

Privatization, Conversion,
and Enterprise Reform in Russia

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with a foreword by
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The State of Public Finance, Fiscal Policy, and the Budget in Russia

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The Soviet system of public finance had two stable, primary sources of budget revenue: deductions from corporate profits and a turnover tax. State spending steadily increased, however, and by 1990 the state's financial situation had worsened dramatically. The escalation of social welfare programs combined with increased government subsidies after a rise in agricultural prices in fall, 1990, and in wholesale prices of industrial goods in January, 1991 (while retail prices remained unchanged), produced a drastic financial situation. Both the federal and republic governments therefore sought to increase public revenues relative to GDP. Additional taxes were introduced, such as a sales tax and a payroll tax, to contribute to a stabilization fund. Social security payroll deductions were increased to 26 percent, while 20 percent of enterprises' depreciation allowances was withdrawn. Finally, exporters were required to sell part of their hard currency earnings to the state at an overstated ruble exchange rate. These measures were aimed at increasing the mandatory tax payment rate, which in previous years had ranged from 42 to 48 percent (around 55 percent of the GDP).

According to official estimates, under the new conditions taxes on corporate and personal incomes would go down sharply compared with taxes on enterprises' payroll and property (depreciation allowances), thus reducing the share of the items traditionally most important for a Soviet budget to increase revenues of extrabudgetary funds: the Pension Fund and the Economic Stabilization Fund.

These plans, however, remained unfulfilled. By the beginning of 1991, legal battles raged between the USSR and its constituent republics. In the course of these struggles, which threw the country's economic system into chaos, legislative bodies and governments at all levels

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made decisions that ran counter to the original budget projections in order to further their specific political agendas. Taxes on individuals and corporate profits were lowered, the sales tax was transformed from a cumulative *ad valorem* tax (as originally planned) into something like a value-added tax (VAT), and many goods were exempted from sales tax. Important macro-economic processes were also occurring, adversely affecting public finances by reducing the tax base.

As early as the end of the first quarter of 1991, it became clear that it would be impossible to implement the original budget plan: actual revenues to the Soviet federal budget were only 40 percent of planned revenues, and revenues to the Russian budget only 60 percent of those planned. The retail price reform of April 2, 1991 was an attempt to improve the budgetary situation. Retail prices were approximately doubled and partly liberalized. The aim of the reform was to reduce subsidies and increase income in the form of the turnover tax, the profit tax, and the sales tax. Unfortunately, this did not happen, primarily due to the almost complete disintegration of administrative control over prices and incomes. Price reform required corresponding wage increases, which increased the budget deficit. This resulted in the faster growth of wholesale prices compared with retail prices (295 percent and 240 percent, respectively, in 1991), which in turn meant increases in budgetary subsidies and reduction of the turnover tax receipts, and counteracted the positive influence price reform had on public finances.

In the first half of 1991, the Soviet federal budget deficit reached 60 billion rubles, approximately twice the planned target. In spite of substantial cuts in expenditures, the Russian republic's six-month budget deficit totaled 10 billion rubles, the figure originally planned for all of 1991. By the end of the year, the increasingly strained relations between the central government of the USSR and the republics' governments and the subsequent disintegration of the Soviet Union complicated the budgetary situation still further. The Soviet budget deficit for 1991 totaled 83.2 billion rubles, and together with the All-Union extrabudgetary economic stabilization fund amounted to 119.6 billion rubles. Taking into account use of state credits to keep farm produce prices from rising, the 1991 deficit of the Russian republic totaled 109.3 billion rubles. On the whole, the total budget deficit of the Soviet Union (including local budgets and extrabudgetary funds) increased from 8 percent of GDP in 1990 to about 15-16 percent in 1991, not including receipts from and expenditures on foreign economic activities.

The urgent financial situation, combined with the increasing slump in production and foreign trade, determined the need for immediate economic reform in Russia. The liberalization of many prices turned suppressed inflation into overt inflation, and the government's attempts to avoid hyperinflation while liquidating the "ruble overhang" demanded tough budgetary, credit, and monetary policies. To a great extent, this dictated the basic principles of the tax reform: stabilizing direct tax exactions at the levels of 1988-1990 (40-42 percent of GDP), increasing the share of indirect, *ad valorem* taxation, which would provide budgetary revenue from growing prices (by introducing VAT at a 28 percent rate), and creating equal taxation conditions for enterprises and firms under any forms of ownership.

In addition, the relation between revenues and implementation costs had changed radically. This is explained not only by the transitional nature of the Russian economy, but mainly by the fact that in 1992 the public finance system began for the first time to fulfill all the functions characteristic of the budget of an independent state.

The Russian State Budget in 1992

In 1992, Russia's financial policy went through three phases. The first phase, which lasted through the spring of 1992, was characterized by a relatively tough budgetary policy. In the summer, the government adopted a softer budgetary policy, leading to a sharp increase in the deficit. The third phase, from the fall until December, saw the implementation of emergency restrictive measures and a tougher budgetary policy.

The original budget estimates for the first quarter of 1992 provided for balanced revenues and expenditures through drastic spending cuts, primarily in the national economy and defense. As revised by the Supreme Soviet, by contrast, the first-quarter budget envisioned a budget deficit of 5.8 percent of the forecast Russian GDP. The first-quarter deficit in fact totaled around 3.8 percent of GDP, taking into account the expenditures envisioned by the Supreme Soviet's plan for the first quarter but financed in April. Not counting these expenditures, the budget deficit would be about 0.3 percent of GDP. This figure was achieved by implementing the budgetary expenditures, which were about 85 percent of the revised plan's target, as revenue came in. The emphasis on tough budgetary policies continued in April and May 1992. In April the budget deficit reached 1.1 percent of GDP, and in May 4.1 percent of GDP.

By spring, however, the president and the government faced mounting pressure to give financial support to enterprises and the population at large. As a result, the period from May to August saw the enactment of about two dozen laws, presidential decrees, and government resolutions that channeled about 400 billion rubles of extra funding to social needs. Industry, agriculture, and other economic sectors received government credits through the Central Bank.

Compared with the first quarter, budgetary expenditures in the national economy in the first half of the year grew from 7.9 percent to 9.7 percent of GDP, totaling 11.8 percent of GDP in the first seven months and 13.3 percent over the first eight months of 1992. Social spending increased from 6.8 percent of GDP in the first quarter to 9.3 percent of GDP in the first eight months of 1992, defense expenditures rose from 4.2 percent of GDP to 6.3 percent of GDP, and expenditures on the state administration bodies and law-enforcement agencies went from 2.9 percent of GDP to 2.5 percent of GDP.

Combined with the discrepancies between planned and actual revenue, these expenditures sharply aggravated the state of public finances. In the first half of 1992, Russia's budget deficit totaled 7.5 percent of GDP. By July, the deficit had reached 9.9 percent of GDP, climbing to around 13.5 percent by August.

The end of the summer saw the monetarization of the budget deficit through increasing loans to enterprises and trade surplus with the states in the ruble zone. This combined with the accelerating growth of the money supply resulted in rapid price increases and a plunge in the ruble exchange rate. Such structural factors as the introduction of new harvest prices for the use of agricultural raw materials and the September implementation of the next stage of fuel price liberalization played important roles in the rapid inflation. Resulting expectations of inflation boosted the demand for money, which in turn spurred on the inflation and caused the exchange rate to drop again in September.

The government consequently embraced tougher budgetary policies as a macro-economic priority in the fall of 1992. Government spending was slashed dramatically from September through November. By December, 1992, spending for the national economy shrank to 11.8 percent of GDP, social programs to 8.3 percent of GDP, and defense to 5.1

percent of GDP. Simultaneously, tax receipts from October-November 1992 grew considerably. The share of tax receipts in the budget revenue increased from 26 percent of GDP in September to 32 percent of GDP in November 1992.

As a result of these policies, in September the Russian budget deficit fell from 820 billion rubles to 716 billion rubles, or by 8.8 percent of GDP. At the same time, state payments for social sphere expenditures, for arms, and for the agricultural sector were delayed, and had to be covered by incoming revenue. In October, the actual federal budget deficit totaled 5.2 percent of GDP. In November, the budget deficit fell to approximately 4.0 percent of GDP (622.7 billion rubles).

The Russian federal budget deficit for 1992 totaled 985 billion rubles (4.9 percent of GDP), a figure only slightly above the limit set by the law "On the budgetary system of the Russian Federation for 1992." At the same time, the increase in the consolidated budget expenditures in December totaled more than 60 percent of the monthly GDP (the consolidated budget is the Russian federal budget, local budgets, and extrabudgetary funds added together), while the increase of the Russian Federation's budget deficit amounted to 13.4 percent of the monthly GDP. This data should be adjusted to take into account a number of the government's financial operations not included in the reports of the Ministry of Finance. Analysis of state revenues should include funds the government received in the first half of 1992 from the mandatory sale of hard currency from exports (at an overstated exchange rate of \$0.018 per ruble). In the first six months of 1992, these budget revenues totaled about 110 billion rubles. An analysis of state expenditures should include import subsidies. Counting imports paid for by funds left by exporters abroad, imports paid for by Russia's Foreign Currency Reserve, and the imports paid for by external loans to be repaid by the state (\$10.8 billion in 1992), import subsidies should total about 1,900 billion rubles (9.5 percent of the GDP), of which the lion's share was funded by external loans. State loans granted by the government should also be included in the budget, and in the consolidated public revenues and expenditures of the extrabudgetary funds.

As Tables 1 and 2 illustrate, in 1992 the balance of the Russian federal budget revenues and expenditures together with loans (minus the repayment deductions) totaled 21 percent of GDP. In regard to the impact of public finances on the money situation, the balance of the federal budget revenues, expenditures, and loans (minus the repayment deductions) shown above, but without subsidies to the importers, is a more informative indicator than the federal budget deficit calculated by the Ministry of Finance (5 percent of GDP). In 1992 this indicator was 11.4 percent of GDP. The Russian federal budget deficit was financed at the expense of foreign loans and loans granted by the Central Bank of Russia.

Out of all loans made by the Central Bank of Russia, the share granted to the government varied considerably during the year. Loans to the government made up 30 percent of the 70 percent first-quarter increase in the credit reserve, with loans to commercial banks accounting for 60 percent and loans to the states of the ruble zone for 10 percent. In the second quarter, loans to the government made up 38 percent of the bank's total loans, which increased overall by 192 percent (loans to commercial banks accounting for 32 percent, and loans to the states of the ruble zones for 30 percent). In the third quarter, loans from the Central Bank increased 131 percent, loans to the government this time accounting for 43 percent of the increase (with loans to commercial banks and states of the ruble zone at 40 percent and 17 percent respectively). In the fourth quarter, loans to the government made up 30 percent of the overall 75 percent increase in Central Bank credits (57 percent to commercial banks and 13 percent to states of the ruble zone).

Table 1. Public Revenues in 1992 (in billions of rubles)

	Republic Budget (% of GDP)	Local Budgets (% of GDP)	Extrabudgetary Funds (% of GDP)	Consolidated Budget (% of GDP)
Corporate Tax	646 (3.2%)	922 (4.6%)	—	1,568 (7.8%)
Income Tax on Individuals	—	431 (2.2%)	—	431 (2.2%)
Deductions for Social Insurance Fund	—	—	2,150 (10.8%)	2,150 (10.8%)
Internal Taxes on Goods and Services	1,701 (8.5%)	720 (3.6%)	—	2,421 (12.1%)
Taxes on Foreign Trade	689 (3.4%)	8 (0.08%)	—	697 (3.5%)
Other Taxes	112 (0.5%)	190 (0.9%)	—	301 (1.4%)
Extrabudgetary Funds	—	—	1,212 (6.1%)	1,212 (6.1%)
Other Revenues	53 (0.2%)	54 (0.2%)	not available	107 (0.5%)
Total Revenues	3,201 (16.0%)	2,344 (11.7%)	3,362 (16.8%)	8,907 (44.5%)
Subsidies	—	299 (1.5%)	51 (0.3%)	—
Total Revenues and Subsidies	3,201 (16.0%)	2,643 (13.2%)	3,413 (17.1%)	9,257 (46.3%)

In 1992, federal budget revenues in Russia totaled 56 percent of consolidated budget revenues, with expenditures totaling 60 percent (without taking into account subventions to other levels of administration, loans and sums transferred under mutual settlements). Estimates made in 1992, however, had totaled revenues at 57.7 percent and expenditures at 69.9 percent, including December adjustments.

In many regions, local authorities tried to separate their finances from the Russian federal ones. In Bashkortostan, Tatarstan, Yakutia, and Chechnya, for instance, local authorities made declarations of sovereignty and adopted constitutions that gave regional laws priority over federal ones. As a result, all tax revenue in Bashkortostan and Tatarstan goes to the regional republics' budgets, and transfers of funds to the federal budget are carried out only with approval of the republic's Supreme Soviet. The amounts and procedures of these transfers are specified in annual or long-term agreements between the republics and the Federation. The agreement with the republic of Sakha-Yakutia, for example, stipulates an increase in the rate of deductions from Russian federal taxes towards Sakha's budget, along with the transfer to the republic of many expenditures previously funded out of the federal budget. In Chechnya, all taxes and payments collected go into the republic's budget. The Federation, however, does not fund any activities on the republic's territory.

Table 2. Public Expenditures in 1992 (in billions of rubles)

	Republic Budget (% of GDP)	Local Budgets (% of GDP)	Extra-Budgetary funds (% of GDP)	Consolidated Budget (% of GDP)
General State Services	42 (0.2%)	64 (0.3%)	–	106 (0.5%)
Defense	855 (4.3%)	–	–	855 (4.3%)
Law Enforcement Agencies	240 (1.2%)	5 (0.1%)	–	245 (1.2%)
Science	104 (0.5%)	3 (0%)	–	108 (0.5%)
Social Services	489 (2.4%)	971 (4.9%)	1,618 (8.1%)	3,078 (15.4%)
State Services to the National Economy	2,995 (15.0%)	964 (4.8%)	794 (4.0%)	4,753 (23.8%)
including:				
Investment in National Economy	315 (1.6%)	–	–	315 (1.6%)
Price Subsidies	313 (1.6%)	–	–	313 (1.6%)
Subsidies to Importers	1,900 (9.5%)	–	–	1,900 (9.5%)
Other Functions	1,184 (5.9%)	246 (1.2%)	–	1,430 (7.1%)
including:				
Foreign Economic Activity	417 (2.1%)	–	–	417 (2.1%)
Foreign Debt Servicing	120 (0.6%)	–	–	120 (0.6%)
Internal Debt Servicing	120 (0.6%)	–	–	120 (0.6%)
Subventions to Other Levels of State Administration	299 (2.5%)	–	–	
Other Expenditures	562 (2.8%)	–	–	562 (2.8%)
Total Loans Minus Repayments (Net Loans Outstanding)	907 (4.5%)	40 (0.2%)	–	947 (4.7%)
including:				
Loans to Enterprises Minus Repayments	876 (4.4%)	34 (0.2%)	–	910 (4.6%)
State Budget Loans to Enterprises Minus Repayments	72 (0.4%)	34 (0.2%)	–	106 (0.5%)
Central Bank Loans to Enterprises Minus Repayments	804 (4.0%)	–	–	804 (4.0%)
Total Expenditures Plus Net Loans Outstanding	7,378 (36.9%)	2,293 (11.5%)	2,412 (12.1%)	11,784 (58.9%)
Revenues and Subsidies Minus Expenditures and Net Loans Outstanding	-4,177 (-20.9%)	350 (1.7%)	1,001 (5.0%)	-2,879 (-14.4%)
Financing	4,177 (20.9%)	49 (0.2%)	–	4,226 (21.1%)
including:				
Domestic Central Bank Credit (Net)	1,912 (9.6%)	49 (0.2%)	–	1,961 (9.8%)
External (Net)	2,265 (11.3%)	–	–	2,265 (11.3%)

Taxation Policy in 1992

It is difficult to show the differences between the fiscal and budgetary structure of the Soviet Union and of the Russian Federation since the structure of public revenues and expenditures has undergone significant transformation. Meaningful comparisons must therefore be made by looking at the consolidated budget of the Soviet Union as well.

Between 1988-1990, the share of revenues in budgets at all levels totaled about 45 percent of the Soviet Union's GDP; in 1985-86, this figure was 47-48 percent of GDP. The accuracy of these figures is diminished due to the difficulty in assessing revenues from external economic activities at that time; nevertheless, these figures may be used for comparison. A reconstruction of the consolidated Soviet budget for 1991 shows a sharp decrease in budget revenues compared with preceding years and planned figures. According to our calculations, budget revenues for 1991 totaled 39 percent of GDP, which explains the catastrophic growth of the deficit.

In 1992, taxes increased to account for about 44 percent of GDP. The increase can be explained by both the successful tax reform and increased deductions in various social and production extrabudgetary funds.

If we consider the state budget alone, separately from the extrabudgetary fund, tax revenues increased during the year. In the first quarter they totaled about 20 percent of GDP, increased to 23 percent of GDP by July, and to 27 percent of GDP by the end of the year. The elasticity of tax revenues in terms of GDP in May, June, and September of 1992 was noticeably lower by one point.

Corporate income tax revenues for 1992 totaled 29.5 percent of the consolidated budget. The amount of real revenue from corporate profits was influenced by both tax remissions and the rate of wage growth as compared with changes in remuneration in prime cost regulated by the legislature. The interaction of these factors led to an increase in the corporate tax rate from 17 percent in the first quarter to almost 33 percent in the first half of 1992, and to 36 percent for the year as a whole. It should be noted that tax benefits for enterprises accounted for only one-third of those planned in the budget.

From January to December, the value-added tax accounted for 37.6 percent of all budget revenue, with excise taxes accounting for another 4 percent. In the first quarter, the elasticity of the VAT and excise tax revenue was fairly high with respect to GDP. This can be explained by small returns at the beginning of the year, and rapid growth in February and March after organizational difficulties in introducing *ad valorem* taxes, which replaced the turnover tax. The turnover tax had been calculated based on the difference between centrally fixed wholesale and retail prices. The steep decline in the growth rate of the excise and VAT revenues in the second quarter was caused by inter-enterprise debt and, to a certain extent, by the hoarding of finished products.

By July 1, 1992, inter-enterprise debt reached 3,004 billion rubles. Products marketed between January and May accounted for about 55 percent of the overall output. In the vast majority of enterprises, profits were assessed not when products were shipped, but when they had been paid. As a result, products already shipped to customers but not yet paid for are not considered when assessing taxable turnover of VAT payments, nor are they considered in the assessment of taxable profits.

The acceleration of the growth rate of VAT returns during 1992 can be largely explained by changes in exaction procedures for the tax. Until May, customers could make advance payments that were not based on actual turnover; they could therefore understate the

advance and delay payment of the tax. Beginning in May, orders for more than 300,000 rubles required payments based on actual turnover. Furthermore, at the end of May it became illegal to subtract from enterprises' VAT liabilities the amounts of tax on inventories received (VAT credit) if the appropriate bills had not been settled. The substantial increase of VAT receipts in July versus June (2.6 times more) was due to the introduction of advance VAT payments. The amount of advance payments was worked out proceeding from the actual payments made in the first quarter, multiplied by 2.5.

The sharply increased VAT and corporate profit tax revenues in the fall can be attributed to precision in tax collection techniques. In October VAT accrued, due to a regulation restricting deductions from VAT to only material resources that can be written off as production costs, and also due to the inclusion in the taxable turnover of all the funds received by suppliers. (Before this change, one widely used method of avoiding taxes was understating prices and remitting to the supplier money designated for other purposes.) According to data supplied by the State Tax Collecting Service, the additional VAT and profit tax return based on actual turnover, as compared with advance payments, totaled about 200 billion rubles. Growth of tax revenues in October was aided by a new policy whereby funds received by enterprises were channeled primarily into the settlement of the debts to the state budget. According to the Russian Central Bank's data, the repayment of the outstanding VAT totaled some 220 billion rubles.

Starting in October, the procedures for advance VAT payments were toughened. Enterprises with a turnover of more than 100,000 rubles a month were to pay VAT every 10 days based on actual sales figures. The final tax figures for each enterprise were to take into account the VAT credit paid for material resources already used, as well as the results of the month as a whole.

In 1992 income tax on individuals accounted for 8 percent of Russian budget revenues and remained very stable. The elasticity of those receipts with respect to GDP is close to 1, which is explained by the similarity of the wage and GDP growth rates on the linear scale of tax levied at the source compared with 1991. Since the minimum taxable income was raised, receipts dropped from 12 percent to 8 percent of national personal income.

Budget Planning and Budget Implementation in 1993

By December the increasingly tough budgetary, credit, and monetary policies carried out in the fall of 1992 slowed the growth in prices and stabilized the ruble exchange rate. However, a substantial increase in the money supply in December owing to expanded crediting and the growing Russian budget deficit provoked a new spiral of price hikes as early as the middle of December and a nosedive of the ruble exchange rate in late January.

The replacement of Yegor Gaidar by Victor Chernomyrdin as the head of the government caused serious concern about the consistency of the measures designed to achieve financial stabilization. The retention of part of the old cabinet, however, as well as the appointment of Boris Fyodorov to the post of vice-premier and later simultaneously to that of minister of finance, made it possible to ensure continuity of the economic policy.

Two fairly distinct periods can be distinguished in the budgetary policy carried out in 1993. The first period lasted from January to September 1993, until the dissolution of the

legislature on September 21, and was characterized by the fact that all the legislative and executive authorities made decisions escalating expenditures, which were not supported by increased revenues. Since in the same period the Russian Ministry of Finance pursued a relatively tough policy, from January to September the gap between the cash budget deficit and the planned one kept growing. Starting in October, however, the fundamental change in political forces made it possible to reduce this gap, giving hope that a more balanced budget could be achieved.

The First Part of 1993, January-September

In January, 1993, the Russian Supreme Soviet approved a resolution financing federal budget expenditures to one-third of the amount envisioned in the fourth quarter of 1992. Expenditures not planned in the fourth quarter could only be financed by a new decision of the Supreme Soviet.

As a result, revenues in January topped expenditures by 29 billion rubles (0.9 percent of GDP), with tax receipts totaling 37.4 percent of GDP (not counting extrabudgetary funds), and making up 23.4 percent of the Russian federal budget.

The Russian parliament did pass a resolution, however, under which the government was allowed during the first quarter to provide monthly funding for programs totaling one-twelfth of the combined appropriations outlined in the budget that had been submitted by the government. In February, this had not yet made any dramatic impact on the state of the budget. Tax receipts totaled 35.2 percent of GDP, and the republic's budget deficit stood at 34 billion rubles (.04 percent GDP).

In March, 1993, state expenditures rose steeply, from 21 percent of GDP in January-February to 26 percent in January-March. (The figure for expenditures rose 240 percent, but high inflation during the same period meant that in real terms the increase was not so dramatic.) As a result, the Russian federal budget deficit grew to 11.2 percent of the January-March 1993 GDP. The deficit was funded by increased Central Bank credits to the government, totaling 1.72 trillion rubles—11.5 percent of GDP.

At the end of March the Russian Supreme Soviet adopted the 1993 budget on its second reading with a deficit of about 18 percent of GDP, which was signed by the president in the middle of May in spite of the opposition of the Ministry of Finance. Almost immediately after it was signed, however, corrections began on the budget because of both the unrealistic precepts on which the 1993 budget had been based and the Ministry of Finance's objections to its extremely high planned expenditures. At the end of June, 1993, the Supreme Soviet considered the draft budget as revised by the Ministry of Finance, which envisioned reduction of the deficit from 18 percent of GDP to approximately 10 percent of GDP. After it had been debated by the parliament, however, the draft was corrected and on July 22, 1993, the Supreme Soviet adopted the law "On the specification of the indicators of the republican budget for 1993," envisioning a deficit of 22 percent of GDP. President Yeltsin refused to sign the law and sent it back to the Supreme Soviet. On August 27 the parliament passed this variant of the budget a second time and adopted the law "On the introduction of changes and additions to the law 'On the republican budget of the Russian Federation for 1993.'" In this version the deficit had been reduced by only 60 billion rubles—to 22.1 percent of GDP.

In spite of 1993's difficult and controversial process of financial planning, the implemen-

tation of the budget proceeded relatively smoothly. After a sharp rise in the deficit in the first quarter of 1993, beginning in May the Ministry of Finance succeeded in stabilizing the situation and, according to official data, in cutting the deficit to 4-5 percent of GDP.

In May, federal expenditures on the bodies of state authority, defense, the national economy, and the social sphere decreased slightly. As a result, the Russian federal deficit shrank to 4.5 percent of GDP or, taking account of the incomplete transfer of some federal budget revenues by the Central Bank, to 5.9 percent of GDP. In June, the slight decrease of the expenditure on the national economy and defense continued, while the other expenditures were stabilized. The total amount of loans granted to enterprises from the central budget minus repayments also became smaller (1.2 percent of GDP in April, 1.2 percent in May, and 0.8 percent in July). As a result, according to official data from the Ministry of Finance, the deficit totaled 3.4 percent of GDP for the first half of 1993 (in cash terms 5.5 percent of GDP), while revenues totaled about 15 percent of GDP.

Over six months, as in the first quarter of 1993, local revenues exceeded expenditures. Over six months this excess added up to 1.9 percent of GDP, the transfers from the Russian Federation budget in the form of subventions to other levels of state administration and budgetary loans also totaling about 2.1 percent. Tax revenues in local budgets fluctuated around 15.5 percent of GDP. Thus, in the first half of the year the revenues (including those not from taxes, which made up 0.2 percent of GDP) and subsidies of the local budgets reached 18-18.5 percent of GDP, with the expenditures totaling 16-16.5 percent of GDP.

In July and August negative trends in the budgetary situation increasingly made themselves felt. Changes in revenues were to a considerable extent independent of the policy of the Ministry of Finance and were connected mainly with growing inflation in the summer of 1993. The consolidated budget deficit increased from 4.2 percent of GDP in June to 6.6 percent of GDP in July and to 7.5 percent of GDP in August. The federal budget deficit increased from 6.1 percent of GDP in June to 8.8 percent of GDP in July and to 9.5 percent of GDP in August. In July and August the revenues coming in totaled about 29 percent of GDP (without the extrabudgetary funds).

No serious changes in the structure of the budget revenue and expenditure occurred in July and August. An important trend, however, was the decrease in taxes from 29.8 percent of GDP in June to 29.2 percent of GDP in July and 27.4 percent of GDP in August. This occurred mainly at the expense of tax revenues to the federal budget, which diminished from 13.9 percent of GDP in June to 13.3 percent of GDP in July and to 12.3 percent of GDP in August. The growing budget deficit was financed by selling hard currency and precious metals and stones (0.6 percent of GDP in June, 1.2 percent of GDP in July), and by selling the hard currency received as an IMF loan (1.2 percent of GDP in July). In July and August these sources brought in 2.3 trillion rubles (3.3 percent of GDP). In addition, in August part of the Central Bank revenues, totaling 260 billion rubles (0.4 percent of GDP), was counted as budget revenue. It should be noted that in the statistics of the Ministry of Finance, Central Bank revenues are counted under "financing," whereas in our tables they are counted as "non-tax revenues."

In September the situation continued to deteriorate. The consolidated budget deficit reached 8.3 percent of GDP, and the republican budget deficit reached 10 percent of GDP, while federal expenditures practically did not increase (from 19.4 percent of GDP in August to 19.5 percent of GDP in September) and expenditures plus subsidies minus repayments even decreased by 0.5 percent of GDP. Budget revenues, however, shrank to 11.8 percent of GDP. Central Bank profits, which totaled 0.5 percent of GDP, were added to budget

revenues. Expenditures were financed by the government by selling hard currency (1.6 percent of GDP over nine months), precious metals (0.8 percent of GDP), and by using the IMF loan (1.6 percent of GDP).

The Second Part of 1993, October-December

The fundamental change in the balance of political power after President Yeltsin dissolved the Parliament in September 1993, and the resulting appointment of Gaidar as First Deputy of the Chairman of the Government, led to radical changes in budgetary policy.

The political change did not affect the cash implementation of the budget (in the fourth quarter the federal budget deficit remained at 9-10 percent of GDP), but it resulted in lower government expenditures. Without legislative interference, the executive branch had the opportunity to implement budget expenditures in accordance with incoming revenues and Central Bank credit limits. Excessive expenditures were reduced in several ways. Indexation of grain and other agricultural prices for state orders was cancelled, bread subsidies for the needy were abolished, import subsidies were liquidated, most preferential loans were cancelled (except for budgetary loans), and the Central Bank refunding rate was raised. State capital investment was sharply reduced, and federal budget expenditures for the fourth quarter of 1993 were sequestered at 20 percent.

The state also succeeded to a considerable degree in battling the centrifugal budgetary tendencies of a number of regions of the Russian Federation. Presidential Decree No. 1774 of October 27 enabled the government to fight violations of Russian law in transferring federal tax receipts to the republican budget. Regional indebtedness to the republican budget diminished considerably.

In spite of fairly tough measures taken in the fall of 1993, the lasting consequences of previous expenditure policies kept the deficit high. In addition, tax receipts as a percentage of GDP continued to shrink, although less precipitously (see Table 5). Cumulative tax receipts into the consolidated Russian budget dropped from 25.4 percent in September to 24.5 percent by December 1993, and receipts into the republican budget from 11.1 percent to 10.3 percent. The structure of republican budget expenditures remained approximately the same as in the first nine months of the year. Expenditures on the national economy decreased slightly from 3.1 percent to 2.8 percent of GDP. Subventions to local budgets increased from 2.5 percent to 2.7 percent of GDP, while loans minus repayments decreased from 2.4 percent to 1.7 percent of GDP.

As a result of this difficult process of going back on prior obligations (which turned out to be politically costly in the December elections), it was possible to keep the federal budget deficit to 9.4 percent of GDP. The government was able not only to avoid financial catastrophe, but to begin lowering inflation (from 16 percent in November to 13 percent in December 1993).

Under this policy, according to data of the Ministry of Finance, the overall sum of unfinanced expenditures, compared with the planned budget confirmed May 14, 1993, totaled 13.8 trillion rubles. Part of this sum made up the state's outstanding debt of about 8.5 trillion rubles. The most essential of these expenditures, totaling four trillion rubles, had to be financed in the first quarter of 1994; 2.9 trillion rubles were repayable at the expense of budget appropriations, while 1.1 trillion rubles were repayable through tax exemptions to

enterprises (0.6 trillion rubles) and the issuing of medium-term treasury promissory notes (0.5 trillion rubles).

Tables 3 and 4 give a reconstruction of the consolidated budget of the Russian Federation in 1993. The analysis shows, first of all, a stabilization in Russia of the level of tax exactions at 43-44 percent of GDP. Tax receipts account for about 95 percent of state revenue. The rest is accounted for by the Central Bank's profits (1.3 percent of GDP), interest on loans to foreign countries, income from privatization, etc. Revenues of extrabudgetary funds remained at the level of 1992—about 17 percent of GDP.

Table 3. Public Revenues in 1993 (in billions of rubles)

	Republic Budget (%of GDP)	Local Budgets (%of GDP)	Extra-Budgetary Funds (% of GDP)	Consolidated Budget (%of GDP)
Corporate Tax	5,472 (3.4%)	11,302 (7.0%)	--	16,774 (10.3%)
Income Tax on Individuals	--	4,388 (2.7%)	--	4,388 (2.7%)
Deductions for Social Insurance Fund	--	66 (0%)	17,528 (10.8%)	17,594 (10.8%)
Internal Taxes on Goods and Services	8,908 (5.5%)	5,523 (3.4%)	--	14,431 (8.9%)
Taxes on Foreign Trade	8,360 (5.2%)	91 (0.1%)	--	8,451 (5.2%)
Other Taxes	37 (0%)	1,018 (0.6%)	--	1,055 (0.7%)
Extra-Budgetary Funds	--	--	9,902 (6.1%)	9,902 (6.1%)
Other Revenues	2,794 (1.7%)	2,345 (1.4%)	--	493 (0.3%)
Total Revenues	25,571 (15.8%)	24,733 (15.2%)	27,430 (16.9%)	77,734 (47.9%)
Subsidies	--	4,296 (2.7%)	--	--
Total Revenues and Subsidies	25,571 (15.8%)	29,029 (17.9%)	27,430 (16.9%)	77,734 (47.9%)

Table 4. Expenditures for 1993 (in billions of rubles)

	Republic Budget (%of GDP)	Local Budgets (%of GDP)	Extra-Budgetary Funds (%of GDP)	Consolidated Budget (%of GDP)
General State Services	658 (0.4%)	818 (0.5%)	—	1,476 (0.9%)
Defense	7,210 (4.4%)	—	—	7,210 (4.4%)
Law Enforcement Agencies	2,513 (1.5%)	111 (0.1%)	—	2,624 (1.6%)
Science	894 (0.6%)	49 (0%)	—	943 (0.6%)
Social Services	2,917 (1.8%)	12,413 (7.6%)	13,182 (8.1%)	28,512 (17.6%)
State Services to National Economy	6,473 (4.0%)	11,847 (7.3%)	5,024 (3.1%)	23,344 (14.4%)
including: Subsidies to Importers	1,930 (1.2%)	—	—	1,930 (1.2%)
Capital Investment	1,321 (0.8%)	—	—	1,321 (0.8%)
Total State Services to National Economy	2,849 (6.8%)	2,628 (6.3%)	1,003 (2.4%)	6,480 (15.5%)
Other Functions	15,784 (9.7%)	1,734 (1.1%)	—	13,190 (8.1%)
including: Foreign Economic Activity	6,111 (3.8%)	60 (0%)	—	6,171 (3.8%)
Foreign Debt Servicing	450 (0.3%)	—	—	450 (0.3%)
Internal Debt Servicing	989 (0.6%)	—	—	989 (0.6%)
Subventions to Other Levels of State Administration	9,328 (2.7%)	—	—	—
Other Expenditures	2,000 (1.2%)	—	1,136 (0.7%)	3,136 (1.9%)
Total Expenditures	38,449 (23.7%)	26,972 (16.6%)	19,342 (11.9%)	80,435 (49.6%)
Total Loans Minus Repayments (Net Loans Outstanding)	3,293 (2.0%)	586 (0.4%)	—	3,897 (2.4%)
including: Loans to Enterprises Minus Repayments	2,834 (1.7%)	586 (0.4%)	—	3,420 (2.1%)
Loans to CIS States Minus Repayments	511 (0.3%)	—	—	511 (0.3%)
Loans Minus Repayments Untransferred to Foreign States	-450 (-0.3%)	—	—	-450 (-0.3%)
Central Bank Arrears to the Government	322 (0.2%)	—	—	322 (0.2%)
Total Expenditures Plus Net Loans Outstanding	41,742 (25.7%)	27,588 (17.0%)	19,342 (11.9%)	84,314 (51.9%)
Revenues and Subsidies Minus Expenditures and Net Loans Outstanding	-16,171 (-10.0%)	1,471 (0.9%)	8,088 (5.0%)	-6580 (-4.1%)
Financing	16,171 (10.0%)	—	—	—
Domestic (Net)	13,021 (8.0%)	—	—	—
External (Net)	3,150 (1.9%)	—	—	—

The 2.4 points difference from the official Ministry of Finance GDP statistics can be explained by the different methods of assessing the government's external economic operations. We do not include the ruble cover for the centrally granted hard currency sums in the revenues from external economic activity. Under expenditures we do not take into account "purchase of goods for centralized export." Instead of these two items we take into account "revenues from the realization of the state monopoly on centralized export operation," which are assessed as earnings from the centralized export minus the expenditures on the purchase of goods for this operation. Moreover, according to our method the import subsidies item under expenditures takes into account the balance between hard currency sums centrally granted to the importers and the corresponding incomings of the ruble cover. As a consequence, in the annual report of the Ministry of Finance revenues from external economic activity account for about 1.4 percent of GDP, while in our estimates they account for 5.2 percent of GDP.

In 1993, the structure of state expenditure changed to some extent. Expenditure on the bodies of state authority and administration increased by 0.4 percent of GDP and social expenditures grew by 1.7 percent of GDP. Expenditures on the national economy diminished quite considerably, but this was due chiefly to the reduction of import subsidies. Capital investment also decreased to a certain extent (from 1.6 percent to 0.8 percent of GDP). On the whole, in 1993 expenditures totaled 51 percent of GDP, which was close to the 1992 figure. At the same time, subsidies minus repayments dropped from 4.7 percent of GDP in 1992 to 2.4 percent of GDP in 1993.

According to our estimate, federal budget revenues and subsidies with the deduction of expenditures and loans minus repayments totaled 9.9 percent of GDP. On the whole, state expenditures exceeded revenues by 4 percent of GDP. Internal financing supported 81 percent of this federal deficit, with loans from the Central Bank accounting for 64 percent of the total volume of financing. It should be noted that in 1993 loans to the government made up 65 percent of all Central Bank loans.

Taxation Policy in 1993

In 1993 the main changes in the tax system were based on taxation regulations adopted by the Supreme Soviet of the Russian Federation in July 1992, the law "On changes and additions to Russia's taxation system" passed in July, and the law "On changes and additions to the Russian tax laws for individuals" passed on December 22, 1992. In accordance with these laws and regulations, procedures for assessing and taxing corporate profits, VAT, and individual income substantially changed.

Provided that depreciation allowances are fully spent on renovation, from 1993 all production and non-production capital investment will be exempted from corporate profit tax.

The technique for regulating the spending of funds on consumption has been altered. The amount by which corporate expenditures exceed the maximum is subject to profit tax at the basic rate or, if it exceeds the maximum more than twofold, at a 50 percent rate. The maximum itself is four times the minimum monthly statutory wage, as it was in 1992. To prevent understatements of advance payments, the difference between the amount payable

based on actual profits and the advance payments is indexed according to the Central Bank set interest rate of the preceding quarter.

From January 1, 1993, the VAT rates were reduced: to 10 percent on foodstuffs (except those subject to excise duty) and children's goods and to 20 percent on other goods. In addition to directly worsening the budgetary situation in 1993, the advance announcement of the measure led to a drop in sales in the fourth quarter of 1993. The reduction of the VAT rates did not produce the anti-inflationary effect desired by the legislators who made the decision, just as the lowering of VAT rates on dairy products, vegetable oil, flour, and other foodstuffs in February, 1992, failed to achieve it.

From February, 1993, existing procedures for VAT and excise payments were extended to cover imported goods. The only products exempted from VAT are imported foodstuffs, raw materials for food production, research equipment, and medical goods.

From January 1, 1993, value-added tax ceased to be gross VAT, the application of which makes it impossible to deduct tax on acquired capital resources from tax liabilities. It has not become a net VAT either, however, since the VAT credit, i.e., the part of the tax paid on fixed and intangible assets, is deducted from the tax due in equal installments over a two-year period, starting from the commissioning of the fixed assets and the recording of the intangible assets in the books. In agriculture such deductions can be done in a lump sum as the assets are entered in the books. Another measure that complicates corporate accounting and control over tax payments is the procedure that grants a VAT credit on acquired inventories (other than capital resources) only if their value is actually written off as production and distribution costs.

Aside from the numerous alterations of the method of assessing taxable income, the one fundamental change in the law on individual income tax is the indexing of the taxation scale. The new law raised the starting point for progressive tax from 42,000 rubles to 200,000 rubles; this is clearly not high enough, considering last year's high inflation, to achieve the Supreme Soviet's goal of saving most workers from income tax. In 1993, the taxation scale was indexed again and now taxes start from one million rubles a year. An important point is the exemption from taxation of money spent on new construction or the purchase of a house, apartment, dacha, etc., as well as any money spent repaying loans received for these purposes.

The rates at which national taxes are channeled into regional budgets have also been changed. Now regional budgets receive 20 percent of the value-added taxes, 19 percent of the corporate profit taxes, 50 percent of the excise duties on spirits and vodka, and 100 percent of the other national excise duties (except on automobiles). With a view to reducing the subsidies to local budgets, the Russian government has increased the percentage of VAT deductions to be channeled to many territories—up to 50 percent.

One worrisome tendency is the shrinking ratio of tax exactions to GDP from 31.1 percent of GDP in April to 27.5 percent of GDP in August. This occurred mainly because tax revenues coming into the national budget went down from 15.3 percent of GDP in April to 12.9 percent of GDP in August.

When analyzing the dynamics of the budget tax revenue in 1993, one should note that the high level of tax exactions at the beginning of the year is explained, first, by the fact that at the beginning of the year VAT was imposed in accordance with last year's rates (28 percent) and, second, by the reassessment of the actual corporate profit tax in accordance with the overall results of the fourth quarter and 1992. Therefore, the 1993 summer tax level should be compared either with the 1992 figures, when the tax exactions level (without the

Table 5. The Dynamics in 1993 of Tax Receipts, Gross Domestic Product, Debit Indebtedness, and Non-Payment of Arrears with Price Index Taxes

Source: State Statistics Committee of the Russian Federation, Ministry of Finance, State Tax Collection Service of the Russian Federation, author's calculations.

	Jan. 1993	Feb. 1993	Mar. 1993	April 1993	May 1993	June 1993	July 1993	Aug. 1993	Sept. 1993	Oct. 1993	Nov. 1993	Dec. 1993
Tax revenues to the consolidated budget (percent of GDP)	36.0	33.8	31.0	30.7	29.5	29.4	28.7	27.4	25.4	25.0	25.1	24.5
Tax revenues to the state budget (percent of GDP)	2.7	19.1	15.8	15.2	14.5	14.0	13.3	12.3	11.1	10.9	10.7	10.3
Growth rates of monthly GDP		2.38	1.68	1.22	0.94	1.09	1.1	1.19	1.31	0.98	1.13	1.37
Growth rates of nominal GDP		2.38	1.97	1.6	1.35	1.29	1.31	1.28	1.29	1.22	1.20	1.23
Growth rates of debit indebtedness (industry and construction)	1.12	1.29	1.21	1.20	1.18	1.27	1.24	1.18	1.18	1.18	1.19	1.20
Arrears in payments to the consolidated budget (percent of GDP)*	3.8	2.7	2.4	2.34	2.02	1.72	1.62	2.25	1.78	1.62	2.19	1.86
Arrears in payments to the state budget (percent of GDP)	2.4	1.82	1.52	1.29	1.14	1.14	1.09	1.48	1.13	0.99	1.22	1.08
Retail price index	1.27	1.26	1.21	1.23	1.19	1.20	1.22	1.26	1.23	1.20	1.16	1.13
Wholesale price index	1.32	1.32	1.23	1.24	1.19	1.17	1.29	1.27	1.21	1.19	1.15	1.11

*Arrears in payments to the consolidated budget include arrears in payments to the state budget.

extrabudgetary funds) totaled about 31 percent, or with the April figures.

The continual, month-by-month shrinking of tax revenues relative to GDP was mainly due to the decrease relative to GDP of such principal budget revenue items as corporate profit tax (from 13.0 percent of GDP in April to 11.6 percent of GDP in August) and VAT (from 9.1 percent of GDP in April to 7.9 percent of GDP in April), while the revenue from

excise duties and individual income tax remained stable, relative to GDP.

The drop in corporate profit tax revenues in May 1993, compared with April, can be explained by the completion in April of the reassessment for the first quarter and 1992. In monthly calculations, the revenue decreased by more than 4 percent of GDP. In cumulative month-by-month calculations the decrease reached 1 percent of GDP. In cumulative month-by-month calculations VAT revenues dropped by 0.3 percent of GDP.

We believe that the main reason the tax revenue increase lagged behind GDP in 1993 was the method of imposing the corporate profit tax and VAT. The profit tax is paid twice a month in the form of advance payments, and the reassessment is done at the end of each quarter; the actual sales are assessed not by the shipment of the goods, but when payment is made. In current conditions, when payment transactions between enterprises take from a few days to several months, enterprises' tax obligations at the time of each assessment are calculated not on the basis of the last quarter, but of a considerably earlier period. The higher inflation gets, the greater the loss in actual tax receipts due to the lag between the manufacture or shipment of goods and the receipt of payment by the manufacturer.

A similar situation is observed with VAT. Major payers pay it three times a month (less important ones only once a month) in accordance with goods actually sold. The reassessment, taking into account VAT on materials purchased, is made by monthly results. So at the moment of payment enterprises pay tax on goods, which were sold considerably earlier and, consequently, at considerably lower prices than those existing at the time of the assessment of tax obligations and the payment of the tax.

Thus, the elasticity of Russia's taxation system depends greatly on the rate of inflation, the length of the delay in settlements between enterprises, and the frequency of reassessment by actual results (the period for calculating the profit tax has been lengthened to 30 additional days after the end of the quarter). The inflation factor was especially strong in July and August, when there was a sharp price increase: wholesale prices increased from 17 percent a month in June to 29 percent in July and retail prices from 20 percent a month in July to 26 percent in August (see data above).

The absence of a strong surge of corporate profit tax receipts in July can be attributed to enterprises' adaptation to the introduction of criminal sanctions for understating advance payments. It should be noted that in 1992 this tendency of tax receipts to drop was not apparent because of the extremely low tax base at the beginning of the year, the worsening non-payments crisis (which lasted until fall), mutual non-payments cancellation, and the continual modifications of the taxation methods (which resulted in increased revenues).

The data given in Table 5 show no serious impact of the dynamics of indebtedness on the decrease of tax revenues, with the possible exception of July; the rate of buyers' indebtedness to their suppliers increased from 17 percent in June to 24 percent in July, which was nevertheless smaller than the growth of the nominal GDP in July (31 percent) and the growth of wholesale prices (29 percent).

According to the Russian Federation State Tax Collecting Service's statistics, the arrears in payments to the budget had no impact on the drop in the tax revenues either, with the exception of August, when tax receipts rose from 1.62 percent of GDP in July to 2.25 percent of GDP in August.

The increase of tax arrears in August and September was to a large extent due to the tax deferral granted to enterprises. Permission to defer tax payments to the Russian federal budget was granted by the Russian Ministry of Finance under the amendment to Article 24 of the law "On the foundations of the taxations system" passed on July 16, 1992. Similar

rights with respect to the territorial budgets were granted to the local bodies of state authority. Growth in arrears was also encouraged by Resolution #672 of the Council of Ministers of the Russian Federation of July 13, 1993, "On measures to stabilize the financial situation of the enterprises and production associations of the fuel and energy complex." This resolution undermined the priority of payments to the budget, since it allowed enterprises to keep at their own disposal 40 percent of the money due to them and paid into their accounts, rather than paying it into the republican budget to reduce their debt.

The shrinking of the tax revenues of the Russian federal budget is partly due to the indebtedness of Tatarstan, Bashkortostan, and Yakutia. All taxes on the territory of these republics are collected in accord with a "one-way system," under which the republics transfer sums fixed by bilateral agreements to the federal government budget. However, these sums are transferred with a long delay (as of January 1, 1994 their debt totaled 465 billion rubles, i.e., 0.3 percent of GDP).

In the fourth quarter of 1993, with the slight drop in inflation and slowing growth of the nominal GDP, the decrease in tax receipts as a percentage of GDP also slowed. In comparison with September 1993, revenues in December dropped by less than 1 percent of GDP.

1994

With the departure from government of Gaidar and Fyodorov, short-term budget policy will be determined primarily by the pace of repayment of the government's outstanding unfunded expenditures and by its commitment to following through on promises made in the spring and summer of 1993.

As of mid-February 1994, the draft federal budget envisioned revenues totaling 16.7 percent of GDP, expenditures totaling 23.6 percent of GDP, and a deficit totaling 7.1 percent of GDP. The structure of the budget is roughly similar to that of 1993. This year, however, it envisions an increase in expenditures on the national economy (by 1.9 percent of GDP), on law enforcement bodies (0.25 percent of GDP), on external economic activity (1 percent of GDP, which incidentally is balanced by planned growth in revenue), on the state administration, the judicial system, and public prosecutors' offices (0.3 percent of GDP), and on financial support for the territories (1.3 percent of GDP).

Obviously, a final judgment on the budget cannot be made until it has been approved by Parliament. So far the Ministry of Finance and the government have in general been continuing the policies carried out last year.