Trade liberalisation in Transnistria

Fiscal impact of a reduction in import tariffs and proposals for alternative revenue sources

Dr. Ricardo Giucci and Jörg Radeke, Berlin Economics

Berlin/Chişinău/Tiraspol, May 2015

Berlin Economics

Background and objectives

Background

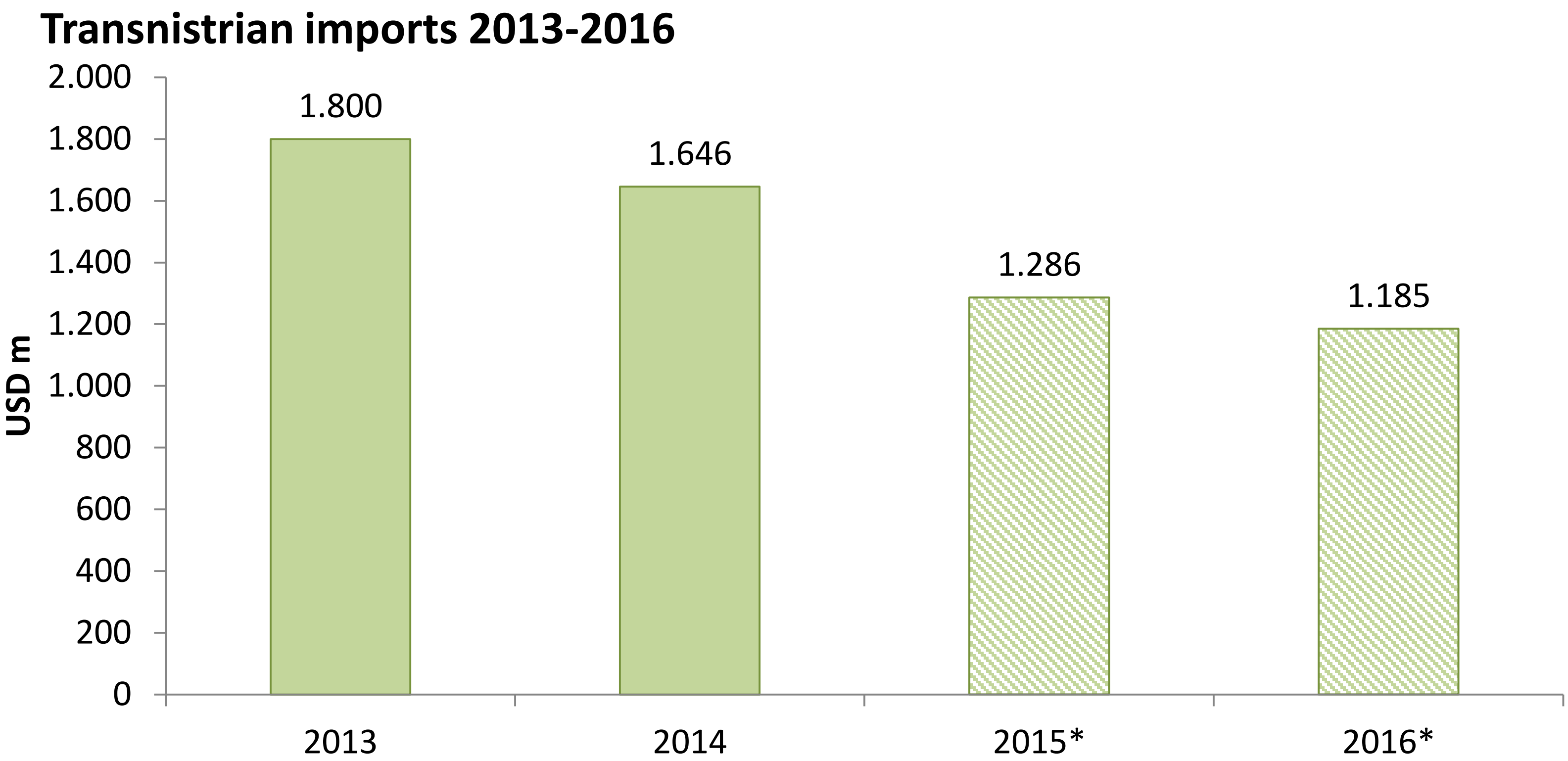
- Current duty free access to the EU market to end by end of 2015
- Necessary condition to avoid this: Abolition of import tariffs on EU goods
- Without preferential access permanent decline in GDP of 5%

Thus: Transnistria is well advised to abolish tariffs on EU goods

Questions addressed in this presentation

- **Fiscal impact**: What would be the revenue loss of removing import duties on EU goods?
- **Fiscal alternatives**: Which fiscal instruments could replace the revenue short fall?

Expected import dynamics



**Forecast*
Source: Own forecast based PMR customs data

- **Imports expected to decline in 2015 and 2016**
- **Reasons: Recession and weaker exchange rate**

Berlin Economics

Import duty revenues for benchmark scenario

Predicted revenues from import duties in 2016 (benchmark scenario)

Benchmark scenario	EU (USD m)	Non-EU (USD m)	Total (USD m)
Revenues from import duties	**13.1**	31.4	44.5

Source: Own forecast based PMR Customs data

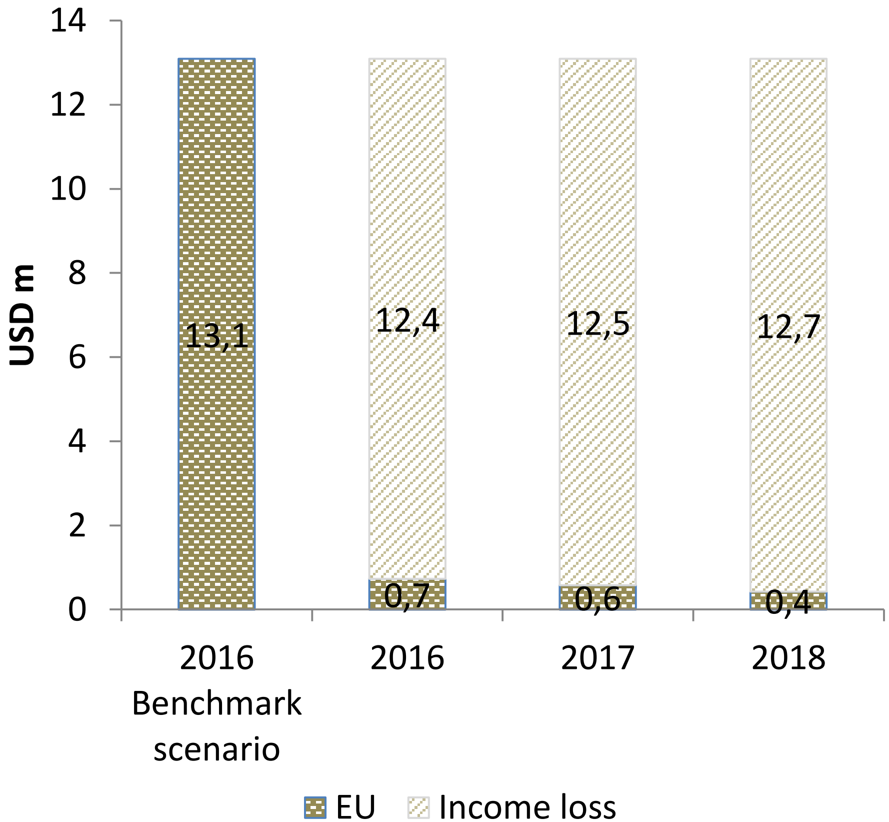
- Necessary for calculation of revenue loss: Setting the *benchmark scenario*

Benchmark scenario: No change in import tariffs takes place

- Total import duties in 2016: USD 44.5 m
- Import duties on EU goods: **USD 13.1 m**

Revenue loss if tariffs on EU goods are abolished

Transnistrian imports 2013-2016



Source: Own forecast based PMR Customs data

Policy scenario

- Transnistria abolishes import duties on imports from EU
- Same time schedule as envisaged in EU-Moldova DCFTA

Revenue loss

- 2016: **USD 12.4 m**
- 2017/2018: Little additional losses
- Practically the whole fiscal impact starts to take place in 2016
- Revenue loss equals 4.3 % of total revenue or 1.3 % of GDP in 2016

Berlin Economics

How to compensate the revenue loss?

- Against precarious budget situation, not taking any compensating measures is not an option
- Therefore, need to either cut expenditure or increase revenues
- Potential for expenditure cuts limited
- Thus: More revenues need to be generated

This leaves two broad options:

Option 1: Increase revenues from *existing sources*

Option 2: Create *new sources* of fiscal revenues

Overview of revenue structure

Revenues by type of source for 2014

Revenue source	2014, USD m	Share of total revenues
Fiscal revenues	229.3	80%
Turnover tax	69.1	24%
Personal income tax	39.8	14%
Customs' duties	62.2	22%
Excises	37.0	13%
Other taxes	20.7	7%
Non-fiscal revenues	56.8	20%
Total	**286.0**	**100%**

Source: Ministry of Finance PMR

Berlin Economics

Option 1: Increasing existing revenue

Option 1: Increase existing revenue sources

- In practical terms this would mean to increase existing gross turnover tax

Assessment of gross turnover tax

- Broad tax base
- Ease of administration
- But a number of negative side effects
    - Taxes business regardless if profitable or loss making
    - Favours large integrated companies
    - Burden for small and medium size enterprises
    - Difficult to combine with international trade obligations
    - Prone to lobbying

Conclusion: Extension of gross turnover tax <u>not</u> advisable

Option 2: Create new revenue sources

Option 2: Establish new revenue source

- Most viable instrument : Modern and efficient Value Added Tax (VAT)

Assessment of VAT

- Broad tax base, large revenue potential
- Avoids negative effects of gross turnover tax
- Thus, boost for SME development
- Similar effect as import duties on import prices
- Consumption tax, companies get VAT refunded
- In line with international best practice
- Promotes trade

Conclusion: Tax reform with VAT introduction preferred option

Two stage implementation plan

- Time is of the essence, new revenue sources needed by 2016
- Against this backdrop, we recommend VAT roll-out in two stages

Stage 1: Limited VAT introduction

- Low rate of VAT
- Only larger companies are liable for VAT
- VAT exists alongside gross turnover tax
- Thus, experience can gathered and necessary adjustments made

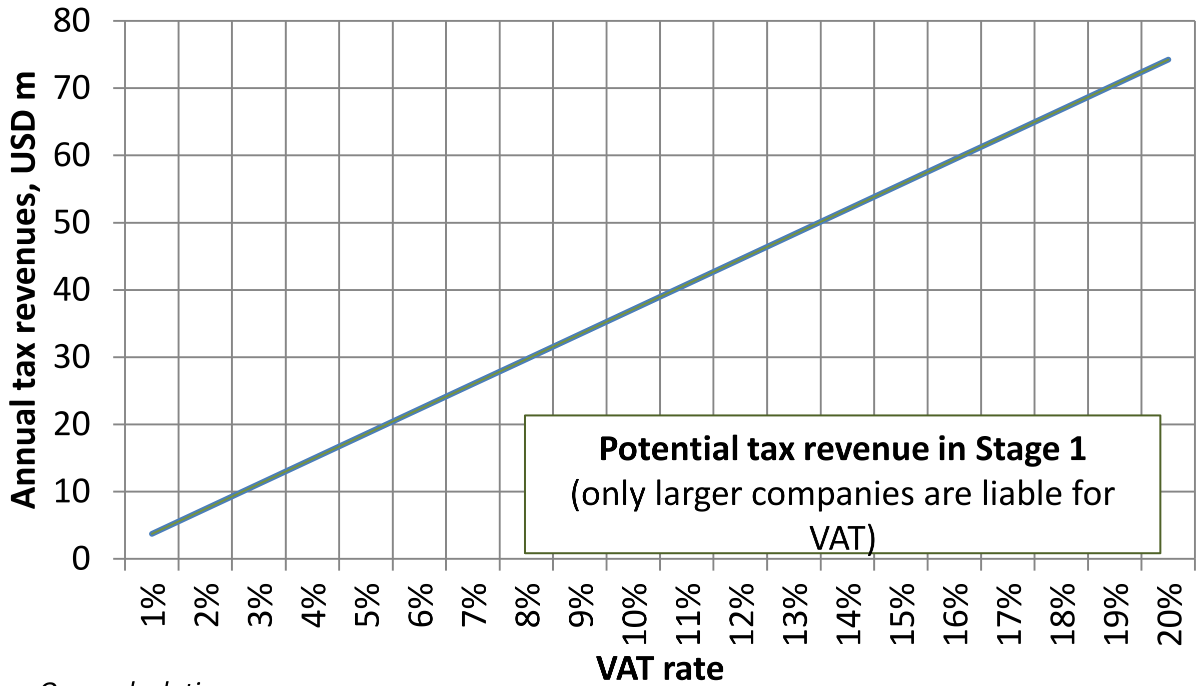
Stage 2: Full-fledged VAT introduction

- After a period of e.g. 1 year, once VAT works satisfactory
- Further companies included to the VAT-regime
- VAT rate increased and gross turnover tax abolished

Important: Two stage approach can only work if from the beginning there is a clear commitment to push through <u>both</u> stages

Tax rate and VAT revenues during Stage 1

VAT revenues in 2016 for various rate levels with only larger companies liable to charge VAT



Source: Own calculations

- Stage 1: VAT rate set at **7%**
- Estimated revenue in 2016: **USD 26 m**
- Sufficient to compensate the revenue loss due to reduction in import duties (USD 12.4 m) and reduce the budget deficit

Berlin Economics

Efficient tax administration, low tax evasion

- Pre-requisite for VAT success: Efficient tax administration
- Otherwise risk of tax evasion and tax fraud

Requirements

- Highly developed IT system with simple software solutions
- Dedicated trainings for the tax administration, training manuals and information materials for companies and consumers
- Rapid tax collection and refund
- Electronic tax declaration
- Strictly non-cash payments
- Special VAT audits on short notice

Time requirement:
- Stage 1: 6-9 months
- Stage 2: 9 months

Combined around 18 month

Authorities should seek technical assistance from international partners for VAT introduction

Final remarks

- Expected revenue loss from trade liberalisation with EU significant
- However, revenue loss could be easily compensated through VAT
- Thus, necessity to abolish import duties offers chance for long overdue tax reform
- At the end could stand a modern VAT system which would form backbone of public finances in Transnistria
- Double benefits: Better trade access <u>and</u> more efficient tax system
- Likely to provide welcome boost for Transnistrian economy and to living standards of population

Contact

Dr. Ricardo Giucci

giucci@berlin-economics.com

Jörg Radeke

radeke@berlin-economics.com

BE Berlin Economics GmbH

Schillerstr. 59, D-10627 Berlin

Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9