

**DRAFT**

June 24, 2000

MEMORANDUM FOR

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cc: Dr. Michael Alexeev  
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From: Bob Conrad

Subject: Tariff and Customs Reform

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Some initial considerations about, and proposals for, customs and tariff reform in Russia are presented below. These proposals are based on my views and on consultation with staff of both the World Bank and IMF, among others.<sup>1</sup> International trade policy is not simply a tax issue. Various donors and governments are interested in Russia's trade tax reform and the path selected by the Government will be subject to pressure from a variety of domestic interests. Accordingly, two variants of tariff reform are discussed below. The variants have several elements in common, and differ essentially with respect to the tariff treatment of intermediate and primary imports. These variants can be a basis for our discussion in Moscow during my next visit. You, your colleagues, can examine the costs and benefits of each option so that those most knowledgeable about Russian international trade policy, and the objectives for reform, can determine the best path to follow.

My belief is still that a move toward a uniform tariff is in Russia's best interest, if free trade is not an option.<sup>2</sup> I understand, however, that a uniform tariff might not be possible in the current political and economic environment.

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<sup>1</sup> After our last discussions in Moscow I contacted several people to obtain their views and to respond to drafts of this memorandum. These actions were taken because I know that some previous studies about Russian international trade policies had been completed. I believe you are aware of the studies completed by the World Bank, Dr. Tarr's study in particular. I will be happy to provide copies of these studies, relevant background studies and academic materials related to this topic should you desire.

<sup>2</sup> Members of our group have advocated a uniform tariff since 1994 and have written a number of memoranda on the issue, the last one being the memorandum drafted for you and the IET staff in 1997. I will bring copies of some of these memoranda to Moscow and, if possible, e-mail the files to the IET prior to my arrival.

Accordingly, the two options outlined below are not uniform tariff proposals. I believe, both proposals are consistent with a move to uniform tariff should the Government decide to move in that direction.

Two conjectures about the empirical situation in Russia form part of the basis for the proposals.

1. A reduction in the variance of effective tariff rates will reduce the efficiency costs of the Russia's tariff structure.
2. A reduction of the average tariff while rationalizing administration, perhaps via the adoption of a new Customs Code, will keep revenues at a level sufficient to satisfy overall budgetary requirements in the context of the overall tax reform.

As you know, evidence from other countries indicates such outcomes are possible, although no direct evidence is available for Russia to my knowledge.

I have not taken into consideration which law needs to be changed, the Customs Code or the Law on Customs Tariffs. Such issues can be decided during our review in July. Finally, I have not considered issues such as intra-CIS trade policy in the context of Russia's trade with the rest of the world. Adjustments might have to be made to tariff structures and to some administrative procedures, depending on how CIS trade policies evolve.

#### **A. Policy Elements Common to Both Proposals**

##### **1. Stop Using Non-tariff Barriers**

Licensing, quotas and other non-tariff import barriers should be removed as soon as possible. There is little or no justification for the continued use of such measures. Tariffs are more effective means to achieve protection and the government is able to collect revenues. Tariffs are more transparent and there will be a reduction in corruption incentives when tariffs levels are known and applied consistently.

##### **2. Stop Using Specific Exemptions**

Less variation will result from either proposal if exemptions are eliminated. Thus it is important that all exemptions be eliminated, except those standard exemptions for diplomatic imports, donor financing and related imports. Exemptions create a differentiated pattern of protection, will corrupt the system and make overall reform more difficult.<sup>3</sup>

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<sup>3</sup> Exemptions for certain inputs might be necessary if the option to impose non-uniform, but nonzero tariffs, is selected. The exemptions noted in the text

### **3. Convert Per Unit Tariffs to Their Ad Valorem Equivalent**

It is important to convert per unit tariffs to their ad valorem equivalent so that the system is more transparent. Exceptions to this general rule might be needed for a restricted list of difficult to value imports (such as used clothing).

### **4. Reduce, or Eliminate, Variance of Tariff Rates Within Major Commodity Groups**

There is little or no justification for there to be one tariff rate of chicken breasts and another rule for chicken thighs and legs.

Analysis, classification and recommendations for these policies can be completed during the next few months. Staff could list exemptions, ad valorem tariffs equivalents can be computed, and within group rate harmonization can be completed by year-end. All changes can be implemented at the beginning of 2001.

#### **B. Begin a Radial Reduction in the Tariffs**

A target average tariff rate, less than or equal to 10%,<sup>4</sup> should be selected based on revenue and other criteria. In 2001, the government will begin moving toward this average tariff in two stages. First, the number of tariff rates will be reduced to between three and five.<sup>5</sup> Second, the government will begin to reduce the variance in the tariff structure by reducing the high tariff rates while increasing the low rates. This program could result in either a uniform tariff or a lower variance tariff schedule depending on the government's ultimate objectives. The changes should be made as fast as practical but should take no longer than two to three years.<sup>6</sup>

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include, but are not limited to exemptions for finished goods for particular individuals, groups or the government as well as discriminatory use of exemptions on inputs.

<sup>4</sup> I assume that policy makers want to reduce the average tariff below the current level of about 13% on a statutory basis. Eliminating exemptions will increase revenues and will increase the average effective tariff unless the average statutory rate is reduced.

<sup>5</sup> This step might reduce economic efficiency if taken alone. I believe, however, that the other steps, if taken, should be sufficient to mitigate any economic inefficiencies.

<sup>6</sup> For instance, if the first four steps are implemented in 2001 then the radial tariff reduction can begin in 2002 and completed in 2003.

**C. Reduce the Variance of the Tariff Schedule, Allowing Zero Rates for Intermediate and Primary Goods**

A target average rate, less than or equal to 10%, should be based on revenue and other criteria. In this situation, however, high rates will be reduced but not as much, given revenue constraints, because certain intermediate and primary goods will be taxed at a zero rate. A move to this rate schedule can be taken at one time, after the initial four steps are taken, because rate structure changes will not be as dramatic.

Neither option is efficient and the appropriate option to choose will depend on a number of factors, including political feasibility. Note is made of two important differences between the proposals.

1. A radial reduction in the tariffs will reduce the rate variance more than the alternative proposal holding the average rate and revenues constant. Effective protection will be reduced for final good where imports or import substitutes are used as inputs. Effective protection might be negative for some industries or firms, however. In addition, exports might be harmed if imported inputs, or import substitutes, are used to produce exports without some type of relief.
2. Reducing the average tariff, without imposing positive tariffs on some imports, will result in more variable rates, mitigating potential efficiency gains. Effective protection may be higher, smuggling may be higher and there is less incentive to produce, or to invest in, primary or intermediate goods that might be import substitutes. Finally, the maximum rates will be higher, relative to a radial reduction in the tariff rates, reducing the efficiency gains from reductions in the highest rates.

On balance, I prefer a radial reduction in the tariffs, given the administrative and other reforms suggested below. A radial reduction in the tariffs will allow Russia to move rapidly to a uniform tariff should the opportunity arise and may result in greater efficiency gains relative to the other option.

**D. Administrative Considerations**

A number of administrative and procedural changes must complement the rate changes in order for the overall system to begin to meet international norms. We will provide a more comprehensive list of changes as we proceed with an evaluation of options for the Customs Code. A few proposals are noted here that I believe will be an essential part of any program.

## **1. Duty Drawback**

A functioning duty drawback system is an essential part of any trade regime where intermediate and capital goods are taxed. A country should attempt to ensure that all indirect taxes, including tariffs, are removed from the exporter's cost. Thus, Russia should review existing structures and adopt procedures for a revised duty drawback, as appropriate. Note is made of the fact that a duty drawback is a cumbersome, but necessary program. It is not possible to trace all the imports used to produce exports and thus less than 100% of the tariffs will be refunded at the time of export. Some adverse incentives are also created by the drawback. For instance, a type of negative protection against import substitutes is created because the drawback is not available for domestic goods protected by the tariff.<sup>7</sup> In addition, the drawback is usually limited to producers who import the inputs. Tracing the imported input through the chain of value added is cumbersome. Thus, it is generally not possible for those who purchase intermediate products produced from imported goods to claim a rebate when final goods are exported. Finally, there is problem determining the amount of imported consumables, such as dyes, contained in exported commodities. Some reasonable but arbitrary formulas are usually developed so that approximate values can be rebated.

## **2. Export Processing Zones (EPZ)**

The presence of tariffs on inputs may generate the demand for export processing zones. Such zones may be inevitable in Russia and the Customs Code should define what types of EPZ's should be allowed operate in the country, who may own them and how operations should be conducted. It will be important for legislation to address issues of transfer pricing between domestic suppliers who might be related to firms operating in the EPZ to limit income tax losses. In addition, there should be reasonable limits about the types of businesses operated in the zones. For instance, EPZ's should be limited to manufacturing operations and those services ancillary to, or in direct support of, those manufacturing services. No banks, insurance companies or other financial institution should be allowed to operate in the zones.

## **3. Tolling**

Tolling has become controversial in Russia, but its economic function may be important. Imported inputs, alumina for instance, are used to produce refined outputs, aluminum. Title to the imported inputs never passes to the domestic producer and the raw input should be re-exported to the owner in finished form.<sup>8</sup>

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<sup>7</sup> Protection is still available on inputs used to produce goods sold on the domestic market.

<sup>8</sup> The economic function served by tolling is similar to the function served by imposing VAT on only the value added of a tailor who produces a suit from

Tariffs, VAT and excises should not be charged in such cases because the importer is not the owner and the goods are re-exported.<sup>9</sup> Abuses in the tolling system need to be addressed, but it is important to maintain a reasonable tolling system, particularly if imported inputs will be charged tariffs.<sup>10</sup>

#### **4. Controlled Exemptions**

Excessive exemptions, either by the Customs Department, by political access or other means needs to be circumscribed if the tariff reform is to be successful. Nothing will erode compliance faster than perceptions of differential access and discriminatory treatment.

#### **5. Capitalization of Tariffs in Inventories and Asset Prices**

It is common for accountants to capitalize the value of tariffs into the depreciation basis of imported assets for profits tax purposes. Thus, the effective tariff will be higher than the nominal tariff, other things equal, and will depend on the assets depreciation schedule. We recommend that any tariff on imported capital goods be allowed as an immediate expense. This would eliminate any adverse interaction between the profits tax and the tariff system.

#### **6. Coordination with Ministry of Taxes**

It will be important for the Customs Committee to coordinate, formally and often, with the Ministry of Taxes about customs valuations and tariffs. The exchange of information will provide a basis for audits in the income and VAT departments as well as allow the Customs Committee to have access to information for post import examinations.

#### **7. Valuation and Corruption**

Finally, some countries have used pre-shipment inspection firms to handle some amount of valuation. Pre-shipment inspection is not a panacea for issues

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material supplied by the customer. Title to the cloth does not pass to the tailor and the tailor performs only a service for which VAT is charged.

<sup>9</sup> Alternatively, the importer could be charged tariff but be ensured that a rapid refund via a duty rebate is forthcoming. Such procedures do not work, in general, creating the need for tolling.

<sup>10</sup> Tolling may continue for some years because of the historical development of Russia's capital stock. Borders now exist that did not exist during the Soviet period interrupting traditional trade and investment patterns. Existing capacity should continue to be used as long as it is efficient and raw inputs might now exist outside Russia's borders. This situation may continue for some time period and thus it is important that no distortive practices are created to limit efficient use of either raw materials or existing capita.

related to goods that are difficult to value and it may not be the best alternative for limiting corruption in the Customs services. Other countries have used, and continue to use, pre-shipment inspection firms for a significant amount of imports from particular areas of the world, however, and Russia may want to explore whether such firms might be beneficial given Russia's circumstances.

I hope this information is helpful and I look forward to our discussions in Moscow.

Thank you.