A RESIDENCE BASED PERSONAL INCOME TAX FOR UKRAINE?[1]

Reform of the personal income tax is on the current policy agenda in Ukraine. Several reform proposals are under consideration and all of them contain significant changes in both the definition of the tax base and the rate structure. One of them, however, would convert the tax from its present origin-base into a residence-based levy. As suggested by Teriokhin (2002), taxpayers would no longer pay personal income taxes to the local government jurisdiction in which they work but would instead make that payment to the local government where they live. The rationale for this switch in tax destination is that most of the local public services consumed by taxpayers occurs in the area where they maintain a residence rather than in the different area where they may work.

Western countries that impose a local personal income tax almost always do so on a residence basis. In Ukraine, however, the personal income tax is not a local tax but rather a national one whose proceeds are assigned to local governments to assist them with their financing needs. The possibility of moving to a residence basis for assigning these proceeds exposes several important issues that are explored in this note. First, how would application of the residence principle affect the distribution of personal income tax receipts among local governments? The answer, somewhat surprisingly, is that it would have no, or almost no, effect on the distribution of revenues. Secondly, is this answer still valid if local governments were permitted to impose personal income tax surcharges, as the draft Tax Code would allow? Third, what other issues arise besides that of revenue distribution? Finally, what changes in tax administration are needed to successfully apply the residence principle? Before addressing these matters in turn, this note raises the importance for local government efficiency and accountability of having a significant marginal revenue source under local government control.

1. Marginal Revenue Sources for Ukraine's Local Governments

Local governments in Ukraine, as in other countries of the former Soviet Union, lack a significant marginal revenue source. Presently, the only revenue sources subject to some degree of local control are a motley array of local taxes and fees and the land tax. However, neither of these revenue sources represents an important incremental revenue source. In the aggregate, local taxes and fees constitute about 3.6 per cent of the total revenue of local governments in Ukraine and the combination of tiny bases and rate restrictions imposed by the central government prevent this share from becoming much larger. Similar constraints apply in the case of the land tax, which comprises about eight per cent of total local revenue. For land that has been recently assessed, local governments are constrained to impose a one per cent rate of tax. Land that has not yet been assessed offers more rate discretion to local governments but only within fairly narrow limits. Just as there is little room for rate maneuver, there is almost no scope for increasing any of these tax bases. In the case of local taxes and fees, the tax bases are miniscule while, for the land tax, canceling exemptions in order to expand the base is not a local option because these are largely controlled by the central government.

Without a buoyant source of marginal revenues, local governments' expenditures are by and large driven by the amount of transfers and the revenues assigned to them, primarily from the personal income tax, for transfer related purposes. Under these conditions, local governments do not have the ability to respond to local demands for more, or fewer, public services by levying higher or lower tax rates on local sources of income, expenditure or wealth. Local governments are thus deprived of the fiscal tools that would allow them to behave in a more fiscally responsive and responsible manner. True, or effective, fiscal decentralization goes hand in hand with local government possession of a major marginal revenue source.

In Ukraine, as elsewhere in the former Soviet Union, two means of supplementing the marginal revenue capability of local governments have been widely discussed and examined. One option is to develop the capacity of local governments to introduce and apply a local property tax. It is

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generally recognized, however, that considerable time, perhaps 5-10 years, will be required to implement a Western style property tax based on market value assessment.

In the interim, another option is to grant local governments the ability to apply local surcharges to the personal income tax. Recent intergovernmental reforms in Poland have adopted this option and a new draft law "On Local Taxes and Fees" that has passed first reading in the Verkhovna Rada promises to move Ukraine in the same direction. According to this draft law, which has been incorporated into the draft Tax Code, local governments (cities and rayons) would be empowered to levy a surcharge of between one and three per cent to the yield from the nationally determined personal income tax base.[2]

This note examines the feasibility and desirability of this income tax surcharge proposal as well as the expected consequences of allocating all income tax receipts on a residence basis. It is argued that, if this surcharge is levied on an origin basis, the tax will likely produce undesirable outcomes. An origin-based surcharge is feasible but unattractive. On the other hand, the application of the tax on a residence basis could founder on administrative grounds. A residence-based surcharge is much more attractive but may not be feasible. These considerations add to the appeal of moving to a viable property tax as quickly as possible.

2. Revenue Redistribution Under the Residence Principle

At first glance, it seems obvious that the adoption of a residence-based personal income tax would reallocate revenues away from communities that hire workers from surrounding areas and towards the communities that supply those workers. This would have been the anticipated outcome before the passage of the Budget Code and the introduction of a formula based transfer system. Now that such a system is in place, however, whatever redistribution occurs under a residence rule would be between the State and local budgets and not between local governments.

To see why this is so, consider a simple example of how the transfer formula works. Suppose there is a community on the outskirts of Kiev City that furnishes its entire work force to employers in Kiev. By assumption, this community collects no personal income tax if it is assessed on an origin basis. Under the current formula, however, it would receive a large transfer from the State budget to finance its estimated expenditure needs. Next, consider what would happen if the residence rule were applied instead. The community in question would experience an increase in its taxable capacity that the formula would take into account and reduce its transfer by the same amount of any increase in personal income tax revenues. The city of Kiev would undergo the opposite set of revenue adjustments. Being a contributor to the State budget, the city of Kiev would see its taxable capacity decline and the formula would reflect this fact by reducing the size of it contribution by exactly the amount of any fall in personal income tax revenues. In the end, nothing "real" would be changed under the residence rule. The overall revenue situation of neither the State budget nor any local budget would be altered by adoption of the residence rule in place of the origin rule.

There is one small qualification to this conclusion. The preceding example assumes that the Ministry of Finance in charge of implementing the formula can forecast personal income tax revenues with complete accuracy. With fallible forecasting, however, some local governments will enjoy unplanned income tax increases that escape the operation of the formula. When this occurs, some local governments will enjoy a revenue benefit under the residence rule that would be denied to them under the origin rule.

[2] The draft law also introduces local surcharges on the enterprise profits tax collected in a local areas. For a variety of reasons, local profits taxation is not an attractive policy option and it is, therefore, not pursued in the following discussion of personal income tax surcharges. A local profits tax is unattractive because it is not a tax on local residents. To the extent that local businesses impose costs on local budgets, these costs should be recovered through some combination of user fees and revenues from business licenses. In the future a non-residential property tax could also be used to recoup these costs.

3. APPLYING THE RESIDENCE PRINCIPLE FOR A LOCAL SURCHARGE ON PERSONAL INCOME

If the consumption of local public services is more closely related to where people live than to where they work, the residence principle is the most appropriate basis on which to levy a local surcharge on personal incomes. The payment of local income taxes to the local government where the individual resides would establish an important benefit linkage between the enjoyment of public services and the tax cost of their provision. This linkage would increase taxpayers' awareness of the resources needed to provide public services and make local public officials more accountable to their taxpayer-consumers in providing the amount and type of public service that is wanted. The result should be a higher level of public sector efficiency in terms of both the level and composition of services supplied by the local public sector.

Because the income tax surcharge would be considered as a local tax, it would lie outside the scope of the formula and any revenues that were realized by it would accrue entirely to the local government that imposed it.

Granted the desirability of applying the residence principle in this manner, the important policy question is how this could be done. At one extreme, individuals could be required to submit an individual return to the tax authorities along with a payment of the amount of surcharge levied by the community in which individual resides. In Ukraine, such a procedure would likely encounter both assessment and collection difficulties, not to mention adding significantly to the administrative burdens of the State Tax Administration. Employees would require a verifiable statement of their earnings from their employer in order to calculate their tax liability and some notification of the rate of surcharge that is applicable in their local area. The STA , for its part, would have to develop new procedures for ensuring that a tax return is filed, that the calculation of tax liability is correct and that payment of tax has been made. For the self-employed, matters would be easier since they already have to file an individual return and the calculation of the surcharge would require only a few additional lines on their return.

In lieu of problematic individual filing, it would be worthwhile to consider retaining the advantages of the present system of employer withholding at source and modifying it to incorporate the residence principle. One approach would be for the employer to withhold both the nationally imposed personal income tax and the amount of the local income tax surcharge.[3] To do this accurately, the employer would need to know the residence of each employee and the rate of surcharge assessed by each locality. Employees would have to declare their place of residence to their employer, a task made somewhat easier by the prevailing "propyska" method of residential registration. As long as surcharge rates were reasonably uniform and all localities levied a surcharge, an employee would not have an incentive to make a false declaration since there would be only a personal cost and no benefit if taxes were assigned to the "wrong" locality.

Verification of residence could be a problem, however, if some localities imposed a surcharge and others refrained making it personally profitable to appear to reside in a no-tax locality. Variable rates, other than zero, present the same, but smaller, problem since a taxpayer residing in a higher rate locality would have to weigh the tax savings from fudging registration with the loss of expenditure benefits that would ensue. Unless tax competition among localities can be relied upon to restrain rate differentials, this temptation to cheat underlines the need to legally limit the level of allowable surcharges within a fairly narrow range. Under such a system, the STA would receive all taxes withheld by the employer and remit to each locality the amount of surcharge it would be owed.

[3] The need for the employer to withhold on the basis of employee residence may be obviated with the introduction of new tax identification numbers (TINs) for every employee. If every employee were issued a TIN and surcharge rates were uniform, the employer would withhold in the normal fashion and the STA would use its TIN information to partition the amount of surcharge collected among the different localities of residence. If, however, surcharge rates were non-uniform, the employer would still need to know how much to withhold from each employee.

Even if the residence principle could be implemented in the manner described, Ukraine could still be left with an anomalous personal income tax system in which the residence principle applied to income tax surcharges while the origin principle continued to apply to normal income tax collections. Collecting these proceeds on an origin basis and the surcharge on a residence basis makes little sense. Even in the absence of a surcharge the current income tax system is administered on an inconsistent basis. Although income taxes are collected on an origin basis, any refunds that a taxpayer may be entitled to are remitted on a residence basis. Local governments are naturally upset if they have to refund a tax they never collected in the first place.

A harmonious personal income tax system requires the consistent application of either the residence or origin principle to both the basic personal income tax and to any surcharges. If the residence rule were adopted for surcharges, the argument for switching to the same rule for the normal income tax becomes much stronger. Whether the alternative origin principle could be usefully harnessed to serve both the regular income tax as well as surcharges is considered next.

4. THE SOURCE OR ORIGIN PRINCIPLE FOR A LOCAL SURCHARGE ON PERSONAL INCOMES

Although there is a long tradition in Ukraine for collecting personal income taxes on the basis of where one works, or the use of the origin principle, this practice is becoming increasingly inappropriate as barriers to worker mobility begin to wither in the face of pressures from a market economy. In Soviet times most employees resided and were officially registered in the local community that employed them. In recent years, however, the rigid “propyska” system limiting residential choice has been relaxed and many more people are now working in areas where they are not formally registered for residential purposes. For example, the relatively more attractive employment opportunities offered by the city of Kiev has attracted a growing number of recent emigrants from other regions of the country. This group, however, not only works but also effectively resides in Kiev so it is fitting that its members should also pay their income taxes, including any surcharge, to the city of Kiev.

Matters are more complicated for another group of workers that reside in one locality and commute from there to work in a different locality. On the one hand, these commuters consume some public services in the locality where they work and should bear some of the cost of their provision. On the other hand, it is clear that not all of their income taxes should go to the locality that employs them and that, when this happens, the locality of employment is able to export a large fraction of its tax burden to non-residents.

The question of whether commuters exploit the city in which they work or whether the city exploits them through its tax policies has stirred controversy in many countries. In the United States, for example, many large cities such as Detroit and Chicago impose payroll taxes in an effort to defray the costs of meeting the needs of a large commuter population. Whether these taxes are too high or too low in relation to the costs attributable to commuters has become a contentious political issue.

In Ukraine, the counterpart to this type of payroll tax is the tax on communal services which uses a portion of payrolls as its tax base. Through this tax commuters defray at least a portion of the extra costs they impose on the cities in which they work. If these cities also received all of the proceeds of a local income tax surcharge it is likely they would be able to export tax burdens to non-residents in excess of the benefits which they provide to non-residents.

This capacity to export income tax burdens has the potential to distort residential location decisions and the ability to levy income tax surcharges on the same origin basis only compounds these pressures. To use the city of Kiev as further example, why not move to Kiev if surcharges are applied and capture some of the additional expenditure benefits financed by these surcharges? One answer may be that in Ukraine it will be some time before residential location choices become sensitive to the tax and benefit attractiveness of competing communities. That said, it is also clear that the task of collecting an origin based income tax surcharge is much easier than it would be under a residence approach as it would only require a simple extension of the existing method of collecting the normal income tax.