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Russian Outlook

Crisis of Confidence

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In the past seven years, the word "crisis" has been used so often in reports concerning the Russian economy, society, and state that the term has become almost commonplace, losing a great deal of urgency and gravity. Yet on few, if any, occasions was the deployment of this word more justified than in describing the situation in which Russia finds itself today.

This predicament is remarkable not only by the grimness of the economic indicators or by the scale of the potential political calamity. It is a qualitatively new crisis at the heart of which is a vast chasm between civil society, demoralized and embittered by decades of totalitarian dictatorship, and the state, saddled with the legacy of the Soviet economy and welfare system. As such, this crisis may not be contained and resolved within the Russian political elite—even with President Yeltsin's signature combination of magnificent political instinct, artful maneuver, and steely determination. This time, the roots of the plight are too deep and too tightly interwoven for it to be alleviated by anything short of a vast overhaul in the ways the Russian state, Russian society, and Russian capitalism interact with one another.

The magnitude of the financial crisis experienced by Russia would seriously challenge the stability of any political system. Since its peak in October 1997, the Russian stock market has lost almost 75 percent of its value and has plummeted to the lowest point since the June 1996 presidential election. Annualized yields on a forty-five-day bond rose above 100 percent—the highest since May 1996.

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The similarity in market behavior between spring 1996 and today is not accidental. Now, as then, Russia is facing a milestone in its grandiose experiment with democracy and capitalism. In 1996, before the first election of the head of state in the country's history, the question was, can a nonauthoritarian Russia govern itself? Now it is, can a nonauthoritarian free-market Russia support itself?

Strains on the Russian Budget

Central to the Russian plight is a gap between state revenues and state expenditures. In 1997, the federal government collected 10.8 percent of gross domestic product in taxes and spent 18.3 percent.

Much of the problem is attributable to the economic and social legacy of communism. The Soviet defense sector consumed at least one-third of GDP and supported every third Russian man, woman, and child, millions of whom lived in impoverished company towns whose sole source of support was state defense orders. Most of Russia's heavy industry is of 1930s and 1950s vintage. At its helm are "red directors" who once managed the Soviet economy for the Communist Party, kept their positions in the aftermath of the "velvet revolution," and knew no other rationale for production than the fulfillment of state orders. In the countryside devastated by Stalin's terrorist "collectivization" and by half a century of forced labor, alcoholism, isolation, and poverty, several generations grew up with no memory of family farming on one's own land.

In addition to the defense sector, entire branches of industry (agriculture, coal mining, and textiles among them) that for decades had posted losses and yet had employed millions became de facto bankrupt almost overnight once real prices were introduced and state subsidies reduced. Not only did these sectors continue to waste resources and to generate no revenue, but the state remained the sole source of support for these workers.

Minister of Economy Yakov Urinson recently cited the conclusion reached by a study commissioned by Mikhail Gorbachev's government in 1989: if the government had ended support of industry and had put enterprises up for sale (if buyers could be found) or had simply let them collapse, 40 million people would have become unemployed within a year.[1]

Although between 1992 and 1997 radical demilitarization of the Russian economy reduced defense appropriation from at least 30 percent of GDP to less than 5 percent, and although the private sector has created millions of new jobs, no market, no matter how fast its growth, could have absorbed and retrained such multitudes. Moreover, many of the largest enterprises were the nuclei of company towns: they ran schools, hospitals, and kindergartens, and supplied water, heat, and electricity.

Even though today the federal government is responsible for less than 20 percent of the wages backlog (with the rest owed by often incompetent and thieving private owners, management, or local authorities), after centuries of the state's custody of the lives and livelihood of its subjects, millions of Russians expected the state to continue to provide. According to Finance Minister Mikhail Zadornov, in recent years the government has channeled more than $10 billion in soft loans to enterprises, and only 14 percent of these loans were ever repaid.[2] The appropriations for miners' salaries alone are to consume $919 million, more than 1 percent of the entire 1998 budget. As of this May, nearly $772 million was owed to the defense sector in back salaries. Urinson called these payments the "price of social peace."[3]

A significant part of that price was exacted by the maintenance of the impoverished but vast welfare state: free medical care, free higher education, and state pensions for all women older than fifty-five and men older than sixty. Among the biggest expenses are the subsidies for residential housing and utilities. The average urban Russian family pays no more than 3 percent of the real service costs. Even in Moscow, the country's most expensive city, where all apartments were nominally privatized, the average tenant pays only 17.6 percent of the cost of electricity, heating, and telephone. Housing subsidies consume a greater share of the Russian budget than does defense.

Fighting inflation while keeping afloat thousands of bankrupt enterprises and an enormous welfare state resulted in what the father of Russian liberalization, Yegor Gaidar, called a "combination of tight monetary policy and soft budgetary policy." Rightly considering low inflation and the stable ruble to be its main achievements and the key conditions for economic recovery and political stability, the Russian government since 1995 has stoically refused to print money to cover the deficit. Instead, it chose what it saw as a lesser evil: financing through short-term, high-yield government bonds (the GKOs.) The exercise proved costly and, eventually, ruinous. Soon this mode of financing became a kind of pyramid scheme, in which payments due were covered by the sales of more loans. This year, a third of the Russian budget was to be spent to service debt. In July alone, the government needed to borrow $6 billion, or 7 percent of the entire 1998 budget. Perhaps even a steeper long-term price has been paid in the stifling of economic recovery, as banks and Russian entrepreneurs alike saw little incentive in taking risks while they could receive a 30–40 percent profit on their investment simply by lending the money to the government.

The pyramid was kept afloat by oil export revenues and by the vogue of emergent markets among foreign investors, who held $20 billion of Russia's $70 billion internal debt and who bid up the Russian stock market, which doubled in value last year and became the world's best performing market. The coincidence of investor flight from emergent markets in the wake of last fall's Asian crisis and the drop in oil prices removed the cushion.

The landing was swift and hard. The Russian Trading System index of stock prices (roughly an equivalent of the Dow Jones industrial average) plunged from the all-time high of 571 points in the first week of October 1997 to 187 points in the last week of May. The holders of GKOs rushed to cash in the bills, exchange rubles for dollars, and take the money out of the country, flooding the currency market with rubles and sending the GKO yields sky-high.

With the government's debt of $1.9 billion in back salaries and with $33 billion of short-term loans maturing this year, the central bank was forced to spend billions of dollars of reserves to support the ruble as the currency fell below the lower boundary of the exchange fluctuation band ("corridor") of around six rubles per dollar (plus or minus 15 percent), which had been maintained for several years. The Russian hard currency reserve dwindled from $23 billion in October to $14.5 billion in May.

The bank had to act to forestall a devaluation that would have been devastating to a population heavily dependent on imports for much of its vital necessities, including food and clothes, and it would almost certainly have unleashed inflation as the people got rid of rubles in panic buying or exchanged them for dollars. The currency devaluation would also have led to the demise of some of Russia's largest banks, which are heavily indebted to Western lenders.

Why the Russian State Cannot Collect Taxes

The inability of the Russian state to raise revenues in amounts even approaching those commensurate with its enormous social obligations is attributable to several factors. On the policy side, a tight monetary control and the prohibitively high cost of credit, made scarce by the GKOs, resulted in a severe shortage of liquidity in the Russian economy. Enterprises were forced to deal with each other by bartering, accounting for more than half of all transactions. In lieu of rubles, Russian banks issued promissory notes (*vekseli*). Accounting in barter and *vekseli* is effectively shielded from the tax collector. A politically motivated prohibition on selling and buying land, which the leftist plurality in the Duma successfully upheld over the president's vetoes, further robbed the Russian Treasury of billions of rubles in profits from the sale of state-owned land, as well as from real estate and sales taxes.[4]

But at the heart of the Russian fiscal crisis was massive and ubiquitous tax evasion. The arcane system of more than 200 overlapping federal and local taxes arbitrarily interpreted and enforced by corrupt federal and local authorities resulted in an unbearable tax burden often amounting to more than 100 percent of entrepreneurs' profit. The predictable result was a vast off-the-books underground economy of unrecorded cash deals, barter, and second jobs estimated at 25–40 percent of the country's official GDP.[5]

The revenue losses were especially great in the case of some of Russia's largest financial and industrial groups (the FIGs), which deploy their enormous political power to avoid paying taxes. The most notorious culprit is the gas monopoly, Gazprom. Protected until three months ago by its ex-manager, former prime minister Viktor Chernomyrdin, it owed 4 billion rubles in back taxes—or more than 80 percent of the state's entire debt to the defense industry.[6]

Personal income tax is something entirely new to Russia. In 1718, Peter the Great imposed a census-based "poll" tax on the entire male peasant population, regardless of individual income, while exempting the wealthiest Russians, the nobles and the merchants. The raising of the money was a seigniorial or collective, rather than individual, responsibility discharged by the feudal lord, the village commune (*mir*), or the town (*posadskiy skhod*).

With such a palpably flawed system in place, most revenue had to be raised by indirect taxes,[7] of which the sale of vodka was by far the most profitable. From 11 percent of the state budget in 1724, the income from this trade rose to 40 percent in the 1850s. In addition, strained by the enormous military machine and endless wars, the Russian state covered the perennial deficit of its budget by the paper ruble (*assignat*), which was first printed in 1769 and which contributed greatly to inflation as a fixture of the Russian economy.

Except for the six years (1922–1928) of a limited market (the New Economic Policy), the Soviet state was the sole employer of the Russian people: there was no need for taxes, either individual or corporate. Indeed, the very notion of profit remained buried until the mid-1960s, when the so-called Kosygin reform attempted, gingerly, to introduce it into the Soviet economic vocabulary and was quickly scuttled by the industrial *nomenklatura*.

After the fall of the Communist state in 1991, superimposed on this decidedly inauspicious national tradition was the reality of a new and deeply polarized democracy without consensus on some of the most fundamental issues, especially private property and the market economy. In the most recent parliamentary elections of December 1995, 32 percent of the votes (22 million) were cast for hard-line leftist parties and 31 percent (21 million) for proreform parties and blocs. In the 1996 presidential elections, 40 percent (30 million) of the voters chose the Communist Party's Chairman Gennady Zyuganov, while 54 percent (40 million) voted for Boris Yeltsin. Thus for a large segment of Russian adults who wish for a return to communism, the present regime is simply not legitimate enough to pay taxes to. To them, the familiar issue of "taxation without representation" is a fact of life, not history.

The Politics of Tax Collection

The campaign to boost revenue by making the system simpler and fairer and the rates lower has been at the center of the government's economic policy since March 1997, when Yeltsin returned to work after his recuperation from quintuple bypass heart surgery. "It is our common duty to enterprises, to all citizens to carry out the tax reform," Yeltsin reiterated in his state of the nation address to the Federal Assembly in February 1998. "We cannot postpone it any longer. We must simplify the tax system, reduce the tax burden, strengthen tax discipline. Only in this case shall we overcome the budgetary crisis and spur economic growth. We need the tax code to carry out this reform."

Keeping faith with the party's program and its extremely hardline electorate is one of the reasons for the spirited and persistent opposition to the new tax code by the Communists and the Communist-led leftist "popular patriotic" plurality in the Duma.[8] Another cause of resistance may be sheer ignorance of the relationship between a market economy and the state. Men in their fifties and sixties, formerly successful *apparatchiks* all, the leaders of the Communist faction in the Duma, have not—not for a week, not for a day—worked in the private sector. Among the Communist Party's guiding lights on economic matters are Gorbachev's Prime Minister Nikolai Ryzhkov and Yuri Maslyukov, the last chairman of Gosplan, the Soviet Union's chief economic agency, which set prices, placed orders, delivered raw materials to plants and factories, and distributed finished products. "Gosplan always knew what the country needed and where to get it," Maslyukov said in 1996. "Gosplan was great achievement in the principles of planning.[9]

Since early 1997, the Duma repeatedly postponed discussion of the tax reform. After a six-month battle with the executive, the legislature passed the 1998 budget in March 1997, but another delay for the debate on a new tax code was among the concessions wrung from the Kremlin.

In addition to its ideological opposition to the present regime, the "popular-patriotic" plurality in the Duma is doubly reluctant to raise taxes or to shift at least some of the burden of the welfare state from the Treasury to individuals before the 1999 national legislative election and the presidential poll in 2000. Among the government's anticrisis measures rejected by the legislature in July 1998 were an increase in taxes on land (real estate tax in Russia had been set at 0.1 percent of the property value) and a 1 percent increase in the employees' contribution to the pension fund.

The Duma has been adamant in its resistance to measures that would result in enormous gains for the budget in the long run: land privatization, the breakup of the so-called "natural monopolies" (gas, electricity, railroads, and pipelines), gradual reduction of housing subsidies, and increased foreign investment and ownership of Russian companies. It was a Duma law (vetoed by Yeltsin and then passed over his veto)—restricting foreign ownership of the government-controlled energy monopoly, United Energy Systems, from 30 to 25 percent—that touched off the most precipitous fall in the Russian stock market this spring.

Because of the Duma's rejection of some key legislation, the net gain for the budget from the government's packet of anticrisis measures was only 28 billion rubles instead of the 102 billion in additional revenue that was needed to put the country's finances in order. Desperate to bridge the gap, the government, since July 19, has adopted measures that not only are bound to be resented by the Russian consumers (and thus damage the regime politically) but will harm economic recovery in the long run. Yeltsin, for example, vetoed the law (which, until then, had been a centerpiece of the government-sponsored tax overhaul) that would have reduced the tax on profits from 35 percent to 30 percent. (The president promised to sign the law once the Duma passes other revenue-enhancing measures.) In addition, the list of products subject to the 20-percent value-added tax was extended, and import duties were raised by 3 percent.

What the Government Can Do

Lack of trust in the state is at the bottom of the current crisis. Such sentiment is well justified, given the notorious corruption of local and federal authorities, the lack of accountability in the way government money is spent, and the ubiquitous tax evasion by the largest corporations.[10] Hardened by centuries of official corruption, brutality, and injustice, the Russian people's attitude toward the Russian state can be changed only by the incremental accretion of trust—which will take generations of democratic politics.

Yet several well-publicized measures might help make the Russian state and its currency viable within a year or so. Such measures must include the adoption of a tax code of clear, consistent, and permanent laws that govern tax collection; the sorting out local and federal regulations and the prohibition on their alteration by local authorities; clear and permanent division of collection authority and revenues between Moscow and the regions; the reduction of personal and corporate taxes; and the adoption of a land code that would allow the selling and buying of land.

A second set of measures should be aimed at what former acting prime minister Yegor Gaidar called "the separation of property and power": the interpenetration of state bureaucracies and big business, which stifles competition, hurts the consumer with higher prices and worse products and services, and perpetuates corruption. The worst offenders are the FIG conglomorates, which accumulated their original capital through cashing in on political connections, currency speculation during hyperinflation, acquisition of the best enterprises for a song during first stages of privatization, and arbitrage between artificially low domestic prices (most notably on oil) and those at the world market.

Since virtually every Russian FIG is a vertically integrated fiefdom with a national bank at its head (much like the Japanese *kereitsu* and South Korean *chaebols*), the lifting of restrictions on foreign banks, which currently represent only 4 percent of the banking capital in Russia, will dramatically decrease the FIG stronghold on power and force the vitally needed transformation of the banking system, whose mainstay has been the purchase of government debt and government-subsidized lending to industrial enterprises. The seizure and sale of FIG-owned enterprises for nonpayment of taxes, as well as consistent enforcement of disclosure rules by the central bank and sanctions against noncompliant banks (including taking them over and auctioning them off) will move Russia's economy still closer to its declared goal of civilized capitalism and bring huge sums to the Treasury. A radical reform of corporate governance (which, among other things, will force the "red directors" to open the books for inspection by independent auditors and shareholders and will guarantee protection of the rights of minority shareholders) is unavoidable if Russia is to attract the vitally needed investments.

Restructuring of the economy (and the increase in state revenues) is impossible without elimination of the so-called offset payments by which a company's tax liability is reduced by the amount owed it for goods or services by state-owned enterprises or state bodies and agencies (most notorio usly, the armed forces). State-subsidized credits to industrial enterprises must be further reduced and eventually phased out. The government has already announced that it will no longer issue GKOs and has succeeded in exchanging short-term high-yield bills worth 27.5 billion rubles ($4.4 billion) for lower-rate dollar-denominated Eurobonds maturing in 2005 and 2018.

Finally, the people's trust in the state will be much strengthened also by the government's taking on the Russian oligarchs. The government's success in getting Gazprom to agree to pay taxes owed (after tax agents had been dispatched to the gas monopoly's offices and threatened to seize dachas, limousines, and hunting lodges of the senior executives) was an important first step. Equally useful will be measures suggested by the recently appointed tax tsar, former finance minister Boris Fedorov, who, while advocating the reduction of the top income tax rate from 35 percent to 25 percent, threatened the investigation of the most notorious tax evaders "who flaunt their wealth into the eyes of the nation but don't file their taxes."

The Duma's resistance makes passage of some of these measures extremely problematic, and time is running short. By most estimates, the government has no more than six to eight months before investors', diminishing confidence in the market and the salaries backlog combine to plunge the country into another financial and political crisis.

President Yeltsin can circumvent the Duma and impose some laws by decree, and he began doing so in the third week of July. Such emergency steps are not likely to solve the central problem of tax evasion in the long run. The Duma may not be the most progressive legislature in the world, but it is a freely elected national parliament whose right to legislate budget and tax matters is enshrined in the 1993 Russian Constitution (article 106). Last year, the Constitutional Court ruled that taxes may be introduced only through legislation, not government directives.[11]

Bypassing the Duma would drastically diminish the legitimacy of the measures and ultimately their effectiveness. Already one leader of the Communist faction in the Duma and the chairman of the Duma's Security Committee, Viktor Ilyukhin (who is also spearheading the drive to impeach Yeltsin), called on the Russians "not to pay any taxes that are not approved by the parliament." Even the staunchly proreform *Kommersant-Daily* (Russia's closest equivalent of the *Wall Street Journal*) concluded that many decrees prepared by the Kremlin would be illegal and advised its readers to ignore changes in income tax or pension fund contributions made by decree.[12]

Democracy to the Rescue

The historically unprecedented "building" of capitalism in a modern, one-person-one-vote democracy requires popular validation of economic realities and practices, such as private property and prices set by the market that in the West had long preceded democracy. Russian reformers were lucky to have received such approval at critical junctions. A year and three months after the liberalization of prices, in a referendum of April 1993, the majority of voters (58 percent) not only "expressed confidence" in President Yeltsin but also approved (by 53 percent) the regime's "socio-economic policies"—at the time when a monthly inflation rate was in double digits. In 1996, after three years of radical demilitarization and privatization of the Russian economy, Russians voted against the return to socialism by giving Yeltsin a landslide (54 percent to 40 percent) victory over the Communist leader Gennady Zyuganov.

In 1993 and in 1996, the Russian voters gave their imprimatur to the state as a guarantor of private property, a free market, liberated prices, and a privatized economy. Taxation requires yet another extension of the social contract between the Russian people and the Russian state—an expression of popular confidence in the state as the collector and distributor of a significant portion of national wealth. Without such a confirmation, no amount of loans from the international financial organizations will help (and, indeed, will be wasted), as the crisis will inevitably recur with even more devastating effects.

Unless the Duma changes its mind at the emergency session scheduled for mid-August, the Kremlin may have no choice but to reprise 1993 and 1996 by calling on the people to decide. This could be done in two ways. First, the president could call a referendum in accordance with article 84 of the Constitution. Second, the prime minister could ask the Duma for a vote of confidence in the government, and if the government fails to get a majority of votes, the president may dissolve the legislature and schedule new elections (article 111). Such a course is risky, but this crisis is not likely to be amenable to solutions confined within economic policies and conventional politics. Given the grimness of the alternative (a likely collapse of the regime), this course of action may soon look sufficiently attractive to the Kremlin.

The outcome is far from hopeless. The present Duma is hardly representative of the majority of the Russian voters, and the success of the Left in the 1995 legislative election owes far more to demography and organization than to the strength of the Communists' appeal. First, the pro-Communist electorate—devoted, disciplined, mostly aged, small-town or rural—turned out to vote almost in the entirety. By contrast, the turnout of proreform voters, who are younger, urban, notoriously truant, and mobilize only in a critical situation (such as the April 1993 referendum and the 1996 presidential election), was nowhere as impressive.

Second, while the Left was united, the proreform vote was badly split among many warring parties and blocs; several failed to reach the 5-percent minimum of the national party list vote required for seating in the Duma. Altogether, 9.6 million votes (14 percent of the total) were cast in December 1995 for proreform and progovernment parties that failed to receive seats in the Duma. As a result, although the proreform parties garnered only 4 percent less votes than the Communists and their allies, the Left ended up with 35 percent more deputies: 187 seats compared with 121 seats. If the government and the proreform parties are united and, more important still, if they manage to impress on the Russian voters the fatefulness of issues before them, they have a reasonable chance to gain the people's assent to another phase of post-Communist transformation.

Taxes and their collection embody the essence of the society's allegiance to and trust in the state. Stemming evasion requires nothing less than a complete overhaul of national tradition and the emergence, for the first time, of a freely concluded social contract between Russian society and the Russian state. Russian capitalism urgently requires another blessing by Russian democracy. Without such a vote of confidence, both may be doomed.

Some of the issues discussed in this essay were raised on July 21 in an AEI lecture by Anatoly Chubais, former first deputy prime minister of Russia and Russia's chief negotiator with the IMF. The text of Mr. Chubais's remarks is posted on the AEI website at www.aei.org.

Notes

1. Yakov Urinson, Vsyo, cho effektivno dlia ekonimiki, boleznenno dlia obshchestva (Everything that helps the economy is painful for society), *Moskovskie Novosti* 19, May 17–24, 1998, p. 10.

2. Mikhail Zadornov, Vlezaem v dolgi? (Are we assuming too much debt?), *Moskovski Novosti* 22, June 7–14, 1998, p. 6.

3. Urinson, p. 10.

4. When the Saratov region defied the federal Duma and passed laws allowing the sale of land, the first auction March 1997 brought local authorities $80,000.

5. According to Urinson, official salaries, taxed by the state, are only 40 percent of the population's income. Krizis v Rossii est, no katastrofy ne budet (There is a crisis in Russia but a catastrophe will not happen), *Izvestia,* July 10, 1998, p. 4.

6. Gazprom claimed, rightly, that only a small proportion (9–11 percent) of the payments received from customers were in cash: most of it was barter, and the rest, especially from state-owned enterprises and government agencies, was not remitted at all.

7. One of the popular demands during the First Russian Revolution of 1905–1907 was elimination of indirect taxation and its replacement by income tax as well as taxes on merchants and industrial entrepreneurs.

8. Among the party's main goals, the KPRF's Program, which was adopted in 1995, lists the power of the majority of the working people, liquidation of exploitation and all forms of social parasitism, and societal ownership of the means of production. The document declares communism the historic future of humankind. Programma Kommunisticheskoy partii Rossiyskoy Federatsii, prinyataya na III s, ezde KPRF 22 yanvarya 1995 goda s dopolneniyami vnesyonnymi na IV s, ezde (Program of the Communist Party of the Russian Federation adopted at III congress of the KPRF on January 22, 1995 and augmented at IV congress), Russian Communists, homepage, http://www.geocities.com/... 1/Lobby/3198/indexrus.htm.

9. For many in the KPRF's leadership (and for the overwhelming majority of the rank and file), these are not just declarations. " abolition of private property is one of the main tenets of Marxism," said the party's Deputy Chairman Valentin Kuptsov. "It still causes the most arguments [in the Central Committee]." Alessandra Stanley, Red Scare, *New York Times Magazine,* May 26, 1996, p. 46.

10. Italy, the Western industrial democracy with the most ubiquitous official corruption and political divisions, also has the highest rate of uncollected taxes, 25 percent.

11. *RFE/RL Newsline* 2, no. 137, pt. 1 (July 20, 1998); p. 3.

12. *RFE/RL Newsline* 2, no. 138, pt. 1 (July 21, 1998); p. 3.