

Thinking about Equalization in Ukraine

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Why Equalize?

Over the last 70 years, national governments have increasingly decentralized public services to democratically elected local governments.

This trend has been motivated by the idea that local governments can provide many public services more ***efficiently*** and ***effectively*** than the national state.

But there are not enough good local taxes to finance all the public services that we might reasonably want local governments to provide.

As a result, the more we want local governments to do, the more they tend to become dependent on national government grants and transfers, including shares of national taxes like PIT and CIT.

Why Equalize?

In the literature this is called the '**Decentralization Paradox**'

At the same time, the tax bases of local governments –their relative wealth– always differs dramatically across any given country.

Taken together, this means that decentralizing significant public services to local governments typically requires both:

- An increase in their dependency on national government grants and transfers;
- And the creation of a special grants and transfers that provide poorer local governments with additional resources.

Why Equalize?

Art. 9 pt.5 of the European Charter on Local Self-Government states:

The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support.

Nations that have decentralized significant public services to LGs need to provide poorer ones with additional resources if all citizens are to have access to public services of at least a minimum standard.

The rise of populism and its association with urban/rural disparities underscores the need for strong equalization systems.

Key Design Issues for Equalization Systems

On average, OECD countries spend 2.3% of GDP (4.8% of public expenditure) on ‘equalization’ (w/o USA; Blochliger et. al. OECD, 2007).

But equalization systems differ dramatically across countries and can be difficult to compare.

They are also shaped by the forms of taxation that they grow-up around.

Because equalization is essentially about redistribution, it is always contentious.

There is no scientific way to determine how much equalization a country should have, or how it should be structured. But there are better and worse practices.

Key Design Issues for Equalization Systems

1. Should the system be based on a General Grant or on equalizing the revenues of poorer local governments to some percentage of the national average (Equalization Grants).
2. Which local revenues should be included in the system and equalized against?
2. Should the system try to account for differences in the costs of local services (expenditure equalization) and if so how?
3. How much of the costs of the system should be paid for by the national government and how much by local governments themselves (vertical vs. horizontal)?

General Grants vs Equalization Grants

There are two basic strategies for equalizing the fiscal capacities of local governments.

The first is based on providing all local governments with a significant share of their total revenues through a freely disposable General Grant.

The second is based on providing additional money only to those local governments whose per capita income from a specific set of local revenues is below the national average.

Some countries rely on only one strategy. For example, Ukraine uses only the second, while the Czech Republic and Albania use only the first. Many countries, such as Poland and Germany use both.

General Grants vs Equalization Grants

Some countries (not Ukraine) define the size of their General Grants through the annual budget decisions of the national government – a terrible practice.

More often, the size of these grants are defined by law as a:

- percentage of a specific national tax (All indirect taxes in Bosnia);
- percentage of GDP (Albania)
- pool of national taxes (X% VAT + Y% PIT+ Z% in the Czech Republic)

Typically, 60% to 100% of these grants are allocated to local governments on a straight per capita basis --which is of course ‘equalizing’.

Sometimes a portion of the grant is allocated on a different basis:

- 15% for LGs with low population densities – Albania;
- 5% for ‘underdeveloped’ LGs– Bosnia.

General Grants vs Equalization Grants

Sometimes the populations of certain LGs are inflated by multipliers:

- 20% for Prague and 10% for other big cities in Czech;
- for high and low-density LGs on a sliding scale in Brandenberg.

The virtue of General Grant systems is that they tend to be simpler.

But they also tend to decrease the importance of local revenue mobilization and focus all eyes on the state, all the time.

That said it may be worth considering introducing a General Grant component into Ukraine's intergovernmental finance system.

A more immediate question is whether revenues other than PIT should be included in the calculation of equalization grants in Ukraine

Which Revenues Should be Included in the System?

The more local revenues that are included in the calculation of equalization grants, the more equalizing (and generally costly) the system will be.

But a well constructed system should not allow LGs to increase their equalization grants by reducing their ‘tax effort’.

LGs cannot reduce their tax effort if all the revenues included in the equalization system are '**shared taxes**' whose base, rate, and collection are fully controlled by the national government (e.g. PIT, CIT, Excise).

Most countries whose equalization systems rely on Equalization Grants include all shared taxes in the system (Poland, Germany)

Which Revenues Should be Included in the System?

Many countries include some LG ***own taxes*** in the equalization system (Sweden, Canada, USA).

But if so, the yield of the own taxes used in the equalization system is ***“standardized” by applying the average tax rate used by all LGs and multiplying it by each LG’s tax base.***

“Standardization” prevents LGs from increasing their equalization payments by lowering their tax rates and/or not fully valuing their base.

It also protects LGs who tax at higher than average rates from receiving lower equalization grants (or making higher contributions).

Which Revenues Should be Included in the System?

Own taxes can only be standardized if the national government knows both the tax rates used by all LGs and the base of the tax in every LG.

This is often not the case.

In Poland, local property taxes were included in the equalization system but not standardized because the national government didn't know the base of the tax in each jurisdiction.

As a result, the collection of the tax has collapsed in many rural LGs.

Local fees and charges should not be included in the calculation of equalization grants because their yields can not be standardized.

Revenue vs Revenue & Expenditure Equalization

Expenditure equalization is the attempt to account for differences LGs face in the costs of and/or the demand for public services.

Most countries do at least some expenditure equalization.

When LGs run schools, grants for education always contain coefficients that provide more money to rural areas where schooling is more costly.

Some countries have systems based on comprehensive expenditure norms for LGs operating in under different geographic, demographic and/or labor market conditions (Nordics).

These systems require years of reliable data on the unit costs of public services and rely on complicated and politically contentious formulas.

Revenue vs Revenue & Expenditure Equalization

More frequently, expenditure equalization is limited to particular services like education.

Or based on rougher estimates about differences in the demand for and/or the costs of public services in LGs of different sizes or population densities.

These systems typically provide additional funding to large urban areas and/ sparsely populated rural ones (Germany, Poland, Czech, Albania)

Many systems also use special coefficients for mountainous areas, LGs with high unemployment, or other ‘special cases.’

Revenue vs Revenue & Expenditure Equalization

A few countries calculate expenditure norms for local public services and then base equalization grants on the difference between these norms and the standardized revenues of all LGs (Sweden, Slovenia).

More frequently, rough guesstimates are made about differences in the demand for and costs of public services based on the size or population densities of LGs.

Here, it is often assumed that the costs of and/or the demand for public services is 10% – 25% higher in Capital Cities, other big cities and/or sparsely populated rural LGs. (Germany, Poland, Czech, Albania)

Vertical vs Horizontal Equalization

In most countries, the costs of equalization are shared between the national government and LGs, with richer LGs providing some of the money to finance poorer ones.

In most countries, most of the costs of equalization are paid for by the national government.

- Poland 79%
- Sweden 83%
- Slovenia 70%

In many countries, the national government limits its financial liabilities for equalization by using ‘closed funds’ or by capping its maximum contribution to the system.

Equalization in Ukraine Today

System is based on the per capita yield of PIT, the most important local revenue.

But unlike in other countries, PIT is allocated to LGs on the basis of where people work (really headquarters of company), not where they live.

This is unfair because money does not flow where families need schools and network infrastructure and schools.

It is inefficient because it overfunds urban centers while underfunding suburban areas, some of which then require equalization grants.

In almost all countries in which PIT is an LG revenue, PIT is returned to the LGs in which taxpayers live.

Equalization in Ukraine Today

In some American states, and until recently in some German lander, some PIT is/was returned to the LG in which people work.

But even here, most goes to where they live.

The Ukrainian system is also based only on PIT, while the equalization systems of most other countries include other revenues.

System is small: 8 billion hr. in 2018: 0.023% GDP; 1.4% of local revenue.

- Poland – 0.86% of GDP, 5.5% of local revenue
- Slovenia -0.80% of GDP, 16% of local revenue
- Sweden – 1.7% of GDP, 13% of local revenue

National Government pays for only 36% of the costs of the system.

- Poland – 79%; Sweden – 80%; Slovenia 70-100%*

Equalization in Ukraine Today

Kyiv does not contribute to the system as either an oblast or CoS, despite being the richest jurisdiction in the country:

- Its per capita revenues are almost double those of other COS (17,250 vs 9,500 hr)
- 40% of its budget goes to investment. For other COS - 23% and for OTH 19%.
- Kyiv exerts less ‘tax effort’ than local governments: Since 2018, own revenue has grown 4% in Kyiv, but 15% in COS and 28% in OTH.

Rayons are equalized to the same level as CoS and OTG, despite the fact that unlike CoS and OTG they are NOT RESPONSIBLE for network infrastructure.

As a result, rayons pay almost nothing into the equalization system (0.5 bl hr in 2018) but get the most out of it (4.35 bl hr)

CoS pay the most into the system (3.3 bl hr) but get the least out of it (0.65 bln hr).

	2016					2017					2018						
	Донори		Отримувачі				Донори		Отримувачі				Донори		Отримувачі		
	к-ть	млрд грн	к-ть	млрд грн	Різниця		к-ть	млрд грн	к-ть	млрд грн	Різниця		к-ть	млрд грн	к-ть	млрд грн	Різниця
Області	6	0.66	18	1.03	0.37		5	0.69	17	1.00	0.31		5	0.73	17	1.04	0.31
Міста обл. значення	61	2.77	52	0.41	-2.36		63	3.01	53	0.43	-2.58		65	3.33	52	0.65	-2.68
Райони	34	0.29	380	4.09	3.79		38	0.41	368	4.00	3.60		45	0.50	356	4.35	3.84
ОТГ	22	0.08	125	0.36	0.27		48	0.17	293	0.84	0.67		106	0.50	497	1.90	1.40
Усього	123	3.81	575	5.88	-2.08		154	4.28	731	6.27	-2.00		221	5.07	922	7.93	-2.86
Витрати центрального уряду на вирівнювання					-2.08						-2.00						-2.86
Стабілізаційна дотація					-2.49						-1.24						-0.21
Загальні витрати центрального уряду					-4.57						-3.24						-3.07
Вирівнювання як % від ВВП					0.035 %						0.025 %						0.023 %

Recommendations

1. Reduce the amount of Base Grants going to rayons by equalizing them to a lower level and use the savings to enhance equalization for COS & OTG.
2. Include Excise and Single Tax revenues in the system. (But only for the 3rd and 4th groups of Single Taxpayers because their rates are set by the national government and don't need to be standardized).
3. Lower the amount of Reverse Grants paid by COS and OTG in order to encourage the growth of medium-sized cities and towns.
4. Require Kyiv to contribute to the system.
5. Increase the national government's contribution by shifting some of the 84 bln hr of 'discretionary' grants that national government currently spends 'locally' into the equalization system.

Recommendations

6. Gather the data and conduct the simulations necessary to assess the impact of shifting the allocation of some or all of PIT to the CoS and OTG in which taxpayers live.
7. Plan on shifting the allocation of some or all of PIT to the CoS and OTG in which people live in FY 2021.
8. Gather the data and conduct the simulations necessary to assess the impact of apportioning CIT across oblasts on the basis of where companies employ their workers.
9. Plan on shifting the allocation of CIT across oblasts on the basis of employment

Recommendations

10. After the full costs and impact of the revenue equalization system can be simulated, creating a separate, closed pool of national government funds (e.g. x% of VAT, or Y% of PIT) to support CoS and OTG with exceptional expenditure needs caused by factors like:

- Extremely low population density
- Extremely high unemployment
- High numbers of Internally displaced persons
- Extremely high shares of the elderly

THANK YOU FOR YOUR ATTENTION