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Russian Federation

NOTE ON **ELEMENTS OF TAX REFORM** prepared by Robert Conrad

Some necessary elements of Russian tax reform are contained here. Discussion is restricted to three taxes (value added tax (VAT), excise taxes, and enterprise profits tax). The document is in outline form and has been designed to facilitate discussion. Some objectives for reform are described first. A discussion of each tax follows. The format for each section is the same. The objectives for each tax are described followed by a list of necessary elements combined with a brief justification.

1. Objectives of tax reform

In a real sense, the Russian tax system needs to be reconstructed, not reformed. Tax concepts, accounting rules and procedures for taxation have not kept pace with the rapid transition to a market economy. The tax system is thus an unhealthy mix of modern market tax principles combined with outdated procedures which were designed to control physical production rather than monitor and enhance tax compliance. One example of this problem is the interrelationship between modern enterprise tax concepts and the soviet accounting system. Taxpayers are required to maintain standardized accounts, regardless of whether or

assumption in the rules for the prior regime was that it is impossible for producers to sell at less than cost regardless of changes in demand or cost structures. These rules, combined with restricted deductions such as advertising and interest expense, result in a tax base which does not reflect the value of the activity and generally results in overstatement of enterprise profits relative to modern accounting systems.

I note that this example is not unusual. Other examples include the use of the same invoicing system since the late 1920's, the use of the margin method for VAT for retail trade, restricted depreciation, monthly filing for enterprise profits tax (enacted in 1997), lack of valuation rules, excessive penalties, and the lack of formal arbitration procedures which are perceived to be even-handed. These factors combined to create a system which cannot be effectively administered. In fact, many of these procedures are not necessary in a market economy where emphasis is placed on value, not volume, and administration is designed to monitor, not control. The result is a mentality where it is assumed that taxpayers are cheats and steal from the state. In part, this is a self-fulfilling prophecy, because taxpayers cannot comply with all the complex rules, do not understand basic procedure, and are penalized severely for computational mistakes. It becomes cheaper not to comply by entering the informal sector, reducing investment, or attempting to influence the process by bribery. Revenues fall and the system becomes corrupt.

Overall tax reform is necessary in such an environment which incorporates several objectives.

- (1) Enterprise taxation should fall both relative to total collections and in absolute terms for those who comply. Investment should not be unnecessarily deterred and the inter-sectoral allocation of capital rationalized.
- (2) Revenue declines can be offset by an expanded VAT and excise tax system, in part. A broad-based consumption tax can be relatively easy to administer and provide the foundation for the revenue system.
- (3) Compliance should be encouraged by developing reasonable administrative rules, penalties, and dispute resolution procedures. Taxpayers should be confident that a rational response will be made to their concerns, that their interests are protected, and that they will be treated fairly by the tax administration. Voluntary compliance cannot be expected in the near term because there is little incentive for taxpayers to comply. Thus, enforcement should be rigorous, but fair. Taxpayer attitudes and compliance can increase by using both enhanced enforcement and enlightened administration.
- (4) Revenues should increase by using a number of tools. Tax bases should be expanded by eliminating exemptions, incentives, and distortionary practices. Compliance should be encouraged. The taxpaying population should be increased and procedures should be developed to encourage timely payments.

- (5) The personal income tax (not discussed here) should become an income elastic revenue source. That is, the share of personal income tax revenues should increase as economic growth returns while not inhibiting employment expansion.
- (6) Intergovernmental revenue allocations and tax assignments should be rationalized. The central government should maintain and collect truly national taxes (VAT, some excises, profits tax, and taxes on international trade). Decentralization of both other revenue sources and administration should be designed for other taxes and tax bases.
- (7) Clear, simple rules which can be administered should be developed. Perfection in tax policy and administration should not be sought. It is better to have simple, even if somewhat arbitrary rules, which are known by both the taxpayer and tax administrator, instead of complicated rules which are difficult to interpret and can create disputes. In addition, scarce, highly-skilled administrative resources are freed for collection and compliance instead of being forced to develop complex procedures.

Implicit in this description is the need for tax administration to provide the foundation for tax reform. Tax administration reform, both law and procedure, is necessary before these objectives can be obtained. Accordingly, simplicity is one significant impetus for the proposals described below.

2. VAT

Value added tax (VAT) is one symbol of modern tax systems. The VAT should be broad-based consumption tax from which significant revenues can be generated. The tax should not be a direct burden on enterprises because the base is domestic consumption, not enterprise activities. However, the base needs to be as broad as possible to achieve this objective because the neutrality of the tax depends on the ability for relative prices to remain unchanged after the tax is imposed. Consumption is more stable than income. Thus, the VAT is a relatively more stable revenue source if properly designed. Several changes should be made to the Russian VAT in order to enable the tax to perform these designed functions.

- (1) **Develop a single rate VAT.** Multiple rate systems are difficult to administer because expert resources are needed to determine commodity classifications and definitions which are often difficult to enforce. In addition, the income distributional justification for low rates on some commodities (food for instance) may not be the most efficient means to achieve particular distributional outcomes. Target subsidies and income transfers are cheaper and more effective than a multiple rate VAT where the benefits are afforded to everyone (both rich and poor).

- (2) **Move to accrual method combined with invoices at all stages of value added (including retail).** A modern VAT is an accounts based tax where compliance is enhanced by introducing accrual accounting. Both tax receipt and **tax credits** will be

accelerated by this shift. Administration is simplified because administrators and taxpayers do not have to keep two records, one for the supply of goods and services, and one for the payment.

- (3) **Recognized small traders with an exemption level based on turnover while including all taxpayer classifications in the system.** The definition of small should be defined with respect to an objective economic criteria such as turnover instead of how the business activity is organized (enterprise or entrepreneur).
- (4) **Develop a system for timely refunds for excess credits, exports in particular.**
Compliance cannot be expected until the government complies with the law by providing prompt refunds, in cash, to those who qualify.
- (5) **Expand the items for which credits are allowed.** Input credits are restricted for capital goods and are denied for legitimate business purchases, such as advertising.
The tax will cascade and contain an element of capital taxation, reducing investment, unless legitimate expenses are allowed immediate credits.
- (6) **Limit exemptions.** Exemptions should be limited because the VAT should be a tax on all domestic consumption. The base is constricted and opportunities for abuse are created by excessive exemptions.

- (7) **Move to a destination basis for all trade.** All major VAT systems, even those in the European Union, are based on the destination principal. Russia's current mixed system is difficult to administer and limit the ability of the tax administration to develop a unified policy.

3. **Excise taxation**

Selective excise taxes are good taxes for financing the transition to a market economy. Administrative emphasis is based on physical control and the number of commodities is limited. Revenues can be stable because demand is inelastic. Administrators do not need to know accounting and enforcement can be straight forward. Some of the policy changes needed for the Russian excise system are noted here.

- (1) **Develop national licensing requirements for domestic alcohol producers.** This is not an excise issue per se but affects administration. Developing a comprehensive taxpayer identification system is not possible without national licensing of domestic producers.
- (2) **Move to complete accrual accounting.** Ad valorem excises should accrue at the same time as the accrual-based VAT. Per unit excises should accrue at the time of production, which for practical purposes may be the time at which VAT accrues(?) Common accrual rules will enhance uniformity and simplify the system.

- (3) **Restrict the number of taxable commodities.** Most revenues accrue from excise taxation on tobacco products, petroleum products, and alcoholic beverages. Expanding the list of excisable goods beyond this short list is generally not worth the administrative cost.
- (4) **Ensure that excises are not used for domestic protection.** Effective excise rates should be the same for domestic production and import competitors. Protection, if desired, should be provided by tariffs.
- (5) **Per unit excises should be automatically adjusted for inflation, at least.** Simple procedures to adjust per unit excises for changes in the price level are essential. Real tax revenues will fall without adjustments for changes in inflation. In addition, tax-induced relative prices are changed, creating incentives to substitute within commodity groups (expensive cigarettes to cheap cigarettes, for instance).
- (6) **Border control systems should be enhanced to establish compliance.** Smuggling is a significant problem and will continue to exist without active enforcement.
- (7) **Interest rates to international levels to the extent possible.** Revenue can be generated in a relatively efficient manner from excise taxes. Thus, rates can be increased to levels consistent with compliance costs and increasing net revenues.

4. Enterprise taxation

Enterprise profits taxation was the largest share of tax revenues in Russia when the transition began. This share has fallen with privatization and with the decline in enterprise profits, and this share should fall further as the transition continues. Enterprise taxation is only part of a complicated series of taxes imposed on the income from corporations. Taxation of dividends, interest, and capital gains, as well as property taxation are other elements of the taxation of invested capital.

Reform of enterprise taxation is essential if investment is to increase and stabilization continues. However, tax concepts and application are complex and rules can be quite detailed. We propose a two-pronged approach to enterprise taxation. First, smaller enterprises, corporate or not, should be taxed under a small business tax collected exclusively by the local level. This tax will help local entrepreneurs and local officials to identify common interest. Hopefully, local officials will be encouraged to promote growth of small business (because the tax base will be bigger). The tax will also be simple and compliance should increase. Larger enterprises should be taxed under a refined set of accounting standards which more accurately reflect profits. Everyone should expect enterprise profits taxes to fall for those who fully comply relative to the existing system. Thus, some education will be needed to show that enterprises are not **getting tax breaks or tax incentives**. Rather, appropriate balance between the corporate tax and other revenue sources is to be restored by enterprises being taxed on profits more related to the true value of their economic activity.

- (1) **Implement complete accrual accounting.** Accrual accounting is necessary to accurately reflect business income, both within and between industries.
- (2) **Ensure rational deductibility of business expenses.** Expenses such as interest, advertising, and related expenses should be deducted as accrued. Limitations should be liberalized if needed to prevent abuse.
- (3) **Implement simplified depreciation similar to the rules described in Decree 685.** Depreciation should be liberalized and simplified. Four asset pools and declining balance depreciation, except for structures, is proposed in Decree 685. Also depreciation rates are higher relative to current rates. Note that faster depreciation and liberalized rules are not a tax incentive under current circumstances. Current depreciation rates are too low.
- (4) **Eliminate all incentives.** For instance, the current investment credit, limited to 50 percent of profit, should be eliminated.
- (5) **Liberalize loss carry forwards.** A deduction of only 20 percent per annum is allowed under current law. Complete deduction should be allowed.
- (6) **Coordinate the enterprise tax rate with other tax rates.** The rate should be determined in the relation to revenue needs and other tax rates, the personal income

tax rate in particular. It will be important to coordinate tax rates to prevent tax arbitrage while generating sufficient revenue.

- (7) **Clarify accounting, source, and valuation rates.** Transfer pricing rules need to be established and valuation method determined in order to measure income and to reduce abuse. Rules should be simple, if arbitrary, for some time period in order to reduce disputes and to facilitate administration.

- (8) **Chance reporting and administrative procedures.** The profits tax should be an annual tax. It is effectively a quarterly, or even a monthly, tax under current law. This is because of the manner in which reporting and estimated payments are made. There is no gain in either revenues or control under the current system. A more rational system of estimated payments should be developed relative to annual income measures. Reporting will be less burdensome and more accurate.

5. **Summary**

Such an outline can be constructed for other taxes. These taxes include tariffs, property taxes, various withholding taxes, personal income tax, and local sales taxes. However, the three taxes described here should form the basis for near-term reforms and revenues. I emphasize again the need for administrative reform. Collection procedures, audits, and taxpayer service are similar for many taxes and much can be gained by creating unified procedures. There can

be no expectation for either reform and increased revenues without significant administrative change.