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The Russian Tax System and Its International Competitiveness

The last several years were very favourable to the development of the Russian economy. While this has partly been the consequence of favourable conditions on the international markets for raw materials, the economic policy of President Vladimir Putin, including the tax reforms initiated at the end of the 1990s, also played a major role. Our authors examine in detail the effects of the tax reforms to date and point out the room for further improvements under Putin's successor, Medvedev.

In 2002 we published the article "The Russian Tax Reform",[1] in which we presented a first evaluation of modern Russian tax policy and the tax reforms of 2000/01; now we are continuing in this vein and following up the topic of our paper by analysing, first, the consequences of the previous tax reform for the Russian economy, second, different aspects of Russian fiscal competitiveness in comparison with its main rivals in the world economy (such as the other BRIC countries – Brazil, India and China – as well as the closest and biggest Russian neighbours from Eastern Europe – Poland and Ukraine) and third, the extent of any remaining shortcomings of the Russian tax system.

In this paper, the "competitiveness" of the tax system is understood as its attractiveness for capital (and, in the second place, highly skilled labour). Therefore, we try to measure (at least approximately) competitiveness in terms of, above all, international capital flows. Attractiveness, in turn, is assumed to be influenced (negatively) by the level of tax rates and (positively) by the predictability and lawfulness of tax administration. It follows that, ceteris paribus, lower tax rates or an improved tax administration should make a tax system more competitive and attract more capital. Admittedly, this is quite a simplistic view because the role of government expenses is completely neglected. It is possible, for example, that tax rates are too low to raise enough revenue to pay for important public goods – the absence or poor quality of which might make the country in question a very unattractive place to invest

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[1] A. Pogorletskiy, F. Söllner: The Russian Tax Reform, in: INTERECONOMICS, Vol. 37, No. 3, 2002, pp. 156-161.

Table 1
Russia in Comparison with the World's Largest Economies, Poland and Ukraine

Total GDP ranking (2006)	Country	Population* (millions, 2007)	Total GDP (US $ billion, 2006)	GDP growth (%, 2006)	PPP GDP in US $* (US $ billion, 2006)	GNI per capita* (US $, 2006)	
						Atlas method	PPS
1	USA	299.0 (3)	13,201.8	3.3	13,201.8 (1)	44,970 (10)	44,260 (4)
2	Japan	127.6 (10)	4,340.1	2.2	4,131.2 (4)	38,410 (19)	33,150 (24)
3	Germany	82.4 (14)	2,906.7	2.8	2,616.0 (5)	36,620 (20)	31,830 (27)
4	China	1,311.8 (1)	2,668.1	10.7	10,048.0 (2)	2,010 (129)	7,740 (102)
5	UK	60.4 (21)	2,345.0	2.8	2,111.6 (6)	40,180 (16)	35,580 (14)
6	France	61.0 (20)	2,230.7	2.0	2,039.2 (7)	36,550 (22)	33,740 (22)
7	Italy	58.6 (23)	1,844.7	1.9	1,795.4 (8)	32,020 (28)	30,550 (30)
8	Canada	32.6 (36)	1,251.5	2.8	1,140.4 (14)	36,170 (23)	34,610 (20)
9	Spain	43.5 (29)	1,224.0	3.9	1,243.4 (11)	27,570 (33)	28,030 (33)
10	Brazil	188.7 (5)	1,068.0	3.7	1,708.4 (9)	4,730 (92)	8,800 (91)
11	*Russia*	*142.4 (9)*	*986.9*	*6.7*	*1,704.8 (10)*	*5,780 (79)*	*11,630 (78)*
12	India	1,109.8 (2)	906.3	9.2	4,247.4 (3)	820 (161)	3,800 (146)
22	Poland	38.1 (32)	338.7	5.8	588.6 (22)	8,190 (70)	14,830 (68)
51	Ukraine	46.6 (27)	106.1	7.1	355.9 (29)	1,950 (131)	7,520 (107)

* In brackets – ranking in the world.

Source: World Bank: http://siteresources.worldbank.org/DATASTATISTICS/Resources/; http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/.

in, the low tax rates notwithstanding. In the case of Russia, however, we may safely neglect this possibility: as long as the budget expands and still shows surpluses (see below), lower tax rates cannot be responsible for any problems with the supply of public goods and may therefore be interpreted as increasing the attractiveness of the tax system (and, thus, of the country itself).

The Growth of the Russian Economy and Its Causes

The last several years were very favourable for the development of the Russian economy: rates of GDP growth averaged 7% annually since the financial crisis of 1998 (8.1% in 2007[2]); at the beginning of 2008 currency reserves exceeded $475 billion[3] and the stabilisation fund contained more than $155 billion;[4] the federal budget has run surpluses since 2001 and ended 2007 with a surplus of 6% of GDP;[5] government debt has fallen to record lows; official unemployment at the end of 2007 fell to 2%;[6] and the ruble has become one of the most stable currencies. Over the last six years, fixed capital investments have averaged real rates of return of more than 10% (in June 2008 the re-financing rate of the Central Bank of Russia was 10.75%) and personal incomes have achieved a real growth of more than 12% per annum.[7] In 2006 Russia was ranked 11th in the world in terms of total GDP, and its per capita indicators were better than those of the other BRIC countries and the Ukraine (cf. Table 1).

Is this impressive development merely the consequence of favourable conditions on the international markets for raw materials (especially the high prices for crude oil and gas – the principal Russian export goods) or is it the achievement of the economic policy of President Vladimir Putin?

It has to be admitted that the favourable economic situation was, to a considerable degree, due to the growth of oil and gas prices on the international markets. According to expert estimates, these commodities were the most important component of both the "stable" economic growth in Russia and the favorable situation of Russian public finances. Thus, in the decade of radical systematic economic transformation (1986–1996), when oil prices were low, the average annual growth of the national economy was *minus* 8.5%. A decade later (1996-2006), after strong oil price increases, the average growth rate of the Russian economy climbed to *plus* 5.4% and forecasts for 2006 – 2010 made by the World Bank predict an average rate of growth of 6.3%.[8] The positive influence of

[2] http://www.cbr.ru/.

[3] Ibid.

[4] http://www1.minfin.ru/ru/stabfund/statistics/volume/; on 1 February 2008 the Stabilisation Fund (almost $158 billion) was divided into two parts – the Reserve Fund ($126 billion) and the National Welfare Fund ($32 billion).

[5] http://www.lenta.ru/news/2008/01/17/itog/.

[6] http://www.lenta.ru/news/2007/12/06/unemployment/. Real unemployment is closer to 6% or 7%; people are officially counted as unemployed only if they apply for unemployment benefits.

[7] https://www.cia.gov/library/publications/the-world-factbook/geos/rs.html.

[8] http://devdata.worldbank.org/AAG/rus_aag.pdf.

Table 2
Size of Oil and Gas Balance of the Russian Federal Budget

	2002	2003	2004	2005	2006
Consolidated budget balance, % of GDP	1.0	1.4	4.5	7.7	7.7
Federal budget balance, % of GDP	1.4	1.7	4.4	7.4	7.4
Balance of the federal budget without revenue from and expenditures for the oil and gas industry, % of GDP (IMF data)	-5.2	-4.6	-4.3	-5.9	-7.4
Balance of the federal budget without revenue from and expenditures for the oil and gas industry, % of GDP (data from the Russian Ministry of Finance)	-	-	-	-5.5	-5.1

Source: Russian Ministry of Finance, http://www1.minfin.ru/common/img/uploaded/library/2007/05/taxpoltend.pdf.

oil and gas prices on the surplus of the Russian federal budget is shown in Table 2. We can see that without the growth of oil and gas export income the real balance of the Russian federal budget would have been negative.[9]

Although high oil prices and a relatively cheap ruble initially drove Russian economic growth, since 2003 consumer demand and, more recently, investment have played a significant role. Thus the medium and long-term effects of the structural economic reforms of the 1990s, such as privatisation and price, market and trade liberalisation, have made themselves felt. One important part of the reforms that has positively influenced the Russian economy was the tax reform initiated at the end of the 1990s.[10] Admittedly, it is difficult to pinpoint the extent of its influence but, as taxation is a very important determinant of international capital flows, the development of these flows seems to indicate that, in any case, the tax system has become more competitive.

[9] Oil and gas related revenue is due not only to the tax on the extraction of natural resources but also to excises and VAT on the sales of oil and gas products in Russia and to the corporate profit tax paid by the oil and gas industry.

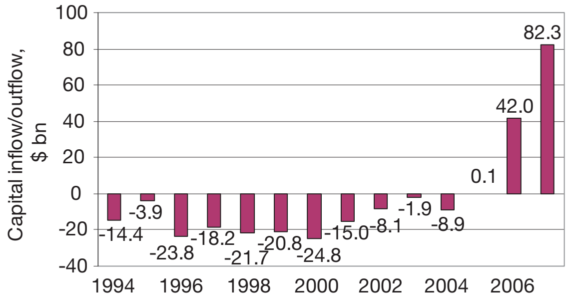
[10] Cf., e.g., A. Pogorletskiy, F. Söllner, op. cit.

Russia's Position in the International Capital Markets

Since 2006 the Russian Federation is a relatively desirable destination for foreign investments; so far, it has even been quite immune to the turbulences on world financial markets in the wake of the US mortgage crisis of 2007/08. Figure 1 shows the positive dynamics of capital movements to and from Russia and illustrates the radical changes in this area since 2005.

The stable economic situation and especially the favourable development of the domestic market now attract more FDI to the Russian economy than in the 1990s and also allow Russian companies in different industries (such as Gazprom, Rusal, Krasair, VTB, Alfa, LSR and many others) to expand abroad by purchasing competitors or creating their own business units in foreign countries. Table 3 shows the current financial situation of the corporate sector in Russia. We can observe strong growth of all domestic indicators during 2006 and 2007 and even stronger growth of Russian FDI abroad. Besides, according to UNCTAD data for 2006, Russia, as an FDI recipient, also did quite well in comparison with Brazil, India, China, Poland and Ukraine: the Russian economy absorbed FDI of almost $30 billion during that year (over $10 billion more than

Figure 1
Net Capital Flow to/from Russia: 1994-2007 Dynamics



Source: Central Bank of Russia, http://www.cbr.ru/statistics/credit_statistics/print.asp?file=capital.htm.

Table 3
Credits and Investments of Corporate Sector in Russia, 2006 and 2007

	2007		2006	
	US $ billion	Growth per annum	US $ billion	Growth per annum
FDI in Russia	47.1	58%	29.9	230%
Russian FDI abroad	47.8	200%	23.5	180%
Debts of banks for the end of the year	171.5	70%	101	200%
Debts of companies for the end of the year	236.0	47%	161	29%

Source: Vedomosti, 14 January 2008, http://www.vedomosti.ru/newspaper/showpicture.shtml?2008/01/14/139545_a_pic1.

Table 4
FDI Flow and Stocks, 2006
(US $ billion)

	Russia	China (without Hong Kong)	India	Brazil	Poland	Ukraine
FDI flow	28.7[a]	69.5	16.9	18.8	13.9	5.2
FDI stock	197.7	292.6	50.7	221.9	103.6	22.5

[a] The difference between $28.7 billion (Table 4) and the respective number in Table 3 ($29.9 billion) is due to fluctuations in the dollar/ruble exchange rate between summer 2007 (when the entries in Table 4 were calculated) and the end of 2007 (when the entries in Table 3 were calculated).

Source: World Investments Report 2007, Geneva: UNCTAD, 2007, http://stats.unctad.org/FDI/TableViewer/tableView.aspx?ReportId=899.

India and Brazil, twice the amount Poland received and more than five times the amount going to Ukraine) and FDI stocks in the country reached almost $200 billion (cf. Tables 4 and 5). Four Russian companies, all of them belonging to the oil and gas sector (Gazprom, Lukoil, Rosneft and Surgutneftegas), were among Fortune's global 500 (along with 24 Chinese, six Indian and one Polish company) in 2007.[11]

An Outline of the Russian Tax System

The tax reform at the beginning of the 21st century was the first step towards building a competitive tax system for the Russian Federation. During the tax reform process the following steps were made:

- *Increasing the fairness and neutrality of the tax system* by abolishing unjustifiable tax advantages and ineffective taxes (such as the sales tax and the road user's tax) by improving collection methods, and by introducing clear rules for tax base determination and tax administration;
- *reducing the overall tax burden for taxpayers* by evenly distributing the tax burden, decreasing the tax burden of the wage fund and lowering individual income and corporate profit taxes (of course, it was the *nominal* tax burden that was reduced; the *effective* tax burden of some tax evaders who were targeted by a more effective tax administration may well have increased);
- *tax system simplification* by reducing the number of taxes and collection methods, and by simplifying and rationalising tax payment;
- *bringing stability and predictability to the tax system* by abandoning the chaotic and unsystematic tax legislation of the Yeltsin era.

The reform was designed to rationalise the tax system by, for example, reducing the number of taxes, and to lower the corporate and individual tax burden. Changes to the tax regime that came into effect in January 2001 included the introduction of a flat-rate personal income tax of 13% and the simplification of social security taxation. The corporate tax rate was lowered from 35% to 24% at the start of 2002. The basic rate of value-added tax (VAT) was reduced from 20% to 18% at the start of 2004, and a regional 5% sales tax was abolished. Furthermore, tax administration has continuously been improved since the beginning of the new century (e.g., tax revenue in 2007 grew almost 30% year-on-year[12]).

In the international context, Russia has more than 60 treaties on double taxation with almost all the major

[11] http://money.cnn.com/magazines/fortune/global500/2007/countries/Russia.html.

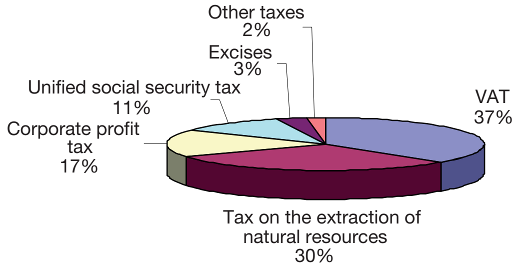
[12] http://www.nalog.ru/html/docs/pril_2007.xls.

Table 5
Foreign Investment Inflow into the Russian Economy

	1995		2000		2002		2003		2004		2005		2006	
	US $ m	%	US $ m	%	US $ m	%	US $ m	%	US $ m	%	US $ m	%	US $ m	%
Total foreign investment	2983	100	10958	100	19780	100	29699	100	40509	100	53651	100	55109	100
Investment from:														
Cyprus	40	1.3	1448	13.2	2327	11.8	4203	14.2	5473	13.5	5115	9.5	9851	17.9
UK	183	6.1	599	5.5	2271	11.5	4620	15.6	6988	17.3	8588	16.0	7022	12.7
Holland	85	2.9	1231	11.2	1168	5.9	1743	5.9	5107	12.6	8898	16.6	6595	12.0
Luxembourg	4	0.1	203	1.9	1258	6.4	2240	7.5	8431	20.8	13841	25.8	5908	10.7
Germany	308	10.3	1468	13.4	4001	20.2	4305	14.5	1733	4.3	3010	5.6	5002	9.1
France	108	3.6	743	6.8	1184	6.0	3712	12.5	2332	5.8	1428	2.7	3039	5.5
British Virgin Islands	17	0.6	137	1.3	1307	6.6	1452	4.9	805	2.0	1211	2.3	2054	3.7
Switzerland	436	14.6	784	7.2	1349	6.8	1068	3.6	1558	3.8	2014	3.7	2047	3.7
USA	832	27.9	1594	14.6	1133	5.7	1125	3.8	1850	4.6	1554	2.9	1640	3.0
Kazakhstan	12	0.4	6	0.1	51	0.2	195	0.6	439	1.1	733	1.4	1116	2.0
Other countries	958	32.2	2745	24.8	3731	18.9	5036	16.9	5793	14.2	7259	13.5	10835	19.7

Source: Federal service of state statistics (Rosstat), http://www.gks.ru/bgd/regl/b07_13/IssWWW.exe/Stg/d05/23-19.htm.

Figure 2
Structure of Tax Revenues in the Federal Budget of the Russian Federation, 2007



Source: Russian Federal Tax Service, http://www.nalog.ru/document.php?id=26174&topic=budjet_fed.

countries of the world. They make it sufficiently easy to repatriate profits (especially dividends, interests and royalties) from Russia to other countries as well as to invest into the Russian economy through low-tax countries and international holding, financial, licensing and service companies and banks. That is why more than 50% of FDI inflow in 2006 came from Holland and Cyprus which both have favourable tax treaties with Russia; Switzerland, Luxembourg and the British Virgin Islands (popular locations of offshore companies used in international operations with Russia) also figure among the ten principal foreign investors (cf. Table 5).[13]

The reform of the Russian tax system was realised by taking into account the insights of modern public finance theory and the results of the neo-conservative tax reforms in the USA and UK as well as of the successful VAT implementation in Europe. Stimulating business by considerably reducing income and profit taxes and shifting the tax burden to indirect taxes (VAT and the tax on the extraction of natural resources) were the specific traits of the Russian tax reform of the 2000s. It became the most coherent and effective reform of all the economic transformations pursued by president Vladimir Putin and his administration. As a result, Russia now has a quite modern and competitive tax system which strongly contributes to making Russia attractive to both domestic and foreign individuals and corporations.

The structure of tax revenues in the Russian federal budget in 2007 is shown in Figure 2.[14] We can see a proportion of 70:30 between indirect and direct taxes in the Russian federal tax system as well as the important roles of VAT (37%) and the tax on the extraction of natural resources (30%) as the principal sources of tax revenue for the central government. Such a tax structure may have been typical for developing countries with problems with the collection of direct taxes. However, it has also become more common in Europe: in the 2000s the share of indirect taxes (taxes on goods and services) in total tax revenue exceeded 30% in Holland, the United Kingdom, Finland, Denmark and Ireland. Moreover, in Ireland, whose tax system is one of the most competitive in Europe, the share of indirect taxes in total tax revenue even approached 50% (it was 46.6% in 2004).[15] In France in 2007 indirect taxes (VAT plus internal tax on oil products) were responsible for 55.8% of total tax revenue.[16] It appears that Russian taxes are not too burdensome either for companies or for individuals, especially taking into consideration the VAT rate of only 18% in comparison with higher VAT rates in Austria, Germany, France, Sweden and Denmark.

Nevertheless budget dependence on oil and gas (revenue from the tax on the extraction of natural resources amounts to one third of the federal tax revenue) makes the cyclical factor in modern Russian fiscal policy quite important. Table 6 shows the considerable growth of the cyclical component of tax income, i.e. of that part of tax income which is due to favourable

[13] http://www.aksionbkg.com/web/resources/materals/infobulletin/InfoBulletin81.pdf.

[14] The income tax does not appear in the graph because income tax revenue (the share of which in the consolidated budget of Russia is about 20%) goes only to state and muncipal entities, not to the federal government.

[15] Cf. OECD in Figures 2007, at: http://miranda.sourceoecd.org/vl=322126/cl=18/nw=1/rpsv/figures_2007/en/index.htm.

[16] http://www.budget.gouv.fr/presse/dossiers_de_presse/voeux080122/01execution_budget.pdf.

Table 6
Evaluation of Structural and Cyclical Components of the Russian Federal Budget
(% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Actual tax income	11.0	10.9	8.8	10.7	13.2	16.2	18.6	18.0	18.8	21.0	22.2
Structural component of tax income	12.3	12.7	12.5	12.8	12.7	16.7	18.9	17.4	16.1	15.8	15.2
Cyclical component of tax income	-1.3	-1.8	-3.7	-2.1	0.5	-0.5	-0.3	0.6	2.7	5.2	7.0

Source: Russian Ministry of Finance, http://www1.minfin.ru/common/img/uploaded/library/2007/05/taxpoltend.pdf.

Table 7
Tax Competitiveness as a Part of Global Competitiveness: International Comparisons

Country	Global Competitiveness Index 2007-2008 (overall)[1]	Tax factors of competitiveness[1]		Taxation as one of the most problematical factors for doing business, percentage of responses[2]	
		Extent and effect of taxation	Total tax rate	Tax regulations (%)	Tax rates (%)
United States	1	48	63	14.8	15.0
Germany	5	85	95	22.9	20.0
Japan	8	66	87	22.1	18.6
United Kingdom	9	45	29	15.5	16.2
China	34	47	114	7.2	5.3
India	48	29	116	7.4	4.9
Poland	51	101	40	17.6	7.5
Russia	*58*	*97*	*90*	*15.0*	*10.0*
Brazil	72	131	109	18.2	16.0
Ukraine	73	123	101	13.4	8.9

[1] Rank among 131 positions. Among the "tax factors of competitiveness", the "total tax rate" rank is based on hard data whereas the "extent and effect of taxation" rank reflects the attitudes and opinions of the participants of the Executive Opinion Survey (EOS).

[2] From a list of 14 factors, respondents to the EOS were asked to select the five most problematical for doing business in their country and to rank them between 1 (most problematical) and 5. To calculate the percentages, the responses were weighted according to the rankings. Thus, in the case of Russia, the 10% value in the "tax rates" column can be interpreted as, e.g., 10% of all respondents having named tax rates as the most problematical factor (rank 1, weight 1).

Source: World Economic Forum, http://www.gcr.weforum.org/.

conditions on global energy markets.[17] Under such circumstances one has to be concerned about the instability of the current federal budget structure. Moreover, the situation in 2006 was even worse than in 1998 when Russia suffered a serious financial crisis provoked by the influence of external factors. Any price collapse on the international raw materials markets can cause a drastic decrease in tax collections because, nowadays, the cyclical component of tax income is equal to about one third of total tax income (7% of GDP). Therefore, the budget is very exposed to destabilising external shocks.

Russia and International Tax Competition

When one looks at Russian competitiveness in the world economy, it becomes clear that the global competitiveness rating of the country is not particularly high. According to evaluations of the World Economic Forum for 2007-2008, the Russian Federation occupies the 58th place among 131 nations (behind China, India and Poland but before Brazil and Ukraine) – which is due to problems like corruption, excessive bureaucracy and (outside the major cities) poor infrastructure. In the field of taxation the Russian position is even worse: ranks 97 and 90 with regard to "extent and effect of taxation" and "total tax rate" respectively.[18] This is quite astonishing in the light of the Russian tax reform and can only be accounted for by the persistent gap between the (good) tax laws and their (bad) execution by the administration (see below). At least in comparison with its international rivals Russia's position looks a lot better: India, China, Brazil, Poland and Ukraine have either a higher tax-to-GDP ratio or higher tax rates or both (cf. Table 7). Besides, complaints by Russian businessmen about taxation as one of the most problematical factors for doing business are quite muted compared to the same complaints in other countries such as the USA, Germany, Japan, United Kingdom, Poland, Brazil and Ukraine.

Comparing present Russian positions in international tax competition with other (big) emerging countries such as Brazil, India, China, Poland and Ukraine (cf. Table 8) we can also see some advantages of the modern Russian tax system in aspects such as the fiscal freedom index and overall tax burden. While the tax burden level in Russia (36.6% of GDP in 2007) was the highest among the above-mentioned countries, this rate is comparable with that of the United Kingdom (36.0%) and even lower than in some busi-

[17] In Table 6, the "cyclical component" is defined as the difference between actual tax income and the hypothetical tax income that would result if the "normal" price of Urals oil (assumed to be $27 per barrel) were realised; thus, a positive (negative) cyclical component reflects particularly high (low) prices.

[18] It should be pointed out that the WEF rankings are not unproblematical: the General Competitive Index (GCI) is calculated as a weighted average of the values of twelve "pillars of competiveness" (e.g. institutions, infrastructure, market size, business sophistication). All in all, 113 variables are used to calculate the GCI and its sub-indices – of which only 34 are "hard" data (such as the inflation rate or the ratio of tax revenue to GDP) and 79 are derived from the Executive Opinion Surveys which the WEF conducts annually. Of course, both the subjective nature of the latter 79 variables and the (unavoidable) arbitrariness involved in determining the weights of the twelve "pillars" make it necessary to exercise some caution when interpreting the GCI results.

Table 8
Levels of Taxation: Comparative Analysis, 2007

	Tax burden (% of GDP)	Fiscal freedom index (%)	Rates of principal taxes (%)						
			Corporate profit tax	Capital gains tax	Withholding taxes on			Individual income tax	VAT (standard rate)
					Dividends	Interest	Royalties		
Russia	*36.6*	*79.2*	*20-24*[a]	*20-24*[a]	*9/15*[b]	*15/20*[c]	*20*	*13 (flat rate)*	*18*
Brazil	35.0	68.6	15[d,j]	15[d]	0	15	15	15, 27.5 (progressive)	7-18[i]
India	15.8	75.7	30[d]	20[d]	0	20/41.82[e]	10/20	10, 20, 30[d] (progressive)	– [f]
China	15.8	66.4	33[g]	33	10[h]	10	10	5-45 (progressive)	17
Poland	34.4	68.6	19	19	19	20	20	19, 30, 40 (progressive)	22
Ukraine	35.4	79	25	25	15	15	15	15 (flat rate)	20

[a] Depending on the tax payable to regional governments.

[b] The 15% rate applies if either the payer or recipient of the dividends is a foreign legal entity.

[c] 20% is the regular rate; the 15% rate applies only to certain state and municipal securities.

[d] A surtax of 10% is also levied.

[e] The 20% rate applies to interest income from foreign currencies.

[f] VAT does not exist in the national tax system.

[g] Of which 30% is national corporate profit tax rate and 3% is local corporate profit tax rate.

[h] Dividends remitted abroad by foreign investment enterprises and foreign enterprises are exempt from withholding tax.

[i] Depending on the State.

[j] 9 per cent social contribution on net profit is also levied.

Sources: Worldwide Corporate Tax Guide, 2007, Ernst & Young; PricewaterhouseCoopers, http://www.taxsummaries.pwc.com; Index of Economic Freedom 2008, http://www.heritage.org/ research/ features/index/.

ness-friendly countries of the European Union such as Luxembourg (37.8%), Holland (37.5%), Austria (42.6%) and Belgium (45.0%).[19] It is necessary to add that before the tax reform of the 2000s the tax burden level in Russia was more than 40% of GDP. The fiscal position of the Russian Federation is also preferable in terms of different tax rate levels, especially those of individual income taxation, where Russia was the first among the above-mentioned group of countries to introduce a flat rate of only 13%. (This decision by the Russian authorities was the most important component of the tax reform.) Even Ukraine has copied this Russian example in its present tax policy. The rates of corporate taxation in Russia (20% to 24%, depending on the location of business) also are quite competitive in comparison with Brazil (overall tax rate in the country is 34%), India (33%), China (33%), Ukraine (25%) and Poland (19%).

In its “2008 Index of Economic Freedom” the Heritage Foundation classified Russia as a “repressed” country, occupying 134th position behind Brazil, India, China, Poland and Ukraine.[20] Nevertheless, Russia’s fiscal freedom index is the highest among those countries and in this field Russia achieved its best results in the investigation. Even under the conditions of Putin’s “sovereign democracy”, characterised by strong government influence on private business, taxation remained the one field not subject to the repressive control of Putin’s administration. Indeed the Russian tax legislation prepared by the team led by Deputy Minister of Finance Sergey Shatalov is one of the most liberal, modern and well-made in Europe. The same is definitely not true of the administration of those tax laws, which continues to be haunted by corruption, inefficiency and political interference. In particular, the Russian government from time to time uses the tax law to crush political opponents – most prominently in the case of Mikhail Khodorkovkiy and Platon Lebedev (who were imprisoned and whose oil company, Yukos, was bankrupted by Putin’s administration on accusations of, *inter alia*, tax fraud).[21]

Still, the modern Russian tax system at least seems to be simpler and better administrated than the tax systems in the other BRIC countries and Poland and

[19] OECD in Figures 2007, op. cit.

[20] The Index of Economic Freedom is the average of ten sub-indices such as “business freedom”, “trade freedom” and “fiscal freedom” (with the latter depending on the level of tax rates and tax revenues as a percentage of GDP); it is expressed in per cent (with 100% indicating total freedom); http://www.heritage.org/research/features/index/countries.cfm.

[21] More recently, in January 2008 a criminal case on tax evasion was opened against Semen Mogilevich and Vladimir Nekrasov (owners of Arbat Prestige – one of the leaders in the Russian retail perfumery trade). Independent observers note the political character of this case because of a connection with some Ukrainian and Russian political opponents of the Kremlin (cf. http://www.newsru.com/russia/30jan2008/krime.html).

Ukraine. So, despite some troubles and problems with tax administration, the country is competitive in the fiscal area, not only relative to its direct rivals but also relative to many developed countries. Indeed, living and working in Russia now, especially in the big cities (such as Moscow – the city with the highest incomes and living standards in Russia, and with the most billionaires worldwide – or St. Petersburg, Ekaterinburg, Nijniy Novgorod, Novosibirsk, Krasnoyarsk) and being a Russian tax resident is quite popular among many Western businessmen and creative people who take into consideration good business perspectives and low levels of individual income taxation.

Nevertheless, in order to defend and even improve its present position in international tax competition Russia needs to further modify the tax system, adapting to new global challenges.

Further Modifications of the Tax System

According to the official positions of the Russian authorities, the tax reform of the 2000s has been all but completed and there are no plans for reforms that would affect the structure of the tax system.[22] Instead, the current tax policy in the Russian Federation aims at improving the present system of taxation by, in particular, removing any remaining inconsistencies. Thus, it is intended to:

- *improve the quality of the national tax administration* (improving relations between taxpayers and tax authorities; controlling transfer pricing between domestic and foreign companies controlled by Russian residents; defining tax residency for juridical persons);
- *increase the effectiveness and neutrality of the main taxes* (correcting taxable income for general income growth and inflation, lowering of basic tax rates, changing the unified social security tax, introducing a real estate tax);
- *integrate the Russian tax system into the global tax system* (signing new treaties on double taxation, fighting international tax evasion and tax avoidance).

We shall consider the most important changes in Russian taxation planned for the near future. All of them are quite progressive and reflect the best international practice of taxation. Doubtlessly, these modifications of the Russian tax legislation will strengthen the country's position in international tax competition – if they can be realised as intended.

- *Tax residency of juridical persons.* The current Russian tax legislation (the Tax Code of the Russian Federation) does not include the category "tax residency of juridical persons".[23] Due to this defect of the Tax Code, it is uncertain under what circumstances tax treaties to prevent double taxation are to be applied to a "Russian organisation" with its headquarters (place of effective management) in, e.g., Switzerland or Cyprus. Also, it allows Russian businessmen to use the various possibilities of international tax planning to transfer incomes from Russia to low tax jurisdictions because the real "residence" of a Russian business unit managed *de jure* from abroad is often inconsequential. To prevent this abuse the Russian authorities are about to introduce the category "juridical person – tax resident of the Russian Federation". It is intended to rely on such criteria of company residence as place of effective management and place of residence of controlling owners. This is intended to help the Russian tax authorities to tax the global profit of companies registered outside the Russian Federation but managed from Russia and belonging to individuals who are tax residents of the country.
- *Controlling transfer pricing.* Articles 20 and 40 of the Tax Code already contain measures to prevent the abuse of transfer pricing to avoid Russian taxes. Nevertheless, the Russian authorities intend to restrict transfer pricing in the tax planning activities of related companies by abolishing Arts. 20 and 40 which are to be replaced by a new Section V[1] of the Tax Code ("Interdependent persons. General provisions on prices for purposes of taxation. Controlling transactions.")[24] First of all, the method of defining related business units will be changed (taking into account the real relations between participants of transactions instead of the current practice according to Art. 20). It is also intended to introduce the categories "identical" and "homogeneous good" into current Art. 38 to make the determination of the objects of taxation easier. In addition, methods of calculation of arm's length price corresponding to the

[22] Cf. Main directions of the tax policy in the Russian Federation for 2008-2010 (approved by the session of the Government of the Russian Federation on 2 March 2007, in Russian), at: www.sovtex.ru/Generators/STDocGenerator.aspx?ID=c1fb0d8e-fb5a-44f1-b3ab-e476a19f3227.

[23] The Russian Tax Code contains such categories as "taxpayers", "tax agents", "tax authorities" (Tax Code, Art. 9), "physical persons – tax residents of the Russian Federation" (Tax Code, Art. 207), "Russian organisations" and "foreign organisations conducting business in Russia" (Tax Code, Art. 246), but does not apply the term "tax resident" to Russian organisations which actually are paying corporate profit tax according to the principle of global income taxation (principle of residence). The actual residency of "Russian organisations" is determined in the Tax Code according to the criteria of incorporation (Tax Code, Art. 11).

[24] http://www1.minfin.ru/common/img/uploaded/library/2007/11/pfzink.doc; cf. also http://www1.minfin.ru/ru/ tax_relations/policy/use_regulation/government_docs/.

Western practice (comparable prices method, resale prices method, cost-plus method) will be mandated. In addition, the interval of the permissible deviation of transfer prices from market prices will be changed. Instead of the current interval of ±20% (according to Art. 40) new formulas for the determination of minimal and maximal prices for transactions between related companies are introduced:

Min. transfer price	Max. transfer price	a – minimal, b – maximal price in transactions with identical goods between non-dependent business units in comparable economic conditions
$\frac{3a + b}{4}$	$\frac{a + 3b}{4}$	

Finally, one more innovation of Russian transfer pricing regulation is the possibility of concluding advanced price agreements (APAs) between taxpayers and tax authorities. This practice – which exists, in particular, in the USA – allows taxpayers to minimise risks due to the evaluation (and possible modification) of transfer price transactions by the tax service – even if these transactions completely respect the letter of the law. APA is a quite radical proposal for the Russian authorities which reflects their interest in achieving compromises and understanding with taxpayers.

- *Introduction of CFC rule.* The CFC (controlled foreign company) rule is also one of the innovations of the Russian authorities. Many Russian businessmen are controlling shareholders or owners of foreign companies and many of them are incorporated exclusively for tax purposes in low tax jurisdictions (like Cyprus, British Virgin Islands, Switzerland and so on). To prevent this practice, which is harmful to the national budget, the Russian authorities intend to introduce as of 1 January 2009 a CFC rule[25] equivalent to that already in use in about 30 major countries including the USA, the United Kingdom, Germany, France and Japan. After implementation of the CFC rule Russia will begin to tax the profits of a number of offshore companies belonging to national residents.
- *Taxation of dividends*. Since the beginning of 2008 the dividend taxation regime has become more favourable for both Russian and foreign investors. Instead of the previous withholding rate of 9%, dividends paid to Russian corporations controlling at least 50% of the dividend paying company are now taxed at the rate of zero. The 9% rate continues to be applied to the dividend income of Russian individuals or corporations holding less than 50% of the dividend paying company. For dividends distributed to foreign individuals the withholding tax rate has been lowered from 30% to 15% – the same rate foreign corporations already had to pay.[26] These measures stimulate the investment in Russian equity by both domestic and foreign investors. Moreover, the withholding tax on dividends for foreign individuals can be reduced from 15% to 5% or 10% according to various treaties on double taxation.
- *Value added tax.* Recently, plans were unveiled by Putin and his successor, Medvedev, to lower the standard rate of VAT from 18% to, eventually, 10% (the current reduced rate applicable to certain food products).
- *Unified social security tax.* This tax, introduced by the tax reform of the 2000s, is now under radical revision. There are several plans to transform the structure of this tax and to reduce its rates because of the crisis of the Russian old-age pension system. According to recent proposals by the Ministry of Health and Social Development only two tax rates (26% for annual wages of up to 600,000 rubles and 0% for those exceeding this limit) will remain to be applied to the wage fund.[27] In any case, the level of social security taxation in Russia is not as burdensome as in some European countries (such as Germany or France), which makes the Russian Federation more competitive in terms of effective wages for some high-skill jobs (software production, manufacturing, R&D). Many leading foreign companies such as IBM, LG, ABB, BMW and others are making use of this tax advantage.
- *Real estate tax.* The current Russian tax legislation does not provide for taxation of the property of individuals. According to government proposals a real estate tax for individuals is to be introduced in the period of 2009–2010. This tax will – like an existing property tax for corporations – be a municipal one.[28]
- *International tax relations.* In the international sphere the Russian tax authorities will continue cooperation with foreign tax administrations using the current network of double taxation treaties as well as signing new ones to expand the possibilities for exchanging fiscal information in order to prevent tax fraud by

[25] Cf. Main directions of the tax policy in Russian Federation for 2008–2010 (approved by the session of the Government of Russian Federation on 2 March 2007, in Russian), p. 42, www.sovtex.ru/Generators/STDocGenerator.aspx?ID=c1fb0d8e-fb5a-44f1-b3ab-e476a19f3227.

[26] Ibid., p. 41.

[27] http://www.finiz.ru/nalog/article1246728.

[28] Cf. Main directions of the tax policy in Russian Federation for 2008–2010 (approved by the session of the Government of Russian Federation on 2 March 2007, in Russian), pp. 60-63, www.sovtex.ru/Generators/STDocGenerator.aspx?ID=c1fb0d8e-fb5a-44f1-b3ab-e476a19f3227.

Russian residents. A priority for Russian tax policy is the fight against tax havens. In December 2007 the Ministry of Justice approved a list of offshore jurisdictions prepared by the Ministry of Finance.[29] The main criteria for a country or a territory to be classified as an offshore jurisdiction are the absence of information exchange with Russia on fiscal affairs or a low level of corporate profit taxation (less than 2/3 of the basic Russian tax rate of 24%). Russian residents doing business with or in countries from that "black list" incur the risk of being audited by the tax authorities with regard to the CFC rule or transfer pricing. Also, Russia intends to conclude double taxation treaties with those jurisdictions on the list for which no such agreements exist at the moment (such as Malta or the United Arab Emirates; Russia already has treaties with, e.g., Cyprus and Malaysia).

Still Anything Left to Be Desired?

In our previous paper we emphasised the need for further reform.[30] Let us see whether the problems we mentioned have been taken care of by now.

- As regards personal income taxation, dividends and interest income are still taxed at special rates (9% and 15/20% respectively, vs. the regular 13% rate). Furthermore, there is still the 35% rate on "excessive" interest. Thus the principle of horizontal equity is still violated – although it has to be admitted that the tax differential has been narrowed considerably.
- There is still a difference between the rates of profit tax (20-24%) and income tax (13%) so that profit taxation discriminates between the profits of corporations and of individual entrepreneurs.
- Taxation still distorts the decision of companies between accumulating and distributing profits – but the distortion now runs the other way: distributed profits (dividends) are taxed *lower* (9% withholding tax, whether they are received by individuals or other companies) than retained profits (20-24% profit tax).
- The standard rate of VAT has been lowered – from 20% to 18%, a rate that now looks almost low in the face of VAT increases in other countries.
- The tax system has been further simplified and tax administration has been improved, albeit it is still far from perfect (in particular as regards political interference).

The overall result is mixed: undeniable progress but still room for further improvements.

Conclusion

Russia has a modern and efficient system of taxation with low tax rates as well as a good quality of tax administration. Thus the tax reform of the 2000s created strong competitive advantages for the current Russian tax system, which is simpler, more transparent and better managed than fiscal systems in countries such as Brazil, India, China, Poland and Ukraine (which, in some way or other, can be regarded as direct competitors of Russia). But Russia also appears to be competitive in the tax field in comparison with major industrial countries. This favourable development will be continued with the introduction of the CFC rule, transfer pricing control and tax haven regulations – necessary elements of a fair tax competition. As far as the tax laws are concerned, there may still be some changes which one would like to see being made, but they appear almost negligible in comparison with what has been achieved.

In theory, thus, things in the field of taxation are looking just fine. However, there are two caveats. First, due to the heavy reliance of the Russian budget on gas and oil related taxes, the favourable situation may deteriorate quickly if energy prices start to fall. Second, the current policy of the tax administration seems to be somewhat arbitrary (to put it mildly). Obviously, tax laws are often used as an instrument to fight political opponents of the Kremlin. Thus, it has only been imperfectly possible to separate the economic and the political sphere, to pursue a liberal policy in the former and a repressive one in the latter. In particular, there is considerable conflict in the field of taxation where the demands of the rule of law and of economic rationality are sometimes sacrificed to political expediency. In this way, Putin's "sovereign democracy" may well have prevented Russia from reaping the gains of its impressive tax reforms – by introducing political risks into the field of taxation.

With Putin's successor, Medvedev, now in office things may hopefully start to change for the better. In many public statements the new President has emphasised the need to fight corruption, to rein in the bureaucracy and to uphold the rule of law. It remains to be seen whether this liberal rhetoric is followed by equally liberal action.

[29] The complete list of low tax countries and non-cooperative jurisdictions includes Andorra, Anjouan (Comoros), Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Belize, Bermudas, British Virgin Islands, Brunei-Darussalam, Cayman Islands, Channel Islands (Guernsey, Jersey, Sark, Alderney), Cook Islands, Dominica, Gibraltar, Grenada, Hong Kong (China), Isle of Man, Labuan (Malaysia), Liberia, Lichtenstein, Macao (China), Maldives, Malta, Marshall Islands, Mauritius, Montserrat, Nauru, Netherlands Antilles, Niue, Palau, Panama, Republic of Cyprus, Samoa, San Marino, St. Vincent and Grenadines, St. Kitts and Nevis, St. Lucia, Turks and Caicos Islands, United Arab Emirates, and Vanuatu; http://www1.minfin.ru/ru/tax_relations/policy/use_regulation/government_docs/ index.php?id4=2766.

[30] A. Pogorletskiy, F. Söllner, op. cit.