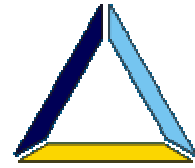


**INSTITUTE FOR ECONOMIC RESEARCH AND  
POLICY CONSULTING**



**Working Paper No.6**

**Ulrich Thießen**

**Presumptive taxation for  
small enterprises in Ukraine**

**March 2001**

**Reytarska 8/5-A, 01034 Kyiv,  
Tel.: + 38 044 228-63-42,  
+ 38 044 228-63-60,  
Fax: + 38 044 228-63-36  
E-mail: [institute@ier.kiev.ua](mailto:institute@ier.kiev.ua)  
<http://www.ier.kiev.ua>**

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*Ulrich Thießen*, Dr.rer.pol.: Research Associate at the German Institute for Economic Research (DIW), Berlin, and member of the German Advisory Group with the Ukrainian Government in Kyiv. His work concentrates mainly on macro-economic analysis, especially on monetary, fiscal and external economic policy.



# Presumptive taxation for small enterprises in Ukraine

Ulrich Thießen\*

## Summary

The results of recent surveys of companies confirm the great problem taxation presents to all sizes of enterprises. The different presumptive taxes introduced in 1998 for small and medium sized enterprises (SME) have contributed to an amelioration of the situation. They also seem to have been "productive" from a fiscal point of view. Nevertheless, a reform of the presumptive tax regulations appears necessary, primarily to improve transparency, to treat all enterprises equally and to stabilise the social insurance system. Our reform proposals for the presumptive tax are:

- Reduction of the number of presumptive taxes to possibly only two: (a) a presumptive tax for "market stalls" (a definition of these market stalls should be arrived at jointly by the central government, the oblasts and tax department. Such "market stalls" would be freed from the obligation of bookkeeping), and (b) a presumptive tax for all other small enterprises (with an obligation to present an accounting for surplus revenue and gross income).
- No introduction of locally defined "unit incomes", but retention of the present gross income limits (of UAH 0.5 m for natural persons and UAH 1.0 m for judicial persons). Alternately, by combining these limits into one average value the system could be further simplified.
- Indexing of the upper gross income limits to the rate of inflation.
- Inclusion of all taxes and fees into the presumptive tax with the exception of VAT and social security contributions.
- Sharing of the presumptive tax revenues with the lower levels of government.

## 1. Introduction

The instrument of presumptive taxation was introduced in 1998 as a measure to decisively further the development of SMEs and to curb the shadow economy. Although all parties involved (i.e. the companies, the government and the tax administration) were in favour of the new approach and rated it as a success, nearly all raised doubts about how to

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\* The author is grateful to Tatjana Vachnenko and Ricardo Giucci for criticism and discussions.



apply it. These doubts do not concern the taxation levels, but the gross income limits, the number of presumptive taxes, the taxes and fees which presumptive taxation is to replace, and the distribution of the revenues to the various levels of government. The two years of experience with these taxes in Ukraine makes a preliminary assessment possible and allows us to evaluate these doubts. Thus we first give an overview of the importance of relatively small companies for Ukraine, then we will look at the problems connected with taxation in general, and finally we will review the present system of presumptive taxation. This then allows us to critically assess Ukrainian presumptive taxation and to present reform proposals.

## 2. The importance of small enterprises for the Ukrainian economy

Data concerning the percentage of small enterprises in GDP are not available, but some estimates of employment within small, medium and large enterprises are (see tables 1 and 2).<sup>1</sup> According to these, employment in small enterprises (50 employees or less) makes up about a third of total employment.

**Table 1**

Ukraine: Estimated number of enterprises and employees in 1999

Enterprise size	Number of employees	Estimated number of enterprises	Estimated employment	Estimated percentage of all registered enterprises	Estimated non-registered employment (in %)
	0 (Sole entrepreneur)	2,651,433	2,651,435	24.6	75.4
Small	1 to 5	148,976	516,947	37.6	62.3
	6 to 10	104,608	850,460	94.1	5.9
	11 to 50	123,757	3,189,226	99.5	0.5
Medium	51 to 250	33,169	4,206,444	99.5	0.5
Large	more than 250	10,851	9,822,542	99.4	0.6
Total		3,073,244	21,237,054	-	-

Source: Management Systems International and Development Alternatives Incorporated and the Kiev International Institute of Sociology, "Small and Medium Enterprises Baseline Survey", Kiev 2000, p. xi.

The important point however is, that in nearly all industrial and transformation countries these small companies produce not only a persistently positive but also the relatively largest employment increase. That is why they are so eminently relevant for economic decision making.

<sup>1</sup> These data are based on a survey taken for USAID during the first half of 1999 among some 5000 enterprises and 4000 private households in Ukraine. See: Management Systems International, Development Alternatives Incorporated, Kiev International Institute of Sociology, "Small and Medium Enterprises Baseline Survey", Kiev 2000.



**Table 2**  
Ukraine: Estimated employment in 1999

Enterprise size	Total estimated employment	Percentage of the total estimated employed population
Small (0- 50 employees)	7,208,068	33.9
Medium (51 – 250 employees)	4,206,444	19.8
Large (250+ employees)	9,822,542	46.3

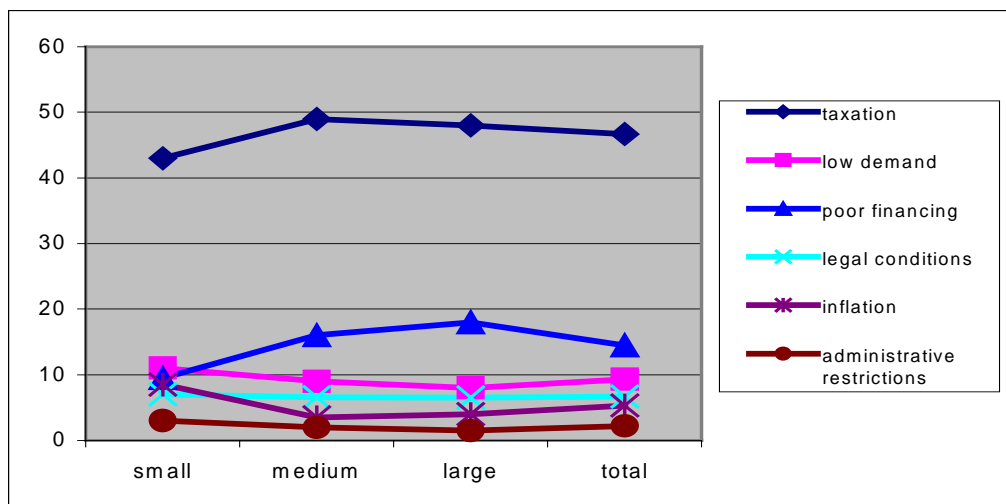
Source: Management Systems International and Development Alternatives Incorporated in collaboration with the Kiev International Institute of Sociology, "Small and Medium Enterprises Baseline Survey", Kiev 2000, p. xii.

### 3. Taxation, a problem for companies

When companies are surveyed they consistently identify taxation as their most serious problem. Graph 1 demonstrates that this assessment is nearly independent of company size. All other problems, such as inadequate financing opportunities, low demand for the goods produced by the company, a poor legal framework, inflation, or administrative interference, rank well below taxation.

**Graph 1**

Ukraine: Most important problems named in 1999 by surveyed companies concerning their development (in %)



Source: Management Systems International and Development Alternatives Incorporated and the Kiev International Institute of Sociology, "Small and Medium Enterprises Baseline Survey", Kiev 2000, p.66.

What aspects of taxation do enterprises find particularly onerous? Is it the tax load or rather the amount of effort required to fulfil all tax law requirements (great number of taxes, frequent tax law changes, expensive



auditing)? According to recent surveys, both aspects are seen to be very important:

29% of all small enterprises (those with 50 employees or less) stated that the total of taxes paid (exclusive of VAT) amounted to between 21 and 30% of gross sales.<sup>2</sup> 48% estimate that their tax load exceeds 30% of gross sales.

With regards to administrative effort, 61% of the small enterprises state that they have to employ one person to deal exclusively with taxes. They say that the number of taxes and fees they have to pay averages 9. (However, in some cities this figure is much higher, e.g. 17 in Lugansk).

When questioning small companies which taxes and fees pushed them hardest to work in the shadow industry, they identified the profits tax, social levies and the VAT for 1999.<sup>3</sup>

Evidently, the burden of taxes and fees, and the administrative effort to enforce the tax legislation are deemed to be very high. Hence it is only logical that small enterprises clearly select the following two from among a number of possible tax reform measures aimed at reducing the shadow economy:

- Reduction of the number of taxes and fees, and
- Simplification of the mandated tax declaration.

Presumptive taxation can be used as an instrument to meet both of these requirements.

#### **4. The present presumptive taxation system for small enterprises**

The present income tax legislation for small enterprises allows them to choose between the normal tax and fee treatment or several presumptive tax regimes.<sup>4</sup>

Companies with up to 50 employees and an annual gross income of up to 1 million Hrivnia can use the present presumptive tax regimes. According to our estimates the great majority of companies with 50 employees or less have gross incomes of less than 1 million Hrivnia and hence can opt for

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<sup>2</sup> International Finance Corporation, "The State of Small Businesses in Ukraine. An IFC Survey of Ukrainian Small Enterprises," June 2000, page. 35.

<sup>3</sup> Due to the "VAT tax credit", the VAT should not normally represent a burden companies, but rather for consumers. It is therefor surprising that companies rate the VAT as being very burdensome. An explanation could be that Ukrainian taxation authorities - because they presume misuse of the VAT tax credit - employ a very elaborate administrative effort for VATs, and do not make repayments on time.

<sup>4</sup> These presumptive taxes replace the profits tax (small enterprises pay profits tax if they are judicial persons) or the income tax as well as up to 12 taxes and fees, including the social levies on the employer. When opting for the 10% tax rate, the VAT is also included.



presumptive tax treatment.<sup>5</sup> In other words, the present presumptive taxation can be chosen by a great number of companies, who represent about 30% of total employment.

Of the total estimated tax revenues for 2000 and 2001, the so-called unified tax is the most important presumptive tax (see Table 3). It applies to natural persons with up to 10 employees and a yearly gross income of UAH 500,000 max, and for judicial persons with up to 50 employees and an annual gross income of UAH 1,000,000 max. The tax rate is 6% of gross income if the VAT is separately assessed, or 10% if the presumptive tax also includes the VAT (In either case there is an obligation to keep books, so that gross income can be verified).

Another important presumptive tax, the "fixed tax", applies to small entrepreneurs (natural persons) with up to 5 employees and a gross income of up to 7000 times the "tax-free minimum income" (now set at UAH 17 per month, i.e. the annual gross income can go up to UAH 119,000 at this time).<sup>6</sup> Depending on the municipality and the type of enterprise, this tax is assessed at between 20 and 100 UAH per month (plus 50% for every employee).

There are three other presumptive taxes for very small companies, which can be assessed by the local administrations within well-defined limits: the so-called trade permit (for services), the small enterprise tax (for intermittent trade activities), and the market fee (for selling agricultural produce).<sup>7</sup>

Although these presumptive taxes had been introduced in February and July 1998 already, data concerning revenues derived from these taxes are available only as of 1999 (see Table 3).

**Table 3**

Ukraine: Revenues derived from presumptive taxation of small enterprises 1999-2001 (in millions of Hrivnia, unless otherwise stated)

	Estimated number of registered enterprises in 1999 <sup>1)</sup>	1999	2000 budget	2001 budget
Unified tax	./.	115.6	351	395
„Fixed“ tax	./.	193.4	219	224
Trade permit	./.	294.5	253	253
Market fee	./.	167.6	193	200
„Small enterprise“ tax	./.	13.8	14	6
<b>Total</b>	<b>929,842</b>	<b>784.9</b>	<b>1,030</b>	<b>1,078</b>

<sup>1)</sup> Estimated total of all sole entrepreneurs, small and medium sized enterprises, which pay a presumptive tax. The estimate is based on: International Finance Corporation, "The State of Small Businesses in Ukraine. An IFC Survey of Ukrainian Small Enterprises," June 2000, p. 36ff.

Source: Revenues derived from presumptive taxation: Ministry of Finance.

<sup>5</sup> Our rough estimates assume that on the average every employee contributes between 5000 and 10000 Hrivnia within the total economy.

<sup>6</sup> This presumptive tax replaces the profits or the income tax, the contributions to the road building fund and social levies.

<sup>7</sup> These presumptive taxes replace the profits or the income tax, the VAT, levies for the innovation fund, the road building fund, natural resources usage, and communal and social levies.



To evaluate the income derived from presumptive taxation, these revenues have to be related, for instance, to the number of small enterprises, their GDP or their gross revenues or profits. Since such data are not now available, we had to make some rough estimates of the number of those small enterprises with 50 employees or less which pay presumptive taxes, as well as their aggregate GDP and gross revenues.

- Estimating the number of enterprises paying a presumptive tax:

According to the above mentioned survey of small and medium sized companies in 1999<sup>8</sup> (hereinafter abbreviated as "IFC") the number of *registered* sole entrepreneurs was 652,255 in 1999, while there were also 56,015 small enterprises with 1 to 5 employees, 98,436 with 6 to 10 employees, and 123,757 medium sized companies with 11 to 50 employees. Thus, in total there were 929,842 registered SMEs.

54% of the small enterprises surveyed by the IFC stated that they could lawfully avail themselves of presumptive rather than standard taxation. However, only half of these companies chose a presumptive tax. This means that in 1999 about 27% or 251,000 SMEs opted for presumptive taxation. On the average each of these enterprises paid UAH 3126 per year in presumptive taxes, or about UAH 260 per month. A segregation of these revenues into the various kinds of presumptive taxes is unfortunately not possible.

- Estimating the aggregate GDP of these enterprises:

We estimated the GDP of these 251,000 companies as follows: Assuming (since better data are not available) that the ratio of employment in the SMEs with up to 50 employees to overall employment roughly applies to their GDP contribution too, and considering also that only 27% of the SMEs opted for presumptive taxation, then all enterprises which paid a presumptive tax created about 9.2% of total GDP (i.e. UAH 11.7 bn) in 1999. Now, if the actual presumptive tax revenues are related to this GDP estimate, then this amounts to 6.7% of GDP for the enterprises that pay a presumptive tax. This crudely estimated ratio (of presumptive tax revenue to GDP) is significantly higher than the ratio of profits tax revenues to GDP which prevailed prior to the introduction of presumptive taxation.

- Estimating the aggregate gross income of these enterprises:

Gross income was estimated as follows: Applying the average gross income of 7500 Hrivnia per employee and year, which we estimated above (see footnote 5), to the estimated employment in enterprises with up to 50 employees, and considering that only about 27% of them opted for presumptive taxation, gives us an estimated aggregate gross income of UAH 14.6 bn in 1999 for these companies. Relating this to the presumptive tax revenues, the latter would amount to 5.4% of the estimated gross income. This ratio too appears quite high.

Based on these estimates and with some caveats, the presumptive tax regime's profitability can be seen as adequate, even successful. This point of view also concords with the tax administration's own evaluation in 1999,

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<sup>8</sup> International Finance Corporation, "The State of Small Businesses in Ukraine. An IFC Survey of Ukrainian Small Enterprises," June 2000, p. 36ff.



where they even suggested to expand these taxes to a greater number of companies.<sup>9</sup> One has to be mindful of this evaluation's limitation however, in the sense that, due to lacking detailed profit and gross income figures for companies with up to 50 employees, one can so far not differentiate between the tax burdens on very small and medium sized enterprises.

The high percentage of companies which - though permitted - did not opt for presumptive but for standard taxation, is probably explained by the fact that during the time of the survey presumptive taxation was still relatively new. The majority of enterprises is likely to switch as time goes on. In some cases a lack of information about the right to choose presumptive taxation could also be a factor.

## 5. Problems with the present presumptive taxation system

The above review has demonstrated that over-all the presumptive taxation experience can be considered a success, and that it should be continued. The problems, which make a reform of presumptive taxation necessary, are:

a) The problem with the multitude of presumptive taxes

The multitude of presumptive taxes is confusing for small enterprises. For instance, it is hard to understand why sole entrepreneurs (no employees) in the service sector and with a gross income below UAH 119,000 per year should have the choice of three presumptive taxes ("unified tax", "fixed tax" or "trade permit"). These presumptive taxes should be combined.

The 1999 draft law for a new "tax code" included a proposal for unification. This proposal foresees only two presumptive taxes: A 5% "gains tax" for judicial persons with up to 50 employees and a gross income of UAH 1,000,000, and a 10% presumptive tax on an estimated fictitious "unit income" for natural persons with up to 5 employees and an annual gross income of up to UAH 200,000. This "unit income" is supposed to be defined by "local councils" for each of a series of different economic activities. The new "tax code" also proposes that the presumptive taxes should now only replace the profits tax or the income tax and two local taxes, i.e. the VAT, social security contributions and various other fees would not be included anymore.

The promotion of transparency and justice demands in our opinion that the number of presumptive taxes be reduced. Different taxation rules for natural and judicial persons should also be avoided, in order to reduce incentives to select the legal form of a company on the basis of the tax burden expected, which would lead to distortions and inequities in the taxation system.

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<sup>9</sup> Semikolenova, Yadviga, "Taxation of small and medium enterprises", Paper presented at a conference of the Economics Education and Research Consortium (EERC) MA Program at the University of Kiev, Mohila Academy, Kiev, 1999, p. 5.



We also find the introduction of a fictitious "unit income" problematic: This approach can lead to regional differences in taxation, which is counter to the principle of equality. It is a fact that every enterprise, even if it only operates intermittently, will in its own interest want to keep track of income and expenses. Even such very minimal bookkeeping will allow gross income to be determined. This gross income should be the basis for presumptive taxation. The rough estimate of revenues derived from presumptive taxation, which we made above, shows that the manipulation of the gross income figure by small enterprises seems to be limited. Where manipulation of the gross income figures is suspected one could, in order to limit fraud, demand that the enterprise maintain exact books.

We believe that the only exemption from such simplified income and expenditure accounting should be market stalls (Sale of goods at fixed sites determined by every town). Thus it can be argued that only two presumptive taxes should exist:

- one presumptive tax on gross income, based on an accounting of income and expenditure,
- one presumptive tax for "market stalls" (no gross income declaration required; the government together with the oblast and tax administrations should define what "market stalls" are).

The right to choose between presumptive and standard taxation should be maintained.

#### b) Which taxes should presumptive taxation replace?

One often hears the argument that the prime advantage of presumptive taxation, i.e. the simplification for tax payers and tax administration alike, becomes effective only when the presumptive tax not only replaces the profits and income taxes, but also the VAT and the many special fees and charges (such as for the innovation fund, the road building fund, etc.) and also the social levies for the employees. We do not accept this argumentation with regards to the VAT and the social levies:

The VAT is a tax which is transmitted from one production stage to the next, up to the final consumer. Due to the VAT tax credit, this tax is not normally a burden to the enterprise. All the enterprise has to perform is a certain administrative effort, i.e. precise accounting. Above we already argued that good accounting practise is in the enterprise's own interest. The extra administrative effort for book keeping, taking into account the tax credit (i.e. the VAT paid by a company for purchases of inputs) is not likely to be excessive. Also, many small enterprises will grow over time to a point where they will not be able anymore to opt for presumptive taxation. At that time they will certainly need to introduce detailed accounting, meaning that they should probably start to do so much earlier. One can therefore argue that presumptive taxation should not replace the VAT, with the exception of market stalls for which no accounting is demanded.

With respect to the social levies for employees we would argue that it is not desirable to include them in the presumptive tax. If they were included, two scenarios are possible:

In case A, none of the revenues from presumptive taxation are transferred from the state to the social insurance system. The danger in this case is



that claims against the social insurance system will eventually arise for which no provisions had been made and no financial planning had taken place. At that time either tax revenues have to be transferred to the social insurance system, which contravenes the principle of a social insurance system financed independently of the state, alternately old age poverty will increase.

In case B the state actually transfers some revenues derived from presumptive taxation to the social insurance system. In this case there is a good chance that the insureds would be treated quite unevenly, since the insureds of presumptive tax paying companies would presumably pay lower contributions. Furthermore, individual accounting for every insured by the social insurance agency would be difficult, since contributions from presumptive taxation would be anonymous. It must also be underlined, that the desired separation between state and social insurance financing would be jeopardised.

Such concerns, as exist for the VAT and social levies, do not arise concerning any other taxes and fees, such as deductions for the innovation and road building funds, for local taxes, etc. The presumptive tax should definitively include all these charges. On the other hand, a part of the revenues derived from presumptive taxation should be transferred to the regions, so that they do not suffer revenue losses because of presumptive taxation.

#### c) Gross income limits for presumptive taxes

Included in the planned reforms of the "tax code" was a proposal to reduce the upper income limit for presumptive taxation of natural persons from UAH 500,000 to UAH 200,000 per year. No change of the UAH 1.0 m limit for judicial persons was proposed.

The large reduction of the tax rates for the profits and income taxes, planned as part of the reform of the tax code, might cause presumptive taxation to lose some importance, since the difference between the tax rates of the standard and presumptive taxes would decrease significantly. A reduction of the upper income limit for presumptive taxation could be acceptable, if these significant tax reductions do indeed come into force. But, as explained above, a tax differentiation between judicial and natural persons, such as the new tax code proposes, would have serious drawbacks. Furthermore, ratification of the new tax code is as yet quite uncertain. It appears therefore that presumptive taxation will for the time being remain an important means for small enterprises to reduce their tax burden and for the general economy to cut back on the shadow economy.

#### d) Distribution of the presumptive tax revenues

If the central government receives all the revenues from presumptive taxation although it comprises all taxes including local ones, then the lower levels of government have an interest to keep companies from choosing presumptive taxation. This in turn would deflect from the goal of presumptive taxation to promote economic growth by simplifying taxes. Therefore the lower governmental levels must obtain a reasonable portion of the presumptive tax revenues.



e) Misuse of the presumptive tax regime

Government personnel have observed that in some cases large companies have divested themselves of certain smaller operations, so that the latter could benefit from presumptive taxation. They believe that use of this tax loophole could increase. We agree that this is possible. But our reform proposal for presumptive taxation foresees the requirement to pay separately for the VAT and for social levies (excepting very small enterprises under the market stall definition), which would have the effect to make this misuse less attractive. Of course, in order to minimise misuse, it might be desirable to authorise the taxation department to remove the right to use presumptive taxation from small enterprises which are likely not to be independent, but part of a larger enterprise. Such a withdrawal of the right to use presumptive taxation needs to be proven before a court of law (a taxation court, once established).

## 6. Proposals for reform of the presumptive taxation for small enterprises

- We recommend to reduce the number of presumptive taxes to two: one for market stalls (no obligation to keep books) and one for all other small enterprises (with the obligation to produce accounting for surplus revenue and gross income). A definition of market stalls should be reached jointly by the central government, the oblasts and the tax department. The basis for presumptive taxation of small enterprises with an accounting obligation should remain gross income. The tax rates for natural and judicial persons should be made identical.
- We believe that the present upper income limits for presumptive taxation should remain, namely UAH 500,000 for natural persons and UAH 1 m for judicial persons. Alternately for the sake of simplicity, one could envision a common upper limit somewhere between 0.5 and 1 m Hrivnia.
- The presumptive tax should replace all taxes and fees, but not the VAT and the social security contributions.
- At regular intervals, the upper income limit should be adjusted to reflect inflation. I.e. the upper income limit should be indexed to the rate of inflation (producer price index), for instance on an annual basis. This adjustment obligation should be anchored in the law concerning presumptive taxes.
- The lower governmental levels (oblasts, rayons and cities) must benefit adequately from the presumptive taxation revenues.
- When a misuse of the presumptive tax regulations is suspected, the tax department should be authorised to present its case to a court. Should the court agree that misuse exists, the privilege of presumptive taxation should be withdrawn.



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