German Advisory Group Ukraine

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# Estimation of the short run fiscal impact of introducing an Exit Capital Tax

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in cooperation with otten Tax · Controlling · M&A

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# Executive summary

- **Topic**: Estimation of the short run fiscal impact if the Corporate Profit Tax (CPT) is abandoned in favour of the Exit Capital Tax (ECT) in January 2018
- **Results for 2018**:
  - Optimistic case: Shortfall of UAH 36.9 bn or 1.2% of GDP (revenue falls from 2.4% of GDP to 1.2% of GDP)
  - Pessimistic case: Shortfall of UAH 47.3 bn or 1.5% of GDP (revenue falls from 2.4% of GDP to 0.9% of GDP)
- **Pessimistic case:** Possibility of large fiscal shortfall exceeding previous estimates
- **Reason**: Taxpayers can react to new reality by lowering the amount of profits to be distributed
- **Further risk:** The ECT in its current shape may enable widespread legal tax avoidance

**Recommendation**

- If the ECT is adopted, budget policy should be cautious and include measures to offset the estimated fiscal shortfall

# Structure

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# 1. Introduction

- Discussion is ongoing about the possible introduction of an „Exit Capital Tax" to replace the Corporate Profit Tax in Ukraine
- A draft law has been submitted by the Ministry of Finance to the Cabinet of Ministers in July that foresees ECT introduction for 2018

- German Advisory Group has analysed ECT in previous papers
  - PS/01/2017 „Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations": Description, ECT/CPT comparison, recommendations
  - PB/03/2017: „Taxation of distributed profits: International Experience": International experience with tax systems similar to ECT
- Conclusion from both analyses
  - High risk of revenue losses from ECT, especially in short run
  - Positive economic impact possible, but uncertain

- This briefing: Estimation of short-run fiscal impact due to ECT introduction
- See TN/02/2017 for the assumptions and methodology used here

# 2. Approach

- We estimate values for the tax year 2018
- Scenario analysis for ECT revenues allows accounting for unknown factors:
  - Incomplete data on ECT tax base
  - Responses of taxpayers to change of tax *base* and tax *rate*
- Possible *range* rather than point estimate as a base for budget planning
- Fiscal shortfall = Foregone revenues from CPT system– ECT revenues
- 2016 hypothetical values allow comparison with other studies

| | | (2016) | 2018 |
|---|---|---|---|
| | Foregone revenues from CPT system | Actual values | Forecast |
| - | ECT revenues | Built from actual data | Forecast |
| = | Fiscal shortfall due to ECT introduction | | |

# 3. Foregone revenues from a CPT system

## Foregone revenues in case of ECT introduction, 2018

| | 2018, UAH bn |
|---|---|
| CPT revenues | 70.7 |
| + Withholding tax on dividends to non-residents | 10.6 |
| + PIT on dividends to natural persons | 0.4 |
| - CPT paid by banks | 1.6 |
| - Withholding tax on dividends to non-residents | 5.6 |
| **= Foregone revenues from CPT system** | **74.7** |
| *% of GDP* | *2.4%* |
| *(GDP, UAH bn)* | *(3,074.5)* |

*Source: Ministry of Finance, IER (CPT forecast), IMF World Economic Outlook Apr. 2017 (GDP forecast), own calculations*

*Note: We subtract two revenues of the CPT system that would be received in 2018 despite ECT introduction.*

- *CPT from banks (excluded from ECT)*
- *Withholding tax on dividends for pre-2018 tax years paid out in 2018 due relaxed NBU restrictions (assumption)*
- *We do not consider here that some CPT revenues for 2017 profits would only be paid to the budget in 2018*

# 4.1 ECT revenues: Calculation and data base

ECT revenue calculation: By component of the tax base

- Components: Transactions of ECT payers „with capital exit“ (distributions of company profit to non-ECT payers)
  - Dividends to natural or legal persons outside the ECT system
    - Tax rate: 15%
  - „Deemed dividends“: Other transactions with capital exit e.g.:
    - Interest payments to related parties above a threshold
    - Specific royalty payments
    - Financial aid or free of charge transfers of goods
    - Tax rate: 20%
- Remark: ECT allows for immediate full expensing of investment (equipment, plant,…)

Data base: SFS data on component magnitudes in 2016

- Data does exists only for 10 of 18 components of the new tax base
- Some definitions/corrections issue for 4 of the available components
- However, for the most important components, data is available

# 4.2 ECT revenues: Scenarios

- We present 3 illustrative scenarios to determine a possible range for ECT revenues
  - S1: Simple extrapolation:
    - Extrapolation of 2016 data on the components of the new ECT tax base
    - No reactions by taxpayers to the new tax system
  - S2 and S3: Reactions of taxpayers incorporated
    - Based on S1 values
    - Taxpayer reactions to new tax base (S2) and tax rate (S3)

**Summary of ECT revenue scenarios**

| | Reaction to tax rate change | Reaction to tax base change |
|---|---|---|
| S1 - Simple extrapolation | - | - |
| S2 - Reaction to tax base change | + | - |
| S3 - Reaction to tax rate change | - | + |

**Correction applied to dividends paid to non-residents. NBU regulations since 2014 restricted dividend payments. Correction assumes constant GDP share of dividends from pre-2014.*

# Scenario 1 - Simple extrapolation

**S1 Simple extrapolation**

| | 2016 | 2018 |
|---|---|---|
| ECT revenue, UAH bn | 23.5 | 33.7 |
| *% of GDP* | *1.0%* | *1.1%* |

*Source: Own calculations. See TN/02 for a detailed table of revenue by tax base component*
*Note: 2016 values included only for comparison with studies only using 2016 values*

- Concept :
  - 2016 data exists on most of the transactions that will make up the new ECT
  - This data is extrapolated to 2018 using fixed GDP shares
    - Exception: Dividends to non-residents increase more in 2018 due to assumption of relaxed NBU restrictions (see TN/02/2017 for details)
  - S1 considers this data as if the ECT already were in operation in 2016
  - Key difference between ECT and CPT tax base: ECT tax base only includes profit distributions, reinvested profit is not taxed
- **Result: ECT would yield revenues of UAH 33.7 bn in 2018, 1.1% of GDP**
- Shortcomings of simple extrapolation:
  - Does not consider reactions of taxpayers to tax base (see Scenario 2)
  - Does not consider reactions of taxpayers to tax rate (see Scenario 3)

# Scenario 2 - Reaction to tax base change (I)

- Crucial to consider the reaction of taxpayers (companies) to vastly changed tax base
- Short-run:
  - Reinvest profits rather than pay out dividends (tax deferment)
  - Profits would eventually be paid out and taxed after investments amortise
  - This is part of the economic motivation of the ECT
  - Also possible: „Wait and see“ reaction, retain profit in company without investing
- Medium-run:
  - Exploit possible tax base loopholes (tax avoidance)
  - This is a typical risk with a new tax base
- Short- and medium-run reactions go in the same direction: Reduction of ECT revenues

- 3 reaction channels by companies
  - Dividend payments
  - „Deemed dividend“ payments
    - As these are mainly related-party operations, we assume that companies can largely control the volumes of these transactions in the short run
  - Profit distributions to the state budget by SOEs

# Scenario 2 - Reaction to tax base change (II)

**S2 - Reaction to tax base change**

| | 2016 | 2018 |
|---|---|---|
| ECT revenue, UAH bn | 19.1 | 27.4 |
| *% of GDP* | *0.8%* | *0.9%* |

*Source: Own calculations*

- Concept:
  - Taxpayers react to new tax base by reducing profit distribution
  - Key assumption: Dividends and „deemed dividends“ are equally reduced by 20%
    - See TN for different values
  - Implicit assumption of relatively strong controllability of deemed dividends
  - Profit distribution of state owned enterprises reduced by 10%
    - SOEs under higher pressure to distribute profits than private companies
  - No reaction of taxpayers to change in tax rates
- **Result: Significant revenue loss possible (S2: Only 81% of S1 ECT revenues in 2018 )**
  - High uncertainty about extent of reaction, which is difficult to estimate

# Scenario 3 - Reaction to tax rate change

**S3 – Reaction to tax rate change**

| | 2016 | 2018 |
|---|---|---|
| ECT revenue, UAH bn | 25.0 | 36.9 |
| *% of GDP* | *1.1%* | *1.2%* |

*Source: Own calculations, elasticity estimate: Dwenger and Steiner (2012)*

- Concept:
  - Under ECT, effective tax rates on distributed profits will be lower than before
    - Main reason: No withholding tax/PIT on dividends
    - See TN/02/2017 for full discussion
  - Companies react to tax rate change by intensifying and/or de-shadowing activities
  - Leads to smaller loss of tax revenues (the „Laffer effect“)
  - Calculated using an empirical estimations of the „elasticity of taxable income“
  - We use a relatively high elasticity result of -0.5, implying an optimistic revenue estimate
- **Result: Slightly higher ECT revenues than under S1 (+UAH 3.2 bn in 2018)**
  - Not a very large effect of reaction to tax rates

# 4.3 ECT revenues: Summary of results

**Summary of results, ordered by revenues**

| Scenario | 2016 | | 2018 | |
|---|---|---|---|---|
| | UAH bn | % of GDP | UAH bn | % of GDP |
| S3 | 25.0 | 1.1% | 36.9 | 1.2% |
| S1 | 23.5 | 1.0% | 33.7 | 1.1% |
| S2 | 19.1 | 0.8% | 27.4 | 0.9% |

*Source: Own calculations*

- Considerable uncertainty remains about ECT revenues:
  - Unclear magnitude of reactions of taxpayers, esp. to tax base change
  - Missing data on several components of the tax base

**Possible range for ECT revenues:**

- Under these constraints, we believe a possible range for ECT revenues in 2018 is delimited by our scenario calculations
  - Optimistic result: S3 – **UAH 36.9 bn, 1.2% of GDP**
  - Pessimistic result: S2 – **UAH 27.4 bn, 0.9% of GDP**

# 4.4 Comparison with other studies

**ECT Revenue estimates**

| | | 2016 | | 2018 | |
|---|---|---|---|---|---|
| | | UAH bn | % of GDP | UAH bn | % of GDP |
| Other studies | SFS | 16.8 | 0.7% | - | - |
| | Ministry of Finance | 25.0 | 1.1% | 32.4 | 1.1% |
| | Institute of the Future | - | - | 40.2 | 1.3% |
| | Shevtsova | 30.5 | 1.3% | 40.1 | 1.3% |
| | Shemiatkin/Shevtsova | 17.4 | 0.7% | - | - |
| Our estimates | Optimistic result | 25.0 | 1.1% | 36.9 | 1.2% |
| | Pessimistic result | 19.1 | 0.8% | 27.4 | 0.9% |

*Source: Studies of authors above, all GDP values from IMF World Economic Outlook April 2017, own calculations*
*Note: 2016 values for comparison purposes only*

- Our optimistic result is fully in line with other studies with ECT rev. of 1.1-1.3% of GDP
- However, our pessimistic result of 0.9% of GDP (2018) is somewhat below other studies
- Pessimistic result incorporates possible reactions to tax base change
- **Our results highlight the large fiscal risks associated with the ECT in the short run**

# 5. Fiscal impact

**Fiscal shortfall in 2018, UAH bn**

| | Optimistic result | Pessimistic result |
|---|---|---|
| Foregone revenues from CPT system | 74.7 | 74.7 |
| - ECT Revenue | 36.9 | 27.4 |
| = Fiscal Shortfall | 37.8 | 47.3 |
| *% of GDP* | *1.2%* | *1.5%* |

*Source: Own calculations*

- **Fiscal shortfall in 2018 between 1.2% and 1.5% of GDP**
  - Fiscal impact broadly in line with experience of other countries that introduced ECT (Estonia, Macedonia) or a similar system (Moldova) - see PB/03/2017

**<u>Further considerations for budget policy:</u>**

- Budget impact of ECT introduction will be split over 2018 and 2019 budget
- Reason: Difference between tax years and budget years
- CPT for 2017 tax year will partly be paid in 2018 budget year
- ECT for 2018 tax year will partly be paid in 2019 budget year
- Full budget impact of ECT in 2019, same order of magnitude expected

# 6. Medium-term perspective

- Tax deferment in short-run only: Eventually, profits will be distributed
- Enforcement: Easier auditing of tax declarations by SFS may increase revenues
  - ➢ Partial recovery of tax revenues is to be expected in medium term
- Risk of large tax avoidance: If ECT tax base not comprehensively formulated, taxpayers can shift profit distribution to untaxed transactions => lower tax revenues
- Indication: ECT tax base much lower than CPT tax base in 2016
- Two possible reasons:
  - Extremely low profit distributions in 2016 or
  - Existence of profit distributions that would not be taxed by ECT
- Implication of latter case: ECT revenues may not recover in medium term
  - ➢ Constant policy response (anti-avoidance measures) necessary

**<u>Outlook:</u>**

- Probable reduction of fiscal shortfall in medium term
  - Depends on effectiveness of policy in implementing anti-avoidance measures
- Risk that loopholes in the ECT tax base may enable widespread legal tax avoidance and reduce medium term revenue prospects unless closed

# 7. Recommendations

<u>Recommendation in case of ECT is adoption, taking effect January 2018:</u>

- A cautious budget policy should include measures to offset the estimated fiscal shortfall

<u>Recommendations in case ECT is adopted, but implementation postponed</u>

- The SFS should collect comprehensive data on the ECT tax base over one full year to allow a more precise estimate
- Further research should be undertaken on reactions to the new tax base
- Intensive efforts should concentrate on closing potentially remaining loopholes in the tax base

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