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Abstract

The article sets out to assess the problems of taxation in Russia in the context of the Russian state, its relationship with the enterprise sector and the transition from plan to market. In this paper, we argue that Russia's well-known tax collection problem is a manifestation of an ineffective and poorly governed state, supported by weak institutions whose authority is not legitimate in the eyes of its citizens. Central to this crisis is the symbiosis of politics and economics that was common in Soviet times and is still prevalent in Russia today. During transition, Russia has witnessed an ineffective state (with a weak civil society) and a systemic crisis of governance. This crisis of a weak state and poor governance, manifesting itself in a severe fiscal crisis, culminated in the August 1998 crash.

Key words: taxation, transition, Russian State, governance

JEL Classification: H11, H2, P5.

1. Introduction

The power to impose and collect tax is a defining characteristic of a modern capitalist state. It was Joseph Schumpeter who, prior to his appointment as finance minister to the Austrian government after World War 1, described the capitalist state as the "tax-collecting state". In his 1918 paper entitled 'The Crisis of the Tax State', he wrote that "…'tax' has so much to do with 'state' that the expression 'tax state' might almost be considered a pleonasm." (Schumpeter, 1918). For Schumpeter, the origins of the state (at least in Germany and Austria) arose, not from political needs, but from financial needs. It is the fiscal demands and the tax-collecting powers, born out of a "common exigency" that distinguishes the modern capitalist system from its predecessor, the feudal system, he argued.

In contrast, a defining characteristic of the socialist state is its administrative powers rather than its tax powers. It is within this context that we examine the transition from the socialist state to the capitalist state that took place at the end of the 20th century. As our primary interest lies in a sovereign state's power to tax, it is appropriate to assess Russia's (the most important of the successor states to the Soviet Union) transition to a "tax-collecting state". Since transition began, many ex-socialist countries have experienced a dramatic fall in tax revenue. Russia is no exception. In 1992, total government revenue as a share of GDP was 39.3%; by 1998 the revenue/GDP ratio had fallen to 33.4%. Moreover, federal revenues fell from 16.6% of GDP in 1992 to only 11% in 1998, of which 2% was non-cash (IMF, 2000). This inability to collect sufficient taxes is a manifestation of an ineffective and poorly governed state, supported by weak institutions whose authority is not legitimate in the eyes of its citizens. Many Russians view the efforts of the central government as the private affairs of the elite and certainly not aimed at enhancing the common interests of its citizens. This crisis of a weak state and poor governance, manifesting itself in a severe fiscal crisis, culminated in the August 1998 crash. It was Sergei Kiriyenko, the Russian PM at the time of the August crisis, who said, "If the state does not learn to collect taxes, it will cease to exist."[1]

This is an outline of the paper. We begin in Section two with a short theoretical analysis of taxation and the models of government. In Section three we focus on the weak state and the symbiotic relationship that exists between government and business. The symptoms of an ineffective state that are evident in Russia's fiscal system are described in Section four. In Section five, we outline the events of the August 1998 crisis – a fiscal crisis that had its origins in a weak and ineffective Russian state. The policy implications arising from our analysis of poor state governance are examined in the final section of the paper.

2. The Theory

Our primary interest is in taxation and different models of government. In a well-functioning market economy, governments oversee the provision of public goods and the orderly payment of taxes, where taxes are defined as compulsory, unrequited payments exacted by government for public purposes. In post-communist Russia, the payment of taxes has been problematic. What follows is a stylized account of tax payments (and its sister activity, bribery) in Russia, since transition.

When an enterprise produces goods/services or engages in trade or employs workers, it incurs tax liabilities of all sorts (for example, value-added tax or export tax or social security tax). Once a tax liability arises and is known by the tax authorities, the enterprise can do one of three things.

[1] Ironically, Jeffrey Sachs was one of those people who recognised the prospect of state collapse or insolvency in Russia. In 1994, in warning about the dangers of a 'bad' equilibrium for the Russian state, he wrote, "Several simple examples of immediate relevance to Russia illustrate the risks of state collapse." He went on to list six, namely tax evasion, criminality, regional separatism, flight from the rouble, foreign debt overhang and panic by government creditors (Sachs, 1995). Although Sachs was quite right in his analysis, namely, of a state in near collapse, it was his policy recommendations that were to attract most public attention. For lessons on government collapse in transition countries, including Russia, see Roland (2000).

One, the tax is paid, either in cash or non-cash form. Non-monetary tax payments are not uncommon in Russia. Explanations vary from liquidity shortages and the demonetisation of the economy that resulted from tight monetary policy to poor financial intermediation leading to lower transaction costs for barter than non-barter to the facilitation of tax avoidance or evasion whereby the barter transaction circumvents the use of bank accounts and the chances of confiscation of revenue by the tax authorities.

Two, the tax is not paid. The delinquent enterprise can either be a profit-maker or a loss-maker. If it is a case of profit-making firms not paying taxes, the problem is generally one of a poor payments discipline (aside from the possibility of individual and legitimate tax disputes with the tax authorities). Although this is interesting, it does not concern us here. Alternatively, if it is a case of loss-making firms not paying taxes, the behaviour and objectives on the part of the economic agents can be described by reference to Kornai's paternalistic government and the soft budget constraint (see below).[2]

Three, payments are made arising from the tax liability but are paid in the form of a bribe to government officials in order to reduce or eliminate the known tax liability. This behaviour, both on the part of the recalcitrant firm and the politician or bureaucrat, can be described by reference to Shleifer and Vishny's predatory government and corruption. This model of government is described later.

We begin with János Kornai's (1980, 1992) analysis of how the socialist system comprised a paternalistic, all-powerful, helping-hand state that gave rise to soft budget constraints and financial indiscipline on the part of state-owned enterprises (SOEs). Unlike private firms in a market economy where the state is, in general, neither paternalistic nor pervasive, SOEs in a socialist economy may face 'soft' budget constraints.[3]

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[2] A loss-making firm will not be liable for profit tax but it will have other tax liabilities.

[3] Of course, the soft budget constraint syndrome is more appropriate to the market socialist system where a price mechanism existed rather than to the Soviet centrally planned system where money was passive and plans were expressed in terms of physical quantities and output targets.

The budget or financial constraint is softened when the state bails out or refinances loss-making firms. The recurring expectation of a bailout, in whatever form it takes, influences ex ante the behaviour of enterprises. This helping-hand model of government depended on a strong and benevolent state whose primary aim was to provide for the enterprise which meant maintaining employment, preventing firm closures and job losses and, ultimately, ensuring security. [4]

As socialist economies were transformed into market economies, the soft budget constraint syndrome was expected to diminish. It is true that many of the features of Kornai's socialist system have indeed disappeared. There are no longer shortages of consumer goods, nor do people spend time and energy queuing for goods. Many firms operate in the private sector offering a variety and quality of goods that were not available under the Soviet system; those firms that remain in the state sector are forced by market conditions to restructure. These economies are now more integrated with the market economies of Western Europe. Of course, it was to be expected that some aspects of Kornai's paternalism might linger longer than others, or might manifest themselves in new ways. For example, some loss-making firms (not to mention healthy firms) are still extracting subsidies from the state, but by means of tax arrears and/or utility arrears rather than by explicit on-the-budget subsidies. The incidence of tax arrears and other non-market economic phenomena suggest that, in some respects, the state is still 'soft' in its relationship with certain loss-making enterprises. Despite these incidences, for countries like Poland and Hungary, Kornai's 'helping hand' has been replaced by Adam Smith's 'invisible hand'.[5] For Russia and other former Soviet Union (FSU) states, neither Kornai's helping-hand model nor Adam Smith's invisible-hand model can explain the behaviour of the state and some firms in the state-owned (and privatised)

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[4] A neoclassical version of the benevolent government model portrays politicians maximising allocative efficiency. Interventions in the economy are limited to cases of market failures.

[5] The symbiosis of politics and economics (with politics taking primacy over economics) that manifested itself in different ways was far more ingrained in the Soviet Union that it was in Central and Eastern Europe and this observation may go some way to explaining the performance differences since 1990. On the subject of performance, although Russia's record since 1992 is considered worse than most of Central and Eastern Europe (with the exception of the former states of Yugoslavia), it compares favourably to many other Commonwealth of Independent States (CIS) countries. This is often ignored in the transition literature on Russia and Eastern Europe.

enterprise sector.[6] The state-enterprise relationship in Russia appears to be somewhat short of Adam Smith's 'invisible hand'.

In addition, Kornai's classical model of a paternalistic state and soft budget constraints has the state redistributing profits from 'profitable firms' to 'loss-making' firms, the so-called leveling effect. Given that price controls were set with social objectives in mind, enterprises were not responsible for losses. Profits were redistributed through various subsidy and tax channels. Bargaining took place along the vertical chain between managers, local bureaucrats and central planners. In contrast to this, many of today's politically-connected, profitable, sectors in Russia manage to engage in socially-costly rent-seeking behaviour, namely, lobbying for subsidies and tax concessions from the government. In turn, politicians (often with short time horizons) extract bribes in return for these lucrative favours, whether they are subsidies, cheap credits, licenses, quotas or permits.

It is in this context that we draw upon the second of the theories, that of Andrei Shleifer and Robert Vishny's 'Politicians and Firms' model (1993, 1994).[7] Shleifer and Vishny's model is predicated on a predatory, activist, grabbing-hand state whose aim is self-preservation and wealth accumulation, leading to rent seeking, corruption and bribes.[8] Using standard economic theory of industrial organisations, Shleifer and Vishny show that the type of

[6] It is important to acknowledge that the enterprise sector that exists in Russia today is not monolithic. It is made up of state, privatised and de novo private firms, profitable and unprofitable firms, viable and nonviable firms, domestic and foreign firms and so on. In this paper, we are primarily concerned with the nonviable firms and the well-connected firms (sometimes one and the same) that are often kept alive by political interference.

[7] With respect to the interaction between bureaucrats (government officials) and entrepreneurs (private sector actors), there are different models of government, as explained by Frye and Shleifer (1997) and, again, by Shleifer and Vishny (1998). There is the market-friendly 'invisible hand', the more interventionist-type 'helping hand' and the predatory 'grabbing hand'. As the transition from Soviet-style socialism (a kind of 'clenched hand') to a market economy based on private property and enterprise (Adam Smith's 'invisible hand') continues, Russia seems to be caught halfway, in a state of limbo. Although Frye and Shleifer refer to the state-enterprise relationship in China as an example of the helping-hand model, we extend its applicability (without changing the basic features of the model i.e. a well-organised, interventionist, welfare-maximising government) and use it to explain the state-enterprise relationship that existed in other socialist countries pre-transition. As indicated by Frye and Shleifer, these models of government are 'ideal types'; in reality, governments may be a mixture of all or a combination of some. A variant of these types of government models is presented in Treisman (1995).

[8] Others, including Jan Winiecki (1992) and Anders Aslund (1994, 1999), have highlighted corruption and the rent-seeking activities of the old elite in explaining Russia's problems in its transition to a market economy. Of course, a predatory view of the state is not new and has followers in both the neoclassical and Marxian traditions.

organised corruption that was prevalent in the former Soviet Union (where the briber was assured of getting the government good) was less damaging than the unorganised crime and corruption that became prevalent in Russia in the early years of the reform period.

According to Shleifer and Vishny, bureaucrats are self-interested economic agents often acting independently of each other, who use their power and position to pursue their own agendas. They did so under the socialist system by restricting output and keeping prices low, resulting in endemic shortages. As bureaucrats did not have any legitimate cash flow rights to goods produced in the state sector, corrupt officials turned their attention to creating shortages in order to enhance their opportunities for collecting bribes. The underground barter economy was used to produce goods that the state failed to supply. In today's Russia, well-connected, state-owned, or privatised firms, often run by the old elite (nomenklatura), engage in rent or subsidy-seeking behaviour rather than profit-seeking behaviour.[9] By lobbying, they manage to extract soft credits, subsidies and tax concessions from the state, often in return for kickbacks. Effort is exerted and resources are wasted in the pursuit of these rents. The effect of this is that compliant firms, often de novo private firms, are penalised. The behaviour of these compliant firms is adversely effected as they, in turn, bargain with government officials for tax concessions and soft loans. The cosy networks and personal exchange that exist between officials and managers of enterprises reduce the risk of exposure and, in doing so, reduce the relative transaction costs of bribery. In this type of environment, firms are more likely to seek a maximisation of political connections rather than of profits.

In developed market economies, the job of market-friendly, representative institutions like the political parties, the media and social organisations is to ensure that the type of distortive and corrupt bureaucratic behaviour described above does not go unpunished. In Russia, these 'checks and balances' were either open to abuse or were simply too weak to prevent the

[9] In the early years of reform in Russia when inflation was high, certain sectors (agriculture and coal, for example), enterprises and bankers gained large rents, either in the form of subsidised credits, loans at negative real interest rates or arbitrage opportunities. As Treisman (1998) and Hellman (1998) have argued, these winners gained at the expense of the population at large. According to Treisman, the Russian government managed to co-opt the winners and, in the process, achieved lower inflation. Hellman argues, contrary to conventional wisdom, that reform governments must restrain these 'winners' (by expanding political participation and competition) as they are more of a threat to successful reform than the 'losers'.

rent-seeking activities of politicians, government officials and nomenklatura-appointed enterprise managers. The political and institutional vacuum that existed in Russia allowed the rent-seeking elite to pursue their political objectives (securing voters' support and maintaining power) and, at the same time, to enrich themselves by accumulating vast sums of personal wealth. The more efficient allocation of resources that the transition to capitalism was promised to bring was hindered by the activities of these rent-seeking interest groups (Olson, 1965; McFaul, 1995; EBRD, 1999). These special interest groups competed (and sometimes colluded with government officials and later even with some of the reformers) for the resources of the state rather than for greater market share.

In sum, Russia's 'peculiar' (a word often used to describe the post-communist Russian economic system) transition from a planned to a market economy has been a story of winners and losers, and powerful vested groups with conflicting and narrow interests, made stronger by the weakness of political parties, of democratic institutions and of the rule of law. The early years of transition left the Russian state in a state of limbo, some place between the 'helping hand' and the 'invisible hand', what Shleifer and Vishny call the 'grabbing hand'. This view was shared by Boris Yeltsin in his State of the Federation address in March 1999 when he talked about Russia getting stuck halfway, and now left with '…a hybrid of the two systems' (i.e. plan and market). This vacuum has being partly filled by oligarchs, rent seekers, corrupt government officials and the mafia. This is what George Soros calls 'robber' capitalism, Grigory Yavlinsky calls 'phony' capitalism, Marshall Goldman calls 'bastard' capitalism and John Gray calls mafia-dominated anarcho-capitalism. It manifests itself in a number of different ways; the problem of tax collection is one of these manifestations. But this is only one side of the story.

There is another side to the story. Russia is by all accounts a market economy. The majority of its output is produced in the private sector. For most goods, prices are not controlled and are close to world levels. Certainly, some Russians are better off today than they were 10 years ago, despite the setbacks associated with transition. As for taxation, the tax/GDP ratio in Russia is higher than the average both for OECD countries and for ex-socialist transition countries (IMF, 2000). Given Russia's level of income, this level of government capacity is quite surprising. Here is one of post-communist Russia's many paradoxes. This is the other side of the story, a side that is often neglected and seldom recognised. Leaving this aside, the aim of this paper is to explore the relationship between the "tax-collecting state" and the "tax-paying enterprises" in a particular transition economy, namely Russia. In effect, it is the story of an economy that has experienced a transformation from an administrative-command economy to a market economy (albeit traumatic and uneven) but whose state is in crisis; an incapacitated state that has failed to change in line with the economy and whose actions, and in some cases inactions, have adversely effected the behaviour of enterprises, both state and privatised.[10]

3. The State and the Enterprise Sector in Russia

In this section, we provide an explanation for Russia's tax problems in the context of the state-enterprise relationship. We argue that the real cause of the problem is the ineffective state, the behaviour of an enterprise sector that is often dominated by powerful vested interests and the non-market relationship that exists between the state and much of the enterprise sector in Russia today. We will deal with each of these in turn.

3.1 The State

As we see it, the problem of the state as exists in Russia is twofold. Firstly, although the state has succeeded in building institutions required in a democracy (a constitution, a parliament, an independent judiciary, a media with freedom constitutionally guaranteed), its progress in building institutions that are supportive of a market economy has been less impressive (see Appendix 1). These institutions are legal (property rights, courts, bankruptcy procedures), regulatory (monopolies, financial sector and securities markets), administrative

[10] This view of a dysfunctional Russian state is shared by others, including Sapir (1999), Brown (1999), Gustafson (1999) and Nagy (2000). For example, in their separate accounts of the August 1998 crisis, they explicitly refer to 'a large-scale failure of state power' (Sapir, 1999); 'a bloated state that …was incapable of performing satisfactorily such basic functions as collecting taxes, paying public service workers, and maintaining law and order' (Brown, 1999); '...a failure of the central state' (Gustafson, 1999) and '…the on-going meltdown of the state' (Nagy, 2000).

(civil service and public administration), financial (adequate financial intermediation, supervision and prudential regulation), fiscal (tax code, tax administration) and social (obligations to workers, welfare provision). Without these institutions in place and working well, Russia cannot properly function as a capitalist democracy. Just as Kornai emphasised the importance of 'norms' under the socialist system, we need to emphasise the importance of institutions in the new market system. Ironically, much of this requires a strong state. As one commentator remarked, "An autonomous and effective state is a necessary condition for carrying out revolutionary economic transformation." (McFaul, 1995).

Secondly, the actions and inactions of the state in Russia today are at odds with its responsibilities in a market economy. On the one hand, it is not doing what it should be doing, whether that is enforcing the rule of law, building an effective public administration, ensuring property rights and contract enforcement, providing essential public services, legitimising the informal sector, ensuring a social contract or encouraging competition. This is particularly true at the federal level of government. The national state has, in effect, abdicated on these responsibilities. Weakened, it has become particularly vulnerable to the small groups of lobbyists and vested interests (agricultural lobby, bankers, energy sector) that seek privileges and favours. These powerful groups have flourished in post-communist Russia in the absence of social organisations and voluntary associations. In particular, it is the politically-connected firms that have managed to "capture" the government in pursuit of their own narrow interests. This leads us to the other dimension of governance in Russia today (see Appendix 2). In sharp contrast to the above, the state is frequently doing what it should not be doing whether it is softening budget constraints of loss-making firms, bailing out insolvent 'banks', exchanging government goods in return for kickbacks, stifling enterprise with punitive taxes, incessant inspections, costly regulations and draconian penalties, keeping power at the regional level at the expense of local government, or maintaining, and in some cases, fostering features of the old system (the privileges and favours, the 'patron-client' networks, the regulations, the bureaucracy, the extortion and so on). This view of a state that is irresponsible in it actions (predatory and interventionist) and inactions (weak and ineffective) is shared by others, including Aslund (1994), Mau (2000) and Nagy (2000). In an earlier work, Evans remarks that the 'conjunction of leviathan and the invisible hand' is not as contradictory or as uncommon as it might appear (Evans, 1992). In that context, the problem in Russia, as distinct from other countries where a symbiotic relationship between government and business is common, Japan and Korea for example, is that the Russian state lacks the 'embedded autonomy' prevalent in so-called developmental states.

3.2 The Enterprise Sector

Part of the state-owned enterprise sector remains unchanged from Soviet days. Whereas the resources sector generates substantial value added and much needed hard currency earnings, the value added and foreign currency earnings generated by the manufacturing sector are less substantial. This is a legacy of Soviet times when negative value added was quite common and enterprises did not trade directly with foreign firms, other than through the trading bloc COMECON. Although many of these enterprises have been privatised, they have been slow to restructure (Frydman et al, 1996; Blasi et al, 1997). Corporate governance is weak with insiders retaining control. This resulted from the mass privatisation programme where the stakeholders (incumbent managers and workers) were co-opted in order to secure their support for the privatisation programme. Much of the capital stock in the Russian state-owned enterprise sector is old and obsolete. Modes of organisation are often antiquated. Labour hoarding is evident, with some social provisions still provided by the enterprise. In rural Russia, many of the one-enterprise towns remain, isolated from the marketplace and even more isolated from the international capitalist world. Labour mobility is often restricted by enterprise provision of social services, derisory unemployment benefits, wage arrears and, sometimes even, residency requirements. Despite the reforms, some enterprises in Russia are still likely to operate with two sets of books, a shell or daughter company, an offshore subsidiary and have unregistered activities. Regular payments to the mafia, government officials and the local governor are not uncommon. Enterprises are as likely to engage in late payment, informal, personalised, private methods of contract enforcement and other non-market activities as they are to engage in prompt payment, formal, anonymous, legal methods of contract enforcement and other market activities. Certain sections of the enterprise sector, namely, the agricultural lobby, banks and the energy sector have, at different stages throughout the transition process, been able to use their influence in pursuit of their own interests. Due to a number of factors, namely the large rent-seeking opportunities associated with partial reforms, the privileged access to government officials, the weak central authority, the lack of representative institutions and the failure to build a sufficient constituency for market-oriented reforms, these entrenched groups have been able to advance their own narrow interests at the expense of the reform process and the welfare of the population at large.

3.3 The State-Enterprise Relationship

Central to the behaviour of enterprises and the slow pace of restructuring is the nexus that exists between the state and the enterprise sector. In a well-functioning market economy, the certain provision of public goods in exchange for the orderly payment of taxes dominates the state-enterprise relationship. This is not the case in Russia (or in many other FSU countries). In the case of a state with weak central authority and a decentralised form of federalism, the state-enterprise relationship is more likely to be dominated by subsidies, tax breaks, payment arrears, asset-stripping and bribes than by public goods and compulsory, unrequited, payments to government (i.e. taxes).

Although the state has been weakened in many respects since the dismantling of state socialism (reflected in a breakdown in the use of law, in the provision of a social security net, in the enforcement of state contracts), the state still retains 'interventionist' features of both the helping-hand and the grabbing-hand models with respect to its relationship with the enterprise sector. Some politically-connected firms manage to extract rent from the state in return for bribes to government officials and bureaucrats. This is the case of the activist, predatory, state ensuring its survival, while, at the same time, enriching public officials. Loss-making firms are bailed out by the state (particularly, at the regional level of government) by means of tax and utility arrears. This is the case of the soft budget constraint phenomenon. In this case, it would appear that the State's behaviour is influenced by a desire to maintain employment and prevent social unrest.

What has changed is the way that the state channels funds to these loss-making enterprises. Arbitrary pricing and budgetary subsidies have been replaced by new, and often implicit, ways of extracting subsidies from the state, including tax exemptions, arrears and offsets[11], utilities arrears, non-payment and, in some cases, barter. This intervention by the state (and in increasing amounts by regional government) prevents a redistribution of resources to the sectors of the economy where there is potential for further value added. Although Russia may be a ‘market’ economy in the sense that most of the output, officially or unofficially, is produced in the private sector and resources are allocated through a decentralised price mechanism, it still retains some features of the old Soviet socialist system. One of these features is the state-enterprise relationship that still exists, preventing the state from carrying out its ‘market’ duties and preventing enterprises from restructuring. By condoning informal activities, by reneging on its obligations to its suppliers and its workforce, by taking bribes and by allowing rent-seeking behaviour, by accepting tax offsets, by negotiating tax liabilities with well-connected enterprises, by allowing mutual indebtedness and barter chains to flourish, by tolerating arrears, by allowing the resources sector to subsidise the manufacturing sector, and by maintaining ‘relational capital’ with the enterprise sector, the state is implicated in the economic and political crisis of the 1990s in Russia, culminating in an outcome like the rouble devaluation and the debt default of August 1998.

Since 1991, governments in Russia have been described at various different stages as soft, weak, corrupt or interventionist. With respect to its relationship with the enterprise sector, we can say that Russian governments have proved to be all of the above at some stage or other. In a market economy the state has responsibilities to the enterprise sector. Among others, it is sometimes an owner (although not often), a creditor (tax collection agency), a legal guardian (courts and contract enforcement, bankruptcy) and a regulatory body (to promote competition and prevent monopoly practices). With respect to the Russian

[11] Goods exchanged in settlement of a tax debt. Often, the goods that are exchanged for the tax debt are either exchanged at an overvalued exchange rate or are in little demand, what Gaddy and Ickes call “soft goods” (Gaddy and Ickes, 1998).

enterprise sector, it is fair to say that as an owner the state is often corrupt, sometimes paternalistic; as a creditor it is sometimes 'soft'; as a legal guardian it is weak and open to abuse; and, finally, as a regulatory body, it is frequently bureaucratic and interventionist. The state-enterprise relationship suffers as a result, failing to develop into a market-type relationship as exists in mature market economies and in some of the leading transition economies (Hungary and Poland, in particular). The state interferes in the obvious ways – appointments, employment numbers, subsidies and soft credits, regulations, state orders - but it can also interfere in less obvious ways – undermining the supplier relations, threatening non-payment and sequestering expenditures, etc…

In conclusion, Russia has experienced a 'soft' transition in terms of the symbiosis between politics and economics, or what Gaidar refers to as the 'intertwining of property and power' and of 'business and bureaucracy' (Gaidar 1999). This is a legacy of the socialist political-economic system, described by one commentator as 'the unique symbiosis of the state with society and the economy.' (Kaminski, 1996).[12] This is not a case for state desertion, but for the relationship between the state and the enterprise sector to be made more formal within the institutional infrastructure as found in the more developed market-type economy.

Although this symbiotic relationship is best exemplified by the existing state-enterprise relationship, the implications reach beyond the enterprise sector. For example, the results for many 'ordinary' Russians have been catastrophic, despite the increase in individual liberty and choice. In the early years, this was reflected in rising mortality rates, greater income inequality and even larger numbers of people living in 'poverty'. In later years, it has been reflected in rising crime and in a general mistrust of state institutions and in the entire

[12] This symbiotic relationship is portrayed in Ericson's depiction of the Russian economic system as characteristic of 'industrial feudalism' with regional fiefdoms (Ericson, 1999). He describes the state-enterprise relationship as one where there '…is a tendency at all levels to look to governments, with their ability to command resource flows, for direction, support and the solution of economic problems' and where there '…is a tendency for governments to look to business organisations for access to the resources needed to maintain their power and control.' One of the key findings of the EBRD/WB survey was that 'States and firms continue to be tied together in a web of interactions in which the state provides a wide range of direct and indirect subsidies to firms, while firms provide public officials with some combination of control over company decisions and bribes.' (EBRD, 1999).

political process. Recall Thomas Hobbes' treatise *Leviathan* wherein he stated that life without an effective state is "…solitary, poor, nasty, brutish and short." (Hobbes, 1651). As the state continued to weaken, ordinary Russians found themselves disengaging from the national state. It is not surprising that the general public do not have trust in the government or its institutions when arrests and charges against state employees of the Central Bank of Russia (CBR), Goskomstat, the Federal Bankruptcy Service and the State Tax Service (STS) for fraud, evasion and other criminal activities are not uncommon.

What are the symptoms of an ineffective state? How does the symbiotic relationship between government and business manifest itself? In the next section, we focus on Russia's fiscal system and the problems of fiscal discipline and tax collection.

4. Taxation and Russia's State-Enterprise Relationship

A central feature of the state-enterprise relationship in any economy is the fiscal system and taxation. Moreover, since transition began a decade ago, nothing portrays the symbiosis between government and business in Russia better than the taxation issue. As one commentator put it, 'In some ways, the tax system replaced the plan as the key instrument for economic and social policy.' (Tanzi, 1999).

Taxation in the socialist system was very different to the Western-style tax system, both in terms of objective and composition. Taxes were mostly transfers within the public sector, from profitable SOEs, that is, state-owned enterprises with surpluses, to loss-making SOEs. For the enterprise, taxes were implicit and negotiable. As for the state, taxes were easy to collect as taxpayers, that is, enterprises, tended (relative to the capitalist system) to be fewer in number and larger in size. In addition, the State Bank, in processing enterprise payments, acted as a tax collection agency. The main forms of tax revenue were enterprise profits tax, turnover tax and payroll tax. The collapse of the socialist system meant that fiscal institutions, as exist in developed countries, had to be built from scratch. Statutory tax systems were required in order to raise enough revenue to pay for the provision of public goods. Income tax systems (both corporate and personal), value-added taxes and tax administration systems were all introduced in the early years of transition. Russia was now confronted with a Western-style tax system where voluntary compliance and confrontation between the tax collector and the taxpayer are the norm. For these and other reasons, it was inevitable that the transition to a market economy would bring a fall in the tax share of GDP. By 1998, the revenue/GDP ratio was 33.4%. Moreover, federal revenues were only 11% of GDP, of which 2% was in non-cash form (see Table 1).[13] We use total government revenue as a share of GDP as this is a good measure of government capacity. Table 1 shows that since transition began, Russia's government capacity has weakened. This is synonymous with recent empirical evidence that poorly performing governments (in this case, Russia), in contrast with better performing governments (many of the ex-socialist Central European countries), collect fewer taxes (La Porta et al., 1999).

The problem of poor tax collection is more than an administrative problem. The problem is more deep-rooted, with numerous possible causes. For a start, there are a large number of enterprises that are either 'unprofitable' or operate in the informal economy. Two, the tax base is narrow and, as a consequence, there is an excessive tax burden on those liable for tax. This encourages those liable for tax to find ways of reducing their tax bill, legally or illegally. For example, competition for enterprise tax revenues between the different levels of government, in conjunction with the practice of tax shifting between regions, provides an opportunity for enterprises to lower their effective tax rate (see below). Three, the current tax system includes a plethora of tax concessions and tax breaks, not to mention tax amnesties. Four, the government is often found negotiating the tax claims of well-connected enterprises. Five, tax liabilities are often overdue, and, in some cases, either written off or reduced. Six, the use of barter and non-monetary exchange makes tax detection difficult. Seven, tax administration is undoubtedly poor. It is also true that Russia has made less progress than other transition countries in moving away from taxing corporations toward taxing individuals. This is a legacy of the socialist system when the state expropriated 'profits' from the enterprises. In Russia today (as is common in many other countries), many

[13] Admittedly, there were improvements in tax revenue in 1999, due largely to discretionary changes in policy, namely, the reintroduction of export taxes and the centralisation of tax receipts.

of these same enterprises, some privatised, are not short of ways of evading detection from the state tax services (STS). Among others, it includes the use of money surrogates, the use of affiliates or subsidiaries, the use of multiple bank accounts or the use of barter transactions.

Table 1: Revenue share of GDP, 1992 – 1999

	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Enlarged Gov. Revenue[1]	39.3	36.2	34.6	34.1	33.5	36.5	33.4	35.6
Federal Gov. Revenue	16.6	13.7	11.8	12.9	12.5	12.3	11.0	13.4
of which								
- Cash	n.a.	n.a.	11.4	11.0	9.1	10.0	9.0	13.4
- Non-Cash	n.a.	n.a.	0.4	1.9	3.4	2.3	2.0	0.0

Source: *Russian Federation: Selected Issues*, IMF Staff Country Report No.00/150, November 2000.

Note 1. Consolidated revenues, including both cash and non-cash items.

For the Russian federation, there is the additional problem of intergovernmental fiscal relations. Russia does not have a well-designed system of fiscal federalism. There is an intense struggle between the federal government and regional governments over revenue-sharing. For one, during the 1990s the share of revenues accruing to the regions increased in an ad hoc and arbitrary fashion, all at the expense of the federal government. Second, federal government has assigned much of its social spending responsibilities to the regions; equal transfers of revenues have not been forthcoming. Three, with income differentials between the regions growing, fiscal transfers have often been ad hoc, discretionary, non-transparent and politically motivated. Four, bilateral power-sharing agreements between the federal government and individual regions have undermined the fiscal system. The centre is often found negotiating from a position of weakness with centrifugal, resource-rich regions whose demands range from devolution of spending responsibilities or conferring of special tax powers to political autonomy. It would seem that the relationship between federal government and the republics is determined more by economic resources, political influence, personalities and bargaining skills than by de jure rights. Five, the incentives for government officials at subnational levels are often skewed toward low tax (particularly in cash) collection, excessive spending and greater concessions to local enterprises. Despite recent improvements, intergovernmental fiscal arrangements remain non-transparent, complicated and uncertain. One implication of intergovernmental relations and fiscal federalism in Russia is the weak position that the federal government finds itself in vis-à-vis the regional governments and the enterprise sector. For example, if the federal government makes a move against the utilities in an attempt to collect taxes, supplies are threatened. Alternately, if the federal government moves on the regional governors, taxes are withheld. Likewise, if the federal government moves on the large enterprises, the managers and regional governors collude. Often the managers of large enterprises play one level of government off against the other; more often than not it is the federal government that loses out (Treisman, 1998; Shleifer and Treisman, 2000).

For some, the fiscal problem is as much on the expenditure side (where some spending is quite wasteful, particularly at the regional level, and some is used for private benefit) as on the revenue side (the need to improve tax collection). Russia, with a GDP per capita less than $2,000 in 1998, does not have the economic capacity to be a big spender. Whereas federal non-interest spending has declined as a share of GDP, regional spending and expenditure arrears have both increased. Those favouring spending cuts advocate further reductions in budgetary subsidies where they are above 'normal' levels, cuts in government bureaucracy and a reform of entitlements so that social provisions are targeted to where they are most needed. Given the limited means of the national state, much of the welfare spending is misdirected, dispersed without regard to the income levels of the recipients. Yet, an equally valid argument can be made for more expenditure in the areas of public sector pay (for one, to prevent corruption and bribe taking), health services, education and the environment.

Tax arrears, or overdue tax liabilities, in the enterprise sector have been of particular concern to the Russian government. On the issue of tax arrears, all enterprises are not the same. What follows is a stylized account of tax arrears in the enterprise sector. For the purpose of explaining tax arrears, the enterprise sector can be divided into four categories. Some enterprises pay their taxes on time; more pay their taxes but with a delay, some in cash and some in-kind; others who could pay, do not pay; and, finally, there are the firms that cannot pay their taxes and do not pay taxes.[14] The first category forms a disproportionately large part of the corporate tax actually paid by the enterprise sector and is not politically strong. The second category uses tax liabilities as a source of cheap working capital in times of financial difficulty; possibly because the government is considered to be the softest creditor and is paid only after employees, banks and trade suppliers have been paid. The third category is either politically sensitive or politically connected. The final category is continually in financial and economic difficulty but does not (for example, because of weak bankruptcy practices) or is not allowed to (for paternalistic or predatory reasons) die. By 1998, much of the tax payments made to the government were not in cash form but in non-monetary forms. According to reliable sources, 40% of all taxes paid to the federal government in 1997 were non-monetary (OECD, 1997). In sum, we feel that the state must shoulder most of the blame in its inability to collect taxes. Many of the reasons for the low compliance result, either directly or indirectly, from discretionary government policy. Ultimately, like so many of the other problems that exist in Russia today, the problems are one of economic incentives, institutional weakness, arbitrary government action and an ineffective state.

The problem of tax payments (and the related problem of non-monetary forms of payment) can be summarized as follows. The incidence of tax and inter-enterprise (trade credit) arrears, offsets and other forms of non-monetary payments paints a picture of mutual indebtedness between certain enterprises, between certain enterprises and the government and between the federal government and certain regional governments. Some enterprises,

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[14] One of these delinquent firms is Gazprom, the gas monopoly and Russia's richest company. Gazprom often acts like a quasi-fiscal institution and has been described as 'the state within the state'. It has political connections, secures favourable tax breaks, has large tax arrears, often conducts barter-trade and continues to supply non-paying customers. The mutual debts that exist between the government, Gazprom and other enterprises make the budgetary process for the federal government all the more difficult.

whether profitable or unprofitable, do not pay their bills and stay in business. Loss-making enterprises are subsidised either by:

(i) profitable enterprises (many of which are in the energy sector) through non-payment, 'discounted' payment or late payment of bills;[15]

(ii) government through the non-payment or late payment of taxes; or[16]

(iii) workers through wage arrears.[17]

In the socialist system, manufacturing enterprises were subsidised by underpriced inputs and low interest charges on the use of capital. Today, the industrial sector is similarly subsidised, with only the form of this subsidisation having changed. Funds are channeled to the enterprises via quasi-fiscal and fiscal institutions. Loss-making manufacturing enterprises stay in business with the aid of tax arrears, non- or late payment of bills to their suppliers and utility companies or non- or late payment of wages to their workforce. These economy-wide, non-market activities are allowed to persist and proliferate because they are 'tolerated' or 'facilitated' and, in some cases, even 'instigated' by the state. Since the collapse of the Soviet Union direct subsidies have fallen. Since the tightening of monetary policy, growth in bank credit has decelerated. As enterprises became more credit constrained, they sought out new ways of surviving. Some combination of non-payment of bills (to utilities, to suppliers,

[15] Gaddy and Ickes (1998) 'Virtual Economy' argument is that enterprises are engaged in exaggerated-price barter transactions whereby the value of a good or service is exaggerated in order to hide the negative value added generated by manufacturing enterprises. Value-creating enterprises are also faced with constraints. For example, the energy companies in Russia are prohibited from disconnecting non-paying customers. In return, the government tolerates tax arrears and arrears to the extra-budgetary funds by the utilities. In response to overdue receivables, some utilities have responded by rescheduling or writing off debts in return for an ownership stake in these recalcitrant firms. The utilities can been viewed as conduits, whose purpose it is to channel funds to favoured firms.

[16] The soft budget constraint syndrome. One difference between the soft budget constraint in Kornai's paternalistic model and the soft budget constraint as currently evident is the absence of any fiscal redistribution from profitable to unprofitable firms. Whereas this was a feature under socialism, in today's Russia, profitable companies are also benefiting (by means of tax arrears, export licenses etc...). This phenomenon is better explained by our second model where these companies are using their political connections and bribing government officials to take advantage of a weak, but self-preserving, state and corrupt officials.

[17] There is a popular perception that it is the Russian household sector that carries the burden through non- or late payment of wages, and of social and welfare benefits. It is not uncommon for some enterprises to use wages arrears to strengthen their case for concessions from the government.

to government, to workers), and late payment to suppliers (inter-enterprise arrears) and to government (tax arrears) and use of non-monetary forms of payment (barter, offsets, veksels[18]) allowed for an injection of 'soft' credit to the enterprise sector. Again, this was sanctioned, in the past by a strong but benevolent state, determined to prevent firm closures and job losses (Kornai's 'helping hand') and more recently by a weak but predatory state, determined to survive and, in the process, to enrich itself (Shleifer and Vishny's 'grabbing hand'). Commander and Mumssen (1998, p. 22) make a similar assertion when they argue that '…the state increasingly injected net credit into the ailing industrial sector….' because of '…concerns about employment, but also a result of corruption, fraud and tax evasion….' In its analysis, the EBRD state that '…payments are consistently made to particular interest groups under the guise of employment protection.' (EBRD, 1999).

In Russia today, probably the greatest source of paternalism and budget softness lies with the regional governments. Attempts by the federal government to instigate reforms have been hampered, if not by the Duma, by the regional governments whose influence resides in their control over the use of land and other real estate. In more recent times (a phenomenon that increased as the economic depression deepened), some regions ceased paying taxes to the 'centre' (partly in response to regional transfers committed by the centre but withheld), engaged in unauthorised spending of budget funds, extended soft credits to (often, unproductive) enterprises, regained stakes in local enterprises by means of debt-equity swaps and imposed 'temporary' price controls on certain commodities. This tendency for regions to behave in a quasi-socialist manner has been described by some as evidence of a feudal system where governors treat their regions as fiefdoms (Ericson, 1999; Fairbanks, 1999).

This crisis of a weak state and poor governance manifested itself in a severe fiscal crash in August 1998, the topic of the next section.

[18] A veksel is a promissory note issued usually by an enterprise, it is passed through the chain and usually presented for payment by the end holder who usually gets paid in kind with the products of the issuer. In Russia, where there is a secondary market in veksels with the value of the veksel depending on the credibility of the issuer, veksels are viewed as close substitutes for money.

5. The 1998 Russian Crisis[19]

As stated previously, the long-term problem with the Russian economy is a failure on the part of the state to meet its obligations with respect to the functioning of a market economy. As we have seen, this includes the failure to enforce laws, to collect taxes, to pay wages and pensions, to repay investors and international donors, to encourage competition in the enterprise and banking sectors, to foster market-type institutions and to provide an adequate social security net. Its relationship with the enterprise sector is problematic. It either condones non-market behaviour by some enterprises (subsidies, cheap credits and other rent-seeking activities) or bails out loss-making enterprises (by way of tax arrears and offsets, concessions). In either case, we have evidence of Shleifer and Vishny's 'grabbing hand' or Kornai's 'helping hand'. This crisis of the state culminated in the August crash of 1998, which we now consider.

The debacle of August 1998 has been described by many commentators as the worst economic and political crisis in Russia since the dissolution of the USSR (Illarionov, 1999; Malleret et al., 1999; Nagy, 2000). A brief account of the August 1998 crisis follows.

On July 13, one month before the August 17th crisis, agreement was reached between the international financial organisations and Russia on a loan package worth US$22.6bn in total, of which US$11.2bn was additional monies agreed by the IMF. For many, this was viewed as both helpful and necessary if a financial crisis was to be averted in Russia. For others, it was seen as yet another bailout, with the inevitable consequences to follow. Critics of the package believed that the terms agreed (fiscal and structural reforms, particularly relating to tax) were unlikely to be met by the Russian Government and parliament. Of the total, US$4.8bn was disbursed at the end of July, down from the anticipated US$5.6bn. A further $300m was disbursed by the World Bank, under SAL III. Another measure aimed at boosting market confidence and providing some relief to the treasury was the swapping of short-term rouble-denominated debt for dollar-denominated debt (Eurobonds). The initial reaction to the package was positive, with a fall in interest rates and a rise in share prices. As we know, this was short-lived.

In its short period in charge, Kiriyenko's Government concentrated on the fiscal system, and, in particular, on reducing the budget deficit. By 1998, the federal budget deficit had been reduced, with current revenue covering non-interest current expenses. However, many of the new Government's tax collection initiatives were of an administrative nature. The Government did succeed in introducing a much needed new Tax Code but there were delays in enacting Parts II and III. Other measures were inevitably rejected by the populist communist-dominated Duma. Some of the remaining proposals had to be passed by presidential decree.

By late summer, as market sentiment deteriorated further, net financing from treasury bills issues was negative i.e. the Government was making net repayments of treasury bills. The Government could no longer roll over treasury bills as holders demanded payment on redemption dates. Matters were made worse by the fact that external reserves continued to fall, forcing the Central Bank of Russia (CBR) to draw down the IMF monies in order to support the much-maligned rouble. Eventually, the Government could no longer meet its financial obligations. On August 17th, the Government conceded.

In essence, there were three separate announcements. First, a change to the exchange rate bands was revealed. There was to be a new 'currency corridor'. The existing currency bands (+/-15%) with upper and lower limits of 5.27 roubles and 7.13 roubles respectively around a central parity value of 6.2 roubles per dollar were to be replaced with wider limits of 6.0 roubles and 9.5 roubles respectively. This was a de facto devaluation of the lower band of 33%. Second, a 90-day moratorium on private debt repayments to foreign creditors was announced. Although described by the IMF as a 'temporary restriction on capital payments

[19] The author acknowledges the substantial Russian-language literature that is available on this vexed topic. The literature used for this research is in the English language and taken from Western journals. A small number of the authors are Russian.

abroad' it amounted to a unilateral default on private foreign debt. Third, a mandatory debt conversion of Gosudarstvenye Kaznacheiskie Obligatzii (GKOs) and Obligatzii Federalnogo Zaema (OFZs) maturing on or before 31 December 1999 into longer-term maturity debt instruments and a suspension of trading in the domestic treasury bill market was announced. This amounted to a unilateral rescheduling of rouble-denominated government debt and its aim was to give the Government some breathing space in its attempt to meet its obligations. The Government also announced that certain restrictions on foreign exchange operations were to be imposed. The combined decision to devalue and default, prompted by an unsustainable fiscal position and excessive public sector debt, brought an abrupt end to Russia's commitment to low inflation, to be achieved by a mix of (possibly prolonged) tight monetary policy and an (seemingly inflexible) exchange rate regime.

In our view, the August 1998 crisis was a fiscal crisis that had its origins in a weak and ineffective state. As in other countries where regime changes have arose out of major economic and political crises, it was hoped that the events of August 1998 and the subsequent changes in government might provide Russia with the opportunity to rebuild an effective and well-functioning state.

6. What is to be done?

Despite the doom and gloom preached by others, economic reforms in Russia have made progress, albeit uneven. The same assessment cannot be made for political and institutional reforms. These are the areas that the government most needs to focus on.

Further reform of the constitution, of the political and electoral process and of government is required, recognising the need for greater competition, democracy and transparency. With respect to the constitution, the powers of the president (who has inordinate powers) and the relationship between the legislature (currently too weak) and the executive (currently too dominant) need to be addressed. Despite local, regional and national elections in the past nine years, the political reforms that took place in the last days of the Soviet Union and in the early days of the market reform period were never fully completed. The party system, as exists in democracies worldwide, has not been fully developed in Russia. This is particularly true at subnational level where local membership is low. Moreover, there are various aspects of the government and its apparatus that need to change. Russia's post-communist political governance and institutions are, in one commentator's opinion, not so different from the central authorities that existed under the Soviet system (Shevtsova, 1999). The structures, organisations and the personnel of government, the relationship between the federal, regional and local governments, and the functions of government need to be redefined and reformed in order for corruption and pilfering to decline, economic reform to continue and public support to be restored. Although this redefinition will require a downsizing of government in many respects (in the area of regulation, for example) it is important that the government fulfils its expenditure obligations and contracts (accepting that a rearrangement of the composition of public expenditure is desirable). Institution building (securities market, courts and bankruptcy procedures, land and housing markets, etc.) must continue, recognising that institutions take time to develop. The building of public institutions alongside the promotion of civic groups can help in the fight against corruption. Above all, many elements of the modern state – the judiciary and the legislature, for example – need to be strengthened. Among other things, this will require a meritocratic bureaucracy insulated from political pressures and interest groups.

As we know from the experience of other countries, the fight against corruption requires a mixture of policies. More legal reform, greater competition and transparency, an improvement in accounting standards, a more simple, less burdensome and more transparent tax system and more deregulation (of government controls, licenses and permits) are required. The building of public institutions alongside the promotion of civic groups can help in the fight against corruption.

On the taxation front, there are several issues that need to be addressed. With respect to tax reform, tax rules need to be transparent and not subject to arbitrary changes or political interference. There needs to be a reduction in the number of taxes. Loopholes and exemptions need to be tightened. As regards taxation and fiscal federalism, the bargaining and open negotiation between the various different levels of government must be avoided. More generally, in order for tax compliance to increase there needs to be a change in the economic incentives faced by taxpayers (and the STS) and a restructuring of the institutions involved in tax collection. Rather than aggressively pursuing the small and medium-sized businesses, as is commonly practised by the tax police, the tax authorities need to use their resources in the pursuit of the large, politically-connected enterprises that are behind in their tax payments. Many of these enterprises either belong to one of the powerful financial-industrial groups (FIGs) or are part of an oligarch empire. These reforms will help to change the perception that the Russian tax system is too complicated, highly distortionary, rife with delinquency and grossly unfair.

In the short term, the federal government in Russia can restore political support, legitimacy and credibility by committing itself to these political, tax and institutional reforms. In the medium to long term, attention must focus on the provision of adequate public services, policies to tackle issues of unemployment, inequality and poverty and a commitment to a stable, strong but limited state with a well-defined capacity and set of responsibilities.

We conclude by returning to Schumpeter's writings and, in particular, his paper on the crisis of the tax state. He wrote that the "…collapse of Russia is a very special case which does not belong here…The fiscal collapse in Russia, too, was only a consequence of the anti-capitalistic will." Although this refers to a different time in Russian history, it is equally appropriate now. The fiscal collapse in Russia at the end of the 20th century may not have arisen from an 'anti-capitalist will', but it did arise from a failure to realise that capitalist-oriented economies require capitalist-oriented (tax-collecting) states. Remember it was Schumpeter, a supporter of capitalism and capitalists, who (inaccurately) predicted the demise of capitalism and the rise of socialism. Despite the setbacks of the past 10 years, Russia and other ex-socialist countries have indeed experienced, in a reasonably short period, a similar transition. But in this case, the transition has been from socialism to capitalism.

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Appendix 1: Institutional Reforms

The development of institutions that support a democratic, market economy is central to a successful transition in the long run. In this context, transition can be viewed as the process of institutional change and adaptation. These institutions, whether they be legal, fiscal, financial, administrative, commercial, social, or political, are necessary in order for a market economy to flourish.

Since 1994, the European Bank for Reconstruction and Development has reported annual cross-country progress in reform using their transition indicators. Aside from price liberalisation and macroeconomic stabilisation, these indicators measure advances in institution building. Using these transition indicators, we can measure the extent of institution building. In the *Transition Report 2000*, progress in institutional development is measured as the unweighted average of the transition indicators for the following: competition policy; enterprise reform and corporate governance; banking sector and non-banking financial institutions. We report the 2000 scores for a selection of transition countries, including Russia, in Table 2.

We can see from the table that Russia's progress in building institutions that support a well-functioning market economy is poor, compared with institutional reform achieved by the leading transition economies, namely Czech Republic, Estonia and Poland. Moreover, Russia has achieved less in terms of institutional development that some of the so-called laggard reformers, namely Georgia, Moldova and the Ukraine. Although the demand for supporting institutions is generated by markets, the supply of institutions depends on a state's capacity. In Russia, a more effective state is needed in order, among other things, to support and develop these market institutions.

Table 2: Development of market-supporting institutions, 2000

Country	**Institution Index**
Albania	1.9
Croatia	2.7
Czech Rep.	3.2
Estonia	3.1
Georgia	2.0
Kazakhstan	2.2
Moldova	2.1
Poland	3.3
Russia	**1.9**
Ukraine	2.1
Turkmenistan	1.0

Source: *Transition Report 2000*, EBRD.

Appendix 2: Governance, State Capture and Intervention

Russia's transition to a market economy has been a story of poor public governance, entrenched interests and bureaucratic intervention. In the *Transition Report 1999*, the European Bank for Reconstruction and Development published cross-country ratings for all of these three aspects of transition, based on an EBRD/WB poll conducted on over 3,000 enterprises in 20 transition countries, including Russia.

The quality of governance is based on the extent to which the state, as viewed by businesses, provides a number of basic services in an efficient and non-discriminatory manner. These services are macroeconomic stability, infrastructure, law and order and a fair tax and regulatory environment. Of the 20 countries surveyed, Russia's governance index, with a rating of 1.16, was the fourth worst ahead of only Romania, Kyrgyzstan and Moldova.

The EBRD's indicator of state capture measures the extent of undue influence on government policy-making by powerful vested interests. In the survey, firms were asked to assess the impact on their business of the sale of parliamentary legislation and presidential decrees to private interests. In Russia, over 40% of firms surveyed reported significant impact from state capture. When measuring the extent of firms' influence on government policy-making, the results for the regional government level in Russia (nearly 10% of firms compared with the national figure of 5.5%) are even more indicative of the enterprise sector's capacity to influence government decision–making. Interestingly, it appears that for the transition countries the quality of governance and the extent of state capture are highly correlated. Higher levels of state capture are strongly associated with poorly governed states. Russia is a good example of a poorly governed transition country where the state has been 'captured' by powerful vested interests.

As for the level of state intervention, firms in the survey were asked whether their business operations were subject to intervention. Enterprise decisions relating to pricing, investment, employment, sales, wages, mergers/acquisitions and dividends were considered. The index was calculated as the average across all the aforementioned dimensions of intervention of the percentage of firms reporting intervention sometimes or more frequently. The results indicate a wide diversity across the transition countries both in terms of the level of intervention by the state and in terms of the types of decision-making in which the state intervenes. The level of reported state intervention in enterprise decisions in Russia, at 18.2, is low compared to many other transition countries including, surprisingly, the leading transition countries. The suggestion here is that it may be the nature rather than the level of intervention that is important for transition countries.

The ratings for a selection of transition countries, including Russia, are reported in Table 3. The average for the 20 transition countries in the survey is also included.

Table 3: Governance, State Capture and Intervention for a Selection of Transition Countries

Transition Country	**Governance index[1]**	**State capture[2]**	**Intervention index[3]**
Azerbaijan	1.53	59.21	17.7
Belarus	1.57	12.5	42.5
Bulgaria	1.38	38.24	16.1
Hungary	1.98	13.79	41.8
Kyrgyzstan	0.85	26.67	24.1
Lithuania	1.54	17.14	21.2
Russia	**1.16**	**40.87**	**18.2**
Slovak Republic	1.65	20	43.4
Slovenia	1.95	8.26	26.5
Uzbekistan	1.83	6.85	29.6
Average (20), unweighted	1.47	25.86	23.4

Source: *Transition Report 1999*; Hellman and Schankerman 2000; EBRD's Office of the Chief Economist.
Notes:

1. An average of the ratings given by firms across nine key functions.
2. The percentage of firms reporting that the sale of parliamentary votes or presidential decrees had a significant or very significant impact on their business.
3. The average across seven dimensions of intervention of the percentage of firms reporting intervention sometimes or more frequently.