GlobalResearch
Center for Research on Globalization

How Neoliberal Tax and Financial Policy Impoverishes Russia – Needlessly

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Global Research, November 28, 2012
Michael-Hudson.com 23 November 2012

Region: Russia and FSU
Theme: Global Economy

A shorter version of this paper has been published in the Russian Academy of Sciences journal, Mir Peremen (The World of Transformations), 2012 (3):49-64 (in Russian). An earlier version was posted by the Global Policy Forum meeting in Yaroslavl, Russia, September 7-8, 2011, on its website.

Russian poverty is unnecessary. Like all poverty in today's high-productivity age, it is the result of bad policy. There is no technological need for it, nor is Russia lacking in a full spectrum of natural resources and economic potential. So future historians no doubt will puzzle over how the nation was convinced to de-industrialize its economy and impoverish much of its population in favor of exporting fuels and minerals, and to impose more regressive taxes on labor and industry than existed anywhere in the West – having been assured that this would streamline growth, not stifle it.

Neoliberal advisors promised that Russia would become more efficient and affluent by following an almost diametrically opposite path from that which Britain, the United States, Germany, Japan and modern China took to raise themselves to industrial power – the policies that classical 19th-century liberals endorsed to reduce the power of rentiers over the economy and government. Instead, post-Soviet polarization between rich and poor over the past twenty years has seen falling living standards and a dismantling of manufacturing, education and public infrastructure go hand in hand with creation of a new class of instant billionaires at the top of a steeper economic pyramid than exists in Western industrial powers.

This polarization was implicit in the policy advice outlined in 1990, a year before the Soviet Union dissolved, at meetings with the International Monetary Fund, World Bank and other inter-governmental organizations in Houston, Texas.
[1] It is part of the worldwide dynamic of financialization centralizing planning in the banking sector – a combination of debt leveraging, privatization and dismantling government's traditional role.

The shock therapy and "grabitization" that concentrated wealth while dismantling public regulation and separating resource rents from the financing of social spending was not a natural or inevitable result of Soviet Communism. This sharply anti-labor policy and rejection of a mixed economy finds its origins in Chile after the 1973 military coup, and the Thatcher and Reagan decade of the 1980s that reversed the Progressive Era's reforms that had broadened the economic base, nurturing a middle class and thriving domestic markets.

Making Russia dependent on Western credit by wiping out Russia's domestic

savings

Today's economic polarization was planned at the outset, in the logic spelled out at the 1990 Houston Summit. Neoliberals were given a free hand in designing the post-Soviet economies, and they had no intention of creating a Western style mixed economy with progressive taxation and anti-monopoly regulation. The very idea was anathema to them. The ensuing dismantling of industry and asset stripping throughout the former Soviet Union stands as an indictment to the advice they gave.

When a government pursues impoverishing economic policies for a sustained length of time, there always are special interests at work. In Russia's case the main beneficiaries were Western investors. Their self-serving program is clearest in what the Houston report excluded from consideration: the prospect of businessmen amassing fortunes through banking and insider dealing rather than by real capital formation, realizing their gains by selling their shares abroad – and keeping the proceeds in the West.

The World Bank, IMF and other institutions adhering to the "Washington Consensus" presented Russia with a plan that started by wiping out domestic savings (dismissed as "the overhang"), it was claimed that when markets were freed, spending the savings that Russians had made in hope of buying cars or other basic needs would be inflationary – so they had to be wiped out. The ostensible excuse was to promote price stability. But the "shock therapy" of hyperinflation and depreciation of the ruble (Houston Report, p. 13) wiped out the value of domestic savings after 1991. The sudden opening of currency markets led to be a flight out of rubles to exchange for the dollars (and some European purchases) coming in to buy enterprises from the managers who had gained ownership. And after hyperinflation, only Westerners had money to pay. Only politically well-placed insiders were in a position to save large amounts in dollars – by selling their shares to western investors.

The only way for most Russians to buy into the nation's natural resources, housing or enterprises was by a voucher plan that was little more than a pretense at giving workers a share of the nation's assets. In practice the vouchers were simply an opportunity for insiders, investment funds and bankers to obtain ownership. "There may well be advantages to giving away some shares in some of the larger enterprises," the Report opined (pp. 26-27). But it advised Russia to block workers from having a voice in management. "Workers' ownership in enterprises … would run counter to the desired objectives of enterprise reform" (p. 22). Workers not be given direct voting stock, but preferably shares in money-management companies, which would vote for the enterprise to make money along financialized lines rather than to promote the welfare of employees.

So, the voucher program was organized throughout the former Soviet economies in a way that workers received little benefit. Everyone was given vouchers ostensibly representing a democratic share of national assets, but for most holders these turned out to be worth only the price of a meal (or about $25) to. They quickly ended up in the hands of company managers and insiders, investment funds and bankers – whose interest was to cash out by selling their shares to Western buyers.

To facilitate privatization, the fortunate recipients were to be given sufficiently firm ownership rights to sell to foreigners without future legal obstruction. "While the portfolio of government properties that could eventually be privatized is, indeed, very large and much in excess of any measure of the overhang, privatization is likely to proceed slowly,

particularly in advance of the clarification of ownership rights" (italics added). This was as highly enriching for the U.S. economy and the West as it was impoverishing for Russia – while its stock market became the deal of a century for global investors.

Meanwhile, the Houston Report's neoliberal advice blocked Russia's government from Keynesian-type spending programs to support the economy and invest in infrastructure. Russia was told to restrict its budget deficit to a drastic low of 2½ to 3 percent of GDP. This blocked it from providing the economy with the purchasing power needed to grow. And as an even more restrictive coup de grace, Russia was told to back its domestic money with foreign exchange.

No country needs foreign-currency reserves to pay public employees or cover other domestic payments. Central banks have monetized government spending from the Bank of England in 1694 through the U.S. Federal Reserve in 1913. It therefore was a radical constraint for Russia to back its domestic money 100% by foreign reserves – in the form of loans to the U.S. Government (that is, Treasury bills). Russia borrowed the money, mainly from Wall Street institutions that made 100% annually in interest by lending to the Russian government to back its issue of rubles. Meanwhile, many employees went six months or more without pay in the mid-1990s as a result of a needless reluctance to create domestic money. Many companies did not even pay wages during the mid-1990s as managers used their cash flow for financial speculation or simply bled companies to use the money themselves – and usually to send it to the West.

There almost always is a special interest that benefits when bad economic advice is followed. The beneficiary of today's neoliberalism is the financial sector and its major customers: real estate and monopolies bought on credit. Russian poverty has created fortunes for bankers, political insiders, corporate raiders and hedge funds. For this new class of billionaires, the poverty and debt leveraging that has prompted many economists to wring their hands is actually a success story. Society's loss has become their gain – and that of the financial markets.

The moral is that finance has replaced military force as today's mode of warfare. It is in the financial sphere that the causes of Russian poverty are to be found, and consequent emigration, capital flight and de-industrialization. Inasmuch as U.S. strategists view industrial manufacturing power, and indeed higher education as being potentially military, Russian poverty has served the aims of U.S. global planners. Russia's economy has focused on exporting fuels and raw materials to the West instead of becoming an industrial and agricultural rival.

Subjecting labor to austerity

In 1990 the impression was that Western advisors would help the Soviet economy become prosperous and competitive by setting it on the path that had enabled North America and Western Europe to get rich. But instead of helping Russia follow successful U.S. experience, they advocated just the opposite policy. In contrast to America's "economy of high wages" doctrine recognizing that highly paid, well-educated and well fed and clothed labor – with subsidized public infrastructure – is sufficiently more productive to undersell lower-paid labor and privatized monopolies, neoliberal doctrine advocates squeezing down labor's rate of remuneration and scaling back public social spending.

The resulting unequal concentration of wealth siphoned off income that would have been

spent on domestic consumption if it were distributed more widely. The Houston Report's anti-labor austerity economics thus stifled demand for domestic Russian output. And instead of making the economy more competitive, poverty-level wages caused a brain drain of skilled labor and failed to provide the education needed for high productivity in today's world. The flat-tax and "financialized" management policies implemented by the Harvard Boys, Jeffrey Sachs and other neoliberals were the opposite of how the Western economies built up their own productive powers and living standards, and spurred the flight of skilled labor and capital.

Few economists have explained why this neoliberal advice was so bad. There has been little discussion of the alternatives available to the shock therapy and hyperinflation that wiped out savings, the voucher disaster, the 1994-95 loans-for-shares deal, and the central bank policy of borrowing abroad to finance the government's budget deficit. It is as if the only alternative to Soviet bureaucracy was to follow the advice given by the IMF, World Bank and Harvard Boys to give away public enterprise, to be sold off in due course to foreign buyers.

Progressive Era policies from the United States to Germany and Japan aimed at bringing prices in line with current costs of production in a mixed economy. Governments provided basic infrastructure at cost or at subsidized rates. By not significantly taxing land and property, post-Soviet governments blocked themselves from playing the positive investment and fiscal role that they did in the West. Instead, they gave a free lunch to rentiers, above all to foreign investors.

How neoliberal anti-government ideology dismantled public infrastructure

If Russia had chosen to emulate the classical Western model, it would have promoted public infrastructure investment rather than privatizing it without price regulation. It would have continued subsidizing popular education and industry, and modernized its agriculture. It would not have given away land and mineral rights to insiders to sell off to foreigners to fuel a Western stock market boom. And it would not have closed down manufacturing and research, leading its skilled professionals to emigrate to the West to find work.

Instead of introducing Western-style checks and balances to modernize public spending and tax policy, Russia threw out the baby with the bathwater. Reflecting a loss of faith in government's ability to function honestly and effectively, public functions were turned over to financial managers. Unfortunately, their scope tends to be short-term and extractive. No agency was charged with steering long-term capital investment and promoting rising living standards.

The former Soviet states did not set out to create a tax policy to make the economy more competitive by minimizing their cost of living and doing business. The greatest international variation in such costs today is for housing and debt service. The Soviet states could have turned over living and office spaces freely to their users in 1991, much as they gave away land and natural resources and public enterprises to managers. This would have provided initially debt-free housing and plant. The rental value of these sites could have served as the tax base, freeing the government from having to tax sales, labor and industry – just at the moment when Western economies were embarking on their debt-inflated real estate bubble.

But Russia and other post-Soviet countries did what the West economies were doing. They let bankers appropriate the rental value of land sites, turning "free lunch" rent into interest payments. Taxing employment and sales of consumer goods rather than land and natural

resources obliged the post-Soviet economies to make their labor and industry higher-cost than was the case in countries relying more on property taxes and progressive income taxation.

Bankers and foreign investors got a bonanza from mortgage lending. Its basic principle is that "What the tax collector leaves 'free' is available for banks to turn into interest." Buyers bid against each other for credit to buy properties, with the winner being whoever agrees to pay the most rental value to bankers. Families, foreign buyers and speculators pay this untaxed rental value as interest, leaving nothing available for the tax collector – while land prices rise, on credit.

The economic shrinkage resulting from this policy is applauded as a success story even in disaster zones such as neoliberalized Latvia – as if austerity, dismantling public enterprise, and taxing manufacturing and other employment rather than land and natural resources make economies more competitive. What actually happens is that labor is forced into debt to buy housing, education and other basic needs – or else, emigrate. Latvia reports a 10 percent drop in its population (from 2.2 million to 1.9 million) since its last census as adults seek work abroad.

Given a free hand in how to make Russia and its post-Soviet neighbors into their ideal, neoliberals promised that vesting a power elite of new billionaires by giving away national assets would make everyone richer. But instead, dismantling Russia's public infrastructure and economic subsidies has spurred emigration and capital flight. This has not been a natural course of development. It is a distortion akin to the European colonialism achieved by military force prior to World War II, and the austerity programs imposed by the IMF and World Bank on Third World countries since the 1960s, achieved by foreign debt leverage. Without being subject to either of such threats, the post-Soviet economies imposed such programs on themselves voluntarily. The result is that instead of Russia receiving the aid that was expected, it transferred wealth abroad via emigration and capital flight to the West, while destruction of Soviet industry has made more fuel and minerals available for export to the West.

Proceeds went in the first instance to oligarchs, for whom Russian banks served as the pipeline through which an estimated $25 billion in flight capital flowed annually to the West for over a decade after 1991 – a quarter of a trillion dollars. Privatizers felt that their free lunch was more secure beyond clawback power of the government. And most important, they had more faith in Western growth than in post-Soviet opportunities. So for Western bankers, raw-materials investors and Cold Warriors, a de-industrialized Russia has been a success story – obtaining natural resources and asset ownership on the cheap while ending the old Soviet Union's potential military rivalry. Russia's giveaways made its stock market the world's best performer, enriching U.S. and other investors from 1993-1997 (and recently once again). So Russia is producing a surplus for foreign investors and for its own large class of billionaires. In this respect Russian poverty finds its counterpart in an enormous transfer of wealth to foreigners and to domestic vested interests since 1990 – and a destruction of industrial wealth-creating capacity.

Although neoliberal policy advice to turn its economy into what American economists used to call a "hewer of wood and drawer of water" came from the West, it is not how Western nations organize their own economies. Rather, it is a money manager's dream of how to extract natural resource rent and install tollbooths on infrastructure mainly to pay Western investors or for Russian investors to extract and send to the West as capital flight.

Russian poverty as a result of economic austerity ideology sponsored by the financial sector

Russia's economic warping and emigration was unnecessary. The economy was self-sufficient in 1990, with a solvent (although inefficient) public sector. Russia started its conversion to neoliberal policy with one of the world's most highly educated populations, above all in engineering and technology, computer science and other key skills. Families were secure in their housing (admittedly cramped). And most important, the economy was free of foreign debt, mortgage debt, education debt, credit card debt, corporate debt, urban and other public debt overhead, and. There was no rentier class to support – no absentee owners living off interest, dividends or property rents.

How then did so much of Russia's population come to suffer poverty? How was manufacturing dismantled while natural resource wealth was monopolized – with much of its revenue sent abroad rather than used to upgrade economic infrastructure and capital formation?

The cost of educating people has long been the most productive investment that economies can make. But it is an expensive investment. Dismantling and privatizing public spending has priced higher education out of range for many people in post-Soviet countries. And the curriculum itself has been de-industrialized. Training people to make money by merely financial means rather than by engineering for industry and agricultural technology is as damaging as dismantling factories and equipment. The financialization of schooling and other public policy focus leaves the economy unbalanced and polarized, with many people out of work, able to maintain themselves only by running up debt – and ultimately by emigrating.

Russia's problem is not that its economy is too unproductive to create prosperity. The problem now is how to develop a less pro-financial and polarized economy. This was the issue that inspired the classical idea of markets free of "unearned" financial overhead, land rent and monopoly rent. This Progressive Era approach – based on progressive taxation, especially of land – could and should have been Russia's model in 1990.

Russia's Achilles heel proved to be a lack of understanding of how financialization already was untracking Western industrial capitalism (having warped economies throughout the Third World). Russia's leaders had lost faith in the Communist State without realizing that every economy is planned. There is more than one mode of planning – depending on which sectors control the state. Replacing the old state bureaucracy did not solve the problem of bad planning. It merely changed its character, shifting it to the banking sector and the new oligarchs most favored by their Western sponsors.

Russia's poverty is unnecessary – and is the result of regressive financial and fiscal policy

Poverty in modern societies always is a result of the way economies are mis-planned. Throughout the West, planning has shifted out of the hands of governments to those of the banking and financial sector. This is euphemized as "free markets," but it is merely markets free of public regulation against fraud and dishonesty, free of government taxation of rentier income – in short, markets free for rentiers, not free from them.

All economies are planned. The question is, who is to do the planning? When governments

are stripped of this role, it passes to financial centers. The shift of planning to Wall Street, the City of London, the Paris Bourse and Frankfurt is more centralized today than government planning was feared to be. And whereas the scope of public planning at least in principle is to promote long-term capital investment and subsidize infrastructure, financial planning is short-term. The result turns out to be even more centralized than government planning – as well as by financial managers looking to their own short-term interest rather than to promote society's long-term development and raise living standards for the population as a whole. The financial business plan is to create a loan market in the two largest asset categories of modern economies: real estate (mainly the value of land sites) and privatized infrastructure, as well as monopolies able to charge prices above their basic cost of production.

The resulting land rent and monopoly rent is paid interest out of the higher fees that privatization-on-credit entails. This enriches the financial sector by turning infrastructure charges into a flow of interest and dividends. As these charges rise, their payout raises stock market and real estate prices – largely by capitalizing the revenue into new debt leveraging. Financial managers leverage their own equity investment by taking on new debt (often to buy other firms or simply to payout as dividends) instead of recycling profits into new capital investment. Tangible capital formation in the means of production gives way to a proliferation of bank loans, bonds and stocks – financial claims on income and production.

Debt leveraging increases the return on equity – until the debt overhead shrinks markets, profits fall and companies go bankrupt, leaving empty corporate shells. But by the time this happens, financial managers take their money and run, keeping the enormous salaries and bonuses they have paid themselves – and looking for new worlds to conquer financially.

The economic agony may be prolonged by persuading governments to bail out the banks, subsidizing the financial house of cards. The pretense is that this will help wage earners keep their jobs. But this is only a populist pretext. The reality is that financialization involves a race to the bottom. It obliges families to pay more of their income as debt service, leaving less consumer demand to warrant new investment and hiring.

Instead of designing a mixed economy with public infrastructure for basic monopolies and taxing the site value of land that public investment in transportation and overall prosperity created, the Houston Summit explained that its aim was to "promote privatization of state property" (p. 12). But privatization without taxation is "free lunch" wealth. What followed was a travesty of the truly free market and tax reforms by which North America and Europe got rich during the 1890-1914 Progressive Era.

An identical pattern of de-industrialization, failed voucher schemes, "grabitization" followed by rising debt, poverty and emigration of skilled labor, has plagued the Baltics and other post-Soviet economies that took Western neoliberal advice. Latvia is the most extreme example – yet privatization lobbyists celebrate it even today as a success story, not as planning gone radically wrong. Even in Russia, the Right Forces party views Augusto Pinochet's asset-stripping privatizations as a successful model. The reality is that by the end of the 1970s all the pension funds were looted by the kleptocratic grupos into bankruptcy. Chilean voters rejected this program as most of the population is now without pensions, free public education and other services available before the coup imposed privatization at gunpoint.

Guaranteed to fail: privatization without progressive taxation and regulation

When the Houston Summit acknowledged that "A process of spontaneous privatization is taking place in large sectors of industry," there was no criticism of how this might prove damaging – no suggestion that managers might bleed their enterprises through short-term income maximization, debt leveraging, paying themselves the surplus and sending it abroad or outright looting rather than building up their tangible capital investment.

The new breed of financial managers in the West as well as in the former Soviet economies treat direct investment, research and development almost as donating charity to the future. And financial managers are not known for being charitable. That is the problem with financial management: It is short-term, hit and run, and extractive rather than productive. But rather than discouraging this financialization process and its concentration of wealth in ways that John Stuart Mill's generation called the "unearned increment," the Houston Report endorsed it (p. 26): "Rapid privatization would not only hasten the benefits of private ownership but can also yield revenue at a time when both the budget deficit and the monetary overhang need to be cut." What was lacking was a discussion of the various ways available to privatize – and to shape markets by a tax system that encourages capital formation rather than rentier overhead.

Classical economists from the Physiocrats through Adam Smith, Mill, Marx and the Progressive Era reformers (the real reformers) dealt with how to do this in a free market to minimize the cost of production and cost of living. If privatization's aim is to encourage new direct investment – and discourage "free lunch" speculation – then governments should tax "economic rent": resource rent, land rent and monopoly rent. The revenue of privatized assets attributable to public investment (such as public transportation increasing real estate site rents) should be taxed on the same principle of taxing land and natural resources.

The Houston neoliberals rejected this idea, and urged Russia and other Soviet countries to do the opposite. Their aim was to not to turn them into viable competitors but to treat them as economic prey. Instead of teaching them to become as rich as the West – without corruption – the advice given to the individuals picked by Western advisors was just the opposite of how the West developed. It was to let the banks and financial insiders do the planning, not government.

Who has benefited most from privatization, neoliberal style: Russia, or the West?

Instead of helping Russia minimize its cost structure to make it more competitive, European as well as the U.S. advisors viewed it as a potential rival. Their aim was to turn the former Soviet states into customers for their exports, and especially for their bank credit rather than developing their own industrial banking systems. Western bank credit is created simply on computer keyboards that Russia and other financial systems easily could do just as well. But the Baltics, for instance, were treated a field for Scandinavian bank credit, while Hungary and Romania were dependent on Austrian banks. These foreign banks found the largest markets to be real estate, thanks to the fact that neoliberal advisors insisted on leaving land untaxed. The result was that initially low site values were "free" to be pledged to bankers as interest. The ensuing real estate bubble loaded down the post-Soviet economies with mortgage debt, ultimately leaving many families bankrupt.

The other major credit market consisted of the monopolies being privatized. Here too, neoliberals urged against anti-trust regulation, price regulation or progressive taxation. This left more monopoly rent to be extracted, and ultimately paid to bankers (mainly in the West). The post-Soviet economies were infested with tollbooth systems for predatory pricing

rather than enjoying the price regulation that characterized the most successful Western economies.

The post-Soviet economies were to become complementarity to the West in their production and credit patterns, not competitive. The commodities that the West wanted from Russia were oil and gas, as well as minerals. And of course Western investors wanted to profit from ownership of these natural resources, by buying shares in their companies. Russia was not to tax resource rents, which would reduce dividend payouts to investors. So in contrast to the progressive taxation and focusing on land rent and other economic rent as “free lunch” income, Western advisors told the post-Soviet states to un-tax real estate and subsoil resources (ostensibly to “raise more money” when the state sold them off).

Neoliberal philosophy was to tax employment in industry and other sectors. The effect was to maximize the cost of living and producing goods and services – while depriving the government of its natural source of fiscal revenue in resource rents and monopoly rents. A secondary effect was to deprive the middle class of the ability to save. They could maintain basic living standards and obtain housing ownership or education only by running into debt.

This model led to dependency of the former Soviet states on the West, not to their development as equals. To be an “equal” is to be a rival, from the Western vantage point – not only an economic rival but also a potential military rival from the NATO perspective. All military power in modern times rests ultimately on industrial capability, and manufacturing was largely dismantled and scrapped throughout the Soviet Union.

The Harvard Boys played a similar role to that of the Chicago Boys in Pinochet’s Chile. Their program of shock therapy, currency depreciation and privatization had the effect of stripping assets and, in due course, making them available to U.S. and other Western investors. Directing governments not to tax the value of land, natural resources and public enterprises made their “free lunch” rent available to pay bankers and investors. Failure to collect these resource rents and windfall gains left this revenue to be capitalized into securities – while forcing the government to tax business and employment. The idea was to make the transfer of wealth irreversible – a transfer of resources to a relatively few individuals enamored with the West, transacted at so far below actual value (often virtually for free) that Russia became the world’s top stock-market performer for three years.

Some excellent economists and property assessors came over from the United States hoping to help Russia. Ted Gwartney proposed to make land-value maps of St. Petersburg, and Moscow so that these cities could collect the rental value as their major source of fiscal revenue. This would have kept housing prices low, by preventing site-value rents from being capitalized into bank loans. The land would have been privately owned, but the rental value that did not reflect new construction costs and other capital improvements would not have pledged to pay interest to banks for loans to load post-Soviet economies down with debt.

A bad tax policy that increases the cost of labor and capital

Neoliberal “value-free” doctrine holds that making income by real estate and natural resource speculation, lending at interest, financial trading and betting (and asset-price gains) is as helpful to the economy as tangible capital investment in the means of production. On this ground the Houston Summit rejected the classical economic principle that tax rates should differ “according to the nature of the income” (p. 21). Yet this was the aim of 19th-century free market theory – to free economies from rentier income in the form

of land rent, monopoly rent and interest. Such revenue is an unearned payment to privilege, not technologically necessary.

To counter Mr. Gwartney's work with Dmitri Lvov of the Russian Academy of Sciences and others, the World Bank and U.S. Agency for International Development (A.I.D.) explained that classical land taxation was not what they had in mind. The idea of rent and monopoly prices as things to be taxed or regulated to keep prices in line with cost-value was expurgated from the program. The aim was for Western investors to receive this economic rent, leaving Russian industry high-cost, highly taxed – and not subsidized.

The Houston Report claimed that capital investment would develop spontaneously as property was transferred into private hands – the quicker the better, even without payment being made and before any evaluation and economic reorganization took place. It acknowledged (p. 26): "Firms might be acquired at far below (or even far above) their actual values, and ownership might become concentrated in the hands of a relatively few individuals with money or connections. Moreover, the state's productive assets are valued at a sum far in excess of the savings available to the private sector." However, the report deemed it too "complicated" to do an assessment of what such a price would be. It recommended that, "for small enterprises, provision may need to be made for buyers to pay in installments." But it did not make the obvious corollary proposal for larger companies to issue a small proportion (say, 5 or 10 percent of the shares) to set a market price, or to assess a fair price for the government to tax or receive for its property as operations were rationalized. The report advised Russia simply to give resources away quickly: "the prospective revenues from privatization should be forgone in the interests of speed and distributive equity." But what it meant by distributive equity" was carefully avoided. The reality was that only Western investors were in a financial position to pay anywhere near a fair price.

Giving tax subsidy to Russian resources sold to the West on the cheap

The Report insisted that tax rates be slashed for wealthy investors, assuming that they are crooks and can get away with tax fraud, given incompetent governments unwilling to implement the tax code, in contrast to U.S. and Western European 20th-century experience. "The top marginal rate of 60 percent will deter taxpayer compliance, and the multiplicity of brackets will complicate administration." Yet high progressive income tax rates went hand in hand with the strongest growth periods of the United States and Europe, especially for the middle class.

Favoring the top of the economic pyramid and the finance, insurance and real estate (FIRE) sector, the Report advised that taxes on interest and other rentier income should be added only "over time" – implicitly after the economy was restructured along lines favorable to finance, real estate and mining fortunes. Most post-Soviet economies were deterred from taxing windfall gains or what U.S. authorities call "unexplained enrichment." Yet the main way to make money in these deregulated economies was indeed to reap a windfall – selling the property a manager had obtained from the public domain, and indeed, selling part or even all one's shares to foreigners, once domestic savings had been wiped out. Russia was to avoid a land tax or other taxes on windfall gains and property as ostensibly "value-free."

In practice this meant a pro-financial VAT tax to establish "a broad and neutral revenue base." But this is not neutral. It increases the cost of consumer goods and hence is anti-labor while not taxing property or lending. We see the result today most notoriously in

Latvia, where employment bears a set of flat taxes amounting to 59%, while property taxes are just 1% of assessed value – with no land-value maps to guide assessors.

So when post-Soviet Russia started with a clean slate in 1991 – with no debt, and with ownership passing into private hands at perhaps 1 percent of real value – the benefit of being debt-free and rent-free was not used as the basis of a Russian industrial renaissance. The nation's vast resources and their potential income were transferred to Western investors at a fraction of their value – giving a profit to Russian sellers but still leaving enough room to enable the shares to soar in dollarized markets as Russia refrained from taxing the windfall.

Neoliberals applaud this as a success story. It has indeed been a success for the West. But Russia's economy has received only a small portion of the value of the assets it relinquished. The policy has made many Russian billionaires, as the Forbes list documents each year. But much of the economy remains in poverty.

Summary

Banking today finds its market in lending against economic "free lunch" rentier income – debt service paid out of real estate rents and privileged opportunities to engage in monopoly price gouging. Tangible new capital formation is funded out of retained earnings (and to some extent, new stock offerings). Even this corporate cash flow is now being bled to pay interest and dividends, and to spend on stock buy-backs to "add value" to the stock options that financial managers give themselves.

This dysfunctional financial philosophy has de-industrialized the U.S. and European economies and now is pushing them into depression. So Russia's problem and that of its fellow BRICS countries is how to protect themselves from having to rely on shrinking financialized markets in what used to be the world's industrial core nations. They henceforth must depend increasingly on their own domestic market growth – which means rising living standards at home.

The European Union has followed the bad advice that the IMF imposed on Third World countries from the 1960s through 1980s, for governments to balance their budgets and international payments by imposing austerity. Fiscal austerity takes the form of heavily taxing consumers and selling off public assets and infrastructure to buyers – who turn around and pay interest and dividends their bankers and stockholders by levying tolls and other access fees. Financial austerity consists of tightening bank credit and raising interest rates to induce borrowing abroad, on the myth that foreign bank loans are inherently more productive.

These austerity policies have not helped economies grow. Latin America, Latvia and now Greece exemplify the waste of economic potential from following neoliberal anti-labor impoverishment as official policy. It slows growth, making economies less competitive and weaker – and more dependent on foreign creditors as domestic markets stagnate and the most employable individuals emigrate.

So the main task at hand is to develop a policy to spur a thriving domestic market, by elevating low-income families to become an economic resource rather than a burden.

APPENDIX

How much poverty is the result of bad economic policy?

Just as there are many ways to get rich, there are various kinds of poverty. It therefore is necessary to distinguish between how much poverty is "economically" justified and how much is unnecessary. The good news is that much of today's poverty does not stem from technological or other "objective" causes such as low productivity. Rather, it is the result of special interests monopolizing the economic surplus at the expense of the economy at large, carving out privileges to extract income without any technologically necessary cost of production. Their way of getting rich is by what the classical economists called "rent seeking." It is an economically unnecessary burden – and one from which the classical economists sought to free society. The idea of a "free market" from the Physiocrats and Adam Smith down through John Stuart Mill and the 19th century socialists was to free industrial capitalism from the rentier class that itself was a carry-over from Europe's feudal epoch.

The main rentiers are the financial class, landowners and natural resource owners at the top of the economic pyramid ownership of "tollbooths": land, mineral rights, or basic monopolies and banks with the public privilege to create credit. It is to these rentiers that the bottom 90% are indebted and must pay interest, rent, user fees and other access charges. And neoliberals defending this state of affairs turn the classical idea of free markets upside down. Their idea of "free" markets is one free from government price regulation, taxes on land rent, monopoly rent, financial interest and other categories of what the classical economists called "unearned income."

So we find ourselves with two opposing ideas of what constitutes a free market. The classical idea is to grow by avoiding extractive forms of wealth seeking at society's expense. The neoliberal alternative to centralized planning is to dismantle the government's ability to regulate markets to steer growth and shape markets in the national interest. The effect of this dismantling is to centralize planning in the hands of bankers – primarily those of Wall Street and the City of London, followed by financial interests in satellite economies.

The success of the vested interests – absentee owners, monopolists and the bankers that finance them – is the main cause of economic polarization and poverty in today's world. These rentiers have bought enough control of politics to obtain tax favoritism to subsidize their rent-seeking "toll booth" economy on credit, with interest being ruled tax deductible in contrast to direct equity investment.

Neoliberal economists endorse as if it were a natural way for economies to grow. But their concept of "wealth creation" takes the form of financial riches and special privileges, inflated in price by debt leveraging on the premise that an asset is worth whatever banks will lend against it, by capitalizing collateral into an interest-bearing loan. This financial concept of wealth is something quite different from tangible wealth in the form of actual means of production, education and skills, research and technology as most people have long thought of wealth. Yet this mode of wealth seeking has become the major threat to national economic growth today, by dysfunctional taxes favoring special interests at the expense of the economy at large. This fiscal philosophy reflects a failure to draw the classical distinction between productive and unproductive investment and credit.

The wealthy justify their status claiming to invest in building up the stock of capital, employing more labor in the process. Economic textbooks depict them as growing rich by investing in economic growth. Corporate profits are depicted as being re-invested in new

plant and equipment, raising productivity. Credit is supposed to finance investment that will generate enough income to pay off loans with interest, leaving a profit over for entrepreneurs and their stockholders.

Business schools and the lobbying tanks endowed by the wealthy depict them as wise managers of companies run by industrial engineers. But in reality it is easier to make money by predatory means. That is how the railroad land barons and Wall Street trust builders and stock market manipulators made the great American fortunes. Their monopolies fought against labor unionization and the drive for safer and better working conditions, raising prices without regard for costs.

This kind of behavior inspired social democratic reforms to shape markets in ways that would raise all levels of society. Immigrants to America arrived poor, but were given schooling, health and social-work assistance to provide the mobility to rise. This enriched the whole economy by what was called the Economy of High Wages. Rising wages were self-justifying by being a precondition for rising labor productivity, thanks to the fact that well-educated, well-fed and well-clothed and housed labor was more productive.

The vested interests broke away from the classical economics that powered this takeoff. The post-classical break occurred mainly over the treatment of all income and wealth as deemed to be "earned." There is no recognition of unearned wealth achieved at other peoples' expense, as what technically is merely a transfer function. It is in this spirit that the neoliberal Chicago economist Milton Friedman claimed that: "There is no such thing as a free lunch." This "value-free" logic rejects not only Marx but also Adam Smith, John Stuart Mill and other classical economists. Every way of getting rich is deemed to be "productive" in proportion to the wealth it creates at the top of the economic pyramid.

Why the gap between the rich and poor is growing

The U.S. and European economies are more and more about how to get a free lunch – on credit. This has led to a post-industrial form of economic polarization. If industrial firms still got rich by squeezing out more profits to invest in capital, this at least would increase employment. But when wealth is concentrated by financial means – and by buying property rights and privileges on credit – the gains are paid out as interest and dividends. These financial payments crowd out industrial profits. This explains why the financial sector has increased its share of reported profits in the U.S. national income and product accounts (NIPA) to 40 percent by2010.

Both globally and within nations, economies are buckling under the attempt to pay debts that have grown beyond the reasonable ability to pay. On the global level the wealth and income gap is widening between creditor nations and debtor countries (most recently Ireland and Greece). Domestically, polarization also is increasing mainly between creditors and debtors – that is, between the financial sector and the rest of the economy. Debt service absorbs most of the surplus: corporate profits, real estate rents, personal income over and above basic needs, and even government revenues over and above necessary public maintenance charges. Financial analysts abbreviate this as ebitda: earnings before interest, taxes, depreciation and amortization. And banks and other financial institutions recycle most of their revenue to make yet more loans – to extract yet more interest and fees, until finally the economy buckles in poverty.

The financial sector today thus plays the role that Ricardo, Adam Smith and the Physiocrats

assigned to landlords in absorbing the industrial surplus. The financial bubble raised the price of housing, forcing buyers to take on a lifetime of mortgage debt, paying out the rental income as interest. Rising educational fees are financed by student loans. In the United States these debts cannot be wiped out via bankruptcy. Many students took on debt that will take a number of decades to pay off – without regard for their ability to earn income.

The financial sector also funds corporate takeovers. In fact, most industrial companies are now run by Chief Financial Officers, not industrial engineers or even salesmen. The aim is not to create wealth by new direct investment but by downsizing and outsourcing, by living from short run to short run – and in the end by asset stripping to pay bankers and bondholders who finance the game.

This is the mentality of the neoliberals who arrived to advise Russia in the 1990s. They did not come to exploit labor by hiring it to squeeze out surplus value. They didn't want much to do with employment at all. They wanted control of raw materials resources on the cheap. They wanted to help leading scientists and industrial engineers emigrate to America, because its schools are producing mainly financial graduates, not technology-oriented students.

Financial polarization has been catalyzed by fiscal polarization. Since the 1980s the tax burden has been shifted off the higher wealth brackets onto the bottom 80% of the population. Taxes on real estate and financial gains were slashed to a fraction of income tax rates, while Social Security and Medicare were treated as "user fee" programs, paid for in advance by employees (up to a $102,000 cut-off point), providing the government with enough revenue to cut taxes on wealth. The result is an anti-progressive tax system. And it is most steeply regressive in the former Soviet states (led by Latvia's race to the bottom).

While average wage levels drifted downward in the United States since the late 1970s, the tax and debt burdens have risen, increasing the cost of obtaining housing, an education and medical care. Debt deflation is now shrinking markets for goods and services, leaving the U.S. economy in a deep L-shaped recession/depression, with Western Europe close in pursuit. Populations are being squeezed and getting poorer. This obviously is not a good model for Russia and other post-Soviet economies to follow. To avoid being dragged down, they must reject the neoliberal financial and tax philosophy they were given in the 1990s.

How to reverse economic polarization and poverty

The most obvious cause of poverty is over-indebtedness. The largest category of personal debt in today's world is mortgage debt to obtain a family home. The debt burden is aggravated by the tax shift off finance, real estate and monopolies onto employees and consumers. Housing prices rise when taxes are shifted off property onto employment and consumers, because this tax shift leaves more rental value for new buyers to pledge to banks for mortgage loans. The winning bidder is whoever agrees to pay the most of this rental value as interest. So the banks end up with the rent. This is why the financial sector has grown so rich while debtors have little remaining to spend on goods and services. So markets shrink and economies fall into recession.

This financial-fiscal problem can be solved by following what classical economists recommended: taxing away "free lunch" income – land rent, monopoly rent and other returns to special privilege – while keeping natural monopolies in the public domain to provide services at subsidized rates or freely, as in the case of roads, water and sewer

systems and the like.

The high point of land taxation in England occurred when William the Conqueror ordered the Domesday Book to be compiled. The idea was for land ownership to be the tax base. But landlords fought to "free" themselves of this tax, ultimately forcing governments to tax labor and industry by sales and income taxes. Lower property taxes "freed" the land's rent to be pledged to the banks for mortgage loans. So higher land taxes actually keep down the price of housing, office building and other debt-financed rent-yielding assets. The tax shift off these assets has had a negative impact on the production-and-consumption economy, by raising the cost of housing, living and doing business. This makes neoliberalized economies less competitive internationally – and hence, poorer.

Cutting taxes on the higher wealth and income brackets leads to budget deficits, which financial lobbyists urge governments to rectify by imposing austerity programs. This is the fiscal philosophy that the IMF and other Washington Consensus agencies have imposed. It prompts a "Take the money and run" strategy by the financial interests to bail out, moving their money abroad. This capital flight hurts national economies in the long run.

The manner in which privatization has been handled (without price regulation, and with tax deductibility for interest payments and "fictitious" offshore charges) is an additional cause of polarization that undercuts competitiveness. American business economists of the late 19th century explained that the nation could become more competitive by treating public infrastructure as what Simon Patten called a "fourth factor of production" alongside labor, capital and land. Its "return" does not take the form of income (wages, profits or rent), but rather the degree to which it lowers the national price structure.

By contrast, privatization in a financialized fiscal regime adds pseudo-cost overhead to the economy. These technologically unnecessary costs are headed by interest charges on credit borrowed to buy public assets, high payments to management, and stock options. Privatizers then install "toll booths" across the economy to extract economic rent.

U.S. economic strategists have long realized this. Back in 1944-46 when the IMF and World Bank were being formed, the Soviet economy was excluded because Western planners feared that its economy was free of the rent and interest charges that "free market" economies permitted. The opposition to Soviet membership was that its debt-free, interest-free and tax-free structure gave its industry an "unfair" advantage over market economies being financialized.

The advice given by the West to Russia since 1991 has led to maximizing the financial, real estate and monopoly overhead from which classical economists sought to free society, treating these rentier charges as unnecessary overhead to be reformed. It was by such Progressive Era reforms that Western economies rose to dominance. Russia and other countries can now take this path of reform to shape more efficient, fair and prosperous economies. In sum, now that neoliberal financial lobbyists have turned Progressive Era reforms upside down, it is necessary to "reform the reformers" in order for Russia to rebuild its economy in the way that made the U.S. and Western Europe so successful during their economic takeoffs.

From the Enlightenment to the flowering of classical political economy into Marxism in Europe and institutional analysis in America, the aim of economics was to free economies from such unnecessary overhead. This is the body of reform that led the Progressive Era to

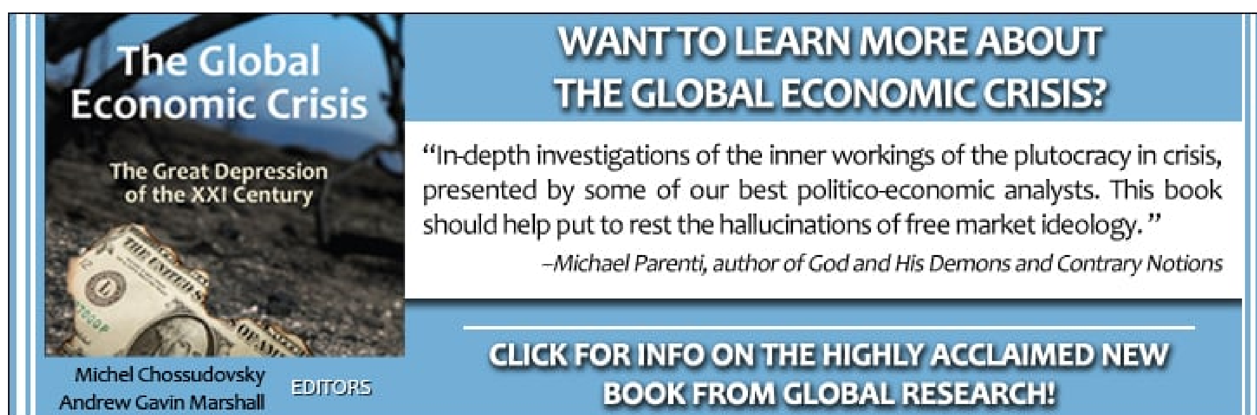
guide public investment and tax policy in the national interest and steer industrial development to raise labor productivity. Keynesian economics subsequently sought to stabilize economies with public spending in the context of "euthanasia of the rentier."

By contrast, today's neoliberal lobbying efforts lead to economic shrinkage and to a redistribution of wealth and income to the rentier classes. This strategy involves disabling government power, while denying the classical distinctions between productive and unproductive (parasitic) investment, credit and modes of wealth seeking.

Ultimately, the wealth of any nation is its population. It is wasteful to reduce families to poverty. The aim should be to make them more productive. The economy is an overall system, which requires a regulatory and tax structure to steer wealth-seeking in ways that add to national output, not merely to benefit the rich (or foreign investors) at the expense of the poor.

Footnotes

[1] This advice is summarized in a joint report by the IMF, IBRD, OECD and EBRD: The Economy of the USSR. A study undertaken to a request by the Houston Summit. Summary and Recommendations. December 19, 1990. I refer to it in this paper as the Houston Report.



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