

Monetarism & the Mafia: the IMF Connection

KARL MARX wrote little about how to transform a capitalist society into socialism. Not surprisingly, he wrote nothing at all about how to reverse history: reconstitute capitalism out of socialism. Market philosophers were no better prepared to help the politicians in such an enterprise, which is why Russia fell under the unholy alliance of Western monetarism and the Russian criminals who have stolen the nation's patrimony.

The natural wealth of Russia is astonish-

ing. It has 25% of the world's proven gas reserves, and one-seventh (6.7 billion tons) of the world's proven oil reserves outside the Middle East. It is the world's third largest oil producer. Throw in the gold, diamonds, and all the rest, and you get one of the richest nations in the world.

And yet, the population is suffering debilitating poverty and a crash in life expectancy to levels peculiar to sub-Sahara Africa. The explanation is not difficult to fathom: the rental income has been privatised for the ben-

efit of a tiny minority. This severed the state's ability to fulfil its social obligations in health and education. This, in turn, is the reason for the dependency of the Federal government on borrowed money and the collapse into bankruptcy on August 17.

The "reforms" of the Yeltsin years created a monopolistically-structured twilight economy in which a tiny minority was able to feed off the nation's taxable resource rents and the working population was short-changed (*see box 1*).

But the arrival of a new Prime Minister may have initiated a new era. Yevgeny Primakov, a former spy-master, has altered the mood of the political system. The financial "oligarchy" has detected that new rules are being written in Moscow which are emanating from the government's White House and not Yeltsin's Kremlin.

ONE OF Primakov's first acts was to investigate the reasons behind the bankruptcy of a government which is supposed to command one-seventh of earth's land mass, containing an estimated 40% of the world's remaining natural resources.

✂ The government is blamed for not paying wages, but 80% of this debt is in the private sector.

Enterprises disclosed low profits. They transferred cash to "daughter enterprises" and spent the money on building villas for the new shareholding directors.

✂ Banks illegally pocketed wages of public sector workers.

When the government transmitted funds to public enterprises via private banks, 40% of the money got "stuck" in the banks.

✂ Local governments nurtured a culture of corruption.

Money intended as wages was used to buy bonds or shares in the privatisation of enterprises.

✂ Federal agencies participated in criminal activity.

Insider dealing meant that many natural resource enterprises were auctioned for far less than their real value. Privatisation agencies colluded with the new shareholders to siphon off value that ought to have gone to the Federal budget, so the nation had to be pawned.

✂ The Federal government was humiliated by deception used to defraud it of revenue.

Businessmen treated sovereign borders with contempt. For example, producers exported oil to Ukraine as if it were to be processed and stored there before being returned to Russia. Instead, the raw oil was

Box 1 Oiling Corrupt Behaviour

THE CRIPPLING leakage of Russia's public revenue is dramatically illustrated in the energy sector. Revenues from petroleum averaged 4.5% of GDP compared to between 10 and 30% in other oil producing countries.

Problems originated with privatisation, when oil and gas assets were sold for a total contribution to the budget of under \$1.5 billion. The assets are worth an estimated \$50-60 billion (mid-1997 market value).

Gazprom controls all gas sector assets, 60% of which were privatised, with managers receiving a large part of the shares. The asset value of Gazprom (end 1996) was \$119 billion, excluding gas reserves.

Energy sector companies were privatised without significant amounts of debt which, according to Dale Gray, a senior IMF economic analyst, meant that they "generated large rents". But those rents were not shared with the public (*see table*).

The relative tax burden is defined as the energy sector's share in general revenues divided by

Revenues from Oil & Gas
(1996: per cent GDP)

	Russia		Other Producers
	Oil	Gas	
TOTAL	2.32	2.04	5 to 40
Relative Tax Burden	2.00	1.33	2 to 4

Source: IMF Staff Estimates

the sector's share in GDP. The relative burden is between two and four for most countries outside the former USSR. It was two in Russia, at the bottom end of the range.

The rationale for a government drawing its revenue from natural resources was identified by the IMF's Gray thus: "The government as sovereign tax authority should collect as much of the 'economic

rent' as possible through taxes that are as neutral as possible. These rents are surplus revenues that remain after allowing for all costs and a minimum return to the owner or investor. The more revenue that can be raised through the taxation of these rents, the less revenue the government will need to raise by using distortive taxes on goods, factors of production, or asset transactions".*

Gray notes that "Weak regulation of energy transportation has allowed significant rents to accrue to the transporting firms". Gazprom's shareholders are being enriched by government default. Or, to put it another way, Russia's taxpayers are being short-changed. This is how Gray puts it: "The structure of taxes does not adequately capture monopoly or resource rents; and tax administration is weak. An unusually large share of rents accrue to the large gas and oil transport monopoly (particularly Russia's Gazprom and Transneft) and is frequently not passed on to the budget".

* Dale Gray, "Energy tax reform in Russia and other former Soviet Union countries", *Finance & Development*, Washington, DC: IMF, September 1998, p.32.

Box 2 The rent scam

THE LINK between resource rents and Russia's astronomical rates of interest has been exposed by an expert in international finance.

Professor Alexandr D. Nekipelov (pictured right), director of the Institute for International Economic and Political Studies, explained that the middlemen who corruptly stole rental income bumped up interest rates. This is how he described the scam.

Producers of energy and metals would not sell direct to the world markets. Instead, they sold to Russian middlemen at low prices. They then sold on at world prices and pocketed the difference. This had two socially significant effects:

- (1) A large part of the rent of natural resources was privatised, which would otherwise have provided funds for the Federal government to invest in the transformation of the industrial base.
- (2) Middlemen did not have the cash with which to finance the transactions. So they borrowed, and were willing to pay any price. They outbid other borrowers because their profits from insider dealings were so large that they could afford to pay enormous rates of interest. So financiers who loaned money

to corrupt middlemen also took a share of resource rents.

The professor's investigations exposed the murky commercial activities of the "newborn businessmen". He used a hypothetical case to illustrate the scam: "I am a manager of an enterprise which exports oil. You are an intermediary. We have a deal with you that officially we export the oil at a reduced price, and you place a part of the difference in my foreign bank account. But you need to pay roubles for the oil, so taking into account the efficiency of this deal, if you need liquidity to pay in roubles you can obtain credit from a bank at a very high interest rate because the profits of this operation is several hundreds per cent. This operation is used widely here. They pump out resources from enterprises in favour of management. The profit is large enough to pay the high interest to the banks and make a profit for the intermediary.

"I can't see any other mechanism to explain how the high real interest rates could be maintained for such a long time. These rates cannot be compared with the profitability of the real sector".



■ Prof. Alexandr D. Nekipelov

Middlemen had no overhead costs to defray and no capital of their own. So they resorted to credit.

But with returns to entrepreneurs in commerce and industry well below the rate of interest charged for borrowing money, industry was stifled of the credit it needed to create jobs and expand output.

Professor Nekipelov said that the banks were able to profit because of distorted property rights which encouraged the scam. As for the IMF, he says: "The IMF ignores this process. They just don't understand how our economy functions".

sold on to Western Europe. The deception was camouflaged with false documents.

In effect, the state itself was stolen by the Mafia which created its own laws and operated an alternative, "black" economy.

WHAT BOOKKEEPING? Why did Yeltsin's previous governments not expose what was going on?

The Ministry of Finance adopted such shoddy methods that it was not possible to keep track even of its own finances. This was discovered by the Chamber of Accounts, the national accounting agency that reports to Parliament. In a document dated August 7, 1997, which was submitted to the State Duma, the Chamber of Accounts catalogued illegal actions and financial mismanagement of breath-taking proportions. Paragraph 5.5 revealed that books were not kept to track the revenue and expenses that flowed through the Federal Budget. Such accounting as existed "is done in a free form" which did not comply with the law.

Before the rouble crashed, the reformers - through their associates, the banking moguls who owned the TV stations - had such a tight control over public debate that the scandals were not exposed to public gaze. Few people were willing to incur the wrath of privatisation supremo Anatoly Chubais. An exception was Professor Veniamin Sokolov, a space physicist who has become a scourge of the Yeltsin administration as one of the elite auditors elected to the Chamber of Accounts. He is determined to expose the corruption

which destroyed the foundations of the Russian state. When the government defaulted on its debts, he urged the IMF to withhold loans until the government had adopted financial controls.

The public prosecutor has now moved in to the Ministry of Finance to check what has happened to the first tranche of the IMF's \$22.6 billion, the package that was negotiated weeks before the default.



■ Prof. Veniamin Sokolov

Sokolov took his campaign to reveal the truth to Washington. Last summer, he flew to the US to brief congressmen on the way in which IMF money had leaked through the Russian government's hands.

Speaking to *Land & Liberty* in July, he predicted a total collapse of the Russian state. His fears were to be realised four weeks later when stand-in premier Sergei Kiriyenko admitted that his government was bankrupt.

For Professor Sokolov it had been only a matter of time. Attempts to audit the government's books, to monitor the privatisation programme and trace where all the money was going were futile because the Federal government did not keep books.

Decentralisation of the command economy should have been achieved progressively, he says. Instead, it was executed by using the shock therapy advocated by Harvard economics professor Jeffrey Sachs. This destroyed the state's ability to function, which had three main components.

- (1) "We analysed the finances of the Ministry of Finance. There were no accounts showing the revenue and expenditures of the state budget. Mr. Chubais received our report, but he didn't answer".
- (2) The Ministry of State Property was audited. "The Ministry was not registering property that was privatised: they didn't know what was privatised, and what was not. There was no record of it."
- (3) The privatisation process was investigated. "The approximate data is that they have already privatised about half of state prop-

erty. Not long ago Chubais said that privatisation had a purely political character and had nothing to do with the economy. This is correct, as we confirmed with our audit. We showed that both privatised and state companies aren't able to work."

On public finance, he said that the complete collapse of the budget was explained by the fact that entrepreneurs had no money in the real sector to pay taxes. "That is why we have such high tax rates, up to 40%. But it is impossible to collect money. Enterprises were cut off from lines of credit, so they were forced to turn to the barter system. The result was they didn't have money to pay taxes."

He identified some of the weaknesses in the economy.

As evidence for his thesis that there was a private agenda to cripple the economy, he cited the deepening indebtedness of the state: "About 50% of state expenditure is for interest payments. Of the R106 billion which the Ministry of Finance managed to collect in the first five months of this year, R51.6 billion was paid as interest for state bonds. That is why the only aim of Kiriyenko's anti-crisis programme was to reduce public spending, which is extremely low anyway. The government is borrowing money from the IMF to pay interest on state debts. This is what Sachs is now writing."

Sokolov's lobby in Washington made an

impact, for the chairman of the House International Relations Committee, Republican Benjamin Gilman, cited him in a *Washington Post* article (June 19) in which he revealed: "While Russia's foreign borrowings in recent years have totaled \$99 billion, a full \$103 billion in capital has been spirited out of the country. Thus, much that Russia has borrowed has not gone into productive investment to create a bigger tax base but has instead filled the gaps left by the disappearance of billions of dollars worth of Russian capital. Meanwhile, Russian households and entrepreneurs starve for such capital, operating on a barter basis, which, again, cuts into Russia's tax base".

Jeffrey Sachs, who was adviser to the Russian government from 1991 to January 1994 when the foundations for the Russian transition model were put in place, now washes his hands of the mess. In a raft of articles in the financial Press, he blamed the IMF for standing by "as the Government squandered tens of billions of dollars by transferring state-owned oil and gas companies to cronies at cut-rate prices" (*The New York Times*, June 4).

The gravy train had to come to a halt one day, as the new Russian owners of capital began to understand earlier this year. Said Prof. Sokolov: "The endgame is not only the end of the country, but the end of capital as well. Either there will be another revolution, and the first to suffer will be Russian capital-

ists or, alternatively, they will be swallowed by foreign capital and end up as managers of foreign capital".

Russian industry had failed to adapt itself to market conditions because it had been starved of cash. "They could obtain only 12% of what they needed. The enterprises lost their own resources, thanks to the policy Gaidar undertook, and so they don't have their own resources and can't borrow from the banks. Their profitability is only 5%, and the lowest interest rates never drop below 23%. The financial sector's share of credits advanced to the real sector for long-term investment is only 3%."

The scam that drove interest rates to unaffordable levels - operated by middlemen who pocketed resource rents - was analysed for *Land & Liberty* by Professor Alexandr Nekipelov (see box 2).

PROFESSOR Sokolov's investigations bore out his worst fears. A quasi-market economy had emerged based on speculation in the financial sector and exploitation of natural resource

✠ Sewing machine manufacturer producing 1.5 million units every year was privatised. The director became the owner. He sought foreign finance by selling 30% of the shares to a western company. That share rose to 97% and the director is now the hired manager. Last year they produced 10 sewing machines: production has ceased. The for-

Box 3

The RentRouble

THE creation of a new currency, the RentRouble, would restore people's confidence if it was located in a new programme capable of guaranteeing sustainable prosperity for everyone. It could, in fact, unify people's social rights with the private benefits of the market economy. The bridge between the two is public finance.

The RentRouble is inspired by what Germany did in November 1923. The Reich was burdened with heavy debts that it could not finance. Enterprises refused to pay taxes. The government churned out billions of marks, causing runaway inflation. People's savings were wiped out. The economic chaos was fertile ground for Hitler. This is a scenario which resonates with the facts in Russia today.

The Rentenmark was launched, backed by the value of farmland and industrial and commercial property. The recovery was immediate. Food returned to the shops; enterprises started to pay their taxes; people deposited their money in the banks again; an attempted putsch by Hitler's thugs was successfully defeated.

The crucial element was psychological. People trusted the new currency because it was guaranteed by tangible assets: rental income from the land. The new independent bank - the Rentenbank - issued only 2.4 billion Rentenmarks, half to agriculture and the other half to commerce and industry. The loans were received by the borrowers, who mortgaged their land and property. The Rentenmark was backed by certificates based on gold value and bearing 6% interest.

The lesson for Russia: it is possible to escape from a catastrophic financial crisis if the public accepts that the value of money has been restored.

The RentRouble needs to be backed by public claims on the land's flow of rental income. In case of default by borrowers, the Rentbank would take control of the enterprises and put them under new management - or declare bankruptcy.

In Russia, people and enterprises do not legally own the land. But they do now benefit from the rental income that can be imputed to the land they occupy. By restructuring taxation to take rent as public revenue, the government could abolish taxes on the profits of capital. This would enable enterprises to repay the loans.

For foreign investors, there would be a powerful incentive to invest in Russia. For the Federal government could abolish taxes on incomes from fixed capital formation. Entrepreneurs who create jobs in Russian factories would retain all their revenue.

The RentRouble is an elegant solution because it addresses - in one policy - a complex set of problems which are creating crises on a broad front. By narrowing down its policy instruments to the one that would be most effective, the Federal Government would accelerate the reform programme in the correct direction: establishing a market economy with a financially viable public sector.

- ❖ Enterprises could not conceal cash in Switzerland and claim that they had no profits out of which to pay taxes.
- ❖ Russia's major source of foreign currency is the rent from natural resources. Solving the foreign-exchange problem (and hence the problem of how to stabilize the currency's international value) simultaneously solves the problem of how to recapture the future rental revenues from the privatisation programme.
- ❖ The privatisers and their foreign backers believed that once they had transferred ownership of Russia's national patrimony into private hands, they had made their appropriation irreversible. But by collecting all the land and natural resource rent for the public - adhering to the capitalist principle of paying for benefits received - the grievous errors in Russia's privatisation programme would be nullified in a way that was legal under international law.

eign owner did not need a competitor in the world markets.

✚ An electronics company was privatised and then the bulk of the shares were acquired by a western company. Production ceased. "They just destroyed the competitor," said Professor Sokolov.

✚ An aircraft manufacturer in Varonish had two new IL-96 aircraft for sale worth \$120 million. The company needed \$40 million to complete the construction of ten more aircraft. Employees had not received wages for five months. They could not complete the aircraft for sale. Yet Aeroflot was buying Boeings because loans were provided. "All specialists say the specifications of IL-96 are better than the Boeing," but Aeroflot was encouraged to buy the US aircraft with the aid of "bribes - 10% of the deal is 'commission' for organising the contract".

He does not disguise the bitterness in his pronouncements on Yegor Gaidar, the premier who steered the economy into the sands. "Gaidar said a number of times, openly, that he would do everything he could to create a class of very rich persons. It was possible to do it only by taking it from the whole population and giving it to the small group. They did this by wiping out the value of people's savings and transferring the funds of enterprises to a small group of very cunning persons who had access to the privatisation process. This mechanism continues to exist to this day. Half of the budget is paid as interest: so everything that is now created by the country is transferred to the private pockets as interest payments".

With the Federal government not just condoning, but actually participating, in corrupt practices, was it surprising that Russian society had degenerated into a kleptocracy? Sokolov cited an example in an article in *The New York Times* (June 1): "The Finance Ministry lent \$150 million to the Moscow Aviation Production Combine so it could build MIG-29 fighter planes for sale to India. An audit by the Chamber of Accounts found that not one cent of the loan reached the enterprise. At the time of the 'loan', the MIGs were already finished and ready for sale".

THE HISTORY of the rape of Russia will occupy scholars for decades, but policy-makers in Moscow are now turning to the problem of developing a plan to create jobs and encourage investment. The precondition for this is reform of public finance. One proposal, which was developed by the London-based Centre for Land Policy Studies, is being canvassed in Moscow. It is based on the proposal to create a new currency - the RentRouble - which is inspired by the experience in Germany (see box 3).

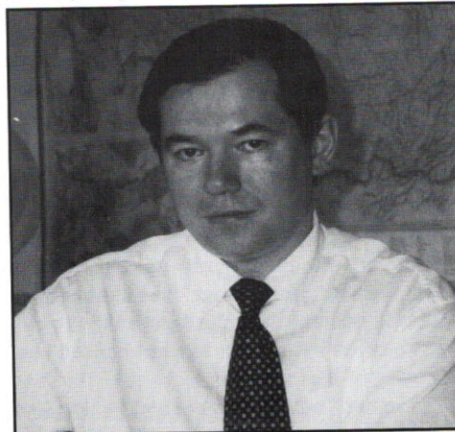
The anger, suspicion and cynicism of the Russian population is understandable: their savings have been wiped out twice in the 1990s. They need guarantees that new reforms will work to their advantage. The only possible way to achieve this is to guarantee every citizen's right of an equal share in the rental income of Russia's natural resources.

Western economists confirm that the way

to achieve this is to base public finance on the rent of natural resources, including urban land. This proposal is now receiving influential support in Moscow. One advocate is Dr. Dmitry Lvov, Academician Secretary (Economics Department) of the Russian Academy of Sciences. He is a close advisor of Premier Primakov.

Another advocate is Dr. Sergei Glazyev, Head of the Analytical Department of the Council of Federation (Parliament's Upper House). He stated in a book published last year (*Genocide: Russia & the New World Order*, Moscow, 1997, p.136) that a reduction in the burden of damaging taxes could be offset by raising revenue from other sources. "Among them, of special significance is natural rent, the main part of which has to be extracted as state revenue via corresponding charges for the resources...[T]he potential volume of extraction of rental charges for state revenue from the gas-producing industry alone could be more than one-fourth of the Federal budget."

Dr. Glazyev also noted that what he called a "very important source of revenue for the



■ Sergei Glazyev

state budget" was rent that would flow from the effective use of urban land. He stressed that the switch in the structure of revenue would be neutral, which would enable the state to meet its spending obligations. The Primakov government has decided to pursue this fiscal strategy by its decision to double the Land Tax rate and increase excise duties on exported energy.

This strategy, if implemented, would ensure that every citizen shared in the rent, through public spending. But can citizen's rights be guaranteed in perpetuity?

The Primakov government would need to amend the Constitution to make every present and future citizen an equal owner of the nation's natural resources. Citizens could be issued with certificates that guaranteed a share of rental income. The certificate would empower people with the legal right to challenge a government that allowed part of the nation's resource rents to be privatised. In a moral society, the publicly created value belongs in the public domain. This policy would lay the foundations for a new contract between citizen and government. This would restore people's faith in democracy and prevent another social catastrophe.

LARGE QUESTIONS are raised by the Russian tragedy. Marxist theorists can hardly be blamed for not having a plan designed to retrieve Eastern Europe from socialism: after all, historical development was supposed to terminate in socialist bliss.

Less excusable was the failure of the West to produce a programme for re-floating the beached Russian economy. Abject failure has to be evaluated in terms of some fundamental defects buried in liberal philosophy. Russian analysts are now recognising that their social anguish was the inevitable outcome of the pursuit of a Western philosophy which emphasised a primitive monetarism. One critic is Dr. Glazyev, who has carefully analysed the convergence of IMF philosophy with the emergence of the Mafia.

He characterises the financial oligarchy as Mafia because many of their deals were illegal from the inception of a privatised financial sector. Many wealthy bankers started by cornering income from state assets.

"This produced a symbiosis of IMF reform and corruption," said Glazyev, who was to become one of the architects of Primakov's rescue plan. "The IMF simply prefers not to see this."

He designed the export tax on energy which accounted for half of petroleum sector revenue in 1993. It was abolished in 1996 by the then Prime Minister and Gazprom functionary, Viktor Chernomyrdyn, and the IMF, "even though there was no distortion in exports". By eliminating the tax, the Federal government was driven into the arms of the IMF and the private banks.

"The G7 countries believe that Russia should not have an economic policy, that it should merely be an economic space. Instructions from experts who are financed by the US-AID take the same view. They insist that we should use just those experts to teach us how to get rich at the government's expense."

According to Glazyev, IMF strictures "correspond with the interests of Russia's financial oligarchy. The liberal approach is very convenient for them. They prefer the government to be as weak as possible. It makes it very easy to cheat, not pay taxes, and to take the national rent. The majority of privatisation cases were done in an illegal way. They used the IMF as an umbrella. There is a symbiosis between them and the IMF.

"Western investors also like this. The less government, the more opportunity for them. But they do insist that the government must service the foreign and internal debts and fix the exchange rate. One-third of the internal debt is owed to foreign sources".

With all the power concentrated around the Presidential family, which was closely linked to the financial oligarchy, the pre-August 17 situation meant that the status quo would be maintained by the use of bribes "and the IMF provides the ideological background for this".

In the first interview he gave to *Land & Liberty*, on May 30, Glazyev claimed that he calculated that the financial pyramid had past

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- Cash-starved governments believe that selling land helps to solve budgetary crises. Wrong, explains economics professor NIC TIDEMAN. By privatising the income stream from land and natural resources, governments short-change citizens. This adds to the pressure to tax wages and savings, and taxes are the major constraint on production.
- Hungary's government is ignoring the illegal sale of land to foreigners. The country's soil is among the most fertile in Eastern Europe. But in the early 1990s the soil-rich landowners were cash-poor, so they, too, thought that the solution was to sell land. They developed illegal methods to get round the ban on sales to foreigners.
- Does it matter if foreigners own a country's land? The Thai government has approved an investment law which would abolish restrictions on majority foreign ownership in all assets except land. The Bangkok government does not realise that last year's financial crisis originated with land speculation financed by foreign creditors who were paid out of land rent.
- In Britain, privatisation of British Rail was condemned in August by a House of Commons Select Committee which revealed the government had undersold by £1 billion. The lesson was ignored: the government plans to sell choice London sites in what a property agent said was "like buying Park Lane and Mayfair on the Monopoly board".

How (not) to short-change taxpayers

MOSCOW mayor Yuri Luzhkov flew to London and announced at an investment conference (*Financial Times*, Oct. 23) that he may experiment with selling a few of the Russian capital's most valuable sites.

He is cautious about the plan, which will have to be submitted to the city council for consideration. He is in no hurry to sell assets: he told bankers and journalists that it was better to do things properly than to rush and make mistakes.

The mayor's caution is warranted. Selling land under freehold terms would be poor economics and poor political economy. Disposing of the land on a leasehold basis would be much better.

There is a simple (actually, over-simple) application of economic theory that says that how the land is disposed of should not matter. The simple theory says that markets work perfectly. This means that the amount of money that can be obtained by an auction of a freehold title to a parcel of land should equal the present discounted value of all future leasehold payments that can reasonably be

expected. In practice, the simple theory does not work (*see box below*).

An advocate of the perfect-markets theory might reply that this is only one example. Markets should not be expected to be perfect in all cases, but only on average. A more formal statement of this proposition is that the sum of the current rate of return to freeholds (the ratio of net leasehold payments to freehold price) and the rate of increase in freehold prices should equal on average the market interest rate on investments of similar risk (such as good corporate bonds). An examination of the data reveals that this is not so. The average net rate of return to good corporate bonds is significantly lower. This implies that disposing of surplus land as leasehold is typically better for the government than disposing of it as freehold.

A more advanced economic theory explains why this should be so. First, the corporate bond rate is lower than the interest rates that successful freehold bidders would typically face. This gives the government a comparative advantage in holding land. Second, freehold bidders face risks that future governments will raise property tax rates or income tax rates, thereby reducing their returns. It is not possible for the current government to make a binding commitment that future governments will not do this. This risk reduces freehold selling prices.

EVEN APART from the narrow efficiency of the government as investor, there are reasons to favour leasehold over freehold. There is a national economic efficiency reason related to land speculation. If land speculation consisted only of keeping land unencumbered by costly improvements until it was ripe for development, one could not complain that it was inefficient.

But the common sight of numerous parcels in built-up areas that sit for decades in private hands with little or no improvements belies this characterisation of land speculation.

Economic theory has an explanation for the inefficiency of land speculation, known as 'the winner's curse'. When an object of uncertain value is auctioned, the highest bidder will be the person whose perception of the value of the object has the most extreme upward error. The person with the most extreme upward error in valuing land is likely to be the person with the most bizarre beliefs about how much the value of the land will rise in the near future, and therefore how profitable it will be to develop the land later rather than now. This concentration of land in the hands of persons with a bias against developing it creates an artificial scarcity of land. This can be eliminated by having land held in the form of leasehold rather than freehold, so that there will be no private gains from land speculation to tempt people into postponing development inefficiently.

There are two coherent arguments that opponents of leasehold might advance.

- Government administration of leasehold may be inefficient, either in setting leasehold rents inaccurately or in simply wasting money. It will be necessary for public officials and ordinary citizens to take care that this does not happen. The leasehold system should be developed so that it is not difficult to determine whether public officials are setting leasehold rents inaccurately.
- People who invest in buildings want assurance that the rent of the land under their buildings will not rise precipitously and destroy the value of their investments. Freehold possession of land provides insurance in the form of the fact that if land rents rise precipitously, what they lose in building value will be more than offset by what they gain in the sale value of the freehold. The inability to have such insurance would reduce leasehold rents and discourage construction. While this argument is a valid application of economic theory, it seems quite unlikely that the actual magnitude of the effect would be perceptible. And if people did find the risk of future rises in rent to be a serious obstacle to eco-

The financial outcome from alternative tenures for a site in the English town of Scunthorpe in North Lincolnshire illustrates the two strategies for privatising the use of land. The site was leased in 1961 on a 99-year ground lease at £550 per annum by the local authority.

- If the site had been sold freehold the council would have accumulated £25,000 by 1998, including interest on the sale price.
- But, a ground lease granted in 1961 with 21-year rent reviews would have produced income of over £100,000 by 1998, including interest if all income had been re-invested. With rent reviews every five years, however (as would be expected on a modern ground lease), the community would have been enriched by £225,000.

*Source: "Industrial Ground Lease Investments", North Lincolnshire Council internal report, 1998, cited in "Do Gordon Brown's Numbers Add Up?", *Land & Liberty*, Spring 1998, p.4

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Moscow's Mayor, the Apple Tree and the Land Tax

PROFESSOR Kemer B. Norkin is a bear of a man whose job is to think strategically. He plans the development of the Russian capital and reports directly to the Mayor, Yuri Luzhkov.

Five years ago he became an ardent advocate of the policy of treating rent as public revenue. "The Moscow community has no more valuable resource than land, and land use is the most efficient tool for controlling city development, especially in collaboration with the private sector," he told *Land & Liberty*.

"We are not allergic to private property in land but we are not intending to sell city land. It is not profitable for the city to do so. We see in Vienna that they have historically had a lot of private land and this created very big headaches." In Russia, in the absence of legal and administrative regulations, "it is most stupid to sell land for private ownership, because many people have not even heard of zoning ordinances. They say 'if it is private I can do anything with it'. Our policy is, if you use the land you have to pay".

The city leases land on 49-year terms. The tax charge on property is determined each year. There are about 50 recognised types of land use, each of which attracts a rental charge. "If there is not enough land for different users, we have to raise the price. Our purpose is, in the future, to cover all city expenses by land use taxation".

Mr. Norkin studied Alaska where the oil economy generates a surplus which is shared among citizens. Russia could have embarked on this model, suggested Mr. Norkin, "but when this stupid Gaidar started the reforms he forgot about it, and he made it so that the rent belongs not to the citizen, not even to the people who extract it, but to the insiders who bought it cheap. This is a revolutionary situation; Russian citi-

zens can't survive. They can't pay for heating even though the heat belongs to them".

Under Mayor Luzhkov the share of the capital's budget financed from property rose from 5% to 25%. The push to recover a larger slice of rental income is part of a strategy to reduce other taxes.

The Mayor has been carefully briefed on the economics of land taxation by Mr. Norkin. For example, they stress that a direct charge on land leads to a more efficient use of land. They also realise that taxing profits deters work and investment. "This is stupid. First people work to hide profit, but at the same time it is not possible to hide it without

ing it to parasitic capital".

The Mayor said that Muscovites were receiving less than they earned. "The main part of this difference is the rent of resources which was stolen from them. That is why we have to maintain subsidies. The only kind of rent which is so far not privatised in the Russian federation is land rent. It is still consumed indirectly and it remains the last foundation of social stability in the country. That is why we are so careful in Moscow and don't rush to privatise land in Moscow. In principle we have nothing against private possession of land, but if the city's community loses rent, there has to be adequate compensation. It is simply very dangerous to give away a hidden part of land rent into private hands before civilised rules of land relations are introduced.

"We have to introduce what is called in the circles of professionals 'incentive taxation'." By this, the Mayor meant the need to untax earned incomes and raise public revenue from the rent of land and natural resources. The city was an economic entity which functioned to ensure the prosperity of "all its shareholders - citizens. The final product of this activity is the value of urban land". The correct tax base was that land value. He illustrated fiscal philosophy with the fable of the apple tree. "Let us remember apple trees. If we introduce high taxes for apple trees there will be neither trees nor apples. But if we tax every land site with apple trees at a tax rate equal to half of the yield from one apple tree, people will start to plant trees. There will be both trees and apples".

After launching this policy, said Mr. Norkin, "People started supporting the Mayor very strongly. During the 1996 election some of his assistants brought 'image makers' to him, but he said 'No, if you follow the policy which is good for people you don't need image makers'. He fired the image makers. About 90% of citizens voted for him".

Mr. Norkin said the rent-revenue philosophy was not clearly expressed in Russia's documents, but it existed in their minds. The Moscow government's strategy was to reduce the tax burden, to encourage growth. "The protocols of Moscow government declare the strategic intention to shift taxes on to land use."

Yuri Luzhkov was one of the candidates nominated as Prime Minister by the Duma in September and he is now increasingly hinting at his presidential ambitions. Meanwhile, the Mayor devotes himself to transforming the capital in the knowledge that his primary fiscal ambition - the public collection of rent - isolates him from the financiers. "The people who capture the rent try to use the money to isolate him. They tried, but they can't because Moscow pays 30% of the federal budget," says his chief strategist, Kemer Norkin.



■ Kemer Norkin

becoming involved with criminals in the business. Those criminals have special laws, which are not civil laws, like the decision whether to kill or not to kill. In the cases where American entrepreneurs were killed in Moscow, it was because they were involved with criminals. But our taxation system which burdens profit forces entrepreneurs to move into criminal activity," says Norkin.

"In the US they try to prove that it doesn't matter which source of income you tax, that the most essential issue is the percentage of GDP extracted as taxation. But I am not sure this holds even for the stable economy. But in our case it is definitely a wrong statement."

Mr. Norkin produced the text of a 1995 speech by the Mayor which contained the fable of the apple tree. This was Luzhkov's first speech on strategy after his election as Mayor. Moscow now receives more from its property than the federal government receives from its property.

The Mayor analysed the Soviet economy by noting that poverty had surfaced in the Yeltsin years because "a parasitic capital has privatised [rent] which under the previous system was indirectly consumed by all citizens.... [rent] was not included in state prices. It was not considered to be important. But now our people not only lack that rent but in addition they are pay-

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conomic development, they could buy insurance against rent rises.

IN ADDITION to the efficiency reasons for privatising land by leasehold rather than freehold, there is an important argument in terms of justice.

It is unjust for one generation to appropriate for itself the value of public assets and leave nothing for future generations. If land is privatised as leasehold, then every future generation can receive the rent of their era, while if it is privatised as freehold, the privatising generation receives all the rent.

While it is imaginable that the privatising generation would invest the proceeds so that all future generations might receive dividends, that has not happened with other privatisations in history. To ensure that each generation will receive its share of the value of public assets, the just and prudent course is to privatise land as leasehold, and to require that the full market rent of the land is paid on an annual basis to the community.