

## **Chapter 2** **Tax Reform in Transition**

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### **I. Introduction**

Despite widespread recognition that tax reform is indispensable to a successful transition to a market economy in the Russian Federation, progress in this area of economic reform has been piecemeal and slow. As of late 1997, the tax system continued to exhibit significant flaws: (1) it has impeded the decentralization of responsibility for providing public services to the most appropriate levels of government; (2) it has maintained taxing authority that is remote from taxpayers; (3) it has produced an uneven distribution of the burden of financing government; (4) it has hindered the restructuring of the roles for the private and public sectors to be consistent with those of a market-directed economy; and (5) it has rendered fiscal policy a weak and unreliable instrument of national economic policy.

The Russian Government has recognized the urgency of tax reform. Numerous reform efforts have been mounted over the past five years and specially during 1996 and 1997. Some of these efforts have produced improvements of specific aspects of the tax system. Nevertheless, Government and State Duma decisionmakers have not been able to put together a genuine tax reform effort over this time period. As discussed further below, there is a new opportunity for reform in 1998.

However, the widespread disappointment with tax reform in Russia has failed to recognize that tax reform is not an event, but a continuous process. The experience with tax reforms worldwide clearly show that today's system may not work as well tomorrow. National goals and priorities change. Technology alters possibilities. These and a thousand other realities provoke a need to modify systems. Thus, a missing emphasis in the Russian tax reform process has been the need to

develop a capacity to deal with such adaptive changes, more than produce the best and final reform package once and for all.

The transformation of the Russian economy since 1992 has resulted in major changes in the country's economic and fiscal institutions. These range from massive privatization and reductions in government expenditures to fiscal decentralization. Russia's economic reform program is now well advanced with more than 80 percent of industry operating in the private sector. Current account convertibility, currency reform, and the creation of an autonomous banking system have been largely accomplished. Considerable progress has been achieved in the areas of macroeconomic stabilization and the development of capital markets. However, it is clear that the speed of the economic transition has suffered from the government's difficulty to adjust tax policy and tax administration to the new market economy environment. In the public sector, the lack of decisive tax reform has inhibited the reform of the system of intergovernmental fiscal relations. The Government of Russia needs to accomplish tax reform to solidify its reforms in the rest of the economy and to reduce tensions between the federal and regional governments.

### **I.1 The Legacy of the Past in Tax Policy**

Tax reform in Russia arguably has been hampered by the enormity of the changes that needed to be introduced vis-a-vis the previous tax system. During the Soviet era, most tax revenues in Russia came from profit, turnover, and payroll taxes levied on state-owned enterprises. Property taxes did not exist. The enterprise profit tax, by far the most important source of revenue bore little resemblance to equivalent Western tax.... was used to accumulate and centralize resources and to regulate enterprise income. While the general profit tax rate was set at 35 percent, in practice the

final tax liability of enterprises was often the product of negotiation. This legacy of customized taxes, negotiated payments, and soft-budget constraints, limited the efficacy of tax reform and tax administration efforts in Russia in the early years of the transition. More recently, state enterprises and privatized businesses continued to lobby the state for individual tax relief and often chose to accrue tax arrears as a negotiating instrument.

Turnover taxes in the previous regime applied to consumer goods and to some services. They were generally single-rate levies differentiated by commodity and sometimes by type of enterprise and were used as a residual wedge between retail and producer prices. They were used more as a tool of economic planning than as a means to raise revenues. Also in the previous regime, wage and payroll taxes were withheld at the enterprise level with their revenues generally earmarked to fund social expenditures. Individual income taxation was relatively unimportant; on the other hand, payroll taxes were significant and were withheld by enterprises. Allowances or deductions from individual income were negligible or non-existent. Although wage policy was used to influence employee behavior, Soviet planners relied more on other policies such as fringe benefits, access to good supplies, and restrictions on residential mobility. The state also played a major role in mediating between enterprises and households through subsidies and transfers, spending at times more than half of gross domestic product (GDP) on this endeavor. Customs tariffs were generally imposed on goods imported from countries outside the Soviet trading bloc but typically represented a small portion of total tax revenues; planning authorities preferred quantitative restrictions over nominal tariffs to regulate imports.

Until 1992, the tax system in place in Russia completely lacked transparency. Frequently, enterprises did not know what other enterprises facing similar circumstances paid. The population

at large were neither aware of taxes nor had any perceptions of tax burdens, since very few individuals actually filed tax returns, paid taxes during transactions, or were aware of turnover taxes or profit taxes. The reliance on implicit taxation during Soviet times raised the odds against successful tax reform during the transition, as the average citizen was being explicitly taxed for the first time. The lack of familiarity and contact with the tax system created a taxpayer culture that was more conducive to tax evasion.

One of the most important reforms in the area of tax policy before the dissolution of the Soviet Union was to replace the complex turnover taxes prevalent in the previous regime with a value-added tax (VAT) on December 6, 1991. While the new VAT had positive features, the new tax also had several shortcomings. When introduced, the VAT had a single rate and it had a fairly broad base covering most goods and services. On the negative side, the Soviet model VAT introduced accounting for tax liabilities from sales on a cash basis, which is incompatible with the effective application of a VAT invoice-credit system. This feature and several other reviewed below, remained problems for Russia's VAT during the transition years.

## **I.2 The Legacy of the Past in Tax Administration**

The effective enforcement of taxes in the Russian Federation has also been hampered by the legacy of a tax administration system which may have been adequate in Soviet times, but it was grossly inadequate for enforcement of a market-oriented tax structure.

Although tax administration had a small capacity prior to 1992, the relatively small number of taxpayers meant that the state could conduct a reportedly 100 percent audit each year to ensure compliance. Restrictions on payment methods and the monopolistic role of the state banks facilitated

administration and enforcement. In addition, the state could and often did retroactively adjust the structure of taxes and administrative procedures to meet its perceived revenue needs. There was little opposition to otherwise controversial tax measures because the state served a dual role as the owner of enterprises and as the tax collector. .... and fragmented. Collections.... offices which then pulled a share of the collections up to the next higher level of government. But because of the many other tools and powers that socialist planning provided to tax administrators, the tax administration system was functional and may have been adequate for the previous economic regime.

The enormity and difficulty of transforming the previous system of tax administration to the demands of a market-based economy has continued to hamper the ability of the Russian government to generate sufficient amounts of revenues to the budget during the transition years. The State Tax Service of the Russian Federation introduced right after independence as a federal agency with regional and local offices, is still primarily organized by type of tax or by type of taxpayer, with the majority of functions located at the lowest level of administration, the Territorial Tax Inspectorate (TTIs). Federal control over the conduct of collections, returns, processing, audit, or appeals continues to be weaker than in most other tax administration systems. Regional offices of the State Tax Service, the State Tax Inspectorates (STIs) have a closer supervision of TTIs, but there is still significant *de facto* dual subordination of STIs and TTIs to regional and local authorities. Compounding these difficulties is the wide variation in information systems across STIs, with multiple TTI's tax administration information systems, often co-existing within the same regional STI. The inability to transfer taxpayer information horizontally and vertically within the State Tax Service has inhibited the diffusion of modern tax administration techniques and has prevented the use of third-

party information except in the rarest of cases. In addition, the lack of standard operating procedures across STIs and TTIs has resulted in administrative inefficiencies.

The lack of reform of the STS has been often described as the most significant obstacle to the consolidation of Tax reform in the Russian Federation. The tax administration system during the transition has been viewed as collections, not taxpayer, oriented. This focus, it has been further argued, created a climate of distrust and suspicion between taxpayers and the tax administration. High compliance costs imposed on taxpayers has not helped matters. Examples of high compliance costs still abound. Taxpayers must purchase tax forms and instructions; in the vast majority of cases, taxpayers are required to file their tax declarations in person at their local tax inspectorate; taxpayers must write checks to a variety of separate accounts; and the frequency of filling and reporting requirements for taxpayers way exceed international practices. The lack of a history of voluntary compliance coupled with the absence of taxpayer services and punitive fines and charges has led during the transition years to a climate in which tax evasion was perceived as the norm and voluntary compliance as the aberration.

### **I. 3 The Significance of Intergovernmental Fiscal Relations to Tax Policy and Administration**

The reform of tax policy and tax administration in the Russian Federation is inextricably linked to the reform of the system of intergovernmental fiscal relations. This latter area, however, presents many problems of its own.

Current problems with the system of intergovernmental relations in the Russian Federation can also be traced back to the Soviet era. In the previous regime, local and regional governments were basically appendices of the central government and the system of intergovernmental relations

was characterized by tightly centralized finances. Revenue sharing and intergovernmental transfers were used as accounting tools to balance subnational budgets, while the size of these budgets was determined by planning expenditure norms established by the central government. The overall level of subnational budget expenditures was politically negotiated. Sharing rates for tax collections were “regulated” or customized. Transfers or subventions were used to provide subnational governments with the required funding for the minimum expenditure budget when revenue sharing and “own revenues” were not enough. Revenue sharing rates and the size of the subventions were subject to intense bargaining and negotiation.

Since the start of the transition process in 1991, the Russian Federation pursued the reform of the system of intergovernmental relations under principles more akin to those of Western-style fiscal federalism. While in the new structure the ultimate responsibility for balancing regional budgets lied with the regional governments, the Russian government did not held subnational governments truly accountable for budget shortfalls until very recently. Major reforms in the system of intergovernmental fiscal relations of the Russian Federation took place in 1994. Uniform sharing rates (for the major taxes) between the federal and regional governments were adopted. Also a system of formula driven transfers were introduced in substitution of the negotiated subventions. The goal was to streamline and standardize the system of intergovernmental finances. Despite the 1994 reforms, the system of intergovernmental fiscal relations has remained problematic. It has lacked stability and transparency. Subnational governments still lack incentives to raise their own revenues. And very significant fiscal disparities remain across regions and across local governments within regions. In practice, the formula-driven system of transfers has not been respected and the federal government has continued to reach special agreements, with some regions outside the framework of

uniform sharing rates and formula-driven transfers. Although the significant charges in the assignment of expenditure responsibilities of the earlier years of the transition have subsided, there is still confusion in the assignment of expenditure responsibilities and some of these responsibilities are assigned inefficiently (e.g., social welfare at the local level). Unfunded expenditure mandates to subnational governments continues to be a source of friction.

Despite the fact that revenue sharing between the federal and subnational governments is no longer “regulated” or the result of bargaining outcomes, important problems remain with revenue assignment issues. The sharing of VAT revenues between the federal and subnational governments is inappropriate given the fact that VAT is credited and debited unevenly across the national territory. The assignment of 100 percent of individual income tax revenues at the subnational level also questions the justification for a progressive income tax, which in other countries is used by governments to equalize income and expenditures across regions. With the current arrangement, richer regions get to keep much higher revenues than poorer regions and this contributes to an increase in fiscal disparities rather than to their amelioration. During the transition, subnational government have lacked autonomy or discretion over any significant sources of revenues.

Although this chapter focuses on two elements of tax reform (tax policy and tax administration), it needs to be clear that these two elements are interrelated and highly interdependent with the reform of intergovernmental fiscal relations. The distinctions sometimes drawn in textbooks between tax policy, tax administration, and intergovernmental fiscal relations are not very useful when searching for a tax system to complement a program of fundamental economic restructuring such as is the case in the Russian Federation. The individuals who make decisions on the various parts of such a system must be aware of how each component contributes to the common goal of fundamental

reform. It's a well known truism among fiscal practitioners that tax policy is tax administration and vice-versa. And in the case of Russia tax policy can not be divorced of intergovernmental revenue assignment issues (including tax sharing and exclusive assignment of taxes) to subnational governments. Neither can tax administration reform be divorced of issues on intergovernmental fiscal relations. Tax collection for subnational taxes or highly shared taxes by subnational governments tends to be more efficient than those of federal taxes or more lightly shared taxes by subnational governments. This reflects the fact that even though tax administration authorities are part of a federal organization, they still may be more responsive to the interests of subnational governments where they have their offices. Solution to tax administration problems such as the introduction of a large taxpayer unit in Moscow can not ignore the implications for subnational governments. This very much needed reform runs counter to the interests of regional governments where the large taxpayers now have to pay their taxes. Here, like in many other reform issues, a compromise arrangement for federal and subnational interests will be needed in order to move the reforms forward.

The rest of this chapter is organized as follows. Section II reviews and evaluates the current and proposed reforms of the tax structure of the Russian Federation against the backdrop of what ought to be the main goals and features of a modern tax system. Section III reviews the main issues and problems with the current tax administration system, it highlights the importance of getting tax administration reform on the right foot for other elements of the reform of the fiscal structure, and suggests the elements for a modernization strategy for the STS. The last section presents an overall summary and conclusion.

## **II. Issues in Tax Policy**

### **II.1 Features of a Modern Tax System**

The basic objective of a tax system is to collect adequate revenues to provide public services necessary for a good quality of life and to support infrastructure required for private sector economic development. The goal should be to raise this adequate level of tax revenues without harming the economy and the social fabric, i.e., without treating people and businesses unfairly, forcing economic agents to make choices based on the tax system rather than the market, or giving the public cause to refuse to comply with the system. Of course, no country does this completely "right" because there are pre-existing distortions in the economy that call for discriminatory taxes, fiscal planners cannot resist the temptation to use the tax system as a lever to influence some set of economic decisions, and politics affect economic decisions. Also most, if not all, practical taxes tend to distort economic activity. However, the level of distortion, or wasted economic resources, can vary significantly between well and poorly designed tax systems.

Most market economies subjected their tax systems to radical reforms during the 1980s. The reasons for and objectives of these reforms contain important lessons for tax reform in the Russian Federation. The general thrust of tax reform in market economies over the last decade has been threefold: to simplify the structures of income taxes by flattening rates and widening the tax base by getting rid of exemptions and other special treatment; to introduce broad-based value-added taxes on the consumption of most goods and services; and to increase excise tax rates. The broadest tax policy objectives were invariably to reduce economic distortions, equalize conditions among economic agents, and simplify the tax system. Many development countries have adopted similarly inspired tax reforms in recent years. This worldwide reform movement was in reaction to tax policies

during 1960s and 1970s when policymakers believed that they could “pick winners” and could direct economic growth in market economies by using tax policies to affect relative prices. Defining the "right" strategy for tax reform in a transition economy, like Russia, is arguably more difficult than in market economies or even in developing countries. In Russia, significant distortions still exist in the pricing system; wage and housing policies are still in process of reform; the social safety net is not entirely in place; the roles of enterprises and governments remain in some cases unclear; and there is a great deal of investor uncertainty. Two other significant complicating factors are: first, that the fiscal relationships between the center and the regional governments are still unstable and contentious, and second, that the tax administration system is not very far along in the modernization process. Finally, some of the features of the present tax system and its implementation are holdovers from the Soviet era and are not easily replaced. Russia is less than a decade removed from the time when taxes took the form of wage controls, profit remittances from enterprises and turnover taxes. This history still affects the views of policymakers and it lingers through the law and through practices followed by taxpayers and tax administrators. These factors are all significant handicaps to tax policy development.

Such considerations would lead many fiscal analysts to restate and to reorder the traditional principles for "good" tax policy. These principles, restated to fit the present Russia context, can guide the formation of a new tax structure.

- Tax reform must be recognized as a process--not a once and for all event. Russia is a transition country whose economic structure will continue to change; tax laws enacted today will need adjustments in a few years. The steps in a tax reform need to be planned carefully, but the modern tax system that Russia needs is more likely to emerge over a period of years even if an entire tax code get approved at one sitting. It is important, therefore, that the sequencing of the reform be correct and pre-announced.

- The tax system should raise a target amount of revenue that will satisfy the public expenditure needs of the country. Tax rates and bases should be chosen with this target in mind. Just as important as the target level of revenue is that the elasticity of the revenue system be adequate to ensure that revenue growth keeps up with expenditure needs over time.
- The tax system should be as simple as can be feasible. The very nature of the transition economy easily leads to complications in the tax code. On the one hand, the Russian economy is very diverse in terms of what is produced and consumed, how businesses are organized for production, and the involvement of foreign investors. On the other hand, the tax administration system is currently inadequate for administering a complicated system with a great number of fine gradations. What good are special rules if they cannot be implemented? In general, the tax system should be streamlined and easy to implement and administer and should follow a basic principle of simplicity (e.g., pursue flatter rate structures and broader tax bases with a minimum of special treatments).
- The tax system should be horizontally fair, (i.e., those individuals and businesses in the same circumstances should be treated in the same way by the tax system). If this principle is generally followed, economic decisions will be driven less by tax considerations and industrial policy will be more in step with market opportunities. Such a system would relieve government officials of the responsibility for “picking winners” and would ameliorate the pressures on politicians from special interest groups.
- The tax treatment of higher-, middle-, and lower-income families should be consistent with the government’s notion of an acceptable distribution of income. The degree of progressivity of the tax system in Russia, however, cannot be determined apart from other policies that affect the standard of living, (e.g., wage policy, public utility and housing prices, the pension system, etc.).
- Certainty in the tax system must be a high priority for Russia. To attract capital for new business and for expansions, the government must offer investors a certainty about their tax liability for the immediate future. Investors who plan for a particular rate of return are more likely to invest in countries with stable tax systems. Although investment in the Russian economy currently offers a potentially higher rate of return than does investment in other countries, an uncertain tax environment can negate this advantage.
- Tax structure reform in Russia cannot be planned apart from reform in the tax administration system and the system of central-local fiscal relations. The tax laws are national and for most taxes a national uniformity is sought. Collections are shared

with subnational governments on a derivation basis for the VAT, the enterprise income tax, the personal income tax, and certain excise taxes. The tax administration must implement the tax code that is enacted and must collect shared revenues on behalf of both levels of government. The intergovernmental fiscal system defines the sharing of taxes and provides incentives for regional governments to reinforce or dampen central efforts to collect taxes efficiently and to impose a uniform national tax burden.

If this is a correct set of principles that should guide the assessment of tax policy directions appropriate for Russia, how well do current and proposed tax policies fit this set of principles? Those are the two questions we turn to in the next two sections.

## **II.2 Overview of the Current Tax System in Russia**

The tax structure in Russia reflects a balance between indirect taxes (value-added tax and excises), a corporate income tax, and taxes on payrolls. The structure of the taxes follows western tradition in many respects, but differs in others. The tax reforms that took place shortly after the independence led to a tax system that had, at least formally, many similarities with the features found in most western countries. However, for the most part, Russia's tax system moved away from that model during the years of the transition. The recent tax reform proposals, discussed in the next section, are an attempt to again move toward the western model.

As already argued, tax reform in Russia has been influenced by the "legacy" of planned socialism. Several features identified with this legacy have particularly impacted the process of reform over the past five years. First, the Ministry of Finance initially had difficulty asserting a coherent and unified view of tax reform for the Government. Over time, however, the Ministry of Finance has become the dominant protagonist for tax policy reform. Second, tax reform in Russia involved an increase in the perceived, if not the effective, tax effort. Under the previous regime, most

taxes were invisible to taxpayers. This structural change made it hard for the government to win political and popular support for the reform of the tax system. Third, the change in political structure and economic regime resulted in confrontation between government and state enterprises who had earlier enjoyed a cooperative relationship. This confrontation hampered not only the passage of new legislation but also its subsequent enforcement. Fourth, the change in political structure resulted in uncertainty regarding ownership of assets and revenue sources, as well as misunderstandings about legal jurisdictions of different governmental bodies.

The structure of the tax system that evolved from 1992 to 1997 has some positive features but also many flaws. The review that follows starts with direct taxes and continues with indirect taxes. As of mid-1997, Russia had the three pillars of a modern system of direct taxation--an enterprise profit tax, an individual income tax, and a payroll or social security tax. Until recently, however, the enterprise profit tax did not allow the full deduction of wages. Further, Russia has imposed an "excess wage tax" on enterprises during many years of the transition.<sup>1</sup>

*The enterprise profit tax:* Reform of the enterprise profit tax has been tortuous and did not always yield the desirable results, as judged by the standard principles of tax policy. However, to be fair with the Russian experience, it must be recognized that the taxation of enterprise profits raises an array of complex issues for which there are no best practice or standard answers. During the early years of Russia's transition, this tax was commonly used to promote certain types of investment

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<sup>1</sup>More recently, the excess wage tax was eliminated. This tax was initially introduced for two reasons: to discourage decapitalization of the firm by workers who granted themselves unlimited pay increases; and to raise revenues. The excess wage tax was an unsatisfactory solution to the more pressing problems of eliminating labor management and imposing stricter budget constraints on enterprises. The excess wage tax discouraged innovation and hampered productivity growth by preventing firms from raising wages to attract and retain highly skilled and motivated workers.

activities through either tax incentives and holidays or differential tax rates. More recently, Russia's Government has followed the early lead of Western tax systems to get rid of special treatments and provide a more level field for business activities across all sectors of the economy.

The correct enterprise profit tax has a general rate of 35 percent and a rate of 43 percent for banks, insurance companies, and financial intermediaries. Distributions of profits to individuals are taxed again under the individual income tax and dividends received by corporations are taxed at source at a final rate of 15 percent. Special lower tax rates are in place for agricultural producers, small businesses, and joint ventures, and higher rates for gambling and some intermediary activities.

The tax base of the enterprise income tax is calculated as the difference between taxable income and allowable expenses. The calculation of the tax base of the enterprise profit tax has undergone profound transformations since 1991. Initially, Russia limited all deductions from enterprise revenues, including wages, capital depreciation, and interest, resulting in the tax being known in Russia as the *enterprise income tax* (rather than a corporate profit tax). The tax law currently allows the deduction of costs incurred in the generation of taxable income (e.g., standard costs of doing business plus the cost of providing social services to workers). The current law still disallows the deduction of certain expenses which, in western tax systems, are regarded as perfectly legitimate deductions. Disallowed production and operation expenses include some types of labor costs (wage bonuses), some interest costs, expenses in research and development or environmental protection, and advertising. The current profit tax allows the carry-forward of losses for a period of 5 years but no carry-back of losses. This latter provision is more stringent than the standard practice in western systems but it is quite typical among countries in transition.

An important feature of the enterprise profit tax in Russia is the lack of adjustments for inflation. Because inflation rates moderated considerably in the past one or two years, the potential distortions associated with inflation in such areas as the depreciation of assets (at historical costs) or the deduction of full interest costs have decreased in importance. Depreciation may be determined on a large number of bases, with permission of the government, but most companies use a straight-line method (based on historic costs).

The two main problems with the current enterprise profit tax are the lack of full deductions for normal business costs, and the presence of special treatments and provisions. These latter measures contribute to lower collections directly and indirectly (by facilitating evasion and avoidance behavior), produce an increasing perception of unfairness of the tax system, and add to the distortions in the allocation of resources in Russia. The lack of full deduction of business costs increases tax burdens arbitrarily in certain economic sectors and contributes to an anti-business atmosphere among domestic and foreign investors.

*The individual income tax:* Individual income tax reform started in 1993. In designing the new individual income taxes, Russia elected not to adopt a global income tax which would combine all taxable income into a single base, but retained the features of a schedular income tax, which allows for different bases and rates depending on the source of income. This approach proved to be a judicious choice. The result has been that Russia adopted for the individual income tax a hybrid base (between consumption and income) by taxing income from some capital sources more lightly or not at all. The coverage of the tax is on worldwide income of individual residents in Russia. Personal allowances and certain hardship deductions are allowed and computed in multiples of the minimum subsistence wage. The definition of employment income is broad, including fringe benefits, bonuses,

allowances and other forms of non-cash income. This broad definition has been important in Russia because of the tendency of enterprises and employees to seek compensation packages loaded with fringe benefits. This has been the result of tradition but also of seeking ways to escape taxation. Unfortunately, non-wage compensation is notoriously hard to tax at the individual level anywhere.<sup>2</sup>

Russia's personal income tax exempts income from pensions, interest income, and capital gains from the sale of private property. The rate structure is progressive, ranging from 12 percent to 35 percent of taxable income, with interest income subject to a rate of 15 percent. Income tax is withheld at the source or paid directly by self-employed individuals. The top marginal rate for this tax of 35 percent is identical to the top rate of the enterprise profit tax.

Besides its narrow base, the most serious problem with the individual income tax is the lack of integration with the enterprise profit tax. The result is that dividends are taxed twice--at the company level as profits and at the individual level as distributed dividends.<sup>3</sup>

*Social security (payroll) taxes:* Employers contribute 28 percent of payrolls to the pension fund, 9 percent to the social insurance and medical funds, and 1.5 percent to the unemployment fund. Smaller amounts are contributed to various earmarked payroll tax surcharges. Two problems exist with current social security taxes. First, social security tax contributions in Russia are high by international standards, potentially making the economy and, in particular, exports less competitive. Second, it makes the social security system 100 percent employer financed. Even though, economic

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<sup>2</sup>One effective way, not frequently used and not used in Russia either, to ensure wider taxation of fringe benefits is to tax them at the company level by disallowing their deduction as an expense.

<sup>3</sup>This lack of integration, which is known as the classical approach, is shared with other countries. The draft Tax Code has chosen a partial integration approach, exempting dividends from profits that have paid the enterprise profit tax from the personal income tax.

theory shows that the incidence of payroll taxes (who actually pays them) should not be affected by the division of charges between employers and employees, in practice, the use of explicit employee contributions, together with employer contributions, offers several potential advantages. First, the system of financing is more transparent, thus helping dispel the misconception that social security benefits are free goods. Second, it may get employees more interested in the overall management of the funds and it opens up the possibility of tailoring contributions and benefits to individual circumstances.

....Russian Federation also has the two main pillars of indirect taxation: a VAT and a system of excise taxes.

*Value-added tax:* The value-added tax (VAT) is the primary indirect tax currently levied in Russia. The Russian Federation introduced a VAT in January 1992 which was largely patterned after the VAT approved by the Supreme Soviet of the Soviet Union in December 1991. Two positive features of the Soviet-model VAT is that it had a single rate (albeit high at 28 percent) and a fairly broad base covering most goods and services. However, the Soviet model VAT presented many peculiarities and problems, some of which have been addressed in Russia over the transition period but some other still remain under the current VAT.

One main problem with the current VAT is it accounts for tax liabilities for sales on a cash rather than on an accrual basis. The cash method of accounting is fundamentally incompatible with the effective application of the invoice-credit system, the cornerstone of most modern VAT systems. This problem gets compounded by the practice of granting taxpayers credits for VAT paid on inputs after those inputs are put into production. Thus, in effects, enterprises may claim VAT credits even when they have not paid their suppliers and the suppliers do not owe VAT until they received cash

payment for the inputs. This arrangement, of course, results in a loss of revenues for the government. The Government has tried to address this problem since 1996, but with limited success.

A second problem with the initial VAT was that the credit-invoice method was used only for calculating VAT liabilities at the manufacturing level. Liabilities at the wholesale and retail levels, in most service sectors, were calculated on the basis of taxpayers' gross margins, using a subtraction method VAT. The Government has recently addressed this problem successfully.

A third problem with the original Soviet model VAT was that it denied credits for the VAT paid on capital inputs. This provision effectively represented a 28 percent tax on capital investment. In effect, the denial of credit for capital inputs destroyed the standard consumption basis of the VAT used in most other countries with a VAT, and it introduced cascading elements in the tax system. This penalized economic sectors unevenly and made exports less competitive even though they were zero-rated from VAT. Currently, taxes on capital inputs may be recovered over a six-month period, but no refunds are allowed for excess credits. The practice in most countries with a VAT is to allow immediate refund or credit on capital inputs.

Another important feature of the Russian model VAT, still currently in force, is that it applies the origin method for trade among CIS countries. Exports within the CIS countries are treated as domestic sales so they are subject to VAT, while imports are exempt from tax. In contrast, most countries with a VAT use the destination method for international transactions with third countries. Under the destination method exports are zero-rated and imports are subject to tax. The application of the origin method can cause significant distortions and redistribution of revenues especially when trade among the countries is not balanced and rates and base of the VAT differ. Ultimately the

question of which method (origin or destination) to apply for the taxation of mutual trade within the CIS depends on how these countries organize economic cooperation among themselves.

Also peculiar to the original Soviet model VAT was the fact that imports were not covered by tax. This feature was reformed early in the transition. Currently, imports from outside the CIS are always subject to VAT, but the number of exemptions and special treatments has significantly increased over time. The narrowing of the tax base through more generous exemptions has been also a problem for domestic production of goods and services. There is currently an extensive list of VAT exemptions for both imported and domestically produced goods. This list is considerably more extensive than that found in other countries with a VAT. This practice has resulted in the narrowing of the tax base and lower revenue yields.

Currently, there are two VAT rates, a general rate of 20 percent and a lower rate of 10 percent for medicines and basic foods. The simplicity of rates is an especially important positive design feature, given the current weakness of the tax administration in Russia.

*Other indirect taxes:* Russia has introduced separate excise taxes on the traditional commodities (tobacco products, alcoholic beverages, and petroleum products) and on several "luxury goods" (passenger cars and jewelry.) In harmony with the origin method used for the VAT for transactions within the CIS, Russia exempts from Russian excise taxes excisable goods imported from other CIS countries. However, imports of excise goods from non-CIS countries are subject to excise taxes. Because excise rates can differ significantly within the CIS, a considerable increase in trade from the CIS to arbitrage these differences and contraband coming through some of these countries appears to be increasing. These important factors has contributed to the chronic poor revenue performance of excise taxes in Russia.

*The score card for the current tax system.* Tax reform during the transition has fallen short of most standard goals for tax reform. Russia's tax system is still far from accomplishing the objective of simplicity. Although the review above has concentrated in the major taxes, there are dozens of unnecessary taxes in the books and the major taxes are still too complex. Russia's taxes also fall short of the objective of economic neutrality. It has proven hard to discontinue the interventionist legacies of the past. The existing special tax treatments lead to distortions, abuses, increased administrative costs, and taxpayer inequities and resentment. Russia's tax system has not provided the desired level of stability in tax institutions over the transition years. Piecemeal continuous changes in the tax structure have contributed to increasing administrative and compliance costs, have facilitated tax evasion, and may have discouraged economic activity by creating uncertainty among investors. The tax system has failed to lower compliance costs for taxpayers. Costly requirements, such as filing balance sheets and income statements every quarter or making taxpayers to physically queue for a long time to pay taxes have been very likely an important contributing factor to the high existing levels of tax evasion. While judging the impact of Russia's tax systems on income redistribution may be premature, the widespread tax evasion has likely resulted in a tax system that is inequitable in both a horizontal and a vertical sense.

Two procedural issues have contributed to the lackluster performance of the tax system. First, the government often has not been realistic about the level of preparation needed to implement tax reform. Routinely, not enough provisions have been made to implement new tax measures. Second, tax reform in Russia has been made more difficult by the slow pace in the modernization of the accounting systems, the strengthening and enforcement of bankruptcy laws, and the reform of the rest of the legal system.

*The perennial problem of inadequate collections.* One of the most important problems during the transition has been the failure to collect adequate revenues. Consistently, revenue collections have fallen short of expected levels and they have not been enough to cover government expenditures. The fiscal gap has been difficult to close although the situation has improved some in more recent years. The current government deficit has been in the range of 4 percent of GDP and this has been taken as clear evidence that the current tax system is deficient to finance the necessary infrastructure and social services programmed by the Government. The persistent deficit on the face of high tax rates and a longer than usual list of taxes presents a paradox. Several aspects of this problem merit separate discussion. First, that government revenues now claim a smaller share of GNP in Russia than in previous times is not a problem, *per se*. One of the fundamental expectations for a government in transition is that the public sector should reduce its role in the economy, causing a decrease in the share of total output taken in taxation. From this perspective, it is the failure to reduce the levels of government expenditures rather than reducing tax revenues that is at the root of the problem. Because the public expenditure share of GNP has fallen less than proportionally to that of tax revenues, the only sensible policy is for government's revenue share of total output to increase to a level that will keep the deficit in an acceptable range. There is no absolute or scientific rule about what the proper share of public expenditures in GNP should be. This share is a reflection of collective values and political decisions and it varies significantly, from country to country. However, good macroeconomic policy requires that the public deficit be contained regardless of the share of the public sector in GNP.

Second, the fact that the tax system in Russia has failed to yield the revenues programmed in the budget has led to a crisis environment and at times to questionable decisions and practices. The

alarming shortfall in collections has often led to the introduction of emergency measures, often under pressure from multilateral lending institutions. The emergency measures on the policy side, such as the enactment of a special VAT rate, further complicated the tax structure. From the administration side, the emergency measures often appear to have been artificial because of their lack of durability. At times, the revenues were increased by asking taxpayers for advance tax payments. Inevitably, sharp increases in revenues have been followed only after a few months by renewed declines in revenues. It has been difficult in this environment to separate among possible causes of land performance such as unrealistic revenue targets, inadequate tax structure, or failure by the tax administration to adequately enforce the tax system. Most likely, there has been a mixture of all three.

Third, there are a number additional factors which need to be taken into account to fully understand the tax revenue adequacy problem in Russia. In the first place, the performance of the Russian economy has been sluggish. Actually, real GDP continued to decline consistently since 1992, and bottomed out in 1997. Therefore, revenue bases have shrunk or grown slowly. However, this explanation suggests why revenues have not grown adequately to cover expenditure needs, but it does not suggest why the ratio of taxes to GDP has fallen. The decline in the tax ratio results because some of the faster growing sectors of the Russian economy remain outside the tax base either because they are legally exempt or taxed in a preferential way or they successfully evade taxes. The latter explanation quite likely holds for the “hard-to-tax” private entrepreneurs and the underground economy. Taxpayers have been resistant and enforcement has been weak, with the result that only a fraction of true liabilities are collected. The lack of tradition with voluntary compliance has hurt tax collections during the transition and has made things harder for the State Tax Service than is the case

for tax administrations in Western countries.<sup>4</sup> We also have seen that many sectors of the economy are still afforded preferential treatment under the present tax laws, which erodes the base and slows revenue growth.

*What structural reforms are needed in the current tax laws?* From a longer-term perspective, structural defects in the current tax system need repair. A list of structural defects were mentioned in the review of the current tax structure above. Here we summarize the most conspicuous problems that needs to be addressed in the new draft Tax Code, which is discussed in the next section. First, the list of exemptions under the VAT and the preferential treatment under the income tax are inconsistent with best international practices and had eroded revenue potential. Broadening the tax base (via the elimination of exemptions and privileges) of the main taxes should be a high priority. Second, the cash versus accrual basis for determining VAT liability is a major detriment to an efficiently operating value-added tax, causing a revenue lag and dampening the incentive for enterprises to fully collect receivables. Third, excise tax rates on certain sumptuary and luxury consumption are low by international standards, particularly on motor fuels, alcohol, cigarettes, and certain items of luxury consumption. If revenue mobilization is one objective of government, increased taxation of these items is a reasonable alternative. Indexing specific excise rates and using ad valorem rates should preserve revenues in an inflationary environment. Fourth, the corporate income tax base overstates profits because it does not allow for full deduction of costs of doing business. In particular, depreciation allowances may significantly understate the full cost of capital consumed and the list of “deductibles” does not include all costs of doing business. A host of other

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<sup>4</sup>It has been estimated that one-third of all enterprises pay no tax at all and 85 percent of all enterprises have some problem with the tax authorities.

CIT problems related to loss carryforward, excessive exemptions, and accounting rules exist. Fifth, the individual income tax needs restructuring and the role of that tax needs to be defined. Will the individual income tax serve primarily in a redistribution role across the national territory or will it be a quasi-user charge for financing local government services? Either way, the present rate structure probably has too many brackets (and marginal rates) and an excessive number of exemptions. In addition, dividends are taxed at both the corporate and the individual level. A provision to eliminate the resulting double taxation and its accompanying disincentives is needed. Sixth, the entirety of the tax system needs to be streamlined getting rid of a multitude of minor taxes that contribute little in revenues and significantly increased compliance and administration costs. Seventh, the entirety of the tax system needs to be revised to lower taxpayer compliance costs and to reduce the current punitive fines and charges for delinquent taxpayers. The goal should be to bring and keep taxpayers in the tax net rather than driving them underground.

### **II.3 Recent Tax Reform Proposals**

In 1997, a comprehensive tax reform proposal, the Tax Code, was submitted to the Duma by the Government but after its passage in a first reading, the draft was ultimately rejected by Duma. There are different possible reasons why the reform proposal was unsuccessful. One possibility it has been argued, mostly at the Duma, was the low quality of the proposals. However, there would appear to have been a wide consensus outside the Duma that the general quality of the reform proposals was good and that the draft Tax Code addressed many of the difficult tax policy issues in an appropriate way. Why then the rejection at the Duma? We can speculate that several other factors may have contributed to the rejection of the draft code:

- The draft Tax Code may have been too massive and comprehensive for anyone to become familiarized and feel comfortable with it.
- The proposals focused on the tax policy side and paid inadequate attention to the intergovernmental fiscal relations. The draft may also have been incompatible with current Russian legislation, such as the Civil Code.
- There may have been a suspicion that the tax administration will not be able to administer the changes or that too much power and discretion was given to the tax authorities.
- Too little educational background work was done with the Duma and with the private sector, and hence there may have been no constituency for the reform program outside the Government itself.
- Too little hard analysis of the impacts of the proposed reforms may have been put forward, and politicians and the private sector used the lack of information to color the impacts of the proposed changes against the draft Code.

Of course, it is all too easy to speculate with hindsight about the causes of rejection of the 1997 draft Tax Code by the Duma. However, there would appear to be some consensus that much more attention should have been paid by the Government to educating and selling the reforms at the Duma and building wide public support for the reforms.

Beginning 1998 the State Duma has considered ten different draft Tax Codes submitted for consideration by different factions at the Duma and outside. Among the draft considered was the Government's new draft Tax Code. In April 1988, the Duma selected the Government's draft and approved it in the first reading as the basis for a comprehensive reform of Russia's tax system. Although there is a good chance that comprehensive tax reform will happen during 1998, the finally approved Tax Code could be quite different from the Government draft code. Parts of other draft Tax Codes may be substituted for parts of the Government's draft. Because the approval of particular taxes may drag into 1999, the Duma has adopted a parallel strategy of reforming the

existing tax laws so that at least part of the new Tax Code will be in effect for the 1999 fiscal year. The rest of this section reviews the main aspects of the new draft Tax Code, putting an emphasis in those areas that will need to be addressed in the discussions at the Duma.

Overall, the new Government draft Tax Code contains a package of administrative and tax provisions superior to all other draft tax codes submitted for consideration of the State Duma in early 1998. With some significant changes, discussed below, the new draft Tax Code could provide the Russian Federation with a tax structure that improves the allocation of resources in the economy, reactivates domestic and foreign investment, erases existing horizontal and vertical inequities present in the current system of taxation, and provides adequate and elastic sources of revenues to the public sector in the years to come. Despite all these promises, there are many areas of the draft Tax Code that could be improved. These are the focus of our comments.

The new Government draft Tax Code still suffers from a high level of complexity. Taxpayers and tax administrators alike should not be expected to assimilate all of these tax rules. It would be desirable to provide taxpayers with a simpler summary document, of course based on the Code, to guide them in their planning and compliance. The summary document should contain the basic structure of the taxes and salient features of administrative and procedural provisions.

An crucial issue for the future of tax collections is whether or not the new draft Tax Code reaches a proper balance between adequately preserving the rights of taxpayers and giving tax authorities the proper means to enforce the Tax Code. It is a serious flaw of the draft Tax Code, that it would appear to go too far in one direction, protecting the rights of taxpayers at the very serious cost of making the tax laws practically unenforceable. More balance could be reached by giving the tax authorities the means to enforce taxes without the extensive intervention of the court system.

Paradoxically, even though taxpayers' rights would appear to be over-protected in the new draft Tax Code, taxpayers' obligations tend to be extraordinary and costly. The new draft Tax Code does little to reduce, actually in many ways increases, the current high compliance costs for taxpayers. A new emphasis should be given to reducing the requirements and periodicity of payments so to facilitate taxpayers' compliance with their tax obligations.

In terms of intergovernmental fiscal relations, the draft new Tax Code moves in the right direction by providing regional and local governments with some degree of tax autonomy. However, significant problems remain with revenue sharing provisions. The VAT continues to be shared with subnational governments on an origination basis despite the serious problem the international experience has shown this practice carries. In addition, there is little rationale for a progressive individual income tax that is assigned 100 percent to the subnational governments also on an origination basis. This practice will continue to add to regional fiscal disparities and it deprives the government of a significant instrument for income equalization across the national territory. The new draft Tax Code....."nuisance" taxes and in many ways improves the structure of the major taxes. Leaving revenue sharing issues aside, the proposed VAT represents a very significant improvement over the current tax. In particular, the VAT becomes more neutral toward economic activity and it will be collected on an accrual basis. However, the proposed VAT still contains an excessive list of exempted commodities. The most important improvement to the proposed VAT would be a more limited list of exempted commodities.

The proposed excise tax system in the new draft Tax Codes present just a few problems. Specific rates still are not indexed for inflation; and thus there is the risk that tax collections will erode over time due to inflation. Currently, the draft indexes only excises on specific types of mineral

resources for inflation. In the list of excisable commodities the draft Tax Code includes oil piping services. This is not a traditional excisable good and its inclusion in the list is likely to be distortionary to oil production. Unlike the case of other excisable commodities, there is no particular negative externality that would justify the special taxation of oil piping services. The new draft Code should also be changed to make sure that the excise on natural gas falls on final consumers.

The proposed enterprise profit tax represents a considerable improvement over past and current practices in the Russian Federation. The new draft Code allows for the deduction of most costs of doing business. However, some problems remain. The drafting of the tax remains is too complicated and there is little justification for the special regimes and beneficial treatments envisioned. Besides sacrificing the principle of horizontal equity and creating distortions in the allocation of resources, the special regimes and beneficial treatments are likely to get abused for evasion purposes via transfer pricing and other mechanisms. The sacrifice in foregone revenues represented by the special regimes and beneficial treatments accomplish little desirable results. The draft excludes the administration tool of requiring consolidated returns for related enterprises. This is still a serious omission given the extent of current tax evasion and avoidance specifically through off-shore operations of related companies. Short of introducing consolidated returns, the tax administration should be given the authority to require information and combine the reporting of related enterprises but without demanding a consolidated return. This is an essential tool to combat tax evasion. The new draft Tax Code maintains a separate tax on income from capital, which relies mostly on withholding methods. This continues to be the right approach to the taxation of this type of income until the tax administration is strengthened and modernized. At that time it will be desirable to introduce a global individual income tax where all types of income is combined into a singletary base.

However, the rate structure of this schedular or separate tax on capital income should be significantly simplified. The reporting requirements on withholding agents in the draft Code are onerous and they should be reduced.

The personal income tax in the draft Code could be simplified significantly by redrafting personal and dependent deductions and reducing the number of tax brackets. It should be also recognized that the tax authorities will not be able to enforce the taxation of all in-kind benefits. A more effective approach to discouraging this type of compensation and actually tax it would be to exempt in-kind benefits at the individual level and disallow them as a deduction at the enterprise level. The "contributions to social security extra-budgetary funds" or payroll taxes proposed in the draft Tax Code represent a substantial cut in rates from their present levels. This should have positive effects on investment and employment and it should help reduce the size of the underground economy. These measures should also help increase the international competitive of compliance enterprises. However, there would be advantages to shifting from a 100 percent employer-financed social security system, as maintained in the draft Tax Code, to one in which both employers and employees (the latter through withholding by their employers) contribute to the social security funds. Introducing a split system of contributions would make the system more transparent, would get workers more interested in the proper management of social security funds, and would make it possible to tailor and link contributions and benefits.

The provisions in the draft Tax Code on state duties are adequate and so are those on customs duty. However, the draft Tax Code does not contain levels and ranges for the customs tariff so it is not possible to wholly evaluate this aspect of the tax structure.

Mineral resources are subject, in the new draft Tax Code to exploration and exploitation fees and production royalties. In addition, oil producers are subject to an excess profit tax. This is a balanced approach to the taxation of mineral resources. However, the difference in tax treatment by type of mineral ore and by ownership of enterprises is not well justified. In addition, the application of the excess profit tax will need further clarification to the current draft. Taxes on the exploitation of wildlife and fisheries, forests, and water resources, as well as the environmental tax are all provisions in the right direction for the much needed protection of natural resources and of the environment in the Russian Federation. However, the current provisions in the draft are not detailed enough to allow an assessment of whether the new taxes will be effective in the control of negative externalities. The true implementation of these taxes awaits further legislation by the Government.

A significant feature of the draft Code is the introduction of a sales tax at the regional level. The introduction of a final (or retail) sales tax in a country that already has a VAT is often criticized on the grounds that two taxes will be levied on the same base. Often, it is also added that the sales tax may hamper the proper administration of the VAT, resulting, for example, in "cascading" effects. Although some risks do exist, much of the criticism is not valid if there is a proper tax administration in place. In this sense it would be desirable for the draft Tax Code to provide a more tightly defined administration framework for the sales tax. Very few countries combine the use of a national VAT with a subnational final sales tax, but Canada serves as an example that it can be done. Because of the importance of providing subnational governments with effective measures of revenue autonomy, the risk associated with the introduction of the sales tax is probably worth taking.

Other regional government taxes such as those on gambling and license fees present no major problems, but by themselves should provide little revenue autonomy at the subnational level. The

draft Code envisions the introduction of a western-style real estate property tax in substitution for the current taxes on real property. But because the new real estate tax is assigned at the regional level (although to be shared with local governments), there may be less incentive for local governments to accept the real estate tax in lieu of the land and personal property taxes (which are assigned to the local governments in the draft Tax Code). The real estate property tax should be reassigned to local governments exclusively.

Several ... are assigned to local governments....The advertising tax, properly assigned to local governments, would be more effective if it were administered by using specific rates for different modes of advertising. The tax on inheritances and gifts is clearly misassigned at the local level. The reasons are that this tax is never a large revenue producer and its main purpose or justification is to redistribute wealth across the national territory. The structure of the inheritance and gift tax in the draft Tax Code is seriously flawed and it would lead to insignificant collections.

Finally, the draft Tax Code....several special tax regimes to reduce compliance and administration costs of certain groups of taxpayers....The simplified taxation system for small taxpayers is a positive development for bringing into the tax net small businesses and entrepreneurs and thus helping increase collections from sectors traditionally hard to tax. However, there are several problems with the current draft. In particular, small taxpayers subject to the simplified regime should not also be subject to pay sales taxes and VAT. After all, the tax base for the “patent” on which the small business tax is based is proceeds from the sale of goods and services. The second special regime of "imputed tax" will also help increase collections from sectors that traditionally are hard to tax. However, a blanket application to businesses in certain sectors (retail, construction, or transport), regardless of size, is not justified. The "imputed tax" regime also lacks the structure and

certainty provided in the simplified taxation system. The third simplified regime for agricultural producers also represents a step in the right direction, but it could be easily abused by large agribusinesses.

In all, there is a good promise that if a revised draft Tax Code is passed by the State Duma, the Russian Federation will have one of the two necessary legs of a modern tax system. The other leg, tax administration is addressed in the next section.

### **III. Issues in Tax Administration**

Whether or not the tax reform effort ultimately succeeds in the Russian Federation depends upon the strength or lack thereof, of the tax administration system. The Government has put much of its attention into the adoption of a modern tax structure. Meanwhile the country has continued to struggle with low rates of revenue mobilization and increasing rates of tax evasion. Until recently, the Government has given much less attention to tax administration. The general consensus is that the modernization and structural reform of the State Tax Service has lagged behind other market-oriented reforms in the country. There is a clear understanding today in Russia, in and outside Government, that without a comprehensive modernization and reform of the tax administration system, the current tax reform effort will continue to face an uncertain future.

The challenge ahead is extremely demanding. What is required is the entire transformation of the State Tax Service from a passive, declaration and collections oriented organization to a proactive, customer and enforcement oriented tax administration. This transformation will require radical changes in the functional reorganization of the federal offices of the State Tax Service and the State Tax Inspectorates and the revision and training in standards and procedures in the most important

functional areas of tax administration including taxpayer services, audit, registration, collections, and information systems. These reforms should focus on lowering administrative costs, increasing productivity of the scarce available resources, and most importantly, increasing taxpayer compliance through a mixture of preventive and enforcement programs.

### **III.1 Overview of the Current Tax Administration System**

Despite the reform efforts of the past year, the organization and operating procedures of the STS remain inadequate for the task. The most significant problems remain following in the following areas:

*Organizational Issues:* The current structure of tax administration in Russia, for the most part, has the same organizational and territorial structure as the previous system. Most collection and enforcement activities are carried out by Territorial Tax Inspectorates (the lowest-level tax office). Regional offices supervise and coordinate the effort of local offices and report aggregate data on collections to the federal STS. De jure, the federal STS has significant control over the operations and standards of regional and local inspectorates. De facto, however, this control has been uneven and remote in some regions. The oversight and control by the federal offices has concentrated more on collections and less on other issues such as registration of taxpayers audit plans, or the enforcement of uniform information systems and procedures.

The current organizational structure of Territorial Tax Inspectorates, by type of taxpayer (e.g. individuals, enterprises, and foreigners) and often by type of tax (VAT, Enterprise Profits Tax), has led to the duplication of tasks and a lack of specialization and integration of activities in the more demanding areas of tax enforcement such as field audit. The lack of functional organization in the

STS has kept the STS from increasing the efficiency of its scarce resources. It has been common that highly trained tax inspectors continue to perform clerical, low-revenue yield tasks, such as data entry and the numerical verification of tax declarations. Quite to the point, the general perception inside and outside the STS is that allocations to tax administration in the State Budget have been too low for the tasks the STS needs to carry out. But, even though these allocations have indeed been too low, the fact is that the STS should be able to do much more with its current resources by increasing the efficiency of its operations. Over the past year a number of reform initiatives have been underway. For example, in those regions where functional reorganization has occurred (Volgograd and Nizhny Novgorod), anecdotal evidence supports the claim that the functional reorganization of the service could increase both administrative efficiency and revenue collections.

*Registration Issues:* Two issues confront the STS in the area of registration: (1) the detection of non-filers and stop-filers, and (2) the registration of individuals who will be required to submit Personal Income Tax returns in 1998. Currently, the STS has not been able to develop systematic methods for the detection of non-filers. And the system currently in place for the detection of stop-filers have not proved to be very effective. For non-filers, the lack of personnel available to canvass neighborhoods and the lack of inter-agency cooperation for the exchange of information present two significant obstacles to overcoming this problem. With respect to stop-filers, unique Taxpayer Identification Numbers are one key for detecting individuals and enterprises who choose to ‘drop out’ of the tax net. However, the lack of standard identification numbers within and outside the STS have prevented the detection of stop-filers. The lack of cross-comparability of information systems at the TTIs and STIs levels has also prevented data exchanges within the STS. Stop-filers may move from one TTI to another, secure in their knowledge that their tax records cannot be electronically

transferred in the vast majority of cases. The lack of a uniform identification number for individuals and businesses has made it impossible to use third-party information and information matching systems to detect tax evaders.

*Collections Issues:* Tax arrears have represented a permanent problem over the past five years in the Russia Federation. There are obviously multiple causes for these arrears, including the existence of governmental arrears with enterprises and the practice of tax offsets, whereby taxpayers are allowed to cancel out their debts to the STS with the funds other government agencies owe to them. The monitoring of collections has been, in many cases, non-systematic. The focus of collections and the structure of penalties and other sanctions has been on the current revenues and not on the potential revenue stream from taxpayers. Information reporting to the STI and STS level of the tax service routinely contains only aggregate information on collections and arrears, with little detail on the historical and present profiles of arrears cases. Lacking this information, available resources have not always been redirected to those collections activities or taxpayers where there could be a greater increase in revenues.

The practice of setting revenue targets for tax offices has an old tradition in the STS but it may have contributed to hamper the performance of local tax inspectorates. Once revenue targets are fulfilled, there is less motivation to vigorously pursue the collections of current and delinquent accounts.

Collection procedures has also lacked in other areas. Taxpayer services are inadequate and the STS could improve efficiency and lower compliance costs by making wider use of banks to collect taxes. Only in the rarest of cases have modern statistical techniques been used to analyze revenue trends and to forecast revenues. The resulting lack of forecasting ability at the STS level may have

led to unrealistic revenue targets, targets that may only have served to demoralize existing tax administration efforts.

*Audit Issues:* This key area of tax enforcement has been perhaps the slowest to develop. The lack of adequate development is related to the nature of tax administration in the previous regime. In the past regime, taxpayers were restricted to a single account and state banks were used to monitor all payments and general compliance. Audit work was mainly limited to conducting ‘cameral’ or numerical audits of taxpayer declarations. Transactions could be verified through banking records. The simplicity and effectiveness of these arrangements are reflected in the organizational structure of local tax inspectorates with a strong Cameral Audit Department. They are also reflected in the still official audit policy of the STS that every taxpayer must be ‘audited’ within a two-year time period. The changes in the economy and payment systems have considerably diminished the effectiveness of the traditional approach. The office or cameral audits have tended to be perfunctory and they are not generating any significant amounts of revenues relative to the potential revenue yield of field audits. It is also uncertain, neither is desirable, that every taxpayer is audited at least once every two years.

The development of field audit procedures has been lacking Federal STS instructions to ensure standards for the conduct of field audits often have not been followed by regional and local tax inspectorates because are not adopted to local conditions. This problem arises as the result of the lack of taxpayer information at the national level. The lack of a common information system standards has limited the ability of the federal STS offices and also the regional STIs to obtain concrete information on large numbers of taxpayers and use this information to increase the efficiency of operation of the audit function. Often, the regional STIs are unable to tailor audit programs to local conditions and must rely primarily on a ‘shotgun’ approach to auditing, that is, auditing every

taxpayer in specific sectors, rather than concentrating available resources on those taxpayers which audit selection programs may indicate are probable evaders with significant tax liabilities.

*Taxpayer Services:* This area of tax administration has been largely ignored over the course of the past six years in the Russian Federation. Taxpayer services were unknown under the previous system. Today in Russia, taxpayer familiarity with the tax system remains low; taxpayers often do not have access to elementary regulations, tax forms, or filing instructions. In fact, taxpayers are required to pay for their tax declarations in Russia and are required to queue for long hours in the street or overcrowded halls in order to pay their taxes.

The interest of many STS officials in creating a taxpayer services section in local tax inspectorates is high. Some regional and local inspectorates have taken their own measures to promote taxpayer education. But, because of the lack of national standards and procedures, at times these measures are a reversion to the previous system in which, for example, local inspectorates require taxpayers to submit their business plans for approval. In too few instances where taxpayer services do exist, tax administration officials must combat the confusion created by rapid changes to the tax code and the deep-rooted mistrust by taxpayers of government institutions.

Information Issues: While adequate information resources exist at the regional and local level of the STS, the application of these resources has been haphazard. Currently, there is a multitude of tax administration information systems in use throughout the Russian Federation, the majority of which are incompatible in terms of data exchange. In a particular state tax inspectorate, in many cases, if a taxpayer moves from one local inspectorate to another, the taxpayer's tax records must be re-input by hand. This incompatibility of data systems means that information exchange between elements of the tax service does not occur, that third-party information cannot be incorporated into

information audits, and that in many cases, basic taxpayer information is not contained in the computer files. At the regional and national level, individual taxpayer information is practically non-existent relative to tax administrations in Western countries.

Other Organizational Issues: Many other structural issues remain to be addressed in tax administration in the Russian Federation. First, is there a need for regional and local government tax administrations given the prospects of the passage of the new tax code? Second, should the STS and the Tax Police be integrated as in many other countries? Third, should the STS be in charge of collections for social security contributions to the extra-budgetary funds? Fourth, what is the role of the STS with respect to the property tax? These issues need to be carefully evaluated by the Government, and some will require a long time to solve.

## **II.2 Importance of Tax Administration and Impact on Other Aspects of the Fiscal System**

Few today would question the idea that the principal determinant of a country's economic success is the quality of its institutions and policies. This is especially true in the area of taxation, where the distinction between policy and administration is not as clear as in other areas of economic policy. Good tax administration is good tax policy. The best tax policy which cannot be enforced by the tax administration is not a good policy. Whatever reforms are introduced in tax administration, it will be very important to keep in perspective their impact on other elements of Russia's fiscal system.

The capacity of the tax administration in the Russian Federation is one of the prime determinants of whether tax and intergovernmental fiscal relation's reform will succeed. If the State Tax Service does not adequately prepare (or if it is not given an adequate amount of preparation time), then the introduction of a new Tax Code (or new separate tax laws) may produce significant

revenue declines and promote evasion. In particular, the State Tax Service should be able assess and collect most of the new taxes that will be assigned to regional and local governments.

With the possible exception of the property tax, the best general approach at this time may be to rely on the State Tax Service as much as possible for the assessment and collection of the new regional and local taxes. Given the current weakness of the tax administration and limited resources, it might be best to concentrate on improving the current tax administration at the federal level before attempting to create new tax administrations at the regional and local levels of government. This must be counter-balanced with the realization that the State Tax Service's primary mission is to raise revenues for the federal budget. Therefore, the assessment and collection of solely regional and local taxes will be of less importance, and potentially costly in terms of resources.

The State Tax Service also needs to play a better role in fostering the development of transparent and fair intergovernmental relations between the federal and regional governments and between the regional and local governments. The current distrust between the federal and oblast-level governments is enhanced by the inability of the tax service to collect the budgeted revenues for each level of government. An example of this distrust is evident in the practice of having taxpayers write separate checks for the federal and oblast governments for shared taxes. This 'revenue-sharing' responsibility clearly should be transferred from the taxpayer to the State Tax Service. This simple but significant improvement in taxpayer services would require significant coordination and agreement between the federal and subnational governments.

The development of forecasting and analytical techniques within the State Tax Service should allow the Government to improve the quality and accuracy of the annual budgets. Currently, only

a handful of regional state tax inspectorates are employing modern, statistically reliable forecasting techniques.

### **III.3 The Principles of a Strategy for the Modernization of the State Tax Service**

The reform of the State Tax Service of the Russian Federation presents many questions and challenges of a technical nature, but there are many other issues that are strictly of a political nature. This is particularly true in those areas where the reform of the State Tax Service will affect the relations between the federal and subnational budgets. Furthermore, the vast territory of the Russian Federation and regional peculiarities need to be taken into consideration in setting a reform strategy and specially when attempting to replicate successful experiences. It is precisely the enormousness of the task at hand and the diversity and expanse of the Russian territory that calls for a pilot or trial and error approach to many aspects of any modernization plan. Many of these modules for reform must be successfully developed in pilot regional local offices, and only then should these results be disseminated, with the proper adaptations to other regional and local inspectorates throughout the Russian Federation.

The process of defining the overall strategy for the reform of the State Tax Service and the weighting of the different objectives to be pursued during this process will not be easily decided. General agreement exists among different Government bodies that tax administration modernization must occur, however, the pace and scope of reform still remain to be defined. Ideally, all the interested parties (to include subnational governments affected by the reform of the State Tax Service) should be involved in determining strategic and operational priorities of the modernization process.

The best way to proceed will be to put in charge of the reform a Modernization Committee with the mandate to continuously update and reassess the Government's objectives and priorities for tax administration reform. This Modernization Committee should be staffed with the highest level of world-wide expertise on the reorganization of tax administration, the development of standard operating procedures in each of the functional areas of tax administration, the development and implementation of a wide-range of audit and compliance methodologies, the design and implementation of taxpayer services, and the standardization of information systems to promote information exchange within and from/to outside the STS. The charge of the Modernization Committee should be to provide the State Tax Service and the Government with a menu of nested reform options that reflect best worldwide experience and practice, and reform options that are best tailored to the Russian economic and political realities.

There are many combinations of objectives that could be drawn for the STS Modernization Reform. What follows is a possible set of objectives:

- Increase administrative efficiency through the functional reorganization of the State Tax Service at all levels (federal, regional and local);
- Decrease delinquent accounts in collections and control the number of non-payers and stop-payers;
- Increase the effectiveness and revenue yield from audits through the implementation of a centrally coordinated audit plans;
- Promote taxpayer compliance through the implementation of taxpayer services; and
- Develop adequate information systems in support of management and internal control, and in support also of registration, collection, and audit functions.

Because the State Tax Service is still far from being a unified and vertically integrated agency, it could be useful to strategize the modernization process at two different levels: the federal offices of the STS and the regional and local offices (or STIs and TTIs).

The central element of the strategy at the federal level should be the functional reorganization of the tax service. Reorganization at the federal level will promote administrative efficiency and will give the STS the ability to re-direct resources to promote long-term compliance, and gain more control on the operations of regional and local offices. This functional reorganization should focus on increasing the administrative capacity and standardizing rules and procedures within each of the functional areas of registration, collections, audit, information systems and taxpayer services throughout the Russian territory. A key element for the strengthening of the federal offices will be to increase the capacity and skills of the tax administration cadre at the federal level. This will require long-term training programs and the development of core curricula in accounting, economics, and

of course, taxation. The need to upgrade the current tax administration training curricula, much of which is still based on lessons of the previous tax administration system, can not be exaggerated.

The core of tax administration activities in Russia takes place at the local or TTI and regional or STI level. A reform strategy that focuses exclusively at the federal offices of the STS would be doomed to be ineffective. A reasonable approach to reform at the local level of the State Tax Service would be to focus first on the functional reorganization in approximately ten (pilot) regions, second, on promoting modernization of all functional areas within these regions, and third, on promoting the vertical integration of regional and territorial STS activities with the federal offices.

The first step in this strategy should be the selection of the (pilot) regional State Tax Inspectorates, and the creation of a coordinating group for each of the pilot inspectorates. With the selection of the regional inspectorates, the strategy for modernization should mirror that of the federal level, but focusing first on the development of administrative capacity in the functional areas of registration, collections, audit, information systems, and taxpayer services.

#### **a. Functional Reorganization at the Federal Level**

In evaluating how the State Tax Service (STS) should approach the strategic objective of improving its structure, there are two guiding principles that stand out:

- The STS should only initiate reorganization after the development of a clear and precise plan.
- Increased compliance and better customer services should be the overall objectives in the functional reorganization of the STS.

Improving taxpayer compliance will involve a variety of factors including the tax administration's public image and credibility, the readiness of the STS employees to serve the

taxpayer, and the management structure in which they go about their daily tasks. At the end two fundamental factors will affect the efficiency and effectiveness of the State Tax Service: (1) its organizational structure, and (2) its human resources.

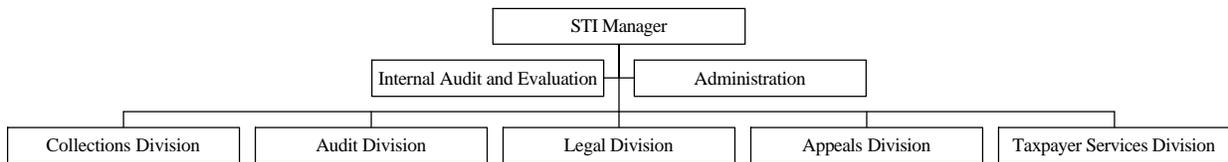
Organizational structure is the formal framework required for an organization to operate as an integrated system that processes information and solves problems. Delineating the responsibilities for each area and its constituent roles and correctly defining the interrelationships among these roles facilitates administrative efficiency and assists the organization in achieving its strategic and operational objectives. The confusion generated by a poorly designed organizational structure occurs when responsibilities are vaguely defined or shared across functional areas. This would appear to be the case under the current STS organizational structure by taxpayer or type of tax. Designing a functional structure for tax administration will reduce ambiguity and increase productivity. Employees will benefit from a coherent set of rules because they will know what is expected of them and what objectives they are supposed to meet. Employees will also see their productivity increased because of specialization in particular tasks and functions. In addition, a functional organization will make it possible to redistribute resources from low revenue yield functions (for example, data processing or cameral audit) to high revenue yield functions (audits, or collections) within established resource constraints.

The functional reorganization should be based on the principles of responsibility and delegation. The reorganization strategy should recognize that tax inspectors at any level of the tax service are accountable to a single managerial or organizational entity. Therefore, the managers of the primary operating units in the STS – managers of regional STIs – must have a single authority to whom they are accountable to for results. To achieve this it will be desirable to create a single

directorates of operations to solve the current problem of multiple subordination (managers having to report to different authorities within the STS).

Another critical element of the functional reorganization strategy of the STS should be to establish, at every level, systems to evaluate performance vis-a-vis STS objectives. The evaluation and monitoring system should take into account not only the quantitative results for the period of evaluation, but also the quality of work done, and of the relations with the taxpayer. This element of the functional reorganization strategy would represent a significant step away from the current ‘collections-oriented’ culture. Explicitly evaluating managers on their performance (and the performance of their subordinates), should help increase collections and the quality of services within the STS.

Figure TA-3  
Proposed STI Structure



The functional reorganization of the pilot STIs (see Figure 1) could run concurrently with the functional reorganization of the Federal STS, however, there are potential benefits to having the reorganization processes run consecutively and not concurrently. By having the Federal STS reorganize first, a knowledge base would be created within the Federal STS that can be used to guide the reorganization of the pilot STIs.

## **b. The Development of Taxpayer Services**

The strategic objective of improving customer service, and increasing voluntary compliance should be guided by the principle of increasing customer satisfaction in every interaction the STS has with taxpayers, including enforcement actions. Taxpayers should come to expect quality service in all interactions with the STS, including taxpayer assistance, filing tax declarations, paying taxes, and examination and collection actions.

Currently, the Russian public does not receive timely, accurate, and respectful service from the STS. This is a result in part from the STS exclusive focus on enforcement. In the vast majority of cases, contacts between the STS and taxpayers are solely for the collection of taxes. Very rarely, these contacts are to facilitate tax compliance by taxpayers by providing information and assisting in the filing of tax returns.

There is, on the other hand, an increasing conviction, in Russia and elsewhere that good customer service and taxpayer education, which assists taxpayers in meeting their tax obligations to the government, eventually leads to increased compliance. The focus of the STS modernization program should be shifting from high-cost enforcement solutions to lower-cost, non-enforcement solutions facilitating taxpayer compliance over the long-term.

The traditional enforcement approach to compliance in Russia of dealing with taxpayers one-by-one through audit and examination of individual returns can not be sustained over the medium-term as the number of taxpayers and the complexity of returns continues to increase over time. Not only is the traditional approach expensive, but it fails to identify patterns of noncompliance. The STS

must shift its efforts from one-on-one interaction to identifying activities that may foster voluntary compliance, such as decreasing filing costs and providing friendly advice and information on demand.

There are several areas that can be used to illustrate the need and possibilities for improving taxpayer services. Currently, STS notices and correspondence to taxpayers fails to state the reason for contact and the notices do not offer resolutions. In fact, there appears to be a wide variation in practices and procedures in the conduct of the relatively simple task of taxpayer notification. Notices, when issued, lack essential and basic information needed by taxpayers. Moreover, the taxpayer can not simply call the STS for assistance. In the overwhelming majority of cases, the STS requires the taxpayer to present themselves personally at a local tax inspectorate to resolve the problem. Even when the taxpayer takes the appropriate action and resolves the matter, the taxpayer rarely receives confirmation from the STS that the problem is resolved. In short, taxpayer initiated contacts with the STS are a struggle with the bureaucracy, rather than an interaction with a customer friendly organization seeking to resolve taxpayers' problems.

Another example is that, currently, instructions, forms, and regulations are issued without significant review for clarity or conflict with existing instructions, forms, and regulations. The resulting confusion increases compliance costs for the taxpayer and leads to the perception that the STS is unable to effectively administer the tax system. A set of remedies for this problem would include clear provisions for internal and external review, public commentary, and pilot implementation of new forms, instructions, rules, and regulations.

Another current problem is that the tax forms issued by the STS fail to provide sufficient instructions to taxpayers on how to comply with existing tax law, and they also fail to provide the

STS with sufficient information to accurately assess if the taxpayer is complying with existing tax law. The current separation of the Enterprise Balance Sheet and Financial Statement from the Enterprise Profits Tax declaration not only increases taxpayer compliance costs (having to fill out multiple forms, increased probability of making mistakes) but also increases administrative costs (having to process multiple forms). The new forms and declarations are consistent and complementary with the objectives of lower compliance and administrative costs.

A fundamental problem in the area of taxpayer services is the lack of customer service centers. At the present time, when a taxpayer has a question pertaining to the calculation, submission, or payment of taxes, they must invariably travel to a local tax office to find an answer to their question. Services such as automated phone assistance or an Internet web site are non-existent, even though the cost of providing and maintaining these service is negligible relative to one-on-one interactions with the taxpayer by a tax inspector. At local tax offices, sufficient space does not exist to provide taxpayer services, and the primary interaction between the taxpayer and the tax service occurs when the taxpayer is required to submit their tax declaration in person -- this is a very costly procedure for both taxpayers and the tax administration.

The modernization strategy for the State Tax Service should include the development of regional and local Taxpayer Service Centers in the (pilot) regional tax inspectorates. These Customer Service Centers should aim to providing low-cost solutions to taxpayer services such as the development of a web-site, telephonic help-lines, customer service facilities and taxpayer "self-help" materials.

### **c. Improving Functions and Processes**

In designing how the STS should approach the strategic objectives of increasing voluntary compliance and finding efficiency gains, it will be important to shift focus from the numerical verification of taxpayer declaration to more aggressive techniques of ensuring compliance, to include field audit non-filer and stop-filer programs, and collection enforcement. To this end, the State Tax Service must employ modern techniques to detect and stop tax evasion through the exploitation of taxpayer information and third-party information.

In the audit area, currently the primary focus of the STS is to conduct ‘cameral’ or numerical audits; there is no use of modern audit techniques and field audits are few and often not effective. The taxpayer is required to submit their tax declaration in person at their local tax inspectorate. A tax inspector then conducts an ‘audit’ of the declaration by numerically checking to ensure that the taxpayer has complied with the tax law. In most tax inspectorates, the number of inspectors engaged in cameral audit activities is significantly greater than the number of inspectors engaged in field audit activities. However, it is clear that this resource-intensive approach to cameral audit fails to produce the greatest increase in taxpayer compliance, given available resources.

In concert with the functional reorganization of the STS, there is an immediate need to upgrade the capabilities of managers at the Federal and regional levels of the STS to conduct, evaluate, and manage the audit function. There are, at present, several serious obstacles to achieving this end. One of the primary limitations in the development of a National Audit Plan is the current inability of the Federal STS to horizontally or vertically transfer or receive information with regional and local offices. Given that the Federal STS will not be able to centrally analyze what groups of taxpayers are more likely to evade until the data information difficulties are solved, it is will be important to start by strengthening the management function of the audit section of the Federal STS.

By strengthening its management function, the Federal STS would be able to effectively direct resources at the regional and local level to those groups of taxpayers for whom field audits will prove most effective. Eventually, the Federal STS should develop audit selection criteria based upon databases on audit information nationwide. Until a national audit plan is developed with the use of national databases, audit selection plans will need to be developed at the regional level using regional databases. Improvements in the methodology for selecting taxpayers for audit will allow the STS to pre-identify for audit those tax declarations with the highest revenue potential. However, to carry out the audit function effectively, the STS still needs to invest further in the development of guidelines (a Standard Operating Procedure) on how to conduct field audits and train its inspectors in modern and market-economy-based auditing techniques.

In the area of collections the strategy for reform should be to reorient resources from passive processing of taxpayer declarations and payments to pro-active collection programs in the areas of:

- Non-Registration
- Taxpayer Identification Numbers
- Non-Filing or Stop-Filing
- Delayed Filing
- Non-Payment/Delayed Payment of Declared Tax Liability

Adequately addressing the problem of collections will require, first and above all, continued political will by the Government to enforce rules with all large delinquent taxpayers in arrears. On

the other hand, the monitoring and enforcement of collections with small taxpayers (stop-filers, non-filers, and those in arrears) will require the introduction of computerized procedures.

Here, as in many other areas of the modernization of the STS, the main technical issue to be addressed is information processing. Systems need to be developed for the gathering, collating, and classifying of information from taxpayers and from third parties regarding taxable transactions made by taxpayers. The STS also needs to develop protocols for access to third party information from Goskomstat, regional statistical committees and other governmental agencies (Customs, Extra-budgetary funds).

In the area of information systems, the STS needs to develop a comprehensive strategy for the standardization of information and systems across all levels of the STS. The objective should be to design a unified tax administration information system throughout the national territory. To this end, it will be imperative that the STS to start with set forth concrete, and achievable, information technology standard with which the regional and local inspectorates will have to comply. It will also be important to design such a system within the framework of the entire modernization effort, as the information system would need to support the rest of the tax reform efforts. More in particular, the STS strategy for a system-wide information system should be:

- unified, meaning that all tax administration offices should use the *same* system. Having a unified system facilitates the sharing of information for multiple purposes. This would require clear standards and core data models.
- comprehensive, meaning that is applicable to all functions of the STS, including registration, audit, assessment, and collections.
- a management tool, meaning that the federal authorities could use the system to evaluate the effectiveness of regional STIs and local TTIs, to carry out a more

effective allocation of resources in functional areas such as audit and collections, and to apply it for analytical purposes such as the evaluation of revenue and burden impacts of alternative tax reform blueprints.