POLITICAL AND ECONOMIC RESULTS OF OCTOBER 2014

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In October the current turmoil in Russia's international relations palpably stagnated. At the same time, Russia's economic-political scene displayed alarming portents of future troubles in her business environment: it is not an exaggeration to say that, in October, Russia found herself on the verge of taking a number of tough decisions that could significantly worsen the situation faced by domestic businesses. Thus, the RF President signed a law whereby the base used to calculate property tax rates was to be switched from inventory values to cadastral values. The Federation Council (the upper chamber of Russia's parliament) approved a law designed to vest the investigative authorities with an unlimited right to initiate criminal cases on tax matters, bypassing the formal preliminary investigation by the Federal Tax Service. Quite unexpectedly, before being approved by the Federation Council and then signed by the RF President, the draft law had been passed by the State Duma in its initial version, without any amendments. The RF State Duma passed at first reading a draft law designed to increase the amount of compulsory annual contributions for high income earners, to be paid by their employers to the Mandatory Health Insurance Fund. Also, a draft law designed to vest regional authorities with the right to scale back by 10 times the officially established small business criteria, thus increasing the number of enterprises which qualify for the benefits entitled to small businesses, was introduced into the RF Government. The attempts of the entrepreneurial community, including the Russian Union of Industrialists and Entrepreneurs (RUIE), at convincing the authorities not to worsen the existing business conditions, or at least to postpone the implementation of these decisions in the event of their adoption, have been to no avail. So far, all these appeals to the Government have yielded only vague promises, and nothing concrete that could make the business community feel more or less comfortable. To deepen the gloom, Rosneft, Russia's biggest oil producer, asked the RF Government for more than 2 trillion rubles from the National Wealth Fund (NWF). If this request is accepted, the NWF in its present form will definitely cease to exist.

As far as the economic-political sphere is concerned, October saw neither any stunning nor extraordinary news. The realm of Russia's foreign relations continued to be plagued by severe disagreements between Russia and the OECD states over the ongoing conflict in the southeast of Ukraine. Although the truce declared in early September was generally being honored, the situation in that region showed a clear trend towards worsening: there was a resumption of heavy fighting around Donetsk airport, and a number of the field commanders of the self-proclaimed 'people's republics' publicly announced that they would not abide by the truce. The Russian delegation to the Organization for Security and Co-operation in Europe (OSCE) blocked the OSCE's proposal to extend the mandate of the OSCE Observer Mission to the entire length of the Russian-Ukrainian border in the conflict zone. As a result, the only option left for the Observer Mission was to monitor only a stretch of a few kilometers out of approximately 300 kilometers of border that was not under Ukraine's control. Moreover, the OSCE's intention to use drones for monitoring the border was nixed by the 'people's republics' who promised to shoot them down on sight. The restrictions thus imposed on the activity of the OSCE Observer Mission have practically invalidated the Minsk Agreement's stipulations concerning border monitoring, which were designed to prevent military hardware from crossing the Russian-Ukrainian border. In fact, the only good news about the crisis in eastern Ukraine is the shaky ceasefire which has already lasted for two months in a row. However, nobody can say whether this ceasefire will keep holding for long[1]. It is not by chance that the 'Minsk Negotiations' have ground to a halt – the parties thereto simply have nothing more to say to each other. The trilateral gas talks between Russia, Ukraine and the EU were equally moribund for quite a long period of time, despite being occasionally held at a very high level – as it happened, for example, at the 'Normandy Four' negotiations in Milan, in mid-October, where the parties were represented by their heads of state. According to the official statements of participants in the 'Normandy Four' negotiations, the parties were close to reaching a compromise. Nevertheless, no debt repayment agreement was concluded because there remained too much discord con-

1 Some observers have expressed concern that hostilities in eastern Ukraine can resume after the Ukrainian parliamentary elections on 26 October and the elections in the self-proclaimed republics on 2 November.

cerning both the terms of debt repayment and, most importantly, the legal form of such an agreement between Russia and Ukraine. Russia insisted that a compromise price for natural gas should be arrived at by reducing the export duty thereon. Ukraine objected to this proposal on the grounds that the determination of the size of Russian export duties is a sovereign prerogative and not a liability of Russia's government. In her turn, Ukraine repeatedly requested that the existing contract on Russian gas supplies (which is valid until 2019) should be renegotiated, and some of its terms be changed. For obvious reasons, these proposals were invariably spurned by Russia. In the second half of October there were a lot of promises of a compromise just around the corner, but no breakthroughs. Bearing in mind the approaching winter and higher demand for gas in Europe, a viable gas agreement must be reached quickly – otherwise Russia will not be able to fill Ukraine's natural gas storage sites and therefore will not be able to technically satisfy the peak winter demand in the EU. At long last, at a trilateral ministerial meeting that went late into the night of 30 October, Russia, Ukraine and the EU clinched a temporary agreement on natural gas supplies to Ukraine during the winter period of 2014–2015. The so-called 'winter package protocol', signed at that meeting, envisages that Ukraine should pay $3.1bn by the end of the year to cover debts for previous gas supplies from the Russian Federation. In order to finance this payment, a special fund should be established, apparently with the participation of Ukraine and the EU (Moscow had demanded a bilateral agreement from the EU to guarantee Ukraine's payments, but no such agreement was actually signed). After the debt is paid, Russia undertakes to supply to Ukraine 4 billion cubic meters of Russian natural gas, by selling it on a prepaid basis at a compromise price of $ 378 per 1,000 cubic meters (preliminary estimates indicate that Kiev needs exactly that amount of gas above what Ukraine currently has in her storage facilities in order to get through the upcoming winter heating period). However, it is still too early to say that the gas crisis is finally over. It will happen only after Ukraine settles her debt to Russia and executes the prepayments stipulated in the 'winter package protocol'. As neither the economic conflict nor the political crisis has yet been resolved, none of the sanctions imposed on Russia has been lifted. Apparently, the possible mitigation of EU sanctions can be expected no earlier than March 2015 (the EU's decisions on sanctions against Russia stipulate that they should be formally revised in October 2014 and March 2015).

On 24 October 2014, President Vladimir Putin delivered a long and exhaustive speech at the final plenary meeting of the Valdai International Discussion Club's XI session in Sochi. Devoted to the current state of international politics, his speech laid the blame for the current havoc on the global political arena on the USA and its hegemonic aspirations. Having vowed to oppose such aspirations, Putin called himself a nationalist (although he had previously instructed Russia's law enforcers to resist nationalism in all its manifestations). Unlike many experts, the author of the current review is scared neither by Putin's remark about being a nationalist nor by the general toughness of his 'Valdai speech'. It should be said that, since his famous 'Munich Address', Putin has made a lot of statements in the same vein. And as early as 2008 he called himself and Dmitry Medvedev 'nationalists in a good sense of the word'. So what's the big deal? Vladimir Putin has also delivered many conciliatory speeches calling for dialogue, partnership etc. As the recent 'Valdai speech' contained no definite and specific promises of action with regard to other countries, nor any specific proposals thereto, it should be considered primarily as an exercise in political posturing rather than a portent of some new extraordinary developments. First of all, it should be seen as a response to things that have already happened, namely to the obvious deterioration of Russia's relations with the OECD countries.

A number of budget-related draft laws generally detrimental to the position of businesses were introduced into the RF State Duma. Formally, some of those draft laws were introduced by MPs, although there can be no doubt that their introduction had been approved by the Presidential Executive Office – otherwise the RF President would not have signed them into law after their passage through the State Duma. It should be added that October saw the emergence of an interesting new situation when the RF Government, when being unable – as it has frequently happened and still happens – to coordinate one or other issue between various agencies, is effectively excluded from the lawmaking process. Thus, the State Duma demonstratively returned from third to second reading and then passed in its initial version, without any amendments, a draft law whereby Russia's tax authorities are to be completely deprived of any say in the initiation of criminal cases. The draft law was duly signed into law by President Putin. Previously, the authorities had repeatedly stressed the necessity of reaching a compromise on that issue, and a possible compromise (admittedly more favorable to the Investigative Committee than to the Federal Tax Service) had been even agreed upon. The compromise proposal had envisaged that the investigative body should require the relevant tax authorities to submit, in two weeks' time, the relevant documents on tax matters, and in the event of their failure to do so, should be granted the right to initiate a criminal case on its own accord. The same sequence of events characterized the introduction into the State Duma of the so-called 'anti-offshore draft law, presented to the floor in a version close to the one that had been put forth by the RF Ministry of Finance and had drawn harsh criticism from the Russian Union of Industrialists and Entrepreneurs. The RF Government had been vainly trying to achieve a compromise between the interested parties for more than a year. As a result of the Government's attempt at mediation, deputies from four parliamentary factions introduced an 'anti-offshore' draft law whereby it is envisaged that, during the period 2015–2016, any Russian company or individual who happens to own 50% of shares in a 'controlled foreign company' (CFC) should be deemed to be the owner of that CFC, and thus become subject to Russian tax on the amount of income derived from the CFC in question. From 2017 onwards, the size of such a stake should be set at 25% (or 10%, if Russian citizens should collectively own more than 50% of shares in the CFC). The draft law establishes that profits from companies situated in the states that are not included in the list of offshore tax havens should also be levied with Russian profits tax in the event of the effective tax rate on corporate profits established in such countries amounting to less than 75% of the Russian profits tax (as is the case of Cyprus, a country extremely popular with Russian investors). According to the draft law in its current version, the threshold for declarable profits in 2015, 2016 and from 2017 onwards should be set at Rb 50m, Rb 30m and over Rb 10m respectively. However, it should be said that it is way too early to draw any conclusions about this draft law, because it can be significantly altered and amended in the course of its passage through parliament.

The State Duma passed in first reading a government draft law designed to abolish the cap on the employee income subject to insurance contributions to the RF Mandatory Health Insurance Fund. At present, the threshold of employee annual income is set at Rb 624,000, and the amounts exceeding the threshold are subject to contributions at a rate of 10%. After this draft law, in all probability, is enacted into law, the rate of such contributions will be increased to 15.1%.

October saw the coming into force of a law envisaging that, by 2020, the base used to calculate property tax rates should be switched over from inventory values to cadastral values. As far as Russian homeowners are concerned, the tax rate for apartments, residential premises, dachas, etc. will be set at 0.1–0.3%. The Law provides for a number of exemptions from the tax base and establishes a number of tax benefits that can be granted, at the discretion of regional authorities, to some categories of citizens. As regards legal entities (trade and administrative business centers, trade units and public catering units), the switchover from inventory values to cadastral values can become a heavy financial burden, as they will be obliged to pay tax at 2% of the cadastral value of their commercial real estate, while the other types of their property will be taxed at a tax rate of 0.5%.

There was an inconclusive meeting between Prime Minister Dmitry Medvedev and representatives of the Russian Union of Industrialists and Entrepreneurs, who vainly tried to persuade the authorities to postpone, for a fixed period of time, the implementation of any measures designed to toughen the tax regime. So far, such requests have been met with silence on the part of the authorities. Bearing in mind Russia's rapidly worsening balance of payments and her weak fiscal situation, this silence can mean only one thing – an inevitable increase in taxation. At the same time, some agencies seem to be less hawkish on various economic issues than other government bodies. For example, the RF Ministry of Industry and Trade suggested that the proposed abolition, from 1 January 2015, of all open-air markets throughout the whole territory of Russia should be considerably postponed, while the RF Federal Antimonopoly Service (FAS) voiced objections to the already introduced ban on selling beer from kiosks and the restrictions imposed on cigarette sales at small shops. In a separate development, the Ministry of Finance introduced into the RF Government a draft law designed to vest regional authorities with the right to scale back by 10 times the officially established small business criteria for trade and public catering units, thus increasing the number of enterprises which qualify for the benefits entitled to small businesses, including the simplified taxation system. At present, in order to qualify for small business status, an enterprise must meet the following requirements: its annual income must be less than Rb 60m, the residual value of its fixed assets must be less than Rb 100m, and it must employ less than 100 workers. Maybe the current financial threshold of Rb 60m per annum is too high, but the proposed 10-fold reduction thereof is equally excessive, especially bearing in mind that a case in point is income, not profit.

The RF State Duma passed in first reading a much criticized draft law whereby Russian citizens are to be allowed to claim compensation, at the expense of Russia's federal budget, for their assets seized abroad. The draft law introduced into the State Duma in the spring of 2014 by *United Russia* MP Vladimir Ponevezhsky envisages that, in the event that a Russian citizen suffers a property loss because of an 'unjust decision' of a foreign court, Russia's federal budget should be obliged to compensate that citizen for the loss of property, while the RF Government should be empowered to recover this expenditure from the corresponding foreign state, including by the seizure of its assets subject to international immunity. The draft law, dubbed the Rottenberg Law' after Russian businessman Arkady Rottenberg whose assets were seized in September by Italian authorities, had been initially, in the summer of 2014, rejected by the Russian Government as 'unconstitutional'. In October, the Government made a dramatic U-turn and wholeheartedly backed the proposed law, and even suggested that its applicability should be extended from 'unjust decisions of foreign courts' to 'unjust decisions of foreign courts and *other agencies of foreign states*' to include not only 'foreign courts', but the other agencies of foreign states as well. It is apparent that no foreign state is going to be frightened by the new Russian law – simply because all the assets owned by them in Russia are subject to international immunity[1]. None of the foreign states will be intimidated into refraining from seizing the assets of Vladimir Putin's friends. If, in response to such actions, Russia confiscates, for example, the building of Italy's embassy in Moscow, Italy can easily respond by confiscating the building of Russia's embassy in Rome. A far greater sufferer will be Russia's federal budget, which will be obliged to become the source of compensation for the overseas losses incurred by Russian private investors, because the number of persons harmed by foreign sanctions, as well as the amount of their losses, can dramatically increase. It is also noteworthy that the draft law envisages that the task of compensating Russian investors for their sanctions-related losses abroad should be given the topmost priority (!), although investments within the territory of the Russian Federation will not be subject to such protection. Moreover, the draft law does not define the term 'losses', which makes it applicable not only to loss of real estate *per se*, but almost to anything, including unachieved profits, loss of reputation, etc. To complicate matters further, the draft law does not define any method for evaluating overseas real estate. The draft law has been severely criticized by the CPRF, the LDPR, *A Fair Russia*, the non-parliamentary opposition, and even by some high-ranking officials. Bearing in mind the harm that the 'Rottenberg law' can inflict on the reputation of Russia's authorities, it remains unclear whether or not the draft law in question will ever be enacted into law.

In October, Russia's oil giant *Rosneft* requested that its application for funds from the National Wealth Fund (NWF) be increased to a whopping Rb 2.2–2.5 trillion (RF Minister of Finance Anton Siluanov tactfully said that he could not remember the exact figures). Bearing in mind that the current cap on infrastructure investments from the NWF is set at 60%, it can be said that if *Rosneft*'s request is approved, the entire amount of the NWF should be spent on keeping this mega-company afloat. Even if the cap is abolished, the NWF would all the same be entirely depleted because its money will have to be invested not only in *Rosneft,* but in a number of other major projects as well (the Trans-Siberian Railroad network, the Baikal-Amur Railroad, the Central Circular Road, a railroad linking Tyva with the Trans-Siberian Railroad, and a nuclear power plant to be built in Finland) – the RF Government has already approved the relevant applications for NWR funds. To allay these fears, Anton Siluanov remarked that the Government was ready to financially assist *Rosneft*, but that the oil company would certainly get less than requested. It should be added that, when such a large company as Rosneft, in spite of its invariably high income, numerous export tax benefits and other tax breaks, keeps on applying for more and more government funds, it clearly deserves scrutiny – not an urgent bailout in violation of all existing rules and regulations. However, *Rosneft* is by far the only wastrel in Russia – for example, in October 2014, JSC Russian Railways (RZhD) put forth an ambitious plan of rapidly building a major railroad to Peking at a cost of several hundred billion dollars (!) – an undertaking that would put a tremendous strain on Russia's already shaky federal budget.

The Russian authorities put forth a very reasonable proposal that, bearing in mind the current difficult economic situation, the Finance Ministry should draw up contingency measures to shave 10% off state spending. The draft federal budget introduced last month into the State Duma and passed thereby in first reading has already become obsolete, because it overestimates the price of oil and underestimates the rate of inflation. As far as economic analysts are concerned, to work on such measures will be more important and fruitful than to discuss the possibility of embarking on any new mega-projects.

1 See, for example, the well-known 'Noga case': when a Swiss firm attempted to make use of the decision of a foreign court which had ruled against Russia, it turned out that practically all 'Russia's overseas properties' (apart from some pictures being exhibited etc), were subject to immunity, and that property of Russian state-owned companies could not be deemed to be Russia's property.