Hopes fade that new tax code will be progressive

With the government preparing to discuss the final version of the controversial draft tax code at a special meeting on Sept. 1, experts say the document is unlikely to fulfill the key promise of relieving the tax burden on Ukrainian businesses, keeping many of them in the shadows.

According to the latest publicly available version of the draft code, the taxation system will largely be preserved in its current form. Most disappointing for business is the likely retention of cripplingly high payroll taxes, which many businesses blame for forcing them to pay employees under the table in order to survive.

Recently published research by the World Bank placed Ukraine as the world's sixth biggest shadow economy with an average of 54.9 percent of the economy from 1999 to 2007.

Currently, employees are to pay a reasonable 15 percent income tax. But many employers discourage employees from declaring their entire salaries, or protect themselves by paying lower salaries, to avoid paying the high payroll tax. This tax is paid by employers as a percentage of the salary they give to employees, and typically exceeds 30 percent.

"I started unofficially and was getting paid completely off the books, so it is better now. But every month I am afraid of not getting that unofficial part and wondering how I would cope."- *Oksana, Kyiv resident.*

According to Valentyna Izovit, the head of Light Industry Association of Ukraine, for every Hr 1 industry earns it pays Hr 0.65-0.80 of tax, forcing many into the shadows. Many prefer to pay employees tiny official salaries or none at all, and hand over the majority of the salary in an envelope.

Kyiv resident Oksana, who did not want to give her last name out of fear of losing her job, works off the books at a land surveying firm. Officially she is paid Hr 900 per month, but the firm is paying her an additional Hr 2,000 in "grey salary" as it's known.

"I started unofficially and was getting paid completely off the books, so it is better now. But every month I am afraid of not getting that unofficial part and wondering how I would cope," Oksana said.

Those who work completely off the books can be let go at any time with no unemployment benefits. Furthermore, they don't get record of length of service – one of crucial criteria for a pension – and have no insurance in case of accidents at work.

Many employers ask their employees to register as private entrepreneurs so that they pay a single flat tax – currently from Hr 20 to Hr 200 per month. The government is now trying to limit those who fall under the single tax, such as Internet providers, accountants, engineers and others. For many professions, the single tax looks set to rise to Hr 600 under the new tax code.

"This will surely force even more people into the shadows," says OleksandrZholud, an economist at the International Centre for Policy Studies, a Kyiv-based think tank.

“Many employees do not have confidence in the Ukrainian pension and social security systems and prefer to receive more undeclared cash to finance their personal needs and take care of their retirement needs themselves.”*- Oleh Chaika, director of tax and legal services at leading consulting firm KPMG Ukraine.*

However, many do not mind working unofficially.

“Many employees do not have confidence in the Ukrainian pension and social security systems and prefer to receive more undeclared cash to finance their personal needs and take care of their retirement needs themselves,” said Oleh Chaika, director of tax and legal services at leading consulting firm KPMG Ukraine.

Kostyantyn Solyar, an associate at Asters law firm, said most Ukrainians do not understand why they should pay taxes and are very reluctant to do so. “This is understandable, as many Ukrainian bureaucrats are inclined to steal money from the state budget rather than invest them for the prosperity of society,” he said.

According to a survey conducted in 2009 by the Kyiv-based Razumkov Center think tank, 38 per cent of Ukrainians are certain their taxes are being stolen by officials and only 4 per cent actually see their taxes returned to them and their families through public services provided by the state.

“The biggest challenge is changing the overall mindset towards paying taxes in Ukraine,” said Jorge Zukoski, President of the American Chamber of Commerce in Ukraine.

“Both business and the population need to be convinced that if they invest into the state, the state will take care of them, their families and their neighbors in the future.”

Some countries have succeeded in bringing employers and employees out of the shadows by lowering the tax burden on them.

In Georgia, payroll taxes were eliminated and instead personal income tax was raised from 12 percent to 20 percent. This increased tax flow and contributed to Georgia moving up to 11th place in the World Bank’s Doing Business rating for 2010. Ukraine, meanwhile, is languishing in 142nd place.

Such a plan is not on the table for Ukraine. “It is a debatable issue, but forcing the economy out of the shadows has nothing to do with lower taxes ... [Lowering taxes] has an effect in short term only, say, in two years,” said Iryna Akimova, deputy head of the presidential administration.

Back in 2008 a single, flat payroll tax of 20 percent was considered by lawmakers. However, the idea came to a dead end.

“There is an ongoing discussion about a single social tax. ... But we simply cannot afford to lower taxes in the near future,” Akimova said.

Finance Minister Fedir Yefymenko said a decrease in payroll tax is only possible after pension reform.

However, some say these are weak excuses.

“We shouldn’t wait until private pension funds are introduced,” says Zholud.

“For starters, we could put everyone in equal position when it comes to pension. For example, governmental officials do not pay into the pension fund at all, while many of them receive a pension of thousands of hryvnias.”

Meanwhile, officials and experts admit that there are other ways to fill the budget while easing the pressure on business and average Ukrainians and restoring people’s trust in tax system.

According to Akimova, the state would save around $20 billion (Hr 160 billion) by eliminating corruption.

“Most businesses and people want to work officially. They just need to be encouraged and given clear simple rules.”- *Dmytro Oliynyk, head of the Employers Federation of Ukraine.*

A property tax and luxury tax – neither of which is included in the code, despite demands from the presidential administration – would mainly hit those who can afford to pay, and could bring in Hr 5 billion and Hr 85 million respectively, according to government estimates.

A deal with Cyprus, which created an offshore tax haven for Ukrainian business, costs the country around 1-2 percent of gross domestic product every year, experts say.

But until these are introduced, the state will continue to squeeze small businesses.

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