

Russia

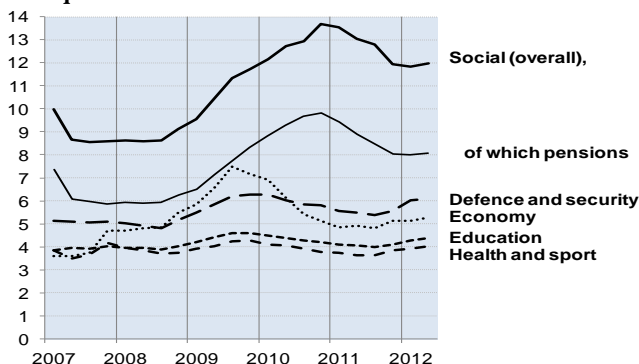
Strong state spending in first half. The consolidated budget (federal, regional and local budgets plus state social funds) saw first-half expenditures jump over 20 % y-o-y. Part of the spending growth reflects a more balanced distribution of spending over the course of the year (Russian administrations have traditionally held back on spending until the second half of the year). The finance ministry figures budget spending will rise this year about 13 % in nominal terms, which could imply some 6 % in real terms.

Defence spending increased in the first half by over 50 %. After a two-year hiatus, spending on education and health care was ramped up, rising 30 % in 1H2012. Growth is expected to abate somewhat in the second half, however. Social spending was up nearly 15 %.

Similar to 2011, the consolidated budget surplus in the first half was nearly 2 % of GDP. The finance ministry estimates that the consolidated 2012 budget will show a small surplus as long as the average price of Urals-grade crude oil is at least \$115 a barrel (first-half average was \$112/bbl).

State revenues climbed over 10 % in the first half. Taxes and fees from production and export of gas & oil increased more than 25 %. Their share in state revenues reached the previous record of nearly 30 %. Steady growth continued in value-added-tax revenue, while growth in revenue from mandatory social contributions slowed due to a rate cut at the start of the year. The rapid rebound in corporate profit tax revenues ended.

Main state spending categories, % of GDP, average of last four quarters



Sources: Finance ministry, BOFIT

New laws diminish Moscow's tax revenues. January saw the implementation of legislation on transfer pricing and conglomerate taxation. The laws are intended to reduce the practice of minimising tax obligations through transfer pricing, followed by enterprises related to each other. The laws also change the division of corporate taxes among regions.

The law on transfer pricing increases possibilities for tax authorities to investigate intra-group pricing arrangements. The law on conglomerates allows large enterprises to form groups with related firms. The conglomerates are taxed as a single entity, and the increased monitoring of intra-group pricing does not affect them, as they gain no tax benefit from transfer pricing.

Taxes paid by the conglomerate will now be divided among all regions where it has operations. The bulk of enterprise taxation earlier went to the region where the company's headquarters were located.

The finance ministry reports that thus far eleven conglomerates have been formed, comprising of a total of 197 firms. These conglomerates consist mainly of groups in the oil & gas sector (e.g. Gazprom, Lukoil and Rosneft), as well as major players in the metals and telecom sectors.

The loss of revenue caused by changes in the tax scheme hits Moscow hardest, but also affects St. Petersburg, Tyumen and some ten other big cities with headquarters of big enterprises. Moscow could lose over 80 billion rubles (€2 billion) a year in revenues. Moscow's 2012 budget assumes over 1.3 trillion rubles (€33 billion) in tax revenues. The biggest taxpayer is Gazprom.

The Duma this spring approved on Moscow's initiative a change in the law to shift Gazprom to conglomerate taxation only gradually by 2016. The change reduces Moscow's tax losses this year to 30 billion rubles. The change was opposed by the Moscow region, whose benefits from the new tax-sharing model are delayed respectively.

Moscow region seeks ways to boost tax revenues. Moscow region officials recently proposed that income taxes of private individuals be paid to the municipality where the individual resides rather than where they work.

At present, employers withhold 13 % of an employee's wages, 70 % of which is sent to the federal government and 30 % to the company's domicile municipality. The practice is especially unfair to the Moscow region and to a lesser extent the Leningrad region surrounding St. Petersburg. Some 1.2–1.3 million people live in the Moscow region and work in Moscow city. The region's annual tax revenue losses are estimated at about 50–70 billion rubles (€1.3–1.8 billion). The region's tax revenues this year will be about 460 billion rubles (€12 billion).

Federal officials do not support a change in the income tax payment practice, arguing that it is burdensome for the employer to pay taxes to each employee's residential municipality. One possibility would be to change the system so that wage-earners are responsible for paying their own income taxes, but there is low enthusiasm for the idea.

The Moscow region also wants compensation for the loss of 1,500 km² of its land area caused by Moscow's recent expansion. Due to that, the region lost a significant part of its tax income. The region puts the annual net loss at about 25 billion rubles.

China

Despite economic slowdown, banking sector profits rose in the first half. The first-half financial reports released this month for China's giant state-owned commercial banks show profitability continued to rise, albeit more slowly. While profit growth had been expected to slow, investors were still disappointed by the financial performances of the big banks, which averaged profits of around 100 billion yuan (€12 billion) per bank in the first half.

Share prices for commercial banks have slumped worse than the Shanghai A-share index this year. Moreover, expectations of further profit growth in the second half are subdued as indicators point to lower economic growth ahead. In June and July, the People's Bank of China also moved to give commercial banks more leeway in setting lending rates, which will increase competition in the sector and reduce bank profit margins.

There has long been a fear among observers and officials that China's massive, rapidly rolled out stimulus of 2009–2010 would ultimately result in a large increase in the stock of non-performing loans. At least for now this fear has not materialised. Among the large banks, only about 1 % of the loan stock is currently classed as non-performing, and that share decreased slightly in the first six months of this year. Two of China's four giant banks (Bank of China and China Construction Bank) reported that 6 % of their current loans have been granted to investment vehicles set up by local administrations as they implemented stimulus policies at the grassroots level. It has been suspected that commercial banks have rolled over some of these loans, thereby shifting the non-performing loan problem into the future.

China expands service-sector VAT experiment. The pilot tax programme introduced at the beginning of this year in Shanghai made some services subject to value-added tax rather than business tax. Before the end of the year the trial will be expanded to the cities of Beijing and Tianjin, as well as the provinces of Anhui, Fujian, Guangdong, Hubei, Jiangsu and Zhejiang. The areas to be covered under the trial generate about half of China's GDP.

The transfer of companies providing services into the VAT system should reduce double taxation by allowing "pass-through" deductions on inputs. This is not possible under business tax arrangement. Deductions should lighten the tax burden on service companies even though the business tax rate is lower than the VAT rate.

Asian Development Bank pushes China to reform environmental policy. Despite the steady progress in some

areas, the new [ADB report](#) finds China's deteriorating environmental conditions call for an overhaul of environmental policy. As the world's largest producer of greenhouse gases, how China chooses to deal with its environmental impacts has a massive global significance.

Water pollution and inadequate water supplies are perhaps China's biggest immediate environmental challenges. Although the government has become more involved in regulating emissions of industry and households, not enough attention has been paid to prevent fertilizers and pesticides from getting into water systems. Air quality is another critical problem. Only a handful of China's 500 largest cities currently meet WHO air quality standards and seven of the world's ten most polluted cities are located in China. Solid waste disposal is still poorly handled, and the higher frequency of natural disasters also poses major challenges for China's economy and society.

China's current model of economic growth based on export-driven manufacturing has largely been achieved at the expense of the environment. Thus, meeting the large challenges facing China and achieving sustainable development depend on the country's ability to evolve into a more service-based economy driven by domestic consumption. Sustainability policies should be reinforced by e.g. "green" tax reforms as the current system does not adequately discourage wasteful energy use. In addition, market-based schemes such as emissions trading and subsidies paid to environmentally responsible firms could be increased. Urban planning needs to shift attention from rapid, large-scale construction to high-quality housing and better quality of life.

Despite the bleak outlook, the ADB's report gives China some credit for progress. In the previous five-year plan (2006–2010), China made some environmental progress even in the face of higher-than-forecast economic growth. Energy efficiency has improved, as products are now produced with substantially lower emissions and energy inputs than in 2005. Sulphur dioxide emissions have declined 10 % since 2005, which has helped improve air quality in some provinces. The total forested area in China also increased to nearly 20 %. Capacity for municipal waste water treatment nearly quintupled over the past decade, and renewable energy production has increased sharply. Trading in sulphur dioxide emissions is already underway. Last week in Shanghai, a new trading scheme for carbon dioxide emissions was launched; it involves about 200 industrial, service and agricultural sector businesses.

Despite a number of rather remarkable improvements, China should make faster progress in environmental protection given how badly conditions have deteriorated and the fact that a wealthier China inevitably puts a greater burden on the carrying capacity of natural systems. More radical measures will be needed for the situation to improve.