

Economic Reforms: Steady as She Goes

Russia's transition to a market economy, now coming to the end of its tenth year, may have finally entered a period of stability and predictability. No longer the focus of front-page headlines in the international press, the economic policy agenda seems to be increasingly centered on structural and institutional reforms and the conventional issues facing policymakers everywhere: taxes, budgets, pensions, and trade. In policymaking circles, the spotlight is less on how to deal with the latest crisis and more on how to unleash the Russian economy's vast potential and how to combine its rich human and natural resource endowments to generate sustained prosperity.

Although this newly found confidence is welcome, the Russian transition is far from complete. Russian per capita incomes remain well below those of other transition economies in Central and Eastern Europe. Reflecting major deficiencies in governance, the last 10 years have been extremely costly in terms of human welfare. Reversing the deterioration of a broad range of social and demographic conditions will take a long time. A brighter future beckons, but success is not inevitable. The missteps of the 1990s can be repeated. President Vladimir Putin's administration will have to internalize the painful lessons of the 1990s if it is to achieve the goals it has set for itself: a more stable and prosperous Russia, increasingly engaged with the rest of the world. In particular, the government will have to broaden its policy

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focus from macroeconomic stabilization to the formulation and implementation of structural and institutional reforms aimed at creating a more favorable environment for private-sector economic activity.

The Output Collapse

From 1991 to 1996, Russia suffered a cumulative output decline of more than 40 percent, one of the steepest in the region. During much of the 1990s, the economy was exposed to demand and supply shocks, the magnitude of which may have no precedent in recent economic history. On the demand side, the emergence of a new political climate for international relations in the late 1980s led to a major crisis in the military-industrial sector and a permanent drop in purchases of military hardware and other defense-related equipment. Given the magnitude of the former Soviet Union's industrial sector and the prominence of military production within it, this demand shock was proportionally far more severe in Russia than elsewhere in the industrial world. Arms exports by the Soviet Union fell from \$20 billion in 1988 to less than \$3 billion by 1992. The cumulative output drop in the military sector from 1991 to 1993 was about 60 percent. In 1992 alone, defense orders in the budget fell by 80 percent, contributing to a sharp contraction in investment and a major slump in the construction sector. The collapse of trading arrangements in the region, as other Eastern and Central European partners opened their borders to international trade utilizing world market prices, resulted in sharp drops in Soviet exports to traditional markets. Declining oil production further undermined output growth. The government also drastically cut consumer and producer subsidies, thus adversely affecting household demand.

Price liberalization in early 1992 resulted in significant supply shocks as well. The enterprise sector was gradually deprived of subsidized resources, foreign exchange at low exchange rates, and raw materials at a fraction of the world price. The easy access to credit on preferential terms was gradually phased out. The government began to tax the military-industrial complex, which during the Soviet era had largely been exempt from paying taxes as a way of enhancing its competitiveness. Disruptions to trade and financial relations among the former members of the Soviet Union, which were especially pronounced in the early part of the transition (1992–1993), also contributed to the contraction of output in Russia. The effective disabling of the institutional mechanisms supporting the central plan, without the concomitant emergence of free-market substitutes, compounded these negative factors.

The combination of these elements, culminating in a structurally induced shock, resulted in the loss of output and, subsequently, rising unemployment,

retrenching investment plans, sharply eroding enterprise profitability, weakening budgetary revenues, and deteriorating living conditions for the population. The disorderly conditions that characterized the transition itself, involving at times a significant measure of political instability and conflicting signals from the authorities on the general direction of economic policies, were an important, though difficult to quantify, additional negative factor.

Unnecessary Welfare Costs

Although the output losses in Russia in the first half of the 1990s were the result of inevitable adjustments to the international environment, the adverse effects of the transition were at times intensified by ill-advised governmental policies. In this sense, Russia's transition to a market economy has been an extremely inefficient process, inflicting welfare losses on the population over and above those that the transition would have implied. Several examples illustrate this point.

FAILURE TO PRESERVE THE SAFETY NET

In *Development as Freedom*, Amartya Sen makes a compelling case that macroeconomic policies significantly affect the distribution of incomes, and social equity and welfare. As a result, responsible economic programs will take these effects into account, particularly as they impinge on the more vulnerable groups in society. Inadequate attention to social safety-net issues in Russia during much of the 1990s greatly intensified the plight of the population and accentuated the deterioration of social and demographic conditions. The real value of pensions for Russia's 37 million pensioners dropped precipitously—more than 35 percent—in the five-year period ending in 1996. Perhaps some increase in poverty rates was inevitable at the outset of price liberalization, but the prolonged plight of vulnerable groups was needlessly harsh.

The government would often argue that resource constraints prevented a more proactive social policy. The need to bring public finances under control and, hence, to create a foundation of macroeconomic stability allegedly created tough choices on the expenditure side. The weight of the evidence overwhelmingly suggests otherwise. On a number of occasions, government initiatives resulted in tax exemptions that massively impacted the budget, amounting in one case (arguably the most egregious, that of the National Sports Foundation, the largest importer in Russia of tax-exempt alcoholic drinks, tobacco, and luxury cars) to \$3–4 billion per year in foregone revenue, roughly equivalent to the average annual amount of International Monetary Fund (IMF) lending during 1992–1998. Similar breaks granted to

the likes of Gazprom, the Afghan War Veterans Union, and the Humanitarian Aid Commission inevitably led to expenditure compression in such areas as education, public health, and infrastructure investment. These actions accelerated the breakdown of long-established Soviet institutions that had performed a vital social safety-net role (sports and vacation camps, public libraries, and support for the arts) at a time when adequate substitutes connected to organizations of civil society had not yet emerged. Thus, they contributed to an institutional collapse that entailed significant social costs, over and above those linked to purely economic factors.

PRIVATIZATION, RUSSIAN STYLE

Further constraining the ability of the government to respond to emerging social needs associated with the move to a market economy were certain initiatives introduced in 1995 and 1996 under the largely indifferent gaze of international financial institutions, depriving the Russian budget of massive resources on a permanent basis. The “loans for shares” privatization scheme resulted in the virtual giveaway of several of Russia’s top companies in the energy and metals sectors at pitifully low prices in what has since been described as “the sale of the century.” This mechanism of privatization involved a permanent transfer of state assets and created a new class of entrepreneurs whose main attribute seemed to be leveraging political connections for private gain, seriously undermining over time the stature of Russia’s policymakers and the government’s ability to manage the transition in a way that preserved a minimum of public credibility. It contributed, therefore, to a visible weakening of the state and its ability to formulate and implement policies in an effective way. Given its apparent readiness to part with its most valuable assets for next to nothing, the government could hardly make a credible case for the public to pay taxes. That tax arrears subsequently skyrocketed and that the ratio of revenue to gross domestic product (GDP) continued its pronounced descent are not totally unrelated phenomena. That donors would underestimate the pernicious effect this situation would have on public attitudes toward key elements of the government’s program is a source of considerable puzzlement, particularly regarding the IMF, which at that time was providing monthly infusions of cash to the budget—loans that would subsequently contribute to the accumulation of some \$22 billion of Russian debt to the IMF by late 1998.

INEFFICIENCIES IN MACROECONOMIC MANAGEMENT

Other sources of welfare losses were associated with inefficiencies in macroeconomic management that limited the ability of the government to re-

spond to social and other needs in a more proactive way. Here the list is long. Two that deserve some attention are government borrowing and capital flight. Faced with severe revenue shortages, the government resorted to extensive borrowing. Due to low confidence in the ability of the government to fulfill its obligations, such borrowing tended to command a high interest-rate premium. The treasury bill market, in particular, introduced in 1993 to tap private savings for the purpose of financing the budget deficit, grew very quickly into a \$50 billion nightmare by the time of the 1998 financial crisis. Add \$30 billion or so that multilateral institutions disbursed, which the authorities to a great extent saw as a substitute for domestic revenue shortfalls, and by 1996 the government was barely able to finance the payment of wages (with some delays) and interest on the public debt. The service of these debts will remain a major burden on the Russian budget for the foreseeable future, higher than combined federal expenditures on health, education, and regional aid.

Macroeconomic instability during much of the 1990s contributed to massive capital flight—resources which could otherwise have contributed to higher levels of domestic investment, economic growth, and, hence, a stronger budgetary position. Russian exports of goods and services from 1992 to 2000 exceeded \$800 billion, a figure that highlights the country's vast wealth-creating potential. Although estimates of capital flight are subject to large margins of uncertainty, the IMF reports that, from 1995 to 1999 alone, capital flight exceeded \$65 billion. This figure exceeds, by a factor of three, total lending provided by international financial institutions during the same period.

Russia's transition to a market economy may have finally entered a period of stability.

The Emerging Market Economy

Russia's transition to a market economy has been disorderly and uneven, highlighting the virtual absence at the outset of an appropriate legislative infrastructure. Costly setbacks have tempered progress in a number of areas, slowing down or altogether postponing the recovery. Nevertheless, although there have been gross inefficiencies and lost opportunities, the last decade has undoubtedly witnessed momentous transformations: in the approaches to macroeconomic management that authorities increasingly adopted; in the emergence of the basic institutions of a market economy; and, perhaps

more importantly, in the mental attitudes and patterns of behavior of an emerging class of entrepreneurs. Three areas deserve special mention.

First, the 1990s witnessed a remarkable opening of the economy. Little by little, Russia has moved from an extremely distorted “state-trading” regime to one that lowered tariff protection levels. Entry into the World Trade Organization is now a realistic near-term objective. Yet improvements can be made. Evasion of import duties remains a serious problem, and the tax au-

thorities need to streamline and modernize customs controls to disable a key source of gray-economy growth. Russia has, at least on paper, a fairly liberal regime for foreign investment; and the increased macroeconomic stability seen recently, if sustained, may well lead to a significant pickup in investment inflows, initially to the energy sector but eventually to other sectors of the economy as well. Investors may well find the potential market of 300 mil-

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lion consumers in Russia and its surrounding neighbors enticing.

Second, the government and even the parliament broadly accept the premises that budget constraints matter, that the country has to live within its means, and that macroeconomic stability is a condition *sine qua non* for growth and an improvement in per capita incomes, where Russia lags behind many of the transition economies of Central and Eastern Europe. The development of the appropriate supporting institutions (a central bank, a treasury, and a tax service), which increasingly resemble those of the developed world, has buttressed this acceptance.

Third, beyond issues of macroeconomic stability, a consensus has emerged—of which parliament is now an integral part—that institutional and structural reforms are central to improving long-term growth prospects. It has taken 10 years for parliament to accept the notion of private ownership of nonagricultural land, that the pension system needs to be reformed and its financial viability safeguarded; that the lack of a working judicial system has poisoned the environment for private-sector economic activity; and that, hence, reforms in these areas are urgent. The short-term effects of this emerging consensus should not be overestimated as, at present, it exists largely in the realm of words rather than visible deeds. At least it is, however, a development with vast potential implications.

Three areas in this broad agenda of structural reform merit further comment. Not only are they central to laying out a foundation for sustainable economic growth but, for different reasons, they illustrate the unevenness of the reform efforts thus far. These areas encompass the tax regime and the budget, where the government and parliament, with delays and after many

missteps, have finally created arrangements that contain the key elements of a modern, market-friendly system; the rule of law and corporate governance issues, where progress has been mixed at best; and the financial sector, where progress has lagged far behind.

THE TAX SYSTEM AND THE BUDGET

The absence of a clear delineation of jurisdiction over tax policy during the 1990s resulted in arbitrary enforcement of tax legislation. The unpredictability of the tax system, with individual tax laws being amended dozens of times, introduced considerable uncertainty in the macroeconomic climate and dampened the recovery of investment. In addition, because of the lack of clarity in the rules governing fiscal relations between the federal authorities and the regions, the number of taxes levied at various levels of government exploded, contributing to an increased statutory tax burden and encouraging evasion and the growth of tax arrears. Weaknesses in tax administration and inefficient taxation of exporters were two additional serious problems. The transfer of economic activity to a rapidly growing private sector put enormous pressures on the administrative capacities of the tax authorities. A key factor behind the 1998 crash was clearly the vulnerability to external shocks of the Russian budget and all the associated institutional weaknesses. The Asian financial crisis and the resulting collapse in oil prices and budget revenues were, in the end, too much for anemic Russian public finances, precipitating debt default.

These problems notwithstanding, much progress has been made in the last two years to establish a more solid foundation for fiscal stability. With some delays and in stages, a new tax code was finally signed into law in 2000–2001 that goes a long way toward clarifying the legal framework for tax policy as well as introducing a degree of transparency and predictability to Russia's tax system. The recent recovery of economic activity and more infrequent recourse to ubiquitous tax exemptions has boosted budget revenues, but other factors have been at work as well.

First, on the revenue side, tax collection has improved across all major taxes, not just those assessed on oil and other commodity exports. Second, on the expenditure side, the government has been quite cautious in the implementation of the federal budget, contrary to what was widely expected in the aftermath of the 1998 financial crisis. It has not used any of the added slack that the boom in energy prices provided to relax expenditure discipline. The end result last year was the achievement of a sizeable budget surplus, the first in the post-transition period. Lastly, evidence indicates that at least some of the improved fiscal situation in 2000 and 2001 reflects a number of reforms in treasury management and more effective expenditure-control procedures.

A return to international capital markets by late 2002 is a distinct possibility.

More recently, the government has submitted to parliament a draft of the 2002 budget that, for the first time in the post-transition period, actually targets a surplus of 1.6 percent of GDP. It also anticipates full payment of all external obligations. The emerging consensus in the markets seems to be that Russia is considerably less vulnerable to external shocks than at any time in the post-transition period. Indeed, a return to the international capital markets by late 2002 is a distinct possibility.

In fact, Russia is so much less vulnerable to external shocks that it is considered well placed to weather a global economic downturn following the terrorist attacks on September 11. It has a comfortable balance of payments position; a sizable cushion of international reserves; controlled public finances; and, unlike Argentina and Turkey, no need to access international capital markets. Increasing references

to Russia among investors as a “safe haven” in the emerging market world and Russian assets as “a flight to quality” are no longer surprising.

RULE OF LAW AND CORPORATE GOVERNANCE

Weaknesses in the rule of law and in governance in both the public and corporate sectors are clearly responsible for the weakness of investment, the lack of effective restructuring at the enterprise level, and ongoing capital flight. If the government began to send more convincing signals that it intends to keep private-sector interests, particularly the so-called oligarchs, at an arm’s length, it would improve the investment climate. Without improved perceptions that the government itself regards the rule of law as a central ingredient of economic reform, foreign direct investment is unlikely to reach the levels seen in the more successful transition economies. This development, in turn, will reduce the growth potential of the economy over the near term. Government credibility is a valuable asset, and the authorities must make strenuous efforts to protect it; transparency in public management is a central feature of this process.

The idea that improved corporate governance will actually enhance the market capitalization of Russian companies may be taking root in the boardrooms of the enterprise sector. Investors have rewarded companies that have cleaned up their act, and the government has at last begun to lend its support to reforms in this area—for instance, through the drafting of a Code for Good Corporate Governance, which is expected to come into force in 2002. The progress that remains to be made in this area, however, is huge; to date,

improvements have been visible only at those companies that have tapped the international capital markets or that are traded on the world's main stock exchanges. For the vast majority of Russia's corporate sector, international accounting standards, reliable audits, and safeguards to protect minority shareholders' rights remain "projects in progress."

Recent government efforts to exercise greater control over the press have raised some concerns at home and abroad that cannot be easily dismissed. Free public debate is essential to a healthy economic environment. Indeed, consensus building, a process whereby the government actively seeks the views of various segments of society—such as labor unions, entrepreneurs, and organizations of civil society—and their support for its economic strategies is increasingly seen as a central ingredient of successful economic development. A free press is thought to be an inseparable component. It would be regrettable if, following the chaos and "free-for-all" that was at times fully evident in the 1990s, the present government would swing the other way and impose a degree of control over Russian society at odds with the values of Russia's main partners.

THE FINANCIAL SECTOR

The government and the central bank need to restructure the banking system to improve the efficiency of Russian banks significantly. This task cannot be accomplished without creating a modern regulatory environment, consolidating the banking system into a smaller number of banks, and substantially increasing the participation of foreign institutions in banks' share capital. All Central and Eastern European transition economies have encouraged the entry of foreign banks into their domestic banking systems. In some countries, the foreign share exceeds 60 percent, compared to 7 percent in Russia. Opening the financial sector to foreign participation has resulted in better services for these countries' populations and their enterprise sectors, more competitive banking systems, improved compliance with central bank regulatory provisions, and higher levels of financial intermediation.

Without foreign participation in Russia's banking system, restoring long-term confidence both in the ruble and in the system as a whole will be extremely difficult and may well take several years. The argument is sometimes made that financial sector reform need not be a top priority because the economy is growing and enterprises are financing themselves through retained earnings and an overall improvement in profits, but this is not true. The absence of a proper financial system will surely slow down the emergence of new enterprises and the diversification of the economy, dampening near-term growth prospects.

The Role of International Assistance

A proper assessment of the role played by donors in assisting Russia's reform efforts during the past decade is beyond the scope of this article. The question of what Russian taxpayers actually received in exchange for \$40 billion of external debt to the IMF, the World Bank, and individual country donors since 1992 is one with important policy ramifications and that, no doubt, will be the subject of future scrutiny. Suffice it to say that the prevailing view in policymaking circles in Russia is that the bulk of this aid had limited utility and was often used for budget-deficit financing by a government increasingly unable to collect taxes. Moving forward, international official-donor financial support is expected to recede very quickly as a central element of Russia's ongoing transition to a fully developed market economy.

Russia is unlikely to have an IMF program in the foreseeable future. Public finances and the balance of payments have recovered sharply, and, in any event, it is highly unlikely that the government would ever agree to the much more stringent monitoring requirements now in place for countries wishing to avail themselves of IMF assistance. Russia under Putin may actually be tempted to pay its remaining debts to the IMF ahead of schedule, as other, more successful economies have been able to do in recent years. The World Bank is likely to be involved with Russia for a much longer period of time, given the bank's broader mandate and Russia's tangible needs for long-term concessional financing aimed at boosting investment and supporting structural reforms across a range of sectors.

Individual governments will continue to provide bilateral assistance in areas where such assistance may involve significant payoffs: enhancing nuclear safety, strengthening civil society organizations, and providing various forms of technical assistance in a broad range of areas. For the next 20 years, under the umbrella of the official creditors' club (the so-called Paris Club), Western governments will also continue to collect cash payments on Soviet-era debts and thus continue extracting sizable resources (more than \$90 billion, including interest) from the Russian budget that doubtless could be better spent on improving the country's much dilapidated infrastructure or modernizing its rundown public services. Russian policymakers have largely resigned themselves to the fact that export credits, which to a great extent should probably never have been disbursed in the first place given the chaotic conditions prevailing in the waning days of the Soviet Union, now have to be paid back, with interest, with real dollars and euros. In a move that many now regard as a sign of foolish magnanimity, Russia assumed the external debts of the other 14 former Soviet Union republics in late 1991. Thus, understanding why many in Russia see Paris Club debt as the worst line-item ever to have made its way into the Russian federal bud-

get is not difficult. Billions of deutsche marks worth of German “tied” credits, lent so that Soviet enterprises could buy shoddy goods from failing companies in declining industries in East Germany, are now being repaid with funds that could instead be used to boost the miserable wages of Russian teachers and doctors.

This and future governments will resist the temptation to dwell unduly on the disappointments and setbacks of the last 10 years, particularly regarding the role of international financial assistance to Russian economic reform efforts. A decade of “international cooperation” may have left a mountain of debt, but it has also acted as a catalyst to generate many processes of internal change. Furthermore, Russia needs the international community in ways well beyond the provision of financial aid in earlier years, and this overriding consideration will keep the government engaged in a fundamentally cooperative spirit.

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New Hopes for a Changing Russia

Russia’s growth potential is high over the medium and long term, certainly at least as high if not higher than other transition economies in Central and Eastern Europe, because of several factors. First, the economic distortions of the Soviet era were far more pervasive in Russia than in any other centrally planned economy; these have been or are being dismantled. Indeed, the painful and at times inefficient processes whereby these distortions began to be eliminated gradually during the past decade may be the defining characteristic of Russian economic reform during the 1990s. Second, Russia has an exceptional natural resource endowment. On a per capita basis, Russia produces many of the primary commodities that fuel the global economy in greater quantities than the United States or the European Union. Third, Russia has a rich human-capital endowment with a highly educated labor force. Although the military-industrial sector employed the best of this workforce during Soviet times, much of it is being redeployed to private-sector nondefense industries that, over the medium term, should boost labor productivity. Finally, Russia is closer, physically and mentally, to the global economy than at any time in the postwar period. This observation manifests itself in multiple ways: in the availability of information, in the ease with which Russians now are able to travel abroad and come into contact with other cultures and new ideas, and in the veritable explosion of organizations of civil society that have entered into partnerships with peers abroad.

Entry into the WTO is now a realistic near-term objective.

High growth rates over the medium term are not inevitable. Ten years after the launch of the first tentative steps toward the creation of a market economy, however, the starting conditions exist which, combined with the credible macroeconomic and structural policies that have been increasingly evident during the last couple of years, could make high growth possible. Indeed, with the worst of the transition likely behind them, Russia's leaders have a unique opportunity to push forward with the modernization of the economy and its supporting institutions. More importantly, this and future governments must realize that, in an age of globalization, rising public expectations, and increasingly integrated markets, no credible alternative exists to the painstaking process of eliminating inefficiencies, strengthening institutions, attracting foreign capital and know-how, and engaging more fully the growing segments of the public in processes of development to help release the latent potential of the Russian population.