

TAX SHARING: ILLUSORY BENEFITS AND REAL PROBLEMS

Over recent past Ukraine witnessed gradual transition from an old system of local budget financing that heavily relied on volatile sharing of national taxes to more transparent system of separating taxes among different levels of government and equalization transfers from central government for financing local governments expenditure needs. This transition is scheduled for completion on January 1, 2002 when corresponding articles of the recently approved Budget Code of Ukraine will become effective. The new Budget Code assigns personal income tax, some types of state duties, specific types of business registration and licensing fees and a part of unified tax on small business to local budgets. All other national taxes, in particular VAT, excises and enterprise profit tax are assigned to national budget. At the same time, the Budget Code establishes transparent formula-based system of equalization transfers to local governments.

Even though the political decision on tax separation has been externalized in the form of new Budget Code, the criticisms of such separation and proposals for return to substantial sharing of major national taxes are still vocal. Advocates of larger national tax sharing believe that it would increase the financial base of local governments and, therefore, reduce dependence of local governments on central government. In particular, there are proposals to share VAT and CIT that starting 1997 and 2000 respectively are assigned to central budget (except Kiev and Crimea that have special arrangements). However, budget and tax policy considerations show that such criticism and proposals are not viable.

1. BUDGET POLICY CONSIDERATION

One of the objectives of budget policy is to maintain fiscal equity, that is the access to public services and the tax cost of such services should not depend on the region in which a taxpayer resides. The local governments provide many of public services such as street maintenance, schooling, etc. The central government usually provides services that can not and should not be provided by any lower level of the government (such as defense, for example).

Typically the tax resources controlled by local governments are not sufficient to finance all public services provided by this level of government. At the same time, national governments control more taxation powers than they need for providing their own public services. Larger sharing of national taxes, advocated by critics of tax assignment arrangements envisaged in the Budget Code, seems to be one of the obvious solutions for correcting such vertical imbalances. However, because bases for national taxes are distributed unevenly across regions, such solution may result in serious fiscal horizontal imbalances among regions. Unless the central government takes actions for equalizing fiscal situation across regions, the access of a taxpayer to public services would greatly depend on a region where he or she resides.

Central government has in its disposal two means of fiscal equalization under large national tax sharing arrangement. First, under sharing arrangement with uniform rates richer regions are ordered to transfer part of own funds to the central government for

further redistribution to poorer regions. However, nobody can guarantee that local governments of donor regions would be punctilious in making such transfers. Indeed, donor regions would be very reluctant to make such transfers while the central government would lack efficient means to enforce compliance. Therefore, if one accepts argument of the tax sharing proponents that the central government is not punctilious either, it is obvious that the system of two way transfers combined with tax sharing is less reliable than the system to be introduced by the new Budget Code. Second, the sharing rates can be established inversely to the relative fiscal capacity of a particular region so that poor regions would be entitled to a higher portion of national tax revenue compared to richer regions. Obviously, one can see that return to sharing of national taxes would not solve the problem of increasing the own financial base of local governments without hindering equal access to public services for population residing in different regions.

Proponents of tax sharing arrangement claim that the rates of sharing should be stable over certain period of time. However, it is highly unlikely that such stability would be maintained. Different groups of local governments will view any existing sharing arrangement as unfair thus lobbying for review of either rates of sharing or amount of transfers. Such appeals may lead to frequent adjustments that, in turn, would make it difficult for local governments to prepare their fiscal plans as they would not know in advance how much resources they will have next year. Furthermore, appeals and subsequent adjustments make the central government an ultimate arbiter of local expenditure levels – it is in the central government power to stimulate or depress the amount of local spending by adjusting sharing rates or subventions.

2. TAX POLICY AND ADMINISTRATION CONSIDERATIONS

One of major problem that makes national taxes, in particular, enterprise profit tax, VAT and excises, unsuitable for sharing is the issue of attribution of national taxes to a particular region. Very often jurisdictions of a tax base and jurisdictions where corresponding taxes are collected are different. For example, the Naftogas Ukrayiny earns taxable profits through branches located across different regions but pays taxes in Kyiv - city where it is registered. Many people from Kyiv's suburbs like Brovary, Irpin, Vyshneve commute every day to Kyiv for work there. Their personal income tax is withheld at the source of payment of wages and salaries and directed to the Kyiv's budget, not to the budgets of cities where those people live. Many goods subject to excise and VAT are consumed countrywide. Because these taxes are taxes on final consumption, the ultimate taxpayers are also located countrywide. However, taxes are collected in one particular region where the producer is located. Good example is the Massandra vineyard. It is difficult to imagine any single region of Ukraine where the products of Massandra would not be sold. But excises levied on Massandra vines are collected entirely in Crimea.

If taxes are shared, that means that public services in some regions are financed at the expense of taxes collected in those regions but born by population of other regions. People actually paying taxes would never be entitled to those services and, at the same time, may receive less public services in their own regions. Obviously, such situation weakens the link between public services provided by a particular region and costs of such service and discourages accountability of local governments. On the other hand regions deprived from collection of taxes born within those regions can view this

situation as draining their share of national taxes. Therefore, they will take actions in attempt to solve the issue of attribution. Those possible actions and their consequences are analyzed below separately for enterprise profit tax, VAT and excise.

Enterprise Profit Tax

Regions that are concerned with draining their share of enterprise profit tax may put a pressure on the policy makers to require registration of enterprises' branches, affiliates and other detached units as separate taxpayers. Indeed, current enterprise profit tax law has such requirement as remains of old system of sharing. Payers of enterprise profit tax have already difficulties in attribution of taxable profits among numerous branches and paying enterprise profit tax locally. Some branches of an enterprise may be profitable while other units of an enterprise may be in loss position. The total amount of tax effectively paid by different branches may well exceed consolidated tax liability of an enterprise (see Case 1). Therefore, resolving issue of attribution under tax sharing arrangement may severely affect business decisions on what the most optimal structure of business should be.

Case 1: Consolidated Payment of Enterprise Profit Tax – Overtaxing Businesses

According to current legislation an enterprise is required to register each branch as a separate taxpayer and pay tax on profits attributable to each branch in the region where a branch is located. The tax law imposes general rules on tax accounting for each taxpayer. Therefore, branches, as registered taxpayers, are effectively obliged to keep full set of records to determine profits earned by particular branch. Then the case may be that total amount of tax paid by different units of an enterprise in respective regions may exceed consolidated tax liability of an enterprise. Let's consider numerical example of an enterprise that has headquarters and two branches acting in different regions.

Units	Location	Attributed taxable profit (+)/Losses (-), UAH	Tax due, UAH	Tax paid, UAH
Headquarters	Kyiv	- 10,000	0	0
Branch 1	Odessa	- 10,000	0	0
Branch 2	Dnipropetrovsk	+ 30,000	9,000	9,000
Consolidated		+ 10,000	3,000	9,000

Because no immediate refund is provided (overpayment of tax is credited against next period tax liabilities), an enterprise pays in particular tax period three times more tax than it should.

To resolve this issue, the law entitles an enterprise to choose filing consolidated return for net profit earned by all its detached units. Amount of tax, payable by each separate unit, is determined by way of apportioning consolidated tax liability according to the ration of gross expenses and depreciation allowances incurred by each detached unit. Tax paid by each separate unit then can be credited against consolidated tax liability of the entire enterprise. However, because tax paid as a result of apportioning may be lower than one calculated by way of conventional accounting, very often local authorities object consolidated filing.

Value Added Tax

Like in case of the enterprise profit tax, a requirement for each branch or any other detached unit of an enterprise to be registered as VAT taxpayer may seem to be a solution for attribution issue. In fact, even in the absence of the explicit provision in VAT law, the State Tax Administration ordered back in 1997 some types of enterprises to register its branches as separate taxpayers. Because of this requirement, many enterprises having extensive network of branches already experienced excessive taxation of inter branch transfers. Branch registration especially hurts financial institutions like banks that are exempt with regard to its main activity and, therefore, can not recover VAT charged on inter branch transfers.

On the other hand, enterprises may benefit from registering branches as separate taxpayers in minimizing their tax liabilities. Because under current VAT legislation the registration threshold seems to apply to each entity subject to registration, a taxpayer can easily avoid registration requirement by splitting activity among a number of branches, affiliates and other detached units. More sophisticated taxpayer that is involved in both taxable and exempt operations may separate entirely those operations between two or more branches. Under such arrangement a taxpayer would attribute lion's share of VAT paid on inputs used in both types of operations to a branch engaged only in taxable operation thus minimizing his VAT liability to the budget (see Case 2). Thus, like in case of enterprise profit tax, tax sharing may lead to serious distortions in decisions of taxpayers on the most optimal organizational structure of the business and may result in substantial revenue losses.

Furthermore, the attribution issue may fuel reluctance of the local governments to allow credits for VAT paid on inputs purchased in other regions or imported. Indeed, it happened in Ukraine when the VAT was shared thus converting VAT in a turnover type tax with cascading taxes paid on inputs. Similar situation observed within the same period of time for taxpayers that were in the refund position such as exporters or new enterprises with substantial amount of investment in fixed assets. Local governments were reluctant to provide refunds at the account of their share of VAT while current receipts of the national budget in a particular region were not enough to cover all the refunds claims especially in the regions with substantial export oriented production. Thus, despite general problem of cascading, sharing of VAT between national and local governments substantially hindered development of export production and large scale investments in Ukraine.

Case 2: Registering Branches as a Means to Minimize VAT – How it Works?

An enterprise conducts both taxable and exempt transactions. Let's assume the value of taxable transactions equal to 200,000 UAH per annum and value of exempt transactions equal to 100,000 UAH per annum (both net of VAT). In providing taxable transactions an enterprise uses inputs directly attributed to these transactions worth 140,000 UAH net of VAT. Inputs directly attributed to exempt transactions worth 70,000 UAH. In addition, an enterprise rents computers and Xerox machine that are used in both providing taxable and exempt transactions. Total rent payments are 60,000 UAH per annum. If an enterprise is a single taxpayer, then it is obliged to attribute this amount to both taxable and exempt transactions in the proportion that those transactions have in total enterprise output. That is, 40,000 UAH are attributed to taxable transactions and 20,000 UAH – to exempt.

	Value, UAH	VAT charged, UAH	Input credit, UAH	Total paid to budget, UAH
<u>Taxable transactions</u>	200,000	40,000	28,000	4,000
			8,000	
Direct inputs	140,000	28,000		28,000
Computers & Xerox rent	40,000	8,000		8,000
<u>Exempt transactions</u>	100,000			
Direct inputs	70,000	14,000		14,000
Computers & Xerox rent	20,000	4,000		4,000
Total paid to the budget				58,000

Assume now that an enterprise sets up a branch that conducts only exempt transactions. The enterprise's headquarters conducts all taxable transactions. Both entities are registered taxpayers. The headquarters charge its production accounts for all expenses on renting computers and Xerox machine while they are used for purposes of both units. Then the VAT position of the enterprise looks as follows:

	Value, UAH	VAT charged, UAH	Input credit, UAH	Total paid to budget, UAH
<u>Headquarters - Taxable transactions</u>	200,000	40,000	28,000	0
			12,000	
Direct inputs	140,000	28,000		28,000
Computers & Xerox rent	60,000	12,000		12,000
<u>Branch - Exempt transactions</u>	100,000		0	0
Direct inputs	70,000	14,000		14,000
Computers & Xerox rent	0	0		
Total paid to the budget				54,000

As one can see, even simple rearrangement of an enterprise's operations may lead to noticeable reduction in VAT liabilities. One may expect that more complex arrangements resulting in large decrease of VAT liabilities may developed in real life.

Excises

Addressing the issue of attribution for excises, the pressure might be to move the tax collection point from production level to the retail sales level. However, this solution would mean total loss of control over long chain of movement of excisable goods from a producer to retailer, thus making collection of excise almost impossible. In addition, it would require additional administrative resources for dealing with substantially larger number of taxpayers at the retail level rather than with smaller number of taxpayers at the producer level.

Case 3: How local governments can prevent “export of tax burden”?

Back in 1999 when excises were shared revenue source, many local governments attempted to prevent “export of excise burden” into the regions. In particular, Lviv and Ternopol regions decided to ban selling alcohol produced outside those regions in local outlets. To justify such attempts to keep local budget Hryvnyas from being fled to other regions, “Ternopol Newspaper” wrote on February 18, 1999: “There are numerous cases, when the production of Ternopol Region distilleries is absent on the shelves of our shops while we consume surrogates and fill coffers of other region budgets. According to information of Mr. Andrievskiy, Head of Department on Trade and Services to Households, Oblast Administration, all traders are obliged to conclude contracts on supply of locally produced alcohol to sales outlets on the priority basis”

On the other hand, if excises are shared, local governments may put a pressure on businesses to sell locally produced excisable goods rather than goods brought from outside a particular region. Indeed, numerous cases of such pressure have been registered back in 1999 when excises were shared (see Case 3). Such intervention substantially alters regional specialization and distorts both inter regional and international trade, thus adversely affecting national economy and its growth. The consumers’ choice will be limited only by local brands that would enjoy monopolistic position on a particular regional market. Desire of local governments to obtain more excise revenue under sharing arrangement can also have an adverse effect on decisions to register new enterprises that are not involved in production of excisable goods.

If several national taxes are shared at different rates tax sharing can alter the incentive to collect different taxes. It is obvious that the region government is mostly interested in collecting taxes in which the region has the largest share. In principle, tax authorities in the field subordinated to the central government should make equal efforts for collecting all taxes that they are responsible for. In a real life, however, region governments have enough means to influence the concentration of collection efforts on different taxes according to their contribution to the total pool of region’s financial resources. Some evidences of that have been observed back in 1997.

3. INCREASEING OWN REVENUE BASE OF LOCAL GOVERNMENTS: WHAT ARE OPTIONS ARE?

The above analysis shows that sharing major national taxes such as VAT, enterprise profit tax and excise would not solve the problem of increasing own revenue base in clear and concise manner. Instead, it would create additional problems that would have negative impacts on revenue, in particular, local revenue, and economic development of

the entire country. At the same time, some other taxes for which the central government has a power to determine base and rates are suitable for assigning to local budgets. However, one can expect that there still would be a pressure to introduce new taxes over which local governments would execute control.

Based on the above analysis, selection of other national taxes to be assigned to local budgets or inventing new taxes should be guided by the following principles:

- Taxes should not be easily exportable outside the jurisdiction where they are collected, since otherwise the accountability of local governments would be discouraged
- Tax base should have relatively even distribution across regions thus providing regions with equal opportunity to raise revenue
- Tax base should be large enough to satisfy expenditure needs for local governments
- Tax should not be levied on highly mobile factors, since otherwise taxpayers will relocate from regions with relatively high tax burden to regions with relatively low tax burden
- Taxes should not create major economic distortions
- Taxes should be easy to administer
- Public services of local governments that are rival in consumption should be financed at the expense of user charges.

One of the best taxes that would comply with above principles and, therefore, should be controlled or assigned to local governments is the real estate tax. The tax base that includes both the land and structures on the land is potentially large and has relatively even distribution across the country. Neither land nor fixed structures are the mobile factors that can be moved from one region to another one. Quantity and quality of public services provided in a particular location such as sewage system, maintenance of streets, schooling, etc reflects in the real estate price level thus establishing clear link between efficiency of local governments and ability of those governments to raise appropriate revenues. With appropriate level of development of real estate market, the real estate tax is relatively easy to administer. Indeed, in many countries around the world real estate tax is the largest source of local government revenue.

In Ukraine since 1995 there were a number of proposals to introduce immovable property tax. However, none of those proposals was approved so far. Given that the implementation of the immovable property tax would take considerable time and would require investment of significant resources, the work on developing immovable property tax should be accelerated.

The land tax, even though it has much narrower base (structures fixed on the land plots are not taxable) than the real estate tax, complies with most of the requirements laid down above. Therefore, it is very appropriate to assign this tax to local budgets. In fact, it has been done in the Budget Code recently approved by Verkhovna Rada. One of the major current problems of land tax is substantial erosion of tax base by numerous exemptions. Back in 1999, exemptions provided by the law or by discretion of the Government of Ukraine that relate to the public services provided by the central government accounted

for 93%¹ of total value of exemptions on land tax. For example, the Yavoriv firing-ground in Lviv oblast and Uzin air force base in Kyiv oblast that occupy substantial area are exempt from land tax. While the situation gradually improved over last two years, extensive power of central government to alter the base of the tax assigned to the local budgets is still an issue. Therefore, reviewing and abolishing of a substantial chunk of such exemptions is a potential source of increasing own tax base of local governments. The other way to deal with this issue is to provide compensation of losses of local revenue associated with such exemptions from the national budget. In many other countries tax on real estate that is used in providing public services by central government is either paid or, if the law grants appropriate exemptions, compensated by the central government (see Case 4). Indeed, Article 97 of the new Budget Code of Ukraine provides possibility for such compensations. Despite increase in own financial base of local governments, canceling many of such exemptions or providing adequate compensation for revenue losses due to exemptions would remove distortions of real cost of public services provided by the national government.

Case 4: How the Federal Government of Canada pays real estate tax in Quebec

There is a provision in the Constitution of Canada that forbids taxation of one government by another. That applies as well to enterprises owned by the Crown. In practice, federal government pays compensation of unpaid real estate tax on a voluntary basis even though it is not obliged to do so. The amount is the result of a negotiation and is generally approximating the tax that would be otherwise paid. The same principles apply for Income Tax or Payroll Tax for example. These taxes are paid by both sides (Quebec and Ottawa) but still on a voluntary basis often described in intergovernmental taxation agreements between the two levels of governments.

Another national tax suitable for assigning to local budget is the personal income tax. Mostly, this tax is paid in the locality where a taxpayer resides. Even though the above analysis pointed out cases when the tax could be paid to wrong jurisdiction, compared to indirect taxes and enterprise profit tax such cases would be rare. The recently observed tendency of increasing share of personal income tax in total tax revenue of consolidated budget is mainly attributed to expansion of the tax base. With improvement of economic conditions this tendency will become stronger. Therefore, the base of this tax is very elastic. Finally, since personal income tax is collected mostly through withholding at the source, this tax is easy to administer.

Search for new sources of revenue controlled by local governments was driving numerous proposals on revision of the existing system of local taxes, especially in the interim period while the immovable property tax would not be implemented. Notwithstanding strict legislative limitations on types of local taxes that can be introduced, local governments attempted to introduce additional local taxes (see Case 5). However, making current system of local taxes compliant with aforesaid requirements for local sources of revenue is another important reason for review of the system. A number of taxes comprising the current system of local taxes, such as due for participation in horserace in hippodrome, due payable by owners of dogs, duty for the right of shooting

¹ Source: STA data

movies and TV have extremely small and unevenly distributed tax base. The advertising tax is an excise tax on business consumption that creates substantial distortions in promoting goods and services and can be easily exportable through inclusion in price of output in other jurisdictions. Furthermore, the base of the advertisement tax, even though relatively large, is highly unevenly distributed. Therefore, consideration should be given to elimination of such taxes.

Case 5: New Local Taxes – Area of Creativity for Local Governments

The Law of Ukraine “On Tax System of Ukraine” determines definite list of local taxes and user fees that local governments can levy within their corresponding jurisdiction. Thus, local governments are banned from introducing any other taxes or fees that are not on this list. Notwithstanding provisions of the law, local governments are in a permanent creative search of new forms of implicit or explicit taxes and fees. For example, Donetsk City Council at one point decided to introduce temporal surcharge targeted to finance completion of the new stadium. The other decision of Donetsk City Council of March 30, 1999 suggested retail and catering outlets to donate 0.05% of their turnover for social protection of poor people living in the city. Despite “voluntaree” form this donation was effectively compulsory – those businesses that did not donate experienced difficulties in obtaining different permits and renewing licenses needed for business purposes (“Business”, July 5, 1999, #27).

Here are some other examples of local government creativity. Chernivtsy region considered a proposal to introduce self-taxation for rural population of the region. The Volyn region considered a proposal to introduce “berry” tax.

On the other hand, choices of new taxes satisfying requirements for local taxes are not all that large. For example, there were already proposals to introduce local turnover taxes or excises. Such taxes imposed on the manufacturing level, would have cascading effect and would be easily exportable to other jurisdiction. Being introduced at the retail level, these taxes would distort the consumption path – people may opt to buy goods in neighboring regions taxes are high in the region of their residence. Furthermore, there is substantial problem in both defining the retail trade and controlling large number of small retail outlets.

Other proposals were made to introduce local surcharge on the enterprise profit tax. This option is not very attractive either because such surcharge would be levied on highly mobile factor – capital. Given even small differences in rates of such surcharge across regions, the businesses would tend to register in the regions with lowest possible rates. In addition, implementation of such surcharges would require substantial changes in methodology of attribution of taxable profits to branches of an enterprise located in different regions. First, net profit attributable to a particular region should be determined only by way of apportioning net consolidated income. Second, consideration can be given to add or substitute with other factors of apportioning currently used gross expenses and depreciation allowances (see Case 6).

Case 6: State Corporate Income Tax in the US – Experience of Determining Tax Base

States in the United States of America are entitled to, and many do, levy local taxes on corporate income. As a general rule, state corporate income taxes have the same base as the federal corporate income tax. Thus additional compliance and administrative cost associated with difference in tax bases is avoided. For enterprises that operate in more than one state the total amount of taxable profit is apportioned among separate units of such enterprises. To secure unified methodology of apportioning, many states that have corporate income tax surcharge entered the Multistate Tax Compact. This document prescribes that apportioning of consolidated net profit of enterprise is to be done through the 3-factor formula. Those factors are the fractions of sales, tangible property and total wages attributable to a separate unit in correspondingly sales, tangible property or total wages of the entire enterprise. For purposes of apportioning, all factors are summed up and then divided by three.

Unlike proposal for local enterprise profit tax, the proposal to introduce local surcharge on the personal income tax looks more attractive. Such surcharge would be levied on income of residents thus establishing clear link between cost and benefits of public services provided in a particular locality. Compared to other options, such surcharge would impose much less if any economic distortions. However, the substantial problem of such tax is on the side of administration since it would require taxpayers to file annual return. At the moment, introducing annual universal filing is not feasible at either national or sub-national level.