MEMORANDUM FOR

Small Tax Reform Working Group

From: Bob Conrad

Subject: Merged Social and Personal Income Tax

Some analysis of the proposal developed by the parliamentarian and which we discussed during our meeting is supplied here. Numerical examples are used to illustrate the various points. I have chosen to use hypothetical rates in order to concentrate on illustrating the nature of the results without regard for revenue effects. The current structure in Ukraine and any proposed changes can be easily adapted to these cases should you decide to proceed with the proposal.

I. Objective

I assume the objective of unification is to establish a flat rate personal income tax system in which the social tax, with or without a cap, can be allocated to fund pensions, and other social programs, and the personal income tax can be allocated to general revenue (or allocated to subnational governments as is now the case). Note that I said, "Personal income tax" as opposed to "wage tax" for reasons to be described below. If the single unified rate is the same as the corporate rate, there are at least three additional benefits: (1) no productive factor is subject to tax discrimination; (2) some distortionary incentives are removed; and (3) there is little incentive for professionals and high-income individuals to organize entities in order to convert wages into capital income which may be subject to lower tax.

Note is also made of the fact that current social tax collections are insufficient to finance the social funds. In addition, the ultimate financing of the social funds, pensions in particular, will depend on reforms in the pension system; reforms that may take years to implement. Current revenue shortfalls must be funded from general government revenue or debt. From a consolidated budget point of view, it is immaterial whether deficits are attributed to general revenue shortfalls or deficits in the social funds. Thus, it is necessary to maintain a distinction between PIT and social fund contributions in order to facilitate future reforms in the social funds, as well as to provide a funding mechanism for current pensions.

The issue then is how to allocate revenue from a unified social tax / personal income tax (PIT) when these taxes are collected via wage withholding. Below I illustrate that there are basically four levers that can be used to determine the allocation:

1. The personal exemption for the PIT,
2. The cap, if used, for the social tax,
3. The combined rate of tax (the flat rate), and
4. The allocation, probably via rates, between social fund contributions and the PIT.

II. A Initial Representation

Suppose the initial situation is:

1. A social fund contribution financed by employers of 20%,
2. A social fund capped at 12,000 (or 60,000 in after social fund income),
3. A personal exemption of 20,000 for the PIT, and
4. A 15% PIT rate above the personal exemption.

This regime is similar in spirit to the current Ukrainian system (as I understand it) and is illustrated in Figure 1. Employers pay 20% until wages are 60,000. Once wages (without regard for social tax) exceed 20,000, employers withhold 15%. Thus, between wages of 20,000 and 60,000, the marginal rate of combined tax is 35%.[1] The combined marginal rate then falls to 15% once the cap for the social fund is reached. In effect, the combined system is regressive at higher income levels.[2]

III. Basic Structure of a Reformed System

Suppose this system is replaced with a flat rate combined regime. There are two elements to this system. First, wages are "grossed-up" for the current social contributions so that all income and taxes (both PIT and social contributions) are now attributable to the individual.[3] Second, the exemptions and rate structure are modified to ensure a unified combined rate. In this first example, the tax system includes:

1. A combined rate of 20%,
2. A personal exemption equal to 60,000 (on a grossed-up basis), and
3. A cap of 12,000 (or 60,000 on a gross-up basis).

This regime is illustrated in Figure 2. Note that the personal exemption level was chosen so that the all taxes below the personal exemption accrue to the social funds. In effect, the cap and the personal exemption are coordinated so that all taxes below the personal exemption accrue to the social fund and all tax on income above the personal exemption accrue to the PIT. All compensation is subject to tax and the only issue is the allocation between the social tax and the PIT.

The benefit of the system is the clear distinction between social taxes and PIT at the cap/personal exemption.

IV. No Cap and No Personal Exemption

A second option could be to have no cap and no personal exemption. No personal exemption is characteristic of flat-rate taxes used in countries like Georgia. Now the only relevant division is the social tax rate and the PIT rate. For illustrative purposes, I choose a social tax rate of 15% and a PIT rate of 5% (in order to show the division graphically), so that the combined rate is 20%. This option is illustrated in Figure 3. The lack of a cap may mean that the social funds may be over (or under) funded depending on the rate and employment in the aggregate. In addition, the lack of a cap means that the link between pension benefits and contributions is broken.

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[1] I take it that the rate subject to the cap is one reason for the significant evasion at these income levels.

[2] Note is made of the fact that individuals receive a pension in exchange for the employers' contributions so the "tax component" is, economically speaking, the payment less the actuarial value of the pension.

[3] It is not necessary to gross-up for the system to work but it does make clear that the social tax is part of the employee's compensation.

V. A Two-Rate System

A two-rate system is an adaptation of a combined rate system. In this regime, the social tax is capped at 12,000 and the combined rate is 20% (flat rate). The allocation, however, now depends on the personal exemption, set at 30,000 for illustrative purposes, and the two marginal PIT rates: 10% on personal income above the exemption but below 90,000 and 20% on personal income above 90,000. Of course, a two-rate system for the PIT means a regressive two-rate system for the social tax: 20% below the personal exemption and 10% above the personal exemption until the cap is reached. Note that I choose the point where the second marginal rate becomes effective to coincide with the income level where the cap is reached in order to preserve the two rates for the social tax.

This system is illustrated in Figure 4. I do not necessarily advocate such a regime but wanted to illustrate the flexibility of using the four levers to achieve almost any desired result. There are many combinations of rates, exemptions and caps compatible with the regime.

In summary, the cap, the personal exemption and the PIT (or social tax) rate given the combined flat rate determine both the amount of total tax and the allocation between PIT and social funds. Ultimately, the rates, exemption and cap should be determined by:

1. The amount necessary to fund the social tax funds during the transition,
2. The general revenue needs of the government, and
3. The desire for a PIT progressive system.

I define a progressive PIT system without regard for the social taxes because of the pension benefits received in exchange for the social tax. Thus, a flat-rate PIT with an exemption is progressive in the context of the overall combined flat-rate system.

IV. Other Considerations

I believe any combined flat-rate system should be complemented with uniform withholding on interest, Honoraria, carried interests, and other forms of wage compensation such as distributions from partnerships. It is important that personal income be subject to tax, regardless of what is it called, in order to avoid issues of form-over-substance arbitrage. In addition, the uniform tax should be applied to "total compensation" including fringe benefits. If fringe benefits prove difficult to tax, then I recommend that Ukraine consider a "fringe benefit tax" which is a system of imposing tax on fringe benefits without having to attribute the benefits to any particular individual. Given a flat-rate system, employers would be indifferent to paying this tax and having the employee pay on the attribution.

The personal exemption can be accommodated via a zero bracket amount, a personal credit or a personal exemption. Again, I will be happy to provide further detail should you desire.

Two final points are noted. First, allocating PIT revenue to subnational governments is a mistake in my view. In effect, wage taxes go to the local government while other components of the PIT accrue to the central government. I prefer general revenue sharing where subnational governments are allocated a portion of general revenue based on clearly defined criteria. Such an approach will begin to increase public understanding that wages are only one component of a unified PIT. Subnational governments can then have direct control over excises and property taxes among other charges.

Second, the small business tax, including the entrepreneur charge, need to be modified if tax reform is going to be successful and the unified tax paid by the self-employed, among others. One way to begin to address the problem is to eliminate the definition of employee for tax purposes and for business to withhold the unified tax on any payments to any physical person who is not a VAT taxpayer. I will be happy to develop this proposal further should you desire.

Please feel free to contact me with questions and comments. I will be happy to develop specific proposals for the reformed system as you require.

I hope this is helpful.

Thank you.

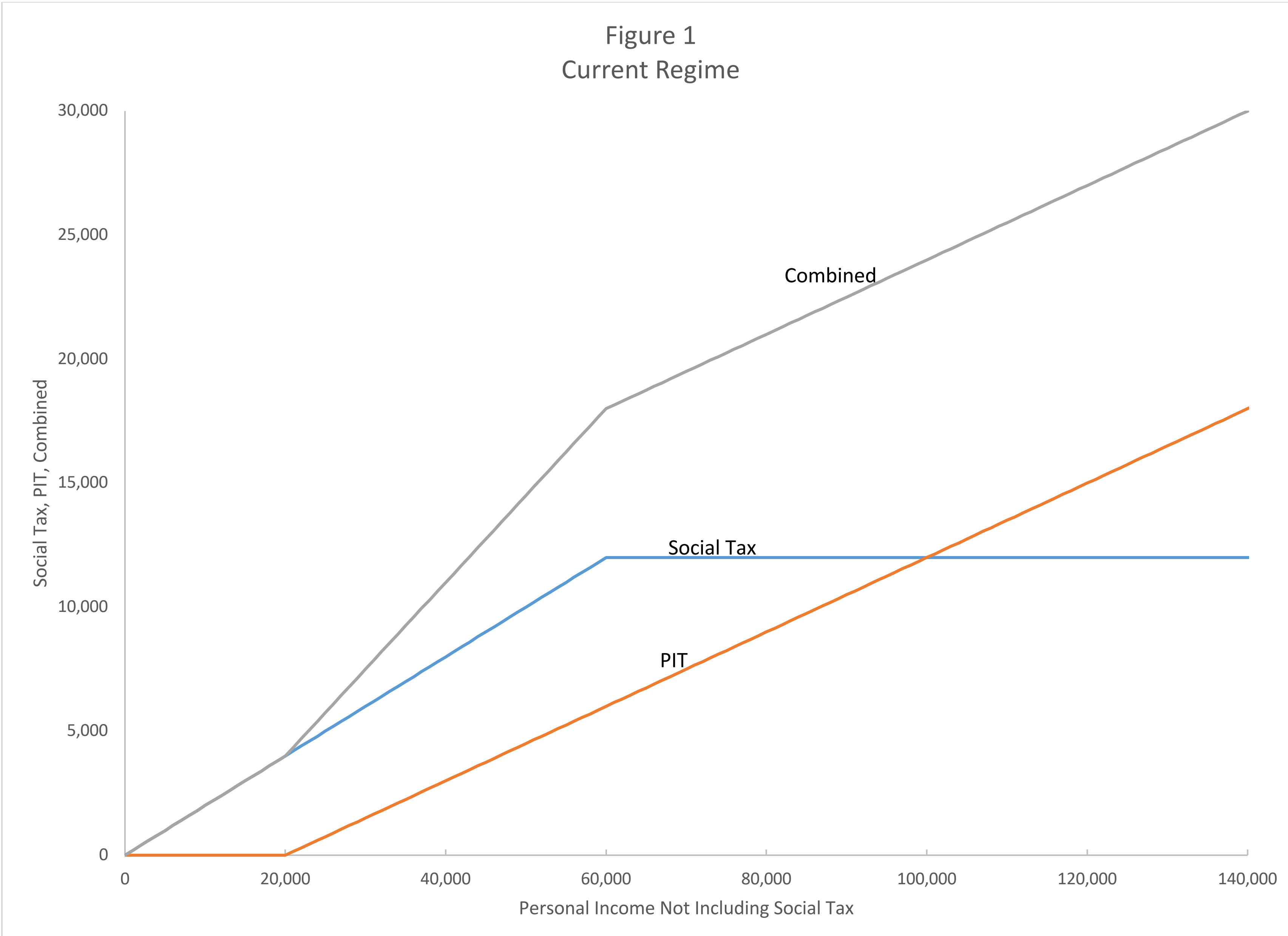
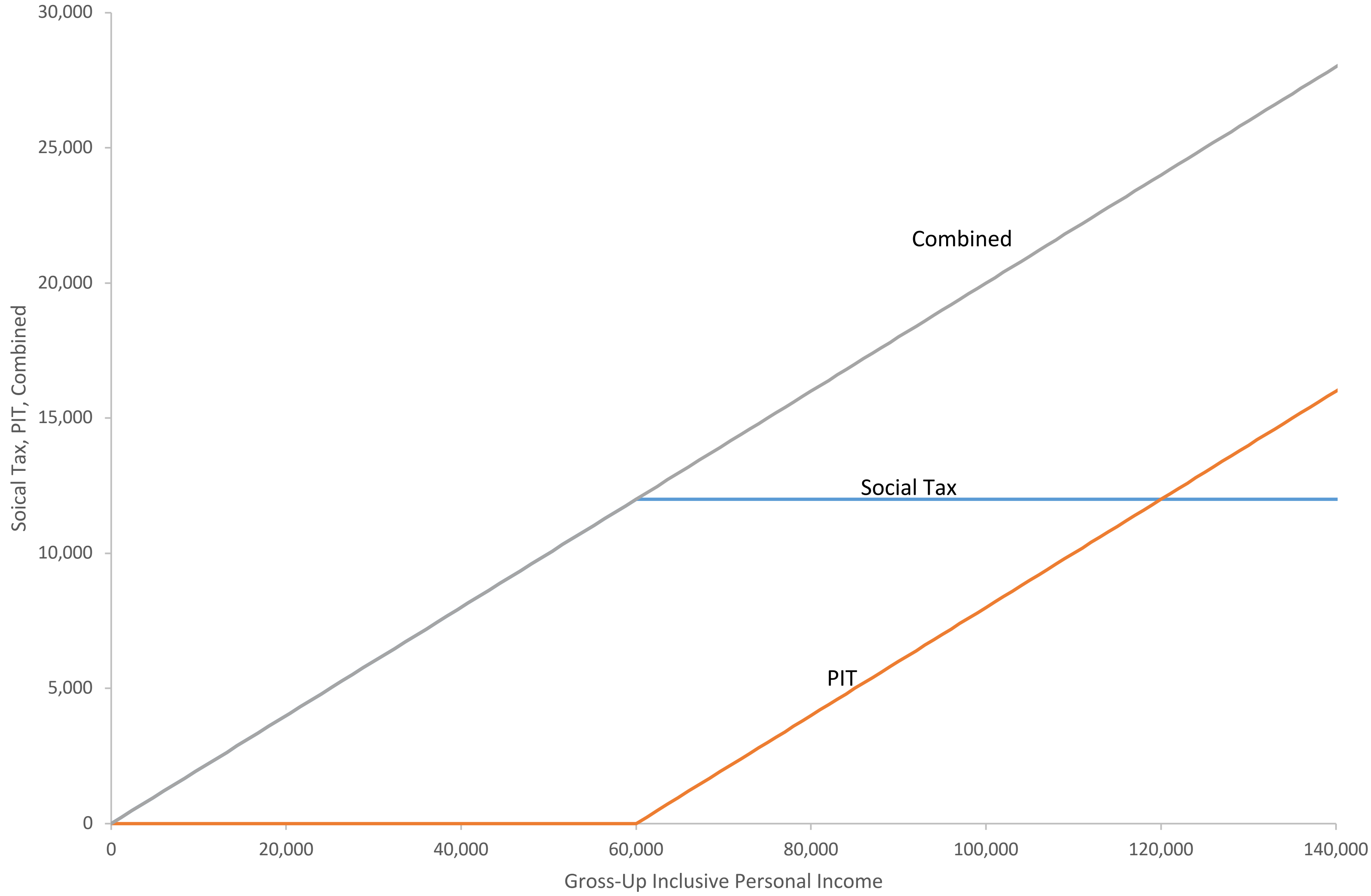


Figure 1
Current Regime
Combined
Social Tax
PIT
30,000
25,000
20,000
15,000
10,000
5,000
0
Social Tax, PIT, Combined
0
20,000
40,000
60,000
80,000
100,000
120,000
140,000
Personal Income Not Including Social Tax

Figure 2
Social Tax Subject to Cap at the PIT Personal Exemption



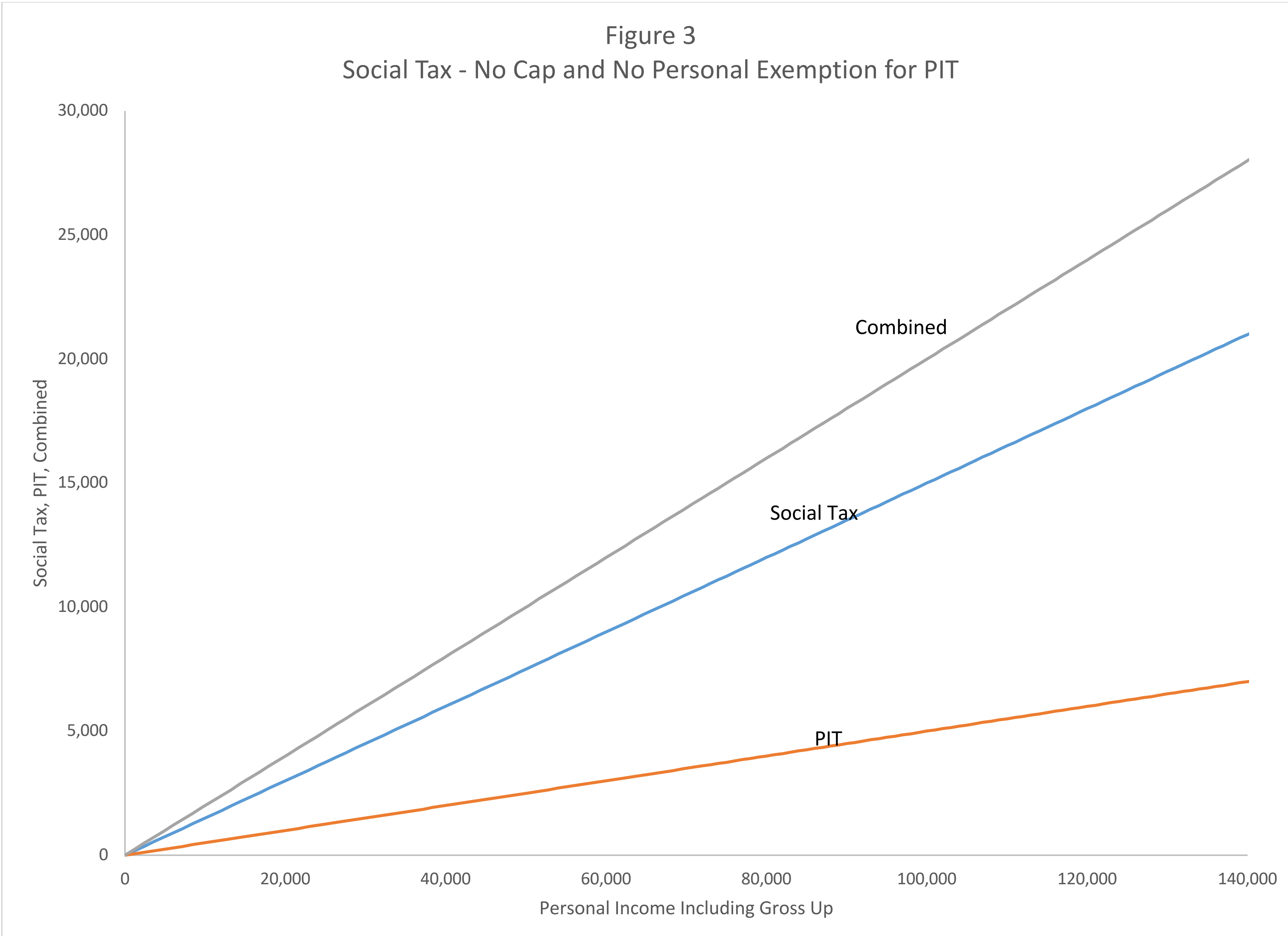


Figure 3
Social Tax - No Cap and No Personal Exemption for PIT
30,000
25,000
20,000
15,000
10,000
5,000
0
Social Tax, PIT, Combined
0
20,000
40,000
60,000
80,000
100,000
120,000
140,000
Personal Income Including Gross Up
Combined
Social Tax
PIT

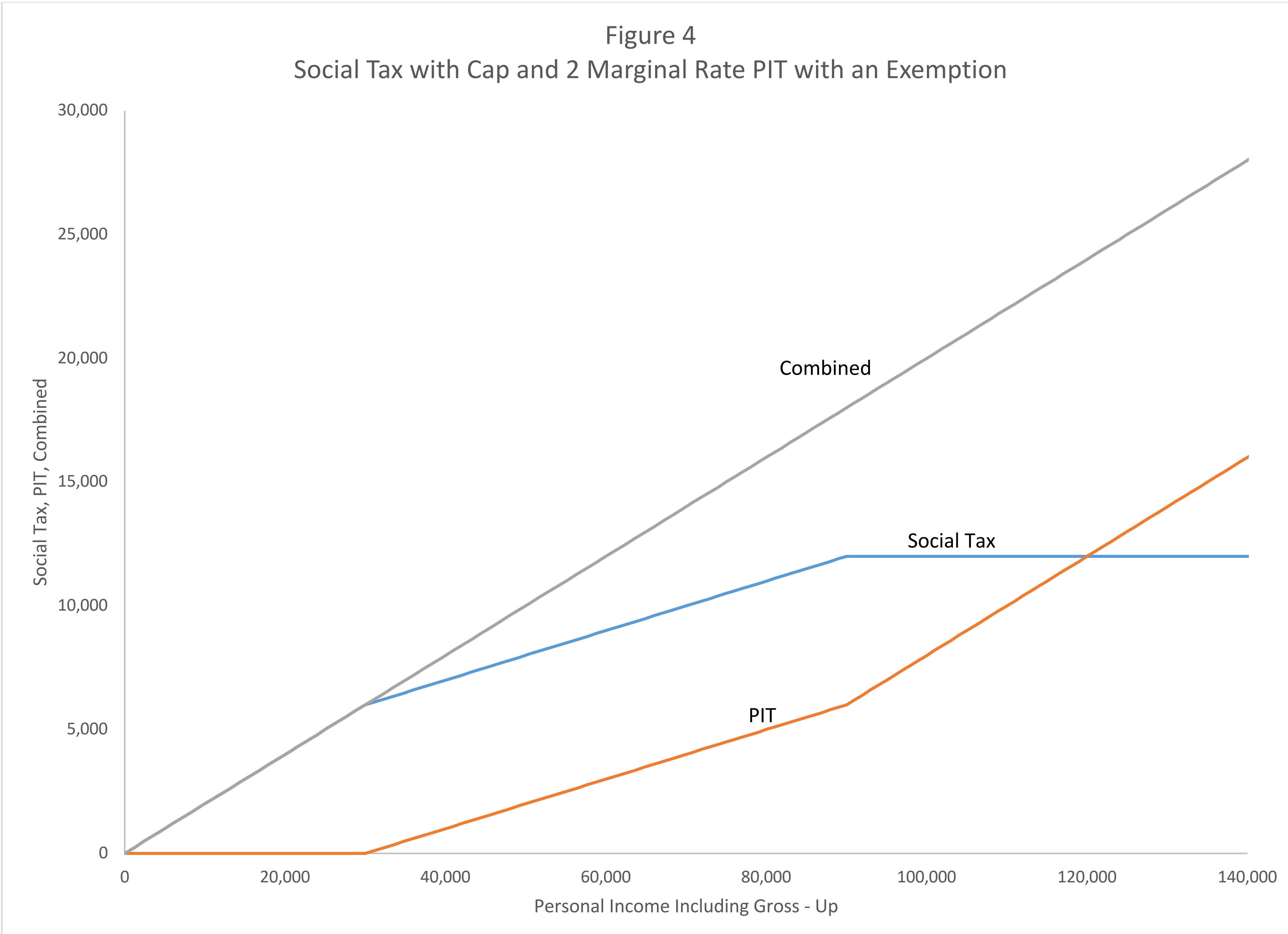


Figure 4
Social Tax with Cap and 2 Marginal Rate PIT with an Exemption
30,000
25,000
20,000
15,000
10,000
5,000
0
Social Tax, PIT, Combined
Combined
Social Tax
PIT
0
20,000
40,000
60,000
80,000
100,000
120,000
140,000
Personal Income Including Gross - Up