Dismantling Russia's Nonpayments System
Creating Conditions for Growth

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Executive Summary
Nonpayments in Russia evolved into a complex, inter-linked system over the latter half of the 1990s, becoming one of the most critical issues facing policymakers. This paper analyzes this system, including its origins, its evolution, the factors that now perpetuate it, and its costs, and identifies a minimum set of economic reforms needed to dismantle it. The paper also proposes answers to key questions about nonpayments, including those listed below:

- How has its course been influenced by government policy at the federal and subnational levels?
- What are the links with macroeconomic policy?
- What is the role of the energy sector, and how has the system affected the way businesses operate?
- What are the implications for economic growth?
- How indeed, as part of Russia’s transition to a monetized, market economy, did the nonpayments system come to exert a stranglehold on virtually every aspect of the economy?

Factors Driving Nonpayments
Nonpayments intensified and spread as a result of inconsistency between macroeconomic and microeconomic policies, as illustrated in figure 1. The macroeconomic policy goal was to stabilize rapidly as a prelude to the resumption of growth. The government attempted to achieve this goal by fixing the exchange rate and tightening credit even though fiscal reforms and the consolidation of the enlarged government deficit (total federal, regional, and Extra-budgetary Funds (EBFs)) lagged behind. As figure 1 shows, this led to spending arrears and a sharp increase in public debt.

While the microeconomic policy goal was not as clearly articulated as the macroeconomic disinflation strategy, it can be inferred from government actions, especially at the subnational level, that the goal was to maintain a social safety net by continuing to subsidize enterprises and thereby encourage them to remain in operation. Even though explicit budgetary subsidies for enterprises were drastically curtailed during the initial years of
reform, enterprises have continued to be supported by implicit subsidies channeled largely through the energy sector and lax tax enforcement. ¹ These implicit subsidies have taken the form of arrears and noncash settlements (NCS) for energy and tax payments, lumped together in this paper under the title “nonpayments.” ² The energy monopolies in turn passed the related costs on to the fiscal accounts, becoming the largest tax delinquents as well as the biggest participants in tax offsets, which were designed to cancel mutual budgetary and tax arrears. This led to the chronic shortfall in cash revenues witnessed during the 1995 to mid-1998 stabilization period.

As figure 1 shows, feedback between macroeconomic and microeconomic policies has been strong. As real interest rates rose, enterprises experienced liquidity problems and moved further toward NCS; at the same time, the need for implicit subsidies increased. In turn, energy companies increased their tax arrears and delayed payments to the EBFs, exacerbating the cash revenue shortfall and forcing the government to borrow more as nonpayments eroded the tax base. This eventually led to the meltdown when public debt service reached insupportable levels.

Nonpayments were thus propelled by an inconsistent economic policy mix of soft budgets for enterprises, coupled with rapid disinflation in the face of inadequate fiscal adjustment.

**Economic Costs of Nonpayments**

Nonpayments has been fiscally costly, has become a critical constraint to economic growth in Russia, and has had ambiguous welfare effects. It has also diluted the credibility of the key strategic reforms undertaken as part of Russia’s transition to a market economy.

As is clear from figure 1, nonpayments has been fiscally costly, raising public debt to levels that forced the macroeconomic crisis of August 1998. In

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¹ This argument applies more broadly, for example, when oil companies are threatened with a cutoff from the oil export pipeline unless they continue supplying nonpaying domestic refineries.

² Nonpayments comprises both arrears and NCS. The latter include operations related to barter, veksels and offsets, which are typically settled at off-market prices, enabling a discount. See Chapter 1.
retrospect, given the scale of subsidies implicit in nonpayments 3/4 estimated in Chapter 3 at 4 percent of gross domestic product (GDP) per year from the energy monopolies alone 3/4 it is not surprising that the stabilization collapsed. All that was achieved was a temporary reduction in inflation. The reason is that nonpayments impeded fiscal consolidation so that, in reality, the government had only two choices: either higher debt today with higher inflation tomorrow; or higher inflation today. The former path was chosen. Thus, with nonpayments, stabilization can at best be temporarily achieved and will finally not be credible because of its adverse impact on the fiscal deficit through the erosion of the tax base.

Nonpayments has also prevented attainment of another key strategic goal: the resumption of growth.³ The reason is that by softening budget constraints, nonpayments has destroyed the incentives for enterprises to restructure and use inputs and existing assets more efficiently. As will be discussed in Chapter 4, a new industrial organization has resulted, based on an alliance of interests between managers of viable and nonviable companies, who have had strong incentives to collude and partly siphon off the implicit subsidies. This has fueled corruption, asset stripping, and capital flight. At the same time, by distorting prices, nonpayments has prevented the new relative prices, which resulted from liberalization, from serving as clean signals for resource allocation.⁴ Growth gets stifled, as there is little incentive for efficient companies or new entrants to invest more and increase output in this climate.

A key finding of this report is that the process of institutionalizing nonpayments has been incentive-driven. In other words, Russia’s economic problems have resulted from distorted incentives in addition to weak institutions. While a strong institution such as a Federal Treasury is obviously important, distorted incentives might have unnecessarily delayed institution building: consider the vested interests of “authorized banks” that benefited from Russia’s weak Federal Treasury. Further, in this atmosphere, tax rules have meant little, as taxes are effectively tailored to individual companies,

³ The rebound in output following the big devaluation in 1998 is a special case discussed below.
⁴ Pricing in the context of NCS is to a large extent arbitrary, and determined more by personal enrichment goals rather than maximization of enterprise profits.
corrupting the formal tax system and the credibility of tax enforcement and further weakening the development of public institutions. For the system of nonpayments to have grown and flourished would have been almost impossible without the active support of the government. As Chapter 2 will show, this has indeed been the case.

Lastly, the positive welfare impact of nonpayments, in its potential role as an informal social safety net, is at best ambiguous, as discussed later in this Executive Summary and in Chapter 5. Thus, nonpayments has impeded growth while making a questionable contribution to equity.

**Key Questions Looking Forward**

In many ways, Russia once again faces the same problems that it faced when it began its stabilization and structural adjustment efforts in 1995: it must meet the challenges of fiscal management, provide lasting stabilization, and create a foundation for sustainable growth. A crucial difference is that these must be achieved in an environment where access to commercial public borrowing will be severely limited. The key questions are:

- Do nonpayments hurt growth?
- What are the inflationary implications of dismantling nonpayments?
- What are the welfare consequences of dismantling nonpayments?
- How to dismantle nonpayments?

These questions are discussed below.

**Sustained Growth with Nonpayments: Unlikely**

In early 1996, expectations ran high that growth would resume in Russia and achieve sustainable rates of 5-7 percent per year by 1997. However, the expectation proved excessively optimistic. Although there was a sharp reduction in inflation, real interest rates remained high in 1996 because of inadequate fiscal adjustment and heightened political uncertainty stemming from the presidential elections. In 1997, following greater political stability and the perception that reforms would accelerate, the international markets turned toward Russia, which benefited from vast portfolio capital inflows. Foreign
exchange reserves rose by mid-year to unprecedented and unanticipated levels; real interest rates fell and output registered its first increase since the start of transition. However, with public debt in the form of short-term ruble treasury bills (GKO) rising sharply, Russia’s vulnerability to market sentiment increased. Moreover, with nonpayments growing, cash revenues persistently fell short of targets, prompting the International Financial Institutions (IFIs) to tighten their stance toward the end of the year, coinciding with the first contagion attack from the financial crisis in Southeast Asia. Thereafter, real interest rates rose, and concerns about lack of fiscal adjustment and the slow progress in structural reforms dominated investor concerns about Russia. In August 1998, these concerns were realized with the macroeconomic meltdown, which called attention to the large agenda of remaining fiscal and structural reforms, while putting economic growth on hold.

After the sharp third-quarter drop in output in 1998, initial prognostications were that the recession would deepen and intensify in 1999, with GDP forecast to fall by 7-10 percent. In contrast, GDP is estimated to have grown by 3.2 percent in 1999. There are two main reasons for this: (a) the sizable real devaluation has encouraged domestic production, largely by cutting imports; and (b) with limited links between banks and the real sector, the collapse of the large Russian banks has not magnified the impact of the meltdown on enterprises, as in Southeast Asia. Furthermore, survey evidence shows a decline in the use of noncash settlements by firms following the meltdown and monetary loosening.

The common thread linking these two episodes—one preceding the meltdown, when sustainable growth never materialized, and another following the meltdown, when the downside was minimized—is that enterprise-level hard budget constraints have been absent in both cases because of nonpayments, which has impeded efficient enterprise restructuring.

*Hard Budget Constraints and Growth.* One of the most robust empirical results documented since the start of transition is the crucial link between the resumption of growth and enterprise-level hard budget constraints. These are
essential for the efficient use of existing assets and resource reallocation through exit and entry, as will be discussed in Chapter 1. Poland’s experience is instructive. Growth resumed long before mass privatization began. The main factors simulating this growth were competition and hard budget constraints. Further, in the initial years, much of the growth came simply from using existing assets better. Thus, while economic growth resumed in 1992, the big boom in domestic investment came only in 1995, and foreign direct investment did not take off until 1996, when Poland was in its fifth year of growth. Although many observers point to the role played by so-called *de novo* private companies in this process, empirical evidence establishes strong links between these new start-ups and old state enterprises, which in many cases sold equipment and machinery to the new start-ups. This linkage is often referred to as “creative destruction” during transition.

Russia’s growth dynamics will similarly demand a hardening of budget constraints, that is, a dismantling of nonpayments. The continuing inefficiency in using existing assets is brought home by one statistic: energy intensity has actually gone up during the transition even though the relative price of energy has risen. This is because firms cannot be disconnected for nonpayment of energy bills, making the price irrelevant.

**Nonpayments and the Question of Inflation**

The experience between 1995 and 1998 shows that if low inflation is achieved while nonpayments persist, the economic costs in terms of the following are staggering:

- misallocation of resources and postponed enterprise restructuring,
- facilitation of corruption,
- a bad investment climate, and
- stifled growth prospects.
To make matters worse, even the inflation reduction is not likely to last. To put it plainly, if low inflation is attained in the presence of nonpayments, none of the benefits associated with low inflation will be forthcoming, while the economic costs will be considerable. In these circumstances, low inflation is neither an index of success nor credibility. The fundamental objective should be to complete the transition by dismantling nonpayments, with the government signaling that the rules of the game have changed, that it has changed course and will impose hard budget constraints on enterprises and itself.

Dismantling nonpayments calls for the following: (a) fiscal reforms focusing on both expenditures and taxes, with the stoppage by the government of expenditure arrears, to set an example for enterprises; (b) complete elimination of tax offsets; (c) stoppage of subsidies through the energy companies, while at the same time regularizing their taxation in a transparent and efficient manner.

Thus, inflation targets adopted must be consistent with a switch to cash expenditure payments with a simultaneous insistence on cash tax payments. It is obviously important that this coincide with the Federal Treasury exercising control over expenditure commitments. It is difficult to predict the short-term inflationary consequences of such a shift, owing to leads and lags in the adjustment process, and the need for the government to set an example by moving first. However, the medium-term consequences for inflation are likely to be beneficial because the elimination of implicit subsidies will facilitate credible enforcement of prompt cash tax collection, thereby easing the fiscal burden. This might delay the return to single-digit inflation levels, but the long-term strategic benefits of dismantling nonpayments and completing the transition will more than outweigh any short-term costs associated with moderate inflation. For example, in Poland, the government was able to establish enterprise-level, hard budget constraints and embark upon a program of fiscal reform without immediately bringing inflation down to single-digit levels. This did not in any way hurt the credibility of macroeconomic

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5 In 1998, twelve-month inflation dipped below 10 percent in February, and remained at single-digit levels up to August, after which it rose. It now remains at moderate levels.
policies because it was evident to the private sector that the necessary political will to implement the needed fiscal reforms existed. In other words, fiscal reforms; enterprise-level, hard budgets; and structural reforms to promote growth, all of which require that nonpayments be dismantled, should be viewed in a strategic, medium-term context of completing Russia’s transition and creating strong microeconomic foundations for both growth and lasting stabilization. The dismantling of nonpayments and the formulation of inflation targets need to be coordinated.

**Welfare Concerns**

The standard view is that the government and policy makers tolerate nonpayments because the social consequences of hard budgets would be difficult to accept. Enterprises are not shut down because of fears of rising unemployment and disruption in the flow of social services they provide.

However, data reported in chapter 2 show that transfers to the population and wages account for a significant part of government arrears at the subnational level. This is difficult to reconcile with the notion that social concerns are driving the no-exit policy for enterprises, i.e. supporting employment by preventing enterprises from dropping out of the market. Indeed, one of the major casualties of the chronic tax shortfalls witnessed during 1995-98-which can be partly attributed to the fact that the biggest tax delinquents are also the biggest implicit subsidy providers in the nonpayments system-has been social spending.6

At the same time, the output of large enterprises has been declining over time, and wage payment arrears are significant. Therefore, the additional social impact of hardening budgets at this point is not clear. It may be that apart from one-company towns, which have to be treated as special cases, the social impact on other enterprises may be much less severe than believed. This is clearly a topic requiring more work, but it is also worth noting that if sustainable growth does not resume-and this is not likely under the present system of nonpayments-then the welfare of the younger generation of

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6 This happens directly, because tax shortfalls means a general compression of cash expenditures, and social spending is cash spending; and indirectly because the implicit subsidies get siphoned off and ironically co-exist with wage payment arrears by firms.
Russians, who will not have much to look forward to, is also a factor that must be weighed. The key issue here is that the absence of exit of nonviable companies is the biggest barrier to the entry of new, more efficient, firms.

**Dismantling Nonpayments: A Minimum Set of Reforms**

The economic case for dismantling nonpayments and the technical solution are straightforward. The impediments are political. First, a political decision has to be made by government at all levels to stop subsidies to enterprises, explicit and implicit, thereby ensuring hard budget constraints. (One-company towns might have to be treated as exceptions.)

Based on the diagnosis of the nonpayments problem in this paper, corrective policies will need to address (a) continued reform to bring the enlarged fiscal deficit under control; (b) tax reform to enable the smooth switch to transparent cash-based taxation; (c) coordination of inflation targets with a switch to budget execution solely in cash form, and strictly avoiding further budgetary arrears, while imposing hard budget constraints on enterprises; (d) efficient pricing, taxation and regulation of the energy monopolies supplemented with a clear policy enabling disconnection of nonpayers; and (e) an assessment of the probable social impact of hard budgets.

Reform should follow two guiding principles:

1. Get the government and the energy monopolies out of the nonpayments web. This would eliminate the subsidies and provide incentive for an automatic dismantling of nonpayments among manufacturing firms in general. This process would work by effectively hardening budget constraints. As soon as the net creditors in the system realize that offsetting compensation from the government in the form of tax breaks and other concessions is not forthcoming, the system will spontaneously begin to break up through a cascading effect. This will also restore integrity to the tax system: the provision of implicit subsidies will no longer provide an excuse for not paying taxes.

2. Coordinate inflation targets with the dismantling of nonpayments as discussed above.

In sum, the strategy for dismantling nonpayments requires a political shock to change the system radically with the government taking the lead. Details are contained in Chapter 5, and summarized in box 1.
Box 1: Measures to Dismantle Nonpayments

**Government:**

- Create political consensus at all levels of government (federal, regional, municipal) about need for dismantling nonpayments, that is, hardening budget constraints.
- Rapidly implement tax reform to eliminate all exemptions and treat all taxpayers uniformly.
- Implement strict expenditure commitment control using Federal Treasury.
- Make all appropriately controlled expenditures on time and in cash.
- Insist on prompt tax cash payments.
- Coordinate inflation targets with fiscal reforms and dismantling of nonpayments.
- Proceed rapidly with social reforms in the context of a well-targeted social safety net.

**Energy Monopolies:**

- Implement efficient and transparent pricing, taxation, and regulation of Energy Monopolies (EMs).
- Change civil code to unambiguously permit disconnection of nonpayers after reasonable notice period.
- Ban, or severely restrict and monitor, use of intermediaries by regional energy companies (AO Energos).
- Insist on prompt and full tax payments by EMs.

**Enterprises:**

- Separate all remaining social assets and provision of social services from enterprises, and introduce transparent taxation.
- Estimate social consequences in one-company towns of hardening budget constraints.
- Signal and advertise improvement in investment climate resulting from hard budget constraints and transparent taxation.

**The Time is Now!**

The present time for dismantling nonpayments is exceptionally good: (a) the real devaluation has given domestic industry a tremendous boost by
discouraging imports, improving its liquidity, and reducing the need for subsidies; (b) the government can no longer postpone difficult decisions because access to commercial borrowing has dried up for the time being; and (c) the lessons learned from the meltdown are still fresh. The most important of these is that attainment of low inflation will lead to sustainable growth only if it is accompanied by genuine enterprise restructuring and fiscal adjustment. By softening budgets, nonpayments destroys incentives for enterprise restructuring and becomes synonymous with the lack of fiscal adjustment, delaying the completion of transition.

It is probable that the real devaluation, which has given breathing space to Russian enterprises and permitted an import-substitution-based expansion of domestic industry, will persist for the next 12-18 months, if not longer. The reason is the massive overseas transfers Russia must make during the next few years. With large foreign debt service payments due, limited access to foreign borrowing and reserves close to critical minimum levels, the only way for Russia to meet its obligations is to generate large trade surpluses, which in turn requires a depreciated real exchange rate. This is an ideal circumstance in which to harden budgets by eliminating nonpayments, which would also help ensure that the one-time windfall gain from devaluation that is now cushioning enterprises gets converted into genuine enterprise restructuring, providing a foundation for sustainable growth.

Another important benefit of dismantling nonpayments would be a strong improvement in the investment climate. For years, portfolio investors have been drawn to Russia on the promise of its huge potential, with abundant natural resources and every element in the periodic table. In fact, the valuation of Russian companies has largely been based on comparing the assets of these companies with those in the same field listed on stock markets in the West. So far, however, the necessary foreign direct investment to extract the income streams from these assets has lagged behind from both domestic and foreign sources. Nonpayments represents a major barrier to such investment because of the resulting opaqueness and the difficulty posed for new entrants. Furthermore, outside strategic investors may be deterred from investing in Russian companies because they cannot easily value these...
companies or determine how loans are going to be repaid in cash. By hardening budgets and increasing transparency, the elimination of nonpayments will also push managers to seek “normal” financing sources, thereby providing incentives for the fair treatment of all shareholders and creditors. Thus, when nonpayments are dismantled, Russia can expect a dramatic improvement in its investment climate, even though the improvement might take time because of the need for establishing a successful record of consistent reforms.

A last point relates to the pace at which nonpayments should be dismantled. While faster would clearly be better, temporary disruptions are bound to arise, including those related to the supply of social services now channeled through enterprises. A plan will be needed to for address such disruptions. SAL3 incorporates a time-phased approach to removing government and the infrastructure monopolies from the nonpayments web. It is vital that the government adhere to the agreed schedules and institute sharp penalties in case of noncompliance.

NB: All rubles used in this report refer to the "new rubles" introduced on January 1, 1998, created by dividing the "old rubles" by 1000 (knocking off three zeroes).

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