodology for tax expenditures estimation. (Annex Tables 18-21 provide the latest methodology being used in Ukraine).

156. Key exemptions in VAT are for sales and importation of medicines and goods of medical purposes, for sales of newly constructed buildings to physical persons, and an array of exemptions in the agricultural sector. None of these exemptions appear defensible on the basis of good taxation practices, nor equity. Pharmaceutical exemptions may represent a giveaway of public funds to pharmaceutical companies as there is no strong evidence that the tax break is passed on to consumers through lower prices. Assistance for construction of houses cannot be poverty targeted, since poor households can hardly afford to purchase new homes. Finally, the system of VAT in agriculture appears highly complex and distortionary, with raw material producers benefiting from tax exemptions, zero rating and agro-processors paying their VAT into a special account to be used for investment purposes.

157. In the past, EPT exemptions were also a major leakage of budgetary revenues. However, amendments to the EPT law passed late in 2002 eliminated the lion’s share of EPT exemptions. The current draft of the PIT law in Parliament, admirably, would also eliminate the remaining PIT tax expenditures. Further efforts are needed beyond addressing VAT and PIT exemptions. Together, exemptions represented within the excise, land tax, import duties, and “other” taxes, are also significant.

Problems Arising from Tax Exemptions

158. Base erosion may be a potential time bomb in the Ukrainian fiscal system if the political process creates and recreates tax expenditures. The inclusion of items that are really tax expenditures as part of the standard accounting concepts damages the integrity of the tax system. By distorting tax returns, tax expenditures can undermine the ability of tax administration to structure its audit system to check taxpayers based on financial indicators. In addition, tax expenditures may not only facilitate tax evasion, but also create incentives for corruption. Once a tax expenditure enters the system, it may subsequently be enlarged through lax interpretation beyond original legal intent. The present array of tax concessions may also serve to defeat the system of self-assessment.

49 The Ministry of Finance estimates that EPT exemptions will represent less than 250 million UAH of tax expenditures. While consideration should be given to removing the remaining exemptions also, this clearly represents a serious effort to clean up the system.
because it does not incorporate the necessary administrative systems, safeguards or approaches to support it.\(^{50}\)

159. Extensive use of exemptions and privileges destroy the credibility of the tax system and encourage a culture of lobbying for concessions, in which the structure of taxation is overly politicized. There is no obvious solution to such problems in a political environment that has demonstrated its preference for using the tax system as a means of managing its political constituency. The danger of the collapse of revenue with continued proliferation of such measures means that a solution must be found. The political problem thus needs to be addressed. Awareness of the problems and dynamics of tax expenditures should be promoted within the government and among Parliament members. Recognizing that some tax incentives schemes will mostly likely continue to exist and/or be legislated in Ukraine’s future, it is critical to structure them as well as possible.

**How to Limit the Problems**

160. Tax economists as a rule do not favor tax incentives, for good reasons. Either they are redundant and ineffective, forgoing revenue and complicating the tax system without adding to capital formation, or else they are distorting and inefficient, directing investment into less than optimal channels. In view of the difficulty of assessing the effectiveness of tax concessions and the ease with which they may be perverted to benefit special interests, as a rule even the best-designed tax incentive is likely to be a useful tool of public policy only when a country has not only a stable macroeconomic environment but also a stable political and administrative system. Nonetheless, many countries like Ukraine that clearly do not satisfy these conditions continue to have recourse to fiscal incentives for investment. To maximize the likelihood of beneficial results and to reduce the damage that may be caused in these circumstances by poorly-designed and implemented incentives, it is critical to follow three simple rules:

161. Keep it Simple. Complex fiscal incentives are unlikely to produce desirable results at reasonable cost and are likely to be conducive to evasion and corruption. Any tax incentives should therefore be few in number and simple in structure. In particular, it is important to treat incentives separately from the normal determination of tax bases and to provide them as much as possible only in the form of tax credits, that is, as explicit offsets to taxes that would otherwise be assessed. Detailed, costly and complex attempts to divert private investment into pre-selected channels should be avoided.

\(^{50}\) A system of self-assessment is the means of transferring responsibility to taxpayers as the foundation of a system of voluntary compliance. Taxpayers complete returns, assess the tax liable, file and pay without intervention by the tax authority. The tax authority accepts the return on face value and conducts any checks or verification after payment, and on the basis of selection based on risk. While such a modern system should be a long term goal, it needs significant change to be used effectively. It requires a culture of mutual trust and cooperation, support through simple laws, record keeping, personal service, automated systems and data accumulation and analysis, and safeguards through sophisticated audit approaches based on risk assessment, technical competence to reveal and recognize tax planning, evasion and avoidance, and sanctions and penalties to deter and punish where required. This is not the current situation in Ukraine and it is doubtful that either the administration or the community is fully ready for the change required by this approach.
162. Keep Records. No matter what incentives are created, clear records should be kept as to who receives them, for how long, at what cost in revenue foregone, and with what results in terms of investment, employment, and so on. Clear procedures need to be in place to follow up the results of any incentives granted.

163. Evaluate the Results. At regular intervals—say annually or at most every three or five years—analyze the data to assess whether the incentive is worthwhile and if it is not, eliminate it. Incentives that do not seem to be achieving their desired objectives in an efficient and effective fashion should be withdrawn.

164. Right now, in Ukraine, tax expenditures seem to be thought of by many to be costless. Certainly, they have been legislated almost at random in a generous way, with no subsequent evaluation mandated. At the legislative level, it is essential to estimate the individual fiscal cost of tax expenditures and make the whole a part of the annual budget allocation decision (a so-called tax expenditure budget). This exercise should be accompanied by the anticipated revenue reduction. Ideally, funds “spent” through specific tax concessions should be allocated in the same way as direct expenditures, that is, attributed to a certain budgetary expenditure heading and reported and treated like any other outlay. The result would certainly be to reduce the number of tax expenditures.

165. Additionally, the Government should clarify its priorities and funds which should be available to implement proper measures to support these priorities. Government should elaborate a tax expenditures budget based on these priorities. Government also should use the tax expenditures budget in its dialogue with the Parliament during approval of the annual budget. Discussion on the tax expenditures budget should be conducted in framework of budget process before approval of total revenues and total expenditures. Government should clearly explain to the Parliament the purpose of introduction of a tax expenditure, and what is the perspective for its implementation in the future. It should be a mutual understanding that tax expenditure is a measure introduced for limited period of time.

166. After agreement on the tax expenditure budget is reached it should be a part of the Budget law and any attempts of introduction of new tax expenditures during the budget year should be done through amendments to the Budget law only.

167. Another way to set limits might be to impose a ceiling on the combined effect of tax expenditures, so that, for example, all tax expenditures combined cannot reduce taxes by more than x%. Such an approach – in effect, a “minimum tax” – is not uncommon in developed countries. In Ukraine, it would be necessary to take the current system of tracking exemptions one step further and define the ceilings in the tax forms.

168. Those who benefit from tax expenditures should file normal tax returns. All tax breaks should explicitly be made part of the tax declaration even if they make it more complex. It makes no sense to hide real complexity by disregarding it as an ingredient in the declaration process. In addition to the form declaring taxable bases, a form identifying and measuring the impact of the tax break at the taxpayer level should be mandatory.

169. These forms could then be used to help electronically define audits of beneficiaries claiming tax expenditure benefits, in contrast to the more usual
administrative approach of ignoring taxpayers with huge benefits because of the misconceived view that there is no additional revenue to be obtained from them.

170. Distortions caused by the defining tax expenditures as part of the list of standard accounting concepts lead to unnecessary divergences between tax reporting and financial accounting results and damage the perception that the tax administration has of the taxpayer. As a result, audit targeting becomes blurred because indicators are distorted. Tax expenditures in effect may stop auditors from deepening their investigations, or choosing the most promising investigations, and thus may contribute to expansion of tax expenditures beyond the levels contemplated by law. Furthermore, the existence of tax expenditures increases the level of discretion of tax auditors and creates bargaining situations—hence the risk of corrupt arrangements—which should be avoided. Such weakening of the tax administration is an important, but hidden, cost of tax incentives.\footnote{Audit targeting refers to audit selection based on aggregate performance indicators. Clearly, selection of under-performers for audit, may simply reveal that the selected taxpayers are exempt or privileged. This leads to a waste of enforcement resources.}

**Special Economic Zones**

171. To illustrate some of the points just made, consider the case of the special territorial tax concessions. Up to now, Ukraine has established 20 special zones. Eleven of these are “Free Zones” (FZ), sometimes called “free economic zones, ten created by law and one (FZ Interport Kovel) by presidential decree. Nine are “Territories of Priority Development” (TPD), seven created by law and two (TPD Shostka city in Sumska oblast and TPD Cheningviska oblast) by presidential decree.

172. Both types of zone have the following tax privileges:

- Free import of raw materials, equipment, and spare parts for own needs for five years.
- No VAT on raw materials, equipment and spare parts for own needs for up to five years.
- No EPT for the first three years, and a 50 percent reduction in EPT for the next three years. (Some FZ – Port Crimea, Interport Kovel, Donetsk, Azov, Reni, Zakarpatty – have an EPT rate of 20 percent.)
- No payment to unemployment fund.
- No land tax.

In addition, Free Zones are free of all export and excise duties on exports of goods produced or processed in the FZ.

173. As of January 2002, 16 of these special zones (eight FZ and eight TPD) were actually in operation. The total cumulative revenue forgone was estimated at UAH 987.2\footnote{Surveys frequently report that investors cite a stable and honest tax administration as an important factor encouraging investment. When the administration is discretionary and suspected of being corrupt, they favor tax holidays in large part as a means of avoiding having to deal with it.}
million, of which UAH 574.5 million was incurred for 2001 – or over one percent of tax revenues in that year. Most of the estimated revenue cost was attributable to the TPD, which accounted for UAH 790.2 million or 84.4 percent of the total. By far the most important single zone was the TPD of Donetsk oblast, which accounted for UAH 672.4 million or 71.8 percent of the total estimated revenue loss, followed by the FZ Syvash, which accounted for UAH 113.8 million, or 12.2 percent. By tax, most was VATforgone (UAH 559.5 million): for 2001, the VAT cost of the zones was UAH 321.8 million (or about 3 percent of VAT revenues in that year).

174. The principal stated reason for creating these zones has been to attract foreign direct investment. The high concentration of revenue losses in the Donetsk basin suggests that their major role may instead have been to serve as a prop for the maintenance of some of the older industrial structure of this region. In any case, not only is there little or no evidence that such policies have been effective in attracting FDI to less favored regions in any country, but there is considerable evidence that such discretionary and non-transparent policies are readily conducive both to corruption and to reducing substantially the effectiveness of tax administration in general. This is not helped by the dual accountabilities of the tax administration and customs. For example, SCA exempts goods at the border on the presentation of evidence of registration in a tax free zone, but the STA is responsible for detecting abuses. 53 Creating such “on-shore tax havens” in a country in which there is already a huge underground economy inevitably adds substantially to the difficulty of enforcing taxes fairly and effectively.

8. THE “SIMPLIFIED” TAX REGIME

175. Throughout the world, governments have attempted to deal with small taxpayers by establishing alternative sets of rules of taxation. The usual argument is that the complexity of the tax system means that it has to be simplified for those not sophisticated enough to follow and comply with the general tax law and basic accounting. Small taxpayer regimes for farming and for small business are thus usually conceived as a way to mitigate the procedural complexities of the general tax system. In practice, however, experience has shown that this approach, when not properly designed and administered, can produce unfortunate results:

- Initially, size (focusing on the small) is usually the stated motivation for the establishment of a special regime. Once the system is in place, however, those who are in the system, may end up staying even as they grow.

- Secondly, the initial focus on reducing procedural complexity, often is never really achieved, and tends to fade. In practice, the main attraction for many simply becomes the (generally lower) level of tax rates. Indeed, in some cases, pressure builds for expansion of the thresholds.

- Finally, what results is almost always a complex system supported by a strong political constituency that fights to preserve and expand it.

53 Customs and the tax administration have jointly developed the rules for this activity.
Some countries that have followed this approach, such as Argentina, Mexico, and Turkey, have eroded their effective tax bases substantially. Firms often reorient themselves to fit within the rules of the tax scheme, which in addition to eroding the tax base, tends to be distortive at the cost of productive efficiency. As a rule, such erosion has occurred only gradually, both because it takes time for taxpayers to become fully aware of the option and to adjust their individual situation (e.g., to appear to be "smaller"), and also because over time legislation tends to include taxpayers at higher threshold levels. Thus, great care is needed in the operation of a small taxpayers regime.

The Situation in Ukraine

Typically, the introduction of special tax regimes for small business and entrepreneurs seeks to simplify rules and to create an environment favorable to the growth of smaller enterprises. Indeed, genuine small businesses, either potential or in operation, in Ukraine certainly have good reason to dislike the tax system and its administration. The formal legal barriers to new entrepreneurial ventures are high, and the cost of complying with taxes and regulations are substantial. Moreover, carry-over practices of the previous “command system” into today’s tax administration has made tax inspectors a specter to be feared by the business community. It is thus understandable that there has been substantial pressure, within the country and from international donors and advisors, to free small business from some of these burdens. Thus, the current special regime designed for small and medium-size business taxation in Ukraine represents an interesting experiment to allow growth of small businesses and formalization of their activities based on smaller formal and financial tax obligations. The information presented below suggests that to some degree the reform has been successful. However, the specific design of the system should be improved in terms of both compliance and administration, to make it more compatible with the traditional tax system. This is particularly important because the simplified system seems to introduce risks of tax base erosion.

The simplified tax system (unified/single tax) was established by Presidential decree in 1998 (On Simplified System of Taxation, Registration and Reporting of Small Business Entities) but came into full effect only in 2000. The system is applied differently for individuals and enterprises. Both are based on a threshold and a maximum number of employees. For natural persons subject to PIT, the parameters are 500,000 UAH and a maximum of 15 employees. For legal entities subject to EPT the respective parameters are 1 million UAH and 50 employees. For PIT, physical persons are taxed at fixed rates set for different activities by local councils, within the range of UAH 20-200 per month (less than USD 50-500 per year). The rates and eligible activities are set by local authorities and may differ among territories. With respect to VAT, two options are available. The first is a combined income and VAT rate of 10 percent on sales (turnover) tax as a proxy for both taxes. The second alternative is a 6 percent tax rate applied on sales (turnover) tax as the proxy income tax. In this case the taxpayer has the right to issue receipts and apply credits as a normal VAT payer.

Of course, other, more developed, countries such as France and Spain have operated simplified systems more successfully. We think, however, that Ukraine is, unless great care is exercised, more likely to emulate the unfortunate Latin American models mentioned in the text.
179. The new simplified system allows persons to be simultaneously wage earners (normal taxpayers) and private entrepreneurs for "moonlighting" purposes. Scattered evidence suggests that well-informed liberal professions (lawyers, engineers and consultants) as well as many wage earners are converting to private "entrepreneurs" to benefit from the tax. However, as mentioned above, there are limits, which vary by community, on the activities qualified for the simplified regime. The end result, however, is that the rules that apply to this system may vary even between two neighboring quarters within a city.

180. Other “simplified” systems are in operation. A “patent” is available for small traders as defined by the Law of Ukraine “On patenting of some types of entrepreneurial activities”. This option may be used by those whose annual gross revenue from entrepreneurial activities are up to 1 million UAH for the period of the 12 months preceding granting of the patent. Gross revenue includes total sales and other income. There are also patents for household services and the gambling business. There are other special regimes introduced in such specific areas as agriculture. A 1998 Law “On Fixed Agricultural Tax” of 12/17/1998 applies to agricultural enterprises including food processors so long as such sales do not exceed 50 percent of gross revenues. The rates are based on estimated land values per hectare as established in the land cadastre and vary by the type of land between 0.1 percent and 0.5 percent. The tax is paid quarterly, and 30 percent of its proceeds go to local budgets. It seems likely that both the fall in the number of land taxpayers and the stagnation in collections from this source in 1999—see Chapter 9—may be attributed, at least in part, to the introduction of the simplified tax.

181. The underlying logic of the simplified taxation is that one tax replaces a number of taxes in order to simplify compliance and administration. In particular, the unified tax substitutes for EPT (for legal entities), PIT (for natural persons), VAT (under 6% scheme), land tax, payments to the social insurance fund, Pension fund, Fund of Social protection of disabled, Unemployment fund, municipal tax, and others. Under the simplified system, participants (and family members involved in the business) appear to be exempted from labor reimbursement fund, handicraft tax, social compulsory insurance duty, and duty to Social Protection of Disabled Persons Fund. They are also not obliged to buy the trade patent and are not subject to licensing.

182. The fixed agricultural tax introduced by the Law of Ukraine "On Fixed Agricultural Tax" replaced 11 taxes (EPT, land tax, communal tax, tax on vehicles owners, tax on exploration work, payment to Chernobyl Fund, payment to Insurance Fund, payment for renovation and repair of the automobile road, payment to Pension Fund, payment to Innovation Fund, trade patent, and payment for use of natural resources). The special trade patent replaced 13 taxes (PIT, EPT, excluding dividends, interests, royalty, etc., land tax, payments to the social insurance fund, Pension fund, and others).

183. However, the variety of options available to small and medium businesses may also suggest that the system is not so simple and may complicate enforcement and administration of the simplified regime.

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55 / Law "On Patenting Certain Types of Business Activities" (98/96-VR).
The data presented below demonstrates that simplified tax regimes are very attractive to entrepreneurs. Their revenue share in the budget grew from 0.3% of GDP in 1999 to 0.7% in 2001 (Table 10). The number of subjects under and the revenues produced by the unified/single tax have grown substantially since 1999. On the other hand, the number of patents issued has decreased and number of fixed tax payers has remained almost stagnant. The growth of the simplified tax has been accompanied by the growth of the total number of small companies. Further, there is a positive trend in the number of large and medium enterprises under the system in 1998-2001 (Table 11).

### Table 10. Subjects of Entrepreneurial Activities and Revenue from Special Regimes of Taxation

<table>
<thead>
<tr>
<th>Year</th>
<th>Unified/Single tax</th>
<th>Special Trade Patent</th>
<th>Fixed Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of subjects</td>
<td>Revenues to consolidated budget from unified tax</td>
<td>Number of patents purchased (units)</td>
</tr>
<tr>
<td></td>
<td>Legal entities ('000)</td>
<td>Natural persons('000)</td>
<td>Legal entities (mln UAH)</td>
</tr>
<tr>
<td>1999</td>
<td>28.6</td>
<td>66.1</td>
<td>66.3</td>
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<tr>
<td>2000</td>
<td>66.6</td>
<td>182</td>
<td>348.69</td>
</tr>
<tr>
<td>2001</td>
<td>91.7</td>
<td>345.1</td>
<td>619.83</td>
</tr>
</tbody>
</table>

### Table 11. Enterprises Considered Entrepreneurial Activities in Ukraine by Size in 1998-2001

<table>
<thead>
<tr>
<th></th>
<th>Total number of companies</th>
<th>Including</th>
<th></th>
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<tr>
<td></td>
<td>units</td>
<td>in % total number</td>
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<td>1998*</td>
<td>211082</td>
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<td>17.8</td>
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<tr>
<td>1999*</td>
<td>234032</td>
<td>36905</td>
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<tr>
<td>2000**</td>
<td>263066</td>
<td>45136</td>
<td>17.2</td>
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<tr>
<td>2001**</td>
<td>279275</td>
<td>45668</td>
<td>16.4</td>
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</table>

*Small enterprises defined according to the Decree of the President #456/98 of 05/12/98 "On state support of small entrepreneurship". They have annual average number of employees is not higher than 50 people and annual revenue does not exceed 1 mln UAH

** Small enterprises defined according to the Law of Ukraine #2063-III of 10/19/2000 "On state support of small entrepreneurship". They have annual average number of employees is not higher than 50 people and annual gross profit does not exceed 500 thousands euro

### Evaluation of the Simplified System

Several issues can be identified in the current approach to the taxation of small businesses and entrepreneurs. It was noted earlier, for example, that the backbone of Ukraine’s tax system is the VAT. The simplified system, however, creates a major
problem for VAT in that the 10 percent simplified regime breaks the VAT chain at a relatively high threshold. Many transactions are thus legally outside the VAT system. Invoices issued on the purchases of these taxpayers by regular VAT sellers are worthless to them—but may of course be used by other taxpayers if sellers agree to issue them in their name - a practice that seems likely to emerge in Ukraine, given the large shadow economy. Invoices issued by taxpayers who take the 10 percent option cannot be credited by purchasers. This, however, is less of a problem as the inability to credit these purchases would probably be reflected in the purchase price.

186. On the other hand, maintaining the chain in the case of the 6 percent regime brings all of the VAT complexity to the small taxpayer and implicitly assumes that these taxpayers have the sophistication needed to comply with the common VAT regime. This approach is inconsistent with the notion of simplicity that inspired the system. It makes little sense to consider a person capable of VAT and incapable of income tax compliance in the same article of a law.

187. In the case of wage earners, the simplified regime generally reduces the amount of social security contributions as part of labor costs to their employers. Given the possibility to substantially reduce the tax burden provided by the simplified system, this creates an incentive to drop out of the payroll even at the expense of losing some social security benefits. This may be particularly true for young workers who do not think of old age as a real possibility and can in this way defer their contributions until later. If this were to happen, both PIT and social security protection erode. Still, the simplified taxation provides the opportunity to remain in the formal system and not to “exit” completely, which is certainly a worst option.

188. For those who remain in the PIT system, the dual connection—simultaneously being a wage earner (normal) taxpayer and a private entrepreneur for "moonlighting" purposes—allows taxpayers to keep their social security contributions and benefits while having a very low rate on marginal income. In terms of tax administration, the system demands additional work because of the additional required registrations and returns.

189. Given the magnitudes involved, the simplified regime, if not properly applied, creates important risks of migration to the least expensive system within the parameters of the law. The substantial initial threshold created for individuals blurs the focus on the small taxpayers, as almost all PIT payers in principle are eligible (in terms of “turnover”), provided they can change their “employee” status. This also favors higher-income people, given the types of moonlighting activities for which they may qualify. It is estimated that over 90 percent of natural persons are below the income range selected as the dividing line. This threshold was about 3000 times the (annual) minimum wage in 2000, when the system was created, and about 2500 times that level in 2002. Although comparisons with the minimum wage are not accurate (since expenses are included into the threshold) the potential of shifting between systems would seem to exist. Having said that, there is no current evidence that such a trend exists since PIT collection has not

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56 The text refers to “entrepreneurs” subject to this tax. Entrepreneurs are supposed to pay 50 percent of the single tax to which they are subject for each person they employ. In addition, it should be noted that the “single tax” is distributed as follows: 43% to the local budget, 42% to pension fund, 11% to social security fund, and 4% to unemployment fund. The issue here, however, is not whether the pension fund gets its share but whether the tax thus shared is the “right” amount.
decreased as a ratio to GDP. Again, this may be helped by the fact that local authorities can define eligible activities, which limits the activities eligible for simplified taxation. The cost, however, may be a wide dispersion in the conditions that apply throughout the country, and the economic distortions that this may imply.

190. It seems contradictory to include formally created enterprises (legal entities) in a regime created for small “informal” businesses. To do so amounts to “informalizing” for tax purposes, what at the taxpayer's initiative, has already been formalized for other purposes. To establish a legal entity requires at least two key formal steps, preparing a statutory document and opening accounting books. In addition, legal entities are obliged to register in the local (rayon) business registry as well as with the STA and the social security system. Once in operation, small and medium-size taxpayers are required to pay and register quarterly. If they do not reregister, they automatically go back to the formal system. All these steps imply the existence of a minimum business capacity well above that of a really small individual private entrepreneur. Moreover, the system of control would not seem to be compatible with the objective of reducing the scope of interference of the tax authorities.

- From a compliance perspective, areas for improvement include the following:
- Ensure that the legislative definitions of employment income, and those to whom the system applies, limit migration to the extent possible;
- Ensure that penalty provisions are adequate to deter misuse (see Chapter 10);
- Accept self-assessment (as opposed to the system of registration and quarterly re-registration into the system) and develop standards by business category in order to spot check those whose turnover level seems abnormal;
- Conduct a quick desk audit or field audit (in relation to existing registrants transferring to the system) to ensure legitimacy, and accumulate relative data on prior year’s income in order to establish revenue forgone.

191. As the simplified system covers PIT, EPT and VAT, each of which are administered in separate divisions of STA, a cross-divisional working group in headquarters should develop a national plan (policy and actions), including service and audit approaches and data requirements.

192. Finally, as established in Ukraine, the “simplified” system(s) paradoxically seems to ignore the real needs of small taxpayers. Small private individual entrepreneurs may have great expertise in their own trade (butchers, bakers, plumbers, carpenters, mechanics, etc.) but may not be good at book-keeping and financial management. Such entrepreneurs should have a system that helps them easily solve their tax problems without the need to incur compliance costs related to professional services for filing returns and keeping records. At the same time, they should be encouraged to “grow” out of this system and into the normal tax system. Ukrainian small business undoubtedly welcomed the new system because it simplified their compliance costs and eliminated some opportunities for rent-seeking by tax inspectors. In addition, it probably lowered their tax rates (whether designed with that goal in mind or not). But this does not mean it
is a good system. Rather, for the reasons suggested above, it is a system that can be substantially improved to the benefit of both taxpayers and the public sector.

Possible Solutions

193. Given the complexity of Ukrainian tax law and the onerous administrative system, it is clear that truly small taxpayers should not face the full complexity of the law and that avenues to reduce or solve their problems need to be established. It is also clear, however, that medium and large taxpayers should assume their proper tax liabilities and should not be given an easy way out. Also, inasmuch as the special regimes may have been introduced to reduce the interference of the tax administration, their design should be considered transitory and due priority should be given to improvements in compliance and enforcement practices.

194. A first recommendation is to apply the regime only to natural persons. In the long-term, legal entities should not be permitted to escape the normal tax system. As in many other countries, small legal entities should be allowed simplified accounting and reporting instead. The required legislative changes would have to be introduced.

195. Second, it is important to establish an appropriate level of turnover at which a natural person may be considered a small taxpayer. The threshold for registration under this system needs much more careful study than it seems to have received. Different thresholds for different kinds of activities might be considered.

196. Third, in order to “grow” the tax base over time, it is essential to have small regime taxpayers grow and enter the standard system. To achieve this objective it is important to keep the effective rates applied to such taxpayers in ranges similar to those of the regular system. A small taxpayers system should not be simply a tax break but rather a real mechanism for simplifying and encouraging tax compliance. For this reason, the system should have a proportional rate (in effect, a low-rate tax on estimated turnover) rather than be a lump-sum tax, whose strong “notch” effect blocks the normal evolution from “small” to normal taxpayer. To facilitate such transitions, it would be most useful if, in addition to the turnover requirement, a standard level of profitability by sector (presumptive income) were established and published, and a simplified form based on the required record of expenditures and revenues filed. When the estimated profitability exceeded a threshold amount, the taxpayer would be moved into the regular system and taxed accordingly. Those who wished to file regular income tax returns, claiming expenses and deductions according to the law, would of course have that option.

197. Fourth, the rules for entering and leaving the system should be part of its definition. To take the example of VAT, once taxpayers achieve a given threshold, they should become part of the VAT system. Situations should be avoided in which the threshold (i.e., the level of sales) is increased over time, taxpayers should be allowed a period of sales above the threshold (say three VAT periods), and then be obliged to enter the ordinary system for VAT and income taxes. Thought should also be given to the unification of the thresholds for VAT and simplified tax eligibility. This, however, would require finding an adequate balance between the low VAT threshold and the high simplified taxation threshold and cannot be implemented as matters stand now.
198. Fifth, rather than waiting for taxpayers to come to STA to renew their registration, STA in coordination with local authorities should establish a monitoring mechanism to check that simplified taxpayers have correctly chosen their classification and also to help them prepare for entering the normal system once the parameters have been passed, with stiff penalties for non-compliance.

199. Sixth, to truly simplify taxation in a revised design, the requirement of quarterly re-registration should be eliminated and replaced by an adequate system of auditing.

200. Finally, even for the smallest taxpayer, minimum bookkeeping standards should be established such as a registered book of gross revenues (incomes) and one of expenditures. Such a basis is needed to ensure that, when ready, they can move more easily to the next stage of “tax citizenship”. This will also provide a starting point for the administration to determine more easily when that day has arrived.

9. LOCAL FINANCE AND LAND AND PROPERTY TAXES

201. Although Ukraine has a unitary system of government, it has 27 regional or oblast level governments (including the Crimean Republic and the Cities of Kiev (Kyiv) and Sevastapol, which have oblast status), as well as close to 500 rayon (district) governments, almost as many municipalities, and many settlements and villages. Rayons and cities are subordinated to oblasts which are in turn subordinated to the central government. On the other hand, the lower levels of local government are controlled by locally-elected councils (radas).

202. There is essentially no significant local tax autonomy in Ukraine, with almost all local revenue coming from shares of national taxes on a derivation basis. However, since the adoption of the Budget Code in 2001, matters have improved in the sense that at least these shares are now fixed in principle rather than negotiated on a discretionary basis, as was the case in earlier years. Although a 1993 Cabinet of Ministers Decree No.56-93 On Local Taxes and Duties established a number of “local taxes”, none of these has much revenue potential and, as seen below, none produces much revenue. Moreover, these local taxes are administered by local tax offices of the national State Tax Administration.

203. All significant taxes on land and property in Ukraine thus remain essentially under central government control, even though in most cases the proceeds are channeled to local budgets on a derivation basis. This section first outlines the existing system of land and property taxation and then outlines briefly the proposed introduction of a real estate tax to replace many of the present local taxes.

Local Taxes

204. The only “local taxes and duties” currently affecting land and property in Ukraine are the following minor levies (share of local taxes in 2001 shown in parentheses, where available):

- Fee charged for permits to move into new apartments (0.05 percent).
• Hotel fees charged to persons who stay in hotels, motels, and other premises of residential type as well as to legal entities that rent hotel space (10 percent).

• Resort fees charged to persons who visit holiday resort areas (0.3 percent).

• Fees charged to legal entities for permission to establish facilities in densely-populated areas and to individuals who receive permission to build residential constructions in such areas. These fees are based on the size of the area used for construction purposes (6 percent).

• There is a similar fee charged to legal entities which operate in the central parts of densely populated areas and in buildings of historical or architectural value (negative receipts in 2001 because some localities reimbursed previous payments).

205. The largest local taxes are “communal taxes” (essentially a head tax, paid by employers) which yielded 30 percent of total local taxes, and market fees for traders (45 percent). In total, about UAH 0.5 billion – about 1 percent of consolidated budget revenues -- was collected for all local taxes and charges. The proposed Tax Code would have eliminated most of the minor taxes and fees.

State Taxes

206. Much more important are land payments and taxes imposed by the central government. Although both a land tax and a real estate tax are specifically enumerated as state taxes, at present the main tax imposed on land is the 1992 law On Payment for Land which imposes a tax on legal entities and physical persons who own or use land.

207. The main characteristics of this land tax are as follows:

• First, there is no tax on buildings as such (other than the small local fees noted above).

• Second, land tax rates vary depending upon the land is intended to be used in agriculture or not. Agricultural land is taxed at rates depending upon what it is used for – arable land and plantations or hayfields and pastures – and upon its fertility according to the land cadastre. Non-agricultural land is similarly taxed at different rates depending upon the category of the settlement – number of inhabitants—and its location within the settlement. Rates varied (in 1999) from

57 Parenthetically, it should perhaps be noted that Ukrainian statistics sometimes show “property taxes” as a revenue source. As a rule, this item refers solely to the taxes on vehicles discussed in Chapter 4. Land tax revenue is sometimes labeled as “royalties for use of natural resources.” The “fixed” taxes noted below are usually classified as “other tax revenues.”

58 Since 1996, there have been 30 amendments to this law. An interesting and potentially important recent provision is Art. 7.1.2 of a 2000 Law On Procedure for Satisfying Taxpayer Liabilities to the Budgets and Government Target Funds” (the “Payments Law”) which specifies that if no person responsible for paying taxes and charges on immovable property can be located, the taxes and charges may be “applied directly to objects of such property.”

59 The State Committee on Land Resources is responsible for land assessment.
UAH 0.015 (in localities with populations less than 200) to 0.21 per square meter (in cities over one million), or 1 percent of land valuation.\(^{60}\)

- Third, the tax is to be self-assessed and paid by legal entities by July 15. With respect to physical persons, for whom the tax is payable on August 15 and November 15, the tax is levied by the tax office.

- Fourth, exemptions include enterprises in the state sector as well as cultural, scientific, education and health care organizations and charitable foundations. Those subject to the fixed agricultural tax (see Chapter 8) are not subject to the land tax. In addition, land tax exemptions are often granted as part of the package of tax incentives (e.g. in “free zones”). The estimated revenue cost of land tax exemptions in 2000 was UAH 0.9 million or about 63 percent of land taxes collected.\(^{61}\)

- Fifth, in 2000, 168,411 land tax payees were registered with the State Tax Administration, of whom 149,537 (88.8 percent) actually filed tax declarations. The total land tax assessed in that year was UAH 1.6 million, compared to arrears of UAH 0.5 million (26 percent of total liabilities).\(^{62}\)

### Revenue Importance of Land Taxation

208. Table 12 shows for 1995-2000, the land tax collections and other information reported by the State Tax Administration which, as noted above, is responsible for collecting all local taxes also. Table 13 places the land tax (still based of course on the STA data) in the context of all government revenues and GDP for 1998-2000. Finally, Table 14 shows the importance of all the taxes mentioned above in local budgets in 2000 and 2001.

209. These tables show clearly that taxes on land and property are not very important in Ukraine. An additional important piece of information is that total resources managed by local governments accounted (in 1998) for 14.4 percent of GDP and 40.1 percent of consolidated government expenditures.\(^{63}\) As in other former Soviet countries, the size of the government sector has shrunk over the last decade, but the share of the local sector has remained relatively constant at around 40 percent of the total. The same source reports that the share of land taxes rose from less than 5 percent of total local revenues in 1993 and 1994 to 8 percent by 1998. Table 11 suggests that this trend has been sustained. “Local” taxes and fees, on the other hand, have never yielded more than 3 percent of local revenues.

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\(^{60}\) Under other laws, special charges are imposed on the use of forestry resources (essentially based on wood cut), on fresh water resources (essentially on water used), and on mineral resources (essentially on extraction). These are not further discussed here.

\(^{61}\) In addition, local governments may exempt taxpayers from paying the share of taxes due to local governments (100% in case of land tax). Such exemptions cost UAH 17 million in 2000.

\(^{62}\) No information is available on appeals.

Table 12: Land Tax Data from State Tax Administration

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<tr>
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<th></th>
<th></th>
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</thead>
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<tr>
<td>RegisteredTaxpayers</td>
<td>190,426</td>
<td>214,766</td>
<td>190,067</td>
<td>196,846</td>
<td>178,158</td>
<td>168,411</td>
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<td>Reporting Taxpayers (as %)</td>
<td>74</td>
<td>75</td>
<td>91</td>
<td>90</td>
<td>87</td>
<td>89</td>
</tr>
<tr>
<td>Collections (UAH ‘000)</td>
<td>649</td>
<td>815</td>
<td>1,005</td>
<td>1,105</td>
<td>1,104</td>
<td>1,375</td>
</tr>
<tr>
<td>Arrears (UAH ‘000)</td>
<td>81</td>
<td>166</td>
<td>220</td>
<td>419</td>
<td>332</td>
<td>494</td>
</tr>
<tr>
<td>Exempt enterprises</td>
<td>31,141</td>
<td>23,889</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue loss (UAH ‘000)</td>
<td>1,642</td>
<td>1,004</td>
<td>871</td>
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<td></td>
</tr>
</tbody>
</table>

Source: State Tax Administration. Note that all land tax revenue went to local governments in 1997 and later years, but that in 1995 only 84.2% and in 1996 73.4% went to local budgets.

Table 13. The Revenue Importance of Land Taxes

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
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<tr>
<td>Land tax (UAH million)</td>
<td>1114.9</td>
<td>1094.5</td>
<td>1376.7</td>
</tr>
<tr>
<td>Local taxes and charges (UAH million)</td>
<td>392.1</td>
<td>440.5</td>
<td>485.3</td>
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<tr>
<td>Land tax as % total revenues</td>
<td>3.9</td>
<td>3.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Land tax as % GDP</td>
<td>1.1</td>
<td>0.8</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

Table 14. Local Revenues (for first nine months of 2001)

<table>
<thead>
<tr>
<th>Total revenues (general fund)</th>
<th>UAH 12.3 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of which:</td>
<td></td>
</tr>
<tr>
<td>Personal income tax</td>
<td>50.3%</td>
</tr>
<tr>
<td>Land payments (tax)</td>
<td>9.5</td>
</tr>
<tr>
<td>Local taxes and fees</td>
<td>3.1</td>
</tr>
<tr>
<td>Simplified tax</td>
<td>2.6</td>
</tr>
<tr>
<td>Fixed agricultural tax</td>
<td>0.4</td>
</tr>
<tr>
<td>Other</td>
<td>35.1</td>
</tr>
</tbody>
</table>


The Reform of Property Taxation

210. Two conclusions emerge clearly from the preceding discussion. First, there is at present no significant local control over taxation in Ukraine, and, second, land and
property taxation is not very important. These observations lead to an obvious conclusion. In principle, the development of a feasible and appropriate local tax base to some extent under local control—specifically, with local responsibility for determining at least some tax rates so that political accountability can be clearly established—is an important component of any sustainable long-term solution to the complex problem of establishing a viable intergovernmental fiscal system. This need has been recognized by many in Ukraine, as has the potential of an improved local property tax to serve this purpose. As yet, however, little progress has been made in this respect.

211. A 1998 examination of property tax reform in Ukraine, for instance, reviewed several earlier unsuccessful attempts to introduce a real estate tax and suggested that, since it would be neither easy nor quick to set up a market value based tax, the best approach might be to begin with a unit value assessment system. This advice still seems sound. The proposed Tax Code, for instance, included a tax on all forms of immovable property, including agricultural land, land plots, buildings and constructions. This tax has a number of interesting features.

212. As under the current system, under this proposal agricultural land is taxed differently and an attempt made to impose higher taxes on more valuable land in populated areas.

213. The tax base for land is set as either value or area, where value has not been established, as it has not been in many cases, and will likely not be for some time. Property valuation is never a cheap nor simple option, especially not in countries like Ukraine in which normal land markets do not yet function.

214. The rates of tax on agricultural land are set as a percentage of value adjusted by a coefficient varied by the usage of the land. Farmers would, however, be allowed to credit property tax against enterprise profits tax (in the perhaps unlikely event that they are subject to the latter). This provision makes no sense: property taxes should simply be deducted like other business expenses. The rate on land in populated areas is set at 1 percent or different fixed rates per square meter if no values are available, with surcharges to be applied in cities. Many other special rates (for railways, recreational land, water reserves, etc.) are specified.

215. For buildings, the base is capital value. Building values are to be revised every five years, but the base can be indexed if inflation exceeds 10 percent in any tax year. Buildings are to be taxed at rates varying from 1 percent to 2 percent. Economically, of course, it makes little or no sense to subject buildings to higher rates than land.

216. In an apparent attempt to provide some degree of local tax freedom, and responsibility, local radas would under this proposal be allowed to impose surcharges up to twice the established rate.

217. Many exemptions are provided in the draft Code: one estimate, for example, is that perhaps 80 percent of all residential property would be exempted. This is a

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particularly bad feature from the point of view of establishing an good local revenue source, since a “good” tax for this purpose is one that is clearly paid by the local residents who elect those who set the tax rate.

218. As this very brief summary suggests, even if the new property tax set out in the draft Tax Code were implemented, many questions and problems would remain. The tax structure is unduly complex. The tax base is not clearly determined. The role of the tax in local finances is not as clearly set out as it should be. These structural issues, combined with the substantial practical difficulties of determining land titles and developing adequate assessment rolls suggest that Ukraine is still a long way from establishing a viable local property tax.

219. From the perspective of state revenues, land and property taxes are not now important, and they are not likely to become much more important in the near future. From the perspective of local revenues and the development of a sound system of intergovernmental finance, however, the establishment of a better property tax system is nonetheless critical in the long term.

220. In particular, the property tax should be imposed initially on a unit-value (area) basis. Over time, as information improves and the administration becomes more experienced, this system can be altered to a value-based system. (As in most countries, agricultural land would likely continue to be taxed to a considerable extent on a unit-value basis in practice, except in the immediate vicinity of urban areas where sales data is more commonly available.)

221. The tax should also likely be imposed at the same rate on land and buildings, regardless of the nature of the activities carried out. A good case can also be made for taxing land alone, or taxing land at a higher rate than improvements. At the very least, there should not be higher taxes on buildings than on land. Exemptions should be very limited: in principle, for example, even public sector activities should pay land taxes if land is to be used efficiently.

222. Finally, the tax should be imposed essentially by local governments, although preferably on assessment rolls determined by higher-level governments in order to capitalize on the substantial economies of scale in assessment. A minimum rate (such as 1 percent) might be specified in the law to prevent richer local governments “poaching” businesses through tax concessions, but otherwise there seems no reason to place any limits on local tax rates. Provided that the same rate has to be applied to all properties, regardless of use, and that assessment is uniform and not under local control, local political and economic realities will adequately constrain local governments from excessive taxation.

223. Although this argument is not developed in detail in the present report, a simple, uniform local tax on land and property along these lines would do much to simplify Ukraine’s current complex intergovernmental finance system – to permit the more prosperous areas to become more self-financing in an economically and politically responsible way and to permit the further adjustment of the already improved intergovernmental transfer system to provide funds to less prosperous areas in a way that
encouraged them to act responsibly and to encourage economic development. To conclude, however, it is important to repeat that this is a long-run aim, and that there is no realistic short-term prospect of significant revenues from this source.

10. **TAX ADMINISTRATION REFORM**

224. The preceding discussion of the Ukrainian tax system has mentioned the key role of tax administration at many points. In many respects, the State Tax Administration (STA) is a capable manager. STA is also initiating a major program of modernization and reform. However, the current problems have many dimensions, and an integrated package of new and immediate activities is required in response, each requiring uncompromising political and legislative support.

225. An effective and efficient tax administration is dependant on its external environment, and the strategies and approaches it adopts to fulfill its responsibilities. Political influences in Ukraine create privileges, exemptions, amnesties and debt forgiveness that are difficult if not impossible to manage. The result is that the law is disjointed and ad hoc and there is little synergy between policy, law, and administration. Larger taxpayers have become familiar with opportunities to minimize and avoid, the shadow economy is larger than can be tolerated, and smaller taxpayers, disenchanted with what they see as high rates and little social return for their contribution, tend to avoid participating where they can.

226. It is in this inconsistent, inequitable, unstable, and unpredictable environment, that the public must contribute, and the STA must raise and collect revenues. It is to the STA's credit that commendable progress has been made toward modernization. In a few short years, they have consolidated the office network, reduced staff numbers by some 2,000, introduced forums for external consultation, created 7 large taxpayer offices, developed a comprehensive education program for taxpayers, and improved the capacity to train and educate employees. However, staff and executives are still developing their capacity to administer a new and complex system in a developing economy, and the underlying policy and legal environment remains unpredictable.

227. As a result, while the STA's energy and continuing commitment to change are evident, there is still an overriding emphasis on compliance by enforcement and day-to-day management, the organizational structure is based on individual taxes (including responsibilities for local as well as national revenues), and the network of offices is widespread and fragmented throughout Ukraine. Business processes and human resource management strategies need to be modernized, and information technology support is inadequate. In addition, the tax administration has little external accountability. In these circumstances the credibility of the system and community confidence in it is low. It is

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67 The office network has been consolidated from around 800 to 480 offices, but a presence has been maintained in most former locations.
little wonder that relationships between STA officials and taxpayers are poor. Dramatic change, led by a more aware and supportive government, is needed.

Building a New Foundation

228. The tax system in any country has three inter-related components. Policy, legislation and administration must be developed in concert. There is little benefit in creating policy that cannot be administered, or writing laws that will not achieve objectives or cannot be understood. In Ukraine there is little synergy or harmonization between these three elements, as evidenced by the privileges and exemptions discussed earlier in this report.

229. One reason is that direct inputs to policy and legislation come from various elements of the government. Another is the lack of analytical, forecasting, policy development, and legal skills in the STA, Ministry of Finance, Ministry of Economy, and Verkhovna Rada, the organizations responsible for policy development and legislative drafting. Much of the legislative work is left for a small group in the Ministry of Finance and government committees, who understandably sometimes seem lacking some of the varied expertise required. There is an urgent need to develop institutional knowledge, skills and inter agency relationships in this area.

230. The substantive tax laws and administrative provisions are disjointed, ad hoc and unclear. Laws can be introduced to the Cabinet of Ministers by different Ministries, thus providing ongoing opportunities to formalize self-interest. There are innumerable laws that are difficult for the STA let alone the community to understand. This situation leads sometimes to local staff interpretation of provisions, reduces the integrity of the law, and creates uncertainty, increases complexity, and raises the costs of compliance.

231. To reduce such problems in the future, before being transmitted to the Cabinet of Ministers, legislative proposals should be closely examined by an independent committee, formed by the Ministry of Finance, the Ministry of Economics, and the STA. The economic and revenue impacts of such proposals, including especially tax concessions, should be made transparent prior to cabinet discussion.

232. Laws should be simplified and minimized. Separate legislation should be developed for each substantive tax, as has now been done. In addition, however, a separate procedural code for the administration is needed. This code should include provisions such as the power to access premises, obtain information, impose interest and penalties, take criminal prosecution and the rights of taxpayers etc. Policies should be developed and promulgated for the consistent application of the law, and common and significant issues requiring interpretation should be documented and made available both to STA staff and to the community at large.

233. The tax administration in Ukraine lacks formal external accountability or transparency in its revenue collection performance and the manner in which it fulfills its responsibilities. While the Control and Revision Department (a separate body reporting

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68 The existing Law on the Tax Service of Ukraine and a more recent Law on Procedure for Satisfying Taxpayer Liabilities to the Budgets and Government Target Funds provide a starting point, but a comprehensive review along the lines set out in this chapter is needed.
to the Cabinet of Ministers) has the authority to audit expenditure. There appears to be some political reluctance to allow external examination of revenue. This lack of accountability is a serious weakness in the administrative process. Potential taxpayers are unlikely to play within the rules when the administration appears secretive, unfair, assertive, and seemingly unaccountable for its actions. Openness, accountability, and transparency to government and the community are essential ingredients in the administration of any tax system, particularly one in which concessions have such a significant revenue impact, are prone to abuse, and are difficult to manage.

234. As a first step, the STA needs to further distribute its internal power base, by delegating more authority to staff, balanced with policies, processes, information systems and reporting mechanisms that impose accountability – though accompanied by support rather than reprisal. The recent introduction of internal control and anti-corruption prevention and control functions moves some way in this direction. But more needs to be done both to focus on the areas of greatest administrative risk and to create an ethical and open work place and culture through codes of conduct and sound human resource management and development activities. Specifically, the STA must be subject to audit by an independent government agency reporting directly to Parliament/Cabinet of Ministries with respect to all aspects of its administration. The development of its relationships with taxpayers and key stakeholders should also be under scrutiny by an independent group or panel that can represent and protect the interests of the public, while reporting directly to the President. The STA should produce an annual report covering its yearly plans and performance and all areas of its administration, and report directly to Parliament and the public. Forums for external consultation need to be expanded and enhanced to include all key stakeholders, other agencies and professional, financial, industrial, and local bodies. More needs to be done to encourage taxpayers dissatisfied with administrative outcomes to complain to the Ombudsman for resolution through the STA, with full reports to Parliament on complaints received and actions taken.

235. One option to provide a higher level of external accountability might be to establish the STA as an autonomous or semi-autonomous body, with a Board of Management separate from the head of the agency and deputies. There are advantages to this approach in terms of autonomy, budget and the capacity to set remuneration levels outside public sector rates. There are also disadvantages in the loss of flexibility and creativity for executives and staff, generally increased costs, and little if any additional impact on the key weakness in Ukraine, i.e. the creation and maintenance of numerous privileges and exemptions and debt forgiveness. On balance, in view of its recently demonstrated commitment to change, we think the STA should be given the opportunity to develop internal and external accountability mechanisms before considering this option further.

236. A complementary issue in the area of accountability is the lack of a code of taxpayer rights. The payments law which became effective in April 2001 introduced the need for court approval for the verification of disputed debt before enforced collection

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69 The first expenditure audit of the STA is planned for December 2002.
70 Article 98 of the Constitution of Ukraine was amended in January 2002 to give the Accounting Chamber of the Parliament supervisory control over the formation and execution of revenue and expenditure, but it was subsequently vetoed.
action, new appeal processes, and the opportunity for taxpayers to seek rulings. Article 1036 of the proposed Tax Code continued this positive move by setting out a number of additional taxpayer rights, for example to receive information on registration free of charge, to receive written explanations, to be present at tax inspections, and to engage an authorized representative and to enjoy tax incentives or provisions to defer payments. However, there were no statements regarding behavioral issues such as treating people fairly and reasonably, with courtesy and within accepted codes of conduct. The current position remains that there is no comprehensive statement setting out the way the tax administration should conduct its dealings with taxpayers, explaining taxpayer rights and obligations, and the standards of performance they can expect, and there is some influential apprehension about their introduction. Table 15 sets out an example of the key features of a Service Pledge from another country. Such a statement should be developed in consultation with the community to provide standards of behavior and performance for staff. If developed, it should be taken seriously.

**Table 15. Example of a Service Pledge**

We are committed to providing excellent service. You can expect Courtesy, Clarity, and Convenience from us.

**Courtesy:** we will be attentive and polite when we serve you.

**Competence:** we will ensure that you are served by well trained officers and our tax assessments are accurate.

**Clarity:** we will provide clear and complete information to help you fulfill your tax obligation.

**Convenience:** we will continuously seek improvements to make it simpler for you to meet your tax obligations.

- we will answer most telephone calls within 2 minutes;
- we will reply to most letters within 2 weeks;
- we will usually attend to you within 20 minutes when you visit us;
- we will usually make refunds to you within 30 days.

We recognize your desire for excellent service. To help us deliver service to meet your expectations, we need your cooperation to:

- be timely in filing your returns;
- give us accurate and complete information;
- pay your tax on time;
- comply with the tax laws.

*Source: Singapore Internal Revenue Service web site*

**Tax Collection and Arrears**

237. Total arrears were some 6.3 billion UAH, or 17 percent of revenue at the end of 2001, which compares favorably with the previous 3 years, which averaged 44 percent in 1998, 45 percent in 1999 and 32 percent in 2000. However, during that period, there were 10 separate acts that forgave or restructured debt. As a result of these repeated amnesties, the financial discipline of the community has been eroded. The expectation of further concessions adds to an already difficult collection situation.
238. In comparison, the arrears level in OECD countries is an average of 4 - 8 percent of tax revenue and penalties, reflecting both effective collection processes free of political concessions and ongoing action to write off genuinely uncollectable debts on an individual basis. Ukraine may not be at the same level of development, but this demonstrates what can be achieved. As noted earlier, the significant arrears owed by State Owned Enterprises are a particular problem that will require substantial political will to overcome. What is critical from a tax administration perspective is that this problem no longer be allowed to distort both tax policy (e.g. the non-payment of legitimate VAT refunds) and tax administration (e.g. the perpetuation of elements of the “offset” system and the pressure to use “command” methods to meet revenue targets). With respect to arrears in general, there is to single solution, all aspects of collection need to be reviewed and a new approach developed. Arrears must be controlled and not allowed to escalate.

239. The government should decide, and publicly inform the community, that there will be no further legislative forgiveness or restructure of debt. The STA should ensure that the current debt does not escalate and set standards of performance that see a planned reduction of arrears over the ensuing 12 months. Moreover, a comprehensive review of all aspects of the collection and enforced collection of tax, developing new policy, and recommending changes to the payments law and administrative operations. Table 16 sets out a possible approach to this problem.

Table 16. Dealing with Tax Arrears

- Arrears performance standards should be set for each element of the administration to control and reduce the balance of arrears, for example, to reduce overall arrears by X% each month/quarter, and/or to achieve targeted balances at period end.

- Collection policies and processes should be built on personal taxpayer contact and endeavors to promote early collection before the need for enforced collection.

- A modern single account accounting system should be introduced that automatically issues notices of demand, records and produces management data that allows the prioritization of collection action based on debt level, age or category of taxpayer. In the short term, other arrangements should be made to ensure the prioritization of collection.

- The tax administration must be given the clear right to access the bank accounts of the energy sector, and any doubt removed over the capacity to access amounts due to taxpayers by debtors.

- A group representing the audit, appeals and collection functions should be formed in each region and large taxpayer office to meet monthly to manage the largest debts within the particular office or organization.

- To minimize frivolous appeals and delaying action, the filing of an appeal should not stop the collection process. In most countries, a proportion of around 50 percent of the tax in dispute (and all tax not in dispute) is payable when it is due - the counter balance is the payment of interest on tax paid and to be credited if the appeal decision is in the taxpayer's favor.

- For self-assessed returns, the due date for payment should be the statutory date for payment, without the current 10 days of grace.
• The advance payment system for companies should be reviewed to determine the effectiveness of the current system of current quarter estimates, and to ensure reasonable sanctions for reckless or deliberate underestimation of income.

• Interest charges and penalties on late payments should be reviewed in line with the recommendations made later in this report.

• Collection staff should be specially selected and trained in client contact and modern collection techniques

Late Charges and Penalties

240. In an environment with ample opportunity to misuse the law, and limited chance of detection, a comprehensive and consistent regime for the imposition of interest and penalties is a prime means of deterring noncompliance, encouraging payment, and punishing those taxpayers who move outside the law. At the same time it compensates the government for revenue forgone. Table 17 summarizes the interest and penalty provisions of the recently enacted payments law, which is the operative means of application of charges payable across all taxes.71

Table 17. Late Charges and Penalties - "On Procedure for Satisfying Taxpayer Liabilities to the Budgets and Government Target Funds"

Definitions

"Tax Liability"
An obligation under which a taxpayer is required to pay to the budgets or government targeted funds the respective amount of money in accordance with the procedures and dates specified in this law or any other laws on tax matters

"Tax Debt" (tax deficiency)
Tax liability including penalties if there are any, agreed by the taxpayer or established by court (arbitration court) but not paid when due, plus interest assessed on the amount of such tax liability

"Interest penalty"
A payment the amount of which is determined by applying a certain percentage to the amount of the tax debt (without the interest) and collected from the taxpayer in connection with his failure to pay his tax liability on time

"Penalty sanction" (fine) (1.5)
A payment in the form of a set amount or in the form of a percentage of the amount of a tax liability (without taking to account the interest and penalty sanctions) which is collected from the taxpayer in connection with a violation of tax rules established in relevant laws

"Application of the law Section 19.6"
"Law and other regulatory acts shall be effective in parts, which do not contradict the norms of this law"

71 There are other legislative provisions that apply penalties to the officials of an organization for tax related failures.
**Late Charges**

**Payment of a tax liability is due:**

For self assessed returns, within 10 days of the last day for submitting a tax declaration (5.3.1), which varies from 20 days after the end of the month for monthly returns, 40 days after the end of a quarter or half year, and 60 days after the end of the year for annual returns for CIT and before 1st April following the calendar year for PIT (4.1.4).

Late Charges accrue on the sum of all tax debts (including penalty and interest), at 120 percent of the discount rate of the National Bank of Ukraine: (16.4.1).

Where the liability is assessed by the taxpayer, from the working day following the due date for payment established by law (16.1.2 (a)), until the date the debt is cleared by bank order, payment or gaining the right of possession to assets (this end date applies to all late charge applications) (16.3).

Where the liability is assessed by the administration, from the working day following the due date for payment established in the notice of assessment; (16.1.2 (b))

Where the tax liability is verified through administrative appeal, during the 10 calendar days following the date of verification (5.3.2) (note here that the appeal process is only available to liabilities assessed by the STA, not to self assessed declarations). (note also that under 5.2.3, on filing an appeal, the tax liability being contested is considered unverified and deferred until the appeal decision is made).

In effect from up to 10 days from the date that the liability is verified by the appeal process.

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<thead>
<tr>
<th>Late Charges</th>
<th>Late Charges</th>
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<tbody>
<tr>
<td>Voluntary disclosures before audit (16.1.3).</td>
<td>If the tax is paid, no late charges apply (some exceptions).</td>
</tr>
<tr>
<td>Disputes (16.2)</td>
<td>If the STA extends the time limits for dealing with a dispute late charges are not accrued irrespective of the results of the appeal</td>
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</tbody>
</table>
### Penalties

<table>
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<tr>
<th>Description</th>
<th>Details</th>
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| Non filing or delays in filing (17.1.1)                                     | A taxpayer who did not submit a tax form, 10 non taxable minimum personal incomes for each case #; (17.1.1) **
For employees, 30 non taxable minimum personal incomes. ## (17.1.1) |
For assessments raised by the administration where a declaration has not been filed within the required period, 10 percent of the tax liability for each month or part month of delay in submitting the return, to a maximum of 50 percent of the liability, but no less than 10 non taxable minimum personal income in addition to the penalties specified in # and ## above. (17.1.2) |

| Audit                                                                       | For assessments raised as a result of audit, 5 percent of the sum of the underpayment for each taxable period starting from the taxable period within which the underpayment occurred and ending with the taxable period within which the taxpayer received the notice of assessment, but not more than 25 percent of the underpayment and not less than 10 non taxable minimum personal incomes (17.1.3). |

| Arithmetic/methodological error                                             | For assessments raised to correct arithmetic or methodical errors, 5 percent of the additional liability but no less than one non taxable personal income (17.1.4). |

| Criminal evasion (sentenced) or when a taxpayer declares an understatement of a large amount as specified by the Criminal Code. | 50 percent of the underpayment, but not less than 100 non taxable minimum personal incomes (17.1.6). |

| Late payment of agreed tax liabilities.                                    | 30 days late – 10 percent |
|                                                                           | 31-90 days late – 20 percent |
|                                                                           | more than 90 days – 50 percent (17.1.7) |
|                                                                           | These penalties apply in addition to other penalties and the late charges for delays in payment. |

| Alienation of assets under pledge.                                         | 100 percent of the tax debt under pledge (17.1.8) |

| Sale of goods or cash payments before paying tax, where this is a precondition of the sale. | Double the tax without relieving other administrative or criminal responsibilities (17.1.9). |

| Voluntary disclosure and payment before audit.                             | penalty of 10 percent (17.2) with exceptions if a declaration had not been filed for the period or if the court rules criminal evasion. |

** one nontaxable minimum
241. Late charges accrue on agreed tax liabilities at the rate of 120 percent of the
discount rate of the National Bank of Ukraine. This rate is a concession to normal bank
lending rates, (if money is available) and encourages taxpayers to use the government as
a source of cheap finance. The rate should be at least 4-8 points above the normal bank-
lending rate to provide the correct incentive to pay on time.

242. Late charges should also be calculated from the time the liability for tax should
have arisen, i.e. the statutory due date for filing. For self assessed liabilities, the
legislation provides a further 10 days grace. In the case of VAT, for example, there are
some 354,000 active payees who file, declarations monthly, which are not due for 20
days after the end of the month. This provides a due date for payment but interest
charges commence only 10 days later. There is no need for this 10-day interest free
concession, which should be discontinued.

243. For official assessments raised, the law provides that late charges accrue from
the due date for payment as shown in the notice of assessment. Such assessments, however,
simply make up for the taxpayer's earlier failure to comply with the law. The liability to
tax arises at the statutory due date for filing, and the late charge should be calculated
from this date, not the assessed due date for payment.

244. Similarly, where an appeal is lodged against an administrative assessment late
charges accrue from the date of verification. For the same reasons, the calculations
should also commence from the statutory due date for filing

245. Late payers are also subject to penalties at a fixed percentage of the tax liability,
10 percent if 30 days late, 20 percent if 31-90 days late, and 50 percent if more than 90
days late. In combination with the interest charges, penalties at this level create a
significant punishment for late payment, and may raise the problem of capacity to pay. A
particular problem arises with the standard approach of crediting current payments
against the oldest debt. The potential is for multiple applications of the fixed amount
while the current year remains outstanding. Adopting an interest rate of 4-8 points above
the bank rate may be a more equitable but realistic option that will both compensate for
the time value of lost revenue and will be a significant deterrent.

246. Self-assessment taxpayers who do not file, or are late in filing, are penalized
either 10 or 30 non taxable minimum personal incomes, from 170 to 510 UAH depending
on circumstances.\textsuperscript{72} Where assessments are raised by the STA, a penalty of up to 50
percent of the tax liability, but not less than 10 non-taxable minimum personal incomes
can be imposed. The penalties for self-assessment seem low, while those for assessed
returns may be high. The general practice adopted internationally is that late or non-filers
should also compensate the government for the lost time value of money. Interest at 4-8
points above the bank rate should thus be charged from the statutory due date for filing.

247. Assessments raised as a result of audit attract a penalty of only 5 percent of the
underpayment for each taxable period, to a maximum of 25 percent of the underpayment.
This is in sharp contrast to the fixed penalties for late payment discussed earlier and does
not have the deterrent effect needed. Evasion or avoidance should attract an interest
charge for the lost time value of money and a penalty for the act of evasion higher than at

\textsuperscript{72} One non taxable personal income is 17 UAH.
present, but taking into account the reasons for the failure, i.e. ignorance, recklessness or deliberate evasion. As a guide, it might not be excessive for an interest charge to accrue from the statutory date of filing (once again at 4-8 points above the bank rate). In principle, outright tax fraud is a crime and should be subject to criminal penalties up to and including prison, although this may not be considered politically feasible in Ukraine. In any case, high penalties (say, 75 or 100 percent of tax due) should be applied in cases of tax evasion, with lower penalties applicable, under strict formal and transparent guidelines, to reduce the amount payable in cases where the underpayment is judged due to carelessness or ignorance.

**Audit**

248. Audit's primary role in tax administration is to focus on the areas of greatest risk to the revenue, and to conduct its activities in ways that encourage compliance and discourage and prevent noncompliance, while bringing those that default to account.

249. Audit is a difficult task in any administration, but it is one that is made almost impossible in Ukraine because of the political nature of the tax system, the complexity of the law, the array of opportunities for minimization, evasion, and debt forgiveness, the consequent non-compliant attitude and expectations of taxpayers, a shadow economy of some 50 - 60 percent, and underdeveloped audit skills and experience.

250. There are currently around 8,000 audit staff in STA. The aim is to audit 10 percent of the active entrepreneur population, but this number is augmented by unplanned audits that arise as a consequence, and "thematic" audits directed by Government. Cases for audit are selected locally and move up through a review process at the oblast level and headquarters to produce a national plan. In 2000 this resulted in 403,196 audits, which represents 31 percent of the PIT entrepreneur and EPT active population. Although high in number, on average, audits produced little revenue. There is little evidence that audits address, in a comprehensive way, the deeper, more complex issues of tax compliance—for example restructuring to take advantage of tax free zones, loss creation, international transfer pricing, and other artificial or contrived local or international arrangements.

251. That is not to say that the audit function has not progressed, or that it is not moving toward a more modern and sophisticated approach. Dramatic and commendable improvements have been made in recent years. For example, in conducting an audit, all taxes are covered, an audit plan is prepared, books and records are examined at the taxpayer's premises, audit outcomes are documented signed by the auditor and presented to the taxpayer for acceptance.

252. Notwithstanding these developments, it is urgent to develop comprehensive compliance strategies, new audit products and skills, and to further develop the techniques and technical knowledge of staff to identify and deal with more sophisticated and strategic methods of tax minimization and evasion. For instance, consideration

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73 In addition, the tax militia plays a role in audit. As discussed later, however, we strongly suggest that there is no role for such a separate body in a modern tax administration. It should perhaps be noted that we do not consider the so-called “desk (cameral) audit” – an exercise that takes many resources but amounts to little more than arithmetic verification that can be better done by computer in most cases --worthy of the name “audit” and hence do not discuss it here.
should be given to the development of an intelligence function within the audit function to gather information in relation to transactions, schemes or arrangements designed to avoid or evade tax, for input to audit planning processes and activities, and reporting to government. As already mentioned, the current interest and penalty regime for non-filing, understated income or late payment also needs to be reviewed to deter and punish non-compliance and to compensate the government for revenue forgone.

Appeals

253. The new payments law gives taxpayers the right of administrative appeal and imposes time limitations (20 days that can be extended to 60) for an STA resolution, with the power to escalate disputes to the higher levels of oblasts and headquarters if not satisfied. There is also the right of direct or ultimate appeal to the Arbitration Court. While this is a commendable move, it needs to be considered in the light of an Appeals workforce of only 168, compared to an audit workforce of around 20,000 (including the militia) or 33 percent of the workforce. During 1999 to 2001, 17,151 administrative appeals were filed. This contrasts with 1.2 million taxpayers audited during the period. In 2001 the average tax in dispute was 597,000UAH (for appeals rejected) and 91,000 UAH (for appeals sustained). Appeals to the arbitration courts during 1999-2001 totaled 18,658. In 2001, the courts decided in favor of the STA 28 percent of the time and in favor of the taxpayers 72 percent of the time. In value terms, STA-favorable findings represented an average of 450,000UAH and taxpayer-favored finding represented 1,240,000 UAH.

254. The current appeals function consequently needs to be expanded, skills developed, and timelines for resolution extended, if it is to deal with the complex issues that naturally arise within any modern tax administration.

Large Taxpayer Offices

255. In recent years the STA has created 7 special offices for large taxpayers (LTOs) that form part of local oblast administrations. Revenue collected by LTOs in 2001 was 3.5 billion UAH, or a little less than 10 percent of total revenue and 20 percent of EPT, VAT and excise revenues. This seems lower than expected from this client base. Offices are structured with separate units for declaration processing and collections, with the compliance and service functions carried out by industry-based segments comprising a mix of inspectors, auditors and lawyers. Appeals are dealt with by the regional office. The head of each LTO reports to the head of the oblast, and a coordination unit in headquarters is responsible for the collection and analysis of performance data, and feedback. The First Deputy Head of STA is ultimately responsible for LTO performance.

256. LTOs potentially play a critical role in raising and collecting a major portion of budgeted revenues and in managing and gathering current intelligence on key areas of compliance. These are also the areas which have immediate contact with and manage the major privileges, exemptions, arrears, and VAT refunds. It seems clear that there is room

74 Since the visit in February 2002, we have learned that an LTO office has been opened in Kiev, raising the revenue coverage of the LTOs. Reportedly the plan is for the LTOs to cover between 60 to 70 percent of revenues in the long-term.
for improvement in compliance strategies, audit products and approaches, and the investigative and technical skills of staff. There is also room for creating the LTO's as a national structure, each office reporting directly to headquarters, to create a single national organization and national strategies and process, as distinct from independent oblast units that are nationally coordinated. The development and improvement of Large Taxpayer Offices should therefore proceed with some urgency. LTOs should be used as a model for the development and implementation of short term improvements in administration as well as for longer term reform.

**Corruption and Internal Control**

257. The STA maintains an anti-corruption unit that reports directly to the Head of the STA. The role of the unit is to identify and prevent corruption in civilian employees and the militia. Around 300 staff are located in the 27 Oblast offices, reporting to a small unit in headquarters. Legislatively, the focus is on the constitution, the criminal code, and a special anti-corruption law. Cases are received for examination from the business community, a hot line that operates 24 hours a day, written complaints, and other agencies such as the Ministry of Interior and Public Prosecutor. Cases are examined independently, and referred to the Public Prosecutor’s Office for consideration of criminal proceedings where warranted. The prime criterion is whether a tax official used his or her position to assist a person or entity to reduce their tax liability. In 2001, there were 321 cases of potential malfeasance, of which 220 were referred to the Public Prosecutor, who instituted 94 criminal proceedings. On the proactive side, one of the prime aims of the unit is prevention, which is achieved by identifying the areas of greatest risk and working with those employees to educate and discourage improper behavior. Outcomes are reported to the Department of Civil Service and are openly discussed within the STA.

258. The internal control function is performed through 3 separate but interrelated units. The Inspection and Control Department that was established in April 2001 has 15 staff stationed in headquarters to conduct enquiries in relation to any aspect of the administration. The Internal Control Department, with 148 staff in regional locations and 15 staff in headquarters, also reports directly to the Head of STA. Its focus is on the inspection of documents to ensure the correct application of procedures such as arrears processing and the application of penalties, the verification of expenditures and the acquisition of assets, the quality of inspection decisions, the conduct of training and development activities, and special issues as they arise. Both local and national taxes are covered, and reports are prepared highlighting the areas of weakness and recommendation for correction or improvement. The Organization and Management Department, which reports to the First Deputy Head, works in oblast, rayon and local office conducting studies and analysis of the execution of work programs relative to the work of the other 2 departments.

259. Both of these functions seem to perform fairly well in the circumstances and to be moving in the right direction.

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75 Here, as elsewhere, time did not permit us to go into detail with respect to LTOs. A much more thorough investigation of this and many other administrative aspects is being undertaken as part of the STAMP program, and much of the present discussion is based on information documented there.
Strategies of Reform

260. While there has been a noticeable shift toward strategic management in recent times, tax administration still remains essentially focused on day-to-day management and enforcement. As a product of history and ongoing pressures to collect, its style of management appears more closed and command-based than open and participative. To deal with its ongoing challenges, STA management needs to spend more time considering the future and listening to external stakeholders, both to hear views of the administration and reform and also to test and gather feedback on the uses and abuses of the tax laws and concessions.

261. Examination of the interrelationship between tax policy and administration highlights STA’s enthusiastic but narrow focus on “enforcement”—direct action aimed at coercing individual taxpayers or groups to declare income or pay amounts owing—as the prime means of raising and collecting tax. This limited approach to managing compliance consumes the minds, energy and activities of administrators at the cost of a more strategic focus based on risk management and compliance in relation to the community as a whole.

262. The traditional mistrust of taxpayers contrasts to control systems that can be loose and create opportunities for abuse. The Tax Militia focus on what is seen to be the criminal element of the community. But in fact the militia is in fact the largest department and highest profile function in the administration, with some 12,163 staff or 20 percent of total employees. While performing some valuable audit functions, they often adopt aggressive methods and approaches that cover areas in addition to tax, and project an unfavorable image to staff and the public. The functions and workforce of the Tax Militia should be reviewed and integrated with normal compliance functions and a special but limited unit should be formed to deal with potential tax crime. Tax administrators should not play a military or police role.

263. Bringing individual defaulters to account is of little overall benefit if done outside a comprehensive strategy aimed at achieving community as well as individual compliance. This is particularly so in a non-compliant society in which non-compliance is actively encouraged by confusing and inadequate legislation that provides legitimate concessions and loopholes that may be readily exploited.

264. While the concept may seem somewhat far removed from today's Ukrainian reality, the administration should shift its focus and overriding business strategy from individual enforcement to voluntary compliance through the development and implementation of self-assessment and risk management and its associated features and safeguards. Only with leadership from the government in providing a clean and level

76 For example, currently all PIT individual entrepreneurs are subject to “cameral audit” — a “checking” rather than “in-depth” audit—, quarterly EPT returns continue to be desk checked and risk assessed on filing, all VAT refunds over 10,000 UAH are field audited and the remainder desk checked before payment. In contrast, 1/3 of imports are cleared at the border on provision of a promissory note payable in 30 -90 days.

77 The Kyiv Post of 7 February 2002, reported “A bulldozer crushed and buried more than 30,000 pirated CD’s seized by tax police at warehouses and shops throughout Kyiv on Feb 1.” The image of the tax administration bulldozer may be one that stays in the mind, but this is not the kind of tax administration that Ukraine needs.
playing field, and appropriate strategies, structures, and business and human resource systems can a fundamental administrative reform succeed.

265. To achieve this end, for example, taxpayer services that build knowledge and understanding, with specific programs targeted to meet the needs of different taxpayer categories, must be developed. To do so, many conditions now not met need to be satisfied:

- simple laws and processes;
- convenient and comfortable opportunities for personal interaction with tax officials through personal meetings and discussions at tax office premises;
- ready telephone access;
- written rulings, advice or explanation;
- personal visits and presentations by tax officials to outlying districts, community or professional forums, and schools;
- service audits aimed at educating with respect to record keeping, for example;
- a comprehensive web site and ready email access to information;
- pamphlets, and other relevant written documentation;
- special personal services to assist and support professional tax advisors;
- and ongoing technical and client contact based training and support program for staff.

266. To achieve these objectives will require modern automated business and information systems that efficiently process and accumulate data, and rapidly provide assessments and refunds. In addition, a comprehensive compliance strategy needs to be developed to:

- legislatively require the maintenance of accounting or modified records;
- manage and control registration, non-filers, collections and arrears;
- maximize collections by withholding, or as income is earned;
- focus audit activity on the features of different taxpayer groups and the areas of greatest risk to revenue;
- create audit plans and auditor skills that focus in depth on the most strategic and complex issues;
- leverage audit outcomes through public rulings, education campaigns, and legislative change, in addition to raising additional assessments and imposing sanctions;
• provide interest and penalties that recompense the government for the time value of money lost and discourages and punish non compliance on the basis of its severity;

• pay interest on tax paid for income wrongly assessed; and,

• undertake enforcement and audit activities under strict codes of conduct.

267. Also needed are dispute resolution processes that aim to resolve issues without the need for reference to a higher authority, and applies the law without favor uniformly and consistently, and appeal decisions to other taxpayers in the same circumstances. Some improvements were made by the Law of Ukraine “On the Procedure for Repayment of Liabilities of Taxpayers to the Budgets and State Target Funds” (# 2181 of December 21, 2000) and laws of procedure of Ukraine.

Organizing for Reform

268. The current structure of STA is based on tax type. While this develops tax-specific expertise, it is inconvenient for taxpayers who have to deal with different divisions, it fosters inconsistent treatment of issues and taxpayers, and it limits staff knowledge and flexibility. It also adds to the costs of administration and makes it difficult to comprehensively focus on the areas of greatest risk. Current thinking is to move to a functionally based administration, across tax types. Some progress has been made in this direction by the establishment of seven functionally based LTOs, but more needs to be done. The STA should be restructured and consolidated along functional lines, or client segments by function, to support the strategy of voluntary compliance through self-assessment and the management of risk.

269. While significant progress has also been made in structurally consolidating the network of offices, (from 800 to 480 in 3 years) a reduced local presence remains in most former locations, and the network remains fragmented, creating excessive numbers of staff and managers, duplication of effort, and adding excessive layers of complexity to communication, interoffice interaction and national management and control. It also adds infrastructure and operating costs to the administrative budget. The network of offices should be consolidated by office closure and integration over a period of time, initially to no more than the 3 levels of headquarters, regional/large taxpayer and local offices, with some provision for service centers in remote areas.

270. The tax administration also retains responsibility for the collection of local taxes. This adds another level of administrative and political complexity and infrastructure as well as additional costs many of which could be transferred to local governments as part of the needed reform of intergovernmental fiscal arrangements. A pilot study should be conducted to determine the best method and cost of collecting local taxes.

271. No tax administration can deal effectively with critical compliance issues without proper business processes and information technology support. At present in STA, many business processes are manual, and influenced by an excessive requirement for checking documentation. Information technology support is limited and is a major impediment to efficient document processing, data collection, information reporting, audit support, and national communications. Arrears management, a major problem within the
administration, is impeded by the lack of a modern automated accounting system. Information technology equipment will soon be outdated, and there is an urgent need to recruit, develop and retain the ongoing capacity for applications development and system operations. While these issues are to be addressed in the STAMP reform, it will be some years before any far reaching changes are made. In the meantime, taxpayers will continue to take advantage of relatively modern processes and technology, and/or hide behind advantageous legislation or the STA's overall lack of compliance capacity.

272. Existing business processes should therefore be redesigned to meet agreed strategic and functional objectives and best practice. Processes should be simplified and automated for the benefit of taxpayers and staff. As this may take some time to achieve, ongoing innovation and design should be encouraged and supported in operational areas, particularly those currently under threat from compliance or collection risks, for example today's audit and enforced collection. All aspects of information technology design, infrastructure and applications development should be the responsibility of the executive team of the STA, and carried out in partnership with functional departments.

273. At another level, in recent years the cost of collection (operating and capital cost to revenue) has been 2.5 percent, a figure substantially higher than the 1 percent found or aimed at in many developed or developing countries. High staffing numbers, a widespread and fragmented network of offices, the duplication of effort that arises from administering by tax type, and outdated methods and procedures are factors contributing to this situation. The costs of collection in managing different aspects of administration such as local taxes, are important management tools in highlighting comparative costs, weaknesses and inefficiencies. Such data should be compared internally and in relation to best practice in areas such as overall costs, the cost of collecting local taxes, and the level of expenditures in key areas such as information technology.

274. Finally, no policy can be implemented, no crisis overcome, no change put in place, and no reform introduced, without good executives, managers and staff. Their level of performance, and consequently institutional outcomes, depends upon both local culture and human resource strategies and processes. While there is no question of the human capacity within the STA, there is some doubt that its full potential has been nurtured and realized. There is little evidence of a comprehensive human resource strategy or function that is consistent with immediate needs. While a significant effort has been made in relation to training, it is under-funded, and in itself is not enough. An integrated package of workforce planning, recruitment policies and strategies, job design and descriptions, selection criteria and processes, remuneration and reward systems based on qualitative rather than quantitative performance, integrated training and development programs, anti corruption control, behavioral change, and performance management needs to be developed, with early attention to the needs of audit and collection staff.
What Needs to be Done Now

275. The STAMP should, in time, create a new environment and opportunities for a modern, effective, and efficient administration. But it will take time. Improvement cannot wait for a formal program of reform, or the latest in infrastructure or technology. Urgent action is needed now in a number of complementary areas, although some of these too will undoubtedly require considerable time and effort to put fully into place:

- Strengthening strategic and collaborative management, devolving more authority to staff, and developing internal systems for information reporting and corporate governance;
- Further developing the Large Taxpayer Offices in line with best practice, and using the LTO as the vehicle and model for improvement and reform;
- Developing new approaches for the administration of VAT, in particular refunds, in line with recommendations of the IMF;
- Continuing the development of strategies, technical skills, and audit methods and products (covering both militia and audit), to support a broader, more strategic in depth and risk approach to compliance;
- Gathering cross agency data and intelligence, and making reports and recommendations to government on the revenue, administrative and social impacts of the areas of greatest risk to the revenue, including aggressive tax planning by large taxpayers, the simplified system for small taxpayers, the shadow economy, and the numerous privileges, exemptions, and tax free zones;
- Adopting a renewed and modern approach to the collection of tax, the management and control of arrears, and recommending changes to government in relation to provisions of the payments law;
- Introducing a comprehensive human resource strategy and function within the STA.

276. While the main burden for resolving Ukraine’s revenue problems clearly rests with political leaders, the tax administration too must contribute. Work needs to start now, to tackle these immediate areas of concern with the tools and resources that are available. In particular, to maximize the revenue impact of administrative reform, the

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78 The STAMP is a comprehensive long term program of modernization and transformation of the physical, systems, skills and cultural aspects of tax administration aimed at both the internal and external environment. There are three phases, each of 3 years, the first of which is to planned to commence by the end of 2002. A preliminary phase is under way, and remarkable progress has already been made. Activity has been aimed at the restructure of the administration on functional lines, the consolidation of the office network, and the related business process and systems redesign. The time constraints of design, tender, procurement development and implementation however will see the first redesign roll out in 2005. For example, early projections for one of the priority developments, accounting, shows design completed in September/October 2002, the procurement process then running for 176 days until March/April 2003, and system development running for 600 days until Nov/Dec 2005.
initial development and implementation of changes such as those just mentioned in the Large Taxpayer Offices should be explored.