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Value-Added Taxation within the Customs Union of Belarus and Russia: Concept, Practices, and Lessons

Summary

Last year, the authorities of Belarus and Russia signed an intergovernmental agreement that introduced the destination principle of value-added taxation for bilateral trade since 2005. The major characteristic of this principle is the absence of border controls since the countries are forming the Customs Union. Therefore, the VAT is collected by tax authorities via a deferred-payment system of zero-rating of exports. This system causes high risks for exporters and relative high transaction costs for businesses, in particular for small and medium enterprises as well as individual entrepreneurs, that makes the destination taxation less efficient.

There are some alternative policy options regarding the design of the destination VAT without border controls. However, there are trade-offs in each of the various ways of instituting a destination-based VAT. It is argued that there is currently no alternative to the deferred-payment system of zero-rating of exports. The current problems are the inescapable consequences of the desirable aim of abolishing border controls.

Yet, there is some room for improvement of the current system. In our view, it is necessary to adopt a 'self-assessment' system of value-added taxation for trade with Russia. Furthermore, it is necessary to create a government agency that would provide information about those taxpayers who don't pay VAT or do not properly comply with the VAT rules. These measures would allow to somewhat alleviate the current problems stipulated by the necessity to preserve the VAT chain.

1. Introduction

The value-added tax (VAT) is a relatively new tax. It was first introduced as a national tax 51 years ago in France. Since then, it became the main source of indirect taxation in many countries in different parts of the world and at different stages of the economic development. The classical VAT is

- a general tax that applies, in principle, to all business activities involving the production and distribution of goods and the provision of services;
- a broadly based consumption tax, since it applies more or less to all goods and services that are bought for final consumption;
- collected fractionally, via a system of partial payments whereby taxable persons deduct from the VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities;
- an indirect tax, which is paid to tax authorities by the seller of goods and services, who is a taxable person, but in economic terms the VAT is actually shifted from the seller to the buyer as a part of the price.

Since the VAT is an indirect tax focusing on business activities rather than on profits or assets, one primary tie of this tax is the location of taxable transactions. In order to ensure the taxation of final consumption in the case of international trade, the VAT should be based on *the country-of-destination principle*. Under this principle, countries levy a VAT on goods and services finally consumed within their borders, i.e. all imports are liable to VAT while zero-rating applies to all exports (exports are tax exempt and all domestically paid taxes are reimbursed). Thus, the destination taxation requires some kind of border adjustments by customs authorities. In contrast, *the country-of-origin principle* assumes that countries levy a VAT on goods and services produced within their borders, i.e. all exports are liable to VAT while all imports are tax exempt.

All countries of the Commonwealth of Independent States (CIS) originally based their VAT on the restricted origin principle: trade within the CIS was taxed according to the origin principle and trade with the rest of the world according to the destination principle. Then, most of the countries, including Belarus, partially moved toward the destination basis, in some cases retaining origin-based trade only with Russia. In 2001, Russia adopted the destination basis for CIS trade (except for Belarus) for all goods and services other than Russia's two major exports – crude oil and natural gas. In 2004, Russia adopted the destination basis for CIS trade (except for Belarus) in crude oil and natural gas. Moreover, the authorities of Belarus and Russia signed an intergovernmental agreement that introduced the destination principle for bilateral trade since 2005. With this shift, the entire CIS is now on the destination basis with respect to VAT.

The major characteristic of the destination taxation on trade between Belarus and Russia is the absence of border controls to monitor the flow of goods and services since the countries are forming the Customs Union. Therefore, the VAT is collected by tax authorities via a deferred-payment system. This causes serious problems on the part of businesses, which argue that the application of destination taxation without border controls cannot be operative. The aim of this paper is to examine in detail the VAT arrangements in Belarus and to evaluate some policy options regarding the efficient implementation of the destination principle within the Customs Union of Belarus and Russia. The discussion is mainly restricted to the taxation of goods. At the same time, the paper does not seek to explore the policy goals behind the VAT or assess its relative merits as a source of government's revenue against other taxes.

2. Previous and Current Systems of Value-Added Taxation on Trade with Russia

In Belarus, the VAT is paid by legal entities, including enterprises with foreign investments and permanent establishments of foreign legal entities; participating parties in joint ventures; individual entrepreneurs in the case of foreign trade or if their proceeds from sale of goods and services for the previous three months exceeded the equivalent of EUR 40,000; enterprises and physical persons that engage in transit of goods via the territory of Belarus; subsidiaries, representative offices, and other independent subdivisions of legal entities possessing a separate balance sheet and a settlement account.

The VAT is calculated according to the invoice method. That is, the tax liability is determined as a product of the taxable transactions and the tax rate. Then, the input taxes are credited against this amount. If the latter exceeds the former, the taxpayer is not obliged to pay VAT. The excess credits are deducted from the VAT liability in the next period or deducted from other tax liabilities or refunded to the taxpayer. The accounting of tax liabilities is optionally on a cash basis or an accruals basis. The VAT is levied at the rates of 0%, 10%, and 18%.

Until the intergovernmental agreement as of 2004 became effective, trade with Russia was taxed according to the origin principle. All exports were liable to VAT while all imports were tax exempt. Since January 1, 2005, the origin principle was replaced by the destination one. At present, imports are liable to VAT while exports are zero-rated.[1] However, since there are no border controls within the Customs Union of Belarus and Russia, the VAT isn't collected by customs authorities at the border (as is the case in trade with other countries) but by tax authorities via a deferred-payment system.

This system supposes that importers declare their imports, calculate tax liabilities, and pay VAT until the twentieth of a month following the month when the imported goods were accounted. To this end, importers submit: (i) tax returns, (ii) import declarations, (iii) bank documentation indicating that the VAT has been actually paid, (iv) contracts, (v) shipping documentation, and (vi) invoices. Then, importers send one copy of the import declarations verified by the tax authorities to the suppliers of goods. As an aid to enforcement, tax authorities also send one copy of the import declarations to the tax authorities of another country via e-mail.

On the other hand, exporters are supposed to submit: (i) tax returns, (ii) contracts, (iii) bank documentation indicating the receipts from sale of exported goods, (iv) copies of the import declarations sent by the importers, and (v) copies of the shipping documentation – within 90 days since the date of goods' shipment. Otherwise, zero-rating doesn't apply and exporters pay VAT on their exports. If the above documents are submitted after the deadline (but within 3 years), the VAT paid is deducted from the VAT liabilities in the next period or deducted from other tax liabilities or refunded to the exporters. Tax authorities are also entitled to provide exporters with zero-rating based on the copies of import declarations sent by the tax authorities of another country via e-mail.

Some measures were also implemented to prevent reduction of the businesses' liquidity due to the adoption of destination taxation on trade with Russia. First, the limit on the total amount of input taxes paid on acquired capital goods was abolished (before, these taxes were credited in the amount of 1/12 per month). Second, the limit on the amount of tax credits on exports was also abolished (before, this amount was reduced by 4% of the proceeds from sale of exported goods and services). Third, the period of deduction of excess credits from other tax liabilities was reduced from 3 to 1 month. The period of refunding of excess credits was reduced from 6 to 3 months. Finally, at present, tax authorities verify tax credits within 15 working days if the excess credits exceed 3,000 base amounts (before – 60 working days and 2,000 base amounts).

3. Evaluation of the Current System of Value-Added Taxation on Trade with Russia

In order to evaluate the current system of value-added taxation on trade with Russia, we consider first the features one would like such a system to have. In addition to the

[1] The destination taxation doesn't apply to goods from third countries. They are still taxed according to the origin principle.

usual criteria of efficiency, simplicity, flexibility, transparency, and equity, the specific features in the present context would include:

- *Taxation according to the destination principle.* The VAT paid should be at the rate specified by, and the revenue should accrue to, the country where final consumption takes place.
- *Autonomy of the countries in tax setting.* The real tax setting powers of national tax authorities should be preserved.
- *Minimal scope for tax competition by the countries.* The exercise of their tax setting powers may trigger external effects across countries with consequent potential for the countries to do themselves mutual harm. Therefore, the scope for either exporting taxes onto foreigners or stealing tax base by under-cutting tax rates should be minimized.
- *Proper collection incentives within existing tax authorities.* The system should provide national tax authorities with the incentives to enforce tax in a manner that is appropriate for both countries. Moreover, implementation should not require the creation of new tax administration.
- *Preserving the VAT chain.* A key advantage of the VAT is that it secures tax revenue by collection throughout the chain of production and distribution. Breaks in this chain fundamentally compromise the integrity of the VAT and lead to distortions of business activities as well as to incentives for fraud.
- *Identical compliance requirements for trade within and between countries.* Ideally, the obligations on taxpayers should be the same wherever in the Customs Union they sell, a condition, which is known as 'compliance symmetry'.

Let us now consider whether the current system of value-added taxation on trade with Russia performs well on the above criteria.

First, the current system of zero-rating of exports and taxing imports is the standard treatment of trade under the destination-based VAT. It stimulates exports as well as investments by avoiding distortions to cross-border trade and hence fosters closer economic integration of the countries. Besides, it allows to get more revenue in Belarus because of the excess of the tax revenue from imports over the VAT refunds for exports since the balance of trade with Russia is in the red. In the first quarter of 2005, the VAT revenue increased by 55.5% (BYR 458.7 bn) in nominal terms and by 34.7% in real terms compared to the same period of 2004. However, the absence of border controls means that a significant element of origin taxation is inescapable. Private persons can still import goods from another country for consumption without having to pay any domestic indirect tax. Cross-border consumer purchases therefore carry the indirect tax of the country where the purchase was made – the origin country.

Second, the current system of destination taxation allows to retain some tax setting powers at national tax authorities. Under the previous system of origin taxation, the tax rates had to be harmonized in order to prevent tax competition by the countries.

Third, zero-rating of exports enforces the destination principle and so minimizes the scope for tax competition. However, the element of origin-based taxation opens the door to tax competition, as countries may be tempted to lower the domestic tax rate to attract foreign cross-border shopping and increase the national tax base at the expense of neighboring country. Allowance for transportation costs would not change these qualitative conclusions, although such costs clearly reduce the scope for distorting cross-border trade.

Fourth, there are no particular incentive problems in collecting the tax, since national tax authorities retain in full all the tax they collect.

The current system fails, however, with respect to the last two criteria set out above.

Fifth, zero-rating of exports generally breaks the VAT chain by removing tax from traded goods. This feature puts great pressure on the ability of tax authorities to control refund claims: limiting the obvious scope for fraud while ensuring prompt refunds for honest taxpayers is one of the most difficult aspects of administering a VAT. Yet, the current system is less vulnerable against fraud since zero-rating applies only if exports have documentary authority and importers have actually paid the tax. At the same time, such a system causes serious risks for exporters. Now, their tax liabilities depend on whether importers have paid the tax or not. This may require exporters to withdraw some capital from production processes in order to make tax payments. To avoid these risks, exporters suspend deliveries or increase prices by the amount of VAT. However, many enterprises can hardly increase prices because of the tough competition on the market.

Besides, this system causes relative high transaction costs for businesses, in particular, for small and medium enterprises as well as individual entrepreneurs, that also has a negative impact on trade. Many importers and exporters abandon to make small contracts since the transaction costs of such a contract are quite high.

These conclusions are supported by the data from the Ministry of Statistics and Analysis of the Republic of Belarus. In the first quarter of 2005, the Belarusian exports to Russia decreased by 7.9% (USD 90.5 m) and the Belarusian imports from Russia decreased by 9.2% (USD 182.2 m) compared to the first quarter of 2004. At the same time, the Belarusian exports and imports to non-CIS countries increased by 49.3% (USD 678.5 m) and 17.9% (USD 153.9 m) respectively. There were also no significant increases of prices in trade with Russia: the prices of exported goods increased by 4.2% and the prices of imported goods increased by 3.5%. On the other hand, in the case of trade with non-CIS countries, the prices of exported and imported goods increased by 32.0% and 10.4% respectively.

Sixth, the current system raises compliance and administration costs by requiring taxpayers and tax authorities to distinguish between sales to residents in the same country (taxable) and those registered in another country (zero-rated). At the same time, it is not clear how substantial a barrier to trading between countries these asymmetries are, or how great a cost saving their elimination would produce.

Box 1. Value-Added Taxation in the European Union

Each member state of the European Union (EU) has a VAT. Since the late 1960s, the national systems of general turnover or sales taxes were step-by-step replaced by a common system of value-added taxation. However, the laws establishing the VAT are still national ones, but they are strictly framed within the parameters specified by the European Commission, in particular by the Sixth VAT Directive as of 1977 on the common system of value-added taxation and the uniform basis for its assessment. This directive guaranteed a strong degree of harmonization by establishing the structure, methods, and technical principles of the VAT, which followed the country-of-destination principle with corresponding border adjustments. Furthermore, it determined the lower limits for standard and reduced tax rates.

As of January 1, 1993, the national borders ceased to exist within the EU and the single market became a reality. The terms of import and export were abolished between member states and became known as ‘intra-Community deliveries’. Therefore, the practical aspects of value-added taxation had to be adapted to the new situation. At that time, the European Commission proposed moving from the destination-based taxation to an origin-based taxation. However, this wasn’t acceptable to member states as the tax rates were too different and there was no adequate mechanism to redistribute VAT revenues to mirror actual consumption. Therefore, until these conditions were right, the European Commission adopted the ‘transitional’ VAT system which maintained different fiscal systems but without border adjustments.

The transitional system contains the following main points. Private persons buying goods in another member state pay VAT in the country in which the goods are bought (based on the country-of-origin principle). Border adjustments according to the destination principle do not apply any more due to the lack of border controls. Only in the case of the cross-border purchases of new motor vehicles the destination principle still applies via the national registration procedures. In the relevant case of trade between businesses liable to VAT, the VAT is levied in the member state to which the goods are transported for trade at the rates and under the conditions of that member state. In this case, the destination principle based on the deferred-payment system is working. The business pursuing an intra-Community supply is allowed to apply zero-rating if its client in another member state identifies as a taxable person via its VAT identification number irrespective of whether the VAT has been actually paid or not. The VAT number was introduced EU wide and covers all businesses that take part in the system. It can be checked using the computerized system for the exchange of information between national tax authorities (VIES – VAT Information Exchange System). The business must submit regular reports regarding such deliveries. On the other hand, the business receiving the goods submits a tax return for the corresponding intra-Community acquisition.

The European Commission acknowledges that applying the VAT at origin would be a better system with fewer compliance and administration costs and less susceptible to fraud. In other words, a true domestic market would be achieved if intra-Community deliveries were treated in the same manner as those within member states, although this has not been achieved to date. In addition, it is acknowledged that the risk of irregularities detected in the control of the system has increased. There are two principal methods of fraud: (a) declaring false intra-Community deliveries, as goods are actually sold on the domestic market without paying tax, and (b) not declaring the VAT returned in intra-Community acquisitions. As a result, the risk to the integrity of the VAT chain became significant.[2] Furthermore, when consumers are free to engage in cross-border shopping and national indirect tax rates differ substantially, the door is inevitably opened to trade distortions and tax competition leading to revenue losses. So far, however, such losses do not seem to be significant, although concern has recently focused on the growing phenomenon of ‘distance sales’ using mail order and especially electronic commerce.

The transitional period was meant to last through 1996 when a ‘definitive’ VAT system was to have been established, based on the country-of-origin principle. However, an agreement on the definitive system for VAT has not yet been reached. Decision-makers are studying and focusing upon the detailed impact of such a system. In the meantime, the European Commission has shifted its emphasis from a move to a definitive system towards measures to improve the present transitional arrangements.

4. Design of the Destination Value-Added Tax: Some Alternative Policy Options

The deferred-payment system and different compliance requirements for trade within and between countries causes serious problems on the part of businesses and hence makes the destination taxation less efficient in the absence of border controls. But is there a way of preserving the VAT chain and ensuring compliance symmetry without redistributing tax revenues and undermining the ability of countries to set their own tax rates? Let us take a look at some alternative policy options regarding the design of the destination VAT in the absence of border controls.

4.1. Clearing-House System

One of the alternative policy options is to remove zero-rating of exports, so that exports would be taxed at the same rate as domestic sales, combined with a credit against foreign output tax in the importing country. Additionally, a clearing-house system should be introduced by which tax revenues would effectively be reallocated between countries so as to preserve the same allocation of tax revenues as under zero-

[2] The recent evidence points to substantial abuses in the field of value-added taxation in the EU. The estimated VAT gap – the amount of VAT being lost each year – has demonstrated increasing losses since the introduction of a single market. For example, in the United Kingdom, the VAT gap increased from about 8% to more than 15% of VAT revenue.

rating. The result is that total tax paid would be determined by the rate levied in, and revenue accruing to, the country in which final consumption takes place.

The major benefit of clearing is that the VAT chain is not broken. It also ensures the identical treatment of trade within and between countries. The difficulty of this approach is to find a way of clearing that preserves proper incentives for tax collection.

One possibility is to clear the single transactions on the basis of each invoice. That is, the countries would claim repayment by summing across transactions the total input tax claimed in respect of imports from another country. This has the apparent appeal of potential accuracy. However, even apart from the administrative cost of processing millions of invoices in this way, this scheme violates the requirement of preserving proper collection incentives. For if an importing country is fully reimbursed for all tax credits claimed in respect of imports from another country then it has little incentive to guard against fraudulent claims: the cost of these will be borne in the respective countries from which the imports stem from. This seems to open the floodgates to corruption.[3]

Another possibility is to reallocate revenues on the basis of aggregate consumption statistics from the national accounts. This reduces the administrative burden. On the other hand, this procedure depends on the reliability of the underlying statistics, which are often mistrusted. Moreover, a general disincentive in tax collection emerges at this point: if the net VAT that a country receives depends only on its level of consumption and the tax rate, it has no incentive to put any effort into collection at all, at least at the margin.

These difficulties point to a more fundamental problem. If tax authorities should have a proper incentive to collect revenues they must retain some of the revenues collected in their country. However, the reallocation of revenues provided the removal of zero-rating supposes that the revenues on exports would be collected on behalf of another country. It is this incentive problem that poses the most severe difficulties for clearing-house arrangements. One way to establish proper incentives would be to hand over the administration of the national VATs, and the clearing-house, to a common agency. But if no such agency already exists, this violates the requirement that no new tax administration should be created. Short of that, one could conceive of an incentive mechanisms that go some way towards aligning the interests of national tax authorities with the wider collective interests of both countries: some degree of sharing of aggregate net VAT collections may be appropriate, for instance.

In the following sections, however, we focus instead on two recent conceptual approaches that address these issues by reforming the structure of the VAT itself.

4.2. Compensating Value-Added Tax

The first approach is a 'compensating VAT' (CVAT) originally proposed in 1995. According to this policy option, trade within countries would be subject to the national VATs while trade between countries would be zero-rated for the national VATs and subject instead to a CVAT at the same rate for both countries. Credit would be allowed for tax on purchases of registered taxpayers, both under the national VATs for trade within countries and the CVAT for trade between countries. The result is that no CVAT would be collected on net in the case of sales to registered taxpayers (it would be collected and then credited). In the case of sales to non-registered taxpayers or private persons, the CVAT would be a final tax.

The CVAT preserves the destination principle and strengthens the VAT chain – relative to zero-rating – to the extent of the CVAT levied on trade between countries. However, the CVAT does not leave the chain entirely inviolate. It is still necessary to refund national tax on exports between countries, and, moreover, it becomes necessary to refund CVAT.

[3] Nevertheless, there is currently a successful destination-based VAT between Israel and the West Bank and Gaza, using a clearing-house system based on computerized and cross-checked invoices.

At the same time, since the tax rate is the same for both countries, there is no scope for tax competition by the countries through the tax treatment of their exports and imports.

The implications for collection incentives are less clear-cut. Administration of the CVAT may require the creation of a central agency that would collect and reimburse the tax. In this case, there is no intrinsic difficulty with incentives: the cost of refunding to the importer the CVAT levied on trade between countries provides the right incentive to collect it from the exporter. That is, the incentive problems are dealt with by internalizing the transfers within a single administration. The only difficulty that arises is that of sharing out the CVAT collected on trade between countries other than to registered taxpayers (which are not recovered). The central agency would have to allocate the tax revenue in some systematic way. At the same time, this approach violates the requirement that implementation of the tax should not require the creation of new tax administration. If, however, administration of the tax on trade between countries is not by some body whose interests over-arch those of the countries, then all of the incentive and administrative difficulties associated with the clearing-house system also apply to the CVAT: revenue must be moved from the national tax authority which collects funds to the tax authority that effectively refunds them.

The clear disadvantage of the CVAT is that it violates compliance symmetry, since trade between countries (liable to CVAT) is treated differently from trade within countries (liable to national VATs), and hence leads to higher compliance and administration costs. Moreover, the rate of the CVAT is determined centrally that undermines autonomy of the countries in tax setting.

Thus, the CVAT is successful in protecting tax revenues of the countries from some obvious frauds. The CVAT is, as well as the clearing-house system, inherently more centralizing though this may be a price that has to be paid to implement a successful destination-based VAT in the absence of border controls.

4.3. Viable Integrated Value-Added Tax

The other new scheme is a viable integrated VAT (VIVAT) proposed in 1996. It requires both countries to set the same tax rate on all sales to registered taxpayers anywhere in the Customs Union, with a full credit given for the input VAT. But the tax rate applied to final sales – to private persons and other non-registered taxpayers – remains entirely at the discretion of the countries. The VIVAT works in a fashion similar to the CVAT. In fact, it combines a completely harmonized VAT in the Customs Union with a national sales tax. Again, in the case of sales between registered taxpayers, the result is that no tax would be collected on net (it would be collected and then credited).

The VIVAT preserves the destination principle and autonomy of the countries in tax setting: the final tax applied to sales depends only on the tax applied at that stage – which remains under national discretion – not on the common rate levied at prior stage. The rate of VAT applying to intermediate transactions only affects the rate at which revenue cumulates, and not the scale of revenue finally collected. At the same time, since this tax rate is the same for both countries, there is no new scope created for tax competition by the countries.

Some form of clearing would be needed to ensure that the tax collected on intermediate sales between countries is reallocated in line with the destination principle. This is straightforward if collection and refunding of the intermediate tax is entrusted to a central agency. However, the familiar collection incentive problems associated with clearing arise if the implementation is kept by national tax authorities. The incentive and distribution problems could be also kept within limits by harmonizing the VAT rate on intermediate transactions at a relatively low level, since this would limit the redistribution of revenue and imply that there would be no high-tax countries to submit false invoices from.

The VIVAT also preserves the VAT chain on trade between countries, to an extent that depends on the level of the intermediate rate. It also strengthens the chain on sales within countries if the intermediate rate is set at the highest of the national tax rates. The VIVAT ensures compliance symmetry, in that the taxpayer's obligations are the same for trade within and between countries.

But the VIVAT has potential disadvantages. The VIVAT weakens the chain on trade within countries in at least one country to the extent that the intermediate rate is set below the highest of the national tax rates. This problem may not be very severe, since the intermediate rate need not be set at the lowest of the national tax rates; but there is a potential difficulty. More specific to this policy option is that the VIVAT introduces a new kind of compliance asymmetry: businesses must treat their customers differently according to whether they are registered for VAT or not. Last but not least, the VIVAT like the CVAT performs better if the new tax administration is created.

5. Conclusions and Policy Recommendations

There are serious practical obstacles to the consistent implementation of destination taxation within the Customs Union of Belarus and Russia. Historically, the administration of the destination principle has relied on a system of national border controls. By controlling all imports and exports at the border, customs authorities were able to check that all imported goods were subject to VAT and that all zero-rated goods were in fact exported. However, with the implementation of the Customs Union, border controls between Belarus and Russia were abolished, partly for ideological reasons, but also because border formalities tended to increase the transaction costs of cross-border trade, thereby inhibiting the creation of a truly integrated market. Thus, the current problems in the field of value-added taxation stem from the fundamental tension between the goal of creating a border-less Customs Union and the goal of preserving tax revenue and national autonomy in tax setting.

Table 1. Features of the Alternative Destination VAT Models

	Zero-Rating	Clearing	CVAT	VIVAT
Destination taxation	Yes	Yes	Yes	Yes
Autonomy in tax setting	Yes	Yes	Yes	Yes
Minimal scope for tax competition	Yes	Yes	Yes	Yes
Proper collection incentives	Yes	No	Yes	Yes
Existing tax administration	Yes	No	No	No
Preserving the VAT chain	No	Yes	Yes	Yes
Compliance symmetry	No	Yes	No	No

Among the possible alternative solutions to the current system of zero-rating of exports are the clearing-house system, the compensating VAT, and the viable integrated VAT. However, there are trade-offs in each of these various ways of instituting a destination-based VAT without border controls (see Table 1). If countries wish to ensure the equal tax treatment of domestic and cross-border trade without changing the distribution of tax revenues, they will have to devise some form of revenue clearing mechanism, which will involve administrative burdens and/or a serious weakening of the incentives for effective tax enforcement. The CVAT and VIVAT provide ways of implementing the destination principle without breaking the VAT chain on exports, thereby reducing the vulnerability of the system to fraud. But these taxes require the creation of a central agency. In this case, both CVAT and VIVAT finesse the collection incentives associated with clearing. If, however, their implementation is through national tax authorities then both face the same difficulties with clearing. Moreover, under the CVAT, businesses must distinguish between sales within and between countries; under the VIVAT, they must distinguish between sales to registered and non-registered taxpayers. Because of these problems, there is probably no clear alternative to the current deferred-payment system of zero-rating of exports. However, in the longer-run, if the creation of the Union State of Belarus and Russia will proceed, these policy options might be an alternative. At the same time, the EU version of the deferred-payment system implying zero-rating of exports irrespective of whether the VAT has been actually paid is too risky for Belarus. It can lead to considerably larger VAT gap compared to the EU.

Thus, it may be thought that the system chosen is the right one, while the current problems in the field of value-added taxation for trade with Russia (high risks for exporters and relative high transaction costs for businesses, in particular for small and medium enterprises as well as individual entrepreneurs) are the inescapable consequences of the desirable aim of abolishing border controls. Nevertheless, despite some measures that have been implemented at the beginning of 2005, there is some room for improvement of the current system. In our view, the following should be done.

<u>First,</u> it is necessary to adopt a 'self-assessment' system of value-added taxation for trade with Russia, under which taxpayers would calculate their VAT liabilities, submit tax returns and payments to the tax authorities, and would be then subject to risk of audit. Although using self-assessment procedures for domestic trade, tax authorities currently place excessive data requirements regarding trade with Russia – taxpayers are requested to attach additional documentation (such as bank and shipping documentation). At the same time, Belarus should not go as far as the EU. That is, taxpayers should submit the confirmation documentation as well.

<u>Second,</u> it is necessary to create a government agency that would provide information about those taxpayers who don't pay VAT or do not properly comply with the VAT rules. A database with such information available for potential exporters should be created. This agency would also advise on how to deal if importers don't pay VAT and support the claims to such importers.

In our view, these measures would allow to somewhat alleviate the current problems of value-added taxation stipulated by the necessity to preserve the VAT chain, which would make the destination taxation more efficient and have a positive impact on trade within the Customs Union of Belarus and Russia.

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