Tax Reform in Russia

DALE CHUA

The failure to arrest the slow decline in government revenues since the early 1990s was one of the key causes of the 1998 debt crisis. While some initial revenue decline was expected during the transition as the economy was restructured and new tax systems put in place, by the mid-1990s tax collection in Russia still showed few signs of turning around. Intensive efforts, drawing on large technical assistance resources provided by the international financial institutions and other donors, produced few concrete results, owing to a combination of weaknesses in the tax structure, the poor legal basis of tax administration, and a lack of political support to reduce graft and ensure compliance by large politically connected enterprises.

As capital inflows reversed in late 1997 and 1998, the difficulties of financing budget expenditures highlighted the need to address the revenue decline. While some key steps to strengthen tax administration were approved by the Duma in July 1998, important revenue measures included in the government's program—supported by the IMF—were rejected by the Duma in July and August, arguably triggering the crisis. Only after the crisis actually hit was the political resolve found to tackle two major issues: the need to force energy companies to comply with their statutory obligations, and the need to eliminate the use of offsets and other noncash payments.

The importance of tax issues—from the perspective of both putting the budget on a sustainable footing and strengthening the investment climate—was well understood by President Vladimir Putin and his administration. A major overhaul of the tax system emerged as one of the
early priorities and fundamental changes have been introduced in the past few years aimed at simplifying both the structure of taxes and their administration. It is still early to provide a full assessment of the impact of these reforms, as revenues during this period have also been buoyed by the strong economy and high oil prices. Compliance appears to have improved, but the true test of this will only come in an economic downturn.

Precrisis Tax Collection Setting

Tax collection has long been a source of tension in Russia. Declining tax revenues compromised adjustment efforts and ultimately shattered hopes of sustaining macroeconomic stability. During the last decade, there were several attempts to reform the tax system, but they were halfhearted and ended in poor results. Most notably, the failure in the mid-1990s to act resolutely during the period of relative stability that immediately followed the post–Soviet era adjustments squandered an exceptional opportunity for laying a proper foundation for medium-term fiscal improvements.

The underlying problem was a lack of political will to take tough actions against politically well-connected taxpayers. Failure to sanction serious tax delinquents and stem the growing deterioration in tax discipline constrained collection and made Russian statutory tax obligations irrelevant. Nonpayment of taxes proliferated and large taxpayers negotiated their payments independently of tax obligations. Cash collection fell precipitously and noncash collection emerged. A policy of offsetting tax arrears against expenditures gained acceptance and spread. Politically powerful enterprises accumulated arrears, which gave them the leverage to force government demand for their goods and services, often at inflated prices, to settle tax arrears.

While frail political resolve was crippling tax collection, weaknesses in tax administration aggravated the difficulties of enforcing compliance. Several critical problems needed to be addressed but received scant attention. For example, the tax code provided little authority or flexibility to tax officials, whose ability to perform tax audits and inspections was highly circumscribed. Taxpayers’ rights were vaguely defined. Where clarity and specificity were needed—regarding large taxpayer compliance, reporting and payment procedures, and the legal status of control measures—ambiguity and a lack of specificity were commonplace. In some industries—for example, the alcohol industry—the lack of a clear strategy for strengthening tax collection oversights permitted organized crime to spread unchecked.
The structure of the tax system presented further challenges (see Box 4.1). In times of need, the institutional relationship between the federal and subnational governments impeded Russia's ability to adjust. The sharing of tax bases and the lack of formal local fiscal autonomy sometimes led to a struggle that created additional taxes and higher rates. Collusion thrived as subnational governments schemed with enterprises to keep taxes away from the federal government. Small, nuisance taxes abounded, providing opportunity for rent seeking. High direct taxes added a further burden on businesses.

Many of these problems were already widely known by the mid-1990s. In response, several multilateral and bilateral donors offered technical assistance in a wide range of areas. Donors proposed to help modernize tax audit operations, establish special tax units for large taxpayers, strengthen controls over excise taxation, set up tax debt recovery services, and improve the structure and organization of the State Tax Service (STS). Long-term technical assistance experts were installed in Moscow.

Even in the best of times, strengthening institutions takes time. In the climate of inadequate political support in Russia in the mid-1990s, striving for improvement was slow and painful. Limited absorption capacity and coordination problems reduced the effectiveness of technical assistance. Besides, the administration was fragmented across too many agencies, and management turnover was high. Tax legislation was complex, and occasionally outright contradictory. Low salaries and morale fanned corruption among tax officials.

The coupling of political forbearance for nonpayment of taxes with a weak tax administration severely eroded the tax system. The public was left with an impression—largely justified—of an arbitrary tax system where the government was unable to enforce statutory tax obligations. Consequently, many taxpayers withheld payments, in expectation of outright tax amnesties that would fully abrogate their liabilities. Others waited eagerly to benefit from more offset operations that would allow them to supply goods and services at inflated prices, in lieu of tax payments. Not surprisingly, tax collection fell steadily as a percentage of GDP from 39 percent in 1992 to 33½ percent in 1998. In this environment, tax arrears accumulated, reaching 34 percent of tax collection in August 1997, compared with about 4–6 percent for Canada, the United States, and Australia.¹

¹The accumulation of tax arrears and offsets was not due entirely to inadequate administration. It also reflected a cycle of nonpayment between the government and its suppliers, with the tax authority caught in the middle.
In the 1990s, Russian taxes were often criticized as being excessively high. The general government tax burden, at about 36 percent of GDP in 1999, was higher than the OECD average of 33 percent and the average of the transition countries of 28 percent, and was relatively high for a country of Russia's level of income. However, these comparisons mask differences in the statutory tax burden and in the incidence of taxes. The Russian tax system was characterized by numerous exemptions, which narrowed the tax base, and by poor tax compliance. These factors combined to make the statutory tax burden on those companies and individuals liable to tax considerably higher than suggested by the comparison of actual receipts. Marginal tax rates were generally quite high. Another problem was posed by the multiplicity of relatively small taxes, which together amounted to a sizable burden both in financial and in administrative terms. There is no single estimate of the number of individual taxes that existed in Russia, but it was probably in the range of 50-100. The majority of these taxes were levied at the regional and local level, and many of them were earmarked taxes for particular budgetary and extrabudgetary funds, most significantly the federal and territorial road funds.

In many respects the structure of the Russian tax system was not far out of line with international standards. Receipts of the major taxes are shown in the figure. Russia was notably more reliant on corporate income taxes, and less on personal income taxes, than typical OECD countries, and, like other transition countries, it was somewhat more reliant on taxes on trade. However, VAT, excises, property taxes, and social security receipts were very similar in Russia to those in both comparator groups.

The most significant disparity between Russia and the OECD country averages was in the "other revenues" category. In Russia this amounted to 8 percent of GDP, compared with about 3 percent of GDP in the transition and OECD averages. Indeed, given the propensity for Russian budgetary entities to manage off-budget funds, financed by quasi-tax revenues, the true level of "other revenues" may well have exceeded the estimate shown.

The general structure of taxes in Russia had not changed very dramatically since the initial transition period. The figure shows the evolution of revenues for the principal taxes over 1993-2000. Although still high by international standards, the share of the profit tax in revenues declined, while excises rose. Taxes on trade fell moderately with the elimination of export taxes in 1996, when there was some compensating increase in import taxes, but expanded more vigorously with the reintroduction of export taxes from 1999. The share of other main taxes remained relatively stable.

2 Part of the uncertainty in this estimation arises because it is often difficult to draw the line between mandatory taxes and voluntary or user fees.
Russia: International Comparisons of Tax Structures
(Percent of GDP)

Tax Structure in Russia and Other Countries

- Russia (1999)
- Transition countries (1995–98)
- OECD (1995–98)

Changes in Russian Tax Structure, 1993–2000

Sources: Russian authorities; and IMF staff estimates.
1 General government, including noncash revenue.
2 Based on preliminary information for 2000:Q1.
3 Composition of "other" revenues changes over time.
Revenue Policy Response to the August 1998 Crisis

In the immediate aftermath of the 1998 crisis, the federal government grabbed at the obvious straws in an effort to raise revenues. In early 1999, the federal authorities reintroduced export tariffs on crude oil, petrochemical, metals, and other commodities. These taxes were designed to capture windfall gains to exporters from the depreciation of the ruble after the crisis—in part an acknowledgement that existing profit taxes were not adequate for capturing these gains. Subsequently, rising world energy prices also provided a justification for increasing the taxation of the energy sector. Once there was the political commitment to go after the energy companies, the export tax was easy to collect. Later in 1999, the tax rates were raised, and taxes on natural gas exports were added in January 2000. The scope of these taxes also expanded to include exports to other Commonwealth of Independent States (CIS) countries. Originally envisaged as only temporary, virtually all these export taxes have remained in place.

In addition, the Duma approved in mid-1999 a luxury tax on automobiles and a reduction in the number of goods subject to the preferential VAT rate (although the number of items under the preferential VAT rate was expanded again in July 2000). There was also an attempt to rebalance revenue sharing between the federal and regional governments through an increase in the federal share of the VAT from 75 to 85 percent. Regions were advised to introduce a new regional turnover sales tax from the beginning of 1999 to make up for the revenue shortfall. More pronounced changes to the structure of the tax system would follow in the next few years, which had wider implications for revenue sharing between the level of governments.

While the immediate fiscal policy response to the 1998 crisis reflected the urgent need to rein in the large budget deficit and ballooning debt ratio, the subsequent tax policy response has been well thought out and deft in execution. Good fortune helped. The rebound of the economy, helped by the recovery in oil prices, allowed the tax reforms to be carried out against a background of rising revenues. Without this benefit, it would have been hard to carry through such a broad and deep tax reform.

A Two-Part Reform of the Tax Code

Remedying the major tax collection weaknesses of the 1990s would require a change in mindset on the importance of tax collection. A bold plan was urgently needed to revamp a system tottering near a dangerous precipice. If Russia was to achieve a sustainable fiscal position, a
new tax system would be needed, with stable, predictable tax rules—one that would be fair to law-abiding taxpayers and reduce their tax burden. Equally important, tolerance of tax evaders and non-filers would need to be eliminated. The Strategies and Measures to Improve the Tax System, submitted to the Duma in 1998, provided a blueprint. The tax system was to be reformed in phases with the goals of fairness, simplicity, stability and predictability, and efficiency.

Specifically, the tax system would need to be:

- *fairer*, by ensuring that all taxpayers were treated the same (without any discrimination), easing tax pressure on law-abiding taxpayers through a more equitable distribution of the tax burden, while gradually reducing rates across the spectrum of major federal taxes,\(^2\) and lowering payroll taxes;
- *simpler*, by establishing an exhaustive list of taxes, duties, and fees to be levied while reducing their total number, minimizing targeted taxes and duties, and adopting uniform computation methods and payment procedures across all the various taxes;
- *more stable and predictable*, thus increasing the level of certainty for taxpayers as to their future tax liabilities on a long-term basis; and
- *more efficient*, by significantly improving tax collection, abolishing inefficient and harmful taxes, eliminating procedural requirements that distort the substance of taxes—e.g., negotiating over rates and accepting noncash payments or offsets—and reducing distortions.

Of course, to avoid significant revenue loss, fewer taxes and lower rates would need to go hand in hand with reduced exemptions and increased tax compliance levels, including by resisting corruption and reducing discretion in settling tax cases. A sustained and determined effort would be needed to achieve these goals.

A realistic timetable that would span several years was established. With commendable speed and hard work, Part I of the new tax code was adopted in July 1998, to come into effect on January 1, 1999. It replaced a large number of federal laws, decrees, and resolutions and significantly improved transparency in the legislation—an important first step. Also dubbed the “tax constitution,” Part I of the tax code contained all the procedural laws and provisions, as well as rules governing the revenue relations among the different levels of government, and “definitions” of tax terms (for example, transfer pricing and customs value). To ensure fairness, it carefully sought to build in safeguards to protect taxpayers. It established a list of rights and obligations for taxpayers. To curb the excessive powers of tax officials, it included a list of responsibilities of the

\(^2\)The term “federal taxes” refers to taxes accruing to the federal budget.
revenue authorities. Part I of the tax code also defined the supervisory role of the revenue administration, and drastically reduced high and uncollectible penalties imposed by the older system. To boost confidence, penalties would be enforced only by courts.

While the foundation for the new tax system was being built under Part I of the tax code, major reforms of federal taxes were being developed under Part II of the tax code. These would include the key taxes: the VAT, personal income tax, excise tax, and unified social tax, which entered into force in 2001, and corporate income tax and mineral resource extraction tax, which came into force a year later. Part II of the tax code also established guiding principles for regional and local taxes (for example, taxpayer, base, and rate) and introduced a special tax regime for agriculture.

Part I of the Tax Code: Tax Administration

Reforming tax administration has proven to be painstakingly slow and arduous. Significant resistance arose in many quarters—particularly from those benefiting from the status quo. Part of this resistance originated in a major deficiency of the organizational structure: tax officials who were matched to firms, rather than being assigned along functional lines, saw their interests threatened, and some resisted change. Part of it could be attributed to how taxes were collected in the old days. For instance, the introduction of a new culture of self-assessment was alien to many taxpayers. Most of all, taxpayers were still unsure if the system would be fair, just, and consistent. Perseverance in pursuit of the reform objectives would be critical to eventual success. Taxpayer education would be a priority.

Nevertheless, important steps have been taken to improve tax administration over the past few years. Progress in developing an appropriate legal, institutional, and administrative framework for tax administration in the Russian Federation has now become apparent (see Box 4.2).

A landmark achievement was the creation of the ministry of taxes and fees in 1999. The new ministry developed a workable strategy for tackling the formidable challenges that it faced. From the very start, it articulated formal role statements for each level of operation, introduced changes to regulations to increase the ministry’s ability to monitor the affairs of large taxpayers, created interdistrict offices to help consolidate large taxpayer administration processes, and developed new registration procedures for the largest taxpayers.

The ministry started establishing interregional tax inspectorates to deal with the most important tax administration issues and closed offices in small regions. Staff positions were reduced from 197,000 to
A significant development for strengthening the legal framework for tax administration was the coming into effect of Part 1 of the tax code on January 1, 1999. This part of the tax code includes:

- administrative provisions regulating relations between, and duties of, the taxpayers and authorities;
- general provisions structuring relations between the taxing authority of the federal and subnational governments and restrictions on the ability of the government to include tax rules other than in the code; and
- substantive definitions and rules that relate to the imposition of specific taxes.

Several amendments to Part 1 of the tax code, largely technical in nature, were enacted during 1999. These amendments included, for example, the elimination of the ceiling on interest accrued on overdue taxes. Part 1 of the tax code, however, still falls short of addressing several legal issues that affect the administration of the tax system. One example is the constitutional court's ruling that taxpayers are deemed to have discharged their tax obligations once a duly completed payment order is provided to a bank. This has led to abuses and counterclaims by taxpayers that they have paid their tax obligations even when such funds have not been credited to government accounts. Other issues include the overall balance of rights between the interests of the taxpayer and that of the tax administration, and the adequacy of the audit and enforcement powers granted to the ministry of taxes and fees.

About 160,000 in 1999, a reduction that accounted for half of all downsizing in the federal government. Nonetheless, over 2,600 local inspectorates (just about one in every local political unit) remained, the majority of which were small and hardly viable. To address this issue, the ministry in 1999 created plans for 10 large data processing centers that would consolidate basic information processing tasks presently carried out in local inspectorates.

Separately, to improve the effectiveness of tax administration and reduce the compliance burden on taxpayers, the ministry of taxes and fees implemented a tax administration pilot project in two regions, Nizhny Novgorod and Volgograd (see Box 4.3). The pilot projects were precursors to a larger administration reform program and envisaged new organizational arrangements based on a functional model, modern self-assessment procedures (including improved taxpayer education and services), increased automation and retraining of staff. The project, however, proceeded more slowly than expected in 1999.

The ministry of taxes and fees took active measures to increase the level of voluntary taxpayer compliance, i.e., payment by the statutory due
Box 4.3. Tax Administration Modernization Project in Nizhny Novgorod, Volgograd, and Moscow

This project aimed to improve the efficiency and effectiveness of tax administration in the pilot regions. It also focused on related areas, such as improved service to taxpayers and reductions in taxpayers' compliance costs. By June 2000, the project had set up data processing centers, trained staff in the use of new software, and focused efforts on large taxpayer operations. More importantly, it introduced self-assessment, with a system of audits and a switch to a functional organization to replace relations between tax collectors and taxpayers. The pilot projects achieved the immediate objectives, but they did not produce the benefits anticipated. Among other reasons, this was due to lack of clarity in the overall goals of the modernization project; a strong tendency to simply automate existing, and at times poorly designed, manual processes, rather than undertaking a fundamental and holistic redesign effort; failure to challenge existing business practices; artificial limitations imposed by provisions of the tax and other laws governing the work of the tax authority; and selection of inadequately skilled staff for the redesign effort. Many of the difficulties reflect the tax administration's lack of experience.

Meanwhile, starting in the second half of 2000, the ministry of taxes began planning for a “Concept of Operations” that would incorporate lessons from the pilot program. The concept envisages:

- improving the link between electronic service delivery and data capture (for example, co-coordinating electronic data services to taxpayers, data collection and information on taxpayer transactions);
- changing methods of paying taxes to reduce the burden on taxpayers while achieving quicker crediting of payments to treasury accounts (for example, use of pre-identified payment vouchers/orders, systems of electronic funds transfer and direct debit, Internet banking); and
- creating data processing centers in coordination with a review of the size of the network of local inspectorates and their internal organizational design; the bulk of staff is located in over 2,600 local inspectorates, many of which may not be economically viable.

3In Russia, compliance rates relate only to payments of assessed taxes, and not to whether or to what extent such assessments cover the real taxes that are legally owed under the statutes. Thus, the 70 percent is not directly comparable to the 80-85 percent figure for developed countries, which covers a much higher proportion of truly owed tax.
taxpayers was introduced. Computer-generated payment demands within 7–14 days of a statutory due date were sent out for other taxpayers. Tax officials initiated further follow-up action within a relatively short time based on the size of debt involved. Nevertheless, tax arrears remained high (over 5 percent of GDP as of mid-2001), partly reflecting the absence of administrative action to write off uncollectible debts (that is, because the taxpayer no longer exists, cannot be located, or has no assets).

Notwithstanding these efforts, two sets of issues remain. The first concerns the ministry of taxes and fees, which needs to address a number of outstanding tax administration issues. The staffing of the ministry has to be strengthened to increase its authority over regional levels. In parallel with the operation of a small and weak headquarters, regional and local tax administrations have been heavily reliant on subnational governments for financial support, which has led to dual subordination and accountability, often with conflicts of interest.

The second set of issues relates to technical amendments for Part I of the tax code. These amendments were developed in the past few years and include proposals for limiting deferral of payment to exceptional circumstances, attempting to better balance the rights of the tax authorities with those of taxpayers, improving means of collection, eliminating caps on interest, and providing adequate authority to issue regulations. These amendments have been submitted to the legislature for approval but have not yet been approved. A big push is now warranted if the full potential of the ministry of taxes and fees is to be realized.

Part II of the Tax Code: Key Taxes

Four chapters of Part II of the tax code were passed by the Duma in July 2000 and have been in force since January 1, 2001: those relating to the personal income tax, the value-added tax (VAT), excises, and social taxes. Overall, this legislation represents a major improvement. The legislation also reduced the turnover taxes (for example, the road tax earmarked for the road fund), but did not eliminate them as originally planned. The road tax was eliminated in early 2003. Legislation on the profits tax and the taxation of natural resources, as well as sections dealing with the numerous smaller taxes, were adopted in 2001 and entered into force in January 2002. The various measures adopted move Russia toward a fairer, simpler, and more efficient tax system.

The reforms in Part II of the tax code also embody a revised concept of fiscal federalism for the federation’s three-tier government system. Significantly, the adoption of the chapters advances the process of codifying tax laws under a single source—the Tax Code of the Russian
Federation. The general approach adopted was to split taxes between the three levels of government, thus unifying in one tax the revenue needs of federal, regional, and local budgets. Accordingly, the same tax base would apply to the three levels. By setting the tax rate parameters in Part II of the tax code, tax bases across the different levels of government could be unified—an important reform objective—without sacrificing flexibility in rate levels. This is one way of addressing a source of tension between the federal and subnational governments in tax sharing, making it possible to take into account specific features inherent to each region, although it does not deal with the issue of optimal total tax level. Each subnational government was provided with some leeway in setting rates for its share of the base, even though the base was to remain identical. This was particularly important in such a vast country as Russia, where economic conditions vary significantly from region to region.

The new tax code, in conjunction with the 2001 budget, introduced major changes to important taxes with a view to making the taxation in the economy more efficient as well as fostering tax compliance. This affected many Russian taxpayers, both individuals and enterprises. Specifically, the following steps were taken:

- A flat 13 percent rate replaced the three-band progressive tax rates of 12, 20, and 30 percent for the taxation of individuals. As a counterpart to the reduction in statutory rate, the base was widened. A number of deductions were eliminated or reduced. Prior to the reform, the average effective tax rate was 14 percent and in practice the tax was more flat than progressive, owing to the extensive use of deductions. Thus, while the change to a single rate flat tax greatly simplified the system with a view to bolstering compliance, it did not in principle represent a significant reduction in the effective taxation rate for individuals.

- A unified social tax was introduced to consolidate payroll taxation. The pension, social, and medical fund contributions were rolled into one social tax with their maximum rate set at 35.6 percent. The 3 percent unemployment fund contribution was eliminated, in effect reducing the highest tax rate on payroll by 3 percentage points. A regressive rate for contributions to the state extrabudgetary funds accompanied the change (with, for example, a 2 percent rate applying to wages in excess of about $21,000 for a given employee).

- Excise tax collection was enhanced with the adoption of new provisions to counteract tax avoidance/evasion schemes. Bonded warehouses for alcohol products were set up. Tax posts were established to check books and records, monitor disposal of goods,
and control access to goods. Tax officials would manage the warehouse and keep track of payments made. The tax burden was shifted from alcohol distilleries to wholesalers by making them liable for as much as 50 percent of the statutory rate. Special regional stamps were introduced.

- The excise base was broadened. Diesel fuel and lubricants were subject to excises, while rates were raised for other oil products, by three times, and for alcohol-containing products, by Rub 2–5 a deciliter.
- A major VAT overhaul was implemented. Changes were made to the place-of-supply rules. The VAT was extended to individual entrepreneurs. The three-payments-a-month system was eliminated. VAT credits were properly assigned to construction inputs rather than capitalization. Several exemptions were eliminated. A small business exemption threshold came into force for reducing compliance burden on small taxpayers.
- The road tax (a turnover tax) was reduced from 2.5 percent to 1 percent of gross sales. Many small, nuisance taxes were eliminated, including taxes on the sale of fuel and lubricants, on maintenance of housing stock and social objects, on individual types of transportation vehicles, and on acquisition of motorcars.
- Starting July 1, 2001, the destination principle was adopted for VAT on non-energy trade with CIS countries (except Belarus), with analogous changes in excise taxes. VAT on energy trade with CIS countries is still taxed under the origin principle.

These changes were highly significant, but would form only a portion of the overall reform package of Part II of the tax code. The government’s priority for tax reform was clearly set and the momentum was maintained throughout 2001. Reforms of further key taxes were on the way, the most important of which were the corporate income tax, an extremely complicated legislation, and the mineral resource extraction tax.

- The overall corporate income tax rate was reduced from 35 percent to 24 percent, among the lowest in OECD countries. One of its greatest achievements was making the tax base uniform for all three levels of governments. This greatly simplifies the calculation of total tax obligations. Only one form now needs to be filed instead of different ones for different level of government. But this could only be achieved by canceling regional and local tax incentives and exemptions, a welcome move.

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4 Shifting the tax liability from producers (distilleries) to wholesalers was a negative development that complicates tax administration.

5 VAT on all trade with non-CIS countries was already on the destination principle.
• The tax on recovery of mineral resources was drastically streamlined. Many taxes relating to the taxation of mineral resources were either merged or eliminated. For example, the mineral excises and the subsurface mineral tax were combined into one ad valorem charge (“natural resource extraction tax”), which became the principal means by which extraction of resources was taxed. Adjustments on charges relating to geological conditions were greatly simplified.

In addition, despite strong objections and fierce lobbying, the excise rate for alcohol was increased by 12 percent and specific rates for oil products were raised (see Table 4.1).

Initial Outcomes of the Postcrisis Tax Reform

Four years after Part I of the tax code was introduced, and two years after the passage of the first tax laws in Part II of the tax code, what can we say about the results of these reforms? While it is still too early to make a final assessment, three conclusions can be drawn:

• The steps taken to strengthen tax administration have improved revenue collections, particularly the collection of arrears;

• Abstracting from an improvement in compliance, the revenue cost relating to the key tax reforms under Part II of the tax code is quite large, at about 2 percent of GDP; and

• The reforms clearly shifted resources away from the subnational governments in favor of the federal government.

At a purely microeconomic level, the analysis of arrears developments since the August 1998 crisis points to an improvement in tax compliance. A key indicator of high tax noncompliance in Russia was the level of tax arrears. As of January 1, 2000, the value of unpaid taxes at the consolidated level (federal and local governments) stood at Rub 378 billion (8.3 percent of GDP). Of this amount, arrears to the federal government were estimated at Rub 247 billion. The increase in arrears to the federal budget was Rub 87 billion in 1999 (1.9 percent of GDP) compared with 4.1 percent of GDP in 1998 and 3.4 percent of GDP in 1997. The observed reduction in accumulation of arrears to the federal budget as a percent of GDP was no mere coincidence, but linked directly to the intensive programs described above aimed at improving tax administration.

Related to this welcome development was the absence of reported tax offset schemes, a factor that had provided incentives for the further

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6 This excludes penalties and interest.
Table 4.1. Tax Code Changes, Including Measures Effective in 2002

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<td><strong>Base and rate</strong></td>
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<td><strong>Split between federal &amp; subnational</strong></td>
<td><strong>Split between federal &amp; subnational</strong></td>
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<td>Personal income tax</td>
<td>Tax on income of physical persons</td>
<td>Federal: 16%</td>
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<td>Up to Rub 50,000: 12%</td>
<td>Subnational: 84%,</td>
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<td>Rub 50,000-150,000: 20%</td>
<td>of which local not less than half of regional share</td>
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<td>Over Rub 150,000: 30%</td>
<td>Uniform rate of 13%</td>
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<td>Federal: 1%</td>
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<td>Subnational: 99%, of which local not less than half of regional share. From 2002 all to subnational</td>
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<td>Profits tax</td>
<td>On profits after depreciation and exemptions</td>
<td>Split according to rates</td>
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<tr>
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<td>Federal: 11%</td>
<td>(see base)</td>
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<td>Regional: 19–24%</td>
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<td>Local: 2%</td>
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<td>Tax on extraction</td>
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<td>of economic minerals</td>
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<td>Petroleum: in 2002-04, Rub 425/ton, adjusted for changes in oil price above</td>
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<td>Rub 4,300/ton (about $17/barrel); as of January 1, 2003, 16.5% of value;</td>
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<td>Extraction of combustible natural gas and gas condensate: 16.5% of value;</td>
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<td>2.5–8% for other minerals</td>
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Table 4.1. (concluded)

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<tr>
<td></td>
<td>Base and rate</td>
<td>Base and rate</td>
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<tr>
<td>Excise taxes on mineral raw materials (oil, gas condensate, natural gas)</td>
<td>Oil: Rub 66 a ton</td>
<td>Oil excise replaced by tax on extraction of economic minerals</td>
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<td>Gasoline:</td>
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<td></td>
<td>High octane: Rub 1,850 a ton</td>
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<td></td>
<td>Lubricants: Rub 1,500 a ton</td>
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<td>Diesel: Rub 550 a ton</td>
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<td></td>
<td>Other: Rub 1,350 a ton</td>
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<td></td>
<td>Natural gas: Levied on value of production excluding dry refining gas:</td>
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<td></td>
<td>Domestic &amp; Belarus: 15 percent; on sales value of exported gas including CIS:</td>
<td></td>
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<tr>
<td></td>
<td>30 percent</td>
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<tr>
<td>Recovery of mineral resources tax (mineral rehabilitation tax)</td>
<td>10% of the value of extracted oil, reduced by a credit for exploration expenditures incurred by the producer. This is meant to recoup the state's costs of exploration of fields prior to privatization.</td>
<td>Replaced by tax on extraction of economic minerals</td>
</tr>
<tr>
<td>Subsurface mineral tax</td>
<td>Tax on domestic sales value of extracted mineral, excluding VAT, excises, and transport costs. The base has not been defined clearly and there are many exemptions and loopholes, depending on the quality of mineral reserves; natural, geographic, mining, technological &amp; economic parameters of field developments; and risks involved. For hydrocarbons, the maximum permissible regular royalty, which is a major form of the subsurface tax, is set at 6–16% of the value of extracted mineral.</td>
<td>Replaced by tax on extraction of economic minerals</td>
</tr>
</tbody>
</table>

Sources: Russian Ministry of Finance; and IMF staff.
buildup of tax arrears in the past. The improved economic conditions since the crisis have also helped. In any event, a more determined approach to enforcement, including tighter monitoring of some key large taxpayers, has paid off and contributed to the slower growth in tax arrears. For example, in 1999, some 242 large enterprises, which were especially singled out for more intensive monitoring and accounted for 30 percent of federal tax collections (including the oil companies, Gazprom, the railways, and Unified Energy System of Russia (UES)), paid 90 percent of their declared liabilities. By comparison, the wider population of all large taxpayers paid only about 80 percent of their declared liabilities. In addition, with the exception of the oil companies and Gazprom, there was a decreased use of negotiated tax payment arrangements for some large taxpayers. Following the reorganization of the debt collection/arrears management unit, in 1999 some Rub 257 billion of extra tax payments, or about 25 percent of all taxes, were collected by the ministry—a significant development.

In terms of the revenue implications of the adoption of Part II of the tax code, the preliminary estimate is that general government revenues were reduced by about 2 percent of GDP in 2002, calculated using a constant 2001 oil price and assuming no change in compliance (see Table 4.2). The reduction in the rate of the road tax (or turnover tax) leads to the single largest loss, amounting to about 1.7 percent of GDP.

The impact of the changes to the VAT is difficult to tie down. Converting the VAT to the destination principle for CIS nonenergy exports results in a revenue loss of about 0.6 percent of GDP. These nonenergy exports to CIS countries are now zero-rated, whereas taxes were collected from them before the change under the origin principle. However, the VAT reform also widens the tax net on imports. For example, nonenergy imports from CIS countries are now subject to the Russian VAT. In addition, several previous exemptions on imports from non-CIS countries were eliminated. These measures are estimated to raise revenue by about 0.6 percent of GDP. Thus, the net change of the VAT reform appears likely to be negligible.

The reform of the profit tax, involving a lowering of the tax rate and broadening of the base, is estimated to lead to a net revenue loss of 0.5 percent of GDP. On the personal income tax, the net loss is

7 A key feature of the tax payment arrangements with oil companies in 1999 was that they should be gradually brought into full compliance with their declared liabilities, and that accumulated tax arrears should be eliminated.

8 The revenue impact is estimated using the 2001 tax base. The impact of measures that are still under discussion in the government (for example, removal of export taxes and possible unification of the VAT rate with fewer exemptions) is not included.
Table 4.2. Impact of Tax Reform at Constant 2001 Oil Price

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Federal</th>
<th>Sub-national</th>
<th>Total</th>
<th>Federal</th>
<th>Sub-national</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total impact of reforms enacted</td>
<td>-2.1</td>
<td>0.5</td>
<td>-2.6</td>
<td>-191</td>
<td>46</td>
<td>-237</td>
</tr>
<tr>
<td>Reforms in 2001</td>
<td>-1.7</td>
<td>0.5</td>
<td>-2.2</td>
<td>-150</td>
<td>47</td>
<td>-197</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>-0.2</td>
<td>-0.4</td>
<td>0.2</td>
<td>-21</td>
<td>-38</td>
<td>17</td>
</tr>
<tr>
<td>Domestic VAT</td>
<td>-0.6</td>
<td>0.8</td>
<td>-1.4</td>
<td>-52</td>
<td>75</td>
<td>-127</td>
</tr>
<tr>
<td>VAT centralization</td>
<td>0</td>
<td>1.4</td>
<td>-1.4</td>
<td>0</td>
<td>127</td>
<td>-127</td>
</tr>
<tr>
<td>Other changes</td>
<td>-0.6</td>
<td>-0.6</td>
<td>0</td>
<td>-52</td>
<td>-52</td>
<td>0</td>
</tr>
<tr>
<td>Import VAT</td>
<td>0.6</td>
<td>0.6</td>
<td>0</td>
<td>51</td>
<td>51</td>
<td>0</td>
</tr>
<tr>
<td>Turnover tax</td>
<td>-1.7</td>
<td>-0.8</td>
<td>-1.0</td>
<td>-156</td>
<td>-70</td>
<td>-86</td>
</tr>
<tr>
<td>Excises</td>
<td>0.1</td>
<td>0.1</td>
<td>0</td>
<td>10</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Gasoline</td>
<td>0.2</td>
<td>0.2</td>
<td>0</td>
<td>16</td>
<td>18</td>
<td>-2</td>
</tr>
<tr>
<td>Other excises</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0</td>
<td>-7</td>
<td>-8</td>
<td>1</td>
</tr>
<tr>
<td>Export taxes</td>
<td>0.2</td>
<td>0.2</td>
<td>0</td>
<td>17</td>
<td>17</td>
<td>0</td>
</tr>
<tr>
<td>Reforms in 2002</td>
<td>-0.5</td>
<td>0</td>
<td>-0.4</td>
<td>-41</td>
<td>-1</td>
<td>-40</td>
</tr>
<tr>
<td>Natural resources taxation</td>
<td>0</td>
<td>0.7</td>
<td>-0.6</td>
<td>4</td>
<td>61</td>
<td>-57</td>
</tr>
<tr>
<td>Profit tax</td>
<td>-0.5</td>
<td>-0.7</td>
<td>0.2</td>
<td>-44</td>
<td>-62</td>
<td>17</td>
</tr>
</tbody>
</table>

Memorandum:
Reforms excluding natural resources taxation: -2.2 -0.2 -2 -194 -15 -179

Sources: Russian Ministry of Finance; and IMF staff estimates.

estimated at 0.2 percent of GDP. On the other hand, changes in the oil and gas export tax regimes lead to a net revenue gain of 0.2 percent of GDP.\textsuperscript{9} The change in natural resource extraction taxation should be roughly revenue neutral.

Although the estimates suggest that the reforms could cost 2 percent of GDP, the ultimate cost will likely be less. The tax reform was specifically intended to improve compliance, whereas the estimates are calculated on the basis of an unchanged level of compliance. Furthermore, as important tax administration measures remain to be fully implemented (see below), compliance rates might continue to improve, further reducing the cost of reform. A preliminary analysis of the personal income tax reform provides some support for the hypothesis that the tax rate cuts have been associated with an improvement in collections, although it has not been possible to pin this down to any one particular factor, including compliance.\textsuperscript{10}

The tax reform shifted resources from subnational budgets to the federal budget. Under the constant oil price and constant compliance assumptions, the federal government realized a net gained of over

\textsuperscript{9}In particular, the gas tariff for non-CIS exports was doubled to 10 percent.

\textsuperscript{10}IMF (2002).
½ percent of GDP in 2001, particularly with the recentralization of VAT revenues at the federal level, which more than compensated for revenue losses elsewhere (for example, the virtual devolution of the personal income tax to the subnational governments). In 2002, despite the revenue-reducing reform of the profits tax, net losses in federal revenues were virtually zero, because changes in the resource extraction tax moved resources away from the subnational governments in favor of the federal government.

Partly because the tax devolution (personal income tax) to the subnational governments was inadequate to compensate for the tax recentralization at the federal government (VAT), and partly because of the phased reduction of certain subnational taxes (road tax) and changes to the taxation of natural resources, subnational budgets are estimated to have lost over 2 percent of GDP in 2001 and a further ½ percent of GDP in 2002.

The new revenue arrangements could create fiscal imbalances, particularly for local governments. Thus, partly to compensate for the shift of revenues away from the subnational governments, federal transfers increased in 2002. Whereas fiscal adjustments at the local government levels were expected, it was recognized that subnational governments might not find it easy to cut expenditures or raise local taxes and fees. For example, pressures have been increasing on local wage bills with the large wage increases awarded in December 2001 for staff paid under the unified tariff schedule. The transfer of responsibility for certain welfare payments to the subnational governments also adds to fiscal pressures. Reform of housing services, still not fully articulated, could also have a significant impact. In the absence of adequate federal transfers, local governments would have to look at generating the additional resources needed to maintain spending. While there are various options available—such as increased cost recovery in housing and community services, or rationalization of local government services—fiscal pressures at the local level are likely to be a source of tension in the coming years.

Put another way, the recent tax reform broadly completes the changes to the revenue side outlined in the Concept of Reform of Intergovernmental Relations for 1999–2001, approved in 1998. As a result, federal revenue has increased from just over one-third of total consolidated government revenue in 1998 to almost one-half in 2001 (see Table 4.3).11 Correspondingly, subnational government revenue has fallen from over 40 percent to about 30 percent in the same period.

11This analysis explicitly estimates and controls for the significant impact on the federal/local split of changes in oil prices.
Subnational revenue, which fell below 13 1/2 percent of GDP in 2000, declined sharply in 2001, to 11 1/2 percent of GDP.

At the same time, extrabudgetary revenue declined slightly, from about 8 percent of GDP through 2000 to 7 1/2 percent of GDP in 2001, following the reform. This came about because of the unification of the various payroll taxes into the unified social tax, which was associated with an overall rate reduction of about 4 percentage points. For 2002, the above projections assume some increases in compliance, which would help stabilize subnational revenues and reverse the decline in extrabudgetary revenues (although the extrabudgetary balance is still likely to worsen).

The Remaining Agenda

Despite observable improvements to date, compliance rates remain low for some taxes and the tax administration still needs fundamental restructuring. The ministry of taxes and fees will need to incorporate the lessons from the pilot project (see Box 4.3) into a strategic plan for modernization of the tax administration, with assistance from the World Bank. To facilitate implementation, the ministry is discussing with the World Bank a second tax administration modernization project loan. This program includes, among other things, measures to:

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• increase the level of tax compliance;
• promote efficiency by streamlining the network of offices, generalizing the functional structure adopted in the pilot projects, and improving links between departments based on computerization;
• create a small network of regional data processing centers to undertake the bulk of information processing tasks together with a new information systems infrastructure and associated applications systems;
• encourage professional ethics by establishing a code of ethics, increasing professionalism of staff, and establishing a strong internal audit function to monitor integrity;
• refine the system of self-assessment;
• improve the fairness of the tax system by improving dialogue with taxpayers and adopting transparent dispute resolution procedures;
• reduce the taxpayer compliance burden by improving service delivery and simplifying procedures; and
• enhance staff development programs.

Tax policy reforms have come a long way and the major taxes are now mainly in place. Nevertheless, a significant unfinished agenda remains—in part to correct for anomalies that had slipped into the legislation, particularly in the corporate income tax where the base risks being eroded. Other areas of focus should include the following.

• **VAT.** The authorities have signaled their intention to continue reforming the VAT. This should include converting VAT accounting to an accrual method and reducing processing delays in VAT refunds for traditional exporters and domestic producers. The authorities have also indicated their willingness to adopt a single VAT rate in the medium term (possibly 15 percent). In 2004, the top VAT rate will be reduced to 18 percent. As for VAT on intra-CIS trade in energy products, the authorities are prepared to consider a shift from the origin to the destination principle (to promote efficiency within the CIS region). This would complete Russia’s transformation of levying the VAT for all goods and services on the destination principle for all countries—a process that began a few years ago with non-CIS countries.

• **Export taxes.** These taxes were introduced as temporary emergency measures following the 1998 crisis. The original plan was to phase them out over 2002–03, when other energy-related taxes were expected to be in place. However, although the resource mineral tax is now in place there is no clear time frame yet for abolition of the export taxes. As export taxes on energy distort Russia’s terms of trade and discriminate against exporters, energy taxation should be returned to its production base, rather than exports.
• Profit tax, personal income tax, and unified social tax. The substantial difference in the tax rates applied to profits and labor income creates incentives to shift income from one category to another. In particular, the relatively low profit tax rate compared with the combined rate of personal income tax and unified social tax may induce employers to compensate employees in the form of profit sharing, which could have a significant negative impact on unified social tax receipts. Furthermore, tax rate differences may have an influence on the organization of business—for example, on decisions about whether a small business should incorporate. Unification of the tax rates on profit and labor income is therefore under consideration. The authorities are also planning to reduce the overall tax rate on the uniform social tax in 2004 or 2005.

• Production sharing arrangements. In view of its complexity, this topic was separated from the reform of natural resource taxation. Consultations are under way with current and potential investors in the minerals sector (particularly in gas and oil). The objective is to arrive at a transparent regime that protects the interests of the state while providing appropriate incentives to investors.

• Property taxes, inheritance taxes, state duties, sales taxes, and small business taxes. Reform of these taxes may be considered as part of the new fiscal federalism arrangements that are now being developed. The authorities have decided to phase out the sales tax in 2004, given its distortionary nature. The other taxes offer bases that could be devolved to subnational governments to better match tax and expenditure assignments. An important development in 2002 was the passage of the small business tax, which has come into force in 2003. The small business tax will replace the simplified tax with the aim of expanding the tax base by encouraging businesses operating in the shadow economy to register with the tax authorities. Under the new tax, small enterprises (with an annual turnover of less than Rub 15 million) can elect to be taxed at 6 percent of their proceeds or 15 percent of their profits. Such businesses will also be exempt from the other taxes, including the VAT and the unified social taxes.

References
