5. Banks and illegal activities[1]

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Capital flight, tax evasion and money laundering are often seen as major problems of post-Soviet Russia, indicating economic breakdown, the government's failure to create a functioning state and the criminalization of society. At the same time, it is often assumed that banks – and especially those banks belonging to influential businessmen, so-called 'oligarchs' – are at the centre of these problems. Illegal capital flight, tax evasion and money laundering are indeed all based on schemes which are intended to hide certain financial flows from state authorities. However, this does not necessarily imply that banks are the main culprits.

This paper will examine the role of Russian banks in these three illegal activities. In the first three parts the main characteristics of illegal capital flight, tax evasion and money laundering will be depicted, devoting particular attention to schemes requiring the involvement of banks. In the following part the findings will be summarized, concentrating first on the importance of Russian banks for the realization of these illegal activities and second on the degree to which the Russian banking sector has been criminalized because of its involvement. The conclusion presents the general policy options available to tackle related problems.

ILLEGAL CAPITAL FLIGHT

Capital exports are used to finance imports of goods and services or investments abroad. They are a result of international economic integration. Over recent decades a general tendency of capital exports from developing countries to the main industrialized economies can be observed. Capital flight is usually defined to include all outflows that occur in excess of those that would normally be expected as part of an international portfolio diversification strategy. This definition covers legal outflows of funds that comply with existing regulations as well as exports of legally owned funds under violation of capital controls or taxation rules and outflows of funds from truly criminal activities (Loungani and Mauro, 2000, pp. 3–4).

The main reason for capital flight is distrust in the domestic economy. In the Russian case residents saw their assets depreciated in the early 1990s due to a high rate of inflation and frequent devaluation of the home currency. In addition income earned in the country has been subject to a tax system often described as prohibitive and chaotic. Moreover, the volatility of domestic financial markets and their unregulated state strengthens residents' unwillingness to invest money at home. Altogether that means residents regard the after-tax rate of return on domestic investment to be below the world rate of return.[2] In addition, capital flight can be used as a means of money laundering.[3]

Extensive capital flight causes instability in the exchange markets and in the long run hampers domestic capital formation, thus deepening a recession or slowing down economic growth. Moreover, it deprives the home government of tax yields. Accordingly, many countries affected by extensive capital flight have reacted with legal restrictions in order to reduce capital exports. In Russia the export of domestic currency is generally banned. Exports of foreign currency are subject to foreign exchange regulations, which make the export of sums of money above a certain limit subject to state approval.[4] Earnings from exports have to be returned to Russia, generally. The relevant conditions are first of all set by legislation and by Central Bank regulation and have been changed regularly.[5] As a result of this regulation the possibilities for legal capital exports from Russia are very limited: that is, most capital that leaves Russia does so by violating at least foreign exchange regulations.

Estimates of illegal capital flight from post-Soviet Russia range between USD 10 and 25 billion per year.[6] The Central Bank of Russia has calculated that illegal capital transfers abroad amounted to USD 25 billion in 1998, declined to USD 15 billion in 1999 and rose again to USD 23 billion in 2000 (http://www.cbr.ru). According to Tikhomirov,

> the major part of Russian capital is transferred to (a) Western countries which have established and stable banking systems; (b) countries with large local Russian-speaking communities; (c) countries that have a liberal off-shore legislation; and (d) countries which offer high returns on investments. The latter has become a feature of capital flight from Russia only in the last 1–2 years.

Typical countries belonging to group (a) are the USA, Switzerland, Great Britain, Germany or Luxembourg. Representatives of group (b) are Latvia or Israel. Classical off-shore centres for Russian flight capital (group c) are Cyprus, the British Channel Islands, Nauru and the Bahamas. The most important countries in group (d) are Malaysia and the People's Republic of China (Tikhomirov, 2001, pp. 272–72).

Mainly, three different ways are used to export capital illegally. The first way is the outright smuggling of foreign currency or of goods which are then sold abroad with the payment remaining in a foreign bank account. The second way is based on false import–export contracts, the third uses financial transactions conducted by domestic banks.

The basic idea of false import–export contracts is to undervalue exported goods and services or to overvalue imported ones. If exports are undervalued, the payment made officially and checked by the Central Bank is less than the real value of the exported goods. The difference between the world market price and the price given in the contract is paid into a foreign bank account, controlled by the Russian company (Sotnik, 1999, p. 12). According to an estimate by the German Institute for Economic Research (DIW), Russian exports to Germany were on average undervalued by a capital flight factor of 43 per cent in the period 1994–96 (DIW, 1997, p. 998). If imports to Russia are overvalued, the difference between the amount officially stated in the contract and the real value of the imported goods is again paid into a foreign bank account, controlled by the Russian company. The Russian company can also declare that the foreign company has failed to deliver goods already paid for or, vice versa, has failed to pay for exports already made. If it is in collusion with its foreign counterpart the Russian company can in both cases ask the foreign company to transfer payment to a foreign bank account controlled by the Russian company. Tikhomirov has estimated that under false import–export contracts altogether about USD 83 billion left Russia illegally in the period 1992–97 (Tikhomirov, 2001, p. 263).

In order to fight such schemes Russia has introduced controls aimed at clarifying the real value of exported and imported goods. In reaction Russian companies have created more complicated schemes by trading services, the real value of which is harder to estimate, by including a number of foreign partners in the transaction or by founding their own subsidiaries abroad.

Since the mid-1990s, when electronic banking became common practice in Russia and business ties between Russian and foreign banks were well established,[7] domestic banks have been increasingly used for illegal capital flight. Banks involved in illegal capital transfers often work from offshore centres. The official advantage of offshore banks is that they are set up in regions with extremely low tax rates. Completely legal investments are therefore attracted (for example, Gorbunov 1995). But offshore zones also have laws which give banking secrecy the highest priority. Registered companies can very often do business without any state supervision. That is why offshore centres are especially interesting for companies trying to invest illegal money. In the late 1990s Russian individuals and companies operated an estimated 60 000 offshore companies (*Segodnya*, 17 January 1997, p. 3).

Flight capital can be transferred from a Russian branch of the bank to the offshore zone by telegraphic money transfer or in the form of cheques. If the value of the transaction remains below a certain limit, which in 2001 stood at about USD 10 000,[8] the bank is not obliged to notify the Russian authorities. Conducting several transactions a day over a longer period of time can be used to transfer considerable amounts of money abroad without notifying the Russian authorities. However, in many cases Russian banks collaborate with their clients and transfer larger amounts abroad, either declaring the money to be their own or that of several fictitious clients or simply ignoring their duty of notification (Pleines, 1998, pp. 26–27).

Insurance companies also engage in capital flight. In such a case a Russian company founds an insurance company, which then sets up an offshore reinsurance company. The Russian company insures its whole property for the highest premium with the insurance company. The contract is made on a ruble basis. The Russian company, therefore, does not even need a license for a foreign currency account. The insurance company reinsures the fixed risks with the offshore reinsurance company on a dollar basis. Thus the Russian company transfers large amounts of capital abroad, is able to hold them in an offshore centre and at the same time reduces its tax payments since it does not have to pay taxes for its payments to the insurance company (*Segodnya*, 27 September 1995, p. 7).

The amount of illegal capital exports organized by Russia's financial sector is hard to estimate. The only indicator available is the number of detected cases and the amount of flight capital involved. Investigations of the business activities of Russian banks conducted by Western audit companies on behalf of foreign creditors after the financial crisis of August 1998 revealed, for example, that USD 1.5 billion had disappeared out of Inkombank between August and November 1998 (*Kommersant-Daily*, 3 November 1998). Between October 1998 and autumn 1999 more than USD 7 billion were transferred illegally from Russia to the Bank of New York in altogether about 10 000 financial transactions, according to reports by US authorities.[9]

Drawing from a number of expert estimates based on data from the Central Bank of Russia, the State Customs Committee and the Federal Service for Export Control, Senchagov comes to the conclusion that in the period 1992–95 about 77 per cent of the illegal capital flight (equal to USD 75 billion) was arranged with the help of false import–export contracts, a further 15 per cent (equal to USD 15 billion) was directly smuggled out of the country,[10] and the remaining 7 per cent (equal to USD 7 billion) left the country as result of international financial transactions. Since measures to fight false import–export contracts have been tightened and the domestic banking sector has gained in importance and professionality, the share of financial transactions in illegal capital flight is assumed to have increased considerably in the second half of the 1990s. However, it seems to have remained well below 20 per cent of the total amount.[11]

TAX EVASION

Tax evasion means the illegal manipulation of information by tax payers in order to deceive the tax authorities with the aim of reducing the officially demanded tax burden or avoiding taxation completely. Enterprises have mainly two possibilities for tax evasion. First, they can hide parts or all of their business activities, thus operating untaxed as part of the shadow economy. Secondly, they can manipulate their accounts of official business activities, thus reducing the tax base, for example, for VAT or profit tax.

In a survey – which was, however, not representative – Russian managers declared in 1997 that a 'typical' Russian enterprise tends to underreport sales by about one-third. Only 30 per cent of the enterprises claimed that they were not hiding any sales (Shleifer and Treisman, 1996, p. 96). In another – again not wholly representative – survey only one-quarter of small enterprises polled in early 2001 stated that they were declaring their taxes honestly (Fruchtmann and Pleines, 2001, p. 48). In general it is estimated that the Russian shadow economy amounts to 30–50 per cent of the country's GDP. The value of taxes evaded is on average estimated to equal 15–20 per cent of GDP (that would have been USD 30–40 billion in 2000).[12]

There is a number of different approaches which try to explain the high degree of tax evasion and shadow activity in Russia. The neo-institutional line of arguments concentrates on the actual benefits and costs a person thinking about tax evasion is facing. As result of a rational choice the person opts for the behaviour that promises the best outcomes. The tax burden in Russia is very high – often called prohibitive, tax regulations are complicated and tax declarations time consuming.[13] In 1998 due tax payments equalled on average nearly 80 per cent of a Russian company's cash earnings (Busse, 2000, p. 132). According to different calculations the tax burden foreseen by the tax code amounted to 55–60 per cent of the country's GDP in that year, (Spravochnik, 1999, p. 96) whereas the corresponding figure for OECD countries averaged 37 per cent, and for the EU 41 per cent (*Economist*, 4 November 2000, p. 150). Russia's tax reform 2000, though simplifying legislation considerably, has not led to a significant reduction in the overall tax burden.[14]

While the costs of being an honest tax payer are relatively high for Russian entrepreneurs, the risk attached to tax evasion is relatively low. Two main reasons for this are the inefficiency of the tax administration and widespread corruption among tax authorities, which allows tax payers to hide offences with the help of bribes.[15] In addition specifics of the Russian economic system, like the considerable amount of barter deals and inappropriate accounting standards, make it more difficult to prove tax evasion.[16]

Whereas neo-institutionalist arguments are based on costs and benefits of tax evasion as perceived by rational actors, the 'legacy' approach stresses the role of patterns of behaviour inherited first of all from the Soviet planned economy. In a systematic analysis of her empirical study Eva Busse comes to the conclusion:

> Systemic shortcomings of Russian taxation provide opportunities to engage in informal evasion practices. It is important to note, however, that the incentive function of these opportunities is greatly enhanced in the Russian context by people's dispositions to act in corresponding ways. This social disposition is rooted in a) people's expectations and skills inherited from the Soviet past and b) their willingness to evade due to the tax system's fundamental lack of legitimacy. (Busse, 2000, pp. 139–140)

In this context it is argued that the traditional personalization of relations between state actors and entrepreneurs leads to a situation where tax payments (and tax regulations) are not only subject to bargaining, but also tax payers are encouraged to evade taxes either with the help of corruption or as the anticipated result of a bargaining process.[17] The impression, derived from personal experience as well as from mass media reporting, that the amount of taxes to be paid is subject to bargaining erodes the legitimacy of the tax code and thus the willingness of tax payers to accept the rule of the tax law (see, for example, Busse, 2000 or Easter, 2000).

In order to evade taxes enterprises can either decide not to report business activities to the state authorities, thus operating in the shadow economy, or they can manipulate their accounts of reported business activities. Illegal ways to reduce due tax payments on reported business activities can be grouped into three categories:[18]

1. Underestimating the value of barter deals. This is for the mutual benefit of all enterprises involved since VAT payments are reduced. In addition the enterprises' earnings (and – in case the enterprise is not officially loss-making – taxes on profits as well) are reduced leading to a reduction in earnings- and profit-based tax payments.[19]

2. Overstating operating costs or declaring fictitious costs. Increasing reported costs reduces reported profits and with that profit-based tax payments.
3. Understating earnings (thus accumulating black cash). In the standard scheme the business contract indicates a lower payment than the one actually made. The difference between the sum stated in the contract and the sum actually paid remains with the supplier as black cash. In Russia two more complicated schemes are applied regularly. In the 'encashment scheme' an enterprise officially receives cashless payment for services. However, these services were performed only on paper. In reality the enterprise returns the monetary equivalent of the payment (minus a fee) to the customer, who does not have to report the cash to the tax authorities. In the reverse encashment scheme goods are delivered to a customer, who does not pay to the supplier but to a sham firm unofficially controlled by the supplier. Both transactions are not recorded. Instead the supplier pretends to have delivered the goods to the sham firm, receiving either non-cash payment or no payment at all, because the sham firm (often called a one-day firm) has already disappeared, leaving the cash received from the customer as black cash at the disposal of the supplier.

The main problem faced by all enterprises engaging either in the shadow economy or in black cash tax evasion is how to spend the unrecorded money without arousing the suspicions of the tax authorities or law enforcement agencies. Owners of small enterprises tend to use black cash to pay their workers (thus in addition avoiding social security taxes) or to spend it on private consumption. Black cash can also be used to finance bribe payments.[20] Bigger enterprises often transfer black cash to bank accounts abroad.[21]

Apart from the transfer of black cash abroad, all transactions related to tax evasion can be conducted without using banks.[22] Accordingly, only 10 per cent of the tax code violations detected by the tax police in 1999 were conducted by companies in the financial and credit sector (Soltaganov, 2000, p. 31). This is no coincidence since Russian banks are often seen as the prolonged arm of the tax authorities. Enterprises can open bank accounts only with the consent of the tax authorities and the banks are obliged to provide the tax authorities with all information 'necessary for monitoring the completeness and accuracy of the payment of taxes and other mandatory charges by those enterprises'. A number of state bodies are entitled to withdraw funds from bank accounts of legal and physical persons without their consent, and often they do not even need to get judicial approval of the action.[23]

The only problem faced by enterprises engaging in black cash evasion is that the state heavily restricts the ability of non-financial enterprises to hold cash legally. Accordingly some smaller banks are affiliated with financial agents running the sham firms involved in black cash tax evasion schemes. These financial agents provide most of the cash needed in such schemes, for example by officially trading junk bonds which they have in fact bought at a fraction of the nominal value, at prices close to the nominal value (Yakovlev, 2001, p. 42).

MONEY LAUNDERING

Money gained through crimes cannot be explained to the tax authorities and therefore cannot be used in the legal economy in larger amounts without raising suspicion.[24] Money laundering is the processing of these criminal proceeds to disguise their illegal origin in order to allow its owner to use the money without specific restriction (FATF, 1999). In Russia the sources of illegal income, which has to be laundered, are first of all the illegal sale of natural resources, the smuggling of drugs, arms, alcohol and tobacco, traditional organized crime activities like racketeering, prostitution or theft and white-collar crimes like tax evasion or embezzlement.[25]

Though money laundering on a massive scale has some negative macroeconomic consequences,[26] it is first of all being prosecuted as part of the fight against organized crime. In Russia money laundering was introduced as a criminal offence with the new criminal code in January 1997.[27] However, the corresponding bill on 'Measures against the legalization (laundering) of illegally gained incomes' was not passed into law.[28] Though a number of cases of supposed money laundering have been investigated, only a handful has reached the courts and there were no convictions at all until 1999. As a result the Paris-based Financial Action Task Force (FATF), set up by the Group of Seven leading economic powers (G-7), included Russia in its blacklist of banking centres with insufficient methods of fighting money laundering. However, in 2001 the Russian government started another effort to tackle the problem. In February 2001 the Russian Central Bank embraced the Wolfsberg principles for the fight against money laundering.[29] In April Russia's parliament finally ratified the international convention against money laundering,[30] which had been created in 1990 and signed by Russia in 1999. In August 2001 the President signed the new anti-money laundering law, which is to enter into force in February 2002.

Drawing conclusions concerning the extent of money laundering in Russia by using the estimated number of unknown cases hardly makes sense with no proven case at all until 1999. Accordingly, figures for the amount of money laundering in Russia are based on estimates of illegal income generated in Russia. It is then assumed that most of the income is being laundered.[31] The Russian Interpol office has come to the conclusion that in the mid-1990s the drug mafia alone laundered up to USD 35 billion a year in Russia (Interfax, 16 April 1997). According to an estimate by the Russian Ministry of the Interior at the time more than USD 300 billion were being laundered annually in Russia (Aminov and Revin, 1997, p. 51). However, taking into consideration that total nominal Russian GDP stood at a mere USD 400–500 billion in these years, this seems to be much too high an estimate.

One of the most widespread ways of money laundering is the illegal transfer of 'dirty' money abroad.[32] However, money can also be laundered domestically. For this purpose organized criminal gangs run completely legal businesses, which – as a result of manipulations in accounting – report profits far above those really achieved. Russian accounting standards make this relatively easy.[33] The gap between real and reported profit is filled with money from illegal activities. Accordingly the money appears as legally gained profit in the books of the company. The main disadvantage of this method is that profit tax has to be paid for the laundered money. Moreover, in order to be able to make credible-looking tax declarations only limited amounts of money can be laundered in one and the same company.

If instead a bank is used as cover-up for money laundering these disadvantages can be avoided. Even small banks can launder money in large amounts by claiming profits from dealings on financial markets, which are difficult to control and can be immensely profitable, by paying money to the accounts of fictitious customers or by transferring money to offshore zones.

Since a lot of private banks were newly founded after the end of the Soviet Union with legal requirements and state controls at a low level, organized criminal groups could easily develop close contacts with banks and could even found their own banks. However, since Russia's banking sector was underdeveloped in the first half of the 1990s, many Russian criminal groups engaged in the Baltic banking sector. In the Baltic states the banking sector had already established international business ties. The Baltic currencies were more stable than the Russian ruble and foreign currency operations were subject to rather limited controls.

The Russian mafia therefore used banks in the Baltics for illegal money transfers to Western bank accounts and for money laundering activities. The biggest scandal arose around the Latvian Banka Baltija. It was the country's number one bank with capital more than four times as high as that of the bank ranking second (*Baltic News*, 1 April 1995, p. 25). Nearly

50 per cent of all Latvian companies had an account with the bank, as well as 19 out of the 26 district administrations. The bank also improved its connections by making illegal donations to members of the Latvian parliament (*Baltic Independent*, 30 June 1995, p. B1).

The bank's connections ensured that control by the Latvian National Bank did not take place. Thus the bank could engage in criminal activities such as shady deals with foreign currencies, money laundering and financing of the illegal arms trade. One of the leading persons in the bank, Aleksandr Laventa, was accused of being personally involved in operations by the Russian and Ukrainian mafia. However, since many documents concerning the bank's business were destroyed, it is very hard to reconstruct the bank's illegal activities (RFE/RL Newsline, 27 October 1997). However, the Latvian Parliament's investigation panel into the case concluded in its final report, issued in October 1996, that the bankruptcy of Banka Baltiya had been caused by its leadership's 'continuous and systematic violation of the law' (OMRI Daily Digest, 30 October 1996).

Moisjeh Gurevich, a member of the board and co-founder of the bank, was killed in May 1995. The former security chief of the bank was shot in 1997. Laventa was brought to trial in October 1997. His case was halted in September 2000 for health reasons (RFE/RL Newsline, 6 September 2000).

With the establishment of the Russian banking sector the Baltic banks lost their importance in the mid-1990s.[34] Their position received a further blow when the discovery of links between banks and organized crime led to a number of bank closures and collapses (*Economist*, 20 January 1996, p. 93). In late 1996 all three Baltic states signed a declaration pledging that they would implement legislation complying with EU and international directives on money laundering (OMRI Daily Digest, 15 November 1996). But at that time the mafia had already turned its back on the Baltic states, since the Russian banking sector was now offering much better opportunities. In November 1995 the acting chairman of the Russian Central Bank admitted that 'there is a small group of banks which deal actively with illegal structures and launder money. The so-called mafia works actively in this area.' (*Financial Times*, 13 November 1995, p. 3).

The best known example of this was the Moscow-based Solntsevo gang, which had established a whole network of companies. The gang was said to be the largest of its kind in Moscow with over 2000 active members. It allegedly controlled several banks and financial organizations and about 100 smaller commercial enterprises. The gang was investigated in 1995 by the largest police action of its kind, with about 500 policemen taking part. But the operation was only partly successful, probably due to leaked information. The organization of commercial structures for money laundering was one of the major activities of the gang.[35]

THE ROLE OF RUSSIAN BANKS

It has been shown that Russian banks play only a minor role in illegal capital flight and tax evasion. Schemes for illegal capital flight are first of all based on false import–export contracts and if banks provide financial services in connection with such contracts, there is no need to inform them of the true nature of the business. The same applies to tax evasion. Again, many schemes are based on false contracts, often involving barter deals, which do not require the participation of banks at all. The minor role banks have in illegal capital flight and tax evasion is due to two reasons. First, banks are often considered to be the prolonged arm of the state authorities, especially the tax authorities. Secondly, many enterprises engage in transactions which can be used for capital flight (import–export business) or tax evasion (for example, barter deals) without the need to let a bank know the illegal nature of the transaction.

Based on the estimate presented above that only 10–15 per cent of illegal capital flight seems to be organized by banks, banks were responsible for an illegal capital flight of USD 2–3 billion in 2000. Their share in the organization of tax evasion should stand at roughly the same level. This would mean that banks knowingly participated in tax evasion schemes involving USD 3–6 billion in 2000. Accordingly, we can estimate that through the organization of illegal capital flight and tax evasion Russian banks ensured a turnover of about USD 4–8 billion in 2000.[36] For comparison, total assets of Russian banks stood at USD 77 billion in mid-2000.[37]

Whereas banks play only a minor role in capital flight and tax evasion the situation is different with the laundering of money from organized crime. In principle, money laundering too can be organized without the participation of banks. However, bigger mafia gangs need to launder huge amounts of money regularly and the risk attached to the laundering of mafia income is higher than the one connected with illegal flight capital or black cash from tax evasion. Accordingly, organized crime often prefers to control the enterprises involved in money laundering. Moreover, because of the illegal nature of organized crime, criminal gangs do not have the possibility to organize capital flight or tax evasion as part of their normal business activities. That means independently of whether they use import–export companies, industrial enterprises or banks, in all cases they have to gain control over or set up new companies. And organized crime is influential enough to gain control over smaller Russian banks. If a bank is controlled by the organizer of illegal schemes to launder money, the risk that the bank will inform relevant state authorities is considerably reduced.

As a result a certain part of the Russian banking sector has been taken over by organized crime.[38] This part mainly consists of smaller banks, which can be more easily controlled by criminal gangs and sometimes have even been founded by them. Bigger banks have been concentrating on rent-seeking often in combination with corruption. In the Russian context contacts between bankers and state officials were in many cases transformed into corruption networks. When making decisions on licenses, credits, the sale of government bonds, the authorization of banks to deal with state funds or – after the financial crisis of 1998 – the distribution of state funds for bank restructuring, state employees had considerable latitude which allowed them to open 'negotiations' with individual banks in order to obtain bribes. For the banks rent seeking was a much bigger game than organizing capital flight. For commercial banks the managing of state budget funds alone meant an annual turnover of up to USD 25 billion in the mid-1990s (see Pleines 2000 and Tompson 2000) compared to a turnover of USD 2–3 billion from the organization of illegal capital flight. If bigger banks got involved in capital flight, they were normally operating on their own account. Especially when the financial crisis of August 1998 threatened many of the big banks with bankruptcy, they used capital flight as a secure way to hide their assets from debtors. However, even these bigger banks have often used smaller banks as front companies, in order to avoid direct involvement in illegal schemes.[39]

Though many Russian banks have obviously been engaged in criminal activities of one sort or another, there are no grounds for the claim, often made by journalists and certain representatives of Russian law enforcement agencies, that organized crime controls a large part of the Russian banking sector. Organized crime has contacts with many banks, but only in a limited number of cases, first of all concerning smaller banks, does this entail outright control.

CONCLUSION

Since all the evidence available suggests that the role of banks in tax evasion and illegal capital flight is rather limited, efforts to tackle these problems should concentrate on other aspects. Important factors explaining tax evasion are not criminal banks but rather a relatively high tax burden, an inefficient and corrupt tax administration, inappropriate accounting standards, the widespread barter economy, racketeering, lack of experience with direct taxes and, last but not least, a personalized relationship between tax inspectors and tax payers. Capital flight is caused not by the conspiracies of Russian banks, but by a highly unattractive environment for domestic investments.

Moreover, if we accept that illegal capital flight and tax evasion are not a problem of banking regulation but rather a consequence of Russia's general economic environment, it makes sense to limit the legal definition of money laundering, as given in the Criminal Code, to money originating from activities of organized crime. Thus it becomes possible to increase the risk attached to transactions with organized crime money and there might be a chance of fighting organized crime more efficiently.[40] After a long discussion this view finally made it into the anti-money laundering law of 2001.

If the primary aim is not to fight illegal capital flight, tax evasion and money laundering, but to clean up the banking sector, money laundering, tax evasion and capital flight are important problems which can only be fought with the help of tight controls. However, in the Russian case this should not mean increasing state control over banks, but rather shifting from attempts by the tax authorities to get information about individual tax dodgers and the liquidity of companies with tax arrears towards the monitoring of business practices of suspicious banks, conducted first of all by law enforcement agencies. However, in order to secure real control it would be vital to cut the corrupt connections most banks have established with state officials and politicians. At the same time, incentives should be created to induce banks to engage in 'normal' banking activities, that is, to function first of all as financial intermediaries crediting investments, instead of building their business around contacts with state officials or criminal groups.

NOTES

1. This text has been prepared as part of the project 'The Role of Economic Culture in Russia's Tax System', which is being sponsored by the Otto Wolff-Foundation and the Alfred + Cläre Pott-Foundation. (For further information on the project see: http://www.forschungsstelle.uni-bremen.de/projekte/wirtschaftskultur_Projekt_engl.html).
2. For an elaboration with special reference to Russia see Loungani and Mauro (2000), pp. 10–13. A general overview of reasons for capital flight is given by Hallwood and MacDonald (1994), pp. 371–372 and Kim (1993), pp. 19–22.
3. According to the Russian Tax Police 30–40 per cent of illegal capital flight from Russia consists of dirty money (Soltaganov, 2000, p. 85). However, it is not clear how the figure was calculated. See the section on money laundering below.
4. The limit was raised to USD 75 000 per year in March 2001.
5. An overview of relevant legislation and regulation is given in Loungani and Mauro (2000), pp. 13–18; Tikhomirov (2001), pp. 266–271; Westin (2000); Mel'nikov (2000); Volzhenkin (1999), pp. 218–222.
6. On different estimates and methods used for the Russian case see Petrov (2000); Kosarev (2000); Westin (2000); Bulatov (1999); Senchagov (1999); Albakin (1998); Tikhomirov (1997). For a general discussion of different methods to measure capital flight see Sheets (1996) and Claessens (1997).
7. By the end of 2000 nearly 1 000 Russian banks had correspondent accounts in German banks and more than 600 in American banks (*Russian Banking News – NewsBase*, 2 May 2001, p. 4).

8. Defined as 4000 times the legally defined minimum monthly wage. With the new Law on Money Laundering the limit will amount to about USD 20 000 from February 2002.
9. There is a huge number of journalistic accounts of the affair. Good overviews are provided by Arsen'ev (1999); Albats (2000); Reuters (15 September 2000).
10. About half in the form of goods and the other half in the form of cash.
11. Tikhomirov (2001), pp. 262–263 and Kuchkin (2000), p. 233. See also Loungani and Mauro (2000), footnote 12.
12. On estimates and methods used in the Russian case see Iakovlev and Vorontsova (1998); Yakovlev (1998); Dolgopyatova (1998); Orekhovskii (1996). See also the chapter on 'Measurement issues' in Feige and Ott (1999), pp. 141–306. A general overview of measures to estimate tax evasion is given by Tanzi and Shome (1993).
13. A good example of this argumentation is Commander and Tolstopiatenko (1997). An empirical study showing a positive correlation between the amount of the shadow economy on the one hand and tax burden, degree of corruption, racketeering and trust in courts on the other hand is presented by Johnson, McMillan and Woodruff (1999).
14. The Russian government officially predicted a reduction of the tax burden equal to 2 per cent of GDP.
15. On this see, for example, OECD (2000), p. 103. A formal model of tax evasion in cases of corruptible tax authorities is developed by Bowles (1999).
16. A more detailed discussion of these aspects can be found in Pirtillä (1999). Related empirical data for the Russian case is provided by Yakovlev (2000).
17. That is, if a tax payer is sure that after having bargained with the tax authorities he will not have to pay all taxes, he is highly unlikely to feel obliged to keep to the letter of the tax code.
18. For a description of different methods of tax evasion see Yakovlev (2001; in an earlier version published as Yakovlev [1999]); Il'in (2001), pp. 84–107; Dolgopjatova (1999); Murzov (1997), pp. 89–130. An overview of related legislation is given by Mikhalev, Danikov and Kasyatina (2000).
19. Detailed documentation of state regulation of barter deals and control by tax authorities is given in Dan and Valeksa (1998) and Kalinina (1998). On the tax authorities' efforts to fight price manipulation through barter deals see Ganeles (2000).
20. In his empirical study Yakovlev has found no evidence for this. However, with only 10 respondents his panel cannot be seen as representative.
21. Since the black cash transferred abroad has been accumulated in violation of the tax law, this is illegal capital flight (see the part on illegal capital flight above).
22. A formal exception is the case of black cash tax evasion, since according to Russian regulations inter-firm cash payments above a certain sum have to be conducted through bank transfers. (Since the end of 1999 the limit stands at 10000 rubles – at present equal to USD 350. Earlier it was set at 2000 rubles.) However, the only practical problem is that for those transactions which are illegal the cash has to be transferred physically.
23. Tompson (1997), pp. 1162–1170. The Russian Constitutional Court has ruled that tax authorities have the right to confiscate overdue tax payments – but not fines and hidden profits – from the bank accounts of judicial persons without prior consent of the account holder. (Constitutional Court decision 20-P, 17 December 1996. A discussion of the decision can be found by Kutter and Schröder (2000), pp. 30–32.
24. In this article – as well as in Russian legislation until 2001 – the definition of money laundering is not restricted to the income of organized crime, but includes all income obtained illegally.
25. Dahan (2000), p. 239. According to the Russian Tax Police organized crime accounts for only 10 per cent of the money being laundered in Russia (Soltaganov, 2000, p. 55). However, it is not clear how the figure was calculated.
26. First of all redirecting investment into speculative businesses and distorting macroeconomic statistics.
27. Art.174 UK RF [=Criminal Code of the Russian Federation]. For a discussion of the new regulation see Bolotskii (1996).
28. Dahan (2000), pp. 242–243. A summary of the bill's draft version as of 1999 is given:

ibid, pp. 246–252. For a discussion see also Aliev and Bolotskii (1999). The bill was rewritten again in early 2001. See Rubchenko and Shokhina (2001).

29. *Central Bank of Russia letter N 24–T* (15 February 2001). The Wolfsberg principles had been set up by leading Western commercial banks in October 2000. The general idea of the principles is that banks should not deal with money of unknown origin.
30. The so-called Strasbourg convention developed by the Council of Europe. The convention concentrates on measures to improve international cooperation in the fight against money laundering.
31. At the same time the possibility is being ignored that illegal income generated abroad is being laundered in Russia.
32. The money then becomes part of flight capital, being first of all directed to offshore banks (see the relevant part above). According to the Russian Tax Police 30–40 per cent of illegal capital flight from Russia consist of dirty money (Soltaganov, 2000, p. 85). However, it is not clear how the figure was calculated. Specifically on money laundering through capital flight see also Dikanova and Osipov (2000), pp. 160–209; Fituni (2000), pp. 214–216.
33. Russian Accounting Standards 'tend to overstate real profitability and the value of the business' (Ivanov 2000, p. 13).
34. In 1994 there were 55 banks in Latvia, 21 in Lithuania and 20 in Estonia, but already about 2 000 in Russia.
35. *Kommersant-Daily* (25 August 1995), p. 14. The alleged boss of the gang was arrested on money laundering charges in Switzerland in 1996. However, he was released after a trial which failed due to lack of evidence that Swiss legislation had been violated. (For details see the documentation of the trial: Yakubov 1999).
36. Since tax evasion sometimes takes the form of capital flight, the amount for tax evasion plus illegal capital flight is lower than the sum of the separate estimates.
37. *Bulletin of Banking Statistics (Central Bank of the Russian Federation),* September 1999, p. 69. The figure for total turnover of Russian banks, which would be the best comparison, is not available.
38. Russian state officials often declare that one-third of Russian banks are controlled by criminal groups (see for example *ITAR-TASS*, 23 March 2001) However, how this figure has been calculated remains unclear. One should expect the state to close down these banks if there exists proof of their connection to organized crime.
39. In the Bank of New York affair, allegedly involving illegal capital flight and money laundering of at least US$ 7 billion, the Russian banks MDM and Sobinbank, at that time medium-size banks, conducted most of the operations under investigation, according to newspaper reports on the order of bigger banks and influential Russian businessmen. (A brief summary of these allegations is given by Albats 2000.)
40. A similar argument is made by Tosunyan and Ivanov (2000).

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