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Personal Income Tax Reform:
How To Feed The Wolf And Keep The Sheep

SUMMARY

Future economic growth in Ukraine vitally depends on continuing economic reform. The reform of personal income tax (PIT) is an integral part of this process. In this context, the new draft Law on personal income tax that was submitted by the Cabinet of Ministers of Ukraine to Verkhovna Rada represents a very important, positive step. While some of the changes proposed in this draft bring much needed transparency, fairness and efficiency into the PIT system, others, however, are likely to cause a serious loss of tax revenue in the short-run. This could lead to budget deficits, macroeconomic and political instability. We recommend that the draft not be passed in the present form, because it is likely to cause a substantial loss of tax revenue.

The purpose of this paper is to present policies that reform the tax system and limit the risk of negative short-run effects.

Overview of the contents

1. Current personal income tax system in Ukraine

The current personal income tax (PIT) system in Ukraine is characterized by a complicated structure of tax rates and numerous exemptions and deductions that narrow the tax base. For example, income from primary employment is taxed at 10-40%, while a 20% rate applies to the income from a secondary employment, and royalties are taxed at 20-60%. Major exemptions include qualified agricultural income, bank interest, dividends, property sales receipts and others. In addition to standard deduction qualified taxpayers – military personnel, war veterans, disabled persons, Chernobyl victims and others – are entitled to deduct additional allowances. There are many more exemptions that are not economically justified and are poorly defined. They provide loopholes for tax evasion and reduce the tax base.

A particularly detrimental aspect of the PIT system in Ukraine is the top tax rate of 40%, which applies to a comparatively low income. It creates an incentive to underreport income, or to declare it as qualified to one of many exemptions.

2. New draft law

2.1. Tax reform in Ukraine

Reform of the PIT system is both important and challenging, because PIT is a major source of the budget revenue. According to the State Tax Administration (STA), UAH 8.8 bn were collected in 2001. It means that PIT generated almost 25% of budget revenue. It is remarkable, however, that UAH 8.4 bn was collected from taxpayers earning less than UAH 400 a month, and only 0.4 bn from taxpayers who earned more. These facts underscore the necessity to reform the PIT system.

In response to this necessity, the Ministry of Finance introduced a draft of the Proposed Tax Code (PTC) as an attempt for a unified reform of the tax system in Ukraine. Since the PTC failed to reach the third reading in Verkhovna Rada in December 2001, the Ministry chose a strategy to reform one tax at a time, starting with PIT.

2.2. Analysis of the new draft law

In Ukraine, there exists a wide consensus that tax reform is necessary to meet future needs of financing the budget and to secure economic growth. While most agree that the long-run effects of sweeping tax reductions are positive, the short-run effects pose some real dangers.

The present draft of the "Law of Ukraine on personal income tax" represents a major step in the reform. It surpasses the existing legislation in a number of areas.

First, it significantly *simplifies the PIT system*. It subjects all taxpayers who are employees or small entrepreneurs to a simple and mildly progressive tax scheme that consists of three rates of 10%, 15% and 20%. The brackets are separated by the annual income of UAH 4,800 and UAH 120,000, respectively.

Second, this simple system will *expand the tax base* by reducing the incentive to avoid the tax by not declaring income, and eliminate schemes that are used to declare income in other countries. Since reliable estimates of the extent of tax avoidance are not available, it is difficult to predict the positive effect that increased compliance will have on the revenue. It will certainly help partly offset the short-run decrease that can be expected when the rates go down.

Third, the proposed draft *improves transparency and fairness* by eliminating some of the exemptions, special rates and other loopholes of the current system. Investment income, income from frequent real estate transactions and other types of income are now taxed with rates that are consistent with the proposed rate structure.

Finally, the simple system can be *administered more efficiently*. Simpler filing requirements place less strain on ordinary taxpayers, as well as on the STA.

2.2.1. Short-run effects of the draft law on public revenue

From the point of view of their impact on public revenue, two main aspects of the draft can be distinguished:

(i) Significantly reduced tax rates that are, in the short-run, detrimental to the revenue, and

(ii) Reduction of exemption, abolition of privileges and increased consistency of rates, which all together expand the tax base and increase revenue.

Reliable prediction of the net effect of the draft on budget revenue cannot be drawn. On the one hand, it can be argued that the reduction of rates even for workers with moderate incomes (UAH 2,040-UAH 4,800 from current 15% to proposed 10%) will likely far outweigh any gain from expanding the tax base. The seriousness of this argument is underscored by the analysis by the Fiscal Analysis Office[1], which estimates that the revenue of regions would fall by 10 to 50 percent.

On the other hand, the recent experience with the PIT reform in Russia (see Box below) shows how unpredictable the effect may be. These results are, however, the outcome of several important factors. First, the new PIT was launched in Russia simultaneously with a sweeping reform of the enterprise profit tax, excise tax and tariffs. Second, the new PIT system closed loopholes and ended widespread schemes of tax avoidance, thus expanding the tax base. And last but not least, these results reflect the forward-looking behavior of Russian taxpayers, who declared some of their 2000 income in 2001. It is

[1] Natalie Leschenko and John Thissen, Evaluation Of Rates And Brackets In The Personal Income Tax Of Ukraine, FAO, SEFR, June 2002.

therefore clear that the success of the Russian PIT reform is a result of a number of factors, not merely a taxcut. It would not be wise to extrapolate this trend into the future, and we cannot expect that such a development could be repeated in Ukraine.

BOX

Experience from the tax reform in Russia

On January 1, 2001 Russia replaced its previous three-bracket system, which imposed a top rate of 30%, with a 13% flat-rate tax. In the first year of its existence, the flat tax generated R254.7 bn, a 46% increase compared to 2000.[2] After adjusting this figure for 18% inflation, real ruble revenues increased by 28%. The contribution of PIT to consolidated budget revenues increased from 12.1% in 2000 to 12.7% in 2001. These results can be largely attributed to the flat tax, because the economic growth, which reached 5.2% in 2001, was lower than the record of 8.3% in 2000.

Flat tax places minimum requirements on filing: of approximately 60 million taxpayers earning personal income in Russia in 2000, only 2.8 mln needed to file the tax return.

However, Russian PIT system is not flat over different sources of income: it applies a different tax rate to dividends (30%), and income from winning lotteries and prizes (35%). In an attempt to remove this unnecessary complication from an otherwise transparent system, the Russian government is preparing the bill that would reduce the 35% tax rate on lotteries to the standard 13%.

Since the corporate income tax was reduced from 35% to 24% in 2001, it can be expected that tax rate on dividends will also decrease.

2.2.2. Possible economic and political consequences

Passing the draft in its current form would likely cause severe deficit in local budgets. The resulting deficit in the consolidated budget would occur at a time when reducing the public debt is a declared priority of the government. The imbalance would cause wage and pension arrears, accumulating default debts and inflation. It has a potential to lead to a macroeconomic and political destabilization, and we therefore **do not recommend that the draft be passed as proposed at this time**.

3. Policy proposals concerning PIT revenue

Primary dangers from the adoption of the draft are:

- In the short-run, it can significantly reduce tax revenues.
- As a result, it can disrupt local budgets, threatening the provision of social, health and education services, and risk macroeconomic and political instability in Ukraine.

[2] Alvin Rabushka, The Flat Tax at Work in Russia, Mimeo, February 2002.

We recommend carrying out the reform of the personal income tax in two steps:

- As soon as possible, implement those changes proposed in the draft law, which enhance the revenue in the short-run. Broaden the tax base by reducing the number of exemptions; close the loopholes by unifying the rates applicable to different types of income.
- Consider gradual reduction of tax rates, starting with the maximum marginal rate, to spread the impact of reform on budget over time. Tax rates should only be reduced to the proposed levels after additional budget revenue (e.g. from privatization) and reduced spending makes up for the resulting loss of revenue from personal income tax.

Since the proposed draft of PIT carries a large risk of destabilization of public finances in Ukraine, we offer two alternative approaches to the PIT reform. Both of them are aimed at introducing the positives contained in the current version of the draft while minimizing its negative impact on tax revenue.

3.1. Approach A: Implement tax reform sequentially

The idea of this approach is an immediate implementation of revenue-enhancing changes, followed later by the reduction of tax rates. This can be done by passing two separate laws.

First, the law should be passed, which will reduce the number of exemptions and simplify taxation of different types of income. This would roughly cover the currently proposed draft with the exception of Chapters 6.1 and 7.4 that deal with tax rates and brackets. Most of these changes need to be implemented regardless of the subsequent tax reform agenda, because they would limit some of the most serious deficiencies of the current tax system.

After assessing the impact of the first law on the budget revenue, the second law determining the new tax rates and brackets should be passed.

3.2. Approach B: Reduce tax rates gradually

If there is a perceived political need to introduce the PIT reform with an early tax cut, a gradual approach is available. We recommend passing the law that would introduce a modest cut of the highest tax rate from the current level of 40% to 35%, or possibly to 30%, which would already eliminate one tax bracket. The negative revenue impact of this change would be rather limited because taxpayers with incomes in the relevant bracket (more than UAH 20,400 annually) currently contribute to the overall tax revenue a very small portion. Based on the information provided by STA mentioned earlier in this paper, the negative impact of such a cut should not exceed 1% of PIT revenues.

Later, when the budget permits, the rates can be further reduced and brackets adjusted towards the values proposed in the draft. This would be consistent with the experience in other countries; a similar approach is currently adopted in the tax reform in Germany.

3.3. Comparison of two Approaches and policy recommendation

Comparison of these two approaches shows that the choice between them should be made based on priorities of Ukrainian government. While Approach A guarantees a high level of safety to the public finance, it is likely to protract the tax reform into a period of several years. On the other hand, tax reform would proceed faster with Approach B, even though a very limited negative impact on the revenue might occur.

In our opinion, **the gradual tax reduction (Approach B) is the appropriate policy for Ukraine at this time**. It is important that the reform begins as soon as possible. This approach will send a clear pro-reform signal to the public, investors and international organizations at a minimum risk of negative macroeconomic and political effects.

4. Proposals concerning the tax base and some technical issues

Aspects of the draft that require further attention are

- Missing or ambiguous definitions of some concepts.
- Numerous exemptions and reduced tax rates for certain groups of citizens.
- Remaining loopholes.

The draft is still *missing a clear definition of some concepts*. Since the proposed tax treatments of residents and non-residents are different, the definition of who is a resident is of crucial importance. The draft offers several diverse criteria for a person to qualify for a resident status, such as the place of a primary residence, the length of time spent on the territory of Ukraine during a year, the closeness of person's interests to Ukraine, the citizenship. These criteria are subordinated to each other, making the concept of residency unclear. If differentiated tax treatment of non-residents is desirable, we recommend that the status of resident be defined simply, preferably with one or two clear conditions, so there may be no ambiguity about the status of a person.

A number of *exemptions and reduced tax rates still remain* in the draft. These special rates apply to single parents, students, veterans of war, and persons with disabilities. Unfortunately, differentiated tax rates are not an efficient tool of social policy. They complicate the administration of budget revenue, and West-European countries tend to replace them with social benefits in the form of transfer payments from the budget. This way, the social "safety net" is administered from the budget expenditure, keeping the revenue side of the budget as transparent as possible.

The Simplified Tax System (STS), an alternative tax arrangement designed to benefit small entrepreneurs, remains an integral part of the draft law. It reduces accounting requirements and lowers the tax burden placed on some of the entrepreneurs whose annual revenues do not exceed UAH 120,000. Notably, two groups of entrepreneurs are excluded from choosing STS: those who have employees, and those involved in the "independent professional activity". The idea of excluding independent professionals is to prevent lawyers and private accountants, who have supposedly low costs and disproportionately high margins, from taking advantage of the lower STS rate. However, the concept of "independent professional" is never defined and can be vaguely associated with a number of professions.

As such, *STS has a flaw, because it treats different professions or industries differently*. Moreover, this differentiation is open to subjective interpretation. We recommend that the qualification of "independent professional" either be clearly defined, or dropped altogether.

The exclusion of entrepreneurs who have employees from STS creates socially detrimental incentives that can lead to undesirable consequences. Namely, the employers will prefer turning their employees formally into entrepreneurs, only to qualify for STS. Conversely, small businesses that create jobs and hire workers will be in disadvantage. This is counterproductive, and we recommend that the criterion of eligibility should be changed to a certain level of turnover. That way, small businesses with employees could take advantage of STS as well.

5. Conclusion

The new draft law on personal income tax represents a major and very positive step on the road to a modern and efficient tax system in Ukraine. We fully support all the proposed changes that will streamline the tax system, close the loopholes and expand the tax base. However, we recommend that instead of a sudden sharp tax cut that could destabilize the economy the government introduce a gradual decrease of rates, so that possible short-run negative effect of the reform on tax revenue can be spread over time.

Finally, it is important to emphasize that the reform of PIT is only a beginning of a comprehensive tax reform. The new PIT law will only bring the expected long-run benefits if it is paired with equally simple system of payroll tax and the enterprise profit tax. The result should be a system, in which all sources of income, regardless of their origin, are taxed at consistent low rates providing optimum environment for the efficient allocation of Ukraine's resources.

R.C., Lector: R.G.

Kyiv, October 2002