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Ukraine Special Focus Note: Tax Reform to Boost Growth, Formalize the Shadow Economy, and Strengthen the Budget

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- ***Ukraine's proposed tax reform is a move in the right direction. In finalizing the design, the authorities need to ensure that potential revenue shortfalls in the short run do not jeopardize debt sustainability and place an undue burden on the budget in supporting the national pension system.***
- ***Given the fragile economic situation, any tax reform must be mindful of the risk of reducing fiscal space to help cope with the recession and protect the vulnerable groups.***
- ***Tax reforms are most effective when coupled with decisive tax administration efforts to reduce informality and strengthen enforcement of the new tax regime. Strengthened mechanisms to enforce taxes will help ensure the taxation burden imposed on businesses and individuals is fairly borne by all, and not only by those who currently abide by the law.***

Why tax reform is needed?

The current tax system undercuts the business environment and competitiveness of the economy, and encourages widespread informal activity. Ukraine's current tax system is based on VAT, income taxes, and social security contributions, which accounted for 21.7 percent, 18 percent, and 28.8 percent of 2014 general government revenues, respectively. The standard VAT rate (20 percent) is broadly in line with those in other European countries. The corporate income tax rate (18 percent) is similar to the European average, yet higher than the tax rates prevailing in peer countries in the region (e.g., Bulgaria, Georgia, Moldova, and Romania have rates ranging between 10 percent and 16 percent). In contrast, the personal income tax rate (around 16 percent) is almost half of the European average, albeit similar to the tax rates found in regional peers (e.g., Georgia, Moldova, and Romania have rates ranging between 16 percent and 20 percent; Bulgaria's 10 percent is particularly low). While the social security total contribution rate (40.6 percent) is slightly above that of European countries, the distribution of the burden between employees and employers is very different. In Ukraine, complying employers bear the bulk of these contributions and pay a 37 percent rate, compared to the 23 percent paid by European employers. By increasing the labor costs facing business, the current tax regime undermines the country's competitiveness and creates strong incentives to under-report wages and employment. In addition, tax bases are narrowed through various exemptions and loopholes, thus facilitating tax avoidance. For instance, in 2013, actual VAT collection was 44 percent of the potential level if the exemptions were eliminated and the statutory rate were applied to all tax payers.

Inefficiency in tax administration, compounded by weak governance, also result in dismal collection rates of the main taxes. In Ukraine, the collection of taxes and social security contributions is unified, thus potentially simplifying tax administration and enforcement tasks. However, collection costs are high and operative efficiency is low. Over 54,000 staff work in the Ukraine tax administration agencies and there are only 60 tax payers per staff, compared to 407 in Poland, 1,100 in Slovenia, and 1,802 in Kazakhstan. These agencies are not only overstaffed but they are also inefficient in their operations. For instance, despite of Ukraine having slightly higher social security contribution rates than Poland, effective collection is 9 percent of GDP in the former and 13.2 percent of GDP in the later. Furthermore, in an overall context of weak governance and poor internal controls, corruption and bribes may occur and further diminish tax collection efforts.

What are the main changes in tax reform proposed by the Government?

The authorities envisage comprehensive tax reform to strengthen and expand the formal economy, boost competitiveness, and increase fiscal revenues. A tax reform proposal by the Ministry of Finance of Ukraine is currently being discussed in the Parliament in the context of the country's overall structural reform agenda. The proposed reform seeks to streamline the tax regime by unifying the rates of major levies, as well as to increase tax compliance by reducing social security contributions. It proposes a single tax rate of 20 percent for the VAT, corporate income tax, personal income tax, and the social security contributions paid by employers. Income tax rates are slightly increased relative to their current levels, while the definition of tax bases is simplified. Radical changes are introduced concerning taxation on labor: the social security contributions by employees are abolished, and those by employers are nearly halved. Such a significant alleviation of the current tax burden is expected to encourage formalization of the shadow economy, improve competitiveness, and increase effective tax collection.

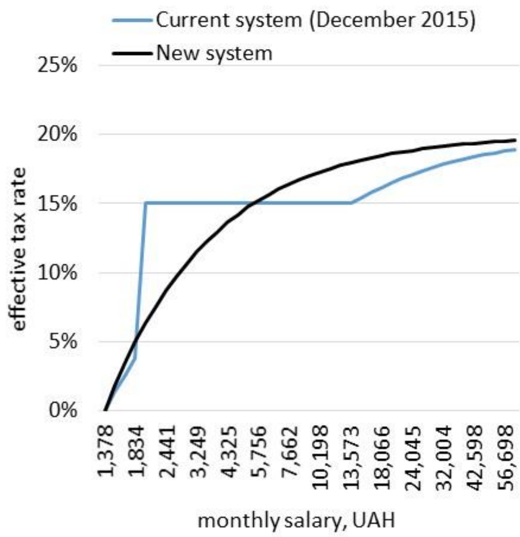
A streamlined tax regime helps address current deficiencies in tax administration. A simpler and more transparent tax regime is relatively easier—and potentially less expensive—to enforce by the tax administration agencies. Registration threshold for VAT is increased from UAH 1 million to UAH 2 million, thus reducing the cost of controlling small firms. Abolition of major exemptions on VAT (e.g., the 7 percent rate for pharmaceutics and the special regime for agriculture) and simplification of tax-base assessment of corporate income tax (e.g., clearer tax deductions and transfer-pricing rules), should help closing loopholes and easing collection.

Estimated fiscal and social cost of the proposed reform

The reform proposes to reduce labor costs facing businesses; however, since incentives to operate in the informal economy are so ingrained, the short-term effect on fiscal revenues is expected to be negative. There is uncertainty about the extent and at what pace the shadow economy can be formalized on the back of reducing the social security contribution rates only. Under-reporting wages and employment to evade taxes is such a lucrative and deep-rooted practice by firms that they may still find it more profitable to continue operating in the informal economy unless the right balance of rate reductions and underreporting penalties is achieved. In this case, the collection of social security contributions is likely to decline in the short term, and the estimated revenue losses in 2016 could be as large as 2.5 percent of GDP. This would result in a major financial imbalance in the national pension system, which is already heavily subsidized from the central budget. It is unlikely that the social security contribution losses—in addition to the planned abolition of transfers from the NBU and the import surcharge—can be offset by the revenue gains expected from the reform to VAT and income taxes immediately. Thus, overall fiscal revenues are anticipated to decline in the short term.

The proposed reform of the person income tax (PIT) envisages a more progressive tax system and a fairer treatment among salaried workers. Under the current regime, salaries below 1.4x the minimum wage are exempted of PIT; a 15 percent rate applies to salaries between 1.4x and 10x the minimum wage; and a 20 percent rate applies to the salary income in excess of 10x the minimum wage. Because of the high marginal tax rate for salaries close to the lower-end threshold, there is an unfair treatment among tax-complying individuals: for an employee earning a salary slightly above the threshold her associated after-tax income is actually lower than for another employee whose salary is slightly below the threshold. Not surprisingly, individuals have strong incentives to under-report salaries to evade PIT. The reforms to PIT aim to achieve a more progressive tax system by establishing a single 20 percent tax rate, eliminating all current thresholds, and introducing a fixed-amount exemption for all salaried workers. The new structure of effective tax rates implies a lower tax burden for poorer workers making less than UAH 5,500 a month, while a somewhat heavier burden will fall on those remunerated more—especially for salaries between UAH 10,000 and UAH 17,000 a month.

Expected changes in PIT distribution



Source: World Bank estimates

Recommendations

Ukraine's proposed tax reform is in the right direction, but the authorities need to guard against potential revenue shortfalls in the short run. The authorities may consider to not reduce social security contribution rates towards the proposed levels immediately, but, instead, envisage a transition period in which the rates will be gradually reduced conditional upon meeting pre-defined, explicit targets for the collection of contributions. Furthermore, if and when the collection targets are not met, tax rates should not be reduced and, in addition, temporary measures must be promptly adopted in order to mitigate the short-term budgetary impact of the tax reform. Admittedly, in the current fragile economic situation, the risk of missing collection targets and thus experiencing unforeseen revenue losses is high and must be managed in advance. To do so, the authorities should explicitly formulate contingent, compensatory measures and make them part and parcel of the reform package. These measures must preserve debt sustainability and safeguard funding of key social expenditures—particularly pensions—along their consolidation path. In addition, the authorities should ensure coordination between tax policy concerning social security contributions and the necessary reforms to the national pension system.

The authorities should make decisive tax administration efforts to reduce informality and strengthen enforcement of the new tax regime. It is laudable that the design of Ukraine's tax reform explicitly aims at attenuating the taxation burden imposed on business and individuals. But the authorities should strengthen the mechanisms to enforce taxes—even more so when rates are being lowered—in order to ensure such a burden is fairly borne by all Ukrainians and not only by those who currently abide by the law. Current deficiencies in tax administration, including poor governance, must be resolved as well, so that the proposed tax reform can effectively deliver its commendable goals.

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