FURTHER COMMENTS ON
"EVALUATION OF RATES AND BRACKETS IN THE PERSONAL INCOME TAX OF UKRAINE"[1]

Even though the article by Leschenko and Thissen was written less than two months ago, already there are substantial additions that can be made to its content. The Ministry of Finance has recently distributed a draft law "On the Taxation of Physical Persons"(TPP), which is intended to replace the current personal income tax (PIT). This draft legislation proposes replacing the current set of five rates and brackets with a set of three annual rates and brackets:

Bracket	Maximum Annual Income	Rate	Tax Credit
1	4,800	10%	28.8
2	120,000	15%	28.8
3	No Max	20%	

In addition to the three brackets, there is included a low income tax credit awarded to all persons in the lowest two tax brackets. The value of the annual credit is the equivalent of 0.6% of the maximum income allowed in the lowest bracket in the month of January (400 UAH), multiplied by twelve.

Using the methods identified by Leschenko and Thissen, we can simulate the revenue and distributional characteristics of the rates and brackets defined by this proposal. To evaluate the proposal, we employ three criteria for evaluation:

1. The proposal should significantly decrease the tax liability of low-income taxpayers. Such tax relief should appear in the lowest three income deciles.
2. The proposal should significantly reduce the tax liability for high-income taxpayers. While socially regressive, such policies will tend to increase saving and spur business development. Such tax relief should appear in the top three income deciles.
3. The proposal should minimize distortions to the system of intergovernmental transfers between the central and local governments.[2]

There are few "good" policies that satisfy these criteria while continuing to raise significant revenue for budget expenditures. Based on the analysis of Leschenko and Thissen, we can compare the TPP rates to the single rate proposal labelled "SR 2" in that paper. These two proposals raise approximately the same amount of revenue. However, while single rate taxes are generally discarded as being regressive, what we find is that the SR 2 proposal is preferable to the TPP proposal in all of the three evaluation areas.[3] The results of the policy comparison by income decile is presented in the figure *Comparison of Single Rate and Proposed TPP.*

[1] By John Thissen, Support for Economic and Fiscal Reform Project / Development Alternatives, Inc (DAI) funded by the United States Agency for International Development (USAID).

[2] The system of transfers from the central government to local governments is based on relative revenue potential. To the extent that the distribution of revenue-raising potential is shifted by new legislation, the formula would require revision. As such changes to the intergovernmental relations would be challenging, it is a worthwhile objective to avoid such redistribution.

[3] Please note that we are only examining rates, brackets, and low-income tax credits. Other legislative changes, such as base adjustments, will also affect the distributional characteristics of these proposals.

Comparison of Single Rate and Proposed TPP

Impact on Liability of Bracket Change by Income Decile

	SR 2	TPP	Change	Percent
Decile 1	33,886	27,109	(6,777)	-20.0%
Decile 2	106,808	85,447	(21,362)	-20.0%
Decile 3	188,891	151,112	(37,778)	-20.0%
Decile 4	282,774	226,220	(56,555)	-20.0%
Decile 5	392,442	313,953	(78,488)	-20.0%
Decile 6	524,316	419,520	(104,796)	-20.0%
Decile 7	689,798	590,668	(99,130)	-14.4%
Decile 8	912,338	857,716	(54,622)	-6.0%
Decile 9	1,255,012	1,268,924	13,912	1.1%
Decile 10	2,161,899	2,357,188	195,290	9.0%
Total	**6,548,164**	**6,297,857**	**(250,307)**	**-3.8%**

Impact on Liability of Low-Income Tax Relief by Income Decile

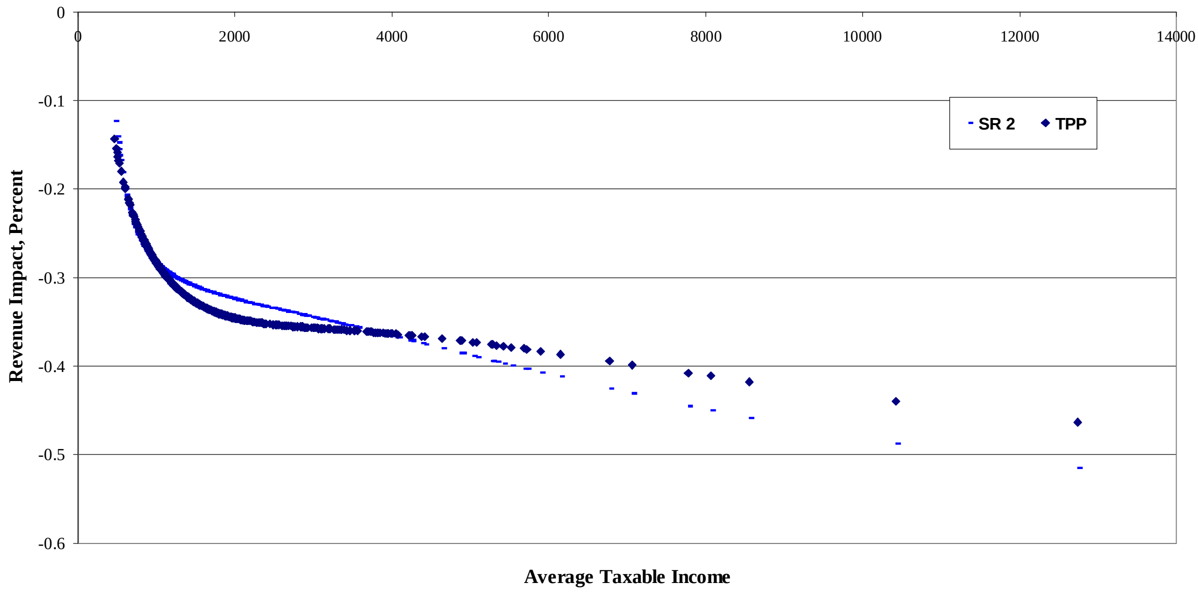
	SR 2	TPP	Change	Percent
Decile 1	33,886	20,860	(13,026)	-38.4%
Decile 2	71,096	28,451	(42,645)	-60.0%
Decile 3	71,127	28,451	(42,676)	-60.0%
Decile 4	71,127	28,451	(42,676)	-60.0%
Decile 5	71,127	28,451	(42,676)	-60.0%
Decile 6	71,127	28,451	(42,676)	-60.0%
Decile 7	71,127	28,451	(42,676)	-60.0%
Decile 8	71,127	28,451	(42,676)	-60.0%
Decile 9	71,127	28,451	(42,676)	-60.0%
Decile 10	71,127	28,451	(42,676)	-60.0%
Total	**673,998**	**276,917**	**(397,081)**	**-58.9%**

Combined Impact by Income Decile

	SR 2	TPP	Change	Percent
Decile 1	-	6,249	6,249	0.0%
Decile 2	35,712	56,996	21,283	59.6%
Decile 3	117,764	122,662	4,898	4.2%
Decile 4	211,647	197,769	(13,879)	-6.6%
Decile 5	321,315	285,503	(35,812)	-11.1%
Decile 6	453,189	391,069	(62,120)	-13.7%
Decile 7	618,671	562,217	(56,454)	-9.1%
Decile 8	841,211	829,265	(11,946)	-1.4%
Decile 9	1,183,885	1,240,474	56,589	4.8%
Decile 10	2,090,772	2,328,738	237,966	11.4%
Total	**5,874,166**	**6,020,940**	**146,774**	**2.5%**

The figure is divided into three tables. The first table identifies the revenue impact of the different tax brackets and rates. The second table compares the low-income tax relief. The SR 2 proposal includes substantially more low-income protection (annual credit of 72 UAH), resulting in 60% more tax relief than the TPP for most taxpayers. The combined effect is illustrated in the last table. As can been seen, these two proposals fall within 2.5% of each other with respect to revenue raising potential. However, there are major differences in the distributional characteristics of these two proposals. Examining the combined impact, we see that the TPP proposal imposes a larger tax burden on the three lowest income deciles. It also imposes a larger tax burden on the two highest income deciles. These two observations conflict with our first two stated objectives above, namely to target tax relief to the lowest and highest income classes.

Impact on Regions, SR 2 versus TPP



Examining the regional distribution of the change in tax liability is also interesting. As can be seen in the figure *Impact on Regions, SR 2 versus TPP,* the revenue impact of both proposals is widely distributed between less that 10% and over 45%. In both cases the resulting reduction in liability is dependent on average taxable income in the region, as would be expected. Poorer regions see a smaller reduction in liability from the reduction of the highest marginal tax rate. While this distribution may seem “fair” in the sense that the poor regions see a smaller reduction in liability, these results are not consistent with our stated objective of treating all regions equally. Should either of these proposals be adopted, it would be necessary to significantly revise the formula for allocating subsidies to regional governments.