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Is the new model of economic growth feasible for Russia?

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Summary

Hit by the crisis of 2008-2009, the world economy is now faced with new challenges. The forthcoming decade will see global changes in the world financial system, a shifting balance of power between developed and developing states. Russia has also exhausted its model of economic growth based on exporting commodities against the backdrop of its current institutional development and active involvement of the state into the economy as shown by the dramatic slowdown in late 2012 and early 2013, with growth rates dipping below 2 %. As a result, Russia's share in the world economy will gradually shrink while the gap in labor efficiency and living standards between Russia and developed countries is likely to widen. The range of economic strategies currently being debated by the government suggests a choice between expansive and conservative scenarios, which vary in monetary and budget parameters but in essence mean the continuation of the current flawed institutions. However, our estimates show that the fiscal and monetary promotion of economic growth are now limited and will not produce a lasting impact on performance while a tough budget and monetary policy distorts the structure of the public sector and increases uncertainty about public obligations beyond budget limitations.

A new model of economic growth requires private enterprise, market institutions and investments in human capital.

In this respect it is necessary to:

- establish the rule of law, fostering the independence of courts
- reshape the relationships between business, law enforcement and judicial agencies as a trust building measure
- reform local government, in order to promote civil society activism
- promote private investment: to reform the pension system, healthcare, education and the housing market
- carry out democratization, establishing reasonable conditions for political competition and regular regime change

The drivers of this new model of economic growth include two increasingly influential groups. These are "new business" – a number of dynamic companies willing to grow in a market environment but lacking incentives to invest within the current institutional framework. And the "new bureaucracy" – progressive regional elites concerned about regional development and federal professionals. However, the current management structure of the economy is a by-product of a "vertical power structure" and fosters opportunism among "new businesses" and

“new bureaucracy”, encouraging redistribution rather that production. The transformation of this system is beyond the scope of an individual “political will” or a small group of loyalists (represented by “Politbureau 2.0”). It depends on the willingness and capabilities of the modern Russian elite to reach a consensus about the “rules of the game” which they are prepared to obey and which will not torpedo long-term economic and social objectives. At the same time, the “voilent pressure” typical of Russia today is a waste of limited resources and could trigger “mutual destruction” amongst the modern elite. Functional agreements on new rules of the game can result only from a dialogue embracing interest groups representing major stakeholders. The “right incentives” for the state machine are ensured by political competition and the pressure exerted by an influential civil society.

1. World economy and Russia

Over the last five years, both the world and the Russian economy have been through dramatic changes and need a comprehensive review. The crisis of 2008-2009 involved several stages. After 2001, the economy boomed following the Federal Reserve System's decision to reduce the discount rate from 6% to 1%. As a result of the easing of monetary policy, the worldwide economy boomed until 2008.

Table1.1. GDP growth in 2010 (year 2000 = 100)

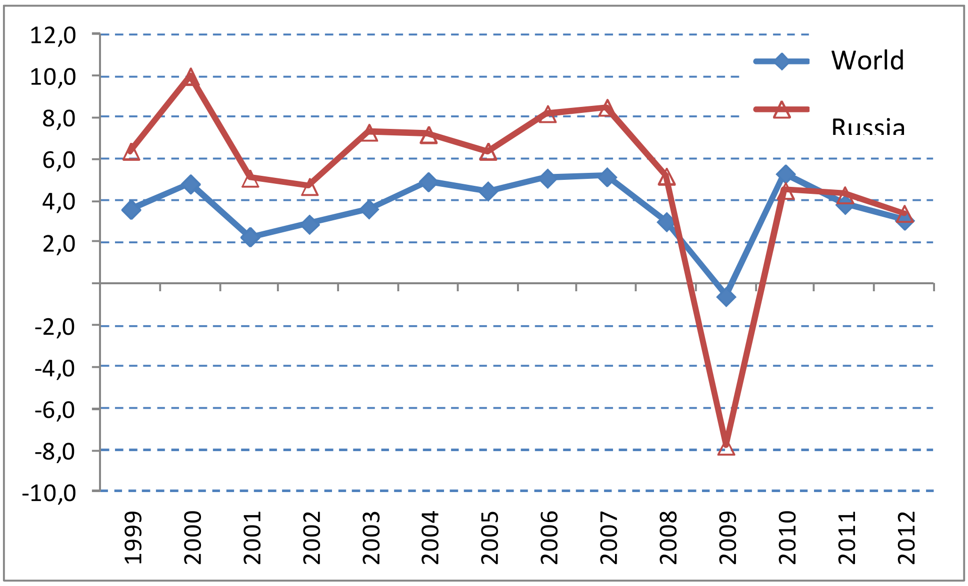
Country	GDP growth
Developed countries	
USA	118
Germany	109
France	112
Great Britain	115
Japan	107
Developing countries	
China	271
India	211
Brazil	133[1)]
Turkey	146
Russia	159.5

Source: Federal State Statistics Service (Rosstat). Russia in Figures, 2011-1012, p. 569

1) In 2009

The fast growth of China should be noted, as it became the world leader during this period. The development rate of India was also impressive and Brazil was very successful in this field too. The Russian economy started to recover after a deep transformational crisis in a favorable environment. It used its domestic reserves as well as soaring export prices (oil and other commodities). As Table 1.1. shows, developing countries were the most successful. Developed countries, while pushing the world forward, were growing more slowly. At that time, the gap between developed and developing countries was impressively narrow.

Fig.1.1. World and Russian economy 1999-2012



Source: IMEMO, Russian Academy of Science. Russia and the World. Annual forecast. M. 2011, p.14.

The crisis which erupted in 2008 showed that monetary easing had not had a lasting impact. This crisis marked a new era. Its attributes so far include, along with the recession of 2008-2009, a slowdown and increased instability almost everywhere around the globe

Recovery and a new surge, which were widely expected, have not been apparent yet. A protracted recession is looming, leading to speculation about its in-depth triggers. All major actors, including the USA, EU, China, India, Latin America, have their own suggestions about its roots. However, it seems that world economy is faced with an unprecedented challenge.

Experts vary in their assessment of the problem. The most frequent explanation is a lack of regulation in the financial markets. A prominent economist[1] in this respect said that tougher control over international financial markets will eliminate independent market regulation by market forces. Others relate global processes to an ageing population and excessive consumption in developed countries, to an almost optimal age distribution in developing countries and a high birthrate in poor countries unable to make savings.

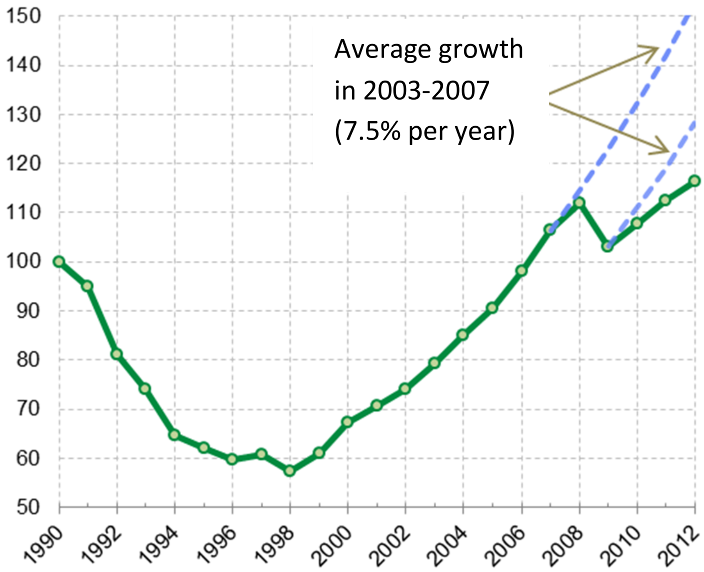
One more point of view is worth considering, which states that the world is in transition from an industrial stage of development to an innovative one. This means that during the industrial stage there were plenty of cheap mineral raw materials and their wide use was an important driver of high growth rates. However, now the price for non-renewable mineral resources is rising and innovations aimed at productivity and efficiency have become the key driver. In this respect there is a need for institutional change which encourages innovation: more

[1] Deepak Lal.

freedom, more competition. One should not ignore the fact that if a new stage of development is dawning, the structure and pace of business cycles should change as well. While all this is taking shape, the economy is prone to adaptation spasms and other problems which can impede growth and upset the balance. In the long run, the relative advantages will go to those who are able to accumulate the largest innovation potential.

The crisis hit Russia quite badly and triggered a big recession (-7.8 % of GDP). However, this could be amplified as the economy was overheated before. As a result, the two years of crisis (2008-2009) were relatively easy for the country. However, later, as Fig. 1.1 and 1.2 shows, the situation in the economy changed.

Fig. 1.2. Russian GDP annual growth (100 = year 1990)



Source: Federal State Statistics Service (Rosstat), the HSE Center for Development calculations

The Russian position is in this case unique, as its economic competitiveness is lagging behind developing countries for as long as as they have cost leadership (labor cost in the first place) and a better price-quality ratio. They also have better innovation prospects. However, there are several ways to narrow this gap. This is the key task of modernization. So far, Russia's strengths have been connected with natural resources, oil and gas. However, at the same time, this could also be a weakness, since the country is tempted to neglect innovations and channel an unreasonable share of resource revenues to support old sectors (for social considerations) or the attributes of a one-time imperial power.

2. Russia's point of departure

Macroeconomic performance: deceleration

The current state of the Russian economy and its medium-term potential are largely determined by a recent model of growth based on the material sector and macroeconomic stability within the existing institutional framework and the active involvement of the state in the \economy.

After the recession of 2008-2009, the Russian economy grew by 4.3-4.5% per year in 2010-2011. As a result, the actual GDP returned to the level of the middle of 2008 and macroeconomic performance considerably improved. The 2011 Federal budget had a 0.8% GDP surplus and the average inflation rate in the first half of 2012 plunged to 4%. All this enabled Russia to reach a score of 22 in the competitiveness index published by the World Economic Forum. Most experts believed that in the medium-term, Russia would be able to grow by 3-4% annually.

Table 2.1. GDP growth as calculated for demand components[2]

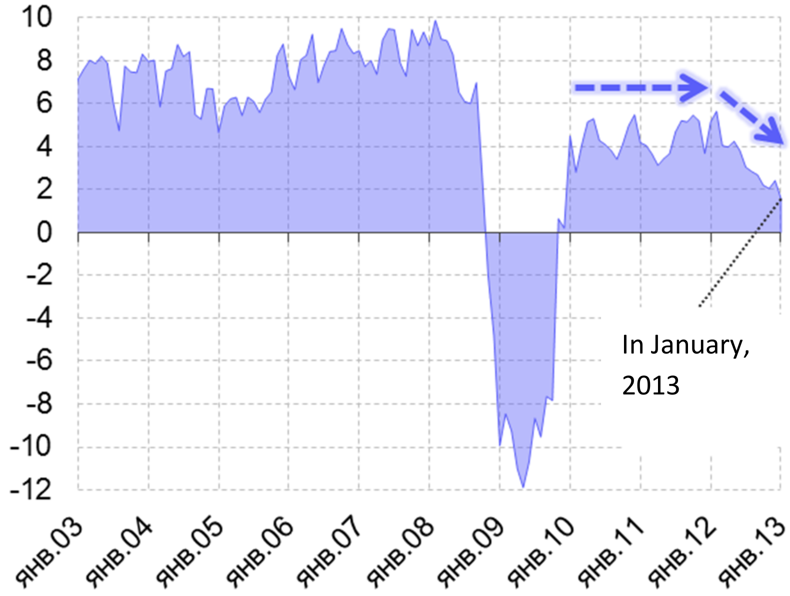
	Growth, %					Contribution to GDP growth, percentage point				
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
GDP	**5.2**	**-7.8**	**4.5**	**4.3**	**3.4**	**5.2**	**-7.8**	**4.5**	**4.3**	**3.4**
Including:										
Final consumption	8.6	-3.9	3.5	4.9	4.8	5.7	-2.6	2.6	3.4	3.2
Households	10.6	-5.1	5.5	6.4	6.6	5.1	-2.5	3.0	3.3	3.2
State governance	3.4	-0.6	-1.5	1.2	0.0	0.6	-0.1	-0.3	0.2	0.0
NPISH (non-profit institutions serving households)	-1.4	-8.0	-0.5	-4.8	-1.0	0.0	0.0	0.0	0.0	0.0
Gross saving	10.5	-41.0	28.5	22.6	5.3	2.5	-10.5	5.4	5.1	1.3
gross fixed capital formation	10.6	-14.4	5.8	10.2	6.0	2.2	-3.2	1.3	2.2	1.3
stock changes	-	-	-	-	-	0,3	-7,2	4,1	2,9	0,1
Export	0.6	-4.7	7.0	0.3	1.8	0.2	-1.5	2.0	0.1	0.5
Import	14.8	-30.4	25.8	20.3	8.7	3.2	-6.7	5.3	4.3	1.9
For reference: Domestic demand	*9.1*	*-6.5*	*4.0*	*6.1*	*5.1*	*7.9*	*-5.8*	*3.9*	*5.6*	*4.5*

Source: Federal State Statistics Service, the HSE Center for Development calculations.

However, in 2012, economic growth decelerated. This became apparent in the second half of the year. Overall, Russia's GDP increased by 3.4% last year, but early in 2013 the rate fell to 1.5-2.0% year-on-year.

[2] The chapter includes calculations of the THE THE HSE *Center for Development* researchers - Kondrashov N.V., Pukhov S.G., Tchernyavskiy A.V.

Fig. 2.1. GDP monthly rate as estimated by the Ministry of Economic Development of Russia (year-on-year growth), %



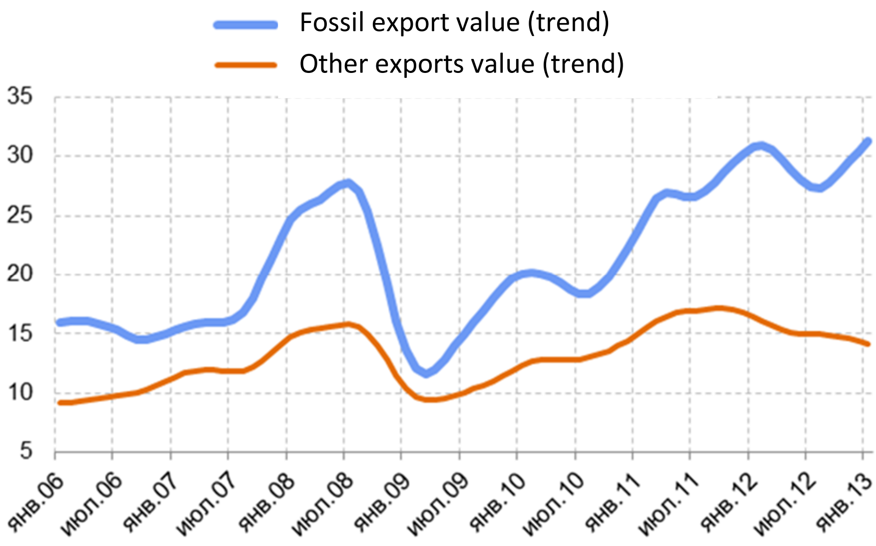
Source: The Ministry of Economic Development of Russia

The current slowdown has been triggered by a number of factors.

Firstly, as fossil fuel prices stopped rising and foreign fuel supplies measured by volume stabilized, the export revenue growth rate fell from 33% in 2011 to 8% in 2012. At the same time non-fossil exports shrank considerably last year, running counter to the hopes of a gradual displacement of market-sensitive revenues through the expansion of other exports.

Despite oil and gas income in nominal terms reaching a historical maximum in 2012, Russian economic agents observed its deceleration. The consensus about the world economic performance suggests a protracted recession in the Eurozone, global disparities and budget troubles in developed countries. Such a forecast hardly provides for a surge in fossil fuel price or export expansion measured by volume, given that competition among gas suppliers to the European market is becoming fiercer.

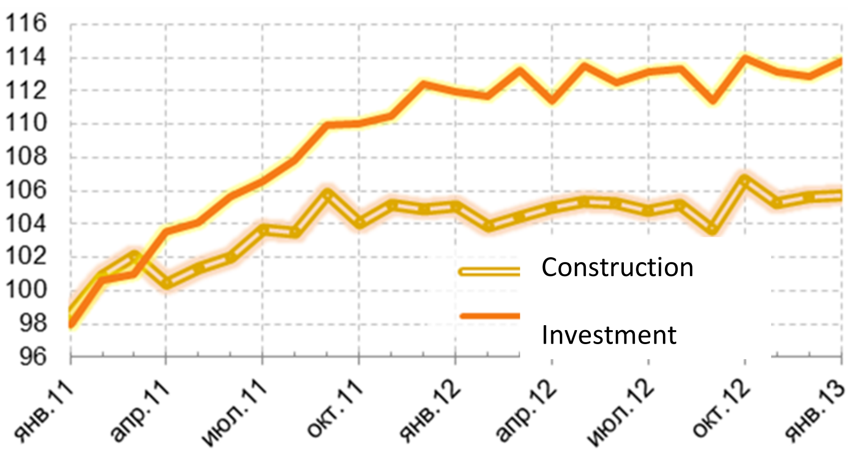
Fig. 2.2. Export value (trend), USD bn



Source: Rosstat, the HSE Center for Development calculations

Secondly, there was a dramatic plunge of investment in 2012, triggered by external and domestic factors. Investment rates almost halved, falling from 10.8% to 6.6%. However, even this decrease was buffered somewhat by the low base effect in early 2011. Over the last year, the investment rate stagnated if we exclude seasonal effects, and by 2013 the rate tended towards to zero.

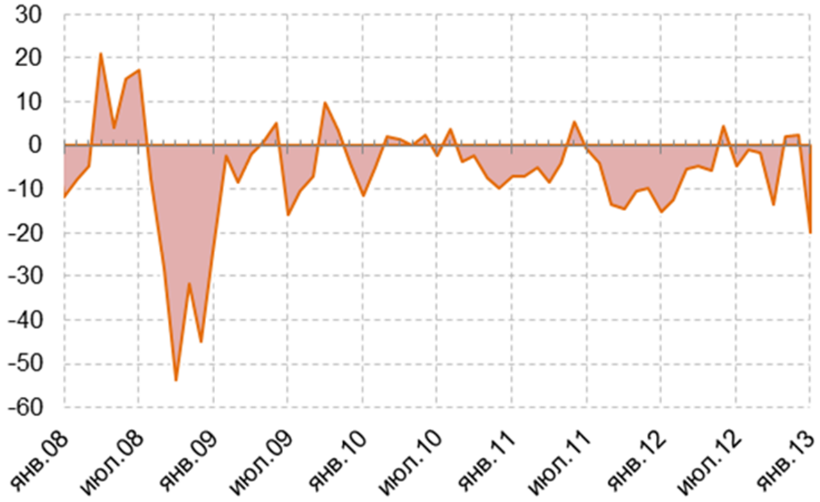
Fig.. 2.3. Construction and investment (100 = December 2010, seasonality excluded)



Source: Rosstat, the HSE Center for Development calculations

Investment rate deceleration was coupled with a continuing significant net capital outflow. In 2012, $56.8 bn left Russia, mainly due to the non-financial sector.

Fig. 2.4. Net capital inflow, private sector, USD bn



Source: Rosstat, the HSE Center for Development calculations

Intense capital outflow along with plunging investment has reduced the growth rates of investment import demand. Consequently, the balance of payments and investment rate provide evidence that both domestic and foreign investors have become less interested in Russia.

Thirdly, slow rates of productivity (2.5% in 2012) and efficiency, which seem to be a priority. A mere surge in investment would not be enough to promote growth if it failed to enhance efficiency in key sectors.

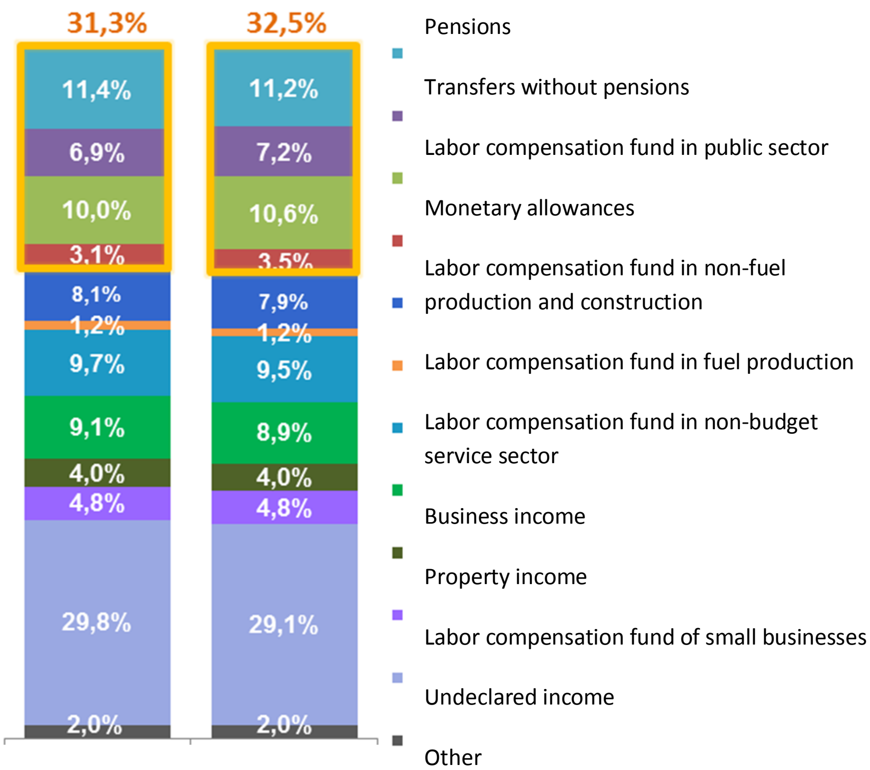
Even though the investment environment in Russia had never been welcoming before, a number of newer negative factors arose in 2012.

On the one hand, we have the unclear priorities of our economic policy. Even after the president was elected and the government formed, these aims clashed with each other. For example, the combination of a countercyclical budget policy with a surge in public obligations in the areas of defense and social security.

On the other hand, the gap between the stated goals and the reality in state-business relations has widened. The opportunity to introduce radical changes in order to encourage business has been wasted. Instead, an even more archaic relationship between the state, bureaucracy, law enforcement agencies and business has been revived. Steady taxation rules are substituted by a multiple increase in premiums for the individual entrepreneur which pushes them to the margins of legal activity. Instead of the protection of proprietary rights, business is more and more often faced with accelerated land and building condemnation when it comes to projects carried out by the government or affiliated agencies. Instead of easing administrative and power pressure on business, security and law enforcement structures are even more active in impeding business. In an environment of this kind, entrepreneurs are forced to make short-term plans, avoiding investment, especially into efficiency-building.

When export and investment are shrinking, consumer demand evolves as a key driver of growth. The overall consumption of households was 6.6% in 2012, keeping pace with 2010-2011. This growth was ensured by a rise in the disposable income of households by 4.2% in real terms, A pay increase in the public sector and a boost in the monetary allowances of the "silovikis" have largely contributed to this growth. At the same time, plunging personal income in non-budget service sector and business income shows that the private sector in Russia is weakening.

Fig. 2.5. Structure of private earnings, %

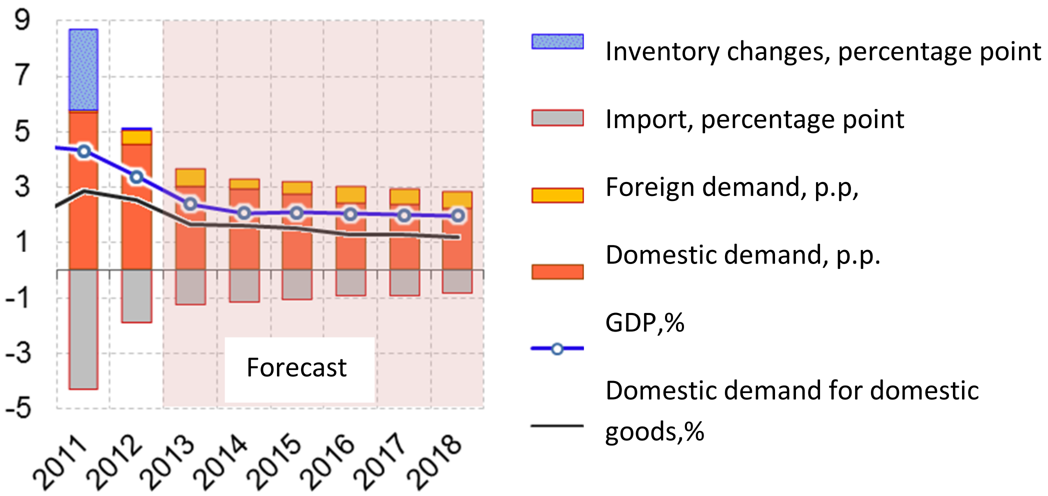


Source: Rosstat, the HSE Center for Development calculations

Increased consumption, which exceeds income, was facilitated by expanded lending. In 2012 the share of loans to individuals compared with their income returned to the level of 2007, at 5.3%. By the end of the year, however, the rate had considerably declined. Consumer demand affected the GDP rate in 2012, which was largely facilitated by import stagnation. However, serious impediments are now beginning to become apparent. Firstly, according to the Bank of Russia, in 2013 individual borrowing rates will drop from more than 40% in 2012 to 25-30%. Second, the growth rate halving during 2012 (from 4-5% to 2% year-on year) will inevitably affect individual income generated by the private sector in 2013. The "business-as-usual" scenario suggests that the final consumption rate will dip to 4-5% over the next two years. Sustainable growth based on consumption will take place if individual income grows, promoting domestic demand, at the same time promoting investments which are sensitive not only to profits, but also to other factors that increase investors' interest.

However, inertia may well torpedo economic growth. Given a sustainable oil price (110-115 USD/bbl) we suggest that economic growth will further decelerate in years to come, dipping below 2%. Such a slowdown may widen the lag between Russia and other countries and contribute to mounting domestic imparities, first of all, in the budget.

Fig. 2.6. "Business-as-usual" scenario of the GDP rate and the contribution of the GDP components estimated by the type of demand (growth YoY)



Source: the HSE Center for Development calculations

Macroeconomic stabilization risks: no room for budget maneuvering and vertical imbalance

The major flaws of the current budget policy include vertical imbalance and an uneven spending pattern. In 2012, the federal budget was nearly deficit-free, although the non-fossil deficit rose to 10.6% of GDP rather than the decrease,that had been expected. This indicates a surge in the country's dependency on the global environment.

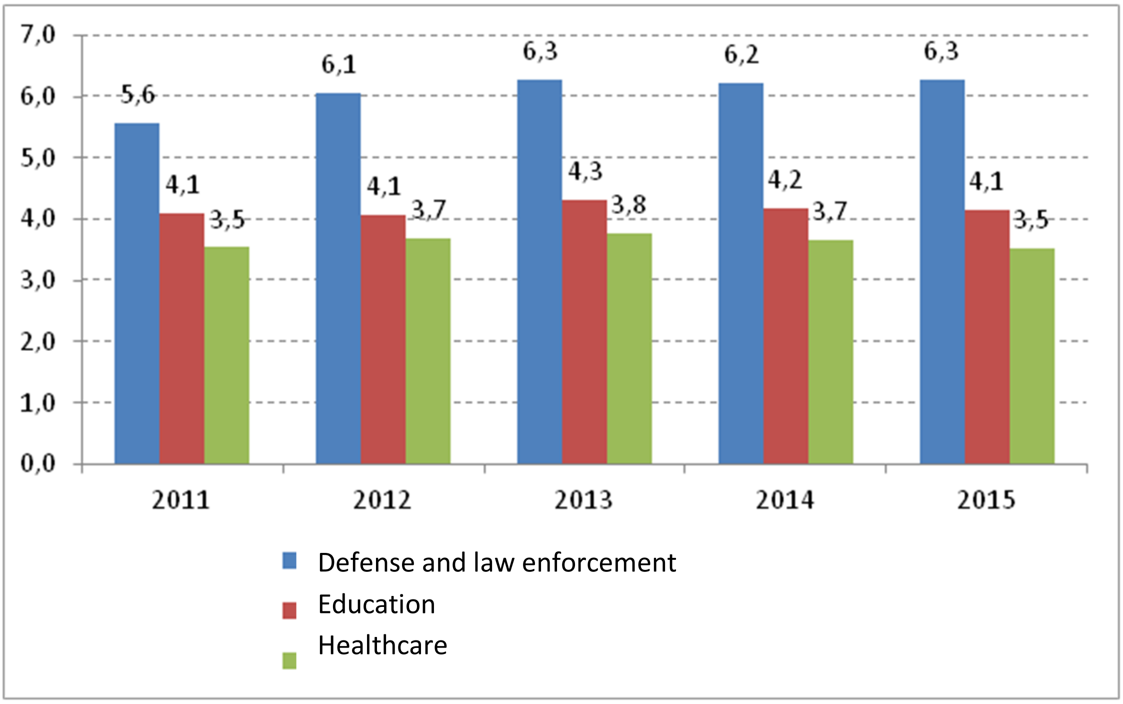
Russian regions were hit by even more serious problems as they badly lacked resources and got new obligations in 2012 according to the 7th of May Presidential decrees. Consolidated regional budget revenues were nearly in line with the forecast of the Ministry of Finance, but regional spending was 240 bn roubles higher than anticipated. As a result the deficit was more than eight times higher than expected (278 bn versus 32 bn roubles).

In the medium-term this imbalance is likely to persist, despite the budget policy.

In 2013-1015, the real priorities of budgetary policy run counter to those stated by the government. Healthcare and education spending suggested to be the fundamental objectives of economic policy do not ensure its increase as a share of GDP in the medium-term as required by a comprehensive reform and development of these sectors. This is likely to impede the growth of innovation as well. Such estimates come from the Strategy 2020 project. The share of spending on these sectors in the federal budget is gradually falling.

At the same time an increase in the monetary allowance for the military, law enforcement and government armaments program, which costs 20 tn roubles, boosted the total military and security spending from 5.6% of GDP in 2011 to 6.1% in 2012. It is expected that this spending will reach 6.2-6.3% of GDP. As a result, although security spending was substituted by the loan resources of the banks and removed beyond 2015 during the debate on the triennial budget, it is increasing more rapidly than investment in human capital. At the same time, any "surplus" arising from fuel revenues (National Wealth Fund) will be channeled by the Government into infrastructure through revenue-yielding bonds.

Fig. 2.7. Budgetary spending by certain types (Fundamental Objectives of Budget Policy), % of GDP



Source: Fundamental Objectives of Budget Policy for 2013-2015 (FOBP)

In 2013, the Ministry of Finance estimates that regional budget obligations will increase by 0.4% of GDP. At the same time, inter-budget transfers will fall by 0.7% of GDP. Any lack of funds shall be compensated by an increase in regional tax and non-tax revenues (by 1.4% of GDP). Taking into consideration that spending is expected to exceed the level anticipated in 2012, the real need for additional resources in 2013 is 0.4-0.5 % of GDP more than the Ministry of suggests. Nevertheless, up to 2015 the government is going to reduce the share of the regional budgets in GDP and simultaneously free them of deficit.

According to our estimates, this puts the economy into too tough an environment, which is especially true with regards to healthcare and education, although additional spending can be partly financed through domestic reserves and improvements in efficiency.

Table 2.2. Regional budgets, % of GDP

	2012 FOBP	2012 De facto	2013 FOBP	2014 NBP	2015 FOBP
Total revenue	12.95	12.93	13.62	13.30	13.21
Tax and non-tax revenue	10.77	10.24	11.67	11.70	11.80
Transfers	2.18	2.69	1.95	1.60	1.41
Spending	13.00	13.38	13.81	13.41	13.21
Deficit	-0.05	-0.45	-0.18	-0.12	0.00

Source: Fundamental Objectives of Budget Policy for 2013-2015 (FOBP), Federal Exchequer of Russia, HSE Center for Development calculations

The Central Bank's policy of defeating inflation as a top priority may lead in the long run to cheaper loans, but in the short-term it will more likely trigger a rise in interest rates simply due to a lack of funds. At the same time, the current economic environment is hardly likely to help curb inflation, at least comprehensively, as long as regulated tariffs and consumption taxes (excise) used as a point of reference by the government are growing faster than income.

At the same time it is important to note that the roll call of businesses in the country is changing. Some of them are succeeding and improving their market posture, others are fighting for survival while trying to preserve and establish special conditions. This process is painful but important as it will eventually define the future of the Russian economy, which may be brighter if this process is rapid enough.

At the same time, the budget rule reflecting the focus on a tough budget and monetary policy is double-edged. On one hand, it fosters private investment and relatively cheap loans to balance accessibility and efficiency. On the other hand, in the current Russian business environment, macroeconomic stability and low inflation impede growth, even at a rate of 3%, mainly due to institutional failures. Moreover, the budget rule, which coexists with a large number of spending obligations exceeding set limits, endangers budgetary balance and actually boosts uncertainty.

3. Choosing the way: scenarios for development

The economic performance of the world and of Russia in the first half of 2013 shows that growth opportunities that were present before the crisis of 2008-2009 no longer exist. A World Bank report states that the Russian economic model was based on the assumption that the world economy would grow and oil prices would remain high. Now it is apparent that the world growth rate will be considerably lower and the demand for Russian oil production will go down as well. In addition to this, the labor market will shrink rather than expand. We need a new model.

When market reforms were carried out in the early 1990s, most market apologists believed that after the transformational crisis, the Russian economy should be driven by market incentives, entrepreneurial energy and business initiative. These forces are all-powerful, but in a favorable environment, the country could have grown faster than developed countries for 15-20 years, thereby narrowing the gap and approaching the top table in terms of productivity, innovativeness and wealth. Naturally, state and society were expected to support it.

The reality turned out to be more complicated that these assumptions. The discrepancies between archaic traditions and modernity in Russia proved to be extraordinary resistant to change. Here we can speak about the transition from an entrenched feudalistic and bureaucratic hierarchy that dominated up to the middle of the 19th century to a system of networking typical for a market economy and political democracy. This transition started with the liberation of peasants in 1861 along with some other reforms of Alexander II, including those connected with local governance and the judicial system. However, progress soon stalled. Unlike the rapid progress in industry and transportation, agricultural development was extremely slow. The political system was also resistant to change. However, following the revolution of 1905, the country entered WWI as a constitutional monarchy with a multiparty political system and a functional parliament, liberating peasants from medieval obligations - a process which was bolstered by Stolypin’s agricultural reforms. But the war itself was a tragedy for the country. The October revolution took place in 1917 with its slogans serving as a cover for return to overbearing bureaucracy, arbitrariness and mass repressions.

Democratic reforms and the market transition of 1989-1994 marked a new turn in Russian history, a fresh attempt to establish a more modern society, rich in inner drivers. However, the way forward proved to be rocky.

From the very beginning, the establishment of a market economy was dogged by the concentration of capital and emergence of big business (oligarchy) ready to influence state authorities and maintain their acquired benefits. A confrontation between big business and bureaucracy broke out. In 2003, bureaucracy, including that of the security forces, triumphed. A new era of confrontation between traditionalism and modernity dawned, when market and entrepreneurial institutions were thwarted and previous methods returned.

The complexity of the process which has been unfolding since the beginning of this century defies any clear conclusions about results. However, it seems that natural business activities have decreased (for our purpose suppose that inflation is 2-3% and interest rates in real terms are 4-6%), which was partly compensated for by rising fuel exports, with 10-12% inflation and accessible foreign loans. Business activity at that time was artificial. Nevertheless, the period between 2003 and 2008 can be seen as successful, with an annual growth of 7.3%, a productivity rate of 5.2%, and GDP rising above that of 1990 (108%). A booming world economy bolstered by the easing of monetary policy in the West, and the rapid growth of developing countries contributed to Russia's performance. It seemed as if Russia had found a new face. However, the crisis of 2008-2009 rapidly destroyed any illusions.

After the crisis passed and recession rates were established, a debate on the scenarios for the development of the country in the 21st century began. The first one was presented by S.Y. Glazyev and is critical of the previous model aimed at curbing inflation.

Expansionary scenario

Even before the crisis there were voices calling for an increase in state investment and the easing of lending to promote the growth of the national economy. Since the crisis, Glazyev and his suporters have reiterated these demands: they claim that growth can be enhanced only through the boosting of investment. Since private investment in Russia is growing slowly (capital investment increased only by 1.1% as estimated for the year to January, 2013 – D.Pichugina, 21.02.2013), the onus should be on state investment. Their scope, as it is meant, should provide for the implementation of the stated goals - growth by 5-6%.

Glazyev opposes the recently established budget policy which requires transfers to the Reserve Fund of oil revenues if they exceed the benchmark (estimated for a number of years) oil price. He believes that these funds should be channeled into investment while money supply should not be limited and interest rates should not be overpriced if compared to the profitability of the inward-looking sectors, which is almost always lower. He says, "The key result of the current monetary and budget policy is the orchestrated thwarting of economic growth".

The Ministry of economy is more discreet but also leans towards this view: to reduce the allocations in reserve from 7 to 5% of GDP, invest the surplus, and reach an annual rate of 4.1%.

It should be noted that the policy of the 2000s, generally balanced in terms of macroeconomics, closely echoes these recommendations. Even given that the Stabilization fund was established in the 2000s, inflation did not go below 11-12%, excluding 2006, when it fell to a single digit rate. Foreign exchange earnings were the largest contributor to money supply. The rate of inflation is clear evidence of the fact that money supply exceeded demand. The macroeconomics of the 2000s can be regarded as an example of a modest approach lacking institutional change. The proponents of this expansionary model aimed at easing monetary restrictions, and those looking to take money from the state saw it as a standard of radical monetarism. Institutional change (excluding tax reform and a certain reduction in administrative barriers) was insufficient, and at times a policy of even tougher state regulation was pursued, which weakened economic incentives, instead replacing them with administrative measures or similar.

An increase in money supply as well as other short-term growth incentives is most often effective when a slowdown or disruption in the growth rate is determined by the environment (for example, deterioration and a sectoral crisis).

The current slowdown in Russia is taking place in a relatively stable environment and is triggered mostly by fundamental production limitations – technological (oil production depletion, capital consumption, technological underdevelopment, lack of professionals) and institutional, which impede effectiveness and investment patterns (lack of competition, bureaucratic overregulation, bad governance, high business costs, etc.).

In this context, short-term incentives should be employed only if they have a lasting impact.

In theory, these include, for example, an increase in infrastructure investment, which is a good incentive in both the short and long term. This example is discussed here in more detail.

The impact produced by infrastructure projects is two-sided: a surge in state investment (in the short term) and benefits for the economy as a result of infrastructure upgrading (cost reduction, new windows of opportunity, improved image of the country). The assessment of the second effect, amplifying as the new infrastructure expands, is based on earlier research (Petronevich, 2009), and suggests 0.04 p.p. of additional growth in 2013-2020. These estimates suggest that additional investment is financed through increased spending, i.e. easing of the budget rule.

To explore the limits of the short-term effect produced by possible fiscal incentives in Russia we used a reference scenario with oil prices at 110 USD/bbl and spending as defined by the budget policy. We compared this scenario to one where the share of federal spending in GDP is the same as in 2012 (21% of GDP) but the current budget policy is abandoned. Our calculations show that the easing of the budget guidelines and an increase in spending can accelerate growth, but this effect is short-term and wanes rapidly. A longer lasting impact is apparent only in the first year after the rules of spending have been changed. Indicators at the bottom of Table 3.1 showing growth rates that depend on the increase (decrease) in spending by 1% of GDP, can be regarded as a fiscal multiplier. As the table shows, if these incentives are employed only for one year, the multiplier is 0.74. However, it later drops.

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Table 3.1. Growth rates depending on the change in spending patterns[3]

	2013	2014	2015
Revenue if the oil price is 110 USD/bbl (% of GDP)	20.2	19.7	19.2
Hypothetical spending (% of GDP)	21.0	21.0	21.0
Hypothetical budget deficit (% of GDP)	-0.8	-1.3	-1.8
Growth rates due to increased spending	0.67	0.58	0.41
Growth rates if spending increases by 1% of GDP (fiscal multipliers)	0.74	0.32	0.19

Source: the HSE Center for Development research, calculated by Tchernyavskiy A. and Kondrashov N.

Fiscal incentives are also limited by the inefficient management of state resources apparent in the overcharging of state purchases for current consumption and investments. As an abstract estimate to assess the effect of overpricing on macroeconomic parameters we used a maximum of 30%, though there are even more extreme examples.

These calculations suggest a mid-term perspective between 2014 and 2016. We mean that a tactical improvement of governance (in particular, the adjustment of legislation on state purchase to curb corruption) hypothetically leads to a reduction of price if compared to a reference scenario with the inertial deflators rate in state governance. The price drops by 10% in 2014 and by 20% and 30% in 2015 and 2016 respectively.

These calculations include the combined impact produced by the price reduction in purchases for current consumption (transportation fees, connection fares, rent, property maintenance, purchase of materials, excluding expenses for regulated tariff services) and state investment given the same amount of purchases as in the reference scenario in nominal terms.

Table 3.2. Macroeconomic indicator rates resulting from the enhancement of state purchase and investment efficiency (percentage points)

	2014	2015	2016
A change in the growth rate of the physical quantity of state purchase	4.58	5.16	5.22
A change in the growth rate of the physical quantity of investment	1.31	1.31	1.26
A change in GDP growth rate	0.47	0.57	0.58
A change in GDP deflator	-0.93	-0.61	-0.52

Source: the HSE Center for Development research, calculated by Tchernyavskiy A. And Kondrashov N.

[3] The calculations involved balance and econometric model elaborated by the HSE Center for Development

Our estimates (Table 3.2) show that the contract discounts for purchases for current consumption growth rate in real terms increase annually by 5 p.p. while with contract discounts for state investment, the total investment increases by 1.3% per year. The increase of real demand for goods and services along with a reduction in the price of state purchases by 30% would trigger a 0.5-0.6 pp. growth in GDP in 2014-2016. All in all, a short-term effect produced by the enhancement of state spending efficiency can be compared to one produced by fiscal incentives, with spending increased by 1% GDP, as described above. It means that the growth rate can be accelerated with no increase in spending, but simply due to an improvement in efficiency.

To produce a lasting impact for infrastructure projects it is critically important to assess the allocation on a case-by-case basis. The return on investment is just one of the aspects. Excessive construction represented by certain ambitious projects means that feedback is weaker than it could be. Russian Railways and Gazprom could finance their investment programs without extra allocations, merely through the use of internal reserves. At the same time additional funds could help to mitigate the lack of infrastructure investment in the regions.

As far as monetary incentives are concerned (an increase in money supply), which was widely used in the 2000s, the practice shows that banks do not use all the funds allocated by the Central Bank to expand lending. From 9/1/2011 to 9/1/2012 the Central Bank provided commercial banks with an additional two trillion roubles. Table 3.3 shows the main directions in which banks used these funds.

Table 3.3. The share of banks which used the funds allocated by the Central Bank between 9/1/2011 to 9/1/2012 as estimated for the major lines of activity

	Share of banks (%)
Share of banks which raised their claims to the CB in assets (correspondent accounts, deposits, Bank of Russia bonds)	38.1
Share of banks which expanded their lending portfolio	47.0
Share of banks which raised the balance on correspondent accounts in non-resident banks	59.1

Source: banker's books, research of the HSE Center for Development, calculated by D. Miroshnichenko

On balance, over this period more than one third of the banks enhanced their liquidity with the help of the Central Bank of Russia. Nearly half of the banks (47%) expanded their lending portfolio for businesses. However, the balance on correspondent accounts in non-resident banks was boosted by two thirds of Russian banks. This means that an increase in money supply in the current environment encourages mainly capital outflow and only promotes lending as a secondary result. It means that an increase in money supply as a growth incentive is far from efficient. It also means that the expansionary policy prescribed by S. Glazyev would logically lead to capital controls, not to say a closed economy.

The main problem with fiscal or monetary growth promotion through investment is the return of "soft restrictions", which should be eliminated by budget guidelines. Consequently, inflation is likely to rise and private investment is likely to fall.

Scenarios for the development of the Russian economy presented by the Ministry of Economic Development of Russia are also currently a subject for heated debate. They are described in the Ministry's estimate up to 2030 and include conservative, innovative and accelerated (target) scenarios.

A conservative or "business-as-usual" scenario essentially means the prolongation of the current policy based on technological drivers of modernization. Unlike Glazyev's scenario, this variant suggests macroeconomic stability and rejects the risk of a deficit or an increase in the supply of money, and follows the stated budgetary policy, including savings in the Reserve fund that amount to 7% of GDP. However, there is no institutional change.

An innovative scenario suggests institutional reforms aimed at the enhancement of the investment climate, promotion of entrepreneurship and better governance. Though we prefer this variant it should be noted that the scope of the institutional change needed must be correctly assessed: these are either measures similar to subordinate technological changes or alternatively, guiding actions. The latter are the core of the policy and embrace key legal and political complications. It is clear that the Ministry has defined responsibilities, but we believe that a tangible result can be yielded only under these conditions. In other words, new institutions should be the focal point. We cannot conclude this from the present Ministry's estimate.

An accelerated scenario is full of optimistic targets as well as uncertainties: it suggests a macroeconomic imbalance, a considerable increase in gross savings (up to 30-33% of GDP against the current 20%) and job cuts, ensuring no efficiency increase. (Mau V.A. Between Modernization and Stagnation: Economic Policy in 2012. The Issues of Economy, №12, p.18). The authors claim that this scenario encompasses all the institutional reforms from the innovative variant. However, their compatibility with the accelerators described above is uncertain.

We should note that the first scenario is close to the conservative one and, oddly enough, to the accelerated as all three scenarios are focused on technological shifts. Political decisions lacking an institutional basis along with increasing state spending are the key drivers here. There is room for budget deficit and an active policy of printing money if production growth is expected to make up for spending. Falling interest rates should make the loans cheaper, contributing to the anticipated improvement in private investment in the long run.

In practice, such a policy provides for the relatively low efficiency of state spending. The increase in savings will be nullified by a decrease in efficiency. A surge in money supply lacking business incentives, including competition, would not trigger the equivalent growth of money demand and would spur inflation. This case is solid enough to firmly reject these scenarios.

Only the innovative scenario of the Ministry regards institutional change as a core assumption. It is clear that the macroeconomic differences typical of other scenarios are minor. They would be important if there were no pressing need for new institutions. However, at the present time, the core of the economic and social policy has been shifted to institutions and their transformation. Consequently, we believe the other scenarios to be invariants of the conservative scenario since they suggest no institutional change.

However, even the monetary scenario will fall short of expectations if we only focus on its macroeconomic specifics. The reserves ensure a certain stability in case of a deteriorating environment. Inflation can be leveled to figures typical of natural business activity. However, business activity per se is not triggered by inflation, the latter shows the balance between money demand and supply. Business initiative and entrepreneurial drive are generated by political and economic institutions, their credibility and market forces. These are the forces the bureaucratic hierarchy lacks or suppresses. Nevertheless, they are inherent for the network market model which reemerged in Russia in the 1990s and can successfully grow now, serving as a key driver. Reforms that will trigger it were incorporated to the Gref's program but stopped as oil prices ballooned. They should be brought back to finish their task. Institutional change provides the backdrop for innovation. This is an innovative scenario in contrast to the "business-as-usual" one. The focus is on those institutional differences that encourage development rather than microfinance. If they reach the necessary scope, growth and productivity rates can exceed those of developed countries. It is a criterion for successful modernization.

However, it ought to be understood that institutional reforms are time-consuming while their results are not always immediately apparent. Institutions change slowly as the process involves the shaping of individual habits, along with wide-scale adoption of the rules and norms that make new institutions functional.

4. New model of economic growth

As mentioned above, the drivers that ensured the recovery of the Russian economy after the transformational crisis in the 2000s are now exhausted. We need to activate new factors and institutions that can reinvigorate driving forces.

The need for institutional change

Most experts believe that it is the unfavorable environment that is the key impediment to economic growth in Russia today. Figures illustrate that the impact produced by institutional change is comparable to the effects of fiscal and monetary stimulation, and could even exceed them.

Bad institutions triggered a capital outflow, which started in the autumn of 2011, as well as low foreign investment. A drop in net capital outflow from the current 4.5% of GDP to zero would increase the rate of savings (the share of investments in GDP) by 2-4 p.p. (in 2011 it was 19.4%). It would accelerate investment growth rates in real terms while the rate of savings is on the rise. As a result, the GDP growth rate would increase in both the short and long term.

The investment rate is just part of the story. Research carried out (Petronevich, Aleksashenko, Akindinova, 2011) provides a more complex quantitative estimate of the institutional impact on growth rates. The results show that a better performance of the key state institutions[4] by a mere one point (estimated by a ten-point scale used by the Vienna institute of management IMD) would facilitate ceteris paribus an annual GDP growth of 0.3%. This is a tangible effect when we take into account that Russia has 3-4 fewer points than developed countries in this respect. (p.16, Volume 24).

In Chapter 3 (Table 3.3) we showed that a quality increase of public administration in state purchases and investment can accelerate growth rates by 0.5-0.6 p.p. of GDP in the short term.

According to research carried out by the Russian Presidential Academy of National Economy and Public Administration in 2012, losses stemming from insufficient competition and potential economic impact produced by institutional change can amount to 2.5% of GDP.

The impact would be more rapid and longer lasting if coupled with an effective credibility building measure, boosting the credibility of the state and its institutions It can be, for example, a declaration on easing the pressure on business followed by a large-scale amnesty of "economic prisoners", punishment of the "siloviki" involved in the illegal prosecution and killing of business people. However, we now see the opposite: law enforcement agencies and the judicial system have their own rules of the game which leave much to be desired in connection with economic growth in the current environment.

[4] The calculations employ the competitiveness index used by IMD. Though this database embraces less countries than the WEF (56 states against 139), it contains comparable data since 1995, i.e. covers the whole period under our scrutiny. We took 10 indicators out of the IMD stock which reflect the rate of development of main public institutions, including: legal and regulatory framework; adaptability of government policy; transparency; bureaucracy, government decisions; competition; bribing and corruption; justice; ease of doing business, personal security and private property.

The key attributes of a new model

The report for the 23rd April conference, held in 2012 (Yasin E. 'Long-term Scenarios for Russia') suggests three other scenarios – modernization "from above", "resolute breakthrough" and "evolution".

Modernization from above suggests a highly centralized decision-making process and tough state control over the economy and public life. Its content is close to the one we called conservative or "business-as-usual". Institutional change is impossible as it suggests a certain initiative from the bottom and interaction between agents outside the hierarchy. The results of its implementation are likely to be poor.

The other two scenarios seem to combine all the variants contrasting with the first one. For our purpose it can be called modernization "from the bottom" (democratic) or an innovative scenario, as the Ministry of Economy suggests. Institutional change here is the core of the policy though it can be implemented at various speeds. It is important in the case of institutional development, as institution building is not only a formality but also a policy which can rapidly change public attitudes (e.g. "perestroika") or evolution with consideration given to the difficulties of change.

The above-mentioned details split the 'modernization from the bottom' scenario into two versions which differ in pace and the number of institutional changes over a given period of time.

A "resolute breakthrough" suggests that most of the critical steps will be taken in the very beginning to promote the impetus for reform. However, the risk of complications and backsliding persists.

"Evolution" puts the emphasis on slower progress enabling society to adopt changes, discuss its content and pace, resolve conflicts and take concerted action. Its implementation can include interrelated complementary institutions encouraging mutual promotion and the mobilization of society. (Yasin E. 'Scenarios', 2012, p. 39).

We opted for the last scenario as it seems to be the most relevant to the current economic performance and the state of society.

It should be emphasized that the new model of economic growth suggests a complex implementation of institutional change which would be better at revitalizing human potential and the unique attributes of human capital currently waiting to be employed. These powers are connected with freedom, competition and those laws which put freedom and competition into a rational framework.

Here we list the most important vectors for the implementation of a new model.

Up to now, development has followed a “business-as-usual” scenario which has not been promising at all. A new stage of reform requires critical decisions to be made. Here we list the most important of these decisions.

1. To establish the rule of law, fostering the independence of courts, eliminating power abuse and selfish decisions driven by short-term advantage.

2. To reshape the relationships between business, law enforcement and judicial agencies as a critical step in the establishment of the rule of law. This is required to enhance the credibility of the state and its agencies. Without it, there will be no economic boost.

3. To reform local government, including the expansion of its authority in taxation and charging. To promote civil society activism based on local governance.

4. Social sector: pension reform, healthcare, education and the real-estate market. This is a sector of individual investment that was virtually absent in the USSR. All the costs were borne by the state or employers, while people were robbed of critical human functions. This cannot be carried over into the future society, citizens should have a chance to choose, save and enhance their efficiency. Demographic trends should be also taken into consideration: the number of children in families is unlikely to rise and nor will the ratio between the working population and those who are retired. Money flow will be transformed. Pensions will be saved as a long-term investment along with medical insurance at the cost of an increased salary.

This chapter aims to start a debate on these issues, and to shape changes aimed at lasting institutional decisions rather than dragging our feet while the situation continues to deteriorate.

5. To introduce democratization and establish reasonable conditions for political competition and periodic regime change. This involves a gradual process including the implementation of a modern electoral system, taking into consideration the current political and social and economic environment. This system shall reduce to minimum the ability of the ruling elite to manipulate the system for their own ends. Democratization also means full-scale freedom of speech, sustainable plurality of political parties and a true separation of powers.

Though we strongly believe that institutional and bureaucratic barriers should be eliminated as soon as possible, we would like to caution against excessive optimism. The impact produced by these changes will not become apparent immediately as the reforms themselves are gradual. The best-case scenario (if all the parties concerned – experts, businessman and civil servants attempt this task in good faith) suggests that the situation will improve in three or four years, once the majority of technical measures have been implemented and the upgraded institutions accepted by those meant to use them.

We should understand that reforms are time-consuming and the amount of time is comparable to that needed to establish and foster institutions, including their adoption by the general public.

5. Drivers of new model and their activators

In practice, the launch of a new model depends on the question of who is going to support the institutional reforms mentioned above, and why they will do so. We can identify a number of such "groups of interest".

The first group can be called "new businesses". The 2000s sent oil prices skyrocketing, triggering the launch of "national projects", the establishment of state corporations and ambitious construction projects in Vladivostok and Sochi. The social and political stability of the 2000s and the rapid growth of consumer demand encouraged many companies targeting the domestic market..

According to research by *Expert* magazine, prior to the 2008 crisis, there were some 5000 medium sized businesses in Russia (those with a turnover exceeding $10 million per year) which generated average annual sales growth at 20% and higher (Vin'kov et al., 2008). Such firms were especially visible in construction and retail, although in fact, they existed in all sectors. At the same time, the share of rapidly growing companies ("gazelles") in Russia was much higher than that in developed countries (Yudanov, 2010).

These results were in line with data produced by a joint project between the HSE and the WB based on a survey of 1000 firms in 2005-2006 which showed a deep non-homogeneity in the manufacturing sector. On one hand, the calculations of the WB experts confirmed that the average labor productivity in the Russian manufacturing sector at that time was three times lower than in South Africa, half that of Brazil and Poland and only slightly better than China. (Desai & Goldberg, 2007, p.17-22). On the other hand, the calculations of Russian team of this project based on the same data showed that the average numbers covered very large gaps in labor productivity in terms of value added among companies of the same sector. Thus, in transport machine building, the gap between the top 20% and bottom 20% of businesses in terms of success was eleven fold, in the textile and garment industry it was sixteen fold, and in timber and the food industry, it differed by a factor of 24 (The HSE, 2007).

In other words, even back in 2005, and given the low average indicators of efficiency in every large sector, some companies were still able to compete in global markets. These successful companies with long-term planning used a favorable market conditions for business development (including investment, technical retooling, new markets expansion, attraction of foreign partners) and in fact contributed to the economic growth of the 2000s. Nowadays such companies, familiar with Russian market, financially stable and run by professional managers, can be the foundation for a new model of economic growth. However, they should have plenty of incentives to invest in Russia. Here we are faced with a traditionally bad investment climate in Russia.

The fact that the business environment in Russia leaves mush to be desired has been widely known for a long time. There has been plenty of work published on the subject (Hellman et al, 2003; Yasin, Yakovlev, 2004; Djankov et al, 2006; BEEPS, 2009; Doing Business; 2012). At the same time, the BEEPS survey, carried out by the EBRD and the WB in emerging markets, confirmed that the business environment in Russia was stagnating in the 2000s. While in 2005 half of the institutional indicators received from the top management of Russian companies had a higher than average score, by 2009 16 out of 18 indicators were worse than the average score for 28 transition economies (Kuznetsov et al, 2011).

However, before the crisis of 2008-2009, high business costs in Russia were balanced by high returns on operations in the domestic markets. Given the social and political stability of the mid to late 2000s (when many people rejected state capitalism with a Russian face, but economic policy was regarded as predictable and prudent) this combination encouraged considerable investment, mainly foreign. After the crisis, the situation changed dramatically: high margins disappeared, barriers remained and an uncertainty in economic policy (mainly involving apparent discrepancies between announced commitment and the decreasing financial potential of the government) led to additional challenges for new investment. As a result, capital rapidly left Russia. This exodus started during the crisis and has not stopped yet. Domestic investment has also shrunk, as mentioned above.

Such a response can be explained in terms coined by Albert Hirschman, one of the classical political scientists; it is an example of an "exit" strategy[5]. However, it should be noted that the majority of successful medium sized businesses which rode the wave of high demand in the 2000s can succeed only in Russia and to them, "exit" means closing the window of opportunity. After the crisis at least some of the business community came to realize this and felt it necessary to take collective action aimed at the transformation of the environment (or use of "voice" strategy, according to A. Hirschman). In should be noted that it is the "Business Russia"

[5] See Hirschman (1970). According to Hirschman, the "exit" strategy suggests that an agent (a firm, an employee, a household or a voter), dissatisfied with the current market environment, quits ("votes with feet"). The "voice" strategy suggests that the agent is willing to make the market change the "rules of the game" and bring them in line with his interests. The second choice, on the hand, is closely related to the "exit" costs, on the other – depends on the cost of collective action.

association that become most vocal in this respect. It represents medium sized and big "non-oligarchical" business.

We believe that the recent attempts by the government to change the investment environment are a response to mounting business pressure and reflect the understanding that only economic growth based on private investment can trigger a surge in individual income and uphold social stability nowadays. However, a real change in the investment environment stemming from declarations is highly dependent on the quality of governance.

The current model of the Russian state machine can be concisely described as a "vertical power structure". This model initially suggested a distance between the government and business as well as power redistribution in favor of the federal center. It evolved as a response to the decentralization of the 1990s which empowered certain social groups while widening inequality and triggering the destabilization of society.

The "vertical power structure" played its role in the recovery of the country early in the 2000s. Many of the steps Putin and his supporters made at that time were in line with the interests and expectations of a large part of the market players. For example, the reestablishment of the united economic space as a result of "taming" the heads of the regions, was beneficial for most businesses. Constraints on the influence of big business on economic policy were initially regarded as a positive sign since businessmen were generally opposed to the "Seven Bankers' Rule" of 1996-1998 when economic policy was clearly shaped by the interests of a handful of market leaders. Improvements in the civil service as a result of an inflow of professionals improved the quality of governance. The tax reform of 2000-2001 and improvement of tax administration is the most illustrative example. It dramatically eased the taxation burden[6]. . As a result while in the 1990s, legislation was widely neglected, in the 2000s the enhanced state machine regained control over the observance of law on the part of the citizens and businessmen. Better fiscal performance combined with tax redistribution in favor of the federal center brought considerable funds to the federal budget and facilitated the launch of a number of ambitious social and infrastructure projects.

At the same time, the state which was being consolidated within the "vertical power structure" was faced with consequences of a different kind. In particular, it suggested considerable expansion of the state machine and its authority in economic regulation. It led to

[6] The WSJ once called it a "tax revolution" – see "The Putin Curve". The Wall Street Journal, November 26, 2002

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soaring corruption, which is still one of the most pressing social problems in Russia. Centralization of power and regulation of the work of the state machine were regarded as the main instruments in the fight against corruption.

These measures are based on some simple assumptions. In a big hierarchical system, rules and regulations enable top management to control their subordinates (especially when there is no clear and transparent assessment of their productivity) and limit arbitrariness and "rent-seeking" of an individual civil servant. Detailed reporting provides top management with all the necessary managerial data. At first sight, such formality establishes a system of universal impersonal rules regarded by Douglas North and his counterparts as one of the most important pre requisite conditions of social development (North et al, 2009).[7]

However, in practice, the bigger the hierarchy, the more centralized and non-transparent it is (there is lack of information about the performance of its components), and the more sophisticated the regulations and accountable figures are. Consequently, more effort is needed to observe the rules and prepare reports than is needed for work-related duties. At the same time the system which undermines initiative at the bottom with set procedures inevitably shifts responsibility to the top. As a result, top management is more and more absorbed with routine regulation instead of strategic planning, while middle management upgrades its manipulation techniques and capacities. Unwilling to implement its mission as an order from above, it gets involved in filibustering. A qualified civil servant in Russia clearly understands that tasks set by his superiors should be fulfilled formally rather than substantially. Only those tasks which are in line with the interest of the agency are subject to a thorough review.

Moreover, detailed regulation of the routine (instead of devolution and productivity assessment) impedes the urgent need to resolve economic and social problems. Most of them requires creativity and awareness about local specifics which do not fit universal regulations set by the government. As a result, while declaring commitment to the regulations, top-level management repeatedly evades the rules (as, for example, the legislation on public procurement is regularly evaded when it comes to "strategic projects"). Thus it has to handle problems through 'manual control" which *per se* is a breeding ground for corruption.

[7] Exploring historic cases, North and his colleagues show that the rule of law was enforced from the above in England, France and the USA – when the key stakeholders within the elite reached a consensus on the transition from personal privilege to impersonal rights and established a set of rules to regulate inter-elite dynamics. Initially it was the rule of law for the elite rather than citizenry. Later it embraced larger social groups. However, the establishment of impersonal rules and their observance by the elite was an important step on the road to the "rule of law".

In other words, the nature of the "vertical power structure" leads to large-scale conflicts of interest within the state machine. Loyalty to duty confronts the abuse of power. So the internal costs of conflict management mount. It ought to be noted that examples of the rejection of innovation, high operational costs and sharp differences in the incentives for civil servants within the administrative hierarchy are numerous in literature and the Soviet past. Such a model is more or less functional in cases when there is a resource surplus (when goals can be achieved at any cost) but it fails if the budget constraints are tight and there is a need to counter internal and external challenges. This was true of the USSR in the 1980s and, we believe, is also the case in modern Russia after the crisis of 2008-2009, where we have mounting social obligations and soaring uncertainty about the future of global markets.

All in all, we have attempted to show that the launch of a new economic model based on flourishing medium-sized business which emerged in the 2000s should be facilitated by change in the institutional environment and a more friendly investment climate. So the "right incentives" for the state machine are needed. Thus the state administration should be dramatically altered. What direction should these changes follow and what social base can they rest on?

In developed democracies, the "right incentives" for the state machine are triggered by political competition and the pressure of a strong civil society. In Russia both factors are weak. However, **inter-regional competition** can ensure pressure within the state machine and provide incentives to facilitate change. In this respect we can use the experience of China where flawed market institutions and rampant corruption have coexisted with high growth rates for over thirty years. (see Box 1).

Box 1. U-form and M-form organizational structures

The difference in the track and results of market transformation in Russia and the PRC can be explained through the comparative analysis of the Soviet and Chinese models of economic regulation. According to (Maskin et al, 2000) , the Soviet economy was administered by more than 60 industry sectoralministries and was structurally close to the Ford corporation (the first to use an assembly line). Its structure had been unitary up to WWII (Alfred Chandler, one of the authors of classical reading on the theory of management termed it the "U-form"). In particular, the management in the Ford corporation was built according to the principle of functionality: production department, sales department, purchase department etc. Every department had its own mission. All in all, they were complementary though different in substance and incomparable.

Unlike the Soviet model, the Chinese planned economy was closer to the "M-shape" pattern invented by General Motors. In General Motors, the internal structure was split into independent automobile companies producing various brands (Chevrolet, Pontiac, Oldsmobile etc.).

As the theoretical model suggested by Eric Maskin and his colleagues showed, such multidivisional structure facilitates productivity comparison for the middle-level management and ensures more effective incentives for managers. The history of the automobile industry in the USA between 1930 and1950 showed that such a structure became a competitive advantage for General Motors and enabled the company to outperform Ford which had been the market leader.

The parallels between the Chinese economy and the “M-shape” rest on Maskin’s assumption that unlike the USSR and other socialist countries, they used decentralized planning in China - distributing the products and resources among 27 large provinces. Mao Zedong’s conviction that either the USA or the USSR would inevitably invade China and occupy a part of this territory contributed to this model. Taking into consideration the guerilla fight against Japanese occupation, it was important to establish relatively autonomous and self-sufficient “support bases” to ensure the army could continue to fight. As a result China, unlike the USSR, was split into ten districts where parallel industries were deliberately established (Qian, 1999).

Such a structure of economy combined with a high role of regional organizations within The Communist Party of China laid the foundation for a unique model of governance established in the course of Deng Xiaoping’s reforms. This model included political centralization and fiscal federalism. At the same time, as Qian and Roland showed (Qian & Roland, 1998; Roland, 2000, Chapter 11), tough budget constraints enforced by the federal center triggered competition for resources which, in its turn, enhanced governance. Empirical research carried out later (Li & Zhou, 2005; Fan et al, 2009) confirmed that the promotion of a civil officer in China was closely linked to the economic performance of the provinces they administered.

All in all, as we see it, decentralization is able to introduce changes essential to the establishment of the “right incentives”. It does not imply, however, automatic allocation of additional funds to close the deficit in regions and local governments. It suggests a real expansion of regional and local autonomy, i.e. a **return to federalism**. It should be noted that if these steps are not taken, a return to the election of governors will make relations even more strained and fuel criticism of the president and the government. Apart from the reduction of excessive functional burden, the return to federalism will give the federal center more room for adequate decision-making in tackling social and economic problems through regional experiments and pilot projects.

Shifts in the structure of the regional elites in the 2000s could contribute to this process. In particular, according to an analysis of regional elites carried out by HSE International Center for the Study of Institutions and Development (ICSID), only 16% of those governors who were in charge of the regions in 2000 remained in office by 2011. Vice-governors and key regional ministers underwent an even more radical clearout: by 2011 only 8% of officials who had been working in 2001 remained in office. The average age of a governor in 2011 was 54 (as opposed to 64 in 2000). Vice-governors are now, on average, two years younger than that - they are typically 46 years old. At the same time, a new generation of the regional elite are embracing more ex-businessmen (every fifth governor and every third vice-governor has experience in business) and professional bureaucrats (nearly 40% of governors and 35% of vice-governors).

On balance, it is obvious that a “new bureaucracy” has emerged. It is comprised of qualified and well-paid professionals who have a good grasp of the market economy, are often aware of modern methods of governance and are ambitious when it comes to their career. Nowadays, these type of bureaucrats works in the regions as well as in federal agencies. However, it is their activity in the regions that can serve as an illustration of their productivity. There they also have more opportunities to tell their own “success story” – as happened, for example, in Kaluga or Ulyanovsk, where regional authorities have succeeded in attracting investors.

These shifts in the motivation of regional leaders can be traced not only through case studies but also by a broader empirical analysis. Regression analysis of the results of the above-mentioned survey among 1000 manufacturing companies showed that large-scale investment projects launched in 2005-2008 were an important facilitator of the regional authorities’ decision to allocate additional funds. For example, regional government supported 36.5% of “active investors” in 2007-2008, compared to 25% of “non-regular investors” and 17% of companies without investment.[8]

However, until last year such positive regional shifts in Russia were occasional rather than regular, as they were not based on rational identification and encouragement of best practices by the federal center. Effective bureaucrats could not be promoted against clear and measurable assessment criteria. Professional training was traditionally conducted by the educational entities which originated early in the 1990s and was based on former Higher Party Schools of KPSU “inheriting” their staff.

All in all, we can conclude that the stability of the 2000s (traditionally related to the “vertical power structure”) has produced two large social groups, both of which are skilled and can afford to be involved in long-term planning.

However, economic and social regulation patterns stemming from the “vertical power structure” foster opportunism of the “new business” and “new bureaucracy”, and encourage redistribution rather than production. The question remains: who can change it and how?

Despite conventional wisdom, it is not a matter of an individual’s “political will” or the will of a small group of loyalists (represented by “Politbureau 2.0”). It depends on the willingness and capacity of the new Russian elite to reach a consensus on the “rules of the game” which they are ready to comply. These rules should not impede long-term economic and social

[8] It should be noted that federal support was less dependent on investment activities; state participation, keeping employment, the date of establishment before 1991 and location in an underdeveloped regions were more important for federal authorities (Yakovlev, 2011).

objectives. At the same time, the "violent pressure" typical of Russia today is a waste of limited resources and can trigger "mutual destruction" among the modern elite.

As noted above, the specifics of the current system suggests that the top elite feel free from any rules. It seems that the rule of law should be established from the bottom rather than from the top (as has been established in modern liberal democracies). Rules, norms and obligations that are publicly declared for all citizens must include the elite as well.

The "bottom-top" vector is in line with the pressure put on the government by different social groups - from drivers locked in jammed streets due to the ever-growing number of "government" cars with traffic privileges to businessmen fighting illegal takeovers and "bullying" at the hands of law enforcement agencies. A tougher budget puts external pressure on the elite as it cannot merely bribe the displeased.

However, pressure *per se* does not result in adequate trouble-shooting. Functional agreements on new "rules of the game" can be produced only by a dialogue embracing those groups which represent the interests of key stakeholders. The current rules of the game were established by the bureaucratic elite, the "siloviki" and big business, loyal to the regime, as a response to the crisis of 1998 and the challenges of the 1990s in general. After the 'Yukos affaire" the structure of the ruling coalition changed and big business found itself in the role of the junior partner. Now, new parties - "new business" and regional elites - should be invited to debate the new "rules of the game". As we have attempted to show above, it is these two groups that can be the drivers of the new model of economic growth. Moreover, the negotiations should embrace professional elites (teachers, doctors, professors, researchers) who represent the public sector since its performance is important for sustainable economic growth.

HSE research shows that the business community is the most active when it comes to self-organization. For example, before the crisis of 2008-2009, along with the "big four" (RSPP, Chamber of Commerce and Industry, "Business Russia" and "OPORA Rossii"), there were more than 300 functioning sectoral business associations (Yakovlev, Govorun, 2011). At the same time, as Table 5.1 shows, the associations included more active businesses.

Table 5.1 Share of enterprises with different levels of investment activity among members and non-members of business associations (BA) in 2009*

2005-2008	Members of BA	Non-members of BA
No investments	19%	36%
Low investments	30%	30%

Large investments	51%	34%

*) According to a survey of 1002 businesses in the manufacturing industry, conducted by the HSE in February-June 2009.

However, even advanced associations representing the collective interest of business have, so far, tended to tackle problems through "vertical links". Such an approach may be effective in the short term, but it is unsustainable for long-term purposes. A tougher budget and soaring uncertainty mean that the regime cannot ensure its commitment to certain social groups. Only those decisions which are in line with the interests of major stakeholders will be put into practice. In this respect it is essential to develop horizontal cooperation, which will curb uncertainty *per se*, enhance credibility and put interests into perspective. In this case the result (new satisfactory decisions) is as important as the process which facilitates any change in the environment.

The urgent social and economic problems which Russia now faces frequently call for creative solutions. In Chapter 7 we present one possible solution aimed at leveling social inequality and the promotion of investment in human capital. However, we do not underestimate our expertise - such ideas should be generated by stakeholders who will then go on to participate in their implementation. Experts can make solutions more formal; build arguments and assess the potential consequences.

In this respect, any dialogue on the new "rules of the game" largely depends on the lobbying groups able to offer constructive solutions and take into consideration the interests of other social groups while defending the interest of their own group. It has to be understood that the search for new solutions will take a long time and they will have to be found by trial and error. Consensus building in this respect is essential. However, it is advanced civil society institutions that ensure sustainable and adequate decision-making for development.

6. The role of civil society in shaping a new growth model

Only the future will show how much Russian elites are ready to try to reach a consensus on the basis of long-term interests as opposed to a situational share of administrative and economic resources. In this regard, the medium term, especially the run-up to the next parliament and presidential elections, will become critically important. Also, only a highly developed civil society can become the basis for institutional change, thereby encouraging economic growth, at least in its post-industrial form.

In Russia the state has traditionally been the driver of change. Its policy was at best determined by competition between the elite and at worst – by the interests and favors of individuals. The wider population only could execute decisions and criticize the authorities. Often these two roles became intertwined since they assumed something like the mindset of a child, who is sure that the life of the family is shaped not by him, but by his parents, and who demands things from his parents, is sometimes grateful, often rebellious, but seldom thinking of himself as of an independent and responsible individual. Undoubtedly, this situation did not stem from the free will of most of the people, but was determined by the conditions in which society and state evolved.

But the nature of the economy of the 21st century implies a multifaceted and diverse interaction between many subjects, who are distinguished precisely by a high degree of independence and responsibility. It is difficult to match a full-scale manifestation of such traits in the economic sphere with either servility or blind rebellion against the authorities.

Can we overcome the tradition where the state is more of a master and mentor to the society than an agent? We do not agree with the two well-known points of view, according to which a tradition is either determined by the genotype of a nation and cannot be changed or alternatively, can be eliminated almost instantaneously after uncompromising democrats come to power. We believe that both an evolving culture and the mastering of the skills of civil self-organization play a key role.

In previous works it was shown that not only is market self-organization emerging in the country, but also a non-market and a not-for-profit one. From the early 2000s it has started to become stronger in society, which was prepared, on one hand, by the appearance of new economic opportunities along with the growth of the middle class, and, on the other hand, by the previous development phases of Russian civil society, from the activities of Soviet dissidents to the intensive import of NGO resources and learning from foreign counterparts in the 1990s. (Jakobson, Sanovish, 2009). The present phase is often underestimated for two reasons: firstly, Due to a number of circumstances, not analyzed here, the development only partly corresponds to the quantitative growth of registered NGOs. Second, the "widening" of the nonprofit sector was naturally characterized by the convergence of the features of NGOs' partisipants with the features of a typical Russian citizen. This disappoints those experts who see civil society only as a composition of politically active groups, inspired by liberal values. Indeed, Russia is similar to most other countries in that the most common group is the non-political self-organization, aimed at mutual assistance and philanthropy, spending joint leisure time together etc.

For instance, in a survey of 1005 NGOs, conducted in 2012 by the HSE, 41% of the respondents, when answering a question about the social and political orientation of their organization, said it was neutral, 20% said they were committed to liberal values, 16% to social-democratic and 11% to conservative values. 16% said they were adherents of other views, among which the most common were communist (5%) and nationalist (3%).[9] The same respondents were asked to assess whether most Russian NGOs would like to take part in bringing about serious political change in the country. 8% said they "would definitely like", 22% "would quite like", while more than a half of the respondents gave a negative answer (16% didn't know).

A lack of close correlation between two aspects of its development is typical of the current situation in Russian civil society. This includes, on one hand, the shaping of a network of sustainable self-organization groups, that can be registered as NGOs or act for a longer period of time without registration, and, on the other hand, the organization of mass actions, mostly protests. The aforementioned survey of NGO leaders showed that only 7% of respondents took part in protests, rallies or strikes.

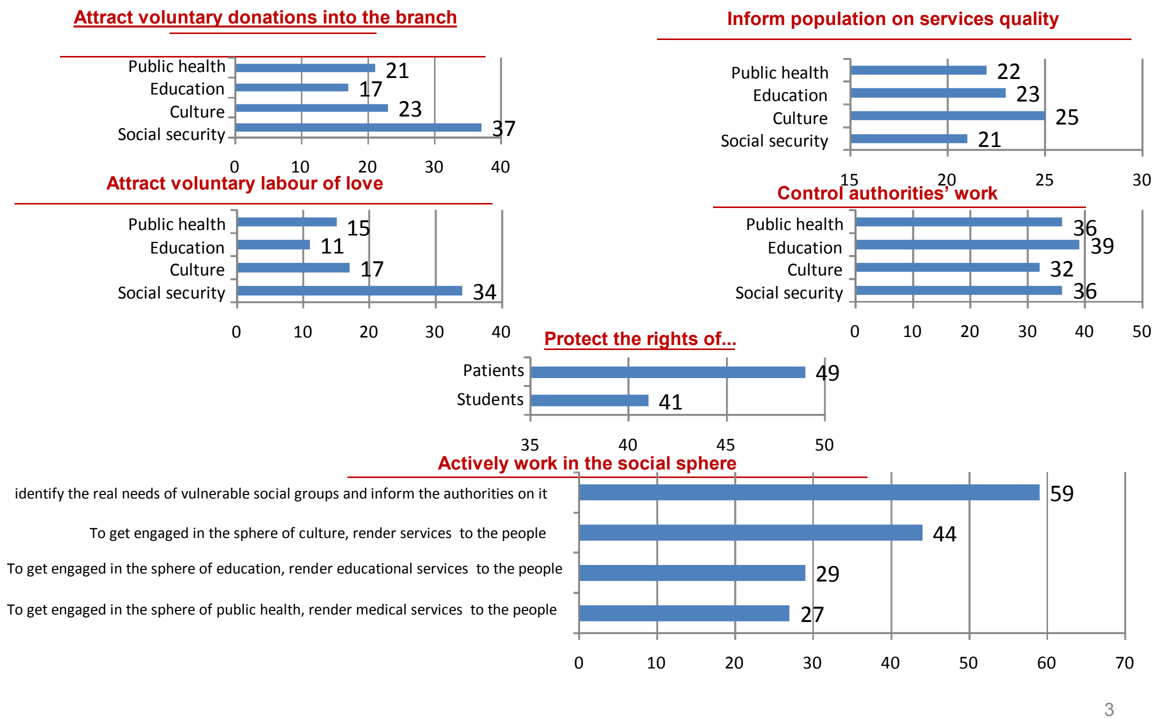
The fact that mass actions are not rooted in the day-to-day activities of registered and non-registered NGOs makes most of those actions ad hoc events in response to the actions of the authorities. Such a situation is clearly more preferable than one that happens in an even less developed civil society. We mean passivity as wel as spontaneous riots "for everything good, against everything bad", which, time and again, bring about regime change in third world countries. Despite this, the current state of Russian civil society does not ensure a continuous, relatively unidirectional and efficient pressure on the elite.

At the same time, although they are often overlooked, there are situations when civil self-organization is mainly seen within the framework of its political means and consequences. Primarily, in recent years a distinct need for NGO participation in what has been previously regarded as a state monopoly has formed in our country.

The data in Fig. 6.1, showing the results of a representative survey conducted by the HSE and the Public Opinion Foundation in 2012 seems significant in relation to this.

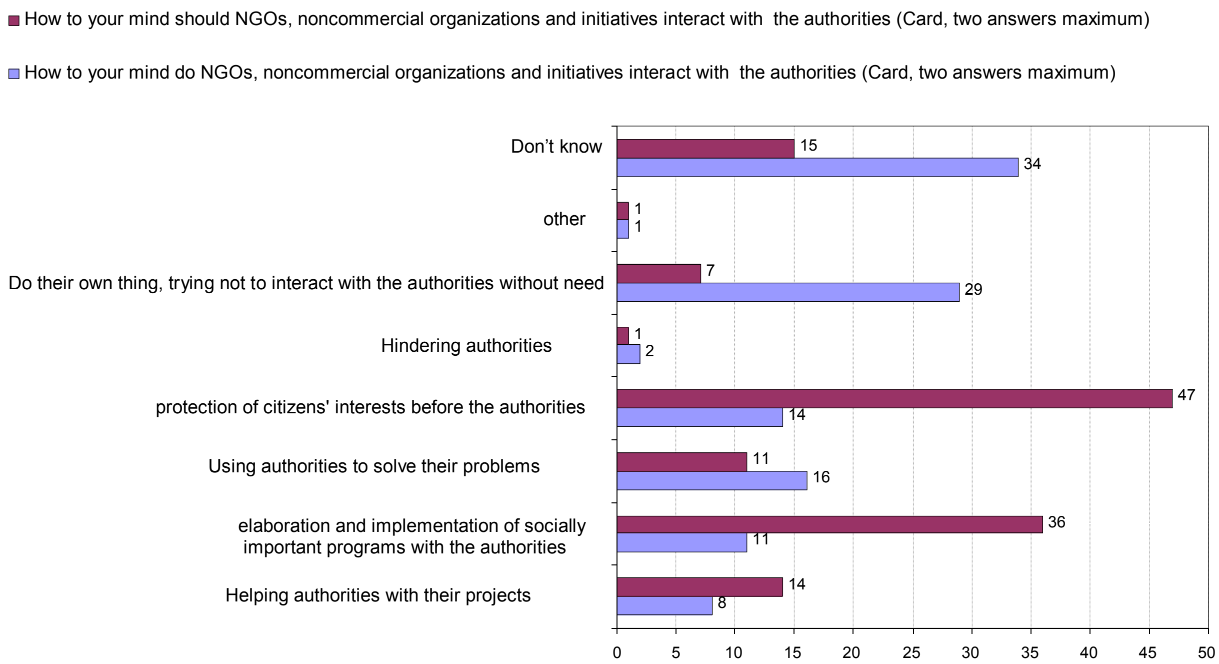
[9] The research was conducted by a quota sample, developed by I.Mersiyanowa in a way to reflect the variety of NGO types, the number of years they exist, the type of the population aggregates and such regional characteristics as the urbanization level and per capita gross regional product values and the number of registered NGOs. Field study conducted by OOO "MarketUp"

Fig. 6.1 Replies to the question: "How could non-profit organizations and civic initiatives to help improve the situation in the social sphere?" (in percent)



The specific character of these times is characterized by the fact that the request is already there, but still unusual and only moderately satisfied. Also, as the analysis shows, there are already many (although separate) examples of successful initiatives. The authorities, for the its part, are gradually beginning to understand that they cannot solve urgent social problems alone. The relationship between NGOs and the state is far from ideal, but the population is no longer indifferent to how this relationship is formed and has made a conscious choice in favor of a real partnership. This can be seen in Fig 6.2., where you can see answers to the question of how the relationship between the authorities and NGOs and civil initiatives should be and how it actually is.

Fig. 6.2 Replies to questions on the desired and actual nature of interactions (in percent)



Second, non-political self-organization, participation in different associations, even if established to solve private problems, is, according to Alexis de Tocqueville, a "school of democracy" (R.Putnam 1993, 2000). In Russia this "school" has been functioning freely for a little over two decades and has been "attended" by many people for about ten years only. Of course one should not expect extraordinary success from this "school". Comparison of the data of the HSE-survey among NGO leaders and public surveys shows that the former not only have a much more distinct attitude towards connecting with other people for joint action (88% vs. 63%), but have also an impressively higher level of overall trust: 52% of them believe that one can trust most people, while the average rate is 17%. Meanwhile the level of trust plays a key role in establishing horizontal relations beyond family and close friends.

Overall, from the civil society monitoring data obtained by the HSE and a number of sociological centers, one can draw the following conclusions. There really are processes in the country involving relatively broad and diverse self-organization. Citizens rely less on the state and see the possibility and desirability of its accountability to civil structures quite clearly. There are more and more examples of free, organized and responsible joint actions in various areas of public life. All this refutes the idea of the "innate statehood" of a nation. Moreover, given the short period of time during which civil activity in Russia was been able to exist without harsh repression, its current level gives us reason to expect that Russia will be able to quickly walk along the path that some other countries have been traveling for centuries.

However, while civil self-organization is no longer perceived as an underground activity or an “exotic foreigner”, the skills needed for it to be effective are only now emerging. The number and diversity of NGOs is not insignificant, but most organizations are economically and administratively weak, and not all of them play fair. Self-organizing cells are usually small, fragmented and have no distinct need for consolidation. There are relatively few horizontal links between social structures, and their mutual “kinship” is most often perceived as a mere coincidence in areas of activity, i.e. they work “parallel” to each other. It is notable that precisely such a coincidence was recognized by 53% of the abovementioned NGO leaders, who took the survey, agreeing with the phrase “your organization has a lot in common with another.” At the same time, only 5% saw a connection through common principles, world outlook, goals and tasks. 6 % spoke of joint action as the definition of the aforementioned phrase. In turn, practical cooperation is characterized mostly by different mutual information formats. In the same survey 58% of respondents cited experience exchange as one of the results of interacting with other organizations, 37% mentioned the formation of a positive image of the organization, 33% spoke about access to information and methodological resources, while 34% mentioned the additional possibilities of solving social problems, but only 20% talked about an increase in influence on authorities.

Most NGOs are not attracted to the idea of being initiators and supporters of mass actions. This means that, on the whole, they tend to act depending on the situation. The state policy in relation to public structures can be described as “carrot and stick”. Ultimately it makes no sense, because it is by definition impossible to manipulate a free self-organization, and a simulated or corrupt self-organization is ineffective. However, there are such attempts, and that, of course, discourages many NGOs. At the same time, there are many organizations that have learned to cooperate with the authorities, without compromising their independence or dignity. There are also those who knowingly exploit the poor judgment of these structures, as well as those who act as tools or even as agents of the authorities.

The available empirical evidence gives us moderate optimism about the prospects for Russian civil society. It would seem that its development is irreversible. However, there is no reason to expect that the pressure of the civil society on the elite and the state in the near future will be a decisive factor for change in those institutions that are fundamentally important for economic growth. Too much still depends on relationships among the elite. This reduces the predictability of the political and economic process. However, the increase in public activity, clearly seen at the end of 2011, reduces policy choices available to the elite and, ceteris paribus, it leads to its greater caution and concern for the long-term future.

With the formation of a network of self-organizing cells reflecting a real range of interests, values, views and requests in Russian society, citizens gradually cease to be content with their limited role as “fans” for this or that elite team. Of course, this applies in different ways to different segments of the population. The leaders are, among others, the professional community of lawyers, doctors, teachers, and especially businessmen.

7. Pabulum for reflection: How can we eliminate inequality and promote investment in human capital?

Income and spending inequality is one of the stumbling blocks on the road to a fully-fledged civil society and its consolidation around common values. The current gap is too high for a developed country. This inequality partly stems from the structural imbalance of the Russian economy, particularly underdevelopment of those sectors which ensure investment in human capital.

In this chapter we present some solutions. While it is less detailed than previous chapters, we decided to open a public debate on our ideas since we believe that a full-scale public discussion is a critical part of strategic deliberations.

This new model of economic growth will be based on human capital in the long-term. Effective economic mechanisms encouraging state and private investment in human capital facilitate the feasibility of this model. Education, healthcare and retirement insurance are the main channels for investment. Furthermore, investment in the environment depends on the affordability of real estate and the quality of housing and public utility services. We believe that a reduction in inequality and a more responsible approach by individuals towards their own investment in human capital for are the only ways to facilitate a breakthrough in these directions.

As a result of the rapid economic growth of the 2000s, income and consumer spending in real terms increased 2.5 times. However, the change in the structure of consumer spending and individual savings was uneven. The share of non-food products grew as opposed to food expenses, and organized savings were generally reduced to bank deposits. At the same time, in the 2000s the share of fee-based services fluctuated around 14-16% of the income achieved in the late 1990s. Over the decade the share of medical expenses and tourism grew only slightly - from 1.2 to 1.3% of income while the share of fee-based educational services after a period of volatility stabilized at 1%. Pension contributions through savings did not exceed a statistical discrepancy during the whole period. Thus, though income has been rising throughout the decade, the structure of spending is still far from the pattern that can be seen in developed countries. Consequently, the share of individual transfers in the structure of investment into human capital remains low.

The share of education and healthcare in GDP has been nearly the same over the last decade. It has followed budget spending in these sectors while private financial services have been reduced to banking. It seemed that a "resource curse" at that time should have not impeded the above-mentioned non-tradable sectors. The lag persisted as a result of the incomplete reforms of the public service and state pension systems which did not grow, but instead created an illusion that they provided the population with their services. In addition to this, a high level of inequality caused by insufficient income in the public sector impeded the growth of investment in human capital.

Our hypothesis suggests that narrowing the salary imbalance between public services and other sectors would increase the share of fee-based services in the structure of consumption. This assumption is indirectly confirmed by the sharp increase in the salary of public sector employees in late 2001. As a result, salaries in education and healthcare grew by 60% in 2002 against an average rise of 35%. This increase coincided with a considerable growth in the share of fee-based services in the structure of spending (including education and healthcare). This effect lasted until the early 2010s.

Table 7.1. Consumer spending, % from income

	2001	2002	2011
Purchase of goods and service payments	**74.6**	**73.3**	**73.5**
Purchase of goods	59.8	57.3	56.4
Service payments, including	14.8	15.9	15.6
Education payments	1.0	1.1	1.0
Recreation costs, tourism and healthcare services	1.1	1.4	1.3

Source: Federal State Statistics Service

We suggest that the mobilization of additional resources and the growth of income of employees in education and healthcare are required for the development of these sectors. However, we need to change the incentives of both producers and consumers in order to drive these sectors into a new orbit. To this end, public services should be assessed in market terms, employees should get competitive compensation while consumers should have the resources and a set of real options and responsibility. As a result, such sectors as healthcare, education, funded retirement insurance, housing and public utilities will emerge as fully-fledged elements of the market economy. Needless to say, this process will be time-consuming.

What should be done to achieve this goal? In fact, the first step has already been outlined in plans to increase salaries in public sector for the majority of employees and to maintain them so that they do not dip below the average level across the region. For some categories of teachers and doctors, salaries are expected to be higher than average. Unfortunately, given the current slowdown in the economy and different priorities in federal budget spending, there are not sufficient funds to guarantee these plans. Even if the number of employees in the public sector were reduced by 15% by 2018, this increase in salaries would require extra costs of at least 15% of GDP year on year.

The leveling of the structural disproportion in income in the public sector and other sectors will reduce inequality. Since this growth in the key producers of investment in human capital require their inclusion into the market, financial flows should be redefined in order to trigger market incentives, positive selection and enhancement of quality as well as to attract extra-budgetary funds into these sectors.

In developed European countries employees pay, as a rule, up to half of their pension contributions. The rest is paid by their employer. The share of private spending on medical insurance is also higher than in Russia. We suggest that salaries should be increased in a way that enables employees to make regular contributions to healthcare and funded pension insurance. Thus the volume and the structure of spending and savings in this category can be substantially transformed. It will also encourage an increase in the supply of these services and can be gradually expanded to employees in the private sector. Healthcare and the pension system are the top priorities as they suffer more than others when it comes to a lack of funding and underdeveloped insurance mechanisms. Later this pattern - providing support for additional spending - can be expanded to education, housing and public utility services and affordable real estate.

We have preliminarily assessed the required resources and mapped the redistribution of financial flows. Being aware of the importance of different aspects, we decided to take into consideration only key factors. So our calculations are approximate. All the figures are estimated as of 2012 and are based on statistics for 2010-2012. We did not pursue long-term scenario building, in order to avoid making forecasts about a wide range of parameters.

In 2012 the total number of employees in the public sector was 14.1 million. 12 million are employed in three major sectors – education, healthcare and public administration. These sectors account for up to 6.5% of GDP as salaries and some 2% of GDP as social expenditure.

Table 7.2. Key parameters of pay and employment in the public sector

	Assessment as of 2012	% of GDP
Average pay in the public sector, ths. of roubles/month	**23.9**	
Employment in the public sector, mn. ppl.	14.1	
Labor compensation fund year[10], bn roubles	4048	6.5
Labor compensation fund incl. transfers (30%)[11], bn roubles	5263	8.4
transfers to the Pension Fund of the Russian Federation (22%)	891	1.4
transfers to the compulsory medical insurance (5.1%)	206	0.3
transfers to the Social Insurance Fund (2.9%)	117	0.2

Source: Federal State Statistics Service, the HSE Center for Development calculations

To assess the resources required to transform the financial flow in healthcare we suggest that an increase in the salary of one employee in the public sector will be equivalent to medical insurance at the market price for one employee and a member of his family. Given the average price of a VHI – 25-30 roubles per year (at 2012 price), the estimated increase in the salary of one public sector employee (insurance bonus) is 5300 roubles per month, including income tax. Additional flat budget costs are 1.4% of GDP. At the same time, additional expenditure of the employers (0.5% of GDP) will go into the Pension Fund, compulsory medical insurance agencies and the Social Insurance Fund.

Table 7.3. Change in financial flows in healthcare

	Assessment as of 2012	% of GDP
Number of running VHI contracts, mn.	4.3	
VHI premiums, bn. of roubles	120	
Average VHI assurance cost, ths. of roubles/year	**27.9**	
Full cost of health insurance for two ppl./year, ths. of roubles	**55.8**	
Same including income tax	64.1	
Same per month	5.3	
Additional budget expenditures for salaries (w/o transfers), bn. of roubles	905.2	1.4
additional transfers to the Pension Fund of the Russian Federation (22%)	199.2	0.3
additional transfers to the compulsory medical insurance (5.1%)	46.2	0.1
additional transfers to the Social Insurance Fund (2.9%)	26.3	0.04

[10] Budget transfers and income-generating activities
[11] Excluding recourse

Additional budget expenditures with transfers, bn. of roubles	**1177**	**1.9**

Source: Federal Financial Markets Service, the HSE Center for Development calculations

To calculate the resources required by the defined contribution pension system, we suggest that all employees in the public sector get an increase in salary which makes up for the cost of the first annual fee for one participant. The period for accumulating a pension is 40 years and the payment period is 20 years. According to a conservative scenario, the annual growth of salary will be 7% per year in nominal terms. The average annual return for the whole period is 6% in nominal terms and 3% in real terms. An accumulated pension should ensure 50% of the average income over the working period (or 17% of final salary). We do not consider the survival probability normally used in actuarial calculations.[12] Such method results in the overpricing of pension transfers against the baseline. However, it is reasonable to use this if pension savings can be inherited (this is the best way to enhance the credibility of the system). To avoid discrimination we suggest that all gender and age groups will get an increase in salary, though savings will be financially reasonable only for those who will be able to accumulate savings for more than 20 years. Senior citizens can relocate the above-mentioned funds as additional transfers to a pay-as-you-go part of the pension system. It will mitigate the deficit and reduce the vertical imbalance of the budget.

The estimated increase in salary of one employee in the public sector required to pay the first annual fee is 2900 roubles per month, income tax included. The additional budget cost of labor compensation is 1% of GDP, with all expenditures included.

Table 7.4. Change in cash flow in the pension system

	Assessment as of 2012	% of GDP
Average annual pay growth rate, %	7.0%	
Average return, %	6.0%	
Premium due date, yrs	40	
Endowment period, yrs	20	
Average pay during pension accumulation, ths. of roubles/month	119.3	
Pension amounting to 50% average earnings (17% of final salary), ths. of roubles/month	59.6	
Pension capital, ths. of roubles	14311.2	
Cost of the annual fee in the first year, ths. of roubles	**30.5**	
Same including income tax	35.1	
Same per month	2.92	
Additional budget expenditures for salaries (w/o transfers), bn. of roubles	495.3	0.8
additional transfers to the Pension Fund of the Russian	109.0	0.2

[12] As we noticed, a number of the biggest Russian non-state pension funds do the same.

Federation (22%)		
additional transfers to the compulsory medical insurance (5.1%)	25.3	0.04
additional transfers to the Social Insurance Fund (2.9%)	14.4	0.02
Additional budget expenditures with transfers, bn. of roubles	**644**	**1.0**

Source: the HSE Center for Development calculations

The above-mentioned changes in health and funded pension insurance should encourage employees in the public sector to generate additional financial flows in these sectors, shape demand for better medical services and establish a source of long-term investment as an upgraded component of the defined contribution pension system.

Table 7.5. General Results

	Assessment as of 2012	% of GDP
Average pay in the public sector, ths. of roubles	**32.2**	
Changes to the expenditure budget		
Additional expenditures for salaries	1401	2.2
Additional transfers	420	0.7
Total additional expenditures, bn. of roubles	*1821*	2.9
Changes to the revenue side of the budget		
Additional transfers to the Pension Fund of the Russian Federation	803	1.3
through payments of employers	308	0.5
through payments of workers	495	0.8
into the PAYG part	248	0.4
into the cumulative part	248	0.4
Additional transfers to the compulsory medical insurance	977	1.6
through payments of employers	71	0.1
through payments of workers	905	1.4
Additional transfers to the Social Insurance Fund	41	0.1
Total additional income, bn. of roubles	*1821*	2.9
Funds to cover the current deficit of the Pension Fund of the Russian Federation, bn. of roubles	556	0.9
Flow of resources into medical insurance and the cumulative part of the pension insurance, bn. of roubles	1265	2.0

Source: Federal State Statistics Service, Federal Financial Markets Service, the HSE Center for Development calculations

The price of the change is an increase in budget spending on labor compensation and expenditures by 2.9% of GDP. The total amount of resources required for change is smaller than the National Wealth Fund. At the same time, most of the funds will immediately return to the budget due to additional transfers to non-budget funds. However, since labor compensation in the public sector is financed mainly by regional budgets, the regions will need additional transfers for this period of transition. As the service sector matures and the regional budgets get additional revenues, the need for transfers will decrease, so our proposal is generally in line with the concept of decentralization. Inflation will be almost unaffected since any additional resources will not directly influence the consumer goods market.

The biggest risks and problems stem from the need to expand this upgraded system to employees in the private sector. If they immediately have to pay medical insurance and pension fees for themselves without any compensation, it could result in a growing poverty rate in those households where no one works in the public sector[13]. The margin for increase in salaries in the public sector can be slightly higher than that required by expenditure so that this "award" promotes aggregate demand. The gradual adaptation of the economy and an increasing supply of high-quality services and expanding resources will need time for transition (approx. 5-7 years).

Citizens will favor the new system if the difference between standard services in compulsory health insurance and high-quality services at market price (for example, the choice between a public health center and a private or ministerial one) is obvious. The upgraded defined contribution pension system should include credibility building measures to ensure the safety of savings and high returns. One possible solution suggests that the process can be launched in those regions with best performance, where income is higher and there are already various medical centers and financial institutions. The supply of high-quality services will increase and be comparable to demand if medical centers attached to governmental agencies are included in this insurance system since they currently provide services to employees in public administration which is a non-market access restriction.

Increased competition in the labor market and pressure for higher salaries from employees in the private sector will be the most important result of this transition to a market with investment in human capital. In this context, the private sector will have to enhance its efficiency and labor productivity (by rationalizing staff or using technological advances). So the changes described above can only be carried out as a part of a full-scale institutional transformation.

[13]The authors would like to thank L.N.Ovcharova and the Independent institution of social policy staff who helped to assess the consequences with the use of microdata.

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