CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

1

Taxes, Representation, and Economic Development in the Russian Heartland

On November 10, 1997, Evgeny Mikhailov sat down with a handful of journalists to discuss his first year as governor of Pskov oblast, a beautiful but struggling region in northwestern Russia just over the border from Belarus and the Baltics. Mikhailov had received his share of attention the year before when he beat out the incumbent governor to become the only member of Vladimir Zhirinovsky's nationalist Liberal Democratic Party of Russia to be elected head of a Russian region. Given Zhirinovsky's often outrageous statements on questions of foreign policy – he once suggested building a giant fan to blow radioactive waste over the Baltic states – many expected Mikhailov's first year to be dominated by saber rattling and diplomatic disputes. However, Mikhailov's electoral platform had emphasized economics, not geopolitics, and in this year-end press conference the focus was on economic achievement.[1]

At the top of the governor's list of achievements during the previous year was the creation of a local vodka industry under government control. To an outsider, it might seem a strange accomplishment to trumpet. Vodka had not been produced in Pskov in recent memory, and consumers could already choose from among a wide range of vodkas produced within and outside of Russia. Any economics student would have suggested that the region focus instead on promoting those sectors in which it had some comparative advantage. In an interview three years later, the governor was explicit in naming those sectors: tourism (the region is a train ride from Moscow and St. Petersburg and boasts many early Orthodox churches and

[1] "Takoi korotkii dolgii god," *Pskovskaia Pravda*, November 11, 1997.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

monasteries) and transit (Pskov oblast is a natural trade corridor between Russia and the West).[2] Vodka had no direct link to either.

Of course, nowhere is public policy governed solely by the prescriptions of an economics textbook. Whatever policy *should* be, social scientists are taught to anticipate that it *does* tend to favor those interests that are organized, that is, those that have overcome their "collective-action problems." However, in Pskov oblast there were no organized interests clamoring for local vodka production. Rather, the regional economy was organized around machine building, some light industry, food processing, and agriculture, all of which could stake a claim for government assistance and all of which suffered from the regional administration's laserlike focus on the vodka industry.[3]

Despite the lack of comparative advantage in vodka production and absence of organized interests calling for its promotion, vodka had one major advantage over other industries that the local administration might have chosen to promote: it is, by Russian standards, relatively easy to tax, a function both of the primary method of taxation (excise taxes that required that the government observe only output, not profits) and of centuries' experience in taxing alcohol.[4] And like most regions in Russia during the 1990s, Pskov oblast was starved for revenue. The collapse of the socialist economy and the Soviet state had left regional finances in tatters. The region subsisted in large part on transfers from Moscow, but this support was seen as unreliable.[5] During the electoral campaign Mikhailov had emphasized the absence of a regional financial base and the futility of counting on federal transfers,[6] and in interview after interview Pskov officials spoke of the

[2] "Idu na tretii srok," *Pskovskaia Pravda*, February 28, 2001. See also Centre of Social Projecting Vozrozhdeniye (2003).
[3] "Zhdem milosti u rynochnoi ekonomiki," *Pskovskaia Pravda*, July 4, 2001.
[4] On the history of vodka in Russian and Soviet politics, see, for example, White (1995) and Herlihy (2002). The relative ease of collecting unit excise taxes was stressed to me by Vadim Petrukhin, head of the oblast Committee for Economic Development and Property Relations, in an interview in Pskov on July 13, 2005. The comparatively low level of barter in the vodka sector may also have made it an attractive source of tax revenue, as in contrast to many other industries during the 1990s, taxes could be collected primarily in cash rather than in kind (Schrad, 2001; Gaddy and Ickes, 2002). Nonetheless, government support of the vodka industry in Pskov oblast continued long after barter began to disappear with the 1998 ruble devaluation. I return to the relationship between barter and taxation in Chapter 2.
[5] "Nam predlagaiut real'no smotret' pravde v glaza," *Pskovskaia Pravda*, August 6, 1998.
[6] Alexseev and Vagin (1999, p. 44).

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

need to increase local tax revenue.[7] (It is important to stress that excise tax *rates* were not under the direct control of the regional government – this is not the traditional argument that governments heavily tax goods such as alcohol for which demand is inelastic.[8])

In essence, Mikhailov opted to structure the tax base to his needs, using the instruments at his disposal to promote that economic activity that he knew he could tax. In its first year, Mikhailov proclaimed, newly established Pskovalko had contributed eight billion rubles (slightly more than one million dollars, big money in a small and impoverished region) to the regional budget, with room to grow.[9] Even after the local economy started to rebound (as did the Russian economy more generally) following the 1998 ruble devaluation, growth in the vodka sector still far outstripped that in the local economy as a whole: in the first nine months of 1999, alcohol production was up 160 percent on the year before versus 19 percent for industrial production overall.[10]

The Pskov experience was by no means unique. Throughout much of the postcommunist world, a politics characterized by "representation through taxation" took shape in the 1990s, with the representation of economic interests in the political arena determined by their anticipated tax compliance as well as by their organization. The winners – those who were best represented in the competition for resources – were not necessarily those who had overcome their collective-action problems. Rather, economic development was encouraged in sectors that were important sources of tax revenue at the expense of those that were not.[11] In other parts of the

[7] See, for example, "Pobeda razuma," *Pskovskaia Pravda*, June 1, 1999; "Biudzhetnye perspektivy u oblasti – est'!" *Pskovskaia Pravda*, January 11, 2000; "U nas vse voprosy vazhnye," *Pskovskaia Pravda*, December 19, 2001.

[8] If anything, inelasticity of demand would have worked against Mikhailov's strategy, as any attempt to shift the supply curve for vodka to the right would have little impact on the total quantity of vodka sold. One consequence, as I discuss later, is that sales of Pskov vodka came in considerable part at the expense of (less taxable) imports.

[9] "Takoi korotkii dolgii god," *Pskovskaia Pravda*, November 11, 1997. Mikhailov's statement predates the ruble redenomination of January 1, 1998. Official estimates of the contribution of regional alcohol policy to oblast revenues vary widely, though they are always substantial. See, for example, "U 'Skobaria' gosudarevo oko," *Pskovskaia Pravda*, June 19, 1997; "'Pskovalko' ne zhalko?" *Pskovskaia Pravda*, October 31, 1997; "A karavan idet . . . k situatsii na alkogol'nom rynke Pskovshchiny," *Pskovskaia Pravda*, December 11, 1997.

[10] "Na pod"eme," *Pskovskaia Pravda*, November 4, 1999.

[11] Although my argument extends far beyond the particular example of vodka politics, at least in Russia the vodka sector seems to have received particular attention in a number

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

postcommunist world, politics took the more familiar form of "representation through collective action," with the organization of interests the primary determinant of the provision of collective goods. Which of the two forms of politics predominated can be traced to decisions made in the early days of transition about what sort of tax systems to build following the collapse of the communist state.

In this book I tell this story. As it is a story that departs in important ways from what has become conventional wisdom in political economy, I begin by discussing the relationship of the book to what has come before. I do not aim here for an exhaustive overview of the literature: those interested in fuller contextualization will find it at the appropriate place in the chapters to follow. Rather, I place my argument in the tradition of three strands of literature, represented by three classic works of social science: Margaret Levi's *Of Rule and Revenue* (Levi, 1988), Mancur Olson's *The Logic of Collective Action* (Olson, 1965), and Robert Bates's *Markets and States in Tropical Africa* (Bates, 1981).

These three books, and the broader literatures of which they are a part, shape much of the way in which we think about revenue, politics, and development. Like all good social science, each of these perspectives is incomplete, abstracting from important features of empirical reality to focus on what is deemed most important. My aim is to show that some of what is absent or underemphasized is in fact a major part of the story, at least in that part of the world I know best. Because I suspect that similar logics may be at work in other political-economic environments, at various points in the succeeding chapters I lay out my argument in general form, hoping that experts in those environments will find my perspective instructive, if inevitably and consciously incomplete.

1.1 Structuring Tax Systems – and the Tax Base

"Rulers maximize revenue to the state, but not as they please," writes Margaret Levi in *Of Rule and Revenue*. For Levi, as for many other scholars, the desire of rulers to maximize revenue is axiomatic. Although there is the occasional exceptional case, in most places and at most times rulers value revenue for the ability it gives them to retain power, fight wars, pursue their

of regions beyond Pskov. See, for example, "New Rules on Alcohol Taxes Deal a Blow to Bootleggers," *Moscow Times*, January 13, 2003; "The Alcohol Issue in Russia and the Baltic Sea Region," Stockholm Centre on Health of Societies in Transition, Newsletter No. 13, June 26, 2000.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

vision of the social good, and improve their own material standard of living. But because revenue to the state comes out of someone else's pocket, rulers cannot merely decree its collection. Rather, they must employ a range of carrots and sticks to encourage the transfer of wealth to the state. "The art of taxation," observed Jean Baptiste Colbert, finance minister to Louis XIV, "consists in so plucking the goose as to get the most feathers with the least hissing."

Of Rule and Revenue was one of the first systematic attempts to offer a general theory of the structure of tax systems. According to Levi, three factors influence the choice of revenue policy: the relative bargaining power of rulers vis-à-vis other actors, the transaction costs associated with negotiating and implementing a revenue policy, and the discount rates – the degree to which the present is valued relative to the future – of rulers. These three factors are in turn determined by the economic structure of society, the international context, and the form of government. Thus, for example, the gradual metamorphosis of the Roman Republic from a city-state based on subsistence agriculture into an empire dependent on grain from Sicily and Africa changed the transaction costs associated with taxation and led to the abandonment of the tribute in favor of tax farming (Levi, 1988, Ch. IV).

I begin my story by applying insights from Levi's and related work to the development of tax systems in Eastern Europe and the former Soviet Union. (Throughout the book, I follow the convention in the literature of referring to the states of Eastern Europe and the Baltics collectively as "Eastern Europe," and I use the phrase "former Soviet Union" to mean all post-Soviet states but those in the Baltics. As I will show, tax systems in the Baltic states of Estonia, Latvia, and Lithuania are indeed more East European than post-Soviet.) Taxation was largely an accounting matter under communism, and all postcommunist states faced the challenge of creating tax systems from scratch to extract revenue from private economic actors. Consistent with the framework suggested by *Of Rule and Revenue*, how these states responded to this challenge depended on incentives created by the international environment, on industrial structures inherited from communism, and on levels of economic development at the start of the postcommunist transition. Roughly speaking, the countries of Eastern Europe undertook the difficult task of learning how to tax individuals directly, in significant part to bring their tax systems in line with those of West European states ahead of the hoped-for accession to the European Union. In contrast, the countries of the former Soviet Union focused more on taxing enterprises and goods and services, the legacy of an industrial structure

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

top-heavy with large, monopolistic enterprises, coupled with generally low levels of economic development and the absence of any realistic chance of joining the EU.

These are arguments that others have made, often based on extensive study of state institutions in particular countries, but I provide new evidence in Chapter 2 through the analysis of cross-national data on postcommunist tax structures. At the same time, I demonstrate that decisions made by state actors in structuring their tax systems had important consequences for patterns of tax compliance across the postcommunist world. In the former Soviet Union, officials focused on encouraging compliance by "old" forms of economic activity: the large, monopolistic enterprises that were the revenue base of the communist system. "New" sources of revenue, including small enterprises in competitive industries, were largely neglected. In contrast, in Eastern Europe there was a more balanced focus on new and old economic activity. The result was that "natural" differences in tax compliance were far greater in the former Soviet Union than in Eastern Europe: small firms were especially noncompliant relative to large firms, and firms in competitive industries were especially noncompliant relative to monopolies.

The consequence of these patterns of tax compliance takes me beyond the arguments in *Of Rule and Revenue* and related literature. Levi and others largely treat economic structure as given: governments form tax systems around existing economic activity rather than tampering with the economy itself. The postcommunist experience, however, suggests that governments may structure their tax *bases* to maximize revenue in the least costly way, promoting through various means those sectors that are relatively tax compliant at the expense of those that are not. In some cases, as with the creation of the vodka sector in Pskov oblast, such activity involves fundamentally *re*structuring the tax base, carving out sectors that did not previously exist for the sake of the tax revenue they will provide. In others, structuring the tax base implies maintenance of the status quo against other forces, with "old" economic activity favored over "new" because of its greater reliability as a source of revenue.

In the former Soviet Union in general, the incentive to structure the tax base to maximize revenue was especially large, given the degree to which familiar forms of economic activity remained important sources of tax revenue. In Russia in particular, federal arrangements that provided regional governments with a share of tax revenue extended the motive to regions such as Pskov. In principle, as stressed by the literature on

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

"market-preserving federalism" (Weingast, 1995; Qian and Weingast, 1996; McKinnon, 1997), this incentive could have been blunted if regional governments anticipated that an increase in tax revenue would result in reduced transfers from the federal government. However, in my discussions with regional officials I found little support for the notion that Pskov oblast would suffer reduced transfers to the extent that regional tax generation improved, and it is worth stressing that systematic evidence for such an effect in Russia relates only to revenue sharing between regional and local budgets, not federal and regional budgets.[12] On the contrary, as stressed above, developing the regional tax base was viewed as necessary given the unreliability of federal transfers.

Another characteristic of "market-preserving federalism" was, however, absent in Russia during the 1990s: the national constitution notwithstanding, regions often imposed barriers to trade with each other, thus preventing the establishment of a common market across the Russian Federation. A particular example is Governor Mikhailov's creation of a state-owned distribution monopoly – the aforementioned Pskovalko – which was used to control the sale of vodka produced outside the oblast. Such "imports" – often from a neighboring region – posed two disadvantages from the perspective of the regional budget, related to the fact that excise taxes were assessed on both the production and sale of vodka.[13] First, that portion of the excise tax collected from producers directly benefited only the region in which the vodka was produced. Second, the share of excise revenue from sales was particularly difficult to collect on imported vodka, as imports entered the distribution system through multiple channels and often with falsified documents.[14] The creation of Pskovalko gave the regional government control over price, which could be used to keep out imported vodka to the extent that such imports were routed through government distribution, while simultaneously making it easier to collect excises on that which was imported.[15] Pskovalko's monopoly status was critical to its success in fulfilling these tasks. As Mikhailov's successor Mikhail Kuznetsov would state

[12] See Zhuravskaya (2000). Blanchard and Shleifer (2001) suggest that poor economic performance in Russia, relative to that in China, can be linked to such fiscal disincentives. Way (2002) and Treisman (2006) provide alternative perspectives.

[13] The division between the two shifted from year to year, with consequences for the distribution of excise revenues among governments. I return to this point in Chapter 4.

[14] "U 'Skobaria' gosudarevo oko," *Pskovskaia Pravda*, June 19, 1997.

[15] "Otvoevannaia alkoNEzavisimost'," *Pskovskaia Lenta Novostei*, May 19, 2005.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

years later in reference to the Pskovalko monopoly, it is "far more difficult to organize the control of five small enterprises than one large one."[16]

In and of itself, this local protectionism would have encouraged the production of vodka in Pskov oblast. But the Mikhailov administration did not stop there. Local vodka production was promoted both through old-fashioned (if legally contested) subsidization and through the application of what Russians euphemistically refer to as "administrative resources." With respect to the former, spirit – the basic component of vodka – was initially subsidized to reduce the production cost of vodka[17]; beginning in 1999 regional law mandated direct transfers to vodka producers.[18] The logic, delightfully expressed to me by a woman who heads a successful nonprofit organization in Pskov, is that of any investor: one takes a little money out of a bag ("meshok"), uses that money to make a profit, and then puts more money back into the bag. Of course, market institutions also provide capital for business development, but the whole point of Pskov policy was to encourage development of an industry that provided the state – not private investors – with an unusually high return.

As to the use of "administrative resources," private manufacturing assets were seized by the regional government in 1997 as payment of debt to the oblast government and used to establish Pskovpishcheprom, a vodka manufacturer majority owned by Pskovalko.[19] Over the next several years, according to an investigation by the Audit Chamber of the Russian Federation, Pskovpishcheprom would be the primary beneficiary of subsidies for vodka production[20] and eventually would displace those other local producers that had emerged after Mikhailov's election. Thus was the regional administration able to establish a state-controlled company with a dominant position on the local market on the cheap, a reminder that in

16 "'U nas teper' rezhim otkrytykh dverei,'" *Ekspert Severo-Zapad*, May 30, 2005. Tarschys (1998) discusses the importance of trade monopolies for taxation.

17 "'Goriuchee'. . . dlia Pskovskoi ekonomiki," *Pskovskaia Pravda*, January 16, 1997; "Brosok na Pskov," *Rossiiskaia Gazeta*, February 21, 1998.

18 "Gospodderzhka alkogol'noi otrasli mozhet byt' otmenena," *Pskovskaia Pravda*, December 11, 2003. "Gospodderzhka proizvoditelei alkogolia zakonna, zakliuchila genprokuratura," *Pskovskaia Pravda*, May 14, 2004.

19 "Komu prinadlezhit Pskovskaia oblast," *Pskovskaia Guberniia*, May 26, 2004; Kryshtanovskaya (2005, pp. 357–358). Readers familiar with Russian politics will recognize a strategy used at other times by regional and national authorities, most visibly in the dismantling of oil major Yukos, whose primary assets were subsequently transferred to state-owned Rosneft.

20 The report is reprinted in "Izvineniia neumestny," *Pskovskaia Guberniia*, March 9, 2005.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

contemporary Russia, as in many developing and transition countries, the state has many instruments with which to intervene in the economy.[21]

1.2 The Nature of Representation

Pskov governor Evgeny Mikhailov's strategy in building a local vodka sector was multifaceted, but the rationale behind the policy was simple, best expressed by the governor himself in an online forum in which he participated under the pseudonym "Specialist" after leaving office: "In all sensible regions the authorities fight fiercely for their producer, especially when the producer pays a lot of taxes."[22] In Pskov oblast this fight created many obvious losers: distributors who were forced out of business with the establishment of Pskovalko, owners of assets seized in the creation of Pskovpishcheprom, and producers and consumers of imported vodka. But the losses were not limited to these actors. The far greater impact may have been on those sectors that suffered from neglect as the regional administration's attention was directed elsewhere.

Mikhailov and his administration had scarce resources at their disposal. In an interview in 1997, Mikhailov spoke of "singling out one or two spheres" where he would "try to achieve success," a sentiment he echoed exactly four years later when he said that given resource constraints it was necessary to find the "most advantageous small projects."[23] In other words, Mikhailov could not be all things to all people. The question was which

[21] It is intuitive that state-owned enterprises are more tax compliant, though as I show in Chapter 2 there is only weak evidence in support of this point for firms in postcommunist states. In any event, with time the state position in Pskovpishcheprom deteriorated: beginning in 2000, a series of share dilutions transferred control of Pskovpishcheprom to other owners, and by 2004 Pskovalko held only a 36.3 percent stake. The circumstances surrounding these transactions are unclear, but as I discuss below, the change of ownership did not eliminate the importance of local vodka production to the Pskov tax base. See "Izvineniia neumestny," *Pskovskaia Guberniia*, March 9, 2005; "'Uvazheniia zasluzhivaiut tol'ko dobrosovestnye konkurenty,'" *Pskovskaia Pravda*, June 3, 2004; "Komu prinadlezhit Pskovskaia oblast," *Pskovskaia Guberniia*, May 26, 2004.

[22] "Otvoevannaia alkoNEzavisimost': Aktual'nyi kommentarii," *Pskovskaia Lenta Novostei*, September 19, 2005. The identity of the "Specialist" was confirmed to me by two individuals in Pskov oblast. At least one forum participant also apparently identifies the "Specialist" as Mikhailov, referring to him as "E.E."; the initials correspond to Mikhailov's first name and patronymic, Evgeny Eduardovich.

[23] "Gubernator Evgeny Mikhailov: 'Ya budu rabotat' po-svoemu, nesmotria na nachavshuiusia strel'bu,'" *Pskovskaia Pravda*, February 28, 1997; "Idu na tretii srok," *Pskovskaia Pravda*, February 28, 2001.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-0-521-88733-5 - Representation through Taxation: Revenue, Politics, and Development in Postcommunist States
Scott Gehlbach
Excerpt
More information

spheres would attract the attention of his administration, that is, which would be best represented.

Mancur Olson provided an answer to questions of this sort in *The Logic of Collective Action*. Taking issue with the pluralistic tradition then hegemonic within political science, Olson argued that "privileged and intermediate groups often triumph over the numerically superior forces in the latent or large groups because the former are generally organized and active while the latter are normally unorganized and inactive" (Olson, 1965, p. 128). In the competition for influence, in other words, the winners are those groups – often small – that have managed to overcome their organizational problems, not those with the largest collective stake in the outcome.

As we have already seen, however, there was no organized lobby asking for state assistance in establishing a vodka sector in Pskov oblast. Rather, the logic of collective action favored existing interests that had inherited Soviet-era networks of organization and influence.[24] These interests lost out not because of the greater organizational capacity of the (nonexistent) vodka sector but because the revenue potential of vodka helped Mikhailov and his administration to satisfy various political constraints. In Pskov as elsewhere in Russia, unpaid state wages and benefits were an enormous political problem that demanded government attention. Vodka revenues were seen as instrumental in addressing this problem.

In principle, other sectors might have competed for government attention by promising that their members would better comply with tax law in return for benefits of the sort received by the vodka industry. After all, if firms are willing to pay lobbyists to represent their interests, why not pay more taxes to achieve the same outcome? But such promises would not have been credible. First, greater tax compliance by any individual firm would have contributed to the collective good of beneficial treatment of that firm's sector by state officials, benefiting not only the tax-compliant firm but also its competitors. Second, any agreement among members of a sector to collectively pay more taxes would have been difficult to enforce, as the tax compliance of individual firms is often hard to gauge, even to other firms within the same industry. Given these two considerations, individual firms had an incentive to hide what they could get away with. As I spell out in detail in Chapter 3, the "taxability" of sectors – the degree to which firms in those sectors find it costly to hide revenues from tax authorities – determines

[24] See, for example, McFaul (1995) and Ledeneva (1998).

© Cambridge University Press www.cambridge.org