THE POLITICAL ECONOMY OF TAXATION IN CIS COUNTRIES

Luca Barbone and Luís-Alvaro Sánchez**

This note explores selected political economy aspects of taxation in Ukraine, compares that experience with Russia's and draws some insights for the CIS region. Ukraine has been unable so far to carry out a comprehensive tax reform, while Russia has. The lessons drawn from comparing the political economy determinants of these two experiences provide valuable insights on the sustainability of reforms and similar experiences in other CIS countries. This note does not attempt to provide a comprehensive treatment of all these issues, but rather to advance some ideas that can help develop a more systematic look at the political economy of taxation in the region.

The note begins with a brief overview of the introduction of modern taxation methods during the Nineties. The note shows why comprehensive reform became a necessity. It follows with a simple framework to consider the political economy issues of taxation in the region. Afterwards, the Ukrainian situation is examined in some detail with a focus on how the legislature has addressed taxation issues and the twin problems of tax arrears and tax exemptions. The note continues with a comparison with Russia's successful experience at comprehensive tax reform. The paper concludes by considering the applicability of the insights obtained to other CIS countries as well as to understanding the sustainability of fiscal institutions in the long-term.

Introduction

CIS countries inherited a similar institutional framework. However, the speed and characteristics of the transition to market economies as well as the emerging political systems have differed across countries. In politics, the spectrum ranges from authoritarian one-man rule, to semi-democratic arrangements. In economics, some countries relish and try to hold on the past, while others have introduced a variety of institutional changes geared to sustaining a market economy. Ukraine represents some sort of middle ground on both accounts. In fact, Ukraine provides a good example of the particular characteristics of the political economy of transition, characterized by considerable muddling-though. The Russian experience, although different, shares similar aspects with Ukraine.

This note emphasizes that political economy in CIS countries has emerged in an environment of incomplete institutions, collapsing political control and enforcement regimes, and shrinking economic activity. This confusing and opaque

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environment put strains on governance. The high costs of operating in this environment favored the appearance of highly concentrated economics and interest groups, which have sought partnership with political parties (often creating them) to gain protection of the state and the opportunities it provides. Gradually, however, countries have succeeded in introducing harder budget constraints and economic activity has rebounded. In this new environment, the new power groups reportedly seek to legitimize their wealth and hence favor greater transparency in their dealings with government and improved institutions overall. This observation is just a working hypothesis, that can only be tested with the passing of time.[1]

The introduction of modern tax systems in the CIS countries has not been smooth, as the complementary market institutions were not in place. The resulting tax systems have been fractured because of exemptions and special treatments, and have become difficult to apply (for government and taxpayers). Hence, the need for comprehensive tax reform as the economic situation improves and greater financial discipline comes into place. However, approval of clearer and simpler rules for taxation and elimination of special treatments is not straightforward, as special interests have emerged. Approval of such type of reforms requires the acquiescence of the legislative, which entails the ability of disparate political forces to cooperate. The experiences of Russia and Ukraine provide valuable insights into how this may or may not come about.

1. A decade of taxation efforts

The Soviet Union at the heyday of Stalinism was probably a classical predatory state, where the state appropriated resources and allocated them at the discretion of the party. This situation softened afterwards and certainly during perestroika. After the collapse of the communist party and the breakup of the Soviet Union, a new dynamics emerged as countries began adapting their tax systems, introducing new legislation and setting up tax agencies. Taxation is a pillar of a market economy; however, it cannot be fully set in place, unless other pillars are also in place (accounting, financial discipline, etc.). This necessarily means a gradual introduction of the new tax rules. It also means that, despite advances made in introducing new tax legislation and accounting standards and setting operating administrative enforcement agencies, the emerging set of rules and their enforcement became inconsistent, complicated and inadequate. Tax practices became a matter of significant controversy either because of failure to mobilize needed resources to assure fiscal balances, or because of the negative effects on the business environment and their association with corrupt practices. Hence, the need emerged for comprehensive tax reform in CIS countries.[2] This section briefly

[1] CIS countries, contrary to Central Europe accession countries, do not have external oversight over the quality of their institutions.

[2] The note focuses on Ukraine and Russia, but current concern with comprehensive tax reform extends to most other CIS countries.

highlights key aspects of the evolution of the tax systems in CIS countries during the first decade of transition.

1.1 Revenue mobilization: divergent experiences

Tables 1 to 6 present basic information on the revenue performance of CIS countries. This information allows some general observations. Of the twelve countries of the Former Soviet Union (FSU) (excluding the Baltic countries), seven collect in taxes 20 per cent or less of GDP. All of these countries are either in the Caucuses or in Central Asia. Uzbekistan is the exception. Russia, Ukraine, Belarus, and Moldova, are all above 20 per cent. Although, there is a rough correlation with income per capita, there are significant variations for similar levels of income. For instance, in Moldova the share of taxes over GDP is rather high for the reported level of income per capita, which is the lowest in the region. Also, in the lower group, some of the countries have made impressive improvements in revenue mobilization since the mid-Nineties. Georgia, Armenia, and Turkmenistan are cases in point. In Georgia, particularly revenue performance dropped significantly after independence as a result of war and the overall collapse of the control structure in the country. Armenia shared a similar fate. This shows that this countries have been able to improve their revenue mobilization capacity, regardless of their lower level of incomes. Tajikistan and Azerbaijan on the other hand show a decline in their revenue performance.

1.2 Introducing new tax systems: the need for comprehensive tax reforms

From a political economy perspective, it is important to note that the tax systems introduced in the CIS countries after independence did not arise out of a structured political process with broad stakeholder participation. As a matter of fact, economic agents in the socialist system did not have a clear perception of their individual tax burden. The design of the new tax systems (rates, bases) was driven by the need to mobilize the resources necessary to maintain the received patterns of public expenditure and the desire to mimic the design requirements of a market economy.

Tax system designs have evolved gradually over the last decade, in a long and iterative process.[3] Initially, experts voiced the concern that a gradual introduction of the new taxation institutions would make it more difficult to achieve modern comprehensive systems in the long-term, as emerging vested interests would slow down fundamental change. Also, there was the fear that continuous changes in tax rules would cause instability and uncertainty and undermine the development of domestic entrepreneurship and foreign investment. Both of these risks have

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3 Martinez-Vasquez and McNab (1997, updated 2000) presents an excellent review and analysis of this process.

Table 1

Composition of Revenue in Eastern and Central European, Baltic and CIS Countries[1]

(average; percent of GDP)

	2000 GDP per capita (US$) [2]	Sample Size	Total Revenue and Grants	Tax Revenue	Other Revenue and Grants	Sample Size	Total Revenue and Grants	Tax Revenue	Other Revenue and Grants
Central and Eastern Europe and the Baltics									
Albania	1,100	1992-95	24.5	18.1	6.4	1996-00	19.8	16.1	3.7
Bulgaria	1,470	1992-95	37.8	30.8	7.0	1996-00	36.5	29.1	7.4
Croatia [3]	4,180	1994-95	42.5	40.8	1.8	1996-00	43.0	40.8	2.2
Czech Republic	4,940	1994-95	44.4	40.3	4.1	1996-00	40.3	36.6	3.7
Estonia	3,510	1991-95	38.8	36.4	2.4	1996-00	39.1	36.7	2.3
Hungary	4,550	1991-95	52.7	40.9	11.8	1996-00	45.9	36.1	9.8
Latvia	3,010	1994-95	36.7	33.7	3.0	1996-00	39.7	34.0	5.8
Lithuania	3,040	1990-95	34.5	32.0	2.5	1996-00	31.5	30.1	1.3
Macedonia	1,760	1991-95	40.8	38.8	2.1	1996-00	35.2	32.3	2.8
Poland	4,100	1992-95	44.8	37.4	7.4	1996-00	41.3	34.4	6.9
Romania	1,640	1990-95	36.2	31.8	4.4	1996-00	31.1	28.6	2.6
Slovak Republic	3,540	1992-95	46.4	39.1	7.3	1996-00	43.1	36.9	6.2
Slovenia	9,160	1991-95	43.6	37.9	5.7	1996-00	42.8	40.1	2.6
Unweighted Average - Central and Eastern Europe and the Baltics	3,540		40.3	35.2	5.1		37.6	33.2	4.4
CIS									
Armenia	500	1994-95	23.8	12.9	10.9	1996-00	20.0	16.6	3.4
Azerbaijan	660	1992-95	35.8	23.4	12.4	1996-00	19.2	14.7	4.5
Belarus	860	1992-95	46.5	41.4	5.1	1996-00	42.9	39.7	3.3
Georgia	560	1994-95	9.2	5.0	4.2	1996-00	14.9	12.8	2.1
Kazakhstan [4]	1,230	1994-95	18.2	17.7	0.6	1996-00	18.5	17.1	1.4
Kyrgyz Republic	270	1994-95	24.7	20.2	4.5	1996-00	21.7	17.7	3.9
Moldova	360	1992-95	27.7	23.7	4.0	1996-00	30.7	26.0	4.7
Russian Federation [5]	1,730	1992-95	36.0	32.1	4.0	1996-00	35.5	29.4	6.1
Tajikistan	160	1991-95	35.8	33.7	2.2	1996-00	13.2	12.7	0.5
Turkmenistan [6]	850	1994-95	18.7	16.5	2.2	1996-00	22.4	20.0	2.4
Ukraine	640	1991-95	38.1	35.0	3.1	1996-00	36.0	33.2	2.8
Uzbekistan [7]	550	1992-95	32.8	26.4	6.4	1996-00	30.6	29.1	1.5
Unweighted Average - CIS	700		28.9	24.0	4.9		25.5	22.4	3.0
Overall Unweighted Average	**2,180**		**34.8**	**29.8**	**5.0**		**31.8**	**28.0**	**3.8**

[1] Consolidated General Government unless indicated otherwise.
[2] At the official exchange rate.
[3] Consolidated Central Government.
[4] Government Budgetary Operations.
[5] Enlarged Government Budget.
[6] State Budget.
[7] Excluding extrabudgetary funds.

Sources: IMF country documents and IMF and World Bank staff estimates.

Table 2

Tax Structure of Eastern and Central European, Baltic and CIS Countries[1] by Selected Tax Group

(average; percent of GDP)

	Sample Size	Taxes on Income, Profits and Capital Gains	Social Security and Payroll Taxes	Domestic Taxes on Goods and Services	Sample Size	Taxes on Income, Profits and Capital Gains	Social Security and Payroll Taxes	Domestic Taxes on Goods and Services
Central and Eastern Europe and the Baltics								
Albania	1992-95	2.7	3.5	7.3	1996-00	1.8	3.8	6.7
Bulgaria	1992-95	8.9	10.7	8.4	1996-00	8.2	7.7	10.6
Croatia [2]	1994-95	4.5	13.7	18.1	1996-00	4.8	14.0	18.3
Czech Republic	1994-95	10.3	15.8	11.5	1996-00	8.9	14.7	11.0
Estonia	1991-95	12.7	10.6	11.7	1996-00	10.2	12.1	13.0
Hungary	1991-95	10.1	12.9	13.3	1996-00	8.9	10.4	13.8
Latvia	1994-95	7.8	12.0	10.6	1996-00	8.1	11.5	12.4
Lithuania	1990-95	11.2	7.6	11.3	1996-00	8.5	8.2	11.7
Macedonia	1991-95	7.6	17.5	10.1	1996-00	5.8	11.3	11.2
Poland	1992-95	12.4	9.2	10.5	1996-00	10.0	9.5	11.7
Romania	1990-95	11.7	9.6	8.1	1996-00	8.6	9.1	8.6
Slovak Republic	1992-95	12.3	11.6	13.0	1996-00	9.2	13.7	11.2
Slovenia	1991-95	6.7	15.5	11.8	1996-00	7.7	13.9	14.8
Unweighted Average - Central and Eastern Europe and the Baltics		9.1	11.5	11.2		7.7	10.8	11.9
CIS								
Armenia	1994-95	6.4	1.8	3.5	1996-00	3.9	2.5	7.7
Azerbaijan	1992-95	7.8	6.6	8.0	1996-00	4.9	2.4	4.9
Belarus	1992-95	12.0	11.6	16.2	1996-00	7.6	10.3	18.0
Georgia	1994-95	1.6	0.9	1.9	1996-00	2.7	2.3	5.6
Kazakhstan [3]	1994-95	5.6	6.3	3.6	1996-00	5.3	4.9	5.8
Kyrgyz Republic	1994-95	4.9	5.9	7.8	1996-00	2.5	4.9	8.8
Moldova	1992-95	7.4	5.7	9.1	1996-00	4.4	6.9	11.9
Russian Federation [4]	1992-95	10.9	8.9	8.7	1996-00	7.2	8.2	9.2
Tajikistan	1991-95	11.5	8.3	11.6	1996-00	2.5	1.2	6.5
Turkmenistan [5]	1994-95	4.9	3.5	8.1	1996-00	5.3	4.4	8.9
Ukraine	1991-95	12.4	10.5	11.2	1996-00	10.1	10.2	10.4
Uzbekistan [6]	1992-95	9.5	0.5	14.6	1996-00	10.1	0.0	15.2
Unweighted Average - CIS		7.9	5.9	8.7		5.5	4.9	9.4
Overall Unweighted Average		**8.5**	**8.8**	**10.0**		**6.7**	**7.9**	**10.7**

[1] Consolidated General Government unless indicated otherwise.
[2] Consolidated Central Government.
[3] Government Budgetary Operations.
[4] Enlarged Government Budget.
[5] State Budget.
[6] Excluding extrabudgetary funds.

Sources: IMF country documents; and IMF and World Bank staff estimates.

Table 3

Tax Structure of Eastern and Central European, Baltic and CIS Countries:[1] by Individual Tax

(average; percent of GDP)

	Sample Size	Individual Income Taxes	Corporate Income Taxes	Social Security and Payroll Taxes	General Sales, Turnover, Value-Added Taxes	Excises	Sample Size	Individual Income Taxes	Corporate Income Taxes	Social Security and Payroll Taxes	General Sales, Turnover, Value-Added Taxes	Excises
Central and Eastern Europe and the Baltics												
Albania	1992-95	0.2	2.5	3.5	3.4	3.9	1996-00	0.4	1.3	3.8	5.4	1.3
Bulgaria	1992-95	4.7	4.1	10.7	5.3	3.1	1996-00	4.3	3.9	7.7	7.8	2.8
Croatia [2]	1994-95	3.7	0.9	13.7	14.0	4.1	1996-00	3.3	1.4	14.0	13.7	4.5
Czech Republic	1994-95	5.0	5.3	15.8	7.3	4.2	1996-00	5.2	3.7	14.7	7.2	3.8
Estonia	1991-95	7.8	4.9	10.6	8.7	1.6	1996-00	8.3	1.9	12.1	9.5	3.5
Hungary	1991-95	7.0	2.5	12.9	7.1	4.6	1996-00	6.8	2.1	10.4	8.1	3.5
Latvia	1994-95	5.0	2.8	12.0	9.0	1.6	1996-00	5.9	2.2	11.5	8.7	3.8
Lithuania	1990-95	5.7	5.6	7.6	8.3	2.6	1996-00	7.2	1.3	8.2	8.0	3.3
Macedonia	1991-95	6.2	1.4	17.5	6.9	3.3	1996-00	4.8	1.0	11.3	5.3	5.5
Poland	1992-95	8.7	3.7	9.2	8.0	2.5	1996-00	7.2	2.7	9.5	7.8	3.9
Romania	1990-95	6.9	4.8	9.6	7.0	1.1	1996-00	3.8	3.3	9.1	5.6	2.2
Slovak Republic	1992-95	4.9	7.4	11.6	9.8	3.2	1996-00	5.4	3.8	13.7	7.9	3.3
Slovenia	1991-95	6.0	0.6	15.5	11.2	0.1	1996-00	6.5	1.1	13.9	13.9	0.3
Unweighted Average - Central and Eastern Europe and the Baltics		5.5	3.6	11.5	8.2	2.7		5.3	2.3	10.8	8.4	3.2
CIS												
Armenia	1994-95	1.3	5.2	1.8	3.0	0.5	1996-00	1.6	2.0	2.5	5.6	2.1
Azerbaijan	1992-95	1.8	6.0	6.6	5.3	2.6	1996-00	2.1	2.8	2.4	4.0	0.9
Belarus	1992-95	0.0	12.0	11.6	..	..	1996-00	0.0	7.6	10.3	..	..
Georgia	1994-95	0.6	1.0	0.9	1.8	0.1	1996-00	1.7	1.0	2.3	4.3	1.2
Kazakhstan [3]	1994-95	..	..	6.3	..	..	1996-00	..	..	4.9	..	..
Kyrgyz Republic	1994-95	1.9	3.1	5.9	5.1	1.6	1996-00	1.2	1.2	4.9	5.5	1.9
Moldova	1992-95	2.1	5.2	5.7	5.9	3.2	1996-00	2.1	2.3	6.9	8.3	3.5
Russian Federation [4]	1992-95	2.5	8.4	8.9	7.7	1.0	1996-00	2.7	4.5	8.2	6.7	2.5
Tajikistan	1991-95	2.3	7.2	8.3	7.3	4.2	1996-00	1.1	1.3	1.2	6.0	0.5
Turkmenistan [5]	1994-95	0.9	4.1	3.5	7.1	1.0	1996-00	1.6	3.7	4.4	7.4	1.5
Ukraine	1991-95	2.8	9.2	10.5	10.1	1.0	1996-00	3.4	5.6	10.2	7.2	1.2
Uzbekistan [6]	1992-95	2.7	6.9	0.5	7.1	7.5	1996-00	3.9	6.2	0.0	7.6	7.6
Unweighted Average - CIS		1.7	6.2	5.9	6.0	2.3		1.9	3.5	4.9	6.3	2.3
Overall Unweighted Average		**3.8**	**4.8**	**8.8**	**7.2**	**2.5**		**3.8**	**2.8**	**7.9**	**7.5**	**2.8**

[1] Consolidated General Government unless indicated otherwise.
[2] Consolidated Central Government.
[3] Government Budgetary Operations.
[4] Enlarged Government Budget.
[5] State Budget.
[6] Excluding extrabudgetary funds.

Sources: IMF country documents; and IMF and World Bank staff estimates.

Chart 1

Central and Eastern Europe and BRO Countries:
Average Total Tax Revenue, 1990-2000
(percent of GDP)

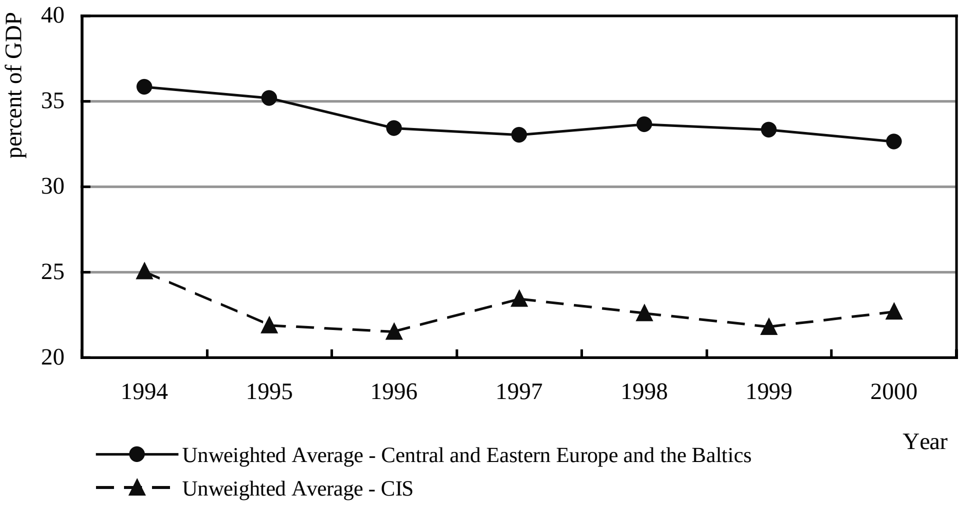
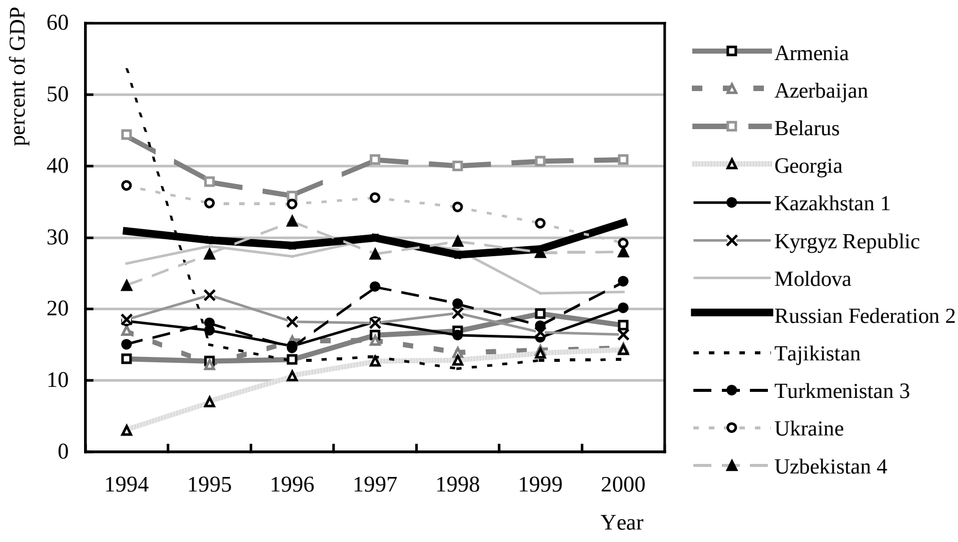


Chart 2

CIS Countries: Total Tax Revenue, 1994-2000
(percent of GDP)



1 Government Budgetary Operations.
2 Enlarged Government Budget.
3 State Budget.
4 Excludes extrabudgetary funds.

Sources: IMF country documents and IMF and World Bank staff estimates.

materialized to different degrees in all CIS countries. However, it is hard to imagine an alternative scenario. To begin with, CIS countries did not have the institutional basis required for a market economy, as these countries had not engaged in a gradual transition before the collapse of socialism as had been the case of Central Europe. Lacking a proper sustaining environment (good accounting, payments discipline), the new tax systems, of necessity, had to be introduced gradually, by trial and error.

Some countries tried to introduce complete tax systems emulating best international practices. This was the case of Georgia, where, however, the initial blueprint was gradually distorted to accommodate local interests and very active legislatures. Georgia faces again the need for comprehensive tax reform. Overall the tax law (policy and procedures) in CIS countries has been a mix of old and new rules, difficult for both taxpayers and tax officials to follow, setting thus the basis for a high degree of arbitrariness.

Table 4

Russian Federation: General Government Revenues, 1997-2002
(percent of GDP)

	1997	1998	1999	2000	2001	2002 (preliminary)
Total Revenue	37.1	32.9	34.0	37.1	37.1	36.1
Tax Revenue	36.0	31.5	32.3	35.3	34.9	33.8
Profits Tax	4.1	3.6	4.6	5.5	5.7	4.5
Personal Income Tax	3.0	2.6	2.5	2.4	2.8	2.9
VAT	6.9	6.2	6.0	6.3	7.1	7.2
Excises	2.5	2.6	2.3	2.3	2.7	2.4
Trade Taxes	1.1	1.2	1.8	3.1	3.6	3.0
Resource Extraction Tax	1.4	0.8	0.9	1.1	1.4	2.2
Social Security Taxes	9.2	8.1	7.8	7.9	7.4	8.0
Other	7.6	6.4	6.4	6.8	4.1	3.7
Non-Tax Revenue	1.1	1.4	1.7	1.8	2.2	2.3

Source: Ministry of Finance.

Table 5

Ukraine: Consolidated Budget Revenues, 1998-2002
(percent of GDP)

	1998	1999	2000	2001	2002 (first half)
Total Revenue	37.7	33.8	36.5	36.5	30.1
Tax Revenue	31.3	28.2	27.3	27.4	21.7
Profits Tax	5.8	4.9	4.5	4.1	4.3
Personal Income Tax	3.5	3.4	3.8	4.3	5.2
VAT	7.3	6.4	5.6	5.1	6.6
Excises	1.3	1.4	1.3	1.3	1.9
Trade Taxes	0.9	1.0	0.9	1.0	1.1
Resource Extraction Tax	1.5	1.1	1.2	1.1	1.2
Social Security Taxes	10.0	9.0	8.9	9.3	…
Other	1.1	1.1	1.2	1.2	1.4
Non-Tax Revenue	6.4	5.5	9.2	9.0	8.4

Note: Total tax revenue for the first half of 2002 excludes Social Security Taxes.

Source: Ministry of Finance.

Most countries adopted high rates of taxation for their level of per capita income. For instance, most CIS countries adopted VAT at a rate of 20 per cent. However, over time, as constituencies and stakeholders feel the burden of taxation and increasingly voice their concerns, there has been an effective pressure to reduce the rates of taxation. Some of that pressure has come about in the form of the search for special treatments and exemptions. Lately, however, as will be reported later, the initiatives have been geared to reduce the overall level of tax rates across the board.

1.3 Main taxes

A brief look at the developments at individual taxes helps garner a better understanding of the challenges of introducing a new tax system in CIS countries.[4]

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[4] A review and detailed analysis of the current tax situation can be found in Mitra, P and Stern N. (2002).

Table 6

Tax Structure in CIS Countries, 2000
(percent of GDP)

	VAT	Excises	Trade Taxes	Profits Taxes	Income Taxes	Social Security Taxes	Total Taxes	Total Non-Tax
Armenia	6.5	2.5	0.8	2	1.4	2.3	17.7	1.2
Azerbaijan	4.1	0.5	2.1	2.7	2	2.3	14.6	6.3
Georgia	4.9	1.5	0.9	1.3	1.8	2.4	14.3	0.8
Kyrgyz Republic	4.8	2.4	0.4	1.1	1.1	3.5	15.8	2.6
Moldova	8.2	4.1	1.4	1.7	1.1	6.1	26.6	3.7
Tayikistán	2.5	0.5	1.5	-	1.8	1.6	12.9	0.6
Uzbekistán	7.6	7.8	0.7	3.2	4.2	-	26.7	1.8
Average CIS	6.2	2.5	1.3	2.1	2.6	3.9	21.6	2.5

Source: WB Georgia Public Expenditure Review 2002.

1.3.1 VAT

Most CIS countries introduced the VAT early on to replace the complex turnover taxes from soviet times. By 1997 all CIS countries had introduced VAT taxes, mostly following the Russian model established on December 6, 1991. The main feature of the soviet model was the application of the origin method to trade among CIS countries. In recent years, CIS countries have been converting their VAT systems to the European model based on the destination principle. Many problems have plagued VAT implementation. First, the VAT based on accrual accounting principles has been difficult to operate, given the poor accounting practices and the weak financial discipline that led to extensive inter-enterprise arrears. The consequence often has been large VAT arrears to the budget. Second, most countries have found it difficult to honor VAT refund claims, partly due to the reluctance of cash-starved treasuries to part with resources and partly because of weak administrative capacity of the tax agencies that makes it difficult to identify fake invoices and ghost companies. As a consequence, the VAT has come to resemble a turnover tax at very high rates, and enterprises perceive it as a tax on their cash flow rather than as withholding a consumption tax. Not surprisingly, different sectors and interests groups have sought and obtained special treatments, leading to a narrowing of VAT bases and hence a mediocre revenue performance. Additionally, the limited administrative capacity of the tax agencies has pressured for high VAT thresholds further limiting the tax basis and performance.

1.3.2 Enterprise Profit Tax (EPT)

Introduction of an EPT operating according to modern principles has been slow and difficult. One of the main problems has been the wide discrepancy between the tax accounting principles and what could be called standard market accounting principles. Governments have sought to protect their revenue sources by limiting eligible expenditures. The end-result has often been an overestimation of profits, and artificially high EPT yields. While the situation has somewhat improved, it continues to be a problem – most countries now allow the deduction of expenses incurred in the generation of taxable income, yet, still reject or limit the deduction of conventional costs in western tax systems, in particular interest on long-term loans, certain labor costs, research and development expenses, costs associated with environmental protection, or advertising. This has led enterprises to seek special treatment.

Also, EPT has been linked to industrial policy, and early on in transition, introduction of *ad hoc* tax incentives, holidays and differential rates became the norm. Often these incentives were negotiated and granted at the discretion of the economic authorities. These practices have somewhat been abated, but still continue to an important part of the political economy of taxation, as privileges and tax treatments became part of the political negotiation processes. As a consequence, it came to be that the effective EPT rates vary considerably across sectors of the economy.

1.3.3 Personal Income Tax (PIT) and social security contributions

Overall, PIT and social security revenue performance in linked directly to the degree of formalization of the economy. In countries with low highly informal sectors (Georgia, Armenia, Kyrgyz Republic, etc.) the ratio of PIT revenues to GDP is low. Also, PIT revenue performance often increases in tandem with real salary increases, as it as been the case of Ukraine and Russia. A common characteristic across all CIS countries has been the high level of labor taxation – the combination of PIT and social security contributions. Initially, this was not perceived as a problem because employees received net wages and most of the taxes and contributions were paid by the enterprises. However, this has become more of a problem as enterprises seek to restructure their operations and become more competitive. The high levels of overall PIT and social security contributions further contribute to the sense of overtaxation by enterprises.

1.3.4 Other taxes

Overall excise taxation tends to be low. Most transition countries have established separate excise taxes on tobacco, alcoholic beverages, and petroleum products. In energy abundant countries, energy taxation has been low and neighboring countries have followed similar practices. Poor administrative systems and the fear of smuggling has led to low excises taxation of cigarettes. Excise taxation of alcohol has also been low. As to import duties, the initial trend was to introduce high tariff rates with wider dispersion, in response to both pressures for protecting domestic activities and for finding additional sources of tax revenue.

Today, however, the effective import tariff rates are low. Countries routinely introduced other taxes, such as excess wage taxes, and many other that produce little revenue. These taxes or contributions went to feed special funds catering to special bureaucratic interests. Elimination of such nuisance taxes has been a constant item in the tax reform agendas.

1.4 Tax administration

The development of modern tax administrations has taken place under difficult circumstances. Countries initially did not give much attention to tax administration as they relied on automatic debiting contributions through the banking systems. This delayed development of modern enforcement systems. Incomplete, contradictory, and inconsistent legislative frameworks provided the tax agencies with significant degrees of discretion and encouraged special deals and preferential treatments. This was reinforced by weak financial discipline environments, where voluminous levels of tax arrears further encourage discretionary enforcement. Moreover, weak tax agencies were hardly equipped to deal with the myriad of practices that emerged to siphon profits from state enterprises, in a widespread process of asset-stripping. Lacking capacity but under pressure to raise revenues, governments developed stringent methods to deal with the emerging small and medium enterprise sector, further creating an image of corruption and arbitrariness. In fact, however, tax administrations were hardly unified state bodies; rather, they were highly fractured, which meant that local offices often developed their own practices and contributed further to the siphoning of revenues. All of these factors have contributed to a certain politicization of the tax agencies and tax practices. In a nutshell, tax administrations are weak, but perceived as arbitrary and corrupt. The need to meet revenue targets (often under agreements with international organizations) further generated perverse incentives, as meeting revenue targets with limited technical capacities, further facilitated extortion, side-deals, and delayed the modernization of these agencies.

2. A framework

The process of transition from plan to market in the CIS countries has come to define a very particular political economy. Most of the institutions in these countries have been fluid, with old and new rules coexisting, while wide discrepancies have emerged between the written and the applied norms. This necessarily led to opaque environments with low levels of accountability. Just as critical is the fact that these countries did not have a culture of property rights, and one has been developing only gradually. In the evolution of market capitalist economies, political interests have traditionally been grounded on notions of property—landholders, industrial, etc. This is not the case of CIS transitional economies, where political interests do not so much arise from property, but themselves are part of the creation of property institutions. At the same time, modern political institutions were weak or even non-existent. This has led to a merger of political and economic interests, where the nature of political parties is far removed from practices in most developed market economies. Two additional background factors have to be noted. The decade of the Nineties was a decade of shrinking economic resources, but the population did not have the political mechanisms to express their discomfort with their deteriorating standards. Also, nation building was possibly the greatest priority for some nations, which had not been independent political entities for a very long-time. Some considerations on these basic facts follow.

2.1 Rules and their enforcement

The incomplete institutional framework typical of CIS transition countries affected tax practices. As mentioned earlier, it would not have been possible to introduce a comprehensive set of tax laws and complementary legislation, not only because of the broad effort this would have entailed, but because of the low implementation capacity. Local bureaucrats and legislators, in adopting new laws, need the preexistent legislation as a model or try to develop their own standards. A good example of this has been the slow introduction of modern accounting standards, which are at the core of so many modern market economy practices, including taxation. Lack of proper accounting, pricing rules, and overall financial discipline no doubt contributed to amplify the inter-enterprise arrears problems and, as a result, tax arrears.

2.2 The State: a myriad of conflicting challenges

In most CIS countries, states continue to have difficulties developing policy positions and implementing decisions, and thus dealing with the often conflicting challenges they face. In the fiscal arena, for instance, the lack of strong ministries of finance has encumbered the building new taxation institutions, as fiscal powers often had been parceled among several authorities. Fractured states are not only ineffective but also prone to capture.

Balancing expenditure demands and revenue possibilities has been and will continue to be a determining factor for the stability of all CIS countries. They inherited a level of public expenditure much higher than that of countries at similar levels of per capita income, as the soviet system placed emphasis on the provision of social services, which were delivered mainly be the state. Continuing with the inherited levels of service delivery would have meant the extraction of a significant a share of total output.[5] Shrinking levels of output during the Nineties meant drops in public expenditure, and in some countries dramatically. Significantly, the drop in the availability of public services has not been accompanied by widespread civil

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5 Belarus continues to do so.

unrest, indicating a low power of political mobilization. It can be said, though, that even in those countries where expenditures have fallen, the expectation remains of the state as provider of public services. Hence, there is an almost permanent pressure to increase expenditure.

CIS countries did not put in place rapidly an adequate sustaining legal basis (tax policy law, procedural law, etc.) and the technical capacity to collect revenues. Revenue agencies have often lacked a clear mandate, have been highly fractured, and have lacked and continue to lack external proper oversight. In some countries, there is the perception that the powers of taxation are being used to further political ends, as in going “after the opposition.” There are also reports that the power of the tax agencies are used as tools to pursue economic ends, as can be by favoring particular enterprises.

Additionally, the highly decentralized revenue and expenditure management under the Soviet Union provided regional and local authorities with ample opportunities to strengthen and extend their hold. Regional government controlled the enterprises that provided the revenues needed to meet the expenditure mandates. Henceforth, efforts to centralize revenue collection have met with considerable opposition from regional authorities. This has been particularly the case in a federal country such as Russia. On the other hand, central governments, when faced with revenue shortages, have transferred expenditure mandates down to local level, creating a tug of war for resources, which led to very unstable revenue sharing systems and big discrepancies between written rules and effective outcomes.

The increased perception of an effective tax burden by economic agents, as noted previously, made it more difficult for governments to win political and popular support for tax reform. Last, passing new legislation and enforcing it was harder due to emerging confrontation between the different emerging interests within the state the various stakeholders. The uncertainly about the legal ownership of revenue sources and assets, including natural resources, further complicated matters.

2.3 Interests

2.3.1 Enterprises

The position of the enterprise sector regarding taxation carries a great deal of weight, as it is the largest contributor of revenues to the budget in all of the CIS countries. The enterprise sector pays the CIT, excises, land, and a large percentage of the social security taxes, and withholds VAT, PIT, and the rest of the socials security contributions. Two factors seem relevant to understand the evolving behavior of enterprise owners and managers: *hard budget constraints and privatization*. Hard budgets make evident the burden of taxation. Ownership determines the responses to a higher level of financial discipline. Reference has already been made to the weak financial discipline and lenient budget constraints. In countries like Russia and Ukraine, it has been only after the 1998 crisis that financial discipline has improved.

Early in the transition, observers realized that, with the collapse of the systems of state control, it became possible for enterprise managers to appropriate resources from public enterprises. Indeed, a good part of what was/is often reported as informal economic activity corresponded to unreported economic activity by public enterprises. This was particularly the case in countries where the structure of control over public enterprises weakened or collapsed. Moreover, weak governance often led to the capture of attractive public enterprises by political interests or, alternatively, provided enterprise managers with the opportunity to create their own political power groups and seek to preserve their interests. Given that public enterprise managers had various options through which to influence their transfer of resources to the public treasury, they did not develop very active stands regarding taxation. They have become more active as harder budget constraints have been introduced.

The advance of privatization was expected to change attitudes towards tax compliance; however, the direction in which they would change was unclear. On the one hand, private companies could be expected to post a better performance, but, on the other, they could be expected to have greater capacity and incentives to avoid taxes. A more detailed study would be needed to determine what has been the effect of privatization on tax compliance. Still, partial evidence from Ukraine shows that private enterprises have been less likely to fall into tax arrears, at least recently, and that overall they are better compliers than public enterprises. However, there is anecdotal evidence that large private concerns, in Russia during the Nineties, reached very low levels of compliance, particularly when budget constraints were weak.

As budget constraints harden and the burden of taxation becomes more evident, private enterprises emerge as one of the leading interest groups in tax matters. Overall, enterprises in CIS countries, either public or private, see themselves as heavily taxed, especially because they tend to perceive the VAT as a tax on production and not on consumption and enterprises pay the largest share of the social taxes, which are high. This has created a favorable environment for lowering the tax burden. The initial tendency, however, was to seek preferential treatments and special deals with the state, particularly by the large economic groups that have emerged in several countries combining financial and industrial interests. These groups have sough direct intervention in politics as a way to protect and extend their interests. As pressure for the elimination of special interests builds up, the possibility arises for enterprise sector to support broad and comprehensive reforms. The interesting political economy question is the extent to which enterprises and/or their associations will seek collectively to improve the quality of taxation practices, rather than pursue purely individualistic strategies.

2.3.2 The broader national constituencies

Gradually other constituencies have been articulating their tax interests through there political system. One important constituency is that of the small and medium enterprises. The shift of the labor force out of the state enterprise sector has made this a policy priority sector. Two have been the primary concerns: (a) simplification of tax norms to facilitate creation of SMEs and income and employment generation; and (b) to isolate the emergent SME sectors from enforcement practices of the governments, which still can have severely negative attitudes towards the SMEs.[6] Today, practically all countries have designed special regimes both for private entrepreneurs and for small legal entities. In the countries where these policies have been implemented, the number of SMEs has increased, as well as their weight in national production. At the same time, SMEs have been politically active, seeking to preserve and even expand their status, raising concerns as to possible negative impacts in the long-term.

Other national constituencies have played a less active role in both taxation and expenditure. Gradually, it is likely that the political systems will start articulating their interests, with an impact the design of the tax systems. The elderly in CIS countries is one such potentially important political group, because of its size and its almost complete reliance on the budget. The pension funds rely on current taxation and are not capitalized to any significant extent. The political economy of the elderly in the CIS countries will differ from that of mature market economies, where wealth is highly correlated with age. Hence, one would expect the elderly to become quite politically active, though this has not yet been the case.

2.4 Politics: the aggregation of special interests

The disappearance of the communist parties left a vacuum of control that has been filled differently across CIS countries. Although most of them have moved to some sort of electoral democracy, the patterns of governance and the structure of the political systems differ among countries. In some of the countries forming a nation (including civil strife) has been an overriding concern to be addressed jointly with the developing viable governments. In other countries, strong presidential systems have arisen with limited contestability from political parties. In any case, the political parties of the CIS countries are far from resembling modern like political parties. Under these circumstances, the aggregation of political interests tends to be rather opaque. What more open countries seem to have are political enterprises, that aggregate narrow (often, regional) interests. These interests may or many not include directly tax policy, but they do include taxation issues in general. In countries with strong presidential systems, the role of the political parties plays a secondary role. Ukraine and Russia fall in some sort of a middle ground.

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6 See Engelschalk (2002).

3. Ukraine

The tax laws Ukraine adopted after independence were revised after 1996 to bring them in line with modern market concepts. This period coincided with the issuance of a new constitution (1996) and the beginnings of macroeconomic stabilization. Also, in 1996, the government established a tax agency as a separate administrative unit.[7] The 1998 Russian crisis delayed the positive effects of macro stabilization.[8] The microeconomic situation continued to be characterized by high levels of inter enterprise arrears and barter, payment of taxes in kind or as offsets to the budget, a shrinking financial sector, obsolete accounting, and mounting debts to and from the budget. This environment made it very difficult to implement the new tax laws properly. A period of muddling-through followed, with constant revisions of tax legislation and implementation decrees. The revisions to the tax legislation centered around introduction of exemptions, amnesties or write-offs, taxation of small taxpayers and procedural matters.

Political forces favorable towards a market economy became a majority in the country after the 1999 presidential election, and the new government took active measures to enforce financial discipline, beginning with its own accounts. The results have been the almost total disappearance of barter, complete payment of taxes in cash, and greater financial discipline all over the economy, including the energy sector where collections in cash went from 10 to around 90 per cent in less than two years. Greater financial discipline has implied a greater confidence in the currency and a considerable expansion of the financial sector. Also, the public sector budgetary arrears have been drastically reduced and bankruptcy procedures are now more effectively implemented. At the same time, after 2000, the economy started to grow and has done so continuously over the last three years.

3.1 The tax reform agenda: the tax code

After 1999 reelection, the president made it one of the top priorities of his administration to obtain approval of a Tax Code, which would facilitate the further development of a market economy in Ukraine. The objectives of the tax code were and have been rather straightforward: streamline, clarify and make consistent existing tax legislation, lower tax rates and broaden tax bases, and set a sound basis for the relationship between tax authorities and taxpayers. Government has shifted tactics and the content of its proposals in its efforts to approval of a code. After failing to obtain approval of the original proposal, the government shifted a simplified code, focused on rate reduction. This strategy was withdrawn, and a new draft tax code was presented. With the new and current parliament, the strategy

[7] State Tax Administration, and currently State Tax Service.

[8] Some argue that the process of economic recovery in 1997 was based on the special incentives given by the government and hence not-sustainable. On the other hand, the 1998 crisis may have a positive effect by creating incentives for financial discipline.

shifted again, this time to the consideration of individual tax laws, each one of them focused on tax rate reduction and base expansion. In the process, the tax design has been changed in line with Russian reforms. This piecemeal approach, however, does not amount to comprehensive reform and the country will have to take stock of the results of the current process, and then see about the consistency and desirability of the reforms.

3.2 The presidency and the parliament

The political system in Ukraine mixes characteristics of a parliamentary and a presidential regime. While parliament elects a prime minister, the president can veto the selection. Moreover, the president can and has exercised power through a various means: the appointment of government officials, and, most importantly, government by decree. This means, that the president can issue decrees *en lieu* of laws, if parliament does not address the issue. Some important initiatives have come this way: land privatization, the special regime for SMEs, the unified land tax, etc. Still, it is not a purely presidential regime, and the ambiguous character of these political arrangements frame some of the delays in advancing institutional reform in Ukraine. Basically, the ability of the president to put together a governing coalition in parliament that elects a prime minister is at the heart of the political jockeying in Ukraine.

3.3 Stakeholders

Large and extended vested interests emerged in Ukraine during the Nineties. These vested interests were not directly linked to ownership of property. In fact, the privatization process in Ukraine has been slow as compared to Russia, for instance. Certainly, Ukraine advanced in small scale privatization during the Nineties, but even here property rights are poorly defined as around 40,000 shareholders left from voucher privatization do not have well defined minority shareholders rights. The state still owns around 60 per cent of assets in industry and land privatization only started in 1999/2000.

The vested interests are linked to privileges and control of state assets. Oftentimes the privileges have proven short-lived, and hence agents are prone to act with a very short-time perspective in mind. The link with political interests is a necessity, is mutually supportive, and sometimes there is no clear differentiation between the two. Particularly important have been the efforts made by regional authorities, political interests and state bureaucrats to maintain the competitiveness of the old industrial complex that continues to account for a large share of the country's industry and exports. In the Donbass region, the regional authorities, the vested interests in the metallurgical and coal sectors are tightly linked. Similarly, groups linked to the old industrial complex (aviation, rocketry, high-tech intelligence, etc.) continue to play an important role in politics and the economy.

The energy sector also weighs heavily in the economy, as Ukraine is very energy intensive economy while resource poor. The transport and distribution of energy resources represents a significant share of national economy, and , with the exception of electricity distribution companies, the bulk of the sector remains in state hands. The state holding NaftoGaz accounts for a significant share of the economy and constitutes a power of its own. Several groups vie for the control of these resources. The overall improvement in financial discipline in the energy sector and the current efforts in addressing the stock of inter-enterprise arrears will certainly increase the attractiveness of these assets for both domestic and foreign investors. But, much remains to be done for this to become a reality.

With the exception of two state banks, the rest of the financial sector is private and growing fast with the accelerated monetization of the economy. Private banks have been active in the privatization process, diversifying through the acquisition of control or participation in industrial assets. Land privatization, since 2000, has added another important dimension to the structure of interests in the country. The government issued close to 6.5 million land certificates and is now in the process of issuing proper land titles. However, contrary to other CIS where privatization led to a minute fragmentation of the land, in Ukraine, large landholding continue to operate leasing the land from the certificate holders. Favorable, almost non-existent, land taxation has led industrial groups to move into agricultural production.

As a result of all of this, powerful regional interests have emerged combining political organization, control of state assets and involving emerging private interests.[9] The emergence of these groups has come to affect deeply the governance structure of the country, as these groups depend for their survival on their relationship with the state, and have actively sought positions of power and continue to participate actively in the political process. They have sought likewise to position themselves favorably in the privatization of the remaining state assets. However, as new groups emerge, linked to the banking system, for instance, the competition amongst interests is increasing. Overall, Ukraine can be thought of as a country of fragmented and regional interests, in which groups vie for power, and where foreign investment is limited. The big question is whether these power groups will agree to fairer and more transparent rules of the game, and whether the executive power can exercise its authority to make this happen.

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9 Ukraine has a tradition of strong “clan” culture in some eastern regions (Dnipropetrovsk, Crimea, Donetsk, Odessa, Kharkiv, Kyiv). These clans operate both inside and outside the state. The power of the regions rest power from the center in Kiev. There are clear correlations between regional clans and political parties. These clans play a preponderant role in making the government coalitions work. Needless to say, these industrial/political groups have been behind drives to forgive taxes and create exemptions.

Table 7

Ukraine: Tax Arrears by Tax Type, 1998-2001
(billion of UAH)

	1998	1999	2000	2001
Tax Revenue	**7.21**	**9.6**	**9.16**	**6.18**
1. Income and Profit Taxes, Taxes on Increased Market Value	1.54	2.45	2.7	1.41
Personal Income Tax	0.03	0.03	0.05	0.07
Profits Tax	1.51	2.42	2.65	0.79
2. Property Taxes	0.01	0.01	0.07	0.07
Tax on Vehicles and Other Self-Moving Machinery	0.01	0.01	0.07	0.07
3. Resource Extraction Tax	0.96	0.99	1.25	0.52
Land Tax	0.42	0.33	0.49	0.27
4. Domestic Taxes on Goods and Services	4.59	6.11	5.1	3.98
VAT Total	4.07	5.57	4.48	3.76
VAT on Domestic Goods	4.07	5.56	4.48	3.76
VAT on Imported Goods	0	0	0	0
Excises Total	0.51	0.54	0.62	0.22
Excises on Domestic Goods	0.51	0.53	0.61	0.22
Excises on Imported Goods	0	0	0.01	0
5. Taxes on International Trade and External Operations	0	0	0	...
Import Duty	0	...	...	...
Export Duty	0	...	...	...
6. Other Tax Revenues	0.11	0.03	0.04	0.2
Local Taxes and Charges	0.03	0.03	0.03	0.01
Single tax for Small-Scale Enterprises and Individual Entrepreneurs	...	0	0.01	0.01
Vine-growing, Gardening and Hop-Growing Tax	...	0	0	0
Nontax Revenue	**3.01**	**1.98**	**0.73**	**0.07**
Revenues from Capital Transactions	**0**	**0**	**0**	**0**
State Earmarked Funds	**0.08**	**0.15**	**0.17**	**0.07**
TOTAL ARREARS	**10.3**	**11.73**	**10.07**	**6.31**
GDP (nominal)	102.593	130.422	170.07	201.93
Tax Arrears as a share of GDP	7	7.4	5.4	3.1
Total Arrears as a share of GDP	10	9	5.9	3.1

Source: State Tax Administration of Ukraine.

3.4 *Tax arrears and hard budget constraints*[10]

Tax arrears continue to plague Ukraine. To some extent tax arrears have been the outgrowth of a level of inter-enterprise arrears so high that it came to exceed the value of the GDP. During the Nineties, enterprises continued to operate regardless of the level of arrears. As Tables 8 and 9 show, VAT obligations originating mostly

[10] The World Bank has recently reviewed tax issues in Ukraine. See World Bank, "Ukraine: Tax Policy and Tax Administration", February 2002.

Table 8

Ukraine: Tax Arrears by Tax Type, 1998-2001
(billions of UAH)

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Tax Revenue	**7.21**	**9.6**	**9.16**	**6.18**
1. Income and Profit Taxes, Taxes on Increased Market Value	1.54	2.45	2.7	1.41
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Pprofits Tax	1.51	2.42	2.65	0.79
2. Property Taxes	0.01	0.01	0.07	0.07
Tax on Vehicles and Other Self-Moving Machinery	0.01	0.01	0.07	0.07
3. Resource Extraction Tax	0.96	0.99	1.25	0.52
Land Tax	0.42	0.33	0.49	0.27
4. Domestic Taxes on Goods and Services	4.59	6.11	5.1	3.98
VAT Total	4.07	5.57	4.48	3.76
VAT on Domestic Goods	4.07	5.56	4.48	3.76
VAT on Imported Goods	0	0	0	0
Excises Total	0.51	0.54	0.62	0.22
Excises on Domestic Goods	0.51	0.53	0.61	0.22
Excises on Imported Goods	0	0	0.01	0
5. Taxes on International Trade and External Operations	0	0	0	...
Import Duty	0	...	...	...
Export Duty	0	...	...	...
6. Other Tax Revenues	0.11	0.03	0.04	0.2
Local Taxes and Charges	0.03	0.03	0.03	0.01
Single tax for Small-Scale Enterprises and Individual Entrepreneurs	...	0	0.01	0.01
Vine-growing, Gardening and Hop-Growing Tax	...	0	0	0
Nontax Revenue	**3.01**	**1.98**	**0.73**	**0.07**
Revenues from Capital Transactions	**0**	**0**	**0**	**0**
State Earmarked Funds	**0.08**	**0.15**	**0.17**	**0.07**
TOTAL ARREARS	**10.3**	**11.73**	**10.07**	**6.31**
GDP (nominal)	102.593	130.422	170.07	201.93
Tax Arrears as a share of GDP	7	7.4	5.4	3.1
Total Arrears as a share of GDP	10	9	5.9	3.1

Source: State Tax Administration of Ukraine.

in the energy sector accounted for most of the arrears, which is not surprising given that energy companies were collecting only 10 per cent of their bills in cash at the end of the Nineties. With hindsight, introducing a VAT based on accrual principles, under these circumstances, may have further escalated the growth of arrears. Moreover, throughout this period, the government introduced (a) the practice of budgetary offsets, by which tax obligations were traded against budgetary obligations, and (b) adopted the practice of issuing promissory notes (veksels) to cover its obligations. These practices further accentuated the problem of tax arrears as enterprises diverted the available cash to cover non-tax obligations and relied on offsets to cover their tax obligations. Notably, regardless of the use of offsets and in

Table 9

Ukraine: Tax Arrears by Sector, 1997-2001
(percent of GDP)

	1997	1998	1999	2000	2001
Not Defined	**0**	**0.07**	**0.06**	**0.04**	**0.06**
Industry	**0.82**	**5.4**	**5.33**	**3.51**	**1.64**
Fuel Industry	0.31	1.51	1.83	1.2	0.63
Coal Industry	0.04	0.28	0.41	0.59	0.31
Electric Power	0	0.68	1.01	0.56	0.58
Ferrous Metallurgy	0.12	0.83	0.13	0.07	0.01
Nonferrous Metallurgy	0.01	0.03	0.01	0	0
Chemical Industry	0.03	0.18	0.15	0.13	0.02
Petrochemical Industry	0.29	0.35	0.16	0.07	0.02
Machine-Building and Metal Processing	0.16	0.77	0.85	0.52	0.11
Woodworking and Cellulose-Paper Industry	0.01	0.07	0.08	0.06	0.01
Industry of Construction Materials	0.05	0.22	0.24	0.16	0.04
Glass and Porcelain-Faience Industry	0.01	0.04	0.05	0.04	0.01
Light Industry	0.01	0.07	0.08	0.06	0.02
Food Industry	0	0.53	0.61	0.58	0.17
Agriculture	**0.29**	**0.74**	**0.57**	**0.1**	**0.11**
Forestry	**0.01**	**0.03**	**0.02**	**0.01**	**0**
Transport and Communications	**0.27**	**1.24**	**0.74**	**0.23**	**0.08**
Construction	**0.04**	**0.52**	**0.63**	**0.46**	**0.1**
Trade and Catering	**0**	**1.85**	**0.35**	**0.29**	**0.21**
Material-Technical Supplies and Sale	**0**	**0.11**	**0.06**	**0.06**	**0.02**
Provision	**0**	**0.04**	**0.04**	**0.02**	**0.01**
Information-Calculable Service	**0**	**0**	**0.01**	**0.01**	**0**
Operations with Real Estate	**0**	**0**	**0**	**0**	**0**
General Commercial Activity	**0**	**0.03**	**0.01**	**0.01**	**0.01**
Production Types of Services for Domestic Population	**0**	**0.03**	**0.02**	**0.01**	**0.01**
Housing-Communal Economy	**0**	**0.23**	**0.38**	**0.15**	**0.18**
Health Protection, Physical Culture and Social Welfare	**0**	**0.02**	**0.02**	**0.01**	**0.01**
Public Education	**0**	**0.01**	**0**	**0**	**0**
Culture and Art	**0**	**0.01**	**0.01**	**0.01**	**0**
Science and Scientific Services	**0**	**0.05**	**0.04**	**0.03**	**0.01**
Finances, Credit, Insurance, Pension Services	**0**	**0.05**	**0.01**	**0.03**	**0.02**
Management	**0**	**0.05**	**1.66**	**0.92**	**0.64**
Union of Citizens	**0**	**0.01**	**0**	**0**	**0**
Total	**1.43**	**10.48**	**9.97**	**5.89**	**3.12**

Source: State Tax Administration of Ukraine.

kind payments, tax amnesties were frequent. Most of the tax amnesties were given by parliament and were both general and sector specific. Furthermore, the discretion of the tax administration in enforcing arrears also has played an important role, and served clear political purposes.

Parliament issued the last general tax amnesty in 2000, covering roughly 5 per cent of GDP. Examination of this amnesty shows some interesting facts. First, some of the potential beneficiaries could not be located, meaning poor record-keeping and an overestimation of the stock of arrears. Second, the public sector and the public enterprises held the bulk of the arrears, mostly in the energy sector as noted above. The 2000 amnesty did not halt the accumulation of arrears, and the emerging patterns illustrate the forces at work. The government has had relative success in controlling the growth of arrears in the non-energy sector. The growth of arrears in the energy sector, specially in the gas holding company NAFTOGAZ, is partly a consequence of the remaining non-payment problem; but, more importantly, is the result of underpricing of energy products and the financial consequences for enterprises. Mismanagement of state enterprises and corruption also play an important role. The difficulties in halting the growth of tax arrears in the energy sector illustrates that solving problems of financial discipline requires more than the willingness or the capacity of the tax agency to enforce the law. Specifically, it requires that various interests within the executive and the legislative branches come together to provide an adequate framework for tax enforcement – energy prices, budget payments, oversight of public enterprises, etc. In the absence of the capacity to bring together conflicting interests, the state cannot fully introduce financial discipline, diminishing its credibility and inviting further plundering of its resources.

3.5 Tax exemptions

Tax exemptions became a regular practice in Ukraine in the Nineties, when even the executive could issue them. Now only the legislature can. The bulk of the exemptions are for the VAT, the EPT and less so the PIT (See Table 10.) VAT exemptions have favored agriculture, pharmaceuticals, constructions, and a host of other customary products and services. Introducing the VAT into the energy sector in the late Nineties, broadened the VAT coverage, but led to significant increases in arrears as reported above. CIT exemptions have favored traditional industries as part of an effort to maintain their competitiveness. As in the case of tax arrears, tax exemptions became part of the political game. Recently (2003), however, both the executive and legislative have cooperated in reducing exemptions for the EPT and the PIT, and to a lesser extent for the VAT.

3.6 Simplified taxation

The size of informal economy is a considerable concern in Ukraine. Some have argued that the reported GDP decline in the Nineties was partly a shift of production to the informal sector. It may well be that size of the informal economy is not as large as reported; however, to some extent it is the perception that matters.[11]

[11] The portion of the labor force that has left the formal sector is not large enough to generate the levels of informal outputs that often are quoted. Most likely, an informal sector may have developed within the formal sector itself, as managers of state enterprises seek to siphon incomes using fictitious constructs.

Table 10

Ukraine: Estimated and Actual Tax Exemptions, 1998-2001
(billions of UAH)

Type of Tax	1998		1999		2000		2001	
	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual
VAT	6.47	9.43	9.98	14.3	2.59	4.94	2.04	5.89
Profits Tax	0.02	0.83	0.59	1.26	1.87	2.7	3.27	2.5
Excises	3.15	0.14	1.78	0.24	0.67	0.15	0.73	0.08
Land Tax	0.9	1.64	1.05	1	1.15	0.42	1.34	0.55
Total (VAT, EPT, Excise, Land)	**10.54**	**12.05**	**13.4**	**16.81**	**6.28**	**8.21**	**7.38**	**9.02**
Total as percent of GDP	**10.28**	**11.75**	**10.28**	**12.89**	**3.69**	**4.83**	**3.65**	**4.47**
Personal Income Tax	0.42	n/a	0.82	n/a	0.94	n/a	0.84	n/a
Payment to Chernobyl Fund	0.98	cancelled since 01/01/1999						
Resource Extraction Tax	0.01	n/a	0.04	n/a	0.02	0.44	0.02	0.27
Payments for Construction and Reconstruction of Public Roads	0.13	n/a	0.13	n/a	0.13	cancelled since 01/01/2000		
Total Exemptions	**12.08**		**14.39**		**7.37**		**8.24**	
Total Exemptions as percent of GDP	**11.77**		**11.03**		**4.34**		**4.08**	
GDP, actual		102.59		130.42		170.07		201.93

Source: Ministry of Finance.

At first, based on the negative attitude against private sector activity inherited from the socialist times, the fight against the informal economy focused on the small and medium enterprises or individual entrepreneurs. Business surveys carried out during the Nineties picked up this pattern behavior. With time, however, to address these concerns and facilitate the emergence of a small and medium enterprise sector, the Presidency introduced in 1998 a special system of taxation for small business. The system applies differently to individuals and to enterprises. A key characteristic is the relatively high thresholds – roughly, US$ 100,000 for individuals and US$ 200,000 for business.[12] The increase in the number of individual entrepreneurs and business registered has been impressive, as shown in Table 11. There are now close to 100,000 business registered and 350,000 individual entrepreneurs. The SME sector has now become an additional lobbying group, politically very active, raising concerns as to whether this special regime could become significant loophole to the formal system.

Table 11

Ukraine: Subjects of Entrepreneurial Activities and Revenue from Special Regimes of Taxation

Year	Unified/Single tax				Special Trade Patent		Fixed Tax	
	Number of subjects		Revenues to consolidated budget from unified tax		Number of patents purchased (units)	Revenues to consolidated budget from trade permits (mln UAH)	Number of fixed tax payers('000)	Revenues to local budgets from fixed tax (mln UAH)
	Legal entities ('000)	Natural persons('000)	Legal entities (mln UAH)	Natural persons (mln UAH)				
1999	28.6	66.1	66.3	57.7	16873	20.8	318	196.4
2000	66.6	182	348.69	225.52	7411	31.6	327.4	229.6
2001	91.7	345.1	619.83	439.03	6986	40	339.3	250.1

3.7 *The quality of enforcement*

With the creation of the State Tax Administration (STA) in 1996, the government set itself the explicit objective to enhance the control structure of the state, enforce the tax law and to create a compliance culture. As in other Former Soviet Countries tax services were initially highly decentralized with a minimum level of central control, providing an opportunity for local interests to control them. Also, with a weak state control over state-owned enterprises, the task of enforcement

[12] Under this scheme, a taxpayer can choose to pay 10 per cent of turnover, and cover VAT, or pay 6 per cent and VAT independently.

fell upon the STA. The results have been mixed, and the efforts to tighten tax enforcement have led to concerns over taxpayer harassment, preferential tax enforcement towards specific groups and regions, and use of tax powers for political ends.

Widespread fear of powers of the STA led to calls to restrain its powers. In fact, parliament, jointly with the 2000 tax amnesty, mandated new enforcement collection procedure that limits the powers of the state, by setting stepwise procedures for the recovery of the arrears and by involving the courts as final arbiter in case of appeal.[13] On the positive side, however, the government, even if with drastic enforcement, seems to have prevented a revenue collapse, although there was a drop of revenue as a percentage of GDP.[14] This no doubt has been an important part of consolidating an independent Ukraine.

3.8 Taxes and the legislature

Changes in tax legislation have to be approved by parliament. Examining how political groups behave in parliament provides some insights into the working of the political economy of taxation in Ukraine. This section examines some characteristics of the political system in Ukraine and dynamics of tax legislation in the latest (third) parliamentary period (1998-2002). Consideration of the present parliament is given thereafter. The review shows that the political party system in Ukraine is unstable; parties or factions appear and disappear and coalitions are difficult to form and maintain. However, when majority coalitions emerge, meaningful legislative agendas can be advanced. Surprisingly, there has been considerable tax legislative activism as measured by the tabling of legislative initiatives. However, approvals of proposals have required building political coalitions, which often extend across ideological camps. In general, parties and factions are driven by narrow particular interests. Only larger parties have anything close to a broad agenda. In these circumstances, it has been difficult to advance a comprehensive reform agenda, as shown by the failure of the past legislature to advance with the tax code. In this very fragmented political environment, it has been easier to advance special interests and get approval for privileges, exemptions, and amnesties. The consequence has been the fracturing of the tax legislation, making its implementation more difficult for the taxpayers and the authorities.

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13 This legislation (similar to that of other CIS countries) represents an effort by parliament to limit the powers of the executive in tax collection.

14 Table 4 shows that ratio of tax revenues over GDP fell between 1998 and 2001. This happened while economic recovery was underway. The final outcome for 2002 produced an increase of slightly less than three points of GDP. The increase was driven by continued improvements in PIT, linked to rising wages, and greater yields in the VAT, deriving from elimination of loopholes that made administration difficult.

3.9 The instability of the political party system

The structure of the latest Ukrainian parliament was unstable.[15] Parties emerged, disappeared and regrouped. The innovation of the current parliament, after the elections and the regrouping that took place in 1994, has been the creation of two blocks – "Our Ukraine" on the right, and "United Ukraine" on the center, with strong oligarchic support. Both of these fronts include several parties or factions, but the coalitions are not fully stable, with parliamentarians regularly crossing lines across parties.

Let's consider in some detail the political dynamics of the parliament elected in 1998. As of July 16, 1999 there were 447 people's deputies in Verkhovna Rada, 430 were united in 12 factions and in 3 groups. During the transitional period from October, 1998 to July, 1999, 158 MPs changed their faction affiliation and two new groups were established.[16] The fate of each party shifted over time: parties disappeared, were created, dwindled and grew.

It is fair to think of the political parties in Ukraine as groups with vested interests, predominantly on economic matters, rather than built around political platforms. Some parties were created with the only purpose of lobbying interests of certain business associations, specific sectors of economy (e.g. gas and oil, coal, agriculture etc.) or certain regions. Besides the specific interests, there is often little or almost no difference among parties' platforms. It is unclear if this pattern of shifting alliances will eventually coalesce into a well structured political system with a broad political agenda rather than narrow interests. The two exceptions are the Communist Party on the left, and the Rukh ("Our Ukraine" now), on the right.

Despite all of this, however, there is an identifiable trend: the number of MPs with clear pragmatic business interests significantly increased. More than 120 people deputies in the last parliament represented large and medium businesses. That number increased in the recent parliamentary elections. The fortunes of the communist party declined in the meantime. The instability of the political system

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15 In accordance with the Constitution of Ukraine (Article 76) *Verkhovna Rada*, or Parliament, consists of 450 People's Deputies (or Parliament Members - or MPs) elected by general, equal and direct vote by secret ballot for four years. Legislation on election establishes system of mixed representation in Ukraine, when half of MPs (or 250) are elected by proportional vote for party lists or electoral blocks (with 4 per cent entry threshold) and the other half from single-mandate districts. The third parliament of independent Ukraine was elected in March 29, 1998 on the basis of this new principle of mixed representation – representatives of parties and electoral blocks that won elections occupied 225 or half of the seats, and the other 225 deputies were elected in single-mandate districts. This new system gave to the political parties of Ukraine additional chance to demonstrate their positions and to seek their contingency. The following 8 parties won elections by overcoming 4 per cent barrier: Communists (24.6 per cent), Narodnyi Rukh (9.4 per cent), Block of Socialists and Peasant parties (8.5 per cent), Greens (5.4 per cent), People's Democrats (5.01 per cent), Gromada (4.67 per cent), Progressive Socialists (4.04 per cent), and Social Democrats (4.01 per cent).

16 "Revival of Regions" (28 MPs) and "Labor Ukraine" (17 MPs); Narodnyi Rukh was divided into two factions – 30 and 15 MPs, respectively; Socialist Party and Peasants' Party Block split establishing two independent factions (24 and 15 MPs, respectively); a new faction was created – "Reforms – Center" consisting of 24 MPs; 55 peoples' deputies left the faction of Peoples' Democratic Party (NDPU); 25 MPs left Gromada and created a new faction "*Batkivshchyna*" (Motherland).

continued into the parliament elected in 2002, when it took several months before a majority coalition supporting the president could be put together and a new prime minister appointed.

3.10 Building reform coalitions

Three sub-periods can be identified during the last (third) parliament: pre-majority (May 1998-December 1999), majority (January 2000-April 2001), post-majority (April 2001-March 2002). The first period was characterized by an excessive instability and it ended up in December 1999/January 2000. The presidential elections towards the end of 1999 turned matters around. After the election, the president proposed and parliament approved the nomination of a reform minded prime minister, Victor Yushchenko. The president also initiated the transformation of the entire system of public administration, streamlining and consolidating the system of ministries and other central bodies of executive power and eliminating branch or sector ministries.[17] These developments pressured parliament and by February 2000 two factions ceased to exist, and two other disappeared later. A parliamentary majority was created comprising all the right wing parties and the center, and consisting of 238 people's deputies. This majority supported the prime minister and his cabinet in their reform effort and approved an ambitious program of activities April 6, 2000. As a majority was created, the composition of groups and factions within parliament stabilized, with some minor changes.[18]

Still, in April 2001, a coalition of left and center-right parties issued a non-confidence vote to the Government of Victor Yushchenko.[19] After that, the third phase of parliament commenced, the stable majority *de facto* ceased to exist, and decisions in parliament were adopted mostly by situational majority. Still, the third phase of parliament's work inherited some stability, and the majority in the parliament continued to work informally, despite serious internal tensions. This parliamentary coalition continued to advance significant reforms. Important legislative initiatives were approved during the third parliament including the Land and Budget Codes.

3.11 Tax legislative activism – initiatives and results

The third convention of the parliament considered 756 draft laws and resolutions on tax issues. Table 12 shows the number of initiatives by party or

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17 The only left over from the soviet era - branch ministry of coal industry has been eliminated and merged with the ministry of energy covering the whole fuel and energy sector.

18 The most significant growth was registered in the Labor Ukraine parliamentary faction, its membership increased by 21 MPs from 23 to 44. Solidarity faction grew from 16 to 27 members.

19 This basically amounted to a coalition between communists and centrist oligarchic interests that found threatening the policies and the popularity of the prime minister.

Table 12

Ukraine: Status of Draft Tax Laws Submitted to the Parliament, 1998-2002

Faction/ Status	Drafts Submitted	Laws Signed by President	Resolution Signed	Drafts Rejected	Inefficiency Rate (%)
UNR	149	13	28	51	34.2
R&O	88	8	10	44	50.0
RU	55	2	0	7	12.7
SDPU(u)	47	3	0	12	25.5
LU	43	2	1	9	20.9
NDP	36	5	4	8	22.2
Batkivshchyna	32	4	1	8	25.0
Yednist	28	1	0	3	10.7
Greens	14	2	0	0	0.0
DU	11	1	0	1	9.1
NRU	9	1	0	1	11.1
CPU	126	20	15	28	22.2
Solidarnist	51	6	2	11	21.6
SPU	41	6	2	13	31.7
Yabluko	26	0	0	2	7.7

faction, the number of laws and resolutions signed and those rejected. Three groups in parliament initiated the most tax laws and resolutions. The UNR, R&O, on the one side of the political spectrum, and communist party (CPU), on the other, submitted together 363 draft laws and resolutions, almost as many as the rest of the factions (393).

3.12 Successful cooperation across factions

Table 13 presents information on the cooperation among different groups in parliament. Effective alliances and coalitions between the CPU (*Communist Party of Ukraine)* and UNR (*Ukrainsykyi Narodnyi Rukh)* led to 17 laws and resolutions approvals. The cooperation between left and right on tax matters is particularly telling of the nature of alliances in parliament. Efficient collaboration between CPU and UNR took place in taxation of agriculture (including machine building for agriculture) (3); VAT (3); enterprise profit tax (CPT) (3); taxation of businesses (2); excise tax (1); taxation for zone with special investment regime (1); and, local taxes (1), and on some other issues. The UNR was keen on the concept of tax system and together with CPU they developed a successful draft concept of the reform. This again demonstrates the possibility of cooperation on tax issues of irreconcilable ideological and political opponents. Of course, cooperation between ideological and political allies happened as well.

Table 13

Ukraine: Signed Laws and Resolutions Initiated by the Parliamentary Coalitions, 1999-2002

Faction	Drafts Initiated by Faction (#)	Drafts Initiated in Coalition (#)	Main Partners	
UNR	52	42	CPU (17)	R&O (11)
R&O	14	27	UNR (11)	CPU (7)
RU				
SDPU(u)	2	3	CPU (1)	R&O (1) UNR (1)
LU	1	2	CPU (1)	Solidarnist (1)
NDP	6	7	CPU (3)	R&O (2) UNR (2)
Batkivshchyna	2	2	CPU (1)	UNR (1)
Yednist	1			
Greens	2	7	CPU (2)	UNR (2)
DU	1			
NRU	1	1	UNR (1)	
CPU	29	41	UNR (17)	R&O (7)
Solidarnist	7	13	CPU (4)	UNR (3)
SPU	5	15	CPU (5)	UNR (4)
Yabluko				

3.13 *Efficiency of political blocks' work*

After the formation of stable political groupings (left, right and centrist blocks), the *Verkhovna Rada* during 1999-2002 adopted 83 laws on taxes developed and submitted for consideration. Table 14 summarizes the number of laws approved on taxes according to political coalitions and blocks in the parliament.

Table 14

Efficiency of Factions and Their Alliances in Terms of Adopted Laws

RIGHT wing factions	37
LEFT wing factions	14
CENTRIST factions	13
Alliance of RIGHT + LEFT factions	9
Alliance of RIGHT+LEFT+CENTER	6
Alliance of RIGHT+CENTER factions	2
Alliance of CENTER+LEFT factions	2

The right wing factions (UNR, R&O, and UNR) were the most effective, and by themselves or in coalition with others obtained approval for 54 initiatives. Center factions initiated or helped with the approval of 21 laws, while the left initiated or supported 31 initiatives. The center and right wing political forces were the most effective political alliance; cooperation between the center and the left was limited.

3.14 Classification of adopted laws and resolutions by their substance

Table 15 presents an overview of the areas in which different groups have developed and submitted proposals that were consequently adopted and signed. The most productive and efficient in their legislative activity were right-wing factions (R&O and UNR), and left-wing factions (CPU and SPU). Factions, which belong to the political center and include the majority of representatives of business and capital and are associated with power or oligarch groups, took an absolutely passive position. For instance, the centrist factions initiated only 6 draft bills on VAT out of 34 bills (or 21 per cent of all laws on VAT adopted); 5 draft bills on enterprises' profit tax out of 35 (or 14 per cent), etc. Such position of the center shows that representatives of business and capital were not very keen on changing existing tax system in Ukraine. Interestingly, the centrist political groups generally support and follow rather than lead, although they bargain hard for that support.

3.15 Regional aspects in tax policy

The parliament of Ukraine was active on regional issues and established in 1998-2002 ten special economic zones in some of the most prosperous regions of the country. The cabinet of ministers of Ukraine drafted and submitted most of them; all factions supported them. Thus the government, under the guise of regional policy has also been a promoter of special tax treatments, in this case, to win the support of powerful regional interest groups.

3.16 Voting on key legislature

An examination of the voting patterns around some key legislative tax initiatives illustrates the diversity of the positions of different political spectrums and factions on tax issues.[20] The tax code was supported mostly by factions close to the president and the green party. The big factions were rather lukewarm on the tax code despite significant activism on other matters. Interestingly, there is a high degree of cooperation around agriculture. As a consequence, agriculture practically does not

[20] Voting patterns on the following legislative initiatives that were approved were examined in detail: Tax Code, On changes and amendments to the Law of Ukraine "On the value added tax", On write-off of debts of collective agricultural enterprises, which undergo reforming, On temporary procedure of taxation of transactions on producing and sale of crude oil and some other fuel and lubricant materials, On fixed agricultural tax, On changes and amendments to the Law of Ukraine "On the value added tax" (moratorium until 2004 to agricultural producers to pay VAT), etc.

Table 15

Ukraine: Signed Laws and Resolutions by Type, 1999-2002

	R&O	SPULCSP	Batkivshchyna	CPU	NDP	Solidarnist	Greens	SDPU(u)	UNR	Others	Total
Total	15	6	5	29	6	7	2	2	36	4	112
Tax privileges				1	1						2
Tax exemptions			1			1					2
cancellation of tax exemptions			1								1
agriculture											
metallurgy											
energy sector											
FEZ and TPD											
Tax amnesty, including	1		3	4	1				2		11
agriculture			2	3							5
metallurgy											
energy sector			1	1	1						3
FEZ and TPD											
machine-building									1		1
cancellation of tax amnesty	*1*								1		2
VAT	4	2	1	3		1	1	2	9		23
CIT	1			3	1	1			7	1	14
PIT	2	1		2		1			1	1	8
Fixed agricultural tax				2							2
Excise tax	1			1					2		4
Taxation of businesses, including	1	1		2	1	2			2	1	10
foreign businesses											
domestic businesses	1	1		2		1			1		6
Repayment of tax obligations to budget and state target funds	1								2		3
FEZ, TPD and zones with special investment regimes				4			1		1	1	7
Local taxes	2			1	2				1		6
Registration of taxpayers				1							1
Measures aimed at improving tax legislation		1		1							2
Other	2	1		4		1			9		17

pay taxes, and, moreover, gets to keep for investment, the VAT it collects. Given the fragmentation of parliament, eventual passage of laws requires the cooperation of even small factions. Voting results for selected laws provide evidence that some bills could be approved with a moderate support of all the factions and no single champion.

3.17 The present (fourth) parliament

The fourth parliament was elected in 2002 and is currently in operation. Forming a majority and appointing a new prime minister took considerable time and effort. A centrist coalition sympathetic to the president emerged in control. This coalition can be said to receive the support of some of the most influential power groups in the country. Outside the coalition are the reformists on the center/right and the communist. This parliamentary section has been very active on tax matters. However, the government has followed the strategy of presenting single tax laws, rather than a comprehensive tax code. Ukraine has already approved a new PIT law, at rate of 13 per cent, in effect in January 2004, and which will increase gradually to 15 per cent in 2005. The draft law approved, was not presented by the Pro-presidential coalition, but rather by a deputy of the center right, now in the opposition.[21] The proposal, however, gained broad support. The reasons supporting this proposal are similar to those given in Russia. Given that the payroll tax has not been changed, it is unclear whether the new law will have any significant impact on compliance. Even if some of the exemptions have been eliminated, it is estimated that the new law will generate a revenue shortfall. Additionally, the CIT tax rate has already been reduced to 25 per cent and the exemptions to the CIT severely curtailed. A VAT law is now under consideration of parliament. It remains to see what will be the net effect of the current piecemeal approach to tax reform, in terms of consistency and sustainability, as it likely that this round of reforms will imply drops in revenues.

3.18 Summary

The dynamics of the third Ukrainian parliament (1998-2002) shows that the system of parties and factions in Ukraine is relatively unstable, but that when a coalition is formed, a significant legislative agenda can be advanced. The review of the tax legislation shows that cross-cooperation across political lines occurs frequently, with the left and right joining forces successfully in many cases. Notably, groups or factions representing business interests took a passive position, as if satisfied with preserving the *status quo.* In this political landscape, the lesson from Ukraine seems to be that systemic reforms, in this case of the tax system, suffer from the unstable political situation in the society as a whole and in the parliament in particular. Analysis of proposals, debates and discussions around tax bills shows that

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[21] The law was approved by 341 in favor, none against and 100 abstained, most from the Communist party.

very often MPs are involved only in lobbying narrow interests of businesses close to them (tax exemptions, low tax rates, excise tax, etc.), and some of them do not even have a clear picture of the tax system in a whole, especially with regard to the draft of a new Tax Code. The parliament supported tax amnesties and privileges, but did not tackle larger issue of comprehensive tax reform. It is likely that the vote of no confidence for the reformist government meant a stop to aggressive legislative reform, including a tax code. The president in Ukraine gets his support from centrist parties linked to conservative industrial/financial groups. These groups have not had a vision of their own, and have shitted alliances to reach narrowly defined objectives. The passage of a new PIT law, with a single rate, further illustrates the point. This law has been the initiative of opposition forces on the right, but gained support of all but the communists.

4. Russia

4.1 Early tax legislation

Before the end of 1991, Russia introduced a conceptual law, "The Basic Principles of Taxation", and a new VAT, Enterprise Profits, and Personal Income Tax laws had been adopted. The "Basic Principles of Taxation" law outlined a system of tax assignments, where VAT revenues were the prerogative of the federal government while the EPT and PIT revenues were assigned to sub-national governments. Overall, from 1992 onwards a defective and complex tax system emerged, as in Ukraine. The EPT, for instance, included a tax on excess wages and grossly exaggerated profits by disallowing many conventional business expenses and numerous regional and local taxes. In 1993, a presidential decree gave the right to regional and local governments to introduce new taxes, leading to additional turnover and payroll taxes. Although this decree was abolished in 1997, the practice lasted for longer. On the other hand, many aspects of the tax legislation were never implemented. For instance, the tax-sharing system included in the annual budget laws differed the rates stipulated in the basic law.

Overall the perception amongst experts on Russia (and similar to Ukraine) was the lack of financial discipline, which had led to significant levels of barter and non-payments, undermined tax discipline by providing opportunities for different methods of tax avoidance and evasion. Moreover, the discrepancies between revenues and expenditures during the Nineties, led to a very unstable macroeconomic environment.[22] There was an overwhelming perception among observers that the government was not strict enough in combating tax evasion, tax arrears, and tax privileges, thus further contributing to a soft-budget constraint. The relationship with the regions was of particular concern, specially because it was the revenues of the central government that contracted the most in relative terms. Since

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22 Table 5 shows that tax revenue dropped sharply from 36.0 per cent of GDP in 1997, to 32.0 per cent in 1998. It has since recovered in part.

the 1998 crisis, like in Ukraine, significant progress has been made in improving financial discipline, eliminating barter, and reducing inter-enterprise arrears.[23]

4.2 Stakeholders

Two groups are reported as playing a significant role in the taxation debate in Russia: the large economic interests, linked to privatizations, and the regional interests. In Russia, as compared with Ukraine, privatization of large scale interests advanced much farther, and state enterprises carry far less weight in the economy. Consequently, economic groups that emerged linked to private assets have played a different role than similar groups in Ukraine. In Ukraine, arguably the control of state owned enterprises provided a less certain terrain where to stand as the privileges could be lost easier. In Russia, private ownership carries its own type uncertainty. In both countries, power groups sought an early access to the state.

Reportedly, during the Nineties, tax collection practices in Russia involved continuous informal bargaining process whereby economic elites controlling the country's industrial enterprises and regional leaders negotiated with the government to establish their individual tax burdens. The government bargained with these highly lucrative and concentrated industries, mostly in the energy sector, as means to seek to ensure sufficient tax revenue. On the one hand, the tax administration apparatus was weak and unprepared to collect revenues in a new environment, where it was at a technical disadvantage. Thus, for instance, Russian oil companies were able to effectively avoid taxation because they could hide their profits through a series of legal and semi-legal schemes. Transfer pricing was the most common form. By some estimates, the oil companies had been able to hide at least 25 per cent of their export proceeds by using this mechanism. As a result of tax avoidance measures, despite the high statutory tax rates in Russia, the government only received 22 per cent of the approximately $30 billion in windfall rent from natural resources sales in 2000 while 78 per cent remained in the hands of (largely oil and gas) exporters. Schemes were also devised to avoid payroll taxes.

On the other hand, economic groups and oil companies benefited from flexible tax rates because they had privileged access to both formal and informal policy-making channels. They exercised political influence through two main forms of lobbying: influence on deputies in the Duma, and direct, personalized contact with members of the executive branch – most importantly the Ministry of Fuel and Energy. The oil and gas lobby was highly effective, and for the latter part o the Nineties, they convinced a sufficient number of deputies and government officials to block tax reform and even to reverse unfavorable changes made by executive decrees.

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[23] There are many accounts of the reform process in Russia: Shleifer and Treisman (2000); Martinez-Vazquez and Wallace (1999) and others in the references.

The struggle for resources between the center and regions has also played an important role in shaping taxation issues in Russia. These issues have been investigated in great detail. A key point in this debate has been how the relative weakness of the central government during the Nineties led to shrinking of the revenues of the central government, growing tax evasion, and widespread unofficial economic activity. A key element of Federalism in the Russian version was the power given to different levels of government to levy their own taxes on common tax bases with the national government. As mentioned, a December 1993 presidential decree authorized regions and localities to introduce additional taxes beyond those formally assigned to them by law. The impact of the decrees was rapid. In 1994, regions and governments introduced local taxes and fees, many of them with bases overlapping with those of existing federal taxes. Grazing on the same tax bases led to overtaxation and drove firms underground. Everything from dogs to the use of foreign alphabets in company names became taxable. The decree was repealed as of 1997, but most of the new regional and local taxes were not abolished.

Also, in many regions, a few large enterprises contributed most of the tax revenue. Tax sharing, in the face of a fragmented tax administration, created an incentive for regional governors to strike collusive deals with these enterprises, at the expense of the federal budget. This may explain why collection of taxes that were more evenly shared among levels of government deteriorated faster in the mid-Nineties than collection of those that belonged entirely to one level. Numerous schemes were employed to make these covert deals possible: profits disappeared from companies' balance sheets through secret accounts and offshore banks or due to creative bookkeeping; contributions to regional off-budget funds out of pretax profits; avoiding the use of cash by companies, and using notes (veksels); issued by the regional governments or banks, instead that could be then used for payment of regional and local taxes, since federal budget did not accept this payment, taxes paid in this from could not be shared; and writing off tax obligations in exchange for public services barter.

A distinguishing feature of Russia has been the fragmentation of the its tax administration.[24] Two factors contributed this fragmentation: the highly decentralized public administration inherited from the previous regime, and the desire of each region to prioritize collection of the taxes accruing to them, as noted above. Regions established special economic zones to attract business to register or realize its profits, regions offered "tax packages" for companies that included low tax rates, aid in evading federal taxes, and other political and economic benefits. This practice covered mainly huge companies that had branches in several different regions. The system of dual subordination facilitated local control of tax collectors, although the tax agency is statutorily a federal body. Reportedly, regional STS directors depended upon and were influenced by regional governments; and local STS directors also relied on and had to take into account the views of local mayors.

[24] The State Tax Service, after 1999 the Ministry of Taxation and Tax Administration.

Putin's government has committed to improve the federal character of the tax administration, and is working with international donors to do so.

4.3 The underpinnings of reform

The perceived dismal performance of the revenue system in Russia led to considerable internal reflection, with the concern with the growing informality, at the top of the agenda. The informal economy was identified, in Russia like in Ukraine, with a sizeable group of wealthy individuals that had amassed fortunes and hided them. Econometric models, for instance, showed that in 1993-96 wages and not incomes correlated best with the income tax base. Salary earners had little possibility to avoid taxes; other incomes were hardly taxed.

The conclusion was drawn that although the personal income tax was progressive on paper, *de facto* it was regressive. A similar argument was made for social security contributions, where, even though the contribution rate was flat, higher income earners saw no advantage to contribute. Moreover, hiding the tax base for income tax accomplishes a similar objective for social security contributions. Thus, the idea emerged to have the PIT be effectively a tax on income and not wages. Hence the proposal of flat income tax roughly equal to the average PIT payment, and a gradually decreasing rate of social security contribution. Note that the argument above is not based on the effect of high taxes on the supply of labor; rather, the argument hinges on the availability of evasion techniques, and the inability of the tax authorities to detect evasion and enforce the law. As such, this is an argument about the formalization of informal incomes, in an environment of a weak tax administration. As a consequence, bringing high incomes into tax net would increase the horizontal equity of the tax system.

There was not a similar emphasis to the reduction in the VAT, as it was not considered that such a reduction would lead to an increase in the tax base. However, there was an emphasis on the need to broaden the tax base by eliminating the exemptions. Emphasis was also placed on the unification of the land tax and property taxes. Energy resource taxation would also be reformed, as well as the regime for SMEs and the CIT.

4.4 The new tax code – part I

4.4.1 The reform initiative[25]

In 1997 the Ministry of Finance submitted a comprehensive draft tax code to the Duma (Parliament). The proposed legislation, drafted with the support of foreign advisors, had little support in the Duma, was significantly opposed by many regional governors, and was criticized by the private sector that lobbied against it. The key

[25] On the overall Russian tax reform process, see Loung and Weinthal (2001) and Fritz (2003).

opponents of the draft tax code in the private sector were banking and natural resources oligarchs who had consolidated their power after the Yeltsin's reelection in 1996. Although the Duma passed the code in the first reading under the pressure of the government, eventually in late 1997, Yeltsin suggested that the government withdraw the tax code.

Thereafter, parliament requested the submission of alternative draft tax codes, either from deputies or from outside of the parliament. After consideration of alternative drafts, the government presented an official draft in April 1998, which was drastically changed by parliament. Major changes included: prohibition for the executive to issue tax legislation; support of taxpayer's rights; increased range of costs deductible under the EPT, and reduction of the EPT rate from 35 to 30 per cent; and, a presumptive regime for small business.

Although the draft tax code was passed in the first reading by the full Duma in April 1998, it became clear that the proposed legislation would not be approved as one piece. It was decided that Part I, the general part, would be discussed and voted first. The redraft produced by the Duma working group radically transformed many provisions, shifting the accent on the protection of taxpayer rights and practically tying the hands of tax administration to enforce taxes. This draft was approved in July 1998 and became effective in January 1999. Hence, in Russia like in Ukraine, legislators wanted to tie the hands of the state as it regards tax enforcement.

4.4.2 The crisis of 1998 as a trigger

It is not unlikely that the August 1998 financial crisis had a significant impact on the politics and economics of Russia and the neighboring countries. It certainly proved the vulnerability of the government and productive sectors, and business as usual did not appear any longer possible. The government needed to buttress its revenue sources and the private sector needed clearer rules. There was certainly a cost to continue operating on the opaque world of inter-enterprise debt and barter transactions, and to have the effective tax burden depend on the relationship with the official at hand. Following the crash in August 1998, some of the oil companies faced bankruptcy and lacked a cash flow to service their debts. Because many of the oil companies had acquired substantial foreign debt, the Russian government's decision to devalue the ruble made it even more expensive to repay these loans. Moreover, the oil companies were unable to pay their salaries, and many companies were forced to shut down their operations for several months, or to radically downsize their operations and decrease expenditures. Similarly, the 1998 crisis and the dramatic fall in world oil prices revealed how vulnerable the government was to global markets due to its dependence on oil exports for budgetary revenue. Federal government revenues and expenditures radically went down.

4.5 The new tax code – part II

Putin became acting prime minister in August 1999, acting president in January 2000, and president-elect in April 2000. A new Duma was elected in December 1999. Unity, a party supporting the president, was second in the parliamentary elections. This parliamentary election represented a shift of power to centrist and pro-government forces. These parties supported lower corporate taxes, reduction in exemptions, and simplification and more stability of the tax system. The communist party, on the other hand, supported increasing the top marginal rate of the personal income tax and higher taxation of the natural resource sector. Putin's presidential election gave a boost to tax reform. The new government presented the second part of the Tax Code to the consideration of the Duma, including the now well known 13 flat PIT rate. Likewise modifications to the part I of the Tax Code were presented, strengthening the enforcement powers of the state. After some lengthy negotiations, in July 2000, Part II was adopted, including chapters on the income tax, a unified social tax, excise taxes, and on VAT, and entered into effect on January, 2001. The profit tax and the energy sector tax were approved in 2001 and came into effect in 2002.

The profit tax was lowered from 35 to 24 per cent, to be shared among the federal, regional, and local governments. In the energy sector, a unified tax on production of raw materials replaced the royalties and mineral-resource tax. This ended a period of "implicit" bargaining in the taxation of the sector. New legislation on these two taxes became effective in 2002. In terms of rates, the code as approved meant lower rates for profit and income, the same for VAT, higher for excises, and, possibly, a higher rate for natural resources.

Alignment between the president and the Duma around a tax reform program contributed to a tax reform more aggressive than those considered by the previous Duma. This higher accord between the presidency and the Duma is likely to have facilitated also the approval of various elements of the Part II of the tax code by the Federation council,[26] which *de facto* lost its veto power. Also, and just as important, Putin managed to reach a broader constituency during the presidential election and thus liberated himself somewhat from the special interests. The president was able to challenge the regional interests. He also challenged the special interest groups, although, as some have argued, some amongst them had become conscious of the need for clear rules in a more level-playing field.

4.6 Outcomes and outlook

How successful has been the Russian tax reform? It certainly represents a comprehensive effort and the main thrust of the effort has been domestically driven. Moreover, the Russian reform is already impacting on neighboring countries, most

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[26] The Federation comprises regional governments and speakers of regional parliaments. It operates as a second chamber. Any veto of the Federation can be rescinded by the Duma.

significantly on reducing the rates of taxation and reducing the scope and extent of the state. However, other countries should better take account of the fact that Russia's taxes are buttressed by oil income and hence the country can afford lower taxes elsewhere. On the domestic front, it is too early for a full assessment of impact.

Revenue performance has been improving since 1999, but has yet to reach the level of 1997 (see Table 5). Tax revenues have slightly dropped from 2001 to 2002, due mostly to a drop in the CIT yield. The personal income, the VAT, and the resource extraction taxes have increased. As to PIT, its performance is still below the pre-1998 crisis level. It is not possible to determine the extend to which the revenue increases are due to the flat tax on compliance, to the greater enforcement efforts, or the increasing the level of wages, although the later appears to be the most likely explanation.[27] A final verdict will have to wait to see if, indeed, the level of formalization of incomes has increased.

Perhaps more importantly would be the impact on the overall business environment, and sustainability of the reforms. This effect cannot be measured with certainty in the short term, and to be effective it requires substantial changes in the administrative practices of taxes and customs. The Russian government has already initiated this effort, with emphasis on the federal nature of the tax administration. Also, important is the sustainability and improvement of the legislative practices, as is the further reduction of special treatments and other tax policy issues still on the agenda. Likewise, one may ask as to the sustainability of natural resource taxation. In this regard, it would appear important to continue consolidating the power of the state, trying to keep at arms' length from the interest groups in society. Moreover, it is important that power groups continue placing an emphasis on normalizing their activities. This is not necessarily a given, as the long-term experience of Latin America shows.

4.7 Russia and Ukraine compared

Russia and Ukraine, during the Nineties, shared a common history of weak financial discipline with all of its consequences for enterprises and the government. But there has also been significant differences, Ukraine extracts a higher share of GDP in taxes than does Russia, if oil is excluded. Russia has advanced far more than Ukraine in the privatisation of the public assets. Also, regional interests play a greater role in Russia than in Ukraine.

Both economies have begun to depart from their transitional phase and started developing more the characteristics of an effective market economy. This has meant a change in the articulation of tax interests, as tax constraints become more binding and economic agents start to feel the burden of taxation. In both countries, economic

[27] Note that most of the taxpayers were already paying close to the flat tax rate, with only a few paying the higher 30 per cent.

groups have developed an interest in formalizing their operations, demanding clearer and enforceable rules. Although, this is likely to be more the case in Russia than in Ukraine.

However, Russia has approved a Tax Code, while Ukraine was unable to do so. Current efforts at piecemeal legislation in Ukraine still leave open the question of the overall consistency at the end of the process. Two important differences stand out in the political arena: the nature of the political parties and the composition of parliament, and on the relationship between parliament and the presidency. The constitution assigns greater power to the president in Russia than in Ukraine. Putin has sought to reestablish this power, based on the mandates obtained from the presidential and the parliamentary elections. The alignment of powers in the Duma and the presidency has allowed the federal government to block regional interests. Putin, it would seem, has sought the support of the broader constituencies in distancing the state from narrow vested interests.

During the last parliament, Ukraine managed to form a parliamentary majority, which supported a reform program. However, the past parliament did not support a broad tax reform. This, notwithstanding, the level of legislative activism on tax matters was significant. A highly fractured parliament led the approval of several tax amnesties, special tax treatment, and special zones. The most ambitious piece of tax legislation changed the norms for the collection of overdue taxes, limiting the powers of the tax administration. The same piece of legislation approved the largest tax amnesty in the history of Ukraine.

The vote of no confidence for a reformist government in 2001 by a center/left coalition, blocked the advance of an ambitious legislative reform agenda, the tax reform included. The political groups representing the business interests in Ukraine have not been very enthusiastic about comprehensive tax reform, perhaps because they prefer to deal directly with the state. The pressure to eliminate special privileges and enforce tougher budget constraints is bound to change attitudes in Ukraine. Still, it remains a fact that the president in Ukraine has not been able to establish an at-arms'-length relationship from the power/interest groups.

An additional element that helps explain the difference between the two countries is the higher degree of privatization in Russia. State Owned Enterprises in Ukraine seem less likely to go beyond narrow interests and take broad policy positions. Loung and Weinthal (2001) have argue that private domestic interests have been the forces behind the Russian reform. Specifically, they have argue that large energy groups benefit from a clear transparent tax system, not only in their dealings with the state, but also in their capacity to develop business with foreign partners. While this indeed has been a factor, other factors noted above are likewise relevant, particularly the consolidation of state power and the alignment between executive and parliamentary (political) forces. Also, special interests have to realize that "preferential treatments" are often temporary, and best if to agree on universal and stable norms.

5. Other CIS countries

In other CIS countries, besides Russia and Ukraine, the nature of the political arrangements also affect revenue reform and performance. It would take a longer review to look into the political economy experience of taxation of other countries.[28] But, the review of the Russian and the Ukrainian experiences shows the importance of the mechanisms of political control, which allows some speculation as how the level of political and administrative control could affect revenue performance in other CIS countries.[29] Belarus and Uzbekistan have reintroduced strong mechanisms of control, and both have relatively high rates of revenue generation over GDP.[30] To a lesser extent, this seems to be true of Turkmenistan. Belarus, for instance, is a country that has maintained both a structure of strong control and a highly formalized economy, and both factors contribute to explain its high revenue rate of extraction. The improved performance of Georgia and Armenia after the middle of the Nineties is due partly to the greater control exercised by the central authorities after internal wars. In the middle of the spectrum are countries like Ukraine and Russia, where the command structure collapsed somewhat, but overall new governance structures have arisen. Moldova seems to represent a special case, because it has managed to keep a relatively high levels of revenues, while reforming the institutions and suffering a drastic income contraction, without development a tight system of political control. It remains to see if the present situation is sustainable.

CIS countries with low ratios of revenue to GDP have characteristics more similar to developing economies – highly informal economies with weak control structures. Efforts to improve revenue mobilization, as may be required by the expectations of the basic constituencies, will depend to a great extent on improving their administrative capacity and addressing the political problems that state-consolidation entails. This may become increasingly difficult as interest groups become highly entrenched in the political system, as the experience of Latin American countries shows.

Now, while a high degree of political control favors high rates of revenue extraction, it does not by itself serves the advance the modernization of the tax systems. In fact, the high level of revenues may not be sustainable. To generate a demand for tax reform is necessary to introduce hard budget constraints so that the

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28 For instance, the Georgian experience shows how political factors came to distort the tax design. See IMF Country Report No 211, November 2001 – Georgia: Recent Economic Developments and Selected Issues.

29 Political factors are not often used to explain revenue performance. Traditional explanations center on tax handles, such as the (a) the size of the formal sector of the economy, and (b) size of foreign trade in the economy. The size of the formal sector affects the collection of income taxes and of social security employment, which are levied on wages. It is also likely to have an effect on domestic VAT collection and possibly CIT's, although much will depend here on the profitability of enterprises, their compliance and the ability of tax collectors. The level of international trade is particularly relevant for the collection of VAT and excises. Not surprisingly, highly informal economies (Georgia, Armenia, Tajikistan) have low revenues from income tax and social security contributions, and also their over collection ratios in general.

30 Refer to Tables 1 to 3.

economic actors feel the burden of taxation. It is likely that privatization also helps, as owners are more likely to articulate their interests, when faced with binding budgets and tax obligations. But, also a political system is needed to articulate the interests and develop the vision.

6. Conclusions

This review has emphasized the peculiar characteristics of the political economy of CIS countries, built upon interests that have developed in very incomplete institutional environments. The tax systems developed in these environments were highly inconsistent and incomplete. As hard budget constraints become the norm and property rights are better defined, the need has emerged for comprehensive tax reform to best suit the requirements of a market economy. However, effective comprehensive tax reforms require a tax constituency that can articulate its interest and a political system (executive and legislative) that can aggregate those interests. The review of Ukrainian and Russian experiences showed, that pure political factors such as the alignment between the president and the parliament, and the leadership of the president play an important role. Important also appears, as others have noted, the level of privatisation (in hand of local owners.). Therefore, three factors play an important role in advancing tax reform: (a) the degree of political control; (b) tax constituencies capable of articulating their own interests; and, (c) a political system capable to develop a vision of a tax system that supersedes the boundaries of narrow interests.

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