Exposure of the "virtual" economy

■ Dmitry Lvov met Prince Michael of Kent at Kensington Palace, to brief the prince on Russia's new economic programme. The BBC Foreign Service broadcast to Russia its live interview with Dr Lvov.

RUSSIA'S top academic economist, Dr. Dmitry Lvov, flew to London to explain how the new government of Prime Minister Yevgeny Primakov planned to rescue the country from its financial crisis.

Dr. Lvov is one of the architects of a plan to reduce taxes on labour and capital and to replace the revenue with rental charges on land and natural resources. In December, as he was briefing economists in Britain, the Duma in Moscow pushed through cuts on profits and payroll taxes and doubled the Land Tax from 2% to 4%.

In a lecture at the London Business School, Dr. Lvov attacked Russia's 30 Federal taxes and 170 local and regional taxes administered by an army of 180,000 tax officials. Based on the tax burden on labour, employees were supposed to have contributed 70% to GDP in 1996. Capital contributed 17%, and according to the low charges on rental income, land and natural resources contributed a mere 13% to the nation's wealth.

In fact, land and natural resources were responsible for three-quarters of GDP. Logically, argued Dr. Lvov, who is Academician-Secretary of the Economics Department of the Russian Academy of Sciences, the burden of public finance should be on the flow of rental income. And this is the logic of tax changes now being proposed by Premier Primakov, despite the strenuous opposition from the International Monetary Fund - which does not want Russia to cut VAT.

At Parliamentary Hearings in the State Duma in Moscow on January 19, Dr Lvov forcefully restated his case. According to the Academy's estimates, the net income of Russia was $80-85 bn a year. "At the same time we are waiting, yearning for some credit facility which is much less than this amount, and we cannot pay our debts. But if our calculations are correct, there are enough resources to carry out the transformation of the Russian economy."

Why, he asked, did Russia owe foreign lenders $150 bn when it could pay its way? The problem was that official policy failed to recognise that the bulk of income potential was from land and natural resources.

Russia: the Virtual Economy Contributions from Factors of Production to GDP: %

	Contribution Based on Relative Tax Burden	REAL (estimated)
LABOUR	70	5-7
CAPITAL	17	7-10
RENT	13	80-85

Source: D.Lvov, Duma Parliamentary Hearings, Moscow, Jan.19, 1999.

"We don't understand what the real economy is that we are dealing with. If most of the income is rent, why, today, is 70% of all budget revenue derived from salaries and wages? The most exploited factor is labour. How can you tax an income which doesn't create much income for the country?

"The natural component is not taken into account," said Dr Lvov. "The main flow of income is outside the system of accounting and management. This flow is from gas, oil, timber, rent payments in big cities, especially in Moscow, and the criminal world exports this revenue from the country." Since all of this rental income is ignored, said Dr Lvov, what emerges in the official version "is a virtual image of our economy." Therefore, the tax base should be shifted away from wages and profits. "I support making the rental component the main income of Russia. It is important to change the system of financing. The burden of taxation should be on the rental component." Rent, he insisted, could constitute "the bulk of the revenue for the budget."

RUSSIA continues to need Western support, but until the beginning of January Western plans were coloured by the suspicion that the former spymaster who had now effectively taken over the reins of power from Boris Yeltsin was hankering after a return to the planned economy.

Dr. Lvov's visit to London helped to demolish some myths. He participated in a private briefing for Whitehall economists from the Treasury, Foreign Office and Cabinet Office. They were impressed.

But educating Western governments would not be quick or easy. Dr. Lvov grasped an opportunity that arose when he was invited to meet Prince Michael of Kent, who is Patron of the Russo-British Chamber of Commerce. The Prince asked the academician to suggest action which he could initiate. Dr. Lvov suggested a roundtable conference to afford the Primakov team the chance to enlighten Western governments on the economic philosophy that was now being developed in Moscow. Prince Michael agreed to consider the proposal.

PHYSIOCRAT MODEL OPTION IGNORED

THE PHYSIOCRATIC tradition of public finance - basing revenue on the rental income of land - is known to Mario Nuti, Professor of Comparative Economic Systems at the University of Rome. He is also Director of Research at the CIS Russian Studies, London Business School.

But a fiscal driven recovery is not one of the options that he perceives for Russia. According to Nuti, Russia faces two options.*

■ Mario Nuti

- Populist government expenditures with inflation or a fiscal deficit; government by decree; no more privatisations and discouraged foreign investment.
- Government inaction leading to a pre-capitalist system in which the economy recovers after a large-scale recession.

Professor Nuti adds as an afterthought: "Another scenario, of a rapid and orderly resumption of fiscal and monetary restraint, the completion of economic reforms (e.g. tax reform, land ownership, plant closures), the resolution of constitutional and political uncertainties, is at present so remote as to belong to a world of fantasy".

Even as he offered this pessimistic analysis, Premier Yevgeny Primakov was gathering around him in Moscow economists who identified a third scenario - based on the Physiocratic principles - which was escaping Western observers like Professor Nuti.

* D. Mario Nuti, "A Macro-Economic Overview", Seminar, London Business School, 13.11.98.