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Legal and Institutional Obstacles to Growth and Business in Russia

Prepared by Elaine Buckberg

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Abstract

Although financial stabilization has laid the foundation for growth, structural reform of the economy will determine whether Russia achieves sustained medium-term growth. The next step for Russia is to create an institutional and regulatory environment that fosters investment and promotes new private sector activity. This paper examines the most critical reforms for promoting private sector development: reforming the tax system, reducing red tape and bureaucratic corruption, strengthening the judicial system, and improving capital market infrastructure.

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Author's E-Mail Address: Ebuckberg@IMF.org

I. INTRODUCTION¹

With financial stabilization in place, Russia has established a key precondition for growth. It has also made substantial progress in the structural reform process—most notably by liberalizing prices and the trade regime, and in privatization—although the last is not yet complete. In addition, however, achieving successful transition requires the creation of an institutional and regulatory environment that fosters investment and promotes new private sector activity. Declining investment, the rising share of activity in the gray economy, and sluggish foreign investment all signal that Russia's policies in those areas are still not fully conducive to growth. To lay the foundation for sustained medium-term growth, Russia must establish a legal and regulatory infrastructure that will attract capital and encourage businesses to operate fully within the law.

The present climate for business in Russia may appear hostile in several respects rather than facilitating. A complex tax system and high statutory tax burden, onerous regulatory requirements, backlogs at regulatory and administrative agencies, and inadequate legal infrastructure all serve to deter business starts, drive businesses into the gray economy, and reduce businesses' profitability and rate of expansion. Encouraging private sector development requires eliminating such distortions across the board. The most critical changes, addressed in this paper, are: reforming the tax system, revising legal and regulatory requirements to make them simple and transparent, eliminating bureaucratic corruption, strengthening the judicial system, and improving capital market infrastructure.

II. TAX SYSTEM

The tax system must be reformed to reduce the tax burden on fully compliant enterprises, to make it less cumbersome, and to reduce distortions.² The heavy burden of full compliance has led to concealment of activity, increased reliance on nonmonetary transactions, and the sheltering of incomes and assets offshore. The transfer of assets offshore, moreover, has deterred economic activity by reducing the resources available for either financial intermediation or investment in Russia. Also, it is unlikely that the return on assets held offshore is repatriated.

The business community in Russia commonly argues that its total tax burden, as a share of profits, is excessive due to the simultaneous taxation of turnover, wage costs, profits,

¹This paper is based on the author's discussions with members of the business community, and business and legal advisors in Russia.

²For analyses of businesses' objections to the tax system, see American Chamber of Commerce of Russia, *Investment White Paper: Barriers to Investment in the Russian Federation* (January 1996), and Foreign Investment Advisory Council, *Internal Barriers to Foreign Investment in Russia* (mimeo).

and capital, such that full compliance may leave almost no after-tax profit. The tax system is further regarded as unfair due to the distortionary proliferation of tax preferences and rates, distortionary rules, and the uneven application of the code by tax inspectors. Imprecise drafting and ill-defined terminology give tax inspectors a large margin of discretion and facilitate corruption. Particularly at the regional and local government level, tax requirements may be undocumented or not publicly available. Despite the law's ambiguities, inadvertent errors are penalized at the same rate as willful noncompliance; penalties run as high as 500 percent of the error plus interest from the date the error was made at a rate sharply higher than the central bank's refinancing rate.

Tax evasion, as a result, has become increasingly sophisticated. Firms rely heavily on legal means of reducing reported profits, using transfer pricing to report all profit as accruing to offshore subsidiaries, underinvoicing of exports and overinvoicing of imports, and concealing income in the general directorate office by overstating the office's expenses. Many smaller enterprises do not pay taxes, and larger firms are believed to falsify their returns.

Press reports and the author's interviews with businesses suggest that corruption involving tax inspectors further undermines tax compliance and collections. A firm's total tax obligation is widely accepted to be a negotiated settlement between a business and its tax inspector, with inspectors exploiting the ambiguities in the code to adjust a firm's assessment and extract bribes. Inspectors are reportedly skillful at determining how much they can extract from a business without driving it under or without the business challenging the assessment in court.³ According to interviews with Moscow businesses as well as research on organized crime in Russia,⁴ collusion between tax inspectors and organized crime groups has severely undermined tax collection. The collusion may involve either the sharing of bribes paid by taxpayers in exchange for reduced tax assessments or the sale of tax information, such that taxpayers are wary of fully reporting either corporate or individual incomes or assets.

The specific provisions of the tax laws that are viewed as most objectionable by the Russian business community include:

- High combined payroll and income tax rates, particularly for high-wage workers, which can cumulate to nearly 100 percent of wages. By driving a wedge between wages paid to workers and the employers' cost of labor, the high combined payroll and income tax rates reduce demand for labor,

³Court challenges to tax assessments are increasingly common although still rare. Although certain courts are becoming somewhat specialized in tax issues, decisions are still treated as case-specific, rather than as a means of setting precedents.

⁴Louise Shelley, address to the EU conference on "The Mutual Impact of and Measures Aimed at Combating Organized Crime within the European Union and the Russian Federation," Helsinki, Finland, December 4-5, 1996.

especially for high-wage jobs, and thereby contribute to unemployment.⁵ These high rates also lead to under-the-table cash payments and, for high-income workers, direct deposit payments to offshore bank accounts.

- The property tax, which applies to all assets except cash, including inventories, is perceived as excessive. Moreover, the appraisal rules are believed to overstate property values. For 1997, firms must revalue their property by 50 percent relative to 1996 unless they obtain a new, expensive private appraisal of its value.
- Nondeductibility of conventional expenses under the profits tax, including advertising and part of interest on borrowing for capital investment.
- Multiple turnover tax rates: 3.9 percent on manufacturing turnover versus 1.5 percent on trading turnover.

The proposed comprehensive tax reform now before the Duma would modernize Russia's tax system, in line with the needs of a market economy. The draft code would simplify the tax system to facilitate tax administration and tax compliance, and relies on broad-based taxes at uniform rates to widen the tax net and distribute the tax burden more equitably. Among the key reforms are the introduction of uniform VAT and corporate income tax rates; the reduction of inappropriate VAT and corporate income tax exemptions; the wider definition of deductible expenses for the corporate income tax (notably to include interest, advertising, training, and research and development); and the shift of the property tax base from balance sheet costs to market value. Further, the draft tax code provides for the creation of improved administrative appeals procedures, including the creation of specialized arbitration court panels dealing exclusively in tax cases. It is hoped that with the passage of the new code, a key obstacle to growth will be alleviated.

III. EXCESSIVE RED TAPE

Another factor hampering growth and contributing to the expansion of the gray economy in Russia is the bureaucratic burden and expense of playing by the rules. According to press reports, given the large number of approvals required for legitimacy—each involving extensive documentation, lags for approval, and fees—many businesses prefer to operate underground or to shortcut administrative approval processes by paying bribes. In order to promote private sector activity, the regulatory and administrative requirements of starting and operating a business need to be streamlined so as to protect the public interest while

⁵To give an employee take home wages of \$1000 each month, a firm needs to pay a 35 percent income tax rate (\$350); then the firm is liable for 41 percent social taxes on the employee's gross income of \$1,350 (\$553.50). This brings the total monthly cost of employing the worker to \$1,903.50.

minimizing the burden of compliance. Accordingly, fewer bureaucratic approvals should be needed while remaining requirements need to be rendered transparent and require a minimum of paperwork. Also, adequate funding should be allocated to administrative offices in order to reduce corruption.

According to a study by the American Chamber of Commerce in Russia, the difficulty of compliance, whether with requirements for import clearance by the State Customs Committee or for hygienic certification of consumer products, consistently originates from lack of transparency in legal and administrative requirements and the underfunding of the administering agencies.⁶ The process of registering a business, for example, can take months because registrations need to be obtained in a prescribed sequence, such that one cannot initiate all procedures simultaneously.⁷ Because of the poor drafting of laws and regulations—combined with the lack of public access to those regulations—substantial managerial and financial resources are consumed simply in identifying the statutory requirements—determining what range of approvals are needed in order to operate in full compliance with federal, regional, and local laws; in what sequence; and what documentation is required for each.

The inadequate funding of administrative agencies and low salaries of bureaucrats lead to obstructionist implementation and rent seeking in the form of high fees for services and demands for bribes. The lack of clear, published requirements facilitates such corruption because applicants cannot independently verify the requirements for approval. Based on a survey of 55 small shops in Moscow, Frye and Shleifer found that in 1995 the average shop had submitted to over 18 different inspections, conducted by three to four different agencies, and that 83 percent of shops had been fined by at least one inspector.⁸ Moreover, on a scale of

⁶American Chamber of Commerce in Russia, *White Paper on Standardization, Certification, and Licensing Issues in the Russian Federation* (June 1996). See also American Chamber of Commerce in Russia, *Investment White Paper: Barriers to Investment in the Russian Federation* (June 1996).

⁷Among the requirements of opening a business are registration with the local government, registration of the charter capital with the local government, registration with the state tax service, agreement to retain the real estate profile of purchased or leased premises (e.g., these premises will be retained as a bakery), and certification of specific products. Additional requirements apply if foreign investment is involved, including registration of the shareholding structure; approval by the antimonopoly committee if foreign ownership will exceed 20 percent; and receipt of a license from the central bank for foreign currency denominated equity investment or borrowing over 180 days.

⁸Frye, Timothy, and Andrei Shleifer (1997), "The Invisible Hand and the Grabbing Hand," *American Economic Review Papers and Proceedings* (forthcoming May 1997), as cited in
(continued...)

1-5 (with 5 being the highest), shopkeepers rated on average the frequency of needing to bribe officials at 2.9. *Pravda* found corruption sufficiently common that in 1994 it published the following bribe rates for Moscow: \$2,000 for quick register of foreign joint ventures; \$1,200 to get the documents, stamps, and signatures required to open a bank; and \$300,000 to avoid banking regulations.^{9 10}

Ad hoc public expenditure reductions through budget sequestration and wage arrears exacerbate the situation, as ad hoc charges for services become the means by which public sector agencies fund their operations and salaries. The costs of corruption and bureaucratic delays may price some potential new businesses out of the market, or drive them underground. Similarly, the costs of compliance affect existing businesses through changing requirements (typically without notification or grandfathering), the need for regular recertification, and onerous record keeping requirements.

IV. LEGAL INFRASTRUCTURE

An orderly environment for business requires a comprehensive and effective legal system to impose the rule of law and resolve disputes. In this area, Russia has especially far to go—public access to the existing law is limited, major areas of law are incomplete, the judiciary has yet to develop independence and specialization, and courts lack mechanisms to enforce decisions:¹¹

- The very first step in creating a transparent and effective legal system is disseminating the law by ensuring that all judges have full, updated codes, and that the public has access to the code to guide business practices and investment decisions.

⁸(...continued)

Shleifer, "Government in Transition," Harvard Institute for Economic Research Discussion Paper No. 1783 (October 1996).

⁹International Maritime Bureau, *Special Report on Trading with Russia Today* (prepared in conjunction with the International Chamber of Commerce Commercial Crime Services), December 1995, as reprinted in *Trends in Organized Crime*, Volume 2, Number 1 (Fall 1996).

¹⁰Corruption reportedly is closely linked to organized crime. The International Maritime Bureau estimated that 50 percent of the profit gained through criminal activity is spent on bribes to government officials and the police.

¹¹American Chamber of Commerce in Russia, *Investment White Paper: Barriers to Investment in the Russian Federation* (January 1996) provides a detailed analysis of the weaknesses in Russia's legislative processes and legal enforcement.

- Legislation needs to be overhauled to include clear statements of purpose, so as to direct judicial interpretation and prevent abuse of the law by administering agencies.
- The hierarchy that exists in principle is often ignored in practice.
- Property right protections and contract law must be developed.

Only with stronger courts can stronger laws be implemented effectively. Although the 1993 Constitution establishes judicial independence, the evolution of precedent has been slow. The creation of specialized courts would enable judges to develop expertise and facilitate the evolution of judicial interpretation norms, particularly in technical areas such as tax, bankruptcy, patent, and intellectual property rights. Some progress is occurring: judges and attorneys are gaining expertise, notably in tax law, and lawsuits are increasingly being brought to challenge contract violations and bureaucratic corruption.¹² However, many judges and prosecutors are also believed to be corrupt and incidents of violence against judges undermine the system.

The courts will only become effective, however, if judges have mechanisms to enforce judgments. Important requirements in that regard would include the power to charge a party with a crime for not complying with an adverse judgement; an enforcement service to protect judges and to force compliance (by seizing unyielded assets or forcibly selling illiquid assets to satisfy a judgment); and jurisdiction to seize offshore assets.¹³

Rendering the courts effective also requires controlling organized crime. Frye and Shleifer (op. cit.) report that 76 percent of Moscow shops in their survey felt it necessary to pay for protection. Reportedly, the use of force often precedes recourse to the legal system.¹⁴

¹²Frye and Shleifer (op. cit.) found that 65 percent of Moscow shopkeepers felt they could use the courts to settle a dispute with a business partner and 50 percent thought they could bring a dispute with the government to court.

¹³Also, the corruption of any enforcement service will need to be prevented, inter alia, by adequate compensation of its employees.

¹⁴For a description of the role of organized crime groups in collecting debts, resolving disputes, and providing private security services, see Yuriy A. Voronin, "The Emerging Criminal State: Economic and Political Aspects of Organized Crime in Russia," *Transnational Organized Crime*.

V. FINANCIAL INFRASTRUCTURE

Improved capital market infrastructure is urgently needed in order to promote financial intermediation and improve corporate governance as well as to attract investment. Arguably the single most crucial reform is the introduction of accrual-based internationally accepted accounting standards so as to provide a meaningful and transparent assessment of firms' financial condition. Further, in order to force corporate managers to maximize profits and shareholder interests, investors need to be able to purchase controlling shares through the markets. The most urgent reforms would enable investors to assess a firm's value; facilitate registration, clearing, and settlement of securities transactions; and simply the tax treatment of transactions:

- Internationally accepted accounting standards should be introduced without delay in order to provide a commonly-accepted and meaningful measure of enterprises' financial position and profitability, and thereby promote financial discipline, corporate governance, and investment. The ability to assess a firm's financial position is prerequisite to bank lending and to direct or portfolio investment—yet, current cash-based Russian accounting does not provide a meaningful assessment of profit. Moving to transparent accounts will not only promote bank lending, portfolio and direct investment decisions, but will also facilitate shareholder discipline over corporate managers and the use of bankruptcy against unprofitable companies.
- In order to make shareholding secure, verifiable, and easily transferable, share registries need to be centralized, independent, and regulated. In contrast, today many companies control their own share registry, making transactions costly because registry changes need to be verified in person and making ownership uncertain because firms have altered their registers and unilaterally decertified shareholders.
- The system for taxation of capital income deters securities transactions, driving many settlements offshore. Among the problems are the 43 percent tax on broker profits and the treatment of capital gains, which allows neither adjustment for inflation nor offsetting of capital gains against capital losses.

VI. CONCLUSION

Russia's success in implementing these and other key structural reforms will determine whether sustained growth will take hold, or whether growth will stagnate. The experience of other transition economies indicates that structural reforms make the single largest contribution to growth, beginning two years into transition.¹⁵ Renewed efforts at reform in early 1997—including the consideration of the draft tax code in the Duma, measures to regulate natural monopolies, and stepped-up efforts to collect or restructure the tax arrears of large enterprises—suggest that the government is now prepared to tackle the structural agenda. Furthermore, as part of the Russia's economic program with the IMF, the government has committed to undertake key reforms in tax administration, privatization, capital markets, banking, natural monopoly reform, and land reform. The government's implementation of this reform program will substantially determine Russia's growth in the medium-term.

¹⁵Berg, Andrew, Eduardo Borzensztejn, Ratna Sahay, and Jeromin Zettelmeyer, "The Evolution of Output in Transition Economies: How Different is the FSU?" (mimeo, July 1997).