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# An Overview of Normative Documents on Taxation Issues for September-October 2012

*In October 2012, the RF State Duma approved in the first reading the draft federal budget for 2013 and the planning period 2014–2015. We believe it to be necessary that, in the situation of an ongoing financial crisis, the issue of mandatory payments as a non-refundable renewable source of budget revenue proper should be dealt with in connection with government borrowings as one of the sources for covering budget deficit, because the budget has been prepared with due regard for the increased expenditure allocated to the social obligations declared in course of the electoral campaign and later on confirmed by the edicts issued by the new RF President.*

According to the generally applied rule, any alterations to the RF Tax Code may be entered no later than one month prior to the moment of the draft federal budget being submitted to the RF State Duma. However, this year alterations can be adopted throughout the entire period determined for the discussion of the draft federal law on the federal budget for 2013 and the planning period 2014–2015.[1]. In this connection, we believe that innovations introduced in the tax sphere will be applied as one of the available methods for balancing budget revenue against budget expenditure and for attracting the votes of certain groups of deputies (in support of decisions lobbied by the RF Government in exchange for a tax exemption). No doubt that such an approach has nothing at all to do with market; however, it is a reflection of the real situation in the national economy.

The organizational work aimed at implementing the RF President's decisions formalized as presidential edicts issued after the inauguration has been continuing through the period of the draft budget being considered by the RF State Duma. This process also involved consideration of the issue of introducing a special tax regime for the Far East and the Baikal region, which represented, so to speak, the final evolution of the task designated by the RF President as the provision of funding for the development of Siberia and the Far East[2]. One gets the impression that the 'roadmap' (the term that has become very fashionable) for coordinating the planned measures with the allocated volumes of financing has not been properly elaborated in every detail[3]. Given the difficulties with earmarking direct budget allocations, it can be concluded that the federal authorities have evidently attempted to replace them with tax exemptions (based on the idea that, instead of allocating 'live' money from the budget, it is worthwhile to leave part of the resources in a region, thus also making it easier for the regional officials who may fail to

[1] Federal Law of 16 October 2012, No 175-FZ.

[2] D. Kaz'min, *Minfin vystupil protiv shchedrykh nalogovykh preferentsii na Dal'nem Vostoke* [The RF Ministry of Finance Spoke Against Liberal Tax Preferences in the Far East]; see www.vedomosti.ru of 19 October 2012.

[3] Plan of Measures Designed to Implement the Strategy of the Socioeconomic Development of Siberia until 2020, approved by Regulation of the Government of the Russian Federation of 5 July 2010, No 1120-r; further specified by Regulation of the RF Government of 11 October 2012, No 1898-r.

collect taxes for their own budget, while money will come from the federal budget to cover the shortage of revenues).

Such a policy is essentially destructive for the Federation and the regions alike. Federal officials have totally disregarded the possibility that a region may actually fail to raise a sufficient amount of revenue after having been granted the relevant tax exemptions, while no regulations exist in regard of these 'released' resources. As, until recently, heads of regions were appointed and not elected, local authorities voiced no objections to the replacement of the loss of tax resources in regional and local budgets that had been produced by the newly introduced tax exemptions, by 'live' money from the RF budget. And they did not object to the resulting shrinkage of the regional revenue base coupled with the increased dependence of the regions on the federal center. Following this general trend, Senator for Amur Oblast Pavel Maslovsky suggested, on behalf of his region, that manufacturers should be made exempt from practically all the federal, regional and local taxes that form that region's revenue base, including personal income tax (PIT) (for a period of three years – in order to attract workforce), the regional profit tax, mineral resources extraction tax (MRET), as well as VAT and the payments to state off-budget social welfare funds ('as they do it at Skolkovo').

Why does a region ask to be made exempt from profit tax? In fact, Item 2 of Article 283 of the RF Tax Code already contains stipulations whereby manufacturers are allowed to carry forward their losses (expenditures in excess of the amount of proceeds from sale are either included in the value of newly created depreciable fixed assets, or recorded as losses – the amount of which is then written off against finished products over the next ten years). The conclusion is inevitable: when a regular tax scheme is applied, expenditures need to be backed by properly formalized documentation; thus, a tax exemption is needed – so that neither incomes nor expenditures could be properly calculated and recorded. Why do they ask for an exemption from VAT? VAT on exports is already levied at a zero rate, and when the products exempt from VAT are sold, the amount of 'incoming VAT' increases the manufacturer's (or supplier's) production costs. In other words, as a result of this alteration, the products exempt from VAT will become much more expensive for the buyer, because no 'incoming VAT' will be charged to such costs, and no deductions will be made from the amount of VAT levied on that buyer's own products. The outcome will be an unjustified growth of prices for the processing industries' products. Another inevitable conclusion will be that the exemptions from VAT are needed only in order to make in unnecessary to properly enter in the tax records the information as to what and how much of it is actually manufactured, and which products are delivered and where these are delivered[4].

[4] We have already emphasized more than once that VAT is the only tax based on a conflict of the economic interests of contracting parties, where each successive participant in a production chain is willing to declare to a tax agency the amount of VAT refunds that is due to them in regard of the goods (or work, or services) purchased by them, and so the tax agencies automatically receive information on the amounts of sales and the types of the goods (or work, or services) being sold by each producer (or seller) of goods (or work, or services) throughout the entire territory of the Russian Federation. But this is not a tax that is levied on producers – its amount is ultimately paid by end consumers, so it is a classical example of tax on consumption.

Former RF Minister of Finance Alexei Kudrin remarked that, in fact, no tax exemptions are needed in the Far East: 'Whether an enterprise is a new or an old one – this provides strong grounds for falsifications'. Instead, he believed, what that region really needs is proper incentives for promoting production of mineral resources, which can generate revenues capable of covering the cost of the upkeep of its welfare system and infrastructure[5].

The RF Ministry of Finance allows for the possibility to apply the regime of a special economic zone (SEZ) of the same type as applied at Kaliningrad. Some types of tax exemptions can also be allowed, but on condition that the decision concerning their implementation be adopted directly at a relevant region's level (in other words, the federal budget will not be covering the amount of lost regional revenue[6]). It is suggested that full exemption should be granted in regard of property tax and land tax; as for tax on profit, its federal component (2%) should be levied at a zero rate for a period of 20 years, while its regional component (18%) should be completely eliminated during the first 10 years and reduced in part (no less than 10%) over the next 10 years. In this connection, the RF Ministry of Finance believed that the exemptions must only be granted to newly adopted projects, launched strictly in the period between 2013 and 2022. The aforesaid exemption should not be applied to any oil and gas projects, the manufacturers of alcohol and tobacco products, or in the fields of trade, financial services, or utilities and other similar services rendered to the population, or to the participants of consolidated taxpayer groups. Besides, the companies applying for such exemptions will be required to make investments in amounts of no less than Rb 400m, and also to keep separate accounting records for their tax-exempt transactions.

The extent to which the policy of replacing a region's own tax-generated revenue by subsidies coming from the upper-tier budgets is harmful for the relevant territories has been revealed by an analysis of changes in the revenue structure of local budgets conducted by Standard & Poor`s (S&P)[7]. In the case of regions, similar problems arise in their relationships with the federal budget. According to S&P, the low degree of revenue autonomy displayed by territories represents an issue of fundamental importance. Thus, after the centralization of many of the existing taxes (which formerly had been transferred to the local budgets) carried out in 2004–2005, the share of municipalities in Russia's national budget shrank from more than 30% in 2004–2008 to less than 18% in 2011. Simultaneously, they became much more dependent on interbudgetary transfers. Since 2000, the share of such transfers in local budget revenue has doubled, while targeted transfers have been playing an increasingly important role. In 2012, according to the rating agency's estimates, the share of taxes in local budget revenue is 30%; that of non-tax sources – 9%; that of non-targeted transfers – 19%; and that of targeted transfers –

[5] www.finmarket.ru/z/nws/news.asp?id=3090415. 16 October.

[6] Hereinafter we are offering a number of graphic examples of how Russia has already been faced with the necessity to adopt some fundamental adjustments to the basic parameters taken into account in the process of drawing up a budget; it is feasible to formalize these adjustments as alterations to the RF Budget Code.

[7] V. Visloguzov. *Rossiiskie goroda bedny i nesvobodny. S&P otsenilo problem munitsipalitetov Rossii* [Russian towns are poor and constrained. S&P has estimated the problems faced by Russia's municipalities]. See kommersant.ru No 193/П (4978), of 15 October 2012.

42%, which means that transfers constitute more than 60% of the size of local budgets. The share of transfers to other budgets in federal budget expenditure is 37.6%[8].

The replacement of taxes by subsidies granted to regions increases the burden imposed on the federal budget, which manifests itself in a shift of the sources of funding for budget expenditure towards growth of the size of tariffs set by natural monopolies, thus artificially increasing the need for government borrowings.

International experts, at their meeting with Chairman of the RF Government Dmitry Medvedev, raised the question as to the causes of the continual growth of natural monopolies' tariffs in the Russian Federation[9]. They noted that the constantly increasing tariffs trigger price inflation which, in its turn, is a manifestation of the government's inability to ensure macroeconomic stability in this country. It should be reminded that RF President Vladimir Putin set macroeconomic stability as one of priorities of the RF Government's economic policy. The rising tariffs of natural monopolies may be regarded as a hidden form of capturing some additional amount of budget revenue (hidden taxes) – unauthorized by the RF Tax Code, – or an authorized form of mandatory payments (pseudo-taxes) collected for the benefit of those same monopolies. In any event, growth of tariffs in an evidence of a certain failure of the measures being implemented in order to ensure this country's economic development.

The experts disagree with the statement that a systematic growth of tariffs at a rate of 13–15% per annum (which is twice as high as the inflation rate) is a necessary source for investment. According to the explanation offered by *Business Russia*'s Executive Director Nikolai Ostarkov, an investment component must not be included in the tariffs for electric energy or natural gas. Instead, the monopolists could have taken bank loans for the implementation of each of their projects. Given that they are regarded as 'super-reliable' borrowers, the terms for such loans can be very tempting.

The situation can be explained in more detail. If an organization makes investments funded by its own profit, its costs are first charged to the value of its newly created fixed assets, and then by means of depreciation are written off as current costs. In this case, the periods and volumes of investments are determined by the state monopoly itself, and all its ineffective expenditures are automatically 'swallowed' by its tariffs and covered from its customers' pockets. If a loan is attracted for the purpose of creating a new fixed asset, the timelines for loan repayment are stipulated in the loan agreement, while the cost of its servicing (interest on the loan) can immediately be charged to current costs. In this case, the size of tariffs can be set at once for a long period, without their annual adjustment by 13–15%. In other words, experts are pointing it out that the introduction of market mechanisms (bank loans) in the sphere of tariff regulation can improve the efficiency of operation and transparency of expenditures of the existing natural monopolies, as well as stabilize the level of prices.

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[8] Federal Law of 2 October 2012, No 151-FZ 'On the Execution of the 2011 Federal Budget'.

[9] I, Naumov. *Zapadnym investoram potrebovalsia VIP-perevodchik. Dmitrii Medvedev ob"iasnit inostrantsam, pochemu pravitel'stvo ne ogranichilo appetity monopolii* [Western investors felt that they needed a VIP-level interpreter. Dmitry Medvedev will explain to the foreigners why the government had not restrained the appetites of monopolies]. See ng.ru , of 1 October 2012.

But evidently, the State needs some supplementary money for subsidizing the regions. This is the reason why the tariffs are rising. Tax payments can be introduced, altered or abolished only by law, and so, when they are actually eliminated (by way of introducing tax exemptions), the result is the increasing prices for the services rendered by state monopolies (that is, their tariffs). Consequently, the introduction of tax exemptions undermines social stability in the country because, at present, the accelerated growth of the value of utilities (by comparison with the rate of market inflation) coupled with their inadequate quality represents one of the most painful social issues.

Experts' opinions differ also with regard to the issue of government borrowings.

*Troika Dialog*'s head economist Evgeny Gavrilenkov has noted the growing volume of government borrowings on the domestic market at 8% per annum, with later placement of that monies in the Reserve Fund at 1–2% per annum even in a situation of budget surplus. He explains that this policy reflects the government's lack of certainty in its ability to ensure stable growth of the ruble's exchange rate. If money is being withdrawn from the national economy by means of such a method, this effectively means capital outflow, according to Evgeny Gavrilenkov. By giving preference to the USD, the government shows a bad example to the other market participants; besides, it disorients foreign investors, for whom the situation in Russia appears tricky and uncertain[10]. We also believe that the government's current policy is compatible with financial logic – while ordinary logic, regretfully, cannot be applied in the field of finance.

By way of comparison, it is worthwhile to consider some other viewpoints. Chairman of the Management Board of the Institute of Contemporary Development Igor Yurgens, in contrast to Evgeny Gavrilenkov's opinion, does not see any threats in the RF Ministry of Finance's preparedness to make debts in order to increase the size of the Reserve Fund[11]. 'The volume of Russia's foreign debt is negligible. It is profitable to borrow, given that money today is cheap on the world financial markets' – this is the opinion of Igor Nikolaev, Director of FBK's Strategic Analysis Department. He believes that the RF Ministry of Finance's position with regard to government guarantees is too harsh, noting that these guarantees can serve as an efficient instrument in the support of enterprises – without direct spending of budget resources. All these opinions share sound common sense: money must be taken while it is cheap. This tactic would have been correct if the government could also effectively invest it. But is there really any sense in borrowing money 'for storing' if capital is flowing out of Russia? In other words, there is no desire to invest market capital in those companies which, according to Igor Nikolaev, can be granted government guarantees for their development at the expense of cheap loans. Besides, we do not really understand the standpoint shared by some officials at the RF Ministry of Finance,

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[10] Ibid.

[11] I. Naumov. *Minfin meniaet starye dolgi na novye. Rossia gotovit rynok goszaimstvovanii dlia inostrannykh investorov* [The RF Ministry of Finance trades old debts for new ones. Russia is preparing a government borrowing market for foreign investors]. See ng.ru , 8 October 2012.

who now interpret the fact of current capital outflow from Russia as a beneficial opportunity[12] – where is the benefit? Is it really beneficial that the period of reevaluating Russian assets in the international market prices is over, and there are no businesses in this country in which the available capital could have been invested with a yield that can be estimated as good according to world standards?

The existing situation has been interpreted more frankly and honestly by RF Minister of Finance Anton Siluanov. A total of Rb 1.145 trillion was allocated in the 2013–2015 budget to the implementation of the presidential edicts issued last May. To cover this expenditure, the RF Ministry of Finance had, in addition to optimizing (i.e., cutting or delaying) its current expenditures, also to apply the so-called credit schemes, when the contractors fulfilling government orders receive, in lieu of direct budget funding, credits with guarantees of subsidies to cover the interest on those credits, and the actual payment from the budget under the contracts takes place at the moment of a contract's fulfillment, or with a delay. The payments are thus carried forward beyond the current three-year budget period – to the budget for 2016. 'We are adding to the liabilities of the next years', Siluanov remarked [13].

So, the opinions concerning the suggested policy of borrowing vary greatly.

It seems altogether that at present Russia must not aggressively increase the scale of government borrowings. Our own viewpoint is as follows. The USA follows a policy of quantitative easing (the government provides funding for the buyout and withdrawal from the market of the 'toxic assets' that arose as a result of large-scale housing mortgage loans issued by banks). In technical terms, this means buying up 'bad' liabilities from market participants and paying with liquidity; but there is no implication that after the national economy's revival these liabilities are not going to be presented to the debtors in order to capture the liquidity issued specifically for the purchase of those liabilities. The European Union, acting in this respect in unison with the USA, is also issuing currency for buying up bad debts (this, for example, is the method applied in order to provide Greece with liquidity – in exchange for Greece's government bonds). This does not mean, however, that later on, when the crisis is finally over, these liabilities will not be presented to the debtors (to be bought back by Greece). We distinctly see that Western countries are pursuing a policy of easing in exchange for liabilities (suspension, temporary withdrawal from the market of bad debts, to be replaced by current liquidity). China will, most likely, also react in a certain way to the unconstrained quantitative easing of the world's major currencies. China's accumulated assets will be depreciating in US dollar and euro terms, while the yuan will be strengthening – which is unprofitable for an exporter. Under such conditions, surplus (and consequently, cheapness) of other countries' is by no means the reason for the Russian government to urgently make debts only because it will be cheap to do so. On the contrary, it is not advisable for Russia to actively create convenient and profitable refuges for currency speculators across the globe by issuing her government bonds at 8% per annum (with

[12] A. Bashkatova. *Samoopravdatel'noe nou-hau Minfina. Chinovniki nazvali stremitel'nyi ottok kapitala blagom dlia Rossii* [The RF Ministry of Finance's self-justifying know-how. Officials called the rapid capital outflow a benefaction for Russia]. See ng.ru , 15 October 2012.

[13] O. Kuvshinova. *Dlia vypolneniia ukazov Putina Minfin 'zalez v karman' budushchikh let* [In order to implement Putin's edicts, the RF Ministry of Finance has borrowed from the future]. See vedomosti.ru, 19 September 2012.

the possibility to subsequently place them on the market at only 1–2% per annum), in addition issuing unlimited guarantees against the liabilities of state-owned corporations. It is probably not feasible, either, to raise competition on the market for domestic manufacturers by artificially boosting the price of foreign cheap liquidity at the government level and in the spheres related to the government. The existence of foreign cheap liquidity is indeed a real chance for speeding up the development of the domestic market economy in RF territory. It becomes especially relevant in such a situation to create comfortable conditions in Russia for doing business, and so the main goal for the government must be to avoid tying up the existing capital by investing in government liabilities at an effectively loss-making interest rate, thus pushing money away to the zones of intense business activity (which will be springing up around the world in the event of continuing quantitative easing of major currencies); instead, capital must be attracted into Russian territory. This can be achieved only through increasing this country's investment attractiveness. It should be noted in this connection that no competitive production entities can be created by introducing tax exemption, because then businesses will be oriented towards distorted profitability parameters.

To borrow money in order to store it, or to support and thus maintain inefficient state-owned companies (including by means of granting government guarantees to them) will be a sure way to tumble into a 'debt pit'. If the government really must keep one or other type of production, the only proper source for its funding will be taxes – the government's own, non-refundable and annually replenished resources. But a tax base needs to be properly grown, and the only source for its formation are competitive production entities.

Another special note: we are strongly for Russia's incorporation into the civilized financial and stock market, and that is why we are saying that a clear distinction must be made between simple human logic (that something should always be taken while it is offered or is cheap) and the logic of financial relations. It is contrary to the logic of financial relations to borrow money at an interest (even if the interest rate is very low), if its investment cannot yield an acceptable rate of return.

For several years already, draft budgets have been approved with a continually increasing debt. In 2011, the cost of government debt servicing markedly increased (by 27.0% on 2010), which can be explained by the increasing volume of domestic government borrowing over the period of economic crisis in 2009–2010.[14].

In the resolutions of the RF Audit Chamber on the 2011 and 2012 draft budgets, the following data concerning the Russian Federation's aggregate debt and the amount of debt outstanding can be found. The volume of aggregate foreign debt of the RF as of 1 July 2011 was \$ 538.6bn (28.3% of GDP), being by \$ 14.1bn (or by 2.7%) greater than that of RF international reserves (\$ 524.5bn); and when taken less the volumes of the Reserve Fund and National Welfare Fund – by \$ 133.3bn, or by 32.9%.

The value of the indicator of foreign debt stability – 'ratio of payments against aggregate foreign debt to the volume of exports of goods and services' in Q1 2011 amounted, according to

[14] Federal Law of 2 October 2012, No 151-FZ 'On Execution of the 2011 Federal Budget'.

data released by the Bank of Russia, to 28%, which is by 3 pp. above the ceiling determined by the IMF for analytical purposes (25%).

Although the size of RF government debt is relatively small and does not exceed the IMF's analytical parameters, it is increasing at an accelerated rate. The volume of RF government debt has increased from 11.8% of GDP in 2010 to 18% of GDP in 2013. Government debt will further increase mostly due to the growth of government domestic debt, whose share amounts to 79%. Budget allocations to cover the servicing of government domestic debt in 2013 will increase 2.5 times on 2010, to about 1% of GDP. The ceiling established for the budget liquidity index (10%) has been exceeded. This index describes the ratio of the cost of debt servicing and redemption to the size of federal budget revenue, which in 2013 will go above the level of 12%. An analysis of the structure of the sources of borrowing that formed government debt has revealed that about one-third of the monies attracted predominantly on the domestic financial market is earmarked for debt redemption, and the share of such allocations is also increasing: in 2011 – 22% of the total volume of borrowing money; in 2012 – 25.6%; and in 2013 – 29.3%.

Given that RF government debt displays an upward trend and that Russia's aggregate debt exceeds her international reserves, the RF Audit Chamber has raised the question of introducing a number of alterations to the RF Budget Code, thus making it possible for the text of the Federal Law on the Federal Budget's articles to reflect operations involving the sources of financing the federal budget deficit, the volumes of monies attracted to (or received by) the federal budget, the redemption of debt (the size of payments) from the federal budget, and the amounts by which federal budget residuals will be increased (or reduced)[15]. We believe this issue to be worthy of consideration. It would be highly advisable to provide legislative substantiation for the dependence between budget revenue and the established ceiling for the size of government borrowing, for example by applying for this purpose the budget liquidity index[16].

It should be reminded that part of government debt represented as guarantees against loans has already been carried forward beyond the timelines of the 2013 budget and the planning period 2014–2015, as has been explained by Anton Siluanov. This means that the amount of the government's own, non-refundable, renewable revenue (generated only by taxes) needed for implementing its current financial policy will be continually declining every year – in view of the accelerated growth of government debt and the debts of state-owned corporations (represented by government guarantees granted to them), because that revenue is already 'bound' against the government's future liabilities. The ceiling on government debt is established by the federal law on the federal budget for a corresponding planning period, but its parameters are sufficiently flexible.

In our opinion, any further obligations relating to government debt can only be assumed with due regard for the budget liquidity ceiling (the level recommended by the IMF is 10%), which must be established by the RF Budget Code. Besides, it must be legislatively established that the size of expenditure allocated to annual government debt servicing in the periods beyond

[15] The RF Audit Chamber's resolutions on the 2012-2014 draft budget, Point 12.5, Paragraph11.
[16] It describes the ratio of the cost of debt servicing and redemption to the size of federal budget revenue.

the 3-year budget period (including the 2-year planning period), must not exceed, say, one-third of the cost of government debt servicing entered in the budget for a current financial year.

Among the normative documents and explanatory notes issued over the period under consideration, we should like to note the following ones.

1. By Federal Law of 2 October 2012, No 161-FZ ‘On Introducing Alterations in Part Two of the Tax Code of the Russian Federation, and Recognizing As Null and Void Some Provisions of the Legislative Acts of the Russian Federation’, alterations are introduced to the RF Tax Code concerning tax exemptions for agricultural producers. In particular, a VAT rate of 10% is established for the proceeds from sale of purebred. Grants and subsidies from budgets allotted to heads of peasant (or farmer) households are exempt from personal income tax. A zero rate of profits tax is established for an indefinite period of time for agricultural producers (including fisheries), to be levied on operations relating to sale of their own agricultural products or to processing of their own agricultural products. Consumer cooperative organizations whose personnel number exceeds 100 are granted the right to apply the single agricultural tax (SAT).

2. Federal Law of 2 October 2012, No 162-FZ ‘On Introducing Alterations to Articles 251 and 294 of Part Two of the Tax Code of the Russian Federation’ granted exemption from profits tax to insurer associations in regard of their monies accumulated in their compensation funds created under agricultural insurance agreements that are subject to government support in accordance with Federal Law of 25 July 2011, No 260-FZ ‘On Government Support in the Sphere of Agricultural Insurance, and on the Introduction of Alterations to the Federal Law “On the Development of Agriculture”’. The mechanism for supporting the insurers providing insurance to agricultural producers is, to a certain extent, based on the same principles as the system for insuring bank deposits, and so this tax exemption cannot be considered a typical tax benefit. The losses of organizations – agricultural producers are covered by a joint insurer fund which, by accumulating the contributions of insurers, consolidates the relevant profits and losses within the limits of the amounts transferred to the fund by each insurer. It is somewhat similar to the system for insuring bank deposits in that the fund pays for the losses incurred by an agricultural producer as a result of the destruction or damage to crops, perennial plantations or livestock in the event when the insurance compensation cannot be paid by the insurer with whom a relevant insurance agreement has been made – for example, if the latter goes bankrupt. Given the existence of a compensation mechanism for agricultural producers established by this Federal Law, the granting of direct tax exemptions to agricultural producers, in accordance with Federal Law of 2 October 2012, No 161-FZ, appears to be superfluous.