Ukraine's Tax System: Background Note

Content

Preface

This note was commissioned by the GIZ “Support to the reform of public finances” project to inform a short-term visit by the project expert to establish priorities for activities in the area of Public Financial Management in Ukraine. The author of the note is Yuriy Dzhygyr, public finance consultant at FISCO id (www.fisco-id.com). The views expressed are those of the author and do not necessarily reflect the approaches or views of the GIZ or the “Support to the reform of public finances” project.

Acronyms and Abbreviations

BCU	Budget Code of Ukraine
CACP	Code of Administrative Court Procedure
CCU	Customs Code of Ukraine
DTT	Double Tax Treaty
ECA	Europe and Central Asia
EPT	Enterprise Profit Tax
IFC	International Finance Corporation
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
PFM	Public Finance Management
PIT	Personal Income Tax
SME	Small and Medium Enterprise
TCU	Tax Code of Ukraine
TIC	Trade and Investment Council
UAH	Ukrainian Hryvnia
US	United States
USSC	Unified Social Security Contributions
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organization

1. Description of current situation

Legislative framework

Ukraine's Constitution requires that all taxes and fees levied within the country's taxation system must be established exclusively by laws enacted by Ukraine's Parliament (Verkhovna Rada)[1]. Major laws which define the current taxation system are described below.

- **Tax Code of Ukraine (TCU)[2].** The TCU is the key framework law on taxation, which defines basic concepts, guiding principles, and establishes the list of existing taxes (discussed in detail in the next section). The TCU was introduced in December 2010 and came into effect on 1 January 2011. The TCU also sets out broad rules for appeals against decisions of tax authorities (Article 56).

- **Code of Administrative Court Procedure (CACP)[3].** Procedures for challenging the decisions of tax authorities in courts are elaborated in the CACP, Articles 17-19. These provisions outline the scope of administrative court jurisdiction and establish guidelines on choosing the level of court for appeal.

- **Budget Code of Ukraine (BCU).** Ukraine is a unitary state with three levels of local (sub-national) government (regional, sub-regional (rayons and cities) and sub-rayon (villages and settlements)[4]. The Tax Code establishes two separate types of taxes: national taxes (mandatory throughout Ukraine) and local taxes (which could be introduced by local councils, but only out of the list outlined in the Tax Code and with rates within the ranges specified in the Tax Code)[5]. At the same time, some of the national taxes are later shared between the central (state) budget and sub-national budgets. The rules for such central revenue sharing between these levels of government are described in the country's Budget Code[6]. The Budget Code also defines rules for transferring tax revenues to the budgets of respective tiers.

- **Customs Code of Ukraine (CCU)[7] and the Law "On Ukraine's Custom Tariff"[8].** Detailed customs procedures are established by the Customs Code, which defines terms and principles, and describes key customs regimes. The Customs Code also introduces the concept of Ukrainian Classification of International Trade Goods, while the Classification itself is approved within the Law "On Ukraine's Customs Tariff". The Law "On Ukraine's Customs Tariff" also defines the actual tariffs / duties levied on imported goods, grouped by the Ukrainian Classification of International Trade Goods.

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[1] Article 92 of the *Constitution of Ukraine*, http://static.rada.gov.ua/site/const_eng/constitution_eng.htm

[2] Approved 02.12.2010 (latest amendments - 19.11.2012); Document No 2755-VI, http://zakon1.rada.gov.ua/laws/show/2755-17

[3] Code of Administrative Court Procedure, approved 06.07.2005 (latest editions 01.12.2012), No 2747-IV, http://zakon2.rada.gov.ua/laws/show/2747-15

[4] The top tier includes 24 oblasts, the ARC (Crimea) and two cities of special status (Kiev and Sevastopol). The sub-regional level includes 488 rayons and 177 cities "of oblast significance". The third tier of government includes over 12 000 villages, settlements and towns "of rayon significance".

[5] Article 8-10 of the Tax Code of Ukraine.

[6] Revenue sharing arrangements are clearly defined since 2001 reform when the first Budget Code was approved. The currently effective version of the *Budget Code* was approved on 08.07.2010, No 2456-VI (latest amendments – 07.11.2012).

[7] Approved 13.03.2012 (latest amendments - 07.11.2012); Document No 4495-VI, http://zakon1.rada.gov.ua/laws/show/4495-17

[8] Law of Ukraine "On Ukraine's Custom Tariff", No 2371-III, approved 05.04.2001 (latest amendments – 01.01.2012), http://zakon1.rada.gov.ua/laws/show/2371-14

- **Law of Ukraine "On collecting and accounting for United Social Security Contributions to Mandatory State Social Insurance"[9].** In addition to taxes and fees established by the Tax Code, Ukraine operates a mandatory contributory social insurance scheme, regulated by a separate Law (the Law "On collecting and accounting for United Social Security Contributions to Mandatory State Social Insurance"). The unified mandatory contributions are levied from all taxpayers as a single payroll tax administered through the Pension Fund for subsequent redistribution between the four separate social insurance programmes:

  - Industrial accident insurance
  - Temporary disability insurance;
  - Unemployment Insurance; and
  - Pension Insurance.

Profiles of major taxes

General Overview

Overall, the regulations listed above establish 18 national taxes and fees (including import duties), 5 optional local taxes and fees, and a single payroll tax for social insurance. All these taxes are listed in Table 1 below.

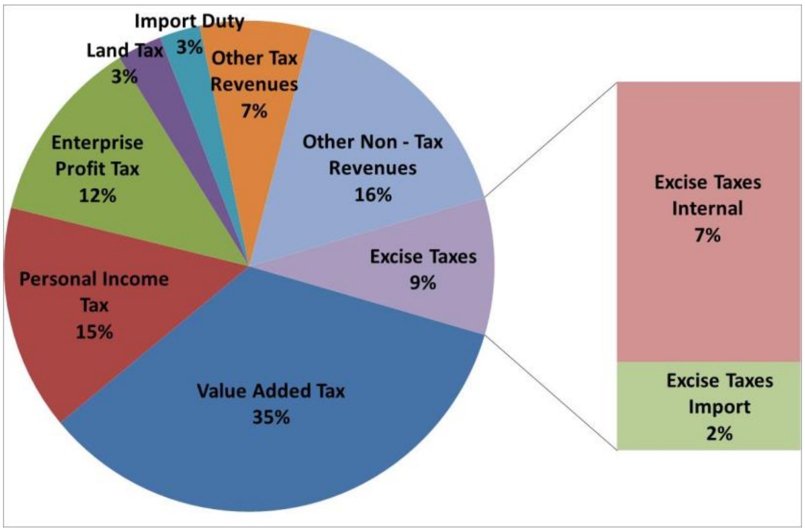
Table 1. Comprehensive list of Ukraine's existing taxes and fees

National Taxes and Fees	Optional Local Taxes and Fees	Payroll Fund Taxes
Taxes: ▪ Value Added Tax (VAT); ▪ Personal Income Tax (PIT); ▪ Enterprise Profit Tax (EPT); ▪ Excise Taxes; ▪ Import Duties; ▪ Land Tax; ▪ Single Agricultural Tax; ▪ Environmental Tax; ▪ Wine-Growing Development Tax;	Taxes: ▪ Property Tax; ▪ Single Business Tax;	Taxes: ▪ Single Social Tax (Unified Social Security Contributions, USSCs)
Fees: ▪ Oil and Gas Transit Fee; ▪ Oil and Gas Extraction Fee; ▪ Vehicle Registration Fee; ▪ Subsoil Utilisation Fee; ▪ Radiofrequency Resource Utilisation Fee; ▪ Special Water Utilisation Fee; ▪ Forest Resources Utilisation Fee; ▪ Earmarked Surcharge on Electricity Tariffs; ▪ Earmarked Surcharge on Gas Tariffs.	Fees: ▪ Business Licensing Fees; ▪ Parking Fees; ▪ Tourist Fees.	

[9] Law of Ukraine "On collecting and accounting for United Social Security Contributions to Mandatory State Social Insurance", approved 08.07.2010, Document No 2464-VI (latest amendments – 07.11.2012), http://zakon1.rada.gov.ua/laws/show/2464-17

Relative importance of the existing taxes is illustrated in Figure 1, which shows the share of each tax in the Ukraine's Consolidated Budget in the 2012 Budget[10]. The country's biggest tax is VAT (which brings 35% of consolidated revenue), followed by PIT (15%), EPT (12%) and Excises (9%). The bulk of the Excise Taxes are levied on domestic goods. Import Duties and the Land Tax are each responsible for 3% of revenues. All other taxes and fees (including Oil and Gas transit and extraction fees, and also Local Taxes and Fees) jointly represent 7% of the consolidated budget.

Figure 1. Share of major taxes in Ukraine's Consolidated Budget in the 2012 Budget



Tax rules by individual taxes

Key rules and major policy issues regarding key taxes are outlined in Table 2 below.

Table 2. Profiles of major taxes

Tax	Rate	Base	Exemptions	Issues and Comments
Value Added Tax (VAT)	2014: 17% Current rate: 20%	VAT Payer Registration mandatory for businesses with annual turnover above UAH 300 thousand	▪ Zero-rated mostly for exports and a range of specific services (TCU, Article 195); ▪ Not levied on a range of business activities, mostly financial services (TCU, Article 196); ▪ Exemption for a range of operations (detailed list available in TCU, Article 197).	Distortions in the system of VAT administration allow fraudulent agents to account the bulk of added value on accounts of missing traders, minimising tax liabilities within the country and claiming fictitious refunds of this tax through pseudo-export.
Personal Income Tax (PIT)	TCU, Article 167: ▪ 15% on regular incomes; ▪ 5% mostly on passive incomes; ▪ 17% on amounts above 10 minimum wages per month;		▪ The TCU relies on two concepts: "Tax Discount" (Article 166) and "Social Tax Privilege" (Article 169). In essence, both represent deductions from taxable income: – Tax discount includes	▪ Paid at source; ▪ The tax is an origin-based levy, with individuals paying their income tax into the budgets of jurisdictions where they work, rather than where they

[10] 2012 Budget figures are quoted as presented in the Monthly Budget Execution Report of the State Treasury for January-September 2012.

	▪ 30% on lottery prizes but with a wide range of disclaimers; ▪ 10% on wages of miners;		part of interest on mortgages, charity contributions, and spending on education and healthcare. – Social Tax Privilege reduces taxable income by amounts in specified proportions to subsistence minimum (100%, 150% and so on) for certain categories of taxpayers. Moreover, the right for a social tax privilege in a size of 100% of one subsistence minimum is provided to all taxpayers. ▪ Article 165 also lists a range of incomes which are not taxable. Most of them represent various social benefits.	live. Although this principle is traditional for post-soviet countries and strongly engrained in their administrative systems, it is a significant barrier to labour mobility and to the possibility of introducing local surcharges on income tax (which would lead to undesirable outcomes if applied at source). The comprehensive Budget and Tax reforms of 2010 left this principle unchanged and do not assume the prospect of PIT surcharges in the foreseeable future.
Enterprise Profit Tax (EPT)	2014: 16% 2013: 19% 2012: 21% 2011: 23%		▪ Insurance companies pay EPT from their turnover at the rate of 3%. This rule is temporary and will remain in effect until the end of 2012. ▪ Incomes of a specified range of organisations are exempt from the EPT. The list of criteria which define such organisations is provided in Article 154 of the TCU.	The fact that costs of insurance are deductable from taxable income combined with the fact that insurance companies enjoy a special EPT taxation regime, creates opportunities for tax arbitrage. Businesses can minimise their EPT liabilities by insuring fictitious risks in captive insurance companies.
Excise taxes	The TCU defines three types of excise rates: ▪ Ad valorem rates (defined for the value of goods); ▪ Specific rates (defined for a unit of goods); ▪ Mixed rates (which combine ad valorem and specific rate calculation). Complete list of excise tax rates by individual groups of goods is provided in the Article 215 of the TCU.	Excise taxes are levied on the following types of goods: ▪ Alcohol; ▪ Tobacco; ▪ Petrol; ▪ Transport vehicles.		

Land Tax	▪ 1% of assessed land value. ▪ If the land was not assessed, the rate equals UAH 0.24-3.36 per metre depending on the size of the municipality. ▪ For cities of oblast significance, rates are used with a multiplier set in a range from 1.2 to 3.	Assessed value of the land plot or, if the land was not yet assessed, its area.	▪ Reduced rates for agricultural and forest areas; ▪ Privileges for this tax are provided for a range of taxpayers, defined in Articles 281-282 of the TCU. These mostly includes selected social groups (disabled, pensioners) and socially significant organisations (national parks and reserves, rehabilitation facilities etc). ▪ A range of particular types of land plots (listed in Article 283 of the TCU) is exempt from Land Tax (such as contaminated areas, roads, cemeteries etc). ▪ Local authorities can establish local privileges for this tax within the amounts which are due for including into the respective local budget according to the revenue sharing arrangement with the central government.	Although land tax is classified by the TCU and the BCU as a central / shared revenue, in reality it consists of two different parts: the <u>land tax</u> (with the rate set centrally) and the <u>land lease fee</u> (defined through individual negotiations in each individual leasing case). The bulk of the land tax proceeds (about 6.5% of local revenue including transfers) are actually collected through <u>land lease fee</u>. The rules and limits for levying a <u>land lease fee</u> are clearly regulated by the TCU (Article 288) based on the general rules for land evaluation and Land Tax rates.
Import Duty	Tariffs for import duties by groups of goods are listed in the Law "On Ukraine's Customs Tariff".	The list of goods on which import duties are levied, grouped by the Ukrainian Classification of International Trade Goods, is provided in the Law "On Ukraine's Customs Tariff".		Throughout 2010-2012, there has been a range of complains from Ukraine's major trade partners over opaque procedures for defining customs value of imported goods, which – they claim – results in significantly overvalued amounts of chargeable import duties. In particular, this concern was voiced by the US delegation to the third meeting of the Trade and Investment Council (TIC), established by the United States-Ukraine Trade and Investment Cooperation Agreement, held on 13 October 2010. The US delegation leader, Deputy United States Trade Representative Miriam Sapiro, stated that while Ukraine had decreased

				customs tariffs after acceding WTO, it had also started to use lack of clear regulatory procedures to raise the customs value of imported goods by extreme amounts, nullifying the initial tariff decrease. In one quoted example, one US pharmaceutical company found that the customs value of the anti-cancer medications was increased from $16 to hundreds of dollars, leading to a 1600% increase, without transparent explanation [7].
Simplified Tax Regimes	Simplified business taxation regime is described in detail in a separate section on Page 11.			
Property Tax	▪ Defined by local councils as a % of minimum wage per square meter of property area; ▪ Rate ceiling at 1% for flats below 240 m and for houses below 500 m. For bigger properties, the rate is set at 2.7%.	Property area	Tax based is reduced for flats – by 120 m and for houses – by 250 m.	Will become effective from 1 January 2013
Payroll Fund Taxes (“Unified Social Security Contribution”, USSC)	The USSC consists of two contributions: By Employee: ▪ 3.6% ▪ 2.6% for contract-based workers and military service By Employer: ▪ 36,76% - 49,7%, depending on occupational risk (67 risk groups) ▪ 34.7% for contract-based workers and military service	Payroll Fund Maximum base for the USSC is set at 17 times the subsistence level (established by separate law).		SMEs operating under the simplified taxation regime are liable to pay a Single Social Tax (Unified Social Security Contribution, USSC). However, such taxpayers are allowed to define their social security contribution on voluntary basis at any level not lower than a minimum USSC contribution defined as 34.7% of the minimum wage (Article 8).

Tax sharing arrangements between tiers of government

The rules for tax sharing are outlined in Table 3 below. The key source of funding for local governments is a mixture of shared taxes (Personal Income Tax, Land Tax and Single Tax from simplified tax regime) and equalisation transfers, allocated based on relatively simplistic criteria. Local taxes remain very small and do not imply sufficient autonomy and predictability, as described below. All local governments keep a percentage of PIT, Land tax and Single tax collected in their jurisdictions according to the following rules:

Table 3. Rules for revenue sharing between budget tiers

	PIT	Land Tax	**Single Business Tax** (simplified business taxation system)
Towns, villages, and settlements	Keep 25%; Transfer 50% to rayon and 25% to oblast	Keep 60%; Transfer 15% to rayon and 25% to oblast	Keep 43%; Transfer 42% to the Pension Fund and 15% to Social Insurance Fund
Cities of oblast significance	Keep 75%, transfer 25% to oblast	Keep 75%, transfer 25% to oblast	
Rayons	Receive 50% collected by towns, villages, and settlements on their territory	Receive 15% collected by towns, villages, and settlements on their territory	
Oblasts	Receive 25% collected by local governments on their territory	Receive 25% collected by local governments on their territory	
Kiev and Sevastopol	Keep 100%	Keep 100%	Keep 43%; Transfer 42% to the Pension Fund and 15% to Social Insurance Fund
Who sets the rate?	It is a regular practice for the central government to introduce exemptions to both taxes, as well as change its rate and base, without systemic and transparent compensation to local governments (e.g. during PIT reform in 2003).		Local governments set the rate within a specified limit (UAH 200 per month)
Sharing arrangement with Central Government	Included into calculation of fiscal capacity by the gap-covering formula	For towns/cities: included into calculation of fiscal capacity by the gap-covering formula; For rayons, oblasts – excluded from formula.	Included into calculation of fiscal capacity by the gap-covering formula.

Local taxes remain meagre since independence. In 2012, local taxes (with rates defined by respective councils) represented 1.63% of total local revenue. An ambiguous land tax (the bulk of which is collected in a form of land lease fee set by local council) was bringing an additional 6.67%, but it was mostly levied by rural communities, with very low base available in the cities, and until 2010 the rules for setting up the size of land lease were completely unregulated (the rules were streamlined in the new Tax Code approved in 2010). The Property Tax introduced by the new Tax Code will become effective on 1 January 2013. Local governments do not have independent local tax collection agencies and all taxes are administered through central State Tax Administration. The same applies to collection of local taxes.

International double-tax treaties (DTTs)

Taxation of incomes gained abroad by residents of Ukraine and of incomes gained by foreign residents in Ukraine is regulated by Articles 3, 13, and 103 of the Tax Code of Ukraine. In addition, Article 14 provides definitions of key terms and concepts (resident, non-resident, incomes from domestic sources, income from foreign sources). The key taxation rules of such incomes are the following:

- **International Double-Taxation Treaties overrule domestic tax provisions.** This rule is established by Article 3 (Clause 3.2) of the TCU.
- **As of 1 January 2012, Ukraine was a signatory to DTTs with 68 countries.** The list of the countries is available in the Letter of the State Tax Administration of Ukraine of 12.01.12 No 811/7/12-1017 "On international double-taxation treaties".
- **Incomes of Ukraine residents received abroad** are taxed according to standard procedures (Article 13). Taxes paid by Ukraine residents abroad may be taken into account in calculation of the domestic tax liabilities of such residents.
- **Incomes of non-residents gained in Ukraine** are taxed based on standard procedures if no DTT was signed with respective country. If a DTT with such country does exist, tax liabilities of non-residents towards Ukrainian budget are adjusted by taxes paid in taxpayer's country of residence (after provision of complete package of supportive documentation) (Article 103).

Transfer pricing

At the moment, Ukraine effectively does not apply any rules for transfer pricing, but new transfer pricing regulation will become effective on 1 January 2013.

- **At the moment, rules for transfer pricing are vague and not practically applicable.** Currently effective rules are described in Clause 1.20.2 of the Law of Ukraine "On Enterprise Profit Tax"[11]. This provision assumes estimation of transfer prices based on comparable uncontrolled prices method, and for the cases when this is impossible it advises proving transfer prices on the basis of national accounting and property valuation standards. These rules were assessed as insufficiently clear for practical implementation by both international observers[12] and domestic stakeholders[13].
- **New transfer pricing rules are established by Article 39 of the Tax Code, which will come into force on 1 January 2013.** Article 39 contains clear and detailed rules for estimation of transfer prices. Notably, in the terminology applied in Ukraine, transfer prices are defined as "usual process" («Звичайні ціни»). Based on analysis by KMPG, the new rules are generally in line with the OECD Transfer Pricing Guidelines and the arm's length principle[14]. However, some analysts believe that new rules still deviate from international best practice and could be again difficult to implement in practice. In particular, detailed methodology for determining arm's length price is still lacking, and tax authorities do not have sufficient capacity to ensure compliance[15].

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[11] Law of Ukraine "On Enterprise Profit Tax" (approved 28.12.1994, No 334/94-ВР) lost effect after introduction of the Tax Code, with the exception of Clause 1.20 which remains effective (http://zakon2.rada.gov.ua/laws/show/334/94-%D0%B2%D1%80)

[12] *Ukraine 2013: Transfer Pricing*, by Ernst & Young, http://www.ey.com/Publication/vwLUAssets/web-AmCham-Country-profile-Article-Transfer-pricing/$FILE/web-AmCham-Country-profile-Article-Transfer-pricing.pdf

[13] Conclusion of Ukraine's High Administrative Court No K-31541/05 of 19.07.2011 which looked into the issue and confirmed that regulatory basis for transfer pricing does not exist at the moment.

[14] *Ukraine: New transfer pricing rules*, in KPMG "Tax News Flash" Volume 2011-67 of 9 November 2011 (http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Lists/Expired/transfer-pricing-ukraine-nov9.pdf)

[15] *Ukraine 2013: Transfer Pricing*, by Ernst & Young.

Taxation of small and medium enterprises (SME)

Simplified taxation regime for SMEs is established by Chapter 1, Section XIV of the Tax Code. The simplified regime covers both physical and legal entities and includes the following rules:

- Taxpayers are broken down into 6 groups, based on their legal status (physical person or legal entity); turnover and number of employees.

- Simplified business tax is paid as a fixed amount or percentage of turnover:

  - Taxpayers in Group 1 and 2 pay a fixed amount, defined as a percentage of minimum wage (1-20%). The size of minimum wage as of November 2012 was equal to 1110 UAH. Therefore, the amount of the single business tax for this group currently varies between 11 UAH and 224 UAH.

  - Taxpayers in Groups 3, 4, 5, and 6 pay a percentage of turnover: 3% or 7% for those registered as VAT payers, and 5% or 10% for those not registered as VAT payers.

- SMEs operating under the simplified taxation regime are liable to pay a Single Social Tax (Unified Social Security Contribution, USSC). However, such taxpayers are allowed to define their social security contribution on voluntary basis at any level not lower than a minimum USSC contribution defined as 34.7% of the minimum wage (Article 8 of the Law "On collecting and accounting for United Social Security Contributions to Mandatory State Social Insurance"[16]).

Institutional arrangements and key stakeholders

Roles and responsibilities in taxation policy design and implementation are broadly distributed as follows:

- **Legislative authority.** As described earlier, Ukraine's Constitution requires that all taxes and fees levied within the country's taxation system must be established exclusively by laws enacted by Ukraine's Parliament (Verkhovna Rada). Respectively, the Parliament holds the key role in enacting tax policy decisions. The main stakeholders within the Parliament are two key Parliamentary committees:

  - **Finance, Banking, Tax and Customs Policy Committee** (which leads in Parliamentary consideration of all legislative initiatives in the area of taxation).

  - **Budget Committee** (which leads in Parliamentary consideration of all legislative initiatives with impact on the country's public finance).

- **Executive authority:**

  - **The Ministry of Finance** leads in policy development and implementation; as well as internal financial oversight. It also coordinates activities of the two major revenue generating agencies (the State Tax Administration / Service and the State Customs Service).

  - **The State Tax Service** and **the State Customs Services** are the country's key revenue generating agencies.

[16] Law of Ukraine "On collecting and accounting for United Social Security Contributions to Mandatory State Social Insurance", approved 08.07.2010, Document No 2464-VI (latest amendments – 07.11.2012), http://zakon1.rada.gov.ua/laws/show/2464-17

- **Judiciary authority:**
  - **Administrative courts** are responsible for proceedings in the area of tax matters, as described in detail in the next section.

- **External financial oversight (Accounting Chamber).** The mandate of Ukraine's Independent financial oversight agency, Accounting Chamber, has been debated and modified over the recent years, and its role in external control of budget revenues has bene questioned. However, the currently effective *Concept for Development of Public Financial Management*[17] clearly specifies that one of the core direction of PFM reforms in Ukraine must be estension of the Accounting Chamber powers in executing independent oversight over public revenues at central and sub-national levels.

Appeals against decisions of Tax Authorities

The Tax Code (Article 56, Clause 56.1) establishes two possible ways for taxpayers to appeal against the decisions of tax authorities:

- **Challenging tax authority decisions through administrative channels.** In such case, the taxpayer must send a written appeal to the tax authority of the higher level within 10 days after the decision which is being challenged. Decision on appeals has to be made within 20 days (with possible extensions but no longer than 60 days). This decision is considered ultimate but can be challenged in court (Article 56, Clause 56.10)[18].
- **Challenging tax authority decisions in court.** Appeals against decisions of Tax Authorities should be made to Administrative Courts, whose jurisdiction includes matters arising from exercise of executive powers by state authorities (Article 17 of the Code of Administrative Court Procedure (CACP)). Moreover, Article 19 of the CACP strictly prescribes which territorial office of the Administrative Court should deal with each type of appeal, and, in most cases, appeals must be sent to local courts at the place of taxpayer residence. Court proceedings must follow rules established by the CACP with due account to the provisions of the Tax Code[19].

According to anecdotic evidence, in case if the Administrative Court makes a decision in favour of the taxpayer, the respective Tax Authority (whose decision was challenged in court) is obliged to counter-appeal such court decision in an Administrative Court of higher level. This loop is repeated if the resulting decision is again in favour oft he taxpaer, until the matter is elevated tot he attention oft he Higher Administrative Court of Ukraine. Respectively, based on this adecdotic evidence, enforcing court decisions which favour taxpayers normally take several years of court proceedings at various levels.

2. Strengths and weaknesses of the current system

Most international observers acknowledge significant reform effort in the tax policy area in Ukraine in the last decade. In particular, the Public Finance Review of the WB in 2006-2008 recognised the Government's progress in streamlining tax legislation, gradual elimination of distortive tax exemptions, removal of mutual offsets, tax amnesties and budget arrears, as well as overall impressive improvement in fiscal discipline.

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[17] Resolution of the Cabinet of Ministers of Ukraine No 633-p of 3 September 2012 "On approval of the Concept for Development of Public Financial Management in Ukraine", http://zakon2.rada.gov.ua/laws/show/633-2012-%D1%80

[18] Detailed description of the administrative appeal process is available at http://www.juryst.lviv.ua/articles/category/3/message/35/.

[19] Detailed description of court appeal process is available at http://www.juryst.lviv.ua/articles/category/3/message/40/

At the same time, Ukraine's tax system continues to suffer from a range of weaknesses, which create risks and discourage private sector. Traditionally, Ukraine ranked poorly in international assessments of business climate: its ranking in the 2013 WB/IFC Ease of Doing Business Assessment is 137 (out of 185 economies)[20]. Notably, this latest survey has increased Ukraine's rank from a much lower 152 in 2012, including it into the group of top-ten fastest improving countries in the world. This development had a mixed reception among domestic experts. While some experts and the Government agreed that improvement was due to streamlined business registration procedures, introduction of electronic tax reports and elimination of a range of small but administratively cumbersome local taxes in the new Tax Code, others reckoned that the changed sampling methodology of the WB/IFC survey increased the share of SMEs in comparison to large taxpayers, who currently suffer disproportionately as a result of administrative fiscal squeeze[21].

The main risks for the private sector created by the weaknesses in the tax system include:

- **High marginal tax burden.**

  Already by 2006, the World Bank Public Finance Review has came to conclusion that the only way for Ukraine to expand its fiscal space without damaging macroeconomy was to widen the tax base and improve compliance, rather than increase tax rates. This analysis shows that already at the time the tax burden on the private sector was very considerable, and that further increases in the tax rates would slow down economic growth. On the other hand, the government should expect that additional public funds would be required to finance structural reforms in key social sectors and in case if external economic shocks would change the positive dynamics of budget revenues (as it happened by 2008). The only way to collect such extra revenues without damaging macro-economic implications would be to eliminate current exemptions and loopholes which allow significant amounts of assets and incomes to remain outside taxation system.

  Although the there was some marginal reduction in selected tax rates within the new Tax Code, the marginal tax burden remains high and is quoted by business surveys as a major constraint. In the 2013 WB/IFC Survey, high rates were named as a major business constraint by 55.1% - the biggest obstacle in comparison to tax administration, identified as the biggest problem by 35.3% businesses, and licencing/permit system, identified as the biggest problem by 32.7% businesses. Moreover, this shows a change in perception in comparison to 2004 IMF Cost of Doing Business survey, which ranked high tax rates as the least significant obstacle in comparison to high sanctions, poor predictability of tax liabilities, possibilities of extrajudicial confiscations and dependency on tax inspectors.

  One of the most problematic elements of the high tax burden is the high level of the payroll taxes. Although administration of these taxes was streamlined by the Tax Code (which subordinated previously four fragmented tax schemes to joint administration by the Pension Fund), the tax burden of the scheme remained invariably high.

- **High regulatory cost of doing business.**

  Based on the WB/IFC 2013 Survey, a considerable proportion of businesses in Ukraine still consider tax administration and licensing system as major constraints (35.3% and 32.7%, respectively). During 2008-2012, a growing number of reports was registered by the media witnessing claims from businesses of various administrative measures directed at extracting taxes, such as, e.g., refusal of the tax authorities to accept tax returns with low tax liabilities or requests of advance payments of taxes and fees. Such claims have been regularly monitored by FISCO id at www.fisco-id.com.

[20] http://www.doingbusiness.org/data/exploreeconomies/ukraine
[21] See, e.g., http://www.unn.com.ua/ua/news/985465-svitoviy-bank-pidvischiv-biznes-reyting-ukrayini/, http://smi.liga.net/articles/2012-11-23/7207089-reyting_legkost_vedennya_b_znesu_pokrashchivsya_.htm#

Moreover, likelihood of administrative fiscal squeeze was supported by irregular EPT actual collection patterns during the recent years, and its dramatic overperformance in comparison to most other taxes[22].

- **Obstacles to transparent and fair competition.**

  As was discussed earlier, Ukraine's current distorted system of VAT administration allows fraudulent agents to account the bulk of added value on accounts of missing traders, minimising tax liabilities within the country and claiming fictitious refunds of this tax through pseudo-export. This means that the supply chains of well-meaning exporters may include a fraudulent fly-by-night company, without the exporter's knowledge. Providing refunds to such well-meaning exporters represents an indirect subsidy. This situation results in permanent cross-subsidisation of fraudulent *and* well-meaning exporters at the cost of other well-meaning exporters. This distorts the market and makes it impossible for any company to compete in a fair and transparent way.

  Illustration of this problem was witnessed in 2004 when the Government considered introducing special VAT accounts as a counter-measure against VAT refund fraud. According to anecdotic evidence, one of the large transnational corporations reported that, in view of this incipient legislative change, all of its domestic suppliers have informed the company of the need to raise their prices by around 20%. This anecdote was an indirect proof of the presence of missing traders somewhere in the supply chain of that transnational company, and the fact that identifying and eliminating such missing traders across the entire supply chain is and will be beyond realistic control of any exporter.

3. Selected reform issues

Reforms to ensure compliance with WTO requirements

Ukraine joined WTO in May 2008. Upon accession, a range of permanent institutional mechanisms were created to ensure on-going monitoring of legislative compliance with WTO requirements. Full-scale analysis of particular issues where compliance should be enhanced is outside of the scope of this brief report.

However, a few observations on the current tax regulations and fiscal performance may be of relevance:

- **The already mentioned problem of indirect export subsidisation via non-paid VAT.** The problem of VAT refund fraud was described in detail in earlier sections. Availability of large scale opportunities for VAT refund fraud coupled with the still functioning system of refunds spurs a vicious circle of cross-subsidisation of selected exporters (which do receive refunds and which have, often unwittingly, missing traders in their supply chains). This circle creates significant distortions and significantly limit opportunities for fair competition.
- **Concerns about discrimination of imports through distorted administrative practices.** Fiscal performance data for 2011-2012 show that actual collections of excise taxes on imported goods systemically over-peform in comparison to excises levied on goods produced domestically. This must be explained by one, or combination, of the following:
  - by relatively poorer forecasting of foreign excises (in comparison to forecasting of domestic excises),
  - by fundamentally poorer administration of the domestic excises (perhaps as a result of shadow market trade), or
  - by higher administrative effort to levy excises on imports.

[22] For continuous monitoring of this phenomena, see FISCO monthly PFM reports on www.fisco-id.com.

This means that there exists a speculative possibility (requiring verification) that, despite legally equal treatment, in reality imported goods are discriminated in comparison to goods produced domestically, via administrative measures, assuming a relatively higher tax burden.

Reforms to reorient tax system to wider voting public

Ukraine is classified as a country with relatively high tax collection and relatively low tax effort, which calls for restructuring of existing taxes to encourage employment and economic activity. 2012 analysis by the World Bank included Ukraine into the group of countries with high collection but low effort (along with 9 high-income countries and 10 developing countries, most of which belong to the ECA region). Moreover, these countries tend to impose “high factor income taxes, especially on labour”, which discourages economic activity and employment. This regional observation strongly resonates with Ukraine’s extremely high burden of payroll taxation and its negative effect on the labour market and business activities. To avoid these adverse effects, the WB advises such countries to restructure their tax mixes away from production to consumption sources (given that these countries already collect relatively higher taxes, compared to world average)[23].

[23] Tuan Minh Le, Blanca Moreno-Dodson, Nihal Bayraktar.Tax Capacity and Tax Effort: Extended Cross-Country Analysis from 1994 to 2009. March, 2012.