

MILITARY EXPENDITURE IN TRANSITION COUNTRIES FROM A PUBLIC CHOICE APPROACH

(Comments Based on Professor Keith Hartley's Paper)

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Professor Hartley's paper raises, in a highly professional way, a number of issues using the framework of public choice economics. This approach suits Western countries well and it is tempting to use it also for transition countries. Rather than commenting on the paper itself - which provides an excellent overview of the problems of military expenditure and new challenges for the West in a context of budget stringency - I will try to examine the issues raised by Professor Keith Hartley in the context of transition economics, in particular referring to Russia, and to draw attention to a number of caveats which one should be aware of when adapting the public choice approach to transitional economies.

The first point raised by Professor Hartley is that according to the public choice view on government budgets, "decisions are made in the policy market". This implies the democratic arena, responsiveness to public demands, responsibility of decision-makers and lobbying by interest groups. Is a policy market functioning in transition economies? While, by and large, one can answer in the affirmative for most Central European Countries where political parties have been formed, have their constituencies, have a role in shaping political programmes and decision-making and are subject to the electorate's judgement according to democratic rules, the answer should be qualified for Russia and elsewhere in the CIS where political parties in the Western sense have not yet developed.

In Russia, for instance, while the Communist Party is represented in all regions, Gaidar's reformist Democratic Choice is represented in only eight regions. Other parties may have a larger representation but they cannot, overall, compete with the regional organisation of the Communist Party which remains the best organised political force even though its understanding of market mechanisms and institutions is still inadequate. The political arena is much influenced by personalities and the representation of different groups' interests in the Duma (Parliament) is quite inadequate. The political game is thus played outside the Duma through deals, compromises and personal favours.

The Duma is dominated by the Communist Party, a situation that is not likely to change in the foreseeable future. Decisions are actually taken at the top, that is, by the President and they are often in conflict with the Duma. While this process - which finds support in the Constitution - leaves room for institutional changes in spite of the hostility of the Communist Party, there are unfavourable consequences such as slow and inconsistent implementation, lack of transparency, inconsistency and political instability. Even if the Presidential Decrees have force of law, they need the adoption of other acts to be implemented: the negative effects of the lack of consensus manifest at this point either through bureaucratic obstacles or through endless political debates. Presidential decisions are influenced by a narrow circle of people, either within or outside the government. The lack of transparency provides opportunity for all sorts of speculations about concealed motivations, procedural matters, and effective aims.

Structural reforms, often influenced by the President, are inconsistent with macro-economic policy which needs discussion in the Duma before the approval of the budget. Macro-economic policy itself is inconsistent, since the policy of the only independent institution, the Central Bank, does not find support on the fiscal side. Thus, for instance, while inflation is falling, interest rates pulled by the fiscal deficit either remain high or even increase. The outcome is political instability even under a highly centralised power structure since scapegoats for bad results must be found either among ministries, leading to frequent turnover in ministerial posts, or through government reshuffling. Recent events relative to the dismissal of the government and the time consuming and costly formation of the new Russian government signal the worsening of an already existing trend. In the end, the country is perceived - how could it be otherwise? - by foreigners as a high risk country which means that it is subject, on the one hand, to speculative attacks, and on the other to weak long-term investment support from abroad (low FDI).

Overwhelming problems with fiscal imbalances can also make it difficult to carry out other options which, in principle, would be available according to public choice economics. First, it is difficult to privatise public goods even when experience and procedural terms of reference are available. For example, public utilities - where enormous progress has been made with privatisation in Western countries - are often used as quasi-fiscal sources.² They finance first of all social peace by tolerating non payments from both enterprises and private customers. Secondly, they help to conceal the magnitude of the public deficit which would look much larger if the total public sector was in the picture. Thirdly, they complicate any assessment of the true amount of subsidisation which is still going on in the economy and is not reflected in the budget.

For similar reasons, displacement effects (such as persistent budget lines for overestimated needs) are difficult to identify. Banks, for example, whether public or private, continue to finance loss-making companies under political pressure

or due to personal networks. This was the case in Bulgaria before the financial crisis and was the main factor which triggered it. With the formation of financial-industrial groups, this practice is even less visible. While official figures put bad debts in Russia as low as 13% of total banking credit, OECD estimates put it at 30%. It is very likely that at least a part of military industry enjoys the privilege of old connections. Thus, looking at the budget to see the size of the displacement effect of military expenditure is not enough. Russian fiscal developments, for instance, show a sizeable decrease in military expenditure on the total consolidated budget up until 1995 (see Table 1). Moreover, one should keep in mind that the practice of sequestration of budget expenditure, widely used by the Russian government, also affects the military³ to the extent that effective expenditure could be lower than budgeted. On the other hand, the Russian government also applies state guarantees to banks' financing of output, whose returns are far from guaranteed.⁴

**Table 1 - Budget Developments in Russia:
Percentage of Military Expenditure on Total Federal Expenditure (1)
and on Total Expenditure of the Consolidated Budget (2)**

	1992	1993	1994	1995	1996	1997
(1)						
Defence	21.5	20.4	19.1	17.3	17.9	19.2
Internal security	6.0	7.1	7.3	7.0	8.0	10.7
Total military	27.5	27.5	26.4	24.3	25.9	30.2
(2)						
Defence	14.3	12.5	11.9	9.8	9.8	9.9
Internal security	4.1	4.7	4.9	5.2	6.0	7.1
Total military	18.4	17.2	16.8	15.0	15.8	16.0

Source: Russian Budget Data, MOF, respective years.

Professor Hartley argues that there are several reasons (and motivations) for believing that NATO member countries overestimate the demand for military goods. It all boils down to overestimating the potential of the enemy. What are the motivations and the scope for Russia to do the same now? Surely the Russian government does not consider NATO as a threat anymore, even should the Duma disagree at times. But NATO's expansion to CEECs and the Baltics can be used, and is being used, to sustain demand for military expenditure, particularly if Russia is kept outside of any evolving partenariat with NATO. Thus, overestimation of military needs is likely to occur also in Russia. But Russia, unlike NATO member countries, needs to watch the enemy from within. Military expenditure should, therefore, be interpreted in a broader sense to include not only national defence but also internal security. A notion of what

could be the possible threat from regional developments (including Chechnya) is needed to distinguish effective from inflated demand for the military.

The restructuring of the volume and type of military expenditure both in the West and in transition countries has been forced by budget stringency. While fiscal consolidation is an imperative for the European countries joining the monetary union, and a well established policy aim for the United States under Clinton's administration, it is a *sine qua non* condition for sustainable growth in Russia. Increasingly high interest rates are eroding budget revenues to an unprecedented scale. Unless the budget deficit is brought down to a manageable size, neither lower inflation and interest rates, nor stable exchange rates will be sustainable. Pressures to devalue the currency will undermine the efforts to restore credibility in the currency, capital flight will continue and could also increase, with negative effects on liquidity, financing of output and resumption of growth in the secondary sector. Efforts to raise adequate tax have not yet been successful: after the ephemeral burst in tax revenues in the first quarter of 1998, tax collection fell in April and May, thus prompting the sacking in May of the head of the State Tax Service, Mr. Pochinok, who was hastily replaced by the hard-liner Boris Fedorov. With the new emergency programme approved in May 1998 in response to the threat of a major financial crisis which could destabilise the country economically and politically, the Russian government is now striving to diminish expenditure. It is unlikely that this will not also affect the military, which, although hit by years of falling investment and output (Table 2), have so far been spared dramatic cuts.

**Table 2 - Military Expenditure of Consolidated Budget
(National Defence and Internal Security) in Percentage of GDP:
1992-1997**

	1992	1993	1994	1995	1996	1997
National defence	4.50	4.21	4.59	2.92	2.83	2.98
Internal security	1.29	1.59	1.87	1.57	1.74	N.A.

Source: Official statistics and MOF budget data for the respective years. GDP estimates before revision in April 1998.

Considering that the economics of defence (final output, substitution) also depend in Russia on potential enemies from within, substitution capabilities are perhaps lower than in NATO countries. Russia has also problematic neighbours (China, Pakistan and India) with rising nationalistic impulses. But this does not exclude gains stemming from a competitive environment. One can observe from the breakdown of military industry that aviation, for instance, is faring better in export markets than other branches, such as missile-space, shipbuilding and armaments, whose output fell less than aviation from 1991 to 1997.⁵ It is unclear,

however, just how much military industry in Russia is indeed exposed to a competitive environment that is not only relative to quality (this should be assured by the need to compete with foreign suppliers in the international market) but also to costs. As for most industry, military industry also survives due to the non-payment to suppliers, state and workers. Tax offsets are still used in Russia. With barter deals, it is difficult to assess the real volume of costs. Goods and services acquired by the armed forces at subsidised or artificially low prices also matter in assessing improving competitiveness: for instance, the prices of weapons have risen much more slowly than those of most other industrial goods.⁶ Moreover, in assessing the performance of aviation, for example, one should keep in mind that a number of export registered deals (Hungary, Slovakia) involved the clearing of ex-Comecon countries' debt positions through exports.

On the issue of free-riding, it would be interesting to know how many CIS countries can be considered (and do consider themselves) as free-riders on Russia's back. The share of military expenditure in GDP in some of Russia's neighbouring countries should provide some hints about this. Tajikistan is very likely to be a free-rider on Russia. But other countries, such as Belarus, may also belong to this group.

Disarmament can be seen as an investment process, argues Professor Hartley. Indeed, in France, military enterprises have turned to civilian activities, often acquiring other enterprises. In the United Kingdom and the United States downsizing has progressed for many years resulting in military output being produced in few huge companies. In the United States the shift to a largely integrated civil/military industrial base is apparent, with positive effects on the production cycle which for a number of products has become shorter. All transition countries had to undergo parallel developments under even stronger budget pressure. Hungarian military industries have started producing from 30 to 70% civilian output (security technology, information techniques, hospital appliances). In principle this process should occur even more widely in Russia which was a militarised country. Russian military industry, even during Soviet times, produced a number of civilian goods. With the transition to a market economy and increasing demand for consumer durables, together with larger unused capacity for military purposes, one could expect that this output would rise comparatively faster. However, foreign competition in this sector is fierce and given the Russian commitment to trade liberalisation, sluggish investment and increasing technological backwardness, one wonders whether Russian industry is indeed competitive in cost and quality.

In fact, the effects of this process are not yet fully visible and there are frictions due to legacies in industrial location and in alternative source of funding. There remain serious problems with the interregional mobility of resources, especially labour. For a virtuous circle to start, there is a need to substitute highly priced public procurement with credit from commercial banks. However, unless personal networks provide for smooth changes in the allocation

of resources, credit is unlikely to be channelled to conversion. In the Russian situation, it is more likely that credit will be channelled to military industry working on a commercial basis which in effect means to successful exporters of weaponry. These are the companies which, according to B. Hilton,⁷ have been able to become competitive and to sell abroad.

There could be an argument for endogenous growth in this process, i.e. growth based on accumulated skills and knowledge redeployed in highly productive civilian fields, which Professor Julian Cooper develops in his contribution to this conference. However, a counter-argument is that new products (highly sophisticated information technologies, etc.) may be better produced by a younger workforce and new management. In the United Kingdom, the need for highly capitalised, low production cost and continued production of small batches of military products has been met by greenfield industry. Production has even been moved to other sites to allow for labour substitution, a new capital structure, new management and outsourcing of non-core industrial production. It would be interesting to know whether, in Russia, the regions where more military industry was located are developing comparatively faster in sophisticated civilian production, or are instead comparatively lagging behind.

All in all, the public choice approach to military expenditure is very useful and should also be adopted in monitoring developments in transition countries. While budgetary constraints in these countries are even more stringent than in the West, there also remains much room for streamlining state expenditures, decreasing state intervention and providing an adequate economic and institutional framework for military production to be carried out on a truly competitive basis. Subsidisation on a larger scale than what is made visible by narrow budget data has been going on in Russia for quite a time. The volume of tax arrears and payment arrears to the energy sector and the rescheduling of non-performing loans by banks provide robust evidence of this ongoing practice. But the economic conditions of the country do not allow this process to continue.

Notes:

- 1 The opinions expressed are those of the author and do not necessarily reflect those of OECD.
- 2 OECD Economic Survey of the Russian Federation, 1997.
- 3 A recent example concerns the Ministry of Defence still unpaid arrears to Sukhoi for 1996-1997 (ITAR-TASS news agency [World Service], Moscow, in Russian 0950 gmt 26 May 1998).
- 4 For instance the two Russian banks, Menatep and Inkombank, which provide financing for the construction of the Tu-204s at the AviaStar plant in Ulyanovsk, are counting on this type of state support from the 1998 development budget ITAR-TASS news agency (World Service), Moscow, in English 1321 gmt 29 May 1998.
- 5 I am indebted to Professor Julian M. Cooper for these data.
- 6 Julian Cooper, "The military expenditure of the USSR and the Russian Federation, 1987-97" forthcoming 1998.
- 7 Brian Hilton, presentation at the NATO seminar in Warsaw, 6-7 October 1997.