

THE 100% REPATRIATION RULE: AN OPTION FOR RUSSIA

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For a decade, the International Monetary Fund, supported by the U.S. Treasury, various international organizations and experts, has advised the Russian government to strengthen tax collection. At the same time, the IMF has encouraged the Russian government to pursue financial liberalization in its international transactions, a standard IMF policy. Article VIII of the IMF requires member countries, save for a balance-of-payments crisis, to maintain full convertibility of their currencies on current account (trade in goods, services, and factor income). Russia complies with this provision, although it was temporarily suspended in part after the default of August 1998. The IMF also encourages member countries to maintain maximum convertibility on capital account. Russia does not fully comply with this objective, and perhaps for good reason. The problem for Russia, and the IMF for that matter, is that unrestricted convertibility on capital account is at odds with increasing tax remittance. The IMF wants, but cannot have, it both ways.

In a previous article entitled “How Big Are Russia’s Foreign Exchange Reserves?”, we explained that the Central Bank of Russia has become the country’s implicit tax collector. The Central Bank assumed this role several months after the default of August 17, 1998, by the imposition of a rule which requires that 75% of the foreign currency proceeds of all Russian exports be repatriated and converted into rubles.

The mechanics of this process are straightforward. Exporters receive a license or explicit and implicit export quotas from the government for specific natural resource commodities or products. In the case of oil and gas, the two largest exports, the government counts physical volumes. Oil flows through directly or indirectly government-owned pipelines, access to which is subject to enterprise-specific quotas after meeting quantitative domestic deliveries. The government applies world market prices to accountable volumes to determine revenues and their repatriation. Violations are penalized by restricting export pipeline access. The case of natural gas is more convoluted, because the producer and exporter, Gazprom, owns the pipelines outside of government control and applies its own transfer prices to sales to its own export middleman. The government can only impute export revenues and repatriation amounts. But the government uses the leverage of regulated domestic prices and their periodic raises to induce the desired volume of revenue repatriation.

These cases add ad hoc and industry-specific enforcement to a more general enforcement practice. Its main protagonists are banks. The banking system, while not performing most regular banking functions, serves, among other things, as a tool of foreign exchange policy and implicit fiscal policy. Exporters hold accounts in Russian banks. Banks can incur penalties or even lose their license if they don’t enforce repatriation and conversion of export earnings. The dollars and other foreign currencies received by exporters are sold by banks on their behalf on the market in Russia and purchased by the Central Bank, the government, enterprises, banks, and households.

How successful the 75% rule has been is an empirical question. Only very crude estimates can be offered. It is well-known that even highly detailed and sophisticated reconstructions of Russia’s balance of payments in the 1990s, which evaluate external capital outflow (the so called capital

flight), run into big, often insurmountable, estimation difficulties. The task of evaluating repatriation of foreign exchange earnings is, in effect, the other side of the coin of estimating external capital outflow. We can attempt only a crude cash flow procedure.

The full-year data on the balance of payments in 2000 is not available yet, but the three-quarter data on the Central Bank's web site gives us a general picture. During the first three quarters of 2000, Russia earned \$83 billion from merchandise exports and non-factor services. The latter represents regular services, primarily tourism. Factor services, primarily investment income, debt service, etc., earned another \$4 billion. Total current account income sums to \$87 billion. Capital inflows (foreign direct and portfolio investment and loans) amounted to \$12 billion. In all, Russia's potential foreign exchange resources during January-September 2000 can be estimated at \$99 billion.

From these resources, Russia financed its foreign exchange purchases and savings. It spent \$44 billion on merchandise imports and non-factor services and \$9 billion on factor services (chiefly interest payments). Total current account expenditures were \$53 billion. The current account surplus for three quarters of 2000 was \$34 billion (current account income of \$87 billion minus current account expenditures of \$53 billion). Adding in \$12 billion in capital inflows yields \$46 billion for capital expenditures. What were those?

From the first half-year analytical presentation of the balance of payments, the three-quarter neutral presentation, and the budget reported by the Ministry of Finance, one can deduce that the government purchased about \$5 billion for repayment of principal of external debt. The Central Bank purchased \$12.5 billion during the first three quarters of 2000 to build up its foreign exchange reserves. From the data on broad money in the monetary survey and on M2, we find that banks increased dollar-denominated deposits during the first three quarters of 2000 by \$4 billion. Given the multiplier of two, this implies currency purchases of about \$2 billion. We assume that households increased their dollar cash balances by \$5 billion. Thus total internal capital expenditures on dollar-denominated assets amount to \$25 billion. This leaves \$21 billion (\$46 billion minus \$25 billion) in the proverbial capital flight in the first three quarters of 2000.

Extrapolations and estimates for the full year are even more tenuous. We can rely on merchandise trade data for eleven months of 2000 in conjunction with the three-quarter data on other articles of the balance of payments and some sketchy data on government debt service and repayment of principal. However, full-year data on foreign exchange reserves of the Central Bank is available. Merchandise exports reached about \$103 billion-\$105 billion in 2000, imports, \$43 billion-\$44 billion. The trade balance amounted to around \$60 billion, which is an often cited value but is not very meaningful in itself. The balances of non-factor services and factor services can be estimated as \$7.5 billion each. This leaves the current account balance at around \$45 billion. Annual foreign capital inflows probably reached \$16 billion. Of the resulting \$61 billion available, internal dollar purchases for capital expenditures can be annualized as follows: The government, for the repayment of debt principal, \$5.5 billion; annual addition to the Central Bank foreign exchange reserves, \$15.5 billion; household cash balances increment, \$5 billion; currency base in the added foreign exchange deposits in the banking system, \$2.5 billion. Total internal dollar purchases for capital expenditures can be rounded to \$29 billion. This leaves external capital outflow at \$32 billion.

Applying the 75% repatriation rule to \$103 billion-\$105 billion in merchandise exports would yield

around \$78 billion. If external capital outflow was \$32 billion, around \$72 billion was actually repatriated. This implies a high compliance rate.

Our estimates are admittedly rough. Even when complete balance of payments data for 2000 will become available in a detailed, analytical presentation several months from now, its reconstruction is bound to be as difficult as it has been in the past. However, the objective of our approximations is not to estimate external capital outflow or, conversely, accurate repatriation of merchandise export revenues. All we need to establish as a policy matter is that the Central Bank's 75% repatriation and conversion rule appears to have been largely successful. Repatriation may not be complete but it is rather close to the mandated level. If the government wants to have at its disposal more foreign exchange resources, given the current difficulties of external debt service, its options lie between more strict enforcement and increasing the repatriation rate. Our estimates suggest that additional enforcement, even if successful, cannot generate substantial foreign exchange inflows, and enforcement costs may not even be worth additional gains.

Before further discussing an alternative option of raising the repatriation rate, let us recapitulate from our previous research how the repatriation rule is important for the current Russian economic system. In addition to the obvious reason of providing a source for purchasing foreign exchange for external debt service and repayment of principal, other fiscal and economic considerations stand out.

We demonstrated in Chapter 1 of *From Predation to Prosperity* that what we call the "payment jam" in the Russian economy results from the issue of excess invoices by the network of enterprises. As receivables go unpaid for an average of 4 months, enterprises are able to confiscate tax revenue to sustain internal cash flow, rather than send to the government all or most of the taxes they have withheld or collected. Any attempt by the government to strengthen tax enforcement under the condition of the payment jam would disrupt production and destroy the tax base.

The 75% conversion rule eases the payment jam. As more dollars are converted into rubles, cash flow increases, receivables are paid more quickly, and the stock of excess invoices declines or its growth slows relative to the money stock. Enterprises are able to remit more taxes. The government knows it can toughen tax enforcement and disregard the threat of disrupting the economy.

The Russian economy improved in 2000 due to a dissipation or slower accumulation of payment arrears relative to the money stock. It was the 75% rule that brought additional dollars to Russia and facilitated payments after their conversion. It is important to emphasize that a simple increase in the money supply by the Central Bank would have only accelerated excess invoicing whereas conversion of foreign exchange that enterprises owned did not. Furthermore, the increase in tax remittance reduced tax arrears. Increased enterprise cash flow reduced payroll and other arrears. At the same time, the Russian government repaid some \$11-12 billion of external debt in interest and principal without new IMF loans.

The performance of the Russian economy in 2000 under the application of the 75% rule suggests that there are potential benefits from imposing a higher percentage rule. Effective compliance with a 100% rule in 2000 would have curtailed more than \$30 billion in external outflow. This is no small sum given that the Russian federal budget for 2001 amounts to about \$40 billion.

What would be the consequences of a 100% rule? The full value of the current account surplus, adjusted by the effective enforcement rate, would be returned to the Russian economy. The additional proceeds would result in the following benefits:

(1) Increased tax remittance to the government, thereby enabling it to further reduce its arrears, expand public spending on education, health, and infrastructure, and purchase dollars to repay foreign creditors, thus reducing the likelihood of future defaults

(2) Increased foreign exchange reserves at the Central Bank, enabling it to defend the exchange-rate value of the ruble, if necessary.

(3) Increased cash flow for enterprises, further easing the payment jam, resulting in further reductions in wage and other arrears and speeding up payment of invoices and promoting production.

(4) Reduction of Russia's external debt, thereby improving the country's credit rating in overseas financial markets.

These results would be accompanied by increased confidence on the part of potential foreign investors.