I. Sokolov, S. Sinelnikov, I. Trunin

Does Russia Need a reform of VAT?[1]

In recent years there has been a constant discussion of the need to reform value added tax and this discussion has become increasingly relevant with the development of a long-term strategy for socio-economic development. Whereas some have proposed that the rate of VAT should be reduced, more radical "reformers" are examining the implications of replacing VAT with a sales tax or of using the Addition Method for the calculation of VAT.[2]

Critics of the present system argue that particular defects of the tax and the complexity of its administration render it inefficient not only in Russia but also in other countries. Above all, there are problems relating to VAT refunds and offsets against tax, which in some cases deter Russian companies from competing in export markets. There are also problems arising from the use of various illegal schemes for minimizing payment, avoiding tax and even obtaining direct illegal refunds from the budget.

The critics of the present system point to other defects. The relatively high cost of the administration of VAT is borne mainly by the taxpayer (according to a survey conducted in OECD countries the distribution of costs between tax authorities and taxpayers is 1:5)[3]. Moreover, the widespread use of schemes for avoidance of tax on imports creates unfair conditions of competition for tax-compliant importers and provides the entire sector with an incentive to join the "shadow economy".

It is clear that there are problems with the administration of VAT; even so, we should not forget that VAT makes a significant contribution to overall tax income[4] and, being less vulnerable than other major taxes (Profits Tax, Tax on the Extraction of Natural Resources, Unified Social Tax) to the volatility of world market prices for natural resources, contributes to the sustainability of the system of public finances in the long term. Such stability is

[1] Some of the material in this article was published in the article: I. Trunin 'Is there a need for VAT abolishment in Russia? (Problem Analysis Subject to Long-Term Forecast of Stability of the Tax System)', *Voprosy Ekonomiki*, No. 9, 2008.

[2] The Invoice Method of VAT currently in use implies payment to the budget of the balance between VAT charged to the taxpayer in a given period (quarter year) ("output VAT") and the VAT paid on goods, works and services purchased for business activity ("input VAT"). In the event that "input VAT" exceeds "output VAT", the taxpayer is entitled to a refund. VAT assessment on the basis of the Addition Method will be discussed below.

[3] «The Value Added Tax: Experience and Issues», Background paper prepared for the International Tax Dialogue Conference on VAT, Rome, March 15–16, 2005.

[4] In 2007, its share in the total tax budget revenues of the Extended Government of the RF exceeded 23.2% and it was above 29% of the total revenues of the Federal budget.

extremely important during the current financial crisis. So any proposed measures for reform should be subjected to careful cost-benefit analysis.

What is the Background?

During the past 45 years VAT, as a tax on consumption, has almost everywhere replaced sales tax. In 1965 only three OECD countries used VAT, but at the present time it is used in 29 out of 30 OECD countries (not including the US).

The adoption of VAT was in part inspired by the process of European integration – a variety of largely incompatible models of cascading taxes were replaced by a uniform system of VAT. In conditions of economic globalization and development of international trade, the introduction of VAT, which involves taxation of international supplies according to the country of destination, was admirably suited to the logic of taxation of consumption. However, there were other reasons for the transition to VAT:

Firstly, under VAT enables revenues to be more easily linked to efficiency of production than does sales tax.[5] Also, it has less of a distorting effect on consumer choice than a unitary or cascading sales tax;

Secondly, VAT has a broader tax base, being applicable not only to retail sales, but also to all of the non-productive purchases of which the enterprise is the end user, including the purchase of services performed by the enterprise for its own use;

Thirdly, the widespread transition to VAT took place at a time of significant growth of public expenditure, when it was clear that, if growing social needs were to be met, it would be necessary either significantly to increase income tax or find new sources of revenue that would be sustainable over time, guarantee a steady flow of income to the budget throughout the year, and bring in significant sums. The choice was made in favor of taxing consumption;

Finally, since VAT involves the collection of tax at all stages of production, it guarantees a steady flow of revenues, irrespective of short-term volatilities in retail trade, external shocks, and the behaviour of particular categories of taxpayer (the problem of tax avoidance). In fact, the VAT tax base has been, as a rule, defined so broadly that any variations to it depend only on the dynamics of economic growth. Structural changes and external factors, by contrast, have little impact.

[5] The base of cascading sales taxes that were levied in European countries often included capital investments, including the amount of tax paid on the value of fixed assets. This was subsequently reimbursed through depreciation (this procedure was applied in Belgium, France, Germany, Italy and the Netherlands). Value added tax paid on capital investments is subject to a full refund, as with the other goods and services purchased, and this ensures the neutrality of the tax as regards choices between consumption and investment.

As the number of countries using VAT has increased,[6] the share of the budget revenues of OECD countries deriving from VAT and from sales taxes has also increased (see *Table 1*). At the same time, there has been a noticeable decline in the share of all taxes on consumption owing to a relative decline in revenues from excise and other specific taxes.

TABLE 1

Breakdown of tax revenues in the OECD, %

Tax Groups	1965	1975	1985	1995	2005
Personal Income Tax	26,2	29,8	29,7	27,1	24,6
Tax on enterprise profits	8,8	7,6	8,0	8,0	10,3
Social Security Contributions	17,6	22,0	22,1	24,7	25,6
Turnover Tax	1,0	1,3	1,1	0,9	0,8
Property Tax	7,9	6,3	5,2	5,5	5,6
Tax on Consumption	38,4	32,8	33,7	32,4	31,9
• Of the above: VAT and Sales Tax	13,6	14,5	16,4	17,7	18,9

Source: OECD, Revenue Statistics 1965–2006.

However, for all its worldwide popularity, in nearly all OECD countries the administration of VAT has become increasingly complex, owing to the use of a variety of concessions (exemptions, lower tax rates). The result has been a decline in tax revenues, increasing administrative costs and risks in relation to collectability. It is clear that the dependence of VAT on exemptions and refunds makes it more expensive to administer than income tax or sales tax. Companies that pay more "input VAT" as compared to "output VAT" are entitled to a refund. As a rule, these are either companies at the lower level of processing or exporters. In so far as the submission of false (fictitious) applications for a VAT refund is tantamount to an appropriation of budget funds, there has had to be increasing audit of applications for refund.

Estimation of the true scope of losses to the budget as a consequence of schemes for evasion or refund is a matter of expertise, and it is only in the UK that revenue losses resulting from non-compliance with VAT legislation is calculated annually. In the UK estimates are made of VAT Tax Theoretical Liability (VTTL) on the basis of national consumption data, which are then compared with actual VAT revenue to determine the gap in VAT collection (the VAT tax gap). The tax gap for the period 2002 to 2007 has increased

[6] According to the International Bureau of Fiscal Documentation (IBFD), VAT was applied by 135 countries worldwide in 2004.

from 12.4 to 16.1%. In other European countries there are less rigorous calculations that have evaluated losses from non-payment of VAT through fraud at about 10% of total tax revenue.

The struggle against VAT fraud is a trade-off between reducing the cost of administering the tax and minimizing the risk of fraudulent refund. The latter risk can be reduced by giving tax inspectors more time to check the validity of applications for refund; but at the cost of delays in compensating honest taxpayers that have the effect of reducing their liquidity and competitiveness.

The Cost of reducing VAT to 12%

Problems with the administration of VAT, a sharp decline in tax revenues (in 2006) against a background of favorable conditions in the world market for raw materials, relatively rapid economic growth and an increase in tax revenues to the consolidated budget of the Russian Federation gave rise to the argument that the basic rate of VAT should be reduced to 12-13 % and the reduced rate of VAT abolished.[7] The assumption was that this would significantly improve the investment activity of manufacturing enterprises and encourage the development of innovative industries with high added value.

There can be no doubt that reducing VAT in circumstances in which the benefits for the population and the business community are unclear will result in a reduction of revenues to the Federal budget.

Given that the benefits of a reduction will be distributed in inverse proportion to the elasticity of the response of business entities in the market, in the medium term the total savings to the economy will be distributed between the population and businesses in a ratio based on the flexibility of supply and demand for each individual product. However, in the longer term, it is mainly consumers who will benefit from a reduction in VAT since the elasticity of supply will tend towards infinity.

This being the case, we have reviewed three model scenarios in a 3-year time frame (assuming that the elasticity of markets in the medium term remains unchanged):

The first scenario assumes that with VAT reduced to 12% prices will fall by the same amount (all benefits from the lower rate will be to consumers). This would be characteristic for markets with perfect elasticity of supply or inelasticity of demand);

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[7] The Ministry of Economic Development and Trade proposes to reduce the tax rate from 18% to 12%. In the opinion of Deputy Minister S.Voskresensky this would make an important contribution to the development of the tax system, ensuring that “taxes will be collected when the taxpayers are already making money, rather than at the stage of investment and production”// No. 17 (606) *Expert*, April 28, 2008.

The second scenario assumes that prices will remain unchanged (markets with perfect elasticity of demand and inelasticity of supply) and all benefits from the reduction of VAT will accrue to producers;

The third scenario assumes that prices will fall by half of the reduction in the rate of tax, i.e., by 3% (in other words, the benefits of the reduction in VAT will be distributed equally between the consumers and producers).

Consequently, the algorithm for calculation of the impact on the budget of a reduction in VAT in each of the above scenarios will be as follows.

In the first scenario we can assume that enterprises will obtain no additional financial resources directly; by contrast, households will benefit from a fall in retail prices, which will encourage higher spending owing to the marginal propensity to consume (the multiplier effect of consumption). Higher spending will result in a growth of GDP, which will stimulate a growth of induced investment. In our case it is assumed that a part of the GDP formed during the first year of the new VAT rate will be used to finance investment in the second year, which in turn will ensure the formation of additional GDP.

In this way, the overall growth of GDP in the second and subsequent years will be equal to the aggregate growth of GDP as a consequence of the effect of multipliers of consumption and investment expenditure.

This means that in terms of impact upon the budget, a reduction in VAT would result in direct losses to the budget by the amount of decreased revenue from VAT and an increase in revenue from tax on profits, unified social tax and personal income tax as a result of a redistribution of the total growth in GDP.

In the second scenario the algorithm of assessment is practically identical. Thus, if the benefits from reduced rates accrue directly to enterprises, their profits will increase whilst other elements in prices will remain constant. Under the existing system of financial management, the additional profit will be spent on consumption (increase in wages, growth of the consumption fund) on investment (increase in fixed capital), whilst a share of the funds would remain undistributed. Ultimately, an increase in the wage fund will encourage additional demand and growth in GDP through the multiplier of consumer spending. An increase in investment will also make for a growth in GDP, albeit with some time lag.

The third scenario, will contain elements of both of these algorithms in equal measure.

To sum up, a reduction in VAT will have the following consequences for the budget:

- direct losses to the federal budget by the amount of potential revenues from VAT;

- growth of revenues from profits tax on enterprises, single social tax and personal income tax.

Evaluation of the direct losses deriving from the reduction of VAT revenues (see *Table 2*) was based on following assumptions:

- the share of revenues from VAT on imports charged at a rate of 10% constitutes about 7.5% of all VAT revenues from imports;
- the share of revenues from VAT on domestic transactions at the rate of 18% constitutes about 95% of all VAT revenues;
- in estimates of the tax base for VAT revenues in the domestic market revenues from the Yukos oil company were not included;
- the structure of the tax base, the grounds for allowing deductions and exemptions remain at the level of 2007.

The calculations were made before the crisis, but they give an idea of the consequences of a reduction of VAT in conditions of normal economic development. Data used for estimates for 2009-2011 are by now outdated. However, the authors see no need to amend the information base for calculations, in so far as these estimates illustrate the impact on the budget system of a reduction in VAT after the emergence of the economy from the crisis.

TABLE 2

Estimates of the direct loss of budget revenues following transition to a single rate of VAT in 2009-2011

Single VAT Rate	% of GDP	Blln. RUR		
		2009	2010	2011
10%	–2.56%	–1316.9	–1513.1	–1729.7
12%	–1.84%	–949.3	–1090.8	–1246.9
15%	–0.77%	–398.0	–457.3	–522.7
17%	–0.06%	–30.4	–34.9	–39.9
GDP, Blln RUR		51475	59146	67 610

Source: Authors' Calculations

However, the effect of a reduction in VAT will be not only direct losses to the budget by the amount of potential revenues from VAT, but an increase in revenues from profits tax, unified social tax and personal income tax owing to increased sales by producers (or the volume of trade) and extension of the base of these taxes

Taking this into account, the losses to the budget has been estimated under the three model scenarios of distribution of payment of VAT amongst consumers and producers as described above.

In addition, for all scenarios the following assumptions were made:

1) According to the estimates, about 77% of all funds of households released thanks to the reduction in VAT will be spent in the domestic market and will stimulate the growth of GDP. We assume that the remainder will be taken out of circulation and contribute to the savings of the population.

2) Taking into account the existing structure of GDP (see Table. 3), we can conclude that the growth of the base for profits tax, unified social tax and personal income tax will match not the entire growth in GDP, but only that a part of it that comprises “official wages of employees” (on average, 34% of the growth of GDP) and the “net profits of the economy and net mixed income" (on average, 31% of the growth of GDP).

Table 3

The structure of GDP by type of primary income in 2002-2007,%

	2002	2003	2004	2005	2006	2007
Gross domestic product	100	100	100	100	100	100
including:						
- official wages of hired labour	*35.2*	*35.8*	*34.3*	*32.0*	*32.2*	*33.7*
- unofficial payments to employees	11.5	11.3	11.7	11.8	11.9	11.9
- net tax on production and imports	17.0	16.0	16.9	19.7	20.0	18.9
- consumption of fixed capital	7.8	7.2	6.4	6.0	4.8	4.5*
-Net profit of the economy and net mixed income	*28.5*	*29.7*	*30.7*	*30.5*	*31.1*	*30.9*

- *Estimate*
- *Source*: State Statistical Service

3) According to calculations based on data of the State Statistical Service (ROSSTAT), about 20% of net profits the enterprises go towards investment in fixed capital. Let us assume that the remaining 80% are used to finance current activities taking into account the formation of the liquidity reserve: around 42% of all net profits will go towards increasing the

wages of employees (including deductions for social insurance) and towards dividend payments and the remainder will go towards the creation of liquidity reserves in the form of investments in financial assets, including cash assets in current accounts and towards other tax payments associated with increases in the volume of production.

4) During 2009-2011 the multiplier of consumer spending remains unchanged and is assumed to be 2.27. Meanwhile, the growth of GDP attributable to the multiplier effect of investment is 0.32 kopeks on each ruble of funds invested in the preceding year.

5) The rate of collection of VAT in the period under review remained unchanged.

The results of estimates of the impact of the reduction of VAT to 12% on the budget in the period 2009-2011 are presented in *Tables 4-6*.

Table 4

Scenario 1. Impact of the reduction of VAT from 18% to 12% on budget revenues

	2009		2010		2011	
	Blln. RUR	% of GDP	Blln. RUR	% of GDP	Blln. RUR	% of GDP
Budget revenues lost as a result of the reduced rate of VAT	–949.3	–1.84%	–1090.8	–1.84%	–1246.9	–1.84%
Volume of expenditures of households within the Russian economy	731.0	1.42%	839.9	1.42%	960.1	1.42%
Value of the multiplier of consumer expenditure	2.27					
Growth of GDP:	1659.28	3.22%	1930.81	3.26%	2231.86	3.30%
- due to additional demand of households	*1659.3*		*1906.6*		*2179.5*	
- due to increase of investment expenditure (32 kopeks per ruble invested)	–		*24.2*		*52.4*	
Increase in official wages of employees (including social insurance):						
- 34% of growth of GDP	564.2	1.10%	656.5	1.11%	758.8	1.12%
Increase in profits before tax in the economy						
- 30% of growth of GDP	497.8	0.97%	579.2	0.98%	669.6	0.99%
Growth of investments in fixed assets (20% of net profits of enterprises)	75.7	0.15%	88.0	0.15%	101.8	0.15%
Additional tax revenues to the budget:						
Tax on profits	119.5	0.23%	139.0	0.24%	160.7	0.24%

UST*	105.5	0.20%	122.8	0.21%	141.9	0.21%
Personal income tax	59.6	0.12%	69.4	0.12%	80.2	0.12%
VAT**	106.2	0.21%	123.6	0.21%	142.8	0.21%
Net change in budget tax revenues owing to the lowering of VAT	–558.5	–1.09%	–636.1	–1.08%	–721.3	–1.07%

* In the calculations of this scenario, the effective rate of the unified social tax is fixed at 23%, which corresponds to the data of 2007

** The effective ratio of VAT to GDP over the period of 2000-2007 in Russia was 6,4%.

Source*:* authors' estimates.

TABLE 5

Scenario 2. Impact of the reduction of VAT from 18% to 12% on budget revenues

	2009		2010		2011	
	Blln. RUR	% of GDP	Blln. RUR	% of GDP	Blln. RUR	% of GDP
Budget revenues lost as a result of the reduced rate of VAT	–949.3	–1.84%	–1090.8	–1.84%	–1246.9	–1.84%
Increase in net profit at disposal of enterprise	721.5	1.40%	829.0	1.40%	947.6	1.40%
Increase in investments in fixed assets (20% of enterprise net profit)	168.4	0.33%	196.0	0.33%	226.6	0.34%
Volume of expenditure of households within the domestic economy	233.3	0.45%	268.1	0.45%	306.5	0.45%
Value of the multiplier of consumer expenditure	2.27					
Total growth of GDP:	529.64	1.03%	662.49	1.12%	812.28	1.20%
- due to additional demand of households	*529.6*		*608.6*		*695.7*	
- due to increase of investment expenditure (32 kopeks per ruble invested)	–		*53.9*		*116.6*	
Increase in official wages of employees (including social insurance):						
- 34% of growth of GDP	180.1	0.35%	225.2	0.38%	276.2	0.41%
Increase in profits before tax in the economy						
- 30% of growth of GDP	158.9	0.31%	198.7	0.34%	243.7	0.36%
Additional tax revenues to the budget:						
Profit tax	266.0	0.52%	309.5	0.52%	357.7	0.53%
UST*	33.7	0.07%	42.1	0.07%	51.6	0.08%
Personal income tax	19.0	0.04%	23.8	0.04%	29.2	0.04%
VAT**	33.9	0.07%	42.4	0.07%	52.0	0.08%

Net change in budget tax revenues owing to the lowering of VAT	–596.7	–1.16%	–673.0	–1.14%	–756.3	–1.12%

* * In the calculations of this scenario, the effective rate of the unified social tax is fixed at 23%, which corresponds to the data of 2007

** The effective rate of VAT to GDP over the period of 2000-2007 in Russia was 6,4%.

Source: authors' estimates.

TABLE 6

Scenario 3. Impact of the reduction of VAT from 18% to 12% on budget revenues

	2009		2010		2011	
	Blln. RUR	% of GDP	Blln. RUR	% of GDP	Blln. RUR	% of GDP
Budget revenues lost as a result of reduced VAT rate:	–949.3	–1.84%	–1090.8	–1.84%	–1246.9	–1.84%
Increase in net profit at disposal of enterprise	360.7	0.70%	414.5	0.70%	473.8	0.70%
Increase in investments in fixed assets (20% of enterprise net profit):	122.1	0.24%	142.0	0.24%	164.2	0.24%
Volume expenditure of households in the domestic economy:	482.1	0.94%	554.0	0.94%	633.3	0.94%
Value of the multiplier of consumer expenditure	2.27					
Total growth of GDP:	1094.46	2.13%	1296.70	2.19%	1522.07	2.25%
- due to additional demand of households	*1094.5*		*1257.6*		*1437.6*	
- due to increase of investment expenditure (32 kopeks per ruble invested)	–		*39.1*		*84.5*	
Increase in official wages of employees (including social insurance):						
- 34% of GDP growth	372.1	0.72%	440.9	0.75%	517.5	0.77%
Increase in profits before tax in the economy:						
- 30% of growth of GDP	328.3	0.64%	389.0	0.66%	456.6	0.68%
Additional tax revenues to the budget:						
Profit tax	306.6	0.60%	355.2	0.60%	408.8	0.60%
UST*	69.6	0.14%	82.4	0.14%	96.8	0.14%
Personal income tax	39.3	0.08%	46.6	0.08%	54.7	0.08%
VAT**	70.0	0.14%	83.0	0.14%	97.4	0.14%
Net change in budget tax revenues due to the lowering of VAT	–463.7	–0.90%	–523.6	–0.89%	–589.2	–0.87%

* * In the calculations of this scenario, the effective rate of the unified social tax is fixed at 23%, which corresponds to the data of 2007

** The effective ratio of VAT to GDP over the period of 2000-2007 in Russia was 6,4%.

Source: authors' estimates.

Our analysis of the impact of reduced VAT on budget revenues therefore indicates that the reduction of VAT to 12% under extreme scenarios of distribution of the VAT burden between consumers and producers (the first and second scenarios) would result in losses in VAT tax revenues of 1.08-1.14% of GDP. In the third scenario, where the VAT burden is shared equally between consumers and producers, fiscal losses resulting from the lowering of the tax would be minimal - about 0.9% of GDP.

The reduction of VAT to 12% would therefore have a fairly significant impact upon the budget. At the same time, it is not evident that a reduction in VAT would provide a stimulus to business activity and the level of investment.

Consequences for the budget of replacing VAT with a sales tax

As a way of dealing with the deficiencies of VAT, it has been proposed that it should be replaced by a sales tax. Sales tax has been proposed as an alternative because it is thought to be easy to administer for both tax authorities and taxpayers. However, in theory and in practice this is not so. Whilst the tax authorities do have to supervise a significant range of taxpayers under VAT, the bulk of the tax revenue is paid by a relatively small number of organizations (in Russia the largest taxpayers provide up to 80% of total revenues from VAT). By contrast, sales tax is levied only at the stage of final consumption and so, in the event of its being introduced, the tax authorities would have to restructure their effort so as to monitor the tax compliance of hundreds of thousands of retailers. The possibilities for tax evasion, as well as the risks for budget revenues are greater and the potential risk is proportional to the rate of sales tax - the benefits of tax evasion if the tax rate is relatively high (15-20%) significantly exceed losses from potential penalties for non-compliance.

Another advantage of VAT is that for all products and services an obligation for payment is placed upon different taxpayers at different stages of the production and business cycles. This means that even if there is evasion at one stage of the cycle the budget receives tax at the other stages. In the case of sales tax, evasion by a single taxpayer means that the budget loses the total tax amount.

Also, if a sales tax is introduced, it becomes necessary to reform the tax regime for small businesses, by creating rules for distinguishing the sales of goods and services for the purpose of final consumption and sales for the purpose of production. The point is that according to the logic of a tax levied at the stage of final consumption, goods and services that are purchased for business purposes should be exempt from taxation. To deter entrepreneurs from exploiting their status to purchase goods and services for personal, non-business purposes, the administration of sales tax could be arranged for entrepreneurs in a manner resembling the “export” scheme of VAT administration: individual entrepreneurs and other physical persons, regardless of the purpose for which goods and services were acquired, would pay the sales tax; but, in the event of onward sale of the purchased goods and services the final consumer would also be required to pay the tax. The difference between “input” and “output” sales tax would then be transferred to the budget. If entrepreneurs sold their goods and services to other entrepreneurs or organizations for production purposes, they would be entitled to appropriate reimbursement at the end of the tax period. Such a system does not differ from the system of VAT collection and that is why in many countries sales tax gradually turned into VAT.

In other words, the introduction of the so-called “simple and understandable” sales tax is possible only at considerable expense to taxpayers and with the creation of a special system of administration which would make it possible to distinguish between the sale of the same goods to either a final buyer or an intermediary reseller and also to identify any possible cascade effect, when the sale of one and the same product is taxed several times over.

The replacement of value-added tax with a sales tax would, therefore, be risky in conditions of globalization and Russia's growing participation in world economic relations. Certainly, in the absence of VAT there would be no need to maintain the system of VAT refund to exporters. However, in the absence of VAT, imported goods would also not be taxed. Under VAT only exported goods are taxed at zero rate and in the majority of countries this provides a competitive advantage to these goods in the country of destination. Unless the rules governing territoriality are harmonized with trading partners, difficulties arise in relation to the taxation of goods and services in cross-border transactions. At the same time, the operation of the cascade effect suggests that even if sales tax is collected only at the stage of retail sale, exports would not entirely escape indirect taxation.

One thing is clear - large Russian corporations operating inside Russia, whose activities are not related to the production on a large scale of consumer goods or goods for the domestic market have a vested interest in the abolition of VAT. On the one hand, abolition would allow them significantly to reduce their tax payments without bearing the burden of a new sales tax in the short term; and, on the other hand, it would assist them in reducing other costs associated with the VAT refund for exports and ever-increasing taxation of imports and an opportunity for avoiding the taxation of sales and purchases of services, the place of realization of which, according to current tax legislation is deemed to be the territory of the Russian Federation. Not surprisingly, having substantial resources at their disposal, these advocates of the abolition of VAT are able to enlist, by a variety of methods, an ever increasing number of allies, including employees of public authorities. Yet this policy is economically senseless and could cause serious economic damage in a long term.

A realistic estimate of the impact of the replacement of VAT by a sales tax must take into account the volume of revenues foregone and then estimate the value of possible revenues under different rates of sales tax, using the economic indicators of 2009 whilst allowing for the impact of the abolition of VAT on the level of business activity.

Following the logic of revenue losses to the budget when the VAT rate was reduced to 12% under the third scenario, we estimate that the loss of revenues to the budget in the event of abolition of VAT and allowing for partial offset by additional revenue from other taxes would be about 4.1-4. 3% of GDP under 2009 conditions (in 2009, revenues from VAT were planned to be 6.4% of GDP).

In order to estimate what share of reduced income would be offset by the introduction of a sales tax, we must first define the tax base. For example, when experts of the Finance Academy[8] in 2006 attempted to calculate potential revenues from the sales tax, they significantly enlarged the base of the tax by comparison with previous Russian practice. In addition to household expenditures on final consumption (purchase of any goods, works and services), they included the expenditures of organizations, with no allowance against the gross totals for profits tax; and also state purchases of goods and services from outside organization. In our view, such a definition of the tax base is not appropriate.

Firstly, the imposition of sales tax on public (municipal) procurement is equivalent to redistribution of budget funds amongst different levels of the budget system. Moreover, the sales tax is a mechanism for the taxation of final consumption, whereas, in the procurement process, government authorities only formally act as final consumers. Local authorities are, in fact, intermediaries in the production and commercial chain of delivery of goods (works, services) to the population and so their procurement should not be subject to sales tax.

As regards the expenditures of organizations towards funding the final consumption of employees, these derive either from the social insurance fund (vouchers for children’s holiday camps, health resorts, etc.) or from the net profit of organizations (payment of communal services, food, recreation, education, etc. for employees) and are regarded as benefits in kind that are liable to personal income tax. In other words, there is no sale of goods, works or services and, consequently, no object of taxation in such operations.

[8] Research report «Comparison of VAT against Sales Tax», 2006 //http://www.taxreform.ru/th_nsp.html

In our view, if the base of the sales tax is to be broader than that of the previous model, only sales to physical entities for cash and non-cash payment (including bank cards) of all goods (works, services) should be regarded as subject to taxation. It is reasonable to exclude from taxation transactions in real estate and the acquisition of valuables (precious metals and stones, antiques, works of art, etc.) that can retain their value over the long term, since they are not items of final consumption and represent gross savings in the economy. Following the same logic, transactions with financial instruments (securities, foreign currency, deposits, loans, insurance instruments, shares, etc.) should be excluded from the list of taxable goods.

Since the base of the proposed sales tax is the value of final goods (services) sold to a physical person, its approximate value can be estimated by reference to household expenditure on final consumption, less the value of goods and services received in kind (as wage payments or produced by households for their own consumption) and the net amount of purchases of goods and services made abroad.[9] One can see from the calculations (*Table 7*) that the average sales tax base for 2003-2007 would have been 91-92% of all household expenditures on final consumption, i.e., in 2009 would have been about 22,800 billion RUR.

TABLE 7

Estimate of the Tax Base of Sales Tax

	2003		2004		2005		2006		2007	
	Blln. RUR	% of total	Blln. RUR	% of total	Blln. RUR.	% of total	Blln. RUR	% of total	Blln. RUR	% of total
Household expenditures on goods of final consumption:	6540.1	100.0	8405.6	100.0	10590.0	100.0	12880.9	100.0	15815.5	100.0
Of which: Value of goods and services in kind	446.2	6.8	538.2	6.4	633.3	6.0	718.3	5.6	787	5.0
Net value of goods and services purchased abroad	205.3	3.1	301.3	3.6	327.7	3.1	287.6	2.2	323.2	2.0
Base of ales tax	5888.6	90.1	7566.1	90	9629.0	90.9	11875.0	92.2	14705.3	93.0

Source: State Statistical Service (ROSSTAT); authors' estimates.

In other words, only if sales tax is set at 10% will revenues reach the level of losses to be expected from the abolition of VAT (4.4% of GDP), that is, compensate for these losses.

[9] Net purchases of goods and services made abroad is a statistical indicator, calculated as the difference between purchases made by residents abroad and purchases of non-residents in the territory of Russia.

However, this would apply only in the highly improbable eventuality of 100% of the tax being collected. The actual collection rate of sales tax in 2002 was 30%. This level may be considered as a first scenario for estimating the collectability of the tax. A second scenario would be to assume the same rate of collectability as obtains with VAT, which is calculated as the ratio of actual VAT revenues to a theoretical amount estimated using socio-economic statistics. According to estimates, this ratio was approximately 57% on average for the period 2003-2007.[10] Estimates of potential revenues using economic indicators of 2009 with different rates of sales tax are given in *Table 8*.

TABLE 8

Sales tax revenue under different tax rates

	Tax base	Tax rate		
		10%	8%	5%
Revenue from the new sales tax, Blln. RUR	22800			
- assuming collection of 30%		684	547	342
- - assuming collection of 57%		1300	1040	650
Revenue from the new sales tax, % of GDP:	44,3			
- - assuming collection of 30%		1.3	1,1	0,7
- - assuming collection of 57%		2.5	2,0	1,3
Lost revenue as a consequence of the abolition of VAT (third scenario), % of GDP		4.2		
Balance of incoming and lost revenues, % of GDP:				
- - assuming collection of 30%		–2.9	–3,1	–3,5
- - assuming collection of 57%		–1.7	–2,2	–2,9
For reference: revenue from the sales tax levied in Russia before 2004, % of GDP		0.5		

Source: authors' estimates

As may be seen from the estimates, revenues from the introduction of the new sales tax in 2009, depending on the rate of tax and level of assumed collectability, varied from 0.7% to 2.5% of GDP. At the same time, a new sales tax, even at a rate of 10% cannot compensate for the loss of revenues, which would at this rate have amounted from 1.7% to 2.9% of GDP.

Moreover, to achieve the level of revenues from the sales tax specified in the Table, all organizations and business involved in retail trade would have to be taxed irrespective of any

[10] It should be noted that calculating a volume of tax using a tax base derived from socio-economic statistics does not mean that this volume of tax could, even theoretically, reach the budget. The reasons have to do with the methodology for calculating the statistical indicators and the peculiarities of the tax system.

special tax status that they enjoy and levy sales tax on all goods, works and services consumed by the population, including those not currently subject to VAT. This means that the losses of budget revenues resulting from the replacement of VAT by a sales tax would probably be significantly greater than in the estimates.

Impact on the budget of a transition to VAT under the Addition Method

In 2007 there were lengthy discussions of the merits of the so-called Addition Method of calculating VAT.[11] This would involve replacing the current Invoice Method by the use of balance sheet data on profits and wages as the basis for calculating value added. For a given accounting period value added by the taxpayer would be estimated as the sum of profit, wages bill, single social tax and taxes paid on output.

It is argued that the main advantage of the Addition Method is that it does not require procedures for reimbursing input VAT and that this would greatly simplify tax administration. However, this would only be possible if the rules of territoriality for paying VAT were amended.

Currently in Russia, as in the majority of its trading partners, in the collection of VAT the principle of taxation by country of destination applies: exports are exempt from VAT and imports are taxed. A change-over to taxation in the country where value is added (the Addition Method), with no refund of VAT, presupposes application of the principle of taxation in country of origin, whereby exports are subjected to VAT and imports are exempt. Both systems for levying VAT can be effective provided counterpart-countries apply the same principles in their foreign trade relations. Otherwise the goods exported from one country to another could be subject to VAT in both countries. Alternatively, reverse export would not be subject to VAT in either country. This would impact upon the competitiveness of Russian goods exported abroad. Here we need to take into account the fact that medium-term forecasts of socio-economic development of Russia suggest that there will be a substantial deterioration in the balance of export-import transactions (potentially to zero), and so the budget might receive no benefit from adopting the principle of taxation in country of origin.

Conscious of the impossibility of an amendment to the territorial principle of VAT collection in Russia, the draft legislation ("Concept" document) for reform of VAT has adopted a dual approach, whereby there would be no refund of VAT in the domestic market, whilst exporters would continue to reimbursed for input VAT (VAT on materials and components of exported goods). But whereas at present the refund is made on the basis of

[11] In October 2007, the Coordinating Council of the Unions of Entrepreneurs of Russia (KSPSR) submitted a "Concept" document to the RF Ministry of Finance, proposing changes to the VAT assessment system.

receipts of input tax paid, the Concept document envisages “verifying the tax offset or refund against contracts, invoices (bank documents), shipping documents, customs declarations and calculations”. As things stand, the reimbursement process is laborious enough, but in the proposed reform exporters would only be able to challenge an assessment through the courts, since documentation that does not record deductions of VAT cannot provide the tax authorities with a basis for accurate estimates.

This means that the principal merit of the method of Addition Method, as understood in the “Concept” document is negated, whilst the proposed system for refund of VAT to exporters will complicate arrangements that are already problematical.

Second, it should be noted that under the Invoice Method VAT is charged as the difference between output and input tax at different stages of the production and sales chain. This makes it possible to track compliance at all stages. Under the Addition Method, as understood in the “Concept” document, no use of invoices is envisaged, so it will be possible to ascertain the degree of compliance only by auditing the profit and loss account and the wages bill.

Thirdly, the transition to the Addition Method envisages the abolition of tax credits and refunds and so a problem arises in relation to the reimbursement of VAT on investment products as is practiced under the existing system. It is clear that canceling reimbursement will increase the cost of investments by a sum equivalent to the rate of VAT, whereas the inclusion of VAT on investments goods in input tax in a given tax period does not significantly affect the overall tax yield.

Fourthly, despite the fact that the indirect character of the tax is preserved, under the Addition Method, tax will be levied as a percentage (the tax rate) of objects of direct taxation, i.e., profits and wages bill, and so, in reality, for taxpayers VAT will become a direct tax. Moreover, taxpayers will acquire opportunities for altering their tax liabilities, by adjustments to profits and the wages bill. Quite probably, this will make for a return of “gray” schemes of payment of wages, with a view to avoiding payment of both unified social tax and VAT) and of attempts to disguise taxable profits (for example, through “fictitious works or services provided by fly by night companies”).

Fifthly, the “Conception” document does not include in value added such elements as tax on output (land tax, vehicle tax, property tax) and so actual value added will be taxed incompletely.

Sixthly, according to the “Conception”, imports are exempt from taxation, notwithstanding the fact that collection of VAT on imports is highly efficient and makes a substantial contribution to the national budget. Moreover, foreign goods that are exempt from VAT will gain a significant competitive (price) advantage over domestic goods.

Seventhly, the proposed Addition Method proposed by the KSPSR cannot be applied by a tax agency since it will not possess information on profit, wages, etc., for completed transactions.

And finally, one should take into account the fact that despite all the complexity of administration of the current system of VAT, taxpayers and tax authorities already possess the necessary skills for assessment, payment and compliance with tax laws. The introduction of a new system involves the need for developing and testing completely new approaches to compliance and administration. As a result, there will be at the outset additional administrative costs, both to businesses and to the tax service.

All of the above arguments and the absence of positive international experience of the Addition Method[12] point to the conclusion that the reform proposed in the “Conception” document is unlikely to enhance the effectiveness of collection of VAT and that it cannot seriously be considered as means of improving the system of taxation as a whole.

In order to make a comprehensive assessment of the impact of transferring to the Addition Method let us estimate the volume tax revenue under the proposed method in the economic conditions of 2009. To this end, the wages bill, the volume of profits and taxes on output in those activities and sectors of the economy, that are by law exempt from VAT (Article 149 Tax Code) should be deducted from the amount of the value added created in that year.

According to the tax statistics (see *Table. 9*), the largest amount of exemptions apply in the financial sector of the economy in the following operations:

- banking operations (excluding cash collection) (Sub-item 3, Item 3 of Art. 149 of the Tax Code);

- insurance, co-insurance and re-insurance services provided by insurance companies, as well as provision of non-governmental pension funds (Sub-item 7, Item 3, Art. 149 of the Tax Code)

- sale of shares in the authorized (reserve) capital of organizations, shares in mutual funds and cooperatives, investment funds, securities and term bargain (Sub-item 12, Item 2, Art. 149 of the Tax Code);

[12] The Addition Method is used in only one developed country - Japan where it is applied as a special regime for small businesses.

- provision of loans in cash and of financial services facilitating loans in cash (Sub-item 15, Item 3, Art. 149 of the Tax Code).

Table 9

Estimate of VAT not collected owing to exemptions of financial activities

Benefit code in the RF Tax Code	Value of output, works, and services sold				VAT not collected owing to tax exemptions			
	2004		2005		2004		2005	
	Blln. RUR	% of total	Blln. RUR	% of total	Blln. RUR	% of total	Blln. RUR	% of total
Financial activity, total	*7 921.5*	*92.2*	*11 750.3*	*93.2*	*775.1*	*91.0*	*994.7*	*91.6*
Sub-Item 12, Item 2 of Art. 149 of the Tax Code	5 282.4	61.5	8 002.1	63.5	493.5	57.9	555.7	51.2
Sub-Item 3, Item 3 of Art. 149 of the Tax Code	2 220.9	25.8	3 252.2	25.8	220.8	25.9	369.6	34.1
Sub-Item 7, Item 3 of Art. 149 of the Tax Code	357.5	4.2	394.2	3.1	53.6	6.3	55.9	5.2
Sub-Item 15, Item 3 of Art. 149 of the Tax Code	60.7	0.7	101.8	0.8	7.2	0.8	13.5	1.2
Total exemptions under Art. 149, RF Tax Code	8 594.5	100.0	12 605.7	100.0	851.6	100.0	1 085.4	100.0

Source: Form 1-VAT, Federal Tax Service

Another sector that is not subject to VAT (Sub-Item 4, Item 2, Art. 146 of the Tax Code) is the public administration sector. Moreover, the Tax Code defines specifies the operations carried out by federal and local government authorities that are exempt from taxation:

– services provided by the authorized agencies, for which a state duty, all types of licensing, registration and patent fees are levied and charges, customs fees for storage, as well as fees and charges levied by state and local government authorities, other authorized bodies and competent persons for granting particular rights to organizations and individuals (Sub-Item 17, Item 2 of Art. 149 of the Tax Code);

– work of research and development/design that is budget funded or funded out of the RF Fund for Basic Research, the Russian Fund for Technological Development or out of extra-budgetary funds of Ministries, Agencies, Associations that have been created for these purposes in accordance with RF legislation, the carrying out scientific research and development work by educational institutions and scientific organizations on the basis of commercial contracts (Sub-Item 16, Item 3, Art. 149 of the Tax Code).

Available statistics do not enable us to separate out the value added by all the categories of activity that are exempt from VAT in accordance with Art. 149 of the Tax Code, but the reliability of our calculations remains rather high, even for the financial sector, the share of which in the total value of exemptions from VAT is over 91%, and in the public administration sector, the activity of which is totally exempt from VAT.

According to our calculations, the value added in these sectors and that is subject to exemption amounts on average for 2004-2005 to about 16.6% of the total value added in the economy.

Let us therefore calculate the volume of VAT revenues under the Addition Method in the economic conditions of 2009 on the assumption that the share of value added in the sectors of financial activities and public administration subject to exemption, remains at a level of 16.6% and that the share of other exemptions does not exceed 10% of the value added in the financial sector.

Given that the major categories of exempt transactions and activities were excluded from the volume of value added, the level of tax collection should reflect the volume of possible arrears in VAT to the federal budget, and in conformity with the estimates of the Ministry of Finance should be under the current VAT system about 90%.

The estimates are presented in *Table 10*.

TABLE 10

Impact of transition to the Addition Method on revenues to the RF budget system using economic indicators of 2009

	Blln. RUR
Value added in basic prices (disregarding hidden wages), is assumed to be 74% of GDP	38090
Exempt value added of the financial sector as a % of total value added	4.2
Exempt value added of the public management sector as a % of total value added	12.4
Exempt value added created in other economic sectors, (10% of VA in financial sector)	0.42%
Tax base under Addition Method	31538
Level of tax collection	90%
Budget revenues:	
- at a tax rate of 18%	5109
- at a tax rate of 12%	3406
For reference: estimated VAT budget proceeds in 2009, RUR bln.	3271
For reference: estimated GDP in 2009, Blln. RUR (as per the first edition of the Federal Budget Law for 2009)	51475

There are several reasons for such high values for tax proceeds:

Firstly, since the necessary statistical data are not available, the share of value added created by the taxpayers under special tax regimes and by those exempt from VAT has not been excluded from the total of value added.

Secondly, under the Addition Method, investment expenditure, which according to Art. 39 of the Tax Code does not relate to sales operations and is not subject to VAT, is not excluded from the tax base.

Thirdly, under the Addition Method the value-added created in export is subject to taxation, whereas the value of imported goods is not included in the tax base. According to estimates of the Ministry of Economic Development (August 2008), in 2009 net export was planned at 7.7% of GDP. Therefore, under the Addition Method, this amount of added value is included in the tax base, whereas under the Invoice Method it is lost through refunds and credits. Taking into account that VAT on imported goods in 2009 is planned in the budget at a level of RUR 1,403.25 trillion (2.7% of GDP), about 70% of which is subsequently agreed for refund, while the value of claims for VAT refund approved in 2005-2007 was on average 3.5-3.6% of GDP (in conditions of 2009 this is equivalent to RUR 1830 billion), we can estimate the difference in VAT proceeds due to the use of different territoriality principles for VAT collection at approximately at RUR 1.4 trillion under conditions of 2009. If the credit-invoice method of taxation is retained in 2009 accompanied by application of the principle of taxation by appellation of origin of goods (works, services), budget revenues would increase to RUR 4.7 trillion.

What should be done?

There is no doubt that current problems with delays of VAT refund to exporters and the extensive use of “gray” refunding schemes inflict significant damage on the federal budget and require urgent resolution. However, in our view, it is also clear that the existing problems of VAT administration should not be resolved by radical tax reform.

Measures that have been taken to address certain specific problems in the tax code, in the absence of the kind of comprehensive approach that was adopted in 2000, when Chapter 21 of the Tax Code was being developed, have damaged the effectiveness of certain provisions of tax legislation and there are instances in which the law on VAT is an impediment to the conduct of business. All of this adds to such basic problems as the absence of a tradition of administration and of implementation of tax legislation, the specific shortcomings of the judicial system and inadequate monitoring of the ability of tax authorities to carry out their responsibilities, enforce compliance and, for a variety of reasons, reach reasonable and balanced decisions.

We should also bear in mind that, given the current rate of VAT and specific features of the Russian economy (high share of exports, low level of institutional development, magnitude of the shadow sector, etc.), budget revenues from VAT for a variety of objective reasons, exceed forecasts. This means that in the nearest future it is quite possible that some measures for reform that will improve the efficiency and impartiality of the tax and reduce the costs of compliance to taxpayers will reduce VAT revenues,

As a priority, the following steps should be taken:

1) Streamline and simplify procedures for refund of VAT where a zero rate applies and in similar cases. In particular, for confirmation of export only one proof should be required - the fact of transfer of goods across the customs border. The requirement to produce such documents as proof of payment for exports or a contract exclusively with a foreign buyer should be abolished. Particular attention should be paid to procedures for application of the zero rate to export-related services (for example, when the goods are transported by pipeline, taking into account the specificities of arranging this kind of transportation, the nature of the goods being transported, requirements for periodic temporary declaration, and the export of goods by rail).

2) Harmonize various provisions of the Tax Code that relate to VAT and eliminate internal inconsistencies. In countries using VAT, for the majority of taxpayers, not involved in complex operations, this tax is one of the easiest as regards calculation and payment. We should try to achieve this simplicity in Russia. To this end, the rules for processing invoices should be amended, the rules for tax offset in various circumstances should be unified, as well as the rules on exemptions; the wording of the Tax Code, which is often ambiguous and creates problems for both taxpayers and tax authorities should be clarified.

3) Improve the effectiveness of the monitoring agencies. This means creating viable working relations between tax authorities and customs authorities; setting up a monitoring system based on modern methods of risk assessment of tax avoidance that is not disclosed to taxpayers but is used exclusively by the tax authorities; increasing the level of accountability of tax officials and expanding their powers of decision-making, including the right to make decisions based on professional judgment as to compliance of the taxpayer with the spirit and letter of the Tax Code; elimination of corruption in public bodies and an improvement in the system of registration of taxpayers.

If, as a result of all the above measures there is an improvement in the efficiency and impartiality of the systems of taxation and tax inspection, even if there is a reduction in budget revenues in the short term, then the measures will be justified. The multiplier effect that accompanies improvements in the system of tax administration and in the tax system in as a whole will not only reduce the tax burden on economic agents, but eliminate a range of problems in other areas. For example, improvements in tax administration will make it possible to introduce new taxes, something that is currently impossible owing to the un-preparedness of the tax authorities: these would be, first and foremost, taxation of surplus revenue in the extraction of hydrocarbons; and taxation of real estate. Above all, these measures would substantially improve collection of the major taxes and contribute to the financial sustainability of the budgetary system in the long term.