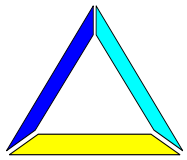
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To change or not to change? Economic and Fiscal Implications of Turnover Taxation

Executive Summary

VAT administration in Ukraine has been traditionally criticized for its inefficiency. The problems related to VAT varies from low tax compliance to problems with tax refunds generated inter alia by outright fraud and corruption.

Despite numerous attempts to improve VAT administration by means of introductions special VAT accounts, eliminating of some tax-privileges and complicated systems of cross-checks of VAT refund claims the problems have been persisting thus prompting the arguments that VAT is a tax of highly developed countries while the transition economies (like Ukraine) are not ready to use this fiscal instrument and VAT is to be replaced either by sales or turnover tax. We argue that Ukraine should make efforts to increase VAT administration efficiency, rather than replacing it by turnover tax (TT).[1]

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[1] We have already addressed these issues, see, for example, VAT replacement or better administration. Advisory paper T36 (http://www.ier.kiev.ua/English/papers/t36_en.pdf)

Introduction

The government is considering the possibility of the introduction of turnover tax instead of VAT.[2] At the same time no convincing evidence supporting this idea has been presented so far.

In this respect two fundamental questions arise: what are economic and fiscal effects of such a reform – and we addressed them in the framework of current paper.

We begin with some definitions and short description of the fundamentals of turnover tax.[3]

In Part 2 we investigate the economic implications of turnover tax in terms of its effect on investments, structure of the national economy, international trade, organizational form of business. We argue that TT introduction is incompatible with Ukraine's efforts to join EU. In Part 3 we present the calculations of the fiscal impact of turnover taxation and identify branches losers and beneficiaries. Part 4 contains our principal conclusions.

2. Indirect taxation: brief overview

TT is a cumulative tax on the sales of producers and traders. TT is levied at each stage in the production and distribution chain. Cumulative or cascade effect is augmented with a number of economic transactions. By TT government tax not only the value added produced by economic agents, but costs incurred for production. Taking into account the full production cycle, we can say, that multiple taxation of inputs is attributable to TT.

Economic transactions rather than household consumption fall under taxation by TT. Under turnover taxation effective tax rates for the goods and services with different cost structure are different. Thus, TT inevitably leads to the distortions in prices for final and intermediate products. In such conditions tax neutrality criteria is violated. VATis a consumption tax collected at each stage of production and distribution chain as fixed proportion of value added and then partially reimbursed when the good is sold. **VAT is consumption tax** because it is borne ultimately by the final consumer. This tax is **neutral** regardless of how many transactions are involved and is paid to the revenue authorities by the seller of the goods, who is the "taxable person", but it is actually paid **by** the buyer to the seller as part of the price, thus it is an indirect tax.

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[2] On the 11.03.2005 at a business forum Prime-Minister Y. Tymoshenko declared, that Cabinet of Minister would initiate the replacement of VAT by Turnover Tax with a rate of 7-10%. According to quoted calculations, Turnover Tax will yield more budget revenues while its administration is simpler and less vulnerable to corruption and fraud.

[3] For detailed description of VAT see: VAT replacement or better administration. Advisory paper T36 (http://www.ier.kiev.ua/English/papers/t36_en.pdf)

Main features of TT as compared to VAT are presented in Table 1.

Table 1. TT versus VAT

	VAT	TT
Economic essence	Consumption tax, collected fractionally as a percentage of prices	Indirect tax on the sales of producers and traders
Cumulative (cascade) effect	-	+
	VAT	TT
Tax base	Value added produced	Turnover (value added plus inputs)
Deductions of the taxes previously paid	+	–
Taxation of investments	-	+
Impact on relative prices of different commodities and services	-	+
Neutrality in regard to organizational form of business	Neutral	Non-neutral
Neutrality in regard to exports-imports	Neutral	Non-neutral

Source: own presentation.

Currently in the world VAT dominates in the system of indirect taxation. Among industrial countries only USA and Australia don't have VAT (in USA retail sales and in Australia wholesales are used). In 1980-1990s all transition countries, except Bosnia&Herzegovina, Montenegro and Serbia, introduced VAT.[4]

In the countries with a market economy TT functioned until the end of 1960s. It was applied in Austria, Belgium, France (at the local level), Germany, Greece, Italy, Luxemburg, Netherlands and Spain (see Table 2).

Table 2: Consumption Taxes in OECD countries, as of 01.01.1967

Sales tax levied on wholesales	Sales tax levied on retail sales	Cumulative turnover tax (TT)	VAT
		Austria	
Australia	Canada	Belgium	Finland
Dania	Iceland	France	France
Ireland	Ireland	Germany	
New Zealand	Norway	Greece	
Portugal	Sweden	Italy	
Great Britain	USA	Luxemburg	
Switzerland		Netherlands	
		Spain	

Source: Institute for Economies in Transition. Problems of Tax System in Russia: Theory, Experience, Reform, http://www.iet.ru

Mass switch to VAT took place at the end on 1960-ies when six European countries signed the Treaty of Rome. Since sales and turnover taxes applied in different way in Member Countries produced high obstacles for their trade, they decided to harmonize the system of indirect taxation within European Economic Community (EEC).

VAT was the first to be established and harmonized in EEC. The first and second VAT Directives enforced VAT introduction in 1970, they were aimed at replacement of production and consumption taxes. The sixth VAT directive required the tax to be applied to the same transactions in all Member States.[5]

[4] For details see: P. Miltra, N. Stern. Tax System in Transition // World Bank, 2002.
[5] European Commission. Tax Policy in the European Union. – http://europa.eu.int/comm/publications/

2. Economic Implications of the Turnover Tax

TT is not neutral in regard to prices, resources' allocation and consumption choice. Thereby TT distorts economic decisions. The number of re-sales determine the effective rate of TT, that is not compatible with equity condition. Thus, both criteria of efficient taxation (equity and neutrality) are violated.

2.1. Effects on investments

As it was said 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. On the contrary, TT is a charge on companies. Gross investments and production inputs are taxed along with value added. Moreover, TT is levied on full value of product, including TT paid at the previous stages.

Investment spending is included into TT tax base, i. e. TT would not be neutral in regard to investments. Purchases of machines and equipments (together with other inputs) would be taxed by TT, and such tax payments would not be eligible to deductions. Under current system of VAT taxation investments are not taxed (if VAT is timely reimbursed).

Thus, TT introduction would have a detrimental effect on investments. Fixed assets taxed by TT at different stages of production would become more expensive. Thus, replacing VAT by TT would hamper renovation and modernization of the Ukrainian economy. This fact is particularly worrisome, taking into account the obsolete technological base of Ukrainian production facilities and high level of depreciation of fixed assets.[6]

2.2. Structural shifts in the economy

TT introduction would change the cost and price structures in the Ukrainian economy. Different TT component in the prices of different goods and services would affect the profitability of different sectors and induce the changes in relative prices.

Shifts in the relative prices are known to effect the allocations of capital within the national economy and involve the structural changes. TT introduction will be detrimental for manufacturing branches, especially those located at the highest stages of the production chain; and will be beneficial for the raw materials and commodity producing branches (for details see calculations below).

Since attractiveness of a definite branch would be determined by its proximity to the primary processing and low share of inputs in total output, TT would involve inter-sectoral distortions in the allocation of capital. More capital would flee to gas and oil extracting industries, trade, transport, gas supply, hotels and restaurants, post and telecommunications. On the other hand, manufacturing of coke products, petroleum refinement, food industry, production of chemicals, non-metallic mineral products, paper industry, water supply, metallurgy and production of machinery would suffer from the relative shortage of capital (see Table 3) other things being equal. Relative prices distortions, in its own turn, would generate efficiency losses.

2.3. Organizational form of business

[6] As of 01.01.2003 the total depreciation coefficient for the fixed assets in Ukraine equaled 47.3%. Most depreciated fixed assets have operated in construction (59%), energy, water and gas distribution network (59%), education (57%), manufacturing (55%).

TT would foster establishment of vertically integrated entities involved in production, assembling, wholesale and retail sale. TT would stimulate vertical integration and concentration of the production since enterprises with full turnover cycle would minimize their tax obligations on TT. So TT would distort economic decisions in regard to organizational form of business and lead to efficiency losses.

Moreover, the peculiarities of current tax system in Ukraine are to be taken into account. Small business enjoys preferential tax treatment and huge incentives to split business activity exist. In such conditions introduction of TT would make the middle business the worst off and undermine the revenue potential of the Ukrainian tax system (both small and large business would minimize their tax payments).

2.4. Influence on export-import dynamics

TT as opposed to VAT is not neutral in regard to international trade. The cumulative effect of TT would affect international trade and distort international pricing. TT would create barriers for Ukrainian exports.

TT would promote imports and hamper exports, so turnover taxation would contribute to trade balance deterioration. Under TT system imports would enjoy preferential treatment in Ukraine, since inputs for the imported goods are not taxed in the producing countries and the only tax levy for the imported goods in Ukraine would be 7-10% of TT.

On the other hand, inputs for Ukrainian exports would be eligible for multiple taxations by TT and when delivered to foreign consumers – by VAT in recipient country. TT administration makes hardly possible to calculate the exact amount of taxes paid on inputs, so TT (paid on the earlier stages of production) may not be reimbursed for exports. As opposed to TT, VAT is rather traceable and may be effectively reimbursed for exported goods. TT taxation would be most detrimental for exported products with a long production chain, thus export of machinery and equipment, chemicals, products of metallurgy, manufactured products of food industry would be the most affected.

Turnover taxation would affect the competitiveness of the domestically-produced goods both at the internal and external markets. Raw materials produced domestically would have the higher prices (multiple TT inclusive) than imported materials (taxed once). Goods and services, supplied by domestic producers for final consumption, would have the higher tax component (cumulative TT) in their value, than foreign goods and services. In such a way foreign producers would partially displace domestic producers at the Ukrainian market.

Thus, TT would create basis for "fiscal" export discrimination and preferential import treatment and as such TT would act as a factor of Ukraine's comparative disadvantage and undermine the economic growth in Ukraine.

2.5. Perspectives for EU accession

EU Treaty (Art. 93) calls member states for harmonization of indirect taxes. It is reasoned by the fact, that indirect taxes affect free movement of goods and freedom to provide services, so setting up a single market requires the coordination of tax policy in the sphere of indirect taxation.

Majority of transition countries adopted VAT on the base of European model. Their desire to join EU played an important role in their decision to introduce VAT. If Ukraine abolishes VAT and replaces it by TT, its fiscal system will become incompatible with EU standards and Ukraine's accession to EU will be problematic even in the long run.

3. Fiscal Implications of Turnover Tax

3.1. Tax compliance and revenue losses

Lack of tax credit in case of TT (paid at previous stages) deprives TT self-enforcement mechanism: both producers and consumers would be interested to hide economic transactions to avoid TT taxation. On the contrary, VAT taxation enforces buyers to care on VAT payments that enable them to receive a tax credit. The same refers to taxation of services. On the other hand, VAT urges buyers of production services to record the relevant transaction in order to decrease their final obligations on VAT. Thus, VAT is more efficient in taxation of production services.

TT system has potential stimuli for the growth of shadow economy. If some sales are hidden from TT taxation, appropriate tax collections are lost forever. Under VAT taxation losses at some stages of production are compensated at the subsequent ones.

VAT minimizes the possibilities of tax evasion for imported goods, since VAT is paid on the border. On the other hand, TT would be paid domestically during the first sale of imported good. Thus possibilities of evading TT would be much higher than for VAT.

In case of VAT revenues are lost because of non-reported sales of products for final consumption and false VAT refund claims. For TT any unrecorded economic transaction would result in revenue losses.

These considerations are relevant to tax privileges too. Under TT taxation enterprises would have strong incentive to lobby for tax exemptions since cost of their production would go down and their profitability would go up. Thus, revenue losses, induced by TT exemptions, would be significant. On the other hand, VAT exemptions are beneficial only for enterprises producing (selling) goods and services for final consumption and amount of revenue losses, induced by VAT exemptions, are not comparatively high, since relevant goods have been taxed at the earlier production stages.

3.2. Revenue potential of Turnover Tax

Tax base of TT is much broader than VAT base. It includes not only the value added produced, but intermediate consumption too. Moreover, if intermediate consumption for a given branch is not a primary product and has been processed at earlier stages of production, its costs include TT paid before.

In order to calculate the potential TT revenues we worked out 3 hypothetical scenarios based on 2003 data. These scenarios differ by TT tax rates (10%, 7% and 4%)[7], primary data are derived from the input-output table published by Derzhkomstat. Our calculations are based on the assumptions of the absence of tax evasion induced by TT and absence of tax avoidance through vertical integration. So they reflect TT collections in pre-adjustment period.

Output in basic prices plus trade and transport margins, plus imports less exports constituted the tax base for our calculations. In addition, we tried to take into account the rise in prices for inputs induced by turnover taxation at the earlier stages of production. To encompass this effect we used the indicator of average number of links in production chain. Intermediate consumption multiplied by number of links and TT tax rate gives us the increment in tax obligations on TT

[7] 10% and 7% are the rates proposed by Y. Tymoshenko and 4% TT was effective in Western Germany until 1967.

induced by inputs taxation. To arrive to relative indicators of tax burden for every branch we divided branches' tax charges on output and GDP.

Our calculations suggests, that under different assumptions the branches with the longest production cycle (education, production of machinery and equipment, etc) will bear the highest tax burden in terms of TT generated price increase (see Table 3). At the same time, branches with high value added and relatively little inputs as well as some industries of primary commodity sector will benefit from the new system of turnover taxation. If TT is charged at a rate of 7% the relevant TT obligations of forestry will constitute 8% of gross value added, extraction of oil and gas – 5%, gas supply – 11%, trade – 12%, hotels and restaurants – 8%, transport – 7%, post and telecommunication – 10%.

TT obligations as percentage of output will vary insignificantly – from 7% in primary commodity branches to 7.8 – 8% in production of chemicals, non-metallic mineral products, metallurgy and metal processing, production of machinery and equipment, etc.

Altogether, according to our hypothetical scenarios, TT revenues from (before vertical integration effect comes into force) would amount up to 21.2% of GDP under 10% TT rate, 15.7% of GDP under 7% TT rate and 8.8% of GDP under 4% TT rate. However, tax base erosion caused by vertical integration and shadow transactions would decrease TT revenues, at least, twofold.

Table 3: Potential TT revenues by the branches of economy in 2003 with TT rates 10%, 7% and 4%, UAH m.

			Tax rate is 10%				Tax rate is 7%				Tax rate is 4%			
	Output plus Imports	Exports	Increment of interm. consump	TT colle-ctions	TT collect, % output+ Imp-Exp	TT collect. on dom.pr. % of GDP	Increment of interm. consump	TT colle-ctions	TT collect, % output+ Imp-Exp	TT collect. on dom.pr. % of GDP	Increment of interm. consump	TT colle-ctions	TT collect, % output+ Imp-Exp	TT collect. on dom.pr. % of GDP
Agriculture, hunting	76175	4052	0	7091	10	22	0	4963	7.0	15.6	0	2836	4.0	8.9
Forestry	1450	502	0	94	10	11	0	66	7.0	7.7	0	37	4.0	4.4
Fishery	1306	52	0	123	10	35	0	86	7.0	24.5	0	49	4.0	14.0
Mining of coal and peat	15953	503	0	1529	10	30	0	1070	7.0	20.8	0	612	4.0	11.9
Productions of hydrocarbon	47253	4273	0	4193	10	7	0	2935	7.0	4.9	0	1677	4.0	2.8
Productions of non-energy materials	14271	3852	0	1030	10	19	0	721	7.0	13.6	0	412	4.0	7.8
Food industry	91171	12246	0.1	7199	10	30	0.07	4984	7.2	20.7	0.04	2817	4.1	11.7
Textile and leather industry	16601	5070	0.21	1236	11	25	0.07	811	7.2	15.2	0.04	457	4.1	8.4
Woodworking, pulp, paper industry, publishing	18731	3650	0.21	1753	12	33	0.14	840	7.5	16.3	0.08	631	4.3	12.2
Manufacture of coke products	8559	1271	0.1	797	11	134	0.07	543	7.5	91.3	0.04	302	4.2	50.6
Petroleum refinement	28436	8044	0.1	2105	11	57	0.07	1436	7.4	38.5	0.04	800	4.1	21.4
Manufacture of chemicals, rubber and plastic products	40844	13361	0.21	3083	12	28	0.14	2065	7.8	17.9	0.08	1128	4.3	9.3
Manufacture of other non-metallic mineral products	12598	1626	0.21	1246	12	42	0.14	834	7.8	28.2	0.08	455	4.3	15.3
Metallurgy and metal processing	75451	46908	0.21	3424	12	23	0.14	2268	8.0	14.7	0.08	1225	4.3	7.8
Manufacture of machinery and equipment	81665	23319	0.33	6210	11	20	0.23	4185	7.6	12.8	0.12	2304	4.2	6.7
Other production	7425	1213	0.10	616	10	43	0.07	427	7.2	30.1	0.04	242	4.1	17.0
Electric power industry	20575	608	0.10	2096	11	22	0.07	1431	7.4	14.7	0.04	797	4.1	8.2
Gas supply	2112	0	0.10	191	11	17	0.07	130	7.5	11.4	0.04	72	4.2	6.4
Heat supply	6371	0	0.10	602	11	40	0.07	415	7.2	27.3	0.04	234	4.1	15.4
Water supply	2320	0	0.10	225	11	26	0.07	154	7.3	17.6	0.04	86	4.1	9.8
Construction	28038	272	0.21	2640	10	22	0.14	1844	7.0	15.2	0.08	1051	4.0	8.7

Trade	55564	16	0.00	5498	10	17	0.00	3848	7.0	11.9	0.00	2199	4.0	6.8
Hotels and restaurants	5689	1788	0.21	382	11	11	0.14	260	7.5	7.5	0.08	144	4.2	4.1
Transport	53960	20008	0.21	3668	12	11	0.14	2453	7.8	7.3	0.08	1338	4.3	3.9
Post, telecommunications	14689	443	0.21	1496	11	15	0.14	1013	7.6	10.3	0.08	560	4.2	5.7
Informatization activities	2302	65	0.21	244	12	16	0.14	164	7.7	10.6	0.08	90	4.2	5.8
Research and development	4184	282	0.21	431	11	18	0.14	292	7.6	12.1	0.08	162	4.2	6.7
Services to legal entities	10957	381	0.10	1141	11	16	0.07	778	7.5	10.7	0.04	433	4.2	5.9
Public administration	19548	42	0.21	136	1	-1	0.14	66	0.3	-1.3	0.08	21	0.1	-0.9
Education	18658	128	0.33	161	1	1	0.23	77	0.4	0.5	0.12	24	0.1	0.2
Health care and social assistance	15081	99	0.21	122	1	1	0.14	59	0.4	0.6	0.08	19	0.1	0.2
Sewage, cleaning of streets	1588	0	0.1	9	1	1	0.07	4	0.3	0.7	0.04	1	0.1	0.2
Social activities	976	0	0.21	8	1	1	0.14	4	0.4	0.6	0.08	1	0.1	0.2
Recreation, entertainment, culture and sports	4543	22	0.21	462	10	18	0.14	319	7.2	12.7	0.08	179	4.1	7.1
Other activities	1404	1	0.21	150	11	16	0.14	102	7.5	10.6	0.08	56	4.2	5.9
Total	836757	154394		**56910**	9	16		**41646**	6.4	11.6		**23451**	3.6	6.5

Table 4: Potential VAT collections and TT collections in 2003 under the assumption of no frauds, tax exemptions, and vertical integration incentives, mln. UAH

	House-hold consu-mption	Non-profit entities consum	Govern. cons of goods,services	Total final consum. expendi-tures	Potential VAT collec-tions	TT collec-tions rate - 10%	TT collec-tions rate - 7%	TT collec-tions rate - 4%
Agriculture, hunting	23611		799	24410	4150	7091	4963	2836
Forestry	22		112	134	23	94	66	37
Fishery	1116			1116	190	123	86	49
Mining of coal and peat	995		1	996	169	1529	1070	612
Productions of hydrocarbon	1965		107	2072	352	4193	2935	1677
Productions of non-energy materials	185			185	31	1030	721	412
Food industry	48806			48806	8297	7199	4984	2817
Textile and leather industry	7091			7091	1205	1175	811	457
Woodworking, pulp, paper industry, publishing	1175		7	1182	201	1603	1093	608
Manufacture of coke products				0	0	797	543	302
Petroleum refinement	6468			6468	1100	2105	1436	800
Manufacture of chemicals, rubber, plastic products	5446		308	5754	978	3083	2065	1128
Manufacture of other non-metallic mineral products	1227			1227	209	1246	834	455
Metallurgy and metal processing	454			454	77	3424	2268	1225
Manufacture of machinery and equipment	8895		425	9320	1584	6210	4185	2304
Other production	3439			3439	585	616	427	242
Electric power industry	2376		536	2912	495	2096	1431	797
Gas supply	394		32	426	72	191	130	72
Heat supply	3261		204	3465	589	602	415	234
Water supply	762		75	837	142	225	154	86
Construction	455			455	77	2640	1844	1051
Trade	820			820	139	5498	3848	2199
Hotels and restaurants	2029		155	2184	371	382	260	144
Transport	6322		2340	8662	1473	3668	2453	1338
Post, telecommunications	6494		197	6691	1137	1496	1013	560
Informatization activities	109		6	115	20	244	164	90
Research and development			1472	1472	250	431	292	162
Services to legal entities	574		79	653	111	1141	778	433
Public administration	318		8352.5	8670.5	1474	136	66	21
Education	3750	690	6553.5	10993.5	1869	161	77	24
Health care and social assistance	1768	1024	5320.5	8112.5	1379	122	59	19
Sewage, cleaning of streets	513		321	834	142	9	4	1
Social activities		976		976	166	8	4	1
Recreation, entertainment, culture and sports	1588	410	1038.8	3036.8	516	462	319	179
Other activities	739			739	126	150	102	56
Total	146301	4493	30158.3	180952.3	**30762**	**56910**	**41900**	**23428**

From the other hand, VAT if properly administered, could generate much higher revenues. Our calculations suggest, if tax privileges had been eliminated and VAT frauds had been kept off VAT receipts could amounted to 11.5% of GDP (See Table 4). Thus, only in the case of TT introduction with a rate of 10% Ukraine could compensate VAT abolishment and increase budget revenues in the short run. However, in the medium run TT taxation would result in less dynamic economic growth (as explained in Part 2) that made the Ukrainian economy worse off and reduced TT revenues.

4. Conclusions

Despite different attempts Ukraine has not achieved desired level of VAT administration and under these circumstances attention of the Government to VAT problems is quite justified. It is only natural that the Government considers the possible alternatives to this system. But our analysis shows that in general TT would not be a good alternative for VAT due to two principal reasons.

Firstly, in general TT would have a negative economic impact. TT would increase the overall price level because it implies multiple taxation of inputs thus reducing both consumption and investment demand.

TT would contribute to relative price distortions that induce unfavorable structural changes and attempts of economic agents to change organizational forms to avoid taxation.

Switch to TT means inter alia introduction of taxation of investment spending that hamper renovation of the national economy, which is unacceptable under specific Ukrainian circumstances.

Second, TT introduction would not be advantageous from a fiscal point of view. The most heavy tax burden will be imposed on the branches with long production cycle and with low value added. Branches with high value added and little inputs plus some branches in primary commodity sector will benefit of new system of turnover taxation. In this case production structure could clearly deteriorate.

Altogether, according to our hypothetical scenarios, revenues from TT (before vertical integration effect comes into force) would amount up to 21.2% of GDP under 10% TT rate, 15.7% of GDP under 7% TT rate and 8.8% of GDP under 4% TT rate. However, tax base erosion caused by vertical integration and shadow transactions would decrease TT revenues, at least, twofold.

One can say that under persisting problems with non-reimbursement of VAT in Ukraine there would be no difference between VAT and TT because in both cases multiple taxation exists. But we should be aware that multiple taxation is and intrinsic feature of TT system while VAT reimbursement arrears are rooted in the poor VAT administration.

Summing up we strongly recommend the Government not replace VAT by general TT but to concentrate efforts on improvement of VAT administration. Abolition of privileges has been a very good step in the right direction. Further steps are necessary, as our previous research shows[8]. We are confident that Ukraine is able, as most other countries, to run an efficient VAT system, which is compatible with the EU ambitions of Ukraine.

I.B., T.V., Lector: R.G.

[8] For details see: IER, VAT replacement or better administration? Policy Paper T36, June 2004.