Russia Today

(Draft version in English of new chapter included in the Russian-language version of *Gold: the Once and Future Money*.)

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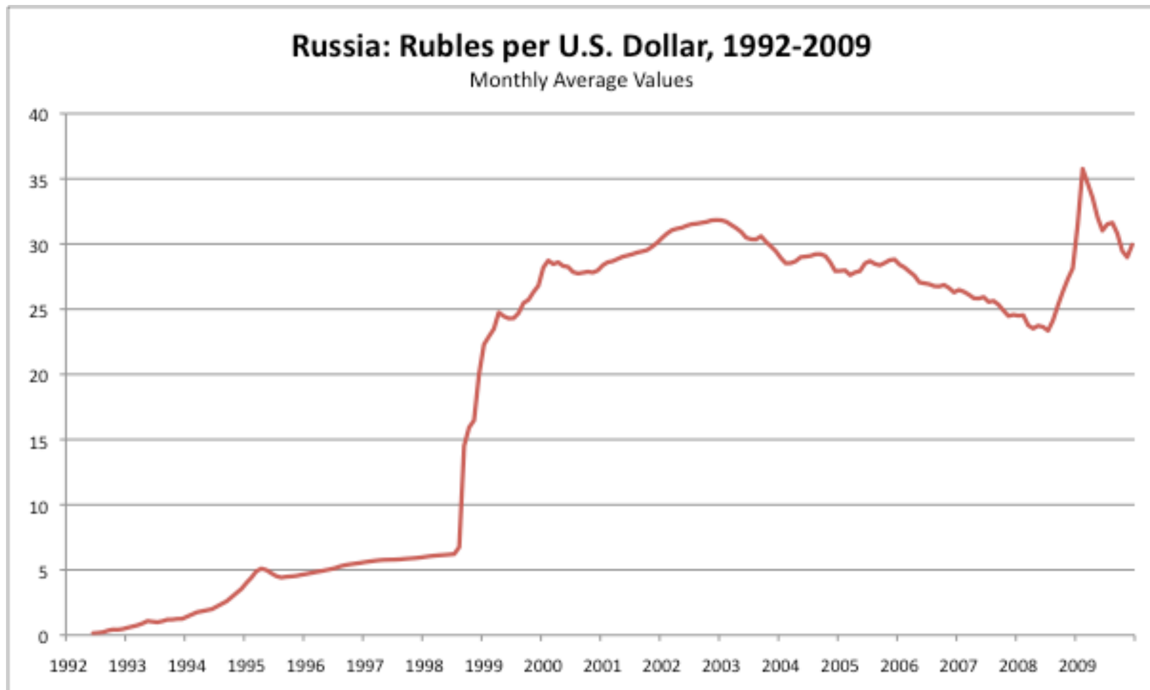
Throughout history, the most successful governments have often adopted some variation of the Magic Formula: Low Taxes and Stable Money. Stable Money is ideally a gold standard system, although for smaller countries often a currency board with a major international currency (in practice either the dollar or euro) can also work well. Low Taxes can take several forms, with the most common today the "flat tax" system, with top income tax rates typically in the 10-20% range.

In the mid-1990s, Russia managed a tepid recovery from the hyperinflationary disaster of 1989-1994, as the ruble was stabilized around 5/dollar. However, the country still struggled with a suffocating tax system. This fragile arrangement broke again during the worldwide currency crisis of 1998, and the ruble's value collapsed to an average of 28/dollar in 2000. As was the case throughout the emerging markets at the time, this currency collapse made Russia's foreign currency-denominated debt unbearable, and the central government defaulted on its bonds in 1998.

At this point, many governments might have chosen a typical IMF-approved "austerity" course, a combination of higher taxes and reduced spending, with repayments to bondholders a top priority. The IMF playbook might include still more currency devaluation, supposedly to gain foreign currency with which to pay the foreign debts. The result would be stagnation, decline and even disaster, as the Latin American countries experienced with this strategy in the 1980s.

Russia took a different direction. In 1999, the VAT was reduced to 20% from 23%. This was followed by the legislation of the 13% flat tax in July 2000, with implementation at the beginning of 2001, which touched off one of the most impressive economic recoveries ever witnessed. The previous income tax system had a top rate of 30% on income exceeding the equivalent of $5,000.

The 13% flat tax was paired with Stable Money, in practice a loose link with the U.S. dollar around 28 rubles/dollar. The flat tax itself probably made this dollar link much easier to establish and maintain. Major tax reforms often increase the demand for money, as economic activity increases, making the exchange rate easy to control even for central banks with a somewhat haphazard approach to currency management. With its flat tax and dollar link, Russia adopted a strategy much like Germany and Japan after World War II.



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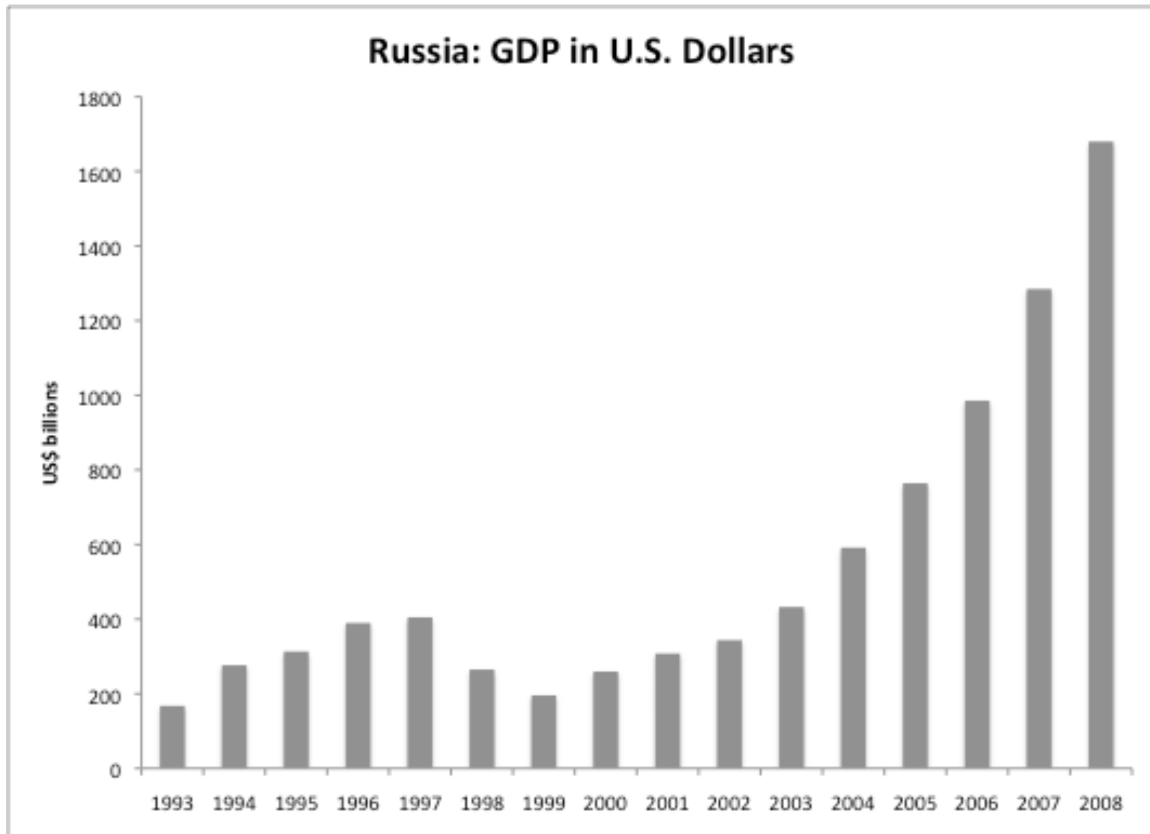
In 2002, the official corporate tax rate was reduced to 24% from 35%. Small business taxes were further lowered that year. In 2004, the VAT rate was reduced to 18% from 20%, and the Unified Social Tax, a payroll tax, was reduced to 24% from 35.6%. In 2005, inheritance and gift taxes were eliminated. In 2008, the rate on dividend income was reduced to 9% from 15%. In 2009, the corporate tax rate was reduced to 20%.

In 2001, the first year of the new tax regime, nominal government revenue from the personal income tax increased by 47%, and revenue from all taxes rose by 27%. Thus, the personal income tax's contribution to total tax revenue actually grew. In 2002, revenue from the personal income tax increased by an additional 40%, while total revenue grew by 32%.

Between 1999 and 2007 – a mere eight years -- the official nominal GDP of the Russian economy increased by 757% in dollar terms, an average compounded growth rate of a phenomenal 31% per annum. Much of this represented a rebound from the incredible lows reached in 1999, when the fivefold devaluation of the ruble resulted in Russia's per-capita GDP falling to $1,326 in dollar terms – an ignominious decline indeed for the former superpower. Russia began from a very low base. However, even in 2008, when the bad old days of 1999 had been left long behind, nominal GDP increased by 25% in ruble terms (and 31% in dollar terms) from a year earlier.



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Tax revenues of all levels of the Russian government were 31.4% of GDP in 2000, and 31.6% in 2008 – thus mirroring a pattern we have seen among tax-cutting governments throughout history. Apparently, it is rather difficult to lower this ratio even with aggressive reductions in tax rates.

Russia's great success with its version of the Magic Formula went almost completely unnoticed in English-speaking countries. In 2006, an IMF paper concluded that there was no sign of "Laffer-type behavioral responses generating revenue increases from the tax cut elements of these reforms," demonstrating the usual IMF obliviousness to economic reality. The fact that Russia's premier stock market index, the dollar-denominated RTSI index, went from a low of 38.57 in 1998 to 1765 in May 2006 -- a 46-fold increase! -- before the paper's publication apparently made no impression on the IMF's economists. The RTSI continued its rise to 2487 in 2008, before it was halted by worldwide economic difficulties and currency instability.

Those who put an excessive emphasis on demographics (especially regarding Japan) should note that, between 1999 and 2000, Russia's population actually declined from 147 million to 142 million. Per-capita productivity, the ultimate foundation of economic growth, does not depend on population.

Germans and Austrians, due to their proximity to Russia, perhaps paid a little more attention. During the decade, German banks and chain retailers were eager to expand their operations in the resurgent East, where they experienced phenomenal

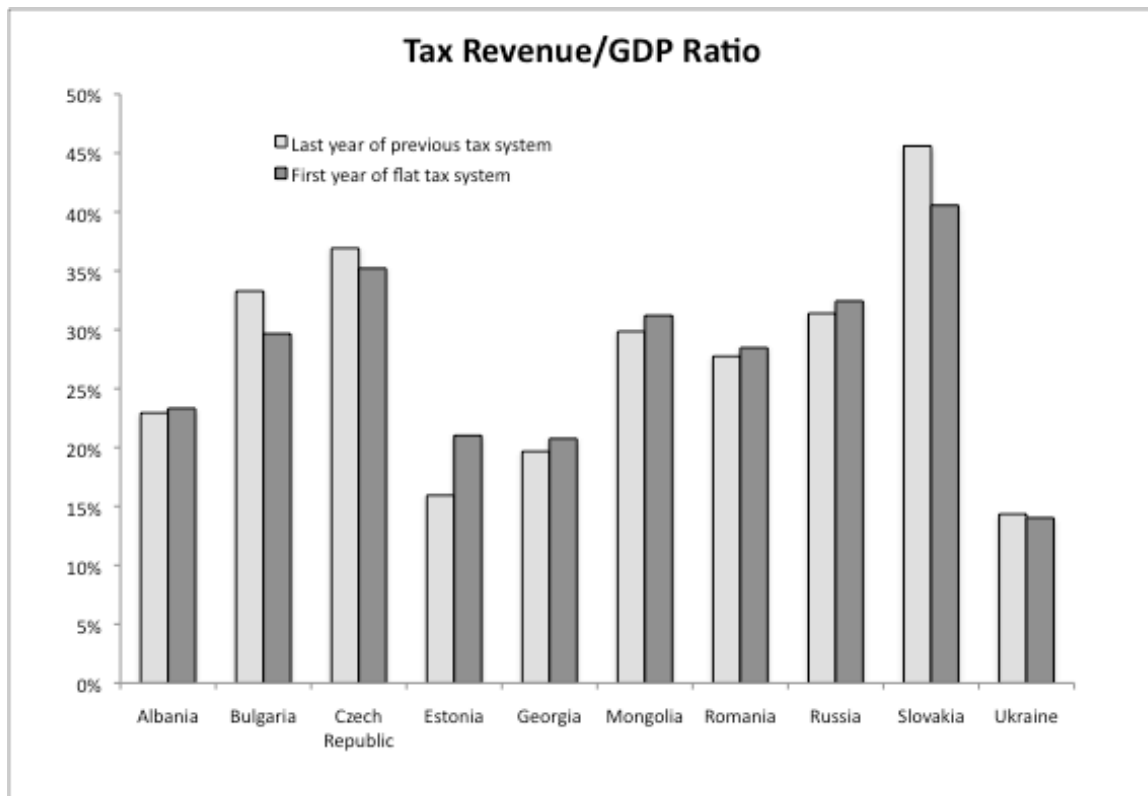
returns on equity sometimes exceeding 100%. However, Russia's astonishing comeback was best appreciated by the former republics and satellite states that made up the Soviet Union. In the mid-2000s, they began to adopt flat-tax systems much like Russia's. By 2010, at least thirty-five governments had flat tax systems, up from nine a decade earlier. These included:

Country	Start Date	Flat tax rate	Prior Rates	Notes
Jersey	1940	20%		Corp. rate 20%.
Hong Kong	1947	16%		Corp. rate 17.5%.
Guernsey	1960	20%		Corp. rate 0%.
Jamaica	1986	25%		Corp. rate 33.3%
Tuvalu	1992	30%		Corp. rate 30%.
Estonia	1994	21%	16-33%	Corp. rate 0%.
Lithuania	1994	15%	18-33%	Cut to 24% from 33% in 2007. Cut to 15% in 2009. Corp. rate 15%.
Grenada	1994	30%		Corp. rate 30%.
Latvia	1995	23%	25% top	Corp. rate now 15%.
Russia	2001	13%	30% top	Corp. rate cut to 20% from 35%. VAT cut to 18% from 23%.
Serbia	2003	12%	10-20%	Corp. rate cut to 10% from 20%.
Iraq	2004	15%		Corp. rate now 15%.
Bosnia and Herzegovina	2004	10%	5-30%	Corp. rate now 10%
Slovakia	2004	19%	10-38%	Corp. rate cut to 19% from 25%
Ukraine	2004	15%	10-40%	Corp. rate now 25%.
Georgia	2005	20%	12-20%	Payroll tax cut to 20% from 33%. VAT cut to 18% from 20%.
Romania	2005	16%	18-40%	Corp. rate cut to 16% from 25%.
Turkmenistan	2005	10%		Corp. rate now 20%.
Egypt	2005	20%	32% top	Three rates of 10%, 15%, and 20%. Corp. rate cut to 20%.
Trinidad and Tobago	2006	25%	25-30%	Corp. rate cut to 25% from 35%.
Kyrgyzstan	2006	10%	10-20%	Corp. rate now 10%.
Albania	2007	10%	30% top	Corp. rate cut to 10% from 20%.
Macedonia	2007	10%	15-24%	Corp. rate cut to 10% from 15%.
Mongolia	2007	10%	10-40%	VAT cut to 10% from 15%. Corp. rate reduced to 25% from 30%.
Montenegro	2007	9%	16%-24%	Original rate 15%; cut to 12% (2009) and 9% (2010).
Kazakhstan	2007	10%	10%-40%	Corp. rate now 15%.
Pridnestrovie	2007	10%		Declared independence from Moldova. Also known as Transnistria.
Mauritius	2007	15%	15-25%	Corp. rate cut to 15% from 25%.
Tajikistan	2007	13%		Two rates of 8% and 13%.
Bulgaria	2008	10%	20-24%	Corp. rate cut to 10% from 15% (2006).
Czech Republic	2008	15%	12-32%	Corp. rate cut to 19% from 31% in 2003. VAT cut to 19% from 22%.
Timor Leste	2008	10%		Formerly part of Indonesia. Corp. rate 10%.
Belarus	2009	12%	9-30%	Corp. rate 24%.
Belize	2009	25%	25-45%	Corp. rate cut to 25% from 35%
Nagorno Karabakh		5%		Disputed territory within Azerbaijan. Corp. rate 5%.
Seychelles	2010	15%		Replaced payroll tax of 22.5%. Corp. tax rate cut to 33% from 40%.
Paraguay	2010	10%	none	Corp. rate 10%.
Hungary	2011	16%	17-32%	New prime minister plans 16% flat tax; replaces 58 other taxes.
Abkhazia		10%		Region in Georgia. Date of flat tax adoption unknown. Corp. rate 18%.

These flat tax systems were often accompanied by a dramatic simplification of the tax code, and elimination of many minor taxes. The government of Georgia said that its flat tax system reduced the complexity of the tax code by 95%. The government of Hungary said that its flat tax plan, likely to be implemented in 2011, would replace 58 other taxes.

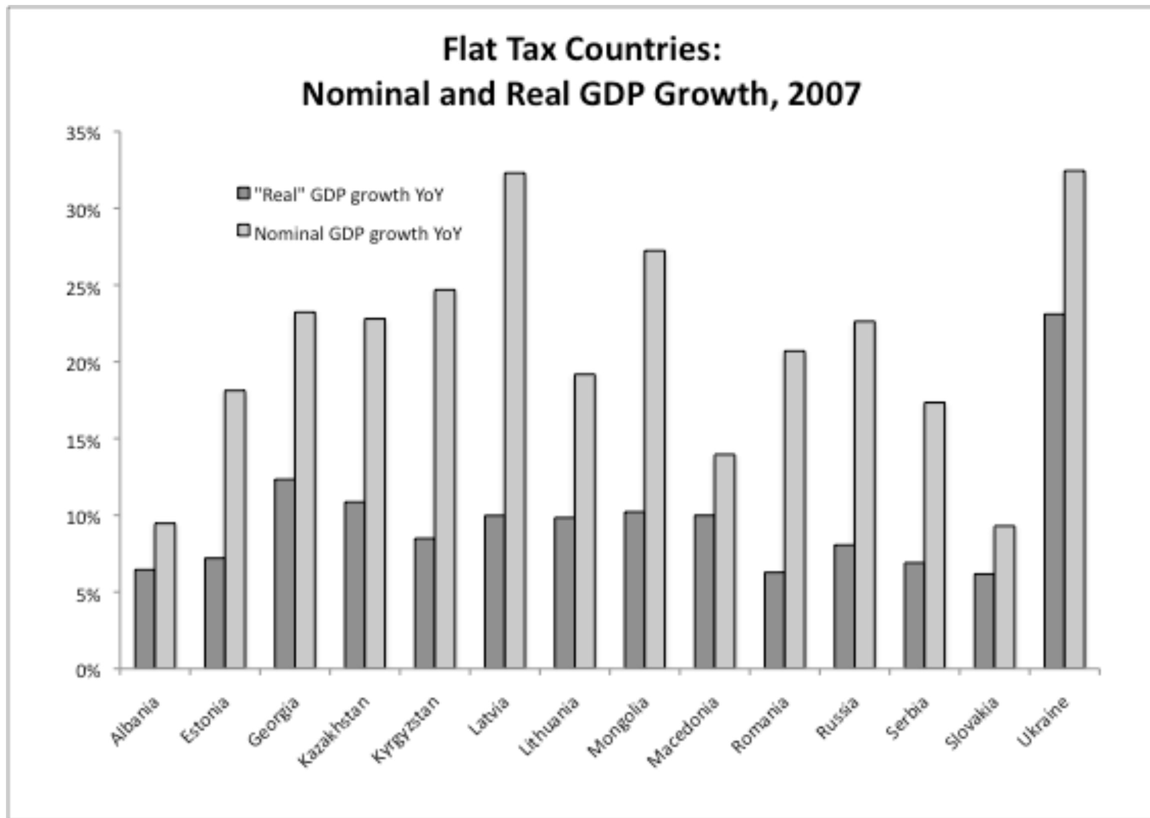
The flat tax systems did not introduce any significant decline in tax revenue as a percentage of GDP. Out of ten examples, for which data is available from the IMF, the introduction of the flat tax resulted in a rise in the revenue/GDP ratio in six instances, and a decline in four. Combined with strong growth in nominal GDP, the result was growth in nominal tax revenues in nine out of ten cases. The Czech

Republic was the exception, with its 0.5% decline, but this can be explained by the fact that the country adopted its 15% flat tax system in 2008, a year of economic crisis worldwide.



source: IMF International Financial Statistics

The result? Taking 2007 as an example – before the worldwide crisis of 2008 – all the flat-taxers enjoyed excellent GDP growth, with headline rates typically in the range of 5-10%. This is a fine result by any measure. However, as is often the case with high-growth countries, these "inflation-adjusted" figures masked more dramatic growth, as is evidenced by the nominal GDP figures. As was the case in Japan in the 1960s and Hong Kong in the 1990s, high growth rates are often accompanied by significant rises in local prices, for the simple reason that many things – rent, hotels, restaurants, doctors, universities -- tend to cost more in wealthy countries than in poor ones. Thus, as a country becomes wealthier, prices tend to rise. In 2007, Eastern European prices continued to converge towards Western European levels. Nominal GDP increases in excess of 15% were common, and were reflected in similar rises in tax revenues, corporate profits, wages and so forth. Although many like to say that Russia's economic rebound in 2000-2008 was due to rising oil and commodity prices, in fact countries with similar flat tax/stable money strategies but without significant natural resources had roughly the same experience.



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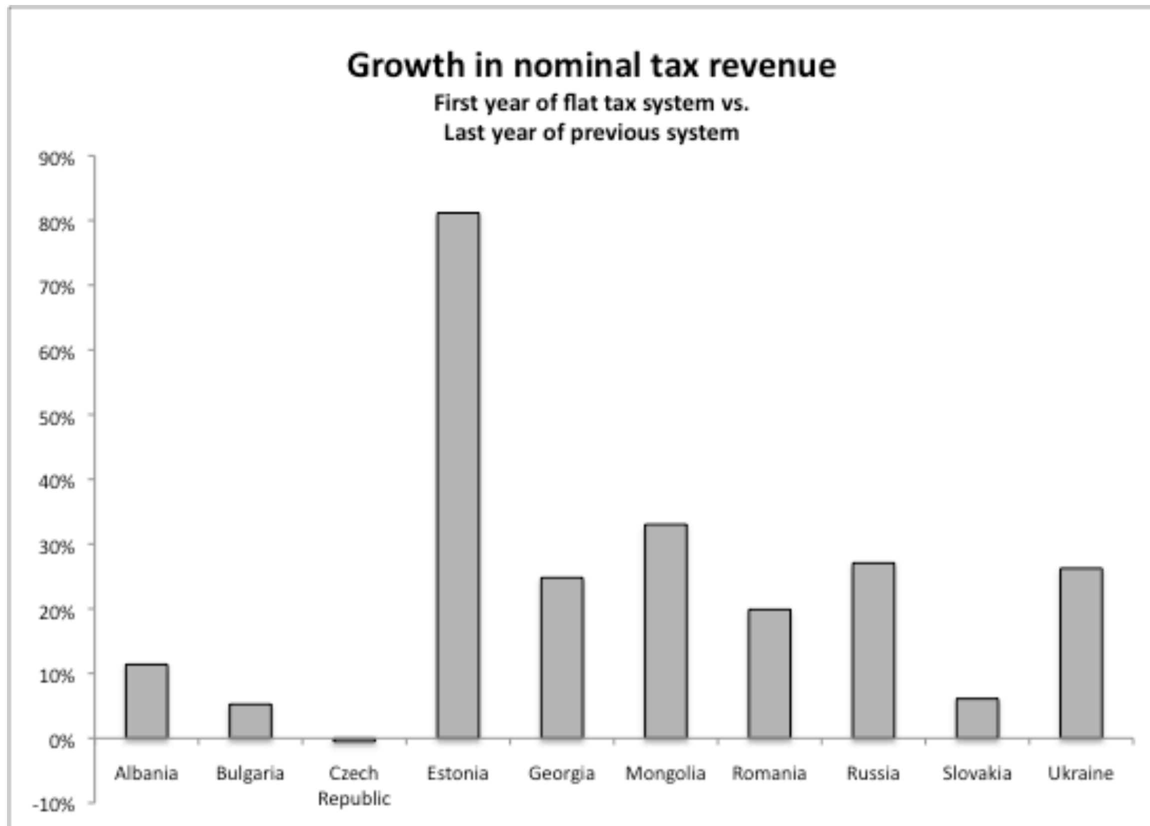
The flat tax is not the only path toward an economy-friendly low-tax environment. During this time, many governments that did not adopt a flat tax nevertheless reduced their local tax rates substantially, with predictably beneficial results. In 2006, Turkey reduced its corporate tax rate to 20% from 30%, and the top income tax rate fell to 35% from 40%. In 2004, Poland reduced its corporate tax rate to 19% from 27%. In 2009, Poland reduced its income tax rates, with the top rate falling to 32% from 40%. In 2006, Hungary's VAT rate was cut to 20% from 25%. Hungary's corporate tax rate was cut to 10% from 19% in 2010, and the top income tax rate dropped to 32% in 2010 from 38% in 2004.

In practice, the tax systems of the recent East European flat-taxers are not nearly as libertarian as that of Hong Kong, which pairs its 16% top income rate with a complete absence of taxation on capital gains, dividends, interest income, and inheritance. Hong Kong has no payroll taxes, VAT or sales taxes. Among most of this new cohort of flat-taxers, VAT and payroll taxes tend to be quite high, once again mirroring Russia's example, with typical levels around 15%-20% for VAT and 20%-30% for payroll taxes. Considering that lower-income citizens typically pay both payroll and VAT taxes on the first dollar earned, this arrangement could rightly be called rather unfair, especially considering that the marginal rate for higher incomes and corporate income could be in the 10%-15% range. Indeed, the situation is reminiscent of France before the French Revolution, when peasants were taxed at crushing rates while nobles and the clergy paid no tax at all. A VAT rate in the mid-

teens alone should be enough to finance substantial government services, while payroll taxes could be lowered to sub-10% rates or even eliminated entirely.



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Russia's payroll tax rate in 2010 was 24%. In a rather disturbing development, this was scheduled to rise to an effective 34% in 2011. It would be better to start with something like clean sheet of paper: if we assume that Russian citizens want to pay the government about 31% of GDP – as all the evidence of the past decade suggests -- and receive in return services including universal healthcare and a government pension system, what would be the best way to accomplish this? The 31% figure is not far off of the 28.3%-of-GDP ratio for the United States in 2009, although the United States had a 16.6% effective payroll tax rate, and sales taxes in the neighborhood of 6%-10%. Probably, Russia's government could generate its 31%-of-GDP revenue with a payroll tax of 10% and the existing 18% VAT. In other words, if the payroll tax rate were reduced to that level, tax revenues as a percentage of GDP would remain stable around 31%, and revenue would grow as the tax cut enabled further GDP expansion.

A more ambitious Russian leader might propose eliminating the payroll tax altogether, perhaps in a series of steps -- reasoning that the 18% VAT is more than enough burden for those with the lowest incomes to bear. The increased economic growth from such a move would result in higher nominal tax revenues, even if revenues as a percentage of GDP might dip by a few percentage points. For example, a 10% (3.1 percentage point) drop in the revenue/GDP ratio, to 27.9%, would be

effectively countered by a 10% increase in nominal GDP. Considering Russia's recent history of 20%+ annual increases in nominal GDP, and the growth effects of eliminating this rather large tax, this is a rather low hurdle indeed. Certainly, a move of this sort would be rather daring, but not nearly as daring as the reduction of the VAT in 1999 and the introduction of the 13% flat tax in 2000 -- in the midst of crisis while the government, in default on its bonds and unable to issue debt, was scrambling for every penny. Has Russia lost its nerve so quickly?

* * *

Russia adopted what amounts to a loose link with the U.S. dollar. The other Eastern European states' version of Stable Money is a link with the euro, which was formalized when thirteen Eastern European states joined the European Exchange Rate Mechanism in 2004, followed by another four countries in 2005. (They are now known as "Central European," perhaps denoting their new alliance with the Western European states.) ERM membership required that the countries' currencies maintain a stable exchange rate with the euro, in preparation for the replacement of local currencies with euros at some future date. Slovenia managed to overcome this hurdle, and adopted the euro in 2007. Slovakia adopted the euro in 2009. Three micro-states, Monaco, San Marino and Vatican City, signed agreements with the EU to use the euro as their sole currency without participating in the EU directly. Andorra, Kosovo and Montenegro adopted the euro as the sole currency, without an agreement with the EU.

This happy Magic Formula wealth-creation story, and wonderful upward slope of growth, was cut short by the worldwide economic turmoil in late 2008. The property boom -- in many instances rightly called a "bubble" – that appeared on a virtual global basis in 2003-2008 did not bypass Russia and the other Eastern European countries, where soaring property prices were in part justified by the astonishing increases in wealth and productivity appearing at the time. However, much of this property – indeed most corporate borrowing as well – was financed in foreign currencies, either dollars or euros.

Currency chaos always causes problems, but they are exacerbated many-fold when combined with substantial amounts of borrowing in foreign currencies. This is practically a template for disaster in the emerging market countries, as was the case in the Asia Crisis of 1998 and also the Latin American debt blowup of the early 1980s.

The financial crisis of 2008 and 2009 was bad enough in the U.S. or Western Europe. In Eastern Europe, it was paired with a currency crisis and a foreign-currency debt-financing crisis. The Magic Formula was lost. Taxes were low – just as they were in Asia prior to the Asia Crisis -- but money was no longer stable. The Russian ruble went from 23.25/dollar in July 2008 to 36.34/dollar in early February 2009, as dollar-denominated debtors everywhere scrambled for survival. The ruble fell 21% against the dollar in January 2009 alone. This qualifies as a crash. The ruble was eventually stabilized around 30/dollar, with the help of a direct reduction in the monetary base by the central bank. Russia's monetary base shrank a whopping 22%

between January and February 2009, leaving it 12% lower than a year earlier. The ruble stabilized in February, and leapt 10% to 33/dollar in March. The crisis ended.

Similar disasters took place throughout Eastern Europe in late 2008 and early 2009. The Hungarian forint fell 18% vs. the euro, before recovering. The Polish zloty fell 32%, and recovered. Some currencies never recovered. The Ukrainian hryvna was 6.7/euro in early September 2008, and was around 11/euro (a 36% decline) two years later. Ukraine is one of the largest countries of Eastern Europe with a population of 46 million, compared to 60 million in Italy.

This is extreme turmoil by any measure, but all the more unfortunate considering that these countries aimed to stabilize their currencies against the euro and eventually adopt euro notes and coins. The correct way to do this is with a currency board, such as the one Estonia has used with the euro (and previously, the deutschemark) since 1994. Estonia's currency board passed through the currency violence of late 2008 unscathed. Bulgaria's euro currency board dates from 1997, and it too passed the crisis uneventfully -- as did the currency boards of Lithuania and Latvia. These four currency boards, which predated the euro, were grandfathered in. Euro currency boards used by the West African CFA franc and the Central African CFA franc, which serve a total of thirteen African countries – grandfathered in from their previous link with the French franc -- also passed the crisis uneventfully. The six euro currency boards had a perfect track record. Alas, due to a bizarre series of rationalizations, the other new eurozone-hopefuls were actually banned from implementing currency board systems by the EU itself. Their euro links were to be maintained by what amounted to a string of good luck. Unfortunately, their luck ran out in 2008.

Another excellent way to achieve Stable Money would have been to adopt the euro directly, without a prolonged and unnecessary probationary period. If Stable Money is good, then it is good right away, precisely to avoid the sort of currency crisis and foreign-currency-denominated debt disaster that actually happened. A debt crisis is not only bad for debtors, it is bad for creditors – German and Austrian banks – who don't get paid on their loans. The whole purpose of a European unified currency is to avoid these kinds of problems, but it doesn't work if you don't use it.

The eurozone bureaucrats were worried about the potential consequences of including these countries within their common currency area. They imagined that, if one of these countries encountered some sort of economic difficulty, there would be consequences for the entire eurozone. The same line of thinking applied to the original eurozone members, who had to comply with all sorts of fiscal oversight and restrictons. In fact, such developments should have no effect on the euro itself, if it was being managed properly. Since a currency only goes up or down, the only significant consequence of one country's fiscal failure would be, presumably, a decline in the value of the euro. However, this situation could be managed simply by reducing the amount of euro base money – in other words, by exactly the method used successfully by Russia in February 2009.

Unfortunately, as was so amply demonstrated by the eurozone leadership's appalling handling of sovereign debt crises in Greece, Ireland and other countries in 2010, the eurozone bureaucrats do not have this expertise. They intend to manage their common currency by the usual combination of interest rate targeting,

sterilized foreign exchange intervention, bravado, hints and innuendo common to central banks around the world today. The inevitable result is chaos.

Thus, even adopting euro notes and coins is no guarantee of currency stability, if the euro itself is unstable. Not only does the eurozone lack a coherent currency management system, as of 2010 all major international currencies were in a long period of depreciation dating back to 2001. When the premier international currency is devalued, all other currencies tend to follow along due to the trade consequences of foreign exchange instability. An intellectual trend toward Keynesian “easy money” policies, especially in the United States, has resulted in a decline in the dollar’s value from an average around $350/oz. in the 1990s to over $1,250/oz. in 2010, a nearly fourfold depreciation over ten years. The euro and yen have roughly followed alongside. Thus far, this inflationary trend has not had dire consequences, which has emboldened the cheap-money Keynesians still further. It appears that this trend will continue for some time longer, and probably accelerate.

Already some governments have been getting visibly nervous about the possible consequences of this currency devaluation habit. Russia, China and some other large non-European governments began discussing alternatives to the existing dollar-centric world currency system. At a G8 meeting in July 2009, Russian President Dmitry Medvedev held up a ½ oz. gold bullion coin and said that it was an example of a “unified future world currency.”

However, Russia, China and others may find it difficult to set forth with their own alternative currency system until the present one becomes intolerable. For example, if Russia and China adopted a gold-linked currency in 2010, and the dollar and euro declined another fourfold (from $1,250/oz. to $5,000/oz.) in following years due to “easy money” ideology, then of course the gold-linked ruble and yuan would quadruple in value vs. the dollar and euro. This could have rather intense trade consequences, and industrialists of all types would complain loudly about declining exports and a flood of cheap imports. Other countries in Eastern Europe would be faced with a difficult choice: to keep their alliance with the declining euro, or to join the Russia/China gold bloc.

The potential path for Russia, China and others to provide an alternative gold-linked currency bloc to the dollar/euro/yen fiat-currency devaluation bloc is, unfortunately, rather messy. Probably, the dollar/euro/yen bloc will have to deteriorate to the point at which it becomes clear that other countries gain no advantage from participating in that system. This could involve sovereign default, financial system chaos, and possibly devaluation of such scale that finance becomes impossible. (In practice, this would be with official CPI and government bond yields around 20% per annum.) Remember that the various republics of the Soviet Union themselves declared independence, and issued their own currencies, when it became apparent that participation in the ruble bloc was no longer feasible.

If Russia, China and some other allies (notably Brazil and India) did manage to establish an alternative currency system, then Shanghai and Moscow would soon become the financial capitals of the world. The reason for this is quite simple: if the dollar and euro are no longer reliable, nobody would make dollar- or euro-denominated loans. They would insist on being paid in gold-linked rubles or yuan. The other states of Eastern Europe – refugees from the imploding eurozone -- would

soon join this Russia/China gold currency bloc, as would the smaller states of Asia as they abandon the disintegrating dollar.

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From this potential maelstrom of crisis could emerge a new sort of 21st century capitalism. Capitalism of the 19th century was characterized by very low taxes and gold-linked currencies. The industrial advancement of the time was astonishing, but the arrangement degenerated into one of merciless exploitation and an intolerable gulf between rich and poor. These problems inspired the early Marxists, and also various less radical socialists. Twentieth century capitalism was characterized by rather large governments, high taxes, and ample social spending, along with a trend toward floating fiat currencies (originally to reduce unemployment). This helped solved many of the problems of 19th century capitalism, with reduced working hours, minimum wage laws and unionization, workplace safety and environmental regulations, public education up to the secondary level, state pension systems, and universal healthcare. However, the punitive high tax rates of this system tended to cause chronic unemployment, poor capital formation and stagnant growth, especially when combined with floating fiat currencies after 1971. The United States' middle class, once the world's great success story, has been in decline ever since. An unhealthy economy leads governments to try the "easy money" trick over and over to deal with chronic underperformance and to placate their unhappy citizens. Increased welfare demands lead to still higher taxes. Existing entitlement-based public pension and healthcare systems, and absurd levels of compensation for public employees, are plainly unsustainable and have no long-term future.

This 21st century capitalism could combine many of the 20th century's government services with a 19th century-style focus on low taxes and gold-linked currencies. Hong Kong perhaps exemplifies this best. With its rock-bottom (though highly progressive) tax system, it is one of the most libertarian places in the world today. Hong Kong's currency is, of course, dollar-pegged, functionally not much different than a gold peg, and the government has no discretionary "monetary policy." However, Hong Kong also provides most of the public services common to developed countries today, including public education, a welfare system, and an excellent universal healthcare system. Hong Kong's leaders have perhaps sensed best of all that a healthy economy translates into less need for welfare services, and also more money to pay for them. The managers of even the most profit-oriented Hong Kong corporation can appreciate the benefits of Hong Kong's well-educated population – and health care costs that are very modest compared to the burdens that cripple corporations in the United States.

The Soviet Union provided employment, healthcare, education, and a retirement plan for all its citizens. Unfortunately, an economy that consisted of 100% government jobs had a strong tendency toward despotism, corruption and stagnation. From the wreckage of 20th century statism, the former communist states – including China -- seem ready now to invent a new sort of arrangement that marries the best parts of capitalism with the best parts of the last century's socialist

experiments. Low Taxes and Stable Money must form the foundation of this new capitalism. There is no need to imitate the declining West, whose own postwar-era institutions are crumbling from abuse and internal corruption.

Nathan Lewis
September 30, 2010

"The Flat Tax(es): Principles and Evidence," Michael Keen, Yitae Kim, and Ricardo Varsano, IMF Working Paper WP/06/218, 2006.