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Republic of Kazakhstan
Tax Strategy Paper

(In Two Volumes) Volume I: A Strategic Plan for Increasing the Neutrality of the Tax System in Non-Extractive Sectors

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CURRENCY AND EQUIVALENT UNITS

(Exchange Rate Effective as of October 31, 2006)

Currency Unit	=	Kazakhstan Tenge (KZT)
KZT 1	=	US$0.01
US$1	=	127.82 KZT

GOVERNMENT FISCAL YEAR

January 1 to December 31

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS AND ACRONYMS

ARU	Annual Reference Unit
ASR	Agricultural Simplified Regime
BEEPS	Business Environment and Enterprise Performance Survey
CEE	Central and Eastern Europe
CIAT	Inter-American Center of Tax Administrations
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CNY	Chinese Yen
EBRD	European Bank for Reconstruction and Development
EU	European Union
FEACN	Foreign Economic Activity Commodity Nomenclature
FIFO	First In First Out
GDP	Gross Domestic Product
GOK	Government of Kazakhstan
IMF	International Monetary Fund
IT	Information Technology
ITC	Investment Tax Credit
ITIC	International Tax and Investment Center
ITP	Investment Tax Preference
KZT	Kazakhstan Tenge
LCO	Loss Carry Over
LIFO	Last In First Out
M&E	Machinery and Equipment
MEBP	Ministry of Economy and Budget Planning
METR	Marginal Effective Tax Rate
MLSP	Ministry of Labor and Social Protection
MOF	Ministry of Finance
MRS	Minimum Reference Salary
NFRK	National Fund of the Republic of Kazakhstan
OECD	Organization for Economic Cooperation and Development
PIT	Personal Income Tax
PR	Presumptive Regimes
R&D	Research and Development
RK	Republic of Kazakhstan
RUB	Russian Ruble
SEZ	Special Economic Zone
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
SSSF	State Social Security Fund
ST	Social Tax
TC	Tax Committee
UN	United Nations
USAID	United States Agency for International Development
VAT	Value Added Tax
VIES	VAT Information Exchange System
WB	World Bank
WHT	Withholding Tax on Dividends
WPI	Wholesale Price Index
WTO	World Trade Organization

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KEY POLICY MESSAGE

- Over the past few years, there has been a proliferation of preferences, exemptions, and special regimes for selected tax payers, leading to an erosion in the tax base and making the system difficult to administer and prone to corruption. If current policy trends continue, large tax hikes would be needed in a downturn to compensate for the erosion in the tax base.
- Kazakhstan is in the enviable position of being able to afford to offer a low tax burden to **ALL** tax payers in non extractive industries—one that does not discriminate in favor or against some tax payers. Widening the base will allow substantially lower rates and a switch to flat rates, benefiting a large number of tax payers.
- Changes in tax policy are a key precondition to improve tax administration and reduce corruption. To increase the neutrality of the tax system, and to simplify administration, the authorities could enhance the proposed tax reforms in various ways.

1. To ease administration, motivate self-compliance, and make the system pro-poor, consider a radical simplification of taxes on labor

- Fully integrate the personal income tax (PIT) and the social tax (ST) into a single PIT with a flat rate, which:
  - Would be the sole responsibility of employees, but will continue to be withheld at the source (e.g., enterprises and farms).
  - Would apply to ALL workers with income above certain threshold, using the same criteria for all (currently different criteria are used for levying social taxes in agriculture and some services).
- A decision should be made regarding the combined flat rate (e.g., 20%), the threshold below which no tax will be due, and the amount that can be deducted from the taxable base (i.e., the allowances).
- Such threshold and allowances would determine the extent to which the combined PIT would be pro-poor.

2. To encourage investment, reduce corruption incentives, and to avoid discrimination, consider a substantial broadening of the base for the Corporate Income Tax (CIT) in exchange for a <u>lower rate</u>:

- Consider limiting the simplified regimes:
  - Replace the various simplified regimes by a single system targeting only VERY SMALL enterprises and farms, whether incorporated or not incorporated.
  - Firms and farms would qualify for the single simplified regime on the basis of a turnover threshold, and the rate could be based on turnover.
- Consider phasing-out exemptions to the CIT (e.g., Free economic zones, technoparks, petrochemical industry) using one of the following options:
  - Introduce a sunset provision for all exceptions (say 2010?).
  - Offer voluntary switching to the full CIT regime in exchange for a one time subsidy (paid as a tax credit).

- Free Economic Zones and Technoparks can be assisted through provision of infrastructure and the reduction of red tape.

- Replace the current highly discretionary system of Investment Tax Preferences by a general investment tax credit for everyone.
- To help new companies and companies in highly volatile sectors, consider extending the period for carry-loss forward (e.g., to 10 years or more). Consider also introducing indexation of depreciation allowances to reduce the upward pressure inflation exerts on the CIT burden.
- Align depreciation schedules with economic depreciation to avoid penalizing the manufacturing industry and favoring construction.
- Avoid eroding the working capital of firms by allowing refunds or credits for excessive advance payments.
- Consider the phasing out the 80 percent discount on CIT for agricultural enterprises[1] (gradually if necessary); the tax regime is a highly inefficient and non-transparent means of subsidizing agriculture.
- Lower the CIT rate to 20-25% depending on the extent of base broadening, and to bring it more in line with neighboring countries and EU rates. The reduction should apply strictly to non-extractive industries.[2]

3. To minimize distortions, consider enlarging the domestic base of the VAT, while also improving the refund mechanism:

- Eliminate most exemptions (e.g., farmers, lawyers, the construction of infrastructure projects for government, economic zones and technoparks, and newly created residential buildings); exemptions break the VAT system and make it inefficient.
- Preserve the single VAT rate –introducing more than one rate complicates the system unnecessarily and it does not help the poor.
- Introduce a deferred payment scheme for imports of capital goods and a system to expedite refunds to exporters.
- Review the high VAT exemption threshold.

4. Consider simplifications in the rate structure of excises and an increase in rates to reflect the costs that smoking, drinking and polluting impose on society.

5. Consider conducting a separate assessment of the taxation of real estate and land.

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[1] The possible creation of a government holding for the agricultural sector provides an opportunity to introduce the recommendations we made on the CIT, PIT, and VAT treatment for agriculture.

[2] The issue on how to deal with conglomerates owning companies in both the extractive and non-extractive industries should be analyzed carefully.

EXECUTIVE SUMMARY

A. CONTEXT

1. The Government's key medium-term objective is for Kazakhstan to be among the 50 most competitive nations. To achieve this goal, the country needs a tax system that is neutral with respect to firms' decisions (e.g., investing, hiring) and households' choices (e.g., saving, or entering the labor market). This points to building tax systems substantially around broad income and expenditure bases and minimizing differences in tax rates that can be applied. As indicated in a recent OECD report,[3] improvements in efficiency can be achieved by: (i) broadening tax bases by eliminating exemptions and special regimes; (ii) flattening rate structures; and (iii) integrating or aligning different tax rate structures to avoid arbitrage opportunities. An additional consideration for taxation is the negative external costs that certain economic behavior (e.g., smoking, burning fossil fuels) impose on society. If a tax system is to restore neutrality, taxes should reflect such externalities, regardless of the need for non-oil revenues, because they improve the efficient allocation of resources.

2. Policymakers in Kazakhstan have already established the link between tax neutrality and competitiveness. In his 2006 address to the nation, the President underscored the need to simplify tax and customs policies, eliminate corruption, and promote the development of business and trade. He mentioned, among other needs, the need to reduce the number of taxes and to introduce a flat rate for the personal income tax (PIT).

3. This study focuses on the tax system for **non-subsurface** users in Kazakhstan. It takes as given the tax reform package that the authorities and stakeholders are designing, but proposes a number of additional steps to be taken over the next 2-3 years aimed at maximizing the benefits of tax neutrality on competitiveness. The study focuses mainly on tax policy: taxes on labor, capital, and consumption. A draft report on administration was also produced for discussion, which includes an initial assessment for organization, planning and staffing, a large taxpayers unit, anti-corruption issues, taxpayer services and education, audit and inspections, collection activities, and legal issues and appeals.[4] The summary of this report is included in Annex 7.

B. STRATEGIC DIRECTION

4. Kazakhstan introduced a modern tax policy framework with the new Tax Code in 1995. A few years later the Tax Administration began to be modernized and further progress in both areas have been achieved since then.[5]

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[3] Taken from OECD (2001): "Tax and the Economy: A Comparative Assessment of OECD Countries"; OECD Tax Policy Studies No. 6; p 17.

[4] As agreed beforehand with the authorities, the study does not cover taxation policies for property, land, financial transactions, or imports (other than as part of the general framework). Nor does it cover subsurface issues. Our assessment of the tax administration aims mainly at answering various requests from the government (e.g., on how to deal with corruption issues) and at serving as a background paper for a brainstorming session on tax administration modernization, which was held in the fall 2006.

[5] The World Bank Finance and Enterprise Development Project reallocated US$17.3 million for the Tax Administration System in 1998, which was used to finance expert advice, software development, hardware and other equipment purchase, and training.

Policy Trends

5. Confidence has grown regarding the size of oil revenues, and as a result recent tax reforms for non-extractive industries have focused on reducing the tax burden, in some cases quite significantly (e.g., labor taxes). While efforts to reduce the tax burden should be commended, past tax reforms have achieved much less in terms of neutrality. In fact, a particularly undesirable feature of the changes introduced over the past 2-3 years to the Tax Code has been the proliferation of special taxation regimes, which have: (i) provided alternative tax bases for complying with the same tax; (ii) provided discounts on existing rates to certain activities; and (iii) introduced outright exemptions.

6. The presence of alternative bases for a particular tax is of particular concern because this action **complicates** rather than **simplifies** self-compliance and enforcement. For example, physical and legal entities (up to medium-size enterprises as measured by international standards) can comply with the Social Tax (ST) by making payments based on their annual turnover rather than on their payroll. But these entities still need to withhold Personal Income Tax (PIT), for which they have to keep good payroll records. Thus, it can hardly be argued that the "simplified" regimes actually "simplify" recording and compliance by medium-size enterprises.

7. In addition to creating new avenues for compliance, regimes based on turnover have their own specific problems. First, enterprises are not protected against a downturn in economic activity when profits can be negative. A profit tax may be slightly more cumbersome to comply with, but it has this desirable property. In this respect, the "simplified" regimes are unsustainable over the medium term since, in a downturn, political pressure from enterprises to eliminate them would be difficult to resist. Second, a tax on turnover is easy to evade and thus it is difficult for the administration to enforce compliance. Finally, a turnover tax is less neutral than a profit tax with respect to economic decisions.

8. Special taxation regimes also provide discounts or exemptions to certain industries (most notably petrochemicals and agriculture, but investment incentives could be applied to 22 branches in manufacturing, and in water, electricity generation, construction, hotels, transport, communications, culture, and sports). Agriculture and agribusiness have many tax regimes. A farm can comply with the ST either by paying a lump sum tax per worker (equivalent to one Annual Reference Unit) or by taking advantage of an 80 percent rebate on the computed full tax—all that is needed is to register as a peasants' farm, or as an agricultural enterprise. Agribusinesses (which pay practically no taxes if they are within a farm) could register as a legal or physical entity, which multiplies the number of their options to comply with the tax system. There is also a geographical dimension for exemptions, as enterprises in economic zones and technoparks enjoy tax concessions. The treatment of agribusiness has the additional undesirable property of discriminating against the processing of primary products outside of the farm as is explained in Chapter 2.

9. The myriad regimes introduced over the past several years significantly complicate tax administration. They are likely to explain the strong deterioration of tax administration services between 2002 and 2005 in the eyes of taxpayers.[6] Measures that increase the number of taxes and

[6] At the moment, the Tax Committee does not contract service delivery surveys. But the Business Environment and Enterprise Performance Survey (BEEPS), which contain an extensive sample of business climate perceptions, detects a deterioration in tax administration issues, such as bribes related to tax payments, and number and length of audits. The BEEPS is an EBRD-World Bank joint initiative that asks questions about a broad range of business environment issues, including taxation and its administration.

the ways to file them reduce the transparency of the tax system and increase the room for discretion for both taxpayers and tax officials. In such an environment, opportunities for corruption thrive. In essence, the tax regime has become increasingly complicated and, in association with this, more prone to 'negotiations' between tax collectors and taxpayers. In this respect, the call for simplification made in the presidential address to the nation is not only appropriate but is also timely.

10. Several factors may explain the trend to develop new regimes and ultimately reduce the tax system's neutrality. The explanation most frequently quoted by stakeholders (such as Parliament, research institutions, nongovernmental organizations, and business sectors) relates to the process: namely, the short preparation time devoted to tax reform, generally carried out by otherwise overloaded government officials who must deal with the rapidly changing nature of the economy in a hasty manner. Another set of explanations, including the more official ones, falls under the umbrella of providing incentives for "industrialization." In essence, special interests have argued that their industries are "infant" or vulnerable, are unable to file properly, or are in need of tax rebates to survive. Finally, this trend in taxation could also be a manifestation of the so-called "oil curse" in society (i.e., a struggle among the various interests in the country to appropriate part of the current and future oil revenues). We subscribe to the latter explanation.

11. To deal with the malady of the "oil curse," a simple principle could be applied: if oil revenues are to be distributed to society via reductions in the non-oil tax burden, the best way to do this is by being fair with all taxpayers (such a principle is also consistent with the tax neutrality argued for earlier). Tax policy is a highly inappropriate tool for pursuing industrial policy, or for redistributing oil revenues on a case-by-case basis (e.g., industry by industry or household by household). Whether for efficiency or transparency reasons, neutrality is thus a highly desirable property for a tax system.

Medium Term Direction

12. The announced tax reform package for 2007-10 has a number of commendable features. One of these features is that the package is aimed at increasing participation in the formal economy and reducing the tax burden in the non-extractive sectors. The measures include further reductions in VAT rates (to a proposed 12 percent over the medium term), the introduction of a 10 percent flat PIT rate, and a compression of the regressive rates that apply to the social tax.[7] But the reform package is not ambitious enough in pursuing the neutrality of the tax system. We thus advocate a more ambitious package for two reasons: (i) it would be a win-win situation even for special interests; and (ii) important pre-conditions exist in Kazakhstan, including the following:

- The country's macroeconomic outlook is extremely favorable
- The real and financial sectors have reached a reasonable level of development
- The authorities have built a strong consensus around the need for reform among the different stakeholders in society.

13. Our proposed "enhanced" package would include a strong drive to broaden bases, with rate reductions given only in exchange for greater compliance (fewer special exemptions). We also focus on harmonization and simplification (e.g., for labor taxes). The following strategic directions should be considered for broadening tax bases:

[7] The reform will be complemented by an amnesty on property ownership that the authorities are currently designing. Such an amnesty, in essence a declaration of ownership of assets, is expected to increase the transparency of all economic transactions including tax payments and collections.

- **PIT/ST**: Several inconsistencies in the base of the PIT and ST make compliance with these taxes on labor unnecessarily difficult. We recommend fully consolidating these two taxes into a single PIT with no exemptions other than a basic allowance (best designed as a given amount per family member) and a zero band, both of which can be generous (e.g., up to half the average wage for both taxes) (Chapter 1).

- **CIT**: The basic structure of this tax is good, although the period over which losses can be carried forward should be extended. The main threat is the number of exemptions and special regimes. The tax base should be broadened to incorporate: (i) Special Economic Zones (SEZs) (a review of these is needed to align them with a carefully considered regional economic policy and to ensure that they are properly structured—e.g., with no tax holidays); (ii) all but a minor part of the special regimes and patent systems (all of these can be phased out in return for lower CIT rates, with the exception of truly small farmers and vendors for whom a simplified presumptive taxation system can be defended); and (iii) Investment Tax Preferences (ITPs), which is a system of accelerated depreciation provisions that can be replaced by a more general system of investment tax allowances (Chapter 2).

- **VAT**: The **domestic base** of the VAT is small by international standards and the standard VAT rate should thus be lowered only if the base is broadened by the following measures: (i) removing exemptions for postal services, lawyers, public notaries, sales of lotteries, geological prospecting and exploratory activities, government contractors on infrastructure projects, firms employing handicapped persons, and cultural services; (ii) reviewing the small business exemption in light of the international experience (but probably sometime after key exemptions are eliminated); (iii) making all farmers subject to the full VAT except for those whose sales are below the small business exemption (as in the Czech and Slovak Republics); (iv) eliminate the zero-rating of supplies to free zones and technoparks both for neutrality and as an anti evasion measure; and (v) eliminate the VAT exemption for newly created residential housing (Chapter 3).

- **Others**: Carrying out a full-fledged review of property and land taxes to formally increase the revenue base of these taxes over the next two to five years (i.e., reviewing the state of the municipal and national cadastres as well, which might need to be further modernized).

14. With respect to **tax rates**, the strategic direction should be to flatten rates and harmonize:

- **PIT/ST**: Phase out the ST and replace it with a 20-25 percent flat PIT rate at the earliest possible opportunity (Chapter 1).

- **CIT**: Consider a reduction of the CIT for non-extractive industries (e.g., to 25 percent or, if revenue considerations permit, to 20 percent) as long as measures to widen the base are taken as explained above (Chapter 2).

- **VAT**: Avoid a dual rate structure for the VAT tax rate, and consider tying future rate reductions to the broadening of the VAT base (Chapter 3).

- **Excises and Taxes on Road Transport**: Double or triple revenues from excises by increasing the rates (to make taxes consistent with the negative externalities that excisable goods impose on society). Simplify the rate structures. Maintain specific

(per unit) taxation rather than shifting to ad valorem (value or price related) taxes for ease of administration, but index the amounts of the specific taxes for inflation; and fully harmonize the treatment of imported and domestically produced excisable goods (Chapter 4).

15. The above set of proposed reforms to tax bases and rates should be complemented with three measures to ease the **excessive cash flow demands** that the tax system imposes on enterprises:

- Introducing a deferred payment scheme for VAT on imported capital goods (Chapter 3).
- Introducing a system to process VAT refunds expeditiously for bona fide enterprises that will mostly be exporters (Chapter 3).
- Ensuring that excess advanced payments on the CIT, which have to be processed monthly, are fully deductible from the payment for the next period. Over the medium term (two to three years, and particularly as the Treasury improves its cash management projections as well as related bond issuances), Kazakhstan should move the system of monthly payments to a system of quarterly advance payments (Chapter 2).

16. The priority should be given to phasing out the ST so that labor is taxed only through a single tax (i.e., the PIT) applicable to all enterprises and farms in full force. If the tax rate is flat as has been suggested, the overall PIT would be slightly progressive owing to the zero band and basic allowances. A second priority should be to extend the VAT to the first sale of newly created residential housing and agriculture (except for the small enterprise/farm threshold) in parallel with some of the services and zones currently excluded. At the same time, excises should be raised to compensate for the revenue losses on account of the lowering of the rates of the PIT/ST, CIT, and VAT. A third priority should be to phase out special regimes for the CIT (in exchange for a lower rate), starting with investment preferences, agricultural enterprises, and the generous thresholds that apply to the simplified regimes.

17. All of the above reforms are fully consistent with the government's proposed reform package, but they take it one step further. They are based on experience in New Zealand, which does not impose payroll taxes (the equivalent of the ST) and which has broad bases for most other taxes. They also borrow from the experience of the Slovak Republic, which has harmonized the rates for the PIT and CIT (as well as those for the VAT) while at the same time phasing out numerous exemptions. Furthermore, the proposed reduction in the CIT rates would make Kazakhstan a more attractive country for investment than Russia or China (two cases that are reviewed extensively in Annex 2).

18. Over the medium term (e.g., 2010-15) the government should consider further reductions in tax rates as long as measures are taken now to increase the yield from excises and property taxes and to broaden the bases for the PIT (inclusive of ST), CIT and VAT. Among the potential medium-term directions (not examined in this report) that the authorities could study are the following:

- Harmonizing the rates for the PIT and CIT at around 20-25 percent to ensure that the tax regime is neutral with respect to the form of association (self-employed, physical entity, or legal entity).

- Introducing a 10 percent flat duty on all imports from countries outside of the free trade areas (e.g., by 2012), which jointly with the VAT would impose a 20 percent nominal burden on the consumption of imported goods. (The burden on the consumption of domestic goods would be much lower.)

19. If properly designed to ensure that a targeted level of non-oil fiscal revenues is raised (as a share of GDP) over the medium term, these options for reform (after full assessment and greater development) can be introduced irrespective of the outlook for oil revenues.

Macroeconomic Consistency

20. The proposed tax reforms should be consistent with the macroeconomic framework in two important dimensions: (i) how the tax regime performs in business cycles, particularly in a downturn; and (ii) how the tax burden is imposed across capital, labor, consumption, property, imports, and excisable products.

21. The business cycle in Kazakhstan is overwhelmingly determined by the fluctuations in the extractive industries, particularly oil. In this regard, the least desirable tax policy would be to use the taxation of non-extractive industries to smooth out the volatility of oil revenues. If Kazakhstan were to reduce rates and narrow bases during boom periods and to take the opposite measures during recessions, the non-extractive industries would basically perish, because during boom periods they would focus on lobbying for tax exemptions rather than improving productivity and during recessions they would face higher taxes despite having lower sales and lower profits. In addition, such a policy would be a disaster for tax administration, which would be making efforts to "catch up" with the shifts in policy in every turn of the business cycle. The longer the upside cycle is, the more difficult it would be for the tax administration to reconstruct itself after a crisis.

22. The ideal tax system for the non-oil sectors would be designed to collect (whether in boom periods or in recessions) a reasonable amount of revenue raised from non-extractive industries. The targeted level of revenue would depend on the desirable path for total fiscal spending, which in turn is a function of how the role of the state (e.g., in the provision of infrastructure) is defined in the coming years. If the government, through the formulation of its medium-term framework, wishes to maintain spending at around 23 percent of GDP, we believe that non-oil revenues should be maintained at about 17-18 percent of GDP. Achieving such a revenue target must be the most important objective of any tax reform. Within that target, the goal of tax reform is to increase the neutrality of the tax system (i.e., by flattening taxes, broadening bases, and aligning tax structures). Such efforts would change the composition of taxes but not the overall collection levels.

23. The approach of imposing a "revenue collection constraint" on any tax reform for the non-oil sectors is highly complementary to the new tools for fiscal management that the government is introducing, in particular with the new rules governing the National Fund of the Republic of Kazakhstan (NFRK). These rules introduce stability to the part of oil revenues that is spent across the business cycle, while the suggested revenue constraint for the tax reform ensures stability of non-oil revenues.[8] If both tools are in place (stability in revenues from non-extractive industries, and stability in oil revenues spent), and the government runs a balanced budget, the pattern of public spending over business cycles should be smooth and predictable (as a share of

[8] See World Bank Country Economic Memorandum (2005): "Getting Competitive; Staying Competitive: The Challenge of Managing the Oil Boom in Kazakhstan."

GDP). The economy of Kazakhstan will still face considerable volatility coming from its total oil revenue, but such volatility will be reflected in the amount of oil revenues saved in the NFRK and the overall fiscal balance (inclusive of the accumulation in the NFRK). It is thus important that the government's Medium Term Fiscal Framework for the budget "locks in" these rules consistently, starting with the forthcoming framework for 2007-09.

24. The second dimension in which the tax regime should be consistent with the framework for economic management is the choice of how to divide the tax burden—between capital and labor, and between production and consumption—and how much revenue to raise from assets (e.g. land or real estate):

- Should Kazakhstan tax capital more heavily and labor less heavily (by reducing the PIT and maintaining the levels of CIT)?

- Should Kazakhstan tax production more heavily than consumption (by maintaining the PIT and CIT but reducing the VAT and keeping excises unusually low by international standards)?

- Should the tax regime raise funds mainly from production rather than ownership (by maintaining very low taxes on real estate and land and relatively high taxes on labor and capital)?

25. These questions are currently highly relevant, given that the proposed reforms move the tax system away from the taxation of labor and consumption and (by omission) also away from the taxation of property, leaving the burden of revenue collection mainly to the CIT. This is undesirable, the ideal policy is to tax all bases equally so that the burden on any of those bases is relatively low. This would require a careful aligning of the various tax structures to avoid arbitrage or substitution among bases. In addition to its neutrality, such a policy is also important for risk management by the fiscal authorities. Taxing all bases (labor, capital, consumption and property) would be an asset in an economic downturn when revenue needs to be raised. Annex 1 provides a simulation of how the proposed "enhanced tax reform package" would perform across these two dimensions. The assumptions and all of the calculations are explained in the Annex.

1. THE TAXATION OF LABOR

1.1 This chapter describes recent trends in the social tax (ST) and the personal income tax (PIT) in Kazakhstan and evaluates them from the point of view of their effectiveness in meeting key objectives such as increasing compliance, widening tax bases, and eliminating distortions. It also compares these trends with international experience. The analysis shows that reforms have gone in the right direction, except for opening up ways to avoid the formal ST through alternative regimes, which undermine its neutrality and also the base of the PIT. The analysis also shows that the PIT and the ST are not well coordinated (e.g., regarding the same definitions of income, deductions, and tax administration structure and procedures) and that the Tax Code has various inconsistencies in the definition of taxable income. Our main recommendation is to fully integrate the PIT and ST to avoid problems of coordination and inconsistencies. If a flat 20 percent PIT rate is introduced (with no ST), a small percentage of the collection could be earmarked to the Ministry of Labor and Social Protection (MLSP) and the rest to local governments.

1.2 This chapter has three sections. The first outlines the changes made to these two taxes since 2001 and reviews the announced reforms for 2007 and 2008. The second section includes our analysis of the combined tax burden that these taxes impose on labor and reviews the base of these taxes and the trends in revenue collection. The last section presents our recommendations for reform.

A. CHARACTERISTICS OF THE TAXES ON LABOR

1.3 Labor in Kazakhstan is taxed through the PIT and the ST. Although the liability for these taxes formally falls upon different entities (i.e., enterprises for the social tax, and individuals for the income tax), both taxes are fundamentally levied on labor, since the base is the wage bill, and should have similar economic effects. Both taxes are collected through enterprises which pay their liability for the ST and withhold, on the government's behalf, the PIT. Together, these taxes influence an individual's decision to work and to save, and more fundamentally, the decision of firms and individuals to remain outside of the formal economy.

The Personal Income Tax[9]

Background

1.4 Since the adoption of the Law of the Republic of Kazakhstan No. 2235 of April 24, 1995 "On Taxes and Other Mandatory Payments to the Budget," the PIT has been withheld by enterprises. Individuals who are not part of the payroll of any formal enterprise or institution are required to file directly. Individuals accruing non-labor income (e.g., rental income from shares or real state assets, honorariums, and commissions) are also required to file directly with the Tax Committee. The filing unit for the PIT is the individual (for both withholding and self-assessment). There are no provisions in the Tax Code for working spouses to file jointly.

[9] This chapter focuses mainly on the taxation of labor, while Chapter 2 deals with issues of taxation of capital income earned by individuals. The PIT in Kazakhstan taxes both labor and capital income earned by individuals. In practice, if measured by the bulk of what is collected, it functions more like a labor tax.

Because the PIT is essentially a withholding tax, the enterprise for which each of the spouses works retains the PIT for each spouse. Workers hired by individual entrepreneurs and legal entities applying special tax regimes, as well as peasant farms and agricultural producers, *are* liable for PIT as individuals (using the progressive scale of rates).

1.5 The evolution of the key parameters of the PIT is presented in Table 1.1. The key features of the PIT in mid-2006 are:

- Taxable income is equivalent to gross income minus the 10 percent obligatory contribution to the (private) pension fund, one annual reference unit (ARU) for the head of the household and one for each of his/her dependents, and other allowances provided by law. In 2006, the ARU is equivalent to 12,360 KZT or about US$96. Other allowances include voluntary contributions to the pension funds, interest on mortgages, and insurance premiums.

- A zero band (i.e., a threshold under which the rate is zero) determined by one minimum reference salary (MRS), which has been set for 2006 at 110,400 KZT or about US$859 per year.[10]

- Six marginal brackets with a maximum rate of 20 percent. The taxable income brackets are fixed in terms of ARU.

- Income from dividends, interest (except for insurance payments) and lottery prizes are taxed at a rate of 15 percent. Income of attorneys and notaries is taxed at a rate of 10 percent.

Table 1.1: The PIT Rate Structure 2003, 2006, and Proposed 2007 Reform

Before 2004 Changes to the Tax Code (2003)		Changes Effective from Jan. 2004 (2006)		Proposed Tax Reform (2007)	
Annual Taxable Income, kzt[1/]	Marginal Rate[2/]	Annual Taxable Income, kzt[1/]	Marginal Rate[2/]	Annual Taxable Income kzt[1/]	Marginal Rate[3/]
Below 60,000	0	Below 110,400	0	Below 116,400	0
60,000 to 156,960	5	110,400 to 185,400	5	Above 116,400	10
156,960 to 418,560	10	185,400 to 494,400	8		
418,560 to 6,278,400	20	494,400 to 2,472,000	13		
Above 6,278,400	30	2,472,000 to 7,416,000	15		
		Above 7,416,000	20		

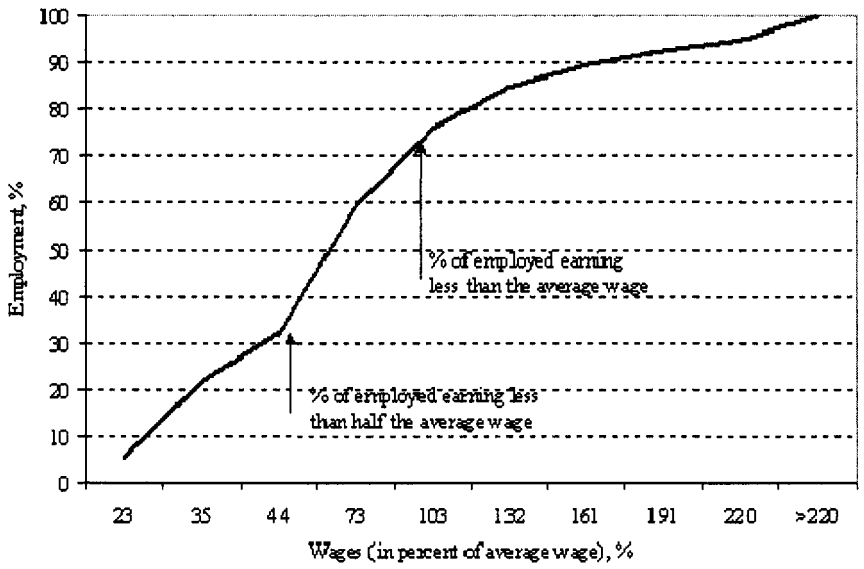
[1/] Taxable Income = Accrued Income – Tax Deductions prescribed in the article 152 of the Tax Code of RK.
[2/] *Source:* Tax Code of RK, section 6.
[3/] *Source:* Address of the President of RK March 1, 2006.

[10] Clause 1-1 in Article 145 of the Tax Code has generated substantial misunderstanding (between accounting firms and the Tax Committee) about the exact definition of taxable income for the purpose of applying the zero band. In this analysis, we assume that taxable income is defined uniformly across all brackets of the PIT, including the zero band.

1.6 From an international perspective, the zero band (at 110,400 KZT or one MRS) appears appropriate for Kazakhstan. In 2006, it was equivalent to 27 percent of the earnings of an average production worker—where around 10 percent of the workers are concentrated according to the Agency of Statistics (Figure 1.1). In 2003, this indicator was around 20 percent of the average wage in Canada, Norway (central government), and the Czech Republic; 52 percent in Hungary; and 43 percent in Ireland, the United States (central government) and the United Kingdom. Recent trends in OECD countries with respect to modifications to this parameter are ambiguous, as 11 countries have increased the zero band between 1985 and 2003, while 10 have reduced it.[11] In Russia, the zero band was extremely high prior to the 2001 reforms, at 187 percent of the average wage. From this vantage point, the zero band in Kazakhstan appears appropriate at this time as it seems to be roughly in line with practices in OECD countries.

1.7 As for the basic allowance, its level is reasonable especially if analyzed jointly with the zero band. These two parameters combined reach a level of 30 percent of the average wage, and leave around 15 percent of the workers outside the PIT; the percentage of employed is likely to be slightly higher than that since taxpayers with large families receive larger allowances (Figure 1.1).

Figure 1.1: Kazakhstan: Cumulative Distribution of Employed by Wage Level, 2005



1.8 Since both the ARU and the MRS, and thus the tax brackets and allowances, can be modified by the executive, the PIT load could in principle be shifted between income groups without having to amend the Tax Code. This was done often in the 1990s, but over the past few years these parameters have been stable, except for adjustments for inflation. However, public sector salaries are set based on the MRS and thus, this parameter has advanced significantly in real terms because of wage increases (see Table 1.2).

[11] See, OECD 2004, Special Feature: Thresholds for Paying Income Tax and Social Security Contributions.

Table 1.2: Value of Annual Reference Unit and Annual Minimum Reference Salary

	Nominal Tenge			Constant 2003 tenge (deflated by average CPI change)			Percentage growth in real terms			US Dollars (at period average KZT/USD exchange rate)		
	ARU	MRS	AE	ARU	MRS	AE	ARU	MRS	AE	ARU	MRS	AE
2003	10,464	60,000	277,536	10,464	60,000	277,536	--	--	--	70	401	1,855
2004	11,028	79,200	339,948	10,318	74,102	318,065	1.4	23.5	14.6	81	582	2,499
I half of 2005	11,652	84,000	408,792	10,178	76,032	357,086	1.4	16.4	12.3	88	640	3,076
II half of 2005		110,400			96,436						821	
2006	12,360	110,400	472,318	10,010	89,407	382,506	1.7	3.7	7.1	102	914	3,909
2007 (proj)	13,223	116,400	576,134	10,134	89,209	441,550	1.2	0.2	15.4	113	997	4,936

ARU: Annual Reference Unit; MRS: Minimum Reference Salary; AE: Average earnings in the economy.
Note: The amounts of MRU and MRS are established by the Law of RK on the Republican Budget.
Source: Actual average earnings data is provided by MoF; values corresponding to 2006 and 2007 are WB staff estimates based on a speech by the MEBP in early 2006.

The Proposed 2007 PIT Reform

1.9 Earlier this year the executive announced a reform of the PIT that is expected to come into force on January 1, 2007. It is to be the first step in various other modifications to the Tax Code over the next few years. This proposal, whose main purpose is simplification, has wide support in Parliament and among entrepreneurs. The main thrust of the proposal is:

- To increase allowances from one ARU each for self and dependents, to one MRS regardless of the number of dependents
- To introduce a flat rate of 10 percent for all taxable income above the PIT threshold
- A position on the zero band has not yet been formulated (with some arguing for its phasing out given the increase in allowances).[12]

1.10 The introduction of a flat rate for PIT in Kazakhstan would follow similar changes adopted in recent years in the Baltics, Russia, and other countries in the Central Europe region (Table 1.3). For Russia, analysts argue that the reform increased compliance with PIT by up to one-third, especially because the change in rates was accompanied by improvements in administration and a reduction in social taxes. It also increased revenues, although only marginally once the effect of external factors (e.g., oil prices and the increase in real wages) is taken into account.[13] In

Table 1.3: Countries with Flat Rates for PIT

Country	Tax Rate in %	Year Introduced
Estonia	26	1994
Lithuania	33	1994
Latvia	25	1995
Russia	13	2001
Serbia	14	2003
Slovak Republic	19	2004
Ukraine	13	2004
Georgia	12	2005
Romania	16	2005

Source: The Economist, in Ivanova, Kleen, and Klemm (2005).

[12] For our analysis, we assume that the zero band will be left at one MRS and the basic allowance increased to one MRS. If the zero band were to be eliminated, the point of entry of the 2007 regime would be slightly lower than under the current regime, since de facto only the 2006 allowance (one ARU) will be left out.

[13] See Ivanova, Kleen, and Klemm (2005): "The Russian Tax Reform," IMF Working Paper No. WP/05/16.

Slovakia, where the rates for the PIT, the corporate income tax, and the value added tax were all set at 19 percent) the tax reform is expected to improve the level and efficiency of capital investments, while the combined tax and social security reforms has enhanced labor supply and demand. Since the tax base was broadened, analysts expect that revenue performance in the Slovak Republic will improve.[14]

1.11 The reform proposal to change the basic PIT allowance from one ARU to one MRS (i.e., from US$96 to US$859 for a single taxpayer, and from US$385 to US$859 for a taxpayer with three dependents), would produce a substantial increase in the allowances for both types of taxpayers. Its new size, at about 25 percent of the average salary, appears reasonable. Combined with the zero band, this basic allowance will exclude from the PIT anyone earning less than 221,000 KZT (US$1,718). This total value is equivalent to half of the average wage, and thus about 32 percent of employees would benefit from it (Figure 1.1, above). Since these workers earn the lowest wages, this measure should be welcomed by the Tax Committee as it can focus its resources on enforcing the compliance of high wage earners.

The PIT Over Time

1.12 Figure 1.2 illustrates the evolution of the average effective PIT rates for two types of families over time: (i) single; and (ii) married with two children. For simplicity, we assume that the income of these two types of families comes exclusively from labor (the family does not earn either rental or capital income). The average rates are calculated in nominal terms since, as shown in Figure 1.2, brackets have been adjusted with inflation regularly.[15]

1.13 Figure 1.2 illustrates various noteworthy features of the PIT reform in 2004 and the proposed reform for 2007:

- For singles, the reform would make those with a gross annual income of less than 289,000 KZT (about US$2,200) or more than 785,000 KZT (about US$6,000) **better off** in terms of effective rates. Those whose incomes fall between these two numbers are made slightly worse off by an average effective rate of up to 1.0 percent higher (Figure 1.2, panel 1).

- For households with self and three dependents, the reform would make those with a gross income of less than 270,000 KZT (US$2,076) or more than 970000 KZT (US$7,400) **better off** in terms of effective rates. Those whose incomes fall between these two numbers are made slightly worse off with an average effective rate that is up to 1.5 percent higher than the current one (Figure 1.2, panel 2).

- If these two different types of households are compared (i.e., only self, and self and three other dependents), the 2007 reform is biased in favor of single households (although both households are better off in absolute terms). Figure 1.3 shows the relative advantage that larger households will be losing over smaller households.

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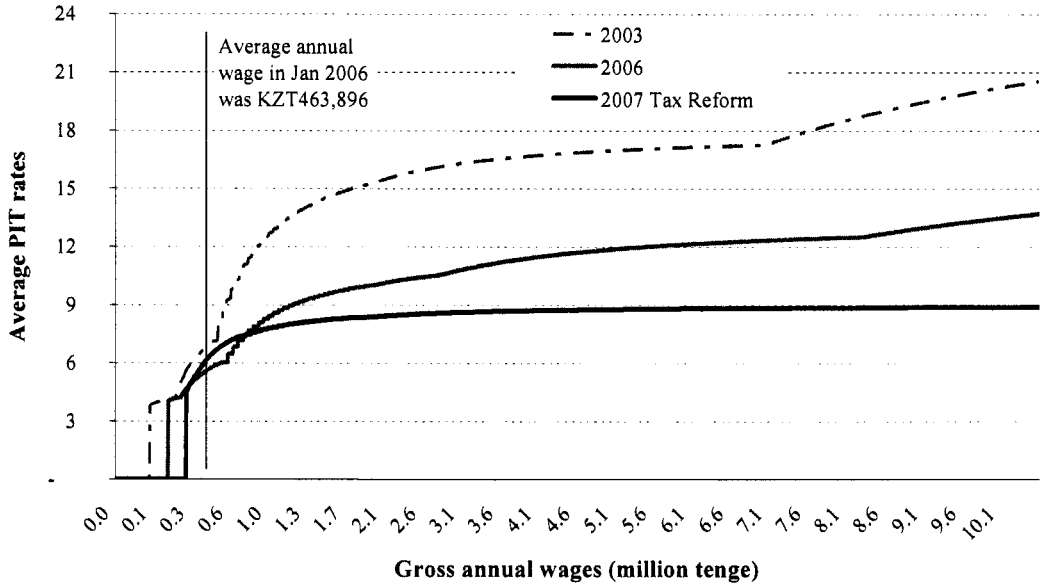
[14] See Brook, A., and W. Leibfritz (2005): "Slovakia's Introduction of a Flat Tax Rate as Part of Wider Economic Reforms," OECD Economics Department Working Papers, no. 448. See also David Moore (2005): "Slovakia's 2004 Tax and Welfare Reforms," IMF Working Paper WP/05/133.

[15] In this and other figures below, the line indicating the average wage should be used only against the average tax rate for 2006. It should be mentioned that we left the analysis of how inflation has affected the tax burden on wages for future research.

- Exemptions and the zero band result in a progressive distribution of tax burdens under the proposed flat rate for 2007. For instance, a person earning 50 percent of the average wage in the economy will be taxed at an effective rate of 6 percent. This progressivity in the system is not negligible given that approximately 76 percent of the population earns wages below the average wage.

Figure 1.2: Kazakhstan: PIT Average Effective Rates, 2003-2007

Panel 1: Single Taxpayer



Panel 2: Taxpayer with Non-working Spouse and Two Children

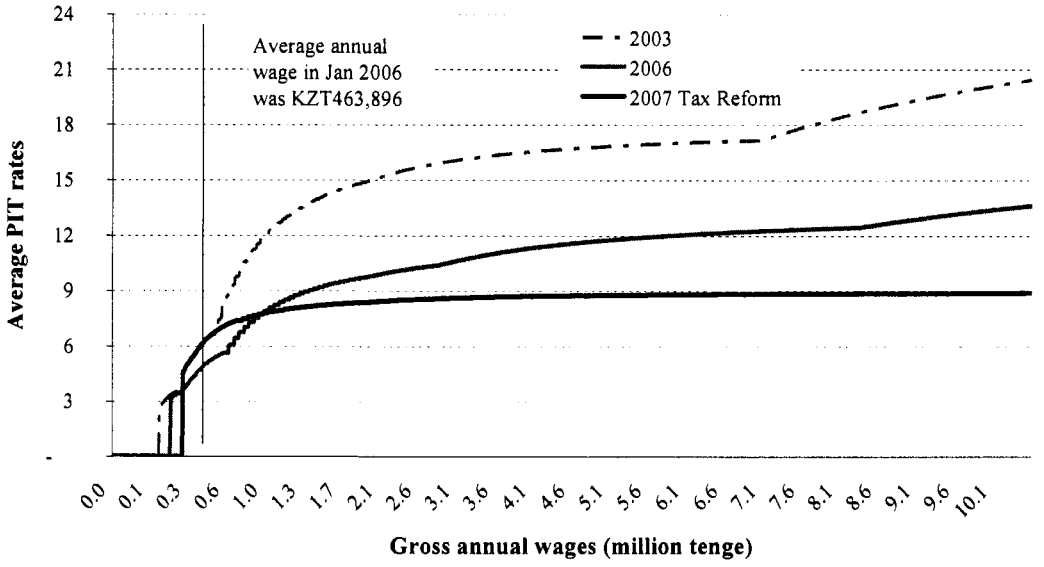
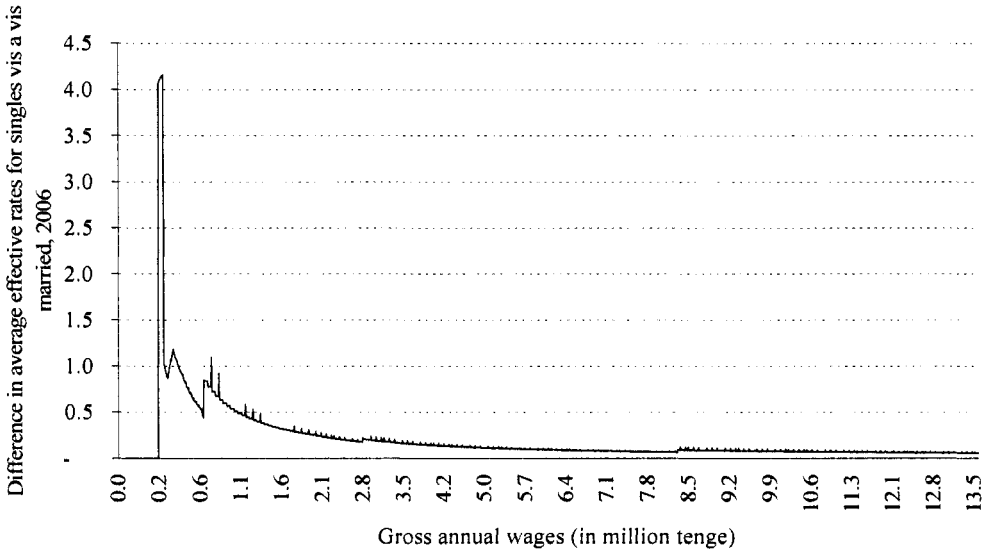


Figure 1.3: Differential in Average Effective Rates: Singles versus Married with Two Dependent Households, 2004-2006



1.14 In summary, the reform would: (i) increase the PIT threshold (which can be visually captured by the fact that the line for the 10 percent flat rate starts farther away from the axis than other lines in Figure 1.1); (ii) make everyone better off except for a layer of low and middle-income taxpayers (although this difference is not major, it is important for policy makers to be aware of); (iii) make large households worse off relative to single households (but better off in absolute terms except for the layer noted above); and (iv) maintain some progressivity below the average income level of the economy owing to the interaction of the zero band, the allowance, and the flat rate.

The Social Tax

Background

1.15 As part of the pension reform package introduced on January 1, 1999, the ST was set at a level of 26 percent of gross income for all workers. Despite its name, revenue associated with the ST is used for general budget purposes while pensions are paid from general budget resources. That year, the ST replaced a social security contribution which amounted to 31.5 percent of the wage.[16] On July 1, 2001 the rate was reduced further to 21 percent for all employees. Foreign workers in Kazakhstan pay the ST at rates about half of those for local workers.

1.16 The ST was further reformed in January 2004 when it was set according to a scale of rates that are lower as incomes rise. Like the PIT, the brackets for the ST were derived from the annual reference units (ARUs). Legal liability for this tax falls on the employer, which makes it relatively easy to administer for the formal economy (an advantage that also applies to the PIT which is withheld by the employer) (see Table 1.4).

[16] The old tax consisted of a 25 percent contribution to the pension fund, a 3 percent contribution to the medical insurance fund, a 1.5 percent contribution to the social insurance fund, and a 2 percent contribution to the employment fund.

Table 1.4: Social Tax Rate Structure before and after Reform

Before 2004 Changes to the Tax Code (2003)		Presently (2006)		Proposed Tax Reform (2008)	
Annual Taxable Salary, kzt	Marginal Rate (domestic-foreign)[1/]	Annual Taxable Salary, kzt	Marginal Rate (domestic-foreign)[1, 4/]	Annual Taxable Salary, kzt[3/]	Marginal Rate[2/]
Any	21-11	Below 185,400	20 - 11	Below 211,860	13
		185,400 to 494,400	15 - 11	211,860 to 564,960	10
		494,400 to 2,472,000	12 - 9	564,960 to 2,824,800	8
		2,472,000 to 7,416,000	9 - 7	2,824,800 to 8,474,400	6
		Above 7,416,000	11 - 5	Above 8,474,400	5

[1] Tax Code of the RK, section 11.
[2/] According to the address of the President of the RK dated March 1, 2006, starting from 2008 the ST rate will be reduced by 30 percent and foreign and domestic workers will be subject to the same rate.
[3/] Estimated based on 2007 ARU adjusted for 2008 inflation forecast (7 percent).
[4/] This is made up of contributions to the State Fund for Social Insurance (2 percent of taxable salary) and social tax payments.

1.17 The rationale behind the introduction of the declining rate schedule was to encourage compliance by enterprises and individuals. This has its merits since high wage earners will, in any case, underreport their income and thus effectively enjoy much lower rates. Armenia used this logic when it introduced a similar regressive scale for the social tax. However, Armenia has a progressive PIT and a regressive ST which jointly yields a single positive marginal rate. The Russian Federation also introduced in 2001 a regressive scale for its social security contribution, ranging from 36 to 5 percent that followed the same rationale.

1.18 On January 1, 2005, the equivalent of 1.5 percent of taxable wages was earmarked for programs administered by the Ministry of Labor and Social Protection (MLSP), but the total rates were not changed. In 2006 the earmarked proportion of the ST was increased to 2 percent. This change affected the allocation of the revenue among government institutions, but did not change the overall burden that the ST imposed on labor. For simplicity, we use the term "ST" to denote the total burden in the analysis below.

1.19 An interesting feature of the 2004 reform is that it gave ownership to local governments over the revenue of the PIT and the ST. Thus, the change made in 2005 (and further in 2006) was in essence a reduction in the amounts earmarked for the local governments, which were then passed to the MLSP.

1.20 Unlike most OECD countries where there are no deductions for the purpose of taxes analogous to the ST, Kazakhstan allows for the deduction of the 10 percent contribution to the private pension funds.[17] While this is justified from various angles, it is still worth pointing out that essentially the Tax Code allows a double deduction of pension contributions on the same stream of income. To understand this point, it is useful to imagine that the ST is the worker's liability rather than the employer's—and note that the worker would have been able to deduct

[17] It should be noted however than in OECD countries the ST is earmarked for specific uses while in Kazakhstan it is not. It is also noteworthy, that of all the OECD countries, neither Australia nor New Zealand levies social security contributions—although Australia imposes a 1.5 percent medicare levy based on taxable income. See OECD (2005), "Taxing Working Families: A distributional Analysis," Tax Policy Studies No. 12.

pension contributions twice (once before complying with the ST, and again before complying with the PIT) (see Articles 152 and 316 of the Tax Code). State institutions can also deduct maternity benefits, temporary disability benefits, and hardship allowances for women or men who adopt children—a privilege that is not extended to non-state institutions. Such additional allowances suggest that in many ways the ST is beginning to be treated like a PIT.

1.21 An important characteristic of the ST in Kazakhstan is that firms can select from various tax bases (other than payroll) to comply. This is essentially the result of the various simplified regimes that have been introduced over the past few years:

- Under the simplified declaration system for physical and legal persons, the ST is calculated on the basis of an enterprise's turnover rather than its payroll
- Peasant farms comply with the ST by paying a lump sum amount per worker that is equivalent to 20 percent of an ARU (i.e., less than US$25)
- Agricultural enterprises do calculate the ST on their entire payroll, but enjoy an 80 percent discount on this tax liability
- Certain types of entrepreneurial activities (gambling, games) pay one ARUs per worker
- Individual entrepreneurs applying established procedures pay three ARUs for self, and two for each worker hired
- Private notaries and lawyers pay three ARU for the owner and two ARUs for each worker hired.

1.22 These exemptions apply to a substantial part of the labor force (around 20 percent of the total). Together, agricultural enterprises and peasant farms employ about 16 percent of the labor force. Since entities filing under simplified regimes can employ up to 50 workers (if registered as legal entities), they can also account for a significant part of the labor force. They also create significant loopholes, as the rationale for a special regime for law firms, notaries and casinos is unclear.

The Proposed ST Reform

1.23 The plans for the reform of the ST are far less reaching than those for the PIT, despite the fact that entrepreneurs, parliamentarians and households perceive the ST as the most burdensome tax on labor.[18] These claims are valid because the ST's effective rates have always been higher than the PIT rates for the levels of income that matter most to the population.

1.24 The plan is to introduce two changes to the ST: (i) to harmonize the rates for foreign and local workers; and (ii) to further "compress" the rates to lower the ST tax burden. Changes are expected to come into force on January 2008 (i.e., a year after the introduction of the single flat rate).

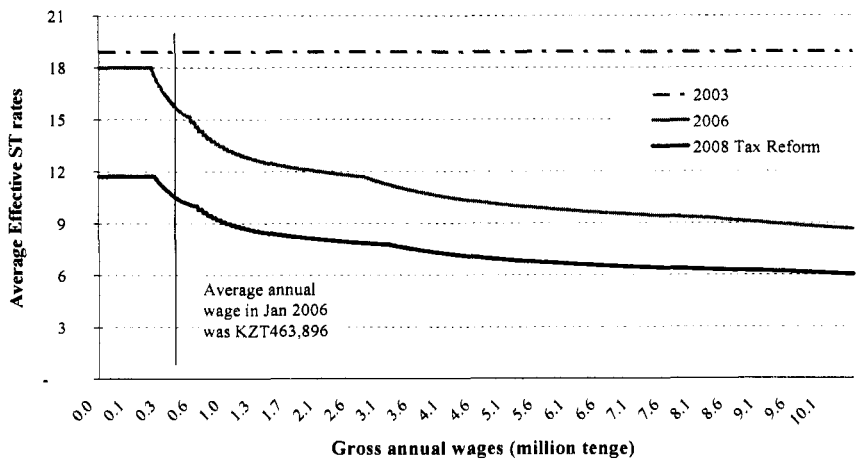
[18]Our reference comes from discussions during a workshop on the Taxation System organized by the Budget Commission of Parliament on or about April 2006, and from meetings with entrepreneurs.

1.25 As is the case with the PIT, the announced reforms do not include measures to broaden the ST base, which is undermined, as mentioned earlier, by a myriad of exemptions to its basic principles.

Evolution of the Social Tax

1.26 Figure 1.4 shows the evolution of the average effective ST rates as a share of gross wages.[19] In Figure 1.4, the statutory rate of 21 percent that prevailed during the 2001-03 period corresponds to a 19 percent average effective rate.[20] Figure 1.4 also shows that the average effective rate was substantially reduced in 2004, converging towards 8 percent of gross wages as income grew. The proposed tax reform for 2008 will further reduce average effective rates.

Figure 1.4: Evolution of the ST, 2001-2007



B. THE COMBINED TAX BURDEN ON LABOR

The Rate

1.27 In this section we analyze the combined burden on labor coming from the PIT and the ST.[21] Figure 1.5 illustrates the evolution over time of the average effective rate of the combined PIT and ST—for a single taxpayer. The reduction of the tax burden on labor from close to 45 percent in 2003 to around 30 percent this year has been remarkable. If the reforms proceed as announced, by 2008 such a burden will be at most 15 percent—in average effective terms.

1.28 The fact that the lines in this figure are not smooth reflects the design of the combined system of taxes on labor, rather than errors of calculations. Essentially, there are various inconsistencies in the bases and the allowances that make their combined average effective rate

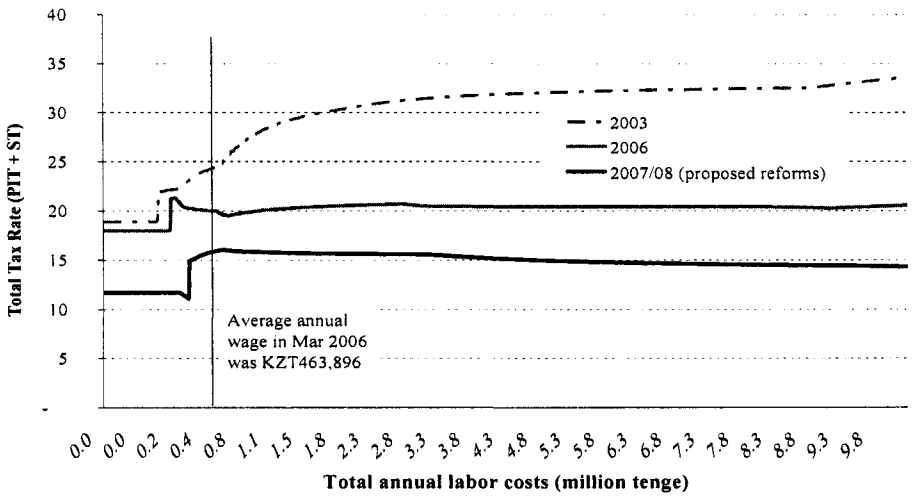
[19] That is, measured as a share of the tax exclusive base.

[20] The effective rate in 2003 would have been around 16 percent if measured as a share of labor costs. (i.e., the tax inclusive base).

[21] The calculation of the total burden in this section is done in a tax inclusive way, while in previous chapters it was done in a tax exclusive way.

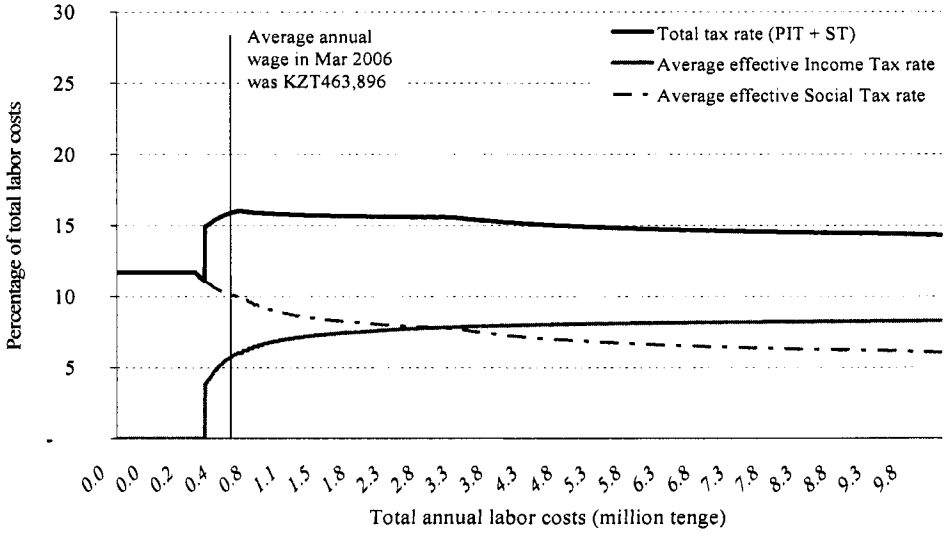
"bumpy"—even in our simplified example. An undesirable result of the current system is, for example, that the highest average rate in 2006 (i.e., around 22 percent) is applied to middle income workers (i.e., those earning around 150,000 KTZ). In other words, the combine system of a regressive ST and a progressive PIT is neither progressive nor regressive but rather "biased against the middle".

Figure 1.5: Evolution of the Combined Labor Taxes, 2003-2008



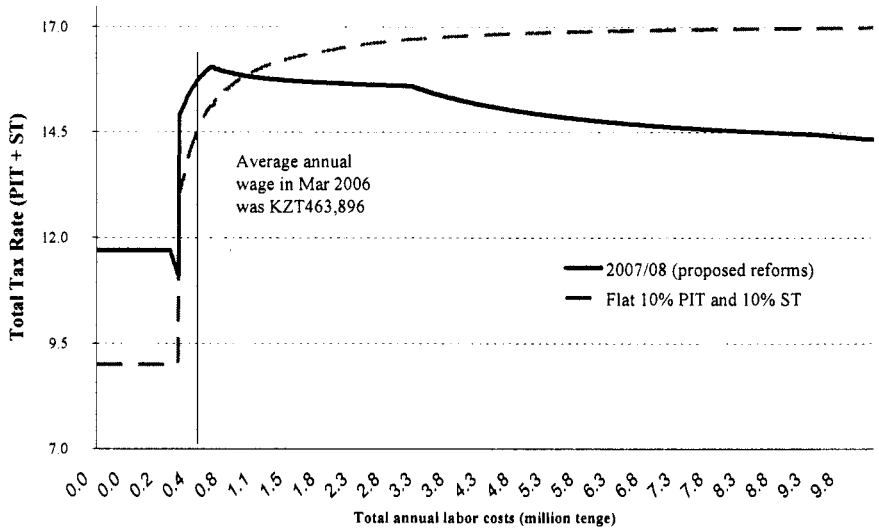
1.29 Figure 1.6 decomposes the combined labor tax that can be expected for 2008 into its two main components: the ST and the PIT. The combination of a flat PIT rate (which increases smoothly towards the flat effective rate of around 10 percent) and a regressive scale for ST results in an almost flat overall tax above an income level of 800,000 KZT. However, the combined tax rate still exhibits a slight overall regressive scale—and it "dips" around incomes of 200,000 KTZ.

Figure 1.6: Decomposition of Labor Taxation, as Expected for 2008



1.30 If the main objective of the 2007-08 reform is to eliminate discretion in the Tax Administration and misinterpretations by taxpayers, it would be more practical to also introduce a flat rate for the ST. In this way, a full flat rate effect would be achieved with a much simpler regime. Such flattening would also eliminate the "bumps" in the combined taxes on labor. Figure 1.7 shows that two flat rates would result in a much simpler regime than the current proposal. Two flat rates would be smooth over the income spectrum, creating greater fairness, and reducing the room for confusion and taxpayer (or tax inspector) interpretation.[22]

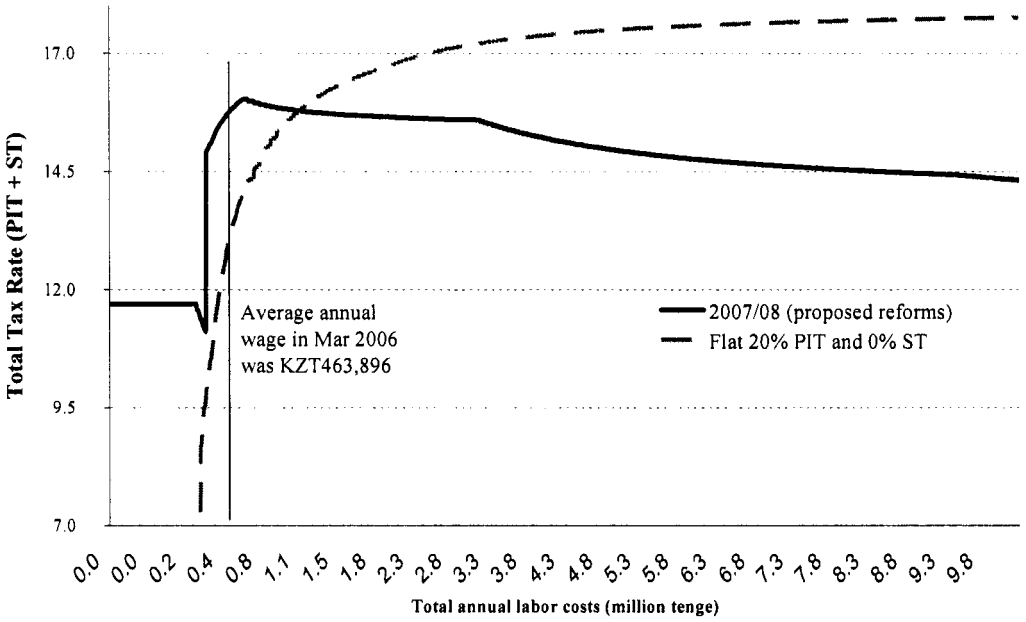
Figure 1.7: Proposed 2008 Reform vis-à-vis Flat Rates for PIT and ST



1.31 But the ideal case from the conceptual and administrative point of view would be to fully phase out the ST and replace it by a higher PIT rate (Figure 1.8). From the conceptual point of view, a single rate and a single tax is optimal as it increases the transparency of the tax regime (only one tax on labor), and is significantly more "pro-poor" since low-income workers would not need to comply (those earning under the zero band and the allowance). From the administrative point of view, a single tax would allow the Tax Committee to concentrate resources that are now spread across the enforcement of these two taxes; and enterprises' filing requirements would be halved. Finally, a single PIT with a higher rate should yield significantly more revenue than the current proposed reform, because the burden would remain constant rather than falling continuously as income grows. The challenge of the single PIT is to define well the zero band and the threshold so as to ensure that a sufficient number of low income workers are left outside.

[22] It should be noted in particular how around income levels of 400,000 KTZ the rate goes down before going up.

Figure 1.8: Proposed 2008 Reform vis-à-vis a Single Flat Rate PIT



Collections and Bases

1.32 Since the rationale for the 2004 PIT and ST reforms was to increase compliance, it is relevant to ask whether these reforms have resulted in greater collections or an expansion of the tax base. Unfortunately, the available data are insufficient for an in-depth analysis, since the Tax Committee does not keep a record of the number of potential and actual contributors (persons rather than entities) to the PIT and ST.

1.33 Table 1.5 summarizes some of the information available, including revenue, active entities, and employment. It shows that PIT/ST revenue declined from 5.4 to 4.3 percent of GDP between 2003 and 2005. Of course, this has not been of great overall concern, given Kazakhstan's growing levels of oil revenues.

1.34 Of greater concern would be a reduction in the number of taxpayers, and in the share of total employment that complies with these taxes. In the absence of data on individual taxpayers, we look at the trends in the number of entities that withhold PIT and pay ST in one way or another. We also calculate the ratio of PIT and ST collections over the wage bill of the economy (the collected rates) and compare them with the statutory rates.

1.35 **Entities**. The number of entities complying with labor taxes increased by 183,000 for the PIT and 116,000 for the ST between 2003 and 2005. Of the total increase, about half (159,000) are entities filing under special regimes rather than complying with standard rates and bases. Since part of the increase in the number of entities complying with the standard rates and bases must be due to external factors (e.g., vigorous economic growth of about 9 percent of average), it seems safe to conclude (based on this one measure) that the reforms have not resulted in major gains in compliance (i.e., the merit can be allocated to the introduction of simplified regimes, not the reductions in rates).

1.36 The case of special regimes in agriculture is interesting. In this sector, the number of cooperative firms is growing while the number of agricultural enterprises is stable (and actually fell in 2004), which could suggest that entities are moving from formal ways of registration (e.g., agroenterprises) to more informal ones (e.g., cooperatives). While it is unclear whether a farm actually saves money by switching, there is clearly a simplification in filing that results from such a move.

Table 1.5: Trends in General Indicators on the PIT and ST Base, 2001-2005

	2001	2002	2003	2004	2005
Revenue, % of GDP, of which	5.9	5.6	5.4	4.5	4.3
Personal income tax	2.1	2.0	2.0	1.7	1.7
Social tax	3.8	3.5	3.4	2.9	2.6
Revenue, % of wage bill, of which	38.7	34.6	34.8	29.0	27.8
Personal income tax	13.7	12.7	12.9	10.7	10.7
Social tax	24.9	21.9	21.9	18.3	17.1
Number of total entities, 000s					
Personal income tax	508	613	703	742	886
Social tax	576	565	643	686	759
Entities under special regimes, 000s		432	506	560	665
Simplified declaration		79	106	140	176
Patents (for individual entrepreneurs)		93	105	129	159
One time vouchers		137	158	144	168
Unified land tax		119	133	142	156
Agricultural enterprises		3	3	2	3
Casinos, etc.		2	2	2	3
Difference, total entities PIT and special regimes		181	197	182	222
Total employment, 000s, of which	6,699	6,709	6,985	7,182	7,261
Agriculture and fisheries	2,379	2,380	2,463	2,406	2,353
Manufacturing	830	824	855	870	892
Construction	264	268	329	381	416
Public sector	1,144	1,162	1,249	1,320	1,348
Trade, services, commerce	1,827	1,821	1,850	1,955	2,013
Others	255	253	239	251	240

Sources: Ministry of Finance, Tax Committee, and Statistical Office.

1.37 **Collected Rates.** Another way to understand the trends in compliance (and whether the recent reform has broadened the tax base) is by calculating the wedge between the average **effective** rates and the average **collected** rates (calculated in this order so as to obtain a positive sign for the wedge). In both cases, the rates are measured against the total potential base (the gross wage bill of the economy net of deductions). As Table 1.6 shows, following the 2004 reform wedges increased for the PIT,

Table 1.6: Wedges in Collections for the PIT and ST, 2001-2005

	2001	2002	2003	2004	2005
PIT collected rate, %	7.1	6.7	6.7	5.5	5.5
PIT general effective rate, %	7.1	7.1	7.1	6.0	6.0
PIT wedge	0.0	0.4	0.4	0.5	0.5
ST collected rate, %	12.2	11.0	10.9	9.0	8.5
ST general effective rate, %	18.9	18.9	18.9	15.2	15.2
ST wedge	6.7	7.9	8.0	6.2	6.7

Source: Bank staff calculations based on the information from the Ministry of Finance and the Agency for Statistics.

and fell slightly for the ST (although increasing again between 2004 and 2005). This is consistent with the previous analysis of number of entities. For the PIT, it appears that the reduction in rates has not generated gains in collections (through broadening its base). For the ST, collections have increased relative to the base and the effective rates, but this is more likely the result of the creation of special regimes (i.e., the firms that actually comply with the full ST regime are not, at first sight, likely to have increased).

1.38 In short, the 2004 reforms have most probably achieved their main objective partially: (i) some enterprises have registered for special regimes rather than the formal PIT/ST as a way to avoid ST; but (ii) overall compliance in the economy has increased slightly, particularly for the ST.

1.39 As for the effect of the tax reforms on labor supply, total employment in the economy has increased by significantly less than the rate of growth in the non-oil GDP in every year included in Table 1.5. This suggests that total labor supply has been very inelastic relative to the reforms. While this issue merits an in-depth analysis (to account for demographic issues, and exits from the labor force, as well as to separate the income and taxation effects on labor supply), the observed pace of growth in employment suggest that reforms did not induce major shifts in the labor supply.[23]

1.40 To ensure that the 2007-08 tax reforms will indeed result in greater compliance and efficiency gains (in terms of an enhanced labor supply), the authorities will need to do what has been avoided since 2001: to broaden the base of the formal PIT and ST regimes significantly, and to harmonize fully the structures of these two taxes.

C. Suggestions for Reform

1.41 The income tax system of Kazakhstan has been significantly improved since its introduction in 1995. Over the past few years, the trend has been to reduce rates for the PIT and the ST in light of the strong performance of commodity-related revenues. But this trend has not been accompanied by efforts to increase compliance with the basic thrust of the regime. Instead, there have been rate reductions along with the proliferation of ways to "avoid" the formal system of taxation (at least for the ST) through various simplified regimes. There are, in addition, inconsistencies between the structure of the PIT and the ST, such as differences in bases, allowances, rates and, most important, administration. The special mechanisms and inconsistencies have prevented major gains compliance from coming out of the reduction in rates. They may have also compromised efficiency gains.

1.42 Our options for reform follow two lessons from international experience: (i) flattening rate structures and integrating or aligning different tax rate structures to avoid arbitrage opportunities, and (ii) broadening tax bases.

Flattening Rates and Aligning Structures

Strategic Direction

1.43 **The best alignment is full integration**. The decision the introduce a flat rate for the PIT is commendable, but unless the PIT is carefully aligned with the ST, efficiency gains may not

[23] This is an issue that researchers and universities in Kazakhstan may wish to explore more rigorously.

fully materialize as the government wishes under its competitiveness agenda. Our recommendation is to *fully integrate* these two taxes to ensure the following:

- Easiness of self-compliance for taxpayers, as they would focus only on one tax
- Easiness of administration by the Tax Committee, as it would focus its human resources on the compliance of a single tax
- Easiness for Policymakers (e.g., the Ministry of Finance and the Ministry of Economy and Budget Planning) to monitor the impact of the tax reform on the economy
- Maximum neutrality with respect to firms' decisions (to hire, to invest) and households' choices (to work)
- Full reduction in the incentives to avoid these taxes
- Full elimination of any policy inconsistency between these two taxes
- That the tax system is pro-poor even in the context of a flat rate (as the allowance and the zero band would exclude low wage earners).

1.44 The simplest way to integrate the PIT and the ST would be to collapse them by phasing out the ST while introducing a higher flat rate for the PIT. This would be easy to implement since these taxes are collected at the enterprise level. Such a measure would move the taxation system in Kazakhstan towards that being applied in New Zealand, which is recognized by the OECD as one of the most broadly based, neutral, and efficient systems among its members.[24] The key feature of the New Zealand taxation system (which to a large extent is also shared by Australia) is the fact that it does not have payroll taxes (social taxes).

1.45 In moving forward with full integration, a key decision is the choice for the total rate. In Figure 1.7, we compared the current proposal of the government for the PIT and ST with a 20 percent combined PIT/ST flat rate. This rate, which is equivalent to a 15 percent average effective rate relative to total labor costs, is attractive for various reasons:

- It should be at least revenue neutral (but likely revenue enhancing) in comparison with the regime envisaged under the proposed reform (which creates headroom to reduce taxes on, say, capital).

- It should invite consideration of further rate harmonization, particularly that between the PIT/ST and the CIT that applies to non-extractive industries.

- It would still give significant comparative advantages to the private sector relative to other countries, as is shown in Figure 1.9.

1.46 It should be noted that in Figure 1.8 the current proposal for the 2007-08 reform results in a flat average effective rate, while a 20 percent flat PIT is actually progressive in that the average rate for an individual earning 67 percent of the average earnings is slightly lower than that for someone earning the average wages. As was explained earlier, this feature reflects the combined effect of the PIT allowance and the zero band. Choosing the size of the zero band and the allowance is another key choice in the full integration of these two taxes, as these two parameters will determine the percent of the population that does not have to comply with the single PIT regime.

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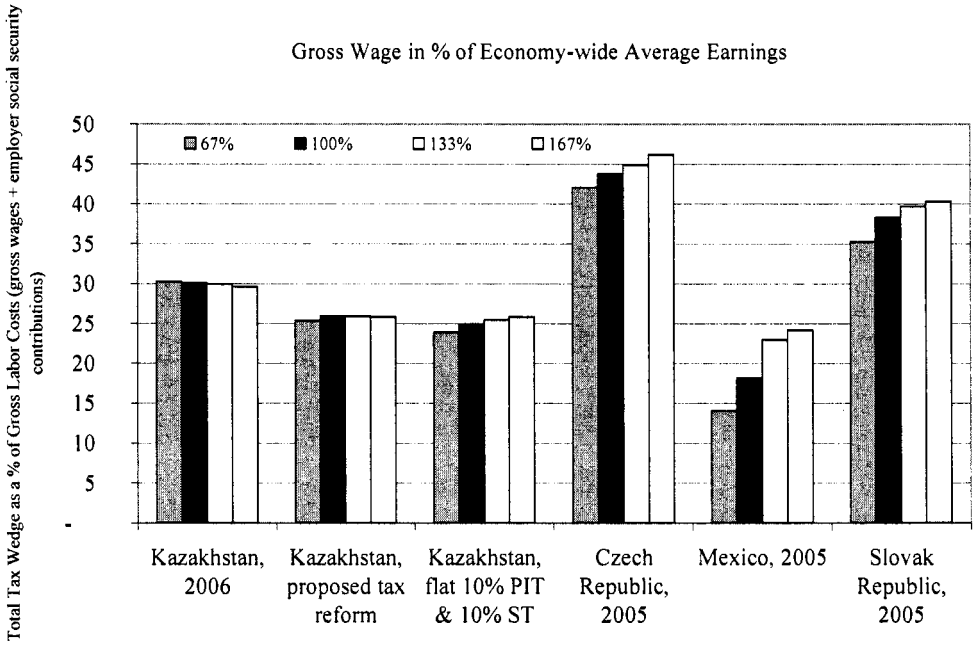
[24] See OECD 2001: *Tax and the Economy: A Comparative Assessment of OECD Countries,* OECD Tax Policy Studies No. 6. See in Particular Table 1.1.

Figure 1.9: Total Tax Wedges[1/] and Earnings
OECD Measure, Single Taxpayer



Note 1: Total tax wedge includes personal income tax, pensions + employer social tax expenses and social insurance contributions.
Note 2: The bars for each country represents the tax wedge as a proportion of a gross wage that is equivalent to a percentage (as indicated in the legend) of the average earnings of a regular worker in the country. For Kazakhstan, this denominator is the total labor cost (given that social taxes are the responsibility of the employer).
Note 3: The calculation for Kazakhstan includes the 10 percent contribution to the private pension funds. The calculation for other countries includes pensions, health and, among other things, contribution to unemployment insurance.
Source: World Bank staff calculations for Kazakhstan, and OECD for other countries.

Additional Considerations

1.47 Whether the authorities move forward with the full integration of the PIT and ST, there are issues for each tax that would still need to be addressed, as outlined below.

1.48 **Harmonizing the Treatment of Foreign and Local Workers**. The current proposal for the ST envisages a harmonization of the rates for foreign and local workers. This is the direction that Kazakhstan should follow irrespective of whether or not companies have formal representation offices. The PIT and ST should apply in full force equally to foreign and local workers—except as prescribed in double taxation treaties.

1.49 **Harmonizing the Treatment of Public Institutions and Private Enterprises**. We recommend that the special allowances provided for public institutions under the ST be either phased out or extended equally to all entities.

1.50 **Allowances**. While the priority should be to focus on neutrality and economic efficiency, equity across families is an issue. The current proposal would significantly increase the allowance for the two types of families we studied, but it would make large families worse off in

relative terms. Maintaining a system of allowance per dependent may better serve a policy of poverty reduction to the extent that poverty in Kazakhstan (both in absolute and relative terms) correlates strongly with the number of dependents. An allowance per family member may also be an effective policy to encourage fertility which appears to be a policy priority in the country (alone, or accompanied by the current policy of transfer of a lump sum benefit when a child is born, and after one year).

1.51 The fact that allowances, other than the basic allowance, are limited is a commendable provision of the current Tax Code that should be maintained. However, the Tax Code should specify that the allowance for interest on mortgages should apply only to the house in which the person lives (but not to second or third houses).

1.52 **Zero Band**. The current zero band, at about 25 percent of the average wage, is appropriate. If it is combined with the proposed new basic allowance for 2007, most workers earning less than half the average wage would be exempted from PIT. This is a good measure, as about 30 percent of the poorest workers would not have to file returns (or their enterprises would not have to withhold PIT), which would allow the Tax Committee to focus its resources on compliance by high wage earners.

1.53 Although there is room for the authorities to fine-tune the size of the zero band and the basic allowance, we would advise against giving away one of these parameters as has been considered at some point. These two parameters have a role to play in the system, and there is no need for Kazakhstan to lose one tool in taxation. But it is very important that the definition of taxable income be exactly the same for all brackets (including the zero band). Currently, there are a number of unnecessary interactions between the Tax Committee and firms due to the nuisances regarding how the Tax Code defines the income for the purpose of the zero band.

1.54 **Non-labor Income**. Under the current enforcement framework, the PIT is essentially a wage tax (collected essentially from public institutions and large enterprises). The priority for administration is clearly to ensure that all enterprises (including those subject to special regimes and all farms) comply with withholding (and audit particularly the income and consumption of high earners within an enterprise). A second priority is to increase compliance by the self-employed (with relatively high income, i.e., professionals). Over the medium term, the challenge is to ensure greater compliance regarding the income earned out of capital (e.g., rental of real state properties). Since the Tax Code already specifies that the PIT covers such income, the Tax Committee needs to start, at the appropriate time, to undertake audits of the PIT so as to ensure that non-wage sources of income are appropriately declared.

1.55 **The Social Security Contribution**. If the authorities decide to consolidate the PIT and ST, a decision needs to be made on whether the social security contribution will be:

- Maintained as a 2 percent payroll tax (much the same way in which Australia maintains a small payroll tax to finance health)
- Phased out and financed from the general budget
- Replaced by earmarking a certain percentage of the new PIT (e.g., 2 percent out of the 20 percent).

1.56 We recommend the last option, as it maximizes the simplicity of self-compliance and tax administration.

1.57 **Loss of Revenue for Local Governments.** Since the PIT and ST are currently earmarked for the local governments, the proposed sharp reduction in rates will hit these budgets particularly hard as revenues can be expected to fall (although by much less if the bases are also broadened as proposed in these conclusions). The government is considering compensating this loss by increasing the equalization grants from the republican budget. This, however, may not be a credible solution for local governments over the medium term. Local governments are giving up a significant proportion of a tax they "own" in exchange for a promised transfer that can fluctuate with political and economic conditions. To address these justifiable concerns, the Government of Kazakhstan may wish to consider earmarking part of the VAT (e.g., 25 percent, with the actual amount depending on the estimates that the MOF has for the revenue loss coming out of the reduction in the rates) for local governments. As outlined in a recent World Bank report on intergovernmental relations, this would follow the example of Germany.[25] Such earmarking of the VAT is advantageous for two reasons: (i) the VAT is a broad based tax that is likely to reflect the level of consumption, and hence the base, for each oblast; and (ii) it will buy some support (at least of local governments) for not reducing the VAT beyond the current levels planned.

Broadening Bases

1.58 Past reforms have created rather than reduced exemptions for the ST, and this also undermines the base of the PIT. The sharp reduction in rates presents a unique opportunity to broaden the base significantly. Essentially, this entails phasing out **all** special regimes, especially in relation to compliance with the ST. This of course would not be an issue if the government decides to go with the phasing out of the ST, because under the current Tax Code the PIT is to be withheld from workers under all special regimes.

1.59 Such broadening of bases would reduce the burden on the Tax Committee since they would not need to deal with special regimes. To date, the Tax Committee has been shifting resources (staff, IT, and other resources) away from enforcing PIT and ST as an integral system in the taxation of labor, and towards the building of departments dealing with special regimes. Thus, the phasing out of special regimes for the PIT/ST would allow for a reallocation of resources to more productive activities.

1.60 As part of this effort, the Tax Committee should start to monitor PIT compliance in terms of number of persons and entities. This will not be easy, as many entities do not actually keep records on employment. For example, government institutions do not utilize a formal payroll system in the Treasury and thus cannot actually report their payroll by worker (without undertaking some additional accounting work and personnel management). Such a situation is probably replicated in farms and many enterprises. The effort to seriously monitor this base (and to base audits and compliance enforcement on the basis of such information) would be greatly facilitated by the introduction of a single identification number for individuals, which the Informatization Agency is working on developing as part of the e-government initiative.

[25] See Dillinger, William R. (2006), "Kazakhstan: Reforming Intergovernmental Fiscal Relations," WB Report No. 33709-KZ.

2. CORPORATE INCOME TAXES

A. DESCRIPTION

A Brief Overview and International Comparison

2.1 As in most resource-rich countries, in Kazakhstan the government derives a relatively large part of its revenue from the taxation of corporations, even when oil companies are taken out of the comparison.[26] Table 2.1 compares corporate tax revenues as a percentage of all central government revenues for a number of developed and developing countries. The percentage in Kazakhstan (4.9 percent) is high by EU or US standards. Presumably because of high capital mobility, Western Europe and the United States derive little revenue from taxing corporations, although rates in the United States, for example, are not much lower than in Kazakhstan. In the EU, the accession of eight relatively low tax rate countries has started a steady erosion of the corporate income tax (CIT) revenues as rates are lowered competitively; the EU number can be expected to stabilize at US levels. Comparisons with developing countries are possibly more relevant but also more difficult. Most resource-rich countries rely heavily on this tax (see, for example, the figures for Russia). Nevertheless, Kazakhstan clearly relies more on the corporate tax than most other comparable countries.

Table 2.1: International Comparisons

Tax Revenues as % of GDP (2003)	CIT	PIT	Social Contributions
Average EU-15	2.2	9.8	13.2
Average EU-8	2.3	5.6	12.3
Kazakhstan	7.6	2.1	3.5
--- of which non-oil	4.9	--	--
--- of which non-extractive (oil and minerals)	4.6	--	--
Russia	6.6	3.4	7.8
--- of which non-oil	4.0	--	--
Slovak Republic	2.8	3.3	13.9
United States	1.2	7.3	6.6

Note: Social contributions for Kazakhstan exclude the 10 percent contribution to private pension funds.
Source: Author's calculations based on OECD database, and Ministry of Finance information.

2.2 Both privately owned companies and state-owned enterprises (SOEs) are subject to a tax of 30 percent on their taxable income except for corporations in the agricultural sector ("using land as their primary means of production"), who pay only 10 percent. Taxable income in some sectors is reduced substantially by investment incentives and specific exemptions. In addition, there is a withholding tax of 10 percent on interest paid, where the corporation is considered to act as a tax agent for the PIT. A withholding tax of 15 percent on dividends of legal entities was abolished in the middle of 2006. Joint ventures with foreigners are taxed as Kazakhstan corporations. The tax rate is not especially low by international standards (see

[26] Taxation of oil companies, in particular foreign ones, involves considerations that are entirely different from those governing the regular taxation of capital because of the rental nature of most oil revenues. We therefore do not cover it in any detail in this chapter or in the corresponding annex.

Annexes 2 and 3). While China has a corporate tax rate of 33 percent, Russia's rate is 26 percent. Corporate tax rates in CEE countries are even lower (Cnossen, 2005).

2.3 The Kazakhstan tax system does not attempt to protect the value of allowances for the depreciation of physical capital from inflationary erosion. The details of the depreciation system are discussed below. Inflationary erosion of nominal debt is not recognized either; the total amount of nominal interest payments (not just real interest payments) is deductible from taxable income.

2.4 Another feature concerns the interaction between personal and corporate taxation. The most important criterion here is whether the combined personal and corporate tax system favors one form of corporate finance over another. If it does not, tax neutrality obtains. In most countries debt finance is favored over equity finance by making interest fully deductible while keeping retained earnings and/or dividends as not fully deductible. The Kazakhstan system distorts that choice further by withholding 5 percent from dividend payments but not from banks or from interest paid on debt securities held by legal entities.

2.5 The withholding tax on dividends paid out to corporations used to add another problem in Kazakhstan: dividends that make their way to final equity owners through a chain of companies used to be confronted with the withholding tax repeatedly (the so called *cascading* effect). In mid 2006 the tax legislation was amended to avoid double taxation of dividends, and starting from January 1, 2007 legal entities' income from dividends is no longer taxed. Cascading of the corporate tax is avoided because dividends paid to corporations are not subject to corporate taxation in the receiving company. Income distributed through interest payments is not subject to cascading because there is no withholding tax[27] on interest paid out to banks or to related companies if the debt contract is properly structured.[28]

2.6 Dividends from which the withholding tax has been collected are exempt from personal income tax (PIT). Retained earnings are not subject to the withholding tax, but on the other hand capital gains on shares in companies are not exempt from PIT when realized. Since the PIT is higher now than the withholding tax, at 10 instead of 5 percent from 2007 onwards, the Kazakhstan system of direct taxation distorts the choice between retained earnings and new share issues as a source of finance, although in a relatively minor way. This is a usual feature; almost all countries in the world discriminate much more against new share issues.

2.7 If the tax system favors rewarding shareholders through capital gains rather than through the paying of dividends, it is not profitable to finance investment through new share issues. The choice is between paying dividends and using new share issues to obtain finance versus paying less or no dividends and using the money thus saved to finance capital outlays. Not paying dividends and using the money so retained to finance investment will result in capital gains that are worth more than the dividends that would have been paid otherwise because of this tax discrimination.

2.8 Debt finance is treated differently, in almost the opposite way: interest payments are exempt from corporate taxes, and no withholding tax is applied as part of the personal income tax as long as the interest is paid to registered banks or on debt securities held by legal entities. The

[27] Some categories of interest income are subject to withholding tax, but cascading can easily be avoided through carefully structuring inter-company claims.

[28] Interest paid on current accounts held at a corporate cash pool arrangement may trigger cascading if no proper debt security exists.

remainder is not covered by personal taxes, even if the taxpayer is in a higher bracket. The traditional discrimination in favor of debt finance is, therefore, also a feature of the Kazakhstan tax system.

An International Comparison of the Kazakhstan CIT System

2.9 When we compare the characteristics of the Kazakhstan CIT regime with comparable countries (cf. Annex 3), several features can be noted.

2.10 In the first place, the Kazakhstan profit tax rate (30 percent) is rather high. Only China has a slightly higher rate, but all the other countries have a CIT rate roughly equal to 20 percent. As a result, corporate tax revenues are relatively high in Kazakhstan (see Table 2.1), even when oil revenues are excluded. This might give rise to problems in future if capital mobility increases, thereby intensifying tax competition and exercising a downward pressure on CIT rates.

2.11 On the other hand, withholding taxes on interest and dividends are relatively low. However, here Slovak Republic clearly has a superior system since dividends are not taxed, thereby preventing the double taxation of dividends. As, for example, Poterba and Summers (1985) argue, double taxation of dividends has a reducing effect on corporate investment and exacerbates distortions in the intersectoral and intertemporal allocation of capital. Furthermore, the State Tax Commission has issued an instruction to the effect that bank deposit interest received is exempt from the withholding tax. This is clearly a distorting and therefore unfavorable feature of the Kazakhstan tax system, since this hampers the development of direct financial markets to the benefit of financial intermediaries.

2.12 Another important difference arises with respect to the permitted depreciation methods. In Kazakhstan only the declining balance method may be applied (with the exception of subsurface users and investment projects eligible for investment tax preferences or ITPs), while the other countries are also equipped with the straight line method. Since the declining balance method is in fact a form of accelerated depreciation, and even more favorable provisions (enabling depreciation within five years) exist for subsurface users and ITP projects, the Kazakhstan tax system subsidizes investments heavily compared to other countries. This might distort investment decisions by driving a wedge between tax depreciation and true economic depreciation (see Nam and Radulesco, 2003).

2.13 Kazakhstan exempts companies in Special Economic Zones (SEZs) from the CIT, the property tax and the land tax, thereby trying to stimulate economic activity in these areas. China, Poland and Russia have similar programs. Furthermore, Kazakhstan as well as Russia also has special tax provisions for the agricultural and subsurface sector. With respect to the tax treatment of subsurface users in Kazakhstan, it should be noted that several provisions exist, all working in different directions. On the one hand, subsurface users are favored by beneficial arrangements regarding depreciation (enabling depreciation within five years) and loss carry forward, but on the other hand they are subject to an additional excess profit tax. Russia, which also taxes oil companies separately, has a more univocal and therefore more transparent system regarding this sector.

2.14 One can also observe fundamental differences regarding investment incentives between Kazakhstan and comparable countries. The granting of investment incentives (investment tax preferences for short ITPs) in Kazakhstan can be characterized as too open-ended and based on vague eligibility criteria, thereby opening the door to corruption. The granting of investment incentives in other countries is in most cases conditional on the nature and location of the

investment projects. For example, the Slovak Republic only favors companies qualified as "strategic investors," Russia favors property that contributes to the capital of Russian companies, and Poland and China encourage investment in areas that are economically lagging behind, thereby intentionally stimulating investment in these sectors and areas.

2.15 Thus, the Kazakhstan CIT system differs from that in the comparable countries in a few important aspects: in the first place, the Kazakhstan CIT rate is relatively high—a feature which may become problematic if Kazakhstan's capital mobility increases. Moreover, in comparison with to the other countries, the Kazakhstan CIT system has certain unfavorable features in that it hampers the development of financial markets, heavily subsidizes new investments, and grants investment incentives in a manner that is too open-ended and is based on excessively vague eligibility criteria, with too much discretion in granting or refusing eligibility.

General Provisions

2.16 The calculation of taxable profits on the CIT return begins with book profits. Then an adjustment is made for expenses not allowed for tax purposes. Losses incurred during the previous three years can be carried forward and deducted against income. These losses cannot be adjusted for inflation that took place during the carrying period. There are no carry-back provisions.[29]

2.17 From the amount calculated as described above, certain additional deductions are allowed. The most important of these deductions are the investment allowances (ITPs) described in the next section.

2.18 The taxpayer is not allowed credit for amounts withheld at the source of income. But credit is allowed for foreign taxes paid. Foreign tax credits are calculated on a country-by-country basis and are limited to the amount of Kazakhstan tax that would be due on the foreign source income. There is no provision in the Tax Code for dealing with the situation in which these tax credits exceed tax liability. It is not clear whether the excess can be refunded or whether it has to be applied to satisfy requirements for advance payments during the following year.

2.19 *Depreciation allowances* are based on historical cost, and are not adjusted to reflect the rate of inflation. Depreciation must be taken under the declining balance method, for which purpose all assets except buildings are grouped in one of four groups. The declining balance method is then applied to the group total. This means that a group-specific percentage of each group can be added to deductible costs and then has to be subtracted from the group value. New acquisitions or investments are added to the group value, again at actual (historical) cost including installation charges, interest accrued on loans taken out to finance construction, etc. The taxpayer can switch from the declining balance method to straight-line (but not from straight-line to declining balance) during the life of an asset only if the relevant group value falls short of 300 monthly assessment indices (in 2005, approximately 1,000 tenge, for a threshold value of about US$2,500, clearly a negligible amount in most cases). After such a switch the remaining balance can be written off entirely within a year in all depreciation groups.

[29] Under a carry-back provision, losses in a given year can be applied against profit taxes paid in earlier years to obtain a refund (typically a limited number of earlier years is allowed only). The remainder can then be carried forward to offset future tax payments under carry forward or carry-over provisions.

2.20 *Imported capital goods* are entitled to double the relevant depreciation rate in their first year of deployment. During that first year the asset is accounted for separately, after which the depreciated value is added to the relevant subgroup. This facility is available to domestic and foreign owned resident entities alike.

2.21 Buildings and other facilities[30] (Group I) can be depreciated at a maximum rate of 10 percent, up from 8 percent in 2005. Machinery and equipment (M&E)[31] constitutes Group II and can be depreciated at a maximum rate of 25 percent (up from 20 percent before 2006). Office equipment and computers make up Group III, with a maximum depreciation rate of 40 percent. Group IV is a catch-all group for all fixed assets not covered by groups I-III and can be depreciated at 15 percent.

2.22 *Leased assets* are considered as transferred under a financial lease if (i) the (discounted) value of the lease payments is at least 90 percent of the asset value; (ii) the lease period is three years or more and exceeds 75 percent of the useful life of the asset transferred; and (iii) the transfer of ownership at the end of the lease period is arranged in the contract at a fixed price. Apparently options to buy, even at a preset price, are not allowed under a financial lease. The value of an asset transferred under a financial lease is added to the relevant group value of the lessee and subtracted from the relevant group value of the lessor.

2.23 The proceeds of assets sold at a value exceeding the relevant group value at the moment of sale are part of taxable income for the excess over the group value. This rule implies that in practice in most cases capital gains over depreciated value after asset disposal remain untaxed under the CIT.

2.24 The tax code indicates that deductions for the costs of goods sold from inventories are to be based strictly on historical costs, with no adjustment for inflation. It is likely that in practice, if historical acquisition costs cannot be determined, LIFO will be used. There is no attempt to value at replacement costs or otherwise correct for inflation.

2.25 Nominal interest payments are deductible, again with no adjustment for inflation. There is no adjustment in the case of excessive interest rates, not even between connected parties.

2.26 There is a correction in case of *thin capitalization*, but that correction is only applicable to interest payments to foreign residents. If the equity-to-debt ratio is smaller than the maximum allowable debt-to-equity ratio 4 (7 for financial institutions), interest payments to non-residents are scaled back by the ratio of the equity-to-debt times the relevant maximum factor. However the excess is not fully treated as dividends either, since it is not subject to withholding tax if properly structured (i.e., if there is an underlying debt security). There are no specific limiting provisions concerning debt instruments with equity characteristics (such as interest payments conditional on or otherwise dependent on profitability), nor are there any thin capitalization rules for interest payments to domestic residents.

2.27 There exists a system of advance payments for corporation tax. Monthly advance payments have to equal at least the advance payments of the previous period, or the payments established under the declaration of the previous tax period's corporate tax liability. Advance payments can be adjusted upon written request, but not before the declaration for the previous tax period has been submitted. The law makes no provision for the refund of excess advance

[30] Oil and gas wells and "conveying devices" are treated under a separate regime.

[31] Again M&E used in the oil and gas industry falls under a different regime.

payments and enterprises claim that there is no resource to recover excessive payments over the actual CIT liability. Enterprises are not even allowed to apply them against future advance payments and tax liabilities.

Investment Allowances, Income Exemptions and Other Incentives

General Exemptions

2.28 The Kazakhstan tax code does *not* provide for tax holidays or accelerated depreciation allowances for foreign residents investing in Kazakhstan. There is an accelerated depreciation allowance for imported capital goods, but that allowance is available to domestic residents also. Imported capital goods are allowed double depreciation in their first year, after which the depreciated value has to be brought into the relevant depreciation group.

2.29 Research and Development expenditure, expenditure on training if the relevant person will work for at least three years for the taxpayer following completion of the training, and so-called "social expenditure" (a very limited category of payments concerning maternity leave, work-related injuries and temporary illness) are all fully deductible.

Specific Allowances and Exemptions

2.30 Kazakhstan provides extensive incentives and exemptions to the following:

- Specific groups of taxpayers (through a variety of presumptive taxes).
- Specific sectors of the economy and specific regions/localities (through the establishment of Special Economic Zones [SEZ] where a favorable exemption regime applies).
- Investment in particular sectors of the economy through so called Investment Tax Concessions.

2.31 Some of these schemes are recent, but all of them are open-ended, so that extensive undermining of the base of the corporate tax and its average rate is likely.

Presumptive Regimes (PRs)

2.32 Both individuals and legal entities can qualify for one of a variety of simplified regimes under which their personal or corporate tax liability is assessed in a (presumably) simplified manner. These regimes are only partially intended to simplify compliance; another objective is to gradually induce entrepreneurs to enter the regular tax system as their business expands.

2.33 Under the ***first PR***, the so called *Single Use Coupon* System, entrepreneurs working less than 90 days in a given calendar year can buy off any corporate and personal income tax liability by paying a small amount determined by the local council based on surveys done by the local tax authorities. Entrepreneurs in this regime are also exempt from social taxes.

2.34 Under the ***second PR***, the P*atent* system, entrepreneurs pay 1 percent of turnover in PIT and 1 percent of turnover in social taxes. They can credit any contributions to the State Social Security Fund to the amount payable as social taxes, however. To qualify for this regime, annual turnover should not exceed 2 million tenge (approximately. US$15,000 in 2005).

2.35 Under the ***third PR***, the *Simplified Regime*, different rules apply depending on whether the taxpayer is incorporated or not (see Table 2.2). In both cases the taxpayer pays a percentage of turnover, to be split 50-50 between (i) PIT (for unincorporated payers) or CIT (for incorporated payers) and (ii) the social tax. The tax rate for unincorporated businesses can be further reduced by up to 15 percent of the rates listed in the table if the number of employees goes up (to a maximum of 10, at which point the full discount of 15 percent is given).

2.36 As is clear from Table 2.2, a substantial extension of the coverage of these two regimes is in the works.

Table 2.2: Simplified Regimes, 2001-2007

	Rates			
	2001-2002	2003-2005	2006	2007
Unincorporated (physical entities)	4~11%	3~7%	3~5%	3%
Incorporated (legal entities)	5~13%	4~9%	3~7%	3%
	Eligibility			
	Annual Income (million KZT)		No. of Workers	
	2001-2005	Since 2006	2001-2005	Since 2006
Unincorporated (physical entities)	18	40	15	25
Incorporated (legal entities)	36	100	25	50

Source: Tax Committee of the Republic of Kazakhstan

Simplified Regimes for Agriculture

2.37 There is a second *Simplified Regime variant* that applies to agriculture only. Like the first variant, it is subdivided into two "sub-variants," depending on whether the taxpayer is unincorporated ("peasant farmer") or an incorporated agricultural enterprise. The "peasant farmer" pays 0.1 percent of the assessed land value, at valuations that are generally considered to be substantially below market values. In 2005, about 156,000 farm households chose this regime. These farms are not necessarily small: in the north the average farmer using Agricultural Simplified Regime has 2,000~3,000ha, and in the south approximately 5ha. There is reportedly one farm under this regime with no less than 1.5mha. If a farm household chooses this regime, no other taxes, direct or indirect, are due.

2.38 The second variant of the ASR is not based on land values but is a patent system: agricultural enterprises can escape corporate and social tax liability by choosing to buy a so called *patent* for 20 percent of the assessed total tax burden under the property tax, the VAT, CIT, ST and three other, smaller taxes, and thereby be exempted from all seven taxes. It should be noted that the regular corporate tax is already assessed at a low rate of 10 percent. Thus, incorporated farms pay only about 2 percent of profits in CIT (20 percent of 10 percent) and a 3 percent VAT (20 percent of 15 percent), where regular corporations face a 30 percent CIT rate and a 15 percent VAT rate. About 3,000 farms are covered under this variant of the ASR.

2.39 The agricultural patent system can be used only by farms that grow their own produce and applies only to the revenues from processing their own products. If a farm also processes products from other entities, the taxpayer is required to account separately for these activities and keep them outside the patent system, that is, subject to the regular CIT system as it applies to agriculture. This system strongly discourages the establishment of an agricultural processing

industry, as the agricultural patent system provides very strong incentives to process one's produce on-farm.

Table 2.3: Distribution of SMEs over Different Regimes, 2002-2006

	2002	2005	2002	2005	2002	2005
	Nr. of users (thousands)		Revenue (bT)		Tax Burden (%GDP)	
Single Use Coupon	137	168	3.3	3		
Patent System	92	159	1.6	2		
Simplified Regime, unincorporated	74	165	3.6	9	4.8%	3.5%
Simplified Regime, incorporated	4.5	11	1.5	3	10.1%	5.7%
Total	308	503	10	17		

Source: Tax Committee of the Republic of Kazakhstan

Table 2.4: Distribution of Taxpayer over Different Regimes, 2002-2005

	2002	2005
Regular CIT	36.0%	27.2%
Simplified Regime	17.2%	25.9%
Agriculture Simplified Regime/LT	26.0%	23.0%
Agriculture Simplified Regime/Patent	0.3%	0.3%
Patent System	20.2%	23.4%
	99%	99%

Source: Tax Committee of the Republic of Kazakhstan

2.40 Tables 2.3 and 2.4 indicate that the coverage of the special regimes is expanding, even before the relaxation of the eligibility criteria which took place in 2006.

Special Economic Zones (SEZs)

2.41 There are a variety of SEZs operating or in the planning stage in Kazakhstan. The concept is rather loosely used: some are based on location and some on sector of activity, or a combination thereof. There is also an SEZ that depends only on the share of value added in total turnover plus some broad sectoral activity based selection criteria.

Location Specific, Cluster-based SEZs

2.42 There is a planned SEZ for a location in Almaty where Information Technology based firms qualify for an 80 percent reduction of CIT and VAT exemption for transactions within the SEZ. Sales outside the SEZ are subject to regular VAT withholding (0 percent for exports and 15 percent for domestic sales). The opening of the SEZ has been delayed as of the writing of this report (April 2006).

2.43 A similar SEZ is planned for *cotton* related activity, to be opened in the south. Construction for preparing the site has started, but no opening date has been set.

2.44 Finally, there is an SEZ in the seaport Aktau, on the Caspian, that has already opened but has not yet seen any taxpayers register for activity in the sector, because the port itself is not yet open. This SEZ will not enjoy VAT privileges. Companies need to be active in the chemical or metallurgical industries, or to produce finished metallic items or machinery and equipment.

2.45 Further plans exist for energy-related activity in an SEZ in Uralsk (West Kazakhstan) and for a construction-related SEZ in Astana.

General SEZs

2.46 The tax code includes extensive tax preferences for firms with at least 40 percent value added of total turnover. For qualification, the Investment Incentive Committee has to approve the application. No clear criteria have been published. There are also plans for an SEZ focusing on capital equipment for the oil industry where no location restriction seems to apply or to have been set as yet.

General Issues Concerning SEZs

2.47 For location-specific SEZs there are restrictions on the following:

- Ownership (no subsidiaries outside of the SEZ)
- Activity outside of the SEZ (not more than 10 percent of total income from sales of goods produced by the company)
- Registration; required to register as a taxpayer in the SEZ

2.48 There are no restrictions on common ownership of companies within and outside of the SEZ, however, which implies that these privileges are vulnerable to abuse through transfer pricing. No special precautions or audits are envisaged for this specific problem. The VAT privileges constitute a break in the VAT chain, thereby compromising the integrity of the VAT system (cf. Chapter 3 in this report).

Investment Tax Preferences (ITPs)

2.49 Investment tax preferences (ITPs) are provided for new projects, by old or new companies. According to Article 138.3 of the Tax Code, newly formed taxpayers receive a 100 percent income tax exemption when undertaking new investment projects, for the period for which the preferences are provided. Existing taxpayers who expand or renovate existing facilities are allowed to use five-year straight line depreciation instead of the group-specific declining balance method, but receive no income tax exemption other than the partial one following out of the new depreciation rule (Art. 138.4).

2.50 Existing taxpayers undertaking new projects are not explicitly covered in the Code, but Article 138.4 includes all taxpayers not covered by Article 138.2, and this existing taxpayers undertaking new projects according to this clause also qualify for the five-year straight line depreciation.

2.51 ITPs are extended for five years, renewable for at most another five years. During the initial five years, ITPs also include exemptions from property and land taxes. Criteria for granting the ITPs are broadly defined in the Law on Investment Preferences and Government Resolution 436, but in the end the granting of ITPs is at the discretion of the Investment Committee in the Ministry of Industry and Trade. The criteria for granting preferences are unclear.

2.52 The use of the preferences is growing rapidly, with a tendency to increase the number of projects and their size. In 2004, 84 licenses were granted for a total value of less than US$800 million, while in 2005 the amount more than doubled to about US$2 billion for 117 projects (Table 2.5).

Table 2.5: Investment Tax Preferences

Year of Signing the Contract	Number	Investment into Fixed Assets	
		KZT billion	US$ million
In compliance with the RK Law on "On state support of direct investments" of February 28, 1997, there have been:			
1997	11	2.46	33.4
1998	72	17.9	229.5
1999	67	101.1	847.1
2000	76	34.6	243.5
2001	115	188.2	1 282.9
2002	2	0.126	0.822
Subtotal	**343**	**344.4**	**2 637.2**
In compliance with the RK Law on "On investments" of January 8, 2003, there have been:			
2003	64	52.95	361.9
2004	84	103.2	777.1
2005	117	290.8	2 171.9
2006	99	163.6	1 292.9
Subtotal	**364**	**610.55**	**4 603.8**
Grand Total	**707**	**954.9**	**7 241.0**

Source: Ministry of Industry and Trade, Investment Committee

2.53 Most recently, licenses have been concentrated in the processing industry, mostly in the building sector.

B. ASSESSMENT

2.54 This section describes ways in which the corporate income tax system affects economic choices and suggests how it could be improved. The discussion concentrates primarily on the economic effects of investment incentives, exemptions and the tax treatment of debt and equity finance, especially in a world of high and variable inflation. Though the impact on economic decision-making is the primary criterion underlying this discussion, equity and the ease of taxpayer compliance and administration are also considered. The impact on economic decision-making involves two aspects: first, the impact of the tax system on investment and hence on inter-temporal production efficiency, and second, the impact on the method of financing a given level of investment (debt, new share issues or retained earnings). We refer to the first aspect as the efficiency costs of the corporate tax system and to the second aspect as tax neutrality.

2.55 A major cause for concern is the effect of inflation on the efficiency costs and neutrality aspects of the corporate tax system. Inflation affects the marginal tax rate through several channels. First, inflation is not taken into account in the adjustment of depreciation allowances. Thus, positive inflation reduces the discounted value of depreciation allowances and so raises the tax burden on corporations in a presumably unintended manner. Second, carryovers of investment tax credits by loss-making firms into years with positive profits are not adjusted for inflation. Third, there is a 15 percent withholding tax on interest payments to individuals[32] and

[32] The withholding tax is part of the PIT and therefore applies to interest payments to individuals only.

intra-conglomerate loans. However, this withholding tax is applied to nominal rather than real interest rates. This means that at higher inflation rates actual tax payments rise even if the real rate of interest remains unchanged (and nominal rates go up with inflation). However, the withholding tax on interest payments to individuals and intra-conglomerate cash-pools is likely to be of limited relevance since interest payments to banks and on formal debt securities are exempt from the withholding tax. There is a fourth channel through which inflation increases the tax burden: inflationary capital gains on inventories are not deductible from taxable profits since Kazakhstan tax law does not allow replacement cost accounting for inventories.

2.56 The fifth and final channel works in the other direction, however. Under Kazakhstan corporate tax law, nominal interest payments are deductible from corporate taxable profits. But the inflation premium in nominal interest rates really represents the repayment of (the real value of) principal; therefore this provision implies that the repayment of principal is partly made by the state through the reduction of tax liabilities when inflation is positive. Therefore, through this channel, inflation reduces the tax burden on corporate capital that is (at least partially) debt-financed. Much of the next section is devoted to an analysis of how inflation, through these channels, influences the effects of the corporate tax system.

The Basic Tax Structure

2.57 The basic structure of the CIT in Kazakhstan is relatively simple, the problem lies with the exemptions (through special regimes, economic zones and ITPs) more than with the underlying structure itself. Of particular impact is the structure of depreciation allowances.

Depreciation Allowances

2.58 Depreciation allowances are not adjusted for inflation. As a result, the present value of a stream of depreciation allowances depends on the rate of inflation. The higher future inflation is, the more the value of depreciation allowances (and thus the value of the corresponding deductions from the corporate tax) is eroded by inflation. The effect of this failure to adjust depreciation allowances completely for inflation is shown in Table 2.6:

Table 2.6: Inflation and Value of Depreciation Allowances

Scenario 1				
Real interest rate	0.0%	0.0%	0.0%	0.0%
Inflation	0.0%	10.0%	15.0%	25.0%
Group				
I	100.0%	33.7%	24.7%	15.8%
II	100.0%	54.4%	43.7%	30.8%
III	100.0%	65.6%	55.4%	41.6%
IV	100.0%	42.0%	32.0%	21.2%
Scenario 2				
Real interest rate	2.50%	2.50%	2.50%	2.50%
Inflation	0%	10%	15%	25%
Group				
I	100.0%	41.0%	31.1%	20.5%
II	100.0%	57.7%	47.0%	33.7%
III	100.0%	67.1%	57.1%	43.3%
IV	100.0%	47.7%	37.3%	25.4%

Source: Author's calculations based on the Tax Code and information provided by the Tax Committee

2.59 Table 2.6 clearly shows that inflation has a major impact on the value of depreciation allowances and the associated tax deductions. Not surprisingly, the drop in value is steepest for the assets with the lowest depreciation rates: the further depreciation allowances are stretched out in the future, the more their value is eroded by inflation. Thus, Group I (buildings and facilities) is hit very hard; the value drops by no less than 66 percent for an inflation rate of only 10 percent,

by 75 percent for an inflation rate of 15 percent, and by a staggering 84 percent for an inflation rate of 25 percent (admittedly, a very high rate by Kazakhstan standards). The group with the fastest depreciation life, Group III (Office equipment, etc.) is the least affected, but the decline in value still ranges from 34 percent at zero inflation to almost 60 percent at 25 percent. Since depreciation allowances are the most important deduction under the corporate tax, their decline in value as inflation rises implies that the tax burden on a given flow of real income rises with higher inflation. This is surely an unintended consequence of the structure of corporate taxation in Kazakhstan. Of course, if the rate of inflation were to drop dramatically, the present value of future depreciation allowances would increase again. This would, in itself, reduce the real tax burden on investment.

Marginal Effective Tax Rates (METRs)

2.60 The value of depreciation allowances presented in the previous section is an instructive but incomplete description of the investment incentive system. Among other things, the value of such allowances depends on the corporate tax rate. More important, it compares the value of incentives to the cost of investment, but from there, the process of deriving how the rate of return on planned projects is affected is not straightforward. The answer to the latter question gives more information on the actual incentive effects of the subsidy regime.

2.61 A more comprehensive measure is given by the marginal effective tax rate (METR). The METR is a measure of the difference between the rate of return on a given project before taxes, subsidies, etc., are applied, and the rate of return on the same project after all taxes, subsidies, etc. are incorporated. The marginal effective tax rate represents an attempt to capture in one summary number the effects of all provisions for the taxation of income from capital. It compares the after-tax real rate of return on an investment with the before-tax real rate of return. The percentage difference by which the after-tax return falls short of the before-tax return is the METR. If the after-tax return is higher than the before-tax return, the METR is negative; that is, there is a subsidy. For more on the rationale and methodology of METR calculations, see King and Fullerton (1984).

2.62 Table 2.6 reports on the results of calculating the METR for investment in various types of assets, sectors and investment regimes in Kazakhstan, for three alternative rates of inflation. We first consider the METR for projects/firms that are entirely equity financed and focus on the dependency of the METR on the nature of the asset being financed and on various characteristics of the tax code. After that, we also consider the case of 50 percent debt-50 percent equity finance to assess the extent to which the tax system distorts the choice of the capital structure of the firm.

Equity Investment

2.63 Table 2.7 indicates that with an inflation rate of 0 percent, METR are approximately equal to the statutory rate of 30 percent for a typical "mixed asset" project. The METR is calculated for a project that consists of 45 percent of buildings, 45 percent of M&E and for 10 percent of office equipment. The advantages of the very favorable depreciation regime are roughly offset by the 15 percent dividend tax for the mixed project. The impact of the depreciation regime becomes clear if we inspect the METR for asset-specific projects; the METR is low for buildings, where the maximum allowable depreciation rate

Table 2.7: Basic Marginal Effective Tax Rates (METRs)

Mixed Project	0.34
Buildings	0.30
Machinery and Equipment (M&E)	0.36
Office Equipment	0.43
Other	0.24

Source: Author's calculations.

(10 percent) substantially exceeds the likely economic rate of depreciation, which for buildings is usually assumed to be in the range of 2~3 percent. The METR is highest for office equipment, where the difference between economic and tax depreciation is small.

2.64 There are some further small anomalies in the tax system which influence the final METR value (see Table 2.8). For example, the basic rate on a mixed project (33.9 percent) drops by 2 percentage points if the LCO period is increased from the very short 3 years it is now to a more customary 15 years. This would be especially advantageous for new companies. They normally go through a period of 3~5 years of startup losses, some of which can be recouped through lower taxation in profitable years. For startups, an initial period of approximately. Five years of negative profits is not excessive; since accumulated tax losses will need several years of profitability for the company to be able to use them up, a minimum of 10 years is necessary to avoid an implicit tax on start-ups, and 15 years is customary in many jurisdictions. We come back to this in the discussion of special regimes and ITPs, below. There is a further smallish impact on the METR if the delay in obtaining a VAT refund on imported capital goods is eliminated—for example, by introducing a deferred payment system as proposed in Chapter 3.

Table 2.8: METRs for Two Projects under Various Regimes for LCO, Refunds, and Withholding Tax on Dividends

	Mixed Project	All Imported M&E
Type of project/effective rate		
Basic METR	0.34	0.36
- loss carry over (LCO) 15 years	0.32	0.33
- no delay in VAT refund on Imports	0.31	0.30
- no dividend withholding tax	0.14	0.14

Source: Author's calculations.

2.65 In line with the dependence of the METR on asset type, the impact of these factors depends on asset type. In Table 2.8, second column, we decompose the components of the METR for a project that consists of imported machinery only. This means that there is a much shorter depreciation period, in line with a shorter economic life of the asset. We further assume that the M&E are all imported and so are hit by the impact of the slow refunding of VAT paid over inputs. The basic METR of 35.8 percent (see also Table 2.6) is much more affected by a lengthening of the carry over facility for losses (LCO) to 15 years: the METR drops by more than 3 percentage points. This is because initial losses are higher because of the faster depreciation. And, of course, projects that rely more heavily on imported machinery and therefore import more than the mixed project would profit more from the immediate refunding of VAT over imports. For example, a project that exclusively consists of investment and machinery and that imports all of this would see its METR reduced by a substantial 2.8 percentage points after the introduction of a payment deferral system for VAT on imported capital goods.

Dividend Withholding Taxes

2.66 The largest impact on the METR would result from abolishing the withholding tax on dividends. In Kazakhstan, a 15 percent withholding tax on paid out dividends was lowered to 5 percent for individuals and was excluded from the taxable base for legal entities in the middle of 2006. Dividends are a way of distributing capital income, so taxing them after capital income has already been taxed under the CIT constitutes double taxation. Abolishing the withholding tax accordingly lowered the METR to 14.1 percent, more than halving it from its original level (see Table 2.8). Similar results obtain for all asset types. Table 2.7 demonstrates this by redoing the analysis for an M&E only project. Abolishing the dividend withholding tax eliminated the double taxation of profits paid out through dividends and so restored some neutrality to the tax system. It

also greatly simplified the administration of the corporate tax by essentially switching to what is known as the dual income tax system: taxing labor income through the wage tax and capital through the corporate tax. Both taxes are greatly simplified in that way. Their base is expanded so that lower rates can be used to generate the same revenue, and no complicated corrections are necessary to offset the double taxation of profit flows paid out through dividends.

Impact of Debt Finance and Inflation on the METR

2.67 At zero inflation and a real borrowing rate of interest equal to the pre-tax project return, 50 percent debt finance essentially comes down to just halving the project throughout: 50 percent of the real return is paid out in interest but on the other hand, 50 percent of the initial purchase is debt financed and so provides only half of the drain on cash flow. In essence, the project is halved, but without any change in the time pattern of cash flows.

2.68 However, this relative neutrality depends very much on the assumption of zero inflation, obviously an unrealistic assumption in today's environment. The METRs on income from equity-financed investment are clearly extremely dependent on the rate of inflation because of the severe erosion of depreciation allowances pointed to earlier in this section. Even at a modest inflation rate of 10 percent (not so far above the expected s006 inflation), the METR on full equity projects jumps to 64.5 percent. Now switching to debt finance does matter, and becomes highly favorable when compared to pure equity finance. Even with the limited three-year LCO period, the METR drops down to a still high 50.7 percent, much less than in the case of pure equity finance. Extending the life of the LCO reduces the rate by a further 1 percentage point (Table 2.9).

Table 2.9: Effect of Debt Finance

Inflation and Debt Finance	Cost of borrowing equals project return Inflation 10%
100% Equity	0.65
50% Debt / 50% Equity	0.51
Debt / (Debt+Equity) 50%, LCO 30 years	0.50

Source: Author's calculations.

2.69 Much of that inflation dependence is caused by the failure to index depreciation allowances. Table 2.10 lists an example in which marginal tax rates are compared at 10 percent inflation. The calculations are performed under two alternative assumptions about financing methods: the first one assumes 100 percent equity issue while the second is based on the assumption of 50 percent debt and 50/ percent equity financing.

Table 2.10: Effect of Inventories and Inflation

Inflation and Debt Finance	Indexing Inventories	Inflation 10%
100% Equity	No	0.65
	Yes	0.51
50% Debt / 50% Equity	No	0.51
	yes	0.41

Source: Author's calculations.

2.70 The table shows that for both financing methods about *half* of the increase in the METR after an increase in inflation is due to the erosion of regular depreciation allowances. Further effects occur because with debt financing part of the repayment of the real value of the debt (i.e., the inflation component in interest rates) is deductible from the CIT although it really should be a capital account transaction. Thus, indexing inventories goes a long way toward reducing the impact of inflation on inventories. Of course, not all of the effects of inflation would be eliminated; there are other non-neutralities, such as the taxation of nominal capital gains, the inflationary erosion of loss carry-over provisions, and so on. But inflation rates in Kazakhstan

are too low to merit the effort of fully inflation-proofing the tax system. It might be easier to actually settle for lower inflation and to adjust macroeconomic policies accordingly.

Investment Tax Preferences

Existing Taxpayers

2.71 For existing taxpayers, ITPs come down to allowing the use of five-year straight line depreciation instead of a group-specific declining balance. This implies an equal depreciation regime for all groups, with two presumably unintended consequences. First, the extent of the subsidy depends on the type of asset being invested in. And second, the extent of the subsidy for any given asset class depends crucially on the rate of inflation. Table 2.11 shows both points clearly. We define the ITP subsidy as the reduction in the value of depreciation allowances for projects with ITP compared to projects without ITP, for a given asset class and inflation rate.

Table 2.11: Effect of Investment Tax Preferences (ITPs) on Discounted Value Depreciation Allowances

	Real rate of Interest 2.5%, inflation 0%		Subsidy
Net Present Value Investment Tax Preferences	Regular	ITP	Percentage
Group			
I	65.75	86.44	31.5%
II	83.16	86.44	3.9%
III	88.77	86.44	-2.6%
IV	74.64	86.44	15.8%

Source: Author's calculations.

2.72 The first point, the asset class dependence of the impact of ITPs, is very clear from the table. The subsidy level is largest for the long lived asset classes I (buildings, etc.) and to a lesser extent class IV (other). For asset class II, machinery and equipment, the ITPs do not have much of an impact, while for office equipment the ITPs actually increase the tax burden! The reason is not difficult to find. ITPs give a uniform five-year depreciation schedule to all asset classes; that is a big advantage if the regular effective depreciation period is long, and the advantage is small if the effective regular depreciation period is short. Thus asset class I (buildings) profits most from the ITPs, M&E is largely unaffected, and office equipment and computers actually loses out through using ITPs.

2.73 International evidence (Delong and Summers, 1990) links productivity gains most closely to investment in what in Kazakhstan constitutes asset classes II and III. Thus, the fact that these classes do not profit from ITPs or that they actually lose out under them, is a very undesirable feature of the Kazakhstan system of ITPs.

2.74 Table 2.12 also demonstrates a second, presumably unintended, feature of the ITP system: its dependence on inflation. By and large, inflation reinforces the initial impact of ITPs (the impact at zero inflation). The impact of inflation is also highly non-linear, meaning that equal increases in inflation have different effects depending on whether they start at zero inflation or at higher rates. The largest impact is for the first 10 percentage points of inflation; for buildings the subsidy level almost doubles. The subsidy level increases further when inflation goes up additionally, but by much smaller steps. The impact on M&E remains small and behaves somewhat erratically as a function of inflation, but remains negligible at all rates. The tax on office equipment implied by the ITPs increases substantially as inflation rises, from a small 2.6 percent at zero inflation to a very substantial tax at 25 percent inflation.

Table 2.12: Effect of Inflation and ITPs on Discounted Value Depreciation Allowances

	Subsidy Percentage ITPs and Inflation			
Group/Inflation	Inflation 0%	Inflation 10%	Inflation 15%	Inflation 25%
I	0.31	0.91	1.03	1.12
II	0.04	0.07	0.06	0.02
III	-0.03	-0.14	-0.18	-0.26
IV	0.16	0.45	0.49	0.51
Value Investment Tax Credit	Rate of Return 0.025			
Inflation 0%	86.44			
Inflation 10%	51.52			
Inflation 25%	28.56			

Source: Author's calculations.

2.75 To sum up, the impact of the ITPs varies by asset class in undesirable ways; the classes most closely associated with technological progress are subsidized least or even taxed additionally. And the effective rate of subsidies implied by the ITPs depends in a complicated but arbitrary way on the rate of inflation—also a very undesirable feature.

2.76 A final feature of the ITPs is the lack of transparency regarding their granting. The decision is essentially at the discretion of a committee in the Ministry of Economic Affairs, which bases its decision on very general criteria. Such a structure is basically open-ended, making the instrument a potentially dangerous one from a fiscal control point of view. In addition, the lack of transparency and the amount of discretion in the granting of the licenses are an open invitation to corruption.

ITPs and METRs

2.77 Whether the ITPs influence the marginal effective tax rate depends a great deal on whether we are looking at new projects or at projects undertaken by existing profitable firms. Existing firms will see their tax burden reduced if the five-year straight line depreciation allowed under ITP regimes actually improves matters compared to the regular schedule (Table 2.13). Investment projects consisting mostly of buildings profit substantially; with full loss offset available (as will be the case for existing profitable firms), the tax rate falls dramatically. But for firms investing mostly in Machinery and Equipment, the METR actually goes up.

Table 2.13: The METR with and without ITP for Existing Companies

	Full loss offset in early years	
	without ITP	with ITP
100% Building	0.29	-0.06
100% Machinery & Equipment	0.32	0.36

*Source :*Author's calculations.

2.78 For new firms the situation is different. Since there are no other profits against which to offset the loss, the ITP is set up differently: it consists of a five-year tax holiday rather than accelerated depreciation. Yet with mostly initial losses in the first five years, the tax holiday does no good and may actually do harm if it also means that, since no corporate tax liability was possible in those initial years, losses may not be carried forward either. In that case, the METR would actually rise under the ITP regime. T hus the ITPs seem to be poorly designed from the point of view of new firms.

Interpretation

2.79 The overall structure is clear:

- The METR on average projects is somewhat higher than the statutory tax rate, in spite of the very favorable depreciation regime, because of the double taxation resulting from the former withholding tax on dividends;

- Moreover, there are several biases in the tax system that discriminate against investment in machinery. They are hit relatively hard by the failure to adequately refund VAT over imported capital goods, they have a less favorable depreciation regime and they profit least (if at all) from ITPs.

2.80 The tax regime applied to corporate source income in Kazakhstan is relatively unusual. Corporate income is taxed at the corporate level, unless liability is eliminated by investment incentives or other extraordinary deductions. Corporate-source equity income is taxed again when distributed to shareholders-individuals through dividends. Since this is a PIT withholding tax, corporations cannot shield dividends even if they are only passed on to final shareholders. Interest payments are a deductible expense. The interest income received by banks and other financial intermediaries is taxed under the corporate tax system. Interest income of individual lenders is subject to a 10 percent withholding tax only, and is not taxed further under the PIT.

2.81 The practice in other countries for the taxation of corporate-source income commonly follows one of two quite different approaches. Under a "classical" system of the type employed in the United States, corporate profits are taxed, and the individual income tax is levied on dividends and (at a preferential rate) on capital gains on corporate shares. The double taxation that results from such a system produces aggregate (corporate and personal) tax burdens that differ from statutory individual rates; incentives for the retention of earnings and the substitution of debt for equity finance; distortions in favor of labor-intensive production in the corporate sector to the extent that double taxation raises capital taxation; and discrimination against the products of the corporate sector.

2.82 The conceptually ideal solution to these problems, a completely integrated tax system, is probably not administratively feasible. Many countries (e.g., France, Italy, the United Kingdom, and Germany), however, have adopted a less ambitious approach to the integration of the corporate and personal income taxes—a shareholder credit for part of the corporate taxes attributable to income from which dividends are paid. This approach partially integrates the two taxes, at least for distributed corporate-source income, and reduces the distortions and inequities of the classical system. Some countries (most notably Germany) apply a lower tax rate to income that is distributed than to income that is retained. (Germany eliminates double taxation of dividends by applying a reduced rate to distributed income and allowing a shareholder credit for that reduced rate.) All of these approaches substantially increase the administrative burden of the corporation tax. An equivalent alternative is to allow a corporate deduction for (part of) dividends paid to shareholders.

2.83 To the extent that interest is deductible for the corporation, but not taxable for the recipient, it is, in effect, subject to a negative tax that generates a bias in favor of debt finance that may be even more damaging than that under the classical system (with interest deduction and the taxation of interest income). Under the classical system, the bias in favor of debt finance is not badly aggravated by inflation as long as interest income and expense are treated symmetrically; both taxable interest income and interest deductions rise with the rate of inflation and the nominal

interest rate. If, however, there is no (or little) offsetting taxation of interest payments (including the inflation premium) made for creditors of the corporation, there is a substantial incentive for debt finance.

2.84 A radical approach would be to completely abolish the withholding tax on dividends, thereby eliminating all problems of double taxation and cascading. This would result in a dual system whereby the capital income is taxed through the corporate tax, and wage income is taxed through the PIT (in this case basically a wage tax). Such a system minimizes the impact on the choice of capital structure, is administratively easy, and can be readily implemented.

Investment Incentives

2.85 The fact that the investment incentive system reduces the tax burden for investment in favored zones and industries should not come as a surprise; that is, after all, the purpose of the system. The pattern of marginal effective tax rates presumably results from conscious government policies intended to encourage the development of particular regions, stimulate the growth of selected industries and encourage capital formation in general. It seems unlikely, however, that a conscious decision was made to provide a pattern of stimulus (and penalties) with the characteristics of those that actually exist. A clear example of presumably unintended effects is the heavy tax on agricultural processing implied by the fact that agricultural tax benefits are available only to farms processing their own produce. That activity would suddenly be faced with high corporate tax rates as soon as a farm decided to outsource its processing. Yet the government has, as one of its objectives, the promotion of agricultural processing industries in order to increase value added in agriculture; but that objective is thwarted by the very tax incentives that are intended to help agriculture. Rather, it is more likely that the magnitude, and perhaps even the direction, of many of the incentives provided by this system are unintended.

2.86 There may be some truth to the arguments that some interference with market forces is justified in order to encourage Kazakhstan's entrepreneurs to venture beyond the traditional sectors in which they are comfortable. However, one must wonder at the wisdom of going as far as, for example, the various tax regimes (or, rather, non-tax regimes) for agriculture. Kazakhstan's tax policy favors undeveloped regions as well as selected industries. However, such encouragement does carry economic costs. Presumably, these investment incentives are needed because the encouraged projects have a lower rate of return than the alternative projects that the private sector would have undertaken without these regional incentive schemes. The economic cost of the regional incentive schemes is this rate of return difference times the volume of investment projects only undertaken because of the incentive scheme. It is not possible to directly assess these economic costs, since we do not know which projects would have been undertaken in the absence of the incentive scheme. However, the rate of return differences introduced by the incentive scheme are so large that the economic costs could be substantial.

2.87 Several other forms of discrimination need to be mentioned. There are substantial differences in taxation for different types of assets (buildings, machinery, etc.). First, Kazakhstan investors are encouraged to use domestically produced machinery and equipment rather than imported equivalents. Differential treatment takes place under the VAT: the delayed rebate of VAT payments implies differences in the implied tax rate on purchases of different capital goods. Table 2.8 illustrates the differential treatment of domestic and foreign capital goods. Importing machinery instead of using domestic machinery raises the tax burden by almost 10 percent. This constitutes an industrial policy that favosr the Kazakhstan's industry producing such machinery and equipment. A disadvantage is that this treatment may undermine the competitiveness of those industries relying on either more expensive imported capital goods or less efficient

domestic goods because of this policy. Second, investment in buildings is favored over investment in M&E through the depreciation regime. This seems at cross-purposes with the objective of promoting domestic M&E manufacturing. While influencing the allocation of investment is conceivably a justifiable matter (for example, to maintain a sufficiently diversified presence in the traded goods sectors) it is not clear why subsidies should differ across asset types.

2.88 Also, regional policy works through investment incentives; this means that Kazakhstan businesses are encouraged to employ overly capital-intensive methods of production while presumably the government's objective is to promote employment. This policy seems particularly perverse given the still high rates of unemployment in the country outside of the main cities and the presumed desire to encourage settlement of the priority development regions.

2.89 Furthermore, the fact that both the level and the structure of the subsidies depends so crucially on the inflation rate is surely an undesirable feature. Moreover,, the tax treatment of equity income depends very much on the rate of inflation. This is undesirable for several reasons. First, it creates substantial uncertainty for taxpayers considering investment: they will need to project inflation far ahead to assess their likely tax liabilities and hence the after-tax rate of return on the project under consideration. Second, it has undesirable macroeconomic effects. Allowing nominal interest deductibility means that corporate tax revenue and hence general revenue will fall whenever inflation accelerates. But this is exactly the time that fiscal deficits would need to be reduced to check the very inflation that undermines corporate tax revenues. Nominal interest deductibility makes the corporate tax system into an automatic destabilizer from a macroeconomic point of view.

2.90 Finally, the tax treatment of debt favors the use of debt finance, rather than equity finance, and so hampers the development of capital markets.

C. Summary and Recommendations

2.91 The basic structure of the CIT in Kazakhstan is relatively clean. There is no discrimination by sector, with the (big) exception being agriculture; also, foreign and domestic investors receive equal treatment. Therefore, the main problem is not with the tax system itself, but with the extensive system of special regimes, exceptions and tax preferences for selected projects. A major suggestion is therefore to trade substantial rate reduction for a significant rollback of these incentives.

Basic Structure

2.92 The basic structure itself of the CIT does not need an overhaul, but improvements would be advisable in three areas: the interaction between the CIT and the PIT through the withholding tax on dividends and interest payments to individuals; the special tax rate for agriculture; and the inflation dependence of key features of the tax system. Furthermore, tax rates could be lowered substantially if the tax base would be widened; eliminating exemptions and preferences that seem ineffective or even at variance with stated government objectives should allow ample room for that. Such a reform would also put Kazakhstan in the mainstream of corporate tax reform, which has tended to trade off lower rates for base widening. Since the distortionary impact of a tax increases with the square of the tax rate, lowering rates while widening the base reduces the efficiency cost of the tax system.

Withholding Tax on Dividends (WHT)

2.93 The WHT till recently used to be the source of the double taxation of profits paid out through dividends, and so used to distort the financial decisions of firms. Investments financed through debt escape this tax if the lender is a bank. In addition, rewarding shareholders through capital gains (by financing either through retained earnings or through share buyback programs) becomes more attractive than paying dividends. A second problem with the WHT, related to a cascading problem, because it is also levied on payments to corporate shareholders, was also abolished as a result of amendments made to the tax legislation in the middle of 2006.

2.94 Since January 1, 2007 the double taxation of dividends paid out to corporations is abolished. That in effect transforms the Kazakhstan tax system into a dual system, with capital taxed through the corporate tax and labor taxed through the wage tax or the PIT. It also substantially simplifies tax administration.

Inflation Adjusting the Tax System

2.95 Unless rates of inflation can be brought down to very low levels, and can be confidently expected to remain low, the adjustment of the tax system to reduce its sensitivity to the inflation rate should be considered. This should be done to prevent the rate of inflation from acting as an important but wholly arbitrary and unpredictable method of raising revenue. At present, inflation erodes the value of depreciation allowances, in particular for asset classes with low depreciation rates. The indexing of depreciation allowances would remedy this problem. In addition, the value of LCOs is eroded by inflation. This is not as yet a major problem in Kazakhstan, since the carry-over period is only three years. However, another recommendation is to extend that period to at least ten years, so as not to tax new firms unduly. In that case, indexing LCOs would also be important. The final feature of the tax system through which inflation influences the effective tax burden is the deductibility of nominal instead of real rates of interest. Correcting this would be possible but complicated (see Annex 7), and should only be considered if inflation reaches higher levels than is currently the case.

Extending the Period in which Losses Can Be Carried Over

2.96 Currently, losses can be carried forward by only three years. This is not likely to be a major issue for most firms, except for start-ups. Most start-ups need three or four years to make it into positive cash flow, and another year before actual profitability sets in. And in most cases firms will need more than one year of profitability to exhaust any losses carried forward. This means that most start-up losses cannot be applied against earnings, so this unusually short time period acts as a tax on new firms. Since this segment of the business community is likely to be the most dynamic, it seems particularly unwise to keep its tax burden unintentionally high. A period of at least 10 years for the LCO would solve this problem.

Allowing Refunds or Credits for Excessive Advance Payments

2.97 Currently, the inability of firms to obtain a refund or tax credit for excess advance payments constitutes in effect an increase in the tax rate in bad years, which is a probably unintended and somewhat perverse twist on the tax law. It raises the burden of taxation just when firms are weakest, while it is unlikely to yield much revenue. It would be advisable to make excess advance payments refundable, or at least to allow firms to apply excess payments to their tax liability (and advance payments) in the following year once the final tax liability of the earlier year (in which the advance payments took place) have been established definitively.

Lowering the Basic Tax Rate to 25 Percent

2.98 Kazakhstan is at the high end with a tax rate of 30 percent. Only China has a slightly higher rate. But Russia and most of Western Europe are moving to rates of around 25 percent, while the CEE countries have rates of around 20 percent. Kazakhstan should consider lowering the basic rate to 25 percent to remain in the mainstream with its basic tax rate or, if revenue considerations permit, even to 20 percent,. The associated revenue losses could be mitigated, if not fully offset, by raising the tax rate on agriculture to the same base rate (perhaps over time) and disallowing special regimes for all but small farmers.

Reforming Tax Preferences and Other Tax Incentives

a. The problems with the Kazakhstan system of corporate taxation lie mostly in the complex and often counterintuitive series of special regimes and investment incentives that leave most taxpayers outside of the regular CIT. We will consider them in turn.

2.99 Whether all variations in METRs across industries and regions should be eliminated is perhaps questionable. However, there is a proliferation of regional, sectoral and generic incentive schemes in existence, all rapidly growing but most set up with opaque eligibility criteria and resulting in a patchwork of incentives in which no reasonable industrial policy can be recognized.

2.100 The special regimes in particular do not seem to meet their objectives well. While they were originally set up to coax people into the formal CIT framework through a serious of intermediate steps (the voucher system, the patent system, the special regime, the full fledged CIT), no such dynamic shifting up is occurring. A substantial number of large farms, for example, still operate under the patent system, where an already low tax burden is once again reduced by no less than 80 percent. In addition, the fact that farms can apply the regimes only to their own processing activities implies a heavy tax on an independent processing industry. In that way the government itself, through the agricultural subsidy scheme, is the worst enemy of its other agricultural objective—the promotion of the processing industries. Therefore, the patent system should be restricted to truly small farms, with all other players subject to the regular CIT. Moreover, the 10 percent rate for agricultural activities should be aligned with the base rate, possibly gradually.

2.101 The regional zones also present problems. First of all, it is not clear that they reflect a coherent industrial policy instead of a concerted series of disparate lobbying efforts, which results in an incoherent patchwork of tax incentives. Moreover, because there is no clear transfer pricing regime in place for such zones, the leakage may be larger than suspected. And the larger the loopholes are, the more the rest of the economy has to pay through higher than necessary tax rates in activities that do not profit from subsidies. There is a strong argument for a full review of the whole system to see if a rationalization is possible.

2.102 Similar issues arise in the discussion of tax preferences. First the eligibility criteria are entirely unclear as are the procedures followed by the Investment Committee in the Ministry of Industry and Trade, which administers this subsidy scheme. While Kazakhstan has not succumbed to the massive frauds that characterize many oil producers, designing a system as intransparant as this one is almost asking for more corruption. Second, the system is poorly designed. In particular, new projects receive for fewer benefits than large existing firms and may even be hurt by enrolling in such a scheme.

2.103 And their use is increasing rapidly (more than doubling in 2005). The government should realize that more incentives for one group means less cash for other groups; someone is paying. The rapidly increasing erosion of the tax base means that those that do pay are paying too much, Kazakhstan should join the worldwide move towards lower tax rates and more comprehensive tax bases.

2.104 Serious consideration should be given to abolishing all special regimes, in exchange for a substantially lower corporate tax rate. The coverage of the regimes extends well beyond where presumptive taxes are reasonable—and will extend even more if the eligibility criteria are eased as planned for 2007. Companies with up to 50 employees have all the information necessary to file CIT returns; therefore, for that reason presumptive regimes are not necessary. Most countries have no presumptive regimes for the CIT or PIT except perhaps for small farmers, market sales persons and the like. Kazakhstan should consider bringing back its multitude of special regimes to a simple presumptive tax for individual farmers and truly small enterprises, to ease the transition from the informal to the formal economy. As in most countries, such a presumptive regime could be offered as a choice, as an alternative to the regular CIT.

2.105 Similar problems exist with the special economic zones and the ITPs. At present they work in often unintended ways and discriminate against new enterprises (which was surely not the intention of the authorities). Replacing the entire system by a much simpler system of first-year investment allowances coupled with a significant extension of the LCO period to at least 10 years, should result in an easier to administer and less distortionary incentive system.

2.106 An alternative approach employed in some countries in order to reduce the bias toward capital-intensive production is the grant of a tax holiday or period of exemption from income taxes. This approach has the disadvantage of creating substantial opportunities for the manipulation of transfer prices in transactions between members of an affiliated group. In view of the difficulties of preventing the manipulation of transfer prices in international transactions between affiliated firms, it would be a mistake to bring the same problem into the domestic economy in this way. All things considered, it would appear better to rely on generic investment tax incentives, where manipulation is more difficult, than to shift to a tax holiday approach, considering the additional burden such a shift would impose on the tax authorities.

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3. VALUE ADDED TAX

A. INTRODUCTION

3.1 Kazakhstan has a modern tax-credit invoice type of VAT. Basically, the tax base is confined to consumption. This is achieved by permitting VAT-registered entities a full and immediate tax credit (deduction) for the tax on inputs (including capital goods) taxed in previous stages of production and distribution and used for business purposes. Exemptions are limited to merit goods, such as health care and education, and services that are administratively hard to reach, such as finance and insurance. The VAT extends through the retail stage, but small business firms can choose to remain outside the VAT if their sales in the previous year did not exceed 15,000 times the monthly calculation index of 1,030 tenge (US$120,000). Agribusinesses are taxed, but (large) agricultural enterprises and "peasant farmers" are exempted from the VAT. Instead, they pay an alternative land tax or patent tax, respectively, even if their turnover exceeds the small-business exemption. As elsewhere, the taxation of foreign trade is based on the destination principle—that is, exports are zero rated and imports are taxed on a par with domestically produced commodities. From 2001, a single rate, currently 15 percent, applies to all transactions. The government intends to reduce this rate to 14 percent in 2007 and further to 13 or 12 percent in 2008-09.

3.2 This chapter examines three issues. The first issue concerns the VAT's revenue performance. The VAT is an ideal tax handle for increasing revenue should the need for more non-oil revenue arise. The VAT distorts economic choice less than most other forms of taxation, consumer expenditures are a more stable tax base than is income, and revenue reacts faster to an increase in the rate. The VAT is also the best tax to make up for revenue losses in the wake of trade liberalization and WTO requirements. It is important, therefore, to ascertain whether the VAT delivers on its potential. The second issue has to do with the VAT's burden distribution. It is thought that the VAT is distributed regressively with respect to income: in other words, proportionately, the poor pay more than the rich. Accordingly, it has been suggested that a lower than standard rate should apply to foodstuffs which are disproportionately consumed by the poor. In fact, however, as this report shows, the VAT is slightly progressive, and so a dual-rate structure is not recommended. The third issue is, the proliferation of special schemes and concessions that erode the VAT base, as well as delays in settling refund claims which undermine the integrity of the VAT. Accordingly, it is recommended that various design and administrative features should be reconsidered.

B. VAT REVENUE PERFORMANCE

3.3 The VAT is the second largest source of government revenue in Kazakhstan, accounting for 26 percent of total non-oil tax revenue or 4.6 percent of GDP in 2005 (Table 3.1). This is close to the level of 4.7 percent of GDP in 1998 when the standard rate was 20 percent and a 10 percent rate applied to cattle, poultry, and most foodstuffs. As the figures in Table 3.1 indicate, the VAT has generally been a stable source of revenue. This is to be expected, since the VAT would normally expand at about the same rate as the economy; in other words, the GDP elasticity of the VAT should be close to unity.

Change in the Composition of VAT Collections

3.4 Surprisingly, however, the composition of VAT revenues has changed dramatically over the years. As shown in Table 3.1, in 1999 the VAT/GDP ratio with respect to domestic transactions was 3.1 percent, while the VAT on imports accounted for 1.3 percent. In other words, for every 3 tenge of VAT on imports, some 7 tenge were collected on domestic transactions. By contrast, in 2005 the VAT on imports accounted for 3.4 percent of GDP, while only 1.2 percent was collected on domestic transactions, a ratio of nearly 3:1. Clearly, the revenue importance of the two VAT-base components, imports and domestic transactions, has reversed completely. Although it is not unusual for half of the VAT revenues to be collected at the import stage, three-fourths is a share that requires further examination.

Table 3.1: VAT Revenue Performance, 1995-2005

Year	VAT Rates		VAT Revenue as percent of			Revenue Productivity[a] based on	
	Standard	Lower	GDP		Cons.	GDP	Cons.
			Overall	Imports			
1995	20	10	3.3	.	4.7	0.17	0.24
1996	20	10	3.8	.	5.7	0.19	0.29
1997	20	10	3.5	.	5.0	0.18	0.25
1998	20	10	4.7	.	6.4	0.24	0.32
1999	20	10	4.4	1.3	6.2	0.22	0.31
2000	20	10	4.4	1.5	7.2	0.22	0.36
2001	16	-	4.9	2.3	8.6	0.31	0.54
2002	16	-	4.7	3.0	8.8	0.29	0.55
2003	16	-	5.0	3.3	9.5	0.31	0.59
2004	16	-	4.1	3.2	8.0	0.26	0.50
2005	15	-	4.6	3.4	8.8	0.31	0.59

[a] Calculated by dividing revenue as percent of GDP or Consumption by the standard VAT rate.

Source: Data provided by the Kazakhstan authorities.

3.5 Various factors might explain this unusual trend.

- The composition of imported goods changed dramatically over the years. While the share of food in total imports remained at the same level of 5 percent, the relative importance of "other consumer goods" declined from 32 percent of total imports in 1995 (39 percent in 1999) to less than 10 percent in 2005. While "other consumer goods" are taxed in full at the import stage, presumably a substantial part of the value added of domestically produced "other consumer goods" is not taxed in view of the sizable small-business exemption.

- Over the same period, the share of intermediate and capital goods in total imports rose from 44 percent in 1995 to 75 percent in 2005. In principle, these goods are taxed at the import stage, while a tax credit is provided in subsequent domestic stages of production or distribution. In other words, VAT collections at import increase at the expense of collections at the domestic stages of production and distribution. On the other hand, the share of petroleum and energy products in total imports dropped from 18 percent to 11 percent.

- On balance, these changes in the composition of imports go some way toward explaining the prominence of imports in the VAT base. They should also be conducive to the VAT's overall revenue performance owing to the relative ease of collecting the VAT at the point of importation. Moreover, importers or domestic manufacturers have a stake in seeing that the VAT on imports is duly credited against the VAT on subsequent domestic sales, which may promote compliance with the VAT.

- On the other hand, from 2003, a deferred payment system (no tax at import, but tax and tax credit in the domestic stages) was applied to specified imports for the agricultural sector. However, this should not have had much of an effect on the import VAT/GDP ratio, because these imports represented only 7 percent of total imports. The domestic VAT base would not be affected either way if the imports were mainly purchased by exempt agricultural enterprises and peasant farmers.

- The changeover from the origin principle to the destination principle in 2001 with respect to Russia is likely to have resulted in a net gain in VAT collection (on imports) for Kazakhstan, because Kazakhstan exported lower taxed domestically produced agricultural products while it imported higher taxed CIS-made consumer goods.

- The absolute and relative decline in the domestic VAT/GDP ratio may be partly attributable to the introduction of the generous small-business exemption in 2000, since previously all firms were taxable. But the associated revenue loss should not be more than some 0.2-0.4 percent of domestic VAT revenue, because the inputs (other than agricultural products) of the small firms continue to be taxed, while the small firms supplying goods and services to registered VAT payers would probably opt for registration and payment of VAT.

- Perhaps the largest and in any case most serious erosion of the domestic VAT base is the exemption as of January 1, 2005 of the first sale of newly created residential buildings, as well as, a year later, the exemption of new infrastructure projects (project development, building, construction and assembly operations) by private contractors on behalf of the government. Both new exemptions reduce the domestic VAT base, although the exemption of new infrastructure projects does not affect net VAT revenue (if taxed, the contractor would pay VAT but the government's spending department's bill would increase with the same amount). The housing exemption does not appear to have affected VAT revenues in 2005. Perhaps revenue offsetting effects have been at work. In any case, the exemption should cause a serious dent in future VAT revenues.

3.6 These factors provide an explanation of the marked reversal in the composition of VAT revenues from being mainly collections on domestic transactions to becoming predominantly VAT collections on imports.[33] They also highlight the need to keep the domestic VAT base as broad as possible and to strengthen VAT administration, because the domestic VAT would have to be relied on more heavily if imports were to decline in the wake of a decrease in exports.

[33] For a similar but discouraging development in the Ukraine's VAT, see Richard Bird, "VAT in Ukraine: An Interim Report," ITP Paper 0503, International Tax Program, Rotman School of Management, University of Toronto, February 2005.

VAT Revenue Productivity

3.7 Another way of assessing VAT revenue performance is through its "productivity," measured as the ratio of VAT revenues to GDP divided by the standard VAT rate. This indicates what percent of GDP is collected by each percentage point of the standard VAT rate. As shown in Table 3.1, in 2005, Kazakhstan collected 0.31 percent of GDP for each percentage point of the standard VAT rate, a ratio which has changed little over the last five years. Since it may be misleading, however, to measure VAT revenue performance on the basis of production (GDP) rather than consumption, the VAT productivity, also referred to as its collection efficiency (C-efficiency) is perhaps better expressed as the ratio of VAT revenues as a percentage of (private) consumption divided by the standard rate. Accordingly, it would have unit value for a uniform tax on all consumption. On this basis, in 2005 Kazakhstan's VAT collected 0.59 percent of consumption for every 1 percentage point of the tax rate. Again, this ratio has not varied greatly in recent years.[34]

3.8 The purpose of calculating VAT revenue productivity ratios is to compare them across countries to see which countries perform better or worse, and then to look for the reasons behind this performance. As shown in Table 3.2, the revenue productivity of Kazakhstan's VAT computed on the basis of GDP is lower than in five EU countries (Hungary is an exception). This is probably due to the smaller share of consumption in GDP in Kazakhstan. If the VAT revenue productivity is measured against consumption, the EU countries in 2003 averaged 0.50 in 2002-03 against a much higher 0.59 for Kazakhstan. The good revenue performance of Kazakhstan's VAT so far will turn into a much bleaker picture, however, once the full effects of the new exemptions for housing and infrastructure projects are felt.

Table 3.2: VAT Revenue Productivity in Kazakhstan and Selected EU Countries, 2003

Country[a]	Current VAT Rates		VAT Revenue as percent of		VAT Productivity based on[b]		Year
	Standard	Lower	GDP	Cons	GDP	Cons	
Kazakhstan	**15**	**-**	**4.6**	**8.8**	**0.31**	**0.59**	**2005**
EU countries							
Hungary	25	5; 15	7.8	10.1	0.31	0.40	2002
Czech Rep.	19	5	6.9	9.3	0.36	0.49	2003
Slovak Rep.	19	-	7.5	9.6	0.39	0.51	2002
Germany	16	7	6.5	8.3	0.40	0.52	2003
Austria	20	10; 16	8.0	10.6	0.40	0.53	2003
Netherlands	19	6	7.7	10.2	0.40	0.54	2003

[a]/ EU member states listed in order of lowest VAT revenue productivity based on consumption.
[b]/ Calculated by dividing revenue as a percent of GDP or Consumption by the standard VAT rate.
Source: International Monetary Fund, Tax Policy Division, VAT Productivity Database, last updated April 4, 2006.

3.9 An important point to note is that the revenue productivity in five EU countries is below the potential, because a lower than standard rate applies to foodstuffs, books, newspapers, public transportation, and a few other items. (This lowers VAT revenue collections and hence

[34] Interestingly, at the turn of the century, Kazakhstan's VAT revenue productivity ratios went up sharply (see Table 3.1) despite various conflicting trends. Apparently, the positive contribution from an increased share of imports in the VAT base and the merger of the lower rate with a reduced standard rate, were not offset by the negative effect of the introduction of a generous small-business exemption.

revenue productivity ratios.)[35] As set out below, this lower rate cannot be justified on equity grounds and greatly complicates the administration of the VAT. The reasons for the differentiated VAT rates in most EU countries have to do with the history of the tax. When the original member states (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) introduced their VATs in the late 1960s and early 1970s (at this time the VAT was still a very novel idea) they differentiated the rates so that the impact pattern would be as close as possible to that of the previously existing turnover taxes (which also had differentiated rate structures). The intention was to avoid complicating the discussion of the VAT's merits with the debate about the proper distribution of the impact of the new tax. This (bad) example was followed by subsequent EU entrants. Later on it was acknowledged that differentiated rate structures could not impart progressivity to the VAT burden distribution,[36] but political inertia and vested interests prevented the member states from rectifying the situation. Fortunately, Kazakhstan had the political will to unify the standard and the lower VAT rate.

3.10 The lower than standard rates in various EU countries erode the VAT's revenue productivity, but the low small-business exemptions in most countries increase it. Similarly, above average effective enforcement should contribute to revenue productivity. From a worldwide perspective, Kazakhstan's VAT revenue performance, crudely measured, does not differ substantially from the average performance of other countries at the same level of economic development. This is evident from statistics gathered for 23 countries in the range of US$1,000-5,000 per capita income (similar to Kazakhstan). The group's average VAT revenue productivity is 0.49 when based on consumption and 0.36 when based on GDP.[37] As noted, for Kazakhstan these figures are 0.59 and 0.31, respectively.

3.11 Further work is currently being undertaken at the World Bank and elsewhere to explain the observed variations in revenue productivity between countries. For example, a 2005 study by Aizenmann and Jinjarak[38] of the U.S. National Bureau of Economic Research estimates that, for a panel of 44 countries, 55-67 percent of the variance in VAT revenue productivity based on consumption over the period 1970-99 can be explained by structural and political economy factors. A one standard deviation increase in important structural factors, such as urbanization, trade openness (measured as the ratio of imports in GDP), and the share of agriculture in GDP changes the VAT's revenue productivity by 12.7 percent, 3.9 percent, and 4.8 percent, respectively. In addition, a one standard deviation increase in GDP per capita increases VAT revenue productivity by 8.1 percent. Regarding political economy factors, the authors find that a one standard deviation increase in the ease and fluidity of political participation increases VAT revenue productivity by 3.6 percent.

3.12 Similarly, in a more recent study, McCarten[39] of the World Bank finds that 41 percent of the variability in the ratio of VAT revenue to consumption is accounted for by the level of the standard VAT rate, the openness of the economy, the level of literacy, and indexes of

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[35] It should be noted that the Slovak Republic's VAT productivity ratio based on consumption is lower than that for Kazakhstan, although the country also has a uniform VAT rate.

[36] See, for example, "Taxing Consumption," Paris: OECD, 1988.

[37] See K. Edmiston and R.M. Bird, "A Fresh Look at the VAT," Working Paper, Andrew Young School of Policy Studies, Georgia State University, and Center for Business and Economic Research, University of Tennessee, 2004.

[38] See J. Aizenmann and Y. Jinjarak, The Collection Efficiency of the Value Added Tax: Theory and International Evidence, Working Paper 11539, National Bureau of Economic Research, August 2005.

[39] W. McCarten, *The Role of Organizational Design in the Revenue Strategies of Developing Countries: Benchmarking with VAT Performance*, World Bank Institute, March 2006.

government control over corruption and the cost of registering new businesses, with all dependent variables except the last being statistically significant. The conclusion this author draws from his analysis is that there is nearly always room to improve VAT productivity through better tax administration. Commendably, McCarten proceeds to focus on organizational design as the key to effective tax administration reform.

Conclusion and Recommendations

3.13 The revenue productivity of Kazakhstan's VAT is above the average found in other countries at the same level of economic development. This should largely be attributed to the higher share of imports in GDP, which facilitates collection. The domestic VAT base is small by international standards; recently, it has been further eroded by exemptions for housing and infrastructure projects. In view of the VAT's commendable revenue performance, the government should lower the standard VAT rate from the present level of 15 percent only if the recommendations below on base broadening are introduced.

C. VAT Burden Distribution

Background

3.14 The impact of the VAT on the poor and the rich is usually gauged from household budget surveys which show detailed VAT-inclusive expenditures of individuals or families by income deciles. The expenditure items can be grouped according to whether they are taxed, exempt or not taxed. Next, for taxable expenditures, the VAT included in the individual expenditure items can be computed by dividing the amounts by one plus the (decimal) VAT rate and subtracting the result from tax-inclusive expenditures. For exempt expenditure items, an assumption has to be made regarding the VAT that has been paid in respect of the inputs of the exempt items and passed on to the consumer.

3.15 Subsequently, the VAT amounts calculated for each item of expenditure are aggregated per income decile and expressed as a percentage of income or consumption. On the plausible assumption that the VAT is borne by consumers, changes in the percentage or ratio of VAT paid to income or consumption (excluding VAT) by individuals or households in different income deciles may then be taken to indicate the nature of their impact: a declining ratio across income deciles implies that the VAT is regressive, a rising ratio implies that it is progressive, and no change in the ratio means that the impact of the VAT is proportional.

3.16 Although the mathematics of this kind of impact analysis seems simple, there are usually conceptual and empirical difficulties in defining and measuring both the numerator (VAT paid) and the denominator (income or consumption) for various levels of income or consumption.[40] The following empirical difficulties should be kept in mind.

- Household budget surveys are usually undertaken to collect information for cost-of-living indexes. Hence, they tend to concentrate on expenditures for basic products such as foodstuffs and excisable goods, rather than, say, items of luxury consumption.

[40] For an early but still useful discussion of the issues, see Charles E. McLure, Jr., "Income Distribution and Tax Incidence under the VAT," Chapter 3 in Malcolm Gillis, Carl S. Shoup, and Gerardo P. Sicat, *Value-Added Taxation in Developing Countries*, Washington DC: World Bank, 1990.

- People may not remember accurately expenditures on goods and services that consist of small amounts spread over relatively long periods of time, while many individuals may be reluctant to disclose large outlays on, for example, alcoholic beverages.

- Certain government-provided services (e.g., health care and education), the value of non-market services and the value of production for own consumption are usually not covered for lack of adequate data.

- Low and high income groups tend to be underrepresented, because dissavings, occurring when annual consumption exceeds annual income, are usually ignored, as are large purchases of consumer durables (dwellings) and expenditures on holidays abroad.

3.17 Conceptual difficulties arise regarding the question of whether the VAT impact should be examined at the level of households or at that of individuals. It can be argued that tax policy should be about the welfare and taxable capacity of households, since the individuals that belong to a household may pool their resources and undertake a wide range of joint expenditure decisions. On the other hand, it may be conceded that the individual is of most significance, since before being able to comment on how tax burdens should be distributed, it is necessary to know the resources at the disposal of individuals.

3.18 Furthermore, the impact of the VAT appears different according to whether income, which includes savings, or consumption, is chosen as the base for comparison. Since the share of income saved rises as one moves up the income scale, it follows that the VAT will appear to be more progressive or less regressive if measured on a consumption base rather than if measured on an income base. The choice of the denominator is usually made in favor of income if the intention is to compare the impact of the VAT with that of an income tax. However, if the intention is to examine how the structure of a VAT can be made less regressive, consumption appears to be the better denominator.

3.19 Finally, income is usually defined as gross income, including earned and unearned income plus social transfers, but excluding output for own consumption. Consumption, on the other hand, is defined as current consumption on market goods and services.

The Impact of Kazakhstan's VAT

3.20 With these considerations and caveats in mind, Table 3.3 presents the impact of Kazakhstan's VAT. The analysis is based on a household budget survey undertaken in 2004 by the Department of Social and Demographic Statistics of the Kazakhstan Agency for Statistics. The interviews covered approximately 4,000 individuals in each income decile. Gross income excludes the value of output produced in the individual's own household. Transfers represent taxes other than VAT and excises, and repayments of loans. All expenditure items are shown net of VAT and grouped under two headings: "15 percent VAT" and "Exemptions."

3.21 A simple inspection of the table indicates which expenditure items are income inelastic (defined as expenditures that decrease by less than 1 percent if income falls by 1 percent) and which are income elastic. Accordingly, an income elasticity of 1 broadly separates essential goods disproportionately consumed by the poor from nonessential (luxury) goods disproportionately consumed by the rich. Foodstuffs clearly are essential goods since expenditures decline from 45 percent of income in the lowest decile to 24 percent in the highest

decile. By contrast, audio-visual equipment, communications, cars and motor fuel, health care, education and cultural services clearly are income elastic items of consumption.

Table 3.3: Individual Household Budgets' Income and Expenditures (by deciles in 2004)

	Decile 1		Decile 2		Decile 3		Decile 4		Decile 5		Decile 6		Decile 7		Decile 8		Decile 9		Decile 10	
	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%	tenge	%
Revenue	36,216		49,332		58,572		67,980		78,816		91,560		106,584		125,808		155,484		246,576	
Own output	7,140		8,711		10,327		10,859		10,476		11,358		11,406		11,305		12,380		13,677	
Gross income	29,076	100	40,621	100	48,245	100	57,121	100	68,340	100	80,202	100	95,178	100	114,503	100	143,104	100	232,899	100
Transfers	873	3.0	1,362	3.4	1,484	3.1	1,911	3.3	2,441	3.6	3,160	3.9	4,181	4.4	5,582	4.9	8,044	5.6	19,097	8.2
Consumption (+VAT)	28,204	97.0	39,259	96.6	46,761	96.9	55,209	96.7	65,899	96.4	77,043	96.1	90,998	95.6	108,921	95.1	135,060	94.4	213,801	91 8
VAT	2,412	8.3	3,560	8.8	4,508	9.3	5,560	9.7	6,879	10.1	8,337	10.4	10,164	10.7	12,557	11.0	16,039	11.2	26,074	11 2
Consumption (-VAT)	25,792	88.7	35,699	87.9	42,253	87.6	49,650	86.9	59,020	86.4	68,706	85.7	80,834	84.9	96,364	84.2	119,021	83.2	187,728	80.6
15% VAT	24,747	85.1	33,957	83.6	39,905	82.7	46,425	81.3	54,523	79.8	62,931	78.5	73,392	77.1	86,697	75.7	106,054	74.1	165,287	71.0
Foodstuffs	13,041	44 9	17,220	42 4	19,241	39 9	21,709	38 0	25,025	36 6	28,294	35 3	32,394	34 0	37,001	32 3	43,131	30 1	56,740	24.4
Exempt	*12,058*	*41.5*	*14,598*	*35.9*	*14,863*	*30.8*	*15,112*	*26.5*	*15,467*	*22.6*	*15,331*	*19.1*	*14,950*	*15.7*	*14,105*	*12.3*	*13,050*	*9.1*	*12,611*	*5 4*
Taxed	*983*	*3.4*	*2,622*	*6.5*	*4,378*	*9.1*	*6,596*	*11.5*	*9,558*	*14.0*	*12,963*	*16.2*	*17,444*	*18.3*	*22,896*	*20.0*	*30,081*	*21.0*	*44,129*	*18 9*
Restaurants	187	0 6	350	0 9	483	1 0	710	1 2	942	1 4	1,201	1 5	1,813	1 9	2,378	2 1	3,236	2 3	6,790	2.9
Tobacco products	644	2 2	755	1 9	918	1 9	1,087	1 9	1,274	1 9	1,421	1 8	1,626	1 7	1,765	1 5	1,940	1 4	2,654	1.1
Soft drinks	680	2 3	833	2 0	981	2 0	1,090	1 9	1,285	1 9	1,449	1 8	1,636	1 7	1,900	1 7	2,285	1 6	3,311	1.4
Alcoholic beverages	286	1 0	420	1 0	552	1 1	683	1 2	813	1 2	965	1 2	1,168	1 2	1,337	1 2	1,784	1 2	2,875	1.2
Clothing, footware	2,685	9 2	4,058	10 0	4,834	10 0	5,692	10 0	6,624	9 7	7,470	9 3	8,277	8 7	9,681	8 5	11,556	8 1	18,664	8.0
Furniture, appliances	1,084	3 7	1,542	3 8	2,086	4 3	2,392	4 2	2,856	4 2	3,385	4 2	3,936	4 1	4,965	4 3	6,709	4 7	12,511	5.4
Housing, utilities	3,115	10 7	4,189	10 3	4,848	10 0	5,671	9.9	6,519	9 5	7,550	9 4	8,578	9 0	10,124	8 8	11,536	8 1	14,371	6.2
Housing repairs	137	0 5	239	0 6	373	0 8	455	0 8	664	1 0	866	1 1	1,022	1 1	1,562	1 4	2,161	1 5	4,545	2 0
Transportation	844	2 9	1,266	3 1	1,592	3 3	2,031	3 6	2,489	3 6	2,875	3 6	3,638	3 8	4,310	3 8	5,459	3 8	8,767	3.8
Cars, motor fuel	140	0 5	267	0 7	520	1 1	620	1 1	747	1.1	974	1 2	1,382	1 5	2,112	1 8	3,643	2 5	12,841	5.5
Newspapers, books	190	0 7	235	0 6	281	0 6	336	0 6	379	0 6	449	0 6	532	0 6	622	0 5	751	0 5	1,141	0.5
Communications	222	0 8	350	0 9	549	1 1	708	1 2	1,001	1 5	1,289	1 6	1,711	1 8	2,255	2 0	3,006	2 1	5,311	2.3
Recreational goods	68	0 2	132	0 3	157	0 3	220	0 4	292	0 4	355	0 4	439	0 5	511	0 4	718	0 5	1,402	0.6
Hygienic goods	991	3 4	1,372	3 4	1,664	3 4	1,959	3 4	2,339	3 4	2,822	3 5	3,230	3 4	3,718	3 2	4,566	3 2	7,311	3.1
Audio-visual equip	109	0 4	323	0 8	400	0 8	587	1 0	733	1 1	964	1 2	1,349	1 4	1,670	1 5	2,661	1 9	4,584	2 0
Individual services	323	1 1	406	1 0	425	0 9	478	0 8	541	0 8	601	0 7	660	0 7	787	0 7	913	0 6	1,467	0.6
Exempt services	1,045	3.6	1,742	4.3	2,349	4.9	3,224	5.6	4,497	6.6	5,774	7.2	7,442	7.8	9,666	8.4	12,967	9.1	22,441	9.6
Health care	112	0 4	134	0 3	196	0 4	256	0 4	414	0 6	601	0 7	698	0 7	996	0 9	1,404	1 0	2,533	1.1
Drugs, medical eq,	411	1 4	572	1 4	679	1 4	904	1 6	1,139	1 7	1,422	1 8	1,858	2 0	2,340	2 0	2,945	2 1	4,087	1.8
Education	331	1 1	695	1 7	987	2 0	1,386	2 4	1,916	2 8	2,522	3 1	3,252	3 4	3,859	3 4	5,084	3 6	8,207	3.5
Culture	47	0 2	92	0 2	117	0 2	202	0 4	326	0 5	434	0 5	546	0 6	874	0 8	1,159	0 8	2,393	1.0
Other	144	0 5	248	0 6	370	0 8	475	0 8	701	1 0	797	1 0	1,088	1 1	1,596	1 4	2,375	1 7	5,221	2.2
A. 15% VAT as % of:																				
disposable income	8,29		8,76		9,34		9,73		10,07		10,40		10,68		10,97		11,21		11,20	
consumption	9,35		9,97		10,67		11,20		11,66		12,13		12,57		13,03		13,48		13,89	
B. 15/7.5% VAT as % of:																				
disposable income	7,32		7,66		8,10		8,36		8,55		8,75		8,91		9,10		9,29		9,50	
consumption	8,16		8,60		9,12		9,46		9,74		10,02		10,27		10,58		10,92		11,54	

3.22 Before calculating the effective VAT rates across income deciles, it should be noted that the impact of VAT on foodstuffs is difficult to estimate if they reach consumers through production and distribution channels that are not registered for VAT purposes (e.g., directly from farms to markets) and/or if they fall under the small-business exemption. Presumably, the poor buy more of their foodstuffs in local markets than the rich and more often from exempt small businesses. Accordingly, the price of these foodstuffs would include (very) little VAT which would be confined to the VAT on the taxable inputs of exempt producers and distributors. (The urban poor might be an exception, because they would have less access to untaxed foodstuffs.) On this assumption, a distinction is made between partially and fully taxed foodstuffs. Processed fish, oils, sugar and confectionery are more fully taxed than other foodstuffs, while bread, vegetables and dairy products are assumed to be partially taxed. Furthermore, total expenditures on partially taxed foodstuffs are assumed to decline as income rises, from 90 percent of expenditures in the first decile to 80 percent in the second decile, and, finally, to 0 percent in the tenth decile.

3.23 Another issue concerns the tax included in consumer expenditures on exempt services and goods. From calculations made elsewhere, for example in Russia, it is assumed that in effect half of the expenditures on exempt items are subject to a 15 percent VAT. This represents the VAT on inputs, such as buildings, means of transportation, office equipment, computers, and other taxable purchases of exempt entities. Presumably, the VAT on these items is passed on in the price consumers pay for the exempt services, while the value added by the exempt entities is not subject to VAT.

3.24 Next, the VAT on individual items of expenditure can be aggregated and expressed as a percentage of gross income or consumption (excluding VAT). As the bottom of Table 3.3 indicates, Kazakhstan's VAT is mildly progressive with respect to gross income, rising from 8.3 percent of income in the first decile to 11.2 percent in the tenth decile, or by 35 percent. As can be expected, the VAT's impact is even more progressive when measured against consumption. The average person in the highest consumption group pays a 13.9 percent VAT on his expenditures, or over 50 percent more than the 9.3 percent that the average person in the lowest group pays. These results are similar to those found in Russia and Pakistan.[41]

3.25 Clearly, the analysis indicates that the VAT is not regressive and that a lower rate on foodstuffs can only be justified if the intention is to make it even more progressive. To see whether this makes sense, a dual rate structure has been simulated with a standard rate of 15 percent and a reduced rate of 7.5 percent applicable to all foodstuffs. The result is shown at the bottom of Table 3.3. Not surprisingly, the impact distribution pattern is broadly the same as the 15 percent pattern. Notably, the VAT does not become more progressive. Admittedly, the effective rates are lower, but this effect must be fully attributed to the implied rate reduction. Under an equal yield assumption, a dual rate structure of, say, 18 and 9 percent would have to be used, but its burden distribution pattern would not differ from the 15 and 7.5 percent pattern.

3.26 Finally, it may be pointed out that the VAT has a more progressive impact than the social tax because of the latter's rate structure and because it burdens only wage-earners.

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[41] For Russia, see A. Decoster and I. Verbina, "Who Pays Indirect Taxes in Russia?" WIDER Discussion Paper No. 2003/58 (2003); and for Pakistan, see S. Refaqat, "Social Incidence of the General Sales Tax in Pakistan," IMF Working Paper WP/03/216 (November 2003).

Further Arguments against a Dual-Rate Structure[42]

3.27 These findings are in line with the OECD's observation, made as early as 1988, that it makes hardly any difference to the VAT's impact if foodstuffs are zero-rated (the United Kingdom), taxed at a reduced rate (the Netherlands) or taxed at the same rate (Denmark). In Kazakhstan, as in many other countries, the better-off spend twice as much on foodstuffs measured in tenge than the poor and accordingly would get twice as much relief if a lower VAT rate would apply to foodstuffs. (In Table 3.3, expenditures on foodstuffs in decile 10 are more than twice as high as expenditures on foodstuffs in decile 1.). This is because higher-income groups often buy varieties of particular foodstuffs that are more expensive than the varieties bought by lower-income groups, they eat out more often, and they tend to throw away more food. In fact, the uniform taxation of food raises an extra amount of revenue that is more than sufficient to compensate the poor for the higher VAT burden. In Kazakhstan, of course, the effects of the single rate on the VAT burden distribution are further mitigated because most food reaches the consumer through untaxed production and distribution channels.

3.28 Furthermore, a dual-rate structure would mean a significant increase in administration and compliance costs, particularly if the VAT on differentially rated sales must be accounted for separately. Also, differentiated rates require additional audit oversight increase refunds, give rise to various definitional problems and invite misclassification.[43] Anomalies cannot be avoided, particularly if a distinction is made between foodstuffs consumed at home (taxed at the lower rate) and foodstuffs consumed in restaurants (taxed at the standard rate). In the United Kingdom, business firms with dual-rate sales have double the compliance costs of firms taxed at a single rate.[44] Furthermore, research indicates that a reduced rate reduces compliance by 7 percentage points.[45] Beyond that, differentiated rates erode the tax base because they increase the pressure to shift "deserving" goods and services subject to the standard rate into the reduced rate category. All this is highly wasteful of scarce administrative resources. Not surprisingly, 70 percent of the countries that have introduced the VAT in the last decade have opted for a single positive rate when doing so.

Recommendation

3.29 Kazakhstan's VAT is distributed slightly progressively with respect to income and more so with respect to consumption. In other words, as a proportion of income or consumption expenditures, the rich pay more than the poor. These considerations, as well as administrative

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[42] For a review of the experience in OECD member countries, see S. Cnossen, "What Rate Structure for Australia's GST? The OECD Experience," *Tax Notes International*, May 24, 1999.

[43] Quite telling is the admonition found in the loose-leaf edition of Value Added Taxes in Europe (International Bureau of Fiscal Documentation) regarding France's VAT rate structure:

"The application of the reduced rate is very complex. It applies to a great number of goods and services whose technical description generally falls outside the scope of this book. The application of the reduced rate is sometimes also dependent on the circumstances under which the transaction was effected. The tax authorities have issued a number of rulings in order to solve particular difficult questions. The following discussion, therefore, gives only an indication of the cases in which the reduced rate applies."

[44] Perhaps the United Kingdom's VAT is not far behind in matching the complexity of France's VAT. To illustrate, the following factors have to be considered in applying the zero rate to food: place of consumption, timing of consumption, temperature, saltiness, number, volume, concentration, sweet content, use of fingers in consumption, and alcoholic content.

[45] See A. Agha and J. Haughton, "Designing VAT Systems: Some Efficiency Considerations," *The Review of Economics and Statistics*, 78/2 (1996).

and compliance cost arguments, point strongly towards the advisability of maintaining the uniform single VAT rate.

D. PRESERVING THE INTEGRITY OF THE DOMESTIC VAT BASE

3.30 The integrity of the VAT as the workhorse of Kazakhstan's tax system can be maintained only (i) if there are as few breaks as possible in the VAT chain from primary producer to ultimate consumer, and (ii) if refunds of excess VAT credits are made as expeditiously as possible when claims for refunds are valid. Breaks in the VAT chain occurring before the retail level will cause cascading (double taxation) effects that distort economic choices, imply that the VAT included in consumer prices is indeterminate, and require extra audit oversight. Exemptions at the retail level imply under-taxation, and thus distort economic choices. Delays in making refunds similarly have non-neutral and discriminatory effects. Businesses forgo the return they could otherwise earn on the amount of the delayed payment. Moreover, refund delays undermine the credibility of the VAT because the VAT administration retains monies to which it is not entitled.

3.31 The integrity of Kazakhstan's VAT is compromised in a number of ways through unnecessary exemptions, a larger than usual small-business exemption, the partial exemption of large-scale farming, the zero rating of selected inputs for use in economic free zones, and the suggested zero rate for imports of raw materials. These aspects are reviewed below.

Exemptions

3.32 Exemptions (inputs taxed, outputs not taxed) violate the basic tenet of the VAT that all consumption should be taxed at the same effective rate. Pre-retail exemptions have a number of serious drawbacks: (i) they cause double taxation of value added occurring before the exempt stage and thus penalize purchases from exempt suppliers; (ii) for the same reason, exemptions can become a tax on exporters because they preclude refunds of the tax paid on inputs; (iii) exemptions penalize outsourcing and provide an incentive for firms to integrate; and (iv) exemptions complicate VAT administration through the need for tax allocation rules, that is, attributing the VAT on purchases to taxable turnover (with credit for the tax on purchases) and exempt turnover (without credit for tax on purchases). Exemptions at the retail (final) level promote "exemptions creep," since exempt firms will try to induce the authorities to extend the exempt treatment to their suppliers.

3.33 These drawbacks apply to all exemptions, including those for health care, education, and, particularly, banking and insurance. These "standard exemptions" are widely accepted, however, and it is not proposed that Kazakhstan should blaze a new trail by taxing these exempt services. However, there are a number of "non-standard exemptions" which the VAT authorities should review and withdraw if possible.

- Postal services should be taxed since they compete with taxable private letter or parcel carriers; postal stamps represent the VAT base for postal services. Admittedly, in the EU postal services are not widely taxed, although Finland and Sweden include postal services in the VAT base.

- Certainly, there is no reason to exempt the services of lawyers and public notaries, which tend to be highly income-elastic and compete with taxable services by consultants and accountants. If supplied to VAT-registered businesses, the exemption breaks the VAT chain and is of no benefit to lawyers and public notaries. If supplied

to households, the exemption is an invitation for consultants and accountants to masquerade as lawyers and public notaries. The services of lawyers and public notaries are taxed in nearly all EU countries. Belgium and Greece are the only two countries out of 25 member states that exempt legal services.

- Many EU countries also tax funeral, cemetery and cremation services, but the distortions of continued exemption should be small. Accordingly, no change is recommended.

- Under VAT, sales of lottery tickets should be taxed and a tax credit should be permitted for payouts. This obviates the need to distinguish lottery ticket sales from the lottery services required to administer the present exemption in Kazakhstan.

- An unusual exemption, not found outside the former Soviet Union, is the exemption of sales by firms employing handicapped persons who constitute not less than 51 percent of the labor force of workshops. Reportedly, the exemption leads to abuse. Workshops provide the VAT authorities with fictitious names of disabled persons in order to be able to claim the exemption. Following World War II, the exemption had a clear rationale under the previous turnover taxes. Today a better approach would be to provide income support to handicapped persons through the budget;

- There is no rationale for the exemption of geological prospecting and exploratory activities. Presumably, the exemption was put into the law so that oil and mineral companies could import their capital equipment free of VAT and would not have to apply for a refund if the VAT on purchases exceeded the VAT on sales. A properly functioning refund mechanism, however, should take care of any excess VAT credits that might arise owing to the long-term nature of the activities. This type of exemption is not found in any of the EU countries. A full consideration of the implications is outside the scope of this report.

- Similarly, the exemption for registered VAT businesses that undertake infrastructural projects for the government should be terminated. Elimination of the exemption does not yield any extra revenue because the businesses would charge VAT on their invoices which would be paid by the government's spending department and collected by the VAT office. But the removal of the exemption prevents the fraudulent diversion of exempt labor services engaged in infrastructure projects to taxable activities simply by mislabeling the services. The exemption breaks one of the most fundamental rules of a "good" VAT, namely, that a registered business should be told to always charge VAT regardless of the legal status of the customer or the nature of the good or service that is being supplied.

- The exemption for cultural services should also be reconsidered. Admissions to theaters, concerts, museums and the like compete with taxable forms of entertainment such as sports, travel and reading, and should therefore be taxed. Similarly, public radio and television broadcasts compete with taxable privately financed broadcasts and other forms of communication which are taxed. Very few EU countries exempt cultural services and radio and television broadcasts.

Housing Exemption

3.34 The most serious exemption – in terms of lost revenue and administrative complications – is the exemption of the first sale of newly created residential buildings effective from January 1, 2005. This exemption opens up an enormous hole in the VAT base with detrimental effects on revenues. Housing services, comprising rents and rental values of owner-occupied dwelling amount to 15 percent of total personal consumption expenditures in 2005 as computed for national accounts purposes. Clearly, housing is too large a sector to ignore in the design and operations of a broad-based, well functioning VAT. Since new residential housing should be an income elastic item of consumption in Kazakhstan, the exemption is also regressive with respect to income: the rich benefit more from the concession than the poor. Last but not least, the exemption greatly increases opportunities for evading the VAT, particularly in conjunction with the exemption of infrastructure project and economic free zones.

3.35 In all European countries, the first sale of newly created residential housing is taxed at the standard VAT rate, while rents and rental values of owner-occupied dwellings are exempted. The rationale for this approach is that subjecting rents and rental values to VAT would be politically impossible and too cumbersome administratively. But the taxation of newly created housing is a good proxy for the VAT that should be levied on rents and rental values. After all, the purchase price of a house may be taken to represent the capitalized value of its future services. By extension, the VAT on the purchase price may be considered a good proxy for the capitalized value of the VAT that should have been levied on the flow of housing services. As a result, the consumption of housing services, in the form of rents and rental values, is taxed on a par with other consumer goods.

3.36 Two approaches are used to effect this philosophy: the tax method and the exemption method. Under the tax method, found in Australia, Canada and New Zealand, the sale and rental of real estate is, in principle, taxable, but residential rents (and rental values) are exempt, as is the sale of previously occupied residential property. This implies that the construction, alteration and maintenance of all buildings is taxable, as is the rental of business accommodation. Sales of existing buildings also are taxable, unless such buildings constitute residential property.

3.37 Under the exemption method, found in the Sixth Directive of the EU, the sale and rental of real estate is, in principle, exempt, but newly constructed buildings, as well as alterations and maintenance of the existing building stock are taxable. Unlike the tax method, which requires a definition of residential use, the exemption method needs a definition of specified nonresidential use, such as hotel accommodation, boarding houses, camping facilities and parking space, all of which are taxable. Furthermore, since commercial uses and sales of existing real estate are exempt, an opportunity for optional registration must be provided to avoid potential discrimination and cumulation of VAT.

3.38 Both methods must address the VAT implications of the supply of land, which is traded less often than buildings and is used more often for productive purposes in exempt sectors, such as agriculture. Australia, New Zealand and Canada exempt only agricultural land. Under the Sixth Directive, on the other hand, all land is exempt, except building sites. As may be expected, the reach of the tax method is greater than the reach of the exemption method. As a result, it provides more even-handed and neutral treatment.

3.39 The second-best solution that all countries with a VAT apply to housing services (exemption of rents and rental values, taxation of newly created houses) broadly satisfies generally accepted criteria of horizontal equity, neutrality and feasibility. The tax method (tax all

real estate, exempt housing services and the sale of existing dwellings) is superior, however, to the exemption method (exempt all real estate, except new dwellings). Under the tax method, commercial exploitation of real estate, not being houses, is fully taxed. Under the exemption method, increases in the value of commercial building services, are not taxed. Moreover, optional taxation causes differential effects. More generally, under the philosophy of the VAT, it is better and easier to define selective exemptions than to define selective charges to tax.

3.40 Before 2005, when the current exemption for newly created residential buildings was introduced, Kazakhstan appeared to employ a mixture of the tax method and the exemption method plus some exemptions not found elsewhere. The creation and subsequent sales of commercial buildings were taxed, as was the first sale of newly created residential buildings. In addition, hotels (and hotel accommodation) and car parks and storage were taxed. On the other hand, services associated with the management, maintenance and use of residential housing or with the rental of housing space were (and continue to be) exempt. Clearly, the latter exemption is an invitation to tax avoidance and evasion, since new construction or renovation can easily masquerade as housing maintenance.

3.41 The tax method, outlined above, is the best approach to the taxation of real estate under the VAT. It would mean that all sales of new and existing commercial (and governmental) buildings would be taxed, as well as the sale of newly created residential buildings. In addition, all building materials, repair and maintenance services, and leasing of commercial buildings would be subject to VAT.

Small-Business Exemption

3.42 In most countries, 20 percent of all VAT registered businesses pay 80 percent of the VAT. By contrast, in Kazakhstan 10 percent of all businesses pay 80 percent of the VAT on domestic transactions. This is unusually low. Similarly, the VAT density is low in Kazakhstan, which has 160 inhabitants per registered business, versus, on average, 55 in Hungary and the Czech and Slovak Republics.[46] In addition, only 60 percent of all registrants actually file and pay VAT.

3.43 This situation should be attributed in large part to the generous small-business exemption of 15.45 million tenge (US$120,000) which is much larger than in any EU country. Table 3.4 shows the exemptions for six member states. As indicated, fairly large exemptions are also found in the Czech and Slovak Republics, but these are still only one-third of the exemption in Kazakhstan. In the EU countries the exemption is limited to natural or physical persons. All legal entities are required to register for the VAT; they therefore cannot benefit from the exemption. Partnerships and associations are considered as one entity for VAT purposes, although each partner is obliged to register. Also, most countries have provisions ensuring that small businesses cannot split up their operations to benefit from the exemption. Proprietors of more than one business have to add up the sales of all their outlets to determine eligibility for the exemption. The Czech VAT, for example, defines precisely what "related persons" are in determining the size of a taxable person's business unit. It is recommended that Kazakhstan follow the same approach if it decides to maintain the high threshold. Obviously, optional registration should continue to be available as well as the two-year mandatory registration period before a business can opt out of the VAT.

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[46] See S. Cnossen, "Value-Added Taxes in Central and Eastern European Countries: A Comparative Survey and Evaluation," European Commission and Organization for Economic Co-operation and Development, Paris (1998).

Table 3.4: Treatment of Small Businesses and Farmers in Kazakhstan and Selected EU Countries, 2006

Country	Small-business Exemption (million tenge)	Concession for Farmers	Treatment of Farm Inputs		
			Seed, Feed	Fertilizer, Pesticides	Machinery, Equipment
Kazakhstan	**15.4**	**Alternative land or patent tax**	**E**	**S**	**S**
EU Countries					
Czech Republic	5.4	Small-business exemption	L	S	S
Slovak Republic	5.6	Small-business exemption	S	S	S
Hungary	3.6	Sector exempt and presumptive 12% VAT credit by purchaser (animal husbandry 7%)	L	S	S
Austria	3.4	Sector exempt and presumptive 10% VAT on farm sales	L	S	S
Germany	2.7	Sector exempt and presumptive 11% VAT on farm sales (forestry 5%)	L	S	S
The Netherlands	0.2	Exemption and presumptive 5% VAT credit by purchaser	L	S	S

S = Normally subject to the standard rate.
L = Normally subject to the lower rate.
E = Normally exempt.
Sourcse: Kazakhstan: data provided by the tax authorities; Europe: F. Annacondia and W. van der Corput, "VAT Registration Thresholds in Europe," *VAT Monitor*, November/December 2003.

3.44 The large small-business exemption eliminates all sole proprietorships that make a net margin of, for example, 33.3 percent or 3.9 million tenge on their purchases. For sole proprietorships, the 3.9 million tenge (US$30,000) represents the labor income of the proprietor. This net margin should not be unusual for most beauty shops, garages, repair shops, fashion wear retailers, etc., and it is questionable whether they should be exempted from the VAT. Surely, these businesses keep adequate records, such as a cash and bank book, which can form the basis for monitoring their compliance with the VAT. Whether the small-business exemption should be lowered to, say, 12 million tenge, depends on whether the small businesses are exempt from the income tax (or some alternative tax). If they must comply with the (business) income tax, then the extra costs of meeting the VAT obligations should be small, particularly if small businesses would be allowed to keep their accounts on a cash basis. The costs of complying with the VAT would be more onerous, however, if the small businesses were not subject to the income tax.

3.45 It is often said that a large small-business exemption frees VAT administrative resources for monitoring large VAT payers, but this is only partially true. Small businesses can be expected to keep single-entry accounts, such as a cash and bank book, from which the annual balance sheet and the profit and loss account can be constructed. Large businesses, on the other hand, maintain intricate sets of double-entry accounts and publish consolidated annual accounts. In this situation, the audit of small businesses can be performed by VAT staff with a bookkeeping diploma, while the audit of large businesses must be done by staff with accountancy degrees. In Kazakhstan the most appropriate sequencing would be to broaden the VAT base (e.g., by bringing farmers into VAT compliance as suggested below) and then let the threshold be eroded by inflation. If small businesses are made liable for VAT, they are likely to formalize much of their bookkeeping.

Treatment of Farmers

3.46 The so-called peasant farmers, regardless of size, are not subject to the regular VAT. Instead, they pay a single land tax (which is supposed to cover the PIT, VAT, land tax, transport tax and property tax) of 0.1 percent of the (outdated) value of their land (as well as a social tax). In effect, of course, the land tax is unrelated to VAT of any kind, regardless of the assumed coverage. Furthermore, agricultural enterprises can apply for a "patent" whose tax liability represents 20 percent of the total of the annual corporation tax, social tax, land tax, property tax, transport tax and VAT. Again, this is not a VAT but is rather a tax on the tax base elements that go into the patent. The upshot of the special tax regimes (which apply only to agricultural units that produce, process and sell their own products) is that the agricultural sector hardly pays any tax, including VAT. By contrast, agribusinesses that process and sell the products of (other) farmers are subject to the regular VAT (and other taxes).

3.47 The special regimes that apply to farmers regardless of the size of their land holdings are difficult to rationalize. Elsewhere, in the Czech and Slovak Republics (see Table 3.4), as well as in the Scandinavian countries, agriculture is subject to the regular VAT. The only form of VAT relief is the small-business exemption. In other European countries, such as Hungary and the Netherlands, agriculture is not taxed but purchasers of exempt agricultural products are permitted a presumptive tax credit for the VAT that can be attributed to the taxable inputs of exempt farmers (of course, farmers can also opt for VAT registration and payment). The same result is achieved in countries such as Austria and Germany, by permitting farmers to include a presumptive VAT in their sales invoices to purchasers, representing the VAT on their inputs. Accordingly, for farmers the VAT on inputs is the same as the VAT on output. Hence, they do not have to register for the VAT. Of course, the presumptive VAT credits and rates are crude and highly arbitrary methods for eliminating the VAT on farmers' inputs. In addition, they form an inducement to politicians to press for an increase in VAT credits or rates in order to subsidize the agricultural sector through the VAT.

3.48 In some non-EU countries farmers are also exempt, while agricultural inputs, such as feed, seed, fertilizers and pesticides, are zero rated to minimize the VAT burden on farmers' inputs and hence output. Obviously, this approach cannot be applied to dual-use goods such as buildings and tractors. There is the danger, moreover, that over time the zero rate is extended to other goods and services. Under the presumptive methods as well as the zero-rate approach, agricultural products sold to consumers through organized distribution channels would be subject to the full standard VAT (or a reduced VAT rate, if any).

3.49 In view of the large agricultural production units in Kazakhstan, particularly for wheat, it is recommended that farmers be made subject to the full VAT (provided their sales exceed the small-business exemption), allowing them to offset the tax credits on their taxable inputs. The special regimes could then be abolished with regard to the VAT (and, it is hoped, the other taxes). The application of the full VAT implies that the (large) small-business exemption would be the only form of relief for small farmers, who would then be stuck with the VAT, if any, on inputs. This is by far the preferred approach to the VAT treatment of the agricultural sector. However, if it would be considered desirable to eliminate the VAT on the inputs of exempt small farmers, particularly in the cotton sector, a zero rate might be applied to fertilizers and pesticides but not to any other goods or services used in agriculture (it is unlikely that there would be much of a tax on seed and feed). Probably, this measure would eliminate nearly all VAT for the exempt small farmers, but in administrative terms it would be second-best to the application of the small-business exemption without further ado. Finally, the inclusion of large-scale agriculture in the

VAT base should not materially alter the VAT burden distribution on account of the large small-business exemption.

Economic Free Zones and Technoparks

3.50 Special arrangements have also been designed for economic free zones (textiles, petrochemicals, pipelines, information technology) under which materials for buildings, infrastructure and production facilities are zero rated when supplied to enterprises located in these zones. Clearly, this concession has no plausible economic rationale, while it complicates administration and invites VAT leakage and evasion. There is no economic rationale because the VAT on business inputs would be credited against the VAT on sales if products are sold in the domestic market, or refunded if products are exported. Evasion is invited because zero-rated building and infrastructure materials can be diverted to the domestic market without the payment of VAT (the "borders" between the economic free zones and the domestic market are much more porous than the borders with foreign countries). This is an inappropriate form of industrial policy which has no place in a well-designed VAT system. Aside from cash-flow (timing) benefits, moreover, there is no benefit in the absence of evasion. Zero-rate creep (lobbying to receive the favorable treatment extended to suppliers and other upstream firms) is also a problem, as is the prevalent but largely useless practice of monitoring the VAT by "audit by checking" (perfunctory perusal of invoices) instead of proper in-depth audits. This potential time bomb should be defused as soon as possible.

Recommendations

3.51 The previous review of the domestic tax base yields the following recommendations.

- Eliminate the exemptions for lawyers and public notaries, cultural services, geological prospecting and exploratory activities, infrastructural projects undertaken for the government, lotteries, and workshops run by handicapped persons.

- Eliminate the recently introduced exemption for newly created residential buildings as soon as possible. This exemption erodes the VAT base, is regressive and seriously complicates administration.

- Review the small-business exemption. If the small-business exemption is not reduced, a definition of "related persons" should be developed to counter the VAT-induced incentive to split up businesses.

- Subject agriculture to the full VAT, subject to the small-business exemption. The VAT-burden on the inputs of small exempt farmers should perhaps be mitigated by zero rating the supply of fertilizers and pesticides.

- Eliminate the zero rating of supplies to economic free zones and technoparks.

E. Treatment of Imports and Exports

Deferred Payment Scheme

3.52 The concessions that are given or contemplated at the import stage are another instance in which the VAT chain is broken. Thus, a deferred payment scheme is applied to the importation of agricultural equipment and machinery, helicopters and airplanes, railway locomotives and

carriages, and pesticides. In addition, thought has been given to the introduction of a zero rate for raw materials imports used in the manufacture of exports.

3.53 Under the deferred payment scheme, used in the EU for all imports, accounting for the import VAT is deferred to the first inland production or distribution stage. No VAT is charged at the border, but the importer or first purchaser has to charge the VAT on a self-assessment basis, include it in the business' VAT return, and take a VAT credit at the same time. As a result, the VAT chain is repaired. Although the scheme works well in the EU, it is backed up by an elaborate VAT Information Exchange System (VIES) under which all exporters (suppliers) and importers (purchasers) have to file quarterly reports to the VAT authorities regarding their supplies or purchases from abroad separately, by name and VAT payer identification number. Obviously, Kazakhstan cannot use a VIES system with respect to its imports, because this would require a cooperative agreement with other countries, most importantly with Russia. Moreover, the advantage of being able to collect VAT at the import stage would be lost. The only disadvantage would be that importers might lose some interest on the advance payment of the VAT. This opportunity cost arises because there is no immediate offsetting tax credit for the purchaser of the imported goods.

3.54 Nevertheless, businesses legitimately complain that the VAT on imports affects their cash flow detrimentally and discourages investment, a defect which is remedied by the deferred payment scheme. Accordingly, it is recommended that the merits and demerits of the scheme should be reconsidered. Obviously, the scheme should not be applied to consumer goods. In addition, raw materials and intermediate goods should be excluded from the scheme, because they can easily be diverted to non-taxed uses. But there is a case for deferring the payment of VAT on imported capital goods. Harrison and Krelove[47] list the main characteristics of a sensible deferred payment scheme for capital goods; these are reproduced in Box 3.1.

[47] G. Harrison and R. Krelove, "VAT Refunds: A Review of Country Experience," IMF Working Paper, WP/05/218, November 2005.

Box 3.1: Deferred Payment Scheme for VAT on Imported Capital Goods

- The scheme is limited to registered VAT payers who import large items of capital goods;
- Capital goods (both imported and domestic) are subject to the standard VAT-rate;
- Registered VAT importers of capital goods are permitted to defer accounting for the VAT liability until their next return is filed;
- In this return, the VAT applicable to those goods is reported as a VAT liability and, in the same return, the VAT input tax credit is claimed for the capital goods;
- If the importer is entitled to 100 percent input tax credit (equipment used exclusively in taxable activities) the VAT applicable to the importation, reported as a liability, will be completely offset by the corresponding input tax credit;
- The customs office is furnished a copy of the VAT return to close its records of the importation.

Source: Harrison and Krelove, 2005.

3.55 It will be seen that this deferred payment scheme is both more limited and broader than the current scheme. Emphatically, it is confined to capital goods and does not apply to consumer goods, raw materials and intermediate products. Second, it does not apply to exempt entities which should be taxed in full on their inputs. Third, it also applies to agricultural equipment and machinery, although the need for doing so would be greatly mitigated following the VAT registration of agricultural enterprises and peasant farmers whose turnover exceeds the small-business exemption.[48] Fourth, the deferred payment scheme could, exceptionally, also be applied to fertilizers as well as pesticides if the decision is made to mitigate the non-creditable input tax on small exempt farmers. Fifth, the deferred payment scheme would make it easier to apply the full VAT to geological prospecting and exploratory activities. Obviously, careful consideration should be given to the definition of capital goods (no sinecure) and to the administrative feasibility of the revised deferred payment scheme.

Zero Rating Supplies to Exporters

3.56 The proposed zero rate for raw materials imports should be dropped from consideration even if it is confined to manufacturers who would incorporate the raw materials in products which would subsequently be exported. The proposal can be abused if imported raw materials for, let us say, buildings and infrastructural projects, would be diverted to non-taxed purposes. Furthermore, the business community would pressure the authorities to extend the zero rate to all supplies made to exporters. This would add to the complexity (similar to the zero rate for economic free zones and technoparks) and increase the revenue risks of the VAT administration.

[48] Under the present arrangements, it can be argued that agricultural enterprises and peasant farmers that are exempt from VAT are stuck with an element of VAT on the importation of agricultural equipment and machinery which they cannot pass on to the purchasers of their products.

In France and Azerbaijan, it has been shown that the concession shifts the need to monitor compliance with VAT obligations away from a small number of well-known exporters to an often larger and lesser-known group of suppliers.

3.57 Under the deferred payment scheme and the zero-rate mechanism, VAT payers would no longer be interested in securing a credit for the VAT paid at import. More generally, the importance of imports in the VAT base and the ease with which the VAT can be collected at the border are important reasons for not introducing a general deferred payment regime at this time and for rejecting the zero rate for supplies to exporters. The administration of the VAT at importation and with respect to the domestic stages of production and distribution should be put on a very sound footing before general VAT deferral measures are contemplated. For the time being, the VAT policy priority should be the full taxation of newly created housing and the incorporation of the agricultural sector in the base.

Refunds to Exporters

3.58 The previous points all focused on the integrity of the VAT base, which is jeopardized if all sales are not taxed and if all purchases have not been taxed, or if all potential VAT registrants are not on the VAT rolls. Basically, the only break in the VAT chain should be at the retail level: consumers and end-users would not be able to take a credit for the VAT on purchases, and hence they would be stuck with the VAT, as they should be.

3.59 The VAT's integrity is also jeopardized if refunds are not paid out in a timely manner. Reportedly, in Kazakhstan the refund issue arises nearly exclusively with respect to exporters. The application of a single standard rate to domestic transactions minimizes the occurrence of refunds because, as a rule, the VAT on purchases should not exceed the VAT collected on sales. Similarly, there are few seasonal producers that would face VAT on purchases at the beginning of the season but would have to wait until the end to be able to pass this VAT on to their customers. Furthermore, no complaints have been raised by new starting enterprises that would incur VAT on capital goods purchases which would not be immediately creditable against the VAT on sales.

3.60 Exporters, however, complain that they are discriminated against because they may have to wait up to a year before obtaining a refund of the monies they have already paid to their suppliers. If true, this implies that exporters provide an interest-free loan to the government to the detriment of their cash flow, profits, and investment opportunities. In the process, the VAT becomes partially a tax on exporters. More broadly, refund delays undermine the competitiveness of the export sector— potentially a serious issue in Kazakhstan in view of the continuing appreciation of the exchange rate. Not surprisingly, refunds have been called the Achilles heel of the VAT.

3.61 How serious are the claims by the business sector that refunds are hard to obtain in Kazakhstan? In 2005, refunds amounted to 139.5 billion tenge or 30 percent of gross VAT collections (including refunds) over the year. VAT refund claims outstanding at the end of the year amounted to 98.5 billion tenge or 22 percent of gross collections in 2005. These figures of refunds paid or claimed in percent of gross VAT collections show an increase over similar figures for the period 1998-2001, when average refunds were some 17 percent of gross VAT collections. Presumably, the increase in refunds reflects an increase in non-oil exports, because oil exporters would be integrated forward with the export stage (and thus not be subject to VAT), while they can import their plant and equipment free of VAT. The changeover to the destination principle in 2001 with respect to the CIS countries also should have involved an increase in export refunds.

3.62 On the basis of international comparison, the export refund situation does not seem to be exceptionally serious in Kazakhstan. An IMF study reports that in most countries VAT refund levels exceed 40 percent of gross VAT collections, and in former Soviet Union countries the refund levels average 30 percent. Based on the IMF study's regression equation and using 2005 data for Kazakhstan, the predicted refund level would be 37 percent compared to the actual level of 30 percent.[49]

3.63 The previous discussion does not indicate that the level of export refunds is truly a serious problem in Kazakhstan. In addition, the legal procedure for the processing of export refund claims has various commendable features, although some features should be reconsidered. The commendable features are that VAT refunds of non-exporters can only be offset against future VAT liabilities (the introduction of a deferred payment scheme for capital goods should make this provision less onerous) or against the liabilities of other taxes which are due and payable (not subject to dispute or merely anticipated). This general provision does not apply to export refunds (defined to arise if 70 percent of sales in the previous three months were exported) which the VAT administration has to pay out within 60 working days from the date on which the refund claim was filed. The government is obliged to pay interest after this period on any outstanding refund claim at the daily rate of 2.5 times the official refinancing rate established by the central bank. Perhaps the only problem here is the 60-day period which in other countries is 30 days or less.

3.64 The 60-day period was probably put into the VAT law because all refund claims are subject to verification prior to payment, and this is a less commendable feature of the refund scheme. Obviously, verification can have various meanings, ranging from a mathematical check of the refund claim to a thorough in-depth audit of the claimant's books of account. Nevertheless, following best practice in other countries (among others, Pakistan), it is recommended that Kazakhstan should make a distinction between "certified" and "non-certified" refund claimants. The claim of certified compliers should be honored without further ado within 30 days from the date on which the claim was filed (with interest paid on late refunds). This is the most common statutory period for making refunds in other countries. Certified compliers would be identified on the basis of their VAT compliance record as well as the record and audit results for business income taxes. At most, they would be subject to a post-refund audit.

3.65 The current 60-day period could then be reserved for the following situations: the claim is a first-time refund claim; previous claims have been rejected or reduced as a result of verification checks; the claimant has a poor compliance record with regard to other taxes; or the claim deviates from the regular refund pattern of the claimant (again with interest paid on late refund claims which turn out not to be suspected). These high-risk cases could be subject to pre-refund audits of accounting systems rather than a check on an individual transaction. The audits should be combined with audits for business income tax purposes. After all, in principle an audit for business income tax, like one for VAT, is aimed mainly at a proper evaluation of reported sales. This division between certified and non-certified compliers should be part of a comprehensive risk management approach to processing refund claims.

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[49] See Harrison and Krelove (Footnote 15). The IMF study's regression equation of "expected" refund levels takes into account exports (measured as the share in GDP), growth (as a percentage of GDP), literacy (literacy rate), range (difference between the highest and the lowest VAT rate), and three dummies of which only one (refunds paid out of gross collections rather than a special fund) would be applicable to Kazakhstan. The equation (adjusted R squared = 0.8826) is Refunds = 0.16*Exports + 0.75*Growth + 0.19*Literacy + 0.90*Range + 3.8D.

Recommendations

3.66 It is recommended that the VAT treatment of imports and exports should be improved along the following lines:

- Expand the current deferred payment scheme to all imports of capital goods (but capital goods only), subject to stringent conditions on compliance control.

- Do not introduce a zero rate on supplies to exporters whether in the form of imports or domestic supplies.

- Improve the procedures for refunds relating to export by making a distinction between certified and non-certified claimants. Refunds of certified claimants should not be subject to pre-refund audits and should be honored within 30 working days. The 60-day refund period should be maintained for non-certified claimants.

F. Some Observations on VAT Administration

3.67 Kazakhstan did surprisingly well in designing and introducing the VAT in early 1992, particularly since the new tax had little in common with the product taxes levied previously. However, no tax is better than its administration. Accordingly, the attention of policymakers should also focus on improving VAT procedures and compliance enforcement techniques. Here, the shortcomings are a matter of both doing too much and doing too little. Too much is done on checking invoices and eligibility for tax credits and tax refunds; too little is done on comprehensive audit oversight. Some aspects seem to require special attention, as pointed out below.

- The VAT rests on voluntary compliance by the vast majority of businesses. Accordingly, good taxpayer relations through appropriate taxpayer information and education programs are essential. This should be helpful in inducing businesses—reportedly 60 percent of the total—to leave the informal economy if their sales exceed the small-business exemption.

- In line with this, the VAT administration should guard against pursuing legal, procedural and accounting purity, which increases compliance costs instead of revenues. Declaration and reporting requirements can be simplified. VAT returns should not require more information than is needed to process the accompanying return. VAT invoices should meet minimum information requirements, but otherwise should be left to the needs of the business issuing them.

- Grievances should be dealt with equitably and expeditiously if the public good of voluntary compliance is to be maintained. Prompt resolution of objections against assessments is essential.

- Late filing and payment charges should be indexed for inflation and exceed commercial rates of interest. Charges should impart a continuous disincentive to delay payment but should not be so high that they have a perverse effect on the business' willingness to pay.

- The processing of registration and declaration forms and access to the relevant information has been nearly fully automated, but the possibility of relying on manual procedures should be retained for small businesses, particularly if the agricultural sector is also made subject to VAT.

- Audit selection techniques are still in their infancy and are largely at the discretion of the audit inspection staff. Control of fraud is mostly reactive, with no proper investigative structure. More sophisticated credibility checking is needed.

3.68 The main recommendation on VAT administration is that compliance control should shift away from generalized "audits by checking" to audits targeted at selected businesses, involving comprehensive examinations of the entire accounting system.

4. EXCISE DUTIES

A. INTRODUCTION

4.1 Kazakhstan has a limited excise tax system, largely confined to the usual traditional excise goods—tobacco products, alcoholic beverages, petroleum products, motor vehicles, betting and gambling—augmented by a number of license fee type of duties on various activities. In recent years environmental levies, which can also be labeled excise duties, have been added to the excise duty list, while various duties on luxury items of consumption, such as caviar, jewelry and crystal ware have been removed.

4.2 The most remarkable thing about the excise duties in Kazakhstan is that they yield so little revenue and that their design and level are not suited to the achievement of their proper economic roles. Excise duties can be designed to improve the efficient allocation of resources by internalizing the social costs of (excessive) consumption and production. Accordingly, a detailed review of the excise system leads to the following conclusions:

- Revenues from excises can, and should, be doubled or tripled.
- Increased reliance on excise duties is consistent with an equitable tax system.
- There is considerable scope for efficiency enhancing changes in the level and structure of excise duties.
- Excise duties should continue to be confined to the traditional excise goods, as well as environmental "bads."
- Excise tax administration can be substantially improved by adopting best practices from other countries, but this issue is not explored further in this report.

4.3 As reflected in the discussion below, in practice excise taxation is the outcome of several often conflicting considerations which include revenue-raising efficiency, externality correcting aspects, distributional incidence, and the impact of cross-border shopping and smuggling. To put the discussion of the individual excises in perspective, therefore, the following background section deals with issues common to all excises. This sets the stage for separate sections on the taxation of tobacco products, alcoholic beverages, road transport, pollution and luxury products.

B. BACKGROUND

Revenue Aspects

4.4 Excise duties are often one of the most important workhorses of the tax revenue system in developing and transitional countries. As shown in Table 4.1, however, this is not the case in Kazakhstan, where excise duties on tobacco, alcohol, petroleum products, motor vehicles, pollution and a few other items account for less than 5 percent of total tax revenue, or 1.0 percent of GDP.[50] This contrasts sharply with EU member states where excise duties contribute on

[50] For comparative purposes and following the usage in the literature, excise duties have been broadly defined to include all specific taxes on goods and services (item 5120 in the OECD revenue classification) plus taxes on the use of goods and the performance of activities (item 5200) plus environmental levies, if any, listed under other taxes (item 6000) minus customs and import duties (item 5123). For more on the definition of excise duties, see S. Cnossen, "Economics and Politics of Excise Taxation" in S. Cnossen, ed.,

average 11.6 percent of total tax revenue (more than twice as high as in Kazakhstan, even though the overall tax level is also twice as high) or 4.3 percent of GDP (more than four times as high). Even the new EU member states—the Slovak Republic, the Czech Republic and Hungary—collect considerably more revenue from the traditional excises than does Kazakhstan.

4.5 On a rough, comparative basis, it should be possible to double or triple excise tax collections in Kazakhstan. This is true for nearly all excisable goods and services, but particularly for the duties on tobacco products, petroleum products and motor vehicles. As a percentage of GDP, the level of tobacco excise duties is only one-seventh of the level in EU member states, alcohol excise duties are one-half, petroleum excise duties are one-eighth, and motor vehicles duties are one-fourth of the level in EU countries. Perhaps the reason why excise duties do not play an important role in Kazakhstan's tax system is that their rationale is insufficiently understood.

Table 4.1: Excise Duty Collections in Kazakhstan (2005)[a] and selected EU Countries (2003)

Countries	Excise Revenue as % of		Revenue of Individual Excisable Items (in % of GDP)						
	GDP	Total Tax	Tobacco Products	Alcoholic Beverages	Petroleum Products	Motor Vehicles	Energy, Pollution	Betting, Gambling, Entertain.	Other
Kazakhstan	**1.0**	**4.9**	**0.09**	**0.12**	**0.22**	**0.14**	**0.34**	**0.01**	**0.10**
EU Countries									
Slovak Rep	4.1	13.2	.	.	.	.	.	.	.
Austria	4.3	10.1	0.59	0.15	1.46	0.87	0.35	0.24	0.66
Czech Rep	4.3	11.5	0.74	0.37	2.31	0.31	0.26	0.05	0.30
Germany	4.1	11.4	0.65	0.17	1.99	0.34	0.32	0.10	0.48
Hungary	4.5	11.7	0.86	0.37	2.26	0.20	0.12	0.27	0.42
Netherlands	4.7	12.0	0.38	0.19	1.33	1.32	1.11	0.02	0.31

[a]/ No breakdown is available for excise receipts collected at the import stage on tobacco products, alcoholic beverages and petroleum products (30 percent of the combined total). Accordingly, these receipts have been allocated to receipts of individual excisable goods on the basis of domestic excise collections.

Source: Kazakhstan—data provided by the tax authorities; EU countries—OECD, Revenue Statistics 1965-2004, Paris. In OECD terms, excises are defined as the sum of taxes on specific goods and services (5120) plus taxes on the use of goods and the performance of activities (5200) plus pollution levies, if any, listed under other taxes (6000) minus customs and import duties (5123).

Rationale for Excise Duties

4.6 In Kazakhstan the poor revenue performance of the excise duties is in violation of several important taxing principles.

Theory and Practice of Excise Taxation, Smoking, Drinking, Gambling, Polluting, and Driving, Oxford: Oxford University Press, 2005.

- The marginal cost of collecting excise duties is considerably lower than that of all other taxes, including the VAT. The demand for excisable products tends to be price inelastic precisely because they are addictive or indispensable. This means that the potential for the distortion of economic decisions by the imposition of excise duties is relatively small. From an administrative point of view, excises on tobacco, alcohol, gasoline and motor vehicles are low-cost sources of revenue, because the products are easy to identify, the volume of sales is high and the fact that there are few producers (wine is an exception in most countries) simplifies collection. Studies for other countries indicate that the administrative costs of excise collection are merely one-fourth of the costs of VAT collection per unit of revenue.

- Excises on smokers, abusive drinkers and polluters promote efficiency in the allocation of resources. If properly designed, they can serve as proxies for the cost of the damage—physical, financial, psychological—that consumers of excisable products impose on other people. It is reasonable, equitable and efficient that they should pay for these costs, ideally in the form of an excise that is equal to the marginal cost of the damage caused to other people.[51] Although the external or social costs are often difficult to measure, there can be little doubt that the revenue collected through excise duties in Kazakhstan on tobacco, alcohol and polluting products is far below their external cost.

- Excises on motor fuel and motor vehicles can be rationalized as proxies for the cost of government-provided road services. Road and transport services resemble goods produced in the private sector that are used optimally when their price—commonly referred to as the economic user charge—equals the total social costs of constructing and operating the road network. Again, the duties imposed in Kazakhstan do not seem to fulfill this function properly.

- Excises on items of luxury consumption may be used to promote progressivity in taxation. Because the demand for luxuries rises faster than income rises, an excise on them is disproportionately paid by the rich. The central issue here is whether the taxation of luxury goods is worth the cost of the administrative effort. As will be seen below, the answer is "no"—with one very important exception: namely, passenger cars.

4.7 It should be emphasized that duties based on externality (social cost) considerations should always be raised to their appropriate level regardless of the need for non-oil revenues, because they improve the efficient allocation of resources.

Other Issues

4.8 In Kazakhstan nearly all excise duties are specific; the only exception is the excise on the importation of cars. It is strongly recommended to keep it that way. After all, the external costs caused by smoking, drinking and polluting are independent of the price of the related excisable products, so that the correction of externalities favors specific over ad valorem (value) taxation. Importantly, specific duties tend to involve less avoidance and evasion, because they can be imposed at the factory gate, they require only counting (e.g., of cigarettes) or measuring volume (e.g., of motor fuels), and there are no contentious valuation issues to be dealt with. Excises on luxury goods are an exception to this rule. They are best levied on an ad valorem basis.

[51] It should be noted that payment for external costs takes priority over considerations regarding the distribution of the excise burden over rich and poor. Even poor drinkers cannot be excused from the damages of accidents caused by them.

4.9 A major issue relevant to all excises is that the specific duty should be indexed for inflation. Although annual ad hoc adjustments can be made and may take account of the rise in the consumer price index, nevertheless, parliamentary approval is required. In other countries excises are automatically adjusted for inflation on the basis of discretionary power granted to the Minister of Economy or Finance. It is suggested that Kazakhstan incorporate a provision to this effect in the Tax Code.

4.10 The excise duties on excisable goods imported into Kazakhstan are higher than the excise duties on domestically produced goods. From January 1, 2007, however, they will be the same. This is correct policy, because the protective function of the tax system should be left to the import duty proper. Excise duties should solely serve an allocative (and revenue-generating) function regardless of the origin of the product. Furthermore, the VAT would only have a revenue role to play and therefore should be the same on imported and domestic goods. The proper way to coordinate the three functions of indirect taxation (that is, protection, revenue-generation and externality correction) is to levy the excise at the import stage on the import duty inclusive value of goods. Next, coordination with the VAT is achieved by levying that tax at the import stage on the value of imports plus import and excise duties and in the domestic market on the excise duty inclusive value of manufactured products.[52]

4.11 The higher proposed excise duties, of course, would not affect the competitive position of the tobacco and alcohol manufacturers—firstly because excises on imports would be raised in tandem, and secondly because the demand for tobacco products and alcoholic beverages is rather inelastic. In addition, the export position of these manufacturers would not suffer, because the excise on exports would be refunded. Indeed, no excise duty would be levied if the manufacturers would be integrated forward with the export stage.

4.12 All excisable products are subject to 15 percent VAT through the retail stage. Below, this tax is left out of consideration, because the VAT simply treats excisable goods on a par with other consumer goods (that is, it does not affect relative prices).[53] It should be noted, however, that the small-business exemption implies that as a rule the retail margin of tobacco products and alcoholic beverages would not be included in the VAT base. Presumably, the retail margin on petroleum products and motor vehicles would be subject to VAT in view of the larger outlets through which these items are sold.

Recommendation

4.13 Nearly all excise duties are "criminally" low in Kazakhstan. They should be reviewed urgently on the basis of widely accepted efficiency and revenue considerations. Increased reliance on excise duties is consistent with an equitable tax system. Additional revenues can be used to lower other more distortionary taxes. Excise duties should be indexed for inflation.

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[52] See also M. Gillis and C.E. McLure, Jr., "Coordination of Tariffs and Internal Indirect Taxes," in R.A. Musgrave, President, and M. Gillis, ed., *Fiscal Reform for Columbian*: The Final Report and Staff Papers of the Colombian Commission on Tax Reform, Part II, Harvard Law School, International Tax Program, Cambridge, 1971.

[53] VAT should be taken into account if the excises would exceed the social cost of consumption or production, but in Kazakhstan this does not seem to be the case.

C. TOBACCO PRODUCTS

4.14 The excise duties on domestically produced tobacco products in Kazakhstan are shown in Box 4.1.

Box 4.1: Excise Duties on Tobacco Products, 2006

- A specific excise, expressed as a fixed amount per 1,000 cigarettes: (i) 130 tenge on cigarettes without filter, and (ii) 230 tenge on cigarettes with filter.
- A specific excise of 825 tenge per kg on smoking, chewing and snuff tobacco.

4.15 Table 4.2 shows the excise duties on cigarettes in Kazakhstan along with those found in three new EU member states (the Czech Republic, the Slovak Republic, and Hungary) that have low tobacco excise duties (and do not yet conform to the minimum requirements of the EU) and three old member states (Austria, the Netherlands, and Germany), whose tobacco excise duty levels conform to the EU-wide agreed minimum requirement of 197 tenge per pack of 20 cigarettes (€64 per 1,000 cigarettes from July 1, 2006).[54]

Table 4.2: Excise Duties on Cigarettes in Kazakhstan and Selected EU Countries, 2006 (value figures in tenge)

Country	Excise Collections per Capita	Pack of 20 Cigarettes		
		Excise Duty (filterless)	Retail Price (filterless)	Excise as % of price
Kazakhstan	**460**	**2.6**	**30**	**9**
EU Countries				
Czech Republic	9,000	117	229	51
Slovak Republic	.	151	277	55
Hungary	9,500	158	271	58
Austria	25,100	280	477	59
Netherlands	16,500	323	567	57
Germany	26,200	429	688	62

Sourcse: Kazakhstan: data provided by the Kazakhstan authorities; European countries: calculated from European Commission, Excise Duty Tables, 1 January 2006 (Brussels) and from OECD Revenue Statistics 1965-2004, Paris. Figures have been rounded. € 1 = 154 KZT.

4.16 Clearly, Kazakhstan's tobacco excise duties are extraordinarily low: merely 2 percent of the low Czech duty and 0.5 percent of the German duty. Since excise duties are generally shifted forward into consumer prices, by extension cigarette retail prices in Kazakhstan are obviously only a fraction of the retail prices in EU member states: less than one-seventh of the most popular price category of cigarettes in the Czech Republic and one-twentieth of the most popular category in Germany. By the same token, per capita excise duty collections on a pack of cigarettes are only 460 tenge in Kazakhstan compared with 9,000 tenge in the Czech Republic and over 26,000 tenge in Germany.

[54] For a review and evaluation of tobacco excise duties in Europe, see S. Cnossen, "Tobacco Taxation in the European Union," FinanzArchiv 62 (June 2006), pp. 305-322.

4.17 Tobacco excise duties in Europe approximate or exceed the social costs of smoking, but they probably come nowhere near that mark in Kazakhstan (studies of the social cost of smoking are not available). As is well known, smoking is a primary cause of lung cancer, emphysema, and chronic bronchitis, and a major cause of heart disease and stroke. The economic costs—related primarily to the expense of treating smoking-related illnesses, as well as the well-being and market earnings that are lost as a consequence of smoking-related illnesses and death—are relevant to public policy if external (i.e., imposed on others, as in the case of disease and discomfort associated with second-hand smoke or the financing of public health care), rather than internal (that is, borne privately by the smoker). Along with information failures (that is, lack of knowledge about addiction and health risks), the external costs establish a case for government intervention through excise taxation, as well as, or instead of, through regulation and education. Presumably, in Kazakhstan taxation should be the primary means of government intervention.

4.18 The external costs of smoking should be measured on a net basis. After all, smokers tend to live shorter lives than non-smokers, which saves on the pension payments and health care costs of age-related diseases. The external costs of smoking are difficult to estimate, but in Austria and the Netherlands, for example, smokers probably pay their way in the form of excise duties. Obviously, pension and health care costs are much lower in Kazakhstan, but even if this is kept in mind a case can be made for raising the excise duty to, say, 50 percent of the excise-inclusive retail price, or about 30 tenge (in real terms) per pack of cigarettes over a period of, let us say, three years. A start could be made by doubling the excise duty on a pack of cigarettes to 18 tenge in 2007 and adding real increases in succeeding years. The extra tax revenue could be used to reduce other more distortionary taxes. The duty increases would not be inflationary. Expenditures on tobacco in the lowest income decile comprise merely 2.2 percent of total expenditures (see Table 3.3 above). In addition, the reduction in the VAT rate should have an offsetting effect.

4.19 Three further issues deserve consideration:

- The current cigarette excise duty is differentiated: the duty on filter-tipped cigarettes is nearly twice as high as the duty on cigarettes without a filter. This is exactly backwards from a social cost point of view because unfiltered smoke is more likely than filtered smoke to cause illness. Also, the filter which prevents impurities from being inhaled is taxed along with the tobacco itself. The better approach would be to tax both kinds of cigarettes at the same duty per 1,000 sticks. Understandably, the argument is that filter-tipped cigarettes are mainly bought by better-off smokers, but this argument is fallacious: the poor have no greater license to impose social costs on other people than the well-to-do.

- The specific rate on smoking, chewing and snuff tobacco is much higher than on the tobacco that goes into cigarettes. A thousand cigarettes contain three-fourths of a kilogram of tobacco (0.75 gram per cigarette) which is taxed at 307 tenge per kilogram if used in filter-tipped cigarettes, while the same volume of smoking tobacco is taxed at 825 tenge. Accordingly, on the basis of social cost considerations, cigarettes are undertaxed compared with smoking tobacco. Assuming that cigarettes cost one-third more to produce than smoking tobacco and that the excise should be a proxy for social cost, at current duty rates cigarettes, with or without filter, should in fact be taxed at around 550 tenge per thousand or 11 tenge per pack to put them on a par with roll-your-own tobacco. This is another argument for quadrupling the excise next year.

- The definition of tobacco products does not seem to include cigars and cigarillos.

4.20 **Recommendation.** The tobacco excise is a proxy for the social costs that smokers impose on other people. To reflect this rationale, it is recommended that the tobacco excise duty should be increased to 30 tenge per pack of cigarettes (1,500 tenge per thousand) over a three-year period and that the same duty should apply regardless of the type of cigarette. Smoking tobacco should then be taxed at 1,250 tenge per kilogram.

D. ALCOHOLIC BEVERAGES

4.21 Box 4.2 shows the excise duties that Kazakhstan levies on alcoholic beverages and alcohol. At current rates these duties do not pay for the social costs that abusive drinkers impose on other people. As is well known, chronic heavy drinking has harmful effects on health (organ damage, birth defects) and causes (road) accidents and domestic violence. Also, most crime is alcohol-related. The World Health Organization has provided evidence that in most countries excessive consumption of alcoholic beverages is responsible for up to 10 percent of the total disease burden.

4.22 The duties on alcohol and alcoholic beverages are very low compared to those found in six EU member states (see Table 4.3). The excise duty on beer is merely 4 percent of the duty in the Slovak Republic (which is by far the lowest among the EU member states), while the duty on spirits is 40 percent of the Slovak duty. Not surprisingly, per capita alcohol excise duty collections are also very low, even if allowance is made for the much lower per capita consumption of alcohol beverages in Kazakhstan (2.6 liters of pure alcohol per capita) compared with the high consumption levels in European countries (10 liters per capita).

Box 4.2: Kazakhstan: Excise Duties on Alcoholic Beverages, 2006

- **Spirits** (taxed on alcohol by strength)
  - 80 percent or higher: 400 tenge per liter, or 140 tenge per bottle of 70cl of 40 percent, the most common comparable measure in the EU;
  - Less than 80 percent: 475 tenge per liter of 100 percent, or 133 tenge per bottle of 70cl of less than 40 percent;
  - Less than 80 percent: 47.5 tenge per liter of 100percent if sold to other producers of alcoholic beverages, or 19 tenge per liter of 40 percent;
  - 12 percent or less (low alcoholic beverages): 250 tenge per 100 percent alcohol, or 21 tenge per bottle of 70 cl;
  - Cognac and brandy: 100 tenge per liter of 100 percent alcohol, or 28 tenge per bottle of 70cl of 40 percent;
  - Denaturized alcohol with a strength of 80 percent or higher sold to industrial users of alcohol: 40 tenge per liter.

- **Wine** (taxed on alcohol by volume)
  - Still wine: 20 tenge per liter, or 15 tenge per bottle of 75 cl;
  - Sparkling wine: 40 tenge per liter, or 30 tenge per bottle of 75cl wine drinks: 50 tenge per liter, or 37½ tenge per bottle of 75cl;
  - Processed wine materials: 20 tenge per liter.
- **Beer** (taxed on alcohol by volume)
  - 8 tenge per liter, regardless of strength, or 4 tenge per half liter.

4.23 The average optimal duty on alcohol can be calculated as the total net external costs of alcohol misuse divided by the number of liters of pure alcohol consumed (subsequently, appropriately divided over beer, wine and spirits). Unfortunately, the marginal duty is much more difficult to compute, because the relationship between alcohol consumption and external costs seems far from linear. According to the medical profession, two glasses of wine are good for you, while the social cost meter starts running—at an exponentially increasing rate—beginning with the next glass.

4.24 The marginal duty would be considerably higher than the average tax rate if the external damage caused by alcohol consumption varied across units of drink consumed by each individual. Applying an average tax rate, therefore, means that the external costs generated by abusive consumers are compensated at the cost of reducing the consumer satisfaction of non-abusive consumers. Elsewhere, however, it has been shown that nearly all external costs are caused by 10 percent of the drinking population who consume half of all alcohol sold. This may suggest that differences in external costs arise from differences between individuals rather than between units of alcohol consumed by a particular individual. According to theory, this provides some support for regarding the average external costs as a rough-and-ready indicator of the optimal externality duty.

4.25 A further issue is whether alcohol duties should be related to alcohol content. As is well known, the medical profession measures the damage caused by excessive alcohol consumption in cubic centimeters of pure alcohol. A large volume of weak drink is just as harmful as a smaller volume of strong drink. On externality grounds, therefore, there appear to be good reasons to base the excises on alcohol content, but as can be seen from the right-hand side of Table 4.3, on average spirits are taxed three to four times more heavily in Kazakhstan (and other countries) than beer and wine per unit of alcohol. But research has also shown that the average relative (tax inclusive) prices of beer, wine and spirits indicate that one obtains the best value—that is, the largest amount of pure alcohol for a given amount of money, when purchasing spirits, followed by wine and, lastly, beer. So, if consumption damage control is the objective and assuming that beer, wine and spirits are close substitutes, spirits should be taxed higher than wine which should be taxed more heavily than beer. There is also the point that taxation on the basis of alcohol content would be difficult for wine if produced by small holders.

Table 4.3: Excise Duties on Alcohol in Kazakhstan and Selected EU Countries, 2006 (value figures in tenge)

Country	Collections per capita	Excise Duties			Excise Duties by alcohol content		
		Beer per 0.5 litre	Still wine per 75 cl	Spirits per 70 cl, 40%	Beer 5%	Wine 12%	Spirits 40%
Kazakhstan	**490**	**4**	**15**	**133**	**.**	**28**	**100**
EU Countries							
Slovak Republic	3,100	92	0	314	33	0	100
Hungary	3,600	154	0	380	22	0	100
Czech Republic	4,500	162	0	390	21	0	100
Austria	6,500	154	0	430	25	0	100
Germany	6,800	162	0	560	31	0	100
Netherlands	8,000	200	68	650	29	31	100

Sources: Kazakhstan: Data provided by the tax authorities. EU countries: Sijbren Cnossen, "Alcohol Taxation in the European Union," forthcoming. Figures have been rounded. € 1 = 154 KZT.

4.26 Two other issues deserve consideration:

- The duties on spirits are based on alcohol strength, while wine and beer are taxed on alcohol by volume. Since it is the alcohol that should be taxed, it is recommended that the duties on spirits should be based solely and uniformly on strength; in other words, there should be no 80 percent or 12 percent dividing line. For the same reason, a distinction should be made between ordinary wines (with an alcohol content of up to, for example, 12 percent) and fortified wines (sherries and ports), which should be taxed at a higher rate. Similarly, low-alcohol beer might be taxed at a lower rate than normal beer of, let us say, 5 percent by volume. Broadly, uniformity based on alcohol content should be the criterion. For the design of an alcohol duty scheme, reference might be made to the EU's classification of alcoholic beverages.

- A greatly reduced rate applies to denaturalized spirits sold to industrial users, such as pharmaceutical companies and manufacturers of beauty products (for example, perfumes). Of course, denaturalized alcohol cannot be used for alcoholic beverages, but the problem is that the alcohol may not be denaturalized at all and may be redirected illicitly into alcoholic beverage production. To avoid this problem, it is recommended to tax denaturalized alcohol in full with a credit (and refund) against the tax due on the finished pharmaceutical or beauty product.

4.27 **Recommendations.** On the basis of social cost and revenue considerations, it is recommended that the excise duty on spirits should be doubled (in real terms) in the coming years. Furthermore, the excise duty on beer could be raised 10 times and the excise duty on wine 3 times. There should be little or no impact on the cost of living index. Industrial use of spirits should be taxed at regular rates with a tax credit and refund at the users' level.

E. TAXES ON ROAD TRANSPORT

4.28 Like the excise duties on tobacco and alcohol, taxes on motor fuel, motor vehicle use and motor vehicle purchase are also very low in Kazakhstan compared to European countries, as shown in Table 4.1 above.

4.29 Box 4.3 lists the details of the various taxes, duties and charges on road transport in Kazakhstan. The revenues from motor fuel taxes, the motor vehicle import duty and the transit levy accrue to the budget of the central government, but the revenues from motor vehicle licenses (use taxes) go to the oblasts. It will be noted that all taxes except the import duty are specific, and also that only the motor vehicle licenses are indexed for inflation.

4.30 Since Kazakhstan is a major oil producer, there does not seem to be the same urgency as in European countries to use taxes on road transport to raise revenue for general purposes, particularly since Kazakhstan appropriately applies world market principles in setting prices for petroleum products. Nevertheless, economic considerations relating to efficient infrastructure charging and environmental effects should still be heeded in decisions on the level and structure of taxes on road transport. This implies that taxes on fuel and vehicles should ensure that individual travel and transport choices (approximately) reflect the cost that road users impose on others over and above the private costs of operating motor vehicles.

Box 4.3: Kazakhstan: Taxes on Road Transport, 2006

- **Motor Fuel Excises**
  - Gasoline: 5 tenge per liter;
  - Diesel: 1.2 tenge per liter.
- **Motor Vehicle Use (License) Taxes**
  (annual tax, calculated as a multiple of the monthly calculation index)
  - Passenger cars, depending on engine capacity – 7 cc classes from 1,100cc or less/4,120 tenge to 4,000cc or more/120,510 tenge;
  - Trucks, depending on load carrying capacity – 4 ton classes from up to 1 ton/6,180 tenge to 5 ton or more/14,450 tenge;
  - Buses, depending on seating capacity – 3 classes of up to 12 seats/9,270 tenge, 12-25 seats/14,420 tenge and 25 seats or more/ 20,600 tenge;
  - Motor cycles depending on power: up to 55kW/1,030 tenge and over 55kW/10,030 tenge;
  - Special rates apply to vessels (depending on horsepower), aircraft (depending on kilowatt power), and self-propelled machinery;
  - Motor cars with an engine capacity between 1,500cc and 4,000cc pay an additional tax of 7 tenge per extra cc;
  - Adjustment coefficients (resulting in a lower fee) are applied to light motor vehicles that are older than 6 years (7 years for trucks) (differentiated by origin: CIS versus other countries), calculated from the date of registration, and to aircraft depending on age and use (differentiated by date of purchase: before or after 1 April 1999).
- **Motor Vehicle Import Excise**
  - 10 percent of value, but not less than €0.50/cc for vehicles with engine capacities exceeding 3000 cc.
- **Transit Levy**
  - Applied to international road haulage.

4.31 The social costs of road transport include the following categories:

- Physical wear and tear caused by motor vehicles using the roads: fuel and license fees, particularly regarding heavy trucks, can be designed to charge users for these costs.

- Environmental costs on account of air pollution: urban lead which harms health, nitrogen oxides which contribute to acid rain, and carbon dioxide which causes global warming. (Differentiated) fuel excises are the most suitable instrument for charging road users for air pollution costs.

- Injury and property costs due to traffic accidents. Probably the best instrument, not discussed here, is a tax on car insurance premiums

- Congestion costs in urban environments where nearly 60 percent of the country's inhabitants reside. Usually, this is the subject of regulation rather than taxation. This issue is also not discussed here. Currently, it may not be important, although the number of cars is rapidly increasing.

4.32 There is little doubt that Kazakhstan should raise taxes on road transport to reflect the social costs of road use. Beyond this, the case for using road transport for revenue-raising purposes—over and above the social costs—is strong, because the economic and administrative costs of doing so are lower than for other taxes. The distortionary impact on private sector activity tends to be limited. Furthermore, the fuel excises can be collected from three major producers, while the motor vehicle license fees can be linked to the residence of the owner of the vehicle (presumably oblasts have to keep records of the addresses of vehicle owners). In other words, the taxes are difficult to evade if a few simple controls are put into place.

4.33 But in the absence of a detailed examination of the social costs of road use and an evaluation of the difficult trade-offs and compromises needed in view of the multiplicity of the objectives, no specific recommendations are made regarding the taxation of road transport. For the same reason no comparison is made with EU member states, where taxes on road transport are many times higher than in Kazakhstan. Basically, some general observations are made that can be used as a starting point for further discussion and research.

Motor Fuel Taxes

4.34 The differential between the gasoline excise and the diesel excise (4:1) is larger than in other countries. Presumably, this reflects the government's concern about the impact of high diesel excises on the cost of industry and agriculture, and perhaps more important on the use of diesel fuel in commercial vehicles. Although there is no justification for imposing revenue-raising excises on the intermediate uses (inputs to production) of diesel, diesel-powered commercial vehicles should always bear appropriate externality correcting taxes, because the latter should be passed on in price if the fuel excise is to perform its economic role. Diesel-powered vehicles emit particulates—for example, soot—which cause health problems (respiratory ailments and cancer), particularly in urban areas.

4.35 Although the picture is complicated, on balance the differential excise duty in favor of diesel fuel is inconsistent with the relative environmental damage caused by diesel engine versus gasoline engine vehicles. Beyond this, the fact that diesel engines are more fuel-efficient per kilometer than gasoline engines indicates that, per liter of fuel, diesel-powered trucks impose more damage to roads than gasoline-powered trucks. Thus, diesel should be taxed at a higher not a lower rate than gasoline. Admittedly, diesel oil is also used by buses, which provide transportation for the poor, but the impact of a higher excise on fares would be so small that it would have a negligible effect on the cost of transportation for any individual passenger.

4.36 A further point to note is that the motor fuel excise structure distinguishes gasoline from diesel oil, but not one kind of gasoline from another kind. In this connection, consideration should be given to the higher taxation of leaded gasoline versus unleaded gasoline, to encourage fuel switching towards less polluting motor fuels. Perhaps the excise taxation of motor fuel should be merged with environmental taxes on fuel (see below) and collected at the central level. Presumably, oblasts can be compensated for the loss of revenue.

4.37 A good case can be made for increasing the motor fuel excises in Kazakhstan. Experience elsewhere indicates that the impact is likely to be small. Higher motor fuel taxes would tend to reduce vehicle ownership, reduce vehicle use and encourage the importation of more fuel-efficient motor vehicles. The impact would be greater on fuel use and vehicle emissions than on vehicle use and congestion. If motor fuel is going to be taxed at a higher rate, then the position of kerosene (apparently not subject to a fuel excise) should also be considered, because kerosene is partially substitutable for diesel oil. Since kerosene is mostly used by poorer households for

cooking and lighting, an excise on it would have a highly regressive distributional impact. For this reason the exemption for kerosene might be maintained, while dyeing and chemical marking as well as spot-check inspections of fuel tanks could be used to forestall diversion.

4.38 Last but not least, motor fuel excises should be indexed for changes in the domestic price level and exchange rates if the real value of the excises is not to be eroded through inflation.

Motor Vehicle License Taxes

4.39 Practically all physical wear and tear on the road surface is caused by heavy trucks. In fact, road damage costs are roughly proportional to the fourth power of the axle load. Based on this consideration, the government is strongly advised to raise motor vehicle license taxes on trucks by substantial amounts (axle load would be a better yardstick than load carrying capacity).[55] Higher diesel excises cannot alone reflect the damage, because the additional fuel used by a heavier vehicle is by no means proportionate to the very much higher road damage that the vehicle causes. As an extension of this argument, transit fees for trucks passing through Kazakhstan should also be raised to reflect the wear and tear on domestic roads. Clearly, fuel taxes are much less effective in doing so, since many trucks today are equipped with large-capacity fuel tanks, allowing them to travel 1,000 kilometers without refueling. Taxes could justifiably be levied (and rebated) at the border on the contents of fuel tanks.

4.40 The highly differentiated motor vehicle license fees on passenger cars based on seven classes of engine capacity make little sense from a social cost point of view. There is likely to be no difference in road damage and environmental pollution caused by a car of 1,000cc versus a car of 5,000cc, while the classification offers scope for straightforward evasion based on misclassifying vehicles to lower tax categories. Indeed, the classification system provides an incentive for corrupt classifying officials. Perhaps the entire system of license fees should be examined with a view to simplifying its structure, providing less discretionary power to tax officials and fewer compliance costs to vehicle owners.

4.41 An unusual feature of motor vehicle license fees is that lower rates apply (through the use of adjustment coefficients) to light motor vehicles that are more than six years old. Surely, old motor vehicles tend to emit more pollutants and are likely to cause more traffic accidents than new motor vehicles. By this argument, the owners of old vehicles should not pay less tax than the owners of newer vehicles. It is suggested, therefore, that the distinction in favor of older vehicles should be abolished. Similarly, there seems little sense in increasing the tax by 7 tenge (not subject to the monthly calculation index) for each cc by which the vehicle's engine capacity exceeds 1,500 cc but is less than 4,000 cc.

4.42 In addition, the various exemptions from the vehicle license tax are inconsistent with the function of these taxes as a proxy for social costs. Currently, exemptions for any type of license fee are provided for payers of the unified land tax, agricultural producers, state institutions, war veterans, disabled individuals, and national heroes. Exempt persons, like all other users of motor vehicles, also pollute the environment, cause wear and tear on roads, etc. Accordingly, they should be taxed like other users, particularly payers of unified land tax, agricultural producers and state institutions. It is suggested that the exemptions be reviewed along with a wider review of the taxation of the agricultural sector.

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[55] The ideal solution, of course, would be to track mileage for trucks of different weight and levy a tax on mileage at a rate that depends on weight, but probably this is not feasible. Experience elsewhere shows that, if properly enforced, mileage taxes tend to have very high administrative and compliance costs.

Motor Vehicle Import Excise

4.43 There is a 10 percent excise on the import value of new and used motor vehicles. Reportedly, the government intends to convert this ad valorem levy into a specific excise similar to the motor vehicle license fees shown above. It is suggested that this issue should be given careful consideration. Although a good case can be made on the basis of social cost arguments for levying specific excises on motor fuel and motor vehicle use, the ad valorem import excise imparts some progressivity to the tax system because it tends to be higher in absolute terms for newer and more expensive vehicles presumably bought by the better-off. Contentious valuation issues can be avoided by using the list prices of new and second-hand motor vehicles that foreign excise departments publish for imposing ad valorem purchase taxes.

4.44 **Recommendations.** This section has emphasized that taxes on road transport should be designed, individually and in combination, so that they reflect, as closely as possible, the social costs of vehicle use. A strong case can be made for increasing the fuel excises, particularly on diesel oil, and the motor vehicle license taxes on trucks. The motor vehicle license fee structure could be greatly simplified. Beyond the social cost and administrative arguments are equity considerations. Motor vehicle ownership and use are strongly correlated to income and, therefore, are a good proxy for ability-to-pay. The last section of this report deals with this issue.

F. ENVIRONMENTAL LEVIES

4.45 Kazakhstan imposes a large number of environmental levies on a wide variety of pollutants. Box 4.4 lists the levies that are administered by the oblasts. In view of the government's intentions to encourage investments in petrochemicals as well as to make the country more attractive for tourists, ecological considerations should be given due weight. As with taxes on road transport, the design and effects of environmental taxation deserve further study. A detailed analysis and evaluation is beyond the scope of this report. A start might perhaps be made with a review of the relative merits of excise duties, regulations and tradable permits.[56]

4.46 Excise duties, command-and-control regulations and tradable permits are alternative, often supplemental, although not necessarily equivalent, ways of achieving a given standard of environmental protection, or, alternatively, achieving a greater environmental impact for a given economic cost. The case for the use of excise duties over conventional regulatory policies based on technology or emission standards is now well established. If firms are faced with different marginal costs of abatement, excise duties can achieve a given level of abatement at lower total abatement costs. And even if the available instruments can take account of differences in abatement costs, excise duties can sidestep the need for the regulatory authority to acquire detailed information on the abatements costs of individual sources. In addition, excise duties provide a continuing incentive for polluters to seek ways to reduce emissions, are more robust to negotiated erosion ("regulatory capture") and insulate polluters from the risk that regulatory requirements might involve excessive abatement costs.

[56] For a useful introductory treatment on which this section draws, see S. Smith, "Energy Taxation and Environmental Policy," in S. Cnossen, ed., *Excise Tax Policy and Administration in Southern African Countries*, Pretoria: UNISA Press, 2006, and for a review of the situation in OECD member countries, see J-F. Barde and N-A. Braathen, "Environmentally Related Levies," in S. Cnossen, ed., *Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving*, Oxford, Oxford University Press, 2005.

Box 4.4: Kazakhstan: Levies on Environmental Pollutants, 2006

Type of Pollutant	Duty per (cond.) ton
1. Air pollutants from stationary sources	281
2. Air pollutants from mobile sources	
• Ethyl gasoline	990
• Unblended gasoline	324
• Diesel oil	428
• Liquefied gas	236
3. Soil and water pollutants	
• Water	12,944
• Engineering facilities (after purification)	12,253
• Engineering facilities (without purification)	15,929
• Relief	17,522
4. Manufacturing waste disposed in landfills (non-toxic)	148
5. Radioactive waste (purification not possible)	14,024
6. Stripping and environmental formations (non-toxic)	4
7. Ashes, slag, slime, tailings (non-toxic)	66
8. Solid domestic wastes	143
9. Agricultural waste (manure, dung)	87

Notes

¶*Clustered correction factors increase the duties of specified oblasts.

¶*Clustered correction factors increase the duties for water pollutants of specified oblasts.

¶*Coefficients increase the duties for manufacturing and consumer wastes by toxicity class.

¶*A multiplier increases the duties by a factor of 10 for storing and disposal sites not in compliance with ecological requirements.

4.47 A drawback to environmental excise duties is that they cannot guarantee that a particular environmental impact will be achieved; polluters' behavioral responses may be less, or more, than expected. By contrast, quantitative instruments guarantee a particular impact on pollution, but at uncertain abatement costs. In making the choice, the risk of environmental quality must be balanced against the risk of the costs of environmental policy. Environmental excise duties are likely to be particularly valuable where wide-ranging changes in behavior are needed across a large number of production and consumption activities. Source-by-source regulation, on the other hand, may achieve a more efficient outcome if pollution damage varies depending on the source of the emissions. Another point worth making is that minor environmental duties may be ignored by business; hence, if enforcement is not problematical, environmental duties should be high or not imposed at all.

4.48 This leaves the choice between pollution duties and tradable pollution permits. In theory, duties and permits are very similar. After all, in an efficient, competitive auction market the market-determined price for each permit would be expected to equal the rate of environmental duty per unit of emissions that would otherwise achieve the same emissions reduction. However, excise duties and permits differ regarding the impact of uncertainty. A system of tradable permits guarantees the envisaged quantitative reduction in pollution but at an uncertain cost, while an environmental duty has an uncertain impact on the quantity of emissions but fixes the marginal cost of emission controls for polluters. A drawback of pollution permits is that they tend to deter new firms from entering a market dominated by large firms that are able to buy up pollution licenses in excess of the firms' cost-minimizing requirements. An advantage is that pollution permits can be freely distributed to existing firms (grandfathered) and thus do not significantly increase the average financial burden on existing polluters. Grandfathering, however, forgoes the

chance to raise revenue that can be recycled through cuts in the marginal rates of other more distortionary taxes.

4.49 **Recommendation.** Commendably, Kazakhstan imposes a fairly wide range of environmental levies whose design and proper implementation are important if investments in petrochemicals are encouraged and the tourist sector is developed. It is suggested that these levies be made the subject of a separate study.

G. EXCISE DUTIES ON LUXURY GOODS

4.50 The last issue concerns the application of excise duties on products that may be considered proxies for taxpaying capacity. As argued below, the case for taxing a wide range of luxury products is weak, but the case for taxing a few specific goods is very strong.

The Case Against Taxing a Wide Range of Luxury Goods

4.51 If consumer products for which expenditures rise faster than income are taxed more heavily, then this should promote the progressivity of the tax system, because higher-income groups would pay more tax than lower-income groups. Until 2005, Kazakhstan levied excise duties on sturgeon and salmon caviar, jewelry made of gold, platinum or silver, and guns and gas weapons, and until 2002 excise duties were also levied on electricity, crystal ware and crystal luminaries. Most of these items may be considered luxury goods, and during the mission the question was raised as to whether excise duties on luxury goods, more broadly defined than previously, should perhaps be reintroduced.

4.52 The case for separate excise duties on luxury goods should be rejected for the following reasons.

- Class differentiated consumption patterns that are helpful in excise duty design for imparting progressivity hardly exist in Kazakhstan for most luxury products.

- Experience elsewhere shows that the coverage of the usual luxury products tends to be extremely narrow—hardly comprising more than 1 or 2 percent of consumption expenditures. (In addition to the products mentioned above, other luxury products would be toiletries, cosmetics, perfumes, watches, clocks, cameras, television sets, recorders and videos.) Consequently, the effect on progressivity or revenue is insignificant. Most of the luxury excises levied elsewhere are truly nuisance levies.

- Separate excises add to the costs of administration and compliance. The definitional refinements that are required to tax luxury items more heavily usually give rise to casuistic disputes on interpretation. Sound equipment is an example. Cheap items and spare parts are difficult to exempt and must therefore be taxed along with expensive items.

- Higher-income groups can easily purchase various taxable luxury products abroad. Subsequently, their importation could be concealed (for example, an expensive wristwatch) or would fall within the limits of the personal exemption.

- Progressvity in the tax burden distribution can be better achieved through the income tax, which is more comprehensive in coverage and more adaptable to the individual circumstances of taxpayers.

The Case for Taxing Cars

4.53 This is not to say that excise duties and other selected product taxes cannot be used at all to increase the tax system's overall progressivity, but the requirements for effective progressivity in product taxation should be heeded. First, the cross-section income elasticity of demand for the products considered candidates for separate excise duties should exceed unity. Under this definition, luxuries are commodities for which expenditure rises proportionately faster than income. Second, for progressivity to be appreciable, consumption by the higher-income groups must be significant. There are few products that meet these requirements, but cars, pleasure yachts and aircraft (as well as residential housing) are good candidates for differentially higher product (and property) taxes. Most other products do not meet these criteria.

Recommendations

4.54 The (re)introduction of separate excise duties on a wide range of luxury goods should not be considered. If the government wishes to use the product tax system to impart some progressivity to the tax system, then the excise duties and motor vehicle license fees on motor fuel and cars should be increased, as well as the excise on the imports of new and second-hand cars.

ANNEX 1: TAX REFORMS SIMULATIONS IN KAZAKHSTAN

A. INTRODUCTION AND KEY RESULTS

A1.1 This annex illustrates a possible outcome of the tax reforms. The simulation was carried out in mid-2006 for the first draft of the report and its results are valid as of that time. It contrasts two reform packages: the package initially proposed by the authorities at the beginning of 2006 (called scenario 1 or SC1), and the reform outlined in this study (referred to as scenario 2 or SC2). Both sets of reforms are presented in a simplified way for the purpose of the simulation. Our simulation results are summarized in Table 1 in this annex and are presented in a more comprehensive manner in Annex 1, Table 3.

A1.2 Under reform SC1, total non-oil revenue is expected to fall to about 17 percent of GDP by 2015. This result is driven by the lowering of tax rates (income tax, social tax and VAT), and there are no plans for broadening the tax base(s) to compensate. In contrast, under reform SC2, total non-oil revenue will be maintained at about 19-20 percent of GDP by 2015. While SC2 also envisages a reduction in rates for the ST, PIT and VAT, and in fact proposes a reduction in the tax rate for non-oil CIT (not envisaged in SC1), it differs from SC1 in that: (i) all simplified regimes from the ST are removed; (ii) the domestic base for the VAT is broadened; (iii) a series of adjustments are made to the CIT, the most important of which is the removal of special regimes; (iv) significant increases are made in the excise taxes; and (v) a reform of the property tax is considered.

Annex 1, Table 1: Summary – Fiscal Framework, 2004-2015 (of GDP)

	2004 Actual	2005 Actual	2006 Estim.	2007 SC1[a/]	2010 SC1[a/]	2015 SC1[a/]	2007 SC2[b/]	2010 SC2[b/]	2015 SC2[b/]
Total revenue[c/]	23.7	28.8	25.8	24.4	21.4	20.3	25.2	23.9	23.0
Total oil revenue	5.7	8.2	7.2	6.1	4.2	2.9	6.1	4.2	2.9
Total non-oil revenue	18.1	20.6	18.6	18.3	17.2	17.4	19.1	19.7	20.1
Total expenditure & net lending	22.1	22.7	22.7	22.7	22.7	22.7	22.7	22.7	22.7
Education	3.2	3.5	3.7	--	--	--	--	--	--
Healthcare	2.2	2.5	2.6	--	--	--	--	--	--
Social security & welfare	4.6	4.6	4.5	--	--	--	--	--	--
Agriculture	1.2	1.2	1.1	--	--	--	--	--	--
Transport & communications	1.8	1.7	1.7	--	--	--	--	--	--
Overall balance (Budget & NFRK)[d/]	1.7	6.1	3.1	1.7	-1.3	-2.4	2.5	1.2	0.3
Non-oil balance	-4.0	-2.1	-4.1	-4.4	-5.5	-5.3	-3.6	-3.0	-2.6
Real spending growth, % change	16.8	21.5	9.7	8.2	8.2	4.9	8.2	8.2	4.9

[a/] SC1 – The government's proposed Tax Reform Package encompasses reductions in the value added tax 17.2(VAT), the introduction of a flat rate for the personal income tax (PIT), a reduction in the rates for the social tax (ST) which are also to be harmonized for foreign and local workers, and reforms in issues such as double taxation. These reforms will be phased in during 2007 and 2008.

[b/] SC2 – The government's enhanced Tax Reform Package described above and accompanied by an increased burden on agriculture and increased rates for property taxes and excises.

[c/] Including revenue directly going into the NFRK, except for the sale of oil shares and similar transfers.

[d/] NFRK - The National Fund of the Republic of Kazakhstan.

Sources: Ministry of Finance and World Bank staff calculations.

B. ASSUMPTIONS AND METHODOLOGY

A1.3 The fiscal framework is built on the basis of three sets of assumptions:

1. The assumption for macroeconomic conditions, including GDP growth, real exchange rates, and oil prices as illustrated in Annex 1, Table 2. These assumptions are exactly that: assumptions rather than predictions of these variables. The aim is to anchor the fiscal framework to macroeconomic parameters that can be changed at any point. We did not carry out an exhaustive exercise to predict, for example, real growth or the exchange rates into 2015.

Annex 1, Table 2: Macroeconomic Assumptions, 2004-2015

	2004 Actual	2005 Actual	2006 Estim.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2015 Proj.
Total GDP, billion tenge	5,870	7,453	8,920	10,336	12,044	13,996	16,199	30,245
Oil GDP	688	991	1,102	1,082	1,076	1,119	1,168	1,509
Non-oil GDP	5,183	6,462	7,818,	9,254	10,969	12,878	15,031	28,736
Total GDP real growth, %	9.6	9.4	9.0	8.3	8.9	7.6	7.5	5.3
Oil GDP	15.3	4.3	1.7	6.3	9.0	10.6	11.0	4.1
Non-oil GDP	8.9	10.1	10.1	8.6	8.9	8.4	7.9	5.4
GDP per capita, US$	2,874	3,703	4,835	5,754	6,817	7,818	8,929	15,605
CPI, % change	6.9	7.6	9.0	7.0	7.0	7.0	7.0	7.0
Exchange rate (pa), KZT/US$	136.0	132.9	120.8	116.7	114.2	115.2	116.1	121.0
World oil price, US$ per barrel	37.7	53.4	64.2	61.3	57.2	53.3	49.7	37.0
Oil production , million barrels per day	1.3	1.3	1.3	1.4	1.6	1.7	1.9	3.2

2. The introduction of the rules for the National Fund of the Republic of Kazakhstan (NFRK) as approved by the National Fund Committee in November 2005. These rules include:

   a. Determining the amount spent in the budget for oil by following the rule:

      Transfer to the budget = A (a fixed amount) + b (an expected long term return on assets) * F (the stock of the NFRK in the previous period).

   b. The F is expected to reach US$13 billion by the end of 2006.

3. Detailed Assumptions for the tax reforms as described in Annex 1, Table 4.

A1.4 The methodology for the projections built on the analysis carried out in each of the four chapters in this Volume (e.g., the productivity coefficients of VAT obtained in Chapter 3, the Marginal Effective Tax model used in Chapter 2, and the simulations of effective taxation included in Chapter 1). A few additional features of the variables that drive the projections are explained below:

- For the PIT/ST, the key endogenous variable is the collected rate, which we defined as total PIT/ST revenue received as a percent of the PIT/ST tax base. Since SC2 has a broader base than SC1, as described in the assumptions, the collected rate increases faster in this scenario.

- For the CIT, the key endogenous variable is also the collected rate.

- For the VAT, the key endogenous variable is the productivity coefficient, which we defined as the VAT tax base as a percent of GDP.

- For excises, we adjusted the duties for various products as suggested in Chapter 3.

A1.5 Our simulations were not made on the basis of a computable general equilibrium model. In this regard, there are variables (such as the composition of consumption among locally produced and imported goods) that are not under our control. In addition, growth in this model is not endogenous. The focus is on how the tax measures will perform in terms of revenue collection, as opposed to their impact on economic productivity, efficiency gains, investment and labor market decisions and, ultimately, on the level of long-term growth in the non-extractive sectors. Arguably, SC2 would have a greater effect on long-term growth, given that it significantly simplifies the tax regime relative to SC1. But the task of proving this statement is left to future research activities by researchers and universities in Kazakhstan.

Annex 1, Table 3: Simulation Results-Fiscal Framework, 2004-2015 (% of GDP)

	2004 Actual	2005 Actual	2006 Estim.	2007 SC1 a/	2010 SC1 a/	2015 SC1 a/	2007 SC2 b/	2010 SC2 b/	2015 SC2 b/
Total revenue	**23.7**	**28.8**	**25.8**	**24.4**	**21.4**	**20.3**	**25.2**	**23.9**	**23.0**
Tax revenue (incl. NFRK) c/	**22.3**	**27.0**	**24.3**	**22.9**	**19.9**	**18.8**	**23.7**	**22.4**	**21.5**
Oil sector	5.7	8.2	7.2	6.1	4.2	2.9	6.1	4.2	2.9
Non-oil sector	16.6	18.8	17.1	16.8	15.7	15.9	17.6	18.2	18.6
Corporate income tax (CIT)	8.3	11.4	9.3	8.7	7.5	6.7	8.7	6.8	6.0
Oil sector	4.0	5.6	5.0	4.3	2.9	2.0	4.3	2.9	2.0
Non-oil sector	4.3	5.8	4.3	4.4	4.5	4.7	4.4	3.8	4.0
Labor taxes (PIT+ST)	4.5	4.3	4.3	4.4	3.7	3.6	4.7	5.2	5.3
Personal income tax (PIT)	1.7	1.7	1.6	1.6	1.7	1.7	..	..	..
Social tax (ST)	2.9	2.6	2.6	2.8	1.9	1.9	..	..	..
Property taxes	0.7	0.7	0.7	0.7	0.7	0.7	0.7	1.4	1.4
Value added tax (VAT)	4.1	4.6	4.6	4.4	3.8	3.8	4.7	4.2	4.1
Excises	0.5	0.4	0.4	0.4	0.4	0.4	0.6	1.4	1.4
Revenue from natural and other resources	3.0	4.5	3.9	3.2	2.7	2.3	3.2	2.5	2.1
Oil sector	1.6	2.7	2.2	1.9	1.3	0.9	1.9	1.3	0.9
Non-oil sector	1.3	1.8	1.4	1.4	1.4	1.5	1.4	1.2	1.3
Fees for business and professional activity	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
International trade taxes	0.9	0.8	0.8	0.8	0.8	0.9	0.8	0.8	1.0
Other tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Mandatory payments charged for performance of legal actions	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Non-tax and capital revenue	**1.5**	**1.8**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**
Total expenditure and net lending	**22.1**	**22.7**	**22.7**	**22.7**	**22.7**	**22.7**	**22.7**	**22.7**	**22.7**
Education	3.2	3.5	3.7	..	..	..	..	..	..
Healthcare	2.2	2.5	2.6	..	..	..	..	..	..
Social security and welfare	4.6	4.6	4.5	..	..	..	..	..	..
Agriculture	1.2	1.2	1.1	..	..	..	..	..	..
Transport and communication	1.8	1.7	1.7	..	..	..	..	..	..
Overall balance (budget and NFRK)	**1.7**	**6.1**	**3.1**	**1.7**	**-1.3**	**-2.4**	**2.5**	**1.2**	**0.3**
Non-oil deficit	-4.0	-2.1	-4.1	-4.4	-5.5	-5.3	-3.6	-3.0	-2.6

/ SC1 – The government's proposed Tax Reform Package encompasses reductions in the VAT, introduction of a flat rate for the personal income tax (PIT), a reduction in the rates for the social tax (ST) which are also to be harmonized for foreign and local workers, and reforms in issues such as double taxation. These reforms will be phased in during 2007 and 2008.

b/ SC2 – The government's enhanced Tax Reform Package described above and accompanied by an increased burden on agriculture and increased rates for property taxes and excises.

c/ NFRK - The National Fund of the Republic of Kazakhstan.

Annex 1, Table 3 (cont'd.): Simulation Results-Fiscal Framework, 2004-2015 (% of Total Revenue)

	2004 Actual	2005 Actual	2006 Estim.	2007 SC1 a/	2010 SC1 a/	2015 SC1 a/	2007 SC2 b/	2010 SC2 b/	2015 SC2 b/
Total revenue	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Tax revenue (incl. NFRK) c/	**93.8**	**93.6**	**94.2**	**93.8**	**93.0**	**92.6**	**94.0**	**93.7**	**93.5**
Oil sector	23.9	28.6	27.9	25.1	19.7	14.4	24.3	17.6	12.6
Non-oil sector	69.9	65.1	66.3	68.8	73.3	78.2	69.8	76.1	80.8
Corporate income tax (CIT)	35.0	39.5	36.1	35.5	35.0	33.0	34.3	28.3	26.2
Oil sector	17.0	19.3	19.5	17.5	13.7	10.0	16.9	12.3	8.8
Non-oil sector	18.0	20.2	16.7	18.0	21.3	22.9	17.4	16.0	17.4
Labor taxes (PIT+ST)	19.1	14.9	16.6	18.2	17.1	17.9	18.8	21.7	22.9
Personal income tax (PIT)	7.1	5.7	6.4	6.5	8.1	8.6	..	..	..
Social tax (ST)	12.1	9.2	10.2	11.7	9.0	9.3	..	..	..
Property taxes	3.1	2.4	2.7	2.8	3.2	3.4	2.7	5.8	6.0
Value added tax (VAT)	17.4	16.0	17.9	17.9	18.0	19.0	18.7	17.5	17.9
Excises	2.1	1.6	1.7	1.8	2.1	2.2	2.4	5.7	5.9
Revenue from natural and other resources	12.5	15.6	15.1	13.3	12.7	11.6	12.8	10.4	9.3
Oil sector	6.9	9.3	8.5	7.6	6.0	4.4	7.4	5.3	3.8
Non-oil sector	5.6	6.4	5.3	5.7	6.7	7.2	5.5	5.0	5.5
Fees for business and professional activity	0.3	0.2	0.2	0.3	0.3	0.3	0.2	0.3	0.3
International trade taxes	3.6	2.9	3.2	3.4	3.9	4.4	3.3	3.5	4.3
Other tax revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Mandatory payments charged for performance of legal actions	0.6	0.6	0.6	0.7	0.8	0.8	0.6	0.7	0.7
Non-tax and capital revenue	**6.2**	**6.4**	**5.8**	**6.2**	**7.0**	**7.4**	**6.0**	**6.3**	**6.5**

/ SC1 – The government's proposed Tax Reform Package encompasses reductions in the VAT, introduction of a flat rate for the PIT, a reduction in the rates for the ST which are also to be harmonized for foreign and local workers, and reforms in issues such as double taxation. These reforms will be phased in during 2007 and 2008.

b/ SC2 – The government's enhanced Tax Reform Package described above and accompanied by an increased burden on agriculture and increased rates for property taxes and excises.

c/ NFRK - The National Fund of the Republic of Kazakhstan.

Annex 1, Table 4: Main Tax Base/Rate Assumptions for Projections

Type of Tax	Planned Tax Reform Package	Enhanced Tax Reform Package
Corporate income tax (CIT)	Timing: not defined Tax base: exempting dividends Tax rate: no reform	Timing: 2008 Tax base: (See Chapter 2) • All sectors to comply with CIT, possibly also agriculture • Changed depreciation and allowances • Inflation adjustment for inventories • Exempting dividends • Reduced thresholds for special regimes (5-10 workers) Tax rate: Reduction to 20% for non-subsurface users
Taxes on Labor (PIT+ST)	Timing: 2007 (PIT), 2008 (ST) Tax base: • PIT withhold by firms in all sectors, irrespectively of availability of simplified regime • Base for ST depends on simplified regimes and sectors (e.g., agriculture) Tax rate: • For PIT, flat 10% • For ST, regressive with scale reduced by 30% and applied equally to local and foreigners	Timing: 2007 Tax base: • All earnings (from labor) • Simplified regimes for ST phased out (with the entire tax) • Allowance and zero band as suggested in reform SC1 Tax rate: 20% (as PIT)
Value added tax (VAT)	Timing: 2007-2009 Tax base: no reform Tax rate: reducing by 1 percentage point a year	Timing: 2009 Tax base: taxing agricultural enterprises at a general rate; reducing threshold to 7,500 times the monthly reference unit
Excises	Tax base: no reform Tax rate: no reform	Timing: 2007-2009 Tax base: no reform Duties on spirits: should be doubled (in real terms); beer: could be raised 10 times; wine: could be raised three times; tobacco: should be increased to 30 tenge per pack of cigarettes (1,500 tenge per thousand); the same duty should apply regardless of the type of cigarettes, with or without filter; smoking tobacco should be taxed at 1,250 tenge per kg
Property taxes	Tax base: no reform Tax rate: no reform	Timing: 2010 Tax base: revising taxes' bases to ensure revenue doubling Tax rate: revising taxes' rates to ensure revenue doubling

ANNEX 2: CORPORATE TAXES IN COMPARATOR COUNTRIES

A. SURVEY OF THE RUSSIAN TAX SYSTEM

Corporate Income Tax

A2.1 Corporate taxpayers in Russia are subject to taxes levied by the Russian Federation and its 88 regions. The Russian corporate tax system is a classical system, which means that corporate profits are taxed at the level of the company and the distributed profits are taxed in the hands of the shareholders.

Taxable Income

A2.2 Legal entities registered under Russian laws are liable to taxes on their worldwide income. Foreign legal entities are subject to taxes only on income derived from the business activities of a permanent establishment within the Russian Federation and on certain particular Russian-source incomes. All types of income are included in gross income.

A2.3 Generally, the tax base is the balance sheet profit as computed for tax purposes. Profit for tax purposes is defined as profit from the sale of goods and the supply of services, from fixed assets and other property, from property rights and from non-sales transactions.

A2.4 There are, however, some minor exempt forms of income, but these are of less importance in this context.

Valuation

A2.5 ***Capital Gains*** from the disposal of assets are included in business profits. As a general rule, capital losses from the alienation of depreciable assets and inventory are fully deductible. However, losses from the alienation of depreciable assets are deductible in equal instalments over the remaining useful life of the asset. Capital losses from the alienation of securities issued under domestic or foreign legislation may be set off against capital gains of the current year or carried forward under the general rules. However, a distinction must be made between listed securities and other securities. Capital losses from one category may not be set off against capital gains from the other category

A2.6 ***Depreciation.*** Fixed assets are initially valued at their historic acquisition cost or at their production costs. Depreciation is compulsory. It may, however, be claimed only in periods when the asset is in use. Depreciable assets are subject to depreciation based on their useful life, on the basis of which depreciable assets are subdivided in into 10 depreciation groups.

A2.7 For tax purposes the following methods of depreciation may be used:

- The straight-line method
- The accelerated (non-linear) depreciation method.

A2.8 Where the straight-line method is applied, the monthly depreciation rate for each depreciable asset is determined as follows:

$K = [1/n] * 100$ percent,
where K is the depreciation rate on the historic cost of the asset
and n is the useful life in months.

A2.9 Where the accelerated depreciation method is applied, the depreciation rate for an item is determined as follows:

$K = [2/n] * 100$ percent.

A2.10 A taxpayer may apply the straight-line depreciation method only with respect to buildings and structures with a useful life of 20 to 30 years.

Deductions

A2.11 In general, all justified and documented expenses incurred by the taxpayer are deductible. For certain categories of expenses, limitations are set (e.g., for certain insurance premiums paid for employees, advertising costs or interest) or deduction is denied (e.g., for donations). Dividends are also not deductible.

A2.12 ***Employees' Remuneration.*** Labor expenses and associated employment taxes and duties are fully deductible. However, as noted, the deductibility of certain benefits granted to employees is subject to limitations. Non-obligatory insurance payments to licensed private pension funds and insurance companies for the life and pension insurance of employees are deductible up to an amount of 12 percent of the labor costs. Non-obligatory insurance payments for the medical insurance of employees are deductible up to 3 percent of the labor costs.

A2.13 ***Interest.*** Interest is deductible, provided that the amount of interest does not substantially (i.e. an upward of downward deviation of less than 20 percent) deviate from the average level of interest charged on obligations under comparable conditions.

A2.14 ***Research and Development.*** R&D expenses are fully deductible in equal installments during three years.

Special Tax Regimes

A2.15 ***Oil, Mineral and Gas Business.*** The Russian Tax Code provides a special tax regime for the oil, mineral and gas business. In 2002 a new mineral tax was introduced, followed by the abolition of the excise duty on natural gas in 2004. The tax on the extraction of minerals replaced the royalties for the right to use subsoil resources that were abolished from 2002.

A2.16 From 1 January 2002 to 31 December 2006, the taxable base for crude oil is the volume of crude oil extracted, and the tax rate is RUB 419 per ton from 1 January 2005 (basic rate). This basic tax rate will be multiplied by K, which is calculated as follows:

- until 1 January 2005: $K = (P - 8) * R/252$
- from 1 January 2005: $K = (P - 9) * R/261$

where P is the average oil price in US$ per barrel of "Urals" oil
and R is the average exchange rate of US$ to RUB.

A2.17 From 2007 the tax will be calculated as a percentage of the production cost (value of crude oil), excluding export duty, excise duty and transportation costs, at a rate of 17.5 percent. The tax on the extraction of mineral resources is deductible in computing Russian CIT.

A2.18 Annex 2, Table 1 gives an overview of the most important tax rates of Russian subsoil resources.

Annex 2, Table 1: Tax Rates of Russian Subsoil Resources

Oil	RUB 419 per ton multiplied by *K*
Natural gas	RUB 135 per 1,000 cubic meters
Gas condensate	17.5%
Gold	6%

A2.19 ***Simplified Tax Regime.*** Legal entities and individual entrepreneurs may opt for the simplified tax regime if their turnover (excluding VAT) does not exceed RUB 11 million for nine months in a year. Legal entities and individual entrepreneurs applying the simplified tax regime are exempt from the CIT (the PIT for individuals), VAT, sales tax, property tax and unified social tax.

A2.20 Under the simplified tax regime, the tax is levied on (i) the revenue received on a cash basis at a rate of 6 percent, or (ii) the profits (defined as revenue less paid allowable expenses) at a rate of 15 percent.

A2.21 ***Tax Regime in Free Economic Zones.*** Federal law has introduce special tax regimes for the zones in the Kaliningrad Oblast and in the Magadan Oblast.

A2.22 Only the Kaliningrad special economic zone has the useful features of a classic economic zone with respect to components imported and used for the manufacturing of final goods in the territory of the zone and subsequently exported. Goods produced in this zone are exempt from export duties. Imports are not subject to import customs duties.

Rates

A2.23 The standard rate of the CIT is 24 percent. This is a combined rate, which consists of three parts: federal, regional and local. From 1 January 2005, the federal portion is 6.5 percent and the regional portion is 17.5 percent. In addition, regional state bodies may decrease the rate of the CIT by up to 4 percentage points. Therefore, the rate of the CIT paid to regional budgets is at least 13.5 percent.

Taxes on Payroll

A2.24 There are no major payroll taxes payable in Russia. However, there are compulsory social security contributions. All resident employees are covered—that is, they are entitled to receive benefits and tax is due on their salaries.

A2.25 In general, the tax is levied on the income made by the employers to their employees, whether in monetary form or in kind. Certain payments are exempt from the social tax, such as all types of compensation payments.

A2.26 To this taxable income, the degressive rates shown in Annex 2, Table 2 are applied:

Annex 2, Table 2: Taxable Income in Russia, Digressive Rates

Tax Base Per Employee	Federal Budget (%)	Social Insurance Fund (%)	Federal Compulsory Medical Insurance Fund (%)	Compulsory Medical Insurance Fund (%)	Total (%)
Up to 280,000	20	3.2	0.2	2.6	26
280,001 – 600,000	7.9	1.1	0.1	0.9	10
Over 600,000	2	0	0	0	2

A2.27 These contributions finance coverage for old age, disability and death, sickness and maternity, work injury benefits and family allowances.

A2.28 In addition, employers must pay disability and sickness contributions at rates varying between 0.2 and 8.5 percent, depending on the category of risk established for the relevant industry.

Real Estate Tax

A2.29 Land is a municipal tax payable by all companies and individuals that own plots of land or possess them on the basis of certain in rem titles. The taxable base is the value of the land as stated in the state land register. The tax rate varies depending on the purpose for which the land is used. At the federal level, the maximum rates are established at (i) 0.3 percent for agricultural land and land used for housing purposes, and (ii) 1.5 percent for other types of land.

Investment Incentives

A2.30 ***Accelerated Depreciation.*** Accelerated depreciation (see 1.2.2) is available to all businesses. Additionally, agricultural businesses organized as an industry are entitled to apply a special coefficient, up to 2, to the general depreciation rate calculated under the provisions of the Tax Code.

A2.31 ***International Investment Incentives.*** Property imported into Russia as a contribution of the capital of a Russian company with foreign participation is exempt from customs duties. The current Law on Foreign Investment contains no other tax exemptions or privileges. It does, however, allow the government to grant additional incentives or privileges in "priority areas" of economic and social policy and recognizes that further advantages may be provided under the terms of international treaties.

Personal Income Tax

A2.32 At the beginning of 2001 Russia unified its marginal rates of personal taxation—previously at 12, 20 and 30 percent - at the flat rate of 13 percent. Over the next year, revenue from the PIT increased by about 46 percent (about 26 percent in real terms). As a percentage of GDP, PIT revenues increased by nearly one-fifth (Ivanova, Keen and Klemm, 2005, p. 4).

Taxable Income

A2.33 Individuals are subject to the PIT, which is levied on employment income (see 2.1.1), investment income (see 2.1.2), business income (see 2.1.3) and other types of income (e.g., income from lotteries). There are also some forms of exempt income (see 2.1.4). The Russian tax system provides for the taxation of the worldwide income of residents and the taxation of the income from Russian sources for non-residents.

A2.34 ***Employment Income.*** Employment income, whether in cash or in kind (e.g., company meals and drinks, contributions paid by employers to employees for the private pension plans of funds), is subject to a final withholding tax. Only a limited number of expenses may be deducted from the tax base (see 2.2).

A2.35 State pensions are exempt from tax. From 1 January 2005, payments from private pension funds received on the basis of the recipient's contributions are also exempt. However, payments under other voluntary pension schemes are deemed taxable income.

A2.36 Employment income is computed as the total of salary, wages and similar payments received in cash or in kind, reduced by deductions provided for in the Tax Code (see 2.2). Expenses directly related to employment income (e.g., travel costs) reduce neither the annual nor the monthly tax base. Furthermore, social security contributions paid by an employer are not deductible for tax purposes.

A2.37 ***Investment Income.*** Dividends are defined as income received by a shareholder from the distribution of profits net of tax. For individual shareholders, dividends are subject to a final withholding tax at a rate of 9 percent. Substantial corporate shareholders are taxed at a rate of 15 percent. The dividends are not included in the CIT income tax base. The tax base for a withholding tax is reduced by the amount of dividends received.

A2.38 Interest is defined as a previously fixed income on loans of any kind. Interest income is generally taxed as ordinary income at a regular rate.

A2.39 ***Business Income.*** Business income is taxed in a similar manner as the business income of companies (see section 1).

A2.40 ***Exempt Income.*** Under the Tax Code, exempt income includes, inter alia, the following:

- Interest on state bonds, treasury bills and other state securities of the former USSR
- Interest on bank deposits not exceeding the central bank refinancing rate for domestic currency deposits and 9 percent per annum for foreign currency deposits
- Unemployment, maternity and similar state benefits
- State pensions and qualifying private pensions
- Income from agricultural activities performed in a partnership within a period of five years.

Deductions

A2.41 As a rule, the personal allowances, deductions and credits provided for in the Tax Code are limited.

A2.42 Since the employer qualifies as the taxpayer for social security contributions, the payments may not reduce the employment income. The employee is not eligible for the deduction of other expenses related to employment income.

A2.43 The taxpayer may deduct mortgage interest expenses and mortgage payments incurred in connection with the acquisition of living space. This property-related allowance is granted only once. The taxpayer is not allowed to deduct other interest expenses

A2.44 Insurance premiums are not deductible for individuals; educational expenses may be deducted up to the amount of RUB 38,000. In addition, taxpayers are granted a deduction for payments to educational institutions for his children (deduction is limited to RUB 38,000 per child for both parents).

A2.45 The Tax Code also provides for the following standard allowances:

- A monthly allowance of RUB 3,000 or of RUB 500 for certain groups of taxpayers (e.g., disabled persons as a result of Chernobyl), or
- A monthly allowance of RUB 400 (RUB 4,800 annually) for other taxpayers whose annual income does not exceed RUB 20,000.

A2.46 In addition, a child allowance of RUB 600 per child per month is granted to every taxpayer, provided that the annual income does not exceed RUB 40,000.

Rate Structure

A2.47 Under the Tax Code, income is taxed at flat rates. The general rate is 13 percent and applies to the major parts of income. Dividends are taxed at 9 percent and interest on mortgage bonds is subject to a withholding tax of 9 percent.

A2.48 The rate of 35 percent applies to the following income items (inter alia):

- Interest on bank deposits exceeding the central bank refinancing rate for domestic currency deposits and 9 percent per annum for foreign currency deposits
- Payments on voluntary insurance contracts in excess of the sum of the contributions to the insurance contract increased by interest calculated on the basis of the refinancing rate of the central bank.

A2.49 Income paid to non-resident individuals is taxed at the unified rate of 30 percent.

General Remarks

A2.50 The changes in the rate structure of the PIT, which took effect on January 1 2001, are summarized in Annex 2, Table 3.

Annex 2, Table 3: The PIT Rate Structure before and after Reform

Taxable Income[1/]	Marginal Rate	Taxable Income[1/]	Marginal Rate
Below 3,168	0	Below 4,800	0
3,168 to 50,000	12	Above 4,800	13
50,000 to 150,0000	20		
Above 150,000	30		

[1/] In Russian rubles.

Source: Russian Tax Code Part II, copied from Ivanova, Keen and Klemm (2005)

A2.51 Annex 2, Table 4 shows the same changes for the social tax rate structure.

Annex 2, Table 4: Social Tax Rate Structure before and after Reform [1/]

Legal Incidence	Before Reform (2000)		After Reform (2001)	
	Income Range	Marginal Rate	Income Range	Marginal Rate
Employee	Any	1	Any	0
Employee	Any	38.5[2/]	Below 100,000	35.6
			100,000 – 300,000	20
			300,000 – 600,000	10
			Above 600,000	5 from (2002:2)

[1/] Different rates apply to agricultural workers, lawyers and the self-employed. In some regions some additional charges were levied, e.g., in Moscow an Education Levy of 1 percent.
[2/] This is made up of contributions to the Pension Fund (28 percent). Social Insurance Fund (5.4), State Employment Fund (1.5), and Medical Insurance Fund (3.6).
Source: Russian Tax Code, Part II, copied from Ivanova, Keen and Klemm, 2005.

A2.52 Annex 2, Table 5 shows the development of government revenues as a percent of GDP.

Annex 2, Table 5: General Government Revenues, 1994-2003 (in percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Revenue	34.6	36.8	35.8	39.3	34.4	33.6	36.9	37.4	37.6	36.6
o/w Personal Income Tax	2.9	2.6	2.8		2.7	2.4	2.4	2.9	3.3	3.4
Profit Tax	8.0	8.2	4.9	3.2	3.7	4.5	5.5	5.8	4.3	4.0
VAT	7.0	6.9	7.6	4.4	6.4	5.9	6.3	7.2	6.9	6.6
Excises	1.2	1.7	2.8	7.3	2.7	2.2	2.3	2.7	2.4	2.6
Taxes on trade	1.0	1.7	1.1	2.7	1.3	1.8	3.1	3.7	3.0	3.4
Payroll taxes[1/]	8.9	8.1	8.2	1.2	8.4	7.7	7.7	7.3	8.0	7.8
Resources taxes	0.0	0.9	1.1	9.7	0.9	0.9	1.1	1.4	3.1	3.0
Other tax revenue	5.1	3.4	3.6	1.5	3.6	2.9	2.8	2.4	2.8	2.3
Non-tax revenue	0.0	1.5	1.2	4.9	1.5	1.7	1.8	2.3	2.5	2.6
Budgetary funds[2/]	0.5	1.9	2.4	1.2	3.1	3.4	4.0	1.8	1.3	0.9

[1/] Payroll taxes include annual accumulation of a fully-funded stat3.2e pension systems. Budgetary funds inclusive of on-budget and off-budget regional road funds.
Sources: Ministry of Finance, CBR, Goskomstat, and IMF estimates. (Table copied from Ivanova, Keen and Kleem, 2005.)

A2.53 The Russian tax structure is presented for the period 2002-06 in Annex 2, Table 6.

Annex 2, Table 6: Russian Tax Structure, 2002-2006

Tax Revenues as % of GDP from	2002	2003	2004*	2005*	2006*
Income Tax	7.6	7.4	8.6	10.8	10.0
CIT	4.3	4.0	5.2	6.9	6.1
PIT	3.3	3.4	3.4	3.9	3.9
Resource Extraction Tax	2.2	2.6	3.5	4.3	4.0
Social Tax	8.0	7.8	7.8	6.5	6.4

* Estimates.
Source: IMF (2005).

Sources

IMF (2005), "Russian Federation Staff Report for the 2005 Article IV Consultation," IMF Country Report No. 05/377, International Monetary Fund, Washington, DC.

Ivanova, A., M. Keen and A. Klemm (2005), "The Russian Flat Tax Reform," IMF Working Paper No. 05/16, International Monetary Fund, Washington, DC.

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B. SURVEY OF THE CHINESE TAX SYSTEM

Corporate Income Tax

Taxable Income

A2.54 A resident company of China is taxable for worldwide business income, while a non-resident company is taxable only for business income that has its source in China. Taxable income is generally income less allowable deductions and losses.

A2.55 For taxpayers other than individuals, all income, regardless of type, earned in a taxation year is included in the taxpayer's taxable income for the year. Deductions are made from the gross income, and losses may be carried forward for five years. In the following situations, income is not aggregated but is taxed in a different manner:

- Dividends derived by non-residents are subject to a 10 percent withholding tax on the gross amount of the dividends (except dividends received from a foreign investment enterprise, which are exempt from withholding tax)

- Interest, royalties, rental or leasing income and taxable capital gains derived by a non-resident and not effectively connected with an establishment of the non-resident in China are subject to a 10 percent withholding tax on the gross amount.[57]

Valuation

A2.56 ***Inventory.*** Inventories of merchandise, finished products, products in process, semi-finished products, raw materials and other goods are valued at cost price. For income tax purposes it is therefore not possible to use the lower amount of cost or market value in valuing inventory. In accounting for inventory values, taxpayers may choose one of the following methods:

- FIFO
- LIFO
- Moving average
- Weighted average.

[57] Both dividends and interest are included in the ordinary taxable income of the enterprise for resident companies.

A2.57 Once a method of accounting for inventory has been selected, the method may not be changed "arbitrarily." However, if a taxpayer has to change its method of inventory accounting, it may apply to the tax authorities for approval prior to the commencement of the taxation year in which the change is to be implemented.

A2.58 ***Capital Gains.*** There is no separate concept of capital gains as opposed to other forms of income in the Chinese laws: some gains are recognized as income and are taxed in the same manner as income from business and property.

A2.59 The term "gains" is defined in the Chinese Tax Code as the proceeds from the transfer of property which exceed the original cost of the property. They are taxable as "other income" and taxed at the regular rate where the gains are derived by a joint venture or a wholly foreign-owned enterprise. Gains are subject to a 10 percent withholding tax if they are derived by a non-resident enterprise.

A2.60 Residents are liable to taxes on taxable gains from all sources. Non-residents are taxed only on gains derived from Chinese sources.

A2.61 ***Depreciation.*** Depreciation may be applied to fixed assets. "Fixed assets" refers to "buildings, structures, machines, machinery, means of transportation, and other equipment, appliances and tools used for the purpose of production and business operations with a useful life of more than one year."

A2.62 Some assets are deemed not to be "fixed assets" for the purpose of depreciation if they have a cost of less than CNY 2,000 and are not part of the main equipment used in production and business operations, or if they have a useful life of less than two years. The cost of acquiring such assets can be deducted currently.

A2.63 Depreciation of fixed assets is computed on an annual basis. For the purpose of calculating depreciation, fixed assets are valued at the original cost. This original cost is determined as follows:

- Purchased assets: the purchase price plus freight and installation expenses and other related expenses incurred before the assets are put into use (such as insurance premiums)

- Fixed assets that are manufactured or constructed by the taxpayer: the actual cost of production or construction

- Assets contributed as investment in a joint venture or wholly foreign-owned enterprise: the original cost is deemed to be the reasonable value of the assets determined on the basis of their age and pursuant to an investment contract or their value appraised on the basis of the age and market price of the assets, plus relevant expenses incurred before the assets are put into use

- Fixed assets that are acquired as a gift by the taxpayer: the original cost is the reasonable price after appraisal.

A2.64 Depreciation for fixed assets is computed annually on a straight-line basis on the assumption that there will be a residual salvage value of 10 percent of the original cost. In other words, only 90 percent of the cost of an asset may be written off. Approval from the local tax

authorities must be obtained before a taxpayer may claim a lower (or no) salvage value for an asset. Once an asset has been fully depreciated, no further deduction may be claimed.

A2.65 Depreciable assets are grouped into classes for the purposes of depreciation. The period over which each class may be written down is prescribed in the Chinese Tax Code as follows:

- 20 years for buildings and structures, and the facilities attached to them for use in production and business operations, and for the provision of living quarters or welfare services for staff and workers
- 10 years for railway rolling stock, vessels, machines, machinery and other production equipment
- 5 years for electronic equipment, means of transportation other than railway rolling stock and vessels, appliances, tools and furniture
- 6 years for assets used in the production of petroleum and natural gas.

A2.66 If a used asset is acquired, and the remainder of the useful life of the asset is shorter than the prescribed period of depreciation, the depreciation period is deemed to be the remainder of the useful life of the asset. If an asset remains useful after it has been fully depreciated, no further depreciation can be claimed.

A2.67 ***Accelerated Depreciation.*** According to the Chinese Tax Code, accelerated depreciation may be approved in the following cases:

- Where machinery and equipment are exposed to highly corrosive materials or where buildings are in a state of vibration throughout the year
- Where machinery and equipment are in operation 24 hours a day throughout the year, or
- Where the assets are the fixed assets of a joint venture which has an operation term shorter than the prescribed depreciation period of the assets, and the Chinese party to the venture takes title to the assets upon termination of the joint venture contract.

A2.68 ***Balancing Adjustments.*** The Chinese Tax Code also provides that, where a depreciable asset is disposed of, a taxpayer:

- Must realize a recapture of the previous depreciation deducted if the proceeds of the disposition exceed the undepreciated balance of capital cost or residual salvage value and relevant expenses, and
- May realize a terminal loss if the proceeds of the disposition are less than the undepreciated capital cost or residual salvage value and expenses.

A2.69 The recapture or terminal loss is treated as regular income or loss, respectively, for the year of disposition.

Deductions

A2.70 Losses and expenses are generally deductible to the extent that they are incurred in gaining or producing income and the amount to be deducted is reasonable under the circumstances.

A2.71 Expenditures are classified as capital and current expenditures. Expenditures incurred in acquiring fixed assets or in developing intangible assets are not deductible in the year they are incurred, but can be depreciated or amortized over a number of years. Expenditures incurred in the course of carrying on business, such as cost of goods sold, taxes on sales, manufacturing costs, marketing expenses, administrative expenses and financial expenses, are deductible in computing income.

A2.72 Dividends are not tax deductible.

A2.73 ***Interest.*** Interest expenses are deductible in calculating income if they are incurred in connection with the business activities of the taxpayer and the amount of the interest is reasonable. The deduction is subject to approval by the local tax authorities, to whom information concerning the loan and payment of interest must be provided.

A2.74 An interest payment is considered reasonable if the rate of interest is not higher than the rate applicable to ordinary commercial loans.

A2.75 Interest on capital (which—according to the IBFD—"presumably refers to interest payable on a loan incurred by a party to obtain funds for its capital contribution to a joint venture or wholly foreign-owned enterprise") is not deductible.

A2.76 ***Wages and Welfare Benefits.*** Wages and salaries are deductible if they are paid to employees. Premiums for old-age pension insurance, medical insurance, contributions to the housing fund, the educational fund or the union paid by the employer for the employee according to the norms set by the relevant government department are deductible for tax purposes. Other benefits for employees paid by the employer are deductible up to 14 percent of the total approved wage amount of the enterprise.

A2.77 ***Research and Development.*** The rules relating to the tax deductibility of research and development (R&D) costs are summarized as follows:

- Costs relating to the purchase of equipment and research installation for developing innovative products can be treated as allowable management fees, provided that each purchase is less than CNY 10,000.

- Costs relating to the development of new products, new technologies, including product design costs, experimental costs of raw materials or semi-finished products, and any other costs of auxiliary services (such as the wages and salaries of the employees engaged in the research and the development of new products and technologies) can be treated as allowable management fees.

- Fifty percent of the costs incurred by profit-making enterprises from the R&D of new products and new technologies, provided that these costs exceed those of the previous year by 20 percent or more, are deductible against business income tax payable for the year (the "20 percent rule"). However, no carry-forward of unused

R&D costs is allowed. Loss-making enterprises can deduct R&D costs as they are incurred against their income tax payable and, unlike profit-making enterprises, do not have to conform with the "20 percent rule."

A2.78 There is also a tax credit given to the foreign investment enterprises which have increased R&D expenses.

Rates

A2.79 From 1 January 1994, all domestic enterprises became subject to the enterprise income tax on their income from production and business operations, whether derived from inside or outside of China.

A2.80 Profits are taxed at a flat rate of 33 percent.

A2.81 Taxable income is defined as the excess of gross income over permissible deductible costs and other expenses. The taxpayer's total income includes the following:

- Income from production and business operations
- Income from the transfer of property
- Income from interest
- Income from leases
- Income from royalties
- Income from dividends
- Other income.

A2.82 The following items are deductible in computing taxable income:

- Interest on loans from financial institutions paid in the course of production and business
- Interest on loans from non-financial institutions, where the interest is not higher than that charged by financial institutions on the same category of loan for the same period
- Wages paid to staff and workers
- Payments to workers' trade union funds, welfare funds and educational funds, which are deductible on the basis of 2 percent, 14 percent and 1.5 percent, respectively, of total taxable wages
- Donations to charities and relief funds, up to a maximum of 3 percent of annual taxable income.

A2.83 Additional rules apply to foreign investment enterprises. Their income is in principle also taxed at 33 percent, but because more than 80 percent of the foreign investment is in the special economic zones (see 1.6) the effective rate applying to foreign investment is 15 percent or 24 percent. On dividends, interest, royalties and taxable capital gains earned by non-residents there is a final withholding tax of 10 percent of the gross payment. It should be noted that the rates of withholding taxes can be reduced under tax treaties.

Losses

A2.84 Losses are generally deductible by a taxpayer in computing taxable income in a year. Under the Foreign Income Tax Law, losses incurred by a taxpayer in a tax year may be carried forward for five years; however, no provision is made for the carry-back of losses. Losses realized by one branch can be used to offset income from another branch.

A2.85 No distinction is made between capital losses and ordinary business losses, since capital gains are taxed in the same way as ordinary income.

Investment Incentives

A2.86 Generally speaking, tax incentives are granted to foreign enterprises provided that such foreign enterprises meet certain requirements laid down in the Chinese Tax Law. There are five major qualification criteria for tax incentives. Each of these qualifications deals with an enterprise's specific aspect.

A2.87 The qualification criteria for tax incentives are as follows:

- The entity must be a so-called "foreign investment enterprise."
- Only designated industries are eligible for tax incentives. Designated industries are those that are production-oriented, advanced technology-oriented or export-oriented. Sectors such as agriculture, forestry and animal husbandry, or infrastructure (such as harbours, highways, railways, airport power generation and coal mines) are also designated.
- The location in which the enterprise is established (or will be established) is relevant. There are different zones or districts where tax incentives apply.
- The operating period of the enterprise must be considered.
- The investment amount must be of a certain level.

A2.88 For the purpose of investment incentives, China has established (among others) Special Economic Zones (SEZs) in the cities of Shenzhen, Zhuhai, Shantou and Xiamen, in Hainan Province, and in Pudong New Area in Shanghai. The tax rate in the SEZs is 15 percent.

A2.89 Particularly important tax incentives are tax holidays (see 1.6.1) and reduced tax rates (see 1.6.2).

A2.90 ***Tax Holidays.*** The Foreign Income Tax Law provides for tax holidays that apply to different types of enterprises. Under certain conditions, the period of tax holidays varies from 3 to 10 years. For huge infrastructure projects, this period could be extended to more than 10 years. However, a tax holiday of more than 10 years is the exception rather than the rule. The type of enterprise and the duration of the operation are decisive when determining tax incentives. The location seems to be disregarded.

A2.91 The 10-year tax incentive program includes a tax exemption for the first 5 profit-making years and a 50 percent tax reduction for the following 5 years with respect to the following types of enterprise:

- Equity joint ventures with a term of operation of 15 years or more that are engaged in port and pier construction projects

- Enterprises with a term of operation of 15 years or more that are engaged in infrastructure projects or in agricultural development in the Hainan Special Economic Zone

- Enterprises established in the Pudong New Area of Shanghai that have terms of operation of 15 years or more and are engaged in construction projects in energy and transportation.

A2.92 The 5-year tax incentive program provides a 2-year tax holiday, followed by a 3-year 50 percent tax reduction for all foreign investment enterprises engaged in production that operate for a period of 10 years or more. A further tax reduction of 15 percent to 30 percent for an additional 10 years may be granted if the enterprise operates in farming, forestry, or animal husbandry or is located in a remote or economically underdeveloped area.

A2.93 The 3 year program consists of a 1 year tax exemption followed by a 2-year 50 percent tax reduction and is granted to the following enterprises:

- Branches of foreign banks and joint-venture banks established in the SEZs with a term of operation of 10 years or more. To qualify, the banks must have foreign investment capital or, in the case of branches, head office working capital allocations exceeding US$10 million.

- Equity joint ventures with a term of operation of 10 years or more that have been established in the High-Technology and New-Technology Industry Development Zones.

- Enterprises established in the SEZs which are engaged in service industries.

A2.94 The above-mentioned exemptions and reductions do not apply to enterprises engaged in the exploitation and development of oil, natural gas or rare or precious metals.

A2.95 ***Reduced Tax Rates***. In China there are reduced tax rates of 24 and 15 percent for enterprises doing business in special areas of China. Here, the review will be limited to reduce rates for the western regions, since these incentives are by far most important for Kazakhstan.

A2.96 On 17 September 1999, the State Administration of Taxation issued a notice which provided that a 15 percent income tax rate would apply in the middle and western regions from 1 January 2000 to encourage foreign investment there. If the foreign investment is simultaneously recognized as technologically advanced, or if exports make up more than 70 percent of the annual value of the output, the income tax rate could be further reduced, but not to below 10 percent.

A2.97 Furthermore, in 2002 the State Administration of Taxation issued a notice on the implementation of other tax incentives for the western regions. This notice implied that all enterprises located in the western region would be taxed only at a 15 percent rate if more than 70 percent of the business is a business encouraged by the state. Moreover, enterprises engaged in transportation, hydro, electricity, postal communication and broadcasting/television projects may enjoy income tax exemptions in the first two years from the day of the start of the operation, and a 50 percent reduction of the income tax rate of 15 percent in the following three years.

International Aspects

A2.98 ***Unilateral Relief from Double Taxation of Income.*** Residents are taxed on income derived from both inside and outside of China. The credit method is used to grant relief from the effects of international double taxation. The amount of the credit is limited to the amount of Chinese tax that would otherwise have been payable on the foreign income. There is a per country limitation: the total foreign tax paid on income from all sources in one particular foreign country is credited up to the amount of the Chinese tax that would otherwise have been payable on that income. There is, however, no limitation with respect to the type of income. Tax sparing relief is available under most tax treaties concluded by China.

A2.99 The amount of credit that can be claimed by a foreign investment enterprise is limited to the lesser of the following:

- The amount of foreign tax paid, or
- The amount of Chinese tax that would otherwise be payable on the amount of income derived from a foreign country, which is determined according to the following formula:

$$\text{tax payable on total income} \times \frac{\text{income from a foreign country}}{\text{total income}}.$$

A2.100 In computing income from a foreign country, deductions may be made for costs, expenses and losses that are attributable to the obtaining of the income and are allowed in accordance with the Chinese Tax Law and regulations.

A2.101 Where the foreign tax paid is less than the amount of Chinese tax payable, the taxpayer can deduct only the foreign tax in computing taxable income. If the amount of foreign tax paid exceeds the Chinese tax otherwise payable, the excess portion cannot be deducted as a credit nor as a business expense; it can, however, be carried forward for five years.

A2.102 ***Treaty Relief from Double Taxation of Income.*** Whenever taxation has an international element, domestic rules may be modified by the provision of a relevant tax treaty. Although the main laws governing the taxation of foreign investments and businesses have been in existence for only a short time, China has been remarkably quick to institute a program for the negotiation of tax treaties. The first tax treaty China concluded was with Japan in 1983, and since then China has concluded more than 80 treaties.

A2.103 The tax treaties are based on the OECD Model of Double Tax Convention and the UN Model Double Tax Convention. They all require China to provide a credit to residents for foreign tax paid on foreign income and may also grant exemptions from Chinese tax for Chinese-source income.

A2.104 Where a resident of a treaty state derives dividends, interest, royalties or rent in China (other than through a permanent establishment in China), the rate of the withholding tax is reduced from 20 percent to either 15 percent or 10 percent. In many treaties, the withholding tax on Chinese-source interest earned by established financial institutions of a treaty state is exempt.

General Remarks

A2.105 Annex 2, Table 7 gives an indication of the tax structure in China.

Annex 2, Table 7: Tax Structure in China, 2000-2005

	2000	2001	2002	2003	2004	2005	
					Prel.	Budget	Proj.
Total revenue	15.3	17.0	18.2	18.7	19.4	18.8	19.6
Tax revenue[2/]	14.1	15.7	16.8	17.1	17.6	17.1	18.2
Taxes on income and profits	2.9	4.0	4.5	4.1	4.3	4.2	4.5
Taxes on goods and services	9.5	10.0	10.6	11.1	11.2	10.8	11.7
Other taxes	1.7	1.7	1.7	1.9	2.1	2.1	2.1
Nontax revenue	1.2	1.3	1.5	1.6	1.8	1.7	1.4

Source: IMF (2005).

Sources

IMF (2005), "People's Republic of China Staff Report for the 2005 Article IV Consultation." IMF Country Report No. 05/411, International Monetary Fund, Washington, DC.

http://ip-online2.ibfd.org/chti/ via www.ibfd.org.

ANNEX 3: INTERNATIONAL COMPARISON TABLES

	Kazakhstan	**Slovak Republic**	**Poland**
Corporate Tax Rate	* 30 percent profit tax * withholding taxes on dividends and interest of 15 percent (except bank int)	* 19 percent profit tax * no taxes on dividends * 19 percent withholding tax on interest	* 19 percent profit tax * 19 percent withholding tax on dividends and interest
Depreciation Schedule	* declining balance method * straight line depreciation under ITPs * beneficial arrangements for subsurface users	* straight line method, or * accelerated method must be applied consistently	* straight line method
Special Regimes	* 10 percent CIT for agricultural sector * special regime for subsurface users who are also subject to excess profit tax in addition of CIT * no CIT, property tax, and land tax in SEZs	-	* 1994 – 2002: SEZs with full CIT exemption for 10 yrs and 50 percent exemption for next 10 yrs * since 2002: cash grants up to 50 percent of investment expenditure
Simplified Regimes	* simplified regimes for small business entities	-	-
Investment Incentives	For investments eligible for ITPs: * shortened period of depreciation (5 year straight line depreciation) * exemption of property tax * exemption of customs duties * benefits in kind	* 5 year tax holiday (100 percent CIT credit) for foreign investors incorporated in Slovak Republic before '04 * 10 year credit for companies that qualify as strategic investors	* companies operating in areas with high unemployment may benefit from more favourable tax depreciation * a coefficient of 2 may be applied for assets that may rapidly become obsolete due to technical developments
Inventory Valuation	* FIFO, LIFO, average cost or specific identification must be applied consistently * inventory revalued monthly * gains are part of aggregate annual income	* purchase price, weighted-average purchase price, FIFO or average cost * inventories produced internally are valued at production costs	* FIFO, LIFO or weighted average cost must be applied consistently
Tax Treatment of Losses	* may be carried forward up to 3 yrs * may be carried forward by subsurface users up to 7 yrs	* may be carried forward up to 5 yrs	* may be carried forward for 5 yrs. Up to 50 percent of the loss may be set off in each year

	Russia	China	Hungary
Corporate Tax Rate	* 24 percent profit tax (incl. interest) * a 9 percent (15 percent for substantial corporate shareholders) withholding tax on dividends	* 33 percent profit tax (incl. dividends and interest)	* 16 percent profit tax * 25 percent withholding tax on dividends * 0 percent withholding 'tax' on interest
Depreciation Schedule	* straight line method, or * accelerated (non-linear) method	* straight line method * accelerated method may be applied in case of high wear * residual value of 10 percent is assumed	* straight line method * declining balance method * production proportionate, or * depletion method
Special Regimes	* for the oil, mineral and gas business * in the Kaliningrad and Magadan SEZs no customs- and export duties	* reduced rates of 24 percent and 15 percent for enterprises doing business in SEZs	-
Simplified Regimes	* small legal entities/individual entrepreneurs may choose between a 6 percent cash tax or a 15 percent profit tax	-	-
Investment Incentives	* accelerated depreciation is available to all businesses * agricultural businesses may apply a coefficient up to 2, to general depreciation rates * property that contributes to the capital of a Russian company is exempt from customs duties	* tax holiday periods varying from 3 to 10 yrs for specified investment projects in SEZs	* many incentives repealed from 2003 * Ministry of Finance may still grant tax credits * small businesses who take a loan from an FI for acquisition of tangible assets may deduct 40 percent of interest paid from their tax
Inventory Valuation	* production cost, weighted average cost, FIFO or LIFO method must be applied consistently * inventory is valued at year-end	* FIFO, LIFO, moving average or weighted average must be applied consistently	* FIFO, acquisition cost or weighted-average cost method may be applied
Tax Treatment of Losses	* may be carried forward up to 10 yrs	* may be carried forward up to 5 yrs	* may be carried forward indefinitely * agricultural companies may carry losses back 2 years

ANNEX 4: SIMPLIFIED REGIMES IN KAZAKHSTAN

A4.1 Apart from the generally established taxation regulations, certain types of SMEs can apply for a special tax regime with simplified payment procedures for the social tax (ST), the corporate income tax (CIT), and the personal income tax (PIT). The special tax regime can be used by (i) individuals and firms engaged in small business activities (except for the production of excised products, consulting, financial and accountancy services, sale of oil products, glassware collection, subsoil usage, and certain licensed activities); (ii) peasant farms; (iii) agricultural enterprises; and (iv) the owners of gambling and certain entertainment places (bowling, carting, billiards and lotto).

A4.2 **Individual entrepreneurs** can choose to pay taxes under (i) a *single-use coupon,* which can be applied by individuals (without registering as an individual entrepreneur) whose activity is individual and episodic (does not exceed 90 days per calendar year), (ii) a *patent,* which can be applied by registered individuals whose activity is individual and if their revenue does not exceed 2 million tenge (US$16,000) a year; or (iii) a *simplified declaration,* which can be applied by individuals whose activity involves no more than 25 people (including an individual concerned) and if their revenue does not exceed 40 million tenge (US$330,000) a year. **Small firms** can use a *simplified declaration* regime only (with a revenue ceiling of 100 million tenge [US$829,000] a year and with a limit for hired staff of 50 people).

A4.3 **Peasant farms** which produce, process and sell their agricultural products (except for excised products) can use a special tax regime by paying a *single land tax* (covering the PIT, VAT, land tax, transport tax and property tax) of 0.1 percent of the estimated land plot's value and a *social tax* of 20 percent of the monthly base unit[58] (decreased by the amount of social contributions to the State Social Security Fund [SSSF] per each employee, as well as the head and the members of a farm). **Agricultural enterprises** which produce, process and sell their agricultural products (except for excised products) can apply for a *patent* which costs 20 percent of the total annual tax commitments (covering the CIT, ST [decreased by the amount of SSSF social contributions], land tax, property tax, transport tax and VAT).

A4.4 **The owners of gambling and certain entertainment places** can apply for a special tax regime and pay a *fixed aggregate tax* which is subdivided into a CIT/PIT of 30 percent of the total amount and a VAT of 70 percent of the total amount paid. The fixed aggregate tax rates are set by local legislative bodies for each piece of equipment (cards/roulette-playing table, game-playing machine, bowling lane, cart, or billiard table) or organizer (in the case of a lotto).

[58] The monthly base unit is a unit measure used for defining pensions and other social payments, as well as various tax payments and fees to the budget. The monthly base unit is set in the budget law every year and is adjusted to the next year's expected CPI inflation. In 2005 it was set at 971 tenge (US$7) and in 2006 it is set at 1,030 tenge (US$8.5).

Annex 4, Table 1: Tax Payments and Other Contributions under the Special Tax Regime For Individuals and Firms Engaged in Small Business Activities

	Single-Use Coupon	Patent	Simplified Declaration
Individual Entrepreneur	PIT: daily payment amounts which are determined by local maslikhats (local legislative bodies) based on surveys made by local tax authorities Social tax: exempt	**Annual revenue of up to 2 million tenge:** PIT: 1 percent of revenue Social tax: 1 percent of revenue minus social contributions to the State Social Security Fund (SSSF)*	**Quarterly revenue of up to 10 million tenge:** PIT: 1.5 percent of revenue Social tax: 1.5 percent of revenue minus social contributions to SSSF*
Small Firm			**Quarterly revenue of up to 25 million tenge:** CIT: 1.5 percent of revenue Social tax: 1.5 percent of revenue minus social contributions to SSSF*

* The State Social Security Fund (SSSF) is an extrabudgetary fund which was created to insure people in cases of disablement, loss of breadwinner status, or loss of job, and started operating since January 1, 2005. SSSF social contributions are calculated as a percentage share of gross salary (net of deductions, such as mandatory pension contributions to the Accumulative Pension Funds) or minimal wage (in the case of the special tax regime for the self-employed):
Starting from January 1, 2005: 1.5 percent of gross salary/minimal wage
Starting from January 1, 2006: 2 percent of gross salary/minimal wage
Starting from January 1, 2007: 3 percent of gross salary/minimal wage.

ANNEX 5: INVESTMENT TAX PREFERENCES (ITPS) IN KAZAKHSTAN

A5.1 Investment preferences are regulated by the Republic of Kazakhstan Law on Investments dated January 8, 2003. This Law determines the legal and economic basis for encouraging investments, ensures that investors' rights are protected when making investments in Kazakhstan and determines measures of government support to investments and procedures for the resolution of disputes where investors are involved.

A5.2 A new mechanism for delivering government support to investments has a range of serious advantages.

A5.3 First of all, the Law provides for equal support to and encouragement of both domestic and foreign investors. The time for the consideration of applications for investment preferences has been significantly reduced (30 working days) and the procedures for issuing such preferences have been simplified. In addition, the current Law does not have a minimum threshold for investments, which enlarges its scope of application to cover small and medium enterprises investing capital in priority economic sectors.

A5.4 The Law provides equal rights and opportunities to foreign and domestic investors for receiving guarantees against requisition and nationalization, for the time when they are subject to government inspections, for the resolution of investment disputes, for the use of revenues and for the indemnification of damages caused by actions of government agencies and their officials.

A5.5 Pursuant to the Law, the following **investment preferences** can be provided through signing a contract with the competent authority:

(a) Investment tax preferences, including:

  (i) Corporate income tax preferences
  (ii) Property tax preferences
  (iii) Land tax preferences

(b) Exemption from customs duties
(c) Government in-kind grants.

A5.6 **Investment tax preferences** are provided for a period which is determined depending on investments into fixed assets.

(i) Corporate income tax preferences can be issued to the following:

- Existing enterprises implementing investment projects to enlarge and to refurbish operating productions: in such a case these enterprises are entitled to deduct the cost of placed fixed assets from the total annual revenue during not more than 10 years.

- Newly established enterprises implementing investment projects within one (only one) activity: in such a case these enterprises are exempted for 10 years from a tax on income gained from investment activity *(this provision was introduced from January 1, 2005 through amendments to the Tax Code).*

For your information (FYI). *In accordance with the current legislation, the taxable income of taxpayers (legal entities) properly adjusted and reduced by amount of losses is taxed (corporate income tax) at a 30 percent rate.*

(ii) **Property tax preferences** entitle a taxpayer to exemption from property tax for newly placed fixed assets under investment projects for up to five years;

FYI. ***The*** *taxable base is the annual average depreciated cost of tax objects determined on the basis of accounting data. Legal entities and individual entrepreneurs calculate property income as 1 percent of the annual average cost of tax objects.*

(iii) **Land tax preferences** entitle taxpayers to an exemption from the land tax for land plots acquired and used for the implementation of investment projects for up to five years.

FYI. *According to the current legislation, some categories of land are subject to taxation. And tax rates are determined for each category based on certain criteria, in particular, the following:*

a. Agricultural land – base rates are determined per hectare and are differentiated by soil quality and yield class. Base rates range from KZT 0.48 for yield class 1 to KZT 202.65 for yield class 100+.

b. Land in settlements (including land for housing, including supplementary facilities) – base rates are determined per square meter depending on location and range, from KZT 0.09 for land used for housing in villages to KZT 28.95 in Almaty for land not used for housing.

c. Land for industry, transport, communications, defense and other non-agricultural designations (industrial land)—base rates for industrial land in settlements are determined in accordance with base rates for land in settlements. Base rates for industrial land outside of settlements are determined per hectare, pro rata yield class and range from *KZT 48.25 for yield class 0 to KZT 5,790 for yield class 100+.*

- The date for the application of investment preferences is determined in contract in accordance with the Tax Code of the Republic of Kazakhstan.

- As for activities performed by legal entities for which the special tax regime is applied, as well as activities under natural resource contracts, such investment preferences are not provided.

- Investment tax preferences are not provided for fixed assets provided to a legal entity as a government in-kind grant.

A5.7 **Exemption from customs duties** is provided when importing equipment and its component parts for the implementation of an investment project.

- Exemption from customs duties is provided for the period of contract life but not more than five years after the contract is registered.
- Decisions concerning the exemption from customs duties and its prolongation are made by the competent authority in charge of investments.

FYI. *According to the current legislation, rates of customs duties are determined following the general customs framework and calculated in accordance with codes in the Foreign Economic Activity Commodity Nomenclature (FEACN). At present, there are about 11,000 commodity items. Export duties are collected only when exporting skins and scrap metal.*

A5.8 **Government in-kind grants** are provided, following the established procedures, by the competent authority in coordination with the relevant government agencies in charge of the management of state property and land for temporary free use or for land use with the further transfer of in-kind grants into ownership, provided that all investment obligations under the contract are fulfilled. This means that a government in-kind grant is handed over after the investor fulfills its obligations under the investment contract.

A5.9 Government in-kind grants are assessed by market value following the procedures established by the RK legislation.

A5.10 The maximum amount of an in-kind government grant shall not exceed 30 percent of the investments into fixed assets of a legal entity in the RK (size of investment project).

A5.11 If the assessed value of a requested government in-kind grant exceeds the above ceiling, a legal entity in the RK can receive the requested property covering the difference between its assessed value and the maximum size of the government in-kind grant.

FYI. *Government in-kind grants may include land plots, buildings and facilities, machinery and equipment, computers, measurement and control instruments and devices, vehicles (except for motor vehicles), production and household equipment.*

A5.12 Since 1997 and up to January 1, 2007 within the framework of state support for investments, 707 contracts have been signed totaling KZT 954.9 billion (US$7.2 billion), including the investments shown in Table 1 of this annex.

Annex 5, Table 1: Investments Attracted through Government Support

Year of Signing the Contract	Number	Investment into Fixed Assets	
		KZT billion	US$ million
In compliance with the RK Law on "On state support of direct investments" of February 28, 1997, there have been:			
1997	11	2.46	33.4
1998	72	17.9	229.5
1999	67	101.1	847.1
2000	76	34.6	243.5
2001	115	188.2	1 282.9
2002	2	0.126	0.822
Subtotal	**343**	**344.4**	**2 637.2**

Year of Signing the Contract	Number	Investment into Fixed Assets	
		KZT billion	US$ million
In compliance with the RK Law on "On investments" of January 8, 2003, there have been:			
2003	64	52.95	361.9
2004	84	103.2	777.1
2005	117	290.8	2 171.9
2006	99	163.6	1 292.9
Subtotal	**364**	**610.55**	**4 603.8**
Grand Total	**707**	**954.9**	**7 241.0**

A5.13 Currently, there are 331 active contracts, totaling KZT604.6 billion (US$4.5 billion).

A5.14 Out of the total number of contracts, terms of tax credits and preferences totaling KZT 344.6 billion (US$2.6 billion) have been completed for 255 contracts. Owing to investors' defaults on obligations, 121 contracts totaling KZT 5.7 billion have been discontinued.

A5.15 Among active contracts in the processing industry, the number of projects is growing in the production of the following items:

- Non-metallic goods (brick, gypsum, concrete, roofing materials, glass)
- Food products (including beverages), and plastic articles.

A5.16 A growing number of projects are oriented to the expansion of the fixed capital of enterprises engaged in transport services delivery, agriculture, and the production and distribution of energy, gas and water (see Annex 5, Table 2).

Annex 5, Table 2: Sectors with a Growing Number of Projects

Sector	Number of Contracts	Investments KZT billion
1. Processing industry	227	366.5
2. Transport activities	29	101.7
3. Agriculture	24	13.6
4. Production and distribution of energy, gas, water	17	65.4
5. Construction	20	23.1
6. Social Services Delivery	5	9.2
7. Tourism	9	25.1
TOTAL:	**331**	**604.6**

A5.17 A major investment flow is oriented toward the expansion of the material and technical base of the processing sector (227 projects totaling KZT366.5 billion or 68.6 percent of the total number of signed contracts). Considerable investments are being made in the transport sector (KZT101.7 billion). This is due to the implementation of transport services projects.

ANNEX 6: INFLATION PROOFING THE CORPORATE TAX SYSTEM

A. INFLATION AND INCENTIVE RATIONALIZATION: TWO OPTIONS FOR CORPORATE TAX REFORM

A6.1 The first option for corporate tax reform is to allow a first year write-off of depreciable assets, to disallow interest expense as a deduction, to exclude interest income from taxable income and to add the proceeds of sales of already depreciated assets to taxable income in the years of the sale. The second option involves economic depreciation, the deduction of interest expense, the carry-over of tax credits from loss making to profitable years, and the taxation of interest income. The second option would require replacement cost accounting for inventories, or at least allow LIFO evaluation rules to be used. The first option does not involve any special treatment for inventories or goods sold from inventories.

Option 1: Expensing

A6.2 An immediate first year write-off, or expensing, as this system is also called, is administratively much simpler than conventional depreciation allowances, especially under a system that includes inflation adjustment. Moreover, this system avoids the difficulties of collecting taxes on interest income and is also immune to inflation, if (at least) tax credit carry-overs are properly indexed.

A6.3 The combination of an immediate write-off and the disallowance of interest expense (and the implied exemption of interest income) is attractive for its administrative simplicity but presents three major problems. The first problem is its start-up costs. Once the system has been in place for a few years the average corporate tax revenues should be at least as high as under the current system, mainly because of the disallowance of interest expense. However, in the first few years, corporate revenues will decline dramatically under this accelerated depreciation scheme. This is especially likely if the not-yet-depreciated part of the existing capital stock is also brought into the system. If this is done at once, corporate tax revenues are likely to be zero for some years to come. Not bringing old capital in would create the awkward situation of different rules for old and new capital. Moreover, such rules might be difficult to enforce with a market for second-hand machinery. Also, the different treatment of interest payments under the two systems would create problems in a hybrid system.

A6.4 A second problem with first-year expensing, as this system is called, involves asset sales and the repayment of depreciation allowances taken on these sales. Since this would need to take place by the adding of proceeds from asset sales to taxable income, firms could greatly reduce their tax burden by selling assets in loss-making years and buying them back in profitable years. The value of depreciation allowances could substantially exceed the purchase price through the repeated application of this system, especially at the current high level of interest rates.

A6.5 A third problem with expensing is a more fundamental one. Expensing is a tax system designed for corporations engaged in real activities as opposed to financial transactions. The fact that under this system interest earnings are not taxed and interest payments are not deductible implies that financial institutions would escape corporate tax altogether [59]/: such institutions

[59] Non-interest income of banks would not escape taxation under expensing.

make their profits by charging higher lending rates than borrowing rates. This is a major problem. Also, experience in Israel with different inflation adjustment mechanisms has shown that treating different sectors of the economy differently opens up substantial possibilities for tax avoidance, thus compounding the revenue effects highlighted in earlier paragraphs. Introducing a separate and different tax system for financial corporations would create similar avoidance problems.

Option 2: Economic Depreciation with Inflation Adjustments

A6.6 The second option involves economic depreciation, the deduction of interest expenses, the carry-over of tax credits from loss making to profitable years, and the taxation of interest income (and the appropriate inflation adjustment of all these items). In a world of stable prices, the statutory tax rate and the marginal effective tax rate are equal under such a regime. However, in the absence of complete inflation adjustment, inflation distorts the calculation of real economic income resulting from investment in depreciable assets. It also changes the real tax burden owing to the taxation of nominal interest income and the deduction for nominal interest expense. To deal with this problem, it is necessary to adjust depreciation allowances, interest income, and interest expenses for the loss of purchasing power caused by inflation. In addition, carry-overs of nominal tax credits would need to be adjusted for inflationary erosion and the time delays involved. This approach (inflation adjustment) has been implemented in some developing countries that have been plagued by chronically high inflation, but is not used in any developed country. Kazakhstan already has a system, admittedly incomplete, of inflation adjusting depreciation allowances; the major change would therefore be the disallowance of the deduction of the inflation component in nominal interest payments, allowing a LIFO system of inventory accounting in the calculation of taxable profits, and adjustment of carry-overs of tax credits. Especially the switch from nominal to real interest deductibility would certainly lead to an immediate and substantial increase in corporate tax revenues from the non-financial corporate sector, although it is difficult to predict exactly by how much corporate tax revenue would increase.

Treatment of Inventories under Each Option

A6.7 Currently, the deduction of the costs of goods sold from inventories is based on historical costs where available; otherwise it is based on average acquisition costs. In times of rapid inflation, this results in a substantial over-statement of taxable income. Income would be measured more accurately if taxpayers were allowed the option of using last-in-first-out (LIFO) inventory accounting. The use of replacement cost accounting or indexation in conjunction with first-in-first-out (FIFO) or average-cost accounting might be considered, but these options appear to pose too many problems of compliance and administration to be viable options.

A6.8 Hence, under option 2, we recommend allowing LIFO evaluation rules for inventory accounting.

Recommended Option

A6.9 Neither system provides complete immunity for the corporate tax structure from inflation. The first system is imperfect because a general inflation index would have to be used rather than the relevant asset price, which could generally not be available. The second system would also not provide complete immunity: the lumpiness of investment would regularly reduce taxable profits below zero, forcing the firm to carry such losses forward. This destroys the simplicity of first-year expensing and reintroduces dependence of the corporate tax structure on inflation.

A6.10 Even the system proposed in the preceding paragraphs would leave a major channel for inflation effects open if carry-overs of tax credits remained fixed in nominal terms as they are now. These credits, earned in loss-making years, are fixed in nominal terms when carried over to subsequent profitable years; they therefore become less valuable as time goes by for two reasons. First, inflation wouldl erode their real value, since they are currently fixed in nominal terms. Second, even if carry-overs were indexed to inflation, it would still be preferable not to defer them as long as real interest rates are positive. These two problems could be solved in one go by adjusting carry-overs not by inflation but by nominal interest rates. This would imply paying interest on outstanding tax credits. In such a case firms would be indifferent to either taking tax credits in the present or carrying them over to subsequent periods. Thus, the possibility of the need to carry-over tax credits with such an adjustment would not cause distortions in the economy.

A6.11 However, the main difference lies in their initial revenue response and their effect on corporate tax payments by the financial sector. The first system, properly accounting for capital gains and losses due to inflation, would immediately yield a substantial increase in revenues because the inflationary erosion of monetary liabilities (debt) would be added to taxable profits. Switching to first-year expensing, however, would probably wipe out all revenues from corporate taxation for several years to come, because of the start-up problems discussed earlier and because it would effectively exempt the financial sector from corporate taxes. It is for this reason that no country in the world has accepted first-year expensing. Therefore, we recommend the second option, properly accounting for inflation-induced capital gains and losses in the definition of taxable profits.

Implementation Issues

A6.12 Implementation problems should be an important consideration in the design of an inflation-insensitive corporate tax system. Theoretically appealing solutions need to be judged in the light of the prevailing circumstances in the country considered; these circumstances include the level of bookkeeping, the standards of tax compliance and enforcement, the quantity and quality of the available personnel responsible for administering the adjusting system, and, finally, the administrative burden the proposed system implies for the corporate sector itself. A built-in trade-off exists between fairness and accuracy on the one hand and administrative feasibility and chances of enforcement on the other. In what follows we discuss the subjects listed below:

- The appropriate basis for inflation adjustment
- The implementation pitfalls of the switch to real interest rate deductibility and the effects of different methods on financial corporations
- The choice of a price index
- Indexing versus forward looking adjustment
- Transition problems and the potential of an excessive tax burden.

The Appropriate Basis for Inflation Adjustment

A6.13 There are four methods for adjusting taxable profits for the inflation component in (net) nominal interest payments. The first three use balance sheet information about stocks of assets and liabilities to derive the inflationary erosion of nominal debt; the fourth tries to deduce that number directly from interest payments. The balance sheet based methods add an estimate of net debt times inflation to taxable profits. The fourth, income based, method would scale down the proportion of nominal interest payments that firms are allowed to deduct from corporate profits

by a factor reflecting the inflation component in total interest payments. These four methods are as follows:

a. Equity minus non-monetary assets, as was at one time used in Israel and Brazil
b. Monetary assets minus monetary liabilities, as is done in Argentina and Uruguay
c. The net worth concept as is used in Chile
d. Direct measurement of gross income and deductions by the adjusting of interest payments (this was at one time part of a tax reform proposal in the United States ["Treasury-I"]).

A6.14 The first three options are equivalent, as the simple manipulation of accounting identities shows. Since total assets equal total liabilities, the difference between non-monetary assets and non-monetary liabilities equals exactly minus the difference between monetary assets and monetary liabilities.[60] Hence, adding inflation times the latter difference to taxable profits is equivalent to subtracting inflation times the former difference from taxable profits. Since the root of the problem is the erosion of the real value of net monetary liabilities, (b) seems the most natural of the three. The fourth option, direct income adjustment, was at one time proposed in the United States, but creates either an excessive administrative burden or causes serious problems with the collection of taxes from financial institutions.

A6.15 The basic problem with the fourth, income based, approach is the following: one cannot from interest payments and debt level alone derive the average interest rate. The average holding period is the missing piece of information: there is no way to deduce from the reported interest payments during the tax year whether these payments are due to a loan held for the entire year at the corresponding average interest rate or to a loan held for, say, half a year at an interest rate twice as high. Clearly, for equal interest payments, the inflation component will be a much larger share of the total nominal interest payments in the case of the one-year/low interest rate loan than in the case of the six-month/high interest rate loan. One way out of this problem is to ask firms to report all changes in monetary assets and liabilities on a monthly or even a weekly basis, as has been done in some high inflation countries (for example, in Israel in the last decades of the twentieth century). This would allow reasonably exact assessments of the timing and magnitude of net borrowings and hence the calculation of the average interest rates paid. However, this would in our view impose an excessive administrative burden on firms and tax authorities alike: the current accounting requirements in Kazakhstan call for annual reporting only. There are two alternatives: to assume an average real interest rate and deduce the holding period, or to assume an average holding period of new loans and deduce (implicitly) the average interest rates. The two approaches, as is shown below, have a dramatically different impact on the taxation of financial institutions.

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[60] Balance sheet identity implies that total assets equal total liabilities plus equity:
(1) $NMA + MA = NML + ML$
with NMA non-monetary assets, MA monetary assets, ML monetary liabilities or debt, and NML non-monetary liabilities or equity. (1) can be rewritten as
(1a) $NMA - NML = -(MA - ML)$

A6.16 First we will consider the option of assuming a real interest rate. This was done in the "Treasury-I" proposal, and works as follows. That proposal simply assumes that the average real rate equals 6 percent. The inflation component in interest payments then is calculated by multiplying the total of net interest payments by a factor $p/(6 + p)$; p stands for the rate of inflation in percentage points. The resulting number is then added to taxable profits. This procedure is administratively simple and probably does not create serious distortions in the calculation of taxable profits of corporations engaged in real activity.

A6.17 However, it would, on average, produce substantial tax reductions for the financial sector, reductions due to this particular approximation method alone. The problem stems from the fact that banks, contrary to corporations engaged in real activity, make most of their profits by charging lending rates on nominal assets in excess of the borrowing rates paid over their nominal liabilities. Banks will therefore receive net interest payments even when they do not hold NET monetary assets. Hence, under this method, they will receive a tax credit (since their net interest payments are negative) even if they have zero NET monetary liabilities and therefore should not receive any deduction. Thus, the Treasury-I approach to inflation adjustment would distort corporate incentives to engage in financial as opposed to real activity. We therefore advise against the income based adjustment method.

A6.18 Approaches a, b, and c, those based on balance sheets rather than on profits and loss accounts, would produce no such problem. Under the net monetary liability approach, banks would receive tax credits only as recompensation for inflationary erosion to the extent that they carry positive net monetary assets. At zero net liabilities, there would be no inflation adjustment, and with negative net monetary liabilities banks would increase their tax liabilities just as non-financial corporations would under this system.

A6.19 However, there is another problem which arises only with balance sheet based approximation methods. Taking "beginning of period" net monetary liabilities will underestimate inflationary gains if net liabilities have increased over the year; similarly, taking "end of period" liabilities will overestimate the inflationary gains in a year in which these liabilities have increased. There is no exact solution to this problem short of requiring monthly or even weekly accounts, and this would lead to an excessive administrative burden. However, since the "beginning of period" assumption always provides the opposite bias to the outcome of the other choice, a simple average of the two is a reasonable approximation. This, then, is our recommendation: to take the average of beginning and end of period net monetary liabilities, multiply that number by the appropriate inflation index, and add the resulting estimate of inflationary erosion gain to taxable profits. What constitutes an appropriate inflation index is taken up in the paragraphs below.

The Choice of a Price Index

A6.20 Economic theory suggests that the relevant price index to use for the revaluation of any asset is the market price of that particular asset. This is clearly not implementable in practice: those prices will in most cases simply not be available. This is not just a matter of keeping better statistics; in many cases particular assets are simply not traded or not traded at sufficient frequency for market prices to exist at the time they are required. Hence, there is a need to use a common, generally available price index for all inflation adjustments. An obvious choice is the consumer price index (CPI). A potential problem with the use of the CPI is that it includes indirect taxes such as the VAT. Thus, a change in indirect tax rates (for example, an increase in VAT) would set in motion a series of inflation adjustments for other tax instruments. This is probably not a serious problem, since VAT rates are not changed often and then only by small

amounts compared to inflation rates in Kazakhstan. In any case, it can be avoided by using an index such as the wholesale price index (WPI) or the deflator of GDP at factor costs. Of these two, the WPI is preferable, since it is measured with greater accuracy and at a higher frequency.

Indexing versus Forward-looking Adjustment

A6.21 An often heard objection to inflation adjustments is that such adjustments, when based on actual "ex post" inflation, are backward looking. This would thus build last year's inflation into this year's costs and so trigger inflation inertia with the associated macroeconomic problems. Whether this is a serious problem for the corporate tax system is open for debate. In any case it could be avoided by, for example, basing the adjustments on the mid-year inflation projection for the corresponding year. This would have the added advantage of allowing firms to assess their forthcoming tax burden much earlier than would be possible under actual ex post indexation. Such a scheme would also reduce the incentive to systematically underestimate inflation, since the government would actually lose revenue by doing so.

Transition Problems and the Potential of an Excessive Tax Burden

A6.22 An immediate implementation of the recommendations might cause severe transitional problems. Corporations have structured their finances and incurred their current levels of debt based on the current tax system. Although they could adjust the flow of new debt to a new tax system, the existence of a large stock of old debt, incurred under the old rules, might cause major changes in tax liabilities and, quite possibly, bankruptcies due to the ensuing liquidity problems. Such bankruptcies would bear no relation to economic efficiency, since it would be a change in government rules in the presence of a stock of old debt affected by these rules that would trigger them. Therefore, both efficiency and equity consideration require transitional measures to eliminate any problems caused by unanticipated increases in tax liabilities due to the reforms.

A6.23 The most important rule change from this perspective is the change in allowed interest deductibility. This is likely to lead to substantially higher tax liabilities as long as the old debt stock needs to be serviced.[61] The particular form in which inflation adjustment takes place allows for a simple transitional measure that addresses this problem. The recommendation is to add inflation times average net monetary liabilities to taxable profits. This could easily be phased in gradually without serious incentive effects by, for example, spreading the implementation out over, say, five years. Under such a scheme, only 20 percent of the inflationary erosion of net debt would be added in the first year, 40 percent in the second year, and so on. The new system would then be phased in in the fifth year, in which the complete adjustment term would be added to taxable profits.

A6.24 It is difficult to predict how the **average** tax burden would change under the proposed reforms, among other reasons because that would depend on which inflation rate is likely to prevail.

[61] However, the switch to LIFO accounting rules would reduce the tax liability and would thus alleviate this problem.