RUSSIA'S FISCAL PATTERN REDUX: TESTING AN OLD HYPOTHESIS WITH THE NEW DATA

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Several episodes at the end of fiscal year 2001 illustrate the systemic features of Russia's post-Communist economy.[1] They show how the liberalized and privatized network of enterprises determines fiscal and monetary policy through the system of trade arrears. We described this system in detail in chapter 1 of *From Predation to Prosperity* and relayed its origin in chapter 2. The chapters ended in mid-2000. The new episodes and the national data extend this pattern through the end of 2001. They form an important test of our earlier-stated hypothesis. The data assembled below indicate that the pattern is consistent month by month for ten years, from the beginning of reforms in early 1992 through the end of 2001. We will line up the new episodes in the first section and in figures 1 through 3 and consolidate their flow of funds in figure 4. We will briefly discuss their fiscal implications in the second section and suggest their short-term cause in the third section. We will summarize the systemic cause and national data in the fourth section and in figures 5 and 6.

The new evidence and brief comments

The first episode is straightforward. In December 2001, the Central Bank deposited $700 million from its foreign exchange reserves with its subsidiary, the Bank for Foreign Trade. The latter exchanged dollars for rubles with its parent, the Central Bank, and made a ruble loan worth $500 million to the natural gas monopoly, Gazprom, and one or more ruble loans equivalent to $200 million to other enterprises. Then the natural gas monopoly and other loan recipients remitted their tax arrears to the Treasury.

A comment: The Central Bank printed rubles in the amount of $700 million to finance tax remittance by delinquent enterprises. The Central Bank, in effect, monetized a budget deficit before it occurred. But the Central Bank holds the debt of its subsidiary, not the government, while the subsidiary, in turn, holds the debt of an enterprise, not the government. This episode is depicted in figure 1. For consolidation with the next episodes, we will call Gazprom Enterprise 1.

The second episode is more complicated. The Treasury deposited R40 billion ($1.35 billion) with an unnamed bank or banks and instructed them to make a loan in the same amount to the national electricity generator and utility, The Unified Electric Systems (UES). UES, which we will call Enterprise 2, dispensed this loan as depicted in figure 2.

1. Enterprise 2 paid off R18.1 billion ($0.6 billion) in trade arrears to Gazprom (Enterprise 1).

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[1] These episodes were initially reported in the joint publication of *The Wall Street Journal* and *Financial Times* in Russia called *Vedomosti*, nos. 235 and 239, on December 24 and 28, 2001, and on the Internet site http://www.polit.ru on December 20and 28, citing the Ministry of Finance and Central Bank sources, and then restated in other publications.

FIGURE 1. THREE FISCAL EPISODES, RUSSIA, DECEMBER 2001: EPISODE 1

Episode 1

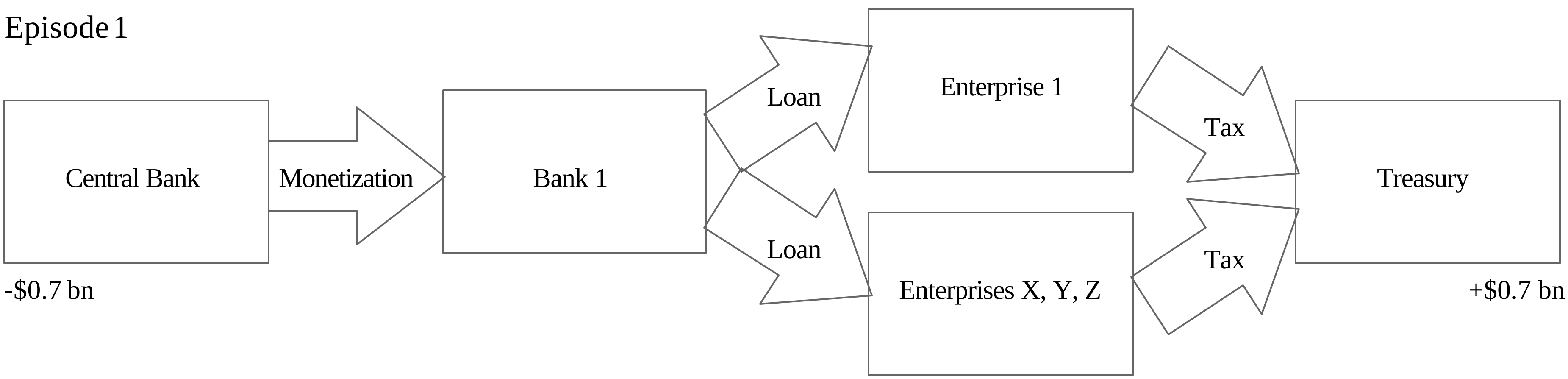
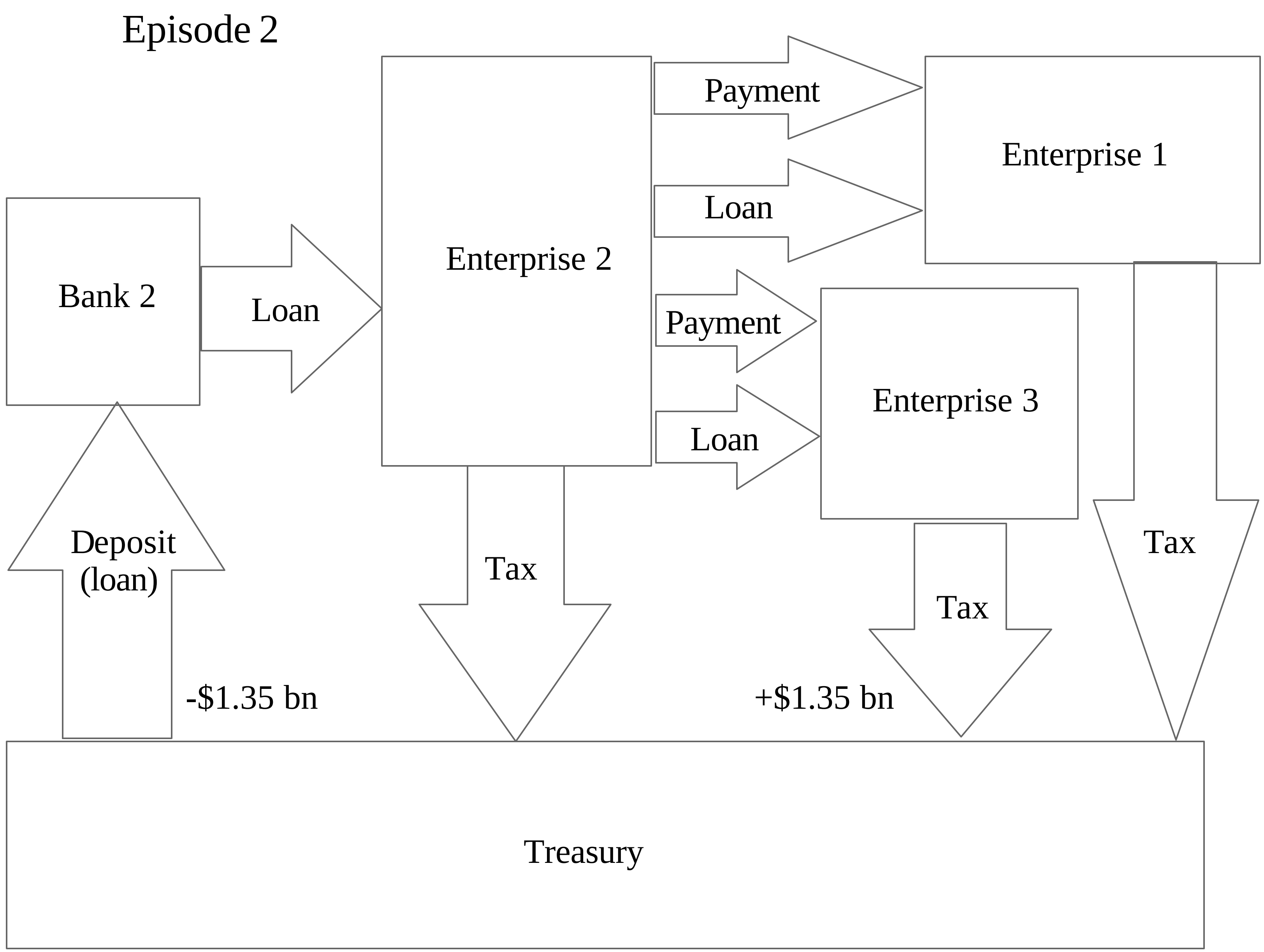


FIGURE 2. THREE FISCAL EPISODES, RUSSIA, DECEMBER 2001: EPISODE 2



2. Enterprise 2 made Enterprise 2 a loan in the amount of R10.1 billion ($0.35 billion).

3. Enterprise 2 paid off R5.3 billion ($0.2 billion) to the Russian Atomic Energy Monopoly, which we will call Enterprise 3.

4. Enterprise 2 made Enterprise 3 a loan of R4.5 billion ($0.15 billion).

5. Enterprise 2 remitted its tax arrears to the Treasury worth R2 billion ($0.07 billion).

6. Subsequently, Enterprises 1 and 3 used their payments of trade arrears and loans from Enterprise 2 to remit their own tax arrears to the Treasury, in this instance, R38 billion ($1.3 billion) in total.

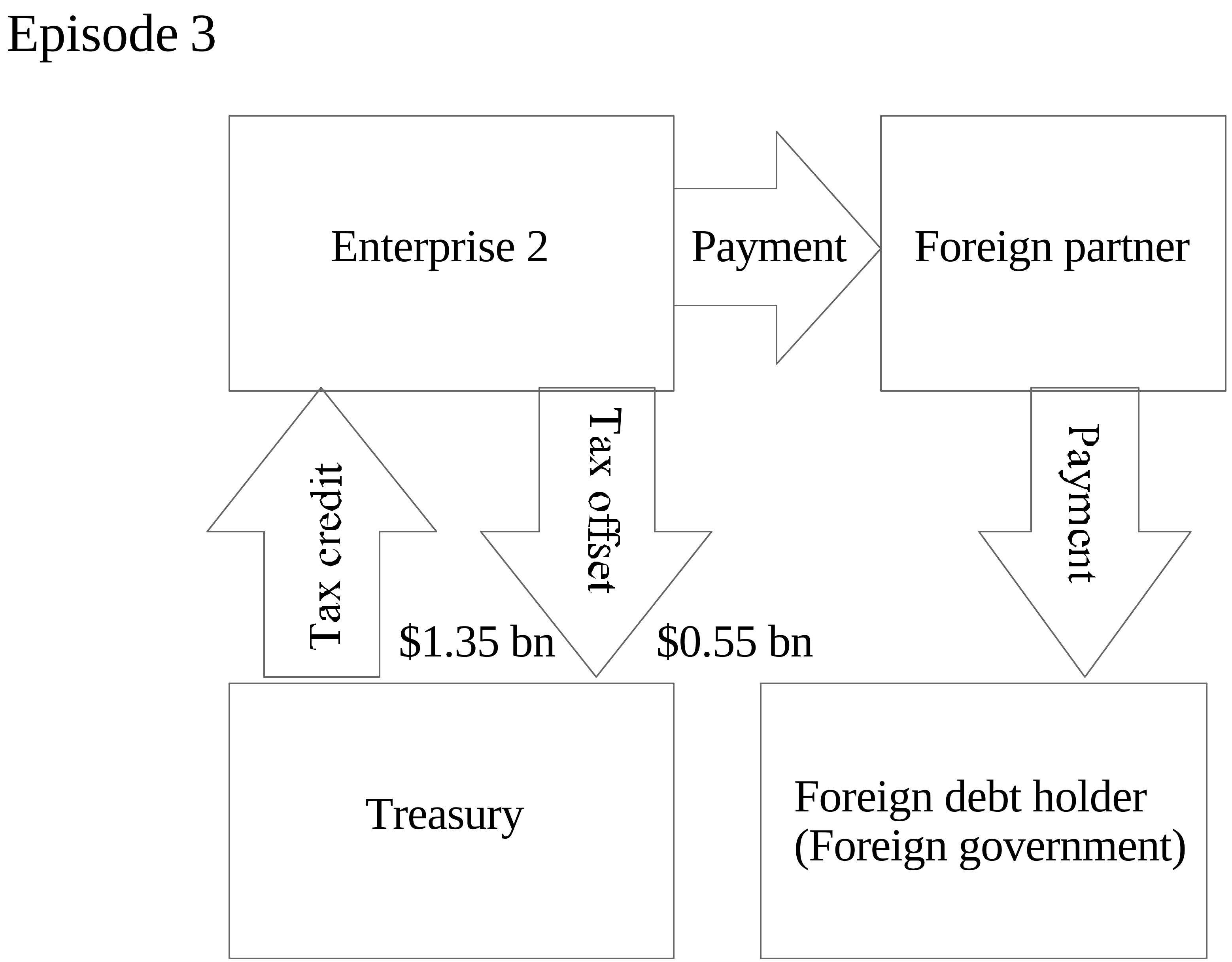
Together with the remittance of tax arrears from Enterprise 2, the Treasury recouped its R40 billion ($1.35 billion) loan to Enterprise 2.

A comment: The budget lists this amount as revenues. According to Russian fiscal accounting practice, which is accepted by the IMF and Western auditors, the Treasury does not add the same amount to expenditures on financing or subsidizing enterprises. The Treasury adds income to the budget even though there is no change on the balance sheet. The Treasury merely transferred its liquid assets (deposits) from the Central Bank to commercial banks, which made the loan to Enterprise 2, and then re-deposited the same amount with the Central Bank, when Enterprises 1, 2, and 3 remitted their tax arrears. The Treasury substituted one bad asset, its deposit with the commercial banks, for another bad asset, tax non-remittance. The balance sheet of the banks did not worsen in appearance because a liability to the Treasury is matched by the asset in the form of the loan to Enterprise 2. The balance sheet of the banks did not worsen in reality, because the Treasury would not withdraw its deposit in the near future and, when it does, the Central Bank can be expected to monetize this amount. The government balance sheet did not worsen in appearance and in reality (one bad asset, another bad asset). But the budget has improved in appearance.

The third episode, which we depict in figure 3, is involved. The Treasury credited R40 billion ($1.35 billion) of tax non-remittance of Enterprise 2, The Unified Energy System, in the (so called) tax offset for the latter's re-purchase of a specious debt. This is the trade debt of the former Soviet Union to former Czechoslovakia. A partner of Enterprise 2, the Czech financial operator felicitously called Falcon, purchased the book value of $1.35 of Soviet debt from the Czech government at the discounted market value of $0.4 billion and sold it to Enterprise 2 for $0.55 billion. The Treasury accepted the book value of this debt, $1.35 billion, from Enterprise 2 in lieu of tax payments and recorded this so called offset as budget revenue.

A comment: The Treasury reduced its liability, external debt, and its asset, tax non-remittance, by

FIGURE 3. THREE FISCAL EPISODES, RUSSIA, DECEMBER 2001: EPISODE 3



the same amount and increased its tax revenues by this amount.[2] According to the ten-year Russian practice, accepted by the IMF and Western auditors, the Treasury does not increase its expenditure on debt service or retirement or any other expenditure by the same amount when it conducts offsets and credits enterprise tax liabilities. As we discussed in chapter 1 of *From Predation to Prosperity*, the general problem with using tax offsets is twofold. A lesser problem is that the government credits tax payments in exchange for services performed by enterprises on government behalf at prices far exceeding market prices. A bigger problem is that the government records these tax credits (offsets) as revenues received in cash but does not record services, for which offsets are made, as budget expenditures. Revenues are overstated or expenditures are understated, and tax non-remittance is also understated. Usually, tax offsets involve domestic sales of inputs by enterprises to other enterprises on government direction. The episode above is unusual only in that it involves capital account and government debt. Falcon made $150 million in one flight-by-night operation. The Unified Energy System received an $800 million subsidy—an electrifying (taxpayers could say, electrocuting) switch. The Treasury books—although not the real budget—fared even better: External debt is reduced by $1.35 billion, tax non-remittance is reduced by R40 billion, and recorded tax revenues increase by R40 billion. All that at no recorded cost.

Figures 1, 2 and 3 depict these episodes. Figure 4 consolidates their flow of funds.

Fiscal implications

The fiscal arithmetic is straightforward even if the accounting practice is convoluted. Russian GDP in 2001 can be preliminarily estimated at R9 trillion (about $300 billion at the current exchange rate, but twice as much in world market prices, at purchasing power parity). Russian federal budget revenues can be preliminarily estimated at R1.5 trillion ($50 billion). The subsidies in the three episodes above add up to $2.85 billion: $0.5 billion to Enterprise 1 and $0.2 billion to other enterprises in the first episode, $1.35 billion to and through Enterprise 2 in the second episode, and $0.8 billion to Enterprise 2 in the third episode. These numbers sum up without double accounting. The unrecorded government expenditures or overstated federal revenues add up to $3.4 billion: $0.7 billion in the first episode, $1.35 billion in the second episode, and another $1.35 billion in the third episode.

These three episodes alone dispense subsidies worth 5.7% of federal budget revenues and nearly 1% of Russian GDP. They understate government expenditures or add non-existent federal budget revenues by almost 7%. The federal budget surplus is overstated or potential budget deficit understated by 1.1% of GDP. When the federal budget surplus is projected in the range of 2.0-2.5% of GDP, these three episodes alone can erase it by half. If there are reasons to think that these episodes are not exceptional, a federal budget surplus is 2001 becomes tenuous and a budget deficit possible.

[2] Although tax non-remittance is delinquent and represents a sunk debt, it still constitutes an asset on the government balance sheet. This asset can be compared with non-performing loans which banks retain on their balance sheets.

A short-term cause: Re-liberalization of capital account

Why such a flurry of hectic activity in December 2001? The outlook for the federal budget has sharply deteriorated in view of declining world energy prices and other commodity prices and especially since the reduction, in Summer 2001, of the rate of mandated repatriation of export revenues from 75% to 50%. Re-liberalization of capital account is yet to reveal its full impact in 2002 but the preliminary data for 2001 already indicate some of its effects.

Russia's current account balance declined from $46.3 billion in 2000 to an estimated $34.2 billion in 2001, and from $20.9 billion in the first half of 2001 to $13.2 billion in the second half of the year.[3] The impact of declining oil and other commodity prices has been compensated by increasing export volumes, so that oil export revenues fell only slightly, from $25.3 billion in 2000 to $24.4 billion in 2001, and total energy exports remained around $52 billion. Total merchandise exports and the officially recorded non-repatriated export proceeds worsened insignificantly in 2001 compared with 2000. Tax remittance and the budget should not have lost ground on that account. But there is a mysterious capital transfer from Russia to the rest of the world in the amount of $10.4 billion in the third quarter of 2001, immediately after the reduction in the mandated repatriation rate of export revenues. It implies that Russia has reversed from being a net recipient of foreign direct investment of $11 billion in 2000 to a net direct investor of $10.4 billion in 2001. That is as if Russia built and owns an oil pipeline in Alaska or an automotive plant in India. Without anecdotal evidence to corroborate this point, an accounting dissection suggests that $10 billion of capital transfers (and several billions more, to nullify the amount of foreign direct investment in Russia) hides simple external capital outflow, in the form of non-repatriated export revenues by commodity exporters.

Apart from the reduction of the mandated repatriation rate of export revenues, there were no other factors in the second half of 2001 to negatively impact tax remittance and the budget. There were certainly no other factors to accelerate monetization for the purpose of financing enterprise tax remittance.

A systemic cause

The years 1999-2001 have been unusual. Rising energy and other commodity prices coincided with de-liberalization of capital account—mandated repatriation of 75% of export revenues (50% since mid-2001). This capital control served as an enforcement of tax remittance. As a result, Russia minimized the budget deficit and, at times, even ran some budget surplus. The budget surplus was not as large as reported because part of recorded tax revenues represented tax offsets (cash revenues were overstated or budget expenditures were understated), but it was still a surplus. Mandated repatriation of export revenues also helped dissipate arrears in enterprise receivables. Faster payments increased the turnover of output. This led to economic growth under ample supply capacity left idle during the Great Contraction

[3] These and the following data on the balance of payments are cited from the Internet site of the Central Bank of Russia, at http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=bal_of_payments_est_e.htm and http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=bal_of_payments_01_e.htm.

of 1992-98. We presented the data to document this unusual turn of events in 1999-2001 on this web site (see "The Secret of Russia's Economic Growth" and "Bush and Putin at the Ranch").

These unusual chain of events and policy arrangements of 1999-2001 are fading away. Russia is gradually sliding back to rising enterprise arrears, tax non-remittance, its monetization, budget deficits, and output contraction. They characterized the Russian economy in 1992-98. The systemic features of Russia's post-Communist economy outweigh short-term reliefs. Figure 4 consolidates the three episodes of figures 1 through 3 and demonstrates these systemic features. It shows that tax remittance by enterprises depends on payments by other enterprises and, ultimately, on subsidies (tax credits, loans, etc.) from the Treasury and monetization by the Central Bank. Enterprises, in turn, rely on government subsidies and bank loans, which are monetized by the Central Bank, and also on tax non-remittance to make payments for inputs to suppliers. Tax non-remittance subsidizes enterprises because they collect payroll taxes from workers and value-added taxes from consumers but do not remit them to the Treasury until they receive an alternative subsidy.

We discussed these systemic relations in detail in chapter 1 of *From Predation to Prosperity*. Figure 4 demonstrates that these relations are possible because enterprises do not exist as independent units with separable finances but they rather act as a unified network with the unified and fungible flow of funds. Loans to one enterprise (themselves originated from the Central Bank or from the Treasury) become loans and payments to another enterprise and this other enterprise's remittance of taxes to the Treasury. The enterprise network thus collectively derives a significant proportion of its income not from the market but from the Treasury, the Central Bank and, through tax non-remittance, directly from taxpayers. As we discussed in chapter 2 of *From Predation to Prosperity*, this system of Enterprise Network Socialism naturally evolved from central planning. Under central planning, the entire economy functioned as the nation-enterprise. Abolition of central planning and withdrawal of government from forcing production left the nation-enterprise intact and devolved it into the liberalized and privatized enterprise network. We call this new system Enterprise Network Socialism.

Its principal feature is that subsidies to enterprises are not given by the government but taken and self-enforced by enterprises. If the government does not provide subsidies such as bank loans (monetized by the Central Bank) or Treasury subsidies (loans, tax credits, etc.), enterprises do not remit taxes, that is, they confiscate tax collection. If the government tries to enforce tax remittance, the enterprise network slows down payments to suppliers, which spreads the payment jam throughout the economy and further disables tax remittance.

Figures 5 and 6 demonstrate how the enterprise network uses the payment system to enforce subsidies to itself. The figures plot the two largest subsidies, tax non-remittance and Central Bank monetization through the banking system.[4] They also plot enterprise receivables, which are about three month in arrears on average and which serve as a claim on subsidies and as a device of enforcing subsidies.

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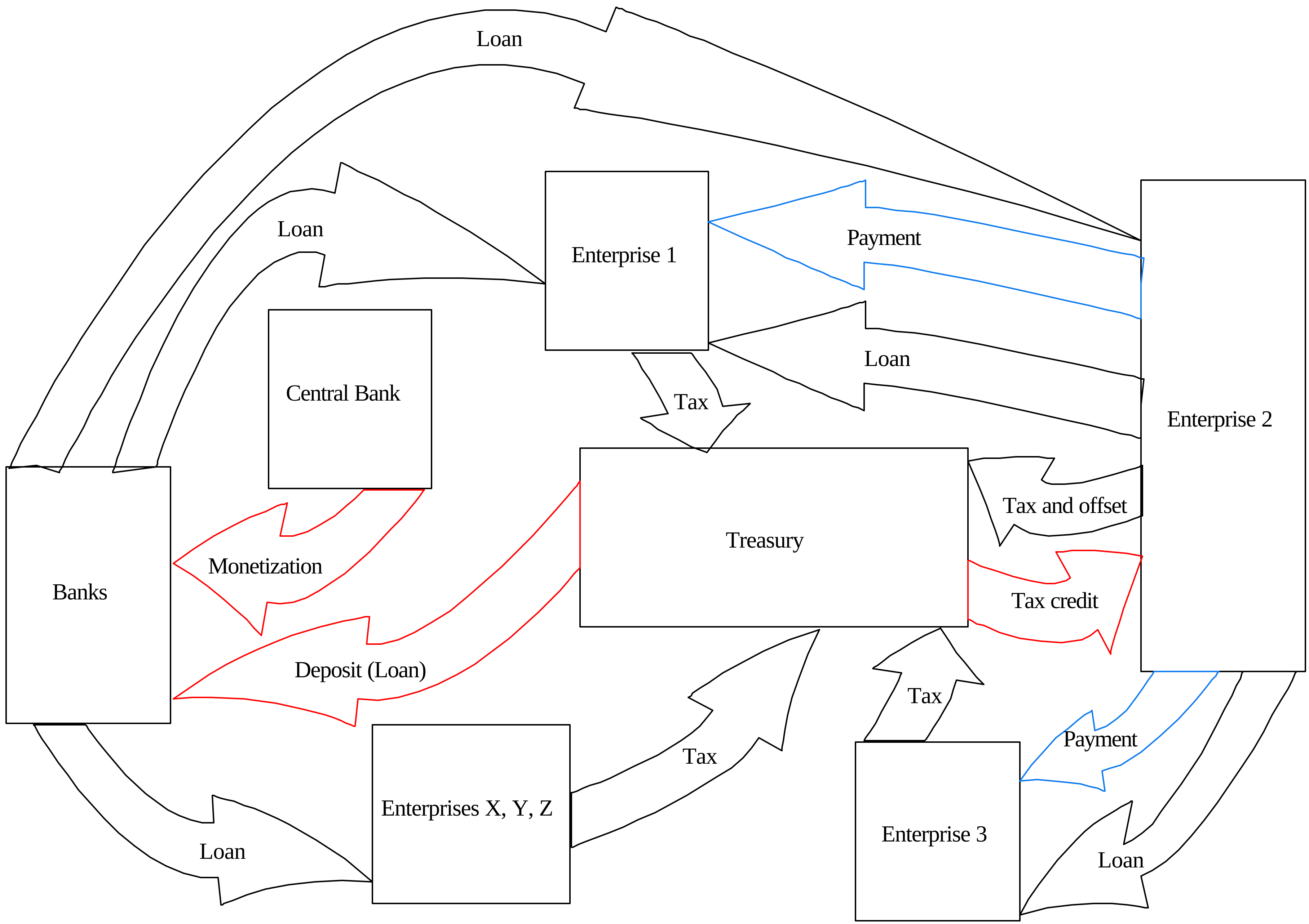
[4]Chapter 1 of *From Predation to Prosperity* explains why we use the money stock M2 to approximate this monetization.

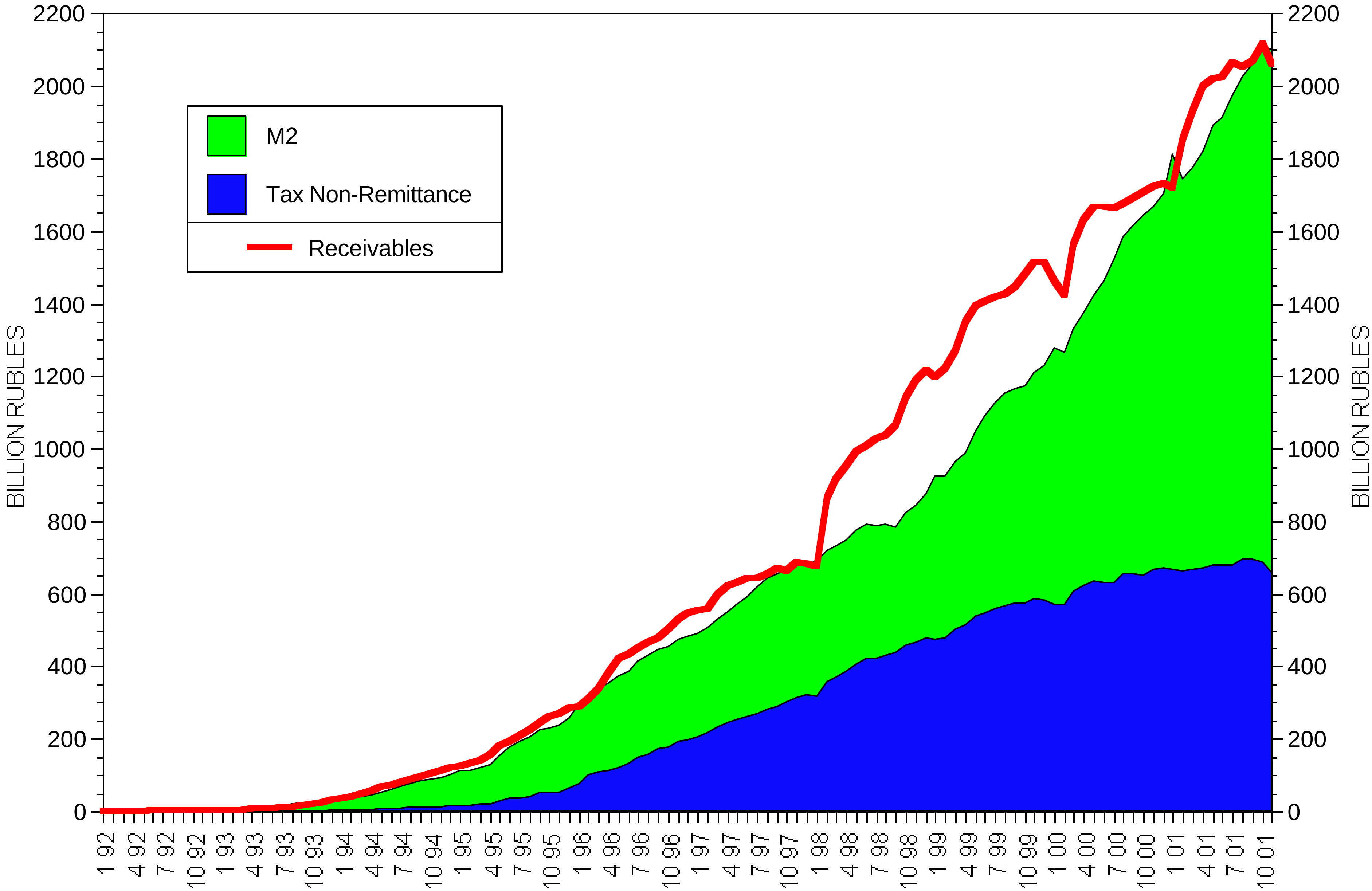
FIGURE 4. FUNGIBLE COMMON INCOME UNDER ENTERPRISE NETWORK SOCIALISM



The national data extends month by month for almost ten years, from January 1992 to November 2001. Figure 5 presents the data on the linear scale, figure 6 places the same data on the logarithmic scale. Figure 5 shows tax non-remittance and monetization as additive areas, figure 6 sums them up in one line. We use two scales for the same data in order to nullify the visual effect of the high inflation of the early 1990s and this provide a comprehensive illustration over the entire ten-year period. Because of high inflation in the early 1990s, the linear scale makes all values in those years too small and indistinguishable on the diagram. The logarithmic scale corrects this impression. Both figures demonstrate the close match between the claims on subsidies (enterprise receivables in arrears) and the actual subsidies (the sum of monetization and tax non-remittance).

Tax non-remittance slowed down in 2000-2001, as mandated expatriation of export revenues increased liquidity and allowed the government to enforce more tax remittance. A reversal of this temporary state of affairs will increase enterprise subsidy in both its major components, tax non-remittance and monetization for the purpose of tax remittance. Enterprise receivables in arrears will rise as the mechanism of pushing the limits of the self-enforceable subsidy. The three fiscal episodes in December 2001 may represent a harbinger of this development. It will be interesting to follow this development as a natural test of our hypothesis.

FIGURE 5. THE SELF-ENFORCEABLE TAX SUBSIDY: THE RELATIONSHIP BETWEEN ENTERPRISE RECEIVABLES, TAX NON-REMITTANCE, AND MONEY, RUSSIA, 1992-2001

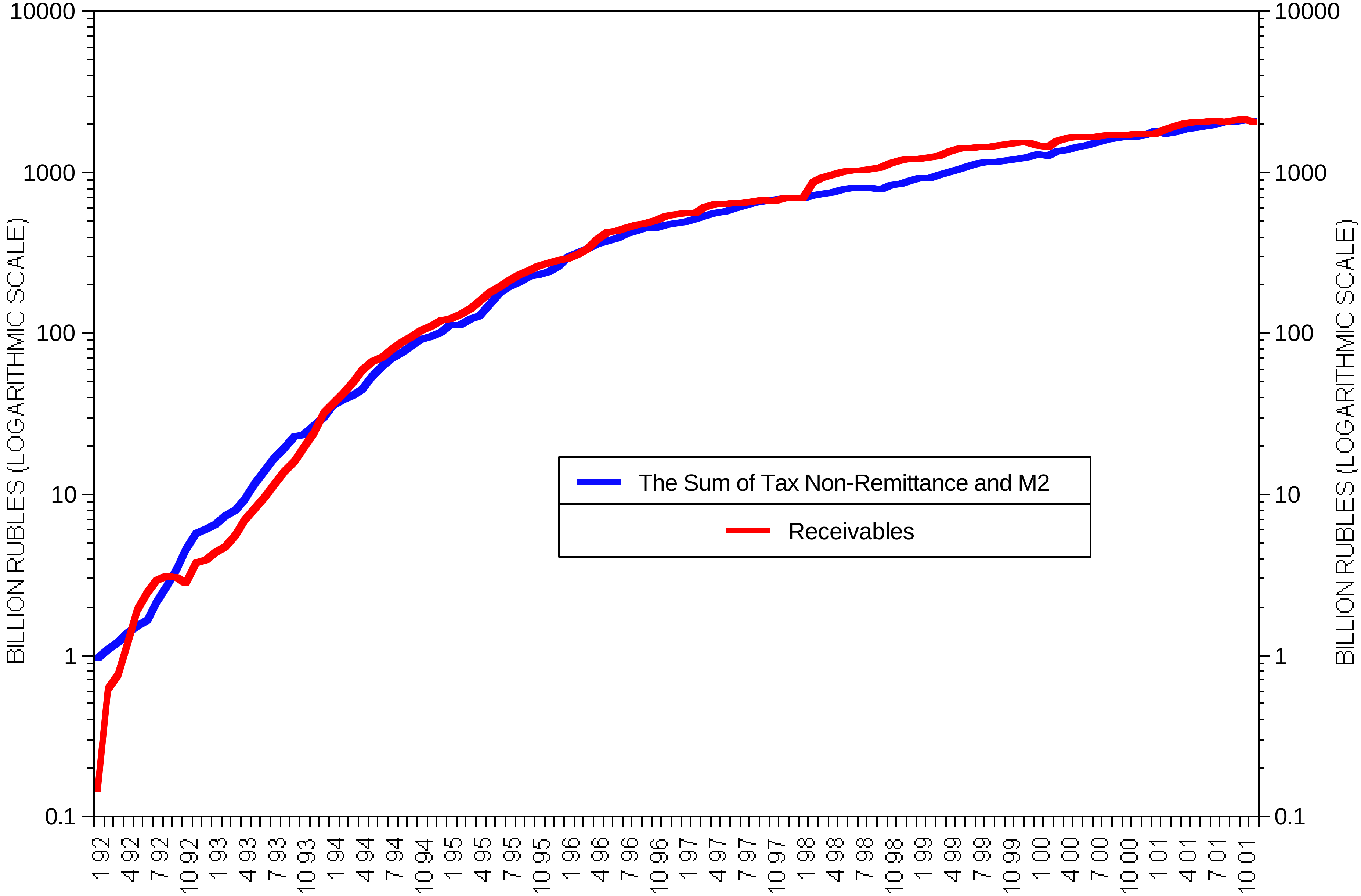


Note: All data are denominated in billion 1998 nominal rubles.

Sources: Receivables and tax non-remittance: Russian State Committee on Statistics.

Money: Central Bank of Russia.

FIGURE 6. THE SELF-ENFORCEABLE TAX SUBSIDY: THE RELATIONSHIP BETWEEN ENTERPRISE RECEIVABLES, TAX NON-REMITTANCE, AND MONEY (LOGARITHMIC SCALE), RUSSIA, 1992-2001



Note: All data are denominated in billion 1998 nominal rubles.
Sources: Receivables and tax non-remittance: Russian State Committee on Statistics.
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