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The Problems with Foreign Assistance

President Yeltsin's Administration and many enterprise directors hope American financial aid and private investment will to help modernize and rebuild Russia. Current estimates of the amount needed to upgrade Russia's productive capacity runs into the hundreds of billions of dollars. So far this year, America has committed $1.6 billion, promised another $1.8 billion and has joined with the other members of the group of seven wealthy nations to promise an additional aid package of approximately $28 billion. Last year, the West promised $24 billion but provided only $12 billion. Even if Western leaders, like Bill Clinton, do what they promise, the amount of aid would not be enough to turn Russia into a modern, competitive nation. But then again, Western governments, especially America's, do not want a prosperous, independent Russia whose enterprises successfully compete with Western corporations in the international markets or in Russia's market because competition reduces corporate profits. For example, just look at America's reluctance to permit high technology satellites to be transported to Russia for inexpensive launchings aboard Proton Rockets; the U.S. pressuring Malaysia to buy F-16 and F-18 fighter jets instead of MIG-29s; America's continuing ban on most farm imports from poorer nations while America dumps its own subsidized farm surpluses in Russia and other nations; the wealthy nations increase in tariffs and restrictions on importing manufactured goods from poorer nations; GATT's 284 agreements to prevent the populations of GATT's member states from buying inexpensive products from poorer nations; and the 20 out of 24 industrial countries that have more protectionist barriers to trade now than they did a decade ago. Besides the fear of Russian competition, Western businesses do not want to lose their supply of cheap raw materials from Russia. The demand for raw materials by upgraded Russian enterprises would reduce the supply and therefore increase the cost of oil, natural gas and other raw materials needed by Western corporations. As long as the output of Russia's industry continues to decline, the reserves of Russian raw materials available to Western corporations will increase and the price will fall.

The United States Government will not endanger the profitability or interfere with the opportunities of large American businesses because the officers and major owners of such businesses funnel a lot of money into the election campaigns of U.S. politicians, like Bill Clinton. In America, the more money spent on an election campaign, the more likely a politician will win. (Bill Clinton spent millions of dollars more than President Bush in 1992.) In order to keep the money flowing into election-campaign-chests, American politicians will act in ways that help -- not harm -- U.S. businessmen. Accordingly, the U.S. Government will provide only the type of aid and amount of aid that will increase, not lessen, the profitability of American corporations.

Western government financial aid usually takes two forms: grants and loans. Grants do not have to be repaid, but loans do. The money from both grants and loans, however, is used mainly to buy Western -- not Russian -- goods and services. Western companies, therefore, profit immediately from grants and loans provided Russia; whereas, the goods and services purchased from Western companies are often overpriced and may or may not help Russia become a modernized manufacturing nation.

Grants to Russia have generally provided goods, such as food and medicine, in amounts calculated to satisfy the minimum needs of the people in order to defuse any potential social upheavals against the Russian Government. It would benefit Russia more if such grants were used to modernize the production and distribution of food and medicine in Russia, so in the future Russia would be not only self-sufficient but could earn hard currency from its export of both food and medicine. Of course such a situation would hinder American businesses from profiting through the exchange of their goods and services for U.S. grant money, and the Russian agriculture and pharmaceutical industries would soon compete with American enterprises in the world and Russian markets. Some grants, however, do partially aid the development of industries in Russia, but these grants are never large enough to significantly benefit Russia's production facilities. For example, Bill Clinton's $1.6 billion aid package provides $50 million to encourage joint ventures and $60 million to help privatization of state enterprises. Western grants to Russia, therefore, will never provide what Russia needs -- enough money to upgrade Russia's production facilities to world standards so Russian enterprises can effectively compete in overseas markets as well as in Russia.

The largest portion of Western aid to Russia consists of loans. The West distributed around nine billion dollars in loans last year and promises nearly $20 billion this year. Most of the money from last year's loans, most of the money from this year's loans and most of the money from any loans in the future will go directly to Western companies, which in turn ship goods or services to Russia, such as food, industrial equipment, consulting services, etc. The Russian taxpayers and Russian enterprises must repay these loans and the interest charges in hard currency over long periods of time, interest charges can actually exceed the amount borrowed. A large portion of these loans can be used to acquire capital goods and services to update Russian production facilities, but the amounts are still not large enough to meet Russia's current needs. The most insidious aspect of loans, however, becomes clear when Russia tries to meet its yearly debt service. The burden of repaying past, present and future loans will eventually drive Russia into bankruptcy as happened to many indebted Latin American countries in the 1980s.

Russia's total debt to the West, including the amounts owed to governments, international agencies and private commercial banks, stands at around $80 billion. Each new loan and each missed payment on prior loans increases Russia's repayment burden. Russia's debt payments owed to the West in 1992 totaled $20 billion and for 1993 will amount to $30 billion. Since Russia does not have the hard currency, most of the payments due in 1992 and 1993 have been postponed -- but not forgiven. For the amounts not postponed, Russia must still raise enough hard currency each year to meet these payments. Since Russia lacks an up-to-date manufacturing sector that produces large quantities of goods saleable in the world's markets, Russia's main source of hard currency comes from the export of its natural resources and partially processed commodities. At present, much of that currency goes to pay Russia's debt rather than to upgrade Russia's production facilities. For instance, in 1992, seventy-six percent of Russia's exports consisted of natural resources, and Russia's export surplus was a little over four billion dollars. Two of that four billion dollars went to pay Russia's reduced debt service for 1992. With each new debt then, the noose tightens around Russia's future as a manufacturing nation because greater amounts of hard currency must pay an ever increasing debt service rather than being invested in Russia's industries. Consequently, as long as Russia relies on Western loans, it will never have sufficient capital to modernize its industries to the point where they can compete with Western industries.

When the West finally decides to demand full debt service payments -- and it will -- Russia will then be officially bankrupt. The West, however, will then offer an apparent solution to the debt crisis by which private commercial banks will trade some of the debt owed them for ownership in key Russian industries, such as telecommunications, transportation, oil and gas reserves and strategic metals reserves. Western commercial banks will also offer other means of restructuring Russia's debt, such as commodity-linked financing, bond collateralization, debt buy-backs and interest rate reduction bonds, all of which will make the banks a nice profit and increase their ownership of Russian assets. Governmental and international agency creditors will also offer solutions including debt forgiveness, but in return Russia will have to adhere to an International Monetary Fund and World Bank program that ultimately benefits Western businesses over Russian enterprises and the Russian people. For example, drastic reduction in the government's spending for pensioners, unemployed workers and worker retraining programs will make more money available for repaying Western loans. An overly-tight credit policy will make investment in enterprises prohibitively expensive; thereby, reducing Russia's manufacturing capacity and its ability to compete even further. In the end, Russia's reliance on Western loans will result in the sale of valuable enterprises for below market prices, reduce investment in Russian industries, continue the decline in Russian production and competitiveness, deplete natural resources to the West's benefit, and increase unemployment and destitution of Russian workers.

Decades of lending for development by wealthy Western nations to poorer countries has resulted in the transfer of $21 billion a year from the poorer to the richer nations. The same will happen to Russia.

The Russian Government and some enterprise directors, hoping to avoid relying on more Western loans and grants, seek financing in the form of private equity investment. Such investments would make Western businesses partners with Russian enterprises; thereby, giving Westerners a reason for wanting Russian enterprises to succeed: Westerners would share in the profits. In order to attract sufficient amounts of foreign investment, the risks of investing in Russia must be perceived as reasonable when the potential rewards are taken into account. Right now, Western investors perceive the risks as too great because of the uncertainty that Russia's civil courts can adequately and timely resolve contract disputes, the uncertainty whether courts have the power to enforce a judicial or arbitration judgment, the lack of laws on private property that grant investors specific, enforceable rights in their investments, the unstable political situation, the inability of many directors and chief engineers of Russian enterprises to act reliably and competently, and the absence of the likelihood of a reasonable return in hard currency on investments. As a result, the risk of any equity investment far outweighs the potential rewards, so most investors will wait until the risk is commensurate with the reward.

For Russia to survive as a modern industrial power, it will have to create its own capital and not rely on the largesse of Western governments or, for now, the investments from private Western businesses. A first step could entail legal actions to return the $8-17 billion in Russian export revenues deposited yearly in overseas accounts. Amounts this large could greatly assist the modernization of Russia's industry instead of building fortunes for some nomenklatura and bolshaya shyshka.

Most of the Russian export revenues that have remained in America have been placed in bank accounts or bank safe-deposit boxes, or with financial service companies, such as brokerage firms. Whenever a non-resident alien places money with banks or financial service companies, he must produce two forms of acceptable identification, such as a passport and another identity card, before an American company will accept the foreigner's money. The American company then notifies the United States Internal Revenue Service that the non-resident alien opened an account or safe deposit box. Some Russian exporters use a more elaborate way to hide dollars overseas by setting up American corporations, usually in Delaware, to act as their agent and receive payment for exported goods, which the corporation deposits with a bank or financial service company. Such corporations are considered American juridical persons and not alien persons, which makes it more difficult for the U.S. Internal Revenue Service to track Russian export revenues paid to these corporations but not impossible.

The Internal Revenue Service keeps information on non-resident alien financial accounts and American corporation accounts confidential, but the U.S. Government would probably provide this information to the Russian Government if requested since the repatriation of this capital would make President Clinton appear as an effective supporter of democracy and market reforms in Russia at no cost to the American taxpayer. The question of course is whether the Russian Government wants this information or would take appropriate action to force Russian biscrats to repatriate their export revenues. Many members of both the executive and the legislative branches have accounts overseas, and they would not want their secreted funds returned for the benefit of their fellow countrymen. The hard currency in overseas accounts will not turn Russia into a modern industrial state overnight, but as long as the Russian Government pursues the individuals who horde Russia's wealth overseas, every year billions of dollars will become available for investment in Russia.

Additional capital, both hard currency and rubles, could initially be obtained from a 100 percent tax on the net worth above a certain amount of wealthy Russians. The tax would set an upper limit on the net worth for all households and would prevent high concentrations of wealth and ultimately distribute Russia's riches more equitably. Taxing at 100 percent the net worth above, for example, 100 million rubles would bring in large sums of hard currency and rubles from all the bureaucrats, politicians and mafioses who have grown rich by robbing Russia's assets. The 100 million ruble amount could be indexed for inflation, so as the ruble declines in value the amount above which the tax applies would increase. A net worth limit of 100 million rubles or higher should provide more than enough incentive for Russians to take risks, use their ingenuity and work long hours for the rewards of material success. Once a successful businessman, professional or any other worker reaches the net worth limit, he may retire with his wealth or continue working without material reward but still earning all the psychological benefits that come from exercising his talents and knowledge. The 100 percent net worth tax would make it possible for many more persons to participate in and contribute to the creation of capital in Russia, avoid the growth of a moneyed ruling class and still offer material incentives to inventors, innovators and hard workers.

Russia could use some of the repatriated export revenue and net worth tax to stimulate exports. The Russian Agency for International Cooperation and Development could help Russian exporters secure credit for foreign buyers to purchase Russian goods. Often a foreign buyer cannot obtain financing because private Russian and foreign lenders perceive the risk of foreign buyers not repaying or only partially repaying a loan as too high. The Agency could encourage private lenders, both Russian and foreign, to extend credit to foreign buyers by providing private lenders with guarantees that in the event foreign buyers do not repay the private lenders, the Agency would. While foreign buyers would repay their loans over a period of time, the money loaned by private lenders would be paid directly to Russian exporters immediately and not to the foreign buyer. The foreign buyer would only receive the Russian exporters' goods or services. The exporters, therefore, are assured of obtaining payment for the goods or services exported to foreign buyers. Only the Agency has to worry whether foreign buyers repay their loans. Under another program, the Agency could just provide direct loans for the purchase of Russian goods by a foreign buyer and eliminate the need for any private lenders. The Agency would transfer the funds directly to Russian exporters and the foreign buyers would have to repay the Agency, with interest, over a period of time. An additional program would have the Agency making short-term, low-interest loans directly to Russian exporters to enable them to finance their exporting operations until they received payment from their foreign buyers.

Other services the Agency could provide Russian exporters in order to expand their markets overseas include: market research to define the countries or regions where opportunity exists; information on local or foreign government regulations; location of overseas distributors for Russian exports; promotional activities such as press releases, advertising, direct mail campaigns, telex campaigns and tradeshow production; product managers who contact foreign buyers directly and arrange for the sale of products; and entrepreneur funds to provide financing for middle, small and micro-enterprises. Micro-enterprises include every Russian who informally sells goods or services. Micro-enterprises have a special need for a government operated entrepreneur fund because of the unwillingness of commercial banks to lend to small one- or two-man operations due to the high costs of transacting small loans, higher perceived risks and the lack of collateral.

Repatriated export revenues and a net worth tax can provide Russia with capital to stimulate exports, which will bring in more hard currency that can be used to upgrade Russia's production capacity without having to indenture itself to the West, pauperize its people or sell its most valuable assets at bargain basement prices.