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Informal Tax Competition on a Regional Level: The Russian Scenario[1]

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Abstract

One major problem of the Russian economy is large-scale tax evasion. Using standard assumptions of tax competition theory it is possible to show that under certain conditions it is not profitable for regional governments to suppress tax evasion. Indeed, the decrease of regional tax rate can lead to a decrease of subsidies and financial transfers from central government. Therefore a better instrument for the region to attract a taxpayer is the *change of informal tax regime*. Taxpayers are informally allowed not to pay a part of regional and federal taxes and regional governments have not to choose between high or low tax rates, but whether to suppress or to ignore tax evasion. Thus weakness of the federal government enforces opportunistic behavior of the regional governments and eventually leads to tremendous losses primarily for the

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federal budget. Moreover, massive tax evasion occurs even without corruption of taxation authorities or regional governments.

KEYWORDS: Russian economy, tax evasion, tax competition.

JEL classification: D21, H26, O17

Introduction

The large-scale tax evasion is one of the crucial problems of the Russian economy. It is usually analyzed in connection with non-payments and barter (Gaddy & Ickes (1998) etc). However, non-payments and barter are instruments of tax avoidance but not of tax evasion. At the same time, according to many surveys, almost every enterprise in Russia uses black cash payments. In 1995-1997 unaccounted cash turnover represented a share of about 30% in wholesale trade and about 20% in industry (Yakovlev & Glissin (1996), Yakovlev & Vorontsova (1997), IPSSA (1998)). These percentages decreased in the late 1990s, but with little significantly (Yakovlev (2001)).

The macroeconomic indicators show an indirect evidence of the broad dissemination of this phenomenon. As an example we can observe the relation between monetary aggregates M0 and M2, which shows the amount of cash in the money supply, broadly used in the economic literature to measure the scale of tax evasion and shadow economic behavior (Tanzi (1983), Hepburn (1992), Spiro (1996) etc). This indicator increased in Russia from 17% at the beginning of 1991 to 40% at the end 1993. During the last 7 years this variable has been equal to an average of 35%, which is 4-5 times higher than similar indicators in the US and Western Europe in the 1990s.

It should also be pointed out that cash dollars are actively used in Russia together with cash rubles. By different estimates, the amount of cash dollars circulating in Russia reaches 20 to 50 billions. Most are used as savings, Due to the general distrust in the banking system as a whole (for more information on the role of savings in cash dollars see Avdasheva & Yakovlev (2000)). However, some of these dollars are also used by companies for settlement purposes (see data of surveys of industrial and trade enterprises by Yakovlev & Glissin (1996)), which grow the actual corresponding statistical indicators of the Central Bank of Russia from 0% and 2% higher.

The large-scale black cash turnover is based on fictitious deals between real sector enterprises and sham (one-day) firms. A network of small and medium-sized banks, as well as investment companies provides technical and administrative support for these transactions in Russia. It has now developed to become a separate and quite profitable financial industry (see details in Yakovlev (2001)). It should be emphasized that, unlike officially functioning off-shore companies (registered, for example, in Cyprus), Russian one-day firms do not pay any taxes. In fact, their business is illegal; it is based on systematic report falsifications.

This kind of business, however, is not unique to Russia. It is also found in Europe as well as in the US, but unlike in Russia, it is only used by criminal elements (drug dealers, illegal arms traffickers, etc.) : The cost of such services representing 40% to 50% of the “laundered” amount, which is higher, than the official tax rates in those countries. This is also due to their strict governmental policy in this sphere. In Russia, however, the interest paid to sham firms by their legally operating clients usually does not exceed 3% and, according to entrepreneurs, these operations are almost risk-free. We will now try to explain why this is possible in contemporary Russia.

General theoretical framework

The analysis, given here after, is based on the tax competition theory (see McLure (1986), Janeba (1997) etc). However, in standard conditions tax competition provides incentives for tax avoidance rather than for tax evasion. Due to the novelty of the topic, analysis of tax evasion within the framework of tax competition theory has yet been the object of few studies (probably the most interesting one being that of Treisman (1999)). All these studies assumed the presence of a strong link between tax evasion and corruption. Western scholars usually stress corruption on the regional level as being the main reason for tax evasion in Russia. We will here expose an alternative approach to this subject.

We, here, look at a federal state with a multi-level budgeting system, where regional governments are strong and transparent while the federal government is weak and corrupt. The tax authorities represented by federal and regional level officials also play a significant role in this scheme. For the purpose of this paper, we will assume that these officials; act for the benefit of their agency, are not involved in corruption, and do not violate the law.

In this system, real sector enterprises can choose between tax compliance and tax evasion and can change their location depending on the tax rates in different regions, as well as by sham firms that provide black cash and money laundering services for real sector enterprises.

The federal tax rate is the same for all regions but the federal government can support some regions with subsidies and financial transfers. Initially, the regional tax rates, as well as the mobile tax base is quite high and equal for all regions.

The federal tax rate is fixed, while regional governments can change their tax rates. And tax officials can choose different tax inspection strategies, while tax authorities are not independent and can be influenced by federal and regional governments.

Selection of a regular tax inspection strategy by a rational tax officer

The starting point of our analysis was an interview with an accountant who offered the following explanation for the inactivity of the tax authorities (the language is simplified):

> "The tax authorities have a tax collection plan. Under that plan, each tax inspection must collect a certain amount of taxes and fines. To accomplish this task, each inspection has a certain number of personnel. Typically, the area within the jurisdiction of a tax inspection comprises some large and medium-sized enterprises and a number of small businesses. Tax legislation is complicated and inconsistent. For those reasons, in the course of an audit of a large or medium-sized enterprise, the tax inspector can usually find mistakes in the accounting or tax calculation records and charge the enterprise with extra taxes and fines. Since the quality of bookkeeping in small business is generally lower than that in large and medium-sized firms, the tax inspector will almost always be able to find grounds for charging extra taxes and fines. The tax inspector is likely to spend less time on finding mistakes in small enterprises as compared to large and medium-sized companies but the extra budget revenues generated in the first case will be proportionate to the size of the business. What more, in the case of a small firm not providing any reporting at all, the tax inspector faces even greater challenges in terms of having to track down the firm's director, accountant, owners, and reconstruct the firm's financial documents. The cost of this may well exceed any possible taxes and fines recovered from the errant firm. Indeed, it is possible that the non-reporting firm is actually a real-sector

enterprise that stopped operations because of poor competitiveness of its products or services but did not file bankruptcy for lack of means to engage the costly procedure. Therefore, the tax inspector finds it much easier to pay regular visits to 'stationary' enterprises, no matter what their size be, than run about in search of 'wandering' firms and companies."

At first glance, this explanation seems to be quite plausible. We tried to present it in a more formalized way in Table 1. If we agree with the assumptions in terms of tax inspections' goals and constraints, as well as with the differences in audit conditions for different types of enterprises it becomes clear that ignoring the third strategy is rational. The search for disappeared firms implies high costs and does not guarantee any results. However, this explanation is true for local tax authorities only.

Table 1. *Selection of inspection strategy by head of local tax inspection*

Goal	Successful promotion (= to maximize the amount of additional tax payments and penalties)
Constraints	Number of inspectors at local tax authorities and their working time

Strategy	**Effort**	**Expected result**	**Probability of getting the expected result**
1. To inspect large enterprises	High or middle*	Large additional tax payments and penalties	High
2. To inspect small enterprises	Middle or low*	Small additional tax payments and penalties	Very high
3. To search for non-reporting firms	High	?	?

** depending on the professional level of the enterprise's accountant*

The central offices of the Ministry for Taxes and Duties, the Federal Tax Police Service, and other bodies have extensive statistical resources and access to the best information channels. In facts, the central MTD and FTPS offices always have complete information (broken down by regions, industries, and time periods) on the number of registered and reporting tax payers, the share of one-day companies in the number of the found non-reporting firms, and the average scale of operations of the found one-day companies. With all this data and administrative resources, even back in 1994-95 the central tax service office could easily compare the cost of searching for one-day companies to the actual losses resulting from their operations and effectively destroy the black cash industry. This did not happen. Why?

In order to explain the inactivity of the federal tax authorities, we will look at the investigation procedures used for such crimes. An interview with a lawyer showed that current Russian legislation did have the provisions needed to curb these tax evasion schemes. At the same time, in order to file suite, the tax police have to have detailed information not only about the sham firm itself and its organizers, but also about its clients. These informations, becoming available only in the course of the investigation, and the impossibility to predict who the clients of the sham firm are, account for the reluctance of tax authorities. (For example, the investigation of the case with the Saratov branch of Sviaz-Bank covered in the RTR news programs on 14/12/1998 revealed about 400 firms that were involved in "cashing" operations.) Initiators of investigation are often afraid of finding *well-known political figures* on the customer list.

Table 2. *Registered taxpayers (reporting and not reporting to the tax authorities) in the Russian Federation and some selected regions as of January 1, 1997 (calculated on the basis of State Tax Service data)*

	Number of taxpayers registered with STS (thousands)	**Including**			
		Taxpayers reporting to STS		**Taxpayers not reporting to STS**	
		(thousands)	**%**	**(thousands)**	**%**
Russian Federation	2793	2196	78.6	597	21.4
including					
Moscow	422.3	270.3	64.0	152.0	36.0
Moscow region	115.3	69.4	77.6	25.9	22.4
Total for the two selected regions	537.6	359.7	66.9	177.9	33.1
Total for all the other regions	2255.4	1836.3	81.4	419.1	18.6

As an example, we will recall the notorious story of a box containing half a million dollars. General Alexander Korzhakov's people found it in June 1996 in the possession of two fellow members of Mr. Chubais, campaign manager of President Eltsin's, as they were leaving the RF White House. It is not the finding of the box that matters most, but the inadequate reaction of the political opponents who then made attempts to remove Anatoly Chubais from power. They tried to do so by three times: in June 1996, during the presidential elections; in January 1997, when the information on Chubais very high 1996 income was published in the mass media; and in August 1997 in the form of a scandal, and a huge fee for having written a privatization brochure.

In the second and third cases the attacks on Chubais, in the State Duma and mass media, were much worse than in the first case. While in the first case, when the money was undoubtedly "black", not only the presidential administration and the government, but also the parliamentary opposition preferred to hush up the incident. It was in the second and third cases, about his *legal incomes* for which all taxes had or would surely have been paid later on, that people started talking.

The poor reaction of Mr. Chubais' opponents to the "paper box" can be easily explained. Comments in the Russian mass media on criminal investigation against businessman Mikhail Zhivilo in February 2001 included some facts about black cash financing of the communist party (see, for example, interview with State Duma member Mr. Semago in the ORT news programs on 28.02.2001). And if we assume that the opposition also used black money during the elections, then further elaboration of this issue could have been destructive for everyone.

This assumption explains why the tax and enforcement authorities are so inactive in regards to sham firm organizers. Too much politics was involved in this business and every serious investigation on the activity of banks or financial organizations working with unaccounted cash could end up sadly for the investigators themselves. Therefore, it was easier for the tax and enforcement authorities *simply to ignore this business*. This made the activity of *all* sham firm organizers (not only those involved in politics) *almost risk-free* and eventually led to a broad dissemination of this tax evasion scheme.

Table 3. *Strategy selection by federal tax official*

Goal	Successful promotion (= to maximize the amount of additional tax payments and penalties)
Constraints	Number of inspectors at local tax authorities and their working time Loyalty to policymakers who have an influence on the professional career of high-ranking public servants

Strategy	**Economic effect**	**Political effect**
1. To inspect large enterprises	A large sum of additional tax payments and penalties (at present) / moderate total costs	Positive

2. To inspect small enterprises	A large sum of additional tax payments and penalties (at present) / high total costs	Positive
3. To search for non-reporting firms	Reduction of tax evasion (in the future) / high total costs	?

Table 3 presents all the elements mentioned above, presented in a more formalized way. Unlike local tax inspections, the central tax authorities do have consolidated statistical data and can use expected and predicted values without probability factors when selecting a tax inspection strategy. Successful promotion criteria are also different. At the regional level the main criterion is the amount of tax collections, while at the federal level there is one more criterion – loyalty to the politicians who decide on the appointment of high-ranking officials. This, however, creates another factor of uncertainty, federal level officials being objectively incapable of evaluating the risk (or the probability) of the investigation of banks or financial companies' activities affecting someone's political interests. This uncertainty is the main reason preventing them from selecting the third strategy, oriented towards the suppression of black cash tax evasion.

Tax competition and behavior of regional governments

In the previous section we tried to explain by logical means, the reasons for the tax authorities' negative motivation, which hampers the efficiency of their struggle against the black cash industry. However, if we take a closer look at the situation our explanation of local tax authorities' preferences on choosing a tax inspection strategy, is found to be true only at the initial stage of one-day firms' development. If the number of sham firms is relatively small, the risk of investigations taking up a lot of time and being useless is indeed high. But if such a tax evasion scheme is applied massively (as it was in Russia after 1994) the situation is significantly altered and chances that investigations end up to be successful grow dramatically.

We should also take into account that in a multi-level budgeting system it is not only the federal tax authorities but also local and regional governments that can encourage the local tax authorities to search for sham firms and investigate their activities. A wide and rapid dissemination of tax evasion schemes deeply affects local revenues and regional budgets, in a situation where local administrations do not have enough money to resolve even the most urgent social problems. On the longer term this problem will shift to the federal level as well but it is the local and regional bodies that are the first ones to face it. It is then logical to assume that they are best placed to influence regional tax authorities and motivate them to struggle with tax evasion mechanisms.

Paradoxically, we find that under certain conditions it is not profitable for regional administrations to motivate investigations. We will explain this idea using standard assumptions of tax competition theory (see McLure (1986). (A recent example of practical application of this methodological approach to dividend taxation analysis, when no restrictions on capital flows between countries exist, is a paper by Janeba & Peters (1999)). In Russia, tax competition is encouraged not only by lowering legally defined *nominal tax rates* but also by providing *official* tax concessions. The problem being that - because federal officials can say that the region has enough money if its government can decrease tax rates - a decrease in regional tax rates can lead to a decrease in subsidies and financial transfers from the central government.

Table 4. *Selection of behavior pattern by regional administration*

Strategy options		**The other regional governments prefer**	
		…to suppress tax evasion	**… to ignore tax evasion**
		A	**B**
1	To suppress tax evasion	Increased revenue to the regional budget because tax evasion is impossible	Decreased revenue to the regional budget because of capital outflow to the other regions
2	To ignore tax evasion	Increased revenue to the regional budget because of low real tax rates (offshore zone effect)	Decreased revenue to the regional budget because of widespread tax evasion

Thus, we argue that in the conditions of a weak federal government and non-transparent budget system, a better way for many regions to attract capital is to *change the informal tax regime*, indirectly allowing taxpayers not to pay portion of the taxes (not only regional but also federal). In short, legitimate taxpayers will be informally allowed to use the services of illegal one-day companies in order to reduce their tax payments.

Thus, we can say that an alternative strategy for the regional administrations is not to choose between high or low tax rates, but to decide whether to suppress or ignore tax evasion. Under these circumstances, the effectiveness of the local authorities' efforts to suppress tax evasion in a specific region will fully depend on the strategy chosen by the other regional administrations. The possible outcomes of such an option are presented in Table 4.

The data shows that tax evasion will be constrained and revenue to the regional budgets will grow if black cash tax evasion is suppressed not only in one specific region, but in the other regions as well (square A1). In case the other local administrations choose to ignore tax evasion (square 1B) while one region still suppresses it, the actual tax burden on enterprises of this region will grow as compared to the other regions. This will lead to the reallocation of business activity (in the form of capital outflow) in favor of the other regions and will eventually result in a reduction of tax revenues.

Let us now look at the consequences of an alternative strategy, the government of a given region choosing to ignore black cash turnover. In case the other regional administrations choose to suppress such tax evasion schemes (square 2A) our region will gain the status of an *informal offshore zone*. Legal business, which is the main black cash scheme user, will start to function in the conditions of a *favorable tax regime*. Furthermore, it will be difficult for the federal government and other regional governments to identify this favorable tax regime because of its informal nature. However, information on such “incentives” will spread fast in the business community due to tangible cost reductions. This will result in an inflow of additional financial resources to the region, growing business activity, and, in a second period, in an increase of the budget.

If the authorities in the other regions use a similar strategy (square 2B) the actual tax burden averages out and the conditions for interregional capital flows disappear. This, however, will happen only when the level of tax collections for the local budgets reaches a significantly lower level. In these conditions, attempts of one regional administration to change the situation by introducing sanctions for tax evasion will not produce any desired results. Trying to get back to A1 they will in fact return to 1B where the region will systematically suffer from capital outflow instead of experimenting a growth in tax collections.

This situation is similar to the well-known prisoners’ dilemma. In the same way, we here have two poles: “Pareto optimum” (square A1) and “bad equilibrium” (square B2). But unlike the prisoners who are placed separately, regional governments can choose to work out a joint and mutually beneficial strategy.

However, there are two obstacles in this scenario. First, since tax inspectors prefer to check regularly reporting “stationary” enterprises, local administrations will have to incur additional costs in order to force a search for sham firms. Second, the incentive that breaking the mutually beneficial strategy will give the breaker substantial short-term benefits.

In order to prove the last statement, above exposed, let us assume that there are N regions where local administrations can choose the first (suppress) or the second (ignore) strategy with the same probability of 0.5. Then, following our logic, the probability for a local administration to obtain positive results from the first strategy is: $(0{,}5)^{N-1}$. In all the other cases this strategy will lead to capital outflow from the region. The probability of obtaining positive results from the second strategy in the short-term period will then be: $(1 - (0{,}5)^{N-1})$. It is obvious that $(1 - (0{,}5)^{N-1})$ is larger than $(0{,}5)^{N-1}$ for any $N>2$.

Hence, every regional administration will have serious grounds for opportunistic behavior. Therefore, the securing that all parties will stick to the agreement and pursue strategy 1 (suppression of black cash tax evasion) requires an efficient control over this process and strict sanctions applied to possible breakers. The federal government could perform the control functions. However, as we saw earlier, central officials also have reasons to avoid the fulfillment of their functions.

We can now conclude that if the federal government initially ‘punishes’ the regions that choose strategy 2 the “good” equilibrium will remain stable (square 1A in Table 4). On the contrary, if the center does not punish the supporters of strategy 2 the “bad” equilibrium will be stable (square 2B in Table 4).

At the same time, the “bad” equilibrium not only creates obvious negative effects on local administrations but also creates new and quite effective *informal leverage on SME*. The point is that the cost of black cash tax evasion is low because local administrations and tax authorities turn a blind eye to black cash turnover. This favors a broad dissemination of tax evasion schemes and changes the competitive environment in certain market sectors.

If in the past a company entering the market could choose whether to be law-abiding and pay all taxes or use black cash and pay only some of the taxes, there is no alternative now. An *average* firm that pays all taxes will not be *competitive* because its competitors will benefit from a favorable tax regime. Hence, all firms on the market will have to violate the law to a certain extent, in order to exist (otherwise they will be put out of business by the competition).

This means that sanctions for breaking the law can be *legally* applied to any market player at any time. This explains why, not a single company will dare turn down local authorities' "request" to transfer a certain amount to the off-budget account of a foundation at the local administration in order to resolve social issues, to celebrate the next anniversary of a city, or to build a church. Obviously, there can be no effective monitoring of such "voluntary donations", which creates a lot of opportunities for abuse. This mechanism of informal expropriation of some of enterprises' savings resulting from their non-payment of taxes allows local and regional governments to *make up for the losses suffered by regional budgets* or even to increase their revenues. The natural upper limit for this informal re-distribution is the difference between the amount of taxes and social charges that enterprises would legally have to pay and the amount they actually do pay. As long as "voluntary donations" remain lower than this difference private local business will be inclined to put up with the informal pressure of the local authorities.

Conclusion

We can conclude that weakness of the federal government resulting from too close informal relations between politicians and large business (i.e. political corruption - see Hellman, Jones & Kaufman (2000)) causes opportunistic behavior of regional administrations and eventually leads to tremendous losses (primarily for the federal budget). Moreover, massive tax evasion can occur even if there is no corruption in tax authorities and regional administrations.

The federal center and subsidized regions that strongly depend on financial transfers from Moscow are the first to suffer from low tax collection rates. Therefore, the current system of relations contributes to the growing inefficiency of the Russian government and secures the existing structural distortions among the regions. This situation is a good example of the so-called "institutional trap" (see Polterovich (1998)). It is noteworthy that although the situation is harmful to the country, none of the economic agents in question (private business, local administrations, and federal officials) is interested in changing the current state of affairs.

The deadlock can be broken only by top federal officials fully ready to change the pattern of relations between government and large business created in the 1990s. And even in this case, we believe that improvements are only possible if the main players on the rules of the game reach consensus. Unfortunately, no consensus has been achieved so far. This could result in a repetition of the grim experience of the 1990s, when the radical reforms applied, brought the country to a completely different situation then that promised by the liberal reformers.

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