



Abolishment of Turnover Taxes in Belarus: Economic and Fiscal Implications

Summary

This paper examines the current status of turnover taxes in Belarus and assesses the recent efforts to abolish them. It argues that the turnover taxes are distortionary and that they weaken the competitiveness of the economy. The tax system could be improved by abolishing these taxes. However, there would be a significant fiscal shock. Taking into account the high level of government revenues and expenditures in Belarus, the paper argues in favor of gradual abolishment of the turnover taxes in the next years and no financing of the revenue loss. At the same time, some measures should be introduced in order to offset the revenue loss.

Contents

1. Current Status of Turnover Taxes in Belarus	2
2. Economic Implications of Turnover Taxation	2
2.1. Investments	2
2.2. Structure of the Economy	3
2.3. International Trade	3
2.4. Organization Forms of Businesses	3
3. Abolishment of Turnover Taxes: Some Policy Options	4
4. Conclusions and Policy Recommendations	4

1. Current Status of Turnover Taxes in Belarus

In 2006, the Belarusian turnover taxes comprise:

- (a) Payments to the Republican Fund for Support of Agricultural and Food Producers and Agricultural Science; and
- (b) Payments to the Road Fund.

These taxes are paid by legal entities, including entities with foreign investments and permanent establishments of foreign legal entities; subsidiaries, representative offices, and other independent subdivisions of legal entities possessing a separate balance sheet, current account, and other accounts; participating parties in joint ventures. The tax base is turnover from sales of goods and services (i.e. production and distribution costs and value added as well as other taxes).

The tax rate amounts to 3%. The taxes are earmarked in the following way: (a) 2% to the Republican Fund for Support of Agricultural and Food Producers and Agricultural Science; and (b) 1% to the Road Fund (see Table 1). It should be noted that the turnover taxes are levied along with the 18% value-added tax.

Table 1: Marginal Turnover Tax Rates, 2001–2006, %

	2001	2002	2003	2004	2005	2006
Payments to the local housing-investment funds	0.50	0.50	0.50	0.40	0.40	–
Payments to the Republican Fund for Support of Agricultural and Food Producers and Agricultural Science	2.00	2.00	2.00	2.00	2.00	2.00
Payments to the Road Fund	1.00	1.00	1.00	1.00	1.00	1.00
Earmarked fee for maintenance and repair of public housing	1.00	1.00	1.00	0.75	0.50	–
Total	4.50	4.50	4.50	4.15	3.90	3.00

The turnover taxes are imposed on traders at most levels of economic activity and at most stages in the chain of distribution of goods and services (i.e. from producer to retailer), without any offset for taxes paid at an earlier stage. Unless the goods are specifically exempt or excluded from taxation, the taxes “cascade” on most traders, and repeatedly on goods which must pass through more than one stage of distribution, so the more stages in the chain of distribution the more taxes are imposed.

This paper examines the economic implications of turnover taxation and assesses the recent efforts to abolish them. The structure of the paper is as follows. Section 2 analyses the economic implications of turnover taxation in terms of its impact on investments, structure of the economy, international trade, and organizational forms of businesses. Section 3 presents some policy options aimed at abolishing the turnover taxes and considers the fiscal implications of the proposed tax reform. Section 4 concludes with policy recommendations.

2. Economic Implications of Turnover Taxation

The turnover taxes are defective, because they involve substantial cascading and thus distort economic decisions. Let us consider the impact of these taxes on investments, structure of the economy, international trade, and organizational forms of businesses, as well as to compare it with that of VAT.

2.1. Investments

In contrast to turnover taxation, VAT is a consumption tax borne ultimately by the final consumer; VAT that was paid on the enterprises’ purchases is deducted from the VAT liabilities at the subsequent stages of production. However, turnover taxes are charged on companies. Gross investments and production inputs are taxed along with value added in each firm. Moreover, turnover taxes are levied on the entire value of the product, including turnover taxes paid at the previous stages.

Therefore, investment spending is included into turnover tax base, i.e. turnover taxes are not neutral in regard to investments. Purchases of machinery and equipment (as well as other inputs) are taxed by turnover taxes, and such tax payments are not subject to deductions. At the same time, under the current system of VAT taxation, investments are not taxed (if VAT is timely reimbursed).

Thus, turnover taxation has a negative impact on investments. Fixed assets taxed by turnover taxes at different stages of production and distribution are more expensive. This fact is particularly worrisome, taking into account the obsolete technological base of Belarusian production facilities and a high level of depreciation of fixed assets.

2.2. Structure of the Economy

Under turnover taxation, effective tax rates for goods and services with different cost structure are different. Thus, turnover taxation inevitably leads to distortions in prices for final and intermediate products.

Shifts in the relative prices are known to effect the allocations of capital within the national economy and involve the structural changes. Turnover taxation is detrimental for capital-intensive industries due to the discrimination of investments as well as for manufacturing branches, especially those located at the highest stages of the production chain due to the cascading input burden. It is relatively beneficial for the raw materials and commodity producing branches as well as services.

2.3. International Trade

Turnover taxes as opposed to VAT are not neutral in regard to international trade since there is no border adjustment by refunding the domestic tax burden, as it is the case by the destination VAT rules. Insofar, domestic production is discouraged against foreign competition. As a result, turnover taxes promote imports and hamper exports, so turnover taxation contributes to trade balance deterioration and undermines the economic growth in Belarus.

Under the turnover tax system, Belarusian imports enjoy preferential treatment, since inputs for imported goods are not taxed in the producing countries. On the other hand, inputs for Belarusian exports are subject to multiple taxations by turnover taxes and when delivered to foreign consumers – by VAT in a recipient country. The turnover tax administration makes it hardly possible to calculate the exact amount of taxes paid on inputs, so turnover taxes (paid on the earlier stages of production) may not be reimbursed for exports. As opposed to turnover taxation, VAT is rather traceable and may be effectively reimbursed for exported goods. Turnover taxation is most detrimental for exported products with a long production chain, thus export of machinery and equipment, chemicals, metals, and food products are the most affected.

The turnover taxation affects the competitiveness of domestically produced goods both at the internal and external markets. Raw materials produced domestically have the higher prices (multiple turnover taxes inclusive) compared to imported raw materials (taxed once). Goods and services, supplied by domestic producers for final consumption, have a higher tax component (cumulative turnover taxes) in their value compared to foreign goods and services. In such a way, foreign producers partially displace domestic producers at the Belarusian market.

2.4. Organizational Forms of Businesses

Turnover taxes foster the establishment of vertically integrated entities involved in production, assembling, wholesale and retail sale. Turnover taxes stimulate vertical integration and concentration of the production since enterprises with full turnover cycle minimize their tax obligations on turnover taxes. So, turnover taxation distorts economic decisions in regard to organizational form of business and lead to efficiency losses. Moreover, it has a negative effect on small and medium-sized enterprises.

3. Abolishment of Turnover Taxes: Some Policy Options

Thus, the above discussion indicates that turnover taxes are distortionary, and that they weaken the competitiveness of the Belarusian economy. The tax system could be improved by abolishing these taxes. But, how to do it, especially taking into account the fiscal implications of the proposed tax reform (see Table 2)?

Table 2: Share of Turnover Taxes in the General Government Revenues, %

	2004	2005	2006
Payments to the local housing-investment funds	1.2	1.0	–
Payments to the Republican Fund for Support of Agricultural and Food Producers and Agricultural Science	5.4	5.3	5.6
Payments to the Road Fund	2.7	2.7	2.8
Earmarked fee for maintenance and repair of public housing	2.2	1.4	–
Total	11.6	10.5	8.4

Note. 2005 – preliminary data; 2006 – forecast of the Ministry of Finance.

Source: Own calculation on the basis of the data from the Ministry of Finance.

Let us consider some policy options aimed at abolishing the turnover taxes and assess their fiscal implications.

Option 1: Abolishment of all turnover taxes and compensating increase in the VAT rate in 2007 (a revenue-neutral solution). According to our calculation based on the data from the Ministry of Finance, in this case, the VAT rate should be increased from 18% to 26% (assuming that there would be no change in compliance behavior).

The positive aspects of this policy option include: (i) no change in the total general government revenues (just in their structure); (ii) a principle that all revenues come to the budget (not to earmarked funds). At the same time, any increase in the VAT rate could send wrong signals to the economy. Businesses could consider such changes as an increase in the tax burden. As a result, they could change their compliance behavior and there probably would be a revenue loss (taking into account that the administration of turnover taxation is more efficient compared to that of VAT).

Option 2: Abolishment of all turnover taxes in 2007 and no financing of the revenue loss (a non revenue-neutral solution).

This policy option is more attractive if we accept the goal of reducing the total tax burden in the economy. It also allows to avoid sending wrong signals to the economy since there is no increase in the VAT rate. However, measures to offset the revenue loss are crucial for the success of this policy option. These measures could include streamlining public expenditures, abolishing many quasi-fiscal activities, and improving tax administration still further. At the same time, the tax burden reduction would lead to improvement of the financial performance of businesses and, hence, could probably have a positive impact on the government revenues. In this case, the possible revenue loss would not be significant.

Option 3: Gradual abolishment of all turnover taxes in the next years and no financing of the revenue loss.

This policy option is quite similar to the second one. But it has an additional advantage that there is no major fiscal shock and the room for fiscal adjustment is significantly bigger.

4. Conclusions and Policy Recommendations

There is evidence to suggest that the structure of a country's tax system can have a significant impact on economic growth. Although the tax structure varies among countries depending on their level of income per capita, the tax policy can affect long-term growth performance by promoting neutrality, eliminating distortions, and contributing to capital accumulation. In this context, the abolishment of turnover taxes is crucial

for economic growth in Belarus, insofar as these taxes involve substantial cascading and thus distort economic decisions.

Considering possible policy options aimed at abolishing the turnover taxes, we can say that, in general, Option 1 is better than the current situation. Option 2 is better than Option 1 if we accept the goal of reducing the total tax burden. But there is a problem with regard to balancing the budget or financing the revenue loss. Option 3 is better compared to Option 2 if we assume that the complete abolishment of turnover taxes in 2007 would pose a significant fiscal shock.

Taking into account that the overall level of government revenues and expenditures in Belarus is rather high (among transition countries, Belarus has a relatively high level of government revenues and expenditures, on par with Hungary and considerably higher than other countries with comparable income per capita), we favor Option 2 and Option 3 as opposed to Option 1. In order to avoid a fiscal shock, we recommend to implement Option 3, i.e. the turnover taxes should be repealed, albeit phased over a reasonable time period in order to introduce measures to offset the revenue loss.

Stefan Bach, Ricardo Giucci

Lector: Dzmitry Babicki

Minsk, April 2006