

Personal Income Tax Sharing and Equalization system in Ukraine

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Tony Levitas

Personal Income Tax Sharing in General

PIT can be shared with LGs in two ways:

Grant: A percentage of the national yield of PIT is earmarked for LGs and allocated to them by formula, usually on a per capita basis.

- Grant is usually freely disposable. But can be earmarked.

Shared tax: A percentage of PIT is returned to LGs on an “*origin basis*” and no allocation formula is used.

- Single largest source of LG revenue in much of Europe.
- Origin of the tax is almost always defined as the LG in which taxpayers live.
- In almost all of Europe PIT shares are defined as freely disposable revenue.
- Typically accompanied by equalization grants they bring the revenues of poorer LGs up to some % of the average per capita yield of PIT (80-90%)

PIT Sharing in Ukraine

- As in much of Europe, PIT shares constitute the largest single source of LG revenue in Ukraine. (40% CoS budgets, 30% OTH budgets; 2018, w/o social transfers)
- As in much of Europe, Ukraine has an equalization system that gives grants to LGs whose PIT revenues are below the national per capita average.
- But Ukraine is the only country in Europe that defines the origin of PIT as the LG in which an employer is legally registered.
- Ukraine is also unusual in that the PIT share is not clearly defined by law as freely disposable LG revenue.

Defining the Origin of PIT

- Throughout Europe, the origin of PIT is defined as the LG in which a taxpayer resides (and votes)
 - Only current exception is Romania, where it is defined as place of employment. Once similar in Germany, and briefly in Poland. But no longer.
- This definition aligns political jurisdictions with fiscal jurisdictions.
- It ensures that citizens know that they are voting for local officials who are responsible for spending their taxes.
- It is critical for improving citizen interest in their local governments, and thus local government accountability to citizens.
- It also ensures that PIT shares flow to the LGs in which people actually live and which are necessary to fund the services they need.

Defining the Origin of PIT

- In Ukraine, the origin of PIT is defined as the LG in which a firm is legally registered (and not, as is often thought, where people work).
- This breaks the link between taxpaying and voting and undermines local government accountability.
- It also overfunds large cities at the expense of smaller LGs in which many of their employees live and/or work.
- And this in turn, weakens the efficiency of the equalization system because more jurisdictions need transfers from richer ones and the national government.

Defining the Origin of PIT: Recommendations

- All firms should be immediately required to register the PIT shares of their employees with the Tax Administration in accordance with where those employees work.
- This will not ensure that political and fiscal jurisdictions are perfectly aligned. But it will improve the situation.
- It will also reduce the overfunding of big cities and increase the efficiency of the equalization system.
- In the next few years, however, Ukraine should move the origin of PIT to a taxpayer's place of residence, like the rest of Europe.

What kind of Revenue is the PIT Share?

- Where PIT is shared with LGs on origin basis it is usually defined as a freely disposable local revenue.
- Sometimes it is defined as a LG own revenue, but this is technically a mistake because LGs are not politically responsible for setting rates.
- In Ukraine, both the Budget Code and the new Local Government Law fail to define the PIT share as a freely disposable revenue.
- Neither law defines what kind of revenue PIT is. But both specify that it is to be used to finance **both own and delegated functions**. (Art 82-84 & 89 of BC; Art 29, LSGL)

What kind of Revenue is the PIT Share?

- Both laws also say that with respect to delegated functions, LGs act on behalf the state, and the state can override their decision if it feels that LGs are not fulfilling their responsibilities.
- Both laws also define many functions as delegated functions even though LGs do not receive grants to support these functions. (e.g. Preschool Education).
- This means that the national government has the right to instruct local government to spend their PIT shares on delegated functions if it thinks they are not spending enough on them

What kind of Revenue is the PIT Share?

- Whether the national government will do this is an open question.
- But the legal uncertainty surrounding what kind of revenue the PIT share is, is deeply problematic because:
 - Without the PIT share, only 15-17% of LG revenue is legally considered freely disposable revenue.
 - If the PIT share is not freely disposable, and the national government has the right to direct its use, then LGs have independent control over less than 20% of their budgets.
 - This undermines LG planning and renders long term investment very difficult.
 - Creditors will not lend to LGs if they are not sure that their main source of revenue will be available to pay back loans.

Redefining the PIT Share: Recommendations

- The Budget Code and the Local Self-Government Law should clearly define the PIT Share as a freely disposable LG revenue.
- Some functions that have been assigned to LGs as Delegated Functions, but which are not supported by grants, should be reclassified as Own Functions.
- A category of Shared Functions should be introduced into both Laws in recognition of the fact that many the services local governments provide are simultaneously both national and local.

Equalization in Ukraine Today

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

While the equalization systems of most other countries include other revenues, Ukrainian system is based **only** on PIT,

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: In 2018, own revenue has grown 4% in Kyiv, but 15% in COS and 28% in OTH.

CoS pay the most into the system (3.3 bln hr) but get the least out of it (0.65 bln hr). (2018 data)

	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

- 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).
- Lower the amount of Reverse Grants paid by COS and OTG in order to encourage the growth of medium-sized cities and towns.
- Require Kyiv to contribute to the system.
- Increase the national government's contribution by shifting some of the 84 bln hr of 'discretionary' grants (2018) that national government currently spends 'locally' into the equalization system.

Recommendations

- Consider shifting the allocation of CIT across oblasts on the basis of employment.
- 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 **LSG** 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