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MEMORANDUM FOR

Mr. Egor Timurovich Gaidar

From: Robert Conrad  
Gina Brosius

Subject: Initial Analysis of Trade Policy

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We recommend that the Russian Federation adopt the following changes in its trade policy:

- Adopt a uniform tariff of 15% (if possible under IMF agreements) with exceptions for certain importers (foreign embassies for instance) and certain commodities (alcohol for instance).
- Eliminate any system of tariff deferrals. That is, the tariff administrative system should be based on cash payment prior to, or at, the time the importers receive the goods.
- Institute a simple duty drawback system.
- Ensure that all government import purchases are fully taxable (to the extent possible, with the only possible exception being national defense).

1. Adopt a Uniform Tariff

The following steps should be employed to implement a uniform tariff.

- Announce that the government will proceed to a uniform tariff in two steps six months apart. Low tariffs will be increased in an amount equal to one-half of the difference between the desired uniform tariff rate and the current rate. High tariffs will be reduced by one-half the difference between the current tariff rate and the desired uniform tariff rate. The second step six months later will complete the process.
- Develop a short list of exempt importers (embassies, donor-financed projects, national defense and perhaps some humanitarian activities) and a second list of higher tariff goods (automobiles, tobacco products, alcohol and perhaps fire arms plus gambling equipment).

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- The tariff changes should be announced this summer, in time for presentation at the meetings regarding Russia's accession to the WTO. The rate changes should be implemented January 1, 1998.
- The announcement should be followed by a well-organized educational campaign to inform investors, agriculture and traders about the economic justification for the policy.
- All tariffs should become due and payable at the time of importation as of January 1, 1998. No goods should be transferred to importers until all tariffs are paid.
- Tariffs on capital goods should not be included in the basis for depreciation. Rather, all tariffs on inputs, including those for capital goods, should be fully deductible for profits tax purposes.<sup>1</sup>

#### A. A Uniform Tariff Provides Uniform Effective Protection

The nominal and effective rates of protection are the same under a uniform tariff system.<sup>2</sup> All domestic industries, regardless of their stage of development, benefit equally at the margin. For instance, a uniform tariff of 15% will provide effective protection of 15% for all goods (primary, intermediate and final) produced in Russia. Such results, while simple in concept, can have profound economic impacts. Differentiated tariffs can lead to significant variation in effective protection rates ranging from negative to large positive rates. These rates are subject to changes in world prices and changes in the domestic production structure. Thus, policy makers wanting to design protection for a particular industry would have to change tariff policy often, in particular every time world prices change, in order to achieve a particular outcome. Instead, under a uniform tariff structure, effective protection rates are immune to world price changes and changes in the domestic production structure. Put simply, "what you see is what you get." In this setting, policy makers can design trade policy with

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<sup>1</sup> This provision is a bit different from standard accounting convention. It is recommended for both simplicity and economic reasons. The degree of protection for capital goods will depend on the depreciation schedule when tariffs are capitalized into the asset basis and recovered through depreciation. That is, the present value of the tariff, and accordingly the economic value of protection, depends on how the tariff is recovered for profits tax purposes. Moving all tariff deductions to a current basis simplifies administration and ensures the intended economic outcome.

<sup>2</sup> Nominal protection refers to the statutory rate. For instance, a statutory tariff of 15% on shirts will imply a nominal rate of protection of 15%. Effective protection is a measure of how domestic profitability changes when tariffs on all inputs used to produce a commodity are incorporated. Effective protection measures can vary significantly from nominal protection rates. For instance, suppose (1) cloth is used to produce shirts, (2) cloth composes 50% of a shirt's cost, valued at world prices and (3) that the tariff on cloth used as an input is 0%. Effective protection would be 30%, or twice as high as the nominal protection rate in this case.

revenue and domestic interests in mind and can, in fact, have a policy which is consistent.

A related point is that it is not possible to fine-tune a tariff schedule to achieve any particular type of protection. Customs classification systems, such as the Harmonized System used in Russia, are crude instruments even though the classifications are reasonably detailed. That is, it is not possible to differentiate some items using a classification system. For instance, it may be necessary to impose a tariff on hammers made of steel with wooden handles weighing less than two kilos in order to protect a particular domestic industry. Such detail is not possible with any general classification system. In addition, scarce administrative resources will be lost trying to make such fine distinctions.

#### B. Uniform Tariffs are Easier to Administer

Under a uniform tariff, customs officials must only worry about valuation and quantities in determining tariffs for all imports. Classifications are not relevant. Thus, customs officials do not have to make distinctions, sometimes arbitrary, about whether particular commodities fit into particular classifications. In addition, importers, and exporters from abroad, do not have an incentive to attempt to reclassify goods in order to avoid, or to reduce, tariffs on certain commodities. The entire system is more transparent. Classification can then proceed according to appropriate criteria.

#### C. Uniform Tariffs Can Be an Anti-Abuse Device

Transfer pricing of inputs, and outputs, is one common method for avoiding, or reducing, profits tax liabilities. One desirable property of a uniform tariff is that the effectiveness of such transfer pricing is reduced. For instance, a business will reduce its profits tax liability 0.35 Rubles for every Ruble of import value for a commodity used as an input. The business will have an incentive to “over invoice” imported inputs from related parties to reduce taxable profit in such situations. In general, the opposite effect is created by imposing a tariff. That is, the importer must pay greater tariffs as import values increase. Almost half the reduced profits tax liability is eliminated when a 15% import tariff is imposed.<sup>3</sup> This offsetting incentive is effective for all taxpayers only if the tariff is uniform and the same valuation rules

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<sup>3</sup> It is possible to create an exact offsetting revenue effect in one of two ways. First, the tariff rate could be equal to the profits tax rate. In general, tariff rates equal to profits tax rates are too high. Second, it is possible to combine a particular type of thin capitalization rule, like the one proposed in Presidential Decree 685, and a lower tariff. This system is a bit more complicated and the transfer-pricing effect is a by-product of the other provisions.

are used for tariffs as well as profits tax purposes. The latter policy is one we continue to recommend.<sup>4</sup>

#### D. Uniform Tariffs Can Increase Tax Revenues

Overall tax revenues can be affected in at least five ways by tariff changes. First, tariff revenues are directly affected by rate changes. Second, excise taxes and value added taxes on imports change when tariff rates change. This results because of the convention used to compute each tax. Ad valorem excise taxes are computed using the tariff-inclusive price of the excisable commodity. The VAT is imposed on the tariff-plus-excise inclusive price of a commodity. A tariff increase will then result in increased excise revenue, if excises are ad valorem, and increased VAT revenue, other things equal.

Third, changes in tariffs on inputs will change the cost of domestically-produced outputs. Other things equal, domestic prices of such outputs will increase and VAT revenues will change accordingly. That is, an increase in the tariff on cloth will increase the price of domestic shirts and thus increase VAT revenues, other things equal. Fourth, tariffs should be allowed as profits tax deductions. Thus, changes in tariffs will change taxable profits which will, in turn, change profits taxes.<sup>5</sup> Fifth, and finally, tariff revenues will change because of changes in administration. This effect should not be understated. Many administrative resources are currently diverted to classification of imports and activities unrelated to revenue collection. These resources could be more productively employed under a uniform tariff. Compliance costs are also reduced for the taxpayer. Thus compliance should increase.<sup>6</sup>

We asked Barents Group staff to make some preliminary revenue estimates of a change to a uniform tariff of 15% (except for tobacco, alcohol and automobiles, which remain at their current tariff levels) using 1996 data.<sup>7</sup> This staff has developed a reasonable methodology to measure direct and indirect effects of tariff changes. No estimate is available for changes in profits taxes at this time, nor is there an estimate for compliance changes. That is, the low level of compliance

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<sup>4</sup> Uniform valuation rules for profits tax and tariff purposes enhance audits of both taxes because cross-checking and cross validation are possible.

<sup>5</sup> There is a federalism element to such changes because VAT and profits tax are currently allocated between the federal and sub-national governments, while tariffs are allocated to the federal government. Complete federal allocation is suggested for tariffs under the proposed code, but the allocation of VAT and profits tax will change. The regional issue remains however.

<sup>6</sup> There might also be general equilibrium effects, but they are ignored here. In addition, there could be effects resulting from changes in the nominal exchange rate, an effect also ignored in this analysis.

<sup>7</sup> A more detailed analysis and description of the revenue-estimating methods can be made available if desired.

(represented by an effective average tariff rate of almost 7% when the average nominal tariff is almost 13%) is maintained. Thus, results are reported for the direct effects of tariff changes, excise and VAT changes on imports, and the indirect effect of changes in domestic VAT due to changes in input costs.

The results are reported in Table 1. The results in Table 1 should be interpreted as how a change in tariffs would have affected central government revenues, had the policy change been made in 1996.<sup>8</sup> No attempt has been made to adjust for future changes in relative prices, exchange rates, inflation or the structure of trade. Percentage changes are more accurate for future estimates in this case. Tariff revenues increase because the overall average tariff increases (from about 13% under current policy), other things equal.<sup>9</sup>

VAT and excise revenues increase because of the tariff increase as well. Excise taxes and VAT are based on the tariff-inclusive price of goods, so the bases of these taxes expand with a tariff change. Domestic VAT revenues increase because the higher tariff on inputs results in a higher domestic price of final output, which increases the VAT collected on that output. Note that the increased VAT revenue from higher tariffs on inputs tends to offset the decreased VAT revenue from lower tariffs on final products.

In summary, revenue effects can be significant when the estimates above are combined with increased compliance and related revenue changes. A quarter point of GDP revenue increase (as a minimum estimate) is a significant benefit during Russia's remaining transition period.

#### E. Uniform Tariffs as a Symbol of Economic Reform

A move to uniform tariffs is a strong signal that the government intends to have the economy develop on a sound basis. Political pressure to change tariffs will be muted because all domestic producers are treated equally. Thus, incentives for rent seeking are reduced. More importantly, a uniform tariff has been interpreted as a symbol of reform. This effect should not be understated. Uniform tariffs, if the government adheres to them, communicate that the government is using tariffs to increase revenue and provide uniform protection. Rationalization of procedure and increased integrity of the system are also communicated by rate changes. Such changes have followed elsewhere because the tariff policy was adopted in the context of an overall reform, a course also necessary in Russia.

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<sup>8</sup> Revenue allocations to regions and local governments are excluded.

<sup>9</sup> No account is taken of the change in the weighted average tariff which might occur because of differences in demand between high-tariff and low-tariff items.

## 2. Possible Criticisms of a Uniform Tariff

The gains from a uniform tariff enumerated above should be weighed against the costs. Some costs are noted below and your group should be prepared to respond to complaints about a uniform tariff policy.

### A. A Uniform Tariff is Not the Optimal Tariff

Uniform tariffs are generally not optimal in a restricted economic sense. Like a uniform VAT, which is not optimal, uniform tariffs do not generally satisfy all the conditions necessary for economic efficiency.<sup>10</sup> Again, like a uniform VAT, the relative efficiency costs of a uniform tariff should be weighed against the benefits of reduced rent seeking, transparency and ease of administration.

### B. Importers of Inputs Will Complain

Inputs into domestic production will generally be taxed more heavily under a uniform tariff. Producers of domestic output will complain that they will be harmed by such a move. It is true that the effective protection rate for such producers will be reduced, other things equal. This is the purpose of the policy, however, and the government should be prepared to address such complaints.

### C. Tariffs on Inputs Will Harm Exporters Who Use Tradable Inputs

Inputs which are tradables can be used to produce outputs which are exported. A tariff imposed on such inputs will increase the cost of the final output, making the domestically-produced commodity less competitive internationally. This is one negative side-effect of a uniform tariff which cannot be compensated by market exchange rate adjustments.

There are three ways to address this problem. First, imports used to produce exports can receive tariff exemptions, either in general or on a case-by-case basis. With some exceptions,<sup>11</sup> this is not a good policy. A general exemption will violate the spirit and intent of the uniform tariff policy and will create a significant loss of revenue. Political pressure will then build for other exemptions. A case-by-case exemption is impossible to administer. That is, it is impossible to grant an exemption and try to recapture revenues if importers violate the rule. In addition, such exemptions favor importers who are direct producers of exports or who are otherwise vertically integrated. Exporters who do

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<sup>10</sup> Free trade is always efficient for small open economies. In addition, differentiated tariffs may be efficient in other situations, but it may not be possible to administer differentiated tariffs.

<sup>11</sup> Drilling equipment under production-sharing agreements is one example.

not import directly are thus put at a competitive disadvantage. For example, a firm that produces shirts and imports cloth may be granted an exemption. A firm which purchases cloth on the domestic market, either imported or domestically produced, will be harmed because the producer cannot get an exemption for a commodity once the commodity is traded domestically.

Second, export-processing zones can be created. We believe this is also bad policy. Integrated producers are the only beneficiaries of such policies. Domestic producers who are seeking export markets and those who are less than completely vertically integrated do not benefit from this policy.

Third, a duty drawback system can be developed. A duty drawback is a method where the producer pays the tariff and then gets a refund for the duty paid when the finished good is exported (or the foreign exchange is received). Domestic producers of import substitutes are still protected, as they should be under a uniform tariff, but exports are relieved of the duty component of cost. Such systems are acceptable under GATT and, more recently, WTO rules. The systems can be simple or complex. We recommend that a simple system acceptable to WTO and reasonably accurate be used in Russia. We recommend that a duty drawback be considered for Russia and implemented as soon as practical. We do not believe that introducing a uniform tariff should be delayed until a duty drawback can be implemented. The benefits of a uniform tariff are sufficient without a duty drawback to justify adoption.

#### D. The 15% Rate May Be Too High for IMF Requirements

We understand that Russia may not be able to increase the average tariff rate under the IMF program. If true, then the 15% rate may be too high. The rate can be reduced in this case. Alternatively, Russia could ask the IMF to consider a 15% rate as a transition measure. We believe that the revenue gains are important and that the IMF may agree to a 15% rate if the tariff is indeed uniform.

#### E. Difficulty with WTO

It will be important to move on a uniform tariff soon. A uniform tariff is a defensible position for any economy and should satisfy WTO requirements. Importers who are foreign investors may complain about increases in tariffs, but the government can justify such increases as part of its overall reform. It is important to mitigate debate, however, by proposing the policy prior to submitting a proposal to WTO. This will reduce transaction costs, increase the creditability of the position and speed the accession process.

### 3. Other Aspects of Trade Policy

We note two additional proposals about tariff policy, in addition to a duty drawback, which should complement the introduction of a uniform tariff.

#### A. Tax Inclusive Budget

All levels of government should pay the full tariff, plus excises and VAT, on imports. We understand that this is stated policy but are not sure it occurs in practice. Such a budget is particularly important for imported goods and services. A type of negative protection is created by exempt government purchases. It is cheaper for the government to import goods and services because of the exemptions since the tariffs increase the domestic price of all import substitutes (both domestically produced and imported). Equally important, taxing government purchases will eliminate the incentive to use government purchases as a means to increase personal consumption. Integrity will be enhanced by reducing one additional incentive for corruption.

#### B. Pay at the Time of Importation

We understand that tariff deferrals are possible under current law and practice. Such deferrals should be eliminated. The administrative advantage of a tariff from the government's point of view is that the government can keep the taxpayer from obtaining the goods if the tariff is not paid. Allowing deferrals eliminates this advantage and compliance will suffer. The general policy should be that the taxpayer cannot receive the goods until all taxes (tariffs, excises and VAT) are paid in full. This is the practice in many countries and should be part of the Russian system. Taxpayers should understand that import taxes are part of the commodities cost and they should be prepared to finance such costs. Cash flow concerns should be reduced after the initial transition.

In summary, we believe a uniform tariff is economically defensible and is a good policy for Russia. We will be happy to provide further analysis and develop other proposals in the trade policy area should you desire.

Thank you for your consideration of this matter.



**Table 1: Change to a 15% Uniform Tariff**

	<b>Change in Value (billion Rubles)</b>	<b>Percent Change in Value</b>	<b>Percent Change in Total Federal Revenue</b>	<b>Percent Change in GDP</b>
<b>Direct Effects</b>				
<i>Change in:</i> Tariff Revenue (Import Duties)	2004	17,96	0,72	0,09
Excise Revenue on Imports	83	1,02	0,03	0,00
VAT on Imports	358	1,96	0,13	0,02
<i>Subtotal</i>	<i>2445</i>	<i>20,94</i>	<i>0,88</i>	<i>0,11</i>
<b>Indirect Effects</b>				
<i>Change in:</i> VAT on Domestic Goods	3810	4,05	1,37	0,17
<b>Total</b>	<b>6255</b>	<b>24,99</b>	<b>2,24</b>	<b>0,28</b>

## Notes:

(1) 1996 is used as the base year.

(2) The results are based on federal government revenue only.

(3) 1996 GDP = 2,256,000 billion Rubles.

1996 Total Federal Government Revenue = 278,683 billion Rubles.

Source: *Russian Economic Trends 1997, vol. 1.*

(4) Revenue estimates performed by Barents Group.