



Research Centre for East European Studies
Forschungsstelle Osteuropa



Working Paper No. 30

October 2001

**Tax burden and tax behaviour of branches
of the Russian economy – Part IV**

The taxation of Russian banks

by

R. Hainsworth / W. Tompson

Forschungsstelle Osteuropa an der Universität Bremen
Research Centre for East European Studies, Bremen
Klagenfurter Str. 3 * 28359 Bremen * Germany
Tel.: +49 - 421/218-3687 * Fax.: +49 - 421/218-3269

Arbeitspapiere und Materialien – Forschungsstelle Osteuropa, Bremen

Working Papers of the Research Centre for East European Studies, Bremen

No. 30: Richard Hainsworth / William Tompson: The taxation of Russian banks

October 2001

ISSN: 1616-7384

Richard Hainsworth CFA is the CEO of RusRating and is a Vice President of Citibank Moscow, working on a project basis for the Credit Risk Department. RusRating is a bank rating agency producing risk management research for the Russian interbank market. Within eight months of its inception it has become recognised as the premier national bank rating agency in Russia. Richard Hainsworth is a founder member of the Club of Bank Analysts (in association with the Association of Russian Banks, the Financial Academy, and Eurotrust Bank), and regularly lectures at banking seminars and conferences. He has been resident in Moscow since 1982.

William Tompson is Senior Lecturer in Politics at Birkbeck College, University of London. He has written widely on the development of the Russian financial sector, Russian economic policy and the political economy of Russian reform.

This paper was written within the research project “The Role of Economic Culture in Russia’s Tax System”, which is sponsored by the Otto Wolff-Foundation and the Alfred and Cläre Pott-Foundation.

A short description of the project can be accessed on the internet at

http://www.forschungsstelle.uni-bremen.de/projekte/wirtschaftskultur_Projekt_engl.html

(in English)

http://www.forschungsstelle.uni-bremen.de/projekte/wirtschaftskultur_Projekt.html

(in German)

Die Meinungen, die in den von der Forschungsstelle Osteuropa herausgegebenen Veröffentlichungen geäußert werden, geben ausschließlich die Auffassung der Autoren wieder.

Abdruck und sonstige publizistische Nutzung – auch auszugsweise – nur mit vorheriger Zustimmung der Forschungsstelle sowie mit Angabe des Verfassers und der Quelle gestattet.

© 2001 by Forschungsstelle Osteuropa, Bremen

Research Centre for East European Studies - Forschungsstelle Osteuropa

Klagenfurter Str. 3

28359 Bremen, Germany

Tel.: +49 - 421-218-3687

Fax: +49 - 421-218-3269

e-mail: publikationsreferat@osteuropa.uni-bremen.de

Internet: <http://www.forschungsstelle.uni-bremen.de>

Table of contents

| | |
|---|----|
| Introduction..... | 4 |
| Taxation and Russian ‘economic culture’ | 4 |
| The peculiar position of the banks | 7 |
| The formal rules: Russian tax legislation and the banks | 9 |
| The banks’ complaints | 11 |
| Assessing the banks’ tax burden | 14 |
| ‘Optimisation’ strategies | 20 |
| Formal and informal responses: the tax organs’ strategies | 22 |
| Conclusion..... | 26 |
| | |
| Publications of the Research Centre for East European Studies | 29 |

Introduction

The taxation of the Russian banking sector is far too complex to analyse comprehensively in a relatively short paper. The aim of this paper is therefore rather more modest: it is to deepen our understanding of how the Russian fiscal system actually operates in the banking sphere and to draw out the implications of this for the wider problem of tax reform. The paper begins with a discussion of two aspects of Russian 'economic culture' that are critical to understanding how the tax system works - informality and bargain - and a look at the somewhat peculiar position of Russian banks vis-à-vis the fiscal system. This is followed by an overview of the tax regime applied to the banks and of those aspects of this regime that the banks find most objectionable. Thereafter the discussion turns to the debate between the authorities and the banks over the actual tax burden borne by the latter before describing some of the informal strategies employed by the banks in the pursuit of 'tax optimisation'. The penultimate section describes some of the formal and informal methods by which the tax organs seek to counter the banks' tax avoidance strategies. This is followed by a brief conclusion.

Taxation and Russian 'economic culture'

'Culture', as it is used in many discussions of post-communist Russia, is a slippery and potentially dangerous concept. It is often invoked as something of a residual category, to explain behaviours that external observers find difficult to explain in rational terms, and it is frequently discussed almost exclusively in terms of subjective perceptions.¹ The implication is that the explanation for Russia's post-communist travails lies in 'cultural legacies, habits acquired in the past, which are difficult to shake and which ... obstruct the successful creation and function of democratic and market institutions'.² Attempts to explain corruption on the part of officials and evasion on the part of taxpayers sometimes appeal to 'deep-seated cultural norms' that favour rent-seeking, cheating and stealing, especially from the state.³ All too often, references to 'culture' in social explanation either explicitly or implicitly juxtapose 'culture' against 'rationality', as though cultural factors were impeding agents' progress in learning to function in new conditions.⁴

We reject this view. We do not believe that 'culture' must be invoked to explain apparently irrational behaviour. Rather, we see the country's economic culture as providing rational agents with templates for interpreting new situations and patterns of response to them. There is a strong element of path-dependence in this: confronted with the realities of Russia's half-reformed economy, Russians have responded with variations on many Soviet-era behaviour patterns. Indeed, much of what we observe today long pre-dates even the Soviet regime, including a

¹ See, for example, Alexander Kennaway, 'The Mental and Psychological Inheritance of Contemporary Russia', The Euro-Atlantic Foundation, 1997 (<http://www.eaf.org/f-paper.htm>); see also Antoni Z. Kaminski, *An Institutional Theory of Communist Regimes* (San Francisco: ICS Press, 1992).

² Stephen Holmes, 'Cultural Legacies or State Collapse? Probing the Postcommunist Dilemma', in Michael Mandelbaum (ed.), *Post-Communism: Four Perspectives* (New York: CFR, 1996), p. 26. It should be noted that Holmes is criticising the view quoted, not endorsing it.

³ See, for example, Kennaway, 'Mental and Psychological'; and Donald Jensen, 'Patrimonialism in Post-Soviet Russia', *RFE/RL Newline*, 17 July 1997 (<http://www.rferl.org/newline/1997/07/170797.html>). For criticism of this view, see Gerald M. Easter, 'Institutional Legacy of the Old Regime as a Constraint to Reform: The Case of Fiscal Policy', in Stefanie Harter and Gerald Easter (eds), *Shaping the Economic Space in Russia* (Aldershot: Ashgate, 2000), p. 301.

⁴ For an excellent discussion of this issue and criticism of western observers' use of 'cultural' categories in the post-communist world in particular, see Holmes, 'Cultural Legacies'. See also Slay's criticism of arguments that 'cultural factors' in Russia somehow 'attenuate the effectiveness of reforms that have worked elsewhere'; Ben Slay, An Interpretation of the Russian Financial Crisis, *Post-Soviet Geography and Economics* 40:3 (April-May 1999), p. 208.

bureaucracy that steals, a commercial class that derives its riches from political connections, a reliance on patronage relations in both commerce and state administration, and the manipulation of formal rules to obtain economic benefit. All this would have been familiar enough to Gogol's readers in the reign of Nicholas I. However, these patterns persist not because Russians have clung to irrational beliefs and practices inherited from the past or failed to adapt psychologically to new conditions - far from it: ordinary Russians have proved extraordinarily adaptable. Rather, it is because the easiest strategies of adaptation are often those that are most familiar and therefore most easily deployed. Moreover, because the market transition is so far from complete and so many institutional legacies of the old order remain, such adaptive strategies are better suited to Russian realities than standard western prescriptions.

Our analysis focuses on two closely related aspects of Russian economic culture: informality and an emphasis on bargain. Countless observers over the years have stressed the limited effect of formal rules in Russia and, by extension, the importance of informal rules and norms in how things actually work.⁵ Russian folk wisdom holds that Russia 'is a country of unread laws and unwritten rules' and that 'the imperfection of our laws is compensated for by their non-observance'.⁶ In discussions of the economy, of course, the informal sector is generally treated as a private sphere, a place where agents seek to escape the reach of the state and, in particular, the taxman. The reality, however, is rather different. In a society in which the state is weak and in which an enormous amount of economic activity takes place on an informal basis, it is all but inevitable that the state will cope, at least in part, by adopting informal strategies of its own. The fiscal system is no exception. Indeed, informal practices are so widely employed by Russia's fiscal authorities that one may speak of an 'informal fiscal system', which coexists with the formal system much as the shadow economy coexists with the formal sector.⁷ The formal fiscal system is not, of course, irrelevant: changes in tax legislation and regulations have important implications for both tax administration and bank behaviour; the point is simply that these implications are rarely as straightforward as one might expect.

We do not equate informal fiscal practices with corruption, although informal practices generally do create opportunities for corruption - a fact which makes it all the more difficult to put an end to them once they have taken root. Rather, the 'informal fiscal system' consists of the range of informal practices adopted by the Russian authorities *as a matter of policy* in an effort to cope with the country's fiscal problems and, in particular, with the massive scale of informal economic activity. Efforts are made from time to time to bring the formal rules into closer correspondence with actual practice, but sometimes it is not possible to do this: formalising the rules may deprive officials of the flexibility they believe they need and, in some cases, the formal rules reflect not so much Russia's real fiscal policy as its desire to be seen by outsiders as a 'normal market economy'.⁸ Moreover, the system is constantly evolving, defined not

⁵ For an outstanding recent survey of this issue, see Alena Ledeneva, *Unwritten Rules: How Russia Really Works* (London: Centre for European Reform, 2001). See also James Leitzel, 'Rule Evasion in Transitional Russia', in Joan M. Nelson, Charles Tilly and Lee Walker (eds), *Transforming Post-Communist Political Economies* (Washington: National Academy Press, 1997).

⁶ Ledeneva, p. 2.

⁷ Buch *et alii* write of an 'unofficial fiscal system'; see Claudia M. Buch, Ralph P. Heinrich, Lusine Lusinyan and Mechtild Schrooten, 'Russia's Debt Crisis and the Unofficial Economy' (Kiel Working Paper No. 978: Kiel Institute of World Economics, April 2000), esp. at pp. 12 and 23.

⁸ The case of VAT refunds on exports is a classic example. Russian law provides for the 'destination principle' for the collection of VAT, as this is standard international practice. However, the authorities as a matter of policy go to great lengths to avoid granting exporters the VAT refunds to which they are entitled under law. Changing the law is not an option, as it would complicate Russia's international economic relations, so the country is left with a formal rule that cannot be changed but that the authorities do all they can to circumvent. See W. J. Tompson, 'Russian Exporters Seek Changes in VAT Regime', *CCH New Law Eastern European Newsletter* 35 (November 2000), pp. 140-3.

simply by state policies but by the interaction between private agents and the state, as each responds to the other's moves with new stratagems of its own, with the result that the formal rules of the game continually lag behind. The informal fiscal sector is the realm of budgetary offsets, negotiated tax bills, unpenalised tax arrears and other fiscal practices which depend above all on the attitudes of tax officials rather than on the application of clear, accessible and consistent rules. Indeed, the contradictory nature of tax legislation virtually ensures a degree of informality, since it gives officials considerable discretion in deciding which rules to enforce and when. The problem is that, although informal fiscal practices help the state to mitigate the revenue losses stemming from the existence of a huge shadow economy, they *encourage* shadow activity rather than deter it. The coping mechanism - informal fiscal policy - thus impedes the resolution of the problem, making it harder to bring shadow activities into the formal sector.

Closely related to this emphasis on informality is another aspect of Russia's economic culture we believe is central to understanding how the fiscal system operates in practice. This is the emphasis on bargaining. Outside observers are well aware of the much-criticised practice whereby very large Russian corporates negotiate their tax bills with the state.⁹ Less well known is the extent to which the tax bills of small and medium-sized Russian companies are also negotiated. Tax bills at all levels are largely the subject of informal bargaining between taxpayers and officials. The formal rules of the game - tax legislation, normative acts, instructions from the Ministry of Taxes and Duties (MNS), etc - are important factors in these negotiations but they are scarcely definitive when it comes to determining the actual tax bill that a given taxpayer will end up paying. Clearly, in the field of taxation, bargaining and informality are two sides of the same coin: while there is plenty of scope for bargain in any market economy, tax bills are not ordinarily the subject of negotiation. If the formal rules of the fiscal system were applied in practice, the scope for bargain would be very limited.

The centrality of bargaining may seem surprising at first glance - after all, the relationship between taxpayer and taxman is not normally based on negotiation. In modern societies, at least, it is supposed to be hierarchical and to rest on the strict application of clear formal rules.¹⁰ In Russia, however, the bargained tax bill is no greater a paradox than was the bargained plan. Students of the command economy were well aware during the Soviet period that the process of planning - which in theory was about the disaggregation and assignment of economic tasks by higher authorities to lower - was very much a process of negotiation rather than simply command.¹¹ Enterprises sought to conceal their potential and limit the demands made to them, while ministerial officials pressed for more, always assuming that the enterprise had substantial 'concealed reserves' - much as the tax inspector today tries to estimate how much income or activity a company is keeping off the books. These similarities are not accidental. Post-Soviet tax collectors are no less subject to target-fulfilment pressures than were Soviet-era administrators in the planned economy. Whereas the latter were under pressure to ensure that the enterprises for which they were responsible met or exceeded planned production targets, the former are driven by the need to meet their assigned revenue-collection targets.¹² In Weberian terms, the business of the tax organs is not rule application but task fulfilment. The assignment

⁹ Easter, 'Institutional Legacy of the Old Regime', pp. 307–11.

¹⁰ It should be noted that many other societies have relied on less formal systems and, like contemporary Russia, have made use of material incentives to motivate tax collectors; the institution of tax farming is a classic example.

¹¹ See, for example, Peter Rutland, *The Myth of the Plan* (La Salle, Illinois: Open Court, 1985); Michael Ellman, *Socialist Planning* (Cambridge: Cambridge University Press, 1979); and Alec Nove, *The Soviet Economic System* (London: George Allen & Unwin, 1977).

¹² See Andrei Yakovlev, 'Informal Tax Competition at Regional Level: The Case of Russia' (Moscow: Mimeo, 2001), p. 3; and *idem*, 'Pochemu v Rossii vozmozhen bezriskovyi ukhod ot nalogov?', *Voprosy ekonomiki* 11 (November) 2000.

of revenue-collection targets to tax inspectorates is reinforced by the use of ‘material incentives’ to improve the work of the tax organs by allowing them, under certain circumstances, to distribute a share of the fines and taxes collected in the form of bonuses.¹³ This ensures that revenue maximisation, not law enforcement, is the central concern of the tax organs.

The peculiar position of the banks

Before proceeding to consider the tax regime in the banking sector, it is necessary to highlight a few of the peculiar features of Russian banks that are relevant to understanding how Russian banks manage their relationships with the tax organs. The first point is that the great majority of banks are generally reckoned to be ‘pocket banks’, controlled by a single large corporate shareholder or, more commonly, a small group of related companies and individuals, which operate the bank for their own convenience.¹⁴ One recent survey of the sector concluded that only 10–20 of about 1,300 banks active in Russia in 2001 were genuinely independent financial institutions; the rest were best viewed as tools of business groupings or state institutions of one sort or another.¹⁵ However, many of these independent banks are regional and small, while some of the ‘pocket banks’ are relatively large. Because the controlling groups of some pocket banks are gigantic by Russian standards, their banks have attracted talented staff, who have developed relatively sophisticated financial products that are offered to a wide clientele. In many cases, the franchise value of these pocket banks is substantial, giving those who control them an incentive to develop them as businesses rather than to exploit them for short-term gain.¹⁶ Taking into account independence, stand-alone business operations and client base, there are about 50–60 banks that can be considered to be fully operating financial institutions.¹⁷ Some banks have achieved independence by carefully playing off major shareholders against each other. Such banks are unlikely to seek a broader shareholder base, while the controlling groups behind most pocket banks do not want to let any one else affect their cashflows.¹⁸ This is why the shares of only one Russian bank - the state-controlled savings giant Sberbank - are publicly traded.¹⁹ The attitudes of controlling shareholders towards pocket banks vary, but profit-maximisation is not generally their primary concern. Banks are created and operated to provide payment services and other financial products to their owner-clients and to assist them in ‘optimising’ their

¹³ See, for example, the various schemes for allowing the Tax Police to keep a proportion (from 10 to 50%) of taxes recovered and fines collected: *BBC Summary of World Broadcasts* SU/1996 (13 May 1994) C/3; and Alexander Morozov, ‘Tax Administration in Russia’, *East European Constitutional Review* 5:2 (Spring/Summer 1996), p. 44. Morozov indicates that the practice was discontinued in 1995, but in June 1996, facing massive revenue shortfalls, the authorities announced that the Tax Police would keep 50% of any taxes they recovered to the end of the year; *Segodnya*, 28 June 1996. See also Oxford Analytica, *East Europe Daily Brief*, 13 February 1995, I, and 28 January 2000, I. There was, indeed, some evidence that the authorities in the late 1990s deliberately kept the Tax Police under-funded in order to increase their incentives to collect additional revenue (Oxford Analytica, *East Europe Daily Brief*, 18 August 1998, I).

¹⁴ This view is most strongly put by Lev Makarevich of the Association of Russian Banks, who (despite his institutional affiliation) insists that the vast majority of Russian banks, including state-owned banks, must be viewed as the pocket banks of various institutions and business clans, whose primary interest in operating a bank is not its profitability (interview with Lev Makarevich, Moscow, 22 August 2001). See also Aleksandr Skabichevskii, “‘Bank-truba’ ili ‘koalitsiya zaemshchikov’?”, *Kompaniya-banki* 6(30) (11 June 2001).

¹⁵ Private information concerning an analysis done by staff of one of the international financial institutions.

¹⁶ These are the banks designated by Prill as ‘trust banks’; in many respects they resemble corporate treasuries but they are outside the company and often service a number of companies in a grouping, as well as providing services to outsiders. See Oliver Prill, *Financial Sector Reform in the Soviet Union/Russia since 1987: Options and Consequences* (D.Phil Thesis, University of Oxford, 1995).

¹⁷ Internal estimate by RusRating.

¹⁸ Private information concerning an analysis done by staff of one of the international financial institutions.

¹⁹ Skabichevskii, ‘Bank-truba’, p. 4.

taxes.²⁰ Banks offer significant advantages as providers of tax-related services. They concentrate financial expertise, much of which is dedicated to working out successful tax optimisation strategies, and they are often able to implement the strategies they recommend, which gives them a distinct advantage when competing with accounting firms and financial consultants.²¹ Lev Makarevich of the Association of Russian Banks writes, ‘Avoiding taxes owed to budgets at all levels is a complete industry, and, from the point of view of the Ministry of Taxes and Duties, the banks serve as its most important part.’²²

Secondly, although their lending activity has picked up substantially since 1999, Russian banks still do relatively little actual ‘banking’ in the sense of commercially based financial intermediation.²³ As of January 2001, the sector’s gross assets amounted to no more than about 35% of GDP, which was relatively low by the standards of Central Europe’s transition economies and even lower in comparison with developed western economies. Nor do Russian banks engage much in lending to the non-financial private sector. In early 2001, such lending was only slightly above 30% of the sector’s total assets, not much changed from pre-crisis levels.²⁴ The share of bank credits in the total volume of investment in fixed assets in 2000 has been variously estimated at between 3.9% and 10%.²⁵ While Russian banks have become much more active in crediting the real sector since 1999, their lending tends to be dangerously concentrated - a reflection of their primary concern with servicing shareholders’ needs. Central bank data show around 30% of bank loans outstanding in early 2001 as large credit risks, mainly owing to excessive lending to a single borrower. Many banks exhibit a pronounced, and dangerous, tendency to ‘specialise’ in lending to particular sectors.²⁶

A third feature of Russian banks is that they play a dual role vis-à-vis the tax organs. Banks are, of course, taxpayers, but they are required to act as agents of the fisc.²⁷ Tax collection is largely executed via the payments system and the tax authorities depend heavily on the banks for information about clients’ finances and for cooperation in tax collection.²⁸ The collection of

²⁰ In general, we prefer the Russian expression ‘optimisation’ or the relatively neutral ‘avoidance’ and ‘minimisation’ to the more widely employed western term ‘evasion’. The latter implies a host of assumptions about the nature of the tax system that, in our view, are somewhat problematic in a Russian context.

²¹ Both Skabichevskii and Makarevich see tax optimisation as central to Russian banks’ purpose and functions. See Aleksandr Skabichevskii, ‘Nedokhodnoe mesto’, *Kompaniya-banki* 4(28) (9 April 2001), pp. 8–10; Makarevich, ‘Novye aspekty’, pp. 71ff; and *idem*, *Foreign Investors in the Emerging Russian Market* (Brisbane: Asmo Press, 2001), pp. 46–9; and interview with Makarevich, Moscow, 22 August 2001.

²² Makarevich, ‘Novye aspekty’, p. 71.

²³ See Lev Makarevich, ‘Novye aspekty nalogooblozheniya dokhodov organizatsii v 2001 godu’, *Nalogooblozhenie, uchet i otchetnost’ v kommercheskom banke* 1 (January 2001), pp. 74–7; and William Tompson, ‘Russian Banking after 1998: Problems of Reform and the Future’, in David Lane (ed.), *Russian Banking: Evolution, Problems and Prospects* (London: Edward Elgar, forthcoming 2002).

²⁴ The TsBR’s *Byulleten’ bankovskoi statistiki* 3(94) (March 2001), p. 23, gives a figure of 33.81% for claims on the non-financial private sector and households. Deducting the household share, which was around 2%, would yield a figure closer to 30%.

²⁵ Central Bank of Russia (TsBR) ‘Kontseptual’nye voprosy razvitiya bankovskoi sistemy Rossiisskoi Federatsii’, *Vestnik Banka Rossii* 12 (512) (February 2001), prilozh. 1; *Vedomosti*, 23 January 2001.

²⁶ Aleksandr Skabichevskii, ‘Kreditnyi pereplokh’, *Kompaniya-banki* 5 (29) (14 May 2001), pp. 2–4; the TsBR view is in TsBR, ‘Kontseptual’nye voprosy’, para 2.2.1.

²⁷ A. Yu. Petrov, *Analiz nalogooblozheniya kommercheskikh bankov* (Moscow: REA imeni Plekhanova, 1999), p. 16.

²⁸ These issues are discussed at length in William Tompson, ‘Old Habits Die Hard: Fiscal Imperatives, State Regulation and the Role of Russia’s Banks’, *Europe-Asia Studies* 49:7 (November 1997). The importance the authorities attach to this aspect of the banks’ activities was particularly apparent after the 1998 financial collapse; see *idem* ‘Nothing Learned, Nothing Forgotten: Restructuring without Reform in Russia’s Banking Sector’, in Stefanie Harter and Gerald M. Easter (eds), *Shaping the Economic Space in Russia* (Aldershot: Ashgate, 2000), pp. 73–5, 78–81. This emphasis is also reflected in much Russian writing about the ‘tax obligations of banks’, which is in fact about the mechanics of taxation of other agents *via banks*: see, for example, Petrov, pp. 57–120.

taxes via the financial system gives enterprises an enormous incentive to settle transactions outside that system.²⁹ The easiest way to avoid taxation is, of course, via the use of cash - the so-called 'black cash' (*chernyi nal*) that fuels so much economic activity in Russia.³⁰ However, most corporates can rely on black cash strategies only to a limited degree, and even then they often require the banks' cooperation in securing substantial quantities of cash in violation of restrictions on the use of cash for inter-company transactions.³¹ The banks' participation is thus essential to the success of most tax optimisation strategies. Their handling of financial flows and their access to financial information place them in a key strategic position between the tax organs and other taxpayers, on the basis of which they often build very profitable lines of business.

Indeed, tax optimisation is one of the reasons for the emergence of such a large number of banks in Russia in the early 1990s. Russian law distinguishes between two types of loan: *ssud* and *zaim*. The former is extended by a bank to its clients, while the latter is extended by one business to another. Crucially, interest paid on *ssudy* is tax deductible, while that paid on *zaimy* is not. As a result, two Russian corporates wishing to enter into a loan transaction have good reason to avoid a *zaim*. There were, of course, many other ways for Russian firms to borrow from one another, and for much of the post-Soviet period, most credit creation has taken place outside the financial system altogether.

Russian firms in the 1990s borrowed far more from workers, enterprises and the state by not paying their bills than they did from commercial banks. Overdue payables for much of this period were roughly double the total domestic credit extended by the commercial banks. Moreover, since banks' claims on the non-financial private sector constituted only a fraction of total credit, the ratio of arrears to bank credits to the real sector was even greater.³² In addition, there has been widespread employment of barter, mutual offsets, bills of exchange (*vekselya*) and other money surrogates, which are often employed to extend credit without involving the taxman.³³ However, these mechanisms are insufficient if the borrower requires 'live money' (*zhivye den'gi* - cash or bank money); channelling the loan through a pocket bank then offers distinct tax advantages, as well as ensuring that financial flows run through structures controlled by the clients.

The formal rules: Russian tax legislation and the banks

Russian banks are subject to around 300 different taxes, duties and mandatory payments to budgets and off-budget funds at various levels, although many of these charges are levied only in specific locales.³⁴ The number of economically significant taxes is much smaller. The most

²⁹ Ickes and Ryterman first drew attention to this aspect of the problem in 1992; Barry W. Ickes and Randi Ryterman, 'The Interenterprise Arrears Crisis in Russia', *Post-Soviet Affairs* 8:4 (1992), pp. 356–9.

³⁰ For an excellent discussion of the strategies deployed for obtaining and using 'black cash', see Andrei Yakovlev, "'Black Cash' Tax Evasion in Russia: Its Forms, Incentives and Consequences at Firm Level', *Europe-Asia Studies* 53:1 (January 2001).

³¹ See Yakovlev, 'Black Cash Tax Evasion', p. 42; and Tompson, 'Old Habits', pp. 1162–5.

³² See the data series in *Russian Economic Trends Monthly Update*, October 2000, table 7 and TsBR data. At times, total (commercial and central bank) domestic credit in the financial system was not much larger than total overdue payables.

³³ For an outstanding account of non-monetary exchange in Russia's post-Soviet economy, see David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism* (Ithaca: Cornell University Press, 1999). See also Clifford Gaddy and Barry Ickes, 'Russia's Virtual Economy', *Foreign Affairs* 77:5 (September–October 1998); and William Tompson, 'The Price of Everything and the Value of Nothing? Unravelling the Workings of Russia's "Virtual Economy"', *Economy and Society* 28:2 (May 1999).

³⁴ Petrov, p. 22.

important include VAT, the profit tax, social taxes, the tax on sales of foreign currency and turnover taxes.

VAT is in many ways the least problematic for the banks, in which respect banking differs from most other economic sectors - VAT was by far the most important source of tax revenue in the 1990s and most sectors paid considerably more in VAT than they did in profit tax.³⁵ During the 1990s, the law exempted from VAT those banking operations identified as such in the original definitions provided in the 1990 law 'On banks and banking'.³⁶ Under the VAT provisions of the new Russian Federation Tax Code, which entered into force in 2001, this list has been expanded to encompass other banking operations, including the extension of guarantees to third parties and the provision of certain consultancy and other services within the broader bank-client relationship.³⁷ However, banks are generally required to pay VAT on other transactions, including those which fall within the definition of banking operation but are performed on behalf of another party for a commission. These activities form the bulk of the VAT base of most commercial banks.

Until 1994, the banks did not pay *profit tax* but were instead subject to a tax levied on their gross income. This was changed under a presidential decree adopted at the end of 1993, which scrapped the income tax and subjected the banks to the profit tax levied on all corporates, albeit at a higher rate.³⁸ While other taxpayers paid only a 38% rate of profit tax (later cut to 35%), the banks were subject to a maximum rate of 43%, comprising a 13% rate paid to the federal budget and a maximum 30% rate paid to the budgets of subjects of the federation. This latter rate could be reduced to 25% if the regional authority so chose (only a few did, the most important being St Petersburg). The federal rate could be cut to 8% in the case of banks extending more than 50% of their loan portfolio to small businesses or agro-industrial enterprises.³⁹ Since few regional authorities have cut their profit tax rates and few banks dare concentrate their lending in such high-risk sectors as agriculture and small business, the great majority of Russian banks are subject to a 43% rate of profit tax, albeit with numerous exemptions and loopholes. Until 1997, for example, operations involving government securities were not taxed; thereafter, the tax exemption was removed from operations on the GKO/OFZ market but not from Russian Federation Eurobonds.⁴⁰

Like all corporates, banks have until the end of 2000 been subject to a range of *social taxes* and charges to off-budget funds like the pension fund, which were levied on all employers. Taken together, these taxes imposed an effective rate of tax on wage funds of 38.5%. In 2001, the authorities introduced a new 'unified social tax' (ESN), which replaces payments to three off-budget funds: the Pension Fund, the Fund for Mandatory Medical Insurance and the Social Insurance Fund. This should reduce employers' costs and is further intended to increase

³⁵ VAT was generally a far more important source of revenue for the consolidated budget than the profit tax in the 1990s. In some years, VAT receipts were nearly double profit tax receipts and in the crisis year of 1998, VAT revenues were roughly triple profit tax proceeds (though both were far smaller relative to GDP than in 1997). See Goskomstat RF, *Rossiiskii statisticheskii ezhegodnik 1998g.* (Moscow, Goskomstat, 1998), pp. 650–1; and *idem*, *Rossiiskii statisticheskii ezhegodnik 1999g.* (Moscow: Goskomstat, 1999), pp. 492–3.

³⁶ *Vedomosti S"ezda narodnykh deputatov RSFSR* 27 (6 December 1990), st. 357.

³⁷ See chapter 21 of the new Russian Federation Tax Code.

³⁸ 'O nekotorykh izmeneniyakh v nalogooblozheniya i vzaimootnosheniyakh byudzheto razlichnykh urovnei', Ukaz Prezidenta Rossiiskoi Federatsii No. 2270 ot 22.12.93. The banks' profit tax base was defined by a government resolution (Postanovlenie pravitel'stva RF ot 16.05.94 No. 490, *Sobranie zakonodatel'stva Rossiiskoi Federatsii* 4 (23 May 1994), st. 368), which was further elaborated in the State Tax Service's own instructions (Instruktsiya GNS No. 37 ot 10.08.95).

³⁹ A. I. Ivanov, 'Nalogovaya politika gosudarstva po regulirovaniyu deyatelnosti kommercheskikh bankov', *Bankovskoe delo* 2 (February 1996), p. 9.

⁴⁰ Ivanov, p. 9; *Segodnya*, 14 March 1997.

government control over the finances of the off-budget funds. The rates of the unified social tax are based on a regressive scale ranging from 35.6% to 5.0% (falling to 2.0% in 2002). The aim of this regressive sliding scale is to reduce the incentives for employers to collude in concealing employees' incomes.⁴¹ However, the normative acts adopted by the tax organs have made it much more difficult for most companies to avail themselves of the sliding scale. The lower rates may be applied only if the company has been in operation for more than a year, the formulae set down for calculating salary levels contain a deliberate downward bias, and the lower rates apply only to employees above the relevant threshold in companies where the *average* (as calculated under the downward-biased MNS guidelines) exceeds that threshold. Bizarrely, therefore, it is the tax organs in this case who are effectively depressing the level of reported wages and salaries.⁴²

The *tax on sales of foreign currency* may soon be scrapped. Since its introduction in July 1997, it has been unpopular with the banking community and ineffective as a source of revenue. When the tax was first adopted, it was a 0.5% levy on purchases of foreign currency or financial instruments denominated in foreign currencies, save for commercial banks' purchases of foreign cash from the Central Bank of Russia (TsBR).⁴³ Within a year, the rate was doubled to 1.0% and in 2000 it was doubled again to 2.0%.⁴⁴ Though notionally a tax paid by purchasers of foreign cash, it is effectively paid out of the profits of the banks and other foreign exchange dealers.⁴⁵

Finally, *turnover taxes* have until recently accounted for a large share of banks' tax liabilities, mostly to regional and local budgets. Prior to the adoption of the new Tax Code, banks and other corporates were required to pay a road tax of 2.5% of gross income and a tax for the support of the municipal housing stock and socio-cultural infrastructure at a rate of 1.5%. Since most regional authorities have imposed at least one local turnover tax of their own, it is fair to estimate that the cumulative rate of turnover taxes has, until the introduction of part 2 of the RF Tax Code this year, been around 5% or more. The tax base for turnover taxes in the banks' case is gross income from the provision of banking services. Crudely, this amounts to the bank's gross income, less income from activities enjoying official tax privileges (e.g. operations with government securities), 'paper' income arising when banks' compliance with regulatory norms results in the appearance of income on their books that is not really income in any economic sense, and, in some cases, income from non-bank operations such as the leasing of bank property (this last is included in the calculation of the municipal housing/socio-cultural infrastructure tax and some local taxes).⁴⁶ Garegin Tosunyan of Tekhnbank, the vice-president of the Association of Russian Banks, insists that these are perhaps the most objectionable taxes from the banks' perspective, since they take no account of profitability.⁴⁷

The banks' complaints

In common with sectors such as fuel and metallurgy, Russian banks have consistently complained that the tax system discriminates against them and that they bear a disproportionate

⁴¹ At the same time, the new 13% flat rate of income tax has significantly reduced employees' incentives to conceal income.

⁴² In particular, the MNS has decided that the outliers should be eliminated from the distribution when calculating the 'average salary' mentioned in the legislation. Because outliers at the top are likely to be much further from the median than those at the bottom, this biases the overall 'average' downwards.

⁴³ *Kommersant* -Daily, 26 July 1997; *Segodnya*, 26 July 1997.

⁴⁴ *Izvestiya*, 20 December 1997; Troika Dialog, *Russian Market Weekly*, 20 March 2000.

⁴⁵ Makarevich, 'Novye aspekty', p. 70.

⁴⁶ M. V. Beletskii, 'Novoe v nalogooblozheniya kommercheskikh bankov', *Finansy* 2 (February) 2001, p. 33.

⁴⁷ Interview with Garegin Tosunyan, Moscow, 23 August 2001.

share of the tax burden. The authorities, by contrast, argue that the banks' position is particularly privileged, in practice if not in law, because of their skill at tax evasion - an argument frequently deployed by the authorities with respect to export sectors such as metallurgy, oil and gas.⁴⁸ Makarevich thus write of an 'undeclared war' between the MNS and the banking sector.⁴⁹

Formally, at least, the banks have a point. For one thing, they have been subject to a higher rate of profit tax than non-banks. The major exception to this higher rate - the provision reducing the rate applied to banks concentrating on lending to agricultural or agro-industrial enterprises or to small businesses⁵⁰ - is an economically perverse measure. It rewards banks for lending to high-risk borrowers and thus runs counter to the aims of prudential regulation. At the same time, the tax authorities' definition of the basis for calculating taxable profits has often occasioned complaints from the banks. For example, until late 1998, the GNS did not allow losses from securities transactions to reduce taxable profits.⁵¹ Even if profit from operations with securities over a given period was equal to or less than zero, the income from profitable transactions was included in the calculation of taxable profits, with no provision for deducting losses incurred on unprofitable ones.⁵²

Tosunyan argues strongly that the failure to exclude loan-loss reserves (LLRs) from the profit tax base is also a problem for the banks, since it means that many assets become unprofitable as soon as provision is made for them. Banks get around this by transforming potentially problematic assets into *vekselya* and other such instruments, which are not subject to reserve requirements and which in many cases are off-balance sheet. Since such alternatives are less transparent than loans on the books, these practices also make it harder to assess banks' soundness. Tosunyan argues that funds set aside for LLRs should be excluded from the calculation of taxable profits.⁵³ This would be consistent with International Accounting Standards (IAS), to which Russian banks are now moving. When a bank's LLRs increase because a loan is moved from one risk category to another, IAS rules permit the whole of the increase to be counted as a loss, and hence a reduction of net income. In a stable bank, the number of loans going from poor risk to high risk is roughly matched by loans going the other way, so loan-loss charges should not have a huge impact on the profit-and-loss (P&L) account as a whole. If a loan that has been (wholly or partly) written off is then repaid, the reserve that was formed against it must be shown as income in the P&L account. It thus increases the tax base. The Russian tax authorities fear that if banks were permitted to charge any increase in their LLRs to losses, they would create massive reserves to reduce profits. This would, however, be safer for the banks - hence the TsBR's support for such a change despite the fisc's opposition. The tax organs are willing to allow bad loans to be set against tax, but only when the loan is actually written off. They will not extend tax relief until the loan has actually gone bad.

Tosunyan also argues that banks should be permitted to reduce their tax bases to reflect losses from dealings in securities in previous years. He notes that the law on the profit tax allows such a deduction for losses from the sale of goods and services but not financial instruments.⁵⁴ This last point reflects just one of the many ways in which bankers believe that the fine detail of

⁴⁸ See, for example, Stephen Fortescue, 'Taxation in the Russian Mining and Metals Sector' (Forschungsstelle Osteuropa an der Universität Bremen: Arbeitspapier No. 27, July 2001).

⁴⁹ Makarevich, 'Novye aspekty', p. 70.

⁵⁰ Ivanov, 'Nalogovaya politika', p. 9.

⁵¹ *Kommersant*-Daily, 18 August 1998.

⁵² *Kommersant*-Daily, 18 June 1998 and 18 August 1998.

⁵³ Interview with Garegin Tosunyan, Moscow, 23 August 2001; see also G. A. Tosunyan, 'Tezisy G. A. Tosunyana o reforme bankovskoi sistemy Rossii' (Moscow: mimeo, 9 August 2001), pt 5.

⁵⁴ Tosunyan, 'Tezisy', pt 6.

profit tax legislation has discriminated against them - and will continue to do so even under the new profit tax. For example, the tax organs have often refused to allow banks to take advantage of tax breaks provided for capital investment in the construction and equipping of offices or the opening of representative offices and branches. The fiscal organs argue that this tax break is intended for investment in production and that banks are not normally regarded part of the economy's 'productive sphere' (*proizvodstvennoi sferoi*).⁵⁵ Some observers believe the tax organs' interpretation of this tax break to be correct, in which case it is legislative change that is needed, while others put a broader construction on the rules and believe that the tax authorities are deliberately restricting the application of a provision that banks should legitimately be able to employ. Either way, the Association of Russian Banks has pressed hard for the extension of the list of expenditure items that can be deducted from banks' tax bases.⁵⁶

In addition to the profit tax, banks have with some justice complained about the burden of turnover taxes imposed on them, a complaint they share with corporates in other sectors. The phasing out of most remaining turnover taxes under the new tax code is thus a welcome development from the banks' perspective.

Informally, the banks may be subject to other forms of discriminatory revenue extraction by the authorities. According to Tosunyan, regional and local authorities, in particular, have tended to squeeze the banks via non-tax measures such as more expensive leases on land and other property, as well as higher charges for telecommunications, utilities and other services. It is difficult to assess the validity of Tosunyan's complaint on the basis of the data available, but it does seem entirely plausible. The Russian authorities at all levels have routinely operated complex schedules of tariffs for electricity and transport, in particular, which enable them to favour some consumers (sometimes whole sectors and sometimes individual businesses) at the expense of others. These amount to a form of hidden industrial policy and it is entirely likely that the banks, seen as cash cows by revenue-strapped governors, are often net donors in such situations.

More generally, one would expect the banks to come under greater pressure from the tax organs than most taxpayers. This is because, given the pressure to meet revenue targets and the limited capacities of the tax inspectorate, tax collectors have tended to focus on the most visible, accessible taxpayers and especially on those thought able to pay. When the fiscal press has been tightened, the tax organs have generally found it easier to tighten their grip on those already paying than to broaden the tax base by tracking down funds channelled through fly-by-night 'shell' companies (*firmy-odnodnevki*) or investigating complex tax frauds. While the aggregate losses sustained by the treasury as a result of the activities of the *firmy-odnodnevki* are staggering, the costs of investigation and enforcement in any given case are likely to exceed by far the revenue gained. Thus, the tax organs in the 1990s devoted their energies to squeezing ever more revenue from those they could monitor rather than pursuing those they could not.⁵⁷ By 1998, some 238 corporates accounted for over half of tax revenues paid to the consolidated budget - out of around 2.8 million companies registered as taxpayers.⁵⁸ The logic of this approach to tax administration would suggest that the banks would be prime targets for the tax inspectorate. Petrov argues that this is indeed the case. While outlining the formal legal criteria governing the selection of corporate taxpayers for full documentary audits by the tax inspectorate, he claims that the tax organs are in reality motivated more by the desire to raise

⁵⁵ Petrov, pp. 120–1; Makarevich, 'Novye aspekty', pp. 71–2; Tosunyan, 'Tezisy', pt 6.

⁵⁶ Tosunyan, 'Tezisy', pt 6; see also 'Pis'mo ot 21.01.98 No. A-02/2-48', *Vestnik ARB*, 29 January 1998.

⁵⁷ Petrov, pp. 23–24; Yakovlev, 'Informal Tax Competition', p. 3.

⁵⁸ Russia's 700 largest corporate taxpayers accounted for two-thirds of total tax revenues in 1997; Gazprom, EES Rossii and the Ministry of Railways accounted for about 30%. Oxford Analytica, *East Europe Daily Brief*, 28 January 1998, I, and 28 January 2000, I.

revenue via the extraction of fines and penalties than by the desire to enforce tax legislation. As a result, banks are favoured targets: they are seen to be liquid and their financial affairs are sufficiently complicated to make it easy to find violations. Moreover, banks are often audited as a matter of course when non-bank companies with which they have close links are audited.⁵⁹

Assessing the banks' tax burden

The real question is not so much about the nature of tax legislation as about whether or not the effective tax burden on the banks is really much heavier than on other economic sectors. The authorities routinely accuse the banks of tax evasion on a massive scale - on their own account and on behalf of clients - and insist that the financial expertise of the banks makes them especially well placed to shift funds about in order to avoid taxation. The tax organs have conducted repeated and widespread checks not only of banks' own tax records but of their handling of clients' tax payments, finding - not surprisingly - that delays in the processing of clients' payments are much the more serious problem, although they have also found considerable evidence of underpayment by the banks themselves. The sums cited have frequently run into the tens of billions of roubles (tens of trillions prior to the 1998 redenomination).⁶⁰ In one of the biggest cases, a group of banks in the northwest were found by the Tax Police to have defrauded the state of Rb200bn in tax revenues, using illegal encashment and conversion schemes to move funds abroad in violation of currency controls. Both the banks and their leading clients were found to have been engaged in large-scale violations of tax and currency control legislation.⁶¹

The authorities have tended to focus on the breakdown of tax revenues by sector of origin. In particular, they complained publicly and at length when it appeared that the banks' share of tax revenues was declining. Altogether, the banking sector's share of total tax revenues fell from around 12% in 1994 to around 3% in late 1996 and 5.2% in the first quarter of 1997, largely as a result of the halving of the banks' share of profit tax revenues, from 11.6% in 1994 (the first year in which the banks were subject to the profit tax) to 5.6% in 1996. Further declines were registered in 1997.⁶² Although it was clear to most observers that the banks were under increasing strain in 1994-98, the authorities attributed their declining share of total tax revenues to increasingly skillful evasion. This was one of the reasons for the attempt in 1997 to introduce a tax on bank assets as a possible replacement for the profit tax. Of course, other sectors concealed substantial profits but this mattered far more in banking, for VAT, rather than the profit tax, was the main source of tax revenue from most sectors throughout the 1990s. Since most banking operations are not subject to VAT, the profit tax was and is much more important in determining the tax liabilities of banks than those of non-banks.

Bankers insist that the nature of their business makes avoiding taxation more rather than less difficult. Their finances are subject to much closer monitoring by the authorities - chiefly the central bank - and, because finance is their business, they are less able to engage in barter transactions and other tax avoidance strategies commonly employed by real-sector firms. As Tosunyan puts it, 'a bank's entire turnover is visible' to the authorities.⁶³ Tosunyan maintains

⁵⁹ Petrov, pp. 23-30.

⁶⁰ See, for examples, *Segodnya*, 27 February 1997, 14 March 1997 and 6 August 1999; *Vek*, 28 March 1997; *Kommersant*"-Daily, 17 September 1996, 16 July 1997 and 29 June 1999; *Finansovye izvestiya*, 11 September 1997 and 13 November 1997; RIA-Novosti, 13 November 1997; and AK&M, 18 October 2000.

⁶¹ *Kommersant*"-Daily, 7 August 1997; *Finansovye izvestiya*, 12 August 1997.

⁶² *Segodnya*, 14 March 1997 and *Vek*, 28 March 1997. See also the complaints by officials in *Finansovye izvestiya*, 10 December 1996 and 2 October 1997; *Russkii telegraf*, 7 October 1997.

⁶³ Interview with G. A. Tosunyan, Moscow, 23 August 2001.

that turnover taxes have, for this reason, been much more difficult to minimise than profit tax bills. He does, however, acknowledge that some informal clearing arrangements among banks do serve to hold down recorded turnover. At any rate, banks appear to have been less able to accumulate large tax arrears with impunity than industrial firms have been.⁶⁴ Thus, despite numerous official complaints about banks' tax discipline in 1997, the banking sector was one of the very few that, according to the State Tax Service (as it then was), registered no growth in tax arrears over the year.⁶⁵ While official complaints about tax evasion on the part of the banks are not uncommon, the authorities have tended to devote far more attention to the banks' collusion in tax avoidance on the part of their clients, which suggests that the taxes paid by the banks themselves are less of a concern.

There is no simple, straightforward way to resolve this issue, since there is no obvious basis on which to compare the tax burdens on different sectors. There are data on 'relative tax burdens' for 1995–99, based on the ratio of individual sectors' share in total tax payments to their shares in GDP. For every year except 1995, these data show the banking and insurance share of total tax payments to be much greater than the corresponding share of GDP (see Table 1). Indeed, the financial sector is the only one to show such high ratios of tax share to GDP share. This suggests that there may be some basis for the banks' complaints that they bear a disproportionate share of the tax burden. However, comparing the relative weights of different sectors in GDP and in total tax revenues is more than a little problematic as a basis for comparison, since it takes no account of the relative profitability of different activities and sectors. Given such wide - and, during economic transition, rapidly changing - differences in relative profitability, there is no reason to expect too close a correlation between share of GDP and share of tax revenues.⁶⁶

Table 1: Relative tax burden (share in tax payments/share in GDP)

| Sector | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---------------------|------|------|------|------|------|------|
| Agriculture | 0.46 | 0.58 | 0.18 | 0.18 | 0.23 | 0.19 |
| Industry | 1.83 | 1.89 | 1.58 | 1.64 | 1.53 | 1.55 |
| Trade | 0.45 | 0.64 | 0.64 | 0.40 | 0.52 | 0.47 |
| Transport | 1.42 | 0.93 | 1.70 | 1.71 | 1.70 | 1.97 |
| Banking & Insurance | n/a | 0.89 | 5.87 | 4.42 | 8.52 | 3.57 |
| Construction | 1.17 | 0.97 | 1.09 | 0.97 | 1.01 | 1.07 |
| Other | 0.40 | 0.53 | 0.55 | 0.68 | 0.67 | 0.64 |
| Total | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |

Source: Calculation of the research project "The Role of Economic Culture in Russia's Tax System" (Research Centre for East European Studies, Bremen) based on data from the MNS and Goskomstat.

A comparison that took profitability into account would tell us more, but data on profitability are the most problematic of all, since declared profits across the economy are grossly understated in an effort to avoid taxation. Nor can one even assume a roughly equal propensity to conceal profits. An assumed 'law of equal cheating' would enable us to make use of the official data, but the point is precisely that we would expect the extent of concealment to increase with profitability. Unprofitable enterprises and sectors have no profits to hide, while the most

⁶⁴ Politically, it is generally easier for large industrial concerns to run up arrears, as their provision of employment and social infrastructure gives them greater leverage.

⁶⁵ 'Taxes in Russia', *Russian Economic Trends Monthly Update* (December 1997), fig. 5. The only other sectors to record no arrears growth were communications and pipeline transport (the latter being a state monopoly anyway).

⁶⁶ In a stable and well functioning market economy, we might expect a closer correlation between shares of GDP and shares of tax revenue, at least over the medium term. In a transition economy, it is to be expected that many unprofitable sectors will continue to loom large in GDP, but not in tax income, as the authorities try to support them, while highly profitable sectors will be heavily taxed to help finance the transition—not least because their profits are very often the result of 'transition rents' arising from their political/economic situation at the start of the transition.

profitable have more to hide and can be expected to do so. Moreover, the market transformation has involved sharp changes in the relative profitability of different firms and sectors, making informed estimates still more difficult. In any case, one can easily argue that both the banks and the authorities have a point, since the formal burdens imposed on banks are a burden even if they are evaded. This is because most tax optimisation strategies involve costs of their own - a point often overlooked in discussions of tax avoidance. Taxes cost taxpayers more than they yield the state. Thus, it is entirely possible for discriminatory provisions such as the higher profit tax rate to impose real costs on the banks and yet for the government to find that the banks pay less than it thinks they should.

Yet if there is no really suitable data on which to base a judgement about the banks' tax treatment relative to that of other sectors, the circumstantial evidence would suggest that the reality may be closer to the authorities' view than a cursory look at the data above would suggest. Several factors point to this conclusion. First, while the banks have complained about aspects of the tax system that they see as particularly detrimental to their interests, tax issues have never been at the top of their lobbying agenda in the way that export duties and other fiscal questions have sometimes dominated the government's relations with the major exporting sectors, namely energy and metals.⁶⁷ Rather, the banks have tended to be much more concerned with regulatory issues, accounting reform and their rights as creditors. As far as macroeconomic policy was concerned, the banks' major problem with the authorities during the 1990s was the extent to which they bore a disproportionate share of the costs of *monetary* rather than fiscal policy. The TsBR's limited range of monetary policy instruments and its heavy reliance on things like reserve requirements as tools of macroeconomic management meant that monetary tightening had a far more direct effect on the banks than on other sectors. The fact that shifts in the monetary stance sometimes occurred without warning merely aggravated the problem.⁶⁸ In so far as they have complained about the tax system, Tikhomirov argues that the banks' biggest concerns have not been with the discriminatory provisions - profit tax is too easily avoided for this to be more than a nuisance for most banks - but with the instability and lack of clarity of tax legislation. The banks have repeatedly found themselves subject to contradictory instructions, most famously when the TsBR, the GNS and the finance ministry chose to ignore an amendment to article 855 of the RF Civil Code and insisted on the priority of tax payments over the payment of wages in cases where corporate accounts had insufficient funds to cover both. The banks could either violate the Civil Code and obey the tax authorities - thereby alienating local authorities, managers and workers - or follow the code and risk the wrath of the tax organs and the TsBR.⁶⁹ In late 1996, the Supreme Court struck down the inter-departmental letter that contradicted article 855, but the tax inspectorate continued to follow the letter, in violation of the code.⁷⁰ This is but one example: the banks continued to face many other contradictions and

⁶⁷ Tikhomirov, Tosunyan and Makarevich all agreed that tax issues, while sensitive, were not at the top of the sector's concerns, a view which is consonant with both authors' observations of the sector in recent years.

⁶⁸ See William Tompson, 'The Politics of Central Bank Independence in Russia', *Europe-Asia Studies* 50:7 (November 1998); and Stephen Lewarne, 'Legal Aspects of Monetary Policy in the Former Soviet Union', *Europe-Asia Studies* 45:2 (1993). The most striking instance was the pre-election 'raid' of June 1996, when the State Duma, prompted by the finance ministry, hastily passed a bill requiring the TsBR to transfer its 1994 profit to the budget. The president quickly signed it. The central bank's response was to raise reserve requirements, lower the ceiling on open currency positions and suspend Lombard auctions, all measures which fell disproportionately on the banks, even though the Bank was countering an action by the executive and the legislature that would not bring any special benefits to the financial sector. For a more general discussion of the TsBR's limited policy tools and their implications for the banks (see Tompson, 'Politics', pp. 1174-5).

⁶⁹ *Izvestiya*, 21 August 1996, p. 2; *Finansovye izvestiya*, 10 October 1996, p. 1; *Segodnya*, 11 November 1996, p. 3; See Vasilii Vitryanskii, 'Paradoksy normotvorchestva: zakon dolzhen byt' dlya vsekh yedin', *Ekonomika i zhizn'* 48 (November 1996), p. 4; and *Segodnya*, 23 December 1996, p. 1. Ironically, President Yeltsin and the Duma both supported the changes in the Civil Code, which were opposed by the TsBR and the government.

⁷⁰ *Finansovye izvestiya*, 11 September 1997.

confusions in tax legislation and considerable uncertainty about how it would be administered.⁷¹

Secondly, the banks' declared profits are generally very small and clearly understated. The declared profits of Russia's twenty (officially) most profitable banks in 2000 (see Table 2) reveal a striking pattern: large profits were declared by banks with large or controlling foreign shareholders and by banks with substantial foreign debt service payments falling due in 2001. In the latter cases, Skabichevskii argues that there was a marked correlation between the size of those obligations and the size of the banks' declared profits.⁷² The list is also noteworthy for the banks not on it, including a number of major banks which appear to external observers to have had good years in 2000 but which have not declared large profits under Russian Accounting Standards (RAS), which form the basis for their tax bills. MDM Bank, for example, has been keen to advertise its profitability under IAS but has not made the top 20 with respect to RAS (i.e. taxable) profits. Indeed, MDM and Alfa ranked fourth and fifth, respectively, among Russian banks when ranked by IAS profits. Other banks near the top of the list on IAS profits but posting small RAS profits included Sobinbank, Zenit and MezInvestBank. The gaps between IAS and RAS accounts are sometimes enormous. Alfa-bank's RAS profits were just 5.4% of its declared IAS profits, while MDM's were only 10.7%. The corresponding figures for Avangard, Sobinbank and Mezinvestbank were 19.7%, 25.9% and 33.4%, respectively, and that for Probiznesbank was 44.3%. Numerous other examples could be cited.⁷³

Table 2: Largest declared profits of Russian banks for 2000

| Bank | Declared profit, 2000 (Rb 000) | Own capital, 01.01.01 (Rb 000) | Return on capital, RAS (%) |
|-------------------------|-----------------------------------|-----------------------------------|-------------------------------|
| Sberbank | 17 444 055 | 47 554 373 | 36.68 |
| Vneshtorgbank | 3 574 690 | 49 428 553 | 7.23 |
| Rosbank | 3 230 733 | 9 490 947 | 34.04 |
| Citibank T/O | 2 112 152 | 2 957 129 | 71.43 |
| DIB | 977 883 | 3 139 299 | 31.15 |
| CSFB | 919 320 | 1 647 232 | 55.81 |
| Deutsche Bank | 815 869 | 2 532 700 | 32.21 |
| Bashkreditbank | 660 700 | 4 184 484 | 15.78 |
| IngBank (Evraziya) | 631 148 | 1 580 789 | 39.93 |
| Menatep SPb | 616 013 | 1 990 904 | 30.94 |
| KreditUralBank | 615 579 | 655 840 | 93.86 |
| Gazprombank | 580 706 | 17 250 131 | 3.37 |
| Mezhprombank | 514 420 | 26 753 429 | 1.92 |
| Promstroibank SPb | 468 592 | 1 670 744 | 28.05 |
| Petrokommerts | 453 592 | 1 485 632 | 30.53 |
| Transkreditbank | 411 445 | 1 430 784 | 28.76 |
| Evrofinans | 379 868 | 2 057 626 | 18.46 |
| ABN Amro | 369 466 | 1 267 550 | 29.15 |
| Mezhmosbank | 354 780 | 2 521 418 | 14.07 |
| Nizhegorodpromstroibank | 342 884 | 903 774 | 37.94 |

Source: IC Rating, 'Spisok krupneishikh bankov Rossii po sostoyaniyu na 01.01.01', (http://www.rating.ru/rus/100/01_01_01_100.htm); and A. Skabichevskii, 'Nedokhodnoe mesto', *Kompaniya-banki* 4(28) (9 April 2001).

This discrepancy between IAS and RAS profits suggests one possible solution to the problem of calculating the true tax burden: estimating profit tax bills based on RAS (i.e. 43% of the reported figure) and comparing these rough estimates of taxes paid with reported IAS profits, on the assumption that the IAS figures, being unrelated to tax bills, are a better indicator of true

⁷¹ For more details, see Vitryanskii, pp. 4–5.

⁷² Skabichevskii, 'Nedokhodnoe mesto', p. 8. See also *Nezavisimaya gazeta*, 31 May 2001.

⁷³ Data on published IAS profits from *Vedomosti*, 23 October 2001; RAS profits from IC Rating, 'Spisok krupneishikh bankov Rossii po sostoyaniyu na 01.01.01', (http://www.rating.ru/rus/100/01_01_01_100.htm).

profitability. Unfortunately, such an assumption is unwarranted. Russian banks have proved adept at manipulating IAS accounts to present whatever picture they regard as necessary, a task made easier by the fact that the IAS figures they release are often based on adjustments to RAS figures rather than on accounts actually kept under IAS rules.⁷⁴ A comparison of IAS and RAS accounts for 24 major Russian banks shows exactly half reporting larger profits under RAS - sometimes much larger. The RAS profits of Surgutneftegazbank and Rosbank, for example, were 39.1 and 36.5 times as large as their IAS profits, respectively, while the figure for Promsvyazbank was 30.1 times larger. There are many reasons why banks might report larger RAS profits: those facing large external debt-service payments need to show an RAS profit and will in any case be able to avoid a good deal of the tax on the reported profit, while banks engaged in restructuring talks with foreign creditors will not want to show too large a profit (both these factors may be at work in the case of Rosbank). State banks tend to report larger RAS profits because their accounting practices are partly determined by the authorities. The key point is that IAS profits do not provide a basis on which to make judgements about real profitability and real tax burdens. Unless managers are under pressure from shareholders to show profits, there is little to prevent them from continuing to minimise declared profits, whichever accounting system they use.

A third reason for thinking the banks may not be so weighed down by heavy taxation is that, while the power of the 'oligarchic' banks in the Yeltsin era was often grossly exaggerated,⁷⁵ the banking lobby as a whole has been very successful in resisting tax innovations that it opposes. In 1996, for example, the banks thwarted a short-lived move by the State Tax Service to use the official TsBR exchange rate, rather than the spread between the buy and sell rates, as the basis for calculating banks' profits from dealing in foreign exchange. On current transactions, this meant nothing in practice except that all transactions were formally executed at the central bank rate, with any deviation from that rate being expressed in the level of commission charged rather than in the recorded exchange rate. However, the authorities sought to apply it retrospectively to 1994 and 1995 as well. The proposal for mandatory use of the TsBR rate was revived in late 1997 as pressure on the rouble exchange rate mounted.⁷⁶ The banks spent most of 1997 and early 1998 waging an ultimately successful battle against proposals to supplement the profit tax on banks with a tax on assets. The early drafts of the new Russian Federation Tax Code proposed calculating banks' profit tax according to the usual method as well as calculating a tax on their assets. They would then be charged the *larger* of the two sums. For most banks, this would have been the assets tax, which would in many cases have been 10 or 20 times greater.⁷⁷ The assets tax would have had particularly perverse consequences under RAS rules, which, for example, treat losses and a host of other balance sheet items that are not assets in any economic sense as assets for purposes of accounting.

In 1998, in the wake of the August collapse, the rouble fell four-fold against the dollar. The rouble value of dollar-denominated assets and liabilities jumped dramatically virtually overnight. Banks whose dollar liabilities exceeded their dollar assets failed. Those with an

⁷⁴ See *Vedomosti*, 23 October 2001, and 5 November 2001; and *Vremya novostei*, 26 October 2001.

⁷⁵ See Tompson, 'Banking after 1998', and Duncan Allan, 'The Shares for Loans Auctions: the Banks as Lobbyists', in David Lane (ed.), *Russian Banking: Evolution, Problems and Prospects* (London: Edward Elgar, forthcoming 2002).

⁷⁶ See Yurii Katsman, 'Kak bankam vyrvat'sya iz obyatii gosudarstva?', *Kommersant* 20 (4 June 1996), pp. 502; and ITAR-TASS, 13 November 1997. It is typical of the handling of tax policy that this innovation was introduced via a letter of instruction from the GNS (NP-4-05/26n) rather than a decree or legislative act.

⁷⁷ See *Finansovye izvestiya*, 10 December 1996, 20 January 1997 and 2 October 1997; *Finansovaya Rossiya*, 24 April 1997; *Delovoi mir*, 1 October 1997; *Russkii telegraf*, 7 October 1997; and 'Pis'mo ot 21.01.98 No. A-02/2-48', *Vestnik ARB*, 29 January 1998. This was not as exotic a measure as the banks pretended: similar approaches were employed in some developing countries in response to accounting manipulations by banks.

excess of dollar assets over liabilities faced a different problem. To the extent that the increase in the rouble value of assets was not offset by countervailing increases in the rouble value of dollar-denominated liabilities, the banks had to put the gains through their P&L accounts. Thus, they faced tax demands for massive but *unrealised* foreign exchange gains. These gains were accounting fictions because the loans had not yet been repaid and in many cases never would be. Unless and until repayment actually took place, there were no real revenues from which the taxes could be paid. The banks and the MNS agreed an *ad hoc* solution in early 1999. However, no permanent resolution has been achieved, as can be seen from the example of the Khrunichev Machine-Building Plant, which produces the launch vehicles for Russia's space programme. The rockets used for the international space station were financed by a dollar loan and entered into the balance sheet at the pre-1998 exchange rate. When Khrunichev finally delivered the rockets, charging the same dollar price as the loan plus interest, it had to record the sale at the post-crisis exchange rate. This generated a massive rouble 'profit', which the tax authorities want to share. In other words, the banks and the MNS struck a bargain over nonsensical rules in a manner that still remains to be formalised.

More recently, the banks have done very well out of the new Tax Code.⁷⁸ The code preserves the exemption of most banking operations from VAT, with the exception of the provision of services for third parties for a commission. Indeed, the range of banking operations exempted from VAT is actually broader under chapter 21 of the new code than it was previously. Many small and medium banks will gain substantial relief from article 145 of chapter 21, which stipulates that a taxpayer whose tax base for VAT purposes is less than Rb1m over a three-month period may be freed from VAT liability altogether for the coming year. Arrangements for calculating and paying VAT have also been made less laborious and hence less costly. The new ESN is also a welcome change for the banks. Its basic 35.6% rate is 2.9 percentage points below the cumulative rate of the taxes it replaces, and the banks are well placed to benefit from its regressive scale, since they tend to pay their employees much higher salaries than are found in most sectors and will probably be better able than most corporates to deal with the restrictions on the application of the sliding scale described above. The falling marginal rate of the ESN will further reduce the incentives to pay those salaries via insurance and other schemes designed to avoid taxation. The effect of this change will not be dramatic, however, as the decline in the basic rate is small and the regressive scale begins to take effect only at a salary level of Rb8,333 per month. The lowest rate (5% in 2001 but 2% from 2002) applies only to incomes of Rb50,000 a month or more.⁷⁹ The banks will also benefit from the introduction of the new profit tax, as its single lower rate will now apply to them as well. The most significant change, however, is the abolition of the federal road tax and the local tax for support of housing and socio-cultural infrastructure.⁸⁰ These taxes were levied on banks' gross income rather than profits and were thus particularly unpopular.

The banks' principal remaining grievance with the code is the introduction of accrual rather than cash accounting when calculating their profit tax bases from 1 January 2002. Like other Russian corporates, the banks bitterly resent having to pay tax on what they claim to be fictitious income (i.e. receivables not yet received). The TsBR, fearing that higher tax bills would impede the banks' efforts to build up their capital, supported their calls for delay, as in late 2001 the banks tried to secure a postponement to 2004, when IAS accounts (which require accrual accounting) become mandatory.⁸¹ The intensity of the banks' opposition to the accrual method is difficult to fathom, since costs as well as revenues can be accrued. It may be born of a fear that the tax

⁷⁸ For a short summary of the changes as they affect banks, see Beletskii, pp. 31–3.

⁷⁹ Beletskii, p. 32.

⁸⁰ *Parlamentskaya gazeta* N^oN^o 151–2, 10 August 2000 and 11 August 2000.

⁸¹ *Vremya novosti*, 16 October 2001.

organs will try to apply the principle asymmetrically - that is, to income but not expenditure. A more likely explanation is that many banks collude with borrowers and other debtors to use agreed payment delays in order to shift tax liabilities from one accounting period to another.

‘Optimisation’ strategies

Russian banks have over their short histories perfected a wide range of strategies for optimising their tax bills. This section provides a brief - and far from comprehensive - survey of the many ways in which banks work to minimise their obligations under the most important taxes to which they are subject.

Despite the fact that their activities are largely exempt from *VAT*, the banks have devised numerous schemes for avoiding VAT on those activities not covered by the exemption. Makarevich, who has both worked in and closely observed Russian banks since the sector was in its infancy, identifies a host of strategies employed to keep VAT bills down. In the first place, the banks adopt the broadest possible interpretations of the exemptions that do exist. They do not, for example, tend to pay VAT on the sale of collateral or the preparation of share certificates and other securities for themselves and their clients. Both these activities could, with some generosity of interpretation, be construed as ‘banking operations’. However, the MNS rejects the claim that the preparation of the physical documents involved in a securities issue constitutes a ‘securities transaction’ and argues that the sale of collateral is not a banking operation at all, but is rather ‘realisation of bank property’, which is subject to VAT. Broking operations performed for a commission are often recorded in bank records as operations with their own funds, thus avoiding VAT on the commission, and banks generally try to pay VAT on forex operations in roubles rather than hard currency.⁸²

In most respects, the *profit tax* is the easiest to minimise while remaining more or less within the law. RAS rules leave considerable scope for presenting a suitably distressing picture to the taxman and thus minimising taxable profits. The following are just a few of the devices employed to achieve this end. One of the easiest is to enter into an agreement with another company (usually one controlled by the bank) to undertake a (fictitious) joint investment project. The funds in question are then ‘tied up’ on the balance sheet until the project is realised.⁸³ Purchases of securities, *vekselya* and other such instruments are often recorded at nominal values rather than at the actual purchase prices, and the banks tend to adopt an extremely expansive interpretation of the tax break applying to capital investment. Many tax officials take the view that this break does not apply to the banks at all, but the banks use it to cover such forms of ‘capital investment’ as the acquisition of automobiles and flats for bank managers.⁸⁴ Banking activities are similarly easy to manipulate. Depending on tax rates and payment dates, bank loans may be ‘front-loaded’ with commissions and fees or, on the contrary, VAT-able commissions may be hidden under the guise of interest charges. Moreover, because penalties paid on loan arrears are not taxable, banks often arrange non-payment with their borrowers: the banks accept the penalties in lieu of repayment, while using the apparently bad loan further to reduce tax bills under other headings.⁸⁵ Officially reported expenditures on advertising, consultancy and information services are routinely inflated, and the commissions charged on many financial operations can easily be hidden if the transactions involved are

⁸² Makarevich, ‘Novye aspekty’, p. 71; Beletskii, p. 31.

⁸³ Ivanov, ‘Nalogovaya politika’, p. 10.

⁸⁴ *Finansovye izvestiya*, 13 November 1997; Makarevich, pp. 71–2.

⁸⁵ This practice makes it all the more difficult to interpret data on problem assets: the general assumption is that they have been under-stated, which appears to be the case, but in some cases what are apparently non-performing loans are in fact being repaid in other ways (thus deserving the classification of ‘non-standard’ assets).

sufficiently complex. Expenditure on security is an especially peculiar item. Banks can write off against tax their expenditure on outside security firms but not spending on the maintenance of their own security services.⁸⁶ However, it does not take much creativity in the field of corporate law for banks to create 'independent' security agencies of their own. When calculating taxable profits, the banks count as costs many other forms of expenditure that should not be excluded from the profit tax base.⁸⁷ In addition, the banks often fail to amortise new fixed assets, treating the entire purchase price as an up-front cost. When transactions in government securities were tax exempt, the authorities claimed that the banks were using operations on the government-paper market to channel income from other sources out of their taxable income. In short, manipulations with GKO and OFZs were used as a form of 'money laundering', not to make criminal money clean but to make taxable income tax-exempt.⁸⁸

In theory, the real constraint on profit-minimisation should be shareholder interests. However, if banks' shareholders are not primarily interested in profitability, then there is little reason for the banks to show profits in their accounts. As we have seen, many if not most banks are controlled by shareholders whose primary interest is in using the banks to maintain control over their own financial flows, to help minimise their tax bills and, in many cases, to evade currency controls.

Like all other employers, the banks devote considerable effort to limiting the employer contributions made under the ESN, which were previously paid as separate *social taxes*, as well as limiting their employees' personal income tax liability.⁸⁹ Payment of a share of employees' income in unrecorded 'black cash' was and remains the simplest and most common method of avoiding social taxes, as well as the personal income tax, but a range of more complex methods has also been employed. Until 1997, one of the most widespread non-cash stratagems - and one the banks were particularly well placed to execute - involved the use of interest-free loans as substitutes for wage payments. The employer would make a small, interest-free loan to his employee in lieu of a salary; usually the loan was for a long period, perhaps ten years or more. The employee would then deposit the loaned funds in a bank savings account on which the bank paid a very high rate - often 1,000% per annum or more. A non-bank employer would then pay the bank the rest of the employee's salary (which was then paid on to the employee as 'interest'), as well as a service charge. In the case of a bank, no service charge was needed. The salary was thus paid as a combination of loan and interest. Until 1997, Russian law taxed neither the loan nor the interest received by the employee. Once the law changed, the employee had to include in taxable income the difference between the interest rate of the loan (usually zero) and two-thirds of the TsBR refinancing rate (assuming the latter was higher) as well as the difference between the interest on his deposit and the refinancing rate (assuming the latter was lower).⁹⁰ In fact, enforcement of the new tax rules was patchy for some time.⁹¹

Other common schemes for avoiding personal income and social taxes involve insurance policies and shares. Until 1995, life insurance premiums were tax deductible, so many firms, including many banks, took out short-term policies for their employees at the end of each month and set these against tax liabilities. Since the policies were very short-term, they would mature

⁸⁶ *Vestnik ARB*, 30 October 1997.

⁸⁷ Petrov, pp. 53ff; Makarevich, pp. 71-2.

⁸⁸ *Segodnya*, 14 March 1997.

⁸⁹ While income tax is not a tax paid by employers themselves, helping employees to avoid it reduces their labour costs.

⁹⁰ See Jennifer L. Franklin, 'Tax Avoidance by Citizens of the Russian Federation: Will the Draft Tax Code Provide a Solution?', *Duke Journal of Comparative & International Law* 8 (1998), pp. 151-2; 'Russia Increases Profit and Personal Income Taxes', *Russia and Commonwealth Business Law Report*, 12 February 1997; *Washington Post*, 26 December 1997, p. A31; *Segodnya*, 21 December 1997.

⁹¹ *Finansovye izvestiya*, 13 November 1997; Franklin, pp. 151-2.

almost immediately, but the resulting payouts would not be subject to social taxes.⁹² Simpler still are stock-for-salary schemes, under which the employee receives a stock option in lieu of salary, allowing him to purchase stock in the company at a nominal price within a specified time period. The employee exercises the option and the employer immediately buys back the stock at an inflated price, with the difference representing a salary substitute.⁹³ More generally, employers can avoid social taxes by simply reducing salaries and wages, while increasing the share of employee income that is comprised of payouts from net profits, whether these be dividends (which requires making employees into stockholders with sufficiently large stakes to secure substantial dividends) or simply bonuses. From 1 January 2002, dividends will be taxed at a 6% rate and bonuses at the standard 13% rate of income tax.⁹⁴ The new, lower income-tax rate has made it far more important to avoid the 35.6% ESN than to avoid income tax and has thus made it easier to construct alternative remuneration schemes.

The banks quickly discovered a simple if laborious way around the *tax on sales of foreign currency*. The tax applies only to cash purchases by individuals, not to withdrawals of foreign cash from foreign currency accounts or to rouble–forex conversions involving only bank money (i.e. non-cash). The banks thus adopted the practice of recording each transaction as the latter. ‘Instant’ rouble and forex deposit accounts were opened. Clients’ roubles were then deposited in the rouble accounts, converted into hard currency and transferred to the forex accounts before being withdrawn as foreign currency. The result was that the law triggered a significant drop in cash dollar purchases and a matching rise in withdrawals from foreign currency deposits in Russian banks. There was little or no real effect on the total turnover on the foreign exchange cash market. From the beginning, therefore, the tax netted the government around 20% of the revenues it had been expected to generate, although it did impose additional costs on the banks.⁹⁵

Formal and informal responses: the tax organs’ strategies

As we have argued above, the tax organs’ responses to the banks’ activities (and to those of other taxpayers) involve a variety of informal - and, indeed, often illegal - behaviours. In many ways, these behaviours exhibit a high degree of continuity with the Soviet period and reflect the extent to which officials have responded to post-Soviet challenges by reaching for familiar templates when devising solutions. During the Brezhnev era, T. H. Rigby drew attention to the fact that Soviet administrative bureaucracies were far more concerned than their western counterparts with *directing* economic and social activities rather than *regulating* them. Most economic bureaucracies, of course, do both, but one or the other normally predominates. Largely as a result of constant pressure to meet plan targets, task fulfilment virtually always took precedence over rule application. Indeed, rule violations were often ‘tacitly condoned in the interests of task-fulfilment’.⁹⁶

Such was the nature of the command economy. The role of the state in a market economy, by contrast, is overwhelmingly regulatory: what the market most requires of the state is consistent

⁹² Oxford Analytica, *East Europe Daily Brief*, 10 May 1995, I, and 7 November 1996, I.

⁹³ Franklin, p. 152; ‘The Strange Saga of Decree No. 1215 reveals Serious Problems in Russia’, *Russia and Commonwealth Business Law Report*, 5 October 1996.

⁹⁴ *Vedomosti*, 23 August 2001.

⁹⁵ ‘Pis’mo ot 06.10.97 No. A-01/5-744’, *Vestnik ARB*, 30 October 1997; Troika Dialog, *Russian Market Weekly*, 20 March 2000.

⁹⁶ T. H. Rigby, ‘A Conceptual Approach to Authority, Power and Policy in the Soviet Union’, in T. H. Rigby, Archie Brown and Peter Reddaway (eds.), *Authority, Power and Policy in the USSR: Essays Dedicated to Leonard Schapiro* (Basingstoke: Macmillan, 1980), p. 17.

and impartial rule adjudication and enforcement.⁹⁷ However, Russian officials have approached many of the challenges of marketisation in a ‘task-fulfilling’ frame of mind - with revenue collection as the most urgent task for most of the 1990s. Faced with a choice between observing formal rules and meeting revenue targets, tax inspectors consistently opt for the latter. Any qualms they may have about the dubious legality of some of their actions are likely to be assuaged by an awareness of the pervasiveness of tax avoidance.⁹⁸ At the same time, the use of both revenue targets and, in many cases, the sort of material incentives mentioned above leaves officials in no doubt about what their political masters require of them.

The weakness of the tax organs is a further factor contributing to their reliance on informal methods. This weakness is both institutional and political. The institutional weakness can be seen as a legacy of Soviet state-building strategies. Early Soviet leaders relied heavily on an informal structure of personal networks to enhance the new regime’s administrative capacities as rapidly as possible. The resulting ‘patrimonial’ system of administration relied more on patron-client ties and the distribution of rewards than on the application and enforcement of rules and formalised codes of behaviour.⁹⁹ Such personalistic administrative structures tend to encourage rent-seeking and corruption and to raise monitoring and enforcement costs. The post-Soviet reformers sought in the first instance to direct the patrimonial structure they had inherited to their own ends rather than to transform it. Easter sees this structure as a major impediment to effective revenue collection and notes that there was no serious attempt to reform tax administration until 1998.¹⁰⁰ The state’s heavy reliance on the banking system for tax collection was in no small measure a reflection of the tax organs’ own administrative weakness.¹⁰¹ This institutional weakness was long compounded by political weakness: for most of the 1990s, Russia’s tax chiefs - initially the head of the State Tax Service (GNS) and latterly the Minister for Taxes and Duties (MNS) - were second-rank political figures who tended to lose their jobs relatively quickly if they were too aggressive in pursuit of delinquent non-payers.

It is hardly surprising, therefore, that senior MNS officials acknowledge the need for a certain ‘creativity’ (*tvorchestvo*) in tax administration, not least vis-à-vis the banks.¹⁰² Examples of such ‘creativity’ abound, with respect to both the banks’ own tax liabilities and their role in monitoring and processing the tax payments of their clients. In the mid-1990s, for example, the fiscal organs adopted a remarkably expansive interpretation of the requirement that a corporate entity wishing to open a bank account must first inform its tax inspectorate of the type of account it wished to open and the chosen bank.¹⁰³ The bank could not perform any operations on

⁹⁷ For an excellent general discussion of these issues, see Adam Przeworski, ‘The State in a Market Economy’, in Joan M. Nelson, Charles Tilly and Lee Walker (eds), *Transforming Post-Communist Political Economies* (Washington: National Academy Press, 1997).

⁹⁸ The tax and customs organs’ permanent campaign to minimise VAT refunds to exporters is a classic case in point: the late joint GTK/MNS order on VAT refunds clearly contradicts article 165 of the new RF Tax Code but is defended as a necessary weapon in the battle to curtail the tax frauds associated with fictitious exports; see *Vremya novostei*, 24 October 2001; and *Vedomosti*, 25 October 2001.

⁹⁹ Graeme Gill, *Origins of the Stalinist Political System* (Cambridge: Cambridge University Press, 1990).

¹⁰⁰ Easter, ‘Institutional Legacy of the Old Regime’, pp. 296–317.

¹⁰¹ William Tompson, ‘Service Providers or Servants of the State? Russian Banks in the Nineties’, *Society and Economy in Central and Eastern Europe* 20:2 (1998).

¹⁰² ‘*Tvorchestvo*’ was the term used by a senior MNS official in conversation with Hainsworth. No doubt this applies to non-banks as well, but the comment was made with specific reference to banks.

¹⁰³ The account cannot be opened until the company presents the bank with a notice from the tax inspectorate indicating that it has been so notified. The bank must then immediately notify the relevant tax organ, and no funds may be withdrawn from the account until the latter informs the bank that it has received this notification. Thereafter, the bank must provide the tax authorities with all information concerning their clients’ activities that is ‘necessary for monitoring the completeness and accuracy of the payment of taxes and other mandatory charges by those enterprises’. *Byulleten’ normativnykh aktov* 12 (December 1994), p. 17; *Sobranie zakonodatel’sтва Rossiiskoi Federatsii* 35 (26 August 1996), st. 4144.

the account without a certificate (*spravka*) from the tax organs confirming that they had been notified. Although the regulations made it quite clear that companies need only *inform* the tax organs of what they were doing, tax officials acted as though they had considerable discretion to decide whether or not to allow the enterprise to open a new account, often refusing to issue the required *spravka*. Usually, they were motivated by a desire to prevent companies from using banks seen as unreliable when it came to transferring clients' tax payments or to prevent enterprises from opening accounts in other jurisdictions - something many companies had good reason to do, given the state of the payments system.¹⁰⁴ Similar creativity was and is applied in respect to the banks' own tax bills. Tax inspectors have been known to treat the sales prices of securities as the actual profit earned in cases where banks engaged in securities transactions could not provide documentary proof of both buying and selling prices.

Though often of dubious legality, the fiscal organs' creativity is not always wholly informal. Often it takes the form of written MNS instructions and rulings that contradict - or at least subvert - primary legislation.¹⁰⁵ Thus, when the government and the central bank agreed that banks would be allowed to use profits generated in 2000 to cover losses from the crisis years 1998 and 1999, the MNS issued an instruction stipulating that profits must be used to cover previous years' losses in equal portions over five years.¹⁰⁶ As noted above, the attempt to redefine the tax base for foreign exchange transactions in 1996 was a GNS initiative. Tax officials' treatment of asset sales and other transfers has also relied on instructions and regulations that appeared sharply at odds with primary legislation. The tax inspectorate in Orel Oblast' at one point insisted that an SBS-Agro branch's taxable profit from the transfer of real property to its parent bank was the full value of the asset transferred rather than deducting from the price the remaining (i.e. unamortised) value of the asset, subject to revaluation if necessary. The tax inspectorate was trying to counter what it believed was the bank's use of transfer pricing to avoid tax on the transaction. Its action was thus a rational, if informal, response to an informal practice widely employed by banks and other corporates. It was also clearly illegal, as it involved stretching the application of an MNS normative act to cover circumstances falling under article 8.1 of the 1991 law on the profit tax.¹⁰⁷

The crude reality, according to many bankers - and, off the record, at least, some tax officials - is even worse. Tax inspectors, working to their assigned plans, pretty well know how much they have to gather from the major corporates they handle. This sum is often the subject of negotiation between the taxpayer and the official, and it is generally best for the taxpayer to reach agreement and pay up. Of course, the terms of the negotiation depend not only on the letter of the law and the financial position of the taxpayer: the political connections and social significance of the enterprise are often important as well, which is why large industrial firms have been able to run up such large arrears with relative impunity. If a taxpaying enterprise that lacks this kind of political support regards the demands as so excessive that they must be resisted, it may do so in court, but it runs the risk of attracting a full-scale audit by the tax organs, which will almost certainly turn up so many technical violations that the resulting bill will be larger than the original demand. The complexity and lack of internal consistency of tax

¹⁰⁴ *Finansovye izvestiya*, 24 April 1997, p. III; *Segodnya*, 14 March 1997; and *Kommersant*'-Daily, 27 February 1997. The tax authorities tended to see the opening of multiple accounts as *ipso facto* evidence of tax evasion, but the poor operation of the payments system, the unreliability of Russian banks and the legal limits on the use of cash meant that there were good reasons to use multiple accounts even if no tax avoidance was contemplated. Multiple accounts also made it easier to manage liquidity so as to secure the best return.

¹⁰⁵ A number of examples of such 'subversive' secondary legislation are detailed in Tompson, 'Old Habits', pp. 1167-8.

¹⁰⁶ *Vremya novostei*, 7 February 2001.

¹⁰⁷ For a detailed account of the case, see T. A. Gus'eva, 'Poryadok ischisleniya nalogoobлагаemoi pribyli pri peredache osnovnykh fondov bankami', *Bankovskoe delo* 9 (September) 1999, pp. 22-4.

legislation virtually guarantee such an outcome. According to Tosunyan, such thoroughgoing tax investigations are often performed ‘to order’, with political opponents or commercial rivals using the tax organs to settle private scores.¹⁰⁸

While relying heavily on informal and/or illegal practices,¹⁰⁹ the GNS/MNS has sought to extend its formal control over the banking system. Long before the financial collapse of 1998, the tax authorities, citing the results of their investigations into the banks’ tax payment records and their handling of clients’ tax payments, were lobbying hard for the adoption of a range of measures that would give them greater legal authority over the sector, including proposals to install tax officials inside individual banks on a permanent basis¹¹⁰ and to empower the GNS to assign major corporate taxpayers to particular banks for purposes of handling tax payments.¹¹¹ This latter proposal, which directly contradicted the law on banks and banking, was aimed at separating major corporates from banks that they themselves controlled and operated in order to facilitate tax avoidance. If adopted, it would have struck at the very *raison d’être* of many banks, which exist chiefly in order to give their owners maximum control over their own financial flows. The most extreme forms of the proposals suggested that the largest taxpayers would be assigned directly to the central bank. The GNS also prepared its own ‘ratings’ of Russian banks, based on their handling of tax payments.¹¹²

The tax ministry was even more aggressive in the wake of the August crisis. Determined to extract tax revenues ‘trapped’ in the frozen accounts of failed banks, the ministry was in the forefront of calls for more bankruptcies, a position that brought it into direct conflict with the TsBR.¹¹³ MNS officials even went so far as to suggest that the TsBR was colluding with commercial banks to protect the latter from the fisc.¹¹⁴ During his brief stint as Minister of Taxes and Duties, the ambitious Georgii Boos demanded the right to disqualify delinquent banks from handling any state funds. Boos also demanded the right to compel taxpayers to shift their accounts to banks designated by the MNS and the right to ask that the TsBR remove a bank’s licence on account of tax arrears. If the TsBR had refused such a request, Boos wanted the central bank itself to present the MNS with a plan for restructuring the delinquent bank’s tax debts.¹¹⁵

Boos also demanded the lifting of over 50 banks’ licences and ordered tax inspectors to refuse to register accounts opened in banks responsible for delayed tax payments.¹¹⁶ His successor, Aleksandr Pochinok, sought to take further the MNS’s encroachment on the TsBR’s regulatory

¹⁰⁸ Both Makarevich and Tosunyan described this basic approach in their interviews; it is familiar to Hainsworth as well from his work in the sector.

¹⁰⁹ We would stress again that they are not the same. Many informal practices are legal but nevertheless are not formally acknowledged, and many illegal practices are formalised, at least to the extent that departmental orders and instructions are issued that contradict statute law.

¹¹⁰ *Kommersant*’-Daily, 27 February 1997; *Finansovye izvestiya*, 6 March 1997; and *Delo*, 25 March 1997.

¹¹¹ *Finansovye izvestiya*, 20 February 1997 and 6 March 1997.

¹¹² *Kommersant*’-Daily, 27 February 1997.

¹¹³ *Vremya MN*, 13 April 1999; *Izvestiya*, 20 May 1999; *Kommersant*’-Daily, 25 June 1999. For a discussion of the TsBR–MNS conflict at this time, see Tompson, ‘Nothing Learned’, pp. 73–5, 78–81.

¹¹⁴ IPR Strategic Information Database, 9 February 1999.

¹¹⁵ *Kommersant*’-Daily, 21 April 1999; and *Vremya MN*, 13 April 1999. The MNS was particularly aggrieved by SBS-Agro’s continuing role in distributing state credits to the agricultural sector, given that it was deeply in debt to both the ministry and the State Customs Service.

¹¹⁶ Irina Andreeva and Natalya Kalinichenko, ‘Legko li proiti cherez finansovoe chistilishche?’, *Itogi*, 9 March 1999, p. 26; and RIA-Novosti, 23 April 1999. A corporate cannot operate a new bank account until it provides its bank with confirmation that it has registered the new account with the tax organs. In fact, the tax inspectors have exceeded their authority: taxpayers are required to *notify* them of new accounts but not to seek their permission to open them; for details of the regulations that apply, see Tompson, ‘Old Habits’, p. 1167.

powers, including a government order preventing the Agency for Restructuring Credit Organisations (ARKO), supervised by the TsBR, from issuing stabilisation credits without MNS approval.¹¹⁷ In the end, little came of any of these proposals, before or after the crisis. The commercial banks, backed by the TsBR, which jealously defended its position as the sector's regulator, successfully thwarted both Boos and Pochinok, neither of whom was a political figure of equal standing to central bank chief Viktor Gerashchenko.

One recent innovation that may have important implications for the future is the shift towards sectoral specialisation on the part of tax inspectorates. This process is in its infancy and may never unfold across the whole country, but recent measures taken in Moscow highlight the authorities' interest in the potential to improve tax administration by allowing local tax inspectorates to specialise. Thus, the tax affairs of all commercial banks in the city of Moscow have been transferred to the city's specially established 42nd inspectorate. Only those banks where litigation issues remain have not yet been transferred.¹¹⁸ The logic is obvious: tax officials with greater expertise in a particular field of economic activity are likely to be better at identifying and thwarting the tax optimisation strategies most commonly employed in that sector. If widely adopted, this could have a major impact on many sectors, but its implications for the banks are particularly significant because of the dual nature of their relationship with the fisc. Banks are, as noted above, both taxpayers themselves and important agents of the state in the field of tax administration. Hitherto, a given bank has generally been handled by the same tax inspectorate that was looking after the bank's clients. The need to secure a bank's cooperation in dealing with the latter might well temper its tax inspectors' treatment of the bank itself. In future, however, it is much more likely that the bank could find itself being handled by an inspector who is a specialist in the taxation of banks, while it deals with other tax inspectors in connection with its clients' activities.

Conclusion

The foregoing points to several conclusions. First, legislative change, crucial though it is, does not represent the greatest challenge facing Russia's tax reformers. No less important, if tax reform is to succeed, will be *formalising* the fiscal system, closing the gap that now exists between the formal and informal rules of the fiscal game. Citibank T/O chief Alan Hirst's claim that 'what we really want is for the authorities to implement the rules that they already have' reflects a widely shared sentiment. Predictability and transparency are both highly desirable, from the point of view of both private agents and, ultimately, the state. Tax reform will not have succeeded until taxpayers know that their tax bills will be determined on the basis of clear, stable rules consistently applied, rather than on negotiating skill and relations with officials.

Secondly, the approach to tax reform taken by the present government is broadly correct. Simplifying the system and lowering rates should make it easier to bring actual practice into line with formal rules. The success of the new 13% income tax is instructive here. Sceptics argued that taxpayers who had avoided paying at the old 30% rate would just as happily avoid payment at the new lower one. However, this overlooked two key points, which should be borne in mind when evaluating other tax changes. First, a simpler tax will tend to close off many legal options for tax avoidance. It should also reduce opportunities for corruption and arbitrary official behaviour, since the complexity of the tax system is one of the greatest weapons in the hands of

¹¹⁷ *Vremya MN*, 13 April 1999, 23 April 1999, and 26 April 1999; *Kommersant*—Daily, 21 April 1999, and 25 June 1999; *Segodnya*, 23 June 1999.

¹¹⁸ Private information provided to Hainsworth by an MNS official in 2001; the proposal, however, is not a new one, having been promised as far back as 1997. See *Vek*, 28 March 1997—a fact which raises questions about whether and when it will be implemented.

revenue-hungry tax inspectors looking for ‘creative’ ways to meet revenue targets. Secondly, as noted above, there is usually a non-zero cost to *not* paying tax. Lowering rates thus changes the calculations taxpayers make about whether or not to pay: these hinge on the difference between the costs of compliance and the cost of avoidance, subject to the risk of detection (raising this risk is also a priority, as at present it is very low). A lower rate will not lead to full compliance but it should increase compliance at the margin. Thus, a simpler tax regime relying on low, stable rates and free of the numerous exemptions and concessions that still exist today, may well increase tax yields while reducing the overall burden of taxation.