

# **MAIN DIRECTIONS OF TAX SYSTEM REFORM IN THE MEDIUM TERM**

by

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## Abstract

In the next decade the Russian tax system will face tremendous challenges, due to both objective factors (significant dependence of the Russian economy on foreign trade conjuncture, etc) and a number of decisions in the field of fiscal policy. Viewing these challenges the authors examine three objectives of reforming the tax system: a balanced budget, improving equity and efficiency of taxation and the development of fiscal federalism – as well as the corresponding measures of tax policy in the medium term.

Key words: tax system, fiscal policy, balanced budget, fiscal federalism

JEL codes: H2, H21, H25, H71

# MAIN DIRECTIONS OF TAX SYSTEM REFORM IN THE MEDIUM TERM

## 1. Contemporary Challenges Faced by Russia's Tax System

Over the next decade, the Russian tax system will have to cope with some formidable challenges created by objective factors: the strong dependence of the Russian economy on foreign trade conjuncture; the depletion of the formerly rich and conveniently situated deposits of mineral resources, with the resulting upsurge of the cost of production at newly developed sites; the ageing of the population, on the one hand; and by the subjective factors associated with recent decision-making in the field of budget and tax policy – the growth in the spending obligations of the federal budget due to heavier allocations to national defense and law-enforcement items, the lack of a systematic approach to the granting of tax privileges and exemptions, the specific structure of this country's tax system in general and that of some taxes in particular, which fail to ensure sufficient progressivity and efficiency of taxation, etc. – on the other.

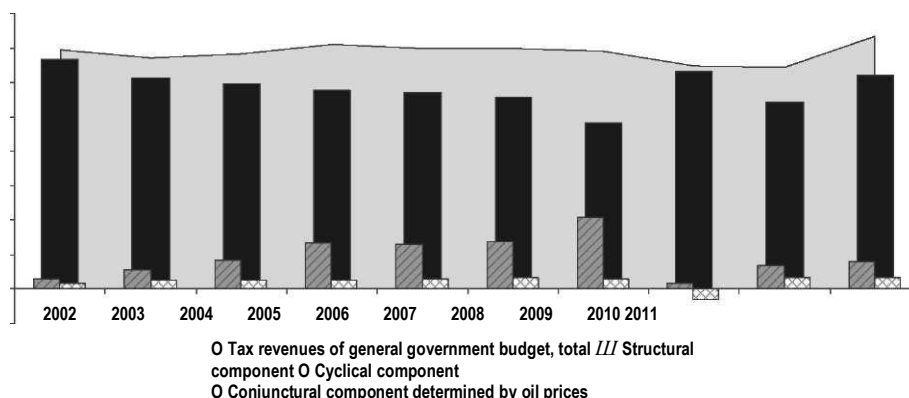
The high degree of dependence of Russia's national economy on the situation on world markets creates serious risks for the fiscal sustainability of the federal budget, especially when the world economy begins to display crisis phenomena. According to the data released by the RF Ministry of Finance, in 2011 the share of the 'oil and gas' component in federal budget revenue amounted to 49.6%; it is noteworthy that oil prices influence not only the size of the oil and gas revenues (generated by mineral extraction tax (MET) levied on hydrocarbons and by the relevant export duties), but also the revenues generated by other taxes – primarily direct ones.

However, in our opinion, long-term fiscal sustainability of the tax system can be more correctly estimated not on the basis of the share of 'oil and gas' taxes (export duties and MET), but by making a distinction between the structural and cyclical components of budget revenue, as is routinely done in many countries of the world. In the case of Russia, given the high dependence of tax-generated revenues here on oil prices, the cyclical component can be further divided into cyclical revenues proper (dependent on a business cycle phase) and conjunctural revenues (dependent on the movement of oil prices on the world market).

Thus, only structural tax-generated budget revenues can be treated as sustainable or guaranteed over a certain time interval. In our definition, these include all tax-generated budget revenues estimated on the basis of oil price projections at a multiple-year average (for example, 10-year average) and for the midpoint of the business cycle (growth rate of real GDP - 3—4% per annum).

As demonstrated by the Gaidar Institute's econometric estimates, general budget structural revenues in 2002—2011 constituted approximately 34% of GDP, whereas the conjunctural component was fluctuating within plus or

minus 4% of GDP, and the cyclical component – within plus or minus 2% of GDP (Fig.)<sup>1</sup>.



Source: MRF Ministry of Finance, IEP's estimates.

Fig. Structural and Conjunctural Component of General Government Budget Revenue (% of GDP)

An additional risk factor is the imminent decline (unrelated to any economic or political decisions) of budget revenue due to the higher cost of oil and gas production at the new deposits, which over the period until 2020 we estimate to be at the level of 2.5% of GDP.

Another factor of paramount importance for the Russian tax system's development will be the demographic trends necessitating that the RF government's policies should be adapted to population ageing. As shown by the UNO's data, by 2020 the share of Russia's population aged over 60 years will rise from the current 17.8% to 21.6—22.7%, and by 2050 this age cohort may amount to one third of the entire population of this country<sup>2</sup>. This will inevitably entail increasing health care, welfare and pension expenditures – even if the service standards remain at their current low levels and the pension system retains its relatively low replacement coefficient. According to our estimates, the increasing number of pensioners will result in a situation where the cost of sustaining the replacement coefficient at the level of 40% by 2020 will increase by 3% of GDP on 2010<sup>3</sup>.

Alongside these unfavorable objective trends with their negative effect on government finance, a decision-making process is under way which is boosting the scale of budget spending obligations. Thus, in particular, it is planned that, until 2020, a total of Rb 23 trillion will be allocated for military purposes; another 1—2% per annum may be allocated to the implementation of the initiatives in the social sphere put forth by Vladimir Putin in his election-campaign papers. Besides, there is the risk of some additional expenditures in

<sup>1</sup> For the substantiation of the breakdown of revenue by component, with the description of the relevant methodology, see Kazakova M. V., Sinelnikov-Murylev S. G., Kadochnikov P. A. *Analiz strukturnoi i kon'iunkturnoi sostavliaiushchikh nalogovoi nagruzki v rossiiskoi ekonomike* [Analysis of Structural and Business Component of the Tax Burden in Russian Economy] // Nauchnye trudy [Scientific Works], No 129. M.: IET, 2009.

<sup>2</sup> See *Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2010 Revision*. esa.un.org/unpd/wpp/index.htm.

<sup>3</sup> See, for example: Nazarov V., Sinelnikov-Murylev S. *O strategii sovershenstvovaniia rossiiskoi pensionnoi sistemy* [On the Strategy for Improving the Russian Pension System] // Ekonomicheskaiia politika [Economic Policy]. 2009. No 3.

connection with Russia hosting the 2014 Winter Olympics at Sochi and the 2018 FIFA World Cup. We estimate that the implementation of such decisions will increase the federal budget deficit to between 5 and 5.5% of GDP.

One of the possible responses to all these challenges can be budget cuts in certain areas (in particular, defense, law enforcement, subsidies to the economy, and the current reform of the pension system implying a redistribution of available resources in favor of older pensioners), as well as the introduction of a budget rule designed to ensure a well-balanced federal budget at a benchmark oil price (multiyear average).

Yet another challenge faced by the Russian tax system is posed by the fact that tax base and tax revenues are distributed unevenly among Russia's regions. Genuine fiscal federalism can be achieved only after decentralization of the tax system. However, in conditions of the extremely uneven distribution of the tax base between different regions (in 2010, the by-region variation coefficient of per capita revenues amounted to 91.3%, which means that, on the average, the per capita value of revenue in some regions deviates from the regional average by an amount that is nearly equal to that of the regional average), no decisions in the sphere of tax policy aimed at taxation decentralization will be able to provide any adequate solutions to the problem that has arisen as a result of the situation when the bulk of regional and municipal budget revenue is generated by their own tax sources.

The qualitative and structural taxation issues that result in public welfare losses are also noteworthy in this connection. A tax system's quality is usually estimated by applying the parameters of taxation neutrality, fairness and efficiency, including also tax administration simplicity and compliance with the requirements stipulated in tax legislation. A comparative analysis of the Russian tax system and the tax systems existing in developed countries has revealed that, in terms of quality parameters, this country is certainly no match for the world's best practices – among other things, due to the insufficient progressivity and cost-effectiveness of taxation.

Thus, although the system of tax exemptions and deductions in Russia became properly organized in the course of the tax reform of the 1990s — early 2000s, since 2007 there has emerged a trend towards extending the list of exemptions from the main taxes, and tax legislation still envisages some exemptions granted to some very select groups – almost on an individual basis. These are, in particular, the exemptions from the tax on profit of organizations granted to the Bank for Development (state corporation) and the Housing and Utilities Reform Fund of the Russian Federation, and also exemptions in the field of financial leasing<sup>4</sup>. Besides, exemptions from tax on property of organizations granted to some natural monopolies – general purpose railway tracks, trunk pipelines, electricity transmission networks, etc. – have also been preserved.

At present there exists a risk that more tax exemptions may be introduced on the grounds that these are required to achieve the goals of modernization, which will give rise to some additional tax expenditures in the budget<sup>5</sup>. It

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<sup>4</sup> See *Malinina T. Otsenka nalogovykh l'got i osvobozhdenii: zarubezhnyi opyt i rossiiskaia praktika* [Recognition and Measurement of Tax Expenditures: International Experience and Russian Practice] // *Nauchnye trudy* [Research Papers] No 146P. M.: Gaidar Institute, 2010, p. 95—96.

<sup>5</sup> The budget tax expenditures linked to the tax on profit of organizations, personal income tax and value added tax, as estimated on the basis of available data, amount to approximately 1% of GDP. Data on income (profit) taxes are unavailable for 75—80%, and data on VAT — for one-third of the tax expenditure items; in this connection it is unclear how their share is coordinated with that of the unestimated items in the aggregate budget revenue loss.

should be remembered, however, that a chaotic expansion of tax exemptions without any comprehensive estimation of their potential impact on the size of budget revenue and the level of economic activity – which can also manifest itself through distorting the incentives for economic agents – can not only worsen the tax system's qualitative parameters, but also pose a threat to macroeconomic stability.

Some of the structural problems of the Russian economy have been caused by the export duties levied on oil and petroleum products. These duties have created a situation where oil refining in Russia is being subsidized by lowered domestic oil prices. The subsidy – which in 2010 amounted to 3.5% of GDP<sup>6</sup> - is divided on a roughly equal basis between the product's end consumers and the sector itself, compensating the latter for losses and ensuring that it be sufficiently profitable. Meanwhile, conservation of domestic hydrocarbon prices over the last two decades has been in no way conducive to quality modernization or an improved competitive capacity of the national economy.

Nowadays it is necessary, for objective reasons, to make tax legislation and tax administration more elaborate, so as to catch up with the increasing complexity of business practices. In particular, the taxation issues arising in connection with operations with financial instruments, the functioning of holding companies, the introduction of transfer prices, and other areas of business activity require very detailed legislation regulation and (or) some new approaches to tax administration, as well as a closer supervision by the administrative agencies and a higher qualification of their personnel. From the point of view of the tax system, this is fraught with the risk associated with growing tax administration costs and the necessity to comply with the requirements stipulated in legislation. Besides, as the procedures of legislative regulation and control are becoming more complicated, the business risks increase accordingly.

## **2. The Goals of Tax System Reform and Related Tax Policy Measures**

With due regard for all those problems and challenges faced by the Russian tax system, three goals of its reforming can be pointed out, which will be discussed in more detail later in this article. The goals are as follows: to achieve a well-balanced budget; to make taxation more just and efficient; and to develop fiscal federalism.

### *Well-balanced Budget*

As noted earlier, in the next few years the decline in budget revenue in response to the shrinkage in oil and gas production as a share of GDP can reach the level of 2.5% of GDP. At the same time, it appears to be feasible to increase the expenditures on education, health care and infrastructure, which will require another 4% of GDP. Pension reform, which is expected to result in a certain drop in the size of expenditure, for objective reasons cannot be accomplished in a short period of time. An important source of funding for this budget maneuver in the period until 2020 will be growth of government debt from its existing level (9.6% of GDP as of 1 January 2012) to 20—25% of GDP. Any further increase in the size of government debt in face of the current strong

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<sup>6</sup> Another 0.3% of GDP in the form of subsidies is received by the chemical and petrochemical industries.

dependence of budget revenue on the rapidly changing situation on the world markets for raw materials and energy carriers is undesirable. So, if the speed of the process of restructuring and cutting budget expenditure, and the rate of implementation of related reforms turn out to be slower than necessary, it may become inevitable to raise taxes in order to ensure budget sustainability. In this connection, increasing the level of taxes will be an unwelcome measure because it will undermine the Russian economy's position in terms of international tax competition and can have a negative influence on the investment climate and economic growth. However, it will still be better to slightly increase taxes – provided that ineffective expenditures cannot be reduced for some social and political reasons – rather than to increase government debt beyond safe limits, or to replenish the budget by means of resorting to the printing press – which may lead to macroeconomic instability.

If it is necessary to raise the level of taxes in order to achieve a well-balanced budget (which – it must be emphasized once again – is a very undesirable measure), the most rational approach will be to increase the rate of VAT. This measure is reasonable because, firstly, growth of taxes on consumption (and in particular VAT) does not exert such a strong distorting influence on the processes going on in the economy as increased taxation levied on labor and capital. Besides, as VAT is levied on exports at a zero rate, an increased basic rate of VAT cannot bring down the competitive capacity of Russian commodities on international markets. Secondly, the revenues generated by VAT are less susceptible to fluctuations in response to the world market conjuncture as the other taxes<sup>7</sup>, and so raising its rate is compatible with the goal of increasing the share of the structural component of the Russian tax system, thus reducing the risk associated with the Russian economy's dependence on the external economic situation.

Estimates have revealed that if a single VAT rate of 20% is applied, then in the conditions peculiar to the period of 2012—2014 federal budget revenue will increase by 1% of GDP.

An additional potential for increasing budget revenue can be provided by increasing the rate of personal income tax to 15—17%, while at the same time keeping it flat. If the rate of that tax is raised to 15%, the amount of tax-generated revenues will increase by 0.6% of GDP; if it is raised to 17%, the resulting increase will be by 1.2% of GDP.

Some other measures beside those discussed above can also be implemented in order to increase the inflow of tax revenues into the budget. In particular, natural monopolies may be deprived of their currently existing exemptions from tax on property of organizations; the rate of MET levied on natural gas may be raised; and the excises on tobacco and alcohol products may be raised more rapidly than currently envisaged in the government's plans. At the same time, these measures should be implemented regardless of whether the goal of properly balancing the budget is actually achieved or not; we are going to discuss them later in the text.

The aforesaid measures aiming at increasing the tax rates in certain areas of the economy may be actually implemented only as a last resort, when all the other possibilities for preventing macroeconomic instability are exhausted. If restructuring of budget expenditure and its improved cost-effectiveness can

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<sup>7</sup> See Kazakova M. V., Sinelnikov-Murylev S. G., Kadochnikov P. A. *Analiz strukturnoi i kon''iunkturoi sostavliaiushchikh nalogovoi nagruzki v rossiiskoi ekonomike* [Analysis of Structural and Business Component of the Tax Burden in Russian Economy].

actually create some opportunities for bringing down tax rates, then the priority will be to set lower tariffs for the compulsory contributions to the pension, medical and social insurance funds (the basic rate must be no higher than 26%). The current high burden on the wages fund is detrimental to the competitive potential of the Russian economy. At the same time, Russia nearly tops the list of countries with highest levels of mandatory contributions to pension insurance. By the size of pension insurance contributions (22% in 2012), Russia is ahead of Canada, Japan, France, Germany and Sweden, where the ratios of the established ceiling for the income levied with this type of tax to the country's average wage are comparable to that in Russia<sup>8</sup>.

An additional measure designed to reduce the tax burden (if possible) may become the lowering of the rate of tax on profit of organizations (to 16%), which will result in a better competitive capacity of the Russian economy on the international level. In recent years, the rates of corporate income tax have been declining in every region of the world. The average corporate income tax rate in 17 OECD countries in 1990 was 41.8%, in 1997 — 38.3%, and in 2006 — 30.8%<sup>9</sup>.

### *Making Taxation More Just and Efficient*

If taxation is insufficiently just and efficient,<sup>10</sup> it creates fertile ground for distorting the process of rational decision-making in the field of economics, has an adverse effect on competition, is fraught with the risks of abuse on the part of government officials, and encourages economic agents to engage in rent-seeking behavior<sup>11</sup>. As a result, overall economic activity is somewhat suppressed. Below we are going to look at some measures that we believe to be the most relevant ones in terms of improving the tax system's efficiency and justness.

*Stage-by-stage abolition of export duties on oil and petroleum products.* An important measure that can improve the quality parameters of the Russian tax system will be to gradually abolish the export duties on oil and petroleum products. The abolition of the export duties on oil and petroleum products must be coupled with the capture of the additional incomes received by oil producers as a result of this measure (their incomes from foreign markets) and due to the rise in domestic prices (their incomes from the domestic market). These incomes should be captured by means of increasing the rate of MET while preserving the existing norm for net profit margin in oil extraction. The additional budget revenues thus generated (resource rent) may be used, among other things, to cover the losses incurred by the population and consumers of energy resources as a result of price growth, and those incurred by the population and consumers of energy resources may be compensated for by means of lowering taxes or by budget transfers.

The abolition of export duties on oil and petroleum products will give rise to some serious changes in the levels of prices for retail and wholesale consumers. Besides, a transition period of 5 to 7 years will be required to accomplish

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<sup>8</sup> See, for example, *Nazarov V., Sinenikov-Murylev S. O strategii sovershenstvovaniia rossiiskoi pensionnoi sistemy [On the Strategy for Improving the Russian Pension System]*.

<sup>9</sup> See *Fundamental Reform of Corporate Income Tax / OECD. 2007.*

<sup>10</sup> Efficient taxation implies a minimal distorting effect on the behavior of economic agents, as well as tax collection with minimum administration costs and full compliance with tax legislation.

<sup>11</sup> See, for example, *Malinina T. Otsenka nalogovykh l'got i osvobozhdenii: zarubezhnyi opyt i rossiiskaia praktika [Recognition and Measurement of Tax Expenditures: International Experience and Russian Practice]*.



technological modernization of the oil refining industry. Thus, the two contradictory goals of reform are its speedy implementation, on the one hand, and the necessity of related institutional transformations in this industry (open and honest competition with imports on the domestic market, development of regional petroleum product exchanges, etc.)<sup>12</sup>.

*The introduction of tax on additional income derived from oil and natural gas extraction.* Taxation of the extraction of oil and natural gas must be levied with due regard for the deterioration, for objective reasons, of the situation for the extraction of these mineral resources: the new deposits are situated in regions with more difficult geographical, geological and mining conditions, and so their development will require higher capital costs, exploitation costs and transportation costs. As mineral extraction tax and export duty are levied on gross proceeds and do not take into account field development costs, more often than not, the development of new oil and natural gas fields is not cost-effective under Russia's current general taxation system.

The solution to this problem can be provided by means of differentiating the rate of MET depending on the specific conditions of oil and natural gas extraction in a given field (including the introduction of tax holidays and other types of exemptions for each category of oil and natural gas fields). In particular, as far as the production of dehydrated, desalted and stabilized oil is concerned, the oil fields situated entirely or in part within the borders of the Republic of Tatarstan or the Republic of Bashkortostan are subject to a special MET deduction, while the oil fields situated entirely or in part within the borders of the Republic of Sakha (Yakutia), Irkutsk Oblast and Krasnoyarsk Krai, if the established terms for a license period are complied with, are subject to tax holidays (zero tax rate) until the accumulated extraction volume of 25 m tons per site is achieved.

It is evident that the mechanism of granting MET holidays is imperfect, because an averaged approach is applied to all the oil and natural gas fields situated in a given region (or shelf zone), which does not take into account the actually existing broad variations in the properties of each site. Moreover, it is more rational, in view of the different conditions at different fields, to levy tax on the additional (net) income. In this way, the tax burden will be automatically differentiated depending on a given site's cost-effectiveness. Such an approach takes into account not only the producer's gross proceeds (as it happens when MET and export duty are applied), but also the cost of oil or natural gas extraction at a given field. Thus incentives are created for deeper development of oil or natural gas reserves and for higher output levels.

It will be feasible, at newly developed sites, to apply tax on additional income in combination with MET, the latter in such instances being levied at a lower rate (for example, with a downward coefficient of 0.2). The levying of MET will provide the government with guaranteed revenues from the very onset of the process of oil production, and a single rate of the tax on additional income will ensure tax progressivity depending on the level of oil price<sup>13</sup>. If the tax on income is applied, then the rate of export duty on the oil produced in the framework of such projects will have to be considerably reduced or even set at zero.

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<sup>12</sup> See *Sinelnikov-Murylev S., Bobylev Yu., Idrisov G. Eksportnye poshliny na nefi' i nefteprodukty v Rossiiskoi Federatsii: neobkhodimost' otmeny i osnovnye problemy* [Export Duties on Oil and Oil Products: Need for Abolishment and Scenario Analysis]. Moscow, IEP Research Papers No. 161.

<sup>13</sup> The method for ensuring tax progressivity with regard to international prices consists in including, in the computation formula for the rate of tax on additional income, of the R-factor representing the ratio of accrued income to accrued costs.

The introduction of tax on additional income for newly developed oil and natural gas fields is fraught with some difficulties. Thus, by comparison with the MET regime, the taxation of additional income will be much more complex in terms of tax administration because it will create the potential – as well as some incentives – for the producers to report underestimated data concerning their tax liabilities, thus resulting in a relative drop in the size of budget revenue.

The necessary conditions for cost-effective levying of tax on additional income will be to apply, for the purpose of calculating the amount of tax, market prices (and not transfer prices), and to elaborate efficient procedures for supervising the costs incurred by taxpayers, which will require a high qualification level of the staff of the tax administration agencies.

*Increasing the rate of MET on natural gas.* At present, the situation in the Russian economy is such that there exist some valid grounds for increasing the tax burden on the natural gas sector, because its level is lower than that in the oil sector. Thus, in 2006—2009, while in the oil sector the aggregate share of all types of taxes in proceeds was 58.4%, a similar index for the gas sector amounted to 34.4%<sup>14</sup>. In 2010, profitability (income after taxes) in Russia's gas industry was at the level of 33.4%, while in the oil industry it amounted to 14%<sup>15</sup>.

It is advisable to adjust the rate of MET levied on natural gas in accordance with the growth rate displayed by the price for natural gas on the domestic market. In this connection, in order to achieve taxation progressivity in the gas sector<sup>16</sup>, a special formula can be applied for the indexation of MET rate that will make it possible to peg the rate of tax to domestic gas prices both in absolute and relative terms (as a percentage of gas prices). A 100% capture of the income generated by the growth in gas prices on the domestic market must be ensured. In that case, the amount of additional budget revenue can be as high as 1% to 1.2% of GDP.

*Switchover to a single rate of value added tax.* A switchover to a single rate of VAT – that is, the abolition of the special 'privileged' rate of that tax – may increase the justness and efficiency of taxation. Firstly, a reduced VAT rate represents a regressive tax privilege, which is more beneficial for high-income consumer groups. Secondly, the existence of a special rate makes the implementation of tax legislation more difficult and the tax administration procedure more complex (in particular, it is necessary to keep separate VAT records). At the same time, it must be noted that, although these drawbacks are universally recognized, in a vast majority of countries there still exist special rates of VAT.

In 2010, the effective rate of VAT – adjusted by the share of commodities levied at the rate of 10% - amounted to 17.15%. Thus, the abolition of the reduced rate of VAT will result in an increase in the amount of VAT-generated revenue by approximately 5%, or 0.33% of GDP. The abolition of the special VAT rate will necessitate the elaboration and implementation of some compensatory mechanisms, because the special rate is applied in the main to socially relevant categories of commodities.

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<sup>14</sup> See Bobylev Yu., Turuntseva M. *Nalogooblozhenie mineral'no-syr'evogo sektora ekonomiki* [Taxation of the mineral sector] // Nauchnye trudy [IEP Research Papers] No 140P. M.: Gaidar Institute, 2010, p. 125.

<sup>15</sup> The Gaidar Institute's estimates based on companies' financial reports.

<sup>16</sup> In the future, the issue of introducing progressive taxation in the other industries of the raw materials sector can also be considered (coal, potassium, metals, etc.).

*Lowering the tariffs for insurance contributions, and transfer of the task of their administration to tax agencies.* The recent reform of single social tax, which replaced the tax with insurance contributions and altered the taxation scale, has failed to ensure long-term sustainability of the pension system, while at the same time has dramatically increased the size of the tax burden and complicated tax administration. The upward trend displayed by the tax load on labor is contrary to the current global trend (where the size of tax load on labor and capital is being lowered in order to boost up the economy's competitive capacity, while that of the tax load on consumption is increasing).

As for insurance contributions to mandatory pension, medical and social insurance (no matter which variant of pension system reform is actually adopted), it will be feasible to consider the issue of returning to a single social tax (at least in the part of solidarity insurance contribution tariff). In this connection, irrespective of the ultimately chosen solution, the administration of the relevant payments must be delegated to tax agencies. Thus, one of the priorities for Russia's tax policy must be the reduction, after 2015, of insurance contribution tariffs to 26% on sums below a certain annual income ceiling determined so as to minimize budget losses (as demonstrated by our estimates, approximately Rb 0.6—1m), while the sums above that ceiling will be levied at the formerly applied rate of 5—10%.

*Raising the minimum personal income tax allowance.* It will be feasible, in order to increase the tax system's progressivity while preserving a flat rate for personal income tax, to raise the minimum income tax allowance (or standard tax deduction) to a level comparable to that of the national minimum wage (from 1 June 2011 – Rb 4,611).

It should be noted in this connection that, from 1 January 2012 onward, the stipulation concerning the size of standard tax deduction granted to all taxpayers until their accumulated income since the beginning of a given tax period exceeds the ceiling of Rb 40,000 was abolished. Instead, as a compensatory measure (backdated to 1 January 2011), the size of standard tax deduction granted to a taxpayer for a third and every next child was increased. The abolition of minimum personal income tax allowance makes the tax system less neutral, because a standard income tax deduction applied to all taxpayers is designed so as to take into account the cost/income ratio.

Thus, it will be advisable to reinstate the minimum personal income tax allowance, simultaneously increasing it to the officially established subsistence level (or to empower the regions to grant that allowance to taxpayers). According to our estimates, the loss of budget revenue as a result of the implementation of this measure will amount to 11% of the size of revenues generated by personal income tax, or 0.4% of GDP. But if the tax allowance is established on a monthly basis<sup>17</sup>, the resulting loss of budget revenue will be less than 0.2% of GDP.

*Reform of taxes on property.* In the medium term, it will be feasible to implement a reform in the sphere of property taxation. As the role played by tax on immovable property within the tax system increases, its progressivity also goes up irrespective of the degree of progressivity of taxation levied on each individual taxpayer's property, because of the heterogeneity of the real estate owned by low-income and high income taxpayers.

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<sup>17</sup> In the conditions specific for the year 2011 this means that the standard monthly tax deduction in the amount of Rb 400 would not have been granted to all taxpayers until their accumulated income reaches the ceiling of Rb 40,000, but only to those whose monthly income did not exceed Rb 3,333. (Rb 40,000/12 months.).

Reform of taxes on property implies that it must be determined whether one or several taxes are going to be levied simultaneously; that taxable properties must be evaluated; and that taxation parameters must be established, namely the tax rates and probably tax exemptions. Each of these issues can be dealt with in several different ways.

Thus, taxable property can be evaluated by an independent valuator; but it seems more reasonable that this should be done on a mass scale by tax agencies on the basis of some formal criteria derived from cadastre evaluation of immovable property units. The main problem is associated with the choice of evaluation methodology, which must be capable of reflecting the difference in the value of various objects at a reasonable cost. In this connection it should be remembered that the principle of correct valuation of property objects for the purposes of taxation does not imply that the estimated tax base must correspond precisely to an object's market price; instead, the relative price level of such objects must be determined correctly, because the price in absolute terms of immovable property units is prone to broad fluctuations in difference phases of a business cycle.

Taxation parameters can be established both at the federal and regional and/or local levels. In this connection it should be noted that the provisions of Article 12 of the RF Tax Code in their current wording impose significant constraints on the ability of regional and local bodies of authority to set many important parameters of regional and local taxes respectively (including tax rates and exemptions). The tax rates, procedure and timelines for the payment of regional and local taxes may be established by them in the procedure and within the limits determined by the RF Tax Code, and only if these parameters are not already stipulated in the RF Tax Code itself. Other taxation parameters, as well as taxpayers, are determined by the RF Tax Code.

Increasing the rate of tax on personal property without granting large-scale exemptions is fraught with risks of negative social consequences. As exemption may be granted in the form of a minimum tax allowance (or deduction), to be determined in kind (in square meters), or in money terms, or as percentage of tax base. At the same time, if exemptions (or deductions) from property tax are granted to individuals on a large scale, then that tax can be interpreted as a tax on wealth, and so it cannot ensure revenue growth.

In principle, individual property taxation may be based on two taxes instead of just one tax; one tax then will be paid by all immovable property owners, and the other — only by the owners of expensive real estate. A similar approach is practiced, for example, in France where two taxes are levied on the owners of immovable property: tax on immovable property (*taxe foncières*) and tax on wealth (*impôt de solidarité sur la fortune*). Tax on wealth is paid only by those individuals whose movable and immovable property is evaluated to be in excess of € 1.3m, at a progressive rate of 0.55 to 1.8%; tax on immovable property is paid by all owners of such property. With due regard for the existing unsolved problems and risks associated with personal property taxation reform, it can be possible to increase the size of revenues generated by that tax to 0.1—0.2% of GDP in the short term.

*Increasing the excise duties on tobacco and alcohol products.* As far as excise duties are concerned, it will be feasible to considerably increase the rates of excise duties on tobacco and alcohol products. The size of excise duties on these commodities must eventually approach the European average.

It appears that a well-substantiated economic solution will be to set the excise duty on tobacco products at Rb 65—70 per package in 2015, which

implies its annual indexation by 50—55%. In this case, the size of budget revenues generated by excise duties on tobacco products may amount to approximately 0.6—0.9% of GDP, which will mean growth of these revenues by 0.3—0.35% of GDP relative to the overall budget revenue volume in accordance with the law on federal budget for 2012—2014.

The total volume of revenues generated by the excise duties on beer, wine and spirits, on conditions of their indexation at a rate that will make it possible to approximate the level of excises for these categories of commodities to the average European level as early as 2011—2014, is forecasted to be at the level of 0.43% of GDP in 2014, which is by 0.09% of GDP higher than the same index for 2010, or is by 0.03—0.05% of GDP higher than the volume of this revenue category as stipulated in the law on the federal budget for 2012—2014.

The introduction of higher excise duties on tobacco and alcohol products must be coupled with some related decisions designed to prevent the access of smuggled and counterfeited products to the domestic market. In particular, stricter control must be exercised over excise-free retail sales across the territory of the Russian Federation, and greater responsibility established for related violations. Besides, the risks associated with the possibility of tobacco imports from the Customs Union countries, including from China and Kyrgyzstan via Kazakhstan, must also be taken into consideration.

*Tax system ecologization.* The existing system of emission standards (concentration limits, emission limits, temporarily allowed emission) should be thoroughly modernized. The emission permits concerning the amount of pollutants that may be released into the environment must be issued to companies on the basis of the estimated health risks. The fees for the issuance of such permits must be supplemented by fines for emissions in excess of the established limits. Similar measures should be implemented with regard to the regulation of industrial wastewater discharges and waste contaminants disposal.

*Augmenting the budgetary process by the phase of estimating the size of tax expenditures in the budget.* The introduction of the phase of tax expenditure estimation in the budgetary process and the resulting optimization of the granting of tax preferences may significantly improve taxation justness and efficiency. Tax exemptions make a tax system less just because some entities may pay less taxes than other entities with exactly the same incomes; besides, exemptions are often regressive. The granting of tax exemptions results in increasing the costs of tax administration and the costs of compliance with tax laws; consequently, the overall functioning of the tax system becomes less cost-effective.

Regular revision of the estimates for tax expenditures in the budget and the publication of related reports will make it possible to reinstate the principle of ‘wide tax base—low tax rate’, which was one of the fundamental principles applied in the elaboration and adoption of the RF Tax Code. An integral component of tax policy must become a regular analysis of previously introduced exemptions and an estimation of their actual effect in conjunction with the expected goals, which will provide the basis for making a decision as to whether they should be maintained or abolished.

Besides, the government must abandon the practice of granting tax exemptions without a comprehensive estimation of their potential influence on the size of budget revenue, the selection of taxpayer categories, and other processes going on in the economy; and the introduction of tax exemptions must be coordinated with budget projections based on a pessimistic macroeconomic forecast.

*Abolition of property tax exemptions for natural monopolies.* We have estimated that, as a result of abolishing the exemptions from tax on property of organizations granted to some natural monopolies (public railways, trunk pipelines, electricity transmission networks, etc.), the additional budget revenue may amount to 0.3—0.4% of GDP. As this is a regional tax, the inflow of revenues into the regional budgets will be increased.

*Tax administration.* The issue of tax administration deserves special attention if we wish to make the Russian tax system more just and efficient. Highest priority in this sphere belongs to the measures designed to complete the switchover to selective control of taxpayers on the basis of the results of risk analysis.

As the approach that involves the conduct of tax audits only by the results of risk analysis, their number will be less than in the case of total control. So, many current issues of tax administration will be resolved – such as failures to conduct tax audits on a timely basis, an excessive amount of documents to be submitted, disputable estimates, etc. Selective tax control based on the results of risk analysis will make it possible to balance the powers of tax agencies against the responsibility of their staff for their actions (or failures to act), as well as to lower the risk that tax administration may be misapplied as an instrument of competition or political pressure. At present, when on-site tax audits are planned, the general tax risk criteria are analytically applied, on the basis of which appropriate taxpayers are then selected as targets for audits<sup>18</sup>. At the same time, so as to take full advantage of that approach, it will be advisable to formulate more clearly the risk criteria applied in the selection of taxpayers to be audited, to further promote the informatization of the tax administration procedure, and to develop methods of remote contacts with taxpayers.

The switchover to selective control based on risks analysis is an even greater priority in the sphere of customs administration – where, however, that process has not yet been started.

An important step towards better tax administration will be to increase the mandatory minimum charter capital size for banks (to Rb 3—5bn, in a gradual procedure until 2020) as a measure against fly-by-night firms. Existing legislation envisages the instruments necessary for revealing the participation of fly-by-night firms in tax avoidance schemes<sup>19</sup> and punishing the beneficiaries. Nevertheless, the actual implementation of such measures is rarely successful, and is associated with high costs. According to the RF Federal Tax Service, the number of taxpayer legal entities who have failed to submit their tax reports for periods over one year constitutes approximately one quarter of all registered legal entities.

At the same time, the use of fly-by-night firms in tax evasion schemes would be impossible without the participation of banks. In this connection, the increase of the mandatory minimum charter capital size for banks will help provide a solution to that problem through liquidating (or transforming into non-banking financial institutions) those small banks that participate in tax evasion schemes, as well as through expanding opportunities for the RF Central Bank to toughen its supervision over the remaining banks.

An important condition for improving the quality of tax administration will be to draw a distinction between lawful methods of tax payment reduction and

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<sup>18</sup> Order of the RF Federal Tax Service of 30 May 2007, No MM-03-06/333@.

<sup>19</sup> See, for example, Decree of the Supreme Arbitration Court's Plenum of 25 May 2010, No 15658/09.

unlawful tax evasion, and to consolidate in tax legislation a ‘business goal’ doctrine.

We mean here the definition of those situations when a taxpayer reduces its tax liabilities by resorting to acts that are not prohibited by the laws, and formally complies with all legal requirements. The practices of foreign countries demonstrate that, as a rule, certain sanctions can be applied to a given taxpayer for operations conducted for the sole purpose of achieving a tax benefit – in other words, for no business purpose whatsoever. The consolidation of a ‘business purpose’ doctrine in tax legislation will make it possible to increase the level of predictability of the consequences of actions undertaken by the participants in legal tax relations, as well as conduce to better implementation of the principle of taxation universality and equality<sup>20</sup>.

In order to reduce the number of violations based on the use of low-tax jurisdictions, it will be necessary to improve the rules against the practice of insufficient capitalization, to establish regulation of beneficiary ownership and controlled foreign companies, to determine more distinctly corporate tax residence, and to develop international tax information exchange systems.

The measures planned in all these fields are designed primarily to ensure transparency of taxpayer activity and to protect, in the course of international transactions, the fiscal interests of the countries of tax residency. These fields are specifically dealt with in regard of taxes on income and capital in the framework of the OECD Model Tax Convention.

An important goal in terms of tax administration will be to improve the existing institutions for explaining tax legislation, the procedures for pre-judicial settlement of tax disputes, and the system of sanctions to be imposed for violating the norms of tax legislation.

In order to limit the freedom of law interpretation by the officials executing tax audits, it is necessary to ensure uniform interpretation of disputable tax legislation issues in the explanatory documents issued by the RF Ministry of Finance, and to make this interpretation mandatory for tax agencies.

It is also necessary to make more precise the list of tax and administrative law violations in the sphere of tax collection, so as to avoid collisions and duplications – including in regard of the size of imposed fines<sup>21</sup>, to abandon the practice of estimating a taxpayer’s intention to avoid taxes when bringing taxpayers to responsibility in connection with the payment of taxes, and to ensure the inevitability of criminal punishment for tax evasion (thus abolishing the possibility of ‘active repentance’ on the part of the tax evader). At the same time, punishments for tax evasion and for concealing property with intent to evade a tax, as well as punishments for avoiding customs duties, should be limited to fines. The size of these fines must depend on the size of taxes in arrears, as well as on whether such acts are repeated or not. In other words, the punishment in the form of deprivation of freedom for tax crimes should be abolished. *Fiscal Federalism Development*

As far as tax policy is concerned, fiscal federalism development will require the implementation of some measures designed to increase the sources of tax-generated revenues in the regions. At the same time, the number of measures that can actually be implemented for this purpose, while at the same time being

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<sup>20</sup> See *Main Directions of the Tax Policy of the Russian Federation for 2012 and the Planning Period 2013 - 2014*.

<sup>21</sup> See Zolotareva A., Kireeva A., Kornienko N. *Nalogovoe administrirovanie. Osnovnye itogi reform*. [Tax administration. Major Reform Outcome]. Moscow, IEP, 2008. V. 3.

compatible with the normal functioning of the tax system in accordance with its basic goals, is rather limited. Among the measures discussed earlier we can point out the reform of personal property tax; increasing the rates of excises on alcohol products; and the abolition of exemptions from tax on property of organizations for natural monopolies.

All these measures in general cannot provide an ultimate solution to the problem of insufficiency of their own sources of tax-generated revenues in regions and municipalities. At the same time, as mentioned earlier, it is difficult to deal with this issue by means of consolidating to regions and municipalities some additional tax sources, because tax base and tax-generated revenues are spread very unevenly across regions. In this connection, it is evident that the desirable results cannot be achieved by implementing the suggested numerous measures aiming at the tax system's decentralization, such as the introduction of sales tax alongside value added tax, the transfer of the federal part of the tax on profit of organizations to the regions, and an increase of the rate of personal income tax by 2—4 pp. These measures will improve the revenue inflow in those territories which are already sufficiently well-provided with cash resources. Thus, such measures can be worthwhile only in conjunction with the mechanism of negative transfer between regions and the federal budget. One of the possible variants of a negative interbudgetary transfer can be the implementation of the same parameters as stipulated in the RF Budget Code with regard to 'extremely wealthy' municipal formations, namely the capture of a certain part (50%) of the estimated tax revenue that more than twice exceeds the national average.

Thus, if the regions actually get the federal part of the tax on profit of organizations (2 pp. of the tax rate), the consolidated regional budget revenue will increase by 6%, and the number of unsubsidized regions can increase by 20% (now there are 14 such regions). At the same time, 40% of the revenue increment will be received by the city of Moscow and Tiumen Oblast with its districts, thus making it impossible to conclude that the goal of tax revenue decentralization has been successfully achieved.

Meanwhile, by giving up the federal part of the tax on profit organizations, the government significantly increases the risks associated with lower transparency in the granting of tax preferences with regard to that tax. At present, the budgetary effect of newly introduced tax exemptions and preferences is indeed estimated by the RF Ministry of Finance in its explanatory notes for the draft of federal laws on the federal budget, but only concerning those taxes that are transferred in full or in part into the federal budget. Thus, if the federal part of tax on profit is given up, it is unlikely that the budgetary effect of any tax exemptions and preferences newly introduced by the regions will be actually estimated. So, some additional preconditions may arise for the formation of a number of domestic offshore zones in this country, which will then require more costly tax administration.

The introduction of sales tax in addition to VAT (the endowment of Russia's regions with the right to introduce sales tax) is by no means an ideal solution, either. Firstly, if sales tax is applied alongside VAT, then two taxes will be levied on the same tax base; related expenditures will increase due to the necessity to administer two taxes instead of just one tax, as well as the expenditures associated with the execution of tax legislation by businesses.

Secondly, although there exists a widespread opinion that it is very easy to collect sales tax, in actual practice there arise some serious problems with tax administration because it becomes necessary to control the payment of this tax



by a large number of taxpayers, including small-sized business entities<sup>22</sup>, as well as to introduce special rules for making distinctions, for the purpose of tax collection, between end-user sales and the sales of products purchased for use as ingredients or parts in further manufacturing.

As shown by foreign experience, the complexity of the process of elaborating and administering such rules can give rise to a situation when, following the logic of tax system development, sales tax in time acquires the features that are typical of VAT. In other words, there will arise some or other forms of tax refund granted to those entities which, in accordance with the tax's specificity, should not pay it (for example, individual entrepreneurs in regard of commodities used by them in the course of their entrepreneurial activity).

Regional sales tax has once already been levied in Russia alongside value added tax. The practice of sales tax collection in the early 2000s revealed that it was not cost-effective because tax collection, at the basic rate of 5%, yielded no more than 0.5% of GDP – that is, effective tax base (the share of GDP on which the tax was levied) amounted to only 10%<sup>23</sup>, while tax-generated revenues were concentrated in a limited number of regions (Moscow, Moscow Oblast, and St Petersburg)<sup>24</sup>. From this a conclusion can be drawn that the introduction of sales tax cannot automatically provide the regions with their own sources for generating tax revenues.

Another solution consists in distributing part of the revenues generated by value added tax (for example, 4 pp. within the effective rate of that tax) between Russia's regions on per capita basis. A similar approach is applied in Germany, where part of VAT-generated revenues is transferred to regional and local budgets, and 75% of the transferred amount is distributed among them in proportion to the number of population in each region<sup>25</sup>. According to our estimates, the amount of additional revenues received by regional budgets as a result of the implementation of that measures may be as high as 1—1.5% of GDP.

## Conclusion

The analysis of challenges currently faced by the Russian tax system in connection with the goals of its reforming and the related tax policy measures in the medium term has led the authors to the following main conclusions. Firstly, any increase of taxes should be avoided; this can be achieved through restructuring and improving the cost-effectiveness of budget expenditures. To increase taxes would be extremely undesirable; such a measure can undermine the position of the Russian economy in terms of international tax competition, and can also have a harmful effect on both the investment climate in Russia and her economic growth.

Secondly, it is necessary to improve the efficiency and justness of taxation by means of implementing a number of measures in the field of budgetary and

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<sup>22</sup> It should be noted that, in 2010, small businesses accounted for more than half of Russia's total retail turnover, while only 15.8% of retail turnover was effectuated through trade networks.

<sup>23</sup> In 2002, retail sales amounted to 34.8% of GDP.

<sup>24</sup> Thus, according to Russia's tax statistics (Form 1-NM) for 2002, out of the total sum of sales tax (Rb 50bn), approximately 36% went to the budget of the city of Moscow, more than 10% - to the budget of Moscow Oblast, and 8% - to the budget of the city of St Petersburg. The top margin of the per capita revenues generated by sales tax exceeds its bottom margin by more than 80 times.

<sup>25</sup> Another 25% of the transferred sum is distributed in the form of an additional subsidy to financially weak regions. On the whole, regional and local budgets receive a little less than half of all the revenues generated by value added tax. See *Werner J., Shah A. Fiscal Equalisation in Germany* / World Bank. 2005. November.

fiscal policies and tax administration. Such measures will improve the quality of the Russian tax system, thus resulting in a positive influence on overall economic activity in Russia.

Thirdly, due to some objective constraints caused by the very uneven distribution of tax base and tax revenues across Russia's regions, it is very difficult to develop fiscal federalism in this country. At the same time, some alterations can be introduced in the tax system aiming at increasing the sources of tax revenues in Russia's regions and municipalities, in particular reform in the field of immovable property taxation, the introduction of higher rates of excise duties on alcohol products, and the abolition of the exemptions from tax on property of organizations granted to natural monopolies.