

The State in the New Russia (1992-2004): From Collapse to Gradual Revival?

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The very notion of the state implies that public authorities hold monopolies on three functions:

- Legitimate use of violence
- Provision of revenues by collecting taxes
- Control of monetary emission

All three monopolies were undermined in Russia during the 1990s to such an extent that the very existence of the state was put into question. The government failure became pervasive and much more visible than the market failure.

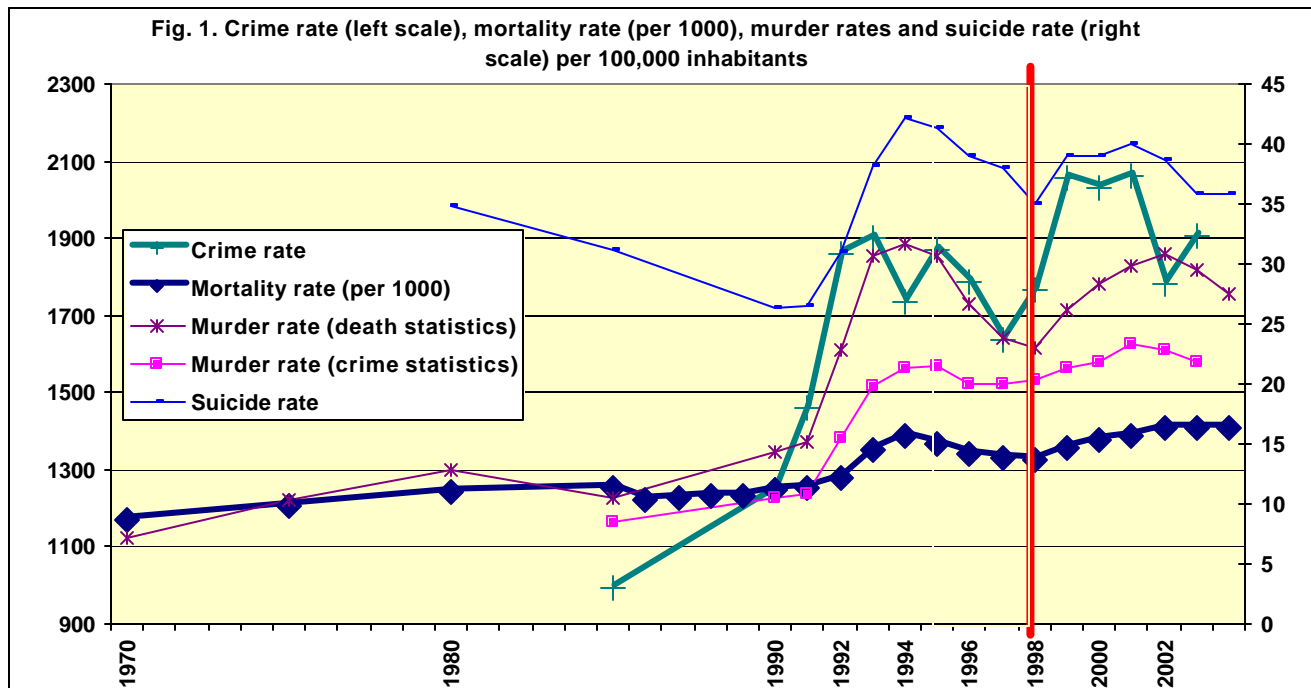
Where have the three monopolies gone?

Violence

Crime rose gradually in the Soviet Union since the mid 1960s, but after the collapse of the USSR there was an unprecedented increase. In the early 1990s, in just a few years, crime and murder rates in Russia doubled and were considered among the highest in the world (fig. 1). Crime statistics are usually perceived to be incomparable in different countries because of large variations in the percentage of reported and registered crimes. But murders are registered quite accurately in both criminal statistics and death statistics. The first one is more restrictive than the second one, since it registers only illegal murders, whereas the second one accounts for all murders, including legal (capital punishment and “collateral damage” during wars, antiterrorist and other police operations). Both rates skyrocketed in Russia in the beginning of 1990s and stay at extremely high levels today. The gap between both indicators widened during the first Chechen war (1994 to 1996) and the ongoing second war (since 1999).

By the mid 1990s, the murder rate in Russia stood at over 30 people per 100,000 of inhabitants compared to 1 to 2 persons in Western and Eastern Europe, Canada, China, Japan, Mauritius, and Israel. Only two countries in the world (not counting some war-torn, collapsed states in developing countries, where reliable statistics are questionable) had higher murder rates – South Africa and Colombia. In countries like Brazil or Mexico

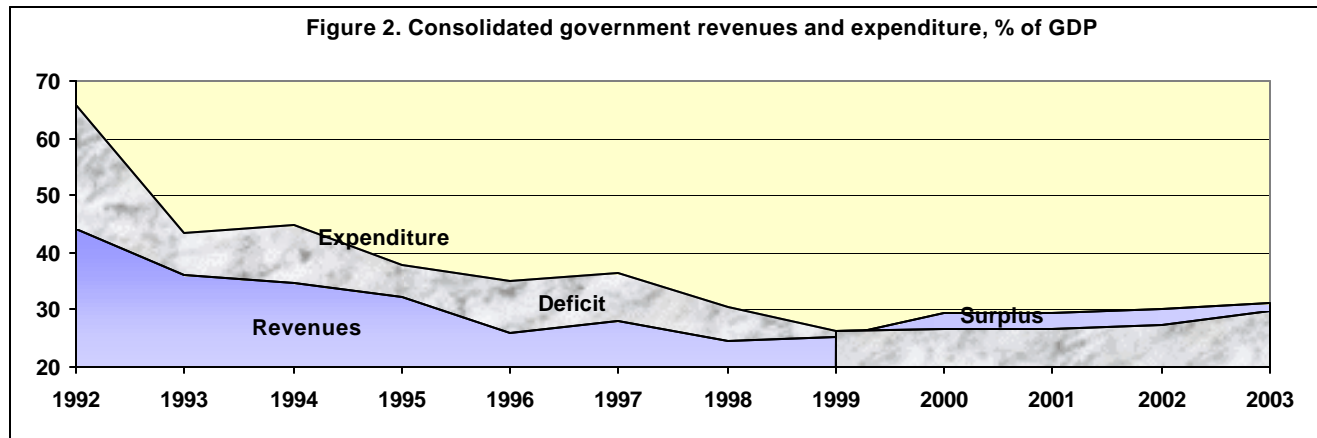
the rate is two times lower. Even the U.S. murder rate, the highest in the developed world (6 to 7 people per 100,000 of inhabitants) pales in comparison to the Russian one.



When the murder rate reaches 40 to 50 people per 100,000 of inhabitants, as it did in Colombia in the 1990s, the country faces collapse of the state authority and degrades to chaos and war-lordism. The unprecedented increase in the crime rate in the 1990s and the shocking murders of famous politicians, businessmen and journalists that went unpunished bankrupted the credibility of law enforcement agencies and brought the Russian state to the point of losing its monopoly on the legitimate use of violence.

Tax collection

Throughout the 1990s, the total revenues and expenditures of the state decreased dramatically as compared to the Soviet times, by two-thirds in real terms. The share of government revenues and expenditures of GDP was cut in half from 1990-98 (fig.2), and the GDP itself fell by nearly 50 percent. This was partly the result of conscious policy to cut tax rates and government spending based on the belief that the state needed to be downsized, but this was mostly caused by the decrease in tax compliance and the increase of the shadow economy. The shadow economy had been growing gradually in the 1970 to 1980s and comprised about 10 to 15 percent of GDP during late Brezhnev era according to the most generous estimates, but it increased to 50 percent by the mid 1990s.



According to the 1999 European Bank of Reconstruction and Development

In the *Transition Report*, the quality of governance (positively) and the state capture index (negatively) were correlated with the decline in the share of state revenues and expenditures in GDP. The state capture index was the highest in Russia. Belarus and Uzbekistan fell into the same group as the Central European countries. Estonia, in contrast, had a small reduction of state expenditure as a percentage of GDP during transition, good quality of governance, little bribery, small shadow economy and low state capture index.

According to [REDACTED], corruption in the Soviet Union in 1980 to 1985 was higher than in most developed countries, but lower than in developing countries. In a list of 54 states the USSR was just about in the middle: the Soviet bureaucracy was cleaner than that of Italy, Greece, Portugal, South Korea and all developing countries, but more corrupt than in other developed states. In 1996, after the transition to market economy and democracy, Russia, in the same list of 54 countries fell to 48th place, between India and Venezuela.

As a result, many government functions – from collecting custom duties to doing justice in the courts – were de facto privatized. Criminal groups started to provide missing public services, like contract and property rights enforcement to businesses and individuals for a fee.

The fiscal crisis of the state probably reached its climax right after the currency crisis of August 1998. Government revenues and expenditures fell in 1999 to 30 percent of GDP. GDP itself was nearly 2 times lower than a decade before. Government debt and external indebtedness reached a maximum, and foreign exchange reserves decreased to \$10 billion – less than in the Czech Republic or Hungary which only have a population of 10 million. To add insult to injury, the regional authorities gained financial strength at the expense of the federal government. From 1992 to 1994 many regions refused to pay taxes in full to the federal government, so the latter had to negotiate separate deals with many of them introducing de facto a system of bargained federalism.

Monetary emission

Three interconnected processes undermined the ability of the Central Bank to control monetary circulation: (1) an accumulation of arrears (payments overdue) that exceeded 300% of the money supply (M_2) at the highest point in August 1998; (2) an increase in

barter transactions to 50% of all contracts in industry by the time of the August 1998 crisis; and (3) the proliferation of money substitutes, like vekseles by regional governments, banks and major companies. The peak for this was reached in 1994-96. After the 1998 August crisis, barter transactions and non-payments gradually dwindled away. But this happened as a result of devaluation and subsequent economic growth: despite, not because of, government policy.

Why the state collapsed

Let us define a strong state as the one that has the power to enforce its rules and regulations. Crime and murder rates and the size of the shadow economy are natural indicators of the weakness of state institutions. A strong state may be authoritarian or democratic - both China and Central European countries with the murder rates of about 2 per 100,000 inhabitants have stronger states than Russia with 32 murders per 100,000 of inhabitants. If democratization occurs in countries with a weak rule of law, the state capacity is undermined.

Zakharia (1997) looks at the rise of “illiberal democracies” - which are countries, where competitive elections are introduced before the rule of law is established. European countries in the 19th century and contemporary East Asian countries moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong before and after hand over to China in 1997 is the most obvious example of the rule of law without democracy). In Latin America, Africa, and now in many former Soviet Union countries, democratic political systems were introduced in societies without the firm rule of law. These authoritarian regimes gradually built property rights and institutions, but substituted rule of law with authoritarian means (lawless order). After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure order, and also without mechanisms of rule of law needed to guarantee property rights, contracts and order.

Democratization is associated with few costs and many benefits, if carried out in *liberal autocracies* (i.e. in countries that have established mechanisms and traditions for the rule of law). But when democratization occurs in *illiberal autocracies* (in countries that maintain order not based on law), the result is the emergence of *illiberal democracies*. Their record on institutional capacities is the worst, which predictably has a devastating impact on economic growth.

The impact of democratization is different for developed and developing countries, especially when the strength of the rule of law is taken into account. For developing countries with poor rule of law, greater democratization measured by the change in the [REDACTED] index of political rights was associated with lower growth rates.

Statistical analysis demonstrates that if an index measuring rule of law is crucial in explaining the relationship of democratization and growth. If the index is higher than 0.72 (measured on a scale from -1 to +1), democratization has a positive effect on growth, if it lower, the impact is negative.

What are the mechanisms that lead to a state collapse? Research shows that in weak democracies, governments are “privatized” and are prone to pressure from industrial

lobbies and populist groups. Civil service in weak democracies is corroded by corruption and crony relationships. These governments cannot ensure high tax compliance and cannot contain the expansion of the shadow economy. They cannot collect enough revenues to finance their expenditures and must resort to inflationary financing of budget deficits. As a result, growth rates in weak democracies are low, and this causes a negative cascade: rates of life expectancy are stagnated in the collapse of preventive healthcare, income and social inequalities grow, and crime and murder rates increase.

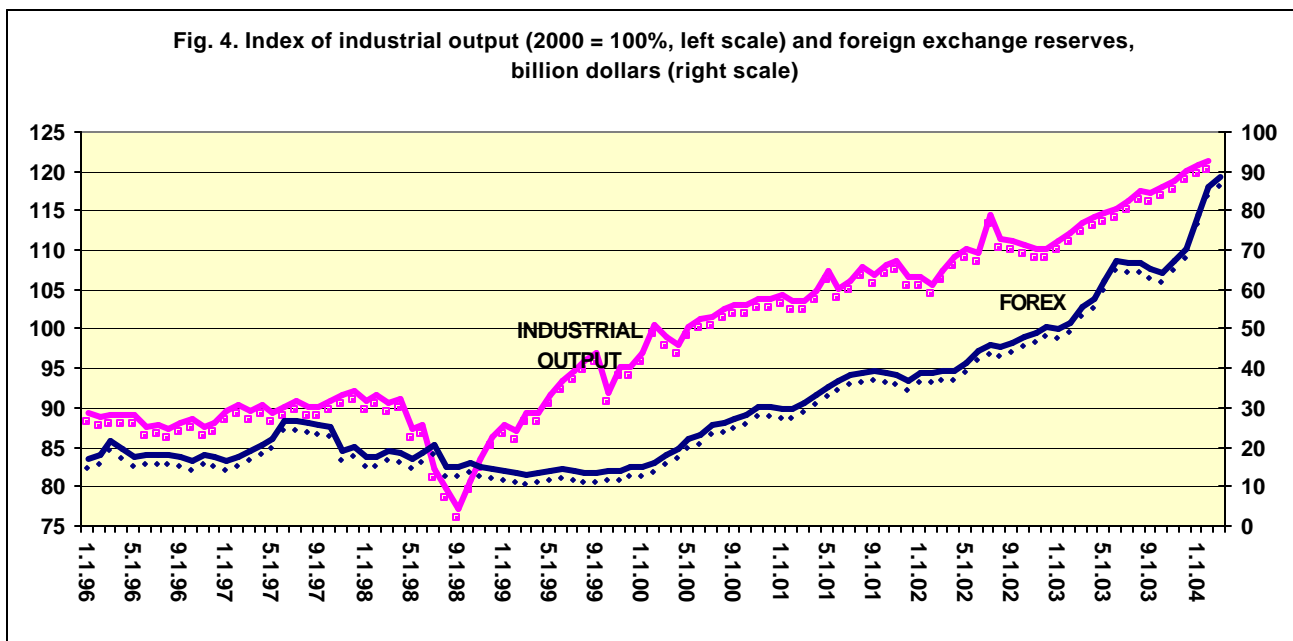
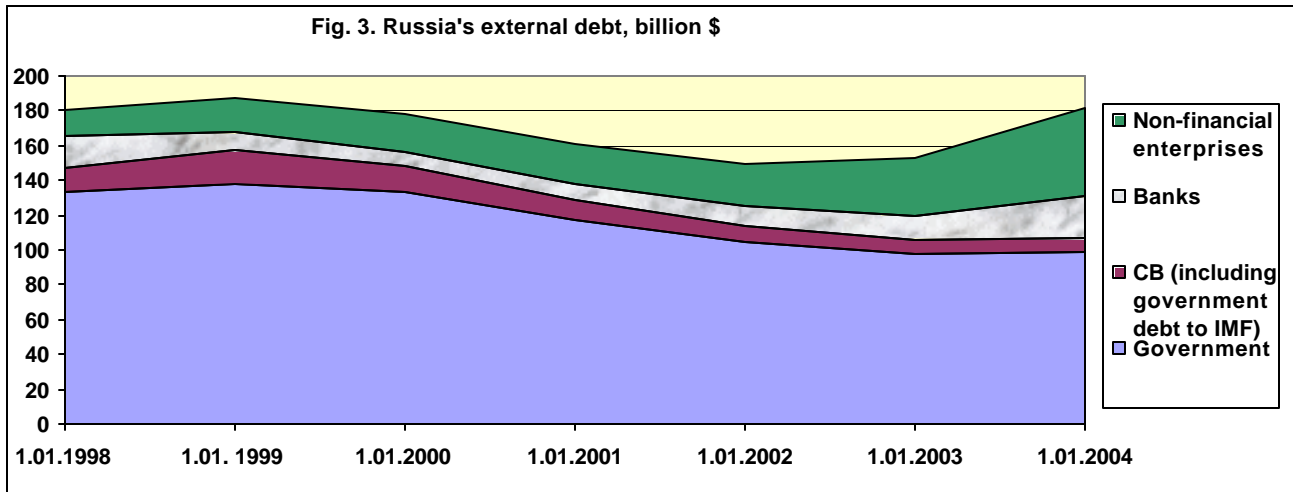
Among the former communist countries, those with the weak rule of law but better economic performance are less democratic regimes (Azerbaijan, Belarus, Kazakhstan, Turkmenistan, Uzbekistan). Countries with weak rule-of-law, but more democratic regimes (the other CIS countries, Balkan states, Mongolia) generally performed less successfully in terms of GDP, life expectancy, and income inequalities.

Russia in the 1990s very much fell into this pattern: growing income inequalities and crime rates, the expanding shadow economy, shrinking government revenues and expenditures, poor macroeconomic policy, growing corruption and high “state capture”. In 1997, Russian oligarchs appeared for the first time in the Forbes list of billionaires. In 2004 Russia had more billionaires than any other country in the world except for the United States and Germany. With GDP per capita below that of Costa Rica and Mauritius, and with life expectancy of 65 years compared to that of 77 in Cuba, and with 25 percent of the population living on less than \$2 a day, Russia in 2004 had 36 billionaires. China, with a similar level of development, had one.

Rebuilding the state

Putin’s efforts to strengthen the state capacity has included centralization changes in the system of fiscal federalism, appointment of viceroys to the regions, and reform of the Council of Federation, the upper chamber of the Russian parliament that previously consisted of governors of the regions. Putin started the second Chechen war that continues today refusing to conduct any negotiations with separatists. He accused several oligarchs of financial fraud and tax avoidance and forced some of them to leave the country and put others in jail. The state took control over the only non-government TV channel (NTV), although on formally legal grounds. More recently, in late 2004, after the Beslan terrorist attack, Putin proposed to nominate governors of the regions (to be approved by regional legislatures) and to elect deputies to the State Duma only from party lists where previously half of them were elected from electoral districts.

The economy, started to grow in 1999. It grew 6 percent in 1999, 10 percent in 2000, and 4 to 6 percent annually from 2001 to 2004. The source of economic growth was devaluation of the ruble in 1998 and higher world prices for oil and gas. Though these feats cannot be fully attributed to him, Putin can take the credit for not stifling this growth. The government budget moved from a deficit to surplus, the decline in the share of state revenues and expenditures stopped (fig. 2), inflation fell from 84 percent in 1998 to 12 percent in 2004, government debt and external debt decreased (fig. 3), and foreign exchange reserves increased (fig. 4).



The most important achievement of recent years is that the growth of the economy and the political stability finally brought about some improvement of social trends: the number of murders reached a peak in 2002 and fell in 2003 to 2004; the suicide rate decreased from 2001 to 2004 (fig. 1); after reaching a 50-year low in 1999, birth rate started to grow, the marriage rate increased, and the divorce rate fell. True, the improvements are very marginal and there are some, like the death rate, that continue to deteriorate, but at least there are signs of improvement.

A growing economy and falling inflation by themselves cannot stop the disintegration of society. If the gap in social inequality widens, criminalization increases, and the shadow economy remains, centralization cannot stop the collapse of the state. A major criticism of Putin in recent years is that his centralization of power has not lead to the improvement of social order. Now it seems that there are some signs of real stabilization and restoration of the state capacity.

As opinion polls show, the majority of Russians believe that the biggest national issue today is strengthening of law and order, not the protection of democracy and not the containment of authoritarian trends. In fact, most Russians would be willing to trade some democracy for greater law and order. Is such an exchange possible?

Strictly speaking, we still do not know. While there is good statistical evidence that democratization under the poor rule of law leads to the weakening of the state capacity, there is less evidence that the reverse movement (to authoritarianism) contributes to the strengthening of the institutions. There are too few observations to make this claim. There is always a danger that an authoritarian regime would not have enough checks and balances to prevent it from abusing power. One should choose the lesser evil, however. The greatest danger that Russia faces today is the collapse of the state, which would result in disorder, chaos and the collapse of the country. If the centralization of power works as it seems have worked in recent years, even at the expense of some democratic freedoms, there is a chance that the worst-case scenario could be avoided. If there is no centralization, there is no chance.*

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* The argument in this memo is based on statistical analysis reported in: Polterovich, V., V. Popov *Democracy and Growth Reconsidered: Why Economic Performance of New Democracies Is Not Encouraging* (2004)