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In partnership with Avenir Accounting



Seminar on the Renewed Northern Dimension Policy and the Next Steps.

Thursday 31 May and Friday 1st June 2007

JON HELLEVIG: “Russia Emerging from the Grey Economy towards Transparency – The View from Business Practice”

I. GENERAL FRAMEWORK: Russia from Anarchy to Statehood

1. Russia’s Near History:

- 1990 – 1993 The Fall of the USSR with Yeltsin’s Glorious Revolution
- 1990 – 1999 The Years of Anarchy = Boris Yeltsin building the New Russia in opposition to the Russian parliament, the Duma, which holds the supreme power in the country (legislative power) and is engaged in a sabotage of reforms with all means possible
- 1999 End of anarchy with the first reform oriented Duma; Yeltsin has finally conquered the communists and steps down, and is instrumental in having Vladimir Putin elected president of Russia
- From 2000 Russia gradually emerging from anarchy to statehood under Vladimir Putin and the democratic and reform-minded parliament (legislature)
- By 2007 anarchy has been replaced with a Russian state that is getting closer – but still far away – from the absolute power typical to the European governments

2. Russia's Economy from Red to Black, and from Grey to White

- The Economy – as society (and civil society) has developed in exact pace with the political reforms: from the **red planned economy** to the **black economy** of years of anarchy, to the **grey economy** of the beginning of the new millennium 2000
- And today we are witnessing the final leap to a **white economy**

3. From Grey to White – The Components in the Analysis

3.1. Statehood

- Before Putin established statehood in Russia there could not even theoretically be any conditions for a real democracy
- From statehood and democracy stems all the other factors (conditions), in infinite variances which affect our today's topic ('from grey economy to transparency')
- Law enforcement: Make the laws known and providing for a level playing field

3.2. Improvement of conditions for Democratic Competition

- Changes in the systems of elections
- Decisive improvement with:
 - dethroning the regional Governors who acted like feudal lords over the respective regions
 - bringing big business ("the oligarchs") within the confines of the legal order

3.3. Legal framework

- Well-planned and just laws to replace the Soviet arbitrary No-Law system

3.4. Judiciary (1.)

- Today stronger than ever independent courts participating in the **competition of arguments**, which is the same as **law**
- **Law is based on traditions, social practices, born in a competition of arguments**
- In the Soviet Union there was no law in the meaning of rule-by-justice, and not even rule-by-law, but an arbitrary command system best deemed as a No-Law system
- Reduction of the influence of Governor's and oligarchs
- The judiciary reform under Putin's administration

3.5. Judiciary (2. cont.)

There are huge improvements in the judiciary every day - here a striking detail:

- **The Putin administration has raised judges salaries to an average 100 thousand rubles per month approx. USD 3800 per months**, in most of Russia this corresponds to a salary of 10,000 euros in Finland (considering taxation and purchasing power parity – I have heard that a judge in Finland receives much less)
- **When Putin became president judges salaries were approx. 4,000 rubles per month, or 150 usd per month!**
- As a sad example of how important indeed this priority has been can be taken with comparing two other professions that of doctors and teachers, where the doctors situation has significantly improved thanks to a concentrated reform program (ranging from an average of 8,0000 to 26,000 rubles depending on region and position, municipal, commercial) but that of teachers is still on the levels of a few thousand rubles (7,000 rubles a month, and this is indeed the major obstacle to reform in the sector of education
- **Nothing can be a better sign of Putin’s commitment to encourage an independent judiciary as his overseeing of this miraculous rise in the salaries of Russian judges, for the independence of the judiciary starts with the independence of the judges**
- We have to wonder why I now am the first one to bring this remarkable news to the Western audience.

3.6. Basic economic prosperity (security)

- Reduction of corruption (corruption is a function of weak state, anarchy, bureaucracy, weak judiciary, underdeveloped framework of law **and poverty**)
- Strengthening of the individuals and hence civil society

3.7. Bureaucracy

- Strong reduction in bureaucracy
- The Soviet culture was so overburden with suffocating bureaucracy that for the superficial observer it is not evident how strong the reduction of bureaucracy has in reality been

3.8. Pay attention to what cannot be measured

* **Freedom – not anarchy – for the competition of arguments**

* **Traditions – time;** time was needed for these changes, just nobody could have expected that so little time was needed, that all this was achieved in 15 years!

II. CURRENT ACTIONS ON THE FRONT

The process of making the economy transparent is a function of social practices in infinite variances: of all what was said above, and e.g. these latest developments:

1. Customs in a shake-up - Statehood has reached the Frontiers
2. Suppression of money laundry schemes
3. Tightened control of VAT collection
4. Suppression of illegal salary schemes
5. Transparency brings Shareholder value

1. Customs in a shake-up - Statehood has reached the Frontiers

1.1. Instillation of legal order at Customs – “The last front” (Customs 1.)

- Having reined in on other pressing problems Putin’s administration could turn its efforts on Customs in 2005 and especially 2006
- Before 2005 an overwhelming majority of all goods imported to Russia were smuggled in the country – (some say “under grey schemes”, but in reality they are all only different forms of smuggling)

1.1. Customs (2.)

Customs statistics shows the effects of increased transparency

- Import duties 2000 186 mrd (USD 7 bln) – 2005 750 mrd (USD 29 bln)
- Import growth (value of goods) 2006 + 40% - 1Q/ 2007 +50%
- Increased transparency seems to account for the bigger part of the growth

1.1. Customs (3.)

Increase of declared customs value is being reported by foreign exporters

- * Fees paid for ‘grey import’ have gone up from an average of 8% to 18-20% today
- * This is near the limit, because in reality this is already even directly as expensive as legal transparent importing – The market participants have such an ignorance of the nature of VAT that they rather pay the same money to organized crime as a cost instead of paying the corresponding sum as VAT and offsetting it from sales revenues
- * Example: Legal import: Customs duty 15%, VAT 18%, COST = 15%
- * Example: Illegal import: Customs duty 5%, VAT 6%, 17% bribes = Cost 22% + transaction fees for organizing the bribe payments and the cost of the mess caused by non-transparency

* VAT is normally deductible in Russia = No gains to be received for grey schemes =
The game is over!

1.2. Suppression of money laundry schemes

- fly-by-night companies
- illegal transfer of money abroad
- illegal conversion of money to cash for illegal operations (“cashing”)
- the cost for “cashing” has gone from 1,5% to 7-9% in a year! It follows that the means and methods for this kind of crime are becoming less, more costly, and more risky – and soon the cost even in direct comparison with transparency are insignificant

1.3. Tightened control of VAT collection

- It was a disastrous mistake in Russia to copy the weird French VAT model to Russia; now there are talks that Russia would go over to an American style sales tax instead – let’s hope for the best!
- A lot of fraud has made VAT administration almost impossible
- A lot of people are in the business of stealing VAT
- Now control tightening and even this kind of fraud is becoming less

1.4. Suppression of illegal salary schemes

- Average statistical salary up by 25% in a year (April 2006: 370 – March 2007 465 USD)
- The increase reflects real increase in salaries, but to a big extent it shows that the Government’s crack down on the shadow economy and enforcement of legal payment of salaries is successful; Russian Government program of gradual enforcement of fully transparent salaries
- Real salaries are still much higher – Avenir Salary Survey
- When analyzing these salary figures, and the Russian economy in general purchasing price parity should be sufficiently accounted for
- Collection of social tax and personal income tax (PIT) shows the same
- Now PIT collection is on par with VAT (after Corporate Profit Tax, and Mineral Extraction Tax)
- Social tax: 2006 up 18% - 1Q/2007 31%
- PIT: 2006 up 31,6% - 1Q/2007 35%
- 6 million Russians have an ‘official salary’ of 2,000 rubles, 70 USD, which is well-below the subsistence level, i.e. it is not real

1.5 Only Transparent Businesses Create Shareholder Value

* Increased understanding of the meaning of transparency for creating shareholder value

* All these issues – both these Current Actions (items II. 1.1. to 1.5.) and the General Framework (items under heading I.) - affect each other in a kind of a hermeneutical circle (or ‘what comes first the chicken or the egg’), as the circle gets tighter the juice of the grey economy is squeezed out and we will be left with the white substance

III. What this means for Finnish business – and for economic research

- 1st Quarter 2007 GDP was up 7,9% an unexpected 2% (more than the usual 6-6,5% for last years), I think this has to do with increased transparency of the economy, and that there will be **a transparency premium on GDP** for a long time to come
- A further 2% p.a. reserve is in the **premium to be expected** when Russian society will be ready fully to embrace the **de-bureaucratization** of the economy (compare Finland whose real number one strength and competitive advantage is being the world's least bureaucratic society)
- Manufacturers have to **take control of distribution** in Russia as the grey schemes in customs are being intercepted
- **Production in Russia** now that the competitors are loosing the illegal advantage of smuggling
- Recognize that the Russian economy will at least **double again in approx. 10 years**
- Understand that economic theory in general fails to account for the shadow economy, exchange rates, purchasing price parity and all the other infinite variances that affect the economy (such as time and freedom)
- **Finland does not have to sink with the EU average index, but can become the Switzerland of the North by making use of the opportunities that Russia offer!**