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The role of state and creation of a market economy in Russia

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Vladimir Mau

The role of state and creation of
a market economy in Russia



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All opinions expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

Vladimir Mau*

The role of state and creation of a market economy in Russia

Abstract

This paper examines the role of institutions in economic growth and the role of the institutions created by the Russian state in particular. The author stresses the finding that growth-supporting institutions vary according to the level of economic development in a country. In a post-industrial society, that Russia aspires to be, further economic development requires promotion of institutions securing e.g. property rights and economic freedom. Finally, based on these observations, the three development scenarios frequently discussed in the current Russian economic policy debates are analysed.

JEL; O1, O2, O3,

Keywords: modernisation, role of institutions, economic development, Russia

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Tiivistelmä

Tutkimuksessa tarkastellaan instituutioiden, erityisesti Venäjän federaation instituutioiden, roolia talouskehityksessä. Kasvua tukevat instituutiot ovat erilaisia riippuen talouden yleisestä kehitysvaiheesta. Jälkiteollisessa yhteiskunnassa, jollainen Venäjäkin haluaa olla, talouden kehitys vaatii mm. omistusoikeuksien ja taloudellisen toiminnan vapautta tukevia instituutioita. Näiden tulosten pohjalta tutkimuksessa analysoidaan myös Venäjän talouspoliittisessa keskustelussa usein esille nostettuja kolmea skenaarioita talouden kehityksestä vuoteen 2020.

JEL; O1, O2, O3

Asiasanat: modernisaatio, instituutiot, talouskehitys, Venäjä

1 Introduction

Factors influencing state involvement in socio-economic functions

The role of the state lies at the centre of any discussion on scenarios for socio-economic development in Russia. Formulation of the issue is inherently infused not only with traditional Russian (and Soviet) ideas about the significance of the state in the setting of economic policy but also, importantly and relevantly, the fact that state actions are critical in resolving challenges such as pursuing a catch-up development strategy. Although well intended, much of our contemporary discussion on the role of the Russian state offers only non-specific conclusions (despite some brilliant insights) that contribute little in the way of practical solutions to real problems.

The state naturally plays an important role in the functioning and development of a modern economy – especially in the case of economies in transition. This is the accepted view permeating the contemporary debate on public policy and the economy from *dirigistes* on the left to liberals on the right. The main issue facing the policy-maker, however, is how such a position should be expressed concretely, i.e. which socio-economic functions should the state appropriately be involved in at the moment. Finding the answer requires a serious and thorough analysis; one where discussion of the state “in general” has no place.

Two factors directly confer (and largely define) the state role in creation the social, political and other conditions for national socio-economic development, and, more specific to this discussion, conditions that encourage entrepreneurial activity. The first is the *stage of technological and economic development* the country has achieved, i.e. the nature of the existing means of production. The second (as a matter of principle) is the *maturity of the state in socio-political policy-making*, i.e. the condition and efficiency of the state and its policy-implementing institutions.

There is no doubt the demands on state participation are different for an agrarian economy, an economy based on manufacturing, one dependent on heavy coal and steel industries or a post-industrial economy. In each case, the possibilities for participation are different and state intervention in the economy requires a specific set of policy tools. This goes beyond the extent of state involvement (i.e. the share of state involvement in GDP) to the specific mechanisms of state regulation of the economy.

Research over the past 15 years has revealed long-term trends in the evolution of state involvement in the economy.² Analysis of this evolution provides four observations. First, present-

day economic growth has been predicated on a gradual increase in the role of the state in the economy. Second, the size of our budget debt relative to per capita GDP has risen, i.e. rising indebtedness reflects new forms of participation by the state in economic life that correspond to newly attained levels of economic development. Third, the intensity of the growth of state participation in the economy varies at different stages of socio-economic development. Fourth, the expansion of the state's presence in the economy has a natural limit and eventually reaches a saturation point.

Even if we accept these four observations at face value, it still does not tell us what specific forms and levels of state participation in the economy are appropriate for Russia to sustain the needed rates of economic growth, implement structural reforms and solve its social problems.

Thus, it is essential to analyse in concrete terms the specific state actions contemplated to move Russia from a transition economy to an industrial economy and eventually to a post-industrial economy – especially given that this transition is occurring against the background of a systemic transformation of a socialist society. This raises a second important issue: How do we evaluate the status and condition of institutions of the state and their capacity to respond effectively and adequately to the challenges of the age? The state possesses its own inherent operating logic; it does not simply react or seek to influence national economic development. This logic has had a distinct character during the transition period from socialism to capitalism. Needed reorganisation of the state has been halting, and from time to time the state has found itself in crisis. This logic not only hampers how the state interprets and resolves real problems in socio-economic life, but in some cases can deflect the trajectory of development in a wrong direction.

In considering the period of post-communist transformation of Russian society, it is imperative to look at three situations that, in a real sense, influence the challenges and possibilities as to how state power is exercised generally and its impact on national economic development in particular. First, there is the revolutionary nature of the transformation of state power and the social system as a whole. This crisis can only be overcome with difficulty due to the sometimes unsuitable ways chosen by the state to bring about its own transformation. Second, the state, finding itself in the midst of crisis, must resolve simultaneously the problems of restoring economic growth, pushing through structural economic reforms, and improving social conditions, while mitigating the social fallout from a radical upheaval of the social order. Third, we see an increasingly pressing need to balance the conflicts from pursuing a catch-up development strategy and attempting to prepare Russia to meet the emerging challenges of a post-industrial economy.

2 Post-communist Russia and crisis of the state

A feature of Russia's post-communist reforms has been the struggle to implement systemic reform amidst crisis and weakened state power. This fact is typically overlooked or treated as an outcome of conscious reform measures in critiques of Russian politics. Some observers have blamed the difficulties that have arisen on a mistaken decision to take a liberal orientation to post-communist reforms, i.e. rapid liberalisation and privatisation are alleged to have caused the crisis of state power. This narrative makes little sense from both the theoretical and historical point of view.

Systemic transformation under conditions of a weak state is essentially a definition of revolution. Russia (with the possible exception of China) is the only country where the communist system was the product of its own development, and not imposed from the outside. Accordingly, Russia's exit from communism has been complicated; it was accompanied with a collapse of the national consensus and an acute exacerbation of the struggle among social forces and interest groups. In contrast, countries of Central and Eastern Europe were unified in efforts to move beyond their communist pasts and join the EU. For Russia, the end of communism and the collapse of the Soviet empire brought with it social disintegration.³

This "revolutionary" transformation has several distinctive features, including some special aspects of economic policy and the dynamics of economic processes.⁴ Economic policy in a society torn by social conflict cannot be stable or consistent. This is particularly reflected in the character and possibilities of state influence over the creation of socio-economic processes. **Such revolution does not, generally speaking, take the form of mass demonstrations, but rather as implementation of systemic transformations under conditions of a weak state.** Researchers ignore at their peril the fact that weakness of the state has been an overarching factor in the development of the Russian economy since the late 1980s.

State weakness has been manifested in the shifts in economic direction and a plurality of competing centres of power, as well as the absence of fully developed, reliably functioning political institutions and intelligible, permanent "rules of the game." State weakness is accompanied by a cluster of special issues related to functioning of the economy.

Here are a few of the economic consequences of the weakness of state power, borne out by experience; not just in present-day Russia, but in all major revolutions:⁵

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- **Inadequate efforts at shaping and developing a market economy.** This leads to distortions in an emerging market, which, in turn, allows some of the darker sides of business to thrive. The state has no opportunity to regulate business in ways that protect the interests of society.
 - **Limited means of collecting taxes.** The sharp growth in the inflation tax and, more frequently, the drastic exacerbation of budget crises, leads to under-financing of a significant share of the state's liabilities. (We emphasise here that this has been characteristic of practically all countries that have found themselves in a similar situation).
 - **A sharp rise in transaction expenses.** This leads to reduced competitiveness of domestic production.
 - **Demonetisation of the national economy.** This shrinks the official GDP figure. The phenomenon has also been observed in countries that have managed to escape inflationary processes. Demonetisation is often accompanied with cash hoarding.
 - **Resolving socio-political (stabilisation of power) and fiscal problems take precedence over economic development challenges.** Here, the weak state is worried about the optics of privatisation measures rather than actual outcomes.⁶

Finally, weak states are vulnerable to corruption and lobbying. This makes it impossible for the state to be strengthened through “point blank” measures to expand direct state involvement in the economy, and leads to a paradoxical inference familiar in our discourse. The syllogism goes like this: It is necessary to *expand* the regulatory role of the state, because the Russian state is weak and corrupt. Therefore, we need to expand the function of the corrupt state! Obviously, it is necessary to strengthen a weak state, but such a task cannot lead to an expansion of the opportunities for bureaucracy to interfere in the economic life of the country, and in particular engage in its favourite activity, discretionary allocation (and “in the interests of the state”) of scarce resources.

The most important feature in the creation of a political process (especially in drafting and implementation of economic policy) for a weak state is that the core of the process **is not occupied by the organisation of a necessary political majority through existing institutions (parliament, parties)**, which are weak, and occasionally even malformed and unstable, **but by a direct interaction between the representatives of power (the government) and leading groups of economic interests.** These groups manipulate the real levers of political power. In the early stages of transformation, these economic groups may even perform the function of political parties.⁷ Andrei

Shleifer and Daniel Triesman are absolutely correct, therefore, when they write that “the reformers knew that the achievements of marketisation will only be preserved in the event that they are able to create a powerful political coalition to support the creation of free markets”⁸ so that the situation may continue to fundamentally evolve. At some point, however, the state has to get on with formation of a party system and begin to exclude economic groups from political decision-making. There is more than a bit of irony here. On the upside, this process restricts the ability of big business to use the state for unbridled satisfaction of narrow self-interest. On the downside, the process may lead to unnecessary confrontations between the authorities and business and failure of the state to act as it should in fostering optimum conditions for entrepreneurial activity.

To sum up, all the factors listed above *in their entirety* would be found in any major revolution. An analysis of the contemporary Russian transformation through this prism helps in creating a narrative for the seemingly strange course of events in Russia over the last twenty-five years.

A caveat is appropriate at this juncture. The challenges and confusion over weak power (particularly during the initial stages of post-communist development) and the inability of the state to implement its own decisions relates to the very process of erecting a democratic regime based as much on precedent and experience as law. Before the collapse of the Soviet Union, many Western analysts had grown comfortable with the notion of the USSR as stable regime in which the authorities imposed state decisions on society.⁹ The transition from Soviet totalitarianism to democracy imposed by non-state actors was seen as a weakening of the system and legal process, yet no reference was made to the revolutionary nature of the transformation. This is particularly important in a country with a federal system, in which, apart from the other problems of creating a democratic system, it is necessary to look for suitable forms of interaction between the institutions of the federal authorities and the authorities in charge of sub-divisions federal power (i.e. regional and local authorities). We know similar problems earlier confronted countries in the West, especially the US. As Triesman notes: “To anyone engaged in the question of why it is so difficult for the central government to root out corruption in the Russian Federation, the question may also be put as to why it was so difficult to overcome slavery and then segregation in the federal United States.”¹⁰

With the introduction of basic post-communist reforms, it became possible to strengthen the power of the state. The government moved ahead with macro-economic stabilisation (budgetary and monetary) and there was a renewal of economic growth nationally. This fact, along with political stabilisation, created the prerequisites for a large expansion of opportunities for the power of the state in regulating socio-economic processes.

Admittedly, the extent of political consolidation should not be overstated. After a period of lengthy and profound crisis, time is still needed to re-establish the effectiveness of the functioning of state power – in a manner adequate in light of the situation and the needs of social development, as well as the specific problems associated with the development of the economy (including stimulating the entrepreneurial climate). Success here depends greatly on suppressing political tendencies that might act as a brake on the process.

3 The state and catch-up development in a post-industrial era

The historical goal of our post-socialist transformation lies, in the final analysis, in the evolution from a contemporary industrial system to a post-industrial economy that gradually narrows the gap between itself and the most advanced economies. The first aspect of this strategic problem – making the technological shift – is qualitative. The second – increasing the scale of production through structural reform – is quantitative. These challenges are interconnected with the post-industrial era determining to some extent the character of policies needed to implement a catch-up development strategy. These challenges will basically be achieved in the day-to-day operations of companies, but it is also critical for the state to provide adequate and appropriate support. Ultimately, the state must create many of the necessary conditions for innovative business activity.

Traditionally, catch-up development policies assume the catch-up state performs specific functions to close the gap with its advanced counterparts. The question of the role of the state has always provoked keen discussion, which invariably goes beyond the bounds of theoretical polemics to the political struggle observable in any society conscious of its backwardness and unwilling to resign itself to such a situation. The basic methodological principles of research into this problem are contained in Alexander Gerschenkron's work in the 1960s, although his arguments must naturally be modified for the modern context.

Gerschenkron distinguishes areas of state activity in pursuit of a catch-up strategy. These are basic structural reforms to promote higher economic growth, actions that directly guarantee opportunities for growth, and conversion of potential growth into actual growth. In his analysis, the role of the state lies first and foremost in the creation of a favourable environment and elimination of institutional obstacles to economic growth (e.g. assuring political stability). The specific set of measures selected by the state depend on the circumstances surrounding the historical development

and the presence or absence of factors that sustain productive capabilities at their current level. There is often a related issue of overcoming negative factors created earlier by the state in its economic development.¹¹ Special measures, of course, are needed to boost economic growth to levels high enough to sustain the catch-up strategy. These are no less varied and appear in the form of certain institutions that serve to ensure economic growth. In the industrial era, some of the institutions that promoted growth include investment banks (as in Germany) or direct state participation in economic life (as in Russia in the late 19th and early 20th century).

In principle, differentiation of these factors should be important in understanding how the state performs its role in different economic policy circumstances. It is ultimately the function of the state to provide the fundamentals for growth, and in so doing remove obstacles to economic progress at each stage of scientific and technical development. State-adopted measures are similar for countries embarking on economic growth and pursuing catch-up development (recall that what we are talking about here is a comparison of measures applicable at the particular stage of social development and scientific and technical progress). Yet measures to foster growth are often different for different countries, even when the decisions taken pertain to similar sets of problems. The state did not play a significant role in promoting economic growth in countries first to industrialise, and its role was quite limited in the catch-up industrialisation of both Germany and Japan. In contrast, the state played a significant role in Russia the first half of the 20th century, and later in the emerging industrial economies of Asia.

What, then, is the connection with the significant and positive role of the state in the resolution of problems associated with catch-up development? Two answers suggest themselves. Gerschenkron, basing his comments exclusively on the experience of industrialisation, explains the connection in terms of backwardness; the more backward the country, the more active the direct intervention of the state needed in the economic process. It can be inferred from his observation that, to the extent backwardness is overcome, the importance of the state as an institution for reducing uncertainty in the process of accumulating capital is correspondingly weakened as its role is gradually ceded to the banks (as was the case in the catch-up development of relatively more advanced Germany).¹² The second suggested explanation of how much state involvement is appropriate draws on experiences from the last decades of the 20th century. Here, the role of the state is seen as largely emerging from the stage of socio-economic development; i.e. the state's role is fundamentally different in an industrial and a post-industrial world. We examine this second assertion in detail.

How much the state can contribute positively to development in an industrial and post-industrial context relates, in the first instance, to the nature of the productive forces at the time. This situation dictates how amenable (or perhaps more accurately, how resistant) these forces are to state intervention in promoting technological progress.

In an industrial society, the central question for state policy is how to marshal resources to support nascent technical development and mobilise all forces and inputs available to society. In a post-industrial society with distinctly more advanced technologies, this approach would not just be ineffective, but impossible. **Instead of marshalling resources, the main problems in post-industrial society are preserving, as far as possible, the flexibility available to individual economic actors, and maintaining a political and legal environment so that all actors are guided towards and focused on active development and satisfying their transactional counterparties (e.g. in contract performance or service delivery).**

We cite below a selection of requirements for the functioning of the state (or economic policy conditions) to enable the resolution of problems associated with a catch-up development in a post-industrial society; a list of desirable aspects of state policy in a modern world.

The political regime. The political regime needs to be stable and possess the adaptability to meet the problems facing the country. Although the connection between socio-economic and political development has received detailed analysis from economists and political scientists,¹³ there appears to also be a connection between the level of socio-economic development and possibilities for creating a political regime conducive of catching up with advanced economies. In other words, the kinds of problems to be solved are linked somehow to the stage of socio-economic development. Thus, the particular political regime best suited to the process of catch-up will necessarily be different in an industrialisation and post-industrialisation phase.

Whereas an industrial growth spurt for a backward (agrarian) country might have been best served by an authoritarian regime capable of marshalling forces and resources, moving to the post-industrial level may demand stable democracy. There is extensive literature showing how and why economic growth fosters a general basis for the establishment of a political democracy and civil liberties.¹⁴ However, for a society whose growth is based on the movement of information flows and individualised needs, feedback is no less important: modern economic growth requires institutions that guarantee freedom (political and intellectual) and protect property.

Creating a flexible, adapting society presupposes encouraging creative activity on the part of its agents, something scarcely achievable where economic and political initiative are suppressed. The freedoms of creativity, information and individual participation are the most important prerequisites to achieving a post-industrial society. It is necessary for political and economic conditions conducive to creation of intellectual property and high-value services. Paraphrasing a cliché of Soviet times, it might be said that **freedom is transmuted into the direct productive force of a society**. At present (i.e. the present stage of development of productive forces) the link between the capacity to adapt and liberal democracy would seem to be sufficiently obvious.

Another political factor is required to safeguard power, and important in any type of catch-up development, consists in preserving a consensus about the basic principles and developmental points of reference between the principal groups and social strata, particularly within the framework of a country's political, economic and intellectual elite. The issue here is the need to create and support a community of ideas among these elites as to the desirable trends and prospects of national development.

Property. The creation of an adequate system of property relations is one of the more fundamental problems of power. As applied in post-industrial society, the issue pertains to **providing guarantees of rights to private property directly connected with the provision of conditions for the self-realisation of the creative individual**. This general thesis must find its realisation in a series of specific aspects concerning the functioning of property relations.

A particular conundrum is found in problems involving the protection and enforcement of intellectual property rights. There is a widespread view that stringent observance of intellectual property rights is a major prerequisite to post-industrial society. Others, however, argue that rapid growth in the post-industrial world demands unimpeded movement of information, and therefore repudiation of private intellectual property rights.¹⁵

While the emerging discussion is still largely speculative, it deserves serious consideration. We can assume that the most advanced economies, which deal regularly with frontier technologies will seek in the post-industrial era to jealously defend their intellectual property rights (and may even play a critical role in their policy-setting). At the same time, countries pursuing catch-up strategies will demand easy and full access to information (particularly with regards to innovation and technology), especially in light of the fact that the lifecycle of products and technologies is has

been drastically shortened by the acceleration in scientific and technical progress and global dissemination of information.

Economic freedom. Political freedom in a post-industrial world is inseparable from economic freedom. The ratio of the budget size relative to GDP may serve as a rough statistical indicator of economic freedom.¹⁶ Judging the evidence, it appears the claim of a low budget-to-GDP ratio (on the order of 20-25 %) for the attainment of high rates of growth remains a subject of discussion both from the point of view of the adequacy of measuring methods and applicability of this indicator in a dynamic analysis (i.e. does growth necessarily increase when the size of the budget relative to GDP is reduced?).¹⁷ An analysis of the existing, albeit limited, experience of development in the post-industrial world currently permits only two conclusions.

First, at the post-industrialisation phase, a country pursuing a successful catch-up strategy requires a lower budget burden than might be tolerated by a very advanced economy. In this respect, there is a real difference from a catch-up strategy in the industrialisation phase, where there is typically extensive marshalling of resources in the budget. In the post-industrialisation phase, a low budget burden recognises high degrees of technological and economic uncertainty that require a large proportion of society's resources remain in the hands of private agents of economic life.

Second, the budget burden is a problem not just quantitative, it has a structural aspect. As a result, it is not merely the scale of state participation that matters, but how state resources are allocated. Hence, an advanced system of education is the most important factor in post-industrialisation, and this requires corresponding expenditure on the part of the state.

In the 1990s, we saw wide dissemination of an argument that might be called “**presumption of state non-intervention.**” Supporters of this approach, whilst recognising the important role of state regulation, draw attention to a series of dangers in restricting economic freedom and expanding the intervention of the state in economic life. These include bureaucracies that seeks to preserve interests far removed from the interests of society at large, the influence of interest groups on state decision-making (which is particularly dangerous in the case of a weak state) and the asymmetry and unreliability of information available to the state.¹⁸

Replicating institutions. Catch-up development presupposes the creation of a new system of institutions. The complexity of this challenge, however, makes it impossible to directly replicate institutions in advanced economies. Certain institutions, of course, are common to all stable developed

societies. Most, however, have little to contribute when it comes to bridging gaps in socio-economic development. In a number of cases, institutions, effective in an advanced society, may act as a brake on development in a more backward context. Similarly, obsolete institutions in the developed context may help foster growth. Moreover, it is rarely the case that institutions that are designed to promote economic growth in one context can readily be repurposed for a different social or cultural milieu. Thus, when designing an appropriate catch-up strategy, one is likely to encounter this problem of relative success in different institutional environments.

At the general level, one may differentiate between: (1) institutions important for the stable functioning of the economy in a contemporary society; (2) institutions typical of a developed society that nevertheless are counterproductive for catch-up development; and (3) institutions not found in advanced countries, but capable of solving problems in the catch-up development context. This differentiation is extremely qualified. **At different stages of economic development and in different countries, the significance of individual institutions can play quite opposite roles. A striking example is that of private property and competition, the restriction of which is typical for catch-up development as a stage of mature industrialism. In a post-industrial society, guarantees of private property and the stimulation of competition are (or are capable of being) important contributors to progress.**¹⁹

A structured policy. In a post-industrial context, competitiveness can be a significant factor of economic life. Instead of direct state involvement in economic life, **the state must now, first and foremost, provide the opportunity for individual economic agents to make decisions and bear the responsibility for the outcomes of their implementation.** In other words, the state must minimise the taking of decisions of an individual nature and instead focus on consistent support for unified rules of conduct.

In the early stages of preparation of a strategy for catch-up economic growth, however, individual decisions may be dangerous. It is still nearly impossible to define the comparative advantages of the country, and it is highly likely that any decisions to support (even give moral support) to individual sectors will be harmful to the extent they are a restraint on the national economy. In the economic structure created, the most influential and financially independent actors will, as a rule, be sectors of the traditional economy that are unlikely to contribute much taking the economy to the next level. Yet these are the very actors with the highest potential for lobbying. They can be expected to seek to impose their own interests in terms of national priorities.

It is not an issue of today's most efficient sectors pushing for policies that will ultimately be ineffective. Obviously, the simplest solution is to grant them a political income to preserve favourable conditions for their industries as long as possible. But as long as the state supports them, it is preserving existing structures developed and missing out on opportunities to take advantage of the adaptive potential of the economy. On the other hand, if the state commits to distancing itself from direct supports to individual branches and sectors, it will nudge incumbents to seek new solutions and new effective areas for the application of capital.

To reiterate, the issue here is rejecting individual decisions that assign priorities for separate branches of industry and undertakings. This does not mean a refusal to support an activity which meets a general and sufficiently well-defined criterion. A refusal to support individual sectors and firms certainly does not deny the expediency of supporting, say, the export of non-raw material goods (or engineering products), i.e. support for those who are capable of demonstrating their competitive advantages in an external market, thereby proving their effectiveness on the basis of objective criteria. The issue here then is the appropriate form and mechanisms of support. Naturally, it need not be a question of direct budgetary assistance or other forms of non-market competition.

The refusal to support industry-related priorities does not mean a refusal to support priorities in the taking of economic policy (including budgetary) decisions in principle. Numerous works of research bear witness to the exceptional importance of investing in human capital, especially where it comes to education. While education was important during the industrial era, its importance in the current context cannot be understated. **The ability of the state to focus resources on development of education and healthcare is one of the most important factors in the acceleration of socio-economic development in the post-industrial age.** Moreover, participation by the state in this matter plays a very important role, since in relatively backward countries the opportunities for private investment in education are quite limited.

4 Institutional factors in economic growth

A key question in contemporary discussions on economic growth and the role of the state is the creation of a modern system of political, economic and social institutions capable of meeting the challenges of the post-industrial age. The key role of institution-building is well documented in the literature of the past two decades.

In analysing institutional problems, the solution of which is necessary to ensure a stable economic development and structural transformation of modern Russia, it is useful to single out certain groups of institutions and define their logical significance. There are four groups of institutions.

The first are political and legal institutions associated with guaranteeing civil and political rights of the citizenry, especially economic agents. These defend basic rights, the recognition of which by the state has, in time, become the basis for modern economic growth. This includes guarantees concerning the inviolability of the person and property, the independence of the courts, the effectiveness of the legal system and freedom of the mass media.

Next are institutions that assure the development of human capital. Here we are talking about education, healthcare, the pension system and the provision of housing. It would be a mistake to attribute the current problems of these sectors solely to under-financing. The key obstacle to their development is the lack of institutional reform, i.e. the failure to redefine their purpose for current needs. The majority of existing models for the functioning of the social sphere were developed during the period of transformation from an agrarian to an industrial economy, when different objective conditions existed. The demographics were different, as the population had large young cohorts. The structures of the population and employment were different. In today's Russia, and in other developed countries, the social situation has changed in a real sense. The traditional institutions of social support (i.e. those established at the late 19th and early 20th centuries) are proving to be extremely expensive and ineffective.

Third, there are strictly economic institutions created through legislation to guarantee the stable functioning and development of the national economy. It is the task of contemporary legislation to guarantee economic growth and the structural modernisation of the economy.

Fourth, we have special institutions aimed at resolving specific, concrete problems of economic growth. It has recently become common to speak of "institutions of development," a select group for which the rules of the game applied generally to participants in economic or political life are suspended. These institutions exercise a discrete influence on the economy unlike strictly economic institutions that act on a general basis.

These four groups of institutions are listed in order of logical importance. This does not mean that, for example, economic legislation is not important to the stable functioning of the economy. It is simply that, without any real guarantees of basic personal rights, any economic legislation would just be a dead letter.

Ultimately, guarantees of basic rights form the basis and establish the conditions needed for stable economic growth (at least, in an economy based on private enterprise). Here, we emphasise issues of personal security, protection of property and effective state control, rather than the more familiar set of political rights characteristic of modern market democracies. As is shown by the experience of the last three centuries, confidence in the security of the individual and the preservation and protection of accumulated wealth helps promote active entrepreneurial activity, irrespective of whether the entrepreneur has the right to vote or bothers to exercise that right, or whether he or she lives under a republican or a monarchical system. Much more important for the creation of guarantees of personal rights are a dependable judicial system and the mechanisms for ensuring the implementation of the law. These reduce transaction costs, which translates into increased business competitiveness. The existence of independent mass media helps assure public control of the functioning of these institutions. At the same time, the traditional democratic institutions are also necessary for a country to reach a certain level of socio-economic development, particularly in the case of countries with a large educated urban population.

In recent economic policy discussions, a widely aired view states that modernisation of the political system is not a top priority. Two lines of argument can be traced here:

The first emphasises the specific nature of Russian political institutions (and, correspondingly, the institutions of democracy) compared to contemporary developed democracies. At issue here the Russia's special path of development, not the typical development path of Western democracies. A distilled view is contained in the "sovereign democracy" discussion of the last two years.²⁰

The second argument recognises a contemporary Western model as a benchmark for development of national political institutions. It does not treat such institutions as a necessary condition for consolidation of economic growth at a given stage in national development, nor is stable and visible growth linked with the creation of an effective, modern system of state control. Instead, the focus is on available potential for pursuing a catch-up development strategy based on technological mimicry. Imitation is claimed to initially support high economic growth rates even in conditions of the weak development of institutions. True innovation is only needed at a later stage when modernisation of the industrial branches of the economy has taken place and the political institutions needed to permit further national development have been established.

This is, to say the least, debatable. It is fully applicable in the context of a country completing the transition from an agrarian economy to an industrial one, i.e. industrial modernisation. A

predominantly agrarian population, as a rule, responds strongly in embracing their improved material well-being without raising demands for modern political institutions. An educated urban population, in contrast, is likely to demand certain guarantees, and to this end, is prepared to participate in the state decision-making process. It is for precisely this reason that the modernisation of the state is an absolute priority for the resolution of all the other problems of economic and social modernisation.

The development of human capital is the second most important factor in modernisation. This is a major institutional problem all countries undergoing post-industrial transformation must solve. The present crisis in the social arena is not only the result of the crisis of the Soviet system, it reflects a crisis of the industrial system. The present model of the social state (a model of the development of human potential) was based, in principle, on different demographic and social conditions, i.e. high population growth, predominance of younger age groups, a largely rural populace, and little involvement with a state-provided system of social support. Ageing populations today expect the state to deliver a broad range of social services, so it is necessary to create a radically new model of the social state.²¹

As a result, the search for an optimum model for the development of human capital should look at minimum at real-world experiences – effective systems to meet contemporary challenges do not exist. Indeed, the country that creates a modern and effective model for the development of human capital will benefit from a powerful advantage in the post-industrial world.

Reforming economic legislation also represents an important trend in institutional modernisation. For the last ten years, a good deal has been done in this direction and the country has witnessed the creation of a fairly developed body of economic legislation. Its lack of effectiveness reflects the lack of development of institutions of political and administrative regulation and the weakness of mechanisms for enforcement of the law.

The following basic trends in the development of economic institutions are presently at the fore in Russia:

- The creation of a competitive environment and the overcoming of monopolistic tendencies in the economy. Of particular importance here are the creation of effective and transparent in regulation by the state, the setting of distinct criteria and assuring transparency in decisions relating to state participation (and state support) for individual sec-

tors of economic and social life, and no tolerance for conflicts-of-interest for civil servants involved in regulatory decision-making or state procurement activities.

- Providing incentives and eliminating barriers to entry for new companies seeking to enter the market. This is the most important condition for intensifying the innovation process as new undertakings are willing to shoulder risk and, as a rule, more productive. Here, it makes sense to create an infrastructure of support for new small and medium-sized businesses, to make it simpler for small undertakings to lease commercial space, to create technology parks and business incubators, to widen the system of micro-credits, and incentivise the export of goods with high value-added (including small and medium-sized firms).
- The development of a market for land and other real property, for these ultimately form the basis for property relations and are an important economic source of guarantees of property rights. This is particularly important for new innovation firms as it provides collateral that can serve as a basis for access to credit.
- The development of financial markets as a source of capital for economic growth. This will require increased reliability of financial institutions, the creation and development of new financial instruments to provide savings alternatives to existing forms of saving and a more reliable protections of the rights of financial market participants.

In forming a system of economic institutions, it is sensible to focus on borrowing from EU legislation.²² The *aquis communautaires*, for example, provide a sufficiently successful example of contemporary market legislation that is particularly for us as over 50 % of Russian goods exports go to Europe. Naturally, not all sections of European legislation are appropriate for stimulating growth, but those basic parts dedicated to economic freedoms, anti-monopoly regulation and so forth are entirely appropriate for present-day Russia.²³

However, in moving in this direction it is necessary to take into account an important fact. European economic institutions *demand* European institutions ensure that legislation is implemented, particularly where the judicial system is concerned. One cannot be effective without the other. Even if laws regulating the economy can be readily replicated in our law and practice, Europe's legal framework cannot easily be adopted. A significant amount of time will be needed to reach the needed level of judicial effectiveness. In this, we encounter a fundamental hurdle for present-day Russia.

Finally, a special place is occupied by the *institutions of development* that have become central to the economic policy discussion of the past two years. There is as yet no strict understanding of what is actually meant by this institutional form. In one view, they are organisations involving a private-state partnership. In the other, they are means of directing state financing to projects involving factors that underpin growth. Apparently, the most accurate descriptor here is that they manifest expressions of discrete rules of the game, i.e. the exercise of state power in the economic sphere affecting a limited part of the economic space and specific economic entities.

These institutions of development may be financial (e.g. investment funds) or administrative (e.g. special economic zones). However, this second category is more qualified as non-financial institutions rely on budget spending. Financial institutions include the Investment Fund of the Russian Federation, Vnesheconombank, the Russian Venture Company, the Agency for Mortgage Housing Credit, Rosselkhozbank, Rosagroleasing, the Russian Nanotechnology Corporation, the Russian Investment Fund for Information and Communication Technologies and the Fund for Assistance for the Reform of Municipal Housing Economy. Among non-financial institutions, we mention again special economic zones (industrial and production zones, technology and innovation zones, tourism and recreational zones, ports and harbours), technology parks, industrial estates, business incubators, technology transfer centres and others.

The most important task for the institutions of development is to create conditions for realising long-term investment projects. At present, the share of credits issued by Russian banks for periods exceeding three years does not exceed 15 % of the overall volume of credit. For several reasons, particularly the absence of a credit history affecting practically all the participants in the economic life of the country, private investors have decided to avoid the long-term credit risk posed by such projects. However, there are serious risks in embarking on a course actively based on institutions of development, i.e. using them as surrogates for private business (and private risk) in the implementation of commercially attractive projects, or to support ostensible makeovers of loss-making enterprises or branches of industry that are either politically motivated or provide opportunities for corruption.

Time will tell how effective these institutions prove to be. In principle, the reasons for their creation are easy enough to understand; there is a political desire to support economic growth, speed up diversification of the economy and Russia's export structure, and to help out new firms lacking any credit history. Of no less importance are the country's enormous financial resources that will inevitably become hostage to this political struggle.

However, the fundamental problem with institutions of development is that almost of all of them are, in one way or another, rooted in the industrial era, i.e. a time when the state, under a centralised system, set the priorities of long-term development and marshalled resources to accomplish development goals. In highly dynamic and technologically advanced post-industrial conditions, defining long-term priorities becomes extremely challenging and mistakes become extremely costly.

There is also the unanswered question as to whether it is possible to design institutions of development in a way that they do not contribute to macro-economic destabilisation.

5 Models of socio-economic development

Present-day economic policy discussions address, in one form or another, three scenarios for socio-economic development of Russia: inertia, growing raw materials exports and innovation. The identification and ranking in logic order of preference of these scenarios is useful in making a model for state economic policy.

The inertia scenario. This assumes the continued predominance of the energy and raw materials sectors against the background of steadily slowing growth in the extractive industries, with fuel and energy exports hampered by lags in infrastructure development. Here, it is unlikely that we will see the realisation of large-scale investment projects in industries outside the framework of the fuel and energy sectors. Instead, we see increased disparities across social strata and regions, degradation in the quality of human capital, a reduction in competitiveness of the manufacturing industry and increased displacement of domestic goods by imports.

Growing raw material exports scenario. This assumes active leveraging of Russia's competitive advantages in the energy sector, the implementation of major infrastructure projects allowing an increase in the productive potential of traditional branches of Russian export. Special attention here is devoted to development of energy products and transport. Given the special character of these sectors, we can assume a strengthening of the state's role in the organisation and regulation of economic life. Under this scenario, the necessity of private-state partnerships becomes especially acute. Here, the economy is more exposed to movements in world commodity prices.

The innovation scenario. Here, competitive advantages in the spheres of fuel and raw materials are used to diversify and qualitatively restructure the Russian economy. Fundamental to this effort is a sharp upgrading in the quality of human capital to allow the adoption of hi-tech production approaches. Economic growth could reach 6–6.5 % per annum. In point of fact, this is a scenario of a post-industrial spurt in which Russia is able to find its niche in the division of labour system of contemporary globalisation. This scenario assumes a structural manoeuvre that increases the share of the innovation sector from the present 10 % of GDP to approximately 20 %, with a corresponding drop in the share of the oil and gas sector's contribution from the current 20 % to about 10 %.

With some reservations, these scenarios might be described as the Nigerian, Mexican and Australian scenarios. Nigeria, a country with abundant fuel and energy resources, has seen stagnation in and degradation of its political and economic institutions – even severe political and economic crises. Mexico has enjoyed extensive income from oil that has permitted a significant, albeit uneven, economic growth. There has been moderate diversification of the economy and low development of human capital. Existing institutions have been unable to take advantages of Mexico's proximity to the North American market. Finally, the Australian experience has been a successful one in a country rich in natural resources has leveraged its favourable endowments to diversify its economy. The export of natural resources to China, Japan and countries of Southeast Asia have provided significant resources that could be applied to diversification of domestic production and the creation of a modern post-industrial economy.²⁴

The three scenarios mentioned should not be viewed as alternatives. More accurately, they reflect stages of effort to be invested in moving the Russian economy to a post-industrial level. For events to unfold favourably the inertia scenario must be abandoned and the growing export of raw materials scenario embraced. This provides (at least based on the Australian experience) the foundations for instituting the innovative mechanisms of socio-economic development. In other words, the first and second scenarios are stages on the road to solving the strategic problems of Russian development. However, these versions may also become alternatives if the transition from one stage to another is unsuccessful.

There now arises a key question: How does a country transition from one growth model to another? There are, in principle, two mechanisms: money and institutions. A change in a country's development model may be achieved with the help of state (and state-related) investments in certain sectors of the economy and the implementation of thorough institutional reforms to create favour-

able conditions for the activities of economic agents, as well as stimuli to promote the higher growth of industries that support development of human capital.

It is on this point that we are confronted with the hard choice in choosing a strategy for socio-economic development of Russia. One strategy is based on a *dirigiste* ideology that assumes a leading role for the state in guaranteeing the desired rates of economic growth, with strong backing of the organisational and financial prerequisites. Here, the major players are corporations that are either formally or indirectly under state control. The budget plays an active role in the financing of major economic projects (not just infrastructure projects). Special “institutions of development” are created and called upon to create special conditions for sectors the state deems important. Led by the state, an institutional system is constructed to deal with e.g. problems of property, bankruptcy, activities outside the official economy, and so on.

At a certain stage, this model could conceivably deliver high rates of economic growth, especially if there is a healthy flow of revenues into the state treasury. However, the drawback to this model is the state’s track record of ineffective investment (including those that are private in a formal sense, but effectively belong to the state), compared with investments that actually are private, i.e. the owner really has his own money on the line. State ineffectiveness in investment has two dimensions.

First, ineffectiveness in setting investment priorities is most acute in the high-level of dynamism of the post-industrial era. Today, conditions and priorities already change so fast than even the most effective state bureaucracy cannot be expected to always react adequately or appropriately. The decisions taken by the authorities are always the outcome of a complicated system involving an agreement of interests. Nor are the challenges of our era the sole problem here. Officials may often find it impossible to reverse an agreed decision once it has been implemented.

Second, there remains the more mundane problem of the overvaluing the potential value of investment projects when state (or quasi-statal) resources are involved.²⁵

The alternative approach discussed bases modernisation on creation of a modern institutional environment capable of stimulating stable economic growth and adapting to the current challenges. Modern institutions (appropriately adapted, of course, to the conditions of a given country) provide the most important basis for modernisation of countries pursuing a catch-up development strategy from the transition stage through to a post-industrial level. In implementing institutional development in stages, a modern developed society (institutions of contemporary market democracy) can secure solutions to a complicated set of modernisation-related problems.

Notes

- ¹ See e.g. *The State in an Age of Globalisation*. M.: IMEMO RAN, 2001. The authors of this collection of essays deserve recognition for clearly setting out the argument concerning the inadequacy of general discussions on the economic role of the state in the contemporary world (p. 8).
- ² A number of views on this subject were set forth in succinct form in World Bank reports, e.g. *World Development Reports: From Plan to Market*. Oxford: Oxford University Press, 1996; *The State in a Changing World*. Oxford: Oxford University Press, 1997.
- ³ Mau, V. and I. Starodubrovskaja. *The Challenge of Revolution*. Oxford: Oxford University Press, 2001. See also: McFaul, M., 1989, "1917 can guide '90s Soviets," San Jose Mercury News, August 19 Sunday morning edition, 1990; McFaul, M., "Revolutionary Transformations in Comparative Perspective: Defining a Post-Communist Research Agenda, in *Revolutions Reader*. Stanford: Stanford University; 1997; Goldstone, J.A., *Revolution and Rebellion in the Early Modern World*. Berkeley, CA: University of California Press, 1991.
- ⁴ A more detailed examination of this aspect of the conforming features of the revolution appears in Brinton, C., *The Anatomy of Revolution*. Revised and Expanded Edition. New York. Vintage Books, 1965.
- ⁵ See e.g. Ashley, M., *Financial and Commercial Policy under the Cromwellian Protectorate*. London; 1962.; Aftalion, F. *The French Revolution: An Economic Interpretation*. Cambridge: Cambridge University Press, 1990.
- ⁶ On privatisation under a revolution see Mau, V., *Russian Economic Reforms as Perceived by Russian Critics // Russian Crisis and its Effects*. Helsinki: Kikimora Publications, 2000.
- ⁷ On the political role of economic agents, see e.g. Mau, V.A., *Economics and power*. M.: Delo Ltd., 1995, pp. 45-46. In explaining the domination of interest groups over state institutions, A. Shleifer and D. Treisman write: "In the real political process, where the implementation of political decisions is also difficult, as also their adoption, and where decisions taken depend to a greater extent on agreements between political groups than on the results of voting, elections, in the majority of cases, form one of many arenas in which interest groups compete with one another." (Shleifer A. and D. Treisman, *Without a Map: Political Tactics and Economic Reform in Russia*. Cambridge, MA and London: The MIT Press, 2000. p.6).
- ⁸ Shleifer A. and D. Treisman, *op. cit.* p. 1
- ⁹ For the classical analysis of the Soviet system as a model system, see: Huntington, S.P., *Political Order in Changing Societies*. New Haven: Yale University Press, 1968.
- ¹⁰ Treisman, D., "After Yeltsin Comes ... Yeltsin," *Foreign Policy*, 1999-2000. Winter. p. 83.
- ¹¹ Gerschenkron, A., *Economic Backwardness in Historical Perspective: A Book of Essays*. Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962. p. 19.
- ¹² Gerschenkron, A., *Europe in the Russian Mirror*. Cambridge: Cambridge University Press, 1970. p. 123.

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- ¹³ Huntington, S., *The Third Wave*; Vanhanen, T., *Prospects for Democracy: A Study of 172 Countries*. London and New York: Routledge, 1997; Mau, V., *Economic reform in light of the constitution and politics*. M.: Ad Marginem, 1999.
- ¹⁴ Kuznets, S., *Modern Economic Growth. Rate, Structure and Spread*. New Haven and London. Yale University Press, 1966. pp. 445-453; Huntington, S., *The Third Wave*. pp. 61-63.
- ¹⁵ Kinsella, N.S., "Against intellectual property," *Journal of Libertarian Studies*, Vol. 15, No. 2 (Spring 2001).
- ¹⁶ At present, a number of researchers are carrying out international comparison of the indices of economic freedom on the basis of a set of criteria (including budget burden, stability of the banking system, the extent of corruption, the development of political freedoms, etc.). However, such measurements suffers from the fact that most of these parameters are based upon expert assessments of the state of affairs in the countries being analysed, which makes the results extremely vulnerable to charges of subjectivism (see, for example: O'Driscoll Jr., G.P., K.R Holmes and M. Kirkpatrick, *2001 Index of Economic Freedom*. Washington, DC and New York: The Heritage Foundation and the Wall Street Journal, 2001). The ratio of budget burden to GDP, while a fairly objective measure, should be used with appropriate caution.
- ¹⁷ Illarionov, A. "Economic freedom and the well-being of peoples," *Voprosy ekonomiki*, 2000, No. 4; Mau, V., "Liberalism in earnest and for a long time," *Ekspert*. 2000. No. 11; Friedman L.A., M.V. Vidyasov and V.A. Melyantsev. *State expenditure (consumption) and economic growth*. M.: RESH, 1998.
- ¹⁸ "Principles and procedures for evaluating the expediency of state regulatory measures." M.: TEIS, 2005, pp. 7-9.
- ¹⁹ See "Imported institutions in countries with economies in transition; effectiveness and expenses." Scientific works IEPP No. 68P. M.: IEPP, 2003.
- ²⁰ The discussion materials on this subject are presented in a collection of articles under the title: *For a sovereign democracy*. M.: Evropa, 2007.
- ²¹ For detailed commentary, see: Gaidar, E.T., *A long time*. M.: Delo, 2005. Chapters 12 and 13.
- ²² See *Common European Economic Space: Prospects for Interrelations between Russia and the EU*. M.: Delo, 2004.
- ²³ For detailed commentary, see Mau, V. and V. Novikov, "Relations between Russia and the EU: A space of choice or a choice of space?" *Voprosy ekonomiki*. 2002. No. 6.
- ²⁴ For detailed commentary, see: Mau, V., "The Russian economy: Strong and weak aspects," *Ekonomicheskaya politika*. 2006. No. 2; Breech A., "Russia's road to prosperity in a post-industrial world," *Voprosy ekonomiki*. 2003. No. 5.
- ²⁵ For an interesting analysis of the effectiveness of dealing with state investments, see Floberg, B., "Strategic evaluation of the planning of major infrastructure projects," *Ekonomicheskaya politika* 2006. No. 1. Floberg investigates the experience of developed market democracies where high standards of state decision-making are typical.

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