

Tax Policy for Russia

by

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I. Overall issues in the tax system

- Structure of the tax system

One of the primary reasons for the failure to date of comprehensive tax reform in Russia is the relationship of the federal and sub-national governments, including the sharing of tax bases and the lack of formal local fiscal autonomy. In this struggle, additional taxes and higher rates have been generated, and the lower levels of government have been led to collude with both major and minor enterprises in keeping disproportionate shares of such taxes as are collected away from the federal government. **It is critically important to the success of fiscal reform in Russia that these relations be straightened out in such a manner as to reduce or eliminate both of these types of incentives.** Over the past two years, there has been some shift in the proportions of overall revenues going to local budgets versus the federal budget. This has slightly mitigated the relative revenue shortages at the federal level. It has largely resulted, however, from the introduction of export taxes to capture windfall gains in the petroleum sector and from exogenous changes in local tax bases, rather than from a considered rationalization of the system as a whole.

There are too many separate small taxes. The number of taxes in the present system calls for simplification to eliminate many nuisance taxes that are not productive in revenue terms, but which can lead to rent seeking and to inefficiency and corruption in administration. Table 1 demonstrates the complexity of the tax system as of July, 1999, including the list of applicable taxes, and the revenue assignment of each between the levels of government.

- Tax burden

Throughout the decade there have been chronic fiscal problems, particularly for the central government, partially as a result of the problems just described and partially for other reasons, including tax administration problems. While overall government revenues

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

are higher than in many countries with comparable levels of GDP per capita, this comparison does not provide an accurate picture, since historic and current expenditure needs and the structure of government versus the private sector have been quite different in Russia and other European and Central Asian transition economies. For example, the age structure of the population and the lack of non-governmental support mechanisms result in pension obligations in Russia, like the European transition countries, that are greatly in excess of those in some emerging market economies. In addition, wasteful and inefficient expenditures continue to increase the need for revenue.

Statutory tax rates are in fact not very high by world standards, other than in the case of wage taxes discussed below. Marginal effective rates are quite high, however, because of shared and incorrectly defined tax bases. Statutory rates at least in the short run generally therefore do not need to be lowered, but bases should be changed and taxes administered correctly. This would relieve excessive taxation of business. For example, if depreciation were rationalized, the corporate tax burden (and revenues) would decline substantially from that alone, keeping the current rate in place.

- The balance between direct and indirect taxes

The direct tax burden is somewhat disproportionately high, relative to indirect taxes. **It would be better to shift some of the burden on income, from payroll and business income taxes, to consumption through the VAT and excise taxes.** Turnover type taxes, however, should be avoided due to the distortions they introduce.

Personal income taxes combined with payroll/social taxes are still extremely high at the margin—approximately 80 percent. This combined marginal rate on personal income should be reduced (an exception to the general status of present statutory tax rates), in conjunction with a simplification of rates and broadening of the base. Social taxes should be consolidated into a single tax for purposes of efficiency and reduced overall. The social insurance fund should be supported at a much lower level than the current 5.4 percent payroll tax which is contributed to it. This fund includes spending which is not really providing a social safety net, rather including areas which should fall within the private sector or be financed individually, such as vacations.

- Approach to drafting the tax laws

The distinction between enacting a comprehensive **tax code**, versus making changes in the separate laws, is not the crucial distinction. After years of effort, the government's new tax code has not been enacted in full; nor, however, have the critical changes in tax policy been adopted on a piecemeal basis. The next several months do provide an opportunity in the context of the new government to finally achieve a comprehensive revision to the structure of tax policy in Russia, and full

advantage should be taken of this, in whatever form most effectively will produce this result. Ideally, this would entail reform of all laws, and the adoption of cohesive laws which exclusively provide the revenue structure for the country in a fully coherent manner. In carrying out this task, however, it is critical to keep in the forefront the adoption of certain priority measures in the major taxes, which will make the greatest difference in the functioning of the policy structure. These would include the following, in the taxation of individuals through the social taxes and personal income tax (PIT), the enterprise profits tax (EPT), and the value-added tax (VAT):

Personal taxes—elimination of exemptions and loopholes such as the definition of employee and the use of fringe benefits, loans, and the like; withholding for all income other than business income, with greatly reduced filing obligations; a single rate for most withholding; merger of the social taxes into a single fund (and possible further merger of the PIT and social taxes into a single structure).

EPT—most important, adoption of tax accounting that properly measures business profits; and adoption of a single rate equal to the top marginal rate for personal income; simplification of the administrative structure (e.g., definition of accounting period should be a full year).

VAT—elimination of the preferential rate; adoption of accrual accounting for the calculation of liability and credits for all but the smallest businesses; adoption of the destination method for all trade, including within the CIS.

These priority changes are discussed more fully in section II below.

Not all details can be included in the laws themselves. Inclusion of all rules and interpretations within the legislation has been a theme in attempting to implement comprehensive tax reform. Attempting to do this is more likely to provide opportunities for abuse and avoidance, and will inevitably result in incomplete coverage of some points and issues as they arise, as not every situation and nuance can be contemplated and resolved in advance. There should be scope for the drafting of regulations and interpretation by the government, elaborating upon aspects of the law.

II. Policy issues in specific taxes

- Generally

The overriding principles with respect to reform of the specific major taxes are to assign non-overlapping tax bases to each of them, and to properly define and measure those bases to avoid distortion and excessive and uneven levels of taxation. While some progress has been made in this regard since the general structure of the current tax system was put in place in 1991, this goal of comprehensive tax reform has not been completed. Indeed, in some instances, steps forward have been accompanied or followed by steps backward.

All taxes raise revenue, but each of the major taxes should play its own role:

- ◆ **The VAT** should serve as the major revenue source for Russia. It should be a general tax imposed with a single rate on as much domestic consumption as possible. The tax should not be used to influence the structures of production or consumption or affect the distribution of purchasing power.
- ◆ **Consumer excise taxes** should be imposed in addition to the VAT on the domestic consumption of a narrow list of products that have a low price elasticity of demand or the consumption of which the government wishes to discourage, for example for health or environmental reasons. The most important excisable goods in terms of revenue are tobacco products, alcoholic beverages, petroleum products, and automobiles.
- ◆ **The personal income tax** should be applied to a base as nearly equivalent as possible to personal consumption plus increases (or decreases) in personal net wealth, in order to introduce an element of progressivity into the tax system. This can be achieved even where the tax is kept to only one or two rates, by using a significant exemption or zero-bracket amount which will exclude the poorest citizens.
- ◆ **The enterprise profits tax** should be imposed on corporate profits, measured by taking into account all legitimate costs of producing revenue at the corporate level. At a minimum, the EPT serves the function of capturing income at the company level which, while ultimately inuring to the benefit of individuals, may escape the tax net at the level of the individual owners or stakeholders in the companies. In the current Russian situation, as is typical of the transition countries, it serves as the second major revenue source (with the VAT). This balance should shift, however, over time.
- ◆ **Import duties** serve the function of domestic protection, as well as providing a potentially effective revenue handle in the current state of tax administration. They should be kept relatively low, and should be the only tax used for protection.
- ◆ Russia continues to levy a variety of **royalties** on raw materials production, including on oil and gas, which are labeled as excise taxes. Such royalties, structured correctly, play the important role of compensating the state for the exploitation of its natural resources.
- ◆ **Export taxes** have been introduced on some raw materials, including oil and gas. While export taxes are distortionary, and in general therefore are undesirable, in this case the taxes serve as a means of compensating for weaknesses in domestic tax administration. These taxes should be viewed as temporary expedients. Until,

however, these tax administration weaknesses can be to some extent overcome, these taxes may have to remain in place to protect the integrity of the otherwise fragile fiscal system.

- Value-added Tax

- ◆ *Accounting method*^{3/4}At present, the taxpayer may choose when the liability for VAT on output arises—whether at the time of shipment or delivery of an invoice (the accrual basis) or only at time of payment (the cash basis). Credit for inputs is available only when payment is made for the inputs (the cash basis). As a result, the great majority of taxpayers are on the cash basis for both. In order for the tax base in each period to equal net consumption in that period, taxation of the seller and credit to the buyer of all intermediate goods or services must occur simultaneously. Either the accrual or the cash method could theoretically achieve that result (though adoption of the accrual basis for liabilities with the cash basis for credits would not). However, for administrative reasons the accrual basis is preferable. The fundamental underpinning of the credit invoice method VAT is the delivery of an invoice for each transaction, which provides proof of entitlement to input credit for the buyer. If liability arises not then but only upon payment for the goods or services all payments must also be tracked and, theoretically, tied to the proper transactions, in order to control the administration of the tax. **VAT accounting should be on the accrual basis for all transactions (other than those of the smallest taxpayers).**
- ◆ *Origin/destination taxation of trade*—The destination basis for taxation of trade under the VAT has been universally adopted as the international norm because it ensures that the tax base is **domestic consumption**. This avoids distorting competition between producers in different countries, and is also less likely to be subject to tax competition than origin based taxation. All countries in the world use the destination basis, other than the countries of the CIS in respect of internal trade among themselves. It has long been believed by the authorities that it is not possible to administer the destination based system for intra-CIS trade, because of the lack of proper border controls. However, this argument is overstated, in the sense that **proper** administration of an origin system also requires controls and identification of the value of traded goods, in order to determine the appropriate input credit attributable to the buyer of intermediate goods from abroad. Likewise, the value of exports must be determined to apply VAT liability, with no domestic record of purchase against which VAT liability could be checked. The primary difference in terms of administration between the two methods is in the fact that without the zero-rating of exports, the need for refunds in the VAT system is greatly reduced.

Regardless of that limited potential advantage of a pure origin based system, however, the present mixed system poses grave problems. It may cause distortion

of trade through schemes to take advantage of the discrepant treatment of internal and external trade. In some instances, it creates substantial fiscal hardships when revenues for value-added in intermediate products are collected from one country, but the intermediate good is further processed in another CIS country and then exported on the destination basis from the second country. At that point, the embodied VAT must be refunded by the second country. Finally, use of the mixed system greatly complicates tax administration, since it is necessary to determine whether exports are really sent outside the CIS or not; and whether imports have come from a country requiring taxation at the border.

Taking these factors into account, it is extremely important that all trade should be taxed on the destination basis. It is true that, on current estimates, shifting trade between Russia and the CIS countries to the destination basis would result in a shift of VAT revenues, on net, away from Russia. However, this revenue loss if necessary should be made up by other means, rather than by a continuation of the present system with all its flaws. For administrative purposes, it would be best in the long run to retain some border controls, in order to implement this by zero-rating exports. Even without border controls, however, it is possible to administer the destination basis (and again, it is not necessarily possible to administer the origin basis any better). It may even be that zero-rating would then remain the best option; however, there are other methods that could be considered.

- ◆ *Coverage and threshold*—**All businesses, including unincorporated entrepreneurs, should be VAT taxpayers.** There is no reason why the consumption of output should be taxed differently if produced in part by a legal person, as opposed to an entrepreneur. The nature of the consumption is not different and this creates distortions in the structure of economic activity. The only exception, which should apply to both legal persons and entrepreneurs, is that **there should be a threshold of turnover below which businesses need not register.** This is critical for administrative reasons.
- ◆ *Exemptions*—**Most exemptions should be eliminated.** They create distortions and inefficiencies and greatly complicate administration. Ideally, adoption of best world practice would mean that the only exemptions from the VAT base should include narrowly defined medical expenditures (e.g., payments for hospitals and medical services, not spas, cosmetic treatments, and the like), education, financial services, and possibly residential rentals and resales of existing housing. Any other exemptions should be based upon product type, not identity of the seller or, particularly, of the buyer.
- ◆ *Preferential rate*—**The VAT should have a single rate, for the same reasons.** As long as there is a preferential rate, the base of goods and services to which it

applies should be as narrow as possible. Preferences with respect to food, for example, serve to benefit the wealthier members of society far more than the poor, at high cost to government revenues. Greater efficiency in social transfers could be achieved by direct subsidies to the poor only.

- ◆ *Input credits*—All inputs to taxable production other than labor costs should be credited in accounting for VAT liability. Otherwise, net VAT liability will not fall upon a base equivalent to domestic consumption but may include elements of income taxation (if all capital inputs are not credited in a timely manner), or will be subject to cascading, where some intangible inputs such as advertising costs are subject to tax on their sale but not credited when used to produce other goods and services.
- ◆ *Refunds*—The Russian VAT suffers from a wide variety of fraud schemes relating to the claiming of refunds for excess input credits, frequently with respect to exports. Nonetheless, **it is critical to grant refunds at least to established exporters, while providing sufficient administrative controls.** Other excess credits should be carried forward to offset future VAT liabilities (not other taxes). Excess credits generated by capital purchases by foreign investors could be refunded if they remain after some period of time, and audits have been conducted. In theory all excess credits should be immediately refunded to all taxpayers. Under the present circumstances, with limited administrative capacity, the present recommendation represents a compromise. It is important to avoid the temptation to generate novel anti-fraud tax structures in this regard, which generally are not effective, and serve to greatly distort the tax base. It is far better to apply the same resources to the proper administration of major refunds, and to development of that capacity.

- Retail Sales Tax

- ◆ **The benefits of the regional retail sales tax should in the longer run be rethought, in the context of determining the appropriate assignment of tax bases to the levels of government.** The retail sales tax theoretically has the same base as the VAT, which is also a tax on final consumption if appropriately structured. It could well be preferable to assign a different tax(es) to sub-national levels of government. In 1999, the tax raised only 19 billion rubles, making its administration little worth the effort involved given the limited tax administration resources available while there is only a single federal tax administration. (It should be noted, however, that the tax was not in effect for the full year in all regions.) Retail sales taxes, contrary to popular perception, are not simple to administer, and can be distortionary as well. It is quite difficult, if not impossible, to identify what sales are truly “retail,” and which ones involve the sale of business inputs.

- Enterprise Profits Tax
 - ◆ *Depreciation*—**Economic depreciation on the basis of only a few pools of assets should be adopted.** Depreciation should fully account for the economic costs of the deterioration of capital assets, at a minimum. If additional incentives for investment are desired, somewhat accelerating depreciation is one of the better ways of accomplishing this, far less distortive and subject to abuse than other methods such as exemptions for certain taxpayers or types of production, or tax holidays. The pooled method, by which individual assets do not have to be tracked over their lives, is a simple method of implementing depreciation..
 - ◆ *Measurement of income*—**All legitimate business expenses, including such expenditures as advertising costs, should be deductible in calculating net taxable income. The sale price should not be limited based upon costs of production.** Transfer pricing rules should apply to transactions between related parties.
 - ◆ *Exemptions and incentives*—**Most existing exemptions and incentives should be eliminated,** reducing economic distortion, simplifying administration, and increasing revenues without increasing the tax rate. The goals of exemptions designed for social purposes (e.g., for enterprises employing the handicapped) can much more efficiently be achieved, with less opportunity for tax fraud, through expenditures targeted to the groups involved. Investment incentives can be more effectively provided through the use of economically appropriate depreciation, accelerated to the extent desired, the provision of loss carryforwards. This type of incentive does not discriminate among types or identity of businesses, and targets actual incremental investment and new companies, rather than benefiting businesses that are likely to be among the more successful without the use of incentives.
 - ◆ *Intercorporate dividends*—**should be exempt.** If they are taxed, the structure of company ownership will alter the total tax burden. The tax system should not influence structural or economic decisions, to the extent that can be avoided.
- Personal Income Tax
 - ◆ *Number of rates*—There should ideally be **not more than two positive rates** of personal income tax. There should be a single large personal exemption amount which would serve to remove a substantial proportion of the population from liability for the tax. This will provide progressivity, and keep administration of the tax simple. The top personal rate should be approximately equal to the enterprise profits tax rate, in order to avoid opportunities for tax avoidance through shifting of income and distortions of business and investment forms. Rate brackets should be automatically indexed for inflation.

- ◆ *Exemptions*—**Should be kept very simple**, with the basic personal exemption for the taxpayer and simple dependent allowances.
 - ◆ *Final withholding*—Personal income taxes should be paid through final withholding to the extent possible. Exceptions would be business income generated by entrepreneurs and investment income which has not been subject to Russian tax, such as substantial capital gains or foreign source income. **Wages, interest and dividend payments should all be subject to final withholding, and persons having only those sources of income should not file returns.** While this does not result in perfect taxation of global economic income, it greatly simplifies the tax, and thus should make it possible to better administer the much more problematic personal tax on entrepreneurs' income.
 - ◆ *Definition of employee*—There have been many schemes and tax avoidance plans involving the inappropriate classification of employees as contractors (entrepreneurs selling services, in effect) in order to avoid the imposition of withholding tax and payroll taxes by the employer. **It is very important to combat these frauds by appropriately defining the concept of wages and employment in the tax law, and for purposes of the tax law, not dependent upon other concepts of civil law and labor relations.** Tax purposes may be quite different from the rationales which may underlie these other sources of law.
 - ◆ *Taxation of fringe benefits*—Many schemes for tax avoidance have involved fraudulently defining wages as “loans,” and similar tactics. Such problems need to be combated in two ways. First, a general anti-avoidance rule should permit the tax authorities to recharacterize transactions that have been mis-characterized by the taxpayers for tax avoidance reasons. Second, true fringe benefits need to be taxed appropriately, that is, included in the employee's net taxable income at their true fair market value. Clear rules for computing the value of benefits must be established. **It will be easiest to accomplish this, in the context of final withholding on all cash wages, by imposing an equivalent “fringe benefits tax” on the employer on the value of the fringe benefits provided to the employees as a whole.**
- Excise Taxes
 - ◆ *Raw material taxes*—The computation of the excise tax on natural gas should—like that on crude oil—be **shifted to the accruals basis.**



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Summary of A...