

Tax Administration for Russia

by

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Conference on Post-Election Strategy
Moscow, April 5-7, 2000

I. Introduction

It is now just over eight years since the establishment of the various institutional arrangements within the Russian Federation to facilitate government revenue collection, including the payroll/social taxes. When viewed against the year-to-year budget goals that were set, one must conclude that revenue collection performance has, with the exception of 1999, been extremely poor while the overall level of tax compliance remains low¹. Indications are that the overall costs of tax collection are high- the administration of these arrangements has consumed an enormous level of human resources² and imposed a significant compliance burden on the taxpaying community.

On the other hand, it must be acknowledged that the task of creating a well educated and highly compliant taxpaying population, supported by an efficient and responsive set of tax administration arrangements, all from virtually a zero base is an enormous undertaking that in the best of circumstances requires considerable resources and time to complete. In the difficult circumstances that have prevailed in the Russian Federation during much of the 1990's, the task has accordingly been that much greater.

With overall tax revenue (including payroll/ social taxes) across all levels of government amounting to almost 33 percent for 1999- see attachment, clearly some progress has been made. The immediate challenge must be to build quickly on this level of achievement, taking the many opportunities that exist to improve compliance with the laws and reduce the costs of administration, while easing the compliance burden of taxpayers. In this brief paper, we discuss the elements of a tax administration reform agenda (a number of which are starting to be addressed) to meet this challenge.

* The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy.

¹ Research efforts conducted by various technical assistance providers indicate that, in overall terms, aggregate taxpayer compliance is likely to be no more than 50 percent.

² The staffing of these agencies devoted to tax collection and enforcement well exceeded 250,000 in early 1998 (although the number of staff working exclusively on domestic tax collection in the Ministry of Taxation has been reduced by around 30,000 over the last two years.)

II. Legal Framework for Tax Administration

It is generally acknowledged that tax administration provisions should have the following characteristics, at a minimum, to be effective:

- A balance should exist between the rights of the taxpayer, whose rights are ensured by due process and fair treatment, and the tax administration, which should have powers sufficient to administer and enforce the tax law in an efficient and even-handed manner.
- A general framework for procedures, including audit, collection and organization, consistent with an emerging market-oriented tax system, should be part of the law.
- The law should be designed so that both the current economic situation and further economic transition can be accommodated.

The primary law governing the administration of tax collection in the Russian Federation is Part One of The Tax Code which came into effect on 1 January 1999³. Despite being an improvement on its predecessor legislation, Part One of the Tax Code (as amended) falls well short of meeting the requirements for effective administration. Particular areas of concern include:

- Taken in its entirety, the code has shifted the balance of rights heavily in the interests of taxpayers⁴.
- Audit and enforcement powers granted to the Ministry of Taxation are inadequate and not consistent with the needs of an emerging market economy or the principles of self-assessment;⁵
- Management and flexibility for tax authorities is significantly limited⁶; and

³ A significant number of amendments (largely technical in nature) were subsequently enacted during 1999. A number of these e.g. elimination of the ceiling on interest accrued on overdue taxes, were made in response to Fund program requirements.

⁴ Two examples- despite its supposed application of the self-assessment principle, the burden of proof in relation to the commission of offences is with tax authorities, not the taxpayer; and the code goes to excessive lengths to provide taxpayers with means to defer payment of tax liabilities, rather than limiting deferrals to cases of exceptional circumstances.

⁵ This includes, for example, restrictions on the duration, frequency and types of audits; limitations on the imposition of penalties for late payment, as well as on the timing and type of enforcement actions that can be carried out by the tax administration; and the lack of personal and/or criminal penalties for tax agents who do not transfer to the budget withheld taxes in a timely manner.

⁶ Examples include the specification of audit, collection and taxpayer registration procedures in the law.

- Its perpetuation of the status quo and failure to anticipate, promote, or accommodate further institutional, financial and banking reforms that are likely to take place as the economic transition continues.⁷

A particularly serious weakness is the lack of provisions enabling access to bank records for the purpose of gathering information needed to identify tax evasion and avoidance.

The generally poor climate of compliance and the obstacles presented to effective administration of the laws by the Code dictate the need for further legislative action to address such deficiencies.

III. Institutional Framework for Tax Collection

There are seven agencies responsible for government revenue collection and associated enforcement actions (i.e. the Ministry of Taxation, Tax Police, Customs Committee, and the Pension, Medical, Social and Employment Funds). By any measure, this is an excessive number of agencies which results in an inefficient and wasteful use of resources, co-ordination difficulties and excessive compliance costs for businesses that are required to deal with multiple agencies. While the establishment of these agencies may have served a useful purpose in the early years of Russia's move to a market-based economy, it now seems an appropriate time to carry out a major program of rationalization to simplify and improve the institutional framework for tax administration.

At the level of the Ministry of Taxation which is the government's main revenue collection agency, there is considerable fragmentation. There are over 2600 local inspectorates spread across Russia that are responsible for the collection of federal, regional and local taxes. With a tax inspectorate located in just about every local political unit across Russia, the existing organizational setup appears to largely reflect local tax considerations, notwithstanding that local taxes constitute a minute proportion of the overall taxes collected. The majority of these inspectorates are relatively small in size (i.e. less than 50 staff), serve a small client base and in all likelihood are not economically viable. A similarly fragmented structure exists for the Pension Fund.

The Ministry of Taxation has started to develop plans for the creation of ten large data processing centers that would consolidate basic information processing tasks presently carried out in local inspectorates. While this is a very positive initiative, it only increases the case for rationalizing the network of inspectorates.

An issue requiring special attention is the headquarters' administration and structure of the Ministry of Taxation. The capacity of any tax administration to respond quickly and effectively to tax compliance problems, to effect major enhancements in administrative systems and procedures and to mobilize resources to address major priorities is critically dependent upon the strength, organization and authority of its headquarters' operation.

⁷ One example of this is the continued reliance on settlement accounts. Further developments in commercial banking should have been anticipated, and with this the likely decrease in the importance of settlement accounts.

Technical assistance work throughout the 1990's has repeatedly emphasized the fact that the headquarters is poorly organized and there have simply not been enough resources and skilled officials to provide adequate direction and monitoring of the operations of the main revenue collection agency. Despite an aggregate staffing level of around 160,000 during 1999, headquarters' staffing was well under 1000. While some positive organizational changes have been made (e.g. the creation of a directorate to supervise large taxpayer operations), these fall well short of what is needed. The resourcing issue has yet to be addressed.

In parallel with the operation of a small and weak headquarters, regional and local tax administrations have been heavily reliant on subnational governments for financial support. This has led to the emergence in practice of a system of dual subordination- regional tax officials are accountable to both the federal center and subnational governments, often whose interests don't match and who, with the variable system of revenue sharing in place, are often competing for tax revenue from the same pool of taxes. This problem is compounded by a headquarters' administration that emphasizes the optimal collection of federal budget revenues, rather than the collection of all federal and regional taxes.

As Russia's tax system evolves and the arrangements for revenue sharing are rationalized, an issue to be considered is whether federal and regional interests might be better served by the creation of separate tax administrations for federal and regional/local taxes, as is the practice in many federations. A similar approach was adopted by the Chinese Government in the mid-1990's. For the immediate future, and recognizing that the vast bulk of tax revenue arises from federal taxes, it would seem appropriate for all financial support for the Ministry's operations to be provided from the Federal Budget.

An organization warranting special consideration in assessing the institutional framework is the Tax Police, which was established in 1993. With its creation, it assumed responsibilities in relation to tax fraud previously performed by the Tax Investigation Directorate of the then State Tax Service. Its purposes, as defined in the relevant legislation, include:

- the exposure, prevention and suppression of tax offences and infringements;
- the provision of security for officials of the Ministry of Taxation; and
- the prevention, exposure and suppression of corruption in tax bodies.

In practice, audit staff of the Ministry of Taxation are generally precluded from independently pursuing cases of tax fraud involving legal and illegal economic activities although they often work with Tax Police officials on such cases.

There have been a number of concerns expressed relating to the operations of the Tax Police. In brief, these relate to its overall poor performance, poor co-ordination and co-operation with the Ministry of Taxation and the use of excessively aggressive and over-bearing methods in situations where such action was not warranted. Given the apparent over-lapping of functions between both agencies as well as the lack of impact the existing arrangements appear to be having in curtailing tax evasion and avoidance practices, there

appears to be a strong case for re-assessing the role of the Tax Police, with a view to confining its charter to tax fraud associated with illegal economic activities and (possibly) the tax staff security functions, and shifting the balance of its responsibilities to the Ministry of Taxation.

Drawing on the experience of how the organization of tax administration arrangements has evolved in industrialized market economies, the following opportunities for rationalization could be considered in the context of a medium term reform plan:

- The Ministry of Taxation's network of inspectorates should be radically streamlined by a program of consolidation into larger and more economically viable units, based on the functional model observed in many national tax administrations. Similar action could be considered for the Pension Fund. Significant savings in operational costs could be achieved from such streamlining action.
- Tax fraud examinations (in respect of legal sector economic activities) undertaken by the Tax Police should be integrated into the Ministry of Taxation, thus enabling the Ministry to develop a more efficient, comprehensive and responsive program of measures to deal with taxpayers' non-compliance.
- The collection of payroll/social taxes, which ideally should be unified into a single tax, should be carried out by the Ministry of Taxation and integrated with the collection of personal income tax, given their similar tax base. This would significantly reduce collection costs, while easing the compliance burden on taxpayers.

IV. Revenue Collection Practices and Tax Arrears

One of the most obvious indicators of high non-compliance has been the growth in tax arrears. As of January 1, 2000, the value of unpaid taxes, at the consolidated level, stood at 378.2 billion rubles (equivalent to 8.4 percent of 1999 GDP)⁸, compared to around 55 billion rubles at January 1, 1996. A factor contributing to the growth of tax arrears over this period has been the practice of regularly granting tax offsets (using a variety of schemes) at both the federal and sub-national levels of government. By creating expectations that past offset schemes would be repeated, such action had a serious adverse impact on tax payment discipline. An additional concern was the fact that some schemes inappropriately benefited those involved through various forms of abuse. The clear lesson to be learnt from the such practices is that they have no role to play, whatsoever, in building an effective tax system.

For fiscal year 1999, offsets at the level of the federal budget were all but eliminated with over 90 percent of tax payments received in cash⁹. This is a laudable development.

⁸ An amount of 327 billion rubles, representing unpaid penalties and interest, was also outstanding as of January 1, 2000.

⁹ With the exception of a complementary period in early 1999 (whereby transactions were booked back to the 1998 fiscal year), tax offsets at the federal level were eliminated in 1999.

However, at the sub-national level offset arrangements were still used widely with over 30 percent of taxes received in non-cash form. The immediate challenge must be to eliminate offsets in any form.

Towards the end of 1999, it became apparent that the rate of growth of tax arrears had slowed appreciably. In addition to improved economic conditions and higher energy prices, two factors contributing to this outcome have been the tighter monitoring of the affairs of large taxpayers and decreased use of negotiated tax payment arrangements for some large taxpayers. These are positive developments for Russian tax administration and the authorities are encouraged to continue with the refinement of large taxpayer operations.

V. Modernizing the Administrative Processes for Collecting Taxes

Effective tax administration requires a tax authority to conduct a broad range of functions that comprise the basic elements of a tax collection system. These functions encompass registering taxpayers, informing taxpayers of their obligations, assisting taxpayers to meet their obligations, applying the tax law in individual cases, receiving and accounting for tax payments, checking the accuracy of declared liabilities, pursuing non-filers, collecting unpaid taxes, and maintaining taxpayer records. In more advanced countries, the operations and procedures for conducting much of this basic but essential work have been modernized during the 1980's and 1990's, with the wide deployment of modern information technology systems playing a very significant role in all of this. In the Russian context, there is enormous potential for re-engineering many of these basic processes and realizing the significant benefits this would bring, e.g.,

- Increased automation should be brought to all elements of the tax payment process (especially in the banking system) to both reduce the compliance burden on banks and taxpayers, and to reduce costs within the Ministry of Taxation.
- The practice of requiring taxpayers to personally attend tax offices to file returns and participate in their examination needs to be significantly curtailed, if not eliminated. Given the frequency of return filing requirements for business taxpayers, this practice imposes an enormous burden on taxpayers, is an inefficient use of staff resources and is inconsistent with the more selective risk-based approaches adopted in modern tax administrations to identify returns requiring examination.
- Given the high level of tax arrears, enforced collection procedures and the associated provisions of the Tax Code require major revision. In particular, the practice of routinely issuing collection orders to banks has to be seriously questioned, given that only around 5 percent of such actions lead to the collection of tax debts¹⁰. At the same time, there is a need to strengthen the Tax Code by incorporating provisions that

¹⁰ According to Ministry of Taxation reports, some 2.8 million collection orders were issued on banks in 1999 for some 331 billion rubles. Only around 5% of these led to the collection of revenue, which amounted to some 12.6 billion rubles of revenue. A similar outcome was achieved in 1998, when some 4.3 million collection orders were issued.

enable directors of companies to be held personally liable for specified debts of a company (e.g. taxes withheld at source) that are not paid following normal enforced collection action.

Drawing on the experience of tax administrations in industrialized market economies, a program of measures to improve tax payment compliance and reduce the incidence of tax arrears could include some/all of the following elements:

- ◆ improved taxpayer education and service measures that are designed to prevent debt situations arising;
- ◆ amendments to the Tax Code directed to limiting deferrals to exceptional situations and providing for directors' personal liability for certain tax debts of a legal entity;
- ◆ the adoption of more timely and systematic follow up actions where non-payment is detected (according to the level of debt and taxpayer risk), employing appropriate operational performance standards;
- ◆ greater emphasis on direct contact (i.e. by mail, phone and personal interview) with delinquent taxpayers by tax officials to ascertain taxpayers' capacity to pay and to enforce tax payment;
- ◆ the use of dedicated 'call center' type organizational arrangements using modern telephone and information technology equipment for large volume direct contact actions with taxpayers;
- ◆ arrangements for ensuring rigorous and systematic application of interest for late payment;
- ◆ selective garnisheeing of funds from taxpayers' bank accounts (rather than the routine issue of collection orders to banks for all outstanding debts);
- ◆ use of liquidation/bankruptcy proceedings in appropriate cases;
- ◆ elimination of offset schemes/ barter arrangements in the tax payment process;
- ◆ use of modern technology systems to support the overall debt collection process.

The Ministry of Taxation is now in the early stages of planning for a major program of modernization, that will include the building of a modern nationally integrated infrastructure and the provision of modern information technology tools and systems¹¹. The modernization program provides an opportunity to redesign many of the basic processes of tax administration. Given the critical importance of establishing a modern and effective tax administration, this project warrants the strongest level of support from government and central agencies.

¹¹ Through much of the 1990's, a lack of funds and an under-resourced headquarters operation have meant that regions have been left largely to their own devices to deploy information technology systems. As a result, a number of different systems and technologies have been deployed across Russia which, while serving the interests of regions and local inspectorates, have not assisted national management of the tax system .

VI. Administrative Issues in Specific Taxes

- **Value added tax (VAT):** Despite its role as Russia's principle tax, the VAT suffers from numerous shortcomings that compromise its effectiveness as a revenue-raising instrument and add to the costs of its administration:
 - ◆ **Registration threshold:** Lack of a threshold for legal entities (of which there are over 2.8 million in Russia) means that many small businesses are required to register and incur the compliance costs of administering the VAT. Most OECD countries (and many others) with a VAT have acted to reduce such costs by adopting a registration threshold (generally based on annual business turnover). The justification for such an approach is that small businesses taxpayers normally do not account for a significant amount of VAT revenue (indeed, in some countries, weak control of VAT credits from the smallest taxpayers has resulted in a loss of net VAT revenue) and because reducing the number of VAT payers facilitates the work of the tax administration.
 - ◆ **Accrual-basis of accounting:** One of the main outstanding issues in VAT administration is the issue of cash/accruals basis of accounting to determine VAT liabilities. Currently, taxpayers have a choice of using the cash method for determining VAT liabilities for both sales and purchases, or a hybrid method of using the cash method to determine VAT liabilities for purchases, and the accruals method for determining VAT liabilities for sales. Using the latter method, many of the benefits of the accruals method of determining VAT liabilities are lost, such as simplicity of accounting and the existence of a clear audit trail of VAT liabilities. The accrual method for determining VAT liabilities is used in the vast majority of countries with a VAT. The accruals method should be applied consistently to both sales and purchases. With a move from the cash to the accruals method, and the Ministry of Taxation will have to specify transitional arrangements for taxpayers to give effect to such a change—an issue which has been discussed in detail in several Fund technical assistance reports addressing this topic.

With the passage of relevant legislation, the credit method of VAT liability calculation should be fully implemented at the level of the retail sector to introduce a VAT that is in accordance with international standards. Strong sanctions for failure to issue VAT invoices or for issuing false invoices need to be introduced along with a program to ensure that taxpayers are complying with these provisions.

- ◆ **VAT refunds:** The arrangements in place for providing refunds of VAT, especially to importers, need to be strengthened to ensure that legitimate claims are processed expeditiously, while minimizing the compliance burden on taxpayers. At the same time, the arrangements need to be enhanced so that fraudulent refund claims can be more readily detected.

The Ministry of Taxation is endeavoring to improve the checks in place and a range of proposals have recently been considered to improve control of VAT refunds ranging from centralized approval over large refunds to revised arrangements for the payment of VAT by exporters. The Ministry should consider adopting a system of risk classification for VAT taxpayers claiming refunds, along the lines used in a number of countries, to improve its capacity to identify high and low-risk refund claims.

◆ **Destination principle for the VAT:** Use of the destination basis for taxation of all trade under the VAT (the international norm) should be the preferred direction for Russia. Consistent with this, efforts need to be made to address the following deficiencies in administration of the VAT:

- a relatively weak VAT refund control mechanism;
- limited self-assessment of VAT liabilities by taxpayers;
- inconsistent use of VAT invoices to document purchases and sales, and poorly designed VAT invoices (making it difficult, if not impossible to establish a paper trail to check compliance with the VAT);
- the widespread use of the cash method to determine VAT obligations, and the lack of invoices to document these transactions; and
- a somewhat improved, but still weak, compliance control, including in respect of filing and payment obligations, audit and collection enforcement. Moreover, institutional coordination and exchange of information between customs and domestic tax administration—a key consideration in implementing taxes on trade—is poor.

● **Personal income tax (PIT):** Of all the federal taxes, the PIT is the most under-developed. For fiscal year 1999, total PIT collections amounted to 2.6 percent of GDP, compared with 6.4 percent of GDP for all VAT collections and 4.9 percent of GDP for the Enterprise Profits Tax. Various estimates place the level of overall compliance for the PIT in the range of 30-50 percent. The key elements of a strategy for improving PIT compliance include:

◆ **Universal taxpayer registration-** all citizens liable to taxation should be registered with the Ministry of Taxation and issued a unique taxpayer identification number (TIN). Taxpayers should be required to supply their TIN to a payer, with sanctions for non-quotation, for specified income and other transactions, with accompanying payer reporting to the Ministry, to assist in the detection of non-reporting of income, where filing is required. To the extent possible, personal income taxes should be paid through final withholding at source.

◆ **Employer withholding-** appropriate sanctions¹² should be contained in the law and enforced for under-withholding of tax (including the social taxes) at

¹² Among others, these could include personal liability of directors for under-withholding and/or non-remittance of withheld taxes.

source. Audit programs should target key risk areas to generally improve employer non-compliance.

- ◆ **Income reporting and matching-** systematic matching of payer reports with taxpayer records to detect non-disclosure of income should form an integral element of the Ministry's compliance improvement activities.

VII. Human Resource Issues

While lacking many of the resources required to run an effective tax administration, human capital has not been one of them. One estimate places the number of staff involved in government revenue collection administration at over 250,000 in 1998 (and probably higher in earlier years). A relative lack of modern technology has contributed to this situation. However, putting aside that factor, revenue collection practices are nevertheless by comparison with more advanced countries considerably labor-intensive, which explains in part the very low salaries on offer to tax officials. Not surprisingly, and in line with experience in other transition and developing economies, this has fueled an environment for corrupt practices which have served to undermine respect for government and the institutions concerned.

There is no single measure that can be employed to significantly reduce the incidence of corrupt practices. A critical first step is that a tax authority should overtly commit to a clearly articulated objective to enhance standards of conduct. It should then devise a systematic strategy for achieving it. Better remuneration and education of tax officials, effective communication of related materials, improved work practices, an effective system of internal controls for detecting and deterring unethical behavior and the imposition of appropriate sanctions for detected cases are the likely main elements of a strategy for enhancing standards of conduct.

For the future, there must also be a concerted effort to significantly downsize agencies through investments in modern technology, organizational restructuring, better management practices, complimented by initiatives to significantly improve staff remuneration levels. A better remunerated body of tax officials offers the prospect of providing a more professional tax service (and the benefits resulting from this) and eliminating the incentive for corruption.

As part of this drive towards increased professionalism of tax officials, attention will need to be given to the development of a larger complement of specialist skilled staff for handling the more complex aspects of tax administration. Complex tax law issues, the ever-present and growing trends in tax planning and avoidance arrangements, the increasing globalization of business and the challenges presented by developments with E-commerce are some of the issues that must be confronted and dealt with.

Attachment 1

Russia: Enlarged Revenue Indicators (1999 fiscal year)

Revenue Type	Federal share	Local share	Total	% of GDP
Import Taxes:	122.5	0	122.5	2.7
- Import VAT	71.5		71.5	1.6
- Import Duties	47.5		47.5	1.0
- Import Excises	3.5		3.5	0.1
Export Taxes:	93.2	0	93.2	2.1
- Export Duties	38.8		38.8	0.9
- Natural Gas Excises	54.4		54.4	1.2
GDP- based Taxes:	111.3	270.1	381.4	8.5
- Profit and Income	100.8	236.0	336.8	7.6
- Resource Taxes	10.5	34.1	44.6	0.9
Domestic-based Taxes:	182.3	223.0	405.3	9.1
- Domestic VAT	149.5	65.9	215.4	4.8
- Domestic Excises	32.8	24.2	57.0	1.2
- Property	0	51.8	51.8	1.2
- Sales and Imputed Taxes	0	25.0	25.0	0.6
- Other Taxes	0	56.1	56.1	1.3
Sub- totals	509.3	493.1	1002.1	22.4
Budgetary Funds	55.2	42.0	97.2	2.1
Extra-budgetary funds	N.A.	N.A.	365.9	8.2
Sub- totals				10.3
Non- Tax Revenues	43.5	35.6	79.1	1.8
Grand Totals			1544.3	34.5

Source: IMF staff calculations.