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CREATING CONDITIONS FOR SHADOW ECONOMY IN
ADOPTION OF MUNICIPAL ACTS

I.I. Galyautdinov (a)*

*Corresponding author

(a) Irkutsk National Research Technical University, 83 Lermontov Street, 664074, Irkutsk, Russian Federation
iliga@irk.ru , phone: +79501411798

Abstract

The article analyses possibilities for shadow economy development at the stage of municipal business regulation legislation reasoning using Irkutsk city as an example. It also focuses on predictions of economic and social consequences of these regulatory acts as far as the issue of shadow economy is crucial in Russia. The study uses system, complex, functional, structural and comparative methods as well as a method of expert and statistics predictions.

The article discusses opportunities for shadow economy development in the municipal commercial property tax regulation act at the stage of reasoning. Social and economic consequences of the act are analyzed as well. The article proves that the municipal act “On the commercial property tax” lobbying interests of large companies to the disadvantage of small and medium-sized businesses results in the growth of the shadow economy and economy criminalization. High utility rates, weak consumer purchasing power, underdeveloped infrastructure, distant location from economic centers squeeze small and medium size businesses, make them too sensitive to external factors and increasing expenditures.

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1. Introduction

Shadow and criminal economic processes have existed since the birth of the economy. Since that time, economic processes have been divided into light (legal) and shadow ones. Legal economic activities are those which have provided benefits to the social formation while shadow or criminal activities are those which have kept benefits from the society.

Shadow and criminal economic conditions in all social and economic formations are determined by different factors based on acting legal acts, because the latter determine what is legal or illegal in this or that social and economic formation.

The present article deals with a factor which legally creates conditions for shadow economy development using Irkutsk city as an example.

The document entitled “Information for discussion of an optimum individual property tax rate for objects specified in Article 378.2 of the Tax Code of the Russian Federation” submitted to the working group of the Legislative Assembly of Irkutsk oblast is an example of the use of legislation for encouraging shadow and criminal economic activities.

Let us look into the historical background.

In 2014, I engaged in debates over possible economic and social consequences of the amendments to Irkutsk Regional Act “On the business property tax” for small and medium-sized enterprises (SMEs) of the region initiated by the Government of Irkutsk oblast. I did not assume so long-lasting debates over economic and social concerns beyond the boundaries of one Russian region.

Only one amendment to the regional act can be a minor problem. But when analyzing it, I had to unravel a growing tangle of problems. It is impossible to ignore any of them if one wants to see into a matter (Galyautdinov, 2015, 2017).

In 1998, in Russia, the number of taxes, including regional and municipal ones, was 200. The first part of the Tax Code of the Russian Federation adopted on July 31, 1998 (No 146-FZ) and becoming effective of January 1, 1999 reduced the number several times. The Code restricted the power of federal, regional and municipal government authorities to impose taxes. The Code also established a limiting list of federal, regional and local taxes.

National economic and social systems seemed to evolve. That progressive development path was prescribed in the Federal Law “On the strategic planning in the Russian Federation” No 172-FZ of June 28, 2014.

The strategy was specified in the document issued by the Russian Ministry of Finance “Key areas of the tax policy of the Russian Federation for 2016, 2017 and 2018”. The document consists of three parts:

1. Determination and analysis of the tax load and its influence on the business activity level in Russia and foreign countries.
2. Assessment of results of tax policies for the last several years.
3. Development prospects and tax policy measures to be taken in the next 2-3 years.

However, despite such fundamental vectors of the tax policy aiming to expand the economy and spur economic prosperity, indicators of the economic growth and hard reality disagree.

Is it a regional feature or a national trend? What are the causes of the situation and what measures should be taken to change it?

It should be noted that if a strategy is based on false assumptions, it cannot improve the situation.

2. Problem Statement

Thus, both federal and regional tax policy strategies are based on false assumptions. The regional government being aware of difficulties of the SMEs does not filter false management impulses from the federal center (they can be false due to poor development, lack of scientific grounds, disregard of local features), allowing them pass through the prism of its powers. It intensifies ill-conceived government regulation impacts on the weak frame of small businesses.

If one takes into account the number of signals sent out from the federal to regional levels, it becomes obvious that executive and legislative bodies make decisions without scientific analysis and in-depth study of legal acts. Among other things, they do not analyze laws in terms of shadow economy development conditions.

In Irkutsk oblast, federal and regional strategic decisions are often imbalanced. How do local authorities justify decisions about tax rates if they are not in an information vacuum and know all the above-mentioned arguments?

Since ancient times, humans have tried to estimate the national income and capital, determine their relationship, find ways to increase the national income and impose taxes on owners of the national capital (e.g., commercial property owners). Executive bodies of Irkutsk city pursued the same goals when they increase commercial property tax rates aiming to increase budgetary revenues.

3. Research Questions

The article analyzes the document which justifies a new commercial property tax rate for Irkutsk oblast and Irkutsk. It assuages doubts of entrepreneurs and challenges facts and calculations demonstrating harmfulness of the tax rate which can create conditions for unfair competition and shadow economy development.

4. Purpose of the Study

As far as arguments of Irkutsk administration are laconic and there is no information in mass media, let us refer to facts.

The document begins with the statement "Based on the assessment of the city of Irkutsk on the average specific indicators of average and minimum value (cadastral units per 1 square meter of commercial buildings and premises), the tax rate on individual property (IPT) is presented below (see table.1).

Table 01. Values of tax payments depending on the type of a taxation object and individual property tax rate for Irkutsk in 2018

	Building		Premise	
	Minimum	Weighted mean by the size	Minimum	Weighted mean by the size
Mean specific indicator of the cadastral value by cadastral units, rubles per one square meter	1 792.7	12 575.3	6 283.4	24 961.6
Expected IPT rate	Calculated IPT rate depending on the type of a taxation object (rubles per one square meter)			
0.2 %	3.6	25.2	12.6	49.9
0.4 %	7.2	50.3	25.1	99.8
0.6 %	10.8	75.5	37.7	149.8
0.8 %	14.3	100.6	50.3	199.7
1.0 %	17.9	125.8	62.8	249.6
1.2 %	21.5	150.9	75.4	299.5
1.4 %	25.1	176.1	88.0	349.5
1.6 %	28.7	201.2	100.5	399.4
1.8 %	32.3	226.4	113.1	449.3
2.0 %	35.9	251.5	125.7	499.2

Based on the presented data, the amount of IPT is 0.2 % (from a weighted average specific index depending on the size) – 25.2 rubles /1 sq.m. The amount of the premise property tax is 49.9 rubles /1 sq.m; the amount of the building property tax is 251.5 rubles /1 sq.m and of the premise property tax is 499.2 rubles /1 sq.m at maximum rates. Additional monthly costs per 1 square meter can be 2.1–41.6 rubles.

According to the website RealtyVision of December 2016, the average commercial property rental cost is 632.4 rubles /1 sq.m. The annual rental cost is 7 589 rubles /1 sq.m (632.4*12). An increase in rental costs, if they are included in a new tax, can vary from 0.3 % to 6,6 %.

Individuals own 154 objects with a total area of more than 100 square meters. Their total area is 350 420 square meters.

Calculation of the IPT amount for objects is specified in Article 378.2 of the Tax Code of the Russian Federation.

Table 02. Increase in the annual rental cost due to increase in an IPT rate for Irkutsk in 2018

Cadastral value of all objects in 2016, 12 002 949 thousand rubles		Tax rate per 1 square meter	Increase in rental costs due to increase in tax rate (PA per 1 square meter)	
IPT rate				
in %	in thousand rubles	rubles	rubles	%
1	2	3	4	5
0.2 %	24005.9	68.5	7608.5	100.9
0.4 %	48011.8	137.0	7677.0	101.8
0.6 %	72017.7	205.5	7745.5	102.7
0.8 %	96023.6	274.0	7814.0	103.6
1.0 %	120029.5	342.5	7882.5	104.5
1.2 %	144035.4	411.0	7951.0	105.5

1.4 %	168041.3	479.5	8019.5	106.4
1.6 %	192047.2	548.0	8088.0	107.3
1.8 %	216053.1	616.6	8156.6	108.2
2.0 %	240059.0	685.1	8225.1	109.1

According to the data presented, the IPT amount at the rate of 0.2 % is 68.5 rubles /1 sq.m, and 685.1 rubles /1 sq.m – at a maximum rate. Additional monthly costs per 1 square meter can be 5.7–57.1 rubles. An increase in the rental price of these objects can be 0.9–9.1 % at rates of 0.2 % and 2 %”.

5. Research Methods

The study uses system, complex, functional, structural and comparative methods as well as a method of expert and statistics predictions.

6. Findings

As can be seen, the document uses the cadastral value and IPT amounts in rubles depending on the tax rate.

Unfortunately, the calculation does not take into account possibilities of businesses to pay at least an additional amount of taxes along with existing taxes which are constantly increasing while the consumer purchasing power is decreasing.

Besides, the calculation has arithmetical errors. For example, in column 5 of Table 2, the value of increasing tax pressure has been decreased in comparison with the calculated rental cost of 7 589 rubles/1 sq.m. It is a new avenue for research.

The calculation disregards the fact that the rental price of 1 square meter taken from reviews cannot be equal to the income of the object multiplied by the number of square meters according to the size specified in its technical passport based on which the cadastral value is determined. The approach disregards the fact that even at 100 % of rented square meters (which is impossible due to economic problems and growing competition), the useful area is 60–70 %. Other 30–40 % are occupied by corridors, stairs, lifts, toilets, engineering and security rooms, etc.

In addition, the cadastral value of isolated buildings and premises used exclusively for commercial purposes (usually owned by large Federal grid companies) is twice the value of premises located in residential buildings owned by small family businesses.

Thus, the calculation presented by Irkutsk administration does not justify the proposed property tax rates. The document does not predict the increase or decrease in the number of SMEs in connection with the introduction of the tax does not take into account the socio-economic consequences of the tax, does not refute the claims of the business community on tax harm, but creates conditions for the development of the shadow economy (SMEs will be in the dilemma of whether to close the business or to engage in illegal activity). Being forced to support a family and lacking real alternatives in the labor market, entrepreneurs will decide on shadow economic activities, which create favorable conditions for corruption.

The property tax rates suggested by the Government of Irkutsk oblast and Irkutsk city create conditions for enforced shadow economy and corruption environment development. They disagree with

arguments stated in previous works of the author (Galyautdinov, 2015, 2017) and in many other publications dealing with this issue (Bonner & Khimm, 2012; Pippin, 2010; Aucutt, 2013; Miller, 2005, Feige, 1989, Raub, 2007, Pitts, 2015, Przeworski, 2006; Thomas, 1992; Kopp, Pommerehne, & Schwarz, 1997; Torgler, 2007)

7. Conclusion

When the article had already been written, at the end of 2017, an event happened which indicates the truth of the author's arguments and inconsistency of the arguments of regional and municipal authorities referring to other regions where the maximum property tax rate was introduced causing no negative consequences. If the tax was imposed in 2016, results could be assessed no sooner than at the end of 2017 when entrepreneurs obtain tax assessment notes.

When Chita owners of small businesses got tax assessment notes, they were outraged. The city duma introduced a maximum tax rate. The amount of taxes increased manyfold. For example, in 2016, one entrepreneur paid the property tax in the amount of 984.8 thousand rubles, and in 2017, the amount increased up to 7.4 million rubles.

The Committee on budget and tax policies of the Legislative Assembly of Zabaikalsky krai is analyzing the municipal decision. The regional deputies want to reduce the tax rate for businesses. The owners of businesses addressed the government authorities with a request to decrease the tax rate. Otherwise, they will go into bankruptcy, move their businesses to other regions or engage in shadow economic activities.

High utility rates, weak consumer purchasing power, underdeveloped infrastructure, distant location from economic centers squeeze small and medium-size businesses, make them too sensitive to external factors and increasing expenditures. Maximum increase in the commercial property tax rate results in capital outflows, business immigration and shadow economy development.

Thus, demonstration of destructive consequences of maximum increase in the commercial property tax rate in the neighbor region gives the Government of Irkutsk oblast a chance to prevent destruction of small businesses and not to create conditions for shadow and criminal economies development.

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