REGIONAL IMPLICATIONS OF THE PROPOSED CHANGES IN PIT RATES AND BRACKETS[1]

Background and methodological information

Draft law on PIT approved by the Verkhovna Rada in the second reading proposes to replace the existing system of rates and brackets with a uniform 13% tax rate for the period until 2006, when there will be a switch to a new uniform PIT rate of 15%. In addition to that, this draft proposes a radical change in the low income tax relief system — namely to cancel the non-taxed minimum altogether and to introduce so-called social tax privilege. The new social tax privilege implies that taxpayers whose annual income is less than 40 legislatively established minimum monthly wages would be allowed to make a deduction — equal to minimum monthly wage multiplied by the number of months the taxpayer receives the salary during the year — from their annual taxable income (and, subsequently, to demand refund). The size of legislatively established minimum monthly wage is under debate right now. Currently, minimum wage is set up at the level of UAH 185. It is, however, intended to increase the minimum wage to UAH 237. The Draft proposes gradual integration of the new low income tax relief system: the social tax privilege is suggested to be equal to 50% of minimum wage for the first year after enactment of this Draft, and 80% and 100% - for the for the second and third years respectively.

Analysis concludes that the effective tax rate will decrease from about 18% to 7% (taking into account the proposed low income tax relief), resulting in an overall reduction in PIT collections of 5 billion UAH (that represents about 61%). The distribution of the losses, however, will not be uniform across the local budgets and will vary significantly.

These changes will have two major direct effects. First, the new system of rates, brackets and low-income relief is highly likely to negatively affect the total size of budget revenues. Proposed elimination of tax privileges, as well as inclusion of additional types of income into the tax base, is likely to provide some compensation for this loss of revenues. Besides, it is expected that the decrease in the rates and the simplification of the whole system will create incentives for new taxpayers to come out of the shadow and that this will also help to compensate the revenue loss. It is important, however, to estimate the size of the potential loss abstracting from the hopes for these two possible compensating factors.

The second important implication of the change in rates and brackets, on which this paper is concentrated, can arise from its distribution effect: how the resulting revenue loss will be distributed among the Ukrainian local budgets. Under current arrangements of intergovernmental fiscal relations in Ukraine, 100% of PIT revenues are assigned to local budgets and represent the bulk of resources available to these budgets to finance their expenditure needs. Consequently, the relative capacity of each community to generate PIT revenues compared to the national average is the major driving factor, which determines the size of the equalization transfer from the central government to each of the budgets. When calculating the transfer for each local budget, the Ministry of Finance computes the index of relative fiscal capacity, which relates the actual per capita revenues in this community for the last three years to the national average. It is possible that the reform of rates and brackets will have a non-uniform effect on Ukraine's local budgets, that is, some of them will have higher percentage losses in PIT revenues and others would be hit less hardly. Such non-uniform changes would create difficulties for the Ministry of Finance in its attempts to define individual indexes of relative fiscal

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capacity for the local budgets since the Ministry would not have a comparable set of historical data for these calculations. The mechanism for defining indexes of local budgets' relative fiscal capacity used for transfer calculations, therefore, may need some modification. On the other hand, if the new system of rates and brackets affects all local budgets proportionally (by the same percentage amount), the current formula for transfer calculations can continue without major changes.

The purpose of this work is to try to estimate regional revenue implications of the proposed change. The analysis is based on a generalized distribution function common to most countries. This function describes the distribution of taxpayers in different income brackets[2] and then use official PIT actuals and official estimated effective PIT rates to simulate the impact of the shift to the new universal rate on the regional budgets (cities and rayons). The approach described is the only feasible option to make such a forecast since a more precise exercise would require microdata which is available neither to SEFR nor to the MinFin. At the same time, this approach has its limitations. First, it does not take into account potential additional revenue gains either from the proposed tax base extension (due to the elimination of privileges and inclusion of new types of income) or from taxpayers' coming out the shadow. Second, it uses official estimates of effective tax rates by oblast. These numbers do not take into account the differentiation in the effective tax rates among cities and rayons within the oblasts. This differentiation, however, most probably does exist since in the rural areas most population is involved in agricultural activities and PIT is collected mainly from employees of budget institutions where salaries typically fall into the lowest brackets, so the effective PIT rates in rural areas are probably lower. Nevertheless, general conclusions from the simulations must be robust to these possible inaccuracies in the number of effective rates.

Description of results

Simulations have revealed that the proposed shift to a 13% unified PIT tax rate combined with the proposed system of low income relief (hereinafter, the "third year" scenario is described that implies a tax relief at the level of 100% of minimum wage) would result in more than UAH 5 billion loss to local budgets. The distribution of the losses, however, is not proportional across the local budgets and varies between 53% and 98%. This distribution is presented below graphically. The graph shows that the change in the rate will hit the local budgets in an inverse proportion to the level of their per capita income; in other words, the poorer the community, the higher will be the revenue loss. Most of the Ukrainian communities (90%) fall into the lowest part of the income range (with an annual per capita income of less than UAH 4 000) and so will suffer a dramatic revenue loss. Almost half of the communities will have losses bigger than 70%.

The key factor contributing to such grim results is the proposal to provide a low income tax relief equal to the minimum wage. In the poorer communities, a significant portion of the population has incomes at a level of the minimum wage. Moreover, many employers choose to disclose the incomes of their employees only in the size of the minimum wage in order to minimize their tax liabilities. The decision to establish a social tax privilege in the size of the minimum wage will rule out all these taxpayers from the PIT system altogether by exempting all their income. This explains why, for some of the local budgets, our simulations predict revenue losses close to 100%.

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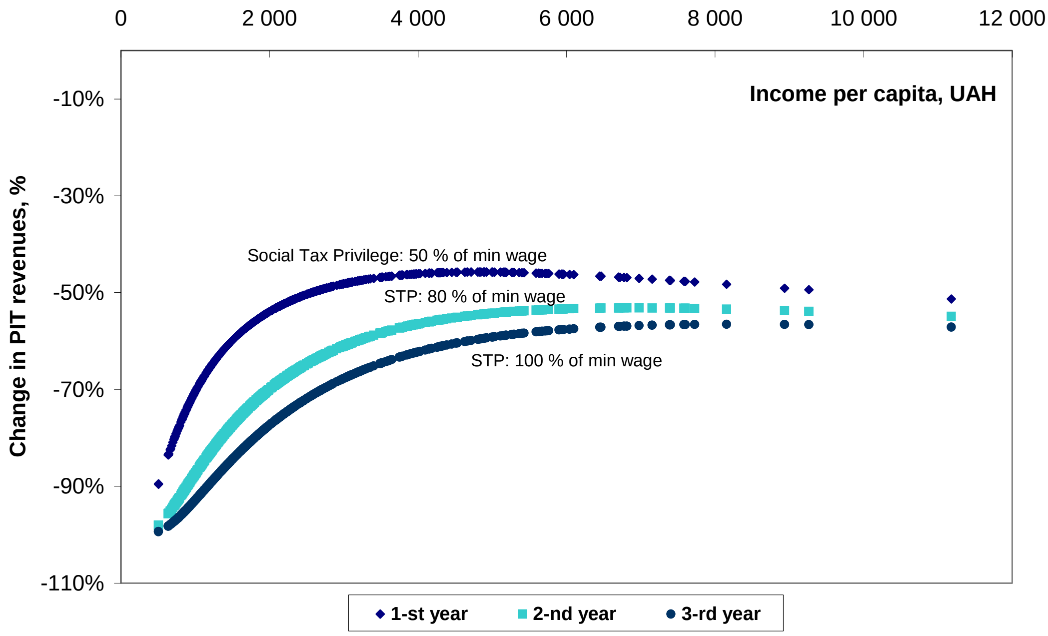
[2] Detailed description of used methodology might be found at the article of J. Thissen and N. Leshchenko "Evaluation of Rates and Brackets in the Personal Income Tax of Ukraine", "Budget and fiscal Review", 1st quarter 2002.

If the provision of social tax privilege is not taken into account in the simulations, and only the change in the tax rate is assumed (i.e. tax is levied on the whole amount of income without any deductions, this means that neither non-taxed minimum nor social tax privilege is applied), the results are diametrically different. This hypothetical simulation proves that the change in the rate itself would result only in an about UAH 2.5 billion loss to local budgets and the losses would be smaller for the poorer communities and bigger for the communities with higher incomes; moreover, the poorest communities might even benefit from the reform. In the poor communities where most of the population receives minimum wages, all these incomes are currently taxed at 10% (second tax break) with exception of UAH 17 of the non-taxed minimum. Switching to the unified 13% rate without any tax relief would increase the tax base for such taxpayers by UAH 17 and add to the rate 3 percentage points.

Expected PIT revenue changes by cities and rayons



What mechanisms are available to compensate these losses?

PIT legislation is able provide some potential sources to compensate for these expected revenue losses. It can, for example, expand the PIT base by including new types of income or eliminating the existing tax privileges. The proposed draft does suggest both of these things. Whether these proposals would prove efficient and whether they would provide a sufficient compensation to the expected revenue losses, remains unclear.

It could be also expected that the shift to the unified 13% tax rate and other changes in the draft aimed at simplification of this legislation would allow new taxpayers to leave the shadow economy and enter the PIT system. This expectation is recognized as doubtful, at least in the short run. Apart from the PIT reform, deshadowing might depend on reforms of other payroll taxes, the prospects for tax amnesty, and the progress of the pension reform (more specifically, on the probability of introducing personalized state pension schemes that would encourage taxpayers to disclose their incomes). The future of all these reforms remains uncertain in the short run.

Losses of PIT for the local budgets may potentially be compensated with alternative revenue sources to be developed at the local level. Discussion over the introduction of a property tax in Ukraine has been evolving during several years but no feasible plan for this new tax has yet been developed. Local PIT surcharges also remain an option, but their introduction is hampered by compelling administrative issues and is also more than uncertain.

Ukrainian local governments have a very large financial mandate with regard to delegated expenditures such as health and education. In order to compensate for the rapid decreases in the major local revenue source, the central government would have to provide additional resources for the local budgets to finance their expenditure responsibilities. However, such resources may be not available for the central government in the short run.

Conclusions

Proposed change in the system of rates and brackets is likely to have a dramatic impact on Ukraine’s local budgets, at least in the short-run. It will also most probably require significant changes in the mechanism for defining indexes of local budgets’ relative fiscal capacity used for calculations of intergovernmental transfers.

The distribution of the revenue losses will not be uniform. Moreover, if the final draft keeps the idea of providing a low income tax relief in the form of social tax privilege equal to minimum wage, the reform will hit heavily Ukraine’s poorest communities, some of which risk to loose their PIT revenues almost completely. In order to avoid this, the provision of low income tax relief has to be revised. It is worth mentioning that one of the most proactive members of F&B Committee Mr. Teriokhin has made public, at a recent round table about PIT reform at Ministry of Finance, the Committee’s intention to revise the tax relief procedure (i.e. to set up an income threshold for individuals to be eligible for social tax privilege).