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Challenges to Reforming Russia's Tax System

Abstract

Tax revenues constitute the main source of public sector funding for most countries. Russia's complex and ineffective tax system has hindered its economy and led to significant decrease in tax revenues. The new Tax Code approved in summer 1997 in the first reading of the Russian Duma was designed to remedy many of the problems with the current tax system. Its main objectives were to ensure simplification of the tax system, restoration of tax discipline, stimulation of production and protection of adequate tax revenues. Subsequently, there has been much discussion as to whether these objectives can be achieved by the proposed Tax Code draft, and thousands of amendments have been proposed. The discussion has centered around income and enterprise taxation, i.e areas where Russian practice differs considerably from other countries. Traditionally, income taxation in Russia has been a minor contributor to state revenues, while enterprise taxation has been a considerable contributor. According to the hypothetical calculations of the Tax Code Tax draft, federal and regional tax revenues as a share of GDP will decline, while revenues from extrabudgetary funds will increase. The aggregate tax burden should decrease from approximately 35.1% to 32.4% of GDP. These estimates are based on the assumption that GDP starts to grow and tax discipline is better enforced. This is the core of the tax reform and a key element in the success of Russia's economic reform as a whole.

Key words: Russia, taxation

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1 Introduction[1]

Tax revenues constitute the main source of public sector funding for most countries. As a rule, the share of tax revenues to GDP tends to increase with per capita income. During 1986–1992, for example, the GDP share of tax revenues was highest in OECD countries, averaging around 30 %. The corresponding figure for Russia[2] was approximately 27 % in 1992, falling to 21 % in 1996.[3]

Since the advent of economic reform, which started in earnest in 1992, tax collection has been constrained by uncertainty over political demands for greater independence at a regional level as well as a significant growth in tax avoidance. This has hindered the economy and forced reappraisal of Russia's ineffective tax system, especially the complexity of fiscal relations among various levels of government.

[1] This article deals with the Tax Code draft passed to the state Duma in April 1997.

[2] IMF (1995), Tax Policy Handbook , pages 279 and 317.

[3] Sinelnikov–Murylev (1995) claims that during the communist era, socialist countries' tax revenues averaged 45–50 % of GDP.

For economic reform to succeed, the state must be able to generate a constant and adequate revenue stream. This need has been addressed in Russia's new proposed Tax Code submitted to the Russian Duma at the beginning of February 1996. The new code is intended to replace much of the present mass of redundant and even contradictory tax laws. In its original form, the code was designed to shift the emphasis of taxation, reduce the overall number of taxes and clearly define tax responsibilities at various levels of government. However, since June 1997, when the Duma approved the first reading of the draft, around 1,500 amendments have already been proposed.

The purpose of this paper is to provide an overview of the present taxation system and possible changes arising from adoption of the new Tax Code. First, the Russian tax system is described with emphasis given to the relative importance of individual taxes as a source of state revenue. The question of fiscal federalism and the underlying causes of the budget crisis of 1996 are briefly discussed. Attention next focuses on the Tax Code draft and the subsequent proposals on taxation reform. A summary, with conclusions, is given in the final chapter.

2 The Present Tax System

2.1 Introduction

For the most part, the present Russian tax system was created in 1992 and represented an attempt, at least, to apply principles found in the EU's leading economies. The objective was to revise taxation principles applicable in a command economy to those that supported production; that is, to promote equality among economic agents, while discouraging economic activities that worked against the interests of Russian society. Fiscal federalism became the issue of the day. Unfortunately, even though the theme of tax reform made a good starting point for launching the transformation of the socialist economy, it very quickly became evident that the tax laws being implemented were quite inadequate in many aspect. In particular, the lack of a coherent legal structure to deal with major matters such as privatization and foreign investment were quite apparent. Thus, the tax reform of 1992 was to a great extent obsolete from the moment of its introduction.

Arguably the most dominant features of Russia's present tax system are its complexity (approximately 150–200 different taxes and about 900 different stipulations on taxation in Russia) and its inconsistency. In theory, tax rules reside somewhere inside this jungle of laws, presidential and governmental decrees, local decisions and instructions from the Ministry of Finance. But then again, an amendment to the legislative norm at the end of 1993 also permitted power organs of the Russian Federation and localities to levy additional taxes beyond those applicable under Russian tax legislation, and thereby increased the number of taxes and reduced consolidated budget revenues. This amendment has been ruthlessly exploited as a means to minimize budget deficits at the regional and local level. In Kurskaya oblast, for example, more than 20 new taxes were introduced.[4]

The myriad of tax stipulations are richly contradictory, which makes them almost impossible to implement. Adding to the confusion, many regulations are changed quarterly. As the authorities themselves are at a loss know what laws they should be enforcing, tax avoidance has become the norm.[5] According to both Russian and foreign businessmen, the instability and discrepancies within the Russian tax system are among the most important problems hindering their activities.

There are clear differences in the share of direct and indirect taxes levied by countries.[6] For

[4] Kommersant-Daily, 15 Mar 1996.

[5] Eg. Russian accounting standards differ significantly from those normally used in the West, because Russian accounts are designed above all to satisfy the requirements of the tax authorities. Russian enterprises can choose whether to show revenues and spending on a cash or accrual basis. Definitions of profit and assets differ significantly from those in the West, and converting Russian accounts to international standards may turn a profit into a loss.

[6] Direct taxation is defined as taxation on the income and resources of individuals or organizations. In general, direct taxation (income tax, corporation tax, capital transfer tax, national insurance contributions) is levied on wealth or income and is in contrast to indirect taxation (VAT, excise duties, betting duties, vehicle

example, America's tax principles clearly favour direct taxes. In 1993, over 90 % of all tax revenues were generated from direct taxes and only about 10 % from indirect ones. This is explained by the heavy emphasis placed on individual taxation as the main source of state revenue and the non-existence of VAT. In Soviet Russia, by contrast, the importance of direct taxes has traditionally been less than indirect taxes because the state was in a position to be able to directly determine the level of personal incomes and, thus, the direct taxation of individuals had virtually no significance for income distribution. Indirect taxation was used to redistribute the country's financial resources and to support the prevailing price system.[7] By 1995, the share of direct and indirect taxes was roughly equal; however, since then the role of indirect taxes has been strengthening.[8]

During 1996, the main revenue bases of the *consolidated budget*, which combines the budgets of the different regional levels of Russia, were value-added tax (VAT), corporate profit tax and personal income tax. Together these accounted for approximately 54 % of all budget revenues. Meanwhile, the taxes contributing most to the *federal budget* consisted of VAT, excise tax, taxes on foreign economic activity and federal corporate profit tax. The main sources of tax revenue for *regional* governments were regional corporate profit tax (paid as part of federal taxes) and corporate property tax. Finally, *local* governments accrued tax revenues mainly from land tax and personal property tax.[9] The total amount of local level subsidiation accounted for 10 % of GDP in 1993 and 12 % of GDP in 1994.

The *enlarged budget*, which consists of all central and local budgets, together with extrabudgetary funds[10] had in 1996 a deficit of 8.3 % of GDP (according to IMF definitions, 5.8 % of GDP in 1995).[11]

2.2 Intergovernmental fiscal relations

While officially federal in structure, the Soviet fiscal system was essentially centralized and aimed at meeting central plan targets. The revenue and expenditure guidelines at each level of government were determined at the next higher level.[12] In practice, these guidelines were not strictly followed, so any deficits were automatically financed by budget transfers in the form of official loans or gifts from the next highest level of government. Likewise, surpluses were either transferred upwards or moved forward to the following year. The local and regional governments received tax and non-tax revenue from the Union budget. This *tax sharing* system – in effect a bargaining process between the different levels of the Union – was partly destroyed as soon as the republics gained more independence and ceased to forward all the required tax revenue to Moscow.

The Law on Basic Principles of Taxation, which came into effect at the beginning of 1992, attempted to readjust the centralized system away from "tax sharing" towards "*tax assignment*". In other words, the responsibility of the federal government became one of defining tax bases and applicable rates, while individual taxes came under the various levels of government. While these new stipulations were claimed to increase the power of regional government; in reality, the old tax sharing principles continue to be applied. During the period 1992–1993, many oblast administrations took it upon themselves to

licence duties, stamp duty), which is levied on expenditure. The categorization of direct and indirect taxation is not always precise.(The Penguin Dictionary of Economics, 1988).

[7] Alekshashenko (1993), p. 187.

[8] Nikitin,... (1996).

[9] Apart from taxes, localities receive revenues directly from the central government. A significant part of these *federal subsidies* to localities is given to local enterprises through the Fund for Regional Support, which is funded from consolidated VAT revenues.

[10] The main extrabudgetary funds are the Pension Fund, Social Security Fund, Medical Insurance Fund and the Employment Fund.

[11] Russian Economic Trends, vol. 5(2), 1996 and 2/97.

[12] Russia consists of 89 administrative areas, which include 49 provinces *(oblast)*, 21 *republics (respublika)*, 1 *autonomous province (avtonomnaya oblast)* and 10 autonomous districts *(avtonomny okrug)*, 6 administrative areas *(kraï)* and the cities of Moscow and St. Petersburg.

determine what proportion of taxes should be shared with the center. Some paid a pre-determined lump sum and some decided to contribute nothing at all to the central budget. In addition, the unequal treatment of local and regional structures intensified tensions with the center.[13]

Despite the existence of these clearly defined laws, ad hoc arrangements are still common between many regions and the center. The - amounts transferred by regions to the federal budget differ substantially. Most federal revenue comes from just 10 donor regions[14], the most important of which is Moscow City, which contributes around 25 % of the federal budget. During 1996, the center transferred to the regions a total of 46.3 trillion roubles (2.1 % of GDP), a somewhat low figure by comparison to some Western economies: for example, the comparable figure for Canada corresponds to 8 % of GDP.[15]

2.3 Taxes as a source of budget revenue

The most visible changes introduced by the 1992 tax reform were the elimination of differentiated sales tax and the introduction of Value Added Tax and excises. In 1992, VAT revenues accounted for over one-third of consolidated budget revenues and one-half of federal budget revenues. Nonetheless, the collection of taxation from the growing number of private enterprises and their owners remained highly problematic. As a result, the bulk of revenues continued to come from the state enterprises or privatized state enterprises, whose budget contributions declined steadily as the arrears on VAT and profit tax increased. Further, the share of VAT revenues fell in 1993 because of the decrease in the tax rate (from 28 % to 20 %, and even 10 % for certain items). The result, combined with a general increase in funding to regional and local budgets, was a sharp fall in federal budget revenues.[16]

The state budget revenues have fallen sharply since 1994, largely due to the decline in *profit tax* revenues, which have decreased from about 28 % of the consolidated budget revenues (8 % of GDP) in 1994 to a mere 18 % (4 % of GDP) in 1996. This decline may be explained by a GDP contraction, an increasing tendency for enterprises to hide profits from taxation authorities and a plethora of new tax exemptions and deductions. Despite an increase in the maximum profit-tax rate from 32 % to 38 % at the beginning of 1994,[17] profit-tax revenues have continued to decline due to increased amortization charges and deduction limits for wages as well as worsening profit tax arrears (amounting to 1.1 % of GDP at the end of 1995).[18]

The dominant role of profit tax is largely a legacy of the command economy, where it effectively served as a tax on the gross income of enterprises. This legacy can be seen today as a broadly defined tax base with minimal deduction possibilities. Although the tax on excess wages was abolished in the beginning of 1996, such normal business expenses as advertising and other promotional activities as well as certain insurance payments are still not considered deductible. The fact that the methodology of defining profit does not properly take into account the level of prices has meant that the tax on profits has risen noticeably during periods of high inflation.[19]

While the importance of profit tax as a source of budgetary income has been steadily declining, the share of *VAT* in the consolidated budget has increased from 21 % in 1994 to 25 % in 1996, or as a share of GDP from 6.1 % to 6.4 %. This occurred in spite of an apparent erosion of the VAT base (as a share of GDP) due to real exchange rate appreciation, concerning the VAT on imports, and numerous exemptions for special importer groups (e.g. joint ventures, technology inputs). An obvious loophole exploited by so cal-

[13] Sutela (1994), 153–163.

[14] In fall 1997 the methods of defining the net receivers from budget were changed so that in 1998 16 regional units will be considered as donors.

[15] Russian Economic Trends 2/97.

[16] Dmitriev, Mikhail (1996b), pp. 5–6.

[17] In 1995, the profit-tax rate was reduced to 35 %.

[18] Kuboniwa, Masaaki (1996), p. 113.

[19] Dmitriev, Mikhail (1996b), pp. 7–8.

Table 1 **Income tax scales (before and after January 1, 1996)**

Prior to January 1, 1996 The present scale

Income received in calendar year	**Tax**	**Income received in calendar year**	**Tax**
under 10 million roubles	12 %	under 12 million roubles	12 %
10–50 million roubles	1.2 million roubles + 20 % of everything over 50 million roubles	12– 24 million roubles	1.44 million roubles + 20 % of everything over 12 million roubles
over 50 million roubles	9.2 million roubles + 30 % of everything over 50 million roubles	24–36 million roubles	3.84 million roubles + 25 % of everything over 24 million roubles
		36–48 million roubles	6.84 million roubles + 30 % of everything over 36 million roubles
		over 48 million roubles	10.44 million roubles + 35 % of everything over 48 million roubles

led "shuttle traders", who paid no VAT on their imports, was closed in July 1996.

The present VAT payment system has been instrumental in causing increasing arrears in debiting the proceeds to the budget. Whereas VAT must be paid by the seller at the time of receiving payment, the buyer has the right to claim a refund on any VAT included in the invoices for the inputs purchased from his suppliers from the moment he receives the product. Sellers are loathe to finance the government at their own expense, so when buyers pay slowly, the required VAT payments are simply not forthcoming.

Since the beginning of the economic reforms in 1992, the share of *personal income tax* has remained at around 2 to 3 % of GDP. This is low by international standards and largely due to the fact that income tax is merely a tax on wages, which in Russia accounts for a mere 40 % of total personal incomes. Other sources of income, such as income on property and entrepreneurial activity as well as non-cash income, have tended to avoid the tax net. A new tax scale was established in 1996 which increased the tax burden for people with middle incomes of 27.5–55 million roubles (4,700–9,500 dollars) annually. The burden of income tax thus falls heaviest on those in the middle-income bracket, who take their incomes mainly as money.

The share of *excise tax* as a percentage of GDP has been steadily increasing since 1994, reaching 2.4 % (9.7 % of the consolidated budget revenues) in 1996. Meanwhile, revenues from *foreign economic activity* have remained reasonably steady at around 2 % of GDP. However, driven by hopes of Russia entering the WTO and future agreements with the IMF, this revenue source is expected to decline in importance in the near future.

Social security contributions are collected in extrabudgetary funds. The share of *extrabudgetary funds* in 1992–1994 was approximately 9.7 % of GDP. In 1996, they accounted for 7.5 % of GDP (7.6 % of GDP in 1995)[20]. During 1996, there was a noticeable increase in the amount of arrears to the extrabudgetary funds, especially to the Pension Fund. Despite the fact that the federal government

[20] The figures are calculated according to IMF definition, which does not count credits as revenues. (Russian Economic Trends, vol. 5(2), 1996 and 3/97)

Figure 1a **Consolidated Budget Revenues (percentage of GDP)**

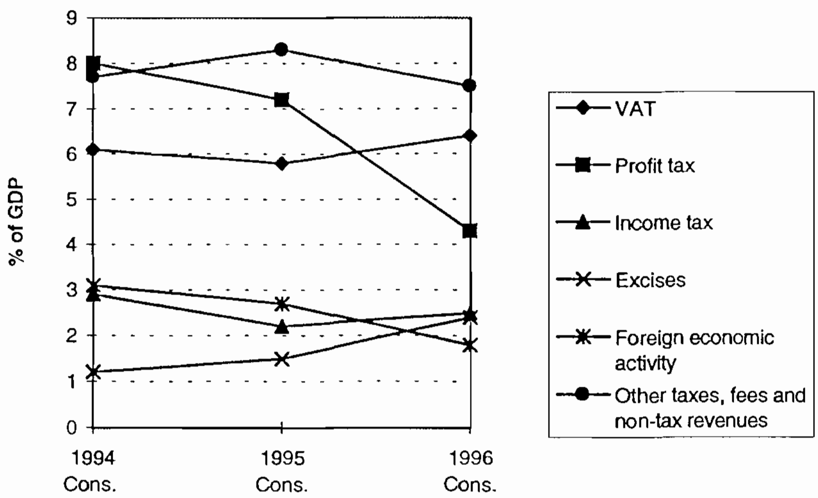


Figure 1b **Consolidated Budget Revenues (percentage of all revenues)**

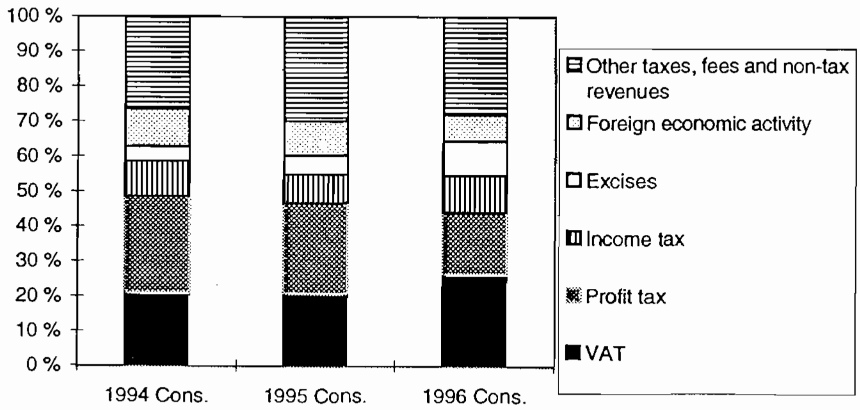


Figure 2a **Federal Budget Revenues (percentage of GDP)**

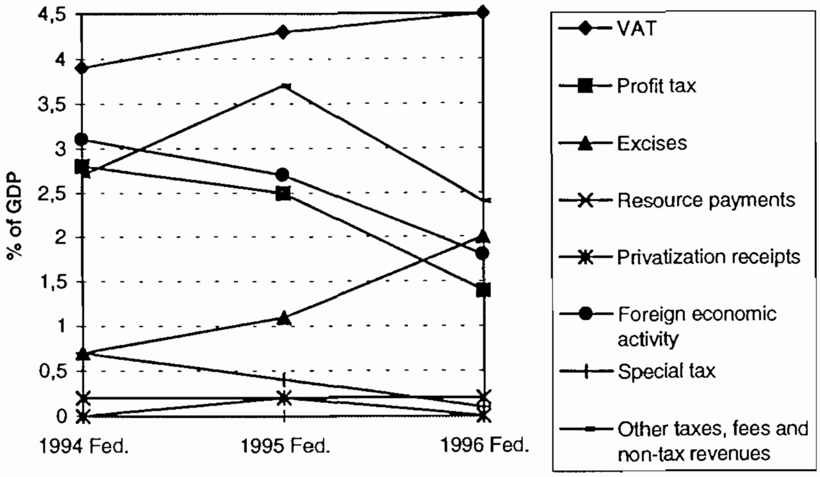
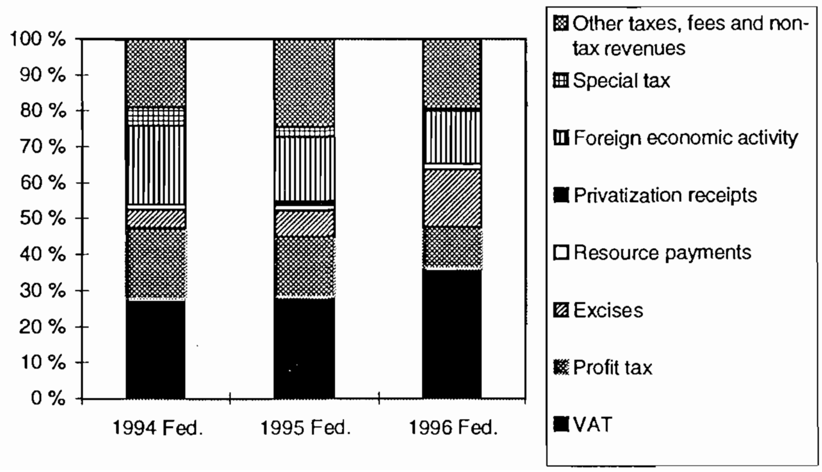


Figure 2b **Federal Budget Revenues (percentage of all revenues)**



paid off all arrears to the Pension fund in summer 1997, payroll tax arrears to extrabudgetary funds seemed to be rising more quickly than other tax arrears.[21]

2.4 Lax tax discipline

During the Soviet era, there were no serious problems collecting taxes as all enterprises and the banking system belonged to the state. Everything functioned according to a central plan. Payments to the budget were handled "automatically" according to the schedule. Following the emergence of non-state enterprises after the beginning of 1988, Russia's traditionally high tax discipline was eroded and tax evasion became common. The rapid increase in the number of "privatized" enterprises was associated with increasing reciprocal indebtedness, exacerbated by high levels of inflation.[22]

Tax evasion has become rampant in Russia, especially among smaller enterprises, and is undertaken through a growing number of methods. These include under-invoicing of exports, over-invoicing of imports, extensive use of transfer pricing in order to transfer profits to foreign subsidiaries and under-reporting of profits. Arguably, however, the most widespread tax evasion method is the Russian-style slush fund, the so-called *"obnalichivanie"*, which according to Sinelnikov-Murylev means *"using cash money obtained from companies specializing in the conversion of clients' resources to cash to pay wages and to finance certain other operations. The latter convert resources to cash under fictitious agreements to render certain services or to deliver goods and are frequently registered to men of straw based on counterfeit documents and so forth."* The same author states that these functions, related to converting resources to cash, are found primarily in either the services, trade or banking sectors. It is well known that in the banking sector *"obnalichivanie"* is used to pay wages to personnel by giving them loans with no or little interest. The income from these deposits are tax free.

The Russian system of accumulating budget revenues also suffers from extensive use of *tax relief and exemptions*, the exact amount of which it is difficult to estimate. The main tax exemptions are on export duties, energy consumption and profits. In an attempt to bolster tax revenues, the government has announced that it intends to cancel all tax exemptions, which has not fully been implemented in practice. A number of draft laws have subsequently been published, canceling the tax exemption status of e.g. libraries, educational organizations, small enterprises and invalids. Although the cancellation of taxes from these organizations may not – if used properly – have a wide economic impact, it serves as a starting point.[23]

The use of non-cash formats in paying taxes has been increasing since 1994. This has been encouraged by the government, which has developed various schemes to assist with this means of payment. The main forms of non-cash revenue include the redemption of government securities against the settlement of tax payments or the settling of federal payments or tax arrears against equal enterprise arrears to the budget. In St. Petersburg, for example, a decree "on settlement of tax arrears to the city budget in the form of products or services" was approved in August 1997.[24]

Political factors and the decline in tax revenues help bring about a severe budget crisis in 1996. Prior to the presidential elections in June, the trend had been one of increasing expenditures, and combined with declining tax revenues, a

[21] Enterprises pay 28 % of the wage sum to the Pension Fund and employees pay 1 % of their wages. The enterprise is responsible for transferring these shares to the Pension Fund.

[22] The underlying concept behind privatization has been subject to much debate in Russia, where enterprises have in practice been transferred to their previous workers and directors, who often neither have the funds nor the willingness to invest in the reconstruction and development of the enterprises. This has led to a situation, whereby the enterprise continues to function as in the "good old days", still largely dependent upon state subsidies and tax exemptions.

[23] Ekonomika i Zhizn 42/96.

[24] Kommersant Daily 15.8.97.

worsening of the deficit.[25] According to the Russian Tax Service, a mere 17 % of all taxpayers paid their taxes properly in 1996 (individuals described ironically as *living* taxpayers). The remaining 83 % can be divided into two groups: 50 % paid taxes occasionally, but not in full (*sick* taxpayers), and 34 % paid no taxes at all (*dead* taxpayers).[26] As a consequence, in the first half of 1996, Russia managed to collect only about 60 % of planned revenues. After the re-election of Boris Yeltsin, tax revenues increased slightly. By October, revenues were running at 74 % of plan. The improvement in performance was not enough for the IMF, which withheld the July, August and November tranches of a US$ 10.2 billion EFF credit due to its dissatisfaction with revenue performance. The 1996 revenue target was achieved by 82 %.[27]

As a part of the EFF program agreed with the IMF in March 1996, Russia promised to take measures to improve its tax collection practices. The most important of these measures include the approval of the new Tax Code. In October 1996, President Boris Yeltsin signed a decree which established an emergency committee, under the leadership of Prime Minister Viktor Chernomyrdin, to expose tax dodgers and prosecute them. The consolidated government budget deficit in 1996 was 4.2 % of GDP, widening from 3.4 % in 1995.

[25] According to some sources (e.g. Nezavisimaja Gazeta 24.9.1996), it was the two-stage election that was the main cause for the financial crisis of Russia in 1996. Given the concern over a communist victory in the presidential race, a substantial amount of financial resources was directed towards the campaign of Boris Yeltsin and to the temporary improvement of the well-being of voters. The newspapers claim that in the preceding six months before the elections the internal state debt of Russia rose by almost 1 trillion roubles (0.2 billion dollars).

[26] Kommersant Daily 17.10.96.

[27] Extended Fund Facility.

3 The Main Directions of Taxation Reform

3.1. Towards a coherent system

Since the formation of the new tax system at the end of 1991, there have been a significant number of changes and supplements to the legislation. Nonetheless, it is still widely acknowledged that the prevailing tax system does not promote economic development. The fate of future economic reform rests to some degree on the new Tax Code, the draft of which has been in consideration of the State Duma from the beginning of February 1996 and was passed in the Duma's first reading in June 1997. Optimists had hoped the Code would come into force at the beginning of 1998, now they are hoping that at least the new personal income tax scheme will be implemented. In the interim, several matters with regard to tax reform have been temporarily dealt with by government and presidential decrees.

The underlying objectives behind the reforms are to develop a more efficient and transparent tax system. The intention is to reduce the number of taxes from perhaps 200 to around 30. In this regard, the Code draft stipulates the abolition of various small taxes and tax-like payments. A number of other taxes and payments are merged. The need for reforming the system stems initially from the aggravated problem within Russia's inability to collect sufficient tax revenues to satisfy the vast transformation costs. While clear signs of economic growth have yet to emerge, the bulk of the problem is still the fact that enterprises continue to hide profits and evade taxes. The apparent inability of the tax authorities to penalize tax evasion has added to the problem. On the positive side, it should be noted that during 1997 some giant enterprises paid back tax debts after the state threatened them with of bankruptcy.

The Tax Code draft consists of four parts: the *"Common part"*[28] (which corresponds to the present law of the Russian Federation entitled "On the basis of tax system in Russian Federation"),

[28] The stipulations of the common part are not dealt with in detail, because that are yet to be published. In its first reading of the Tax Code, the State Duma gave its approval only to parts II, III and IV.

Table 2 **Federal, Regional and Local Taxes, Duties and Payments in the Tax Code Draft**

Federal taxes	**Regional taxes**	**Local taxes**
1. VAT	1. Tax on enterprise property	1. Land tax
2. Excise tax	2. Forest tax	2. Tax on individual property
3. Federal profit tax	3. Tax on vehicles	3. Real estate tax
4. Tax on capital income	4. Regional infrastructure tax	4. Tax on the maintenance of local housing fund and other local objects of infrastructure
5. Income tax	5. Regional license payments	5. Tax on advertising
6. Social tax	6. Payment for the use of regional symbols	6. Tax on retail sales
7. State duties		7. Hotel tax
8. Custom duties and payments		8. Gift and inheritance tax
9. Taxes on the use of land		9. Spa payment
10. Tax on extra income from extraction of hydrocarbon		10. Local license payments
11. Tax on hunting, fishing etc.		11. Payment for the use of local symbols
12. Water tax		
13. Ecology tax		
14. License payments		
15. Payment for the use of state symbols		

"Federal taxes", "Regional taxes" and "Local taxes"[29]. The Code establishes precise rules for introducing, changing and abolishing taxes. The introduction of new taxes or the abolition of old ones, as well as changes in taxation rates, will in future only be considered in tandem with their subsequent implications upon the budgets of the different levels. Official interpretation of tax stipulations may be provided only by the organs which have established them. Any decisions on the introduction of new taxes and obligatory payments will come into force no earlier than the start of the following calendar year. Changes in taxation which have the end-result of worsening the burden of tax-payers cannot be retroactive. The concept of "a tax secret" will be introduced into Russian tax legislation for the first time, requiring the taxation organs to undertake responsibility for the maintenance of confidentiality of information.

[29] Regional taxes refer to taxes in the 89 administrative areas the Federation. Local taxes are stipulated in cities, raions (regions) or other administrative units under regional jurisdiction.

Figure 3 **Hypothetical consolidated budget revenues according to the Tax Code draft**
percentage of all revenues; (of GDP)

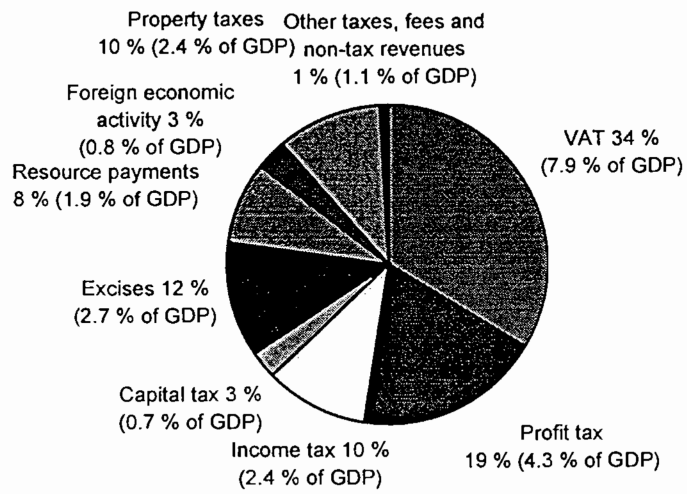


Figure 4 **Hypothetical federal budget revenues according to the Tax Code draft**
percentage of all revenues; (of GDP)

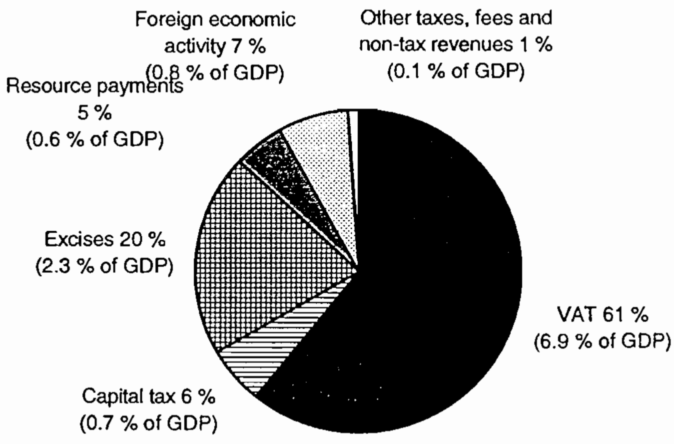
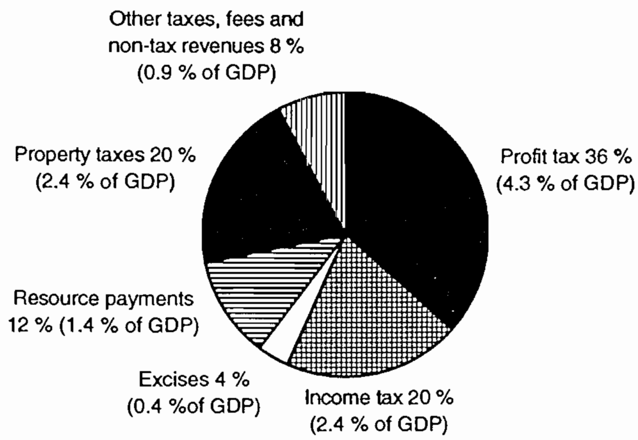


Figure 5 **Hypothetical territorial budget revenues according to the Tax Code draft**
percentage of all revenues; (of GDP)



3.2 Important changes[30]

According to forecasts, the aggregate tax burden in Russia, which equalled 35.1 % of GDP in 1996, would decrease to 32.4 % of GDP under the new Tax Code.[31] This figure includes social security contributions from extrabudgetary funds. Although the tax burden is expected to decrease, tax revenues should grow in the near term through increasing production and economic activity and the anticipated improvements in tax discipline. One of the main objectives of the Tax Code is to reduce the number of tax exemptions gradually and to differentiate the social security contributions – a social tax in the Code – along the lines of income.

The base of the present taxation system – VAT, profit tax and personal income tax – will be preserved under the new Tax Code, but there will be significant changes in the division of taxes between the different administration levels. The most important change is that VAT revenues will be channelled almost exclusively to the federal budget, and account for over 60 % of its total revenues.[32] The share of excise tax is maintained at the 20 % level, and thus taxes from goods and services will form over 80 % of federal budget revenues. Profit-tax revenues are no longer included in the federal budget, but are transmitted to the regional budgets. According to preliminary calculations, they will become the most important source of income for the regions, forming over 35 % of their budget revenues. Finally, the importance of property taxes for the regions will grow.

With regards to the consolidated budget, the most important changes are linked to the proposed increase in the VAT rate from 20 % to 22 %. Once

[30] See figures 3–5.

[31] Deputy finance minister S.D. Shatalov, Finansy 7/97.

[32] The estimations concerning the importance of different taxes (in % terms or as a % of GDP) are based on the hypothetical calculations included in the supplement of the Tax Code draft.

implemented, the share of VAT revenues in the consolidated budget should increase from 26 % to 34 %, or from about 6 % to 8 % of GDP. The shares of profit-tax and income tax revenues are estimated to decrease while the share of property taxes should grow.

The *taxation of profits* has been a main theme of discussion. The core of the debate surrounds the question as to whether the profit tax in Russia is too hefty. Until now the taxation of profits has been driven solely by fiscal considerations, overshadowing other priorities such as the stimulation of production and maintenance of "social justice."

A comparison of profit-tax rates among various countries is somewhat misleading given that the aggregate tax burden of an enterprise is affected eg. by tax allowances or deduction possibilities. Initial attempts to reform the profit tax in Russia centered around the profit-tax rate, which was to be cut to 33 % from the present 35 %. However, in the latest Tax Code draft, this rate has been left unchanged and emphasis is given instead to changing the taxation base. According to the Code, the concept of self-cost *(sebestoimost)* and taxes from aggregate revenues (*nalogi s oborota*) will be eliminated, effectively changing the amount of the taxable profit.[33] All expenses connected with the earning of revenues can be deducted from the taxable profit. The depreciation procedure will be simplified.

The intention is to tax banks along similar lines as other legal taxpaying entities. The profit-tax rate of banks will be lowered from 43 % to 35 %. Some details of the draft have aroused much discussion among representatives of banks. First, the proposal to introduce a tax on bank assets has been widely condemned as unfair on the smaller and medium-sized banks. One problem involves calculation of interest revenues; rather than defining interest revenues based on received amounts, the sums are simply calculated as if they had been received. At the same time, the expenditures for creating funds for loan losses are not considered as expenditures until the loan has been condemned as unpaid.[34] Moreover, the July 1997 decree on the taxation of hard currency purchases has already tempted banks to consider ways of avoiding payment.[35]

Special attention is paid to the methods of consolidating legal taxpaying entities in an attempt to support investment activity. Consolidation refers to a body of enterprises, grouped together as one for tax purposes. Consolidation groups would pay profit tax according to their consolidated result. Limited tax concessions are planned for such enterprises. Thus, for example, consolidation is possible in cases where the parent company owns a large enough share of the subsidiary company. On the other hand, consolidation is impossible for companies involved with different kinds of activities, excluding, among others, all financial industry groups from this arrangement.

As previously mentioned, the main changes in *VAT* are the increases in the preferential rate of 10 % and the normal VAT rate from 20 % to 22 %. The VAT proceeds are divided between the federal budget (86 %), the Pension Fund (9 %) and Road Funds (5 %). The tax is paid according to the earlier of two dates, the date of the invoice or the date of payment. The VAT taxation of exports to CIS countries is conducted on an origin-basis – only Russian exports to CIS are taxed and imports remain free from tax. By contrast, the destination-based VAT taxation continues to be used in trade with non-CIS countries, so only imports are taxed.

Local authorities are given the freedom to establish a sales tax, and the tax base should be determined by the value of the goods sold, including VAT and possibly excise duties. The tax rates applicable to mass consumer goods must not exceed 5 %, and those to luxury goods 10 %.

The five-level *income tax* scale, established at the beginning of 1996, will be reduced to a two-level scale under the Tax Code. This should ensure a reduced tax burden for the majority of Russians. Annual incomes under 60 million roubles are taxed at a 12 % rate and incomes equal or above that level are taxed 7.2 million roubles plus a 30 % rate from the part exceeding the limit. The higher rate applies to a mere 1 % of Russians. A tax on capital incomes is applied to dividends

[33] There are some exceptions to this rate – e.g. small enterprises will be able to benefit from lowered tax rates (23 % if the tax base is under 100 million roubles and 35 % on everything above the limit). Casinos and similar businesses are taxed strictly at a rate of 90 %.

[34] Delovoi mir 30.7.97.

[35] Kommersant daily 26.7.97.

(15 %) and interest returns (12 %) on bank accounts and securities.

The Tax Code draft includes several new taxes, one of which is a *social tax* which unifies three obligatory payments to extrabudgetary funds. The social tax rates are connected with the incomes of the payer, and the income classes coincide with those of income tax.[36] This practice is planned to simplify the complicated payment system of extrabudgetary funds.

A new *tax on immovable property* may be voluntarily introduced by local authorities. It taxes land and buildings on it. The tax is paid by real or legal persons at the same tax rate. If introduced, the tax simultaneously abolishes the present tax on the property of legal persons and the land tax. The tax base is determined by the market price of the taxed object. The tax on immovable property has already been introduced in Novgorod and Tver cities on a trial basis during 1997 and 1998.

4 Summary and Conclusions

The tax reform of 1992 resulted in a confusing system comprising a multitude of different taxes and widespread potential for tax exemption. As was the situation under the old Soviet Union, enterprises continued to be treated on an individual basis according to their strategic importance or powers of negotiation. The aggregate tax system increasingly developed into to a complicated, costly and ineffective one and, as a consequence, tax revenues began to decline.

Given the unrelenting pressure on the government to increase, or at the least maintain, its spending plans associated with the transition from a planned to market economy, the fiscal situation has worsened noticeably. The federal government has responded to this problem by transferring a number of responsibilities to the regional levels, forcing the localities to increase further the tax base and number of taxes. The present state of the Russian taxation system may be summarized using the words of the former prime minister Yegor Gaidar: *"No sensible director, who thinks about the interests of his enterprise and is an economically rational person in the sense that Adam Smith described, should pay his taxes."*[37]

The main objectives of the latest reform are to ensure simplification of the tax system, restoration of tax discipline, stimulation of production and protection of adequate tax revenues. Simplifying the taxation system may be described as reducing the number of taxes, eliminating contradictions and bringing continuity and stability to the tax framework. Foreign investors, in particular, have been subject to arbitrary treatment by the Russian tax system, and taxation is consistently mentioned as one of the major obstacles to business activity in Russia. The Tax Code draft should remedy this situation to some extent.

The restoration of tax discipline requires a strengthening of the tax administration to bring the number and skills of staff into line with present needs. Indeed, given the growth in the number of enterprises and ever worsening payment arrears problems, there can be no doubt that taxation bureaus are now clearly understaffed.

The success of the tax reform must be considered in the light of economic developments, especially developments in industry. There is much debate as to the appropriate level of support for enterprises, prompting many to argue that the suggested measures included in the Tax Code are not sufficient to stimulate production and investments. The profit-tax rate has remained the same, albeit with wider possibilities for deduction. The VAT rate has moved higher. The success of the Tax Code changes will, of course, be determined over time, but the underlying trend is clearly towards a more western approach to the definition of enterprise profit.

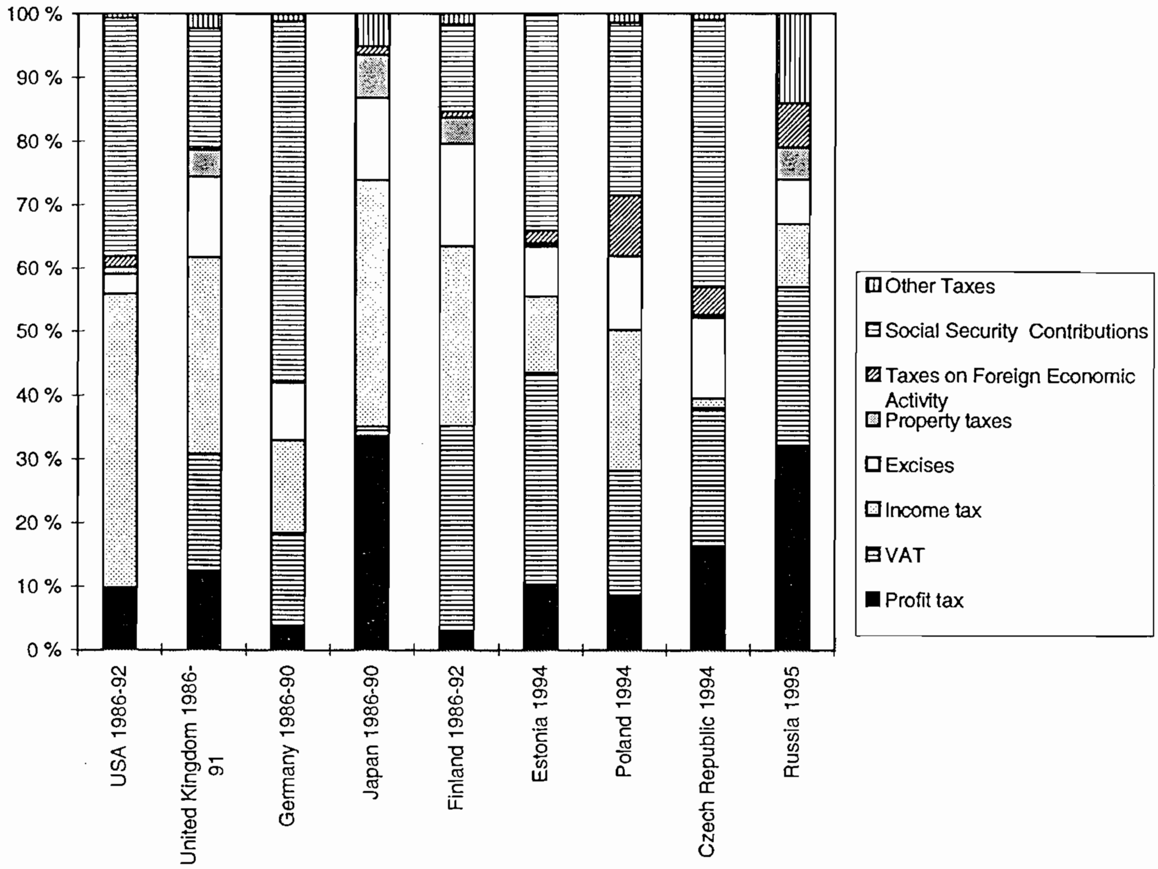
With regard to maximizing tax revenues, there are some details in the Tax code draft which require further clarification.[38] A particular concern is the relatively low rates of income tax applicable to the wealthiest elements of society. The revenue from income taxation could be raised by the

[36] If annual incomes are under 60 million roubles, 3.9 % will be paid to the Social Insurance Fund, 1 % to the Unemployment Fund and 3.5 % to Medical Insurance Funds. With incomes over 60 million the corresponding rates are 1.5 %, 0 % and 2.5 %.

[37] Financial Times 12.11.1996.

[38] A reform of the subsidization system is not dealt here, although it is a key element in reducing budget expenditures and achieving a balanced budget.

Figure 6 **The tax structures in various countries**



adoption of a more progressive system, in which the number of income classes remained the same or was increased (as opposite to proposition in the current draft to reduce the number of income classes to two). Similar arguments apply to the taxation of property.

The tax structure of nine countries is illustrated in figure 6, indicating the proportional importance of various taxes in total tax revenues. At the end of the 1980s and the beginning of the 1990s, the US, the UK and Japan favoured a tax structure which leaned heavily on income taxes. Social security contributions were also an important source of tax revenue in the US and UK, whereas they were not included in the budget in Japan. Other countries (Germany, Estonia, Poland and the Czech Republic) favoured a tax structure with a high share of social security contributions.

Meanwhile, in Russia, the emphasis has been on profit taxation, although this has gradually been overtaken by VAT as the most important source of tax revenue. Social security contributions are contained within extrabudgetary funds in Russia. The share of income taxes is quite low by comparison to, say, the US, where almost half of tax revenues arise from income taxes.

According to Dmitriev (1996), revenues from VAT could be noticeably increased by eliminating the time lag between the calculation of VAT and its payment. Dmitriev argues that, even with an inflation rate of only a few percent a month, the VAT receipts could be increased without changing existing tax rates. This would have a significant impact upon budget revenues.

The different VAT practices in the trade between CIS countries and in the trade with the rest of the world (origin-based versus destination-based) have already led to trade diversion through the CIS countries: this practice is simplified by weak or non-existent border controls. Regardless, the intention is to leave this matter unchanged until the year 2000.

The fact that non-cash forms in the payment of taxes has been encouraged may, in the long run, encourage the avoidance of cash payments. Whereas this may ease the tax arrears and payments problems in the short run, there will be further problems associated with a growing acceptance of non-cash forms, especially those in goods and services.

According to the hypothetical calculations of the Code Tax draft, the tax revenues of the federal budget, as a share of GDP, will decline by approximately 5 %, and those of territories by over 6 %. The revenues of extrabudgetary funds will increase by about 9 %. The aggregate tax burden should decrease from approximately 35.1 % to 32.4 % of GDP. These estimates are based on the assumption that GDP starts to grow and tax discipline is enhanced. This is the core of the tax reform and a key element in the success of Russia's economic reform as a whole.

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