

# Combating revenue underreporting in the simplified tax system: Analysis and recommendations

- Summary of results -

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Berlin/Kyiv, October 2021

# Structure

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4. Abuse potential in the Ukrainian STS
5. Analysis of revenue distributions in the groups of the STS
6. Analysis of three high-risk activities in STS Group 2
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# 1. Introduction

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## **Background:**

- Ukraine operates a Simplified System of Taxation (STS) for SMEs alongside its regular business taxation regime to promote SMEs' growth and operation in formal economy
- While the STS clearly contributes to reduced administrative and tax burdens on SMEs, it is also abused by companies illegally underreporting their revenues or semi-legally splitting revenues into different companies
- Properly targeted and balanced adjustments to STS are needed to reduce the fiscal losses and discrimination against compliant companies while ensuring that nurturing conditions for genuine small business remain in place

## **Purpose of this Policy Briefing:**

- Overviewing current design and the abuse potential of Simplified Taxation System in Ukraine
- Summarising the revenue distribution and high-risk activities analysis
- Providing conclusions and recommended policy changes

## 2. Rationale behind simplified tax system in Ukraine

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There are two main goals for the governments that introduce STSs, all relevant for Ukraine:

- **growth of small and medium enterprises** and its conversion to broader economic growth
- **increasing fiscal revenues** and narrowing the scope of 'black' economy by formalization (legalization) of the SMEs

These goals are pursued in an STS through two policy objectives:

- **reduction of the administrative burden** by simplification of accounting and reporting
- **reduction of the tax burden** compared to regular tax system to allow small businesses to accumulate wealth for further investment and expansion and to induce small companies to be in the formal economy

### 3. Current design of the Ukrainian STS

Group	Subjects	Activities	Hired workers	Max. annual revenue	Single tax rate
1	SP	Market place traders, household services to private individuals	No	167 minimum wages (~UAH 1 m)	Monthly lump-sum: 10% of the subsistence level (UAH 227)
2	SP	Services to single taxpayers and households, wholesale and retail trade (shops, markets, online, except real estate and jewelry), manufacturing, restaurants	Up to 10	834 minimum wages (~UAH 5 m)	Monthly lump-sum: 20% of minimum wage (UAH 1200)
3	SP LE	Most activities with a list of exceptions*	Not limited	1167 minimum wages (~UAH 7 m)	3% (for VAT payers) or 5% (for VAT non-payers) of turnover
4	SP LE	Agriculture	Not limited for legal entities, no for farmers	Not limited	0.19-6.33% of the normative land valuation

\* includes iron ore extraction, processing and trading, mobile communications, postal services, gas and petrol trading, alcohol and tobacco production and trading, car manufacturing and trading, audit services, financial and insurance services, gambling, etc.

## 4. Abuse potential in the Ukrainian STS

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### 1. Turnover limits and cash register limits abuse

- business might underreport cash turnovers to avoid losing the eligibility for their group of simplified taxation system and/or to avoid paying higher taxes, or to avoid becoming obliged to use registrars of payment transactions (tax evasion)
- business may split the turnover into several individual entrepreneurs and transit to the simplified system, therefore paying less tax (often – legal tax avoidance)

### 2. Using SMEs for black import schemes

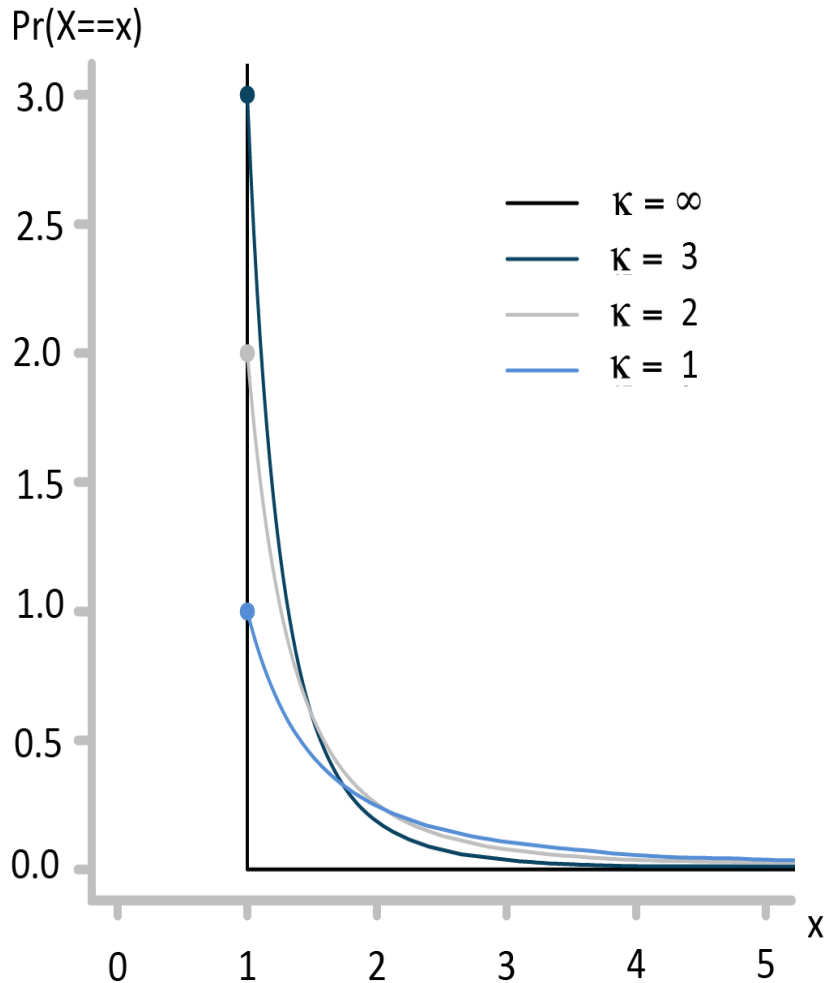
SMEs which are not required to issue fiscal checks can easily sell illegal imports, such as household electric appliances, cell phones, PCs, etc to final consumers

### 3. Using SMEs to avoid labour taxes for 'grey' employment schemes

Contracting full-time employees as individual entrepreneurs is especially common in IT companies, media, consulting and other professional services.

# 5. Analysis of revenue distributions in the groups of the STS

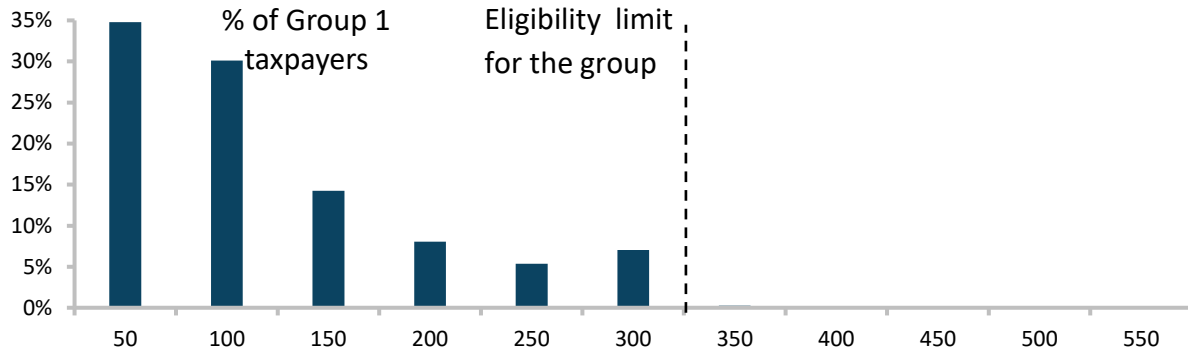
Expected distribution of revenues



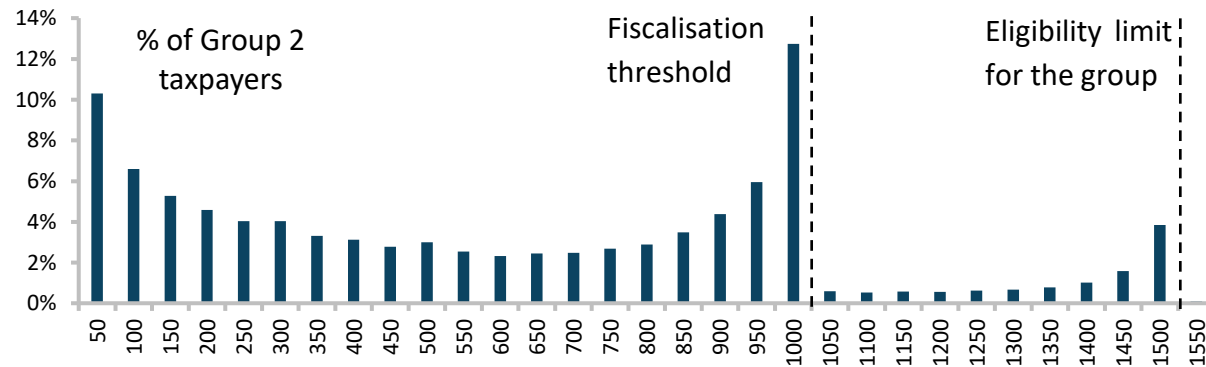
Normally, the distribution of revenues in each group should resemble a Pareto distribution.

That distribution approximates well many distributions in the economy, in particular distributions related to firm size and income.

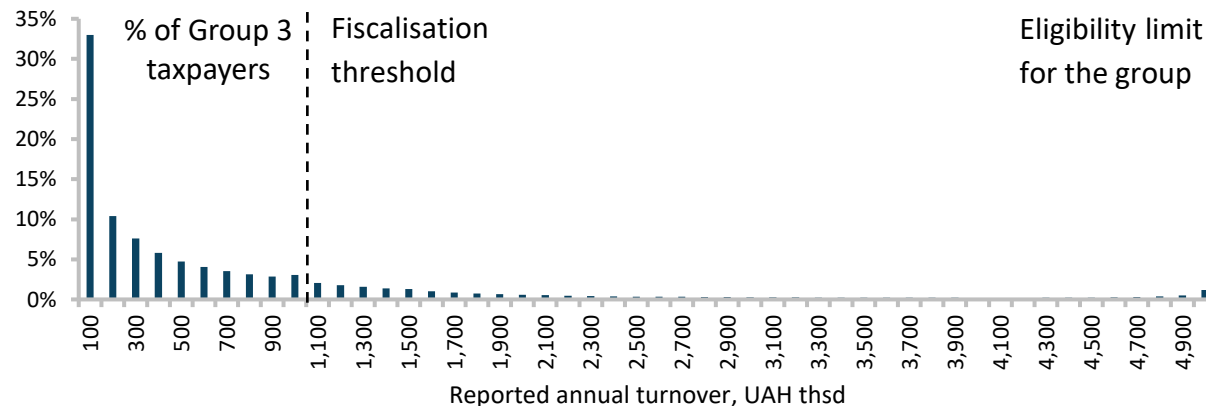
# 5. Analysis of revenue distributions in the groups of the STS



**Group 1**



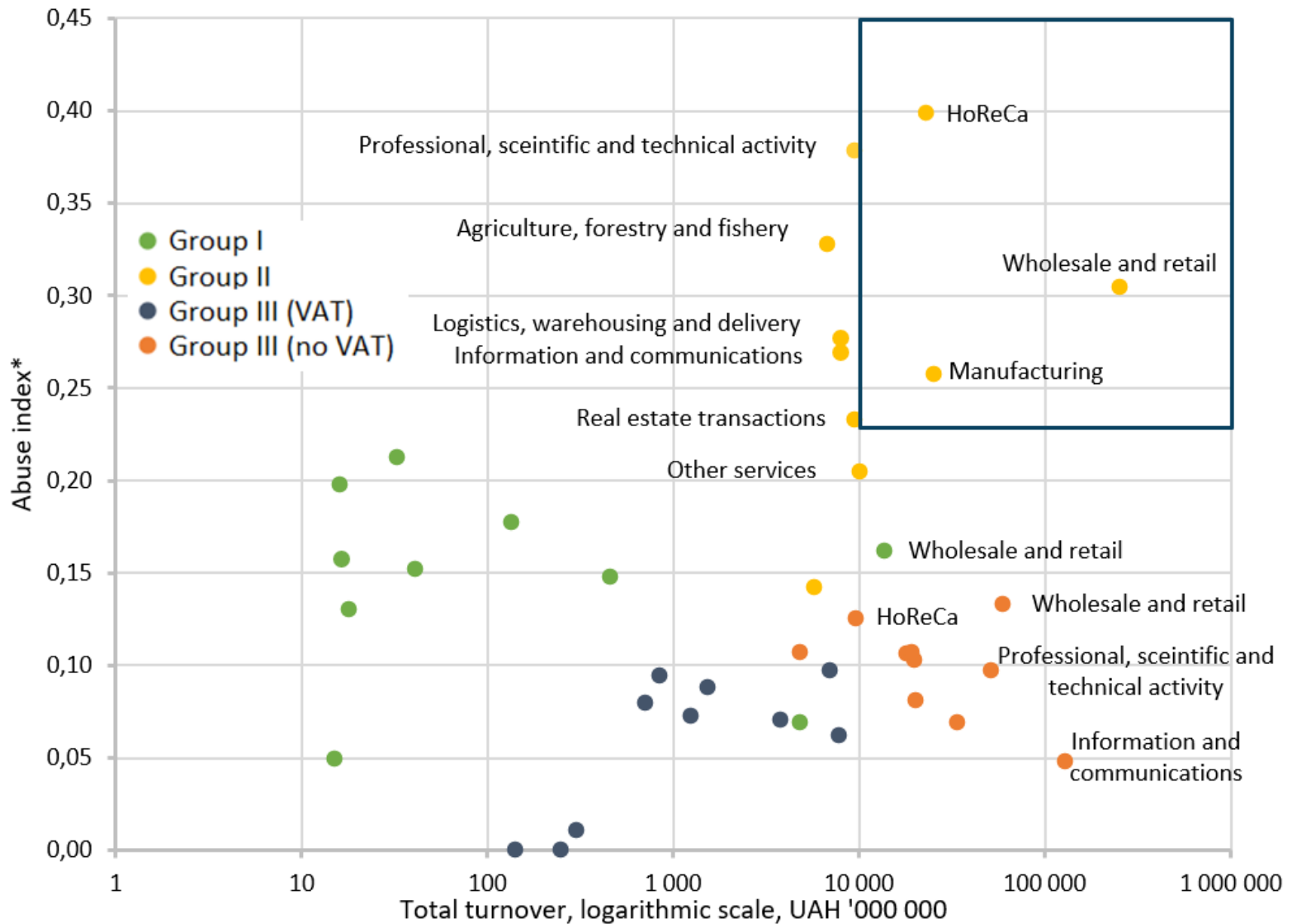
**Group 2 – distribution anomalies indicate widespread threshold abuse**



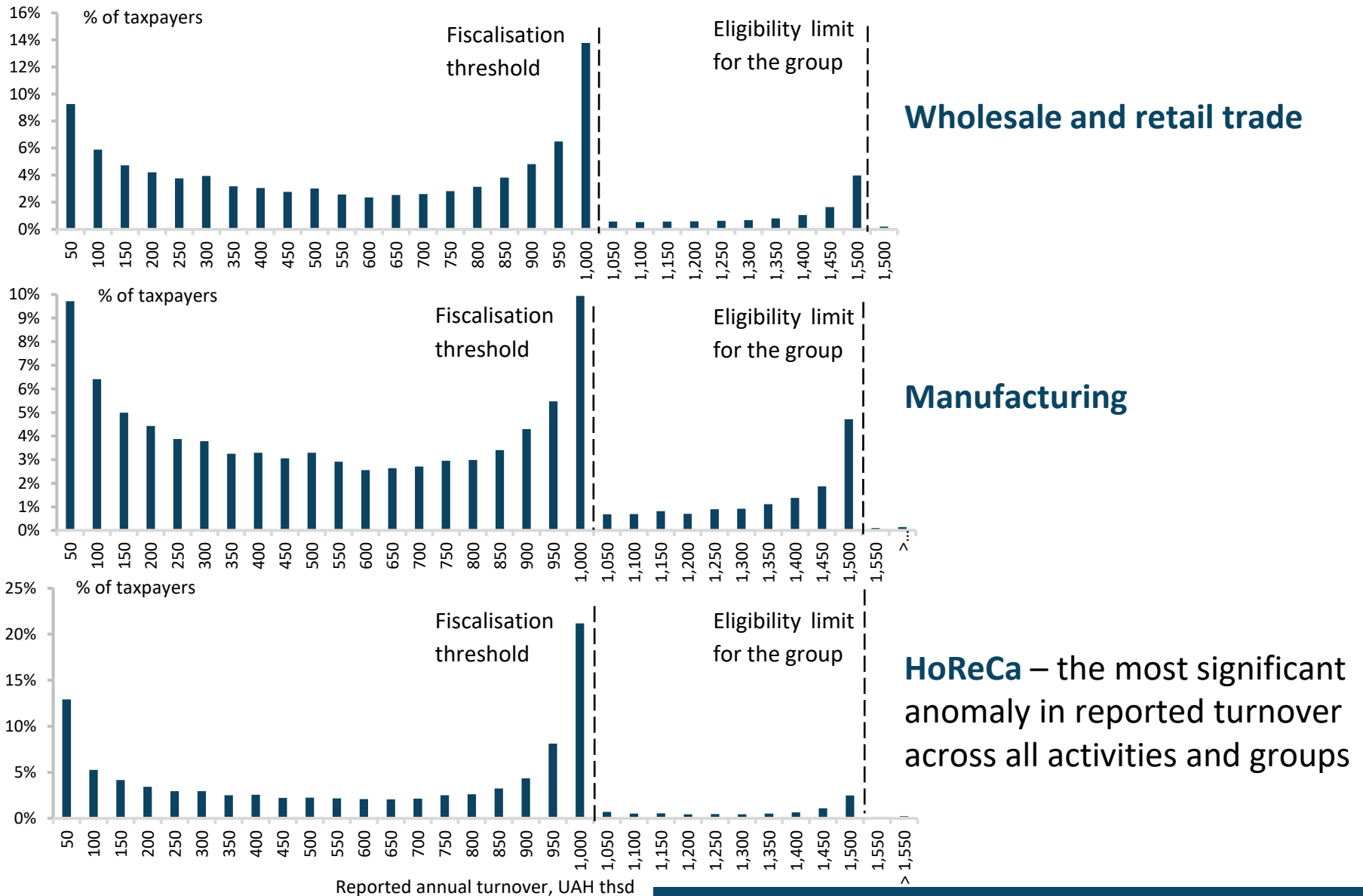
**Group 3**



# 6. Analysis of three high-risk activities in STS Group 2



# 6. Analysis of three high-risk activities in STS Group 2



# 7. Conclusions and policy recommendations

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1. Refocus groups 1 and 2 on the smallest of businesses by restricting substantially the list of eligible activities and adding further criteria:
  - activities should be restricted to small-scale personal services, micro businesses in gastronomy and sale of homemade, artisanal or agricultural products
  - large market stalls and fake individual entrepreneurs in large restaurants or hotels should be excluded
  - consider limitation of sale of goods, purchased from 3<sup>rd</sup> parties and by type of premises
  - turnover limits should be set wide enough for genuine micro businesses to fit in
2. Implement full fiscalisation for Group 3
3. Introduce compulsory VAT for retail business in Group 3 to:
  - eliminate incentives for sale of smuggled goods
  - incentivize the retailers to document and report the transactions to be eligible for the VAT credit

# About the German Economic Team



Financed by the Federal Ministry for Economic Affairs and Energy, the German Economic Team (GET) advises the governments of Moldova, Georgia, Ukraine, Belarus and Uzbekistan on economic policy matters. Furthermore, GET covers specific topics in other countries, such as Armenia. Berlin Economics has been commissioned with the implementation of the consultancy.

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