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Jorge Martinez-Vazquez
Sally Wallace



Georgia State
University

Andrew Young
School of Policy Studies



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International Studies Program
Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
United States of America

Phone: (404) 651-1144
Fax: (404) 651-3996
Email: ispaysps@gsu.edu
Internet: <http://isp-aysps.gsu.edu>

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THE VAT AND THE RETAIL SALES TAX IN THE RUSSIAN FEDERATION*

Jorge Martinez and Sally Wallace

I. The Issue

In 1998, a sales tax was reintroduced in the Russian Federation. Previously, regional governments had the authority to levy a sales tax of up to 5 percent. The right was technically rescinded in 1996, but some regions continued to impose a sales tax into at least 1997. The introduction of a sales tax was a government compromise aimed at appeasing regional governments when the federal government reduced the sharing of the VAT. The federal government also planned to further reduce the tax rate of the VAT while increasing the sales tax rate for goods subject to excises up to 10 percent. This latter proposal was ultimately rejected within the government. However, currently there is a trend to eliminate sales tax, thus, under the effective legislation the latter shall cease in 2004 unless changes are made once again to the legislation.

The Russian Government is again in the midst of an important tax policy decision. It involves the structure and composition of indirect taxation, and more in particular, the choice of the general consumption tax between the VAT and a retail sales tax (RST).

* This report is an update and expansion of "The Choice Between the VAT and the Retail Sales Tax in the Russian Federation," Georgia State University, Andrew Young School of Policy Studies, Atlanta, GA, U.S. Government Technical Assistance Team (1998).

The current VAT is levied at a general rate of 20 percent, and supports the federal government's budget. The tax base of the VAT is relatively broad, but there are some exemptions that, as explained below, could cause difficulties in terms of administration. The current sales tax has recently been rationalized in the revisions of Chapter 27 of the Tax Code, effective January 2002. The previous law that governed the regional sales was somewhat ambiguous regarding the definition of the tax base, and many regional governments had seized the opportunity to define tax bases that suited local needs. Constitutional challenges brought by business people in 2001 resulted in a tax law that was more specific in terms of tax base, methods of transaction, and the implications of nexus.¹

At issue is whether the VAT or the RST is a "better" tax for regional governments. Russia's case of a national VAT and subnational RST is relatively unique. The systems in Canada (and Brazil?) are the most closely aligned system of dual (but different) consumption taxes at various levels of income. An analysis of the relative merits and problems of a VAT or RST must include the economic impacts, the distributional impacts, the tax administration, and the intergovernmental issues.

Both a VAT and a RST have significant merits, and in fact, if they are imposed in their purest forms, these taxes are equivalent. The actual tax base and the administration of the taxes tend to create differences between the taxes. Based on these practical components of each tax, one might be preferred over the other. We do not believe that there is a clear-cut winner in terms of the VAT or RST at the subnational level.

The purpose of this report is three-fold: first, to provide a background analysis of the relative merits of the VAT vis-a-vis the RST from both the perspectives of best principles and international practice; second, to examine in the current Russian context the pros and cons of relying on the VAT or the RST as the main consumption tax from the perspectives of tax policy, tax administration and intergovernmental fiscal relations; and third, to provide several policy recommendations on this issue.

II. A Comparative Perspective of the Value-Added Tax, Retail Sales Taxes and Turnover Taxes

The Value-Added Tax (VAT) and the Retail Sales Tax (RST) are both taxes on consumption.² The VAT is far and away the most popular of the two taxes, with 123 countries imposing a VAT in 2001 (Ebrill, et. Al., 2001). The RST is used widely in only a few countries including the U.S., India, and Canada.

The VAT and RST are theoretically equivalent taxes. In practice, the taxes have different impacts on production decisions and prices, therefore, on revenues. If a VAT works well (in

¹ The new law prevents a region from imposing a sales tax on purchases made in a non-sales tax region. In the U.S., the use tax is an attempt to impose tax in the jurisdiction in which the good is put into use if the good is purchased out of state.

² The turnover tax is a simpler form of taxation in which all transactions are taxed. The turnover tax quickly results in "cascading" or increases in prices at each stage of production and consumption.

terms of its invoice-credit mechanism), the VAT is less easily evaded than the RST. The impact of this “self-policing” of the VAT is diminished when the invoice-credit system is not imposed at the retail. The RST, properly administered, also leaves a trail of suspension certificates, but from a tax enforcement viewpoint the trail left by the invoice-credit system under the VAT is more effective.

The VAT is also easier to remove on producer goods, since this mechanism is built into the system. In the case of the RST, producers would have to be specifically exempted from the system in order to avoid the potential for tax cascading. Under the RST, it is necessary for the supplier to determine whether a good is being used for private consumption or as an input in a production process. This discretion can result in taxation of inputs under the RST or it can open the way for negotiation and potential corruption of the tax administration.

The differences between the VAT and the RST are largely the result of the administration of the taxes. Both systems have an element of self-policing. Under the RST, the vendor polices the system by accepting a suspension certificate, which is an approval of the tax administration to exempt the purchaser from sales tax. Under a VAT system, the tax authorities police the system. But to take advantage of the anti-evasion benefits of the VAT, the tax administration must be able to process VAT returns and ensure that businesses do not receive credits for tax not paid, and for tax paid on purchases for household use. Businesses would have to remit taxes to the authorities for both systems, but the number of such remittances would be greater in the case of the VAT due to its nature of collection at each stage of the production process.

Russia’s economy still retains a relatively high degree of barter and non-monetary transactions, which may affect the administration and evasion of the VAT versus the RST. One of the original cases made for a RST in Russia is that retail (final consumption) transactions are less likely to be in the form of barter or other non-monetary forms of payment than producer or wholesale transactions. This suggests that the RST may be better able to bring in cash revenues versus in-kind revenues to the budgets of the regional governments. Assuming this is the case, does an RST have an advantage over the VAT? Under an extreme scenario of a system in which all transactions except final sales are barter and no VAT is paid on any intermediate transaction, both the VAT and the RST would collect the same (cash) revenues. Clearly, for equivalent tax structures, the RST cannot collect more revenues than the VAT. However, if non-monetary forms of tax payments are allowed (and again assuming that these are more frequent at intermediate stages of production), then the RST can raise a higher proportion of tax revenues in cash (as opposed to non-monetary forms).³

III. Nature of the Value Added Tax, Retail Sales Tax, and Turnover Tax

The value added tax (VAT) and the retail sales tax (RST) are, at least in theory, alternative ways of taxing sales to consumers. By comparison, a turnover tax applies to all (non-exempt)

³ Note that in the case of barter transactions where VAT is paid, then it could also be fully credited. Thus no distortions should be introduced into the prices of intermediate goods. Under current Russian Federation legislation, barter deals are regarded as supplies for VAT purposes with valuation of the transaction based on average selling prices/open market value, and, in theory, credit may be taken on barter transactions.

sales, including those to business. A tax on consumption must be applied only to sales to households; it cannot be applied to sales to business, including sales of capital goods. The reason for this objective is explained below. The VAT and RST use different mechanisms to achieve this objective.

- **Retail sales tax.** An ideal RST achieves the objective of exempting sales to business directly; it is applied only to sales to households and exempts all sales to businesses. In practice all extant RSTs are imposed on many sales to business, which increases the price of inputs in the production process. Note that this is a matter of administration and structure, not of the economics of the tax.
- **Value added tax.** The VAT achieves taxation of consumption in a different manner. VAT is collected on virtually all sales. Taxation of business purchases is eliminated by allowing registered traders to deduct (take “input credit” for) taxes paid on purchases from tax due on sales. Thus the only tax that is not eliminated by input credits is that paid by consumers.
- **Turnover tax.** The turnover tax, by its very nature, is imposed on many sales to business and thus violates the basic objective of taxing only sales to households. It is, by design, a cascading tax that can generate large revenues.

The Mechanics of Taxation under the Three Systems

To clarify the mechanics of the three systems, assume that production involves three stages, A, B, and C (which might be manufacturing, wholesaling, and retailing), as shown in Table 1.⁴ The top panel provides a benchmark; it is used initially to illustrate the results of the three taxes and then to compare the results under other assumptions about the production-distribution process. Table 1 also shows a situation of complete vertical integration, in which all production and distribution occur in one stage (second panel), and the third panel shows a situation in which value is added earlier in the production-distribution process.⁵ In all three cases total sales to consumers are the same, R.1,000.

- **RST.** Under a 10 percent retail sales tax, R.100 would be obtained on the R.1,000 of sales to consumers at the retail stage. This is true, regardless of the nature of the production-distribution process, as long as all sales to consumers, and only those sales, are subject to tax. To see this, compare the RST columns in each case of Table 1.
- **VAT.** Under the 10 percent VAT, each firm would pay tax of 10 percent on its sales, but would receive credit for tax paid on its purchases; see columns VAT on purchases, VAT

⁴ The table assumes that there is no input tax shown at the manufacturing stage although there is likely to be some deduction on raw materials.

⁵ For simplicity, Table 2 assumes that the sale price will remain 1000 in the case of exemption at the pre-retail stage. It is likely that the sale price (and also the VAT due) will actually increase if the wholesaler wishes to maintain his profit level since his costs of purchase will be higher by the value of the exempted VAT.

on sales and net VAT of Table 1. In the aggregate, the tax paid under the VAT is the same as under the RST. Again, this result is independent of the production-distribution process. Because credit is allowed for VAT paid on purchases, as shown on invoices, this method of implementing a VAT is commonly called the credit-invoice VAT.

- *Turnover tax.* Under the conditions assumed in the top panel (benchmark case) of Table 1, a 5 percent turnover tax would also produce the same revenue as the RST and the VAT; this is shown in the Turnover tax column of Table 1. If, however, the production-distribution process were different, aggregate tax liability could be different. In the case of complete vertical integration, a 5 percent turnover tax would produce revenues of only R.50, instead of R.100; see second panel of Table 1. By comparison, if value were added much earlier in the production-distribution process, as in the bottom panel of Table 1, a 5 percent turnover tax would yield revenues of R.135--more than the revenue raised from a 10 percent tax on sales to consumers.

More on the Administration of VAT and RST

A. The problem of eliminating tax on business purchases.

The RST suffers from a basic administrative problem: how to achieve the objective of exempting sales to business (by suspending taxation of business purchases), without opening the door to evasion by households claiming to make business purchases.⁶ (In addition, there is the political problem that there is often pressure not to exempt all sales to business, thus converting the RST into a turnover tax.) Attempting to exempt all purchases by business places the vendor in the unenviable position of determining whether each sale is taxable or legally exempt and creates an incentive for the vendor to “look the other way” when a household purchase masquerades as a business purchase. This problem can be ameliorated by the issuing of “suspension certificates” by the tax authorities. Such a certificate identifies: (i) the purchaser as a registered business eligible to make exempt purchases, and (ii) the business use of the item which makes it exempt. In this case vendors do not have to make the decisions themselves regarding what purchases ought to be exempt. However, auditors still must trace exempt sales to the purchaser to determine whether they are for legitimate business expenses.

By comparison, under the VAT, since all sales are taxable, the vendor does not need to make the distinction between taxable and exempt sales, but must account for tax paid on purchases, in order to claim input credits. Although it operates indirectly to remove tax on business inputs, for both administrative and political reasons, the VAT achieves the objective of avoiding taxation of sales to business much more thoroughly than does the RST.

The turnover tax does not have the benefit of removing taxes on business transactions through the invoice-crediting (as with VAT) or the use of suspension certificates (as with the

⁶Using the terminology of the draft Russian law authorizing oblast sales taxes, the question is how to distinguish legally taxable “sales to the public” from other (legally untaxed) sales.

RST). Taxing each transaction results in cascading, which increases the price at each stage of production.

B. Exemptions and zero-rating.

The concept of exemption is straightforward under either the RST or the turnover tax; the sale of a particular good or service is simply not taxed. The situation is not so clear under the credit-invoice VAT. One must distinguish between exemption and zero-rating and according to the stage of the production-distribution process (retail or pre-retail). If a sale is exempt, there is no tax, and no credit is allowed for tax paid at prior stages of the production-distribution process. By comparison, if a sale is zero-rated, there is no tax, but credit is allowed for tax paid at prior stages.

If a retail sale is exempt, it nonetheless bears VAT from prior stages. Moreover, if a pre-retail sale is exempt, the aggregate tax on the retail sale is greater than in the absence of exemption, not less. By comparison, zero-rating of retail sales eliminates all tax and zero-rating of pre-retail sales has no effect on the aggregate amount of tax on retail sales; in either case the aggregate tax is determined by the tax rate imposed at the retail stage. These results are illustrated in Table 2 and summarized in Table 3.

C. Administration and compliance costs of dual central VAT/subnational RST systems.

Both the RST and the VAT involve considerable administrative and compliance costs, especially for small businesses. Clearly, imposing both systems on business does increase significantly their compliance costs. Because the two systems operate quite differently, implementing both also increases tax administration costs significantly.

How much compliance and administration costs are increased by a dual VAT/RST system depends crucially on how different the bases of the two taxes are. These costs are substantially higher if the exemptions provided by the RST and the VAT are not substantially identical. In this case, vendors would need to distinguish between four possible combinations of tax treatments: taxable under both taxes, exempt under both, and taxable under one, but not the other. To minimize this type of complexity, the bases of the two bases should be coordinated, so that a given sale to households is either taxed or exempt under both taxes.

Economic Effects of VAT, RST, and Turnover Tax

VAT. Because the VAT is, in effect, levied only on sales to consumers, it is essentially neutral with regard to most economic decisions.⁷ That is, it does not affect the cost of capital

⁷ This is the case for a consumption type VAT, where all VAT paid on intermediate inputs, including capital goods, is creditable.

and thus does not distort the choice between saving and consuming, the capital-labor ratio, or other production decisions. It does, of course, raise the price of consumer goods. This is an important point to understand because of the widespread perception in Russia that the VAT is paid by businesses and that this type of tax distorts business decisions.

RST. A pure RST (one that is applied only to consumer goods) would have the same effects as a VAT. In fact, in the real world RSTs are far less pure than VATs. It has been estimated that about 40 percent of the RSTs levied by the states of the United States and some of the provinces of Canada fall on sales to business, including many capital goods. Thus they distort many choices: the saving/consumption choice, the capital-labor ratio, and production decisions. (See also the discussion of the effects of turnover taxes, which an impure RST resembles). Moreover, unlike the typical VAT, RSTs typically exempt many services provided to consumers, thereby distorting consumer choices.

Turnover taxes. Turnover taxes are notorious for their distortions of economic decisions. The degree of distortion of saving-consumption choices and capital-labor choices depends on whether or not the tax applies to capital goods; these distortions are greater, the more capital goods are taxed. What is clear is that turnover taxes encourage vertical integration, in order to avoid paying tax many times as a product moves through the production-distribution process. The resulting concentration of industry is one thing Russia can ill afford.

Historical Background on the VAT, RST, and Turnover Taxes

The turnover tax is the simplest to administer of the three taxes under discussion; all sales are subject to tax and there are no input credits. It thus has the longest history. As early as the 1950's (and probably well before) it was widely recognized, however, that the turnover tax created severe distortions and inequities; because its aggregate burden depended on the nature of production-distribution process, it encouraged vertical integration and placed unintegrated producers and distributors at a competitive disadvantage.⁸ As a result, in the early 1960s, just after the European Common Market (the forerunner of the European Community) was created, a decision was made that all member countries should adopt the VAT--and abolish turnover taxes where they existed. Since then the VAT has become the "revenue workhorse" of the world, having been adopted by more than 100 countries.

The United States and some of the provinces of Canada constitute a notable exception to the worldwide trend to adopt the VAT. (There is a federal VAT in Canada, and some of the provinces also rely on revenues from the VAT.) There is no federal sales tax in the United States, but 45 of the states and the District of Columbia and several Canadian provinces impose RSTs. Several developing countries also have subnational sales taxes and a national VAT.

⁸Moreover, it was impossible to provide accurate border tax adjustments (BTAs) for turnover taxes. BTAs are a) taxes on imports intended to tax imports like domestic production and b) rebate of taxes previously paid on exports so that exports can enter world trade free of domestic taxation. Since the amount of turnover tax paid on domestic production depends on the structure of the production-distribution process, no single set of BTAs can be satisfactory.

The experience of the United States and Canada can be explained by the historical development of taxation in the two countries. The RSTs levied by subnational governments in these two countries predate the development of the VAT. The first RST in the United States was enacted in the 1930s, whereas the VAT was not developed until the 1950s or 1960s. (France had a crude form of VAT in the early 1950s, but the modern VAT dates from the late 1960s.) The introduction of the RST at the state level during the Great Depression in the United States was motivated as a way to get revenues to the state governments when other taxes had failed to do so. That experience showed that an RTS can reliably yield significant revenues, that these revenues can be collected without sophisticated collection methods, and that revenues accrue in a way that is transparent to taxpayers but relatively painless.

There are a number of reasons the American states and some of the Canadian provinces continue to use the RST. First, there is inertia; change is politically costly. This is especially true since a shift to the VAT would a) result in increased taxation of services, which are now largely exempt from RST, and b) require a rate increase, because of the elimination of the presently hidden tax on business purchases. Second, it has been thought until recently that a national VAT and subnational RST is administratively too complex; this is especially true in a context where the central government does not levy a VAT, as in the United States. (Recent experience in Canada has shown that a dual system is feasible but it requires sophisticated administration.)

Both political and administrative considerations explain the lack of a federal VAT in the United States. At the risk of oversimplifying the issues, conservative (anti-government) politicians oppose introduction of a VAT, because of the fear that it would be a “money machine” that would fuel the growth of government. (Liberals favor the VAT for the same reason.) Moreover, there would be strong opposition from state and local government officials, who see sales taxation as their exclusive fiscal preserve. Finally, as noted above, introduction of a federal VAT in conjunction with continued use of the RST by the states would subject taxpayers to a costly compliance burden and entail duplication of administrative efforts. These considerations also motivated resistance to introduction of a federal VAT in Canada until recently.

Intergovernmental fiscal relations and the choice of VAT or RST

Two general principles for the proper design of a system of intergovernmental fiscal relations have a significant bearing on the choice between the VAT and the RST. The first is the principle of revenue sufficiency or vertical balance between the federal and subnational governments. According to this principle, subnational governments should have revenue sources that are proportionate to their expenditure responsibilities. This revenue sufficiency for subnational governments can be achieved through the exclusive assignment of taxes to subnational governments and also through revenue sharing in federal taxes or transfers from the federal government. Currently, the RST generates 45,119 million rubles for regional budgets (based on figures for 2001).

The second principle of intergovernmental fiscal relations is that of revenue autonomy. This means that subnational governments should have a significant degree of discretion in

raising their own revenues. Without this discretion a decentralized system of intergovernmental finances foregoes the efficiency gains associated with responsibility and accountability to local taxpayers and the ability to match local residents' preferences for the level of subnational public services.

The VAT is about the poorest choice to fulfill either of those two principles, and this seems to have been heeded by the Russian Federation. The introduction of regional VATs to provide regional tax autonomy can easily lead to chaotic situations, as the experience of Brazil has shown in recent years. In pure technical terms, the VAT may also be a poor tax to be shared with subnational governments on a derivation basis. The crediting and debiting of VAT in different regions make the VAT absolutely unsuited for direct revenue sharing on a derivation basis. Russia's federal government has shared VAT revenues with the regions since the beginning of the transition. Besides the arbitrariness of crediting and debiting of VAT across regions, the VAT has not truly been shared on a derivation basis (that is according to where the tax is generated) but rather it has been paid according to the place of registration of business firms.

In the past few years, the potential for a subnational VAT has attracted more positive attention than in the previous decades. New legislation in India has mandated the development of a subnational VAT, although the few specific plans have yet been made to institute a subnational VAT. The advent of the European Union has led to unique opportunities to develop a VAT that crosses international borders, although, the EU is a very different context than that of the federation of Russia.⁹ Canada's system of Harmonized Sales Tax and Quebec's sales tax are two examples of the coexistence of sales and value added taxes. In these cases the federal government plays an important role in assisting or carrying out the tax administration. In the case of Quebec, there is no attempt to tax inter-provincial purchases made by final consumers (Bird and Gendron, 2001). While Canada, Brazil and Argentina offer some examples of the potential to impose regional VATs, in most respects a VAT at the subnational level would entail high administrative requirements and high administrative costs.

Because of these problems, there is a very strong case to be made in favor of the full assignment of VAT revenues to the federal government, as is currently done. This was not an easy political decision, but now that VAT is fully assigned to the federal government, the issue of revenue sufficiency becomes even more important for subnational governments.¹⁰ If full assignment were changed, the second best desirable alternative would be the sharing of the VAT with the regions based on simple formulas.¹¹

A subnational RST, on the other hand, is in theory an adequate instrument to fulfill the two principles of revenue sufficiency and revenue autonomy for subnational governments. An

⁹ Keen and Smith (2000) specifically analyze this in the EU.

¹⁰ Early attempts at full federal assignment with the VAT were not successful. This assignment was tried in 1991-92, in the *Law of Basic Principles of Taxation* yet regions failed to comply with the law and the political system accommodated itself to this refusal.

¹¹ For example, the federal government in Germany shares VAT revenues with the regions on a per capita basis.

RST can be a reliable source of revenue for subnational governments and it does not require a high degree of coordination among those governments. In theory, an RST could also be more easily shared among different levels of government. The problem with this solution lies in the costs of administering and complying with a regional RST when a VAT already exists at the federal level. In addition, there are many other reasonable alternatives besides an RST for providing revenue autonomy to subnational governments. One such alternative used in many countries and often recommended in Russia, is a subnational government personal income tax with some degree of rate discretion that piggybacks on the federal personal income tax. This option appears less attractive than the RST option because in Russia subnational governments have historically been assigned almost the entirety of revenues collected from the personal income tax, although there have been changes to this intergovernmental arrangement in many years.

The introduction of an intergovernmental fiscal relations perspective in the choice between the VAT and the RST reveals the existence of worthwhile but also conflicting objectives and the possible need for a compromise. While the VAT may be superior to the RST from economic efficiency and tax administration viewpoints, the goals of revenue sufficiency and revenue autonomy for subnational governments cannot be fulfilled with the VAT choice under the current tax administration in the Russian Federation.

III. Advantages and Disadvantages of the VAT and the RST in a Russian Context

The comparison of the VAT and the RST in the previous section raises a number of issues that are generally applicable to the Russian context. However, both the peculiarities of Russian tax legislation and of the Russian transition economy require caution in the direct application of conclusions from other countries. For this reason it is useful to summarize the main reasons for and against the use of the VAT vis-a-vis the RST in the Russian Federation. (We omit any further discussion of the turnover taxes here since they have been demonstrated to be an inferior choice and actually the only existing policy proposals are for their elimination.)

Advantages associated with the use of the VAT in Russia:

- The VAT works. It brings in approximately 45 % of federal tax revenues. The VAT has become the workhorse of Russia's tax system.
- Taxpayers and tax inspectors understand the tax principally because it has been in operation for some seven years. This is relevant given the poor record in taxpayer education and tax inspector training.
- Use of a VAT is a precondition for entry in to the European Union. While this may not be seen as an issue for Russia at present it is clear that many of the former Central and Eastern European countries see entry to the EU as the next stage in their economic reforms. Given that the Russian Federation already has a VAT which is moving towards the EU style of operation by adopting many of the 6th Directive principles, it is not appropriate to seek to move away from it as the primary revenue raising form of taxation.

- The tax invoice system of VAT offers an excellent audit trail. From a self-policing perspective, there is a real incentive for the buyer of goods and services to demand an invoice in order to secure deduction of input tax, even though this link is weakened at the present time because the invoice-credit system does not extend to the retail sector.
- Import VAT is relatively easy to collect. Even though there may be evasion further along the supply chain, a VAT imposed at import ensures that the first point of entry into the country sees tax collection. Reducing the VAT rate in exchange for a higher RST rate will sacrifice this stable collection point and reduce revenue yields.
- In theory, revenue is turned over to the government on a regular basis due to the taxation at each stage of production.
- The value added concept of the tax ensures that even though there may be suppression of sales by the retailer much tax collection will have already taken place at earlier points in the chain. This is important in Russia because of the existing high levels of evasion.
- It can also be argued that VAT improves accounting standards. This is particularly seen in the instructions introduced by the Government (Decision No 914 of 29 July 1996) which require VAT payers to maintain detailed purchase and sales books supplemented by tax invoices in order to support VAT declarations.
- The VAT covers goods *and* services. International experience suggests that an RST is not likely to offer the same level of coverage simply due to the conventions of the tax, not because of the economics of the tax.

Disadvantages associated with the current VAT in Russia:

- Clearly there can be further improvements made to bring the Russian VAT system up to international standards. There are still some distortion caused by limitations on input tax credit caused by exemptions and some restrictions on capital purchases.
- The sharing of the VAT with regions on a destination basis is inappropriate because of the uneven crediting and debiting of the tax across regions. It is difficult to envision a regional-level VAT that under the current state of tax administration in Russia.
- Apportionment of VAT revenues is actually according to the place of registration of businesses. The current system penalizes regions with significant export activity and is a non-equalizing.

- The VAT may not be an economic neutral tax in Russia. The crediting of VAT on previous inputs does not work well due to significant barter exchanges between firms, and the high likelihood that no liability is incurred in barter transfers between firms. This can result in distortions and in higher prices for outputs.
- The tax administration does not currently monitor transactions and invoices thereby increasing tax evasion and lowering the revenue collected.
- One of the failings of the present Russian VAT system is that there is no incentive for the retailer to obtain an invoice in respect of his purchase of goods for resale. ALISA—IS THIS STILL TRUE?
- The retailer's margin scheme allows him to base his VAT declaration on the difference between VAT inclusive purchase and sales. There are plans, however, to extend the credit system to the retail sector. ALISA????
- The tax administration is such that enforcement advantages of the VAT (invoice-crediting) are not achieved. In particular, the STS do not appear to have taken advantage of the verification opportunities offered by the invoice based VAT.
- The integrity of the invoice-credit system is at risk due to non-timely payment of credits. Lagging the payment of credits is also an increased cost of production that is not foreseen in a VAT in which credits are immediately returned in the form of refunds.

Advantages of the RST:

- At moderate rates, the RTS can provide valuable revenue autonomy for subnational governments.
- If the RST has the same structure of exemptions than the VAT, the tax administration and taxpayer compliance costs associated with the RST can be greatly reduced.
- If retail transactions are more likely to be carried out in cash than intermediate transactions, the RTS can raise a higher proportions of revenues in cash rather than in barter and other non-monetary means of payment that is the case with the VAT.
- If businesses are properly exempted from the tax, the tax does not impose an undue burden on the production process.
- At relatively low rates (5 percent), there is less reason for the vendor to defraud the government.

- The tax is suited to imposing at the subnational level, at relatively low rates. The efficiency is enhanced when similar tax bases are used among governments.

Disadvantages associated with the RST:

- In practice, the RST is levied on business purchases as well as on final consumption, which affects economic efficiency.
- The retail level is noted as the “weakest link” in tax administration due to the vast number of retail outlets and the ability for retail sales to be made without official documentation (“under the table”).
- If the RST were to become a major revenue producer in Russia, there would have to be significant investment in the tax administration for properly enforcing this new tax. To date, the concentration has been on VAT administration and not on RST administration.
- The RST does not offer the same level of audit security as the VAT, especially after the extension of the invoice-credit system under the VAT to the retail sector.

IV. Policy Recommendations

There are a number of policy options that address the important revenue yield, administration, and intergovernmental issues for the Russian Federation. The discussion above demonstrates that both the VAT and the RST have strengths and weaknesses, particularly in Russia. A high RST rate is not feasible. However, as instituted at the 5 percent rate, the RST can be a useful tax for the regional governments. The policy option that was considered in 1998-99 of allowing an RST rate of 10 percent would put Russia’s RST outside the envelope of the international norms for such a tax and would have yielded a third less of a VAT of the same rate.¹² A 10 percent RST rate would likely lead to significant tax evasion. In addition, a high rate would exacerbate many of the shortcomings identified for the RST.

The policy option envisioned in the Government’s draft Tax Code and the stabilization package of the summer of 1998, proposing a sales tax for regional governments of up to 5% levied on retail (final) transactions coexisting with the federal VAT, was a reasonable and acceptable compromise between the conflicting goals confronting the Russian Government. Even though the existence of a regional sales tax side by side with the federal VAT could increase administration complexity and compliance costs to taxpayers, these additional costs are acceptable to pursue the goal of providing regional governments with revenue autonomy. The

¹² See Table 4. Under conservative estimates of the compliance for the RST, a 10 RST/10 reduced VAT proposal would yield 67 percent of 1997 law VAT revenues. This revenue loss is due both to compliance with a new national RST as well as due to a loss in tax on some sectors, which would not be taxed under the RST.

use of both sales and VAT has precedence in some countries (notably Canada). The additional costs in tax administration and taxpayer compliance can be significantly reduced if the exemptions of both the federal VAT and the regional RST are made exactly the same.

The 1998 sales tax law was not without its problems and some of them have been alleviated in the new sales tax legislation that is Chapter 27 of the Tax Code. However, there are still some problematic issues and these include: (ALISA IS CHECKING)

- There are a number of exemptions, which open the way for tax evasion, tax base erosion and equity problems in the system. Among these are certain types of services, children's clothing, and periodicals.
- The Code does not require that the retail sales tax be added to the price of taxable purchases at the point of purchase. Requiring this and also requiring that invoices or receipts provide the amount of the purchase before application of tax, the amount of the tax, and the amount of the purchase with tax included will increase the transparency of the tax.
- The Tax Code should place the responsibility for collection on the vendor and not on the purchaser. The vendor is part of the tax compliance system and making the vendor responsible will ease the administration of the system.
- The Tax Code should define retailer liability to be the product of the value of all taxable product sold during the reporting period (including the value added tax and excises for goods sold subject to the excise tax), not including the tax itself, multiplied by the retail sales tax rate applicable for those sales. This is not made clear in the current Code.

This policy formula does not offer a solution to the problems of assigning VAT revenues fully to the federal government and the other side of the coin, providing subnational governments with sufficient substitute revenues (for the sharing of the VAT) and more revenue autonomy. The Government could explore the reduction of the VAT rate at the federal level from its present level of 20 percent. The rate of the regional RTS could be set at 6 percent but any higher rates would likely promote tax evasion and complicate its administration with the federal VAT. Another option is to return to sharing the federal VAT with the regions but not on a derivation basis. A simple apportionment formula, such as per capita basis or an estimate of regional private expenditures, should be used instead.

As noted earlier, the VAT is generally a more efficient (economically neutral) tax than the RST because of tax practices, not because of the basic structure of the two taxes. Both are far more neutral than a turnover tax. Reducing reliance on the VAT and increasing reliance on the RST would, on balance, increase the distortionary impact of the Russian tax system; by comparison, replacing turnover taxes with VAT would reduce distortions. If RST replaced revenues from the VAT, there would be somewhat more pressure for vertical integration, in order to avoid tax on sales to business, unless businesses were successfully exempted from the RST. Such pressure would be reduced if the VAT replaced the turnover tax. Revenues could, of

course, be comparable under any of the taxes; that is a matter of adjusting tax rates to be revenue neutral. However, while a relatively low RST rate could be competently administered, a rates higher than 5-6 percent are likely to result in significant tax evasion.

As noted above, imposing both an RST and a VAT does impose additional costs because it subjects taxpayers to the requirement of complying with two different systems and requires duplication of administrative effort. However, a dual system can exist, in particular where the VAT is a federal government tax, the RST is a subnational (regional) government tax levied at a relatively low rate, and exemptions under the VAT and RST are essentially the same.

Table 1: Comparison of VAT, RST, and Turnover Taxes

Panel I. Benchmark Case

Stage of Production	Purchases	Sales	VAT on sales	VAT on Purchases	Net VAT	RST	Turnover Tax
1a. Manufacture	-----	300	30	0	30	----	15
2a. Wholesale	300	700	70	30	40	----	35
3a. Retail	700	1,000			$(1000-700)*.1=30$	100	50
4a. Total Tax Liability					100	100	100

Panel II. Vertically Integrated Production

Stage of Production	Purchases	Sales	VAT on sales	VAT on Purchases	Net VAT	RST	Turnover Tax
1b. Manufacture	-----	----	---	----	---	----	---
2b. Wholesale	----	----	---	----	---	----	---
3b. Retail	----	1,000	---	----	$(1000-0)*.1=100$	100	50
4b. Total Tax Liability					100	100	50

Panel III. Value Added in Early Stages

Stage of Production	Purchases	Sales	VAT on sales	VAT on Purchases	Net VAT	RST	Turnover Tax
1c. Manufacture	---	800	80	0	80	—	40
2c. Wholesale	800	900	90	80	10	--	45
3c. Retail	900	1,000			$(1000-900)*.1=10$	100	50
4c. Total Tax Liability					100	100	135

	Stage of Production			Total
	A	B	C	
Exemption of retail stage				
Tax on sales	30	70	0	100
Input credit	----	30	0	30
Net tax liability	30	40	0	70
Zero-rating of retail stage				
Tax on sales	30	70	0	100
Input credit	----	30	70	100
Net tax liability	30	40	-70	0
Exemption of pre-retail stage				
Tax on sales	30	0	100	130
Input credit	----	0	0	0
Net tax liability	30	0	100	130
Zero-rating of pre-retail stage				
Tax on sales	30	0	100	130
Input credit	----	30	0	30
Net tax liability	30	-30	100	100

Table 3: Comparison of Exemption and Zero-Rating, for Retail and Pre-retail Sales		
	Pre-retail sales	Retail sales
Exemption	Increases aggregate tax	Eliminates tax only on value added at retail stage
Zero-rating	No effect on aggregate tax burden	Eliminates all tax

Table 4: Revenue Estimates (Static), (1997 levels, Billions of roubles)

#1: Proposed Law: 10% VAT, 10% Sales Tax:

Compliance Assumption: VAT compliance at 40%, Sales tax compliance at 18% (equivalent to the current estimate of compliance of alcohol excise tax)

Tax	Current Law Revenue	Proposed Revenue	Law	Percent Change
VAT	170.9	96.75		- 43%
Sales Tax	--	17.5		--
VAT + Sales Tax	170.9	114.25		- 33%

#2: Proposed Law: 10% VAT, 10% Sales Tax:

Compliance Assumption: VAT compliance at 40%, Sales tax compliance at 40%

Tax	Current Law Revenue	Proposed Revenue	Law	Percent Change
VAT	170.9	95.89		- 44%
Sales Tax	--	40.01		--
VAT + Sales Tax	170.9	135.9		- 20%

#3: Proposed Law: 15% VAT, 10% Sales Tax:

Compliance Assumption: VAT compliance at 40%, Sales tax compliance at 18% (equivalent to the current estimate of compliance of alcohol excise tax)

Tax	Current Law Revenue	Proposed Revenue	Law	Percent Change
VAT	170.9	144.47		- 15.5%
Sales Tax	--	17.65		--
VAT + Sales Tax	170.9			- 5%

#4: Proposed Law: 15% VAT, 10% Sales Tax:

Compliance Assumption: VAT compliance at 40%, Sales tax compliance at 40%

Tax	Current Law Revenue	Proposed Revenue	Law	Percent Change
VAT	170.9	143.15		- 16.2 %
Sales Tax	--	41.0		--
VAT + Sales Tax	170.9	184.1		0.077

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