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Tax

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On December 6, 1991, Russia adopted a value added tax (VAT). The new tax system, which was meant to replace preexisting turnover and sales taxes, became effective as of January 1, 1992. Thus, the fiscal year of 1992 was the first year in Russian history when the VAT was collected. In this chapter, we present the history of legislation, revenue performance, and administration of the Russian VAT during the fiscal years of 1992-2004. Today, the VAT is one of Russia's major taxes, as it brings about one-third of total tax revenue, only second to revenue generated by the enterprise-profit tax. The history of its collection reveals problems whose importance goes beyond the VAT itself.

The direct predecessor of the VAT was the turnover tax,[2] one of the main sources of tax revenues in the Soviet system. Knowledge of this tax system is necessary to understanding some peculiar features of Russian VAT: as we shall see, the effect of the Soviet-style approach to taxation was substantial on the early stage of development. In the Soviet Union, the turnover tax was raised at retail level, but only on the goods whose retail price was higher than the wholesale price. Such goods included durable goods, luxury products, alcohol, and tobacco. For goods such as foodstuffs and a wide array of consumer goods, which were sold for prices below their wholesale prices, the turnover "tax" became a subsidy. The tax could be raised either as a percentage of projected turnover or per physical unit sold. Effectively, there existed hundreds of tax rates, as every enterprise negotiated with its ministry a rate that would achieve an acceptable level

of profitability. Thus, the turnover tax was not a "tax" in the usual meaning of the word; rather, it was more of an accounting device used to level the profitability of enterprises across industries.

In 1991, many retail prices were set free. The proceeds from the turnover tax began to fall drastically – from 12.6 percent of GDP in 1985 to 6.3 percent of GDP. Indeed, as the amount of tax per unit of a good was fixed, while prices went up, the share of the tax in the final price began to fall. Consequently, revenues from the turnover tax increased more slowly than the turnover itself. For example, in 1991, the nominal value of turnover went up by 70 percent, while proceeds from the turnover tax increased by only 15 percent. At the same time, amounts of subsidies started to increase to the degree that wholesale prices were still kept below the market level. The successful implementation of turnover tax – in the form it was practiced in Soviet Union – required strict administrative controls over wholesale and retail prices, which were no longer possible.

Facing a revenue crisis that arose at the end of the 1980s, the Soviet government was forced to reform the old tax system to make it more compatible with a market system. After some discussion, a decision was made to rely on a VAT. The method for collecting VAT was similar to that implemented to collect the turnover tax, which made the transition easier. As the decision had to be made quickly, all tax legislation was enacted within two months, which did not leave much time for analysis and preparation.

In this paper, our aim is to give a broad overview of legislative and administrative developments of Russian VAT from 1992 to 2006, the fourteen years it took to create a modern, functioning VAT system. Although there have been some further improvements

after 2006, we do not present them in such detail. Rather, the reader may consult the table in the end of this chapter, which summarizes Russian VAT as of year 2009. The material is organized in the following way.

In the first section, we briefly report changes in legislation on VAT, in chronological order, for every year from 1991-2005. This section can be useful as a reference point, especially with respect to the major VAT reforms undertaken in 2000-2002. It can also be used as an illustration of how difficult and lengthy the political process of tax reform can be, as it can take years to implement seemingly obvious and necessary changes.

In the next section, we discuss several aspects of the Russian VAT, as it existed before the beginning of 2006. First, we describe developments in methods of accounting for VAT credits and liabilities, for various categories of economic agents and different types of transactions. We then discuss these methods as applied to Russian economic reality. Second, we discuss the varying treatment of trade with CIS[3] and non-CIS countries, possible reasons for why such treatment was adopted and in whose interest it served. Of special interest is the subsection on VAT exemptions and preferences, which for many years constituted a large problem in the operation of this tax. We present the evolution of exemptions, as they appeared in response to economic difficulties and disappeared in response to backlashes in tax revenues. There is necessarily an overlap between the first two sections, but the goals are different: while the aim of the first section is to give the reader an idea of the timing of reforms, the second section provides a unified view of reforms through an examination of key aspects of VAT.

Finally, the last section provides a discussion of problems with administration of VAT. First we provide a general overview of the situation with tax enforcement, which is the most problematic part of tax administration in Russia. We then elaborate on sensitive topics of VAT administration such as the management of tax returns (such as rebates on exports and treatment of negative liability), and the fight against evasion practices involving "fly-by-night" firms, manipulations with invoices, and accounting records.

A Brief History of Legislation on VAT

In Russia, the VAT has a relatively short history, since 1992. This makes it feasible to track its development on a yearly basis, through an examination of legislation, administration, and revenue performance. It is possible to distinguish three sub periods: first, the period of introduction of VAT into the taxation system, covering 1992-1995, characterized by frequent adjustments to law and practice; second, the period of "stagnation" from 1996-1999, a period of failed attempts to reform VAT, most likely due to political constraints, as there was no lack of understanding of the necessity of such reforms, both by the national government and by western experts; third, the period of active reforms, starting by adoption of the Tax Code (Part I in 1999 and Part II in 2000), when the Russian VAT was moving quickly towards modern standards, practically reaching them from the beginning of 2006.

Early Days: 1992-1995

1992

The initial law, enacted on December 6, 1991, introduced the VAT at a rate of 28 percent, which was relatively high by the standards of Western European countries, where rates varied from 6 to 10 percent in 1992. Taxable persons included all economically active agents whose yearly income from economic activity (production, services, etc.) exceeded 100,000 (later, 500,000) rubles. Cash method of accounting both for tax liabilities and tax credits has been established, with an exception made for some types of enterprises who could choose between cash and accrual method for their liabilities.

On February 3, 1992,[4] a lower rate of 15 percent was introduced for foodstuffs. This rate became effective as of September 1992.

On May 22, 1992,[5] enterprises were allowed to claim tax credits only on inputs for which they had actually paid. New exemptions were introduced, such as construction of housing, enterprises with more than 50 percent of disabled employees, and part of output of agricultural enterprises realized to pay wages. The timing of tax payments was dependent on the monthly revenues of an enterprise: payments were required every four months for those below 100,000 rubles[6] monthly for those above this figure. Also, enterprises with revenues above 300,000 rubles had to make advance tax payments every two months, roughly equaling 1/3 of the previous month's tax payments.

Tax rates were changed soon again, on July 16, 1992,[7] when the base rate was reduced to 20 percent, and the lower rate to 10 percent, effective January 1, 1993. In 1992-1995, the Russian economy experienced three-digit rates of inflation that disrupted the economy. Fighting inflation became the primary goal of economic policy. To this end, the government lowered the tax rate from 28 percent to 20 percent, effective January 1, 1993, hoping that this would have an anti-inflationary effect. This was not the case, however, due to the downward rigidity of prices and high inflationary expectations.

Under the same law of July 16, 1992,[8] credits were allowed for VAT paid on capital goods and intangibles, in equal portions over two years, but only if they were put into production in the reporting period. Also, in response to high inflation, the government increased the size of advance payments required of enterprises with monthly revenues exceeding 300,000 rubles was increased: the size of advance payments was determined by the amount of the previous month's calculated taxes multiplied by 2.5.

The law on December 22, 1992,[9] effective January 1, 1993, increased the tax base by including sales of collateral as well as receipts for all kinds of "financial assistance" or other "special" transfers from customers. Under the same law, imports were made taxable (during 1992, imports were not taxable). A few exempt import categories were introduced: food and agricultural products, equipment for R&D, and medical equipment.

During the year, tax revenue grew rapidly: the share of VAT in consolidated budget revenues increased from 25.4 percent in January to 43 percent in December, and constituted 40 percent for the whole year. Positive dynamics of VAT during 1992 could be explained by frequent changes made to the law. For example, additional revenues created by the amendment that included "financial assistance" from customers into tax

base amounted to 23.5 percent of October revenues. Another source of revenues was the increase in advance payments made by larger enterprises. Also important was the creation of a clearing house by the Central Bank which netted out the mutual debts of enterprises, resulting in marked increase of sales. This episode signaled the role of non-payments in tax collection.

1993

On January 29, 1993,[10] by the instruction of State Tax Service (further, the Ministry of Taxation, as it is called in Russia) the advance payments made by larger enterprises (whose revenues exceed 300,000 rubles) were replaced by payments made every two months on the basis of realized turnover. Soon, the threshold was increased to 500,000 rubles.

In 1993, the Russian VAT became by its nature closer to theoretical standard as credits were allowed for VAT paid on capital inputs, but with a motivation that inputs were allowed for credit only after they were put into production (i.e. accounted as costs of production). Credits were to be paid off (or counted towards VAT liabilities) during two years, in equal portions. An important order, signed by the President on December 22, 1993,[11] mandated that from year 1994, 25 percent of collected VAT would be allocated to the budgets of local governments. This lasted until 1999 when the percentage was changed to 15 percent. Finally, since 2001, fiscal federalism in the VAT was abandoned, and 100 percent of VAT revenues accrued to the federal budget.

The beginning of the year still showed high rates of tax collection, partly because the higher rate of 1992 (28 percent) was still de facto effective due to delays in instructions provided by the Ministry of Taxation, and also due to the inclusion of imports into the tax base. However, revenues fell monotonically later in the year. In addition to the lower VAT rate, factors that contributed to this decline were the proliferation of exemptions and the spread of evasion practices: taxpayers learned about the new tax and figured the ways to avoid it. Since then, VAT performance remained at approximately the same level, if measured by its share in GDP.

1994

Since January 1, 1994, a special tax of 3 percent was introduced, effectively increasing the tax rate to 23 percent (and 13 percent, correspondingly). On January 17, 1994,[12] by order of the Ministry of Taxation, all entrepreneurs who worked on an individual basis (that is, without forming a legal entity) became exempt from the VAT. This remained in effect until 2000 (inclusive). This order also reduced the period for crediting capital and intangible inputs from two years to six months.

The tax base was further broadened to include all transfers received from other enterprises. With this change, the VAT effectively became a turnover tax, because it broke the link between the VAT liability and the instance of sales of goods and services. For example, there were episodes when the VAT was levied on agricultural enterprises on the amount of budget subsidy they received. The immediate reason behind this ruling was an attempt to fight evasion. Firms were using lower prices to reduce their tax

liabilities and side payments to compensate for reduced revenues. Another form of evasion was through the use of loans, that we discuss below, in the section "The nature of Russian VAT". The less obvious reason, however, was that the mindset of tax collectors and the method of administration had changed little since the Soviet era, when the turnover tax was the main tax in effect. This kind of inertia even led to discussions of a possible return to the turnover tax,[13] and although the VAT remained in its place, it kept its hybrid form until the reform of 2000-2002. As a consequence, there has been dramatic increase in the use of cash in transactions, which put them into a zone unreachable by tax collectors.

On January 24, 1994,[14] thresholds for monthly and bi-monthly tax payments were increased to 1,000,000 and 3,000,000 rubles respectively (see above for details).

On August 10, 1994,[15] by order (*ukaz*) of the President, the method of calculating VAT in the case of negative value-added was established. In particular, it was maintained that negative tax liability which arose from selling goods below their cost was not to be reimbursed from the budget. In December[16] of the same year, rules for determining prices for such transactions were further clarified. The law was effective from January 1, 1995 until 1999, when the first part of the new Tax Code was introduced.

1995

This year was characterized by attempts, made by Parliament and the President, to adjust the Russian VAT to Western standards, due to pressure from the IMF. Specifically, there followed a declaration[17] to move to an invoice method of accounting for VAT and to a

delivery (accrual) method for the timing of VAT liability – which, however, remained only on paper; there followed a removal of exemption on construction of housing and a significant reduction of food products subject to lower rate. Another important contribution made during this year was the introduction of a single tax for small enterprises.

On February 23, 1995, a special tax of 3 percent was introduced in the end of 1993. It was subsequently reduced to 1.5 percent and eliminated in 1996.[18]

On April, 25, 1995,[19] the construction of housing was no longer exempt from the VAT. By the same law, the range of food products allowable for the 10 percent rate was reduced significantly.

On December 29, 1995,[20] a simplified method of taxation for small enterprises (comprised of fifteen employees or less) was established. The multitude of taxes (including the VAT) levied at the federal and local levels were replaced by a single tax, paid on the basis of a year's sales.

Stagnation: 1996-1999

1996

Since 1996, the special tax of 3 percent was eliminated, and the schedule of VAT rates returned to 0 percent, 10 percent, and 20 percent.

In order to be able to receive IMF credits, the Russian government was required to further reform the VAT. These steps were spelled out, as in the previous year, in a

joint declaration[21] made by the government and the Central Bank, which expressed the intention for widespread use of an invoice method of VAT accounting across industries and services.

This declaration was supported by a Presidential order, signed on May 8, 1996.[22] This order stated that effective January 1, 1997, every taxable person, for every taxable transaction engaged in with his customers and suppliers, was required to fill in an invoice in two copies. A government order[23] signed the same day, further clarified the accounting of these invoices. To be sure, invoices have been used in taxation before, since Soviet Union, for the collection of the turnover tax. The innovation of the 1996 law was the introduction of specifically VAT invoices, with clear rules of their format and use. However, as seen from the language of government order, these invoices were introduced for double-checking of correct tax filing, and did not completely replace the old (accounts based) methods of accounting that existed before[24]. Further reform of the VAT was achieved on April 1, 1996,[25] when capital inputs and intangibles were finally allowed for immediate credit immediately after they appeared on the balance of the enterprise and not after they were actually used in production, as it was before.

1997

By the law of April 28, 1997,[26] an exemption on imports of technological equipment and public transport vehicles was removed; in reality, however, these items were not taxed in 1997 or 1998 (due to a special law issued in the summer of 1998 that extended the exemption for the rest of the year).

In the end of the year, on December 29, 1997,[27] stricter rules for claiming rebates on exports were established. The main purpose of this legislation was to eliminate a popular method of avoiding VAT by making fake exports (see below). These rules stated that effective January 1, 1998, rebates could be claimed only if documentary proof of actual exporting activity had been provided and only after it had been verified by tax authorities.

1998

In early 1998, the government had issued an order[28] in an attempt to deal with invoice fraud, which gained popularity since 1997, when (partial) invoice-based accounting for VAT was introduced. In particular, the order declared illegal the exchange of blank invoice forms between enterprises. In August 1998, Russia was hit by an economic crisis. As interest rates on government debt skyrocketed, foreign investors began to withdraw. When the Central Bank's reserves were almost depleted, the government defaulted on internal debt and on a restructuring plan on external debt. The ruble depreciated drastically, from six to twenty-six rubles for a dollar in a couple of weeks. Despite the crisis, reform on taxation continued. On July 31, 1998, the government enacted a law that introduced Part I of the Tax Code. However, disagreement between the government and Parliament on certain aspects of reform prevented Part I from bringing about any significant change to the nature of the VAT. Rather, Part I mainly provided a general clarification of tax administration.

Along the same lines, on August 11, 1998, the Ministry of Taxation strengthened requirements of documentary proof for every export transaction of aluminum, in response to the widespread practice of falsified export operations in this industry.

Because of the economic crisis, 1998 saw exceptionally low revenues from the VAT and other taxes: 5.7 percent of GDP in total for the whole year. As the crisis unfolded in August and September, tax revenues dropped to 3.8 percent of GDP. However, the end of the year showed signs of a turnaround, as revenues reached a level of 9 percent of GDP in December.

1999

The highest priority of the new government, headed by Evgeny Primakov, who took office after the economic crisis of 1998, was the implementation of comprehensive tax reform and the unification of legislation through the adoption of a tax code. Thus in 1999, Part II of the Tax Code was debated in Parliament.

In addition to these discussions, several changes were made to VAT in response to the economic crisis. For instance, production and distribution of cinemas were included in the list of articles exempt from VAT. In April 1999, the share of the federal budget funded by VAT revenues was increased from 75 percent to 85 percent. At the end of May 1999,[29] a special economic zone (a tax free zone) was created in Magadan, effective until 2005.

Towards a Modern VAT: 2000-2005

The transformation of the Russian VAT into its internationally adopted version began in 2000. Amendments to the VAT had been passed prior to 2000, but they had a sporadic character that indicated the absence of any well-specified plan which would involve the coordinated efforts of both government and parliament (Duma). It is difficult to judge now why it took so long to arrive at a consensus, especially on such important matter as the VAT – a tax that generates a large portion of budget revenues, the efficient operation of which can benefit all members of society. One possible reason for the delay in reform was dissension within Duma, whose members could not agree on the form which tax reform should take. In any case, it would be unfair to say that government lacked the will for reform. In fact, proposals of tax reforms described in this section were introduced by the government to Duma as far back as 1996; additionally, active discussion of reforms took place among economists, taxpayers, the government and foreign advisors as early as 1995. Below, we first present the main changes made to VAT, as they appeared in the initial version of chapter 21 of Part II of Tax Code that was introduced by the law of August 5, 2000, and, second, point to key changes that occurred after the law was enacted, between 2002 and 2005.

Tax Reform of 2000-2002

The main package[30] of reforms, in the form of the second part of the new Tax Code (the first part was signed in July 1998, effective January 1, 1999), came into force on January

1, 2001. Perhaps the most important advancement of Chapter 21 of the Tax Code was the unification and codification of legislation on VAT. Chapter 21 required that any changes to VAT had to be introduced via federal law, that is, through parliamentary process, and thus made the tax clearer and more predictable for taxpayers. A description of other significant reforms follows below. We discuss some of these changes later, in the section "The nature of Russian VAT".

Entrepreneurs working on an individual basis (that is, without forming a legal entity) again became taxable persons under the VAT (they were exempt from VAT by the law of January 17, 1994,)[31] as well as all other legal persons conducting economic activity. At the same time, all taxpayers with revenues not exceeding one million rubles per quarter of the year (about US $30,000) were exempt. This was intended to improve the effectiveness of tax administration by allowing tax inspectors to focus on more important taxpayers, as well as to reduce the tax burden on small businesses. The voluntary registration of taxpayers had not yet been introduced, however.

Since July 1, 2001,[32] the destination method was adopted for treating trade with CIS countries, not including, however, sales of oil and natural gas (these were included since 2005, see below). Before that, all imports from countries of CIS were treated as if produced domestically (origin method). Transition to the destination method had become possible due to improvements in customs controls on the borders between members of CIS.

There had also been some changes in the administration of export tax rebates, in an attempt to fight tax evasion through falsified exports. According to the ruling of July 1, 2001, the decision of giving a tax rebate was to be made by local tax inspectors, if the

amount of export did not exceed five million rubles per month, or if the exporter were a "traditional" exporter, i.e. engaged in exporting on a regular basis. Otherwise, if an export operation was too large or an irregular one, then the decision would be delegated to a higher level department of the Ministry of Taxation. In any case, the decision had to be made within two months.

The legal status of the zero rating of exports was improved as well. The new Tax Code formally defined the notion of a 0 percent rate, established a list of documents needed to claim a tax rebate, and defined the rights and responsibilities of both taxpayers and tax collectors. This allowed taxpayers to seek protection in the courts if they believed that tax authorities had acted incorrectly. Previously, the administration of export rebates had been governed by a series of orders issued by the State Tax Service itself, which gave plenty of room for refusals or deferrals of tax rebates on exports. As a result of the new legislation, there was an increase both in volume of rebates paid to exporters as well as in rebates owed to them.

Since 2001, all VAT revenues accrued to the federal budget. Exemptions and preferences have undergone a major revision. In 2000, the list of food products and goods for children that were subject to a lower tax rate of 10 percent was revisited and reduced. Some tax free zones, such as Baikonur, have been eliminated or their preferential treatment has been reduced (since 2004, only two free economic zones exist: in Kaliningrad and Magadan). In 2001, the most important innovation was the removal of exemptions on printed products (books, newspapers, etc.) and medical products[33] (except those socially most important). Beginning on January 1, 2002, these products, both imported and domestic, were subject to a tax rate of 10 percent. This led to some increase

in prices for these products in January of 2002 by a few percentage points. At the end of 2002,[34] the 10 percent rate on these products was increased to 18 percent, which has been effective since 2005. This does not mean, however, that the list of exemptions had come into complete concordance with international practices: for example, firms where most employees are disabled were still exempt, as well as public transportation and some other activities.

The VAT paid on capital inputs was allowed for immediate credit. This finally equalized the tax treatment of industries with different capital intensity of production. However, inputs for capital construction were to be credited only when the construction was finished and the object was put on the balance. Also, since 2001, negative tax liability can be reimbursed directly from the budget, as an alternative to carry-forward provisions. However, conversations with business people and tax practitioners reveal that in practice, the government remains reluctant to make cash reimbursements (an informal discount is 30 percent of one's credits). For normally-functioning enterprises, however, if inflation is not high, it does not make a large difference whether or not a tax return is received in cash or as a reduction of future liabilities. Special circumstances that occur when negative liability is generated by selling below cost have also disappeared with the removal of the accounting notion of "cost" from legislation on VAT. This was a step towards disentangling VAT taxation and firm accounting procedures – a process that has not yet been finished.

Regarding VAT invoices, a significant number of improvements and clarifications have been introduced in their use for various economics activities[35], relative to the original law of July 29, 1996. However, the mixed nature of accounting for VAT liability

has essentially remained: while invoices were required from all taxpayers, they were not sufficient for rebates, and had to be complemented by bookkeeping records. This was mainly explained by the fears of fraudulent rebate claims based on falsified invoices.

2003 - 2004

In line with a general policy of reducing the tax burden, the base tax rate was changed in 2003,[36] effective January 1, 2004, from 20 percent to 18 percent (while the lower tax rate of 10 percent was kept in place).

In August, 2004,[37] the taxation of trade in oil and natural gas between CIS countries was put on a destination basis, to eliminate the exception initially created in Chapter 21. Russia was one of the last countries to adopt this method and did so mostly as a result of pressure from other partners, since the original method was more beneficial from the point of tax collection. By estimates of the Ministry of Finance, the change in the method of taxation of oil and gas alone would cost federal budget more than $1.2 billion for 2005.

2005

A large package[38] of reforms was enacted in July 2005, effective January 2006. In particular, the accrual method of accounting for VAT was finally introduced. According to the law, the moment of liability arises on the earlier of two dates: the date on which the goods are delivered (services) and the date on which payment (partial payment) is made.

The reimbursement of VAT credits was no longer conditioned on whether or not payment has been made to the supplier. In other words, the system has finally moved to the accrual method of accounting. This brings the new VAT law much closer to the international standards. One of the remaining major differences, however, was that invoices were still not sufficient for calculating tax credits and liabilities, and had to be supplemented by accounting records.

The same law corrected a much debated aspect of the original version of the Chapter 21 of Part II of the Tax Code, which was adopted in August 2000. According to the new version, VAT paid for capital construction is to be reimbursed only when the building (or other construction) is finished and put on the balance. This was a remnant of differential treatment of capital inputs inherited from the 1990s. From January 2006, construction is treated equally with all other types of inputs.

An important advancement was made in the management of export rebates. From 2007, VAT credits on exports are now administered with the same timing and documentary requirements as credits on domestic sales. The period allocated to tax authorities for validity checks has been reduced to two months from the date of submission of a tax declaration (or a customs declaration in the case of exports), and no more than one month is allowed for the processing of claims by the Treasury (if the claims are found to be valid).

What we have presented above are only a few of many reforms carried out after the adoption of the Tax Code. The list is far from being comprehensive. Rather, we have focused on what we believe were the more drastic changes that made the Russian VAT closer to best practices and, hopefully, more efficient. A more detailed discussion of these

changes from the perspective of the nature of Russian VAT can be found in the next section.

The Nature of Russian VAT

On the surface, the principle of a VAT is very simple. By definition, the amount of VAT owed to the budget is the difference between the tax received from customers and the tax paid to suppliers. However, the exact implementation of this rule in Russia was very different from implementation in developed countries. The principal deviations can be organized into the following categories: first, the way VAT liabilities are calculated and VAT credits are reimbursed for different types of transactions and economic agents; second, the type of information that is used to calculate VAT (e.g., invoice forms, accounting records, declarations, etc.); third, the way international trade is taxed (origin versus destination method, or a combination of both); and finally, the set of exemptions and preferences, which themselves can be grouped into "standard" ones (those that are more widespread across countries) and "non-standard" ones. Most of the deviations have been eliminated through the reform process undertaken from 2000 to 2005, but one should distinguish between formal and actual differences. In the next section, we start with perhaps what was the most problematic part of Russian VAT – the way VAT liabilities are calculated and VAT credits are given for different types of inputs.

Hybrid Method of Accounting for VAT Credits and Liabilities

From the beginning until the year 2006, the Russian VAT was asymmetric in its treatment of VAT credits and liabilities. In this section, we discuss the anomalies of calculating VAT credits and liabilities that made the Russian VAT different from the standard version. There are two main types of anomalies: first, the unequal approach to crediting different types of inputs (capital, inventories, construction, etc.); and second, the use of a cash method of VAT accounting, which makes tax transfers both to and from government conditional on actual payment for the taxed transaction. While unequal treatment of different inputs is obviously distortionary and inefficient (although it did not prevent it from surviving until 1999-2000), arguments can be made pro et contra the cash method in the context of Russian economic reality of that time.

VAT Liabilities

From 1992 until the beginning of 2006, the cash method of accounting for VAT liability was predominantly used. According to this method, VAT liability, which is based on the payments received from customers, arises only when the actual payment for sold goods and services is received. From 1994, taxpayers were given a choice between the cash and accrual (delivery) method for calculating VAT liabilities (when VAT liability arises on the day of delivery), but almost all taxpayers preferred the cash method because it allowed them to defer payment of the tax and, more importantly, because the determination of VAT credits was based only on cash method. We discuss advantages and disadvantages of the cash method in more detail below.

Sales of final output (wholesale and retail) of enterprises are taxed differently from the sales of inputs. The tax base was the difference between sales and the amount paid for supplies, that is, markup. In 1995,[39] the taxation of markup was eliminated for wholesale enterprises (for them, the amount of tax owed was the difference between VAT paid and VAT received), while retail enterprises (including restaurants) were still being taxed on markups, VAT inclusive. Since 2001, markups have been calculated without the inclusion of VAT, which placed the taxation of retail sales on the common ground with everything else. Such a differential approach[40] has resulted in the problem that in practice, it was often difficult to distinguish between production and distribution activities, which allows businesses to optimize their taxes by shifting (or misclassifying) their operations to the least-taxed activity. Essentially, the result is the same as with the existence of exemptions and multiple rates: loss of revenue and distortion of economic decisions.

In response to evasion practices, a law enacted on December 22, 1992, provided that the tax base included not only payments made specifically for purchased goods and services, but also other payments (transfers) received from the customer as a barter or as a "donation". Through subsequent decrees and orders, the Ministry of Taxation has developed this provision to respond to new practices of hiding inter-enterprise payments. One such method of evasion that firms undertook was to decrease the price of supplies and then make a side payment to the supplier, in the form of "financial assistance." Implementation of this rule brought with it both practical and legal difficulties: on the practical side, it required tracking of various payments made to enterprises and their subsidiaries. On the legal side, it was difficult to judge what payment should be included

in the tax base from the view of principles of VAT outlined by law. Adoption of the full accrual method in January 2006 relieved tax authorities of some of these difficulties, but the problem of side payments used to avoid taxation remains. In particular, according to the current version of VAT as spelled out by Chapter 21 of the Tax Code, advance payments received from customers (and paid to suppliers) constitute a tax base, even though goods are not yet delivered, services are not performed. An exception, which can be viewed as a form of tax support, is made for goods whose production cycle exceeds six months (mostly manufacturing, construction, etc.).

VAT Credits

According to the law of December 16, 1991, only supplies put into production were allowed for credit. For example, inputs coming into inventories were not creditable, and only those leaving inventories for production were. Such an approach came from Soviet accounting practices, where production costs were understood in physical terms (i.e., as inputs used in production) rather than in financial terms (i.e., as inputs purchased and to be used in the future).[41] After a few months of uncertainty, the law of July 16, 1992,[42] stated explicitly that a cash method should be used for VAT credits (as well as for VAT liabilities, as said above). Along the same lines, VAT on inputs that were purchased for promissory notes can be credited only when notes were actually paid off. This created an additional incentive for (eligible) firms to choose cash method for VAT liabilities, as the tax base was the difference between taxes received from customers and taxes paid to suppliers.

Among inputs, special treatment was given to capital goods and intangibles. In the initial version of the law, capital goods and intangibles were not eligible for credit at all. Later, the law of July 16, 1992,[43] (effective January 1, 1993) allowed the tax paid for these items to be credited in equal parts during the two years after the items were put into production. Later, the two-year period was reduced to six months and completely eliminated as of April 1, 1996.[44] In fact, this correction turned out to be ineffective, because high inflation and uncertainty about the actual receipt of credit eroded the real value of the tax credit, and no adjustments were made in that respect. Only with the adoption of Part II of the Tax Code in 2000 was the link between the purchase of inputs and the production process abandoned.

When VAT credits and liabilities were calculated by the cash method, the amount of tax owed to the government was the difference between VAT actually received from customers and VAT actually paid to suppliers (until 2001, this applied only to inputs put into the production in the current period). This difference often turned out to be negative. In theory, the situation when VAT liabilities are less than VAT credits does not constitute a problem: the direction of payment should be from the budget to the taxpayer. In practice, however, the state had been always reluctant to do so. In Russia, until 2006, as in many developing countries, excess credits on inputs would be carried forward to count against future tax liabilities. The effect was the same as with inputs that were purchased but not put into production, because such carry-forward provision makes holding capital inputs taxable for some time, which increases the effective tax rate on capital-intensive goods.

A special case of negative tax liability arises due to sales below cost. Since 1995,[45] tax provisions have explicitly stated that such liability should not be credited, as the manipulation of the price of sales was an important channel for evasion. This is yet another example of an attempt to fight evasion by altering the nature of the tax, rather than by solving the problem directly. Only in 1999, with the adoption of Part I of the Tax Code, was negative liability due to below cost sales no longer a problem, at least theoretically; in practice, tax authorities were still willing to account for it against future liabilities instead of paying directly from the budget. A more detailed discussion of tax returns can be found in the section "Administration of VAT."

Cash versus Accrual Method: Discussion

Most countries that levy VAT have favored accrual method over the cash method as the choice of accounting. In Russia, poor tax administration and delays in payments created a significant trade-off between the two methods, which was resolved in favor of the cash method (in fact, a hybrid method, as explained above). Based on theory and the experience of other countries, a strong case can be made for the establishment of a symmetric accrual method as a compulsory method of accounting for VAT.[46] What follows below are conventional arguments in favor of the invoice method, as well as drawbacks of the Russian version of the cash method.

The first and perhaps most important argument in favor of the accrual method is the simplicity of calculating taxes. This method, in Russian practice sometimes called "delivery method", determines the taxable event – i.e., the consumption of goods and

services – more precisely than the cash method, because the timing of payments usually is not related to the timing of consumption. This leads to the more timely arrival of tax revenues to the budget, which is an important consideration during inflation.

Second, the cash method makes it possible to defer the date of VAT liability by accumulating fictitious non-payments – usually, by making sales through fly-by-night firms who avoid taxation. The invoice method makes this accumulation of non-payments meaningless. Moreover, firms would like to receive payment as soon as possible, in order to be able to pay VAT owed to the government.

Third, the accrual method is simpler to administer, as it only requires the establishment of the fact of delivery. The cash method complicates matters by requiring firms (or auditors) to track the different payments and to tie them to particular transactions. Many firms employ various schemes to obfuscate such tracking or to hide payments from the view of tax inspectors. Under the accrual method every taxpayer can be treated as a separate entity for audit purposes, as there is no need to track payments to upstream or downstream partners.

Fourth, the delivery based principle of the accrual method contrasts with the requirement of the Russian version of the cash method that creditable inputs be put into production is questionable because it distorts the tax base and economic decisions. On the one hand, the cash method creates a link between timing of VAT liabilities of supplies to the timing of production decisions. On the other hand, it makes holding inventories more costly, which hurts, for example, retail enterprises. As mentioned above, this requirement was abandoned in 2000.

Finally, the version of cash method adopted in 1992 created an additional burden for the taxpayer, as it required, in principle, full inventory accounting for every reporting period depending on the size of the enterprise. This accounting requirement was even more burdensome for taxpayers if different types of inputs were subject to different tax rates, or if the tax rates changed over time. In such cases, a method of moving average VAT was used to tax outgoing inventories,[47] which further distorted the tax base and made spot checks by tax authorities more problematic.

Despite its shortcomings, the adopted method of accounting for VAT credits had practical advantages during the economic turmoil of the 1990s, which was marked by corrupt and poorly administered tax collection, massive tax evasion, and mutual non-payments among enterprises. Here are some of them.

First, the combination of cash and accounting method on VAT credits protects the budget from the most harmful form of tax evasion, which occurs when fake invoices are produced to overstate claims on VAT credit.[48] During the 1990s, when the tax administration and enforcement were still in development, and corruption among tax inspectors had yet to be eliminated, it was important that such protection worked automatically. The validity of this argument, however, has been questioned by the experience of other CIS countries which adopted the invoice method much earlier than Russia but did not suffer from massive evasion of VAT through false invoices. Also, similarly to fake invoices, fake cash receipts can be produced[49] at low cost. Therefore, it seems this advantage was more perceived than the real one.

Second, an enterprise operating in an environment of mutual non-payments often would not be able to pay taxes before it receives payments for its sales. In this case, the strict enforcement of accrual method is simply unfeasible.

Third, there was a historical reason for the initial adoption of the cash method: Soviet accounting methods based the notion of financial income on the actual transfer of cash, rather than the right to receive it.

Transition to the Accrual Method

There have been considerable economic and political difficulties associated with a transition to the accrual method. On one hand, it would entail a steep increase in tax liabilities for enterprises that are subsidizing the rest of the economy – especially those in the energy sector – as these enterprises have the largest arrears owed to them by their customers. At the same time, it would hurt the most cash strapped enterprises, as these enterprises are often in arrears to their suppliers. On the other hand, moving to the accrual method is costly as it introduces a completely novel method of accounting for VAT. This would require additional training of personnel, development and testing of new forms and protocols, education of taxpayers, etc. More importantly, as it is accompanied by a shift to the use of invoices, it would require an effective system of checking the validity of VAT claims, as fake invoices can easily be produced.

A law signed in July 2005 introduced the accrual/invoice method of accounting, effective January 2006, and provided for transition conditions intended to deal with the problems of greater tax liabilities and of fake invoices. During the two year transition

period, enterprises using the cash method of accounting for VAT liabilities were forced to make an inventory of outstanding debt for unpaid but received supplies and credits for products unpaid by customers but delivered to them, until December 31, 2005. The difference would constitute the tax base for VAT owed to the budget, effective as of January 1, 2006. This amount was to be paid off during a two-year period, from January 2006 until January 2008, by the cash method. VAT owed to the budget for a given transaction was to be paid as soon as the relevant payment was received from the customer. If during two years, a firm failed to pay off this amount, it would be charged in the first tax period of 2008. Enterprises using the accrual method of accounting for VAT liabilities should perform the checks of debits and credits in a similar fashion, and are entitled to receive VAT credits owed to them during first half of 2006, in equal portions (more precisely, these credits are counted towards VAT liabilities that a firm generated during 2006). These transition clauses appear to be very lenient especially to enterprises whose customers do not pay regularly. Essentially, the law provides these enterprises with a two year delay for tax liabilities accumulated up to December 31, 2005, at the expense of the state budget, in the hopes that the transition to the accrual method will be smooth.

The problem of fake invoices is more fundamental, as it is directly related to the quality of tax enforcement. Current estimates of tax evasion in Russia show that the effectiveness of the current system of tax administration does not allow for complete reliance on invoice forms in determining taxes. Therefore, even though by law a property filled invoice together with tax declaration constitute a basis for claiming tax rebate, the

tax authorities often conduct additional checks, using accounting records and payment receipts, to verify the validity of the claim.

Treating International Trade

A significant share of Russian international trade involves country members of the Commonwealth of Independent States (former Soviet republics), which results in a consistently large and positive balance of trade. Despite the fact that these countries are independent states, the long history of economic interdependence created customs borders that are not as strictly enforced as those vis-à-vis the rest of the world. Perhaps more importantly, the shift to the destination method required coordination of CIS countries as well as resolution of some of the tolling. For example, situations was not uncommon where an input from a CIS country would be imported into Russia, used in production and then sent back to the original firm without a sale[50]. These considerations can explain why from 1992 until 2001, the origin principle governed the taxation of trade within the CIS, and the destination principle governed the taxation of trade with non-member countries.

Under the destination principle, which is most widely adopted around the world, exports leave the country without tax surcharges, because tax rebates are given to exporters when their goods cross the border. In other words, the importing country has full control over the tax burden that its consumers face, because imported and domestic goods have the same VAT in their prices. This can be seen as a form of tax support for national exports, but in Russia, this effect was muted due to reluctance of the Ministry of

Taxation to pay off export rebates. The more a rebate is delayed, the less its value for the firm, especially during a period of inflation. It is immediately clear that the ability of customs officials to check that goods have actually crossed the border is the crucial factor in operation of destination principle; when customs controls are weak, as it has been between Russia and CIS, falsified exports are possible when a good receives rebate but never leaves the country.

In contrast to the destination method, exports are taxed under the origin method, while imports are not; thus, imports from different countries will have different VAT in their prices.[51] This does not mean that the origin method is free from problems of evasion that occur when border controls are weak – as soon as illegal exports cross the border, they can be sold in the country of destination on a tax-free basis. This kind of evasion, however, is not as harmful as falsified exports, as it only reduces tax revenues, while the falsified exports lead to direct monetary losses from the budget.

In addition to its prevention of some forms of tax evasion, the origin method also provides benefits with respect to tax revenues: a large positive trade balance means that a country collects more taxes from foreign consumers than from domestic consumers who are paying the price of imports; at the same time, the structure of imports, most of which are agricultural goods, make the destination principle less attractive, as these imports would be subject to a lower 10 percent tax rate. Most likely, this was why Russia was so reluctant to put its trade with CIS on a destination basis while other country members of CIS had agreed on this policy much earlier.[52]

Part II of the Tax Code of 2000 defined the notion of and the rules of application for zero-rated[53] products and services. Such products and services included exports

(except oil and natural gas exports to members of CIS), international transportation, space projects, and certain sales of precious metals to governments and banks. Since January 1, 2002, trade with CIS countries was put on a destination basis as well. According to the projected budget for 2002, this change would have reduced the tax base by about 0.6 percent.

Treatment of trade with CIS countries was further aligned with the destination principle in August 2004,[54] when oil and natural gas exports were included in zero-rated products and services under Part II.

Exemptions and Multiple Rates

Since its inception, the VAT was not only seen as a revenue-generating device, but also as an important instrument of social policy. The VAT was used to stimulate economic activity and to support socially disadvantaged groups by giving exemptions or lower (possibly, zero) rates to certain kinds of activities and by exempting certain categories of economic agents.

Attempts to estimate revenue losses due to VAT preferences often lead to results that cannot be compared to losses incurred by other countries, because there is no universally accepted list of activities to be exempted. The Russian approach to VAT preferences is expansive, in that it categorizes a number of activities not normally subject to VAT as tax expenses, such as exports, holding of financial instruments, educational services, banking operations, insurance, and non-government pension funds. This approach gives rise to inflated, unrealistic estimates of tax losses. Another controversial

aspect of such calculations is that they are often based on the assumption that the tax base would not change if certain preferences were eliminated. Finally, when comparing figures of revenue losses as a percentage of GDP, one should control for tax-raising ability: a figure of 1 percent of GDP in a country that collects 80 percent of the theoretical VAT is completely different from 1 percent GDP in a country that is able to raise only 50 percent of theoretically possible VAT revenues. Nevertheless, it may be of interest to trace the dynamics of revenue losses, while keeping in mind the figures can be only a rough reflection of the reality; for this purpose, we have made some calculations which the reader can find in the end of the chapter.

The law of December 6, 1991, introduced a number of VAT exemptions.[55] Some of the exceptions – such as financial services, education, health care, public transportation, and folk arts – were quite common among countries who levied a VAT. They were aimed at social and economic goals, such as the promotion of research, education, and cooperation with foreign firms. Others were created in response to specific circumstances of the time period (such as stays in sanatoria, which were historically part of a social benefits provided to workers in soviet times), and subsequently were eliminated as the Russian VAT was modernized. The list of exempt or lower-rated products or activities has changed from year to year, in response to economic fluctuations. Currently, the following categories are exempt:

a. some socially important medical products and services
b. city transportation
c. apartment rentals
d. educational services provided by non-commercial organizations

e. international transportation, as well as related services
f. banking operations, insurance, financial operations (stocks, mutual fund shares, etc.)
g. other transactions not considered to be part of the realization of goods and services.

From these categories, one can distinguish a number of motivations for such preferences: support for lower income people and the disabled; public health; the promotion of research and development; education and culture; and the provision of housing. Below, we present a brief history of the evolution of exemptions and attempt to give some estimates of their costs in terms of tax revenues. In the end of this section, we discuss possible arguments in favor of and against such tax preferences.

Support for Lower Income People and the Disabled

It was recognized from the beginning that the transition from social planning to a market system would have a large negative impact on the most economically vulnerable groups of population, such as lower income workers, pensioners and the disabled. As a result, support of these groups was a focal point of VAT since its inception. Such support appeared in the form of lower tax rates for food and goods for children, exemptions for individual entrepreneurs, and exemptions of public transportation.

Food and Products for Children

On February 3, 1992, a lower rate of 15 percent was introduced for food products, as well as for certain goods for children. This rate was subsequently lowered to 10 percent[56] and remains in place today. This measure proved to be one of the largest revenue losers, however. Its projected cost[57] to the budget was 0.21 percent of GDP in 1993 and 1.47 percent of GDP in 1994. The list of products subject to the 10 percent rate has changed numerous times at the discretion of government in response to economic fluctuations and budget shortages. For example, in 1993, imports of the products listed were declared exempt, but in 1995 were subject to a 10 percent rate,[58] in an attempt to correct for poor revenue performance in 1994.[59] A relative success came only in 1998 with the elimination[60] of a lower rate on certain food products and goods for children (both imported and domestically produced), which was supposed to generate 0.34 percent of GDP in additional tax revenues. Among these food products, only bread, other bakery products, milk, milk products (except ice cream), and specialized food for children and for diabetics, were left under the lower rate. The list of goods for children had also been reduced, leaving only goods for babies and school supplies. In reaction to economic crisis, however, many preferences were re-introduced at the end of the year (which was reflected in 1999 figures). As Table 4.2a shows, the year 1998 was one of the best performing years in terms of minimizing tax losses. Thereafter, the list continued to change at the discretion of the government until the reform of 2000-2002, when the list became fixed by law and has remained unchanged since then.

Individual Entrepreneurs and the Disabled.

In the context of unemployment and wage non-payments, small-scale entrepreneurship, such as the sale of home-produced fruits and vegetables or the resale of manufacturing goods and textile bought from abroad, has always been an important means of subsistence. To promote individual entrepreneurship, while saving on costs of administering VAT generated from these small taxpayers, the government exempted these taxpayers. In particular, in 1992-1994, individual entrepreneurs who did not form a legal entity (that is, a firm) were exempt from VAT, given that their revenues did not exceed a certain limit. In 1995,[61] in an effort to simplify taxation of small entrepreneurs, the revenue restriction was removed. Moreover, for all organizations with less than 15 employees, the government replaced VAT and other taxes with a single tax.

Exemptions from VAT based on legal definitions and head counts, rather than on economic activity, proved to be very inefficient, as they created opportunities for tax evasion. Consequently, these exemptions were removed by the Tax Code of 2000, which stated that for an entrepreneurship to be eligible for exemption from taxpayer duties, its quarterly revenues could not exceed one million rubles. In 2005, this limit was raised to two million rubles.

In addition to aiding individual entrepreneurs, the VAT was used to support the troubled agricultural sector. Beginning 1992, the output of agricultural enterprises allocated for wages was exempt from the VAT. Agricultural enterprises were also given special treatment in terms of getting tax credit for purchased capital inputs. Whereas capital inputs in other industries were to be reimbursed during a two-year period (later changed to six months – see discussion in the section "The Nature of Russian VAT"), agricultural enterprises could claim these credits as soon as capital purchases were

entered into accounting. The Tax Code, adopted August 5, 2000, maintained these preferences and provided a more precise definition of "agricultural enterprise," which today can be defined as a firm for whom 70 percent of revenues comes from the sale of agricultural products. Finally, the law[62] of August 20, 2004, in an attempt to revitalize the market for land, made the sale of land exempt from VAT.

The Russian VAT has also been used to support and provide services for the disabled. Inadequate government support for the disabled population, together with the absence of a health insurance system, makes the case for special tax treatment. Since there is usually little market demand for the labor of the disabled, the government attempted to stimulate demand by exempting products produced by such labor. These are usually enterprises that produce simple manufacturing goods, such as electric outlets and tools, using labor-intensive technologies. In 1992, tax reforms provided an exemption for enterprises who fulfill a 50 percent hiring quota of disabled persons. In 1993, this preference was augmented by the exemption of production and imports of equipment for the disabled.

This exemption turned into a popular channel for evasion, in which highly profitable capital-intensive firms hired a sufficient number of disabled persons to become tax exempt. In 1996, a restriction was added, which stipulated that trading, broker, and other intermediary companies who fulfilled the 50 percent hiring quota were no longer exempt, unless these companies were owned by associations of disabled persons. In 1997, companies that consisted of disabled persons but traded natural resources were also excluded from the list, as the government tried to prevent oil companies from using this method of evasion. Despite all the criticisms, and contrary to the exemption of small

entrepreneurs, the new Tax Code of 2000 had left the exemption for disable persons in place. The only change was that the hiring quota for disabled persons was raised from 50 percent to 80 percent. In 2002, revenue losses due to this exemption were estimated at 0.01 percent of GDP – a modest number compared to revenue losses suffered from exemptions on medical services or transportation.

Public Transportation

Public transportation, provided by both public and private entities, was declared exempt since the introduction of VAT in 1991 and remains exempt. In fact, transportation provided by the government is a consistently unprofitable activity even in such cities as Moscow, so if the principles of VAT are applied, such preferences should not generate revenue losses. Thus, most of the revenue losses arise from the exemption of private sector activities, and these appear to be very large. In 2002, for example, revenue losses were estimated to be 0.14 percent of GDP.

Public Health

The system of public health services inherited from the Soviet Union was considered to be obsolete by many, even before the Russian economy became a market economy. Although the coverage was wide and prices affordable, the quality of services was generally poor, with modern medical technologies being adapted quite slowly. With the transition to a market economy, the situation only became worse, as tax revenues

plummeted and the government was no longer able to support the system as it had previously. Plans were made to reform the system to allow for private health providers and insurers. These plans were not implemented, however, and until now, the health insurance industry is still in its infancy. Nevertheless, despite its inability to implement structural changes, the government was resolved to make health services (especially medications) more affordable through the provision of tax preferences. The law of May 22, 1992, exempted paid medical services, production and sales (as well as imports) of drugs and medical equipment, and, as a reminder of the Soviet era, stays in sanatoria. In 1997, government purchases of various types of medical and safety equipment from abroad were declared exempt,[63] beginning May of the same year.

In 2002,[64] the exemption of all drugs and medical equipment was replaced with a tax rate of 10 percent. Together with the removal of the exemption on printed products, this measure was supposed to bring an additional 0.3 percent of revenues. Initially, according to the law of January 2, 2000, this removal was not complete, because it kept exempt a narrow list of "socially important" items, perhaps as a display of reverence to social problems. In December 2001,[65] however, even this list was reduced, leaving exempt certain medical equipment. Medical services remained exempt though, and in 2002, private medical practices were included as well. The wording of "stays in sanatoria" has also changed: today, only services provided by sanatoria located in Russia are exempt and are subject to strict documental requirements (basically, only state-subsidized vacations are eligible). This effectively withdrew most of the domestic market for recreation from coverage.

Promoting Research and Development

Beginning in 1992, research and development activities, as well as cooperation with foreign firms, were given tax preferences. In particular, the law of December 1991 declared exempt patents, licenses and copyrights. Also, R&D operations financed by the budget (and later, R&D funded by state-created research funds) were exempt, as well as R&D activities in universities. It is interesting to note that since 1993, the wording of tax laws that regulated exemptions of patents and licenses had changed substantially: "patents and licenses associated with industrial objects, except intermediary services in this domain."

The laws that regulated imports associated with R&D were a different story. In 1993, imports of equipment for research and development were declared exempt. Later, in 1996, this exemption was significantly expanded: not only was R&D equipment exempt, but also any "merchandise imported within contracts of joint venture with foreign enterprises" (Federal law N 25-FZ, from April 1, 1996). Indeed, this was a generous way to support research cooperation: the removal of this exemption in 2001 generated an additional inflow of revenues in the subsequent year of approximately 0.06 percent of GDP. There has not been any change in subsequent years until 2000, when old R&D related exemptions were removed effective 2001. Today, R&D efforts financed by the government and various research funds, such as those similar to NSF and research conducted by universities are exempt. Thus, VAT preferences for R&D now have a more modest goal – that is, tax relief for a given set of institutions rather than the stimulation of R&D activity in the economy as a whole. As we have seen in the case of public health,

making medical services more affordable is ineffective when they simply do not exist in an adequate quantity and quality. Similarly, in the case of R&D, one cannot hope to revive innovation in the economy by giving innovators tax relief when there is no demand for innovation on the other end.

Education and Culture

Numerous exemptions have been allocated to services in the domain of education and culture. In the initial version of the VAT law, enacted in December 1991, the wording regarding these categories was particularly vague: exempted categories included educational services provided by schools, universities, and other educational establishments; payments for the use of sports facilities by children; services provided by "establishments of culture and art," religious activities and entertainment events (such as rock concerts), and movies. At the end of 1995, "culture-related" exemptions were massively extended, to include all kinds of mass-media products, printed products (except advertising), as well as related transportation services.[66] These categories have become a major source of revenue loss. In 1999, in line with the general policy of supporting national cinematography, the creation and distribution of movies classified as "national cinema"[67] (movies whose production is approved by state officials and is partially financed by government) was declared exempt. The law of January 2000 clarified the notion of educational services as only those provided by licensed non-commercial enterprises,[68] and only those stated in their license. Thus, consultant services and sales of educational material (books), as well as rental of office space[69] are not

exempt. The same law also provided for a deadline for exemptions of printed products (and medical services), which were to expire as of 2002. In 2002, the exemptions were replaced with a tax rate of 10 percent, which was changed to the common rate of 18 percent in 2005.

Supply of Housing

Housing shortages had always been a major social problem in the Soviet era. In order to receive an apartment from the state, people often had to wait for years at a time. After the demise of social planning, however, market forces did not ameliorate the situation. On one hand, people could not afford to buy an apartment, as an affordable mortgage was (and continues to be at this time) non-existent. On the other hand, investors have shown little interest in this domain (although the situation has changed dramatically in recent years). In a naïve attempt to stimulate construction of housing, the government declared construction exempt from VAT on May 22, 1992.[70] It was expected that this preference would reduce the cost of construction by 7-10 percent. In practice, however, it did not make housing more affordable or investment more attractive, and quickly became one of the "leaders" in revenue losses. Revenue losses from the construction exemption accounted for 0.10 percent of GDP in 1993 and 0.85 percent in 1994. Since May 1, 1995, the exemption on construction of housing was replaced with a tax rate of 10 percent.[71] Nevertheless, budget losses from this preference remained high: in 1996, they were expected to amount to 0.32 percent of GDP.

As a result of these losses, the reform of 2000-2002 (Chapter 21 of the Tax Code) removed the exemption for construction of housing by governments of all levels, leaving only housing for military personnel. The size of the eliminated exemption was estimated to be 0.2 percent of the tax base. Also, housing rentals[72] continued to be exempt. Although the construction of housing is no longer exempt, sales of housing are exempt according to the law of August 2004.[73] The same law made sales of land exempt as well, in an effort to facilitate the market for land in Russia. The gradual removal of preferences on construction is a reflection of the inefficiency of this policy.

Discussion

Whether the implementation of a lower tax rate for socially important activities indeed achieved the desired outcome is hard to determine. For example, large revenue losses due to a lower tax rate on foodstuffs could be interpreted as a way of subsidizing the costs borne by the general population. However, the extent to which these subsidies have reached the part of population who need them the most is unclear. Also, lower-income people tend to buy food products on markets from local sellers, who are generally exempt from VAT due to their small size (since 1995). If this is the case, then higher-income people who made purchases in stores benefited the most from these subsidies.

While the benefits from having a zero or lower tax rate are uncertain, the disadvantages are clear: losses in tax revenues and additional complexities in the enforcement and collection of VAT. The latter concern is not to be underestimated, the reasons for which will be described below.

First, the use of multiple tax rates and exemptions introduces two forms of distortions into economic activity. On one side of the equation, activities taxed at a zero or lower rate are naturally stimulated, as their profitability increases. If these are socially important activities, and their positive impact is thought to be greater than the loss of tax revenues, then it is a desirable outcome and the goal is achieved. One the other side of the equation, however, such activities can become the focal points of tax evasion, as taxable entities try to hide their sales under the umbrella of these activities or misclassify their businesses. In this way, what was intended to be a welfare-enhancing instrument becomes a major cause of revenue loss.

Second, tax-exempt products and products taxed at lower rates are costly both in terms of administration and in terms of revenue. Take, for example, a tax reform undertaken in 2000-2002, which taxed previously exempt products, such as drugs and print and medical equipment, at a rate of 10 percent. This created a necessity to reimburse from the federal budget the negative difference between VAT received from sales of these products and VAT paid to suppliers, whose output was taxed at a rate of 20 percent.

Third, the implementation of these privileges is problematic. Because legislation usually provides only a vague wording of exemptions, tax authorities may either interpret the law too narrowly, in which case their effect is minimized, or too broadly, in which case the distortionary effect is likely to outweigh the positive impact. At the same time, because taxpayers tend to present their activities as falling into a tax exempt category, the tax authorities must check the validity of these claims. As the number of exemptions and goods subject to lower rate increases, the probability that false claims will go undetected also increases, given the limited resources of tax inspectors.

Despite these difficulties, Russia cannot abandon the tax relief for the arts, the disabled, lower income people, and innovation. Still, many commentators have argued that lower or zero rates of the VAT is a poor way to provide support. These objections are serious, and some of them have been discussed above. Direct support of socially beneficial activities seems to be much more effective, both in terms of produced results and cost to the budget. However, in a situation marked by poor institutional capacity to organize such support, by corruption at all levels of the bureaucracy, by a tight government budget that already is in deep arrears to state workers, soldiers and pensioners, the automatic support given by tax preferences becomes more appealing. This, for example, can explain the long life of the notorious exemption on enterprises that employ the disabled: despite all fair criticisms of this method of providing support to the disabled, it survived numerous tax reforms that removed many other socially beneficial exemptions (such as medical products, construction of housing, etc.). Indeed, even if, as we argued above, costs are high and most benefits are not received by the disabled, the existence of these enterprises provides jobs for the disabled, jobs which market forces would fail to create without the exemption.

Administration of VAT

The development of tax administration in Russia can be separated in two stages: the period before 1999 and the period after. Before 1999, the progress in tax administration had been very slow. On one hand, proper enforcement of tax law was often infeasible,[74] for a variety of reasons. Among these reasons were economic conditions (mutual non-

payments, barter, lack of liquidity), the inability to cope with widespread avoidance (corruption, incompetence, and lack of resources among tax collectors are responsible), and the political weakness of the government, as tax liabilities of large enterprises were determined through a bargaining process between enterprises and authorities rather than on the basis of law. On the other hand, the law[75] itself existed in the form of various legislation acts, President's Orders, Ministry of Taxation letters, etc. – many of which contradicted each other and which frequently changed. This allowed for different interpretations of tax liability, which resulted in underpayment on the part of taxpayers and overcharging on the part of tax authorities. The result of this failure to develop proper tax administration was a deep fiscal crisis, with the state unable to perform its social functions, and later the debt crisis of August 1998. The government attempted to fill the gap in the budget by giving almost unlimited power[76] to tax authorities, as opposed to taxpayers, by imposing high tax rates and high penalties for non-payments.

The European, in its issue 9-12 February 1998, describes one instance of workings of tax police:

> Two heavily armed men in leather jackets and helmets ran up the stairs of the building and pushed open the door of a Moscow trading company. "Nobody move" – they shout. They point guns at the terrified employees and demand to know where the safe is. They empty it and remove from office everything that looks valuable. This isn't a visit from the mafia but a call from Moscow tax police.[77]

However, the attempt to resolve the problem with force did not succeed. The unbalanced powers of tax collectors created corruption,[78] while high tax rates disadvantaged both firms operating in the formal sector and small firms with little bargaining power. In contrast, the largest enterprises continued to be the largest non-

payers.[79] The fact that emergency measures could not improve the situation was understood early enough, probably in 1996, but, despite this realization and pressures from IMF, constraints of political process and subsequent economic crisis delayed reforms until 1999.

After two years of debate in Parliament, beginning on January 1, 1999, Part 1 of the new Tax Code came into force,[80] whereby the tax legislation finally took a unified form. It was also a completely new code of tax administration, where the powers and responsibilities of tax authorities were clarified and strengthened. Although by itself this did not resolve many of the problems of tax collection, progress was made in several directions.

Most importantly, steps were taken towards the restoration of a balance of power between tax authorities and taxpayers. At least theoretically, tax authorities now had to follow established procedures in performing their actions, especially those of enforcement; taxpayers now were better informed of their rights and, more importantly, were able to seek protection in courts. Such improvement reduced the risk of conducting business and improved tax compliance.[81]

Also, for the first time, the new code defined such basic notions as taxation subject, tax agent, tax declaration, and introduced the concept of a unique taxpayer identification number. Principles of determination of "market price" for purposes of taxation were also established, which reduced the amount of discretion on the part of tax authorities, as well as the amount of uncertainty on the part of a participant of the transaction.

Legislation improvements were accompanied by a reduction in the number of different taxes, the simplification of the tax regime for small enterprises, and a reduction of tax rates. To keep tax revenues on the same level, lower tax rates required better tax collection, so beginning in 2000, the government tightened the tax discipline.[82] In some sense, today we see a reversion to the pre-1999 era; this time, however, improvements are happening not through changes to the tax code itself, but through the addition of detailed instructions that clarify administrative procedures, as outlined by the law.[83] The court system has played an increasingly important role in the administration of taxes, as tax authorities are more actively using the courts to enforce payment of taxes or fines for past non-payments, as well as to resolve conflicts that arise from the application of tax law. At the same time, since 2003, enforcement actions have been performed by a general enforcement agency, the Ministry of Internal Affairs. Previously, the Ministry of Taxation had its own division, the tax police, for enforcing tax collection (the tax police was later abolished in July 2003). Also, it is worth noting that by the order of the President, since March 2004, the power to amend tax laws or procedures was shifted from the Ministry of Taxation to the Ministry of Finance.

While the aforementioned steps are great improvements in making tax collection in Russia more uniform and equitable, the court proceedings of the early 2000s, beginning with famous Yukos case and subsequent cases involving other companies, reveal that there is a still great deal of uncertainty faced by businesses with respect to their tax liabilities, even if a good-faith effort is made on their part to pay taxes. Powers exercised by tax authorities are constantly increasing, yet this is not offset by better formulated and more user-friendly powers of the taxpayers. Tax administration today in

Russia is an actively changing field, and detailed discussion of its problems is outside the scope of this paper. Let us now turn to problems of administration that are specific to VAT. Probably, the two most acute problems are the administration of returns of VAT credits and the fight against various methods of tax evasion.

Tax Returns

The administration of tax returns is, perhaps, the most problematic issue related to the administration of VAT in Russia. Generally, tax authorities have been reluctant to pay VAT credits generated by business activities, whether export operations or an activity within the country. Since rebates can be paid off only when approval of the tax authority is received, the tax authority has the power to delay payment, either in an attempt to extract rents, or because of inefficient bureaucratic procedures governing the verification of the legality of a rebate claim. One way or another, firms, especially exporters, must wait several months and spend a significant amount of human resources in order to receive rebates. In fact, most non-exporting firms prefer not to go to such lengths and settle for the use of rebates to pay their future tax liabilities. Difficulties with receiving rebates create economic distortions, because it disadvantages firms with negative tax liabilities (such as exporters), firms that incurred large investments in the current period, or newly-created firms.

Attempts are made to optimize the existing system of validity checks, mainly through differentiating reputable taxpayers (those that have regular operations and established a history of timely tax payments) from the rest. At the same time, the

discretionary nature of decision making may provide an incentive for cooperation between corrupt officials and firms. For example, the Yukos case demonstrated that the company under investigation had registered several fake firms in tax-preferential zones of Russia (where the tax rate was either zero or low) and conducted the bulk of its sales of gas through these firms. Meanwhile, these firms did not pursue any business activities in these regions, and their directors were employees of Yukos in Moscow. During the years of their operations, they successfully claimed and received VAT rebates of millions of dollars.

In the next section, we discuss the use of fake firms (or, in a popular wording, "fly-by-night" firms, "odnodnevki") in avoiding VAT and reasons why the effort against such schemes has been largely unproductive.

Fly-by-night firms

Fly-by-night firms are created specifically for the evasion of taxes[84]. The name "fly-by-night" points to the temporary nature of these firms: once the action is over, the firm disappears. Some of these firms are short-lived, while others may exist for a longer period of time and implement a number of evasion exercises. Since tax fraud is a criminal offense in Russia (and other countries), the primary reason for creating a separate legal entity is to protect the beneficiaries of tax evasion from prosecution. Usually these firms are registered to people who have no relation to the matter, e.g., a homeless person who was paid to become a director of the firm, or to non-existing people, using information taken from lost passports. At the same time, wholly different people control the flows of

resources, and it is generally difficult to prove the relation of these people to the illegal activities being undertaken. In other words, for such a firm to operate effectively, some tricks are necessary at the registration process, such as falsified documents about persons, location of the firm, capitalization, etc. Through a number of contractual transactions, such firm accumulates a large amount of tax liability as a VAT taxpayer and then disappears without paying it, while the corresponding amounts of VAT credits are left in the hands of the related beneficiaries. Here are a couple of examples of typical schemes used in Russia, all involving a sort of collusion with one or both sides of the transaction, and sometimes with government officials.

One example is that of a company selling imported goods on the domestic market. First, through an agreement between customs officials and the importing company, the customs value of imported goods is lowered (by changing the classification, for example), which in its turn lowers the amount of the VAT owed to budget. Second, imported goods are sold at lower prices to a fly-by-night firm, which then resells the goods to the actual seller (either directly or through intermediary) at much higher wholesale prices. This accumulates most of the added value in the fly-by-night firm. Third, goods are sold and VAT is paid by the beneficiary company, while the fake firm liquidates without paying taxes. This exact scheme is also employed by exporting firms; it exploits the fact giving the tax rebate to an exporter cannot be conditioned on whether the company that procures the exported goods (usually, a fly-by-night firm) has actually paid its incoming VAT. The difference here is that the cooperation of customs officials is not required.

Another popular scheme involves the sale of services by fly-by-night firms to a beneficiary company at a very high price.[85] The nature of this transaction makes it difficult to check the real value of the services, which include consulting, marketing, advertising services, etc. In fact, Russian legislation allows VAT to be paid to the seller of services separately from the payment for the services themselves, so the actual payment for services becomes redundant. The fly-by-night firm liquidates and returns the received VAT to the beneficiary company, in the form of bonds, for example.

The actual beneficiaries of these schemes are legal enterprises that wish to avoid direct involvement with evasion activities. In fact, these enterprises are not involved in the creation of fly-by-night firms, but rather use readily available solutions. The specificity of the Russian market for tax minimization schemes is such that these services are supplied by banks, created specifically for such illegal purposes by some financial company. The head company deals with the creation and liquidation of fly-by-night firms, makes contact with potential clients, and uses its subordinate banks to conduct transactions. If detected, the bank, and not the client company, bears the greatest amount of risk because it is difficult to prove that the client company actually knew about illegal intentions of the fly-by-night firm. In this view, the Central Bank's recent reform which raised capital requirements and thus led many small banks to cease to exist, should have contributed significantly to the fight against fly-by-night firms.

Another noticeable feature of VAT-related schemes is the manipulation of the transaction price.[86] At first glance, this calls for the development of formal procedures to determine the fair market price, but in the context of a bureaucratic culture of a developing country like Russia, these procedures may be actually quite harmful as they

give tax authorities discretion to interfere with market mechanisms and thereby create rents. It is more advisable to make these procedures applicable through the courts rather than through tax inspectors.

It must be noted that tax authorities do not remain idle in this respect; on the contrary, the number of liquidated firms and the amount of imposed penalties has grown, and regular checks and special operations have been undertaken. Thus, the continuing popularity of fly-by-night firms can be explained only by the poor capacity of tax authorities to fight this phenomenon. We now elaborate on possible failures, which can happen either at the registration stage, the detection stage, or at the prosecution stage.

It seems that the most important stage when failures should be minimized is the registration stage. As we have noted above, the possibility of registering a firm by providing false information is key to the operation of fly-by-night firms, as it protects from prosecution. A new law,[87] effective July 2002, which regulated registration of new firms, did much to combat such fraudulent registration. The new law simplified the process of registration through the principle of one window and, perhaps most importantly, consolidated the registration of firms as legal entities and as taxpayers to fall under the purview of one organization, the Ministry of Taxation. Previously, it was not uncommon that a firm would register with the state but fail to register as a taxpayer. It was also hoped that shifting the firm registration process to the tax authority would also solve the problem of fly-by-night firms. However, the law did not specify procedures of verifying this information, or the necessary time frame for doing so. The law also did not have any specific punishment for providing false information at the registration stage, but rather relied on general rules promulgated by administrative and criminal codes. Possible

reforms of the law are being debated at this time and hopefully there will be improvements in the near future. Even with current legislation, progress can be made by improving coordination between tax authorities, enforcement agencies (e.g., the militia), and passport registration bureaus. Government officials hope that creation of a database of lost passports – a project to be launched in 2006 – will facilitate the collaboration. Today, informational exchange between tax authorities and militia is limited because each entity uses different programming products, which allows for registration with incorrect information or documents, such as a person's lost passport.

If a firm has been successful in registering with false information, it will continue with its plan of tax evasion. The question then becomes whether or not these actions would be detected. In addition to the database of lost passports, the government plans to create a database of VAT invoices, which would allow it to compare invoices of sellers and buyers and to identify potential cases of fraud. Although this may be a good idea in theory, in practice, administrative costs of comparing fourteen billion invoices every year in Russia would be prohibitive, especially considering the already limited resources of the tax authority. Characteristics of firms themselves could also be used to identify potential fly-by-night firms – those with a small capital but large transactions, where the founder is usually a single physical person, and which do not report taxes regularly. The task now is to incorporate this filter into legal procedures, which would allow tax authorities to narrow their focus on a group of selected firms.

In the case that illegal actions of a fly-by-night firm are detected, tax authorities submit the case to the court, demanding liquidation of the firm and prosecution of the participants. Such cases are never simple, however, because there is usually only indirect

evidence of the involvement of the actual players rather than the nominal ones (i.e., those whose names appear in registration documents) and even less evidence as to illegal intent. Court practices of handling these kinds of cases have yet to be developed, both in terms of the court's literacy on the subject of taxation, and in terms of the creation of precedents of decisions based on indirect evidence.

Economic intuition suggests that a firm would undertake an illegal activity only if the expected benefits of doing so are greater than the expected costs, which are determined by the likelihood of detection and possible losses in that case. The factors discussed above point to the fact that the probability of detection remains low, and there still is much room for improvement in this area. Such efforts themselves would not be effective unless accompanied by stricter punishment standards, both by increasing the amount of fines and by providing for personal liability, including criminal liability, for managers involved in tax avoidance schemes. Let us now briefly touch on other methods of tax avoidance specific to the VAT.

Falsified Export Operations

From the beginning, Russia adopted a destination method of treating trade with non-CIS countries. As the system of receiving export rebates had gradually improved, firms had greater incentive to shape their sales in the form of exports to exempt them from VAT, which could be accomplished through several methods. For instance, firms could export the goods, re-import them into the country, and then sell them on black markets. Alternatively, firms could sell the goods domestically and hope to receive a rebate on the

claimed exports before it was detected that the goods had never left the country. Close cooperation between tax and customs authorities is needed to counteract such fraudulent activity. In terms of legislation, the legislature should introduce a measure stating that export rebates will be granted only after the goods cross the border and the transaction is recorded by customs authorities. Since July 1, 2001, the power to grant tax rebates is held by local tax inspectors if the amount of the export does not exceed five million rubles a month or if the exporter is a traditional one, i.e. performing such business on a regular basis. If an export operation is larger than five million rubles per month or is an irregular transaction, then the decision is delegated to a higher level department in the Ministry of Taxation.

Fake invoices

By calculations of the Ministry of Finance, the amount of claimed VAT rebates in 2002 was 78.6 percent of VAT owed to the budget. This figure rose to 81.5 percent in 2003 and reached 85 percent in 2004. Many believe that large portions of these claims are generated from fake invoices. Firms can either produce a completely fake invoice[88] (which is more likely to be detected because invoices are registered documents and are identified by unique numbers) or by purchasing an invoice from another firm that actually purchased inputs but cannot claim credit on them, because the Ministry of Taxation is reluctant to grant them. For example, this could be a firm that has negative liability on VAT or a firm whose output is exempt, such as an exporter, and who finds it

difficult to receive tax credit. Thus a black market for false invoices exists, and the value of an invoice is exactly the sum of the VAT calculated for it.

False Accounting Records

The falsification of accounting records is a type of evasion to which the Russian VAT is especially vulnerable. Deviations in accounting records are more difficult to detect than the production of fake invoices. Since this kind of evasion can only be fought by conducting periodic checks, tax laws must set clear standards for the registration and accounting of invoices, in order to reduce costs of such checks and improve their efficiency. The difficulties that hamper an accounting-based system of VAT could also be resolved by the transition to an invoice-based system of VAT, which makes the checking process more automated, since it is sufficient to compare amounts stated in invoices to the actual amount of tax paid.

Appendix

Table 4.1. Characteristics of Russian VAT as of year 2009

(chapter 21 of the Part II of the tax code)

date introduced	1992
base rate	18%
discounted rate	10%: agricultural products, foodstuffs, products for children, periodicals, books, a list of medical products
threshold, scope	Tax period is three months. The threshold is then 2 million roubles of turnover for the last three months (except: for firms and/or individual enterpreneurs selling excises or involved in import operations)
	Excluded are foreign companies related to Winter Olympic games of 2014 in Sochi
exempted transactions and agents	renting out space to foreign companies registered in Russia
	a relatively short list of "important" medical devices, equipment for disabled, glasses, orthopedic products
	a relatively short list of private medical services, related to diagnostic, transportation, giving birth, care for the elderly
	transportation, except taxi
	housing - sales and rental
	culture and entertainment (including cinema, but only movies approved by the government), sport events
	recreation services
	patents and licensing of intellectual property
	creation of technological innovations
	religious organizations
	production and services by disabled
	sales to foreign companies involved in the organization of Winter Olympic games
zero rating	Export operations and free trade zones, related transportation services
	Passenger transportation outside the country
	Products and services related to activity in the outer space
	Products and services for foreign diplomats, missions, etc
	Russian-built ships
burden of proof to claim zero rating:	necessary documents to claim rebates on export:

	copy of the contract
	a notification from the bank confirming the receipt of payment for the goods sold (services procured)
	customs declaration
	copy of transportation documents with a stamp of customer border control
	the time frame of 180 days
	these documents are submitted together with tax declaration
determination of taxable event	Accrual method. The taxable event occurs at the earliest of the dates:
	1) receipt of payment
	2) delivery of the good or service, or the transfer of property rights
	Advance payments, partial payments are included in the tax base, except when the production cycle exceeds 6 months.
	In that case, the taxpayer has the right to determine the taxable event as the date of delivery (finishing the construction, etc).
	Barter, transfers of property, bequests are included in the tax base at market prices
treatment of VAT credits	VAT paid on inputs for production of goods and services, subject to VAT taxation, is to be deducted from VAT liabilities. For capital goods, this happens only after they are put on the balances.
	VAT paid on inputs allocated to the production of exempt goods and services, and also VAT paid by
	enterprises who are not VAT taxpayers, can be included in the cost of production (deduced from the profit tax).
negative VAT liability	If VAT credits exceed VAT liabilities in some tax period, the difference is to be reimbursed from the budget.
	After they receive the tax declarations, tax inspectors can perform checking the validity of such claims, and if the result is positive, the decision to reimburse has to be made within 7 days, and money must be returned within 5 days from such decision.
	If at the time of such claim the taxpayer is overdue on his payment of taxes ore fines to the budget, then the negative VAT liability is contributed towards the overdue items.
	The time frame for filing the tax declaration that claims such reimbursement is three years.
VAT invoices	VAT invoices, together with tax declaration, is the basis for claiming a deduction of VAT credits from VAT liabilities
	The seller has to issue an invoice emphasizing the amount of tax, to the buyer, within 5 days of the transaction (delivery or payment).
	There is no such requirement for retail transactions; it is enough if the receipt contains the amount of tax
treatment of trade	Destination principle.
revenues	as % of tax revenues, as % of GDP

Table 4.2. Projected Revenue Losses by VAT, 1993-94 and 2000-2003
(As a Percentage of GDP)

	1993	**1994**	**2000**	**2001**	**2002**	**2003**
Exemptions	0.61	1.62	0.97	0.86	0.81	0.80
10% rate	0.24	4.13	0.38	0.44	0.54	0.45
Total (% of GDP)	0.85	5.75	1.35	1.29	1.35	1.24

Source: Appendix to federal budget for various years; author's calculations; GDP data from Ministry of Finance.

Table 4.3. Actual Revenue Losses by VAT, 1997-2003

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Exemptions	1.68	1.42	1.9	2.14	1.2	1.39	1.17
10% rate	0.42	0.27	0.27	0.27	0.42	0.42	0.4
Total (% of GDP)	2.1	1.69	2.17	2.41	1.63	1.81	1.57
Total (% of VAT)	28.44	28.38	36.5	38.5	23.6	26.1	23.7

Source: Ministry of Taxation; Ministry of Finance; calculations by Institute of Economies in Transition (IET).

Table 4.4. Planned Revenue Losses due to Exemptions and 10 percent Rate, by Type of Exemption, 2002.
(As a Percentage of GDP)

Total revenue	10.3
Selected exemptions	1.22
Public health	0.43
Transportation	0.14
Education and culture	0.25
Research and development	0.13
Rental of housing	0.26
Invalids	0.01
10% rate	1.04

Source: Ministry of Finance; author's calculations.

Notes

[1] This article was written while the author was a graduate student of economics at Columbia University. I thank Roger Gordon, as well as an anonymous referee for helpful comments. Special thanks to Ilya Trunin of Institute of Economies in Transition in Moscow (www.iet.ru), whose writings on Russian VAT (in Russian) have helped me a great deal in preparing this material.

[2] For a more detailed discussion of turnover and sales taxes, see Summers and Sunley, IMF working paper, 1995.

[3] The Commonwealth of Independent States is a supranational body formed after the breakup of Soviet Union, consisting of former republics whose aim is cooperation in both economic and political spheres.

[4] Ruling of Presidium of VS RF and Ministry of economy and finance RF of 3.02.1992 №2264-1 "O social'noj zaschite naseleniya i ob uporyadochenii regulirovaniya cenoobrazovaniya na otdel'nye vidy produkcii."

[5] Law of Russian Federation "O vnesenii izmenenij i dopolnenij v Zakon RSFSR 'O naloge na dobavlennuyu stoimost'" №2813-1 of 22.05.1992.

[6] At that time, this amount was equivalent to US $500. This figure is not quite reliable, however, since the exchange rate was volatile. Source: MICEX.

[7] Law of Russian Federation "O vnesenii izmenenij i dopolnenij v nalogovuyu sistemu Rossii" №3317-1 of 16.07.1992.

[8] Law of Russian Federation "O vnesenii izmenenij i dopolnenij v nalogovuyu sistemu Rossii" №3317-1 of 16.07.1992.

[9] Law of Russian Federation. "O vnesenii izmenenij i dopolnenij v otdel"nye zakony Rossijskoj Federacii o nalogah" №4178-1 of 22.12.1992.

[10] Letter of State Tax Service №ВЗ-4-05/70н and Ministry of Finance №04-03-02 of 29.01.1993 “O poryadke ischisleniya i uplaty naloga na dobavlennuyu stoimost”.”

[11] Ukaz of President RF №2268 of 22.12.1993 “O formirovanii respublikanskogo byudzheta Rossijskoj Federacii i vzaimootnosheniyah s byudzhetami sub’ektov Rossijskoj Federacii v 1994 godu.”

[12] Letter of State Tax Service №VG-4-16/5n of 17.01.94 “O poryadke primeneniya Ukaza Prezident”a RF №2207 of 22.12.1993 “O nekotoryh izmeneniyah v nalogooblozhenii i vo vzaimootnosheniyah byudzhetov razlichnyh urovnej.”

[13] L. Lykov, “Nalogovaya politika: effektivnost’ rychagov i stimulov,” Voprosy ekonomiki, 1994.

[14] Telegram of STS RF №VZ-4-05/10n, Minfina RF №9 of 24.01.1994 “O poryadke vneseniya NDS v byudzhet.”

[15] Ukaz of President of RF №1677 of 10.08.1994 “Ob utochnenii dejstvuyuschego poryadka vzimaniya naloga na pribyl’ i NDS.”

[16] Federal Law №57-FZ of 6.12.1994 “O vnesenii izmenenij i dopolnenij v zakon Rossijskoj Federacii ‘O naloge na dobavlennuyu stoimost.’”

[17] Government order №334 of 15.04.1995 “Ob utverzhdenii zayavleniya Pravitel”stva Rossijskoj Federacii i Central”nogo Banka Rossijskoj Federacii ob ekonomicheskoj politike v 1995 godu i merah po ego realizacii.”

[18] Federal Law №25-FZ of 23.02.1995 “O special’nom naloge s predpriyatij, uchrezhdenij i organizacij dlya finansovoj podderzhki vazhnejshih otraslej narodnogo hozyajstva RF i obespecheniya ustojchivoj raboty predpriyatij etih otraslej.”

[19] Federal Law №63-FZ of 25.04.1995 “O vnesenii izmenenij i dopolnenij v zakon Rossijskoj Federacii ‘O naloge na dobavlennuyu stoimost’.”

[20] Federal Law №222-FZ of 29.12.1995 “Ob uproschennoj sisteme nalogooblozheniya, ucheta i otchetnosti dlya subektov malogo predprinimatel’stva.”

[21] Statement of Government of RF and Central Bank of RF of 22.02.1996 “O srednesrochnoj strategii i ekonomicheskoj politike na 1996 god.”

[22] Ukaz of Prezident RF №685 of 8.05.1996 “Ob osnovnyh napravleniyah nalogovoj reformy v Rossijskoj Federacii i merah po ukrepleniyu nalogovoj i platezhnoj discipliny.”

[23] Government order №914 of 29.07.1996 “Ob utverzhdenii poryadka vedeniya zhurnalov ucheta schetov-faktur pri raschetah po nalogu na dobavlennuyu stoimost.”

[24] Specifically, forms 868 and 868a – invoices of the old style.

[25] Federal Law №25-FZ of 1.04.1996 “O vnesenii izmenenij i dopolnenij v zakon Rossijskoj Federacii ‘O naloge na dobavlennuyu stoimost’.”

[26] Federal Law of 28 april 1997 N 73-FZ.

[27] Order of STS RF №AP-3-03/252 of 29.12.1997 “O vnesenii izmenenij i dopolnenij v instrukciyu Gosnalogsluzhby Rossii” of 11.10.95 №39 “O poryadke ischisleniya i uplaty naloga na dobavlennuyu stoimost.”

[28] Government order № 108 of 2.02.1998 “O vnesenii izmenenij i dopolnenij v postanovlenie Pravitel’stva Rossijskoj Federacii of 29 iyulya 1996 g. №914 “Ob utverzhdenii poryadka vedeniya zhurnalov ucheta schetov-faktur pri raschetah po nalogu na dobavlennuyu stoimost.””

[29] Federal Law of 31.05.1999 N 104-FZ.

[30] Federal Law №36-FZ of 2.01.2000 “O vnesenii izmenenij v zakon Rossijskoj Federacii ‘O naloge na dobavlennuyu stoimost,’” Federal Law №118-FZ of 5 .08. 2000.

[31] Letter of STS №VG-4-16/5n of 17.01.94 “O poryadke primeneniya Ukaza Prezidenta RF” №2207 of 22.12.1993 “O nekotoryh izmeneniyah v nalogooblozhenii i vo vzaimootnosheniyah byudzhetov razlichnyh urovnej.”

[32] Letter of STS of 29.06.2001 №VG-6-03.502.

[33] Federal Law № 179-FZ of 28.12.2001.

[34] Federal Law № 195-FZ of 31.12.2002.

[35] Federal Law № 117-FZ of 5.08.2000, Government order N 914 of 2.12.2000.

[36] Federal Law № 117-FZ of 07.07.2003.

[37] Federal Law №102-FZ of 18.08.2004.

[38] Federal Law № 119-FZ of 22.07.2005.

[39] Federal Law N 63-FZ from 25.04.1995.

[40] Summers and Sunley, IMF working paper, 1995, page 22.

[41] For further discussion, see Summers and Sunley, IMF working paper, 1995, page 13, footnote 4.

[42] Law of Russian Federation “O vnesenii izmenenij i dopolnenij v nalogovuyu sistemu Rossii” №3317-1 of 16.07.1992 . Also, Law of Russian Federation “O vnesenii izmenenij i dopolnenij v Federal Law RSFSR ‘O naloge na dobavlennuyu stoimost’ ” №2813-1 of 22.05.1992.

[43] Law of Russian Federation “O vnesenii izmenenij i dopolnenij v nalogovuyu sistemu Rossii” №3317-1 of 16.07.1992.

[44] Federal Law №25-FZ of 1.04.1996 "O vnesenii izmenenij i dopolnenij v zakon Rossijskoj Federacii 'O naloge na dobavlennuyu stoimost'."

[45] Ukaz Prezidenta RF №1677 of 10.08.1994 "Ob utochnenii dejstvuyuschego poryadka vzimaniya naloga na pribyl" i NDS.

[46] A. Tait. Value Added Tax: International practice and problems. IMF. 1988; H.H.Zee. Value-Added Tax. Tax policy handbook, P.Shome, ed. IMF, 1995.

[47] For details, see "VAT instruction 1" on December 9, 1991.

[48] This form of evasion is most harmful psychologically. From the purely rational point of view, however, underpayment of VAT to the budget is no less harmful than the overpayment of VAT credit.

[49] I thank anonymous referee for pointing this out.
[50] I thank anonymous referee for pointing this out.
[51] Potentially, the origin method creates incentives for tax competition between countries, but this has not been realized in practice.

[52] The other country-members of CIS include Azerbaidjan, Armenia, Belarus, Georgia, Kyrgyzstan, Moldavia, Tadzhikistan and the Ukraine.

[53] See paragraph 1 of article 164 of Tax Code.

[54] Federal Law N 102-FZ of 18.08.2004.

[55] For further discussion on initially introduced exemptions, see Summers and Sunley, IMF working paper, 1995.

[56] Federal Law № 3317-1 of 16.07.1992.

[57] The projected cost is calculated by dividing planned losses by actual GDP of that year.

[58] Federal Law № 63-FZ of 25.04.1995 "O vnesenii izmenenij i dopolnenij v Zakon Rossijskoj Federacii 'O naloge na dobavlennuyu stoimost'."

[59] In general, 1994 was a record year in terms of revenue losses, which increased sevenfold over the previous year (see Table 1).

[60] Government order of 17.07. 1998 №787 "O prodovol'[stvennyh tovarah, po kotorym primenyaetsya stavka naloga na dobavlennuyu stoimost" v razmere 10 procentov.

[61] Federal Law №222-FZ of 29.12.1995 "Ob uproschennoj sisteme nalogooblozheniya, ucheta i otchetnosti dlya sub'ektov malogo predprinimatel'stva."

[62] Federal Law N 109-FZ of 20.08.2004.

[63] Federal Law № 73-FZ of 28.04.1997 "O vnesenii izmenenij v Zakon RF 'O naloge na dobavlennuyu stoimost'."

[64] Federal Law № 36-FZ of 02.01.2000.

[65] Federal Law № 179-FZ of 28.12.2001.

[66] Federal Law № 188-FZ от. 30.11.1995.

[67] Federal Law of 6.01.1999 N 10-FZ.

[68] Federal Law № 117-FZ от. 05.08.2000 (with later modifications).

[69] In fact, this is an important source of revenue for state colleges and institutes.

[70] Law of Russian Federation "O vnesenii izmenenij i dopolnenij v Zakon RSFSR "O naloge na dobavlennuyu stoimost" " " №2813-1 of 22.05.1992.

[71] Federal Law № 63-FZ of 25.04.1995 "O vnesenii izmenenij i dopolnenij v Zakon Rossijskoj Federacii 'O naloge na dobavlennuyu stoimost'."

[72] This preference has existed since 1992, partially because it was unfeasible to enforce it. Only recently has the market of apartment rentals begun to emerge from the shadow economy.

[73] Federal Law № 109-FZ of 20.08.2004.

[74] See “Federal tax arrears in Russia,” M.Ponomareva and E. Zhurvskaya, Economics of Transition, vol. 12, 2004.

[75] Tax administration in particular was regulated by two main laws (as well as numerous letters and instructions from tax ministry): Law of Russian Federation “O gosudarstvennoj nalogovoj sluzhbe RSFSR” of 21.03.1991 g № 943-1 and Law of Russian Federation “Ob osnovah nalogovoj sistemy v Rossijskoj Federacii” of 27.12.1991 № 2118-1.

[76] These powers included the creation of Temporary Emergency Committee in 1996 by the order of President. For many, this committee was reminiscent of a commission with the same name that existed in the 1920s. It was abolished in 1999.

[77] F. Gregory and G. Brooke, “Policing economic transition and increasing revenue: a case study of federal tax police service of the Russian Federation 1992-1998”, Europe-Asia Studies, vol 52 no 3, 2000.

[78] To fight corruption, the law of 1994 was stated that up to 25% of collected penalties could be diverted to material benefits of tax collectors. This measure greatly stimulated the collection of penalties, but not of taxes. Only in 2001 was the measure abolished as ineffective.

[79] The Large Taxpayer Unit was created in 1998.

[80] For a more detailed discussion of novelties and problems of new tax code from the point of view of the tax administration, see “Nekotorye problemy nalogovogo administrirovania,” A. Zolotareva, IET, 2000.

[81] When interviewed as to why they were avoiding paying taxes, many businessmen referred to predatory behavior of tax collectors (for example, the notorious tax police) as

well as uncertainty about claims on their tax liability. Making tax enforcement more civilized, as well as lowering and clarifying tax liabilities, improved the image of tax collection activity, transforming it from an external threat to survival of business to a social service.

[82] For example, the estimated amount of uncollected taxes at the end of 1994 was as high as 2.4 percent of GDP. This number gives an idea about the level of tax discipline in the 1990s.

[83] Federal Law № 154-FZ "O vnesenii izmenenij i dopolnenij v chast' pervuyu Nalogovogo kodeksa Rossijskoj Federacii" 09.07.1999.

[84] For a more detailed discussion of one-night firms, see D. Treisman (1999), "Russia's tax crisis: explaining falling revenues in a transitional economy," Economics and Politics, vol. 11.

[85] Instead of buying directly from a one-night firm, the purchase can also be made through an affiliated firm whose output is exempt from VAT. This is an especially popular tactic among exporters who do not want to have a direct connection with illegal firms.

[86] In some instances, even without help of one-night firms, parties may be able to reduce the total amount of tax liabilities arising from a transaction by manipulating the terms of agreement and by using side payments. For example, a seller can charge artificially low prices in order to reduce his tax liability; in return, a buyer will give him fake credit (a financial transaction, usually not subject to VAT) that will never be paid back. The buyer will have in interest to do so if he has negative liability on taxes that he finds unlikely to be paid by the government or if he is exempt from VAT.

 Federal Law of 08.08.2001 № 129-FZ “O gosudarstvennoj registracii yuridicheskih lits.”

[88] For a review of best practices in this area, see: Jap K.S. “The Value-added Tax Law in Force.” *Bulletin for International Fiscal Documentation*, International Bureau of Fiscal Documentation (Amsterdam), vol. 40, July 1986.