German Advisory Group Ukraine

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Institute for Economic Research and Policy Consulting

Technical Note [TN/02/2018]

The fiscal impact of Tax on Withdrawn Capital: Methodological explanations

David Saha, Oleksandra Betliy

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About the Institute for Economic Research and Policy Consulting

Institute for Economic Research and Policy Consulting (IER) is the leading Ukrainian analytical think tank focusing on economic research and policy advice. The IER was founded in October 1999 by top-ranking Ukrainian politicians and the German Advisory Group on Economic Reforms.

The mission of IER is to present an alternative point of view on key problems of social and economic development of Ukraine. In the frame of the mission, the IER aims at providing top quality expertise in the field of economy and economic policy-making; acting as real leader of public opinion through the organisation of open public dialog; contributing to the development of economic and political sciences as well as promoting the development of Ukrainian research community.

Institute for Economic Research and Policy Consulting
Reytarska 8/5-A,
01030 Kyiv, Ukraine
Tel: +38 044 / 278 63 42
Fax: +38 044 / 278 63 36
institute@ier.kiev.ua
www.ier.com.ua

About the German Advisory Group

The German Advisory Group on Economic Reforms, which has been active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry for Economic Affairs and Energy.

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de

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Authors

David Saha saha@berlin-economics.com +49 30 / 20 61 34 64 0

Oleksandra Betliy betliy@ier.kiev.ua +38 044 / 2 78 63 42

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The usual disclaimer applies

1 Introduction

The German Advisory Group Ukraine in cooperation with the Institute for Economic Research Kiev (IER) and Otten Consulting, published a range of papers on the currently discussed, possible introduction of an Tax on Withdrawn Capital (TWC, in our previous papers referred to as Exit Capital Tax, ECT) to replace the current Corporate Profit Tax (CPT). Our key papers on this topic are:

- Policy Study PS/01/2017 "Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations", (http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/04/PS_01_2017_en.pdf)
- Policy Briefing PB/02/2017 "Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations – Summary of results", (http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/04/PB_02_2017_en.pdf),
- Policy Briefing PB/03/2017 'Taxation of distributed profits: International Experience", (http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/05/PB_03_2017_en.pdf)
- Policy Briefing PB/12/2017 "Estimation of the short run fiscal impact of introducing an Exit Capital Tax", (http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/08/PB_12_2017_en.pdf)
- Technical Note TN/02/2017 "Estimation of the short run fiscal impact of introducing the Exit Capital Tax: Methodology and further calculations" (http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/10/TN_02_2017_en.pdf)

Our conceptual analysis of the reform proposal including recommendations concerning TWC introduction is featured in PS/01/2017. Detailed estimates of the possible fiscal effect of TWC introduction for 2018, based on the draft law on the TWC that was submitted to the Cabinet of Ministers in July, are the focus of PB/12/2017. The fiscal effect was estimated as a shortfall of revenues ranging between UAH 36.9 bn and UAH 47.3 bn, (1.2% - 1.5% of GDP).

Our estimates have been subject to discussion in the extensive debate led by various actors in Ukraine. In this debate, some claims regarding our arguments and calculations were made that we believe to be incorrect. One such claim is that our fiscal estimate for the TWC – a shortfall ranging between 1.2% and 1.5% of GDP – is too pessimistic due to a number of alleged "errors" in our calculations and assumptions. Another claim is that we are too critical of the TWC proposal as a whole. We would like to clarify our recommendations regarding the TWC and respond to seven main claims criticising our estimates by considering these in turn.

2 German Advisory Group/IER position regarding TWC introduction

Claim: German Advisory Group and the IER are against the TWC proposal.
Response: In our main study on the topic, (PS/01/2017), we analyse the likely economic and fiscal effects of the TWC before concluding that introduction of the TWC can lead to an overall systematic improvement in the long run, but this improvement should not be expected to be radical. We expect negative fiscal effects in the short run, very limited economic effects in the short run, but potentially more positive long-run economic effects.

Crucially, we argue that negative short-run fiscal implications of the reform must be fully compensated and that reform of the tax system does not at all alleviate the much more important need for a comprehensive overhaul of tax administration. We are hence not against introduction of the TWC. However, we emphasise that the reform will have negative fiscal consequences and prerequisites for success (reform of tax administration). Without addressing these, the reform cannot, in our view, become a success.

3 Need for reform of the tax authority (SFS reform)

Claim: German Advisory Group / IER state that a comprehensive reform of the tax authority, the State Fiscal Service of Ukraine (SFS) is needed before the introduction of the TWC. However, TWC introduction would make SFS reform unnecessary.

Response: The SFS is currently highly challenged with the current CPT system. It is lacking capacity and competence to properly administer and enforce the tax, especially difficult aspects of financial accounting at the base of the CPT or issues such as Transfer Pricing. In particular, audit practices are often criticised as inadequate and harmful to the activity of businesses subject to it. This is also linked to institutional weakness and widespread corruption in the SFS.

Introduction of a new corporate tax would require a strong and competent tax authority to ensure the implementation is handled successfully, especially in view of substantial difficulties that should be expected when a new and unfamiliar tax system is to be implemented and new practices have to be adopted by tax authority and businesses alike. Only if the SFS is able to implement streamlined practices in tax enforcement and auditing can the potential for improvement of the business climate that we identify be realised.

Furthermore, although introduction of the TWC would indeed simplify some aspects of tax administration and enforcement, many aspects that the SFS is currently challenged with will remain present. In particular, complicated anti-avoidance aspects such as transfer pricing controls and taxation of interest payments to related parties exceeding the amounts specified by thin capitalisation rules would become even more important and frequent than under the present tax system. TWC introduction would hence not alleviate or replace the need for SFS reform.

4 Macroeconomic/second round effects

Claim: German Advisory Group / IER do not include macroeconomic effects of TWC introduction, e.g. increased investment contributing to economic growth that would lead to increased revenues from other forms of taxation.

Response: Our analysis is focused on the short run, especially the first year (we estimated effects for TWC introduction in 2018, introduction has since effectively been postponed to 2019) of a possible TWC introduction. We do not expect significant macroeconomic effects in this first year that would lead to substantial increases in other forms of taxation (e.g. VAT, income tax). Our analysis, in PS/01/2017 “Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations” shows that macroeconomic effects of introducing the TWC are likely to be very limited. Especially in the first year after introducing this new form of taxation, companies will probably want to evaluate the situation and gather experience and confidence in the new tax system before making long-term commitments by investing in fixed assets.

International experience, as analysed in PB/03/2017 “Taxation of distributed profits: International Experience”, also shows that countries that have conducted reforms similar to TWC introduction (Estonia, Macedonia, and Moldova) did not experience rapid and significant increases in investment or economic growth in the first year following tax reform that could have led to increased revenues from other forms of taxation. Furthermore, the CPT – in contrast with complicated tax administration

– is not named by companies as a large barrier to investment[1], hence it is unlikely that a change of the tax system would unlock large volumes of investment.

5 De-shadowing due to TWC introduction

Claim: German Advisory Group /IER do not consider the de-shadowing of corporate profits and profit distributions that would occur due to TWC introduction. This would lead to higher TWC profits than calculated.

Response: In general, one should be extremely careful with attempting to forecast de-shadowing. It is very hard to predict such an effect in a methodologically sound manner. Other papers, namely the estimations of TWC fiscal effects by the Ukrainian Institute of the Future (UIF)[2] included the effect of de-shadowing by making wholesale assumptions of 30% and more of currently hidden profits being de-shadowed due to TWC introduction. In our view, such assumptions are highly speculative and appear not to be micro-founded by employing a model or using empirical data.

De-shadowing can occur due to two reasons, one of which we model and one of which we cannot model, but believe to be insignificant at least in the first year following the TWC introduction:

1. **Lower tax burden of the TWC**: As TWC effective rates are lower than those under the present CPT system and the tax base appears narrower, it appears that the tax burden on companies would decrease. Hence, companies face a marginally smaller incentive to hide profits from taxes and may to some extent decide to de-shadow for this reason. **This logic is included in our estimates** in Scenario 3, "reaction to tax rate change" by using the elasticity of taxable income. This parameter taken from the empirical economic literature captures the complete reaction of taxpayers to lower tax rates, hence including reduced tax evasion due to de-shadowing in our optimistic scenario.
2. **Better tax enforcement under the TWC**: Some de-shadowing may indeed occur following TWC introduction as transaction-based tax enforcement in the TWC system should be easier than enforcement based on the full financial statements of companies under the present CPT system. However, these benefits will likely accrue only a few years after introducing the TWC and not in the first year after reform, as the State Fiscal Service of Ukraine (SFS) will first need to gather experience and competence in handling the new tax system.

We would also like to point out that even the drastic reform of Social Security Contributions in 2016 did not lead to large and significant de-shadowing of wages in the short term. It is in our view hence unlikely that significant de-shadowing that would lead to improved fiscal results above that captured by our Scenario 3 would occur in 2018 following a possible TWC introduction.

[1] Dragon Capital survey

[2] Study by the Ukrainian Institute of the Future

6 Increased profit distribution due to money previously spent on CPT

Claim: German Advisory Group /IER did not include that companies no longer have to pay CPT, hence, profit distributions (the TWC tax base) would increase.
Response: Indeed, discontinuation of the CPT would lead to larger profits at companies that could be distributed. Before distributing profits, there would be no more taxation, hence the before-tax profit of companies could, in theory, be fully distributed to shareholders. This effect was indeed not included in our calculations.
However, we would urge caution not to overestimate this effect. Some existing papers assume that companies would reinvest/save/distribute money saved on CPT in the same proportion as their other profits. Such an assumption, however, confuses marginal effects (use of additional distributable profits) with the average use of profits. It is entirely unclear, how companies would deal with this additional money. Indeed, it is quite possible that additional disposable money income would be kept within the company at first, i.e. neither distributed nor reinvested, especially during the first tax year under the TWC.

7 Inclusion of TWC revenue from banks

Claim: German Advisory Group/IER do not include the tax revenue from banks in its fiscal calculations
Response: We include the tax revenue from banks in our calculations, but assume that banks would continue to pay CPT for the time being. As the CPT revenue from banks is factored in our calculations, it reduces the fiscal shortfall created by TWC introduction. In fact, the fiscal shortfall due to TWC introduction would *increase* if banks moved to the TWC as the effective tax burden under the TWC is lower than under the CPT.
The draft law currently stipulates that banks can choose whether or not to remain under the CPT system or change to the TWC in the first year after the TWC introduction. It is unclear, what proportion of banks would change to the TWC already in 2018. Generally, the TWC tax burden is lower than that of the CPT, constituting a positive incentive for changing to the TWC. However, moving to the TWC would entail paying all deferred CPT to the state first, which may conflict for some banks with NBU equity requirements. In our estimate, we assumed that all banks would remain under the CPT in order to avoid making speculative assumptions in this regard.

8 Use of 2016 base data for fiscal projections

Claim: German Advisory Group /IER base their estimates on data from 2016 and provide estimates for 2018 rather than 2019, when the reform is supposed to be implemented.
Response: Indeed, our fiscal estimations are based on 2016 data (data for the new tax base of the TWC) and made for 2018. This has the simple reasons that no more up-to-date data was available at the moment of calculation (and is not now to our knowledge) and that at that stage, TWC introduction for 2018 was envisaged. However, the results would in all probability not differ much as a percentage of GDP for 2019.

As our estimate is based on taking the difference between estimated revenues of a new corporate tax system, based on the TWC, and the present tax system, based on the CPT, all main differences between projections for 2018 and 2019 should largely be nominal (i.e. based on inflation and real

GDP growth). Also, using newer (2017) figures for estimating the TWC tax base would probably not result in major changes of the revenue differential between a TWC and a CPT based tax system.

9 Conclusion

Although some of the critics of our fiscal estimates make theoretically valid points, most of the effects are likely to be much smaller than suggested by the critics and none of the effects are likely to significantly improve TWC revenues in the first year after introduction. Current evidence from Georgia, which has introduced a highly similar corporate tax by the beginning of this year, also indicates that our estimate of a fiscal shortfall in the 1.2% - 1.5% of GDP range is realistic. Originally, a reduction of corporate tax revenues by 1.5% of GDP was expected for Georgia. With three quarters of data available, this estimate has been revised by experts, but remains at a revenue reduction of 1.35% of GDP, with the improvement mainly due to the external environment of Georgia having contributed to an improved financial situation of many companies.

It is crucial that fiscal planning is based on realistic estimates and not on highly optimistic best-case scenarios to avoid a situation of unforeseen fiscal shortfalls, especially in Ukraine’s present situation, facing among other issues an ambitious debt repayment schedule on its public debt, with almost USD 12 bn of FX debt repayments (both external and internal) due in 2018 and 2019.