

State University – Higher School of Economics

*Reduced version was published
in 'Problems of Economic Transition',
Vol.42, No.12, April 2000*

**Y. Kuzminov, S. Smirnov, O. Shkaratan,
L. Yakobson, A. Yakovlev**

**RUSSIAN ECONOMY: INSTITUTIONAL
CONDITIONS OF SURVIVAL AND DEVELOPMENT**

Moscow, 1999

This report has been made by a State University – Higher School of Economics team of professionals for the Russian Council for Foreign and Defense Policies in January 1999. It was first presented in February 1999 during the VII Assembly of the Council. Following a series of important discussions in March and April the paper was considerably amended and improved to take its present shape as we finally offer it to a broader audience.

This paper puts forth a comprehensive set of measures to address the current economic crisis, prevent its further aggravation and ensure sustained and ongoing development of the Russian economy. In this study we seek to adopt the viewpoint of common sense and keep free from political and ideological bias. This is why we believe the proposed solutions should be implemented by any reasonable government irrespective of its political coloration.

This text presents our vision of the Russian economy and its problems. We would like to acknowledge Vad.V. Radayev (Russian Academy of Sciences Institute of Economics, Intercenter), Ye. Gavrilentov, T. Klyachko, A. Kryshtanovsky, S. Malakhov (all from State University – Higher School of Economics), who have kindly shared their materials with us. We also greatly appreciate important professional comments and suggestions, provided at different stages of report preparation by A. Abramov, K. Bendukidze, V. Bessonov, V. Boblyov, S. Glazyev, L. Grigoriev, M. Delyagin, E. Yershov, S. Karaganov, V. Lyubovny, V. Mazayev, S. Mdonyants, L. Onikov, A. Svinarenko, A. Sitnin, S. Titov, Ya. Urinson, V. Fadeev, V. Fedosov, D. Khilov, A. Sharapov, A. Sharonov, B. Shtulgerg, Ye. Yasin and other colleagues.

Introduction

The current economic disarray in Russia cannot but cause serious concern and not without reasons. However action programs suggested by economists in government as well as by their opponents to respond to this concern and address the challenges of Russian economy fail to mobilize any public support. Many of these programs have considerably affected Russian economic policies and the public sentiment in the country. However none of them were actually implemented with regard to results projected by the authors. To account for these failures the authors would refer to counteraction of political opponents, self-interest of business, impatience of the population – in short all the factors that should have been considered and reckoned in at the very early stages of program development. Similarly the forces that have not yet been in government will also generate programs whose successful implementation presumes cease-fire in political in-fighting and newly learned patience and endurance.

Of course we would like to see these programs realized. Yet we can hardly expect all the implied presuppositions to happen overnight. And what shall we do if in the near future our citizens fail to develop any extraordinary qualities, or at least become enterprising and law-abiding, and no spectacular take-offs will happen with the level of political and economic culture? International and domestic experience demonstrates that “education of a new man” (communism builder or model businessman) is a far more challenging task than macroeconomic stabilization. To achieve a rapid reformation of a grown-up, repressive measures are required. However they might be appropriate only in regard to a negligible minority of social outcasts. Otherwise the “education” solution can entail all-out terror fraught with social and economic collapse.

If we accept these arguments we shall have to give up the genre of economic programs as it has evolved over the past decade. This genre combined professional economic projections and elated optimistic belief in total manageability of the processes beyond the terms of

reference of economics. In most cases these programs would follow a common pattern:

- Stated impossibility to allow the current sluggish course of events continue as it does;
- Set a number of economic development benchmarks seen as indispensable by the authors;
- Established key economic (chiefly macroeconomic) constraints required to meet the benchmarks set.
- Defined requirements for economic (including microeconomic) and social conditions (parameters) determined by the key limitations.
- Declared the above points the national agenda without any thorough feasibility studies and any detailed development of implementation mechanism.

The above scheme attributes primary importance to macroeconomic **indicators**, while human and business **behavior** is largely neglected. But in reality these indicators are no more than very general indicators. They can be accepted as a reliable guide only when business behavior models have been accepted and are not expected to change.

Why this way of devising programs? Indeed in the environment of new democracy and steep social expectations election victory was possible only for politicians who would promise a miracle. They needed support from economists who would really believe in this miracle and design it. These were odd (unrepresentative) economists because typically the science, focused on rational use of limited resources, will attract mostly those who tend to be skeptical about the limits of choice guided by the *no free lunch* principle. However even the economic community has some optimists fewer as they are than in other professions and trades. This optimistic segment of the economic professional community came to the fore in the 90s. In some cases optimism just served to disguise their incompetence or less than

conscientious approach. Yet in most cases it arose from conviction that unlike “economic” constraints their non-economic counterparts can be dealt with by political will.

What is coming below is no program as we have come to know them. It is rather an attempt to understand what is happening and suggest solutions to avert the worst. What we have in mind is nothing more but concrete actions, stripped of any mythology, necessitated by the current situation and common sense rather than abstract ideals of liberalism, socialism or nationalism for that matter. We do realize that no final or comprehensive list of such actions or measures can be drawn. Yet we would argue that some elements of realistic strategy are quite practicable.

An election year is hardly the right time for politicians to agree with us. Politics unlike economics abhors pessimism as a symptom of professional inaptitude: strong faith in omnipotence of power is absolutely necessary if you choose to fight for it. And yet we are anxious to share our considerations for them to be readily available when they are needed. We are afraid this time is still to come.

1. Myths of economic policies

Economic policies are guided either by specific private interests (tactical) or by formal aggregate indicators (strategic). It seems evident that the Soviet economy could not be reformed on the tactical or adjustment level. Transition to new ownership pattern and new economic units’ coordination required a break from the task of balancing the immediate interests of households and businesses. But unfortunately this transition happened to be inordinately long with the “high-flown” economic policy embarking on a life of its own and taking on a rather irrational character.

Given the strategic lagging of institutional and social reforms the declared macroeconomic objectives (stable ruble, free market, open national economy, etc) were considerably drained of their meaning. As a result keeping inflation low and currency rate stable became an end

in itself, as the barter system was taking firm root in the economy, with money forced out by its surrogates and public finances in disarray.

In the process microeconomic policy was subordinated to fiscal objectives, trying hard but to no avail to meet the inflated fiscal targets. On the level of individual enterprise, investment resources were siphoned off by inordinate taxes, while on the budget level they were pumped out by payments on lucrative government paper. The currently available economy of non-payments, barter and unaccounted cash circulation struck root and blossomed in this fertile soil in 7 years. Essentially it is nothing but instinctive response of businesses to this irrational business environment.

A sequence of failed attempts to stabilize the ruble coupled with lopsided budget and abysmal economic performance year after year forced the government to resort to aggressive political and propaganda support. The cost of these resources was the ever-increasing dependence of the top leadership on certain financial groups. The oligarchs went through two stages in Russia: in 1991-1995 they capitalized on the monopoly conditions, specially created for them (export quotas and import concessions), while in 1996-1998 – on highly remunerative budget crediting and servicing of budgetary flows.

In the distorted realm of indicators business activity serves either to exploit the myths used to disguise plunder or to ensure one's own protection against this system.

For many years market reforms have been associated with these policies, which has badly undermined the willingness of Russians to welcome the market. The latest polls show more people prefer rationing and regulated prices to runaway inflation.

Russia has worked itself in a catch-22 situation: the current Government would like to adopt the policy of balancing real interests, but it cannot do it because of the outstanding budgetary problems, primarily unreformed social sector and labor relations. The situation is aggravated by too many inefficient enterprises and lack of working mechanisms to close them down.

The country has actually depleted its strength. The government has no more resources – neither administrative nor economic – to address its most urgent social and economic problems. The government to come might have the necessary resources but that government will probably be civilized no more.

2. Survival parameters and development constraints

The looming resource depletion calls forth an economic policy focused primarily on ensuring every Russian citizen with a *critically required level of security*. In our view it includes the following:

- Protection from hunger and physical privations; preservation of the basic systems of life support ;
- Access to basic education and health care;
- Social peace, insurance of fundamental human rights, no ideological, class, religious or ethnic identity persecutions;
- Rule of law, fighting crime;
- Preservation of the nation's cultural heritage, of its spiritual development potential, vital for the perpetuation of Russian identity.

The economic policy formulated in this way will **help the country survive**. But survival does not mean development. The above policy implemented will only put off the national catastrophe if no **preconditions for development**, for onward movement are in place. The only way to have it done is to create an environment conducive to *maximum mobilization of resources currently held by business and population*. Resource import or borrowing is constrained by the huge foreign debt and the world-wide lack of trust in the Russian economy and the Russian state. It appears we can expect foreign investors only after we stabilize politically and economically.

Proceeding from the above the following basic economic and social constraints for the Russian economy shall be specified.

Foreign debt burden. This is a critical factor, bearing in mind that international isolation of Russia, should we default on our debt, is sure to result in losses considerably higher than the amount of the debt itself. This is why we'll have to pay it. On the other hand it is evident that Russia is incapable of paying its debt soon and the West will have to settle for some option of debt restructuring. However it seems no less evident that the creditors will not buy the "soft" restructuring scheme, allowing the Russian budget to accumulate resources before it pays off its foreign debt. In this context any hopes for massive government investments propping up aggressive industrial policy, as well as for direct government support to businesses in the near future emerge totally groundless.

It is self-evident that foreign debt restructuring cannot happen overnight. It is sure to take at least several years. During that period "creeping" default can hardly be avoided: business partners of Russia will abstain from making investments and even from crediting foreign-trade transactions. Governments of leading industrial nations will be facing a dilemma: either to continue giving support to Russia (i.e. provide government guarantees to their firms, who invest in Russia or trade with Russia) or back from support to Russia. And this decision-making process will be determined rather by our Western partners' idea of the political and economic path we are heading for than by agreements as such.

This generates an important *political constraint*. Given the abated interest to our country, Russia (not only the executive branch but the whole system of its political institutions) must be constantly making visible attempts at building a sound and potent government, capable of ensuring legal, social and economic security, preserve the freedom of speech and entrench private property institutions.

Inflation. In this year (and probably in the year of 2000 as well) considerable inflation seems unavoidable. Its parameters depend on operational specifics and defy accurate projecting. However it seems evident that inflation can be reasonably curbed (within 50%) only in case we preserve the current underfinancing of the social sector. Meanwhile since August 1998 inflation has already gobbled 30 % of

real earnings, 40% of wages and 50% of pensions. The population cannot stand this pressure for much longer. In the summer of 1999 pensions and salaries of government employees will have to be price-indexed, which is sure to push further the inflation spiral.

The state of the budget also predicts higher inflation. The execution of the budget in most part comes from set-offs as before. Deferred debt is still accumulated. Government expenditures keep outweighing revenue collection. In this context the current government policy ultimately would mean deferred, unpredictable, bumpy inflation, rather than straight-line high inflation.

That means we can scarcely expect business and population to have trust in the national currency. The currency insecurity factor is to grow dramatically: dollars will serve as the basic unit of saving and lending, while borrowing in dollars will be avoided. All this renders futile any hopes for normal operation of loan and insurance institutions.

Dominance of the shadow economy. Clandestine business operations are estimated at a third – 50% of Russian GNP. This sector has become so vast that it has developed its own competitive environment. Whole big sectors of business – ranging from automobile trade to show biz - do not pay any taxes at all. It means a businessman who chooses to pay all the due taxes and fees, automatically becomes unable to meet competition in the industry. Apart from lost revenues the problem has another dimension: the “gray” profit derived from these operations will be wasted on consumption instead of being plowed back. Thus the shadow hyper activity serves to perpetuate the current doldrums. To push the markets out of the present “gray” equilibrium the government will have to carry considerable costs of lower taxes and more vigorous traditional (police) ways and techniques to combat black economy and corruption.

Government inability and government credibility crisis. Over the latest years specialized international agencies keep quoting Russia alongside Nigeria and some other African states as one of the most corruption-ridden governments in the world. The population and businesses no longer expect the government to cope with its major

functions including protection of its citizens, their property and contracts, neither do they any longer wonder when it fails to pay its bills. Government guarantees can scarcely raise any money. The habit of safe contract-breaking tends to limit the market by a small club of long-time reliable partners which inevitably results in less effective transactions. The government will have to take extraordinary steps to improve its credibility, which will claim major budgetary resources.

Transaction costs. Inordinately high costs of market entry and exit as well as operational contract costs tend to drive the firms who have any export possibilities to minimize their Russian market even when there is no price incentive. This will inhibit a fast and full substitution of the “import” lost, resulting in empty rather than restructured markets.

Low economic and technological culture. This factor is to generate lower competitiveness of Russian economy in the medium-term period. To a large degree it will account for investors’ low interest to the Russian manufacturing industries.

Physical survival. Recent sociological surveys say that the crisis has increased social differentiation, deepening social cleavages, since underprivileged strata had no savings to cushion the 1998 autumn outburst of inflation. As a result today we have to address the issue of physical survival of those who failed to adapt to the new economic environment. Expenditures on these purposes will make one of the critical fiscal parameters for the next few years.

Demographic situation. As the population will age dramatically in the 5 years to come, the problem of pensions and senior citizens security will aggravate beyond comparison. To address it the government will have in all probability to raise the retirement age, which, in its turn, can backfire with tenses employment situation.

Social payments and their sources

As the government will be forced to index salaries of government employees and pensions, overstraining the budget, the federal and regional governments will face a rearrangement of the old balance of their authority and responsibilities. Social tension will automatically translate into “center-regions” tension.

3. Available resources to be channeled to development

Material factors. Russia has always been a land fabulously rich in natural resources. For many years they were exploited to alleviate social tension. In the process the resources were grossly squandered, mismanaged and wasted. The recent decade despite introduction of market relations has not proved any different. However Russia still has a wealth of natural resources that can and should be put to use to develop the national economy.

The basic production assets of industry currently operate at less than half stretch. They were built in the centrally planned socialist economy with all the disproportions and distortions of that economy reflected in their composition and structure and inherently non-competitive products. The fact that Russia has to use them classifies it as a “transitional technology” country. That means this resource is simultaneously a limitation. In most areas of technology we cannot compete in the world market and will have to settle for the FSU division of labor with certain markets gradually falling out. For example, the pharmaceutical industry among its 450 licensed companies has only 2 enterprises and 35 minor sections that meet the world standards with another 5 companies running up. However there are some relatively advanced production capacities in the light and food processing industries, in transport and heavy engineering, in metallurgy and chemical industry. Their operations on the domestic market may help the enterprises to accumulate resources for further technological refurbishment. In the industries more tightly constrained by the world standards (electronics, defense industry, shipbuilding, aircraft industry, automotive industry) imported technologies and capital in most cases will be the only option for development.

In the next few years domestic enterprises operating on the internal market will still face a lot of difficulties in importing technologies . Dramatic depreciation of domestic demand in dollar terms scares off foreign investors. Essentially this predetermines widening and aggravating the present lag in technology in a number of industries.

Investment resources. It should be emphasized that unlike public finances and banking system badly hit by the 1998 crisis, the real sector is indeed doing not as badly as it might seem. Many industries have gained from the ruble fall. On top of higher growth rates of selling prices against costs competitive import was also undermined. The spectacular surge of the dollar rate restored partial competitiveness to whole groups of domestic goods, including even consumer electronics that seemed irrevocably extinct by mid 90s. This shift in demand to domestic goods generated extra demand giving a boost to Russian domestic production.

The same refers to savings of the population. Strongly mistrustful of the government and the banking system, individuals tended to save in dollars “stacked under the mattresses”. Thus they were “indexed” and the crisis ultimately produced higher purchasing value of dollar in the Russian market (given inflation lagging behind the dollar growth) that relatively raised investment possibilities of households.

Now the challenge is to mobilize these financial resources of businesses and the population and commit them to economic development.

Human resources. For a long time Russia has featured a high level of education as compared to average wages. Recently (over the latest decades) the situation has deteriorated – caused by emigration of more skilled professionals and by the crisis in the system of education, initially dependent on the budget. However we are not to lose our competitive advantages in this area for another several years. We still have the skilled personnel (aging as they are) of high-tech defense industries, we still have our first-class scholarly and scientific research institutions of the Russian Academy of Sciences and leading Russian universities.

To ensure Russian economic growth the system of education must be injected with major investments to support its competitiveness and make appropriate adjustments in regard to transformed labor markets. Primarily it refers to general education and elementary vocational training. Elementary and secondary school in Russia lasts for 10-11 years, while in most developed countries it covers 12-13 years. Secondary school fails to provide school graduates with vocational or economic skills. The

system of vocational training artificially targets less academically advanced students (PTU-vocational technical schools), is poorly equipped and fails to follow demand. Educated and adequately trained workers are vital for the Russian economy to preserve its status of a developed economy. Otherwise it will be reduced to the role of raw material supplier.

Civic engagement. The years of reform have once again proved a high level of educability, open-mindedness and social adaptation of the population against the background of gradual fading of hopes for government assistance. In this sense the most recent transformations have boosted civil engagement, motivated though by survival in most cases. This engagement was framed by family and clan rather than by enterprises or civil society institutions. At present over 60% of population consider themselves active (independently surviving). Survival-driven activity is primarily about adaptation to the status-quo (no matter how inefficient it might be) of institutions and markets, while development requires new organizations and markets to be established. Over the past decade business initiative has mostly worked to devise ways to “privatize” and squirrel away old enterprises. Only a fraction of these resources was channeled to establish and develop new efficient enterprises with most of resources consumed or exported.

Thus one of immediate priorities is to switch civic activity on the microlevel from survival and consumption to development. This challenge requires realistic and sound actions on the part of the government. It should develop mechanisms to monitor social interests and fine-tune its social and economic programs to them.

In this context a new social stratum shall be mentioned, that has largely emerged over the past decade. These are people who started their active life under economic and political freedom. They were less burdened by the Soviet heritage. They featured high social mobility. These are the reasons why they filled in the newly emerged structures both in business and in government. They are the people who took advantage of many development possibilities, generated by reform.

However their major limitation was the short-term goal-setting (“snatch and run”). This mindset was largely induced by the state policy. And yet we believe these people today, guided by their own

experience, are capable of switching to long-term development goals, of adopting fair play rules, if government on its part can guarantee that these rules are observed.

This social stratum is a most important resource of our society. To tap it we must tell the truth to these people, we must give them a chance to trust the government. This should go hand in hand with the establishment of appropriate democratic institutions to enforce the government's words and promises.

4. Approach rationale

Russia is living through a decade of uncertainty. Vague future distorts motivation and behavior of all economic players from households who spend their limited savings on excessive and even conspicuous consumption to enterprises who are reluctant to leave their narrow market niche, including the state who squeezes its future taxpayers unmercifully instead of providing for its tomorrow revenues. Nobody is willing to invest. Everybody is concerned about his property – but ironically fails to take any wise decisions about it.

Available resources can be effectively exploited only provided the state takes measures to dramatically change the motivation of all economic agents. This will require:

- Maximum consideration for *private interest* and removal of any obstacles to businesses and individuals in their economic activity;
- Alleviation of pervasive uncertainty, establishment of “predictability zones” for economic players.

To achieve the above *macroeconomics* prescribes a sound monetary system, in other words a stable national currency. Theoretically predictability might be possible under inflationary conditions as well. In this case its parameters (emission parameters) should be planned, shared by all the market participants and most importantly should have been regularly observed for a number of preceding years. This scenario was at times implemented in a number of Latin American states. In

Russia in the coming two years neither stable currency nor planned inflation is practicable. Thus macroeconomic uncertainty is here to stay.

This is why we have chosen quite consciously not to focus on macroeconomic policy. On the one hand dozens of professionals of every political feather have made their statements on this and offered a variety of forecasts. On the other hand we believe that budgetary proportions, currency rate, inflation rate and other macroindicators will ultimately depend on the microlevel situation, defined by changes in the behavior of enterprises (as argued above). In this sense the issue of tough monetary policy or “regulated inflation” policy becomes secondary.

In arguing so we do realize that the macrolevel has its own critical constraints. Ultimately we cannot meet the crisis without a sound well-balanced budget and surplus foreign trade. Massive inflationary financing of government programs after a brief surge of activity will only aggravate the crisis. *However these macroconstraints cover a wider area than microlevel constraints.*

The above does not mean however that we are not concerned about macroeconomic policy. We feel it should pursue three objectives:

- 1) To control inflation, as much as the budgetary commitments permit.
- 2) To keep up the parity between the inflation rate and the ruble fall against the major world currencies; to ensure against loss of competitive advantages, acquired by domestic producers in autumn 1998 when price proportions changed.
- 3) To keep the budget well-balanced, to meet unequivocally all the government obligations.

Microeconomic stabilization prerequisites include institutional stability, which makes economic actors try and reproduce as much stability as they can. Households will save in foreign currency and keep their savings in cash, enterprises will keep the entrenched business ties, regional governments will support the social status-quo,

obstructing closures of inefficient enterprises. In most cases individuals (and businesses) tend to start a new business preserving the old one just in case. This also gives rise to widely spread secondary employment.

Against this background government actions have been a troubling and destabilizing factor. The initial period of reform must have necessitated it, because it was vital to break the inertia of centrally planned economy. But today the situation is fundamentally different. The state is in no position to impose economic order on citizens and businesses. The current economic order, which has evolved largely irrespective of the government's intentions, is a sophisticated framework featuring three fundamental components:

- Paternalistic institutions inherited from socialist state (especially in the social and official labor spheres);
- New formal market institutions, with largely distorted significance;
- Informal market institutions as sustainable forms of business and population adaptation to the irrational economic environment.

Primary importance is attributed to mutual maintenance of obligations between government and citizens, among enterprises, between enterprises and citizens, between enterprises and government. To achieve this, obligations must correspond to the realistic possibilities of the parties.

For the first part *the state* must get itself out of the zone of permanent uncertainty to be followed by economic spheres of direct regulation. This will create oases of stability to attract other elements of economic life. It requires the following:

- 1) predictable changes in the norms and actions of the government;
- 2) clear and simple administration of law. Legal acts, regulations and decrees shall have direct action and be tested against ambiguity. Given the current shortage of quality professional legal services, most citizens and businesses have to face legal uncertainty, dominated by club law (or rather money-law). The legal system of

developed countries with their several hundred year history of judicial institutions can hardly serve a model for imitation for us. The Russian system of civil law needs streamlining;

- 3) removal of discredited inefficient institutions;
- 4) pinpointing irrationality and removal of reasons for irrational behavior;
- 5) regulation should follow the observable interests (any action in economic policies shall be backed by social support of certain social groups).

Below we list concrete steps and measures to be taken in the economic and social spheres, as well as in public administration. We believe these measures will work to stabilize the situation and create objective prerequisites to overcome the crisis. The measures suggested are viable even under relatively high inflation, though in this case they will be less effective.

5. Enterprises and households

Taxes and private investment make the key factors in the economic arena today. The former are essential to pay off the foreign debt, to finance a strong state and ensure at least minimum social protection. The latter are vital for industrial restructuring and economic growth. However in both cases businesses and households must be *willing to and capable of* paying taxes as well as of making investments and savings in legal and civilized forms.

Willingness to pay taxes and make investments in Russia as we see it is determined by incentives for legal business operations and negative incentives motivating businesses and households to opt for tax evasion. In this sense **stability and transparency** of property relations become crucial factors to ensure *correct motivation* of firms.

Everything said above does not in any way imply that the present, at times quite irrational and vague framework of property relations

should be fixed and perpetuated. Redistribution of property will certainly be necessary in cases when law was broken in the course of privatization. On the other hand we should be fully aware that the risk of arbitrary unreasonable redistribution of property initiated either by the state or by largely independent managers of major enterprises today can set one of the worst negative signals to businesses. In the absence of clear-cut guarantees of long-term property control over their companies major shareholders will opt for short-term quick gains. And this would also mean every form of tax evasion (since the advantages of law-abiding legal behavior are expected to yield fruit only in the long-term period), as well as siphoning off financial resources from enterprises under control. All this refers to investment. As things stand now major shareholders will at best invest in short-term lucrative projects thus impairing possibilities for restructuring and nipping growth.

From this perspective special importance is given to measures seeking **to reveal information about joint stock companies, to regulate transactions with affiliated entities, to protect shareholders' rights, etc.** No less important is **further elaboration of the bankruptcy procedure**, seeking to reverse the current arrangement when an external manager tends to act in the interests of one major creditor or a group of such creditors and objectively contributes to the sell of the bankrupt company rather than its reorganization. It is also important that the change of ownership in case of conflict should happen through transparent and open judicial procedure. And yet we think that even these solutions are inadequate today. More drastic measures should be considered, primarily as regards the outstanding accounts payable accrued by enterprises.

We contend that the backlog of outstanding payments to the budget makes a critical factor in terms of setting negative motivation signals to real sector companies. In a sense we are in for a deadlock here or an institutional catch-22. As the government faces mass tax arrears, it naturally is unable to bankrupt all its debtors. As a result the government fails to meet its "administrative obligations" to enforce laws. At the same time the recurrent (on and off) threats voiced by the government are more than sound and fury, as every individual

enterprise is indeed running the risk, probably increased today, of being exposed to bankruptcy procedure if only to teach a lesson to others.

Incidentally it appears that the “victims” for such “demonstrational procedure” are selected arbitrarily and depend exclusively on the whim of an individual official. No wonder such activities scarcely have any direct positive effect on the budget. At the same time such actions taken on behalf of the government serve only to aggravate the risk of arbitrary property redistribution thus contributing to increased capital flight from Russia, since most enterprises cannot possibly manage to pay off the whole amount of their accounts payable (which is in fact acknowledged by the government).

The growth achieved by the major import substitutors in October-December 1998, negligible as it is compared to the size of the market niche and to idle production capacities, testifies to the fact that the most fundamental problem of domestic industry is not just lack of working capital but excessive caution of companies in taking development decisions and their distrust of the legal and economic environment.

This is why to achieve a sizable turn-around in industry we need a **complete and unconditional restructuring of the debt owned by enterprises to the budget and to social funds**. This measure will help to reverse the destructive effect of the tax arrears accrued by the companies on their behavior. The restructuring should involve a write-off of all the fines and penalty fees incurred by the companies and a five-year freeze of the principal amount of debt without any preconditions, provided for in a series of government regulations in 1997-1998. Also needed is a **long-term restructuring of debt to federal, regional and local natural monopolies**, still largely under government control.

The strategy designed to lift negative incentives should also be applied to individuals. Today the prevailing arrangement for natural persons (especially well-to-do and wealthy) is to get the bulk of their income in an unreported or “grey” form. A part of this income is invested in the

development of small and medium-size businesses – through black working capital financing, through unreported payrolls for new employees. Yet investment possibilities of such unreported grey income are objectively limited by the scope of the grey cash flows. As a result from the national economy perspective this income is either guzzled away (as exemplified by recent rush of Russian tourists to international resorts), or falls out of business operations, stacked under mattresses in foreign cash. **Tax remission legalizing all the previous grey** (but not criminal) incomes of households would have rendered these investment resources available for the official “white” sector of the economy.

It can be argued that the proposed measures will discourage businesses and citizens from paying their taxes. We would think this is an illusion. People pay taxes (at least in present-day Russia) not out of their free will but under coercion, when they cannot find a way to avoid it. The overwhelming part of tax revenues is collected from the citizens, employed in the “white” sector with their taxes routinely deducted from their payroll amounts. Not infrequently the same people would not pay any taxes on their concurrent earnings in the “grey” sector. Today tax payments and contributions to social funds by enterprises are at present directly dependent on the administrative pressure the government exerts on them.

But that would mean that economic agents normally do not expect the state to exert this pressure or to be subjected to relevant sanctions on the part of the government. We must admit that today these expectations prove quite accurate. Indeed the mass of government “administrative obligations” has by far exceeded its possibilities. In this sense restructuring of the tax debt and tax amnesty can bring the situation back to rationality both for the government and for taxpayers. It is evident however that such measures can yield positive effect only provided both of the following requirements are met:

- If the majority of businesses get a realistic possibility to pay taxes (at least in the amount of current payments) and make legal investments;

- If unavoidable penalties are introduced to deal with new nonpayers and incentives are created for “white” business activity.

Without the first measure it won't take longer than a couple of months for nonpayments to snowball as big as their present forerunners, which will again make inefficient the bankruptcy procedure and will reduce to nothing any possible positive effects of debt restructuring and tax amnesty as regards the motivation of enterprises and households. Besides we should not forget that there can be only one tax amnesty . Otherwise nobody will ever pay taxes at all.

In our understanding specific steps taken to ensure the first requirement belong largely to the field of structural adjustment and industrial policies. This is why we intend to consider them in the next section of the text. At this point we would like to discuss conditions required to discourage businesses from informal operations and tax avoidance.

First it would be advisable **for enforcement agencies to be more active in counteracting direct and blatant tax evasion.** However such actions (launched today) can yield higher tax revenues only in case private business is fully aware that this is not a one-time campaign. This is not about squaring accounts with a number of individual enterprises, but about a comprehensive system of regular activities. To achieve this these measures should from the very beginning cover all the regions, all the economic sectors and cut across the political specter in regard to individuals.

Such measures should target both big business, who in their tax-evading efforts frequently resort to transactions with affiliated mediators, pocketing of export revenues, various deposit and insurance schemes, etc, and small and medium-sized business, who normally evade taxes by means of unreported cash flows. It should be borne in mind at the same time that recent years have seen considerable decrease in profits of small and medium-sized business, caused by keen price competition. This is why any higher tax revenues from these sectors can be expected to entail higher prices, because producers will try to use them to recover their costs of tax payments and contributions to social funds. This trend will first of all show in the consumer market, dealing more than other markets in unreported cash. Layoffs in this sector

will in most probability be followed by unemployment rate growth in big cities and higher social strain.

To take care of the possible negative aftereffects the measures to combat tax evasion should be taken in conjunction with **anticorruption activities** covering every level of government, because today small and medium-sized businesses have to give bribes quite comparable to the taxes they seek to avoid. If they have to pay both bribes and taxes they hardly will be able to continue their operations and will have to close down with all the attendant social implications.

Another important package of measures shall seek to change motivation of employees and encourage them to opt for “white” wages instead of “black”. Today they fail to see any connection between their current social contributions (tied in with their “white” wages) and their future incomes or social security, employees agree to “black” remuneration if it is at least slightly over their official “white” salary for the same work. Thus the only factor deterring small and medium-sized businesses from retreating in the “shadow” zone is tax police, whereas normally the economic interest of the majority of employees should have played that role. We argue that only explicit personalization of social contributions can break the situation, when employees will no longer view these contributions as another exaction charged by the state, but will see their direct relevance to their future incomes.

6. Markets and industries

Most enterprises cannot meet their taxes and legal investments because *their costs are too high*. To some extent they come from inefficient management (requiring a wider practice of bankruptcies and financial reorganization). However for many enterprises during the recent years it was the unreasonable government policies that kept costs higher than market prices. This is why industrial policies today should first of all involve measures to bring down the costs in the real sector or redistribute these costs, by means of restructuring among other ways and methods. These policies should cover the following areas:

1. ***Protect the domestic market and enhance competitiveness of domestic products.*** One of the gravest errors of the early 90s economic policy was a hasty opening of the internal commodity

market, as important barriers for direct foreign investments were preserved and no practicable mechanisms of marketizing restructuring were in place. In this situation competitive imported goods that flooded in, coupled with invariable lead of ruble inflation as compared to the dollar growth, plummeted demand for domestic goods. At the same time the embryonic financial market and inadequate foreign investment brought about unreasonable interest rates, served to preserve old inefficient technologies, thus contributing to artificial raising of costs.

We do not mean to say that Soviet industry produced quality goods. Most of its products indeed could not compete in *the world market*. But Russian enterprises did not get any time to restructure and get adjusted to the new environment. This is why too many of them found the upsurge in competition in mid 90s rather destructive than stimulating.

The ruble devaluation in August 1998 served to cushion this effect and provided a time-out for the domestic industry. Today our “transitional” goods are winning back their share of the market, because the difference in production costs is immense. For the first time in years domestic carmakers and some other producers got export orders. Yet there can be no doubt that this time-out will not last long, and we must make good use of it to implement meaningful and sound industrial policies.

The underlying logic of our medium-term industrial policies should arguably seek to preserve a relative closeness of the domestic commodity market and to open as much as possible for direct foreign investment. And this should be the framework for decision-making about Russian membership in the WTO.

To meet this objective in the sphere of monetary regulation the correlation between inflation and dollar growth should be kept up in such a way as to preserve the protective barrier created by the devaluation for another 4-5 years. **The exchange rate regulation policy should be clear and predictable** for all the foreign trade participants and for investors.

To ensure against negative consequences of the ruble devaluation for a number of socially important markets, the government should probably support establishment of technological chains for import substitution. At the same time certain groups of commodities allow to start and expand domestic production, based on imported technologies, at the expense of differentiated import tariffs for final products, production equipment and parts. Special export taxes can be introduced to keep domestic prices down for products of the industries whose exports have dramatically increased after devaluation. Thus customs duties emerge as a most useful instrument for the government to regulate the market.

However the government must make an explicit public commitment, first, to **lower** all the basic **customs duties in the course of time** and to outline the limits of such cutback for exporters and importers. Second, it should make it clear that it does not mean to support individual enterprises or industries, but is going **to create equal conditions for all companies in each individual market**, which leaves the government free to select priority markets.

One of the sore points of Russian economy is **fixed capital renovation**. The deplorable state of worn out fixed assets builds up the tendency to make Russian economy a source of raw materials and aggravates environmental hazards. Thus government industrial regulation should help in every possible way capital renovation – from tax incentives for investors to easier tariffs for equipment imports including leasing arrangements. These measures will in no way cripple domestic producers, but will only build a competitive environment for them. Fiscal liberalization of investments and innovations is sure to boost demand for new technologies, both imported and domestic.

The above measures will help Russian businesses focus financial resources necessary for technological refitting and restructuring of production. Another key aspect in raising competitiveness of domestic goods is how **to attract direct foreign investments**. They will be impossible without secure guarantees for foreign investors in Russia, including their right to repatriate income (especially important will be the “Product Sharing” federal law and its practical implementation),

and without simpler and streamlined procedure for business establishment.

These measures will result in technology import and higher quality of domestic goods. This effect, induced by fair trading (unlike “shuttle” import trading), will be there even if the foreign investor decides to build a new factory from scratch rather than invest in the old Russian enterprises.

This policy of creating incentives for direct investment will have still another important effect. Coming to Russia, major foreign companies build spawning-grounds of advanced economic and industrial culture, set enhanced quality standards for related producers, to further gradually spread throughout the whole national economy. In this way it works twice to enhance the national competitiveness, directly and indirectly.

On the other hand the government must work to help about **new big corporations with Russian capital**, which will successfully compete in the world market. This objective is especially urgent for machine-building, where Russian companies on the average operate with only a fraction of their competitors’ capital.

Another expedient step is **to review and dramatically reduce the number of federal task programs**. The programs that in fact get no budget financing should be closed down. Duma should approve each such federal task program and pledge a certain amount of funding, expressed in percentage points as compared to the state budget revenues.

2. ***Relieve the industry of the “social burden”***. Throughout the reform years big Russian producers have been weighted back by their obligations to finance the social infrastructure and support redundant labour. The social infrastructure (especially housing and utilities) was made over to the local authorities in many cases only when the enterprises in question were nearing their end. This is why despite all the present budgetary constraints we argue for **financing the social infrastructure of industrial enterprises from the federal budget and from the regional budgets**, with appropriate funds earmarked to local governments.

The state should also **finance public works for redundant employees**, who currently get beggarly wages (often in kind and many months overdue) at their more dead than alive enterprises. Such works should primarily aim at support and development of the technological infrastructure, including transport communications, power supply and other utilities. The public works funds should also take care of the bulk of unemployment benefits. Apart from reinforcing the social infrastructure (which otherwise will not last longer than for another several years in many regions) these measures can also give a boost to domestic demand.

3. ***To reform the natural monopolies.*** Another controversial issue of the economic policy is the relationship of real sector enterprises with the natural monopolies. On the one hand nobody can argue that taxes collected from the natural monopolies account for a considerable portion of budget revenues. On the other hand it is no less evident that the natural monopolies today in most cases tend to make the end consumers bear their costs making active use of price discrimination (by means of different tariffs for different consumer groups and by means of different cash payment quotas for the same nominal price level). In this connection the public sector should introduce tighter control over energy, heat and water consumption, etc. On the other hand the government **should exercise tight control over the costs of natural monopolies.** This will allow to put an end to cross-subsidizing of natural monopolies' tariffs.
4. ***To foster a competitive banking system and a modern financial infrastructure.*** The Russian financial system is characterized by prevalence of degenerate institutions. We apply this name to banks who instead of straight business prefer to either speculate on the currency exchange or the GKO market (T-bills). The same applies to insurance companies who for the most part engage in various deposit and insurance scheme-making to save wages from taxation and social contributions. In this sense the ostensible exponential growth of the Russian financial market is nothing but another myth of the recent years. No wonder very few financial institutions should have credibility with businesses (who prefer to make their mutual settlements by means of off-shore accounts) or with private

depositors who prefer to save in foreign cash. These trends result in capital flight from the Russian banking system, which in its turn raises interest rates and consequentially real sector costs.

The measures to deprivatize and regulate financial institutions and the financial market, taken recently by the Government and the Bank of Russia, can hardly reverse the situation, since businesses and the population have too many reasons for distrust in government. This is why every ruble transferred from commercial banks to the Savings Bank is counterbalanced by faster accumulation of dollar savings in cash.

To quickly restore credibility of the banking system, undermined in the crisis of 1998, we would advise **to open as wide as possible the domestic financial market to major nonresident banks**. Specific measures to this effect may include lifting of all quotas for foreign capital involvement in the Russian banking system. Besides we think the 2-year Russian market experience requirement shall be applied selectively to Western banks, who seek a license for operations with physical persons. This requirement does not seem to have much meaning when we are talking about a major foreign bank, who has a Russian subsidiary under its full control and keeps its original name in the latter's name. It also seems evident that major foreign banks must be guaranteed unrestrained capital movement.

However we should be fully aware of the possible results of such measures. They are certain to attract in the banking system funds from the well-to-do section of the population, currently cautious about both Russian commercial banks and the Russian state (as personified by the Savings Bank). Yet the monies brought by the population to Western banks can hardly be expected to impact in any considerable way the development of the Russian economy. Western banks, who have a strategic interest in the Russian market, estimate that at best these financial resources will be ploughed back in the form of loans to the population, and at worst will be "exported" to less volatile foreign markets. This is why the most important positive effect from wider participation of foreigners in the Russian market will lie in higher quality of financial institutions, their enhanced hardiness and on the

back of it in lower systems risks of clearing operations in the Russian banking system. In the medium term the presence of foreign banks will help to foster competitive environment in the financial sector and ultimately will ensure easier access for domestic producers to credit facilities.

In the short-term period to rectify the situation in the banking sphere a tougher prudential supervision should go hand in hand with support for credit unions, mutual loan societies, etc. Controlled by their depositing members and targeting certain groups of real sector enterprises, such interconnected loan institutions could contribute to restored credibility of Russian financial institutions.

7. Social policies

Russian citizens have always resented any ideologically charged attempts to phase down social protection on the one hand and on the other - the uncertainty and fundamental chaos of the situation, when the government defaults on many of its obligations honoring only some of them, selected at random. Thus we propose:

- To openly admit the “*social default*” of the Russian Government in regard to its citizens, in other words to admit the government’s bankruptcy in regard to its social commitments (currently the government social sector obligations subject to the present legislation, surpass the whole consolidated budget and all the off-budget funds);
- To simultaneously adopt *an agenda for a phased recreation and improvement of social services*, graphically tied in with economic growth;
- To foster *favorable conditions to address social problems on the regional and local level* and to shift considerably social demands from the federal to the regional and local level.

For the first and most difficult stage the program shall provide for the following tasks:

- First, survival and basic health care for those Russians who so far have not adjusted to the new labor market realities (unemployed or low-paid)
- Second, the highest practicable employment rate for efficient labor use
- Third, urgent steps to stop non-targeted squandering of social funds, changeover to requested provision of social benefits and welfare accompanied by needs-testing;
- Fourth, preservation, implementation and enhancement of the innovation creative potential of the population, capable of meeting the crisis and providing for successful post-crisis development; reproduction of the social and cultural sphere financed from every available source.

The first task suggests that the present stage requires most funds *the government* will be able to raise for unemployment benefits to be focused almost exclusively on the subsistence level provision.

Given the current bad deficit of medication financing their free provision for both in-patients and out-patients should depend on their incomes. It is necessary to work out transparent and unambiguous procedures for free access to scarce medical services, to rule out arbitrary decisions and corruption. Voluntary health insurance shall be encouraged.

The low-income category covers such an overwhelming section of the population that any paternalistic methods of their support appear out of the question. The only thing we can plan here is a strategy to be launched in a number of overlapping areas to provide support to the activity of the population, aimed at meeting its most basic needs.

In this connection citizens whose income is not enough to ensure their physical and social reproduction should be encouraged to provide their self-support. In other words regional and local authorities should help households to survive encouraging their self-provision of foodstuffs. Special attention should be paid to urban dwellers in this respect (especially small and medium-sized urban communities). Generally

their plots of land are too small and far away, sometimes the lands are marginal. High-grade cultivable lands in the suburbs shall be deforced from inefficient agricultural enterprises and allotted to urban dwellers (until the demand is fully satisfied).

The second task covering *labor relations* should be addressed with regard to the requirements of the most dynamic segments of the Russian labor market, that can be expected to grow and expand under crisis conditions. These segments feature flexible employment, not quite in line with the present labor legislation, that was meant for a stable situation. This explains why a big section of labor relations retreats in the “shadow”, undermines the taxation base and leaves employees virtually without basic social and legal security that is in fact a direct consequence of their declared “hypersecurity”. At the same time tougher enforcement of the current labor legislation would have caused even worse stagnation in the labor market, higher actual unemployment and lower level of earned income.

We need to adopt temporarily less ambitious but toughly controlled labor legislation to stipulate for freely determined terms of contract between the employer and employee provided they do not constitute any threat to the health of the employee. On the other hand the labor legislation should really ensure against non-payments of wages, unjustified sacks, forced vacations and other breaches of contractual obligations. The labor contract should have the form of a regular civil contract under the competence of arbitration court.

Addressing the third task the government should commit to take care of those who cannot take care of themselves. In other words it should be admitted that the current egalitarian principle of providing retirement pensions cannot be changed in the near future. This is why pensions, unemployment benefits and other kinds of individual social payments shall follow criteria of life and health support.

Alternatively economically active citizens who enjoy stable incomes, will have to make contributions to social insurance funds, including pension, medical insurance and unemployment funds. The funds, accumulated by such citizens in their *public social insurance* accounts

must be considered their *property* payable in case of events insured against (retirement age, illness, unemployment). Of course this system requires voluntary participation.

The fourth task is necessitated by the future of the nation and the challenge to ensure its development towards market information economy. This task requires preservation of our research institutions, brilliant academic schools. It requires support to university education (classical and technical universities), directly linked to scholarly and scientific research. Fundraising for these areas is nothing smaller than a national priority. Government financing for higher education should be dependent on the projected labor requirements and jobs availability. The present degrading and wasteful practice of training the unemployed should be ruled out. Higher education must be made actually accessible to capable low-income young people. To achieve this a workable system of bidding for reasonably big scholarships (enough to provide a subsistence level) should be established. Government support is also required for growth centers fostered on the basis of research and industrial units of the military and industrial complex (VPK), involved in export production and conversion.

We should discard the myth that social and cultural government institutions (education, scholarship and science, culture, health care) get their funding mostly from the budget. In fact the budget covers only some of their expenditures – often less than 50%. The rest comes from their own business activities, when they sell their core and marginal services. Life shows that if the relevant legal environment is conducive to this activity, the institutions are more effective, if it is obstructive – they fail to meet their payrolls even at a minimum level. At present an average Russian university has to use its fee-paying enrollment to finance training of its budget-funded students. Thus there are hardly any more pure government-financed institutions.

All the government can and should do for these sectors is to lift unreasonable restraints upon their business operations, fundraising and pay services while *preserving its control over the scope and quality of the free services*, provided by these institutions.

The current bad shortage of budgetary funds is compounded by their arbitrary and wasteful allocation. To rationalize the process new regulations are urgently needed. The approach should be different from that taken for the new Budget Code and provide for more freedom and flexibility with resource provision and allocation, as well as combination of budgetary and off-budget funds. This flexibility is absolutely vital for the survival of most social and cultural institutions and agencies. Flexibility should in no way interfere with earmarking, regulation and control. However control seems more appropriate in regard to results, that can be monitored by specially designed and introduced performance indicators.

The industries of social and cultural services badly need reform to give them more independence, but at the same time provide for the enforcement of the entitlement principle of social services. Regional policies should supplement local policies and in its turn be supplemented by federal policies.

Very soon we are to face an ever-widening gap between the citizens' claims to social services and the government's actual resources to provide them. Further escalation of these claims will ultimately end either in social turmoil or in an election victory of irresponsible extremist forces. Any attempts to convince people that cutting down social guarantees is necessitated by efficiency and equity concerns can only contribute dramatically to such scenarios. Alternatively, the idea of a reluctant but unavoidable social default, followed by immediate adoption of a well-defined action program of phased restoration and development of social services, might give us a chance to consolidate the society. However this scenario faces one big problem: the current state of budget federalism, actually providing for broader authority and responsibility of the federal center than it is stipulated in the present Constitution.

Thus in relation to education and health care the Constitution refers only "general issues" and "coordination" to joint competence of the Federation and its constituent members. In fact it means the regions are supposed to take care of these spheres as their own financial means permit. However the current tax and fiscal system is based on the

implied assumption of practically unlimited rights and obligations of the federal center as regards leveling the inequalities among the regions. Not every federal state can afford such an approach. To afford it the federal state must have, first, relative economic prosperity and stability, second, balanced numbers of donor regions and recipient regions and third social consensus in the donor regions as regards assistance other regions.

8. Budget federalism

Unfortunately the actual deep-going inequality of social conditions in the regions is here to stay at least for a number of years. At this point all we have to do is admit its tremendous scale. The Soviet-time propaganda fiction that the quality of school education in Dagestan was no different from that in St. Petersburg answered very well its Agitprop purposes but it did a very bad service to people in Dagestan as well as in St. Petersburg. There were decades of largely futile efforts to address these gaping inequalities. Now we cannot carry on with these efforts anyway, given the present economic slump. As we advocate for this long-cherished illusion discarded, we do not mean to provide an excuse for our lack of action, but we believe it will help us to brace for the much needed preservation of *political unity and cohesion* of Russia.

We cannot prevent inequality but we can and ought to prevent an avalanche of claims to the federal government in its capacity of redistributor. General resentment about the social conditions, which in fact follow quite consistently the economic situation, can result in political tensions between donor regions and recipient regions. People in the street are already simplifying it down to straightforward questions like “who is robbing whom” or “has already robbed”. Have we already forgotten how the same process was unfolding in the Soviet Union and how it ended?

If we take a sober and realistic approach we should initiate a tax and fiscal reform to give us a difficult but at least feasible method to avert the collapse. This reform shall include:

- Federal taxes shall cover exclusively the federal government functions as stipulated in the Russian Constitution;
- The regions shall be free to formulate and implement their taxation policies to provide for their functions including their functions shared with the federal government;
- The federal government shall meet its financial obligations entailed by its responsibilities shared with regional governments as stipulated in the Constitution, from a special fund formed by special-purpose taxation; this fund will measure up to nationwide programs, for instance, campaigns to combat epidemics, and to the currently appropriate degree of interregional redistribution;
- A region shall be financed from this fund provided it has assumed a number of commitments stipulated by law, including certain voluntary and temporary self-restraints in tax and fiscal policies.

In the course of redistribution of income sources among different levels of the fiscal system local governments especially in big cities should be considerably reinforced.

Closer linking taxation rights and obligations to local needs and benefits seems the only realistic way to educate responsible taxpayers. It would be an illusion to rely on coercion to break the current persistent nonpayments of federal direct taxes. If we want the next generation to see tax payments as their moral duty, our generation should be convinced to help schools and polyclinics in their community. Naturally this can never happen until every taxpayer stops thinking that every school is the Kremlin's responsibility. As long as this mood prevails against the current unfavorable social and economic situation, voters will go on demanding that their governors take a hard line with Moscow.

In the sphere of budget federalism as well as in any other sphere change of standards for more feasible and realistic should go hand in hand with higher standards of responsibility. In this case it means

reinforcement of the vertical federal-regional-local government structure.

9. Government role and functions

The performance of Russian economy in the 90s seems to have irrevocably dispelled the liberal myth that a free market can of itself generate effective enterprises and institutes. At present stronger government regulation and responsibility for the economy has become a *locus communis* of programs and agendas. Hopes are no longer placed in the market, now people look up to the state for salvation.

As we shake off the grip of one myth we should be careful not to fall under the spell of another. Unfortunately our government is no better than our market. It is no less inefficient and degenerate, it differs much from our idea of it. Before we get down to building up government role in the economy it would be useful to try and understand something about the thing whose role we are going to build.

1. Administrative and judicial “power” of the Russian state does not correspond to its total obligations. The machinery of government is oversized and inefficient failing to serve a workable instrument of economic policy.

The state has made too many commitments. The area of government responsibility is too wide to allow for any but purely formal activity. The state declares its presence but fails to hit the target. To illustrate the point it would be enough to remember how government-owned stakes and enterprises are centrally managed.

The **federal** level has proved the most restrictive for the state with most government resources no longer available (as they have been privatized) and administrative tools to influence economic agents lacking. The recent years have graphically demonstrated that unlike previously during the Soviet era the state is no longer able to force considerable groups of population or enterprises into behavior running counter to their own interests. Government power is limited by sporadic punishment of individual economic agents. Since the federal

level suggests an especially large scale of economic policy tasks, it is the federal level that produces the worst government performance.

On the other hand at the regional and local level governments have enough administrative power. They actively and purposefully interfere in business activities and property distribution. A name has already been coined for this phenomenon: new feudalism.

2. **Government privatization.** Recently Russia (and its government) has given up the barbaric capitalism model. But what do we have instead? Bribes and criminal umbrellas (krysha) have given way to long-term standing relations between a government official and a company with the company involved in a network of more civilized mechanisms of property protection. And indeed it is not always the company who uses the official, in many cases it is the other way round. All this gives rise to corporatist relations following an intricate hierarchical patron-client pattern. These new informal vested interests will necessarily include government units or individual public servants.

Corporations and personal networks bring together and lock together government officials and certain private interests. In some cases an official in question can be bought by a certain business, but in most cases he would be involved in networks of mutual services that do not get paid in money terms but focus on decision-making points (both in government and in business). Such networks of mutually indebted people have always existed in all times and in all countries. But present-day Russia is different because these networks (not contract relationships) account for a larger portion of the GNP than in any developed economy. Even an honest official who abhors bribes and will turn down in indignation any payment offered in return for a certain service, will still have a large portion of his income generated in the “fellowship networks”. This fact makes him too dependent on these networks and thus makes it more difficult for him to resist indirect pressure.

The reason for this predicament is very simple: this country has been trapped by populist policies. V.I.Lenin’s slogan to pay government

officials at the rate of average workers, rejected even by bolsheviks, was finally put into practice in the 90s. As things stand now even a minister (Russia has only about a hundred of such top officials) does not have enough legally earned money to: visit a restaurant once a week, buy a car, buy an apartment, a country house, vacation abroad, send children to a fee-paying school.

This is why government officials in their work give no less consideration to their private commitments than to the interests of their employer – the state. This accounts for the most fundamental reason for the government's inefficiency.

3. **Government privatization – II.** Persistent underfinancing of government agencies makes ministries, departments and their structural units to look for other ways to raise funds. This motivates them to fight with other government agencies for revenue sources: license fees, allocation of budget funds and provision of extra pay services. Funds can be raised openly – like the case was in the customs, Ministry of Internal Affairs and the Federal Tax Police Service. However government agencies cannot do it on their own behalf and enter into affiliation relations with other public and even private enterprises, specializing in such services. In the latter case profits will mostly go to the top administration of the agency rather than to the whole agency.
4. **In a bid to make up for officials' inefficiency by their numbers the state has manned its staff beyond any reasonable proportion to surpass both Soviet and party bureaucracy of the past times, taken together.** In this way it has automatically expanded the arena of government interference in economic and social processes, because each unit of the civil service system claims its own separate zone of engagement. At this point we are talking about interference, which is often destructive, alienated from public and community interest. Regulation is another matter. **Government regulation of business and public life (in its role of a consistent and open policy, aimed at lower chaos, risk alleviation and cushioning of adverse effects of market functioning) was persistently shrinking.**

5. **Judiciary power is not locked in with the executive branch** (or rather they are interlocked in a wrong way with the executive branch influencing the judiciary but failing to enforce court rulings). Autonomy of courts of law and prosecutor's offices is no more but a declaration in most cases.
5. **Government officials have their terms of reference too broadly defined** which leaves them a chance to select what they want to do. The possibilities for their arbitrary decisions are quite extensive, including various departmental regulations that allow convenient interpretations of law, a variety of mutually exclusive rules to select from and last but not least a free hand in non-regulated zones of business activity.

Thus the social and economic need in a strong and effective government and regulation is left unsatisfied because the government we have is inefficient. To rectify the situation any government will have to adopt a set of urgent and politically controversial measures.

Legal reform. Strong government presence is primarily manifested in law enforcement. One of the most destructive myths of most recent times is that a constitutional state is made first of all by achievements in law-making rather than in practical regulation of the economic and social life. This idea has brought about numerous legal acts that have nothing to do with the actual situation in the country, which in its turn makes business activity virtually impossible – whatever you do you are bound to break some law or regulation. Thus people have learned to take for granted the blatant discrepancy between informal and official norms of business behavior, to see laws as nothing more than statements of intent and finally to doubt the very principle of rule of law. This atmosphere can hardly help to ostracize and defeat the criminal community.

This is why we think it expedient to *review and redraft as soon as possible the laws regulating the economy*. Vague and unreasonable “rules of the game”, declared by the state, serves to blur the line between criminal redistribution (racket, bribery, fraud) and productive activity, that for various reasons might be happening in the “shadow”

economy. A careful sorting out should be undertaken to separate fundamental laws to influence the economic and social life from insignificant ones (as proved by few references to them in court decisions) and most importantly from laws that are broken on a large scale either because they are impracticable or because the enforcement mechanisms are not there. This analysis should start the process of streamlining and refining the legal base for economic transformation.

One of the primary legal requirements given the still low culture of economic agents, is relative simplicity of legal rules both for the economic agents to understand and follow them and for relevant agencies to enforce them. The rules should be very specific and realistic, to give fewer chances to officials to misinterpret them.

An autonomous financing support and maintenance system for the judicial branch should be established. Another task is to strengthen the institute of officers of justice in its capacity of a separate enforcement agency to enforce court rulings and ensure security and independence of judges. Apart from the budget financing the judiciary system shall also be additionally funded by litigation charges and fees, as well as percentages from lawyers' and legal councils' fees.

Taxes. At this point we should attempt general *streamlining, if not primitivization* of the taxation system, focusing for the most part on collectable taxes. These are in most cases indirect taxes, including VAT, sales tax, excise duties, customs duties. Claims that these taxes mostly carried by enterprises, are far from being justified. In the final count the distribution of the tax burden depends rather on the nature of individual markets than on the formal identity of the taxpayer. Neither it is true that indirect taxes cannot be used for income redistribution. Just remember excise duties on luxury goods, taxes on real estate and inheritance. Certainly if we forget about actual differences and collectability, direct taxes would appear more effective than indirect. But the actual fiscal situation warns us against indulging in illusions. One of the possible solutions might be to abolish the profits tax and instead impose some direct taxes or imputed tax in accordance with production capacity. We need a system of taxation workable in the situation we have. And in the situation we have any theoretically impeccable system would be impossible.

Civil servants. At present the state is unfair and indifferent to its servants. They feel socially and politically insecure. Saving on civil servants' payrolls became the easiest way to trip the expenditure part of the budget. There can be no denying that standards for public servants performance should be higher and corruption should be persecuted and rooted out. At the same time it is important to realize that the new class of public servants makes the backbone of the state and personifies it much better than politicians. Many public servants today keep loyal to their agency. We can hardly ask for more given the dispersion of declared national interests. But this culture of departmental loyalty makes a good breeding ground for the culture of national loyalty and pursuit of national interests.

To achieve this the civil service system should be consolidated and streamlined, with ministries and departments grouped together where possible, and double and triple competence areas removed. For instance economic regulation shall retain only two ministries: of finance and of economy. The national industrial policy shall be pursued by state concerns and agencies, coordinated by the Ministry of Economy. The Presidential Staff should be dissolved, including the president's local representatives. Our country is not rich enough to feed two executive branches.

An effective government cannot come as windfall. Society will have to pay a high price for the services of responsible government officials. It is necessary to continue developing a system of social guarantees for public servants. Underfinancing of the public service system, including the judicial branch, is absolutely inadmissible. If other budget-funded organizations can earn the funds they lack, an underfinanced official, who has no other source of income, can be motivated to take bribes. Economy is possible and necessary, but it should focus on redundant sections of the system. Officials have to be adequately remunerated.

The level of remuneration for government decision-makers should be high enough to ensure a decent living standard without looking for additional income. We need at least a three-fold increase in salaries and also provide for higher bonuses and seniority pay to federal executive and judicial officials. The funds for such increases can come

from massive layoffs of junior and mid-level administrative personnel of government agencies as well as from closing down some of the agencies. Regional administrations will take these decisions independently, guided by both the federal-level decisions and by the local realities.

To achieve a unity and cohesion of the civil service a uniform system of ranks and rewards should be developed and introduced.

Government self-restraint. This measure is aimed at contracting the area of direct responsibility (regulation or arbitrage), transferring it to self-regulated business, political or civil associations and to local community and neighbourhood associations. A number of examples show that such authority delegating does not negatively affect public interest (if it is to be seen in effective market development and its higher sustainability). Inside the system of government the federal level guided by the principle “I own what I can control” should delegate a fair portion of its property rights to the regions and further down to local governments.

Dramatically improved performance of government bodies and moreover a fundamental growth in the economic and social spheres will become possible as the nation develops its *civil society*. Support to this process, creation of a favorable legal and economic environment for citizens’ self-organization, preservation of civil liberties, - all these conditions are indispensable to give an extra dimension to our current wrangling with the crisis, to ensure that our efforts lay a reliable foundation for long-term sustained development of our society.

Civil society building measures can be grouped in three categories:

First, guaranteed federal and regional government financial support to mass media, aimed at ensuring their diversity and pluralism. Such support should be provided without any government supervisory bodies established and imposed on mass media.

Second, support to non-governmental non-commercial organizations through tax and other benefits, maintenance of an on-going communication of government agencies with public and civil associations. At the same time there should be a tough counteraction to black and gray commercialization of enterprises, which claim a non-commercial status.

Third, consistent delegation of power and taxation functions (together with the above funding responsibilities) to municipal and local government bodies. In their capacity of grass-roots level of democracy local governments may become centers to educate voters and develop their rational behavior.