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MODERNISATION**

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## 1. Four Assumptions

The economic role of the government – meaning less (retreat) or more intervention – has been receiving an extensive coverage in both economic and political press, with a need for more government influence on the economy being repeatedly proclaimed in the recent months. For example, the "Expert", a high-profile magazine, will insist in almost every issue that there is no coherent strategy and that we need aggressive industrial policies. Many influential experts previously explained that the transformation crisis of 1990s was caused by the government's retreat from the economy.

In 1997 the Institute of Economy RAS published a paper on the government role in a market economy, i.e. the topic which we are revisiting 9 years after. The paper stated from the very beginning: "Serious social implications followed when the government retreated from the economy taking a sort of leave". [1, p. 5]. The reason of the crisis on the way towards the market economy, as suggested in the paper, was not the outcome of socialist economic behaviour nor decline of the world oil prices which continued since 1986 and caused the Soviet financial system to collapse but precisely the government's retreat from the economy.

Mr. Illarionov will now argue that there is a definite turnabout of Russia's economic policies towards interventionism. There are indeed serious reasons to revisit this topic. It appears that the entire economic community is divided into two camps, those of liberals and dirigists, with representatives of each being sworn to never abandon their views and almost invariably offer recipes of salvation through either more or less government action.

For a discussion at the professional level it is necessary, in my opinion, to share certain assumptions which, rather than being the essence of the dispute, will constitute its reference points. There are four such assumptions within the scope of this topic.

**First assumption:** the government has always had an economic role which nobody, except die-hard libertines, will dispute by demanding that it should retreat altogether.

**Second assumption:** the controversy is only about the extent of particular functions to be reserved to the government. We will list the main functions by the descending order of their importance to those advocating to leave these functions to the government:

1. shaping the legislation, maintaining law and order, resolving disputes on the basis of law (court of law), enforcement of regulatory provisions and court judgements. These are basically functions of the government as a "night watch";
2. defence and security, protection from outside threats;
3. ensuring macroeconomic stability – preventing inflation, supporting the stability of the national currency;
4. promoting institutions useful to economic and social development, adapting them to a changing environment, and undertaking necessary reforms;
5. provision of public services including, apart from defence and law and order, health care, education etc. to ensure that they are available to the public at large rather than only those who are able to pay for them on a cost basis;
6. protecting vulnerable population groups, providing social guarantees;
7. protecting the environment, ensuring environmental safety;
8. encouraging economic development and promoting useful changes in the economic structure. This is normally called structural or industrial (sectoral) policies;
9. preventing or eliminating so-called "market failures" including through direct public control of prices, wages, rates of consumption of certain goods etc.

10. public enterprise, i.e. ownership and management of companies for production of goods and services which could also be produced by private companies;

This list could be further extended and specified but it apparently covers the main functions of the government.

The first three functions is a liberal minimum. The extent and costs of public involvement may differ but no liberal, while insisting on less involvement, will oppose it altogether. The fourth function may be pursued as necessary but initiatives coming from different strata of society will be finally implemented by means of the state. Functions 5-7 are characteristic of a well-developed social state capable of spending considerable amounts on social and environmental purposes. Advocates of paternalism and dirigisme will normally insist on still larger spending while liberals will agree to an absolute minimum. These are the functions which mark a border line between liberals and dirigists. The field of the latter comes next.

**Third assumption:** Practical policies cannot fully rely on one philosophy. Life brings forth circumstances which objectively make it more expedient to reserve different sets of functions to the government and vary the extent of these functions. The government is the better positioned to manage its objectives, the better it understands how they should be addressed in the light of the prevailing situation. Sometimes increasing the government role may be positive. But all this comes at a price: reserving certain functions to the government will require funds which are to be collected from economic agents through taxation or otherwise.

The role (amount) of public involvement is normally measured by the ratio of public spending to GDP. If there is a budget surplus, the latter should be added to expenditures as being part of the burden imposed by the government on the economy. Disputably, some experts suggest adding expenditures of government-owned enterprises to this amount in order to adequately assess the role of the government. A vast majority of experts will argue that it is not necessary as government-owned enterprises operate on a competitive basis and cover their

expenditures by the own revenues. However, to some extent such assessments are useful, at least with regard to some expenditures of government-owned companies operating under a noticeably different regime than private companies, for example, having soft budget constraints or achieving political objectives which contradict commercial criteria. This is especially true of large government-owned monopolies.

One can imagine an optimal extent of public presence in the economy of a given country within a given lapse of time where benefits and costs are balanced. As the situation changes, this optimum will change too. Correspondingly, this should trigger a change in policies.

**Fourth assumption:** A choice of an optimal or similar extent of public presence in the economy should take into account a number of factors including the situation and stage of development of a given country, its position with regard to other countries, peculiarities of the national culture and institutions.

Economic and social developments are characterised by a high degree of uncertainty which prevent us from exactly determining the optimal size of the government sector or its dynamics. We can only approach the optimum as close as possible. Meanwhile, groups of competing interests and political parties will propose different agendas to reach an optimum whose result will be known only later. In addition, dramatic changes of the situation do not occur often while the relevant changes of institutions and policies also come at a cost. So during long periods of time it makes no sense to maintain stability in terms of a sustainable system of institutions and predictable policies.

Stability is good as long as it does not result in stagnation which occurs when the situation has changed so as to require a change in institutions and policies, i.e. reforms (or completion of already started reforms) but no action has been taken.

While historians will deny any consistent patterns in history, economists will invariably assume them, though each school will often do this on its own. Anyway, we may assume a certain development logic, for example, in transition

from agrarian society to industrial one as accompanied by different processes of industrialisation and urbanisation which countries perform at different points in history. Moreover, there are leading countries and those following in their wake (developing countries). Also, there are countries which lag behind and are at the inception stage of transition, and countries, if any, which are yet to start it. A stage of development will at least mean a certain status of transition. China, for example, is currently at the stage of industrialisation. As regards its position with reference to others, on the one hand, there are countries which are way forward at a higher stage of development but at the same time have exhausted the potential related to industrialisation, for example, possibilities to borrow technologies. On the other hand, there are less or equally developed countries which do not have the resources which allow China to develop at a faster rate than others. I believe that the primary resource is abundance of relatively high-quality and cheap work force. The qualities of this resource are determined by the peculiarities of the national culture which held back the country's development for centuries but after a while, for reasons yet to be explained, including the influence of the progress made by other countries, turned into a powerful force of dynamic development. Public policies obviously contributed to these changes.

On the basis of understanding of the importance and nature of these factors, other countries can also develop close to optimal policies on the role of the government in the economy.

## 2. International Context

Now let us turn to more controversial propositions.

Europe started a transition from agrarian to industrial society in XVI-XVII centuries as Holland and UK took the lead. They were followed by France and Germany, other European countries, United States of America and Russia. These countries demonstrated higher rates of economic development, better living standards and growth of urban population. Starting from the last quarter of the

XIX century, these processes became accompanied by a higher (as compared to the economy) growth rate of public expenditures. While in 1890 in England they would not exceed 10 percent of GDP, in 1980 they were already in excess of 50 percent (minus expenditures of government-owned companies) [2, p. 33]. This process was manifested in all developed countries as evidenced by the data of Table 1.

**Table 1. Growth of general government expenditures in developed countries, 1870-1996 (percent of GDP)**

Country	Late XIX century	Before World War I (1913)	After World War I (1920)	Before World War II (1937)	After World War II			
					1960	1980	1990	1996
<b>Australia</b>	18,3	16,5	19,3	14,8	21,2	34,1	34,9	35,9
<b>Austria</b>	10,5	17,0	14,7	20,6	35,7	48,1	38,6	51,6
<b>Canada</b>			16,7	25,0	28,6	38,8	46,0	44,7
<b>France</b>	12,6	17,0	27,6	29,0	34,6	46,1	49,8	55,0
<b>Germany</b>	10,0	14,8	25,0	34,1	32,4	47,9	45,1	49,1
<b>Italy</b>	13,7	17,1	30,1	31,1	30,1	42,1	53,4	52,7
<b>Ireland</b>			18,8	25,5	28,0	48,9	41,2	42,0
<b>Japan</b>	8,8	8,3	14,8	25,4	17,5	32,0	31,3	35,9
<b>New Zealand</b>			24,6	25,3	26,9	38,1	41,3	34,7
<b>Norway</b>	5,9	9,3	16,0	11,8	29,9	43,8	54,9	49,2
<b>Sweden</b>	5,7	10,4	10,9	16,5	31,0	60,1	59,1	64,2
<b>Switzerland</b>	16,5	14,0	17,0	24,1	17,2	32,8	33,5	39,4
<b>UK</b>	9,4	12,7	26,2	30,0	32,2	43,0	39,9	43,0
<b>United States</b>	7,3	7,5	12,1	19,7	27,0	31,4	32,8	32,4
<b>Average p.a.</b>	10,8	13,1	19,6	23,8	28,0	41,9	43,0	45,0

Source: [3, p. 6].

Those countries which achieved success later as they developed in pursuit would finally also increase public spending even though its low level constituted their important competitive advantage at the beginning.

This is the reason why it is sometimes argued that liberalism is outdated and that dirigist policies are in the mainstream of international development. I believe this is a superficial judgement, especially in the light of experience of Margaret Thatcher and Ronald Reagan whose policy of economic liberalisation achieved a remarkable success in the countries both of which are taking the lead



and strengthened the positions of liberal philosophy as the mainstream of modern economic science. Therefore, it makes more sense to look into what caused an expansion of the public sector in the period of industrialisation.

It is worth noting from the start that a high share of public spending would occur previously in history of specific countries within specific periods but these were almost invariably military expenditures. The second largest area of public spending was only irrigation. The following three groups of factors are likely to be characteristic of the new times.

First, from the late XIX century monopolisation would succeed capitalism of free competition which in its time swept away feudal rules under the slogan *laissez faire*. Large corporations were undermining market relationships providing examples of bureaucratic management of enterprises which produced standard products on a large scale. Ford's conveyor lines and Weber's rational bureaucracy would seem the pinnacles of civilisation. Against this background, it was only natural to imagine a public monopoly at least capable of containing the appetite of large capital and caring more after public interests. If private property is within reach of only the happy few, will public property prove a better deal? Private monopolies should be contained anyway to prevent "market failures" which were becoming increasingly dangerous. Hence the socialist demands to nationalise the industries, anti-trust law, Keynesian theory and F.D. Roosevelt's practices. Hence the alternatives of the free market model – Soviet planned economy, corporate government models of Mussolini and Franco, and Nazi economy. Humankind apparently had to be tempted by these to develop an antidote and assure itself that these development models were leading to a dead end.

Recipes of planned economy were still in vogue after the World War II, and not only in third world countries as evidenced by nationalisation in the UK and indicative planning in France. In West Germany American advisers would oppose price liberalisation proposed by L. Erhard. It appears that a conclusive evidence of hazards behind further expansion of the public sector would not be there until the late 1960s.

In 1994 Hanson and Henkerson published the results of a study of dependence between economic involvement of the government and growth of productivity based on a set of data collected from 14 OECD countries and relating to 1965-82 and 1970-87. They concluded that, from a perspective of promoting growth of productivity, public spending was beyond the optimal level in all these countries by 1982. Public spending (including investments and social transfers minus education expenditures), once increased 10 percentage points, would cause a decline of growth rates of total factor productivity (TFP) by 1.68 percent per annum. But, on the other hand, public education expenditures, once increased 10 percentage points, would annually add 2.78 percent to TPF on average.

Cited by [4, pp. 546-548.]

Secondly, urbanisation which kept pace with industrialisation caused a demographic transition where a nucleus family replaced a large ancient family. Meanwhile, this gave rise to the problem of lonely elderly people who were no longer maintained by families, unemployed persons and younger people who needed to be educated to enter the labour market and become part of society. As society became more prosperous, it was in a position to allocate more funds to new functions of the government, something which marked the trend towards humanism and solidarity.

Thirdly, the leading countries had undergone political transformation. As capitalism gave rise to a conflict between labour and capital, the government was forced to assume the functions of not only providing social protection but also containing this conflict within certain limits through economic and political measures. Workers' and socialist movements insisted on redistribution of wealth through public institutions, reduction of working hours and introduction of universal suffrage which also resulted in a growing role of the government.

Do these factors argue in favour of the fact that inversely oriented shifts associated with reforms of Thatcher and Reagan, i.e. "neo-conservative shifts", were nothing but temporary fluctuations against the background of a sustainable trend? Certain influential sources suggest a close end of efforts to reduce public spending in developed countries which will only grow in the future. However, it

appears that things will take a different course. There are undoubtedly pressures to increase public spending but they are likely to become increasingly opposed by inversely oriented forces. It is worth noting that, according to the data of Table 1, public spending in the UK was declining from 1980 although grew again by 1994. In the United States it ceased to grow while on average its share of GDP in developed countries was growing at a much slower pace. The world economy is undergoing qualitative changes as it enters, primarily through the experience of leading countries, the post-industrial era.

1) Capitalism had passed the stage of industrialisation and the underlying trends lost much of their power. Their influence on people's minds diminished. Large corporations extended their operations well beyond the national borders but at the same time small business proved its competitiveness. Companies of varying size struck a structural balance, a growth in size being no longer a guarantee from failures. Competition exacerbated as new players emerged in the markets. Also, it turned out that the state was anything but a good entrepreneur. On the contrary, it became clear that the most successful countries were those where the national elite was quicker and better aware and willing to accept new challenges, where public institutions were more effectively used to create new markets and achieve domination before those lagging behind and catching up finally made their entry. At this point leading countries have to create revolutionary innovations and new markets. This is new capitalism.

2) Developed countries were already past urbanisation and demographic transition. The population almost ceased to grow but became older as the share of elderly people increased. Pay-as-you-go pension systems established 50-100 years ago on the basis of the generation solidarity principle were no longer adequate as the burden on one worker became excessive. At the same time, increasingly sophisticated financial markets allowed to mobilise and efficiently use investment of any size, so that a vast majority of the population could and should save for their retirement. This means that the government may embark on a phased retreat from the sector leaving it to profit-making and no-profit undertakings to provide relevant

services to households. And the list of these services is becoming increasingly extensive.

New problems had emerged, for example, that of integration of migrants from other cultures. However, it is noteworthy that these problems resulted from developed countries' desire to address the problem of the demographic transition with cheap workforce. This approach proved short-lived and fraught with still bigger problems in the future.

3) Developed countries established democratic political systems based on universal suffrage but with the prevailing middle class. This was in part a legacy of the previous stage since the middle class was a product of social equalisation and resolution of the bitter conflict between labour and capital. Moreover, various forms of workers' movements which emerged in XIX-XX century relied on then predominant type of regular employment: one job, one wage. Over the last few years it is "non-standard employment" which is becoming increasingly widespread (a term coined by V. Gimpelson and R. Kapelushnikov [5]<sup>1</sup>). It assumes various jobs taken by one worker, jobs under several contracts, part-time and informal employment, more worker independence and at the same time fewer possibilities to organise employed workers and manifest their solidarity. They still have enough power to defend their hard-won privileges, especially in countries of continental Europe, but not to win new ones which could lead to more public spending.

Liberal democracy is a combination of stability with dynamic development. This comes from respect of law, human rights and liberties, economic and political competition. This system developed fairly reliable methods of social regulation through education, media and mass culture which ensure more or less competent governance and prevent hazardous manifestations of extremism. The government does not have to excessively intervene to maintain law and order. Struggle for power comes through election rather than forceful suppression of opposition. At the same time, less prosperous strata of population understand that being in power

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<sup>1</sup> In the Netherlands 34,5 percent of employees are part-time workers, which is the highest indicator for developed countries in 2003 (13.2 percent in the United States) [5, p. 377]. Self-employed workers (individual entrepreneurs using hired workers or not, with or without non-corporate sector) accounted for 7.2 percent of total employment in the United States, 34.7 percent in Germany, 24.6 percent in Italy (p. 383).

is not enough to become richer. It is very difficult to remove the already given social privileges but it is easier to evade new obligations capable of undermining economic stability.

Thus, new factors underlying the growth of public spending since the last quarter of the XIX century have lost much of their power. But other factors became manifested.

4) All universal social projects based on ideas of the industrial age and pretending to be an alternative to capitalism, market economy and democracy have failed. The primary failure was, of course, the Soviet experiment. Rather than being defeated, we collapsed under the burden of flaws inherent in the proposed project which provided, in particular, for an absolute power of the state.

In 1990 public spending in the USSR accounted for 51.3 percent of GNP (revenues for 47.2 percent, deficit for 4.12 percent of GNP) or 55 percent to cover the expenditures of public social insurance. It is not too much as compared with the above figures of public spending in OECD countries. But, assuming expenditures of government-owned enterprises, the government sector of the Soviet economy (at least, legal) would be approximately 90 percent. Moreover, the public budget would allocate 38.5 percent of expenditures or 19.8 percent of GNP to finance the national economy, i.e. ease budget constraints [5, p.p.15-16, 18]. This is an example of a large and, therefore, weak state.

Rather than explaining, it is best to compare the outcomes of development in West and East Germany, North and South Korea: the same people and vastly diverging outcomes.

Academician Shatalin, an advocate of centralised optimal planning in his time, had to admit, in light of these examples, that life staged a scientifically pure experiment, and researchers had nothing to do but accept the outcome. This would, in particular, entail certain conclusions with regard to excessive promotion of the role of the state though now even the most ardent advocates of the state will accept a "mixed" economy and rule out reliance exclusively on the "invisible hand" of the market. Nobody would, in fact, propose this.

5) During World War II and afterwards a number of countries in pursuit of development achieved success relying on aggressive economic intervention of the state. They were largely located in Eastern Asia, i.e. the so-called "rice culture" area of Confucian ethics which allowed them to rely on high quality and cheap labour to manufacture export-oriented products for open Western markets on the basis of borrowed technologies. But it should be borne in mind that a vast majority of these countries went through accelerated development as part of the process of urbanisation and industrialisation, already past by developed countries. As they approached the level achieved by the latter, models of development in pursuit proved exhausted, only to put them in the face of the same problems of adapting to requirements of post-industrial society.

China and India seem to stand apart not only because they are not yet past the period of industrialisation, and the prevailing rural population can still provide fuel for moving forward in the foreseeable future. China, in particular, is achieving success also because it has substituted in good time the Soviet-made model of industrialisation for a more liberal model of development in pursuit similar to that of Japan.

6) Competitive advantages of countries in pursuit included, in particular, considerably lower public expenditures due to a lack of a developed public system of social guarantees. Essentially, these countries started off from a level where UK had been in 1890. In the face of principally new competitors Western countries had to consider whether the burden imposed by the state on the economy was too much as advantages of technology, order, law abidance and competence proved deficient. Moreover, new competitors such as Korea and Taiwan, once they achieved the level of economic development of European countries, were unlikely to be caught up by the trap of excessive social obligations. Therefore, this was not a temporary factor.

7) Globalisation is also fraught with implications which are pushing to reduce public spending. On the one hand, multinational corporations, a driving force of globalisation, are crossing national borders. Markets located in different

parts of the world are becoming increasingly interdependent. On the other hand, there is a growing need in international regulation of forces going beyond the control of their home countries. This inevitably leads to emergence of regional associations of countries, for example, European Union, with a part of authority of member-states being delegated to the supranational level. In addition, the role of international economic organisations is likely to increase. This would appear to result only in the growth of international bureaucracy. But, as it turns out, from their early steps these organisations are achieving sustainable financial stability in the interest of everyone. Containing budget deficit is one of the primary clauses of the Maastricht Agreement. Member-states are not free to compete in populist trends. I am sure time will come when the United States will no longer be free to take decisions to further incur a public debt since such policies are fraught with serious risks for the entire world economy.

As a matter of conclusion, the liberal turnabout of Thatcher and Reagan is not a casual fluctuation but a sustainable trend caused by a transition of leading countries, followed by the rest of the world, from industrialism to post-industrial society. Public spending will somewhat decline along the way but not down to the level of China and India. In a vast majority of developed countries it will probably stabilise at 30-40 percent of GDP. Those managing to keep them further down will have a stronger competitive edge.

### 3. Time Context: How We Approached the Stage of Modernisation

Now it is time to discuss the situation of Russia. The Soviet planned economy was an extreme, degenerated case of dirigisme where the government was essentially the only owner and entrepreneur managing the economy through the ubiquitous bureaucratic hierarchy. The inherent flaws of the system caused it to collapse despite attempts to change it. This collapse was delayed for 20 years by high oil prices and development of Russia's rich oil fields. But when oil prices fell (1986), the crisis became inevitable, and future generations received, apart from a

heritage of hardships, a warning of hazards coming from an overblown economic role of the state.

This situation was helped by market reforms which, due to a variety of factors, turned out to be extremely radical and, possibly, added to the pains of the transformation crisis. Since radical changes, as always, needed radical ideological justification, for some time reformers tended to exaggerate the potential of market arrangements, especially as they started out amidst the wreck of the planned economy. Anyway, their opponents, sometimes with good reason but for most part not, condemned a too hasty retreat of the government from the economy including termination of subsidies (tighter budget constraints) and massive privatisation of a considerable part of government-owned enterprises.

Disputes of this kind are likely to last very long. I am personally convinced that no other policy could have yielded a positive outcome, especially in light of accompanying political processes and dramatic weakening of the state due to the combination of all factors. However, it is precisely at that time and **in those circumstances that the government played a very prominent role**, particularly, in implementing institutional reforms.

Curiously, when condemning liberals for their dismissal of public regulation of the economy, including prices, outputs and structure of production etc., their critics would note: "The paradox is that all this is accompanied by more public intervention into the social aspect of economic processes (probably meaning social transfers in support of financial stabilisation – Y.Y.), and strict administrative control over the course, timing, methods and forms of their implementation. The government intentionally controlled dismantling of the public sector of the economy, enforced certain types and forms of enterprise..." [1, p. 22]. It would appear that the state did not retreat that much from the economy, it only contributed to its transformation into a market economy.

Institutions of free pricing, competition, open economy, private ownership re-emerged within a short while. The taxation and banking systems, the pillars of a market economy, were created practically from scratch. While originally far from



being perfect, these institutions generated positive vibrations which provided the economy with energy and direction of development. The transformation crisis was very deep (GDP fell 40 percent, industrial output 55 percent during 1991-98) as to seem the main outcome of reforms. But in fact the reforms only uncovered the ails of the planned economy and marked the start of a passive stage of the structural adjustment. Meanwhile, their main outcome were the aforementioned institutional changes which opened new prospects of development, something which did not become evident until 1998.

At the same time other public functions shrank, especially those of public enterprise and control, while social guarantees became largely depreciated. Also, functions of maintaining law and order weakened, especially since their content should have changed dramatically from directed action in the interest of superior authorities to supremacy of law. For Russia this would have been an enormous achievement. However, it is still not there. Hence, along with economic and political freedom, there is rampant crime, corruption and criminal behaviour in business matters, including in redistribution of property as actively promoted by government officials who are virtually free to pursue their business interests, much as they may conflict with duties of their office.

The main market reforms were implemented in 1992-93. The next stage – 1994-97 – was a period of financial stabilisation. The rate of institutional changes rapidly declined as what had been achieved at the previous stage was taking root. Inflation, reduced subsidies and economic openness had resulted in considerable structural shifts which occurred spontaneously, without government intervention and with a significant loss of previously created production facilities no longer fit to manufacture competitive products in a new environment. The government responded by pursuing moderately protectionist policies: import duties abolished in 1992 were re-introduced along with restrictions on the amount of imports which, as a matter of fact, were shortly dropped under the pressure from the IMF/IBRD.

This was also the peak of the "wild capitalism" of primary accumulation of wealth in Russia. Large capital had emerged, with oligarchs, its crown, attempting

to seize the power. The economic situation was chaotic, tax collection was as poor as could be, while economic policies did not seem helpful at all to overcome the manifestations of crisis. Nevertheless, financial stabilisation did happen. In 1995 the federal budget was performed to 95 percent as compared to 70-75 percent back in 1993-94. In 1997 inflation was down 11 percent as compared to 320 percent in 1994. This threshold was overcome for the first time only in 2005 with 10.9 percent. The crisis of 1998, more than half of which owed itself to outside factors such as the Asian crisis and dramatic decline in oil prices, marked the rock bottom. A new threat to stability was prevented by austere monetary policies pursued by the Primakov government. This helped to lay down the framework for a transition to the stage of modernisation.

Economic growth started off already in 1999, largely at the expense of existing production capacities. In this sense, it might be called a recovery growth. There is, however, no similarity with what was called the recovery growth at the time of the New Economic Policy, except that the 1999-2002 growth was only slightly associated with modernisation in the narrow sense of this term, namely, with investments to upgrade the equipment, improve skills of personnel, innovate and establish new lines of business. Modernisation was supposed to follow in the wake.

It should be underlined that growth was resumed, as liberals had expected, without intervention of the government, except that it supported market reforms and achieved financial stabilisation, only to devalue the rouble under the pressure of circumstances. The last measure, at the cost of rampant inflation reaching 84 percent in 1998 and decline of living standards, improved relative competitiveness of domestic producers. A rise of oil prices which followed helped to resolve a host of problems with payment defaults and barter trade, wage and pension arrears, improve tax collection, overcome a budget crisis and increase monetisation of the economy from 14 percent in 1998 up to 28 percent in 2005.

These years saw considerable structural changes as described by data of Tables 2, 3 and 5. In terms of employment, the most dramatic decline occurred in

industry which lost a third of its workforce, although by 2003 industrial output recovered approximately 80-85 percent of the 1990 level. Since 1998 when this indicator stood at 45 percent, employment in industry practically ceased to grow. Another important change is the growing share of the trade and financial sector, something which is only natural of transition to a market economy as these sectors, being essentially the market mechanisms, perform regulatory functions of former planning. The third noticeable shift is reduction of the share of physical production in general and increase of the share of sectors providing market and non-market services. Thus, a passive structural adjustment of the economy had indeed happened. The sectoral structure of production and employment was changed to match the demand.

**Table 2. Changes to sectoral structure of the Russian economy in 1985-2003 (in terms of employment, %)**

<b>Sector</b>	<b>1985</b>	<b>2003</b>
<b>Total</b>	100	100
<b>Industry</b>	32,3	21,9
<b>Agriculture</b>	13,9	11,0
<b>Construction</b>	9,4	7,7
<b>Transport</b>	8,5	6,4
<b>Communications</b>	1,3	1,4
<b>Trade</b>	8,3	16,8
<b>Utilities and housing services</b>	4,1	4,4
<b>Health care, fitness and sports, social security</b>	5,0	7,1
<b>Education</b>	7,1	9,1
<b>Culture and arts</b>	1,4	1,9
<b>Finance, lending and insurance</b>	0,5	1,3
<b>Administration (including defence)</b>	1,6	4,7

Source: Rosstat [6;8]

Table 3 shows the dynamics of GDP structure (gross value added in basic prices not including taxes on products and subsidies) which allows to observe the process of changes. Here we also see a decline in the share of industry, though to a lesser extent, and dramatic reduction of the share of agriculture which is even more important since employment fell insignificantly from 13.1 to 11 percent in 1985-2003 while GVA fell from 16.6 percent in 1990 to 5.8 percent in 2002. After a

dramatic decline in 1992, the share of communications grew 1.5 times by 2002 due to development of cellular networks.

Dynamics of trade and financial services is especially manifested. While in 1985 the share of trade, catering and provisioning (specifically Soviet sector for purchases of agricultural produce) was 8.5 percent in terms of employment, it grew 16.8 percent in 2003, only to increase from 6.3 percent in 1990 to 22.5 percent in 2002 in terms of value added. Curiously, in a situation of crisis and high inflation at the peak of 1992, trade would accommodate a higher share of GVA, including through redistribution at the expense of a price differential between external and domestic prices. While for many it was a chance to make a fortune, it seems to be a necessary moment for shaping the market economy and making the law of supply and demand work.

**Table 3. Dynamics of GDP structure in Russia in 1990-2002 (% , basic prices)**

Sector	1990	1992	1995	1998	2002
<b>GDP in market prices</b>	100	100	100	100	100
<b>Gross value added in basic prices:</b>	93,1 (100)	98,2 (100)	92,4 (100)	90,6 (100)	88,5 (100)
<b>Including:</b>					
- industry	38,0	35,1	28,2	30,0	27,5
- agriculture	16,6	7,4	7,2	5,6	5,8
- construction industry	9,6	6,5	9,2	7,4	7,1
- transport (2002 – road network)	8,8	7,1	10,8	8,9	7,6
- communications	1,2	0,6	1,6	2,0	1,8
- trade and catering (including provisioning)	5,6	29,9	21,4	20,6	22,5
- housing and utilities	3,3	1,9	4,4	4,1	2,9
- finance, lending, insurance	0,9	4,8	1,8	0,4	3,1
- science and related services	2,7	1,0	1,0	1,0	1,1
- health care, fitness, social security	2,8	1,7	2,7	3,2	3,1
- education, culture, arts	5,4	3,0	3,4	4,1	4,0
- administration (including defence)	2,8	2,2	4,9	6,2	5,4

Source: Rosstat (2000, p.252; 2006, p.306)

The World Bank's country report for Russia (2004) drafted under the guidance of Christopher Rull concluded that a higher share of trade in the Russian economy resulted from the fact that a considerable part of value added generated by the oil and other export-oriented sectors was realised in trade through transfer pricing.

Calculations of this report showed that for this reason the share of oil and gas sector in the country's GDP was largely understated: while in 2000 it officially accounted for 7.8 percent of GDP, it was estimated in the report to be 19.2 percent; in addition, the share of trade was to be lower, from 27.3 percent according to official data down to 14.6 percent as suggested in the

report. These calculations were based on the Canadian trade margin being substituted for the Russian one, as follows (%):

	<b>Russia</b>	<b>Canada</b>
<b>Oil production</b>	30,7	0,0
<b>Oil processing</b>	26,6	17,2
<b>Gas</b>	63,1	0,0
<b>Total for the economy</b>	15,6	7,5

Source: 7, p. 86

Comparing with the UK, Netherlands and Norway will produce an even more striking picture as oil and gas come to account for 22 percent of the country's GDP while the share of trade declines still further down to 9.7 percent (in case of the UK) and 8.4 percent (in case of the Netherlands). The report generally concluded that due to transfer pricing tax collection shortfall alone accounted for about 2 percent of GDP in 2000 [7, p. 88]. Therefore, it would not appear accidental that the general prosecutor's office reserved an accusation against Khodorkovsky and YUKOS for application of transfer pricing which could be launched against any oil company, Gazprom and many other vertically integrated companies.

Indeed, transfer pricing was (and is even now although on a mode modest scale) a widespread tool for "optimising" taxes. But I believe that the extent of redistribution of value added is largely exaggerated as, in fact, trade would account for approximately 20 percent of GDP. This inaccuracy resulted from trade margins of developed countries being applied to Russia, a country only emerging from a period of transition where trade had been the driving force of structural adjustment.

Based on this approach, let us calculate what percentage of GDP was attributable to trade in Russia and United States throughout our transition period.

**Table 4. Share of trade in GDP and employment in Russia and United States ( %)**

	<b>Russia</b>			<b>US</b>	
	<b>1990</b>	<b>1995</b>	<b>2003</b>	<b>1990</b>	<b>1997</b>
<b>GDP</b>	6,38	19,7	20,0	14,8	17,1
<b>Employment</b>	8,7*	10,1	16,8	21,7	21,8

Sources:[8, p.p. 141, 307; 6, p.p. 100-101; 9, p.p. 343,371,380], author's calculations.

\*Note: USSR data.

First, it is obvious that in these years the share of trade was rapidly growing both in terms of value added and employment. While in the Soviet time trade was only the final joint of the administrative distribution system, it was to become the heart of the market economy in a new environment. Second, it approached the indicators of developed countries both in terms of value added and employment. While in employment it stood closely behind, it took the lead in terms of value added at the early stage not only due to transfer pricing but rather because it absorbed all disproportions between domestic and external prices, still regulated and already free prices, those of different regions and markets. For some time all these disproportions would go into trade revenues to ensure higher profitability. This market mechanism was the natural channel to remove these disproportions and generate market price signals to both producers and consumers. As for transfer pricing (by the way, the Soviet economy knew no other), it was only a fragment of the complicated picture of transition processes resulting from structural factors, particularly, the exaggerated market share of vertically integrated companies established with involvement of the government.

This conclusion is confirmed by the data of the financial sector's development: in terms of employment, its share more than doubled in 1990-2003 while, in terms of value added, it grew

more than 10 times. Fluctuations were enormous since at the very start (1990-1992) the share of this sector grew 16 times as all new businessmen rushed to the forex market and banking sector. This was followed by a dramatic decline in the period of financial stabilisation and 1998 crisis, only to stabilise somewhere at 3 percent of GDP and 1.4 percent of employment. Like trade, the financial sector plays a special regulatory role in the market economy. It is at least not correct to compare their indicators with those of developed economies in the period of transition when they only emerge and adapt to their new role.

Let us look at the changes to the sectoral structure of industry, above all in terms of employment (see Table 5).

**Table 5. Average annual employment in sectors of industry in 1990 and 2003**

Sector of industry	1990		2003	
	thousand	%	thousand	%
<b>Total industry</b>	20,998	100	12,384	100
<b>Electric power</b>	545	2,6	893	7,2
<b>Fuel</b>	801	3,8	740	6,0
<b>Ferrous metals</b>	785	3,7	664	5,4
<b>Non-ferrous metals</b>	487	2,3	553	4,5
<b>Chemical and petrochemical</b>	1130	5,4	829	6,7
<b>Machine building and metal processing</b>	9652	46,0	4317	34,9
<b>Forestry, wood processing and paper pulp</b>	1792	8,5	968	7,8
<b>Construction materials</b>	1097	5,3	642	5,2
<b>Light industry</b>	2820	13,4	694	5,6
<b>Food</b>	1598	7,6	1488	12,0

Above all, there is a remarkable (over 40 percent) reduction of employment in industry. The share of industry in GDP declined more than 10 percent (Table 2). Employment increased only in two sectors, electric power and non-ferrous metals, which in 1990s, along with oil, railway, administration and other budget sectors, played the role of a safe haven for many people in search of subsistence in this time of hardships. In the fuel sector redundancies were generally small but its share of employment grew due to more sizeable redundancies elsewhere in industry. It is worth noting that in the coal industry employment fell from 511 thousand in 1985 to 233 thousand in 2003, i.e. more than twice, as a result of the reform and restructuring which included closing of loss-making mines and entire coal fields (for example, Kizelovsky and in Moscow Region). Moreover, coal output declined only 30 percent, with domestic demand being fully satisfied and exports of 60.7 million tonnes or 22 percent of output in 2003.

Employment declined dramatically in machine building (55 percent), light industry (4 times), forestry (1.9 times) and construction materials (1.7 times). These were all sectors producing predominantly to the domestic market. Elsewhere in industry – export-oriented sectors and food sector – employment declined only slightly.

Importantly, employment decline was accompanied by a decrease in output since after 1999 labour productivity grew at a rate close to that of GDP, with few jobs being created.

After 1998 there were no remarkable structural changes to the economy. It is not to argue that Russia has finally turned into a supplier of raw materials whereas previously it had a diversified production structure. Losses occurred largely due to a decline in production of weapons and non-competitive goods. Production of oil and gas condensate is now below the peak of 1980 (542 million tonnes) and start of the crisis (516 million tonnes), with 469.6 million tonnes being produced in 2005 when physical exports even fell 2.2 percent but their value grew 43.1 percent. Gas production is 632 billion cubic meters in 2004 as compared to 641 billion in 1990, its absolute maximum. Steel production is approximately at the level of 1970 while finished steel output is noticeably higher at 81 percent as compared to 68 percent 35 years ago [8, p. 384].

Exports of fuel and raw materials saw more changes than anything. One half of crude oil output is now exported while in the early 1980s, at the time of the Soviet Union, crude oil exports were approximately 120 million tonnes or 20-25 percent of production. Gas exports amount to 190 billion cubic meters, i.e. about one-third of production as compared to 109 billion (17 percent) in 1990. At that time more oil and gas were exported to what is now CIS countries as they were part of the domestic market. Russia is also exporting now more metals, timber, cellulose, chemical products. Exports of weapons are approaching USD 6 billion. The country exports whatever can earn a profit. Changes, if any, in the structure of exports will occur primarily at the expense of prices. Table 6 shows changes in the main items of Russian exports over 1995 and 2003.

**Table 6. Main items of Russian exports according to classification of foreign economic operations (% of total exports)**

<b>Export item</b>	<b>1995</b>	<b>2003</b>
<b>Food and agricultural raw materials</b>	3,3	2,5
<b>Mineral products (including oil and gas)</b>	42,0	57,3
<b>Chemicals</b>	9,9	6,9
<b>Raw leather and fur</b>	0,4	0,3
<b>Timber and cellulose/paper products</b>	5,6	4,2
<b>Textiles and footwear</b>	1,5	0,7
<b>Metals and jewels</b>	26,1	17,7
<b>Machines and equipment</b>	9,9	9,0
<b>Other</b>	1,3	1,4

There is obviously a dramatic bias in favour of mineral products, primarily oil and gas, but, as has been demonstrated above, physical production did not grow as much. Moreover, it cannot be argued that increase in raw material orientation of the Russian economy resulted from current policies. This is only a reflection of the market situation and competitive ability of domestic goods.

So, what has happened over the years of reforms? Yes, production declined dramatically but this was a consequence of economic liberalisation and openness, and tighter budget constraints for the sake of overcoming inflation. These measures allowed to prevent a disaster. The economy re-adjusted in line with realities of the market bringing to the light our genuine current competitive advantages. Serious changes occurred in the structure of Russian society reflecting social and material stratification, wealth of the few and poverty of almost half of the country. But this was to be expected from transition to the market in an environment of economic freedom. Wage-levelling disguised as equality and undermining incentives to work and enterprise had to be overcome. Overshoot and spontaneity abounded but they caused social responses and corrective measures capable of re-establishing the balance.

It is noteworthy that in the period of 1992-2003 economic policies were liberal, if sometimes inconsistent. There were attempts to establish government control over the economy but they largely resulted from demands of certain social groups to respond to negative phenomena or efforts of sectoral lobbyists. On the



contrary, the reforming function of the government remained fairly manifested, especially in 1992-1994 and after Putin's rise to power. Gref's programme drafted in 2000 is still relevant. The tax reform, anti-bureaucracy laws, liberal and yet socially acceptable Labour and Land Codes were all its implemented components. The economic recovery relied on this, not only on oil prices. But modernisation, an active stage of structural adjustment, was yet to start.

#### 4. Objectives and Challenges of Modernisation

Let us ask ourselves once again: what modernisation do we need, if at all? Undoubtedly, there is a need in capital upgrade which one can appreciate without looking at figures of wear and depreciation of equipment reproduced in all papers on this matter. However, it is not as simple as that, and "hardware" upgrade alone will not suffice. The real challenge is to build an open and competitive economy capable of ensuring well-being of the nation and decent position of the country in the world. One has to admit that the Russian economy has never been as open and competitive as required for leadership. Of course, we had military power and could expand and secure enormous territories but at the price of poverty of the nation deprived of generally accepted rights and liberties. The USSR had a diversified but closed economy increasingly dependent on the West in terms of technologies and food. The current Russian economy is relatively open but competitive only in fuel and raw materials and, therefore, dependent on the situation of relevant markets. Judging from their market share, knowledge-intensive and sophisticated goods are primarily weapons. Therefore, openness and competitiveness is an enormous leap forward in quality which will required from the country to embark on enormous, long-term, dedicated and consistent work. This work will assume capital upgrade, infrastructure adjustment and, most importantly, serious improvement of qualities of human capital – professionalism, education, health and longevity, business and work ethics, mentality. The requirements of a post-industrial society which have to

be met regard primarily these qualities, an environment of freedom and confidence favourable for creativity and communication.

But is it worthwhile? There are widespread views that it is better to stick to traditions and reserve a special way for Russia. Or else, concentrate on reinstating the country's past greatness sparing no expense and relying on what we have today: oil, gas, metals, timber; furs, hemp, potash, as in the old days. This is more simple and will reduce uncertainties and risks of development but will not yield anything better than maintaining our current position in the world hierarchy of prosperity and culture.

I would remind that increasing contradictions between developed countries (Western economies in the first place but also Japan, Korea, Taiwan, Singapore) and Islamic countries largely owe themselves to the fact that nations of the latter are unwilling or incapable of giving up their traditional values. Because they share them in their unchanged form, they are less successful in producing innovations, the main driving force of the modern economy. As the gap widens, they tend to be increasingly hostile towards more successful nations. Only two Islamic countries – Turkey and Malaysia – were able to achieve the average level of development but in Turkey Ataturk enforced a secular state back in 1920s, with the army exercising political control over Islamic extremism ever since; while in Malaysia an important role is played by the Chinese community which traditionally controls business. It is impossible to bridge the gap while preserving old ways of life, even with the westernised elite.

Countries of East Asia, including China, are more successful. They learned to organically combine modern ways with old traditions. As has been noted above, the rice culture and Confucian ethics, with some concessions made to trade and enterprise, turned out to encourage high-quality human capital, a rare combination of industriousness, discipline and simplicity, be it even for a while. Other qualities are not so important at the stage of industrialisation. An active involvement of the government as the country pursues development is only natural, customary and not quite obstructing. It will become an obstacle later as the potential of development

in pursuit is exhausted. Here the progress of modernisation is fast and challenging for other countries as competition tightens up.

Russia is also facing challenges of this kind. Its customary modernisation efforts to bridge the gap between it and the West now come under the danger to lose competition also with the East and find itself in a situation resembling that of the Islamic world. Hence there is no other alternative but modernise as our survival is at stake. We cannot afford to sit and wait instead of changing. Moreover, the vector of changes is also set, once we accept the priority of the above objectives – social well-being and a decent position in the world.

So, modernisation is inevitable, being modernisation of society, not only that of fixed capital. What role should the government play in this process?

## 5. Projects of Modernisation and Functions of the State

As we have observed, economic policies in 1992-2003 were liberal. The state weakened by revolutionary changes focused on market reforms and macro-economic stabilisation. What next? Undoubtedly, **the state should play a more active role at the stage of modernisation as compared to the period of market reforms** which primarily assumed liberalisation. This conclusion follows at least from the fact that market mechanisms and private business are unlikely to be in a position to always win the fight for competitiveness from a low start without public support and that business is unlikely at the early stage to undertake long-term and risky projects needed by society.

But what exactly should the government do? This depends on the strategy of modernisation.

Here we will discuss two projects:

a) modernisation from above – initiatives come from the government, politicians and bureaucracy which develop and implement solutions;

b) modernisation from below – initiatives and financing come primarily from business while government agencies create an enabling environment for business activities and support specific projects.

Now let us discuss what functions of the state are more required under each of these models.

**1) Building legislative environment, maintaining law and order.**

It is important for modernisation from above to ensure that decisions taken by superior authorities are implemented as subordination is more important than abidance by rules. Power is concentrated while division of authorities to guarantee supremacy of law is either absent or formal. Therefore, office of a "night watch" is vacant or filled by unimportant figures for the sake of decency. Red tape, violence and corruption are, therefore, inevitable.

Meanwhile, this function is a primary one in case of modernisation from below where sources of initiative are many. Supremacy of law and independence of courts give to entrepreneurs and the public reasonable assurance that the state will care for their rights. These are necessary conditions of freedom and confidence.

Even if initially the "night watch" might fall asleep, there is confidence that relevant institutions will work better from day to day, and this is enough to ensure success.

**2) Defence, protection from outside threats** – this function is invariable in principle. But it should be borne in mind that under authoritarian rule characteristic of modernisation from above the authorities are more tempted to rely on force, including in resolving domestic policy issues.

**3) Maintaining macro-economic stability** – another invariable function but more important for the second option: the state has limited authority but low inflation and stable currency create a more enabling environment for business activities.

**4) Implementing institutional changes and necessary reforms.** This function is very important in the course of modernisation. Under the first option

the authority of the state allows to do without more efficient institutions which are especially important when economic agents act independently. Meanwhile, reform incurs political risks to which the authoritarian government is very sensitive. Once its position is secure, it will not undertake any reform.

But, on the other hand, the second model which has to pay more attention to the public opinion, also finds it difficult to undertake unpopular reforms and will do so only in a crisis. Meanwhile, in critical situations charismatic authoritarian rulers recognised by a vast majority of people will be even more likely to assume responsibility for reforms. But this is the case of only extraordinary circumstances. Where society needs solid institutional reforms taking a long time to implement, this will require consolidation of elite and a broad social consensus.

This is generally a painstaking process which will build up a core of social modernisation. But under certain conditions it might put opportunities of active social life within reach of a larger number of people that would normally have them. It will make their life meaningful and encourage social motivations which is very important for development of participatory democracy and civil society, two institutions characteristic of the second model.

Concerning post-industrial modernisation, functions 5, 6, 7 (public services, social guarantees, environmental safety) are normally associated with unpopular reforms which purport to charge persons and households with more responsibility and increase household expenditures while reducing public expenditures and taxes. Therefore, what has been said above about the role of the state in the process of reforms will apply to them.

**8) Encouraging economic development.** A more prominent role of the state at the stage of modernisation will assume precisely this function. But its content will vary depending on the chosen project of modernisation. Modernisation from above largely assumes that superior authorities will identify national priorities and make decisions regarding large-scale public investments into high-priority sectors and provision of subsidies and benefits to ensure their accelerated development. There may be no alternative to such policies at the stage of development in pursuit.

But at the stage of post-industrial modernisation they are fraught with high risks due to uncertainties and rapid change of priorities as public investment projects take a long time to implement. In countries where corruption is high and law abidance is low, the dangers of wasted investments will be aggravated by their inefficiency.

In modernisation from below the state should also play a more prominent role but primarily to improve market mechanisms including freedom of business operations, guarantees of ownership rights and contractual performance, and fair competition.

This means, in particular, that there should be sound anti-trust policies and independent anti-trust agencies invested with extensive powers and relying on the business community and reports of those suffering from abusive practices.

This means legislative regulation of lobbyist activities capable of containing pressures of different interested groups on all branches of power within legally acceptable limits.

This also means development and regulation of activities of comprehensive system of markets to improve competitiveness of the economy.

Finally, this means large-scale efforts to build up and maintain a system of information to ensure transparency of operations of business undertakings and all public agencies.

It is impossible to create an ideal system of market balance with perfect competition, completeness of markets and perfect information to achieve Pareto-optimality. But we should strive towards that end. Therefore, operations of the government in the above areas have to be regarded as the highest priorities of economic policy.

Due to differences between countries in enterprise and starting conditions, the government has to ensure a combination of economic openness with political protection of national interests, domestic business and domestic consumers over a long term, i.e. not by momentary, jerky responses. Public direct investments, subsidies and benefits, though not ruled out, should be strictly limited and can

apply only to absolutely necessary projects. I personally believe it is absolutely necessary to ensure public support of domestic aircraft engineering in Russia on the premise of the country's vast territory and a need to ensure affordable, reliable and high speed transport. This is also a key component of the infrastructure and a factor of territorial integrity.

Another area is support to innovations and venture innovating business focused on creating new markets, new products and technologies, and new companies.

Finally, investment into research and education is an undoubted priority to guarantee long-term results. All the above areas are focused on encouraging, promoting and supporting private enterprise.

A principally important point: policies to encourage economic development will only achieve success where the government reliably performs functions 1 and 3 ("night watch" and macroeconomic stability). Interdependence of these functions merits special attention by helping to appreciate their priority. Where law and order are poorly maintained, business is unsure of protection of ownership rights and macroeconomic stability is shaky, government efforts to encourage development are likely to fail or expenditures will prove disproportionate to the results.

**9) Eliminating market failures.** One could assume that this function is no different from the previous one or largely overlapping. This is probably so. But I intentionally take these functions apart since extended powers of the government to exercise current control of economic processes is often alleged as being necessary for prevention of market failures. A characteristic example is introduction of meat export quotas which promptly resulted in higher prices of meat without any visible improvement of competitiveness of domestic producers which had lobbied this decision. This is clearly a textbook example of the "cobra effect" described by Horst Zibert [10]<sup>2</sup>. Hermann Gref who wrote a foreword to the second Russian edition of this book remarked that the author analysed the mistakes of the German

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<sup>2</sup>"They say that at the time of the British colonial rule there were too many cobras in India. In order to solve this problem, the governor would give an award for every surrendered cobra head. Indians had to catch these monsters. How did they respond? They started breeding cobras to get an award". You will also find many other examples that show unexpected outcome of government intervention.

state associated primarily with its excessive economic intervention including "its desire to adjust and improve the effect of market mechanisms which are, of course, imperfect. However, improvements which might initially seem useful and logical would sometimes produce a counter effect" (10, p. 8). Curiously, it was exactly Gref's agency which drafted the decision on meat export quotas.

Another example of our recent practices is introduction of higher import duties on imported second-hand cars to encourage sales of domestic cars. As a result, sales of domestic cars did not grow since consumers preferred buying new imported cars, despite their higher cost.

In [1, p. 18] it is stated that "in discussions between themselves Western theoreticians will refer to two symmetrical theories: "market failure" and "government failure"...

It appears, – the authors continue, – that advocates of both are equally wrong". I would, on the contrary, argue that both sides are right but to a varying extent. It is now obvious that ours is not a case of symmetry. There is a prevailing threat of incompetent government intervention which prevents from ensuring efficient operation of market mechanisms where they are needed, and a lack of action where the government should be present at the stage of modernisation.

Every time when government officials have a desire to correct operation of the market they should resort to a sound idea to stop and think that a) after a while the market might itself develop a positive response to previous lapses, and b) the consequences of implementation of their idea might be more destructive than the observed market flaws, for many of which, such as inflation, unemployment etc. the world has already developed a cure and at least learned to contain them within acceptable limits. Of course, it is not a case of emergencies.

Since Josef Stiglitz, a Nobel Prize winner, is a chief authority, if anything, for domestic advocates of state intervention, I will take the liberty of reproducing an extract from one of his non-polemical papers.

"For market failures, Stiglitz writes, it is assumed that the government has a potential role to remove them. But, like the market, the government is often not ideal. Governments also



use imperfect information. They often cannot adequately predict the consequences of their own actions. Thus, they proved unable to adequately predict the destructive effects of highways for urban centres nor consequences of the resulting flight of the population to suburbs. Also, they do not foresee to what extent the reforms to change mental institutions lead to homelessness in cities. They do not take into account how private sector will in fact respond to their actions. For example, in 1990 the government required producers of medicines to sell their products to them at below market prices. The government noticed that pharmaceutical companies would sell medicines to some customers at lower prices than to Medicare and calculated that, if entitled to the same discount, they could save billions of dollars. But pharmaceutical companies called off any discounts as soon as they discovered that, once they gave a discount to the government, nobody was paying them on a regular basis. As a result, rather than saving public expenditures, the new regulation brought about an increase in the price of medicines for everyone.

Both bureaucrats and politicians are encouraged, at least by private business, to act contrary to public interests...

Today, speaking of the role of the state, economists will bring up the issue of not only market failures but also restrictions to be imposed on the government, so that the proposed treatment is not more expensive than market pains" [11, pp.143-144].

Sometimes decisions of government agencies are more than ill-thought, just as the market may be more than spontaneous. They are prevailing a product of someone's interests, either private, or governmental, which are harder to balance than the market. These components, once juxtaposed, may be especially detrimental when trying to introduce a regular public control over markets, companies and entities, and also in implementing large-scale public projects. James Scott analysed a range of failed public projects, from arboriculture in Germany, construction of ideal modernist cities (Brazil – Nimeira, Chandigarch – Le Corbusier which have never been implemented as imagined), forced migration

of people to rural areas in Tanzania (as suggested by Julius Njerere) to the collectivisation plan in the USSR [12]. I believe this country alone could provide enough examples of public failures for a voluminous list, much more impressive than any known market failures.

It would be just to say that there were many successful public projects such as Roosevelt's Tennessee Valley or large-scale housing construction in Russia at the time of Khrushchev, or else oil field development in Western Siberia. Nevertheless, total count will probably be not in favour of the state. Our most ambitious national project – socialist planned economy – was an absolute failure which only proved that the market economy, despite its shortcomings, was better and more efficient. This will assert the liberal doctrine more than anything else, no matter how much it is criticised.

James Scott mentioned four factors which would predetermine a failure of public projects:

- 1) administrative zeal, a desire of officials to excel despite very primitive idea of the object of their efforts; 2) "lofty modernism" – he called this way the exaggerated belief of technocrats in advantages of allegedly scientific rationality and planning, a characteristic feature of political and administrative thinking of the industrial age; 3) authoritarian rule providing for concentration of power to implement ambitious projects and prevent any criticism of them; 4) suppressed civil society [12, p.p. 91-93]. Taken individually, these factors could be neutralised but will become very dangerous in a combination. First, as a matter of special danger, it is often much easier to start than exit a project: when negative consequences are clear, exit is prevented by considerations of prestige. If the project is undertaken on a large nation-wide scale, this may lead to a dramatic crisis or social unrest. This was the case of socialist project in the USSR. Second, consequences will not immediately become obvious, and next generations will normally have to deal with them. In Scott's example with German arboriculture, starting from XVII century artificially planted Norwegian spruce, very profitable, would replace natural mixed forest which had underwood, mushrooms and normal

fauna. Forests would acquire a look of parks. As the reproductive period of the Norwegian spruce is 80 years and it grew well in the soil produced by natural forests, it was not before 160 years that forest decay became evident [12, p.p. 30-40].

Explanations why government failures happen, at least, as often but in fact more often than market failures are given in the work of Atkinson and Stiglitz [2, p.p. 399-438, 482-494] who could be blamed for anything but diminishing the role of the government. They speak only about practices of democratic countries where decisions of politicians and legislators are affected by groups of interests, primarily in business and bureaucracy, and also by the care to be re-elected for another term. In addition, there is an information asymmetry between executive and legislative authorities, all branches of power and electors.

But, despite its flaws, democracy still has the instruments to ensure a feedback between society and government which allow, albeit with delay, to identify policy errors and correct them at least by political competition and a change of governing teams. Meanwhile, where these instruments do not work, an active role of the state inherent in modernisation projects is prone to especially high risks.

**10) Public enterprise.** If we rule out ideological considerations in favour of public ownership which were generally shared in this country only recently, public enterprise might be regarded as a method to prevent market failures or encourage economic development including through structural changes implemented by way of public investment. Where private companies receive high revenues, for instance, by appropriating royalties, and use them in a way which does not seem reasonable to the government, politicians and officials may be tempted to collect not only taxes but also these revenues in order to apply them in the interest of society. Another reason for intervention is where private companies operating in traditional sectors succumb to competition while being important to the national economy for the purpose, say, maintaining a market share or preserving jobs. In this case it would be reasonable to nationalise them or purchase a controlling stake, make necessary investments and save their business. In both these cases the aim is to

make government-owned companies a tool of public policies, normally at the expense of business efficiency.

For this reason and also due to lower motivation of government officials and managers, government-owned companies are normally less efficient than private ones. In requiring to perform non-business functions, the government has to soften budget constraints. As government control is weaker than that of private owners and shareholders, it favours corruption.

It cannot be asserted that these manifestations occur in each particular case. There are exceptions, especially where a government-owned company operates in a competitive environment and has sound management. In a period of transition where private companies are privatised only recently, the process of redistribution of property is ongoing, owners themselves often have little experience or talent to do business while government-owned companies, on the contrary, enjoy benefits of established organisation and produce non-competitive products, one would be hard pressed to tell who is more efficient. This is confirmed by the results of many studies. Advocates of state enterprise will always find arguments to contest those of their opponents. Therefore, it is often praised by those preferring projects of modernisation from above.

But with time the advantages of private enterprise are becoming ever more noticeable while the flaws of state enterprise are turning into one of the most important factors of government failure.

Modernisation from below based on private enterprise will prefer using public agencies only where they are absolutely necessary to perform other government functions or have obvious advantages before private entities in provision of public services. State enterprise is not ruled out in principle, including to implement useful structural changes. But projects of this kind should always be strictly limited in terms of funding and time.

A vast majority of specialists would generally argue that state enterprise is a defective instrument of public policies in a modern environment. Let us assume that authorities believe that business does not live up to their expectations from the

perspective of activity and willingness to invest into sectors of high priority to the government. They will increase the public sector and assign political objectives to government-owned companies. Or else, they will establish political control over private companies and, applying authoritarian methods, will force them to act as desired, i.e. assimilating them to some extent to government-owned companies. It is very likely that, even if results are positive in the beginning, ultimate policy goals will not be achieved while expenses will be much higher than planned. The only party likely to win from using these methods are government officials who will control financial flows on behalf of the state.

State enterprise is the worst instrument of modernisation policies.

The results of this discussion are summarised in Table 7.

**Table 7. Functions of the state under two modernisation projects**

State functions	Modernisation projects	
	from above	from below
<b>General project profile</b>	Reliance on the government and government control over the economy and society	Reliance on private enterprise and control of society over the government
<b>Law and order</b>	* Power is concentrated, possibility of enforcement outside law	*** supremacy of law, division of authority
<b>Defence and security</b>	*** Reliance on power agencies increases their importance	** Purposes – only fight against outside threat and terrorism
<b>Macroeconomic stability</b>	* Useful unless intervening with social peace	*** Necessary condition of business activity and confidence
<b>Institutional reforms</b>	** Dangerous as incurring political risks	*** Required to grow productive institutions and values
<b>Public services</b>	* Useful for maintaining stability	*** Necessary factor of human development
<b>Social protection</b>		** Necessary on condition of democratic control over bureaucracy
<b>Environmental safety</b>		

<b>Encouraging economic development</b>	*** Required due to mistrust in business and market forces	* Useful unless government failures prevail
<b>Eliminating market failures</b>		* To be avoided
<b>State enterprise</b>	High risks; easy to begin, hard to exit the project	Slower but sure
<b>Probable outcome</b>		

Note: \*\*\* – very important, \*\* – important, \* – unimportant.

The profiles of modernisation projects given in Table 7 refer to imaginable, theoretically pure rather than real options. In practice modernisation agendas will always present a combination of ideas and measures proposed in these options which are either declared, or implemented, or both, or stuck in a contradiction between words and actions. Relative importance of these functions is marked with asterisk while their content for each project follows from their general description depending on what reliance is made. The same is true for probable outcome.

Table 7 reflects the position of the author. However, it appears to suggest, in my opinion, that objectives of modernisation – openness and competitiveness for the sake of prosperity of the nation – are rather achievable under projects close to the second option.

## 6. Current Situation and Economic Policies

The current situation of the Russian economy is untroubled, largely due to high oil prices and responsible macroeconomic policies which have been pursued until recently. The potential for growth has not been used to the full, primarily due to controversial relations between the authorities and business in 2003-2005 which caused a decline in business activity and halted further reduction of inflation. But in 2005 indicators of growth turned out to be higher while the inflation rate lower than expected. Money demand grew 38.5 percent as compared to 34 percent in 2004. It is worth noting a surge in consumer loans, development of mortgage lending and growth of wages of public sector employees.

However, the economy is still prone to medium and long-term threats due to its dependence on oil prices and low competitiveness of other sectors, except

mining and defence industries. Modernisation processes are slow even in terms of product line and fixed capital upgrade. Undoubtedly, this is caused by the situation in the market for raw materials and appreciation of the rouble which bring down the relative return on investment into other sectors.

Since 2003 economic policies have considerably evolved, including a focus on the role of the state. Let us discuss what was the outcome for different functions of the government and what modernisation project is actually being implemented now.

As regards strengthening **law and order**, it can be asserted that noticeable changes for the better have not occurred. Political reforms undertaken by President Putin increased concentration of power by making division of authority still less meaningful. Through prosecution of YUKOS, redistribution of assets in the oil sector and tax inspections to collect large tax shortfalls from the past periods, the authorities, relying on the prosecutor's office and court, have demonstrated formal compliance with legal provisions which are in fact being violated. This was also confirmed by further attempts of the Tax Service and Ministry of Finance to make the identified violations legal by amending the legislation. The most characteristic example is how the President's instruction to improve tax administration was dealt with. The draft law which the government submitted to the State Duma caused protests of the business community and certain deputies as new conditions of tax administration, despite the President's instruction, proved to be more stringent than those of the effective Tax Code. The concept of "bona fide taxpayer" introduced by the Constitutional Court and taken up by the tax authorities was used to justify previous decisions controversial from the perspective of justice. This was admitted, albeit unofficially, by Mr. Zorkin, Chairman of the Constitutional Court. As a result, the principle of supremacy of law, while not becoming any stronger, has suffered further damage over the last few years. This area showed a bias in favour of modernisation from above: it was demonstrated to individuals and businesses that obedience to the authorities was more important than abidance by law and that law should serve the interests of the government.

There are positive trends with regard to **defence and security**: key decisions in the area of military reform have been made. It may be just to criticise them for being half-way, protracted and prospectively low productive. But it is a transition towards a professional army and reduction of the term of conscription down to 1 year. So far an increase in financing has been only partially making up for mistakes of the past. Meanwhile, a desire of the authorities to rely on power agencies is beyond doubt.

As regards **macroeconomic policies**, until recently they could be qualified as being closer to the second option: conservatism of the budgeting process, filling up of the stabilisation fund, containing inflation in a situation of massive inflow of export revenues and despite a decline of business activity – all these measures could be regarded as positive. At the same time, there are concerns over slackening of monetary policies in 2006 which is clearly a response to pressures, fraught with inflation increase, of different social groups and advocates of active industrial policies wanting to apply oil revenues domestically. The GDP growth rate which could have dissipated these concerns should be, according to my estimates, around 8-9 percent, with the inflation rate below 10 percent. But, given current business activity, these indicators will be hard to achieve.

Activities regarding **institutional reforms** in the economy and social sector were halted immediately during President Putin's second term in office after a partial monetisation of benefits in the early 2005. While obvious mistakes were made in planning this measure, it was still unreasonable to halt the entire complex of high priority reforms of this basis: education, health care, pension security and, to a lesser extent, utilities. The power industry reform has been protracted while that of the gas industry halted. This function of the state is practically frozen on political grounds though these reforms are vitally important for the country's future. The economic situation, of course, allows a protraction but at the same time it is very favourable to implement transformations. There may be no second chance to do that in the future. It is strongly felt that the trend here is in favour of modernisation from above.



Since **public services and social protection system** include education, health care and pension security, a slowdown of reform in these sectors also means less attention to these functions of the state. National projects to be implemented, apart from agriculture, in these sectors on a high priority basis, could have played an important role if they were closely associated with the necessary reforms. In the meantime, judging by their content, they are likely to be nothing but populist policies of expenditures to increase the share of oil revenues to be distributed to less prosperous population groups.

It could be expected that **encouraging economic development**, promoting structural adjustment should have become part and parcel of current policies. This, in fact, was not the case. While there was much talk, real action in this sector did not happen until the elapsed year. An investment fund was allocated, legislation of special economic areas and concessions adopted, and the Russian Development Bank reinforced. What is especially important though not known to the public at large, the Start Project similar to SBIR programme in the U.S. was launched to mark the start of a new innovation policy. Though financing amounts have so far remained modest, the process has got underway.

These policies are increasingly criticised by many people of liberal views as being inconsistent with the liberal philosophy. Moreover, they are inconsistent with actions of the authorities to "line up" business since success is only possible on the basis of confidence of the business community and high degree of business activity. But, again, the necessary increase of the role of the state at the stage of modernisation should be reflected in well-thought reinforcement of precisely this function. Policies could not be developed on the basis of only one philosophy. The measures adopted so far have not been adequate and have to be complimented by steps to increase confidence between the authorities and business and encourage private enterprise. It is only on this basis that the area of private-public partnership may become really meaningful.

Opponents of a focus on structural policies might argue that higher public expenditures to encourage economic development in the current environment will primarily increase **corruption**. This is a powerful argument.

Awareness of this situation prompted the government to embark on the administrative reform and adopt the laws on civil service, delineation of authority, local government and transition to performance-based budgeting. These steps are important and absolutely necessary to ensure higher efficiency and integrity of government agencies. But the problem cannot be solved within the framework of the executive authorities, in view of long-standing bureaucratic traditions of Russia. There is a need in effective arrangements of social control. It would appear that relevant measures were taken with establishment of the Social Chamber. But the Social Chamber alone will not suffice since it includes only those loyal to the authorities. Independence of control is a condition of its long-term efficiency, even though costs may be high at the stage of inception. But the authorities would like to combine independence and efficiency with obedience, something which is impossible. The system will be able to evolve only if it allows for uncertainty and freedom of choice for many players. This will incur certain risks. But otherwise the fight against corruption will not be successful.

This is the case to argue that more efforts of the government to encourage economic development should be based on supremacy of law and macroeconomic stability, and closely associated with democracy. Institutional reforms may, in their turn, be regarded as a kind of an investment project to establish new efficient institutions.

Let us now turn to **state enterprise**. It is this function that has been largely reinforced over the last 2 years. There is ongoing official privatisation programme to offer for sale government stakes in joint-stock companies and shares of wholly government-owned (municipal) enterprises. In fact, it is failing from year to year. According to the Rosstat data [12, 2005, p. 177], proceeds from sale of public and municipal property were Rb 88.7 billion (USD 3.1 billion at the rouble-to-dollar rate of 28.2) in 2003, Rb 90.1 billion. (USD 3.2 billion) in 2004. In 2004 it was

planned to sell 1702 wholly state-owned enterprises while only 565 were in fact sold. In 2005 performance figures were the same – 1508 and 521. [14, p.38].

It has been explained that only "garbage", as Mr. Gref put it, remained, with the plum picked up already in the 1990s. However, the federal government alone is still holding 8 thousand wholly owned enterprises which, with the exception of "garbage", are not offered for sale. The agencies managing federal wholly owned government enterprises are reluctant to part with them – on the contrary, they tend to establish new ones.

Meanwhile, it is estimated that the government purchased at least USD 35-40 billion worth of assets including Yuganskneftegaz, Sibneft, Silovye Machiny and Kamov Helicopter Plant. The controlling stake in Gazprom was repurchased, control over AvtoVAZ established and Gута Bank absorbed by Vneshtorgbank. This list is not exhaustive. Reasonable explanations were given in each particular case. But a combination of factors clearly suggests a trend towards a higher role of the state in the least desirable form which at the same time is more appropriate for the philosophy of modernisation from above.

According to Alfa-Bank's report, in the course of rapid capitalisation of the Russian stock market the share of government-owned companies grew from 20 to 39 percent or from USD 48 billion to USD 190 billion over 2.5 years [15]. It resulted from a faster growth of capitalisation of government-owned companies and their acquisitions. A demand for stocks of government-owned companies was due not to their efficiency but rather to the fact that they were regarded by the market to be less prone to political risks than private companies. Experts believe this trend to produce negative effects already in 2-3 years. This signals a lack of confidence in the government.

As a matter of conclusion, the analysis shows that there is no real increase of the government role in modernisation of the economy. Economic policies stagger between alternative modernisation projects, with an increasing bias towards the middle option. The government has failed to achieve success in exercising its main function of a "night watch" and affirming supremacy of law. There is a clear trend

to slacken macroeconomic policies. Institutional reforms are for the most part halted. Moreover, economic development and useful structural changes are not adequately encouraged, in particular, due to the flaws of the government system. On the contrary, expansion of the public sector and state enterprise are becoming a priority.

In my opinion, economic policies should be adjusted to make them more consistent. Of course, I believe a transition to modernisation from below should start as soon as possible.

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