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Andrei Kuznetsov* and Lubov Goncharenko**

Welfare State and Taxation in Russia: the Contradictions of the Unified Social Tax

The Unified Social Tax (UST) was introduced in Russia in 2001 as part of a comprehensive reform of the tax and social security system. Five years on, this article offers a preliminary assessment of the positive effects of UST so far and the problems that remain.

Tax reforms continue to be a feature of the Russian economic landscape as policymakers are looking for solutions that would both secure sufficient budgetary income and contribute to economic growth in the country. In 2000 some sweeping changes were launched, amounting to a virtual revolution in taxation. The focus was, first, on making taxes more acceptable and "user-friendly" for taxpayers and, second, on creating an environment in which paying taxes would make more economic sense to taxpayers than meeting the cost of avoiding them.

These reforms stirred interest across the world. In particular, the introduction of a flat income tax at the rate of only 13% and the replacement of the four separate social security taxes with a combined Unified Social Tax payable on a regressive scale with a maximum rate of 35.06% (later reduced to 26%) were seen as the two most notable innovations. The reaction was generally positive, so much so that even President Bush announced that he was impressed with the tax reform in Russia.[1]

Now that almost five years have passed since the new tax rules were adopted it is possible to give some early evaluation of their implications. In this paper we look at just one aspect of the tax reform: the evolvement of payroll taxes and social fund contributions from a plethora of contentious payments into the Unified Social Tax (UST), and its consequences. This choice is not incidental. The dynamics of social taxes in modern Russia are closely related to one of the most divisive and consequential policymaking issues in the country: the role and functions of the system of social welfare. Poor social provisions, suffering from under-resourcing, have been a cause of continual public discontent. As a result, the task of raising funds for social services gains an importance that goes beyond just the issue of ameliorating the tax system.

* Reader in International Business, Manchester Metropolitan University, UK.

** Head of Department of Taxes and Taxation, State Financial Academy, Moscow, Russia.

Designs and Realities

During the first decade of post-communist transition, the Russian tax system acquired a structure and many features which are present in Western Europe (reliance on direct and indirect taxes, including the personal income tax, corporate income tax, payroll taxes, VAT, excises and customs tariffs), whilst tax rates were modelled on the US example. And yet, despite these attempts to imitate best practices, by 2000 the national tax system had discredited itself. It achieved only a very low rate of tax collection, whilst at the same time gaining notoriety for being abusive and corrupt. To an extent this poor performance could be blamed on the legacy of socialist taxation, but even more damaging were some disruptive trends that haunted economic reforms in Russia in the 1990s. A tax reform was needed that would adjust the mechanism of taxation to the realities of a transition economy.

The impact of these realities was felt at different levels. To begin with, the taxpayers as well as tax authorities had no previous experience of modern taxation. The notion of tax burden was new for most taxpayers, voluntary compliance and self-filing were virtually unknown as the old system was characterised by implicit taxation.[2] If we add growing mistrust towards the government and bureaucracy to the equation, it is not surprising that tax evasion emerged as a natural choice for many when economic actors were confronted for the first time with explicit tax requirements.[3]

Things were not helped by the attitude of tax authorities and the politics behind economic reforms. Emphasis on intrusive supervision resulted in the proliferation of tax laws and regulations, providing a

[1] The Washington Times, 28.03.2002.

[2] Jorge Martinez-Vazquez, Robert M. McNab: The tax reform experiment in transitional countries, in: National Tax Journal, Vol. 53, No. 2, 2000, pp. 273-98.

[3] The survey by Public Opinion research centre in Moscow revealed that as late as 2004 about a third of respondents believed that evading taxes was appropriate whilst more than half of the respondents did not condemn tax dodgers or were indifferent to them (Interfax, 01.11.2004).

fertile ground for abuse and discrimination. The situation was exacerbated by an excessive fiscal decentralisation. "As a consequence, tax liabilities have often been negotiated rather than determined by law. To make matters worse, tax authorities were allowed to impose highly punitive penalties which often bear no relationship to the actual tax liability … Because of this administrative leeway … corruption flourished."[4] Attempts to introduce a comprehensive tax code were repeatedly delayed by the vested interests of the oligarchs and bureaucrats, both groups benefiting from the lack of transparency and accountability. When finally endorsed in 1999, the code still suffered from inconsistencies and contradictions.

It was of great significance that tax reforms were taking place against the background of a major economic collapse when millions of people and thousands of enterprises were fighting for survival. The official data are conservative, evaluating the share of population with income below the subsistence level, i.e. the rate of absolute poverty, at 30% throughout this period.[5] As for businesses, the share of loss-making firms exceeded 40% in industry, 60% in transport and 33% in construction.[6] Even under a perfectly working taxation system this would have led to considerable difficulties. However, in Russia the situation was made even more complex by the widely spread inter-enterprise and wage arrears that beseiged the Russian economy in the 1990s. They caused Russian producers to drift away from monetary transactions towards barter. Even employees received their wages as payments in kind, which facilitated tax evasion. Barter had reached an unprecedented scale: for the majority of industrial firms this form of transaction represented half of their entire turnover and for many as much as 73%.[7]

As a result tax collection has turned into a battle in which the state and society at large soon found themselves on the losing end. Entrepreneurs were outraged by high rates and the time and effort it took to comply with all the regulations, which they believed were lethal for their businesses, and found it necessary to move their operation into the parallel or "shadow" economy. According to the Expert Institute of the Russian Union of Industrialists and Entrepreneurs, up to 75% of firms practised concealment of a considerable proportion of income, placement of capital abroad and evasion of excise duty and smuggling as the most common forms of "shadow" activity.[8] A report prepared by the Institute of Sociology of the Russian Academy of Science claims that nearly two thirds of the entrepreneurs would be ready to bribe an official and eight out of ten consider tax evasion and fraud a viable business tactic.[9] The state, which saw its budget deficit soaring, had to increase its spending on tax enforcement but the results were dismal as business found it cheaper to pay off tax inspectors and tax police or expatriate their capital rather than pay taxes. According to official statistics, in the late 1990s only 17% of businesses operating in Russia paid their taxes on time and in full, 50% made only occasional payments and 33% made no payments at all.[10]

The Tax Revolution

Mass impoverishment, barter transactions, corruption, tax evasion, capital flight, catastrophic fall of industrial output and the growth of the shadow economy were the background against which new ideas about the role, structure and administration of taxation in Russia were taking shape. It was accepted that often the main incentives to evade taxes were provided by the tax system itself due to excessive taxation, lack of transparency and fairness, extreme decentralisation and emphasis on disproportionately punitive action. This realisation prepared the grounds for the revolution in taxation that started in August 2000. The blueprint for reforms included the simplification of the tax system; the introduction of lower tax rates, especially of personal and profit taxes; the abolishment of some particularly unpopular taxes; and the use of regressive scales for the calculation of some wage and salary taxes.

New regulations heralded a fundamental change in perception of the role of taxation compared to the attitude prevailing among policymakers in the 1990s. At that time it was sought to resolve problems with tax collection through the establishment of a dedicated police force and an ever-increasing number of authoritarian rules and regulations. The big prize that inspired the new initiatives was the prospect of returning to the official economy the assets, tentatively evaluated at hundreds of billions of dollars, that had been moved into the "shadow" economy under the previous tax regime.

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[4] Alexander Pogorletskiy, Fritz Sollner: The Russian tax reform, in: INTERECONOMICS, Vol. 37, No. 3, May-June 2002, p. 157.

[5] Russian Federation: Poverty Assessment. Report No. 28923-RU DRAFT, World Bank, 28 June 2004, p. ii.

[6] Finansovyi director, No.12, 2003, p. 5.

[7] Sergei Aukutsionek: Barter: New Data and Comments, in: Journal of East-West Business, Vol. 6, No. 4, 2001, p. 24.

[8] I. Yegiazorova: Biznes: priatchetsia v teni, in: Rabochaya Tribuna, May 6, 1997, p. 2.

[9] L. Dushatski: Vzaimodeistvie predprinimatelei s uslovijami sredy, in: Sotsiologitcheskie issledovania, No. 1, 1998, pp. 68-72.

[10] Nizhegorodski predprinimatel, No. 4-5, 1998, p. 20.

The reforms were put into practice in three stages in 2001, 2002 and 2004. The main features of the tax system which emerged as a result are as follows. The three income-tax rates of old (12, 20 and 30%) were replaced by a 13% flat tax (non-residents have to pay a rate of 30% on income from Russian sources); corporate tax was reduced from 35% to 24%;[11] capital gains on the disposal of securities are subject to profits tax at 24%; VAT is levied at a general rate of 18% on taxable supplies that include the majority of domestic sales of goods and services;[12] the four separate social security taxes were replaced by a combined Unified Social Tax payable to the Federal budget, the Social Insurance Fund and Medical Insurance Fund on a regressive scale with a maximum rate of 26%, whilst employers' contributions to the Employment Fund have been abolished. Simultaneously most regional sales taxes, special regulations and exceptions were abolished; new accounting rules were brought forward, introducing international accounting standards to Russia. Despite these steps towards a more compact, manageable and transparent system, a frustrating multitude of taxes remains: there is also a 5% advertising tax, a 2% property tax, a 1% road tax, plus various registration fees.

The initial response to changes in the tax regime was very favourable: in 2001 alone revenue from personal income tax burgeoned by nearly 47% (an increase of 25.2% in real terms after adjusting for inflation), whilst tax revenue overall rose by 50%; the federal budget showed a surplus of 2.4%. Tax collection continued to improve in the following years, in particular with respect to personal income tax: it grew in real terms by 24.6% in 2002 and 15.2% in 2003. The Organisation for Economic Cooperation and Development called Russia's flat tax system a "key accomplishment," a rare praise from an organisation known for its critical stance. However, not all elements of the reform worked equally well. The introduction of the Unified Social Tax, probably the most important new element of the new taxation strategy after the flat personal income tax, has not produced the expected results.

The Failure of Social Taxation

The dynamics of social taxes in modern Russia cannot be fully understood without reference to the dramatic changes in the welfare state that have taken place following the collapse of the centrally planned economy. The extensive provision of subsidised or charge-free social services to the public was a crucial feature of the Soviet system. People's income could have been modest, but they felt well protected as far as the provision of education, health, pensions and social services, including housing and supporting utility networks, was concerned. Significantly, social cervices were provided not only by the state but also by state-owned enterprises: total social spending by the enterprise sector amounted to about 25% of the entire consolidated budget in the early 1990s.

The situation changed dramatically with the transition to capitalism. On the one hand, marketisation, leading to the growing risks of unemployment and impoverishment for a considerable part of the population, has greatly increased the need for social support. On the other hand, both the state and enterprises could not sustian the provision of social resources at customary levels. The consequences were grave. Most people were neither accustomed nor prepared, nor given an opportunity, to look after themselves. The amount and quality of traditional welfare was declining dramatically whilst a modern social safety net of the Western type was non-existent. For example, there was no practice of employers and workers contributing to a pension fund as all pensions were paid from the state budget and funded through general taxation.

Despite continued attempts to design a working system of social payments and taxes, results remained disappointing throughout the 1990s. In 1994, to take one typical year, the Pension Fund of the Russian Federation managed to raise only two-thirds of the expected payroll contributions. In the same vein, territorial medical insurance funds managed to collect just 30 to 35% of the projected total.

The poor performance of social taxes had a number of explanations. To begin with, the system of payments was extremely complex and its management fragmented and cumbersome. Up to 2001 only the rates of taxation were set by the federal law. Social contributions were to be paid directly into non-budgetory specialised funds: the State Pension Fund, the Social Insurance Fund, regional and federal Medical Insurance Funds and the State Employment Fund. The tax base for these payments, the regime of payment and other administrative issues were regulated by numerous instructions, directives and guidelines released by the managing bodies of all these Funds. On top of registering with local tax authorities every firm had to reg-

[11] Of this amount, 5% is payable to the central government, 17% is payable to the regional government, and 2% is payable locally. Regional governments have the power to reduce the regional element by up to 4%, giving a minimum overall rate of 20%.

[12] There is a reduced rate of 10% for certain basic food products, children's goods, certain medical products, medicines, drugs, and newspapers and magazines.

Table 1
Tax Burden on One Rouble of Payroll

Tax Base (1000 roubles)	UST						Personal Income Tax				Total					
	2000		2001-2004		2005		2000		2001-2005		2000		2001-2004		2005	
	Roubles	%	Roubles	%	Roubles	%	Roubles	%	Roubles	%	Roubles	%	Roubles	%	Roubles	%
50	19,750	0.395	17,800	0.356	13,000	0.260	6,000	0.120	6,500	0.13	25,750	0.515	24,300	0.486	19,500	0.390
100	39,500	0.395	35,600	0.356	26,000	0.260	16,000	0.160	13,000	0.13	55,500	0.555	48,600	0.486	39,000	0.390
150	59,250	0.395	45,600	0.304	39,000	0.260	26,000	0.173	19,500	0.13	85,250	0.568	65,100	0.434	58,500	0.390
200	79,000	0.395	55,600	0.278	52,000	0.260	41,000	0.205	26,000	0.13	120,000	0.600	81,600	0.408	78,000	0.390
250	98,750	0.395	65,600	0.262	65,000	0.260	56,000	0.224	32,500	0.13	154,750	0.619	98,100	0.392	97,500	0.390
300	118,500	0.395	75,600	0.252	74,800	0.249	71,000	0.237	39,000	0.13	189,500	0.632	114,600	0.382	113,800	0.379
350	138,250	0.395	80,600	0.230	79,800	0.228	86,000	0.246	45,500	0.13	224,250	0.641	126,100	0.360	125,300	0.358
400	158,000	0.395	85,600	0.214	84,800	0.212	101,000	0.253	52,000	0.13	259,000	0.648	137,600	0.344	136,800	0.342
450	177,750	0.395	90,600	0.201	89,800	0.200	116,000	0.258	58,500	0.13	293,750	0.653	149,100	0.331	148,300	0.330
500	197,500	0.395	95,600	0.191	94,800	0.190	131,000	0.262	65,000	0.13	328,500	0.657	160,600	0.321	159,800	0.320
600	237,000	0.395	105,600	0.176	104,800	0.175	161,000	0.268	78,000	0.13	398,000	0.663	183,600	0.306	182,800	0.305
800	316,000	0.395	109,600	0.137	108,800	0.136	221,000	0.276	104,000	0.13	537,000	0.671	213,600	0.267	212,800	0.266
1,000	395,000	0.395	113,600	0.114	112,800	0.113	281,000	0.281	130,000	0.13	676,000	0.676	243,600	0.244	242,800	0.243

Source: Ministry of Taxes and Duties of the Russian Federation.

ister with the local bureaus of each of the four Funds to which they had to report monthly. Each Fund would send out its own inspectors to verify compliance and impose its own sanctions on offenders. The parallel existence of different payment requirements confused accountants and made them make mistakes. Stifling control and numerous inspections interfered with the normal operations of firms. At the same time the absence of federal laws made it difficult for firms to seek protection in courts in their disputes with the four Funds. The decentralisation of tax collection not only increased the cost for taxpayers but for the state as well: the Funds were less efficient than the state tax service and spent more of their budget per collected rouble than the Finance Ministry. Overall, making each of the funds responsible for the collection of its own contributions multiplied collection costs.

Being a form of wage taxes, social payments proved particularly difficult to collect. Numerous tax evasion schemes had emerged, of which *obnalichivanie* (black cash tax evasion) was particularly widespread. Yakovlev[13] describes this scheme as follows. It is based on the replacement of high-taxed elements of total revenue such as salary or profit by low-taxed elements such as material expenditures, using the contract between the firm-taxpayer and an intermediary "sham" firm. Under the terms of the contract, the taxpayer transfers money to the bank account of the sham firm in exchange for a phoney work report. In exchange the taxpayer receives unaccounted, or "black", cash. The total amount of black cash returned equals bank payments minus the commission of the sham firm, typically less than 2% to 3% of the initial client's payment. The black cash funds are thus available for unofficial salary payments, investment or discretionary use by the firm management or the entrepreneur. According to estimates by Yakovlev, in 1993-1996 alone the four social Funds lost between US$ 20 and 30 billion to this scheme. Whilst in large firms sharing black cash with employees would be too conspicuous, it has become common for small and medium-sized enterprises to operate under a dual salary scheme. Every month they pay their employees a certain sum in cash, often in a foreign currency, but for the tax inspectors they keep another set of records on their books, showing much lower wages in roubles. The gap between real and "official" salaries may be huge. Employees can make between $100 and $300 per month, while on paper they earn a mere 500 to 1,300 roubles, equivalent to $16 to $42.[14] The reason for this practice is evident from the data in Table 1. It demonstrates that before the 2001-2004 reforms taxes on wages were equal to up to 67.6% of the total sum of wages.

On the whole, the system of social taxation in its 1990s guise was a disappointment and had the following drawbacks: it achieved extremely low rates of collections; it had high administration costs; it was extremely intrusive and disruptive as far as the activities of taxpayers were concerned; it was neither transparent nor fair, leaving a lot of room for bureaucratic arbitrariness. Overall, this system encouraged tax eva-

[13] Andrei Yakovlev: Black cash tax evasion in Russia: Its forms, incentives and consequences at firm level, in: Bank of Finland Institute for Economies in Transition BOFIT, Discussion Paper No. 3, 1999.

[14] Eric Engleman: Russia's Flat Tax Rakes in the Cash, Associated Press, April 13, 2002.

Table 2
UST and Personal Income Tax as a Share of GDP, 2001-2004

	1999	2000	2001	2002	2003	2004
1. GDP (billions of roubles)	4766.8	7302.2	9040.8	10950.0	13285.0	16700
2. All federal taxes (billions of roubles)	1338.4	2119.9	2574.1	3073.6	3543.8	4442.1
3. UST, including pension payments (billions of roubles)	357.9	530.3	602.0	745.4	875.6	1073.1
4. Personal Income Tax (billions of roubles)	116.5	174.2	255.5	357.1	455.3	574.0
3. Share of GDP (%):						
- All federal taxes	28.07	29.03	28.47	28.06	26.67	26.59
- UST	7.50	7.26	6.65	6.80	6.59	6.42
- Personal Income Tax	2.44	2.38	2.82	3.26	3.42	3.43
4. Share of UST in GDP as percentage on the previous year	-	97	92	102	97	97

Source: Goskomstat of the Russian Federation; Ministry of Taxes and Duties of the Russian Federation, Report forms 1-HM for 2001-2004.

sion, did little to establish the culture of paying taxes in the country and possibly contributed to social misery during this most difficult period of transition. This was not just because the state could not collect enough resources to support its social programmes, but also because firms were forced to lay off labour or pay lower wages to minimise their tax exposure.[15]

The Introduction of the Unified Social Tax

The Unified Social Tax (UST) was introduced in August 2000 as a solution to the crisis of social payments. It is a federal tax regulated by Chapter 24 of the new Federal Tax Code (Part 2). It became effective on 1 January 2001 and replaced all the payments that the four social funds used to collect independently. Its object of taxation is remuneration of any kind accrued in favour of a natural person employed under a labour or a civil law contract to perform work or render services, and royalty under copyright contracts.

UST has some unique features. This is the only tax for which the law explicitly determines how the proceeds should be used: half of it is allocated to pensions and the rest is split between social and medical insurance. Also, a substantial amount of payments goes directly into relevant social funds, but the scale at which these payments are made is now established in the Code itself. There are not many exceptions or special norms, making this tax transparent and equitable. A further new feature is that the tax base for the UST is not the total sum of payroll as before. The tax is calculated for every employee individually. This has to do with another unique characteristic of the UST: it is paid on a regressive scale in order to encourage enterprises to legalise their black cash payments.

Originally the scale of annual UST payments was as follows: 35.6% on the first 100,000 roubles; 20% on earnings from 100,001 to 300,000 roubles; 10% on earnings from 300,001 to 600,000 roubles; and 2% on all earnings over 600,000 roubles. It must be noted that this radical move did not create any sizable threat to the budget as 99% of officially paid annual wages were below 50,000 roubles.

When the UST was introduced in 2001, its top rate of 35.6% was lower than the summary rate of 38.5% that was payable during the previous decade. The regressive scale made the potential benefits for high-earning taxpayers even more substantial. Not surprisingly, the new tax was favourably rated by the business community. In 2004 UST had become the largest money-maker for the budget, pushing VAT, traditionally the largest earner, into second place. And yet the introduction of UST has not really brought about the desired breakthrough in the collection of social payments. As a matter of fact, the share of these payments in GDP has been falling progressively ever since UST was made operational and has never reached the pre-2001 level (see Table 2).

Still the UST rate of 35.6% proved to be very high in the eyes of enterpreneurs, especially if contrasted with the personal income tax rate of 13% and the corporate tax rate of 24%. In fact, it was lower than in some other European transition countries (Bulgaria 44.7%, Poland 47.3%), but higher compared to developed European countries (Sweden 26%, UK 22%). Almost immediately taxpayers started to exploit loopholes in the Tax Code to avoid UST. In order to implement the principle that payments to employees should be taxed only once, UST was not levied on expenses covered from after-tax profits. After-tax profits were defined as the difference between the financial result for the reporting period, computed on the basis of accounting records, and the amount of profits tax and other mandatory payments due. Therefore, after-tax, or retained, profits for unified social tax purposes referred to funds remaining at the disposal of an organisation after ac-

[15] According to some estimates, in the mid-1990s the payroll taxes raised a private firm's labour costs to about 1.7 times the take-home wage, not including the excess-wage tax.

Table 3
Average Retirement Income Replacement Rate (2004)

Monthly wage (roubles)	Monthly pension (roubles)	Replacement rate (%)
600	600	100
3000	1200	40
6000	1800	30
12000	2400	18
18000	2500	14
30000	2700	12

Source: Analiticheskii vestnik, No. 18, May-June 2004.

tual payment of the profits tax. The owners of an enterprise were free to decide how to use these funds. Under these conditions it made economic sense for employers to show a part of the payroll as profit taxable at 24% and reimburse employees from retained profit by paying them "bonuses". The budget would receive more corporate tax but not enough to compensate the loss of UST chargeable at the rate that was a third higher. Another tax avoidance scheme based on the same idea that particularly suited small and medium-sized enterprises was not to put employees on the payroll but subcontract them as independent entrepreneurs.

Disappointingly, the regressive scale failed to encourage people to state their actual wages. In 2003 only 118.4 thousand employees, only just 0.002% of the labour force, declared an annual income of over 600,000 roubles (about $1,800 per month). Although there are no official statistics, independent experts estimate the number of employees that earned over $2,000 per month as at least 5% of the labour force or 3.3 million people. In other words, only one in 25 eligible taxpayers was tempted by the regressive scale.

Predictably, the response of the policymakers was to apply more of the same medicine. Already in late 2003/early 2004 signals were sent out that the UST was to be reduced soon. However, when the ammendments to the tax were revealed in January 2005, they sent out a mixed signal about the possible future of the UST. On the one hand, the base rate was reduced from 35.6% to 26%. On the other, the scale has become less regressional.

From 2005 UST has the following annual rates: 26% on the first 280,000 roubles, 10% on earnings from 280,001 to 600,000 roubles and 2% on all earnings over 600,000 roubles. The new scale favours those taxpayers who pay wages of up to 25,000 roubles per month and leaves the tax burden almost unchanged for wages above this sum. Consequently it is expected that in 2005 no more than one per cent of employees are likely to reveal wages that put them on the regressive stretch of the scale. In other words, the main objective of the regressive scale, to bring black cash salaries above the board, remains as remote as before.

Does the UST Have a Future?

After a decade of stringent controls, the Russian tax system has embraced liberalism as a key principle of its organisation. As far as the UST is concerned, the objective has been to increase official wages and draw job remuneration out of the shadow sector. According to the calculations of the Budget and Tax Committee of the Russian parliament, under the best of scenarios about 30 billion roubles (US$ one billion) can be expected to be legalised, increasing the tax proceeds of the social funds.[16] In reality the UST has not achieved its objective so far. In fact, in 2001-2004 the share of social payments into the budget was lower than it used to be before the introduction of the UST. On the positive side, in 2004 the collection of social taxes increased over the previous year by 21.7%. If this trend proves to be sustainable, it will signify a major breakthrough in relations between taxpayers and the authorities. In the meantime analysis suggests that it will not be easy for the new tax to meet all expectations.

The UST remains one of the most complex taxes in terms of administration. Employers pay the UST by monthly advances at the end of each calendar month; the balance between the tax due and the sum of advances must be paid not later than on the 20th of the next month and finally the end of the year settlement should be paid not later than 15 days after the annual tax return deadline. The tax is to be dispatched to a number of recipients such as the federal budget, the Social Insurance Fund and federal and regional funds of Compulsory Medical Insurance. This requires filling in as many as eleven payment orders every time the tax is paid. Besides, the taxpayer has to submit regular estimates on advance payments to the tax bodies.

More significantly, the hallmark of the new tax, its regressive scale, has failed to make any noticeable difference in the behaviour of taxpayers. Only a tiny fraction of high salaries has been legalised. This is a reminder that the UST is only a part of the equation that also includes the organisation of social expenditures. The attitude to UST by taxpayers will not change unless there are improvements in welfare provisions. Here the situation is not very encouraging. One of the

[16] ITAR-TASS, 11.06.2004.

big issues is the low pension/salary replacement rate. If in the countries of Western Europe the replacement rate after forty years of service equals 60-70%, in Russia it is only 25-30%. The rate is particularly low for employees who earn more than the national average wage, currently about 5,600 roubles ($200) per month. For this category it quickly falls to as little as 8-12% (see Table 2), undermining incentives to pay the UST. Powerful lobbying groups insist that the regressive scale should be abandoned in favour of a low flat rate. Thus, according to the powerful and representative Business Russia Association, a unified social tax of 15 per cent on payrolls would entice 90% of businesses operating in the shadow economy to go legal.[17]

Lowering the rate even further and simplifying its administration may indeed be a way forward, although it must be noted that after the latest revisions total payroll taxes in Russia came very close to the rates payable in the developed European countries. However, the evaluation of this option requires putting the UST in the context of the national social budget as a whole. The Finance Ministry estimated that the recent reduction of the rates would cost the already strained budget between 189 and 220 billion roubles in 2005 alone. In anticipation of this shortfall the government took the extraordinary decision to use the resources of the emergency Stabilisation Fund as a source for pensions in 2005. It is clear that the problem of social taxes cannot be resolved in isolation from measures that modernise the distribution of social benefits and the social safety net considering that seventy per cent of the population are entitled to benefits. Modernisation may take two directions: achieving greater efficiency by transferring some payments directly to taxpayers and changing the pension and social payments regulations in such a way that they make it less attractive for employees to receive salaries under the table.

For example, it is reasonable to expect that if the payment of medical insurance for short-term illnesses is reassigned to employers, the cost of administration is going to fall in comparison with the current centralised system, increasing the effective rate of taxation. However, a central position should be given to pension reforms because of the link between the UST and pensions (pensions are paid entirely out of UST proceeds at the moment), the great size of pension funds and the critical demographic situation in the country.[18] One option is to make employees contribute to the Federal Pension Fund as is the norm in many countries. Some positive results may be achieved through the development of the market for financial services. At the moment it is in an embryonic state, mostly due to the lack of trust between financial companies and potential clients. However, an increase in the popularity of private pension schemes will put pressure on employees to receive higher official salaries because the current legislation makes the total amount which individuals can invest into the private pension system conditional on their declared salary. Equally, as the demand for consumer credit and mortgages begins to grow, employees will realise that their credit standing will depend on employer-supplied proof of actual wages. However, private pension funds and the availability of other financial instruments are unlikely to make any noticeable impact on the behaviour of Russian people because the economic situation in the country unequivocally encourages short-term choices. Suffice it to say that at 60, the average male's retirement age is higher than his life expectancy of 59 and investors' horizons rarely extend beyond 6 months.[19]

Reforms Must Go On

There have been remarkable improvements in the performance of the tax system in Russia in the last five years. Nonetheless the tax system in Russia has not stabilised yet. The government's strategic line continues to be the creation of a more efficient and transparent system. This attitude was confirmed in the president's state of the nation address at the end of April 2005, when he urged fiscal agencies not to "terrorise" business. The fine-tuning of tax rates is far from being over. There are indications that a reduction of VAT may be on the cards as well as the introduction of additional amortisation premiums for investments and the simplification of the rules of including the cost of R&D and experimental works in expenses. Following this course is going to be a very difficult balancing act as mounting losses will have to be covered somehow. The financial requirements of social security remain immense and may even increase if the adverse social consequences of the transition are not reversed. The price of a mistake can be very high but the pace of reform cannot be slowed if the modernisation targets set by the government are to be met.

[17] The specific rate of 15% may be inspired by the example of such fast growing economies in the world as South Korea, in which the respective rate is 15.5%.

[18] The ratio of economically active citizens per pensioner fell from 2.3 in 1990 to 1.7 in 2002, as people died at more than one and a half times the rate they were being born, resulting in a net population loss over 7.5 million during the 1990s.

[19] Andrei Uspensky: Mutual Funds in Russia: Developments and Prospects, Presentation to the U.S.-Russian Investment Symposium, Boston April 23, 2003. Available at: http://www.usris.com/index.v3page?p=34053.