

# Simplified Tax System in Ukraine: To Be or Not To Be?



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A simplified tax system is one of the essential tools for supporting small and micro businesses and self-employment in Ukraine. Entrepreneurs who are using a simplified system pay a fixed amount of tax or a fixed percentage of income. Moreover, recordkeeping and paperwork for such business entities are also significantly simplified. The system has existed since 1998 and has undergone many changes during this period. The problem is that although the system does, indeed, give some support to micro- and small businesses, it created different types of distortions and disincentives.

Mainly, the distortions are due to that the simplified tax system is widely used by medium and large businesses to optimize their tax expenditures. Companies make their full-time employees quasi-self-employed ones who are working under a simplified system, and thus reduce their tax burden. Society and business are divided. On the one hand, there is the understanding of a necessity to have a tax regime that supports micro- and small business and the self-employed. On the other hand, the abuse of this regime creates imbalances in the market, distorts competition, and leads to injustice. There is a heated debate in Ukrainian society about the future of such a tax regime.

In Ukraine, the enterprises and private entrepreneurs that use the simplified tax system pay a special tax (single tax) that replaces some of the other taxes and fees – primarily corporate income tax (CIT), personal income tax (PIT), and value-added tax (VAT). A single tax is based on a simplified accrual principle that allows its payers to reduce their accounting and reporting costs.

The simplified tax system has played a hugely positive role in Ukrainian his-



## THE SIMPLIFIED TAX SYSTEM IS WIDELY USED BY MEDIUM AND LARGE BUSINESSES TO OPTIMIZE THEIR TAX EXPENDITURES

tory. Twenty years ago, in the late 1990s, it helped bring out of the shadows a large part of the people forced to solve the issue of survival on their own amid the deterioration of living conditions and the economic crisis. To get “live” money (not, for example, goods instead of salaries), people started trading. The country then became a large “bazaar” of small traders and cooperators<sup>1</sup>. Criminals and the state immediately began to press on these entities. The former one took a “tribute” from the traders in the markets, whereas the latter – a large number of documents written in the USSR times and penalties for non-compliance with the rules prescribed in these documents.

In order to simplify the life of start-up entrepreneurs by reducing the regulatory burden and to protect them from criminals, a combination of a simplified taxation system and

<sup>1</sup> See: [https://translate.google.com/translate?hl=uk&prev=\\_t&sl=uk&tl=en&u=https://project.liga.net/projects/29-years/interview2.html](https://translate.google.com/translate?hl=uk&prev=_t&sl=uk&tl=en&u=https://project.liga.net/projects/29-years/interview2.html)

legal status was introduced under the name of “Individual Entrepreneur” (FOP). A key aspect of such a combination is simplicity – only one report and one tax with a simple registration is required.

The simplified tax system contributed to the development of entrepreneurship in the country. Soon after its introduction, partial legalization of doing business in the country took place. Kravchuk, Betliy, and Burakovsky, the authors of a study on the simplified taxation system stated, “comparing the advantages and disadvantages of different options for getting out of the shadows suggests that partial legalization may be quite attractive to business entities”<sup>2</sup>.

However, over time, the system began to be used to optimize the tax burden. The business started to “optimize” the tax burden, including hiring *de facto* workers as *de jure* sole proprietors. This strategy helped them avoid burdensome taxation of the payroll and the personal income tax. Some experts believe that under such conditions in Ukraine, two parallel tax systems exist, and the business substantially reduces the cost of labor in a questionable manner, which creates unequal conditions and distorts competition<sup>3</sup>. Moreover, some experts and business representatives accuse the other part of the business of using a simplified taxation (and reporting) system not for its intended purpose, but for other situations – e.g., for the sale of goods imported with a breach of customs rules (smuggling).

<sup>2</sup> Kravchuk, K, O. Betliy, and I. Burakovsky (2016) *Simplified System: Evaluation in a Contemporary Context*, Kyiv: Institute for Economic Research and Policy Consulting.

<sup>3</sup> See: *Novoye Vremiya* (2020) “What Awaits the FOP? Real Tax Reform Should Abolish “Simplified””. Available [online]: <https://nv.ua/ukr/biz/economics/shcho-chekaye-na-fopiv-data-reform-curative-curtail-sprosh-chenku-worker-prem-yera-newspaper-ukraine-50072310.html>



## THE SIMPLIFIED TAX SYSTEM HAS PLAYED A HUGELY POSITIVE ROLE IN UKRAINIAN HISTORY

In recent years, there has been a debate about the scale of this phenomenon. One of them focuses on whether the simplified system helps (by supporting small and micro-business development and self-employment) or harms (by creating unequal conditions for similar businesses by distorting competition) the taxpayers? Certainly, a wide plethora of studies on the topic of a simplified tax system<sup>4</sup> are available; however, due to a lack of accurate statistical data, their results often depend on the attitudes of the authors. Also, it led to a public debate on the efficiency of a simplified system, which focused in part on political expediency and populism.

### WHAT ARE SIMPLIFIED TAX SYSTEM (SST) AND SINGLE TAX (ST)?

At the time of its introduction, the simplified tax system (SST) offered a possibility for legal entities and single entrepreneurs to pay one tax (the equivalent of approximately USD 80 in 1999). The legal entities should not have more than 50 employees with a turnover that does not exceed UAH

<sup>4</sup> See, for example: <http://iset-ua.org/images/Analitish-na-robotu-dosvid-MSB.pdf?fbclid=IwAR267hywbAMJUhOY9vsdBRJ4aqkPl9yYBwBGFmweKxpzR9fSAXZRPwCyx4o>; <http://ua-outlook.com.ua/en/2019/07/06/smuggling-schemes/>; <https://zn.ua/business/uproschenka-ne-unichtozhat-no-usovershenstvovat-342430.html>; <http://iset-ua.org/ua/doslidzhennya/item/90-yak-zmenshyty-mozhlyvosti-dlia-ukhlyennia>

1 million. The number of employees for a single entrepreneur should not exceed ten persons, and turnover should not be higher than UAH 500 thousand.

Since its introduction, the simplified taxation system has undergone numerous changes concerning: (1) single tax rates, (2) accrual principles, (3) the list of single tax substitutes, and (4) criteria granting the right to use the SST to enterprises and individual entrepreneurs.

The SST remained unchanged from 1999 to 2004. The most significant changes took place in 2010, and included an increase in the liability for single taxpayers to pay contributions to the Pension Fund; and in 2012, when a revision of rates and a change in the ST accrual principle for part of the payers occurred. In 2010, four groups of taxpayers of SST were distinguished – the groups

have a different tax obligation and period of reporting, and also differ depending on the type of activity, volume, client etc., – for instance, the first two faced restrictions on working with taxpayers on the overall tax system.

In 2012, in contrast to 2010, the newly proposed changes in SST were aimed at the liberalization and expansion of the system. As a result, the number of payers who could take advantage of this system has increased. In particular, the updated version of the system (1) raised the threshold for the amount of annual income that gives the right to use SST, (2) abolished the fixed tax rates for each employee, (3) increased threshold for the number of employees, and (4) reduced the list of activities that do not allow to work on SST. In 2012, taxpayers' coverage of the simplified taxation system was expanded to create two more groups (5 and 6) for individuals and legal entities, respectively, with income up to UAH 20 million. Since 2015, the number of groups has decreased from 6 to 3, plus 4 groups for agricultural activities.

To date, legal entities and private entrepreneurs that have the right to use SST must meet the following requirements: (1) the volume of sales is not more than UAH 20 million per year (about USD 840,000)<sup>5</sup>, (2) the type(s) of activity are allowed for ST payers<sup>6</sup>. Permitted activities include all types except those specified in the Ukrainian Tax Code. Currency exchange, the major part of financial, insurance, and investment services, operations on excisable goods, as well as the extraction and sale of minerals (except locally) are not permitted. Also, legal entities are not allowed to use the SST



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<sup>5</sup> In the Tax Code of Ukraine, the amount of sales payers ST designated period of the "annual income".

<sup>6</sup> As noted above, this report does not cover Group 4. payers (agricultural enterprises).

if the share of legal entities that do not use the SST in their statute capital exceeds 25%.

The single tax thus replaces the following taxes:

- 1) income tax;
- 2) personal income tax;
- 3) VAT on the supply of goods and services within Ukraine (except taxation of ST payers who are both VAT payers), and;
- 4) property tax. Also, single taxpayers are not payers of military dues.

There are four groups of ST taxpayers. The three groups relate to the main types of economic activity discussed above, and the fourth group concerns exclusively representatives of agriculture and small farms. The criteria for assigning particular entities to these groups are clearly set [See: Table 1].

#### WHY WAS THE SST INTRODUCED?

During the transition from the socialist economy to the market economy in the 1990s, rapid changes occurred in many spheres of life in Ukraine. In contrast, the regulation of these areas did not correspond to market economy ones. One of the problem areas was the tax system. It still was complicated, cumbersome, reporting and accounting was fit rather for the enormous Soviet industrial monsters, but not at all for the emerging micro-business sector.

It was the entrepreneurial initiative of the Ukrainians that mitigated the harmful effects of *de facto* closing down large enterprises in the 1990s. Thousands of people who were on a "forced leave" flooded the market – they became "shuttles" that carried simple goods from/to border countries (such as Poland, Slovakia, Hungary, and later Turkey). A complex system of tax reporting and accounting, coupled with high and progressive rates of payroll tax in the absence of enforcement, criminal racketeering, and



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economic crime, has put new entrepreneurs in severe conditions. They were pressured by the criminal mafia and rent-seeking government officials.

The country was captured by informal forms of employment, receiving salary "from the pocket" was typical for many *de novo* companies. The role of small businesses was negligible, as SMEs could not develop because of the unsuitable and complicated overall tax system.

Back in 1992, the Cabinet of Ministers introduced a flat tax for individuals who traded on the market up to 100 UAH (about USD 50 in the price of 1999<sup>7</sup>). However, such

<sup>7</sup> Decree of the Cabinet of Ministers of Ukraine "On the Taxation of Citizens" No. 13-92, December 26, 1992.

Table 1. Requirements for different groups of users of a simplified tax system

	1 <sup>st</sup> group	2 <sup>nd</sup> group	3 <sup>rd</sup> group	4 <sup>th</sup> group
<b>Legal form</b>	Individual entrepreneur	Individual entrepreneur	Individual entrepreneur/legal person	Individual entrepreneur/legal person
<b>Maximum annual income</b>	UAH 300,000	UAH 1.5 million	UAH 5 million	No limits
<b>Unified tax rate</b>	Up to 10% of subsistence minimum (per month)	Up to 20% of minimum wage (per month)	5% of income (for VAT non-payers); 3% of income (for VAT payers)	From 0,19% to 6,33% of the normative monetary value of agriculture lands
<b>Number of employees</b>	No employees	Up to 10 employees	No limits	No employees (individual entrepreneurs)/ no limits (legal persons)
<b>Fiscal period</b>	Year	Year	Quarter	Year
<b>Permitted activities</b>	1) retail sale of goods on markets; 2) household services	1) services (incl. household services); 2) manufacturing and/or sale of goods; 3) restaurant industry	Any activities eligible for the Simplified Tax System	Agriculture (legal persons - share of agriculture must be not less than 75% in the previous fiscal (reporting) year; individual entrepreneurs – only production and sale of agriculture products
<b>Consumers</b>	Services can be rendered only to individuals	Services can be rendered to individuals and simplified tax system taxpayers	No limits	No limits

Source: Tax Code of Ukraine

a measure was not enough to make life easier for the Ukrainians, who took responsibility for their own lives into their own hands after many Soviet plants and factories had been closed.

In order to legalize the work of thousands of new entrepreneurs, reduce informal and shadow employment, the Ukrainian government decided to introduce simple rules for taxation and reporting for small businesses. In 1998, the Presidential Decree introduced a simplified tax system, limiting the reporting and accounting burden, which had been in place since 1999<sup>8</sup>.

### **STATISTICS OF SIMPLIFIED TAXATION: RESTRICTIONS**

The statistics of the operations of the simplified tax system are incomplete compared to the data describing the general tax regime. This is due to the fact that the system is “simplified”, and entrepreneurs do not maintain and/or do not submit specific indicators to the relevant state institutions. Under the simplified tax system, micro-enterprises and legal entities provide a general financial statement: balance sheet and an income statement containing only six income and expense items<sup>9</sup>. Notably, the problem of missing or incomplete data relates to the description of those parts of the business that use a simplified taxation system and the legal form of registration of the business activity called “individual entrepreneur” (FOP). The individual entrepreneur does not submit any reports

<sup>8</sup> Presidential Decree “On Simplified System of Taxation, Accounting, and Reporting of Small Business Entities” No. 727/98, July 3, 1998; Presidential Decree “On Amending the Presidential Decree of July 3, 1998” No. 727 “System of Taxation, Accounting, and Reporting of Small Business Entities” No. 746/9928, June 1999.

<sup>9</sup> Angel, I., O. Betliy, and V. Kravchuk (2017) Official Statistics SME in Ukraine, Kyiv: Institute of Economic Research and Policy Consulting. Available [online]: [http://www.ier.com.ua/files//Projects/2015/LEV/pp\\_SME\\_statistics\\_2017.pdf](http://www.ier.com.ua/files//Projects/2015/LEV/pp_SME_statistics_2017.pdf)



## THE STATISTICS OF THE OPERATIONS OF THE SIMPLIFIED TAX SYSTEM ARE INCOMPLETE COMPARED TO THE DATA DESCRIBING THE GENERAL TAX REGIME

to the State Statistics Service. Therefore, to produce any statistical data regarding FOP activities, the State Statistics Service uses impersonal data on total income and the number of employees based on FOP’s tax reporting.

### **IMPACT OF THE SIMPLIFIED SYSTEM ON THE BUSINESS ENVIRONMENT**

After the introduction of a simplified tax system, entrepreneurial activity in the formal (legal) economy has increased in Ukraine<sup>10</sup>.

According to the State Statistics Service, the number of small enterprises increased prior to the emergence of the simplified tax system – from 1996-1998, it increased by 80% – from 96,000 to 173,000. After the

<sup>10</sup> For more, see : Kravchuk, K., O. Betliy, and I. Burakovsky (2016) *Simplified System: Evaluation in Contemporary Context*, Kyiv: Institute of Economic Research and Policy Consulting.

introduction of legal status labelled as “individual entrepreneur” and the simplified tax system, the growth rate of small enterprises from 1999-2003, decreased on average to 9.5%, and from 2004-2007, up to 4.4%<sup>11</sup>.

There were similar trends in the number of employees in small enterprises, as well as in terms of the share of small enterprises in total sales<sup>12</sup>. In the case of the former, in the years 1996-1998, the number of employees grew by 9.5% annually (up to 1,560,000 people in 1998). In 1999-2003, growth rates declined to 5.5% per year on average (up to 2,034,000 people in 2003). In addition, in 2004-2007, the trend changed – every year, the number of employees in small enterprises decreased by an average of 4.8% (to 1,674,000 people in 2007). As of 2013, 2,010,000 people worked in small enterprises in Ukraine.

### INDIVIDUAL ENTREPRENEURS (FOP)

According to the State Registration Service, as of the beginning of the year 2000, 1,047,000 FOPs were registered in Ukraine. From 2000-2008, their number increased rapidly – on average by 215,000 annually. From 2000-2004, the growth rate was 13.7-16.2% per year; starting with 2005, it began to slow down, and from 2011-2013 the number of entrepreneurs was declining over the years. As of January 1, 2014, the number of FOPs amounted to 3,040,000, which is almost three times more than the level since the beginning of 2000.

Not all registered FOPs were active. According to the State Tax Administration, as of the beginning of 2000, only 750,000 FOPs (77.5% of the registered entities) were actual taxpayers. The data on the number



## INDIVIDUAL ENTREPRENEURS USE SST MORE ACTIVELY THEN TYPICAL LEGAL ENTITIES (COMPANIES)

of employees working in the FOP are available only for the period since 2006. During this period, the number of the employed initially increased – from 3,399,000 in 2006 to 4,223,000 in 2009. In 2010, after the introduction of an additional payment of social security contributions for SST taxpayers, the number of employed workers in the FOP fell by 34% to 2,794 million – mainly due to the reduction in the number of entrepreneurs, not employees. Later, the number of employees decreased again, this time to 2,233,000 in 2012; in 2013, it increased slightly to 2,281,000.

Thus, in the early 2000s (shortly after the introduction of the simplified tax system), the growth rates of new business entities in the form of individual entrepreneurs were significantly higher than the growth rates of new business entities in the form of legal entities (enterprises). Such trends thus clearly indicate that for the Ukrainian businesses operating at the time (trading in the markets, wholesale trading in small consignments of goods) the level of business skills, and the status of an individual entrepreneur on the SST was far more convenient.

<sup>11</sup> After 2007, the State Statistics Committee changed the definition of a “small business”, which has made further analysis of growth rates impossible.

<sup>12</sup> Relevant data on FOPs are unavailable.





## ENTERPRISES THAT USE SST ARE WIDELY INVOLVED IN ECONOMIC RELATIONS

### **SIMPLIFIED SYSTEM OF TAXATION: 2019 STATISTICAL DATA**

In 2019, a single tax was paid in Ukraine by 174,297 companies (15% of total number of legal entities) and by 1.3 million individual entrepreneurs known as FOPs (70% of total number of FOPs)<sup>13</sup>. The largest share of FOPs is in the second group of single taxpayers – accounting for 581,000 entrepreneurs (44.5%). 523,000 entrepreneurs who work under SST (40%) use the 3<sup>rd</sup> group of SST, whereas 200,000 (15%) of entrepreneurs use the first group of SST. The most significant number of business entities (companies) in the simplified tax system deals with real estate transactions (14%). Next, there is also wholesale (7.8%), agriculture (7.5%), and activities in the field of law and accounting services (5.7%).

Individual entrepreneurs use SST more actively than typical legal entities (companies). According to the State Tax Service (STS)<sup>14</sup>, as of the beginning of 2019, there were 1,394,500 entrepreneurs under the simplified tax system. By the beginning of

2020, there are already 1,488,300. According to the STS, over the year 2019, budget revenues from the single tax have also increased – taxpayers paid UAH 24.95 billion of a single tax (25.5%; UAH 5.08 billion more than in 2018).

### **SIMPLIFIED TAX SYSTEM THROUGH THE EYES OF ENTREPRENEURS**

The statistics presented above show that the simplified tax system has become a significant component of the economic environment in Ukraine. When analyzing the results of a survey conducted among small and medium enterprises (SMEs), even more arguments for this thesis may be provided<sup>15</sup>.

### ***SST BUSINESS ENTITIES ARE A SIGNIFICANT PART OF THE BUSINESS ENVIRONMENT***

Among the SMEs surveyed in ABCA 2016, there were 47.3% of enterprises (or entrepreneurs) that work under the simplified tax system. Meanwhile, 51.1% of SMEs used the overall system of taxation. Most of the respondents were in the third group of single tax (41.3%). 5.5% of those polled worked in the 1<sup>st</sup> group, 25.6% were in the 2<sup>nd</sup> group, and 15.1% were in the 4<sup>th</sup> group (for agricultural enterprises).

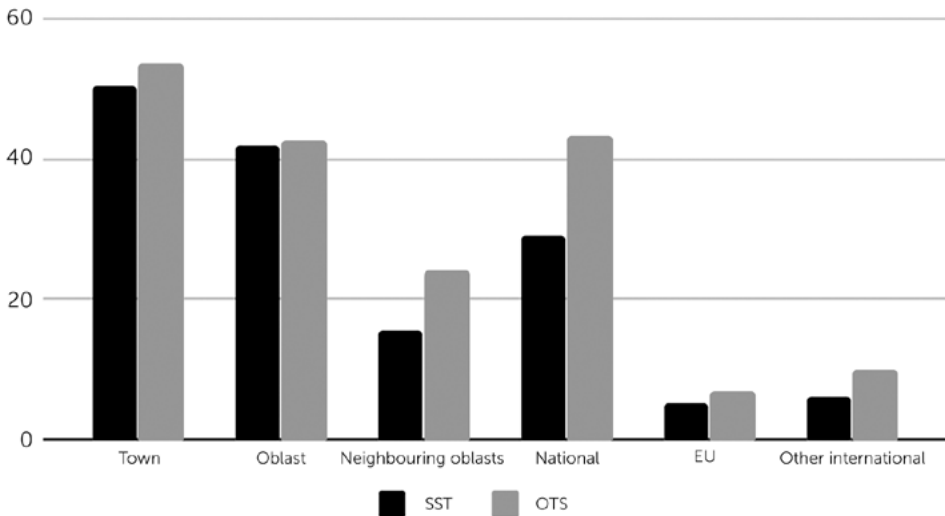
As noted above, the simplified taxation system is used mainly by individual entrepreneurs – FOPs. The SME survey results confirm this tendency. In particular, among the surveyed FOPs, 81.5% worked under the SST, while among the companies registered as legal entities, there were, on average, 33.6%. The larger the SME, the smaller share of SMEs use SST – there were 41.8% among micro companies, among small companies – 25.1%, and among medium-sized companies – 22.1%. On average, 12 persons

<sup>13</sup> As of July 2019, as calculated by opendatabot.ua. Available [online]: <https://opendatabot.ua/blog/340-single-tax>

<sup>14</sup> <https://www.unian.ua/economics/finance/10867751-verlanov-kilkist-fopiv-v-ukrajini-prodovzhuye-zrostati.html>

<sup>15</sup> An Annual Business Climate Survey, with participation of 1800+ small and medium enterprises (including 500 individual FOP entrepreneurs) was conducted in 2016.

Figure 1: Markets in which enterprises operate [%]



Source: Own calculations based on the database of Annual Business Climate Assessment, ABCA (2016)

are employed in a SST business entity, whereas 31 persons are employed by SMEs that use the overall tax system.

Enterprises that use SST are widely involved in economic relations. 57.9% of respondents who work under the overall tax system indicated that their suppliers are SST enterprises, and 52.9% said that such entities are among their clients.

SST entities are also more likely to operate in local markets. For example, only 29% of respondents working in the SST indicated that at the moment (in 2016) the company operated in the national market, while among companies using the overall system of taxation, 43.1% worked in the national market.

Although businesses using the simplified tax system are typically smaller and more focused on local markets, they are also involved in foreign economic activity, yet to a rather limited extent [See: Figure 1]. 8.6% of respondents from the SST said that they

conducted exports in 2016. Meanwhile, 15.5% of entrepreneurs working under the overall system admitted they exported goods. The corresponding data for importers are 6.5% in the case of the former, and 15.5% for the latter.

### ***"TIME TAX" IS LOWER***

One of the reasons why people in Ukraine are afraid to do business is communication with the state, which is still complicated and frustrating. According to the SME survey (ABCA Annual Business Climate Assessment), 27% of small and medium-sized enterprises considered the state an enemy, and almost 60% of SMEs viewed it as an obstacle<sup>16</sup>. The results of the survey show that entities that use SST spend less time communicating with the state. On

<sup>16</sup> Kuziakiv, O., et al (2017) *Annual Business Climate 2016: National and Regional Dimensions. Analytical Report*, Kyiv: Institute of Economic Research and Policy Consulting. Available [online]: [http://www.ier.com.ua/files//Projects/2015/LEV/ABCA2017/ABCA2016\\_full\\_report.pdf](http://www.ier.com.ua/files//Projects/2015/LEV/ABCA2017/ABCA2016_full_report.pdf)

average, management (owners) of an enterprise with SST spends 13% of the time interacting with government representatives, and among those working under the overall tax system, this figure is 16%. Significantly less time is spent on tax-related matters by SST entities compared to the entities under the overall system of taxation – 7% and 10% of the time spent by executives or employees, respectively, addressing such issues.

Moreover, the SST business entities spend fewer resources on accounting. While 68.3% of SMEs working under the overall system always have a full-time accountant, only 31.5% of SST SMEs have a full-time one. 22.0% of the SST business entities outsource accounting services (12.1% are among those under the overall system), and 32.2% maintain accounting independently (among those who work under the overall system, only 9.1%). Here, it should be mentioned that some differences stem from the size of the companies – those under SST are typically smaller than those operating under the overall tax system.

Another argument for the positive impact of the simplified tax system is the analysis of obstacles to business development. Businesses that use different tax systems have different implications for their barriers to business growth [See: Figure 2]. Significantly higher shares of enterprises under the overall system of taxation, compared to the simplified one, indicate a negative impact on business growth of high tax rates (39% vs. 31%), burdensome tax administration (29% vs. 22%), and high regulatory pressure (25% vs. 19%). Also, entrepreneurs that use SST assess the business climate better. Thus, 11.7% of SMEs that used the simplified tax system considered the business environment to be favorable, whereas only 7.0% of those under the overall tax system expressed such an opinion.

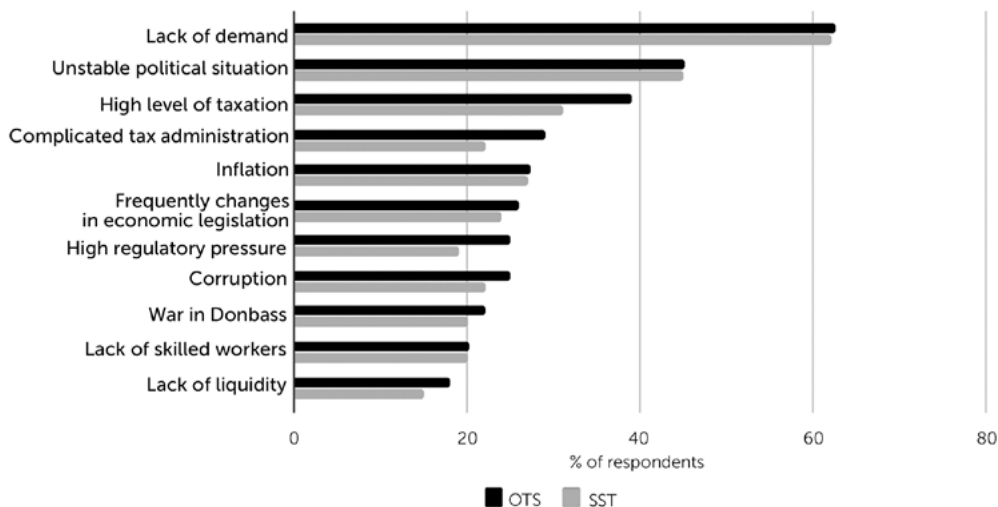


ONE OF THE REASONS WHY PEOPLE IN UKRAINE ARE AFRAID TO DO BUSINESS IS COMMUNICATION WITH THE STATE, WHICH IS STILL COMPLICATED AND FRUSTRATING

In light of these observations, the problems with the tax administration for SMEs that use the overall system of taxation seem more serious than for those under the simplified system. This shows that a fixed tax level, fewer mandatory payments, and, more importantly, simplified accounting, helps SMEs avoid the problems that may hinder their business growth.

Entrepreneurs taking part in focus group discussions assessed the simplified tax system very positively. They noted that it reduces time costs, and facilitates the administration and payment of taxes. Also, entrepreneurs believe that thanks to the simplified system, SMEs are no longer dependent on the state, and rely solely on their forces. "One of the participants stated that "the positive aspect is that the people who are now self-employed are less prone to experience pressure from the government. In principle, people just try to get by on their own". The simplified system is considered

Figure 2: Obstacles to Business Development [%]



Source: Own calculations based on the database of Annual Business Climate Assessment, ABCA (2016)

to be not as complicated in reporting as the overall one, and is, therefore, accessible to people without specialized training. That is, the system, as the respondents claimed, “helps people who are unable to hire a person to keep records”, because they can independently handle their case related to the documentation<sup>17</sup>.

### **WHY ARE ENTREPRENEURS AFRAID OF MOVING TO AN OVERALL TAX SYSTEM?**

Entrepreneurs working under a simplified tax system most often do not plan on switching to the overall one. This opinion was expressed by 85.1% of the respondents in the 2016 Annual Business Climate Assessment, all of who worked under the simplified tax system. The main reasons for such a position are the lack of need (“we

do not plan to grow”) and the complexity of the overall tax system.

Within the focus group, which was examined simultaneously to conducting the survey, entrepreneurs described their fears of moving onto the overall tax system. The overall tax system seems complicated to many businesses because entrepreneurs believe that by working under it they will spend more time and resources to keep records – including the need for warehousing. The more documents, the higher the possibility of making a mistake. Entrepreneurs are afraid of making errors in paper work because tax officials already had a tendency to impose fines or demand bribes.

All focus group participants agreed that moving from a simplified tax system to an overall one would cause a lot of difficulties for entrepreneurs. First, it would mean an increase in tax liabilities, which will raise the cost of production. It should be noted that the respondents understood

<sup>17</sup> The results of the focus groups were analyzed and described in the Annual Business Climate Assessment report and in the advisory paper: Gurama, Z. and M. Mansor (2015) *Tax Administration and Payment: Challenges and Prospects*. Available [online]: [https://www.researchgate.net/publication/327664049\\_Tax\\_Administration\\_Problems\\_and\\_Prospect\\_A\\_Case\\_of\\_Gombe\\_State](https://www.researchgate.net/publication/327664049_Tax_Administration_Problems_and_Prospect_A_Case_of_Gombe_State)

that this would bring deterioration in their competitive position. “How do you justify raising the prices to your buyers?” one of entrepreneurs said. “People are used to the fact that your product has such a price in the market and you can no longer raise it, because you cannot give them an argument that you have switched to another system and, therefore, they must pay more now. The buyer will simply go over to another businessman”, added another one. Second, operating under the overall tax system is more difficult than under the simplified one, so there is a need to hire an accountant, which will entail additional costs, because “(...) *the overall system means that it already involves accounting and the accountant himself*”. This is why switching from a simplified to an overall tax system seems to them like a complicated process – one which requires an adaptive period and additional financial costs.

In order for the SMEs to stop being afraid of switching to an overall tax system, it is necessary to reform the system itself. The overall tax system should become simplified. This idea is supported by SMEs – all focus group participants were of the opinion that the main thing that would need to change was the simplification of the overall tax system. Only such a measure might enable the entrepreneur to avoid various difficulties



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during the administration, payment of taxes and sanctions imposed by the tax inspectors for the potential mistakes made in the reporting. In order for such simplification not to be a source of abuse, the state must take appropriate measures – in particular, to promote the financial culture of entrepreneurs.

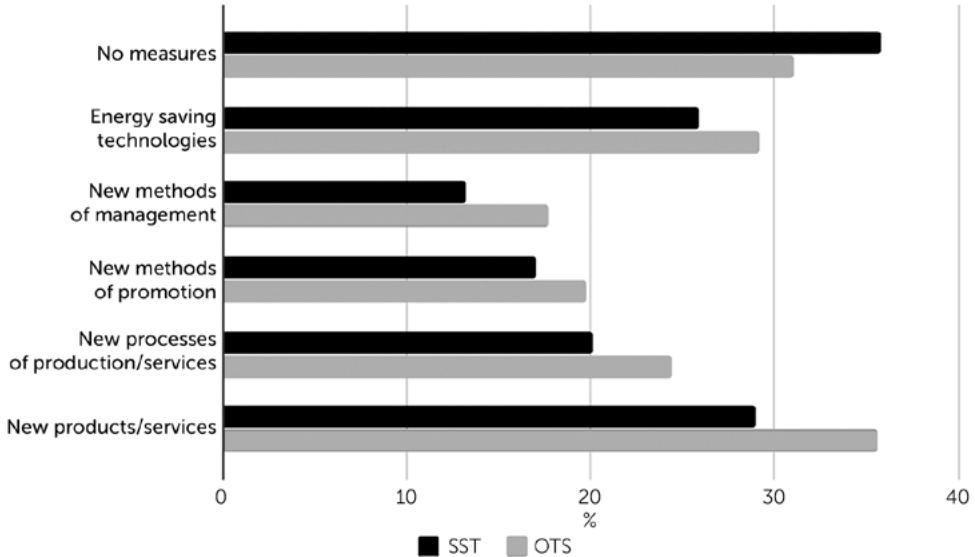
### ***BUSINESS PROCESSES IN COMPANIES WITH DIFFERENT TAX REGIMES: IS THERE A DIFFERENCE?***

Opponents of the simplified tax system said in the survey that internal business processes in the companies that use SST are not perfect, and such business entities do not have external incentives to drive innovation for development and growth. There is, however, no recent data to support or refute this hypothesis. However, an analysis of the results of the Annual Business Climate Assessment 2016 indicates that economic behavior and many business processes are either the same for businesses using the simplified tax system, and those operating under the overall system. If there was any difference in this regard, it was not very significant.

### ***INTRODUCING INNOVATION***

About a third of SMEs surveyed did not implement any innovative measures. Among those who use the simplified tax system, 35.8% of respondents reported the absence of innovation in their businesses. This share is slightly greater than among those who work under the overall system (31.0%), but the difference is still minor. Most often, respondents understood innovation as introducing new products or providing fundamentally new services – which was true for 29.0% of those using the SST, and 35.6% of those using the overall system. The second for both groups was the introduction of energy-saving technologies (25.9% and 29.2% respectively) – the difference between the two groups was also rather insignificant. Interestingly, representatives

Figure 3: Introduction of innovation at enterprises [%]



Own calculations based on the database of Annual Business Climate Assessment, ABCA (2016)

of both types of enterprises paid the least attention to the implementation of new management methods (13.2% and 17.77%).

Thus, the results of the survey do not suggest that there is a significant difference in the innovative behavior of entrepreneurs using different modes of taxation.

”  
 BUSINESSES  
 THAT USE  
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 FOR THEIR BARRIERS  
 TO BUSINESS  
 GROWTH

#### ***USAGE OF THE INTERNET OR SOCIAL NETWORKS AS A MARKETING AND PROMOTION TOOL***

The results of the SMEs survey show that the entrepreneurs who work under a simplified tax system use online tools for marketing and promotion less often than the businesses that use an overall tax system. In particular, 37.2% of respondents using the SST do not use the Internet to promote goods (services), while among those who work under the overall system, it is only 24.2%. Only a third of respondents using the SST have a website, while more than a half of those who work under the overall system have one. Other types of promotion through the Internet or via social networks are also less commonly used by the enterprises operating under SST [See: Figure 4)].

### IMPROVING MANAGEMENT SKILLS

Both the SMEs that work under the SST and those companies that use the overall tax system understand the need to improve management skills in their workplaces. However, among those working under the overall system, the share of respondents who work on developing their skills is higher. In particular, 12.6% of SST enterprises stated that they do not increase their knowledge of management, while among those working under the overall system, the respective share was lower – 7.4%. The top three most popular measures of improving management skills mentioned were: reading professional literature (61.0% among SST respondents and 69.6% among respondents from the overall tax system group), communication with more experienced managers (48.8% and 57.0%, respectively), and attending workshops and seminars (30.9% and 41.1%).

### BUSINESS EXPECTATIONS

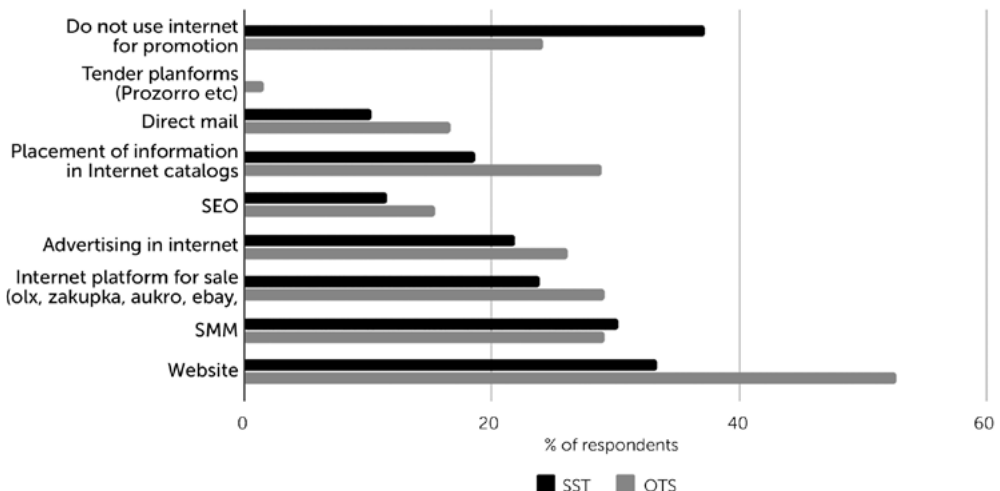
In 2016, general expectations of SMEs regarding business growth in two years'

perspective were very positive. Respondents working under the SST had slightly lower expectations for their development – 41.2% of them planned to expand their business. In contrast, among the surveyed business entities that work under the overall system, the share was 47.5%. Accordingly, 41.3% and 37.5% of respondents from these groups did not plan any changes in the foreseeable future, and 9.9% and 9.3% expected their activity to decline within the next two years. 7.5% of those under the simplified system and 5.7% under the overall system could not forecast a two-year perspective. The more cautious plans of the SST enterprises may have been triggered by attempts to change the simplified tax system and rumors of its elimination, which are discussed in the Ukrainian political environment annually.

### ABUSE OF THE SIMPLIFIED TAXATION SYSTEM

The Ukrainian experience of having a simplified tax system for more than twenty years shows that there are no perfect models. At the same time, any unique

Figure. 4: Using the Internet and Social Networks to Promote Goods and Services [%]



Source: Own calculations based on the database of Annual Business Climate Assessment, ABCA (2016)



THE ENTREPRE-  
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solutions are bound to create inequalities and opportunities for abuse.

Due to the tax burden and the complexity of the overall tax system, some business entities use this system for optimizing tax obligations, and lower the cost of doing business. The companies with a turnover above the level defined by the rules of the simplified tax system split into smaller companies to avoid the excessive burden and have opportunities to use SST. This division usually increases the cost of management, but significantly reduces the tax burden and paper work.

The existing tax regimes (one of which is more friendly for businesses) somewhat reduce the incentives for medium and large

companies to grow because the rules of taxation, reporting, and accounting on the overall system are too complicated, and the tax burden is higher. According to the International Finance Corporation study, tax compliance costs for small businesses operating under the overall tax system are substantially higher than for large ones (with the difference in the corresponding expenditures between small and large taxpayers being significantly higher than in EU countries)<sup>18</sup>, which lead to an increasing interest in SST.

Another way to abuse the simplified tax system is to use it in a *de facto* employment relationship between an employee and an employer. In Ukraine, labor taxation is quite high. There is an 18% income tax, 1.5% military tax, and a single social contribution (22%) paid by the employer from the payroll. For example, to pay USD 1,000 of net salary, an employer must budget USD 1,460.

However, when an employee is hired as an individual entrepreneur (FOP) of the 3<sup>rd</sup> group under a simplified tax system, the employer can easily save money. The tax obligations for the 1<sup>st</sup> and 2<sup>nd</sup> groups are lower than for the 3<sup>rd</sup> group, but only the 3<sup>rd</sup> group allows working with legal entities. As a result, instead of spending USD 1,460, the entrepreneur will spend for such a quasi "individual entrepreneur" about USD 1,093. Therefore, the benefit is quite obvious.

Apart from that, the loopholes in Ukrainian tax legislation allow for using the 2<sup>nd</sup> group of the simplified tax system instead of the 3<sup>rd</sup> one, which also reduces tax liabilities. In particular, in the IER 2016 study, the authors estimated the amount of income, which was hidden by single taxpayers of the 2<sup>nd</sup> group in 2014, at UAH 7.8-13.2 billion

<sup>18</sup> International Finance Corporation (2009) *The Costs of Tax Compliance in Ukraine*.





## IN UKRAINE, LABOR TAXATION IS QUITE HIGH

(about USD 500- 850 mln<sup>19</sup>), constituting 4.9–8.2% of the total income declared by the payers of this group<sup>20</sup>.

Among the experts and business community in Ukraine, there are two opposing views about the relation of the simplified tax system and smuggling. The experts from the Ukraine economic outlook stated that, namely, one of the reasons why business entities with SST are used for smuggling is simplified accounting they conduct. The absence of an obligation to have documents that show the origin of goods and the possibility to sell assets without a cash register creates the opportunity to sell any amount of imported goods illegally. Therefore, as long as smuggling is possible through misuse of the simplified taxation scheme, the whole of the “simplified” system will always be under unjustified pressure from fiscal/controlling bodies, and explicit criticism from the “white” business that works under the overall tax system<sup>21</sup>. Meanwhile, according to the experts from the Institute for Socio-Economic Transformation, tax evasion (“optimization”) through

<sup>19</sup> USD/UAH rate 1/15.7. Source: National bank of Ukraine.

<sup>20</sup> Kravchuk K., O. Betliy, and I. Burakovsky (2016) *Simplified System: Evaluation in Contemporary Context*, Kyiv, Institute of Economic Research and Policy Consulting. It needs to be mentioned that the authors of the research treated their calculations with caution because of data limitations.

<sup>21</sup> *Ukrainian Economic Outlook* (2019) “Analysis of Smuggling in Ukraine”. Available [online]: <http://ua-outlook.com.ua/en/2019/07/06/smuggling-schemes/>

the simplified tax system is negligible compared to other schemes (e.g. offshore)<sup>22</sup>.

Respondents of the ABCA 2016 survey also identified these negative phenomena. They found it unfair for competition when companies selling identical goods had different costs because the goods were imported in violation of the customs regime. To combat this, they suggested an increased control. This attitude does, however, create a clear paradox, as increasing control usually means reducing entrepreneurial freedom and increased corruption.

### WHAT TO DO ABOUT IT?

Is it possible to eliminate a simplified tax system altogether and move all business entities into an overall tax system?

Any complication of the simplified tax system and accounting is detrimental to the development of micro-business in the country. The results of the 2016 ABCA SMEs survey show that small and medium enterprises generally assess the simplified tax system as positively. According to their opinions, this system reduces time costs and makes reporting more straightforward. The transition to the overall system scares entrepreneurs, as it would create the need to increase both communication with the state and spending on accounting. Meanwhile, resources in small and micro businesses are limited.

The presented analysis shows that the economic behaviors of the businesses that use the simplified tax system and those that operate under the overall one do not differ – they both face similar challenges and problems. Entrepreneurs using SST feel more protected from corruption and spend less time and resources on administration

<sup>22</sup> <https://iset-ua.org/images/Analysis-shem-2019-FINAL.pdf>

But the advantages of SST are, at the same time, the same as its drawbacks. There are some kinds of thresholds that keep many companies from growth or even force them to divide into separate business entities. As it becomes clear from the presented overview, growing over the threshold means more administrative burden and higher tax obligations. At the same time, the phenomenon of businesses withholding growth is detrimental to the economy.

Does this mean that SST limits the growth of companies because it is “simplified”? Or maybe it is because the overall tax system is too complicated? The answer to that question seems obvious: it is both.

At the moment, it is unclear which part of the micro and small businesses that now use the simplified tax system will be able to use the overall one without increasing the cost of compliance they will bear (in terms of both money and time).

Therefore, the principle that should be followed when dealing with small businesses is “do no harm” and create conditions when such abuse is not beneficial to the large-size companies. This is precisely why the simplified tax system should be protected from possible abuses from dishonest entrepreneurs by differentiating income and changing the criteria for those who can use it, rather than by strengthening controls<sup>23</sup>. Summarizing, the coping of possible damage must be targeted, i.e. the measures should be directly aimed at fixing concrete problems. In the case of a simplified tax system, it is necessary to counteract precisely the optimization schemes and those business entities that use the system dishonestly. Modernization of this system

<sup>23</sup> V. Dubrovsky (2020) *Simplified System: Do Not Delete but Modify*. Available [online]: [https://zn.ua/business/uproschenka-ne-unichtozhat-no-usovershenstvo-vat-342430\\_.html](https://zn.ua/business/uproschenka-ne-unichtozhat-no-usovershenstvo-vat-342430_.html)



## ANY COMPLICATION OF THE SIMPLIFIED TAX SYSTEM AND ACCOUNTING IS DETRIMENTAL TO THE DEVELOPMENT OF MICRO-BUSINESS IN THE COUNTRY

should maintain its positive features that have contributed to the development of entrepreneurship in Ukraine over the last twenty years – namely, ease of use and inexpensive administration. In parallel, the overall tax system should be reformed so that in the future, all business entities would operate under the simplified tax system.



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