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Fiscal Crisis and Macroeconomic Stabilization in Russia

The economic liberalization in 1992 allowed Russia to try solving various urgent problems: to liquidate monetary overhang and shortage of goods, create money-based market mechanisms of exchange, improve public finance, start negotiations on restructuring the sovereign debt accumulated by the Soviet Union, raise official foreign reserves, and open the economy for international trade. Among important institutional changes at that time were establishment of the two-level banking system, privatization of a considerable part of state enterprises, and capital market creation.

However, all these steps were necessary for the first stage of reforms, but not sufficient to improve investment opportunities and the overall economic environment substantially. In particular, the political situation in Russia in 1992–97 was the main obstacle for macroeconomic stabilization and a radical reform of public finance.

The Chronic Fiscal Crisis

The dramatic increase in the budget deficit in 1991 was predetermined by the earlier economic evolution. A budget crisis in the Soviet Union began to be manifested from the mid-1980s, although this was not

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officially recognized until the beginning of the nineties. The most important reason for the chronic fiscal crisis of mature socialism is the gradual degeneration of central planning and hierarchical management. This in turn was preconditioned by weakening the repression mechanism and eliminating the specific incentives of the orthodox model of the socialist economy. Numerous attempts to offset these changes by partial reforms of planned economy aimed at utilization of various economic incentives (orientation of state enterprises on profit maximization, improvement of the state-controlled price system, and so on) had in fact an opposite effect on productivity and merely speeded up the decay of the planned economy.

The growing share of profit at the disposal of enterprises caused the reduction of the state budget revenue. Attempts in the late eighties to deregulate wholesale prices occurred while retail prices remained fixed. This automatically reduced the turnover tax¹ and increased price subsidies to enterprises.

Among other important factors of mounting budget distortions at the end of the eighties were: the fall of world prices on raw materials, growing military expenses caused by the arms race and the war in Afghanistan, wrong widescale economic decisions in the mid-eighties—for instance, the attempt to begin new industrialization or the antialcohol campaign, which sharply reduced budget income. A series of widescale catastrophes such as the explosion of the nuclear power station in Chernobyl and the earthquake in Armenia required unexpected budget expenditures.

In 1991 the loss of price control led to a dramatic fall of turnover tax. This was aggravated by the collapse of the Soviet Union, which enforced the degeneration of public finance (republics dramatically reduced transfers to the state budget but continued to receive financing from the central budget). As a result, the deficit of the reconstructed state budget of the Soviet Union was 31 percent in 1991.² Under suppressed inflation, the budget deficit was actually financed through the decline of purchasing power of money and nonvoluntary saving by households and enterprises.

The price liberalization in 1992 improved the budget situation. Price subsidies were sharply reduced and a value-added tax was introduced as an instrument of fiscal policy under free market pricing. Due to the liberalization of foreign exchange policy and introduction of a unified exchange rate (the internal convertibility) of the ruble in summer 1992,

import subsidies to enterprises were also reduced. Defense expenses were sharply cut too, from about 7–8 percent of GDP in 1991 to 4 percent in 1992.

As a result, the federal budget deficit was 5 percent of GDP in 1992 and 8 percent in 1993, according to official statistics. According to our estimates, taking into account the quasi-budget operations, the deficit in these years was 29 percent of GDP and 10 percent, respectively.³ Thus, by 1993 the budget deficit notably diminished, but not sufficiently for the beginning of financial stabilization at that time. Still quite huge, the deficit could not be financed without money creation, because the market for government debt did not exist at that time. International financial support was conditioned on the firm intentions (and abilities) of the government to improve public finance and reduce inflation.

Under these circumstances two strategies of reforming the public finance were available. The first strategy was to increase budget revenue by carrying out a tax reform. The second was to reduce and restructure budget expenses. This required a number of deliberate institutional transformations, such as reforming the state management and civil administration, military forces, housing, and utilities. The reform of housing and utilities aims mainly at substituting subsidies to state-owned production units by subsidies to poor households and creation of competitive environment in these sectors. The expenditure-side strategy of reforming the public finance could ensure a sustained long-term budget equilibrium necessary for investment-led economic growth, but its implementation required competence, time, and significant efforts. The implementation of any strategy of improving the public finance required social stability and a certain political will. None of these conditions was fulfilled until 1994, when political circumstances favored the beginning of financial stabilization.

It was easier to begin the macroeconomic stabilization at the end of 1994 by several reasons. First, the adoption of the new Russian Constitution in 1993 and the dramatic change of the political system enabled the fulfilment of unpopular economic measures. Due to the considerable concentration of power under the president, the government was no longer dependent on the populist parliament and stopped the myopic policy of balancing between the threat of resignation and the continuation of reforms.

Second, the new constitutional and legal conditions imposed barri-

ers for adopting populist budget decisions. The budget process in the new conditions met a strict formal procedure, and any decisions concerning the federal budget could be adopted by the State Duma only in case of a governmental resolution. All that made the situation radically different from the chaotic budget discussions in the Supreme Soviet of 1992-93, when budget amendments could be adopted "by voice" and revised at any time.

Third, the balance of political forces in the State Duma of the fifth convocation elected in December 1993 did not favor the adoption of any budget amendments: the left and right parties automatically blocked each other's decisions. The government had to manoeuvre between opposing to get the approval of the submitted budget proposal. However, in cases of deadlock the budget process could be conducted through presidential decrees and this compelled political parties in the State Duma to find compromises.

These political changes were not sufficient to ensure the long-term stabilization of public finance. In fact, there was no restructuring of the expense side of the federal budget, and neither of the above structural reforms was carried out. Instead of reducing social expenditure with a simultaneous redistribution of social subsidies to poor groups, only total reduction took place. This sharply increased income differentiation and decreased the efficiency of health care, education, science, and the cultural sphere. Instead of reducing the army with a sequential cut of defense expenses, these expenses were cut without any attempt to reform the army, and that had extremely negative consequences for the armed forces. However, the reduction of budget spending in 1994-95 made possible the beginning of macroeconomic stabilization in 1995.

Macroeconomic Stabilization in 1995

For political reasons, the adjustment of budget expenditures necessary for macroeconomic stabilization could not be accomplished before 1994. The same obstacles prevented tightening of monetary policy. Until the summer of 1992 each former union republic could issue money and thereby obtain unilateral benefits from the uncontrolled emission. The separation of monetary systems began from the introduction of correspondent accounts of the republics' central banks in the Central Bank of Russia in 1992 and the subsequent introduction of

new currencies in the former Soviet republics. However, it took a year to stop the supply of so-called technical credits, automatically issued by the Central Bank of Russia in case the republic had a negative trade balance in the bilateral trade with Russia. Actually, this emission was not under the control of Russian government.

In 1993–94, this and other channels of money issue were closed. The Central Bank of Russia rejected the supply of cheap credits to some branches of the national economy. According to the new rules adopted in 1993, centralized credits to firms could be channelled only through the state budget within the approved limits. The Central Bank's loans to the government remained for a while the major source of money issue, abolished only in the fall of 1994.

In fact, the loose monetary policy in 1992–93 is explained by the dependence of the Central Bank of Russia on the populist Russian parliament. According to the new Constitution of December 1993, the Central Bank became an authority completely independent from the legislative and executive authorities. However, in 1994–95, there still remained a considerable informal dependence of the Central Bank on the executive power, as the Central Bank was headed by the deputy chair and nomination of a candidate remained a prerogative of the president. Fortunately, Boris Yeltsin's firm support of the stabilization policy neutralized the vulnerable position of central bankers.

The tight monetary policy in 1995 aimed at the reduction of average monthly inflation rate from 10.5 percent in 1994 to 4 percent in 1995. The monetary program adopted by the government and the Central Bank planned a 4.2 percent average monthly growth of money supply in 1995. This program received the consent of the International Monetary Fund [IMF] before Russia received a standby credit of \$6.4 billion. To control fiscal growth, the program imposed monthly limits on the growth of net domestic assets of monetary authorities and monthly upper bounds for net claims to the enlarged government. According to the monetary program, the Central Bank promised not to provide loans directly to the government. The financing of the ruble-nominated part of the budget deficit was supposed to rest on the supply of government securities. The program did not involve explicit pegging of the ruble exchange rate and did not impose any binding commitment on exchange-rate dynamics.

Thus, the choice was in favor of an orthodox stabilization on the basis of money supply control. Initially, the monetary program was not

based on the standard nominal anchor mechanism. This approach seemed quite flexible and was justified in the macroeconomic situation at the end of 1994. First, a loose monetary policy⁴ conducted during that year caused a raise of inflation in the fall and provoked a series of speculative attacks on the ruble in September–October 1994. Gross official currency reserves were exhausted during the attacks; the subsequent real ruble appreciation was motivated by pure political reasons⁵ and reduced to 1.5 billion dollars in January 1995. At that time the government was ready to undertake an extreme measure—a sharp devaluation of the ruble. Obviously, this would be inconsistent with the stabilization program and could cause a new wave of inflationary expectations. Besides, ruble devaluation would probably lead to the immediate resignation of the reform government.

Second, pegging the exchange rate at the beginning of stabilization was impossible because of the lack of credibility of the monetary program and the government's fiscal policy. This was a crucial issue at the beginning of 1995 because three previous attempts of financial stabilization in 1992–94 had failed (merely for political reasons). Any attempt of the government to return to the inflationary financing of the budget deficit with pegged exchange rates would have implied the failure of the stabilization policy. Therefore the government and the Central Bank had to begin with a tight policy of money-based stabilization.

However, the exchange rate policy, conducted during the first months of monetary stabilization, confused financial markets. To accumulate foreign exchange reserves, the Central Bank continued accumulation of foreign exchange reserves through the policy of managed ruble depreciation. Although in January and February 1995 this policy had credibility, in March and April it was in contradiction to the objectives of tight money control. As a result of artificial dollar appreciation, in March and April the Central Bank purchased over \$5 billion of foreign currency. The monetary base growth was 48 percent in the second quarter instead of the target rate of 15 percent. The accumulation of such a volume of international reserves violated the monetary program but ensured the stability of the foreign exchange market in the second half of 1995 and in 1996.

The introduction of the exchange rate corridor of 4,300–4,900 rubles/\$ in July 1995 prevented the fall of the dollar rate below 4,000 rubles/\$ due to overshooting and further decreased inflation expecta-

tions in the autumn. Thus, only in the second half of 1995 could the mechanism of a nominal anchor actually work. The exchange rate-based reduction of inflation expectations in autumn 1995 would be impossible without the tight anti-inflation policy conducted at the beginning of stabilization. Table 1 in the Appendix (p. 64ff.) demonstrates macroeconomic performance in 1995.

In assessing the real effect of the anti-inflationary exchange rate policy in 1995, one should take into account that the real exchange rate of ruble rose by 76.5 percent during that year (in 1994 this rate increased by only 14 percent, and in the first quarter of 1995 by only 4.4 percent). Initially, the macroeconomic program assumed a stable or slowly growing real rate of the ruble. But the increase of real returns on ruble assets and the switch of expectations in the second quarter of 1995 caused a vigorous process of "dedollarization." A growing foreign currency supply could lead to a further overaccumulation of foreign exchange reserves or a higher real ruble appreciation. The actual policy was a tradeoff between these alternatives.

Due to the inflation inertia, the 1995 federal budget underestimated the inflation rate and the actual nominal budget revenue exceeded the planned level by 1.3 times. This favored the fulfilment of the monetary program since there was no automatic indexation of nominal budget expenditures. In line with the monetary program, the 1995 Budget Law included a special order for financing the government. This order excluded the Central Bank credits as a source of budget deficit financing and increased the responsibility of the fiscal authorities for budget expenses. During 1995 total expenses and loans net of redemption from the federal budget were 16.9 percent of GDP. In real terms, the federal budget expenses were reduced by 34 percent in 1995 compared to the previous year. The federal budget deficit was 4.7 percent of GDP in 1995 against 10.9 percent of GDP in 1994.

Financial stabilization and real appreciation of the ruble triggered the beginning of capital inflow to Russia. This in principle could lead to a decrease of the cost of external finance for industrial firms. Reduction of bank loan rates and rates of return on financial speculation increased the attractiveness of industrial investment for financial institutions. In the second half of 1995 the largest Russian banks notably amplified their activity in the industrial sphere despite the severe liquidity crisis. This change of strategy in banking was manifested in the increasing creation of subdivisions aimed at strategic investment

and in the aggravation of rivalry between banks for acquisition of shares of privatized enterprises.

The Acute Tax Crisis in 1996

Reduction of the budget deficit in 1995 occurred without improvement of the structure of public expenses and tax reform. In fact, the government only reduced state expenditures in real terms according to actual inflation because of the absence of an automatic indexation mechanism.

The dramatic decline of tax revenue was inevitable under the myopic fiscal policy delaying radical tax reforms. The main reason for the *tax* crisis is the structure of the tax system, inherited from the socialist economy. The fall in real production under the dominant share of corporate taxes in budget revenue explains the decrease of absolute revenue. Although at the early stage of market transformation, in 1992–93, it was possible to offset the decline of tax revenue by partial improvements of the taxation technique, in 1994–95 these opportunities were no longer available.

Another reason for the decline of the marginal tax rate in 1995–96 is the fall in tax discipline of large industrial enterprises. This was aggravated by the structural shifts in Russian economy: a growing share in GDP of private sector and services, initially characterized by a lower tax discipline. The expanding scale of tax evasion is confirmed by a close statistical link between the level of tax collection and the share of cash in the broad money aggregate M2. Our estimates show a stable statistically significant negative dependence.⁶ Besides that, economic agents learned to make use of various tax evasion methods, including legal ways granted due to tax relief.

The development of political mechanisms and the growing influence of financial and industrial groups led to the spread of lobbying institutions. In 1995–96 the increased lobbying activity resulted in a variety of new tax privileges granted by all levels of power.

As a result of the peculiarities of the Russian fiscal system, the tax pressure has been high only for loyal taxpayers obeying the rules. At the same time a considerable number of taxpayers possesses unreasonable privileges and (or) evade taxation illegally. This results in an unfair and uneven distribution of tax burden. The major burden is carried by large industrial enterprises because they have fewer oppor-

tunities to evade taxes (their technological opportunities, production capacities, and business connections are relatively transparent to tax authorities). A longer production cycle and a higher share of physical capital in such firms also matter. In an inflationary environment these factors raised the efficient tax rate of large capital-intensive firms. Among the population the main burden is on groups with average levels of income relying on legal salaries. Individuals with high income had many ways, not only illegal, to evade taxation (for instance, personal expenses can be represented as corporate expenditures and are deducted from the profit tax base; high salaries can be received as nontaxed interest payments, etc.).

An unevenly distributed tax burden caused the increase of tax arrears. Of course, the main reason for this phenomenon in the postcommunist economy is the lack of an efficient bankruptcy mechanism. However, the volume of tax arrears remained relatively stable up to the beginning of 1996, when it dramatically increased. In particular, the share of tax arrears in GDP rose by over 37 percent for January 1996. The dynamic of tax arrears demonstrates a close connection of this phenomenon with the presidential election in June 1996 in Russia. This election caused a temporary weakening of federal power and narrowed the bounds for a discretionary fiscal policy.

A considerable growth of tax arrears began in January 1996 due to the election campaign. First, participation of the president in the election was inconsistent with tough actions against potential voters and this was anticipated by economic agents. Moreover, the increase of tax arrears served as an alternative mechanism for a pre-election expansionist policy typical for the traditional political business cycle.⁷

Second, enterprises took into account that communist leaders unambiguously demonstrated support to those who avoided paying taxes "to the government of national betrayal." All public-opinion polls indicated a high chance of victory for communists in January–May 1996. Heads of firms counted on a tax amnesty in the case of a communist victory, and also on the possibility of a tax amnesty adopted by a reform government with a populist leaning.

A supplementary hypothesis can to some extent explain the exacerbation of the tax crisis in 1996. A growing process of barterization of the economy accompanied by a quick spread of sophisticated schemes of nonmoney settlement was enforced by the Ministry of Finance policy in 1996. It implicitly utilized barter exchange by issuing the so-

called treasury liabilities, tax exemptions, commodity credit, and so forth. These liabilities were widely accepted and circulated in the economy as surrogate money. As a result many enterprises reduced money balances, causing the decrease of the tax base and the increase of tax arrears. In many cases enterprises transferred surrogate money to the state budget and, clearly, this did not increase budget revenue. Price distortions used by surrogate money and barter exchange among enterprises caused the decrease of the tax base. Unfortunately, the official statistics are helpless in evaluating the scale of such operations.

Thus, the 1996 tax crisis is a complex phenomenon. If it could be explained only by the election campaign, the level of tax revenue would have returned to the initial level after the victory of Boris Yeltsin. But it was not the case. Although the tax crisis improved in the middle of the year, it sharpened again in autumn. In our view the dramatic increase of tax evasion in 1996 triggered a transformation of fiscal crisis to a qualitatively new stage. Financial stabilization in 1995–96 caused the “adverse selection” among taxpayers. Earlier, tax arrears benefited individual enterprises without any notable impact on the market equilibrium. Tax evasion or relief provided excess profit that was a kind of premium for those who took a penalty risk. The increased scale of tax evasion and the widescale utilization of individual tax relief created unfavorable conditions and eliminated opportunities for efficient entrepreneurial activity. As tax evasion becomes a common practice, penalty risk vanishes and obeying tax rules no longer guarantees profitability. This is so because the price mechanism accounts for the dominant level of tax evasion. As a result, loyal taxpayers are either forced out of the market or (more often) have to choose another strategy, trying to obtain tax relief, tax delays, or using numerous illegal ways of tax evasion.⁸

In this situation the government had a choice between tax reform, aimed at increasing tax revenue, and a further accumulation of public debt. The real increase of public debt was a preferable strategy in the pre-election period by obvious political reasons: certain social expenditures, for instance, redemption of pension and wage arrears, were the prior task for the government. At the same time, expansion of debt was predetermined by political uncertainty and polarization.⁹ Since the successful beginning of monetary stabilization in 1995, there are strong economic and political obstacles preventing an explicit rejection from the tight fiscal and monetary policy. Therefore political uncertainty

and polarization led to the growth of public debt instead of the radical tax reform or at least the adoption of an active antievasion strategy. Naturally, political uncertainty in 1996 raised the risk premium for all government debt instruments. As a result, debt expansion increased the cost of public debt and stimulated further increase of tax arrears because taxpayers preferred to use very good opportunities for highly profitable short-run speculation. At the same time the burden of public expenses that were sequestered in the first half of 1996 was put off to the future.

Note that the political efficiency of debt expansion in the pre-election period was minimal. An empirical analysis of election outcome in different regions of Russia confirms that there is no statistical link between this outcome and the redemption of wage and pension arrears in the region. Actually, there is a negative link between the accumulated wage arrears and the share of Yeltsin's electorate. This share is positively correlated with average wage level and volume of foreign investment in the region.¹⁰ The evidence demonstrate that pre-election attempts of the government to get more votes for Yeltsin did not have any influence on the political preferences of population. However, the share of pre-election social transfers was highest in the regions where the Communist Party received a stable majority of votes.

The comparison of public finance performance in 1995 and 1996 shows that in 1996 the federal budget revenue further decreased (1.2 percent of GDP; see Table 2 in the Appendix). This resulted in the growth of the primary budget deficit (2.4 percent of GDP for a consolidated budget and 0.7 percent of GDP). The secondary federal budget deficit increased in 1996 compared to 1995: according to our estimate¹¹ it made up 4.7 percent of GDP (public debt interest payment was 3.2 percent of GDP) in 1995, while it increased to 7.2 percent of GDP (public debt interest payment was 5.6 percent of GDP) in 1996.

Importantly, unlike the prediction of the standard political business cycle models, the government of Russia did not give up the tight monetary policy. In 1996 the monetary program was fulfilled, with annual inflation only 25 percent. While political uncertainty in 1996 had a notable impact on financial markets, inflation expectations further decreased in that year. The major negative contribution of the election campaign on the macroeconomic performance was a dramatic raise of interest rates and redollarization of the economy. This, in turn, created barriers to enhancing the supply of bank loans to the real

sector. The gap between the money market and the loan rates is explained by high default risks. The default risk premia are still extremely high because of the lack of an efficient legal system of contract enforcement.

Note that the problem of public debt overaccumulation has not become yet so serious that it could significantly influence macroeconomic situation, as has happened in many developed and developing countries. The total value of debt, as a share of GDP, was reduced in 1994–95 by nearly half, and was 11.4 percent of GDP at the beginning of 1996. The devaluation of government debt at this period is explained by a relatively quick depreciation of direct loans to the government supplied by the Central Bank before financial stabilization, compared to the growth of real outstanding debt issued in 1995–96. Nevertheless, the total value of debt began to increase in real terms in 1996 and reached 16.2 percent of GDP at the beginning of 1997. This is not a small share for the state that has been borrowing on the domestic financial market for only four years. The stabilization of public debt will depend on the political stability and strong incentives of the government to begin the radical reform of taxation.

The Debt Crisis

All the above processes created necessary prerequisites for capital formation and growth. During the two years of financial stabilization in 1995–96, the budget deficit reduced, inflation dropped, the exchange rate stabilized, and the real interest rate went down. As a result, the credibility problem improved, and monetary authorities acquired the necessary favorable reputation. The Central Bank became an independent authority with the prior goal of ensuring and maintaining price stability. At the same time the new financial institutions were created and developed, for example, the markets for government, regional and municipal securities, and corporate equities and derivatives. A number of new financial intermediates and services appeared, such as mutual funds, investment banks, stock exchanges and over-the-counter markets for bonds and equities, a private depository system, audit, brokerage, and other services.

The tightening of monetary policy aggravated competition in banking and accelerated the selection of efficient and reliable banks. After the liquidity crisis in 1995 the Central Bank of Russia emphasized

supervision and prudential regulation in banking. It was widely recognized that stability of the banking system was one of the main conditions for beginning sustained growth of production investment.

All these processes were necessary but not sufficient for investment-led growth. The role of the government in the poststabilization phase of transitory development was unclear. The fiscal crisis dramatically diminished the state activity, which in fact was not so significant due to the market transformation. The sharp fall of government expenditures in 1995–96 without structural reforms in the public sector had a negative impact on social security, education, science, and medical care. Since private schooling and health care as well as private financing of research are in the infant state, the main sectors for the economywide supply of human capital remain seriously damaged.

Although Russian central bankers continue to adhere to an anti-inflationary monetary policy, the fiscal crisis had a negative impact on this policy's credibility. Reduction of social expenditures increased social tensions and yielded political benefits to the leftist parties. The results of regional elections in 1996–97 demonstrated strong support for communist and populist candidates. For this reason the political cycle 1996–99 is characterized by the threat of a communist comeback or ultra-nationalist counter-reform threat in the new parliamentary and presidential elections of 1999–2000. More important is that leftist and populist parties have a stable majority of seats in the State Duma and persistently created barriers to the development of market reforms by blocking the adoption of crucial laws: the land law, the tax code, the law on production sharing, mortgage legislation, and so forth.

All these circumstances aggravated fiscal problems, in particular the debt crisis that began to manifest in mid-1996. The policy of debt issue allowed the government not to print money to finance deficit in 1995. In the next year the debt expansion allowed the government to finance social expenditures, which increased the chances of Boris Yeltsin winning the presidential election. The rate of return on government securities notably decreased a year after the presidential election (from 150–80 percent per annum in June 1996 to 15–20 percent in May 1997) and debt stabilized. However, the government did not improve its solvency and this was the main reason for the default on internal debt.

In fact, due to the Yeltsin's sickness after the election, an opportunity to improve government finances radically appeared only in the

spring of 1997 with the end of the period of political uncertainty that had lasted a year and a half. But as it turned out, the reform government had a very brief period of time in which to reform the fiscal system. After the first waves of the world crisis, the government was unable to deal seriously with fiscal problems because of increasing political uncertainty and the financial crisis in Russia.

In fact, the Russian crisis was provoked by two external shocks. The first is the flight of "hot money," and the second is the dramatic decrease of oil prices, which caused the balance of payments to deteriorate. The crisis amplified because of the weakness of government finance, the lack of a credible exchange-rate system, and the fragile banking system. The issue of short-run liabilities caused a tremendous increase of budget expenses on debt service and redemption. The monthly ratio of these expenses to federal budget tax revenues averaged 150 percent in the after-election period. Simultaneously, the debt crisis approached: external debt payments were supposed to be twice as much in 1999 as in 1998. This problem was taken into account by foreign investors. All attempts of the monetary authority to prevent the ruble devaluation, even with the IMF financial aid, were useless when the government insolvency became apparent.

However, a major ruble-denominated investment in the first half of 1998 was made in government debt instruments. It was a high-risk speculative game. Government bonds and bills served as collateral for chip foreign-currency-denominated loans received by Russian commercial banks in the international market. This circumstance created prerequisites for a large-scale banking crisis caused by the ruble devaluation and the fall of bond prices. The insolvency of largest banks, in turn, undermined refinancing of short-term government debt, because the banking sector provided a significant part of demand on government instruments. These constituted the most liquid asset in the pre-crisis Russian economy. Such a causality of crises is typical for countries with weak financial systems.

To some extent the financial crisis was a consequence of the stabilization attempt of 1995–96. However, this does not mean that stabilization was a mistaken policy. In any case it is a risky but unavoidable strategy, necessary for the beginning of growth. Normally, radical anti-inflationary measures lead to real appreciation of domestic currency and deterioration of the balance of payments, excessive consumption, and increasing risks in the financial sector. In the case of Russia, the

main macroeconomic risk of stabilization was a high probability of the failure of all subsequent attempts to eliminate the gap between tightening of monetary and exchange rate regime and weakening fiscal policy. Moreover, this problem was aggravated after the stabilization attempt because the federal government voluntarily rejected such a powerful tool of revenue collection as inflationary financing. The stabilization attempt weakened the government's political and economic position and worsened its ability to implement the fiscal reform. In such a situation inflation was delayed but not completely eliminated. From this point of view, the default on government bonds announced in August 1998 was an alternative to a high-inflation regime.

The Main Tasks of Fiscal Policy

During 1995–98 the government made sporadic attempts to increase tax revenue through partial improvements in tax laws, tax administration, strengthening control of money flows and direct negotiations with managers of large enterprises. These were the key problems for the government and for international financial organizations that paid special emphasis on disability of the government radically to improve the tax system.

As an example of such a policy, the government several times attempted to conduct large-scale campaigns against tax arrears. It tried to increase the importance and political role of the state tax service. For instance, the chief of this service took the position of federal minister and further—the position of vice-premier. In 1997–98 the government also tried to condition the restructuring of tax arrears of firms with their current tax payments.

However, all these measures did not produce significant results and could not radically increase tax revenue or prevent further growth of tax arrears. The principal problem was that the marginal tax paid to the enlarged state budget exceeded 30 percent. It was too large a burden for an economy in transition with low fiscal discipline. This fact does not diminish the necessity of the radical tax reform aimed at making the tax system fair, neutral, and more efficient without an economy-wide increase of the tax burden. As an example, the state has to shift a part of this burden from honest taxpayers to those who avoid taxation using legal and illegal ways.

Another key task of the fiscal reform is to cut and restructure budget

expenses. Tables 3 and 4 demonstrate dynamics of the enlarged budget expenses in 1991 and the first half of 1998. As is seen, there was a dramatic decrease of public expenses during the market reforms. Among the mostly reduced items are military expenses, financing of the economy, and subsidies to research and development. The share of expenses in state management, public order and law, and social security remained stable. While total state expenditures fell 2.5 times in real terms, the social expenses decreased only by 32 percent.

The existing structure of government expenditures neither provides preconditions for economic growth nor satisfies conditions for social stability. The burden of social expenses estimated as 16–19 percent of GDP is too heavy a burden for a country like Russia. However, one has to take into account certain political constraints on their reduction because of social habits and guarantees inherited from socialism. Political support of market reforms also depends on the level of social expenses. In addition, public spending on education and medicare are important factors of economic growth. Therefore a preferable strategy is channeling of the major part of social support to the poorest and less protected strata of population.

The major part of other budget expenditures cannot be further cut. Reduction of other expenditure items such as state management, military and defense, law and security, or subsidies to regional budgets requires radical reforming in all these spheres, including interbudget relations. These reforms will lead to temporarily increased state expenses.

During the financial crisis the government attempted to implement reforms rationalizing budget processes on federal and regional levels. Just before the ruble devaluation it suggested a comprehensive program. However, the implemented measures were aimed at reduction of particular expenditure items. In attempting to prevent the debt crisis, the government tried to avoid fulfilling some of its obligations. The problem improved due to the default on domestic debt, but ultimately it has to be solved to overcome the chronic fiscal crisis.

Notes

1. The base for turnover tax was the wedge between wholesale and retail prices. This tax constituted one of the main sources of budget revenue in the socialist economy. In cases when wholesale price exceeded retail price, the wedge represented a price subsidy.

2. "Russian Economic Reform. Crossing the Threshold of Structural Change." World Bank, 1992.

3. S. Sinel'nikov. *Biudzhetyi krizis v Rossii: 1985–1995 gody*. Moscow: "Evraziia," 1995.

4. The Central Bank's attempts to stimulate industrial growth in 1994 were called at that time a "moderately tight" monetary policy, but this was a rather misleading political cliché used to mimic financial stabilization. As a result, the annual inflation rate in 1994 was still very high: 215 percent.

5. Speculative attacks in September–October 1994 led to the dramatic jump of the dollar exchange rate on 11 October 1994 ("Black Tuesday"). The Central Bank was suspected in market manipulation that provoked the currency market crash and allowed this authority (and several large commercial banks) to gain a very high speculative profit. The crash induced the resignation of the Central Bank chief Sergei Gerashenko, who was very reluctant to reject the inflationary policy (and for this reason was called "the worst central banker in the world" by *The Economist*).

6. *Rossiiskaia ekonomika v 1995 gody. Tendentsii i perspektivy*, 1996, no. 14.

7. W. Nordhaus. "The Political Business Cycle," *Review of Economic Studies*, 1975, 42 (April), pp. 1–25; A. Lindbeck, "Stabilization Policies in Open Economies with Endogenous Politicians," *American Economic Review*, 1976, pp. 280–312; D. Hibbs, *The American Political Economy* (Cambridge: Harvard University Press, 1987); N. Roubini and J. Sachs, "Government, Spending, and Budget Deficits in the Industrialized Countries," *Economic Policy*, 1989, no. 8 (Spring), pp. 260–76; K. Rogoff, "Political Budget Cycles," *American Economic Review*, 1990 (March), pp. 220–47; T. Persson and G. Tabellini, *Monetary and Fiscal Policy*, vol. 2, *Politics* (Cambridge, MA, and London: MIT Press, 1994), pp. 164–85.

8. There may be different approaches for a theoretical explanation of the tax crisis. One can think about a policy game under uncertainty or an endogenous policy model generating multiple equilibria with a Pareto-inferior equilibrium implying tax arrears and debt expansion. A model of interenterprise arrears with multiple equilibria was suggested by G. Calvo and F. Coricelli ("Monetary Policy and Interenterprise Arrears in Post-Communist Economies: Theory and Evidence," *Policy Reform*, 1996, vol. 1, pp. 3–24).

9. A. Cukerman, S. Edwards, and G. Tabellini ("Seigniorage and Political Instability," *American Economic Review*, 1992, vol. 82, pp. 537–55) demonstrate theoretical arguments and empirical evidence that political instability and polarization forces the government to delay the tax reform, relying instead on seigniorage as the cheapest way of financing public expenditures.

10. M. Gambarian and V. Mau, "The Economy and Election: A Quantitative Analysis," in *Rossiiskaia ekonomika v 1995 gody. Tendentsii i perspektivy*, 1996, no. 16.

11. Official data on budget expenses does not include all interest payments on government securities.

Table 1

Macroeconomic Performance of **Russia** in 1995-96

	Monetary base (bln rubles)	M2 (bln rubles)	Net domestic assets (bln rubles)	Net foreign reserves (bln rubles)	Official exchange rate of dollar, end of month (rubles/\$)	Average return on government securities (% per annum)	Interbank one- day loan rate (% per annum)	Monthly inflation (consumer price index)
Jan 1995	44,000	93,800	40,500	3,500	4,048	256.0%	222.4%	17.8%
Feb 1995	47,600	101,900	42,000	5,600	4,473	220.6%	124.4%	11.0%
Mar 1995	49,900	107,300	40,800	9,100	4,897	187.2%	125.2%	8.9%
Apr 1995	57,300	123,200	46,000	11,300	5,130	145.6%	95.2%	8.5%
May 1995	64,000	138,200	44,200	19,800	4,995	111.5%	63.7%	7.9%
June 1995	73,700	156,600	47,500	26,200	4,538	84.2%	67.8%	6.7%
July 1995	81,600	165,000	55,100	26,500	4,415	124.9%	110.8%	5.4%
Aug 1995	86,100	173,800	59,500	26,600	4,447	156.7%	103.0%	4.6%
Sept 1995	89,300	179,700	63,800	25,500	4,508	103.8%	64.5%	4.5%
Oct 1995	90,700	184,200	62,500	28,200	4,504	93.4%	31.2%	4.7%
Nov 1995	95,400	195,200	70,700	24,700	4,580	86.9%	30.0%	4.5%
Dec 1995	103,800	220,800	76,500	27,300	4,640	93.9%	48.8%	3.2%

Jan 1996	100,800	216,700	75,500	25,300	4,734	84.2%	30.0%	4.1%
Feb 1996	106,700	229,200	82,700	24,000	4,818	56.9%	26.1%	2.8%
Mar 1996	113,700	241,800	73,500	40,200	4,856	87.1%	56.3%	2.8%
Apr 1996	120,900	251,000	89,900	31,000	4,940	130.0%	34.1%	2.2%
May 1996	118,800	254,200	98,800	20,000	5,031	161.7%	31.3%	1.6%
June 1996	129,400	266,900	108,400	21,000	5,105	230.2%	52.3%	1.2%
July 1996	131,100	271,900	111,600	19,500	5,189	94.3%	38.6%	0.7%
Aug 1996	129,000	275,300	111,800	17,200	5,352	86.6%	30.3%	-0.2%
Sept 1996	125,600	276,000	110,900	14,700	5,396	72.4%	40.4%	0.3%
Oct 1996	124,000	278,800	116,700	7,300	5,455	67.8%	32.0%	1.2%
Nov 1996	125,000	282,300	111,200	13,800	5,510	45.6%	25.7%	1.9%
Dec 1996	130,900	292,500	121,400	9,500	5,554	43.7%	27.8%	1.4%
Jan 1997	123,900	297,400	120,700	3,200	5,629	40.3%	21.4%	2.3%

Source Goskomstat, Central Bank of Russia, IMF, Finmarket.

Table 2

Consolidated and Federal Budget of Russia in 1995–96, % GDP

1995

	<i>Consolidated budget</i>												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	1995*
Tax revenue	21.5	21.5	23.0	25.1	25.6	24.7	23.2	22.9	22.1	21.7	21.7	21.7	30.9
All revenue	23.6	24.6	26.3	28.2	28.3	27.1	26.5	26.8	26.3	25.6	26.1	26.1	34.2
Expenditure and loans net off redemption	25.0	25.2	28.9	30.6	30.2	30.0	29.0	28.6	28.9	28.0	28.8	29.3	39.3
Deficit	1.4	0.6	2.6	2.4	1.9	2.9	2.5	1.8	2.6	2.4	2.7	3.3	5.1
	<i>Federal budget</i>												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	
Tax revenue	100	96	100	110	112	108	107	105	104	106	106	103	
All revenue	119	126	132	139	137	130	129	133	134	135	140	137	
Expenditure and loans net off redemption	138	138	163	171	164	162	156	153	160	158	166	166	
Deficit	19	12	31	31	27	31	27	19	26	24	26	29	
Internal financing	02	15	38	29	24	22	18	12	19	14	14	14	
External financing	17	04	07	03	03	09	09	07	07	10	12	15	

1996

Consolidated budget

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	1996*
Tax revenue	145	153	164	175	177	179	182	192	191	191	194	210	292
All revenue	166	181	199	203	212	219	221	230	227	226	228	248	344
Expenditure and loans net off redemption	187	217	234	252	261	265	267	278	270	266	2659	289	420
Deficit	21	36	36	49	49	46	46	48	43	40	38	42	75

Federal budget

	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Tax revenue	68	67	74	75	74	77	80	84	84	84	87	97
All revenue	79	85	99	94	100	108	109	112	111	110	112	125
Expenditure and loans net off redemption	94	113	132	137	143	148	150	155	148	145	144	158
Deficit	15	28	34	43	43	40	41	42	37	35	33	329
Internal financing	06	17	23	23	19	22	23	26	23	21	18	18
External financing	09	11	10	20	24	18	18	16	14	14	15	15

Source: Goskomstat, the Ministry of Finance.

Note: Secondary deficit of federal budget in 1996—7.2% of GDP

*Includes extrabudgetary funds.

Table 3

Consolidated Budget Expenditure in 1991–98 (% GDP)

	1991*	1992	1993	1994	1995	1996	1997	1998
Public expenditure	69.3	65.1	48.6	47.5	41.1	43.0	42.0	39.2
1. Government	0.6	0.6	0.9	1.1	0.7	0.8	1.1	1.1
2. National defense	6.3	4.7	4.4	4.4	3.0	2.9	3.0	2.1
3. Law enforcement	1.5	1.4	1.6	1.8	1.6	1.8	2.1	1.7
4. Research	0.6	0.6	0.6	0.5	0.3	0.4	0.4	0.2
5. Social outlays and utilities								
incl.:	16	13.8	18.0	18.0	16.0	16.6	17.4	17.1
Education	0	3.8	4.3	4.4	3.6	3.8	4.1	3.6
Culture and mass media	0	0.6	0.6	0.7	0.6	0.5	0.6	0.5
Health	0	2.6	3.3	3.1	2.5	2.6	4.1	3.8
Social expenditure	0	6.8	9.7	9.7	9.3	9.7	8.7	9.2
6. Expenditure on the national economy**	18.3	20.9	12.7	10.9	9.7	9.0	9.4	7.4

*Russian budget expenditure and Soviet Budget Expenditure on the territory of Russia.

**In 1992 subsidies to importers at current exchange rate was estimated at 10.5% GDP, in 1993—1.1% GDP.

Sources: the Ministry of Finance of the RF, Goskomstat of the RF, IET.

Table 4

Real Consolidated Budget Expenditure in 1991 — 97 (bln. rubles at 1992 prices)

	1991*	1992	1993	1994	1995	1996	1997	1998 (proj)
Public expenditure	901	724	493	421	335	336	355	192
1 Government	8	7	9	10	6	6	9	5
2 National defense	82	53	45	39	24	23	25	10
3 Law enforcement	20	15	16	16	13	14	18	8
4 Research	8	7	6	4	2	3	3	1
5 Social outlays and utilities incl.	208	153	183	159	131	130	147	84
Education	—	42	43	39	29	30	35	18
Culture and mass media	—	7	7	7	5	4	5	2
Health	—	29	34	28	21	20	34	19
Social expenditure	—	76	99	86	76	76	74	45
6 Expenditure on the national economy**	238	232	129	97	79	70	79	36

*Russian budget expenditure and Soviet budget expenditure on the territory of Russia

**In 1992 subsidies to importers at current exchange rate was estimated at 10.5% GDP, in 1993—11% GDP.

Sources: Ministry of Finance of the RF, Goskomstat of the RF, IET.