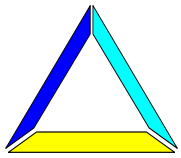
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S27

Should the interest income be taxed in Ukraine?

Summary

The paper considers recently proposed taxation of interest income earned on deposits in Ukraine. It assesses both negative and positive arguments of this measure. The most important contribution of the proposed tax would be that it would help eliminate distortion by aiming at equal taxation of all sources of income.

The most serious risk, on the other hand, is the deceleration of the growth of bank deposits, which would undermine the development of the banking system. The stability of the banking system is a top priority, especially considering that only a few most advanced transition countries introduced the interest tax. The introduction of the proposed interest income tax would aid fiscal purposes at the expense of the deceleration of growth of bank deposits and destabilizing the banking sector. Since the risks associated with the interest tax far outweigh potential benefits, we recommend that the interest tax not be introduced in the near future

1. Introduction
2. Arguments in favor of interest income taxation
3. Argument against interest income taxation
4. International experience
5. Policy recommendations and conclusion

1. Introduction

In November 2002 Verkhovna Rada passed the "Law on Personal Income Tax" proposed by deputy Teryokhin in the first reading. The draft law contains a number of significant changes in the taxation of personal income in Ukraine. In this paper we focus on the introduction of the 5% tax on interest income earned on deposits in both national and foreign currency. According to this draft law, interest income will be subject to final withholding of tax at source at the time when interest income is paid to depositor. It means that interest income earned on deposits is not included in the calculation of taxable income of a taxpayer, and the interest income is not declared in personal income tax report.

Introduction of the interest tax will have opposing effects on Ukrainian economy. On the positive side, it will increase tax revenues of the government and increase consistency of taxation of personal income from different sources. On the negative side, it will cause the slowdown in the growth rate of household deposits. In this paper we will discuss both effects. We highlight international experience in developed as well as transition countries. We argue that if the proposed tax is introduced at this time, it could undermine the successful development of the banking system, while the benefit measured in additional budget revenue would be negligible. In our opinion, the negative effect outweighs potential benefits. We therefore recommend that the 5% tax on interest income from deposits not be introduced for the time being.

Parts 2 and 3 present positive and negative aspects of the interest income taxation, respectively. Part 4 gives overview of international practice of the interest income taxation. It is followed by the policy recommendation and conclusion.

2. Arguments in favor of interest income taxation

Introduction of the interest income taxation is associated with both benefits and costs. In this section we focus on the benefits of the interest tax.

First, the interest earned on deposits is a part of personal income. As such, it is subject to the principle that all income should be taxed, and taxed only once. Interest income earned on deposits is a form of capital income, together with dividends, interest earned on bonds and securities. Exempting the interest income from deposits, while subjecting dividends to tax, leads to distorted investment decisions of physical persons and creates

a potential tax loophole. All types of capital income should therefore be subject to tax, and the tax rates for dividends and interest income both from securities and deposits should gradually converge.[1]

Second, the introduction of a 5% tax on interest income earned on deposits will raise budget revenues, albeit to a small extent. As Table 1 suggests, if the 5% tax on interest earned on deposits was introduced in 2002, the local governments would raise at most additional UAH 92 m, which constitutes less than 1% of total revenues from personal income tax (PIT) planned for 2002.

Table 1. The revenues from 5% tax on interest income in 2001 and 2002

	2001	**2002**
Interest earned on deposits, UAH m	1091	1831
The share of interest income in total money income of households, %	0.99	1.15
The revenues from 5% tax on interest income, UAH m	54.6	91.6
The share of the revenues from this tax in total revenues from PIT, %	0.62	0.84

Source: NBU, State Treasury report, own calculations

3. Arguments against interest income taxation

Introduction of the interest income tax may have negative consequences on Ukrainian banking sector, namely a slower rate of growth of household deposits. The scale of this effect depends on three main factors:

- The level of public trust in banking sector or, alternatively, the level of risk that public associates with the bank deposits,
- The equilibrium effect the interest tax will have on the interest rates,
- And the public's perception and attitude toward new regulation.

We will look at each of these factors separately in order to analyze their relative importance for the interest income tax introduction.

1) Several years of mounting inflation, numerous incidents of collapsed financial pyramids, unreturned deposits held in the state owned Oschadbank strongly undermined public's confidence in the banking system. Even though last two years of monetary and exchange rate stability turned things for better, Ukraine is still characterized by high

[1] Such rule follows international practice and was already suggested by IER and GAG: please see Analysis Paper A8/2001: 7

level of public distrust in the banking system and by high vulnerability of people's willingness to keep savings in a bank. The additional source of uncertainty about the safety of bank deposits is the insufficient protection provided by the state deposit insurance system[2]. In this situation any allusion to interest tax could evoke significantly lower growth rates of household deposits growth.

2) Introduction of the interest income tax will definitely change the equilibrium interest rate on household deposits. In general, the new equilibrium interest rate will be somewhere in-between two polar cases:

=> If banks wish to attract as many depositors as before, they will raise gross-interest rates on household deposits up to the point at which net-interest rates equal the level of pre-tax interest rates. However, this means that banks will also have to raise interest rates for the loans they provide so that lending money will become more costly.

=> If banks do not adjust the interest rate at all nominal interest income to depositors will be reduced by the respective tax rate. In this case the equilibrium interest rate, i.e. the actual interest rate that depositors get, will go down

However, for the proposed tax rate of 5% such changes in the equilibrium interest rate will be rather small.[3] However, whether or not corresponding adjustment effects will also be negligible strongly depends on the perception of the new regulation by private households.

3) In our view, people's perception of new regulation, is the most influential factor. The inflow of household deposits to the banking system depends crucially on people's attitude towards new tax and the tax-withholding scheme. Although it is clearly stated in the draft Law, that interest income tax is to be withheld by banks and is not viewed as taxed income, the lack of knowledge of this fact could divert many Ukrainians from the idea to keep their money in the bank. The reason is that for an ordinary Ukrainian citizen, any report to the State Tax Administration is usually accompanied by huge transaction costs, such as wasted time for collecting auxiliary reports from other agencies, going to the tax

[2] The description of Ukrainian deposit insurance system and recommendation for its improvement are provided in policy paper S15 "Deposit Insurance System: Time for Improvement"

[3] As of the end of 2002 the weighted average interest rate on household deposits in national currency was 7.3 % per annum, in foreign currency 6.5% per annum. After introduction of a 5% interest income tax, depositors will be paid an average 7.0% per annum on national currency deposits, and an average 6.2% per annum on foreign currency deposits.

administration department, which may appear quite far away from home, waiting in a lines and so on. Definitely, bank employees will do their best to clarify the procedure of tax calculation and withholding scheme to their clients, but this will take some time and will not touch those potential depositors, who didn't reach a bank because of wrong perception of new regulation. Thus, negative attitude of citizens towards the new taxation may have huge adverse consequences for the banking sector, which could be mitigated only by well-prepared, widespread government information campaign.

Summing up, mainly due to country-specific institutional characteristics, the implementation of interest income tax at the moment may be dangerous for the development of the Ukrainian banking sector. The deceleration of the bank deposits growth rate will, over time, be reflected in the slowdown of growth rate of bank credits - a source of investment that is needed to sustain economic growth. Therefore, in the assessment of overall effect of the interest income tax we attribute to the slowdown of the growth rate of household deposits the largest weight.

4. International experience

The proposed introduction of the interest income tax in Ukraine follows a proven international practice: interest income earned on deposits is taxed in many countries, although the tax rate and taxation procedure vary from country to country. Majority of countries adopt a dual income tax system, which combines a progressive tax on basic income and a flat tax on capital income (dividends, interest income on deposits, bonds and securities).

There are three possible types of collection procedure of tax on interest income:

1. Majority of European countries applies final withholding tax, with different tax rates (see Table 2). Under this scheme the taxpayer does not "see" withheld money – the tax is equivalent to the decrease in interest rate, which he gets on deposits. Withholding tax is the easiest procedure of tax collection, with low transaction costs for both, taxpayers and tax administration.
2. In Sweden, Denmark and the Netherlands the interest income is declared and taxed according to existing tax brackets as a component of personal income.
3. Germany, France and Spain use a prepayment system for the collection of tax on interest income. Tax from interest income is collected (withheld) as an advance deposit, or prepayment for income tax. The prepaid amount is then deducted from the overall tax

liability. In France and Spain tax rate on interest income earned on deposits is 25%, while in Germany it is 30%.

Table 2. Taxation of interest income in some EU countries and transition economies (final withholding tax)

Country (EU)	Tax rate, %	Country (Transition)	Tax rate, %
Austria	25	**Czech Republic**	15
Belgium	15	**Estonia**	0
Finland	28	**Hungary**	0
Greece	15	**Latvia**	0
Ireland	26	**Lithuania**	0
Italy	27	**Poland**	20
Portugal	20	**Russia**	0
United Kingdom	20	**Slovakia**	15
		Slovenia	0

Source: Oravec Peter, 2002. "Taxation of Interest Income in European Union Countries", *BIATEC*, Vol. X, 7/2002

Tax rates, which vary widely among the EU countries, have provided loopholes for wide-spread tax evasion. Countries with high tax rate suffer from capital flight to the countries where the tax rate is lower. According to some estimates Germany loses about EUR 7 bn annually due to capital flight. This problem is now addressed either by reporting the interest income of foreigners to their home tax authorities, or by withholding the tax on the interest income of foreigners at the source and sending it to their home country's government.

As the table shows, there are substantial differences in taxation of interest between EU and transition countries. In the former, interest income earned on deposits is heavily taxed, usually at the rate higher than 20%. In Eastern Europe only a few countries have introduced taxation of interest income. The main reason for tax exempting the interest income earned on deposits in transition countries is the negative effect of the interest tax on the growth of deposits and development of banking system. For example, in Hungary after tax reform in 1988 interest payments were taxed at the rate of 20%. In 1994, the Hungarian government reduced the rate to 10% to boost savings; and a year later it abolished this tax altogether.

It is worthwhile to note that those transition countries that introduced interest income tax have well-developed banking system compared to Ukraine and other transition countries that do not have such tax. As of the end 2000, deposit-to-GDP ratio in Czech Republic and Slovakia constituted 65% and 47% respectively, whereas, for example, in

Latvia and Lithuania these numbers were 20% and 17% respectively. Currently in Ukraine the ratio also reaches mere 17%[4].

Therefore, it is clear that interest income taxation is usually applied only in countries that have stable banking sector.

5. Policy recommendations and conclusion

Currently, Ukraine is in an early stage of building a strong and stable market economy to prepare for eventual European integration. This process requires both a stable banking sector and the harmonization of its tax system with European standards. Within this context, we have discussed various arguments in favor and against the taxation of interest income. Our conclusion from this discussion is that negative effects of such a tax far outweigh the potential benefits. In particular, we argue that the introduction of interest income taxation will negatively affect the willingness of people to deposit money in commercial bank accounts, reduce the amount of funds available for credit lending, and negatively affect future growth rates of the Ukrainian economy. Thus, we recommend postponing the proposed taxation of the interest income until the creation of stable and solid banking system in Ukraine.

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[4] According to the NBU data, by the end of 2002 Ukrainian banks attracted UAH 37 m of deposits. Since at the time of preparation of this paper the exact data on GDP for 2002 has not been yet available, we based our calculations on the latest estimate of the Ministry of the Economy. According to the estimate nominal GDP in 2002 reached UAH 214 m.