

US Army War College
USAWC Press

Monographs

6-1-1997

The Crisis in the Russian Economy

Vitaly V. Shlykov Dr.

Follow this and additional works at: <https://press.armywarcollege.edu/monographs>

Recommended Citation

Shlykov, Vitaly V. Dr., "The Crisis in the Russian Economy" (1997). *Monographs*. 190.
<https://press.armywarcollege.edu/monographs/190>

This Book is brought to you for free and open access by USAWC Press. It has been accepted for inclusion in Monographs by an authorized administrator of USAWC Press.

THE CRISIS IN THE RUSSIAN ECONOMY

Vitaly V. Shlykov

June 30, 1997

The views expressed in this report are those of the author and do not necessarily reflect the official policy or position of the Department of the Army, the Department of Defense, or the U.S. Government. This report is cleared for public release; distribution is unlimited.

Comments pertaining to this monograph are invited and should be forwarded to: Director, Strategic Studies Institute, U.S. Army War College, Carlisle Barracks, PA 17013-5244. Comments also may be conveyed directly to the Conference Organizer, Dr. Earl H. Tilford, Jr., by calling commercial (717) 245-4086 or DSN 242-4086. Copies of this report may be obtained from the Publications and Production Office by calling commercial (717) 245-4133, DSN 242-4133, FAX (717) 245-3820, or via the Internet at rummelr@carlisle-emh2.army.mil

This monograph was originally presented at the U.S. Army War College's Annual Strategy Conference held April 22-24, 1997. The Strategic Studies Institute is pleased to publish the paper as part of its Conference Series.

All 1995 and later Strategic Studies Institute (SSI) monographs are available on the Strategic Studies Institute Homepage for electronic dissemination. SSI's Homepage address is: <http://carlisle-www.army.mil/usassi/>

FOREWORD

The words, from the 1970s ballad, "Me and Bobby McGee," "Freedom's just another word for nothin' left to lose..." might apply to the terrible state of the Russian economy and, by extension, Russia's armed forces. Since the Soviet Union crumbled in 1991 and the Russian government set the country on its shaky journey toward capitalism and democracy, the Russian economy has been in a downward spiral; one which has drawn a majority of Russians into poverty and even lowered the average life expectancy by some 10 percent. To provide some scale for comprehending the magnitude of this problem, the more than 1.5 million men and women in uniform in the Russian armed forces and the 600,000 civilian employees of the Ministry of Defense, as well as the several million military pensioners throughout the land, must share a total defense budget of \$15-\$18 billion per year. That is about one-fourth of the U.S. Army's budget.

The paper that follows, by retired Soviet Army Colonel Vitaly Shlykov, is a brutally honest appraisal of the harsh realities that are a part of today's Russia. It was presented at the Army War College's Eighth Annual Strategy Conference, "Russia's Future as a World Power," held at Carlisle Barracks, Pennsylvania, April 22-24, 1997. Colonel Shlykov's paper is even more sobering when one considers that the October Revolution of 1917 began in the bread lines of Petrograd and Moscow.

RICHARD H. WITHERSPOON
Colonel, U.S. Army
Director, Strategic Studies

Institute

BIOGRAPHICAL SKETCH OF THE AUTHOR

VITALY V. SHLYKOV retired from the Soviet Army in 1988 at the rank of colonel. During his 30 years of service, Dr. Shlykov was a research analyst in the field of defense economics. He also served on the General Staff. He earned his Ph.D. at the Moscow Institute of Foreign Relations and is a graduate of the Military Diplomatic Academy. After retiring from active duty, Dr. Shlykov spent 2 years as a senior research fellow at the Institute of World Economy and International Relations in Moscow. From 1990 to August 1992 he was the Deputy Chairman of the State Committee on Defense in Russia. He is an acknowledged expert on the Russian defense industry and its associated budget.

THE CRISIS IN THE RUSSIAN ECONOMY

It seems as if the universal laws of economics do not apply to Russia. According to the economic theory, in the period of transition from a rigidly centralized economy to free market, prices are not set, state-owned businesses are privatized, and then there is a phase--2 or 3 years long--of painful adjustment and rising unemployment. After that--and this has been happening in Poland, Hungary, the Czech Republic, and the Baltic states--the economy starts growing.

Russia freed prices on January 2, 1992. It privatized tens of thousands of enterprises, stabilized the ruble, and wrung inflation out of its economy. In 1996 the government squeezed inflation to a manageable 21.8 percent, the lowest since the start of reforms and down sharply from 133 percent in 1995. The monthly inflation rate fell steadily through 1996, sinking to 1.4 percent in December from 4.1 percent in January. Now it has been more than 5 years since the collapse of the Soviet Union, but statistics show a continuous, Great Depression-scale contraction (approximately 50 percent since 1991). In 1996 gross domestic product (GDP) was 6 percent lower than a year earlier. Industrial output has fallen 5 percent for the year, worse than the 3 percent decline in 1995.

Russia's First Deputy Prime Minister, Viktor Ilyushin, has released statistics indicating that, contrary to much of what the government has been saying, each consequent year of reforms continues to pull people into poverty. Characterizing the situation in Russia's social sector as "catastrophic," Ilyushin said that real incomes are now 40 percent lower than they were just 5 years ago. In January 1997 the subsistence level was 394,000 rubles per person (\$70) a month, with 22.4 percent of Russians (about 33 million) earning below that level. A full 75 percent of that total--R290,000--just covers the monthly food basket of 25 dietary essentials such as eggs, bread, flour, and milk. The balance covers costs associated with housing,

transport, medicines, and clothing. Average per capita incomes were 111 percent above the subsistence level (R829,600, or \$150). The country's top 10 percent of wage earners had 12.8 times more income than the bottom 10 percent. Only 7.3 million, or 4.9 percent of the population, earned more than 2 million rubles per month.

The State Statistics Committee also reported wage arrears totaling 48.6 trillion rubles as of January 27, 1997, a 3 percent rise on the previous 5 weeks. Budget shortfalls accounted for 19.5 percent of arrears, while money shortages at companies and other organizations made up the remaining 80 percent. Russian industry workers are owed 22.93 trillion rubles in back wages, with 1.044 trillion rubles of that owed by federal and local budgets, and 21.886 trillion rubles owed by companies themselves. Life expectancy has plunged to its lowest in 15 years. According to the World Health Organization in Geneva, the average Russian man can expect to live 57.4 years, compared to 61.1 years in 1981 and nearly 64 years before Mikhail Gorbachev stepped down and President Boris Yeltsin started Russia's transition to capitalism.

Russia's disastrous economic situation seems on the surface like a social explosion waiting to happen. And indeed, in two of the largest walkouts since the Soviet collapse, coal miners and the Far East energy workers staged huge strikes last year that ended only when the government came up with hundreds of billions of rubles in back wages. And yet despite a steep drop in living standards and a dramatic worsening of the problem of unpaid wages, the rumble of protest has yet to turn into a unified roar--the kind that could stir mass action and perhaps force changes in economic policy.

Many experts, both Russian and Western, express puzzlement over how a significant segment of the work force can go without pay for up to 6 months. Among the possible reasons, they say, are union disarray, fear of

unemployment, a national psyche not fully geared to striking, and, finally, the renowned stoicism of the Russians. Yet, in the land of the original Potemkin village, rarely is anything as it seems.

In Russia, where most firms play down success for fear of paying taxes, poor output figures often hide a booming black market economy. Official figures, reassessed after the World Bank complaints that Russian statisticians were ignoring the black market economy, indicate that it accounts for 22 percent of GDP. But even Prime Minister Chernomyrdin admits that the size of the untaxed shadow economy might be as high as 50 percent of GDP. The Russian Ministry of Economics even refuses to believe the data of the State Statistical Committee about decline of the Russian economy in 1996 and insists that there was no fall in GDP or industrial production last year. As proof, it cites the official statistical data, according to which the electricity output, which cannot be easily hidden, actually grew in 1996.

The fact that from one-quarter to one-half of Russia's GDP is hidden from the authorities probably explains why there is no widespread hunger, even though large swathes of the population have not received salaries for months. There is also a big difference between average salary and average income level of a Russian citizen. Every business either keeps two books or has other ways of compensating its workers because of the obvious impossibility of providing for a family on an average salary or even on two average salaries. The shadow economy means that the economic pie is larger than the official statistics would suggest.

Signs of conspicuous consumption of wealth can be seen in all the large Russian cities. New modern buildings are being constructed, old buildings are being lavishly restored, and the so-called "New Russians," that is, people with large fortunes, race around in their BMWs and designer clothes. The majority of these individuals, with their pompous mansions and

expensive cars, successfully avoid paying taxes. On the other hand, the new "money elite" throws its money around. No one is rushing forward to announce himself the owner of a large fortune by giving the government, society, and the media real figures on the sources of that wealth. And this is probably not just because of the criminal or semi-criminal origin of much wealth, but because, for now, such are the "rules of the game" established by the government.

The separation of the "New Russians" into a special social class is connected not so much with their role in the organization of modern industry and in the effective management of the national economy as it is with the process of acquiring and distributing wealth, with the status and prestige of consuming. Market and banking activities, profitable import-export operations, the use of privatized property by either selling or renting, the apportioning to themselves of huge deposits and "dividends"--these are the main sources of the quick separation of Russian society into the "money elite" and the "average Joes." All of this only leads to the growth of alienation between the disparate social groups. It creates the danger that Russian society will be polarized and unstable, with great potential for unrest and conflict.

There are signs that Russians' resources for getting by have been largely exhausted. The government's strict monetary policy, intended to tame inflation, has been squeezing state coffers and causing unpaid wages and pensions to skyrocket. Overdue wages and social benefits have more than tripled in a year to about 40 trillion rubles (\$7 billion). Workers sometimes get their pay in shoddy or basic goods. Enterprises across Russia offer employees candy, cement, coats, vodka, and even cigarette lighters and brassieres imported from China.

The picture of the Russian economy painted even by the top-level officials in the Russian government is striking both for its blackness and its candor. Deputy

Prime Minister Ilyushin said that Moscow might adopt inflationary policies that "might not please certain international monetary organizations." At the end of 1996, Economics Minister Yevgueny Yasin wrote in a letter to Prime Minister Viktor Chernomyrdin that "if existing trends in the economy are continued without energetic and purposeful efforts to break them and create real conditions for economic growth, the situation will in all probability continue to get worse." He said that the 1997 budget was completely unrealistic and that revenue forecasts should be scaled down, and both social and defense spending had to be cut, even if this increased the risk of political unrest. But Yasin's warnings were not heeded. The government pushed through the State Duma a budget for 1997 that no one believes to be even slightly realistic. Consider these basic numbers: The 1997 budget pledges to raise spending to 19.4 percent of GDP, whereas last year's spending ran at only 15.4 percent of GDP. The budget allows that 3.5 percent of the whole will be filled by borrowing, but the rest must come from taxes. In other words, Russia must collect taxes worth 15.9 percent of its GDP.

Everyone admits that this is impossible. Last year, according to the State Statistics Committee, Russia could only raise revenue equal to 11.1 percent of the GDP from taxes. In fact, the budget offers few clues on how revenues are to be boosted by a hefty 4.5 percent of GDP. The point is that no one, not even those closest to the process, believes that the budget's rosy predictions of a huge boost in spending financed by massive growth in government revenues are real. "Only 70 to 80 percent of the things in the budget will ever happen," said Mikhail Zadornov, head of the Duma's budget committee. Sergei Dubinin, chairman of the Central Bank, said the figures are so wrong that the government will have to cut spending by 60 to 130 trillion rubles this year to compensate.

Well then, what lies behind this elaborate smoke and mirror game if the numbers are all nonsense? The

confusion is a sign that a budget in Russia is something very different in purpose from its Western counterparts. In other countries, the budget is a real plan for the national household for the next 12 months. In Russia, the budget has emerged as something like a statement of good intentions. For the government, the real purpose of the budget is not so much to win detailed approval of its spending plan but to win a mandate to continue fighting inflation and containing the budget deficit. A formal budget bill is necessary for the government to secure International Monetary Fund support for the continuation of its 3-year \$10.1 billion loan agreement.

The good news for the government is that it has more or less won. The new budget incorporates its low inflation target of 11.8 percent for 1997, backed by a relatively low deficit projection of only 3.5 percent of GDP. From the government's point of view, everything else in the budget will take second place to meeting its monetary targets. So in order to hold the line on the deficit and inflation, spending will have to be slashed.

That is what happened last year. The government promised to spend a lavish 18.9 percent of GDP, funded by 15.1 percent in revenue. In fact, revenue collapsed to 11.1 percent, but the government slashed spending to only 14.4 percent. All the numbers in the budget were skewed except for one: the government still met its target of keeping the budget deficit around 3 to 4 percent. Having accepted that the budget is about setting low inflation and budget deficit targets and that spending predictions are just serendipity, the rest of the budget process becomes understandable, albeit rather comic.

Only about one-third of the budget, including spending on education, wages, food, and medicine for the army, and interest on government debt, has been listed as so-called protected items that will receive priority financing. According to the law, if the

quarterly revenue collection falls below 90 percent of the projected amount, the government is supposed to present parliament with a bill that outlines proportional cuts on all spending items apart from the protected items. This will probably wipe out investment spending as well as other crucial items such as subsidies to the pension fund and local governments.

Russia's fairy tale budgets have been allowing politicians to avoid responsibility so far for the non-payments crisis in the country because, in Russia, parallel to the official state budget there exists the so-called quasi-budget sector that includes the huge pension fund, the road fund, and the local budgets. When this wider definition is taken into account, Russia's government spending rises from 14 to 38 percent of GDP. When, in January 1997, about one-tenth of Russia's 4.5 million teachers went on strike to protest overdue wages (some teachers have not been paid for 8 months), the government simply blamed local officials for the problem. The difficulties the local governments face in financing their needs are enormous. Two-thirds of the housing costs in Russia are still assumed by the state. Russians spend only a small percentage of their family income on electricity, heating, and building maintenance. If all the budget expenditures on housing are added together, one arrives at the astronomical figure of 103 trillion rubles (\$18.2 billion). This is exactly the size of the Russian defense budget for 1997. For education and health, the local governments also spend approximately 100 trillion rubles a year.

Simple estimates show that if housing, education, and health reforms are not carried out any time soon, building maintenance and other subsidies will simply eat up the Russian economy. There are signs that the government seems to understand this. Speaking at the World Economic Forum in Davos at the end of January 1997, Economics Minister Yevgueny Yasin stated that Russia was faced with disaster unless it cut spending by about a third in the next 3 years. "If we fail, we

will be faced with the prospect of an extended depression. Russia has probably more social dependents than any other country, with the possible exception of Sweden. We want to build a capitalist market economy with a socialist system of social security," he said. The problem is that strong political will is needed to carry out such reforms. Only a president who will not be running for the next election can carry out the needed reforms. Whether President Boris Yeltsin will decide to do so, however, is another matter.

Yeltsin and the government seem to be preoccupied with more immediate problems. The fact that government revenues remain catastrophically low (60 percent of that planned in 1996) has apparently forced the government to declare war on tax evaders. Russians have had a field day with the president's decision to form in October 1996 a "Temporary Extraordinary Commission"--called Vcheka (nicknamed from a contraction of three Cyrillic letters in its unwieldy full title)--using their wits to keep fighting the war on taxes. The commission has the same initials as a secret police organization that Lenin established in 1917 to spread state terror. The name stuck and, even as the Vcheka (or Cheka for short) mutated over the years into the KGB, Soviet citizens continued to refer to it in fearful whispers as the Cheka. The choice of this name was no accident. Tax evasion is a national sport in Russia, and any worker can cite examples of how his enterprise or organization has managed to evade taxes. So the naming of the tax commission Vcheka was a flamboyant propaganda play to show that the government was serious about collecting taxes.

But it will probably be just a case of much heat with little light. So far, the Vcheka's major move has been to fire a middle-rank customs official and to start bankruptcy proceedings against four companies which owe only a small fraction of the overall corporate tax arrears. No move has yet been made against the really serious tax evaders that enjoy political favor--like Gazprom, the gas conglomerate

once run by Chernomyrdin. Such cronyism causes most Russians to dismiss the new tax war as nothing but power-mongering inside the Kremlin. To many observers, the Vcheka is an instrument of Yeltsin's chief of staff Anatoly Chubais--crafted not merely to tame the financial bedlam, but to strengthen his own power.

While any of the above-mentioned measures would be a step in the right direction, the single most useful action the government could take to increase the catastrophically low state revenues would be a genuine overhaul of Russia's tax system. The existing tax system--if it can be called a system--is made up of 1,200 poorly coordinated or utterly contradictory presidential decrees, government orders, and ministerial instructions. Moreover, there are about another 3,000 legislative and sub-legislative acts that indirectly refer to tax norms. Thus, the more than 4,000 such acts regulate about 20 various taxes. Even the representatives of the tax service are not always able to figure them all out. As for taxpayers, almost anyone can be accused of violating one of the 4,000 tax documents. The debt of taxpayers to the budget is steadily growing. Last year, the sum of taxes that was owed was more than twice the 1995 level. Companies and individuals are not the only tax debtors. Of the 89 subjects of the Russian Federation, only three have fully paid their debt to the federal budget. Furthermore, seven out of the 89 regions provide almost 52 percent of the budget's revenues, with Moscow accounting for 27 percent.

On February 20, 1997, the government considered for the first time the draft of a new tax code, which the Finance Ministry has been working on for years. The idea behind the tax code is to put order into this contradictory and often inscrutable tax system in Russia, limit arbitrary rule by officials, and decrease the opportunities for legally and illegally evading taxes. The tax code proposes to simplify the existing system. It would reduce the number of taxes from 200 to 30. The code also is aimed at making fundamental

changes in tax exemptions. While working on the new tax code, the Finance Ministry uncovered an astronomical number of tax exemptions acquired at various times by various means. The level of lost budget revenues because of these exemptions is estimated by the Finance Ministry at 160-170 trillion rubles a year.

The task of taking away exemptions is a formidable one. Any government which really intends to halt this gravy train will face fierce resistance from an army of special interests and their parliamentary sponsors (for instance, removing the tax privileges from the thousands of generals and hundreds of thousands of officers in the Russian army, who are exempt from paying income tax). The tax police, who are there to catch tax evaders, are exempt from income tax. Even in the government itself, the Finance Ministry has hardly any allies with its new tax code. Many ministers openly and secretly fight to keep their existing privileges-- and not without some success. The tax code, which the government looked at when it convened on February 20, was not sent to the State Duma, as the Finance Ministry had hoped, but was sent back to be reworked. The chances of the new tax code being passed by the present Duma are extremely slim. Compared with what the holders of tax privileges stand to lose, dismissing the finance minister or the government itself, which are trying to abolish these exemptions, would be a very small price to pay.

But what really makes the attempts of the present government to improve the economic situation futile is the beginning disintegration of the Russian military machine. In only a few years the military force that held most of the world in terror has been plunged into penury and humiliation, for the most part by its own government. The government seems totally incapable of solving the financial problems of the military.

The errors that were permitted during the development of Russian military budgets were so elementary for any competent economist that it is

awkward to talk about them. First, the rapid coming together of the purchasing power of the ruble and the dollar was not taken into account. Second, the radical change of the structure of the military budget itself was ignored. In economic practice, the so-called currency purchasing power parity is used to conduct international financial-economic comparisons. This is done because the national currency exchange rate system (both floating and also fixed) does not provide satisfactory accuracy of comparisons of cost parameters because the currency exchange rate system serves only the sphere of foreign economic activity and not the economy as a whole. Moreover, currency exchange rates can fluctuate over the course of a year, a month, or a day for various political and temporary reasons. Simply speaking, purchasing power parity indicates the number of country A's monetary units needed to purchase a certain standard selection of goods and services which one can purchase for one of country B's monetary units. In dollars based upon the market exchange rate, Ministry of Defense military expenditures are shown in Figure 1 (in billions of dollars). It is obvious from the figures cited that military expenditures in dollars are ridiculously small if compared to the military expenditures of the leading Western countries. However, the military expenditures of the USSR, or later of Russia, expressed in dollars always seemed to be a curious thing. In 1989 the Soviet military budget was approved in the amount of 20.2 billion rubles. According to the official currency exchange rate (\$0.70 to R1), this totaled less than \$15 billion per year. And at that level of military expenditures, the USSR contrived to maintain military parity with the United States, which spent \$300 billion per year on defense.

<u>Years</u>	<u>Billions of Dollars</u>	<u>Dollar Exchange Rate (Rubles per Dollar)</u>
1993	7.4	932
1994	18.0	2,204
1995	12.8	4,554

1996

15.1

5,200

**Figure 1. Ministry of Defense
Military Expenditures.**

The conviction that the military ruble is quite a bit "heavier" than the civilian ruble has become ingrained in all the individuals involved in the military budget based upon past experience. Actually, at the end of 1980s, the USSR Academy of Sciences conducted very complex calculations which have convincingly shown that the defense ruble in the production of military equipment was at a minimum 3-4 times weightier than the civilian ruble. So nobody expressed any surprise that the Russian Armed Forces, with a strength of more than two million, could be maintained, for example, in 1993 on a budget that was equivalent to \$7.4 billion, according to the official currency exchange rate.

But as market relations have advanced in the Russian economy, the difference between the civilian and military ruble has gradually disappeared. So, if the ruble's commercial exchange rate in dollars totaled 10 percent of purchasing power parity at the beginning of 1992, then it reached 65 percent of purchasing power parity by the end of 1995 and has been slowly approaching the official exchange rate since then. According to data of the RF State Committee on Statistics, the ruble exchange rate based upon purchasing power parity totaled R271 in 1993, R988 in 1994, R2,759 in 1995, and approximately R4,300 per dollar in 1996. If converted into dollars based upon purchasing power parity, the Ministry of Defense expenditures totaled \$28.7 billion in 1993, \$40.2 billion in 1994, \$21.1 billion in 1995, and \$18.2 billion in 1996. From this data, it follows that in 1993 the Armed Forces actually received not \$7.4 billion, as it turns out during the conversion of the military budget into dollars based upon the currency

exchange rate, but four times as much (\$28.7 billion). Consequently, in 1994 the Ministry of Defense increased its budget by another \$11.5 billion, to the quite impressive sum of \$40.2 billion.

The year 1995 became crucial when military expenditures were immediately reduced by a factor of two (from \$40.2 billion to \$21.2 billion). And that wholesale reduction occurred under conditions of the fierce war in Chechnya, for the conduct of which not a single ruble was allocated according to the 1995 budget (as, by the way, in the 1996 budget). According to Ministry of Defense data, R5.71 trillion (that is, approximately 10 percent of the entire military budget for last year) was spent on the maintenance of the Army Formation in Chechnya alone in 1995. Military budget reductions of that scale occur in world practice only after the end of large wars when the army is being demobilized. However, even in that case, reductions occur more or less gradually because the reintegration of a large number of servicemen into peaceful life is not cheap in democratic states. The situation was totally different in Russia in 1995. It had not completed any war; on the contrary, Russia had precisely unleashed a war, although a local one. There was also no reduction of the armed forces. The reduction of the military budget by a factor of two took place unexpectedly without any preliminary warning whatsoever of the military leadership, thus the latter did not have an opportunity somehow to adjust to it. A further reduction of expenditures for the army, and a quite substantial one (from \$21.1 to \$18.2 billion-- that is, by 13.5 percent) has been set forth in the 1996 budget.

Ignoring the structure of the military budget itself was the authorities' second error. At the end of the 1980s-beginning of the 1990s, if three-fourths of the military budget went for the purchase of arms and military R&D and only one-fourth for maintenance of personnel, this ratio has become the exact opposite in the last 4 years. Right now, one-fourth of the budget

goes for purchases and R&D. The remaining appropriations are designated for the monetary allowances of servicemen and salaries of employees, payment of food and clothing, housekeeping and utilities, infrastructure support of the troops, medical service, payment of fuel, military transport movements, and payment of pensions and construction (mainly housing). As is seen from this list, practically all military expenditures, except arms purchases and R&D where market relations have still not penetrated, are being carried out based upon consumer prices. And this means that the compilers of the military budget were simply obliged to set forth in it the actual level of inflation during its development and not that artificially lowered index-deflator, while predicting military expenditures which lag behind the actual rates of inflation by a factor of 3 to 4.

However, this is not even the main thing. Changing the structure of the military budget has disproportionately increased the impact on the Armed Forces of the military expenditure reductions that were being conducted. In 1992 Gaidar reduced military purchases immediately by two-thirds which did not arouse practically any resistance whatsoever from the Armed Forces. The fact is that it struck not the Armed Forces but the military-industrial complex which usually forced its products on the Armed Forces, without especially being interested in whether or not the military needed them. Therefore the military has always been less interested in the budget items for weapons purchases and R&D (for which it in general did not pay prior to 1991 and right now, it seems, does not pay very much) than for the appropriations for the maintenance of personnel and combat training. Nevertheless, the presence in the budget of large appropriations for the purchase and development of arms substantially alleviated the Armed Forces' financial situation, while permitting them to write off a portion of the military budget reductions at their expense.

Now any reduction of the defense budget already

hits the very foundations of the military's existence-- food support, spares, medical service, and combat training. In practice, all this means that more than 1.5 million Russian Armed Forces and 600,000 Ministry of Defense civilian employees and all the military pensioners must live on \$15-18 billion per year. Common sense rejects accepting the fact that one can maintain a more than two million-man military armed force with very complex modern weapons for this amount of money. And, of course, in real life the Armed Forces have weighty additions to their official budget. The Armed Forces actually do not pay for utilities (electricity, heat, water, etc.) and many of their orders, including those for equipment, food, clothing and transportation. This partly explains why the military has not mutinied or simply dispersed at such a miserly level of official defense expenditures.

But the situation cannot last forever. Defense Minister Igor Rodionov says that the 1997 defense budget covers only one-third of the military's necessary expenses. The budget for 1997 envisions spending R104 trillion, or \$19 billion, on defense. Added to these outlays are expenditures in the budget on other military formations outside the Ministry of Defense (border guard troops, interior troops, different security forces, railroad troops, etc.) which amount to more than R50 trillion. Given that all state expenditures for this year come to about R500 trillion, the share that will go toward defense and national security accounts for one-third of the budget. It is impossible to triple this share, as Rodionov demands, without catastrophic consequences for Russia.

How did this situation arise in the first place? A nearly total absence of competent military economists and financiers whatsoever in both the government and presidential structures and also in the State Duma and Ministry of Defense has had an impact. Only a complete loss of touch with reality can explain the fact that in 1995-96 the Russian leadership increased the strength of the Armed Forces (by increasing the length of

conscription from 18 to 24 months), drove the army into an expensive war in Chechnya, kept an enormous defense industry by using feeble military orders, doubled expenditures for military R&D, purchased from the Ukraine strategic bombers that are mindlessly expensive in operation and *at the same time* dramatically (by more than half) reduced military expenditures.

But of course the present financial predicament of the military would not be so disastrous if it were not for the terrible economic crisis that has been unfolding in Russia in the 1990s. There are many reasons for the depth and duration of this crisis. But there is one which largely goes unnoticed both in Russia and the West--Russia's failure to demilitarize its economy. In hearings before the Senate Intelligence Committee of the U.S. Congress in October 1993, I was quoted as having stated that "there has been no demilitarization of the Russian economy" and that "this is the historic crime of the democratic leadership of Russia." This certainly sounds like a gross exaggeration in view of some well-known facts.

According to the Defense Industries Ministry (Minoboronprom), in January 1997 the production of both civilian and defense goods by the enterprises belonging to the Ministry was only 17.8 percent of the output in January 1991. The total number of enterprises belonging to the Minoboronprom has fallen from 1,800 to just 500 in the past few years. By the end of February 1997 the Defense Industries Ministry had not received a single defense order for the current year. And yet, with all that, I would stick to my "extravagant" statements quoted in the U.S. Senate.

But first, "militarization of the Russian economy" here deals more with macroeconomics, and much less with tanks, guns, missiles, or evil doings of the military-industrial complex. To make this point clearer, there is a great difference in the relations of the defense industry to the economy as a whole in Russia and in the West. In a Western country, possessed of a strong

defense industry--for example, the United States--the defense-industrial base is part of a much larger and often more efficient civilian economy. In Russia, which inherited its defense industry from the former Soviet Union, it was the very core and substance of the national economy. The civilian part of it was merely an adjunct to the defense sector and so inefficient that in an open market economy, it simply could not survive.

The main reason for the low productivity of the civilian sector is that for more than half a century all the best technologies, material, and human resources of the country were being channeled into defense and related industries, while civilian industries and the economic infrastructure were doomed to partial or complete inefficiency. The backwardness of the civilian industries is proportionate to the funds diverted from them into the defense sector. This kind of economy can exchange its products only on a compulsory or noncommercial basis: through direct distribution of resources at artificially fixed prices. In other words, an economy like this can function only if it defies the laws governing market systems. If such an economy were to switch abruptly to prices corresponding to world prices, the system of ties between them would eventually and inevitably collapse. And this is exactly what has happened in Russia over the last 5 years.

The distortion of an economy which does not respond to such measures as cutting defense expenditures or defense purchases and does not allow overflow of financial resources from the defense into the civilian sector is structural militarization as opposed to the usual militarization which can be measured by the shares of defense spending and defense production in national budgets, GNP, etc. All defense procurement in a structurally militarized economy can be stopped, and still this drastic measure will not result in a corresponding increase in efficiency of the civilian economy or other noticeable changes in the economy for the better.

Such an economy is completely unknown in the West, where defense cuts sooner or later lead to a flow of resources from the defense to the civilian sector. People move to new jobs, new specialties, or new locations. Factory buildings are sold, machinery is auctioned to new owners in a very active market, and land is sold to new owners. Defense conversion in the West is thus a diffuse activity. Demand falls in one sector and rises somewhere else. Nothing like this has happened in Russia so far, despite huge cuts in defense purchases--nor is it likely to happen in the foreseeable future, even if defense cuts go on. The failure to comprehend these fundamental differences between the economic systems of Russia and the rest of the industrial world explains the excessive optimism of the Western public and politicians about the prospects of market reform and demilitarization in Russia.

Unfortunately, the difficulties of dismantling a structurally militarized economy have been ignored by the Russian reformers themselves. As a result, they have committed several grave mistakes, have wasted precious time, and, sad to say, lost some irretrievable opportunities to thoroughly dismantle Soviet-Russian militarism. Their biggest mistake was a firm belief that money can play a decisive role in changing the ways of the Russian economy, and that it can be managed with the help of a budgetary and credit policy. It is certainly tempting to use financial indicators in summing up the results of economic development and formulating its goals, instead of getting bogged down in the intricacies and problems of technological and structural imbalances between the civilian and military sectors of the economy. Moreover, this practice of using financial indicators is accepted all over the world and is intellectually and administratively not very demanding, with ready-made and tested recipes galore.

I realize that all my conclusions are not inspiring. I have deliberately refrained from

discussing more desirable or ideal ways out of Russia's current predicament, knowing that the state of mind and the prevailing forces in my country make such a discussion rather unrealistic. Russia to a growing extent displays many of the maladies of a vicious circle of failed reforms. It is difficult to tell if the Russian government really believes in any policy besides its own survival. A series of flip-flops, retreats, and promises over the last years suggest that practically nothing the government says or does concerning economic policy can be taken seriously. Budget revenue is coming in at a rate of just 60 percent of the forecast; investors are not investing; enterprises are bartering to avoid taxes; and, lobbies are begging an already bankrupt government for money. With the news coming from Russia, full of lurid tales of backstabbing, intrigue, and corruption, it may seem as if Russia is back to the age-old Byzantine traditions of the Kremlin politics. And yet the last 5 years of reform were not without their positive sides for the economy. Despite the fact that Russia continues to be misgoverned, a genuine private sphere existing outside the state has appeared for the first time in 80 years. The growth of civil society gives some hope that Russians will one day expect their government to serve them, not the other way around. Besides, virtually everything that unfolded in Russia in the last years did so in the full daylight of media scrutiny. And, by and large, after October 1993 when President Yeltsin dissolved the parliament, no official acted openly unconstitutionally. It is not a real democracy, to be sure, but certainly a vast improvement from just 5 years ago, even in the middle of a no-holds-barred power struggle. Conventional wisdom notwithstanding, the more Russia changes, the more it seems not to be the same.

U.S. ARMY WAR COLLEGE

Major General Richard A. Chilcoat
Commandant

STRATEGIC STUDIES INSTITUTE

Director
Colonel Richard H. Witherspoon

Director of Research
Dr. Earl H. Tilford, Jr.

Author
Vitaly V. Shlykov

Director of Publications and Production
Ms. Marianne P. Cowling

Publications Assistant
Ms. Rita A. Rummel

Composition
Mrs. Mary Jane Semple

Cover Artist
Mr. James E. Kistler