CHAPTER 10

EVOLUTION TO A NEW SYSTEM

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An appropriate system of tax assignment would entail subnational surcharges on the individual income tax, the enterprise income tax, and excises; there would be no subnational surcharges on VAT, for reasons outlined in Chapter 8. Analogous to present practice, the enterprise income tax base would be divided among the *oblasts* on the basis of a formula (rather than being attributed to the *oblast* where enterprises are registered, as before 1996), and, contrary to the present situation, the excise tax base would be attributed to the *oblasts* where consumption occurs (and not where importation or production occurs). In some cases, most notably the individual income tax, identification of the local tax as a surcharge might be only formally correct, in that there might be only an *oblast*-level tax, and no central government tax. The redirection of revenue flows implicit in this new system would entail a need for corresponding changes in transfers from the central government. A system of grants such as that proposed in the previous chapter should be introduced to prevent vertical fiscal imbalance and reduce horizontal fiscal disparities.

Movement to the system outlined above would entail substantial changes in tax administration practices, as well as in revenue flows. It is difficult to predict some of the effects on revenue flows because of lack of data, for example, data on consumption, by *oblasts*, of products subject to excises, and on the factors to be included in a formula used to apportion enterprise income among the *oblasts*. Experience under the system of formula apportionment adopted at the beginning of 1996 will shed light on this. Thus, the transition should probably be accomplished gradually, to allow time for the tax administration to adjust to one change before being confronted with another, to allow time to gather the data needed both to administer the program and to predict its effects, and to avoid the need for *oblasts* and *rayons* to make wrenching adjustments to altered revenue flows. It is, thus, useful to decompose the shift into two stages. In Stage 1, tax-sharing rules would be rationalized and combined with a new system of grants. Stage 2 would see a shift from tax sharing to tax surcharges.

The following discussion describes transition to a system of fiscally strong subnational governments, in which such governments would have substantial control over marginal sources of revenue. At the end of the transition process, *oblast* governments would have access to surcharges on the individual income tax, the enterprise income tax, and excises. Because the treatment of the individual income tax would not change (except for the conversion from tax sharing to surcharges during Stage 2), attention is concentrated on changes in the treatment of VAT, the enterprise income tax, and excises. If only weak subnational governments were desired, subnational use of surcharges might be more limited, perhaps to the individual income tax and some excises. In that case, grant finance would be much more important and the transition described below would be truncated in obvious ways. In particular, only Stage 2 would occur, and only for the individual income tax and excises.

While a tentative three-year timetable for transition is suggested, this is only indicative; if stages can be accomplished more quickly and the process of transition accelerated, so much the better. Moreover, the stages should not be seen as airtight; some developments described as occurring during Stage 2 might occur simultaneously with others described as occurring during the first stage.[1] For example, the shift to surcharges on the individual income tax and consumption-based surcharges on excises, assumed to occur during Stage 2 for most products, might occur during Stage 1 for some. Indeed, there is much to be said for compressing the transition into a single stage, to be completed immediately, to avoid the vagaries of transition, such as pleas for delays, special treatment of certain *oblasts*, and so on. Whether this is realistic or not is uncertain.

This timetable was originally devised in late 1995, based on practice current at that time. Since then, several developments have occurred, namely, the shift to formula-based division of corporate tax revenues and the promulgation of new tax-sharing rates for 1996.

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[1] An earlier draft of this book proposed a three-year shift to a system of tax sharing for the enterprise income tax based on a formula that reflects the location of economic activity. As noted in Chapter 3, this shift has been accomplished, starting in 1996.

STAGE 1: RATIONALIZATION OF TAX-SHARING RULES

This stage has already begun for *the enterprise income tax*. Revenues continue to be shared with the *oblasts*, but the basis of sharing has begun to change. In particular, part of the revenue from this tax is shared on the basis of a formula that reflects the location of the economic activity of enterprises (payrolls, property, and sales at origin), instead of the registration of enterprises. As noted earlier in the discussion of Table 7.2, there may be some large shifts in flows of revenues between *oblasts*, and from *oblasts* (and *rayons*) where enterprises are registered to those where productive activity occurs. If the formula was also to include a measure of sales on a destination basis, there would presumably be further shifts in revenues, away from *oblasts* where production occurs to those where consumption occurs; data needed to document this are unavailable. In any event, subventions would be adjusted to offset most of these shifts.

During this stage, VAT would also be eliminated as a source of shared tax revenues. Revenues from excises should be shifted from *oblasts* where production and importation occur to *oblasts* where consumption occurs. The proposed sharing could be based on estimates of consumption of taxed products, by *oblasts*. If this is not feasible, revenues from excises should not be shared. Such a shift in the tax-sharing rules would have relatively little effect on *oblast* revenues, except in those *oblasts* where production and importation of goods subject to excises are concentrated. It is assumed that these would be offset by changes in sharing rates and subventions. There is no reason that such a shift should follow the same timetable for all products subject to excises, if it can be achieved more quickly for some products than for others. Indeed, the Stage 2 shift to tax surcharges should be made as soon as possible, where feasible, as in the case of registration fees on automobiles. In any event, sharing based on the location of production and importation should be eliminated, as it allocates shared revenues to the "wrong" *oblasts* and results in tax exporting. Doing so over a period of three years would be consistent with other changes being recommended. Table 10.1 isolates the effect of eliminating the use of VAT as a shared tax and allocating all revenues from the enterprise income tax among *oblasts* in proportion to *oblast* payrolls.

Table 10.1. Distribution of Revenues from VAT and Enterprise Income Tax for Current Law and Proposed Tax-Sharing Rules (Hypothetical *Oblast*-Sharing Rates: Enterprise Income Tax, Distributed by Payroll, 100%; VAT, zero)

(by *oblast,* tenge)

Oblast	VAT Current Law Retentions (1)	Enterprise Income Tax Current Law Retentions (2)	Total Retentions (1) + (2)	Enterprise Income Tax Distributed by Payroll	Proposed VAT and Enterprise Income Tax Retentions as a Percent of Current Law
Akmola	1,066,850	1,642,001	2,708 851	1,343,511	49.6
Aktubinsk	895,650	848,158	1,743,808	861,262	49.4
Almaty	374,000	429,800	803,800	495,646	61.7
Atyrau	112,656	458,228	570,884	485,727	85.1
East Kazakstan	1,137,060	1,115,800	2,252,860	1,878,794	83.4
Jambyl	480,200	487,000	967,200	796,088	82.3
Jezkazgan	616,400	263,433	879,833	1,599,186	181.8
West Kazakstan	628,760	640,200	1,268,960	596,083	47.0
Karaganda	1,529,150	1,014,411	2,543,561	4,473,118	175.9
Kzyl-Orda	322,640	370,800	693,440	282,387	40.7
Kokshetau	720,400	442,500	1,162,900	544,381	46.8
Kostanai	784,700	881,343	1,666,043	1,684,203	101.1
Mangystau	75,908	166,850	242,758	1,015,083	418.2
Pavlodar	313,500	563,813	877,313	3,191,884	363.8
North Kazakstan	536,800	271,900	808,700	681,108	84.2
Semipalatinsk	1,025,700	494,400	1,520,100	852,073	56.1
Taldykorgan	205,200	173,100	378,300	454,032	120.0
Torgai	208,100	128,000	336,100	267,640	79.6
South Kazakstan	1,478,400	1,878,800	3,357,200	1,089,146	32.4
Almaty City	1,253,260	459,803	1,713,063	1,783,769	104.1

Note: Oblast payroll is 12 times the monthly wage, multiplied by employment in the industrial sector in the *oblast*.
Source: Data provided by USAID-Barents and authors' calculations.

Table 10.2. Distribution of Revenues under Proposed Tax-Sharing Rules (Hypothetical *Oblast*-Sharing Rates: Individual Income Tax and Enterprise Income Tax, Distributed by Payroll, 100%; VAT and Excises, zero)

(by *oblast*, tenge)

Oblast	Retained Revenue Current Law	Subvention Current Law	Total Revenue Current Law	Retained Revenue Proposed Law	Subventions Needed Proposed Law	Total Revenue Proposed Law	Percent Change in Subventions Needed
Akmola	3,865,271	0	3,865,271	2,266,507	1,598,764	3,865,271	n/a
Aktubinsk	3,439,388	0	3,439,388	3,022,429	416,959	3,439,388	n/a
Almaty	1,490,808	2,797,194	4,287,994	1,080,600	3,207,394	4,287,994	14.7
Atyrau	1,742,554	0	1,742,554	2,217,171	-474,617	1,742,554	n/a
East Kazakstan	4,287,320	742,512	5,029,832	2,577,100	2,452,732	5,029,832	230.3
Jambyl	1,851,300	2,091,946	3,943,246	1,036,600	2,906,646	3,943,246	38.9
Jezkazgan	2,249,333	0	2,249,333	1,591,133	658,200	2,249,333	n/a
West Kazakstan	2,297,280	1,049,475	3,346,755	1,391,700	1,955,055	3,346,755	86.3
Karaganda	5,366,261	0	5,366,261	4,453,139	913,122	5,366,261	n/a
Kzyl-Orda	1,122,520	3,558,303	4,680,823	719,700	3,961,123	4,680,823	11.3
Kokshetau	1,938,860	1,274,824	3,213,384	989,200	2,224,184	3,213,384	74.5
Kostanai	3,538,343	0	3,538,343	4,777,965	-1,239,622	3,538,343	n/a
Mangystau	1,538,668	0	1,538,668	2,141,054	-602,386	1,538,668	n/a
Pavlodar	3,153,277	0	3,153,277	4,233,858	-1,080,581	3,153,277	n/a
North Kazakstan	1,718,420	1,135,419	2,853,839	850,800	2,003,039	2,853,839	76.4
Semipalatinsk	2,209,880	3,074,967	5,284,847	1,069,300	4,215,547	5,284,847	37.1
Taldykorgan	723,140	2,547,252	3,270,392	509,700	2,760,692	3,270,392	8.4
Torgai	609,900	1,023,152	1,633,052	377,300	1,255,752	1,633,052	22.7
South Kazakstan	5,466,260	2,751,602	8,217,862	2,839,300	5,378,562	8,217,862	95.5
Almaty City	5,010,655	0	5,010,655	8,149,626	-3,138,971	5,010,655	n/a
Total	53,619,130	22,046,646	75,665,776	46,294,183	26,371,593	75,665,776	0.0

Notes: n/a = Data not applicable; change is from zero subvention.
Oblast payroll is 12 times the monthly wage, multiplied by employment in the industrial sector in the oblast.
Source: Data provided by USAID-Barents and authors' calculations.

Given that tax sharing is merely a nontransparent form of subvention, tax-sharing rates should be uniform across *oblasts*. Besides being more transparent, this will set the stage for the use of uniform central government taxes and surcharges set by subnational governments.

Table 10.2 shows the effect of the interplay of eliminating VAT as a source of tax sharing, increasing the role of the enterprise income tax as a shared tax, changing the methodology for sharing revenues from the enterprise income tax and excises, and using the individual income tax and "local" taxes as sources of subnational revenue, assuming sharing of revenues from the enterprise income tax in proportion to payrolls. Table 10.3 modifies Table 10.2 to allow for sharing of excises in proportion to national income in the *oblast*. These shifts deserve more discussion.

First, under either of these schemes, all but four *oblasts* are subvention *oblasts*; only Atyrau, Kostanai, Mangystau, and Almaty City remain nonsubvention *oblasts*. To the extent that there is a shift in the fiscal position of subvention *oblasts*, but they do not gain enough revenues to become self-sufficient, the shift in revenues does not cause reason for concern. As now, subventions would be the marginal source of revenue, but the proposed scheme is more transparent and honest, in that it recognizes that there is no difference, ex ante, between shared taxes and subventions, and that, under present rules, tax assignment is essentially irrelevant. There would presumably be even less reason for concern if some subvention *oblasts* were to become nonsubvention *oblasts*.

There would also be some changes in the fiscal position of (initially) nonsubvention *oblasts*; some change to subvention *oblasts*. Again, this would not change the reality that either subventions or tax sharing, which is equivalent, provides the marginal source of revenues for all *oblasts*.

The primary cause for concern would appear to be *oblasts* that gain substantial revenues from the shift. If such shifts are large, it might be appropriate to limit the sharing rate for the enterprise income tax to less than 100 percent to prevent the aggravation of horizontal fiscal imbalance. In that case, there would be greater need for subventions to other *oblasts*. It would not be appropriate to reduce only the sharing rates of *oblasts* that would otherwise gain revenues, relative to the present situation. To do so would restore the "regulating" function of sharing rates, and with it negotiation over sharing rates. The same sharing rate should be used for all *oblasts* for a single tax. Of course, the same sharing rate need not be used for all taxes.

Table 10.3. Distribution of Revenues under Proposed Tax-Sharing Rules (Hypothetical *Oblast*-Sharing Rates: Individual Income Tax and Enterprise Income Tax, Distributed by Payroll, 100%; VAT and Excises, zero)

(by *oblast*, tenge)

Oblast	Retained Revenue Current Law	Subvention Current Law	Total Revenue Current Law	Retained Revenue Proposed Law	Subventions Needed Proposed Law	Total Revenue Proposed Law	Percent Change in Subventions Needed
Akmola	3,865,271	0	3,865,271	2,685,390	1,179,881	3,865,271	n/a
Aktubinsk	3,439,388	0	3,439,388	3,361,869	77,519	3,439,388	n/a
Almaty	1,490,808	2,797,194	4,287,994	1,362,262	2,925,732	4,287,994	4.6
Atyrau	1,742,554	0	1,742,554	2,441,056	-698,502	1,742,554	n/a
East Kazakstan	4,287,320	742,512	5,029,832	3,125,980	1,903,852	5,029,832	156.4
Jambyl	1,851,300	2,091,946	3,943,246	1,376,039	2,567,207	3,943,246	22.7
Jezkazgan	2,249,333	0	2,249,333	1,908,906	340,427	2,249,333	n/a
West Kazakstan	2,297,280	1,049,475	3,346,755	1,601,141	1,745,614	3,346,755	66.3
Karaganda	5,366,261	0	5,366,261	5,233,127	133,134	5,366,261	n/a
Kzyl-Orda	1,122,520	3,558,303	4,680,823	878,566	3,802,237	4,680,823	6.9
Kokshetau	1,938,860	1,274,824	3,213,384	1,306,973	1,906,411	3,213,384	49.5
Kostanai	3,538,343	0	3,538,343	5,370,178	-1,831,835	3,538,343	n/a
Mangystau	1,538,668	0	1,538,668	2,386,606	-847,938	1,538,668	n/a
Pavlodar	3,153,277	0	3,153,277	4,927,180	-1,773,903	3,153,277	n/a
North Kazakstan	1,718,420	1,135,419	2,853,839	1,132,462	1,721,377	2,853,839	51.6
Semipalatinsk	2,209,880	3,074,967	5,284,847	1,322,074	3,962,773	5,284,847	28.9
Taldykorgan	723,140	2,547,252	3,270,392	719,141	2,551,251	3,270,392	0.2
Torgai	609,900	1,023,152	1,633,052	536,186	1,096,866	1,633,052	7.2
South Kazakstan	5,466,260	2,751,602	8,217,862	3,402,624	4,815,238	8,217,862	75.0
Almaty City	5,010,655	0	5,010,655	8,438,510	-3,427,855	5,010,655	n/a
Total	53,619,130	22,046,646	75,665,776	53,516,291	22,149,485	75,665,776	0.0

Notes: n/a = Data not applicable; change is from zero subvention.

Oblast payroll is 12 times the monthly wage, multiplied by employment in the industrial sector in the *oblast*.

Source: Data provided by USAID-Barents and authors' calculations.

THE 1996 CHANGES

The 1996 changes mentioned above (formula-based division of revenues from the enterprise income tax and the new sharing rates) were adopted before this report was made available to the Government of Kazakstan. Thus, they are not totally consistent with the above proposals. In one instance, they greatly accelerated the proposed timetable, and in others they go in different directions.[2] The 1996 decision to use a three-factor apportionment formula to divide revenues from the enterprise income tax is much

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[2] An earlier draft of this book contained the following recommendations, since overtaken by events: This stage might last several years. During the first year, the portions of revenues from the enterprise income tax shared on the basis of residence and on the basis of a formula reflecting the location of economic activity might be 80/20. The relatively low weight given to economic activity in the first year reflects two considerations: the need to avoid wrenching adjustments and the lack of readily available data of the kind needed to predict the shifts in revenues implied by the shift in the methodology of tax sharing. During the next two years, the weights might change to 40/60 and then to 0/100. In other words, by year three, the location of registration would have been eliminated as a factor in determining the allocation of shared revenue from the enterprise income tax.

In the case of VAT, transition might be spread over three years, with one third of the current sharing of VAT revenues being eliminated in each year. (Thus, for example, for a subvention *oblast*, the sharing rate would be reduced to 66 2/3 percent in year one, to 33 1/3 in year two, and to zero in year three. For an *oblast* with a current sharing rate of 60 percent, the sharing rate would be reduced in stages to 40 percent, 20 percent, and 0.)

To replace *oblast* revenues from VAT and excises, it is proposed that the sharing rates for the enterprise income tax be increased. In the aggregate, revenues from the enterprise income tax retained by the central government are roughly equal to the amount of VAT revenues flowing to the *oblasts*. Thus, on average, it would be necessary, at the conclusion of the transition process, to allocate all revenues from the enterprise income tax to the *oblasts*, to replace lost VAT revenues. Of course, this would be phased in over time, as *oblast* sharing of revenues from VAT is phased out. Because *oblasts* currently retain 52 percent of total revenues from this source, it might be appropriate to begin the transition by channeling this fraction of revenues from the enterprise income tax to the *oblasts*. As the process of transition unfolds, it would be necessary to increase the percentage of these revenues flowing to the *oblasts*, to offset declining revenues from VAT. Thus, for example, in the second and third years of transition, the *oblast* shares in revenues from the enterprise income tax might increase to 68 and 84 percent, respectively, en route to 100 percent in year 3. Of course, it is assumed that the shift to formula-based sharing of revenues from the enterprise income tax would be occurring simultaneously. If all this were done, there would be some reallocation of revenues between *oblasts*; some would have more revenues than now and some less. Table 10.1 reports estimates of the effects of this change, when completed. It shows that 13 of the *oblasts* (mostly the poorer ones) would lose at least 15 percent of combined revenues from VAT and enterprise income taxes as a result of this shift; in several cases the losses would be quite dramatic. On the other hand, several of the industrial *oblasts* would gain substantial amounts of revenues.

more aggressive than the three-year transition proposed above, which was more cautious for the reasons indicated. Provided the new system is working satisfactorily, it should not be abandoned. It may, however, require some technical adjustment, including a shift of the sales factor from origin to destination.

The individual income tax is the best single candidate for subnational surcharges. Of all the major taxes, it most easily places revenues in the right *oblasts*. Thus, it is rather disconcerting that in the course of 18 months it has been converted from a local tax to a full-fledged regulatory tax with sharing rates that range from 31.5 percent to 100 percent. Revenues from this tax should accrue primarily to subnational governments, reflecting rates they control.

The reduction of *oblast* reliance on the enterprise income tax is the opposite of what is suggested above. A reduction in sharing rates for VAT would be more appropriate, given that the use of VAT as a regulating tax should be eliminated.

STAGE 2: THE SHIFT FROM TAX SHARING TO TAX SURCHARGES

By the end of Stage 1, revenues from VAT would no longer be shared with the *oblasts* on a derivation basis and revenues from excises would no longer be shared with *oblasts* where production and importation occur. It might be possible during this stage to implement some consumption-based sharing of revenues from excises, or even consumption-based surcharges for some products, which would be preferable. To replace lost VAT revenues of the *oblasts*, virtually all the revenue from the enterprise income tax would be attributed to *oblasts*, but on the basis of a formula that reflected the location of economic activity, instead of the location of registration. Revenues from the individual income tax would be attributed entirely to *oblasts* where paid. It might be possible to introduce a system in which, within limits, *oblasts* choose the rates to be applied to the income of individuals.

Stage 2 would see the shift from tax sharing to tax surcharges. This would be true for the individual income tax (if not done during Stage 1), the enterprise income tax, and perhaps excises, if not done earlier. In the case of the *individual income tax,* it would be necessary to decide whether *oblasts* should be allowed to determine the entire rate schedule to be applied to income earned by their residents, or only the basic rates to be applied to those with relatively low incomes, leaving the more progressive part of the schedule to be determined by the central government and applied nationwide. As noted in Chapter 8, it is usually assumed that the latter is the more appropriate approach. In that case, some modification of the structure of tax rates might be appropriate, so that one rate (to be determined by each *oblast*) would apply to incomes below a fairly high level, with graduation beginning only above that level. (For example, the *oblast* rate might apply to income below x monthly calculation indexes and the rate structure of the central government only above that level. Chapter 8 discusses how this might be done. *Oblasts* need not choose the same tax rate; that would not affect liability for the tax of the central government.) This would give *oblasts* control over revenues they would receive from application of the basic rate, while leaving control over progressivity at the central level. Experience from developed countries suggests that most revenue is gained from the lowest tax rates, which are applied to all income, and that little is gained from the progressive rate structure, which is applied to relatively little income.

In the case of the *enterprise income tax,* the counterpart to a 100 percent sharing rate would be reservation of this tax base for the *oblasts.* If that were thought not to be necessary, the central government might retain a relatively low tax rate (say 5 percent of enterprise income) and allow *oblasts* substantial discretion in setting the surcharge rate to be applied to enterprise income attributed to them.

During Stage 1, sharing of revenues from *excises* with *oblasts* where production or importation occurs would have been eliminated. Sharing would be based on the point of consumption, if feasible. If not, excises would simply be made a source of revenue of the central government. During Stage 2, consumption-based excises should be introduced, to the extent possible; where this is infeasible, tax sharing based on consumption in the *oblasts* could continue or be introduced. In any event, the central government should vacate this area, in order to minimize vertical fiscal imbalance. This is essentially the case now in most *oblasts* (but not for all revenue); it is not completely true only because low-sharing rates are applied in four *oblasts* to keep revenues from going to the "wrong" *oblasts.*

EQUALIZATION AND THE REPRESENTATIVE TAX SYSTEM

The proposed changes in the tax-sharing regime in Stage 1, including the switch to uniform sharing rates for each tax, and the conversion from tax sharing to a system of tax surcharges in Stage

2 would leave substantial horizontal fiscal disparities between *oblasts*. Thus, it is proposed that the system of equalization described in the previous chapter be implemented during Stage 1. Initially it would reduce disparities that result from application of uniform sharing rates to widely differing tax collections. In Stage 2, it would be intended to equalize fiscal capacity as measured by application of typical tax rates to actual tax bases.