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## To Russia ... with money

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The devaluation of the ruble, may cause a collapse of the entire Russian financial system, which in turn may well bring down the political system. Steep inflation will reappear as the price of foreign goods rises.

To avoid chaos, Russia needs immediate help to liquify its wealth. We may be able to afford to tolerate chaos in the Congo and other countries, but we cannot afford chaos in Russia because of a simple fact -they still have tens of thousands of nuclear weapons. A political and economic collapse in Russia means a loss of control over these weapons, and a loss of control could mean nuclear weapons in the hands of assorted renegade groups and terrorists.

We tend to forget how much progress Russia has made. A decade ago few people would have believed Russia would make a largely peaceful transition to a democratic society and market economy, with the vast majority of people working in private and semi-private institutions. Most of this transition has been accomplished by the Russians themselves, with only modest foreign support. As they have hit bumps in the transition process, the IMF, foreign governments, and private institutions have provided financial support, advice, and technical assistance. Much of this assistance has been beneficial, but some has been counterproductive.

The recent IMF assistance package has not worked as advertised because it was based on an incorrect understanding of both the problem and its cure. The IMF cure was to provide additional loans to enable Russia's government to service its existing debt to private and public lenders. In return for these additional loans, the IMF demanded that the Russians greatly increase tax revenues and cut government spending. This may sound reasonable, but it isn't.

The Russian government, like all governments, has wasteful spending, but at the same time it has an Air Force that does not fly, a Navy that does not sail, and an Army that has not been paid in three months. The government is several weeks behind on its salary payments to the secret service, and pensioners in dire need are all but ignored. After a dry summer in Southern Russia, many of the potato and cabbage gardens did not produce a crop. Millions rely on these gardens to get them through.

Those who think big tax revenue increases can be achieved in Russia in the short run are pursuing an illusion. Most Russians still do not think they have an obligation to pay taxes, and tax avoidance carries almost no social stigma. Russia operates primarily a cash and barter economy, which makes it exceedingly hard to collect taxes, particularly income taxes. The current Russian tax system is complex, with many tax rates well above the revenue maximizing rate. As a result, most businesspeople and others with significant tax liabilities find it easier to pay off the tax collector rather than pay the tax -and considering Russia's climate of corruption, it is easy to do. Most Russian companies have multiple sets of books, and individuals rarely keep records that might be found by the authorities. Finally, Russia does not have the large number of highly trained tax accountants and tax lawyers necessary to administer any highly complex tax system.

The current attempt to engage in property seizures to collect taxes has already backfired, by further discouraging foreign and domestic investment, which in turn added fuel to the run on the ruble. What Russia needs is a new tax system with sharply lower rates, with relatively few collection points that can be monitored.

But, in the meantime, if Russia cannot collect more taxes or do much in the way of government spending, it does have available the short-term solution of liquifying its real assets.

Russia has enormous wealth that is not being used productively. This wealth is in a highly educated population which for the most part is being utilized in sub-optimal work; extensive natural resources that are neither being developed

nor used as financial collateral; and extensive dollar savings which are hoarded by the people rather than being used for productive investment.

In a recent study of domestic savings in Russia, Professors Valery R. Nazirov of the Center for Financial Markets Research of the Russian Academy of Entrepreneurship, and Valery K. Zaitsev of the Institute of World Economy & International Relations of the Russian Academy of Sciences found that in 1997, Russians on average had a very high savings rate, 25.6 percent of personal income, but that 84.2 percent of these savings went into the purchase of foreign currencies (primarily U.S. dollars). Their conclusion is that most Russian residents save in dollars. However, because of the fragility of the banking system, most Russians hoard these dollars rather than open the foreign currency deposit accounts that most Russian banks offer.

Well, Russia needs short-term financial help to meet its current debt service and spending needs and, most importantly, to stabilize the ruble and turn its wealth into productive investment. The nation has been unable to turn its wealth into productive funds because of its underdeveloped property rights legal enforcement structure and its immature financial structures. The U.S. government can do the following to help improve the situation permanently:

(1) Lend the Russian government U.S. government bonds (\$20 billion to \$40 billion worth should be sufficient, coupled with the committed IMF funds). The Russian government would have to agree to collateralize the bonds with specific natural resources (i.e. proven oil and gas deposits, gold deposits, other metal deposits, etc.) and fix the ruble to the dollar. (Under this system the central bank would be operated like a currency board.) These bonds could then be used as collateral by the Russian government to obtain loans from financial institutions throughout the world, to meet current debt service and spending needs. The Russian government could either return the bonds to the U.S. Treasury after they have repaid the private lenders, or pay interest on the bonds they borrowed. It would give the Russians the collateral they need to obtain low interest loans. These loans would give them more time to put their fiscal, financial and legal systems in order, and would encourage them to speed

(2) Insist, as part of the above described bond loan deal, that the Russian governments (federal and regional) speed up land sales (e.g. agricultural land, timber land, and land for homes and businesses) to the Russian people. If correctly done, it should begin to unlock some of the U.S. dollars hoarded by the Russian people, because they would have the opportunity to trade one unproductive asset - the cash dollar - for a productive one - Russian land. Land sales should also have a positive supply side effect resulting from the additional investment that could be expected in the land, and in turn higher agricultural and timber output. Since most of the land is still owned by some governmental unit, the government could allow for the land to be paid for over time, thus enabling more people to buy and providing the government with a steady and predictable income stream. Having many real estate owners would also assist in developing real local banks. These new owners would then have collate

The current Russian financial crisis stems from an immature and underdeveloped financial and legal system. What Russia needs is time to put in place the institutions and systems necessary for a modern successful economy. For instance, labor lacks the necessary mobility because of the old Soviet housing and factory systems - where homes were tied to factories in one-factory towns - and it takes some number of years to put adequate housing where it is needed.

Modest help as proposed here will cost us little. A failure to help at this critical time could cost us dearly. We Americans spent something in the order of \$3 trillion to win the Cold War. It's worth risking a few tens of billions to make sure we will not have to fight another one.

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