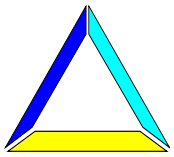
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The pension funds tax on purchases of non-cash foreign currency: Time to go

Executive Summary

In Ukraine, purchases of non-cash foreign currency are subject to a tax of 1.3%, the revenues from which are directed to the State Pension Fund. On the one hand, this "pension funds tax" serves as an important fiscal instrument. In 2006, the tax is expected to collect UAH 2.6 bn or 2.1% of total central revenues. On the other side, the pension funds tax acts as an important impediment to investment. The tax discourages capitals inflows, thus reducing the capacity of the economy to finance domestic real investment. The tax is also detrimental to investment because it raises the price of foreign capital goods. Furthermore, the tax strongly reduces the liquidity of the foreign exchange market and increases the need for interventions by the National Bank of Ukraine. Last, the pension funds tax is a significant impediment for the development of domestic capital markets. Thus, this tax raises a certain amount of public revenues at a very high cost for the country in terms of investment and economic growth. In short, the pension funds tax might be effective, but it is also inefficient. Consequently, we strongly advise the Ukrainian authorities to abolish this tax. But the abolition should not create fiscal imbalances. The best way to finance the abolition of this tax is through a reform and financial consolidation of the first pillar of the pension system.

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1 Introduction

Purchases of non-cash foreign currency in Ukraine are subject to a tax (officially called "duty"[1]) of currently 1.3%. The resulting revenues are earmarked for the State Pension Fund. There are different opinions on the usefulness of this pension funds tax on purchases of non-cash foreign currency (hereafter: pension funds tax[2]) amongst experts and the state officials. An opinion shared by the Ministry of Finance is that the tax is hindering the development of financial markets and should be abolished. On the other hand, Parliament argues in favor of the existence of the pension funds tax referring to its fiscal role for supporting the Pension Fund.

In this paper we analyze the effect of the pension funds tax in on the Ukrainian economy. We also answer the question whether the pension funds tax should remain a part of the Ukrainian fiscal system or not in the near future. Part 2 describes the history, recent developments, current situation and fiscal relevance of the pension funds tax in Ukraine. Part 3 analyzes the economic effects of the pension funds tax. Part 4 explains our proposal to abolish the pension funds tax and to replace it with other less harmful fiscal instruments.

2 A short history of the pension funds tax in Ukraine

The pension funds tax, officially called the "additional duty for mandatory state pension insurance", was introduced in October 1998.[3] The purpose of this tax was to generate additional revenues for the repayment of pension arrears. The tax made an important contribution to solving this urgent fiscal and political problem. In 1999, over UAH 1 bn of arrears were repaid, of which UAH 387 m from the new tax.[4]

The tax has undergone several modifications since it was introduced. The tax base was reduced from all operations (cash and non-cash) to only non-cash operations in 2004 simultaneously with a tax rate increase from 1.0% to 1.5%. This was followed by a reduction of the tax rate to 1.3% in 2006. The exemption of cash operations from the pension funds tax was mainly a response to the danger of the development of a shadow market for cash currency exchange.

Initially the law was rather vague about whether non-residents had to pay the pension funds tax. As a result, most banks did not charge non-residents with the duty. However, in November 2005 the NBU jointly with the Pension Fund published an official explanation stipulating the requirement for non-residents to pay the tax on equal conditions with residents.[5]

Currently practically any non-cash purchase of foreign currency – in order to pay for imports, repatriate capital and earnings, pay interest on corporate and public sector debt, etc. – is subject to the pension funds tax.[6] Upon receiving an order to purchase foreign currency, banks charge, withhold and remit to the special fund of the state budget the tax of 1.3% of the transaction's sum, stated in the order.

Although the pension funds tax has virtually completed its mission as an instrument to urgently repay pension arrears, it continues to remain a sizeable source of fiscal revenue for the government. In 2005 the pension funds tax generated UAH 2.1 bn in revenues, which was 2.0% of the total

[1] We use the term "tax" instead of "duty", since it is more appropriate for our economic analysis.
[2] The pension funds tax should not be confused with the pension funds contribution, which is paid by employers and employees to the State Pension Fund.
[3] See the decree of the President of Ukraine "On the urgent measures to pay off pension arrears" № 957 of 31.08.98.
[4] Source: A. P. Sorokin, First deputy head of the State Pension Fund. Please see http://www.rada.gov.ua/zakon/skl3/BUL145/30_1.htm
[5] Explanation to the resolution of the Cabinet of Ministers № 1740, National Bank of Ukraine, Pension Fund of Ukraine, № 18-310/5174-11819 of 28.11.2005.
[6] The currency transaction tax is paid by legal entities both resident and non-resident, permanent representative offices of non-resident legal entities, owners of corporate card accounts in foreign currency, banks – members of international payment systems, authorized dealers in foreign currency according to international contracts, and physical entities, including non-residents who purchase non-cash foreign currency.

central revenues.[7] The correspondent revenues foreseen in the State Budget 2006 are UAH 2.6 bn or 2.1% of total central revenues.[8]

While preparing the draft of the State Budget 2006, the government proposed to completely abolish the pension funds tax in view of its negative effects upon the economy. However, the Verkhovna Rada in its efforts to secure a high level of fiscal revenues decided to keep the pension funds tax in 2006.

3 The economics of the pension funds tax

The pension funds tax has four main negative effects on the Ukrainian economy. It hinders foreign investment into Ukraine, reduces the import of investment goods, limits the liquidity on the foreign exchange market and hinders the development of the domestic market for capital. For the purpose of conceptual clarity it should be noted that this tax is not a 'Tobin tax' (see box below).

(i) Foreign investment

Typically, foreign investors convert foreign into national currency when initiating an investment activity in Ukraine. When profits are repatriated or when the investment is terminated, the opposite transaction (conversion of national into foreign currency) has to take place. Currently, foreign investors have to pay the pension funds tax of 1.3%. Most importantly, this duty has to be paid by all foreign investors, independent on whether they conducted a direct (FDI) or a pure financial investment and independent of the duration of the investment (short-term or long-term). For this reason, the pension funds tax is also a *tax on foreign investment* in Ukraine.

The strongest impact of the tax is on foreign *financial* investment in Ukraine. As suggested by anecdotal evidence from foreign financial investors and from Ukrainian bankers alike, the explicit inclusion of non-residents as payers of the tax in November 2005 had a very negative impact on capital inflows. Thus, the tax decreases the supply of capital on domestic markets, increases interest rates, and as a consequence reduces domestic investment and economic growth.

Furthermore, the tax has a negative effect on foreign *direct* investment. On top of the financial loss to investors of 1.3% of the sum to be converted into foreign currency, this by international standards unusual tax reinforces the impression that no step in doing business in Ukraine is free of state intervention and taxation. After having spent large amounts to enter the country, investors are taxed again in addition to profit taxes when leaving the country. Because of its nature as a 'substance tax', the pension funds tax has to be paid by all foreign investors, even those who have lost money in Ukraine and decide to leave the country.

The extremely negative effect of the tax on short-term, 'speculative' international flows might appear to be an attractive feature of this instrument at first glance. But it should be noted that this is a very inefficient instrument for controlling capital flows, since it does not discriminate between maturities. Besides, Ukraine has already enforced other and more efficient instruments for managing capital inflows, as we have explained in a recent policy paper.[9]

(ii) Import of investment goods

The pension funds tax has a negative impact upon imports, since importers are charged this tax when they purchase foreign currency to pay their suppliers abroad. The most worrisome aspect of this is that the pension funds tax can discourage imports of investment goods (i.e. machines and equipment, devices, and transport vehicles), which accounted for 28% of total imports in 2005. As a result, the tax reduces investment and has a negative effect on economic growth.

(iii) Liquidity at the foreign exchange market

The standard foreign exchange market in developed countries is based on the "market maker principle" and consists of two parts, the inter-bank market and the market between banks and

[7] Source: State Treasury of Ukraine.
[8] Source: The law on the State Budget for 2006, № 3235-IV of 20.12.2005.
[9] See our policy paper V3 " Managing Capital Flows: Ensuring Long-Term Benefits while Controlling for Short-Term Risks", www.ier.kiev.ua.

clients. Let's assume that a company wants to buy USD 1 m. The company calls a bank and asks for the quotes, i.e. the rates at which the bank buys and sells US Dollar (bid and ask quotes). If the company decides to buy USD 1 m at this quote, then the deal is done. A foreign exchange transaction takes place between a client and a bank (outside transaction). It is important to highlight that the bank has not just intermediated between buyer and seller of US Dollar, but has sold US Dollar on its own account. In technical language: the bank is a "market maker". After the conclusion of this outside transaction, the bank has an open currency position (i.e. a risk), which should be closed as soon as possible, since the markets makers as a rule do not speculate on the foreign exchange market. In order to close the open currency position, the bank enters the inter-bank market, whose main function is to provide liquidity. The bank then buys USD 1 m from another bank and closes its position. Thus, a further currency transaction takes places, but this time the transaction is done on the inter-bank market (inside transaction). Afterwards, the open currency position is exchanged between banks several times like a "hot potato". Several transactions take place on the inter-bank market, until a bank eventually finds a client in need of selling USD 1m. Then, a last (outside) transaction takes place and the chain of events is closed. Thus, the inter-bank market in a market maker system acts as a multiplier. The turnover induced by the original transaction is not just USD 1 m, but around USD 10 m, i.e. ten times higher.[10]

The pension funds tax is in fact a currency transaction tax. Each currency transaction is taxed at 1.3%. As a consequence, the pure liquidity exchange between banks described above becomes too expensive and cannot take place in practice. As a result, banks cannot act as market makers. Instead, when faced with a buying order of say USD 1m, they have to find a company, which wants to sell USD 1m, or a bank, which got such an order. In sum, the pension funds tax reduces dramatically the liquidity and thus the performance of the foreign exchange market in Ukraine.[11] Furthermore, it increases the need for interventions by the NBU on the market.

This view can be empirically supported by the low level of liquidity of the Ukrainian foreign exchange market. In 2005, average daily turnover in Ukraine was USD 366 m or 0.45% of GDP[12], which is low compared with transition economies that do not tax currency transactions. For example, average daily turnover of inter-bank spot conversion transactions in Russia in 2005 was USD 30 bn or 4.0% of GDP.[13]

(iv) Domestic capital market

The existence of the pension funds tax can be considered an important reason for the underdevelopment of capital markets in Ukraine.[14] The taxation of foreign exchange operations strongly reduces the *foreign* demand for Ukrainian securities (shares and bonds). As a result, issuing (supply) of securities by domestic institutions remains rather limited. But also the preference of *Ukrainian* investors and businessmen for conducting transactions off-shore can be partly explained as a means of avoiding paying the pension funds tax. Besides, the tax creates additional incentives for the flight of capital out of Ukraine and contributes to the development of an illegal capital flight industry.

[10] Because of the existence of this multiplier, the common comparison between the official reserves of central banks and the daily turnover on foreign exchange markets in developed countries is not suitable.
[11] The negative effect of a currency transaction tax on the liquidity of the foreign exchange market is in fact one of the central critique of the so-called Tobin tax (see box below).
[12] Source: The National bank of Ukraine, http://www.bank.gov.ua/Fin_ryn/Pot_tend_v/index.htm.
[13] Source: The Central bank of Russia, http://www.cbr.ru/statistics/credit_statistics/.
[14] See our policy paper V1 "Capital Markets in Ukraine: Proposals to Increase Supply and Demand", www.ier.kiev.ua.

Box: Is the Ukrainian pension funds tax a Tobin tax?

James Tobin, a US economist, Nobel laureate and Yale University professor, proposed in 1972 to introduce a currency transaction tax on a global scale. The purpose of the Tobin tax was to reduce short-term speculative currency flows by making short-term trades more costly, and to allow for greater macro-economic and monetary policy autonomy. James Tobin proposed that at each exchange of a currency into another a small tax would be levied at around 0.1% of the volume of the transaction. Tobin's proposal lay dormant for a number of years until it saw resurgence in the 1990s mostly as a favorite cause of the anti-globalization movement. In Latin America, the president of Brazil, Luiz Ignacio Lula da Silva and the president of Venezuela, Hugo Chavez, who recently announced that he is studying the implementation of such a tax, have supported the Tobin tax.

Although it is a tax on foreign exchange transactions, the pension funds tax in Ukraine should not be considered as a Tobin tax for several reasons. First, the pension funds tax and Tobin tax have different objectives. The purpose of the Tobin tax is to discourage short-term currency speculations, while the purpose of the pension funds tax in Ukraine is to generate fiscal revenues. Second, there is a huge difference in magnitudes between the proposed Tobin tax and the pension funds tax in Ukraine. The idea of the Tobin tax is to impose a small tax of around 0.1%, whereas the pension funds tax rate in Ukraine is much higher (1.3%). Third, the Tobin tax was proposed on a global scale as an element of a multilateral system, whereas the pension funds tax in Ukraine is clearly unilateral.

4 Conclusions and policy recommendations

The analysis of the effects of the pension funds tax on the Ukrainian economy in Part 3 shows clearly that this is a very *inefficient* instrument to raise fiscal revenues. The cost of raising a certain amount of public revenues through the pension funds tax is very high in terms of investment and economic growth. In particular, using more common forms of taxation and/or contributions for obtaining the same amount of revenues would impose a much lower cost on the economy. *Consequently, we propose that the pension funds tax be abolished.*

But the abolition of the pension funds tax should not cause fiscal imbalances. Accordingly, one has to think about how to *finance* the abolition of this tax. In our view, the best way to finance the gap is by reducing the huge deficit in the Pension Fund[15], which is both historically and currently the true reason for the existence of this investment-inhibiting instrument.

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[15] See a forthcoming policy paper by the German Advisory Group and the Institute for Economic Research and Policy Consulting for concrete proposals on how to improve the financial situation of the first pillar of the pension system.