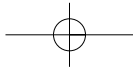
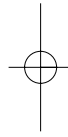
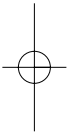


Russia's Future Under **Medvedev**



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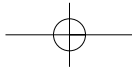
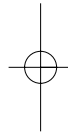
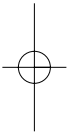
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Introduction

The Centre for Global Studies presents this essay as of particular interest in showing the way intellectuals close to President-elect Dmitri Medvedyev analyse the problems facing Russia and trace the path to their solution.

The most striking thing is that the problems and their solutions are presented in terms which will be wholly familiar to the western reader, and do not rely on any statement of Russia's special identity, exceptional characteristics or unique mission. The goal is the humdrum one of economic development, conventionally defined in terms of economic growth, higher per capita incomes, reduced social, economic, and regional inequalities. Achievement of these goals requires the cooperation of the state, market, and civil society. It thus requires reform of state institutions, the development of a competitive market economy, and the strengthening of civil society.

There is an interesting analysis of the attitude of the main social groups to the reform project, and on the nature of the coalitions which need to be assembled for different elements of the project to succeed.

The authors emphatically reject the 'mobilization' model of the old Soviet state, and also criticise the mixture of rentier capitalism, corruption, and inertia into which the late Putin years drifted. They point out quite rightly that an autocratic state, however strong it may seem to be, is not an appropriate vehicle for the 'comprehensive development' of the society, because it cannot mobilise the necessary support for reform. For this a competitive political system and a free press are needed.

They show how the collapse of the Soviet Union 1990s fragmented the previously homogenized Soviet state into 'micro-communities' that have little contact with each other in values or lifestyles and also produced the large increase in

inequality which has obscured for most people the real income gains achieved in the last seven years of growth.

The fragmented nature of present Russian society prevents a social consensus for reform emerging. The only point of concentration is the Presidency, and this is too weak an instrument to carry through a coherent and substantial transformation project in the absence of a 'broad consensus' for reform.

The authors emphasise in particular the weakness of civil society, as well as the lack of political competition, the weakness of the rule of law, the prevalence of corruption, and the widespread disregard of human rights. This alienates the citizenry from 'the power' and prevents any feedback effect.

They rest their hopes for the growth of a political society favourable to development on the expansion of the middle class, which, in good bourgeois fashion, they consider to be the real carrier of progress.

A liberal might find disappointing the authors' treatment of political and economic liberty not as values in themselves but as the only way of mobilising political support for a sustainable economic reform programme. This leaves the door open to deciding which political and economic rights are more useful than others. But perhaps the recognition that liberal values are instrumentally important does at least mark an advance on the Putin years.

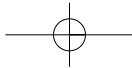
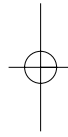
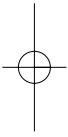
One might also notice a contradiction between the authors' vestigial commitment to central planning and their commitment to market economy. In essence, they expect the market economy to deliver the 'final objectives' which they specify in a given time-span. But it may do no such thing. One of the lessons we have learnt in the west is that it is useless to lay down 'final objectives' (even in the medium term) outside a very narrow range of state-financed or sponsored activities. Apart from fulfilling its social tasks, the state's main role in a market-based economy is procedural: to lay down the 'rules of the game' within which market actors can realise their own aims.

If the new presidential administration takes this programme seriously – and equally important, gets itself in a position to implement it - the Medvedev presidency will be different from the Putin presidency. In particular, we may see the re-birth of a genuine, and not manipulated, democracy. This evolution should not be surprising. All rulers are disappointed in their successors, and in this case the disappointment promises to be a net gain for freedom and progress.

This report deals with the urgent development problems facing Russia today. It outlines four possible strategies for the development of Russia and suggests a new approach in the way that Russia's development strategy is chosen. This approach is based on an analysis of the impact which different interest groups might have upon each strategy. The report was commissioned by the RIO-Centre and was compiled by a group of authors incorporating the SIGMA group.

Robert Skidelsky

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Chapter I:

How to break the vicious cycle: a history of Russia's economic development

Over the last 150 years, Russia has repeatedly fallen victim to the same cycle. The pattern is as follows. First, liberal reforms lead to a rapid economic upturn. Then, different interest groups clash over the distribution of its economic benefits, and are tempted to use these benefits for geopolitical ends. Social tension grows as military expenditure rises. The reforms are checked, and conflicts at home and abroad lead to political and social collapse.

Witte's reforms were followed by the Russo-Japanese War and the revolution of 1905. Stolypin's reforms were followed by the First World War and the revolution of 1917. The war in Afghanistan, the misuse of petrodollars in 1970s and 1980s, economic stagnation and the oil crisis of 1986 led to the collapse of the USSR.

Will Russia suffer the same fate again and cut short its progress towards prosperity, democracy and stability? The range of possible outcomes remains broad: either failed reforms or external shocks could trigger another crisis, or Russia could successfully modernize and regain its role as a world leader.

After the parliamentary elections of 2007 and the presidential elections of 2008, the new government of Russia will have to take strategic decisions that will determine the country's future for generations to come. Russia's unsatisfactory transition from its late Soviet social and economic model has made such decisions inevitable. Domestic and international experts - and most important of all - Russia's citizens all agree on the necessity of reform.

The general aims of Russia's modernization in 2007 are the same as those in 1991: the democratic development of Russian

society, a rise to European levels of welfare for Russia's citizens, and the reform of public institutions.

Given the extent of Russia's present human and natural resources, the question of its future role in the world economy takes on a new meaning. After eight years of economic growth, we can now judge the success of Russia's market reforms by estimating its economy's capacity for modernization.

We have concluded that Russia's future social and economic development will follow one of four possible scenarios.

Our first scenario is called the 'Rentier' – living off rental income. This scenario has found widespread support among a diverse coalition because under such a system the federal government is free to redistribute resources widely. However, modernization is only of peripheral concern in such a perspective. The state is left vulnerable to external shocks and a shortage of resources could trigger a struggle over redistribution.

The second scenario is 'Mobilization'. This would concentrate resources on a few key points, such as making Russia an energy and raw material 'superpower', developing its infrastructure, and building up the military. Such a strategy would fall foul of the same defects which brought the soviet state to grief – namely, the inefficiency of central planning.

The third scenario – "Inertia" – is tactical rather than strategic. The state would act in an opportunistic fashion like a fire brigade. This approach would involve regular intervention as well as the juggling of populist appeals with continual efforts to reform market institutions. It aims to satisfy the demands of different social groups while solving the most urgent tactical problems.

We consider our innovative fourth scenario, 'Modernization', to be the most desirable but also the least likely to be implemented. It would require a broad modernizing coalition which would not be easy to create. It would involve strengthening civil society, the reform of public and market institutions, and the enhancement of business efficiency.

The first three scenarios do not solve the deeper problem of Russia's need to modernize. Furthermore, they all carry risks. A fall in the export prices of energy or raw materials could undermine them. Low oil prices could endanger any strategy requiring extensive state investment or the promotion of Russian energy companies abroad. Such an external shock could, if the state were unprepared, destabilize cash-rich industries, stir social discontent and lead to a slowdown in consumption. The threat of such shocks underlines the importance of taking a strategic approach to reform.

Experience tells us that strategies which have the support of broad coalitions have greater chances of success. Individual members of a coalition are likely to act in their own interests, but in times of crisis they have the capacity to act together by postponing any private conflicts over distribution in the interest of the common good. The question is whether Russian society realizes that the country is at such a critical moment. Basic problems have been solved but difficult issues remain and their resolution is by no means assured. To solve them Russia will need time, a comprehensive approach, the methodical construction of democratic and market institutions and – most important of all – to release and consolidate all the creative forces in Russian society.

Russian society, and in particular its political class – the intellectual, political and financial elite - is concerned about the country's future and its capacity to become an effective member of the world community. The success of the two forthcoming presidential terms will depend on the following factors. First, an accurate analysis of Russia's situation. Second, setting ambitious but realistic aims. Third, taking into account the varied and complex interests of different social and interest groups. The comprehensive modernization of Russia will require a wide coalition. Its participants must acknowledge that their aims cannot be realized immediately without prejudice to others. They must concentrate their efforts on the reform of civil society, of business, and of the state.

Chapter II:

The Strategic Goals of Russia's Social and Economic Development

Eight years of economic growth have transformed Russia. Many of the social and economic problems inherited from the soviet system or which developed during the crises of the 1990s have already been, or are on the point of being, resolved. For the first time in more than fifteen years Russia is in a position to move from short-term crisis-solving – the fire brigade approach - to long-term strategic development goals.

There are two kinds of strategic objectives: final objectives and enabling objectives. Final objectives are those development goals which Russia should achieve within a certain period of time. Enabling objectives are those policies which enable these final objectives to be met.

The most important final objectives are those aimed at improving quality of life in Russia:

- Bring household incomes in line with the approximate EU average by 2020.
- Increase the birth rate in the cities and reverse falling average life expectancy.
- Reverse the “brain drain”.
- Increase vertical social mobility.
- Reduce income inequality.
- Improve citizens’ personal safety.
- Ensure greater protection of human rights and individual freedom.
- Achieve stable ownership, protection of small investors.
- Give broader opportunities for self-realization.
- Achieve a better integration of migrant workers.
- Bring about a favourable moral and social climate.

The achievement of these objectives will depend on the state, business and civil society working together.

Table 1 (*opposite*) and Table 2 (*page 18*) give the expectations of the main social groups. The amount of answers exceeds 100% because several options could be selected. The statistical discrepancy of such polls does not exceed 3%.

The different expectations of social groups play a crucial role in the success of reforms. Reforms must have support across a broad range of social groups if they are to be successfully implemented.

The range and nature of these expectations are not fixed. They depend on political interests and they can vary greatly according to circumstances. What was vital one day may be irrelevant the next. In 1999-2000, Russia's social groups demanded economic growth, a halt to inflation, a fall in unemployment and the resolution of debt and budget problems. All these demands were met within a few years. But, in consequence, a new set of more complicated and more socially-differentiated expectations replaced them.

In 1999, for example, non-payment was still a critical issue for 55% of those polled. In 2007, it remained a vital issue for only 17% of respondents, having fallen from first to ninth in the list of most important issues (see Table 1). Instead, corruption was named as the most pressing. Fears of internal conflict, of the dissolution of the state, of economic crisis and of unemployment have all receded in importance in the past decade.

Federal authorities, the political class, and the intellectual and business elite are more capable of protecting their interests and voicing their concern than other social groups. The reason is that minority groups are cohesive whereas majority groups tend to be split. That is why popular economic actions frequently fail to gather large coalitions. For example, the majority of factions agree on the need to tackle problems like rising prices, the hole in pensions, corruption or drug-use but no such agreement exists when it comes to picking problem-solving policies.

The wider the coalition, the greater the diversity of interests and, therefore, the more general its slogans and aims become.

Table 1: On which problems, from your point of view, should the Russian government concentrate first? (Responses in %)

Answers	1999	2000	2001	2002	2003	2004	2005	2006	2007
Fighting corruption and plunder of public property	22	37	33	34	36	40	38	41	45
Price cutting	46	46	41	44	47	45	47	41	40
Indexation of salaries, pensions, deposits in accordance with price rises	25	35	33	38	34	34	39	33	39
State Price control	37	35	28	31	36	36	36	32	39
Financial support of agricultural sector	17	31	24	20	26	27	33	30	35
Strengthening of law and order, crime control	18	31	27	33	29	31	32	32	30
Strengthening of Rouble, rise of its exchange rate	40	37	28	29	33	30	26	24	26
Return of key economic sector companies into state ownership	14	17	16	19	17	19	20	17	22
Back payment of salaries, pensions and grants	55	26	20	22	22	24	23	18	17
Financial support of state-owned enterprises	18	20	15	18	18	20	19	16	13
Support for civil peace and accord in the country	9	14	12	14	15	12	12	14	13
Strengthening of military & industrial sector and defense capabilities of the country	9	15	9	16	15	15	14	12	12
Guarantees for private business development	6	7	8	9	9	8	10	9	8
Collection of taxes	10	7	9	9	7	7	6	5	6
Support of banking system and safeguard of deposits	7	5	5	6	6	8	5	5	4
Fill shops with goods	12	3	3	3	4	3	2	2	3
No answer	1	1	3	1	1	1	2	1	2

Table 2: Ranking of the country's problems in 2006.
 Poll results on "Which of the listed problems do you consider to be the most important for the country / for yourself?" % (Up to seven answers)

For the country		For yourself	
Drug and alcohol abuse	66	Inflation, price rises	55
Inflation, price rises	55	Pensions	34
Terrorism	44	Unemployment	33
Crime	36	Terrorism	32
Problems with housing and public utilities	34	Problems with housing and public utilities	32
Pensions	33	Drug and alcohol abuse	31
Unemployment	31	Healthcare	27
Demographics	28	Crime	27
Influence of oligarchs	23	Living standard	24
Morals and ethics	22	Ecology	20
Ecology	20	Young people's standing	19
Living standard	20	Morals and ethics	16
Healthcare	19	Education	15
Democracy and human rights	17	Corruption and bureaucracy	14
Corruption and bureaucracy	17	Army	12
Army	16	Democracy and human rights	11
Relations with the countries of CIS	13	Demographics	9
Russia's status in the world	13	Influence of oligarchs	7
Young people's standing	12	Russia's status in the world	6
Interethnic relations	10	Extremism, fascism	5
Upcoming change of government	10	Upcoming change of government	5
Education	10	Relations with the countries of CIS	5
Extremism, fascism	9	National security	5
National security	8	Realization of national projects	4
Implementation of national projects	4	Inter-ethnic relations	4
Energy safety	3	Energy safety	2
Administrative reform	2	Administrative reform	1

Source: Polls by Yuri Levada Analytical Centre (Levada-Centre).

Consensus is seldom reached and only on such crucial issues as elections, national unity, the importance of prosperity for all or the need to modernize the country. We define consensus as a broad coalition in which no faction blocks action. But the problems which result from such consensus are often underestimated, in particular those concerning responsibility, methods and expenses.

Broad coalitions formed in support of specific policies are never fixed. As external circumstances change and old problems are solved, coalitions mutate to meet the latest challenge. The aims and expectations of Russian society today are those one would expect from a country which is working its way out of a transformational crisis. Its people now aspire to prosperity, dignity and individuality. As life improves so plans become more ambitious, the bar of progress is raised and citizens demand higher and higher standards of living. Eventually, a new situation will emerge.

The Key Development Goals

What is the common perception of the main goals to which public policy should be directed? Eight stand out.

- Preserving territorial integrity. This is threatened by inter-ethnic tensions, depopulation of Russian territory east of the Urals, and regional inequalities –including the dramatic difference in living standards between the resource-rich and the resource-poor regions.
- Restoring Russia's international status. The majority of Russians consider the CIS as a 'natural' sphere of Russian influence. But Russia must accept that the CIS countries will be more open to the world and less subject to Russian control. Russia should also have a global footprint. The projection of Russia's influence both within the CIS and beyond depends on its economic strength, its economic competitiveness, and its military power.

- Achieving higher incomes for the majority. Although real incomes have been growing on average, this is obscured by rising prices and greater economic inequality. In particular, the failure of pensions and public-sector salaries to keep pace with the general increase in prosperity is socially dangerous.
- Improving the market economy. This is impeded by over-regulation, corruption, insecurity of property rights, innovative inactivity, and state inefficiency.
- Strengthening private ownership. Investment is impeded by insecurity of property rights, the illegitimacy attached to the largest capital holdings, and the lack of a wide distribution of private property.
- Strengthening the social safety net. The state's abdication in this area is shown by the low level of pensions, the commercialization of public housing, utilities, and health-care, the reduced funding of education and science, the growth of social inequality, and the growing disparity between the regions. The state must fulfil those responsibilities which properly belong to it.
- Strengthening state authority. The weakness of the state in tackling crime, drug and alcohol abuse, corruption, insecurity of property rights and social equality is rightly of great concern to citizens. The public have a dual attitude towards corruption. On the one hand, it is seen to be a key problem, on the other hand, citizens themselves resort to it in seeking to solve everyday problems.
- Strengthening the elective basis of the state. According to polls, democracy itself is not of great value, most probably because the term is associated with the weakness of the state at the start of the reforms.

Nevertheless, citizens do not appreciate the restrictions on electoral choice imposed in the last few years. State inefficiency is to a large extent the result of the absence of powerful, socially-approved opposition groups. In Russia, there is little in the way of 'feedback' from the people to the authorities' actions, which can be taken into account in formulating policy.

Today, Russia has the opportunity to become an intellectual and cultural world leader capable of absorbing as well as producing cultural, scientific and technical ideas and implementing them within the country.

At present, Russia resembles Latin American countries in such respects as the average level of income, high income inequality, preponderance of raw materials in the country's export trade, etc. But it may be more useful to take Canada as an example owing to its similarity in such factors as vast land area located mainly in the North, uneven population density, ethnic and cultural diversity, considerable mineral resources, and so on. Canada's parameters of social and economic development could be the guidelines in determining a long-term ranges of targets for Russia.

Of course, different social groups and branches of the intellectual elite view the country's future differently. But the general idea of commonly-desired long-term results can be expressed in a short formula - "Prosperous Russia". The strategic target structure could be conditionally broken down into high living standards and its stable expanded continuation (see Table 3), while the expected long-term results (final objectives) could be quantified according to a whole range of targets and indicators of their successful accomplishment.

A set of key long-term targets should include the following:

- Average life-expectancy of no less than 80 years (currently 65).
- Infant mortality down to 6 deaths per 1,000 (currently 11).

- Working age mortality of less than 35 deaths per 1,000 population of working age.
- Mortality from external causes of no more than 1 death per 1,000 population (currently 1.9).
- High-quality medical and social rehabilitation services to all disabled (currently less than 50%).
- Replacement rate (average pension to average salary ratio) of no less than 40% (currently 25%).
- Minimum monthly salary no less than two minimal subsistence incomes of a family of three people (husband, wife and child).
- No less than 50% of families with savings.
- Ratio of the average income of the wealthiest 10% to the average income of the poorest 10% equal to no more than 10 to 1 (currently more than 15 to 1).
- Average housing of no less than 30m² of floor area per person (currently 20m²).
- Full secondary education for all young people (currently 80-85%).
- Being amongst the top 20 countries according to the following indices: free press, development of civil society, political and economic freedom (currently in the second hundred).

Russia must maintain its territorial integrity, its population must share a national civil identity, with an independent, democratic, federative state that exists and acts in the interests of its citizens.

These are the fundamental conditions of social and economic development. At the same time they are subject to both current and potential threats emerging from within as well as from outside the country. Such threats can take many forms.

The most important threats faced by Russia in the foreseeable future have been divided into two groups of threats: external and internal.

External threats

Today, the threat of any foreign state invading Russian territory is extremely improbable.

China. The oft-mentioned Chinese factor – both in terms of demographic occupation and as a source of straightforward aggression – poses no threat in the foreseeable future. The Chinese do not lack “living space” and Taiwan is the focus of their foreign policy.

External military threat and arms race. The world has become less stable. A number of conflicts will remain threats in the near future. The US withdrawal from the ABM Treaty, its anti-ballistic missile defense programme with space-based elements, non-resumption of SNF-1, development of new precision warfare and military build-up could all destabilize the existing geopolitical balance. The threat level and possible responses can only be evaluated by military experts. But the domestic repercussions are evident. The Russian government has repeatedly said that it will not be forced into a new arms race, but - as a matter of fact - Russia has already joined the arms race – military expenditure has increased sharply in recent years. At the same time, the country lacks a stable and formalized mechanism for determining the necessary and sufficient rate of military expenditure. Also, there are no institutions of civilian control over military expenditure. This calls for a stable multi-party system and an efficient parliament.

Central Asia. The most probable external threat to Russia is the destabilisation of Central Asia. The threat comes from Islamic fundamentalism coupled with weak governments in Uzbekistan and Turkmenistan. The strengthening of the Taliban in Afghanistan as well as the reinforcement of Pakistan’s radical Islamists could also be a destabilising factor. What this could mean for Russia is a flow of refugees and drugs on an exponentially

larger scale. Destabilisation in Central Asia could also seriously endanger gas and oil business in Russia.

Terrorist threat. Russia is no longer on the list of priority targets for Islamic fundamentalists. But the threat has not entirely gone away. The vulnerability of Russia's infrastructure (nuclear power, hydroelectric power plants, oil pipelines, etc.) to large-scale terrorist attack remains high

Internal Threats

The Soviet legacy of "territorial ethnicity". A breach of territorial unity may be a consequence of nationalist ethno-centrism. The formation of national republics in Russian territory damages the process of democratization, the implementation of authentic federalism, the unity of the legal field and the speed of economic development. Authentic federalism is only possible when it is based on a solid consensus concerning the indivisibility of Russia, which is not possible to achieve while ethno-territorial autonomy exists on any scale. The situation in the republics provokes ethnic Russian nationalism. Any strengthening of Russian ethnic nationalism will simultaneously intensify separatism in multiple regions. The Caucasus are the most vulnerable but there also exists a separatist potential in Tatarstan and Yakutia.

Formation of immigrant enclaves. Russia's demographic decline and the needs of the growing economy make a massive inflow of labour migrants inevitable. The majority are Muslim and resistant to integration. Until now, Russia has successfully avoided the formation of large immigrant enclaves, but the possibility of new ones emerging has increased. If there is no appropriate policy response, major points of tension, like the ones faced by Western Europe, may appear.

The "Brain drain". The emigration of qualified specialists is impossible to stop without undermining basic constitutional rights and liberties. A "Brain drain" on a large scale may be a

major obstacle to innovation and economic development. If the country is to be kept 'open', the only possible solution to the problem is economic: working within the country must become more attractive than working beyond it.

The rise of oil prices to a "threshold level". If oil prices exceed a certain threshold, it will not only be economically sound to develop alternative energy sources, but also a political consensus will develop among the major and technologically-developed oil-dependent countries to make substantial investments, including research investments, in this field. The result of these efforts are hard to predict, but if successful, Russia could face major economic difficulties.

The institutional weakness of the political system. The absence of genuine and honest competition within Russia's political system and the method used to appoint the elite deprive Russian society of the opportunity to discuss its future development, and exclude the majority of the population from taking part in the country's self-determination. This endangers the realization of development goals.

The dependence of the judicial system on the executive. While facilitating the implementation of current policy, such dependence pushes Russian citizens to seek redress for their problems outside the legal field, and further alienates them from the state. This disrupts the nation's unity and weakens its ability to withstand various threats.

Irredentism. Today, irredentism is weak in Russia, but under certain circumstances, it could become stronger as a political movement and receive extensive support throughout society.

"Colour revolutions". "Orange revolution" no longer threatens Russia. However, the "delay price" of the measures taken to block this threat in Russia may yet prove to be high. This could lead to the stagnation of the state, the development of façade-democracy and pose a fatal threat to the development of the country.

Weak national identity. There is a strong tradition in Russia of alienation between authorities and the well-educated strata of society. Today this is being reborn, and alienation may increase drastically after the elections of 2007 and 2008 if expectations of change are disappointed. One of the consequences of this situation would be a weakened sense of national identity.

The search for effective responses to external and inner threats must be based upon two key principles:

1. **The principle of the objective character of threats.** The response to threats must correspond to the actual degree of their significance, evaluation of which must be based on thorough analysis. Neither the attitude of a “fortress under siege” nor complacency is justified.
2. **The principle of minimal sufficiency.** When a large amount of resources is needed for social and economic development, the country cannot afford to divert resources towards defence. At the same time, some investment in national defence is essential.

The Role of the State in Achieving Russia’s Goals

One way of achieving high levels of prosperity for Russian citizens is to entrust the task to government. The state can undertake whatever investment in the national economy is needed. But this approach suffers from two crippling disadvantages. The state is extremely inefficient; and giving it a commanding role in development is bound to reduce the incentives for companies to be creative and innovative. Direct government intervention has an important role to play in industrial development, but its role shifts to the indirect one of ‘enablement’ in the phase of post-industrial development.

The major role in development today is played by human capital, secure property rights (particularly intellectual

property), freedom of entrepreneurship, freedom of information, freedom of movement, political rights, citizens' liberties and so on. It is in countries where these factors are well developed that the innovation is greatest.

The condition required for the social and economic development of Russia is an innovative economy which will encourage the intellectual and entrepreneurial activities of citizens to flourish, allowing them to earn higher incomes. The major responsibility for a high level of prosperity lies with citizens and their families, companies and non-commercial organizations.

The state should concentrate on introducing public benefits which cannot be effectively provided by companies, by citizens or by non-commercial organizations. In its essence, these benefits are the conditions which will make markets work for the development of the country. These conditions include both the institutional environment of the activities of the population, of business and of non-commercial organizations and the network components of industrial infrastructure. Besides, the state assumes direct support for fundamental science, education and public health as well as the responsibility to care for those of its citizens who are incapacitated and who, for whatever reason, are not supported by their families (e.g. single pensioners, orphaned children etc.).

The actions of state officials should be aimed not at finding and appropriating rent but at creating an institutional environment which stimulates the development of honest competition. At the same time, the state must protect property rights by ensuring an impartial judicial system independent from other branches of power. The creation of such conditions stimulates business innovation which is a premise for the formation of an effective competitive economy.

None of this is possible without honest political competition which builds a system of feedback between society and the authorities. It is in these conditions that the dishonest behaviour of an official at any level will lead to sanctions being applied to him by a higher level of authority or by the court.

An effective government must successfully achieve three main objectives:

1. To create, support and develop the environment favourable to businesses that produces and delivers the principal part of goods and services which citizens need to satisfy their material wants and to non-commercial organization that fulfil social and spiritual needs.
2. To protect its citizens, its society and its economy from external threats.
3. Directly to ensure an acceptable level and quality of life for those citizens who are not able to ensure it themselves and who are deprived, for whatever reason, of their families' support.

It follows that an effective government is one that promotes the protective, institutional, infrastructural, legal and social welfare environment necessary to realize the object of 'Prosperous Russia' outlined above.

Chapter III:

The Starting Conditions for the Choice of Strategy

The considerable economic growth between 1999 and 2007 and the country's emergence from a severe crisis have produced a feeling of success. At the same time, this feeling must not transform itself into euphoria as progress is still not based on a new, solid social, economic, legal or political grounds.

In fact, the country "lost" the years of crisis between 1990 and 1999 and recovered the GDP level of 1990 only in 2007. If GDP had grown 2% a year between 1990-1999, GDP in 2007 would have surpassed the 1989 level (actual peak) by approximately 40%.

The development of Russian Society and the pattern of living of Russian Citizens.

The weakness of civil society is reported not only by its representatives, but also by representatives of the authorities and of business. Some maintain that life is easier for both the authorities and for business when pressure from civil society is weak. It is easier, for instance, for corporations to infringe labour legislation or ecological good practice. Local authorities can ignore breaches of the law, personal safety issues, corruption or the violation of citizen's interests. It is easier for unpopular ministers and federal laws to "survive" when the opposition and political competition are weak.

These tactical conveniences are small fry when set against the huge losses which the absence of civil society imposes on a country's progress.

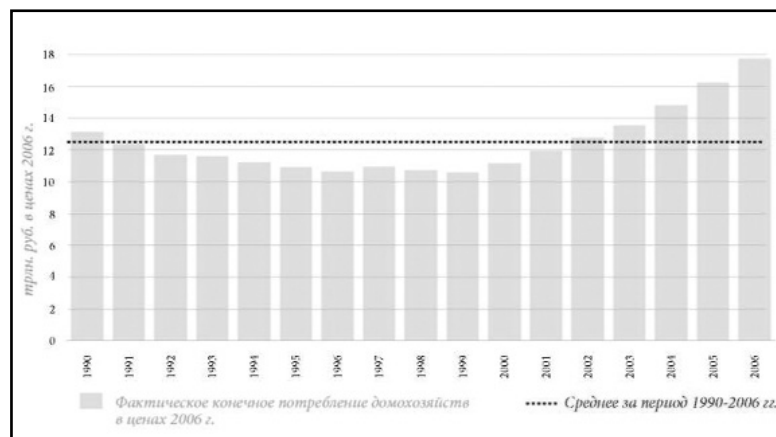
In a short seventeen years, the country has been transformed from the quasi-egalitarian Soviet society to a society with an Anglo-Saxon structure of income and a Latin-American structure of property. Social inequality should not be assessed only by the distribution of income and consumption (*see Table 3*), but also by the distribution of property. As far as property concentration is concerned, Russia seems to outdo the leading countries of Latin America.

Table 3: Level of inequality in countries around the world (2005)

	Russia	USA	Germany	Poland	Brazil
GDP per capita, \$ thousand	12.1	43.4	31.1	14.9	9.1
First (min income)	5.5	5.4	8.5	7.5	2.6
Second	10.2	10.7	11.4	13.7	11.9
Fifth (max income)	46.4	45.8	36.9	42.2	62.1
Gini Coefficient	0.405	0.408	0.283	0.345	0.58

Source: World Bank, IMF, calculations of the Institute of Economy and Finance.

Figure 1: Actual end-consumption of households, 1990-2006 (in prices of 2006)



Source: Rosstat, calculations of the Institute of Economy and Finance.

The weakness of civil society creates an illusion of tranquillity, but at the same time it gives birth to distrust, disappointment and opportunistic behaviour. It is not possible to build a great country on distrust and apathy.

The political and financial elites must realize that the formation of a great country pre-supposes a feeling of comfort and contentment among its citizens. The educated classes must feel that Russia is a safe and interesting country in which to live. Civil society, therefore, is one of the foundations of good government and socially-conscious business. not just by the growth in the population's well-being but by the strength of its civil society. The emerging middle class is still relatively small but its influence and role are bound to increase. The question, then, is how soon it will become critically important in comparison to the upper echelons of bureaucracy and big business.

The importance of the middle class for social stability, responsible electoral behaviour, tax payments and the independence of the mass media is well-documented. In Europe and North America the middle class constitutes about 55-60% of the population. In Russia, it does not exceed 20-25% and is mostly concentrated in several of the most developed regions. However, 80% of Russian society has some attributes of the middle class thanks to a high level of education and the development of Soviet science. The seven-year-long development since 2000 has seen the proportion of families without financial difficulties rise considerably (up to 40%). But the Russian middle class still lacks in its electoral behaviour and attitude to tax payments the stabilizing influence of middle classes abroad.

Civil society is, of course, wider than the middle class, especially in Russian's case where the middle class is relatively small. Only through the expansion of civil society can the lack of trust between different sections of society be overcome. The social capital of our society is small because the level of trust is still low. Only the President has become an exception to this state of affairs. He acts as an immense stabilizing force in the life of society and makes it possible to take important decisions.

The underdevelopment of civil society determines the weakness of the mass-media and civil organizations. Political parties rely on their leaders rather on policies for direction. It is the middle class that could gradually become the foundation of a programmatic approach to the political process and of the formation of mass democratic parties.

Business Development

Russian capitalism mainly took shape in the 1990s before the crash of 1998. It is characterised by the high concentration of property in leading companies. The break-up of previously vertically-integrated Soviet companies during the privatization process was an error. It took Russian companies many failed attempts and an additional 5-7 years to reintegrate on the basis of highly concentrated Soviet assets. The way Russian capitalism was built was very unusual and the result differs from those models which had been supposedly taken as examples.

Privatisation should involve specification and protection of property rights. But in reality, property rights were deliberately rendered vague and un-transparent. It will take a generation to achieve the necessary clarity. The vagueness of property rights has weakened corporate control and made it necessary to hold excessively large controlling stocks for reselling and prevention of forced mergers or dishonest take-overs.

The Russian method of privatization has thrown up the figure of the “semi-hidden” proprietor, who controls the company but is represented on the board of directors by power of attorney from his offshore companies.

Russia is the largest economy in the world in which a major part of private property is represented by nominal offshore proprietors instead of their national owners. This determines why mergers and acquisitions are carried out abroad and have only a minor effect upon the savings process.

The presence of “associates” who claim a share of the income (rent) in controlling industrial assets is another peculiarity of Russian capitalism. Often, they were involved in the original

privatization. Subsequently, they were unable to, or they did not want to, become shareholders, but they continued to claim rights on income as concealed creditors or portfolio investors. Often, these are former officials or serving officials, shady individuals or local administrations.

Due to the initial vagueness of property rights, a phase of redistribution began which has still not finished. When a proprietor has gained ownership of an asset at zero estimation and without charge, his incentive to maximize the company's value is distorted. It is easier to resell below market price than take on the risks of a strategic investor. Takeovers, false bankruptcies, the abuse of rights in corporate conflicts can also be added to the list of dubious practices. It comes as no surprise, then, that in Russia the quantity of savings is so large but the rate of saving so low.

The flipside of this high property concentration with large controlling shareholdings and offshore ownership has been poor distribution of share ownership throughout the country's population both on an individual and collective level. Historically this has been a serious problem. It explains the popular belief that all large private property holdings must have been gained illegitimately.

"Associates" are unlikely to give up their status for a number of reasons. It may cost them financially, they may have advantages not linked to production, the risk of ownership remains high and it continues to be easy to hide their ownership and conceal their income. For such companies, the risk and return ratio is much better than for their European or American counterparts. Relatively high taxes and other economic obstacles to business mean that national savings came to 33% to 35% of GDP between 2001 and 2006, while the rate of savings rose only from 16% to 19%. This affects the speed at which Russia can modernize, the level of risk involved in its investment projects and leads to dissatisfaction among the political elite and the higher echelons of society. As a consequence, business seeks large-scale projects through public-private partnerships

on the *quid pro quo* that “the state will reduce internal political risks and support capital exports in exchange for cooperation in the area of savings”. Such a policy is an attempt to link the internal needs of the country with an uncoordinated positioning of national companies around the world.

The arrival of two dozen large companies on the global stage from a country with only \$7,000 in GDP per capita (or \$12,000 at PPP) has astonished outsiders. The way Russia has built its national giants mirrors the development of such companies in other countries like Brazil or Spain. Along with Indian, Chinese and Brazilian companies, Russian firms form the rapidly growing second echelon of global corporations which have swelled the ranks of global grandees on the basis of their own natural advantages. State support has been amongst these advantages. Large companies from OECD countries have all benefited at various stages of their development from state support. The consolidation of such Russian giants as aluminium, shipbuilding and aircraft companies and their entry into the world of "champions" corresponds to global trends.

The leading companies have access to a relatively cheap European capital market, a pool of first-class managers and have been given the special status of "grandees" in Russia. Major businesses in Russia have the opportunity and the resources to implement long-term global strategies while, at the same time, their “negotiating power” is such that they can reach working compromises with the Russian state and minimize direct government interference in their businesses. As a result, it is been extremely difficult to create any kind of meaningful competition in Russia for these “giants”.

The results of leading Russian companies (*see Table 4*) largely resemble the results of their American counterparts in the first decade of the twentieth century. Small business is overwhelmed by bureaucracy while large companies enjoy greater protection from corruption and the redeployment of funds from savings. The strengthening of the public sector in large-scale industry may lead to a conflict of interests over property rights, the most

delicate area of all that both enables cooperation and also decides the success of development.

Table 4: *The share of the ten largest companies in several countries (2006), % GDP*

	Sales volume	Net profit	Market capitalization
Russia	28.9	5.1	66.7
USA	14.1	0.9	13.0
Germany	34.8	2.6	20.2
Brazil	19.7	2.5	27.9

Source: Financial Times, Forbes, Calculations of IEF.

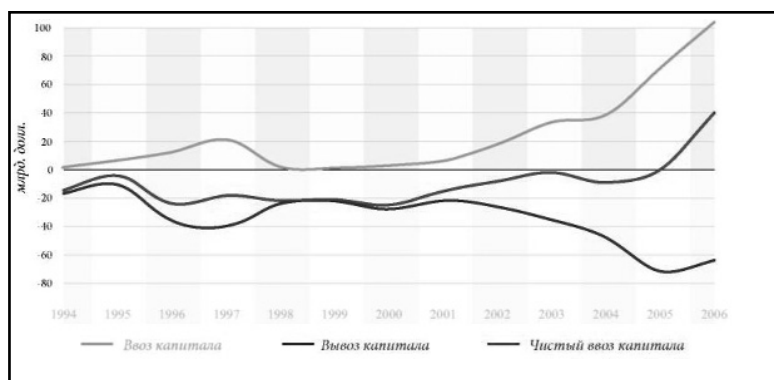
The domination of such ‘giants’ makes life harder for small and medium-sized regional businesses. In particular, government officials and the representatives of large companies overlook the potential power and adaptability of small business and, therefore, ignore its interests. Small business is a natural source of entrepreneurial activity. But for this to become the case in Russia, management practices and the relationship between citizens and the state would have to change.

The major change in recent years in the character of Russian capitalism has been the strengthening of its state companies. Alongside the growth of revenues from export, Russia’s oil and gas sector received gigantic and unexpected windfalls. This brought about a radical change in the global positioning of Russian companies and has led them to expand beyond the country’s boundaries. These changes are important to note because the export of Russian hydrocarbons will remain crucial for the growth of the economy. Renewable and alternative sources of energy are expensive and, so far, under-funded and technically deficient. In this context, Russia is expected to play a stabilising role in the global energy sector.

Growing budget revenues from these windfalls have given Russia the opportunity to finance state investments. But the institutions created by the state to implement these development plans are not ready to undertake such projects. They are of recent formation and they lack the experience and necessary proven mechanisms. The result is capital exports of at least 10% a year over the last eight years, with expensive money and short-term lending at home. In 2006, Russia exported capital on a large scale, while importing a large amount of portfolio capital. But this “carousel” (export of direct capital and import of portfolio capital) has made Russian financial markets more vulnerable to global financial turmoil than they ought to be in a capital exporting country. An example of this was the shock of August 2007.

State investment programs are difficult to implement and historically inefficient. They will add only an additional one or two points to GDP, and will not, therefore, compensate for the gap between the required 25% rate of savings and the actual rate of 19%. Reaching the level of 25% will require tremendous efforts in the development of property rights and ensuring the stability of the investment climate for all business categories and not only for large-scale financial groups.

Figure 2: Export and import of the capital evolution in Russia, 1994-2006, \$ bn



Source: Central Bank

The existing structure of property has led to low free float on the stock exchange while the financial sector has failed to meet the needs of the developing economy. The banking system, and especially the market for corporate bonds, has not keep up with demand for long-term cheap credits. This has acted as a serious brake on development. Russia exports huge volumes of capital while large companies continue to borrow from abroad where it is simpler and less expensive to do so. The structure of the country's economy has tipped in favour of big business even in retail and service sectors which, traditionally, remain outlets for small business all over the world.

Building an effective market economy has proven to be extremely difficult. Russia has yet to write sensible rules, improve the quality of existing regulation and make the direction of policy predictable. The efficiency of the market economy depends on the quality of the legislation and regulatory enforcement governing it. Russia still has much work to do in these areas. Experience has shown that the successful development of a country depends on the rule of law, lower administrative barriers and less state interference with business, ensuring a more attractive environment for investment. Few people in Russia, except experts, understand this dependence and many continue to believe that in obeying the law they put themselves at a disadvantage.

The state is interested making business more effective, but, first, it must have an adequate and feasible legal framework. When civil society is weak in defending its legal interests, so is business. The state has to make a difficult choice. Either it must actively push businesses to pursue specific development programmes, which leads to lower efficiency, and the growth of bureaucracy and corruption, or it must trust business to develop itself. Here, the state attempts to create a stable regulatory and investment environment and fight corruption in order to unleash the market forces seen in other countries. However, the state cannot entirely detach itself from business since the latter will not implement unprofitable projects which

may be to the national advantage without incentives. Industrial and regional policy will continue to fail so long as competition is absent and state policy unpredictable.

Reforming the State and Regulating the State

The economic crisis of 1990-1992 was offset by the enthusiasm of the people who waited patiently for democracy, economic growth, the re-distribution of ex-Soviet property, and the establishment of a new legislature and new independent, market institutions. These institutions, however, have still not been made independent. The effectiveness of the state was reduced by internal power struggles. In the end, the development of the market economy was partly spontaneous and partly the result of a state plan to dismantle the planned economy. Russian capitalism was shaped during these years of 'institutional nihilism', when the interests of many parties were ignored and the behaviour of large companies went unchecked. At that time, people tended to think that the market needed little in the way of management.

The next stage of economic and state reforms took place in years of growth and emphasized macroeconomics. Several attempts to ease the conduct of business were made (flat taxes, technical regulation and lower administrative barriers). But this was never enough change the nature of Russian capitalism. There were no 'bottom-up' reforms, even during the boom years of 1999-2004.

Gradually, however, the state has sought rewrite the guidelines and modernize itself. It has re-established a strong, vertical concentration of power, and distanced big business from the state. At the same time, it has increased its control over the country's economy. The old language of structural and industrial policy was resurrected and crept back into state documents, if not into actual policy.

Eventually, the central authorities freed themselves from their dependence on oligarchs for resources and, instead, faced complex, internal development problems, an

impoverished army and difficulties abroad. In response, the federal authorities set about changing the structure of large property.

The state has expanded rapidly in recent years. From 2001 to 2005 the federal part of the state increased the number of its employees from 377,000 to 593,000. The year 2005 saw another 20% increase in the number of federal officials (excluding law enforcement agencies and the army). Their share of the total number employed has increased from 2.6% to 4.15%. The total number of state officials grew by another 8% in 2006. Why did the state expand to such an extent when we know that the two major obstacles to modernisation are administrative barriers and bureaucracy?

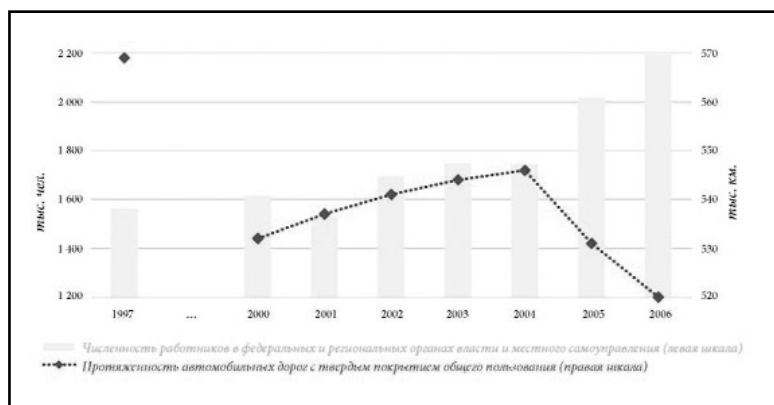
Figure 3 is an illustration of the ineffectiveness of the state rather than of the growing number of state officials. Roads are a complex facility requiring secure property rights and transparent financing and management guidelines. A balance must also be struck between the interests of users and authorities. The fact that the total length of hard-surface roads has fallen during a period of intensive growth in the size of bureaucracy is proof of the inadequacy of the institutional base as the motor of economic development.

Corruption has become a national problem and threatens to turn political. A lack of trust in state authorities and government officials at all levels has made management even less effective. Putting up with corruption is doubly harmful because it forces people to re-adjust when anti-corruption measures are enforced. Anti-corruption campaigns and show trials cannot reverse the situation on their own. Besides, such campaigns will require more and more funds without offering any discernible positive results.

These calculations used the data of: Rosstat and Calculations of the Institute of Economy and Finance.

Note: The diagram does not take into account local roads (the change in the classification of 2006 led to a substantial increase of the length of hard-surface public roads).

Figure 3: Number of state officials and total length of hard-surface roads in 1997 and 2000-06



The inefficiency of state management is aggravated by flaws in the judicial system. Courts do not command public trust. The settlement of financial and property disputes is still problematic. Indeed, privatization deals are no longer challenged in court, not because everything has been settled, but because the statute of limitation has expired. The justice system can improve its functioning, but to do so it needs public trust. Without trust, business and society will continue to look to other means to resolve their problems. An independent judiciary would offer them an escape from the deadlock. Furthermore, the need for a functional judicial system will grow as the economy becomes more complicated and new phenomena require the arbitration of the judiciary.

A strong state is the leading force in development. But if the state is too big it acts as a bureaucratic brake. Bureaucracy undermines the innovative potential of both society and business and isolates them from the process of resolving national problems, and devalues the state institutions themselves.

The state still has much to do. It must learn not to “cut off the oxygen” for innovation when writing new regulation, even when it is accompanied by the allocation of funds. The state must aim

in the next decade to improve the efficiency of management, guarantee the rule of law, make state policy more predictable and reduce corruption.

Regional Development in Russia

An extensive policy of regional development, based on clear principles, has never been implemented in Russia. The crisis of the early 1990s was, in fact, a tremendous experiment in regional development but not one based on clear principles

The limits of “leveling up” budgets

The economic influence of Russia’s regions is determined by a number of factors which have no direct parallels abroad. This can be accounted for by the peculiarities of the Soviet system, the nature of the transitional period of 1990-1999 and the specific character of the reforms implemented in Russia.

In the early 1990s, the survival and stability of each region was determined by factors such as natural resources, industries, the level of infrastructure investment made during the Soviet period and a favourable geographical location. Production in different sectors of the old planned economy fell and recovered unevenly. This is why some regions suffered more than others during the transitional crisis.

From the mid-1990s, procedures were established governing the relationship between federal government and the regions. Tax was streamlined, contributions norms were established. Over the same period, financial streams were redistributed through the federal budget. The main aim of this was to level out the budgetary provisions of the regions, which involved the redistribution of funds from 10 to 15 donor-regions to all the others. The redistribution was based on mechanisms that did not stimulate the development of either the donor-regions or the recipient-regions.

Between 2000 and 2007, relations between the federal centre and the regions were tipped in the favour of the federal centre.

As budget surpluses grew, the more developed regions played the role of donors, but this meant that they could not concentrate the resources needed to undertake large-scale infrastructure projects. All regions were 'leveled up' regardless of their own efforts to develop their economies.

During the period of rapid economic growth between 2000 and 2006, several reforms were attempted at regional level (local government reform, distribution of liability and authority according to regional power). However, the goals of these reforms - i.e. the transparent distribution of financial authority and liability, and a more effective spatial organisation - were never achieved. At the same time, increases in domestic demand and a rise in export prices for almost all raw materials gave many regions new resources for development, and revealed the unequal distribution of these resources. The development problems faced by depressed and backward regions were not solved. During that period, 10 to 15 strong regions demonstrated the highest growth rates. The backbone of these was formed in the early 1990s (*Table 5*).

Another important trend during this period was the increasing concentration of financial and political authority at the federal centre, which reduced the positive effects of the reforms. Regional policy became more Soviet and the government adopted the policy that the modernization of the regions should be directed from the centre. Meanwhile, this rigid vertical structure - 'from the centre to the regions' - weakened the links running from bottom to top - 'from the regions to the centre'. Federal agencies cannot effectively pursue modernisation policies in the regions, since they lacked any understanding of the regions' development and institutions, which had appeared as a result of the transitional period, and the different relations which link the different groups with specific interests.

In turn, the regions lack their own development instruments, such as efficient and relevant regional strategies. Another trend in their development has been the increased competition for attention from the federal centre and more precisely for federal funds.

Table 5: Share of regional groups as shown main economic indices in 2000-06, % of the Russian Federation

	Population		(GRP)		Export	
	2000	2006	2000	2006	2000	2006
Capitals and suburbs	14.6	15.2	27.6	27.8	30.3	43.4
Exporters	9.8	9.9	19.6	23.0	27.8	14.9
Balanced Industry	28.4	28.2	25.6	23.7	25.8	27.5
Medium developed (inshore regions)	13.9	13.9	10.7	9.5	8.7	7.7
Medium developed (inland regions)	11.6	11.2	6.8	6.8	3.9	3.8
Less Developed	21.7	21.7	9.7	9.2	3.5	2.8

Source: Rosstat, calculations of the Institute of Economy and Finance.

Regional Policy Issues

The differentiation of regions by their level of development has reached a factor of 25 to 40 according key indices such as GDP per capita; income per capita, the number of people below the poverty line, and the level of provision with budgetary services. Regional policy must take into account these discrepancies. However, the experience of recent years has shown that the 'leveling up' of budgetary support does not solve the strategic problem of how to modernize the economy and foster greater competitiveness between processing industries and services, and, as a result, accelerate economic growth.

The 'leveling up' of development standards in different regions is the major task of regional policy in developed countries. The main priority, for instance, of the EU is to ensure a uniform level of economic and social development across the regions.

Such tasks are hardly relevant to Russia given the scale of discrepancies in the development of its territories.

It is important for the donor-regions to see that they would also gain from redistribution. Russia could avoid the problems faced by other developing countries with a few preponderantly

rich regions (e.g. the megalopolises of Mexico, Brazil and India). Furthermore, the rich regions would enjoy the synergies afforded by enterprise, competition and cooperation. This would lead to the development of inter-regional clusters, now considered the key to global market success.

Russia must stop seeing its regions as either integrated elements in a closed system or independent autarkic entities. Rather, it should approach regional development policy from both macro and micro perspectives.

After years of economic growth, some regions have gained wide experience in management and in dealing with special interest groups and poverty. Some fifteen to twenty other regions, however, are fully dependent on the state for their development. Great benefits, then, could be gained from the merging of strong and weak regions, the analysis of competitive advantage and determining regional specialization.

In the past, it was thought that the central government knew best. It decided the level of support to be given and the reforms which were to be implemented in each region. This approach was also once widely used in developed countries but has now been discredited. Ignorance of regional peculiarities, political considerations and inefficiency invariably crippled attempts by central governments to dictate policy to regions. Nowadays, an 'evolutionary' approach is taken: the regions are involved in discussions of the proposed policy and its implementation is undertaken in partnership with central government.

Special interest groups exist at regional level. In contrast to medium-sized businesses that invest mainly locally, large financial and industrial groups are free to choose where they reinvest. Some invest outside Russia.

People continue to believe that all decisions are made at federal level leading them to underestimate the importance of local and regional governments. Local institutions and local tradition, however, are key components in the decision-making process. Many of these local, informal procedures are hard to detect or describe and, consequently, hard to change.

The country's aims in regional perspective

The final objectives put forward in the first part of this document can also be viewed from a regional perspective. The definition of instrumental goals can currently differ thirty to fifty times from one region to another (*Table 6*).

Table 6: Desired Targets: Regional Profile

Targets		Criteria For Desired Targets	
First Level Goals	Second Level Goals	Regions Per Capita*	Regional Differences**
High living standards	Strong health	Life expectancy	1.4
	Living standard	Income per capita	6.7
	Personal safety	Registered crime	4.6
	Protected rights & freedom	Involvement of remedial organizations	20 -30
Sustainable reproduction of high living standards	High quality education	Teaching & laboratory area of higher educational establishments per capita	35
	Wide range of opportunities for self-fulfillment	Recreation land plots	200
	Good mental & psychological health	Positive estimate of living conditions in the country	30-50
	Reliable potential for further development	Increasing human capital, morbidity	5-7
	Reliability of the country's defenses to external threats	N/A directly***	N/A directly***

* These indicators were taken conditionally according to the available regional statistics and are relative, estimated per capita where applicable. But we believe that a more thorough analysis on a wide range of indicators will reveal even greater gaps in these indicators for Russian regions.

** The ratio of the maximal value of the region to the minimal, excluding special cases such as the Republics of Northern Caucasus.

*** The perception of the security issue by the regions and elites differ depending on the location within the country.

It is important to note that in Russia there is a large discrepancy not only in the basic indicators of living standards where differences have always existed, such as education, but also in

those indicators where there should be no difference such as the protection of rights and liberties.

Such large discrepancies indicate that each region needs its own individual policy. Furthermore, the country must decide which issues are to be dealt with at federal level and which are to be dealt with at regional level.

Chapter IV:

Four Alternative Scenarios

Russia has survived this transitional period of its development by relying on its intuition and expedient solutions. Since the collapse of the Soviet Union, Russia has gone from crisis to crisis. Finally, Russia is in a position to choose a development strategy. We have identified four such possible scenarios for the long-term social and economic development of Russia.

The Rentier Economy

This would further centralize the state and redistribute the rent from natural resources through the state budget (principally in the form of social transfers) in order to raise the living standards of Russia's citizens. It would increase the state's social responsibilities and expenses) as a percentage to GDP.

Current and future profits from the export of natural resources would be the source of funds. The beneficiaries of its social policy, would be the principal victims of the recession in the 1990's such as public sector employees or the sick. They would form the backbone of government support. This redistribution policy should, in theory, increase the living standards of lower-income groups, but would not resolve the problem of social inequality.

As the income of lower-income groups increases so domestic demand will grow. This would encourage the development of consumer sectors in the economy leading to higher growth rates. A burgeoning middle class would increase the demand for imported goods which would contribute to competition in commodity markets and would improve the quality of goods

made by national producers. An active social policy would also help solve various social problems.

The 'Rentier' strategy would require the following:

- The accumulation of the major part of income from production and export of natural resources.
- The implementation of large-scale public redistribution programmes.
- The implementation of an egalitarian and paternalist social policy.

The 'Rentier' approach would lead to short and medium term social and political stability so long as the market for raw materials remained favourable. If world markets fell then economic and political crisis would ensue wiping out any benefits. In addition, the increase in income would stimulate the consumer sector but not innovation. Finally, the needs of lower-income groups would far exceed the amount which would be available for redistribution.

The 'Rentier' strategy would be championed by populist coalitions, who enjoy support in countries with high social inequality. A section of the political class, the left wing elite and the representatives of the poor will always call for a "return to fairness". But complicated compensation schemes are unlikely to be applied in favour of 'losing' groups, since power would remain concentrated in the hands big business and the political elite who would only look after their own short-term interests.

If budget revenues or markets prices fell, there would be less to distribute, which would undermine the purpose of the coalition. Also, the need for redistribution would increase as social responsibilities grew. This would inevitably lead to the 'Mobilization' scenario.

It is also important to note that the 'Rentier' strategy would not involve an active role for civil society which could help identify institutional threats and avoid bottlenecks.

Mobilisation Economy

The 'Mobilization' economy is one which focuses resources on priority targets: infrastructure, energy, advanced technology, nanotechnology etc. The energy, metallurgy, defense sectors would all be donors. According to the estimates of the Economic Expert Group, the production and export of natural resources has accounted for approximately 40% of enlarged budget revenues in recent years (see Table 7).

By developing the defense industry, the 'Mobilization' approach would shift the economy from a resource-based one to an internationally competitive one based upon the manufacture of advanced technology products. This would have geopolitical benefits.

Table 7: Budget Revenues from the Oil and Gas Sector

	2000	2001	2002	2003	2004	2005	2006
Enlarged Budget Revenues (% GDP)	37.3	37.5	37.1	36.5	37.0	40.1	39.7
including those from Oil and Gas (OGK) (% GDP) (*)	8.6	9.1	8.0	8.2	9.8	13.3	13.7
Share of Revenues from OGC in enlarged budget (%)	23.1	24.2	21.6	22.5	26.6	33.2	34.6

Source: Economic Expert Group.

*Production of oil and gas, refining, transportation by pipelines.

If resources were redistributed to those sectors marked "advanced", public sector incomes and social benefits would fall. To preserve social stability propaganda would be needed. The government would have to emphasize external threats to the country and create new enforcement mechanisms (or partially reinstating those used during the Soviet era) to justify such prioritization in public spending.

Eventually, the growth in exports might recover and increase the amount of resources available for consumption, but higher

export revenues would be invested in developing natural resources and the defense industry before the consumer sector.

Public concerns would play a small role in this scenario. Business will be brought into line through 'administrative methods' such as the introduction of penalties for "lack of innovativeness" or "insufficient responsibility". The potential benefits of government-public feedback would be ignored.

The state would intervene heavily in the economy, and public corporations would assume responsibility for "breakthrough sectors" like public entrepreneurship. Public-private partnership would be common and private business would be required to meet targets set by the government on terms decided by the government.

In order to maximize the rent from mining industries, companies working in this sector would be indirectly nationalized. The defense industry would be a priority sector, which would justify the increase in public financing for R&D. Such companies would be the source of innovation and the material base, therefore, of the economy. Modernization, then, would be financed by the state budget using unequal public-private partnerships. The state would make no attempt to support a business environment conducive to the growth of the domestic market or consumer demand.

Industries given 'priority' status would all be modernized. Economic growth would rest upon the export of natural resources and advanced technology. The 'Mobilization' approach would require a considerable enlargement in the scope of government functions and the diverting of resources from production.

As the main recipient of benefits from export revenues, the defense industry might begin to exaggerate the threats from abroad in order to obtain additional funds. Likewise, the government could make grandiose claims about Russian power and use these to justify the unequal distribution of its resources.

The 'Mobilization' approach would, therefore, lead to highly focused modernization, tension over national resources,

disregard for civil society, and incentives for industrial innovation required for sustainable economic growth.

This strategy would appeal to government officials since it would involve little change in current administrative practices and, instead, would provide for their enlargement and spread into other areas. Certain business groups, primarily the advanced industries, would also be interested since they would obtain access to considerable public resources.

Private business could expand abroad on condition that it remained loyal to the country. The public would have the vicarious satisfaction of international clout instead of personal prosperity. The assumption that changes can be forced through from on top despite limited resources and the lack of competition. If 'priority' sectors are determined on non-market principles, the government risks being permanently left behind in the world economy. Plus, a future shortfall in resources may make it impossible to catch-up.

A further defect is the unreliable source of funding. The fluctuation of world prices, the development of new energy sources or energy-saving technologies could all undermine it. Finally, redistribution would inevitably be accompanied by corruption. This would weaken the state and prevent it from achieving its purpose which is to increase the influence of Russia around the world.

The Inertia Economy

The Inertia strategy is, properly speaking, tactical rather than strategic. It would involve maneuvering between interest groups and prioritizing economic and political stability over development.

The state would make political bargains with each sector of the economy. Issues would be considered on the basis of their urgency. There would be no systematic planning to anticipate calls for, say, increased prosperity or lower social inequality. Living standards, then, would only increase slowly but social stability would be kept at a satisfactory level.

The Inertia economy would aim to avoid any radical economic changes or social innovations which might lead to economic or social instability. This detail is important because everyone remembers the damaging consequences of abrupt change. But, in substituting strategic goals for tactical ones, this strategy would waste resources, fail to determine long-term priorities and largely ignores the importance of development. As long-term decisions are taken without due consideration and the response to threats postponed, so it will become harder and more expensive to deal with them. Inconsistent modernization, the intensification of internal conflicts and economic lag would be the consequences of the 'Inertia' approach.

The Modernization Economy

The 'Modernization' approach would aim to encourage the formation of broad coalitions which could oversee the fundamental reorganization of the institutional mechanisms responsible for innovation, investment and management.

It would consist of a complex mixture of long-term restructuring of the economy over a seven-to-eight-year period and the modernization of sectors where the state already has competitive advantages. Examples from all over the world have shown that the only way to modernize a country's economy is through the development of private entrepreneurship.

The introduction of secure property rights, secure contract rights, an independent judiciary lower administrative barriers for business and the stamping-out of corruption are the means by Russia could be modernized.

Many aspects of infrastructure would need to be improved: information technology, the transport network, banking and other business services, the education system and R&D. But, if the right institutional conditions are created, investments in these areas could become attractive to private investors and would no longer rely upon state support.

Modernization would require an elite of businesses and citizens determined to move in the same direction. Such a plan

could, theoretically, be put into effect by a benevolent dictator but, in practice, modernization will fail without widespread support. Compromise would be essential.

This strategy will succeed if the following conditions are observed:

- Priority is given to strategic problems over tactical ones.
- Social resources are used only for those sectors of the economy where Russia has an undisputed competitive advantage.
- Sectors are not subsidised on geopolitical grounds.
- Creativity and innovation are made the sole instruments of competitive struggle.
- A broad social coalition is established to maintain the momentum of modernization and to overcome the resistance of social or professional groups who have lost out because of reforms.

Modernization would be directed to creating a competitive state and a competitive economy.

A competitive state is one in which the costs of maintaining it, the transactional costs of its business, and the quality of its services are equal to those in competitor states.

A competitive economy is one in which the infrastructure costs to citizens and enterprises are no higher than those in competitor states.

Globalization has made it possible for citizens and companies to leave non-competitive states. This has aggravated what were already complex economic problems. Russia, however, has compensated for its uncompetitive public institutions and infrastructure with resource advantages. But time is running out. Soon the outflow of qualified specialists and processing facilities will be such that Russia will fall so far behind its competitors that catching up will become impossible.

The modernization of society, of the state and of the economy will be painful for all concerned. Some will lose rental income,

others will have to change their working habits or even their way of life. But Russia now has no alternative but to undergo this painful process if solutions to its long-term problems are to be found.

Modernizing Society

The protection of civil rights and freedom is a prerequisite for a competitive state:

- Procedures must be adopted at all levels of federal and regional authority to make decision-making transparent allowing the interests of all parties concerned to be taken into account. Every effort must be made to prevent the monopolization of power.
- Public organizations, business and the state must all have an equal say on issues of public development.
- Every effort must be made to foster the institutions of civil society whatever the cost may be to the smooth-running of the state. They must be involved in the preparation, adoption and supervision of all policies at federal and regional level.
- Freedom of information, freedom of expression and freedom of movement must all be enshrined as inalienable rights.
- Procedures must be drawn up which will restore the public's faith in government and rein in corruption. Ombudsmen must supervise the activities and expenses of the authorities ensuring greater transparency. Some powers must be handed to the institutions of civil society.
- The country must be united behind a common set of civil, social, cultural and family values which are not imposed from on high. Every citizen should have the right to find his or her own way of life consistent with the above values.

Governments in countries with developed civil societies have their powers curtailed, but only in such countries is the creative potential of the population maximized.

Modernizing the State

A modernized state will only perform those functions which corporations and public organizations cannot. Above all, the state's role will be to guarantee the rule of law. This will involve:

- An independent, fair and competent legal system.
- An independent, fair and competent system of law enforcement.
- A system of checks and balances which will ensure big business complies with regulation.
- Prioritizing the protection of property rights over economic or political expedients.
- Improving public services. Access to these must be considered a right for all citizens and their provision must be from public or private sources based on competition.
- State paternalism must cease and the emphasis must switch to supporting the needy members of society (i.e. those without family support).
- The guaranteed provision of free health care and education for all everywhere in the country. The cost will be met by citizens, public organizations and charities.

Living under these conditions will be harder for citizens than living under a paternalistic state. They will have greater responsibilities and must put up with greater pressures to work and be creative. But this is the only way to remain competitive in world markets.

Modernizing the Economy

The following conditions must be met if business is to reach its full potential:

- A conscientious macroeconomic policy ensuring the stability of the Russian Ruble and low inflation.
- A competition policy restricting monopolies and ensuring that the most efficient companies win.

- Fostering innovation so that it becomes the principal instrument of competition.
- An industrial policy which prioritizes 'consumer protection' over 'producer protection' and which supports competitive companies and gives priority to no company for geopolitical reasons.
- A regional policy which supports competitive regions whilst subsidizing underdeveloped regions.
- The development of transport, information and communication networks which attract private investment based on the principle that the 'consumer pays'.
- Full participation in the world economy, the elimination of all restrictions on the movements of goods, services, labour, capital and innovations.

This strategy would involve paying greater attention to the development of institutional infrastructure, public consultation and legislation. As a long-term strategy it carries the risk that its benefits will not be apparent in the short-term (2 to 3 years). However, the share of public expenses as a percentage of GDP will be kept stable both in the mid- and long-terms.

The merits of this strategy are that it would create the basic conditions needed for economic growth and an increase in Russia's prosperity. Such conditions will decrease Russia's dependence on the world market for natural resources and increase the role of the domestic market as the motor of demand. Such institutional reforms do not require such high expenditure allowing funds to be spent on more expedient problems and in particular increasing the prosperity of the needy.

The weakness of the strategy is the effort it will require from the authorities. Moreover, this effort will have to be made in areas with which the authorities are very unfamiliar, such as involving the public in the process of modernizing society, business and the state. Parts of the bureaucracy will resist any such change and this will require both management skills and compensation.

Many will lose out from such fundamental modernization. If resources are used to compensate such losses then the state's ability to meet other, unforeseen challenges may be jeopardized. The authorities must achieve a balance between carrot and stick.

If world prices for natural resources remain high, all four strategies would deliver acceptable economic development and an increase in living standards in the mid-term (the difference between options is only in the correlation of "geopolitical influence to living standard"). But, if the price of natural resources were to fall sharply, the first three strategies would all lead to catastrophe. Only the 'Modernization' strategy can mitigate the effects of a price drop.

Obstacles for the Implementation of Modernisation Strategy

The 'Modernisation' Strategy is the most difficult of all the strategies to implement.

High Expectations. Fifteen years of economic crisis have left both ordinary people and the elites demanding quick and concrete proof of improvement from any proposed strategy. Therefore, the most popular strategies are those which offer 'everything now', compensating the people for their losses and restoring the economic power of the country. The 'Modernization' strategy, however, offers no quick fixes and its results will, by definition, be slow in coming.

Conflicts of interest. Recent sociological research has shown that key groups within Russian society have very different and often contradictory interests.

Inertia. So long as mentalities do not change, altering the law will have little affect on behaviour. Expectations and habits must change if modernization is to succeed.

These factors may create a powerful opposition to modernization. The 'Mobilization' strategy will appeal to them.

Federal officials, state-oriented businesses and sections of the population and the intellectual elite who support the concept of a 'strong state' will want the quick and visible results afforded by 'Mobilization'.

The 'Rentier' Strategy will appeal to regional elites and low-income groups, while the political class and a significant part of business and bureaucracy will tend towards the 'Inertia' Strategy. The 'Modernization' strategy, then, will only succeed if it is accompanied by a broad coalition.

At present, the condition of the high prices for natural resources is most favorable favour the 'Rentier' Strategy (natural resources, territory, institutional context, the quality of human capital and people's creative potential, financial resources of the public, the government and the business). 'Mobilisation' and 'Inertia' strategies are less applicable. For the 'Modernization' Strategy to succeed, Russia must overcome the Dutch disease - the curse of resources - and radically improve its institutional environment. One of the most challenging questions is how to improve the quality of resources required for 'Modernization' and how to determine the range of necessary measures.

Chapter IV:

Coalitions of interest groups and the selection of a modernization strategy

Since the beginning of the reforms in the early 1990s, all development programmes in Russia have been planned and implemented under similar circumstances. As a rule, they were drafted by highly-qualified specialists familiar with the style of the subject at hand and who understood its internal structure. These programmes were supported at the highest level. However, they were invariably of poor quality and their implementation even worse. In each case, the programmes were only partly implemented and then often in a distorted form.

It would be a waste of time to discuss the specific failures of this or that development strategy, but it should be pointed out that all these development plans omitted the same crucial ingredient which was never explicitly taken into consideration, and which, in the end, doomed them all to failure.

The interests of Russian society were ignored in the preparation and implementation of these programmes. Such programmes reflected the needs of powerful interest groups and not Russian society as a whole. This statement was true of Russian development throughout the 1990s.

In other words, different development strategies have always provoked different responses among the various groups within a country. These responses reflect the benefits and drawbacks of each plan for each interest group. Plus, responses are conditioned by expectations as much as by realities and, in Russia, faith in reform is often coloured by the bitter disappointments of the past. For this reason, it is doubly

important to take both expectations as well as interests into account when considering the low level of confidence based on historical experience.

The modernization of society, of the state and of the economy is a complicated and painful process in which different professional and social groups risk losing rental income, their familiar way of life and their accustomed working habits.

Coalitions must be built on two key principles if they are to succeed:

- That those benefiting should feel actively involved.
- That those losing out should feel adequately compensated.

Ignoring either of these principles will lead to failure.

The Different Interest Groups in Russian Society

Research has shown that ignoring special interest groups when developing social and economic policy has led to a low rate of success in the majority of target areas.¹

By 'Interest groups' we do not mean self-interested business or bureaucratic circles but larger groups such as students, the retired, regional elites etc.

The interests of various groups may not be immediately obvious. Sometimes opposition to a policy will grow over a long period of time, sometimes opposition may develop rapidly in response to a particular circumstance. The monetization of benefits in 2005 or the unpopular tightening of road regulations (though it may have been necessary) in 2006-2007 are not the only examples. A typical one is the example of housing cooperatives. Reasonable and necessary measures were made to the law and implemented in such a manner that strong resistance was provoked and the measures were sabotaged by

¹This estimate was based on studies conducted for the third-level strategic goals of the Russian Government. Experts were asked to estimate the current state of a target field and the difference between 2001 and 2005.

both those covered by the law and those implementing and supervising it.

The nature and the needs of special interest groups must be studied with care. The success of any development strategy will depend upon the way in which these special interest groups form wider coalitions.

The importance of taking the interests of different groups into account when formulating strategy

We have established that the success of each scenario would depend upon external factors, like energy prices, over which the state has little control. In Russia's case, however, internal factors, like the vested interests of different groups, are just as important. Often, however, these internal factors are underestimated because it is difficult to place them in a formal framework & hard to quantify their influence.

All four proposed development strategies (Rentier, Mobilization, Inertia and Modernization) are 'direct' strategies which prioritize the development of specific sectors of the economy or industrial and social infrastructures.

It is almost impossible to develop a 'direct' strategy which pleases everyone. At best, such strategies will benefit the more influential groups and leave the rest unaffected. Strategies which try to please everyone risk emptying themselves of any significance. Both winning and losing groups must be stirred into action. All sections of society must be involved in the planning and implementation of strategies.

We propose, therefore, to develop strategies that also which encourage non-benefiting groups to participate. These 'motivating' strategies would aim to compensate people who have sacrificed potential gains as well as those who have incurred losses as a result of reform. These 'motivating' strategies will establish a starting point and from the basis determine the level of compensation due to both direct and indirect losers.

Some experts will identify other social and economic problems and suggest other solutions. First, therefore, it must be demonstrated that it is necessary to resolve the problems we have chosen. Then, it must be shown that the resolution of these problems will improve or at least not aggravate the situation for the vast majority.

Then, the winning and losing groups must be identified. The positive and negative effects of any given policy upon them must be carefully weighed. Then, the power of each of these groups, the resources to which they have access and the level of compensation which might be required must be determined. Finally, the nature of the compensation and the means by which it will be provided will need to be worked out.

Ways of Identifying the Groups

Here, we follow the preliminary analysis conducted by researchers based on indirect polls carried from the Levada Centre, the All-Russia Public Opinion Research Centre and Public Opinion Centre in 2006.

We propose to introduce three levels of interest groups: Analysis-based Groups (high aggregation level), Statistical Groups (middle aggregation level), and Real Groups (low aggregation level).

Analysis-based Groups

At this aggregation level we have identified the basic macro-groups in Russian society according to their status (being formally determined or officially accepted) over the course of the analysis. It is possible to identify simple groups based on the power they have, derived from their wealth, influence over government or their capacity to defend their interests.

Dividing Russian society into the wealthy (20%), the middle-class ((40%) and the poor (40%) is important though not consistent with the model of division prevailing in European countries. The so-called middle class are educated but lack the

income and consumption levels commensurate with a dignified life. Therefore, they feel that the situation is unfair and they join coalitions which demand higher social expenditure. Income distribution levels have remained more or less fixed over the last decade in Russia: the rich account for 50% of income (40% in Europe), the middle-class have 35% of total income (40% in Europe) and the poor have 15% of total income (20% in Europe). It is also important to note that in Latin America the richest 10% account for 35% of visible income compared to 25% in Europe). The Russian model is more uniform than the Latin American one and closer to the American or British model.

The greater the difference in income distribution, the more difficult and intensive the conflicts over redistribution become. In Russia, income differentiation is as high as in the rest of the world (except for the most developed countries and Sub-Saharan Africa). The poor in developed regions are always competing with poor regions. Developing countries have to choose between helping developing countries or helping their own poor. The same situation exists in Russia. Poor regions demand redistribution and assistance but their interests may not be in line with the interests of the poor.

Having identified two large regional interest groups, federal interest groups and three groups divided according to income, we shall now identify the different business groups: large business (both public and private), mid-level regional business and small business. First, we shall focus on the relationship between federal authorities, large business groups and regional authorities.

Having identified nine groups (three business groups, three public groups and three income groups), we must identify two numerically smaller but disproportionately powerful groups, namely the political class and the intellectual elite. The political class includes members of political parties and public organizations. The intellectual elite includes the expert community, non-governmental organizations, represented either individually or in groups, and the mass media. These two groups

exert a considerable influence on the social and political processes in Russia. Their activities reflect the interests of the above groups. When a party system has developed, the parties determine their position on key issues by negotiating with their electorate. In Russia, parties have no clear position as the political process has developing according to its own rules. Traditionally, in countries with weak civil society and high social inequality the intellectual elite are alone in identifying and defending society's long-term interests from expedient political or economic considerations. We believe that the negotiating capacity of the intellectual elite is small in the short-term, but very important in the long-term. The intellectual elite may be divided but it is unlikely to sell its integrity for financial gain.

These eleven groups are not, of course, discrete. The wealthy, for example, are principally concentrated in the most developed regions, especially in the capitals. The interests of regional businesses and the authorities are similar but not identical to the relations between the federal authorities and region authorities. The regions play a more important role in Russia than in smaller, more homogenous countries.

Table 8 shows the varied responses of different interest groups to the problems facing Russia.

Coalitions built around tax and income proposals are the easiest to identify. The calls for tax reduction from big business and increases in salaries from labour unions are predictable. Higher taxes will always be supported by the poor, the poor regions, federal authorities and the political class. But taxpayers may have another opinion.

Corruption is more complicated. Nobody supports corruption and everybody acknowledges it as a significant problem. But people have got used to bribery. The rich add bribes to their list of expenses rather than run the risk of delay. Therefore, public campaigns against corruption may not be sufficient to change habits and introduce risk.

Image is of great importance to most countries but not to Russia. This fact is often ignored by the press both at home and

abroad. Different groups in Russian society have different ideas about what Russia's image ought to be. The intellectual elite would like Russia to be an emblem of universal human rights. Others would prefer Russia's image to be that of a fist. A compromise will be hard to achieve.

Table 8: Framework for coalitions

Groups/Topics	Growth of Non-Oil Budget Incomes	World Image of Country	Modernization Investments	Fight Against Corruption
Intellectual Elite				
Political Class				
Federal Authorities				
Rich Regions				
Poor Regions				
Large Business				
Regional Business				
Small Business				
High-Income (20%)				
Middle-Class (40%)				
Poor (40%)				

Source: Economic Expert Group.

Modernization is another complicated issue. No group opposes calls for modernization on principle, but few groups are willing to forego the benefits they receive from redistribution to make greater investment possible. Many agree that corruption, administrative barriers, ?rental encumbrances? are blocking Russia's potential for innovation but few agree on the solution to these problems.

Each group has many different interests and the coalitions they join will change according to the issue at hand. There is little consensus on national policy in Russia. The development of each policy will have to pass through a chain of coalitions, compromises, agreements and compensation packages. However, society-wide coalitions are needed to tackle national problems and the formation of these coalitions is the most important precondition to the development of the 'Modernization' strategy.

Statistical Groups

Statistical Groups are identified using quantitative and qualitative sociological methods. The sample data is from research conducted by the Levada Centre, the All-Russia Public Opinion Research Centre and the Public Opinion Centre in 2006. The following groups were identified: office employees (10 to 15 million), the retired (38 million), government officials (1.5 million), national security, defence and law enforcement agents (4 to 5 million), members of organized crime groups (up to 80,000), budget sector employees (4 to 5 million), students (6 to 7 million), active internet users (up to 1.5 million), passionate, politically motivated young people (up to 70,000), car enthusiasts (25 to 30 million). People may belong to a number of these groups simultaneously.

Real Groups

At this level, groups have low aggregation. For instance, a single youth movement may be made up of separate real groups each with has specific strengths, weaknesses and resources to offer a coalition. An example of a 'real group' is university students in large cities. A real group has sufficient resources to claim compensation in return for its support for, or non-resistance to, a policy.

How to create coalitions in Russia

Different coalition can be formed to support the different objectives outlined in the first section. These are as follows.

A Coalition to protect Civil Rights and Freedom

Intellectuals and the middle-class would form the core of this coalition. On the fringes of this coalition would be groups like the poor or high-earners who support civil rights but without the same urgency. In theory, they favour the strengthening of civil rights but in practice they may oppose this where it impacts negatively upon their livelihood or business. For instance,

employers may find their costs go up when labour regulation is tightened while employees may find they lose their jobs when their legal status is regularized. Small and large business would form a neutral zone. Small business is concerned with the bottom line whereas big business is more inclined to support large-scale projects offering social benefits. The political and federal governments also have a public mandate to push through these social projects. Regional authorities (with some minor exceptions) and regional business would form the opposition to this coalition. As things stand, they have more opportunities and greater incentives to violate the rights of citizens, they are barely supervised and the risk of sanctions is low.

Coalition to protect business rights

Large and small business would be the core of this coalition. On the fringe would be the less-developed regional businesses, high-income groups and the middle-classes. Those neutral and those in opposition to this coalition are strongly interdependent. Business is considered the key to Russia's development and often in a way that takes its rights and interests as of secondary concern. Business is treated as "cash-cow" and subject to the arbitrary treatment of the authorities. The attitude of the majority of the political class and of the federal and regional authorities as well as the poor is neutral-negative with the likelihood of becoming negative.

A coalition to create competitive markets

At present, there is no stable core to this coalition. Small business, some parts of medium-sized business and regional business all stand to gain from a more competitive market. The intellectual elite are also likely to support this coalition on principle. However, few people see any link between a competitive market and the price of goods, and many find it harder to live in a highly competitive environment. For this reason, support for competitive markets is inconsistent and

often partial. The neutral and opposition groups are once again interlinked. The political class and the federal authorities obey the principle of competition in theory but do not in practice. Regional businesses and big business traditionally oppose competition for fear that they might lose market share. In developed economies these tensions are controlled through anti-monopoly laws and greater transparency.

A coalition to protect property rights

This coalition suffers from weak consensus. The core is made up of business and the rich. It is worth mentioning, however, that these groups rarely acknowledge the property rights of their competitors or neighbours. Small and medium-sized businesses believe that high-incomes or large property holdings must have been gained illegally. On the fringes are the intellectual elite, the majority of whom accept the importance of protecting property rights. The middle-classes and some among the poor are also peripheral supporters of this coalition. They may have small plots of land or cars which they have lost due to the state's failure to protect their property rights. The public authorities, the political class and the regional authorities act as neutral bystanders at best and as the opposition at worst. For them, the vagueness of property rights is an advantage not a drawback. They can interpret property rights in their own interest allowing them to redistribute property to their advantage.

A coalition to abolish Administrative Barriers

This coalition's core is made up of small and regional businesses which lack the means or the opportunity to circumvent administrative barriers in the ways (often unofficial) that are available to larger companies. The parts of big business, the middle classes and the rich who have encountered bureaucratic barriers in everyday life, and who are, therefore, likely to be sympathetic to the removal of similar barriers in the business sphere, stand on the periphery of this coalition. The opposition

to this coalition includes all authorities who expressly or implicitly employ such administrative barriers to control and subordinate private interests.

Can a wide coalition consolidate in support of the 'Modernization' economy as a whole?

The core of a 'Modernization' coalition would include the intellectual elite, big business and high-income groups. The federal authorities, the middle classes and small business, who share many of the same values, would be on the periphery of such a coalition. All remaining groups would be neutral.

Such a coalition, of course, is entirely theoretical. Its creation would depend upon the resolution of a number of important issues. For example:

- Small business and the middle-class must accept large property holdings as legitimate.
- The federal authorities must listen to the public and feedback from the people must not be distorted.
- The status and resources of the intellectual elite must grow. Only then will decision-making become more disinterested.
- The restrictions, e.g. administrative barriers, placed on the growth of small and middle-sized businesses must be removed.

Guidelines for reforms: conflicts of interest and compensation deals

Each of the four strategies we have proposed, including the 'Inertia' strategy, involve changing the rules which govern the social and economic spheres. How helpful are compensation deals for those 'losing out'? Compensation would only be given to those with the power to block reform not just by conventional means, such as votes, but also through emigration or protest. Each reform would entail losses for certain groups. We have developed a mechanism for identifying the losers, deducing the means by which they can be compensated, estimating the transaction costs and, as a result, discovering the cheapest

compensation package. This mechanism offers a wide variety of options which should cover all possible situations.

Market reforms in construction, property and management.

If the federal government reduces regional and local administrative barriers, it will obtain the support of the majority of leading banks and investment companies as well as a significant number of independent large companies.

The number of large companies wanting to be involved in large-scale development projects is increasing rapidly. Alongside the profits from oil and metallurgy, those from agriculture are now being invested in the property sector. However, at the moment it is easier for private business to deal with administrative barriers one by one than to initiate a complete overhaul of the system.

The compensation scheme, then, will be: “lower barriers and participation in work” which, by the way, can be applied to many other industries and sectors.

The ecological repercussions of production

Government efforts to reduce environmental damage through regulation, monitoring and certification will find support among all national companies who depend on world stock or financial markets for raising funds.

Increasingly, foreign loans will carry environmental conditions and businesses will need to improve their “green” credentials if their share price is to rise. Therefore, companies subject to world financial markets are at a disadvantage since they have to comply with stricter regulation than their domestic competitors who do not. But, with the adoption of universal environmental standards, such distinctions will disappear. The approval of world markets, therefore, will compensate companies for the costs of complying with stricter environmental standards.

The Automotive industry.

The development strategy of this sub-industry has already been outlined i.e. to attract investment from leading world companies to build manufacturing plants in Russia.

The national automotive industry remains important but will not be a priority. The main question is the level at which import restrictions on cars manufactured abroad should be set. This question will remain on the agenda. Domestic car manufacturers, despite their size and importance – they are the largest players in the processing industry-, are unlikely and seem unwilling to play an active role in decision-making. Almost all Russian car manufacturers have a stake in the development of joint ventures with foreign manufacturers, so they will not dare to contradict the interests of their senior partners. Therefore, the level of protectionism will be decided by Russian authorities in cooperation with foreign companies involved the Russian market (of course, WTO requirements will also be taken into consideration).

Here rigid protectionism has been foregone in favour of the opportunity to cooperate with world manufacturers in order to create a more liberal form of protectionism in the domestic market.

The Defence Industry

The needs of the big players in this industry are obvious: state support for export of Russian military equipment and an increase in domestic defence spending. As far as exports are concerned, the government already does everything it can to support the industry and has been, to a certain extent, successful in this. It seems that demand for exports will remain constant. The current level of defense spending, however, is considered insufficient and its increase would seem natural and beneficial given the current condition of state. Such an increase would have the unanimous support of the public and, of course, of the industry itself. There is a risk that the defense industry

will not receive an injection of funds because it such investment is a low priority for the public and because any major change in government expenditure disturbs vested interests in government who may, therefore, oppose it.

Retail

The principal players in this sector are the federal retail chains. Ten of them have an annual turnover of over \$1 billion and the top three have an annual turnover of around \$3 billion. Their successful development will depend upon the easy availability of plots of lands and premises in cities.

Municipal, regional and local authorities are the natural opponents of these federal chains. In order to fight the monopoly of local authorities, the federal retailers depend upon federal support and are ready to actively promote federal initiatives on the issue. But if federal authorities remain inactive, then federal retailers are forced to go along with local practices and make separate agreements with local elites which often involve corruption.

Federal retailers also depend on the state not interfering in their relationship with their suppliers. At the moment, the largest retailers show their strength over wholesale suppliers and producers (in particular, foreign ones). These suppliers appeal to the state and its anti-monopoly agencies for redress. National retail chains no longer need to be protected from international ones since large national retailers now regularly meet foreign chains and have learned to interact with them.

What is more, trade chains are of social importance since they offer uniform standards to all parts of the country. Federal authorities support them, as long as the play by the rules, and have developed chains and investments in this particular direction.

The Modernization Coalition: the findings

Having described the different groups in Russian society and outlined the various coalitions that could be formed, we will

now discuss the chances of implementing the 'Modernization' strategy and the likelihood that a modernizing coalition could be kept sufficiently stable to see the strategy through.

The success of a Modernization Coalition will depend upon its capacity to recruit and keep new members. This will depend on its negotiating power and its ability to deliver on the promises it makes. The Coalition will need an inner core to maintain direction and stability. This core will rely upon the security of property rights and an efficient feedback system. The different interest groups within the coalition will have a mixture of short, mid and long-term expectations. For the coalition to keep its momentum, it will need to continuously meet its membership's various demands, and the more it succeeds in doing so the more recruits it will attract. The coalition must take full advantage of this snowballing effect. Above all, the coalition will need the initial impetus to break the status quo and begin the process of reform.

Rules and procedures are drawn up and supervised by the state. This means that the social and political systems need to be modernized along with the economy. In other words, the state itself needs to modernize. However, demand for this is weak and will need to be encouraged using separate measures such as reducing the costs of interaction and strengthening mutual trust.

Conclusion: Steps towards Modernization

The next Russian government will have to deal with a variety of problems. Some are the product of the crises of the 1990s, others inherited from the distant past and aggravated by decades of inefficiency and poor management.

Russia must solve the following problems for its citizens:

- Low confidence in public institutions.
- The lack of civil society: it must provide genuine representation for all social and regional groups in the political process.
- More equitable distribution of income.

- Resolve the demographic decline: increase the birth-rate and the number of children per family, reduce mortality rates and emigration.
- Develop better social infrastructure, including housing, roads, education and healthcare.

In the economic and business spheres, Russia must solve the following urgent problems:

- Develop a responsible macroeconomic policy maintaining internal stability and limiting the effects of external shocks.
- Strengthen property rights and make them more transparent.
- Stimulate economic development by creating an attractive investment climate and increasing the savings rate.
- Reduce administrative barriers and improve the efficiency of the market.
- Encourage competition and discourage rent-oriented behaviour.
- Develop policies for industrial and regional growth.
- Increase the competitiveness of business in anticipation of WTO membership.
- Strengthen the private financial sector.
- Reform the pensions system.
- Make more efficient use of national savings.

The reform of the state remains Russia's biggest challenge. Economic growth largely depends upon the state institutions and the quality of its management. It is particularly important in Russia where the state has traditionally played a prominent role and where the government now possesses enormous budgetary resources and reserve funds. Those who think that the state can act as the motor of development and remain above scrutiny and criticism are wrong. Today, a state cannot grow or develop without efficient and high-quality institutions. The limited efficiency and the high cost of the 'Mobilization' strategy would soon become apparent.

For the reforms to work, Russia must:

- Improve management and increase compliance with the law.
- Significantly reduce corruption.
- Strengthen the judicial system and the independence of judges.
- Separate power from property.
- Halt the growth of bureaucracy and carefully analyze the feasibility, expense and potential consequences of each reform.

Russia's relations with the rest of the world will remain fragile for the foreseeable future. For this reason Russia must:

- Avoid economic shocks, in particular a third "oil shock"
- Provide a predictable economic policy which conforms to the national interest.
- Improve the business environment and protect the rights of citizens abroad.
- Improve the image of Russia around the world by improving the quality of life at home.

The top-priority measure – the development of state institutions – can be divided into two stages.

The First Stage

- Reduce administrative barriers by putting local and municipal bureaucracy in order. The result: a favourable environment for the development of mass entrepreneurship.
- Create a favourable environment for the organizations of civil society and set up dialogue between federal, regional and local authorities on equal terms. The result: constant feedback between the public and authorities. It is important to involve the existing and emerging non-parliamentary parties in this feedback.

The reduction of administrative barriers will involve expert analysis and public consultation. This will pinpoint the most “obstructive” rules, elaborate alternatives and begin the process of introducing these in the shortest possible time. Concurrently, it will be necessary to draw up federal laws to oversee the introduction of any future regulation so as to avoid raising further administrative barriers. The reduction of administrative barriers will stimulate civil organizations and ensure a favourable environment for their development.

The ability of civil organizations to overcome administrative barriers will depend on their capacity to express criticism openly in the mass media and, in particular, on television. Russia will have to accept that in the short-term this may lead to much non-constructive criticism and the “letting-off of steam”. This is why it is important to respond quickly and decisively to criticism, even if it is inaccurate, in the same media where it was published. Criticism must be acknowledged and publicly rebutted. It is essential to emphasize that in responding to criticism the federal government is demonstrating its power and not its weakness.

An environment in which civil organizations flourish will create “bottom to top” flows of information to which the federal government should respond quickly and publicly, thereby eliminating the drawbacks of and justifying the vertical nature of power.

The most significant opposition to reform and modernization will be found among municipal officials. Under pressure from below as well as above, they will have to either change their behaviour or leave. Moreover, local small businesses will provide the basis for further growth in the local economy.

If these initial steps are taken, the ‘Modernization’ strategy will win broad support as its benefits will be felt at once. For people to understand that these changes are not ‘gifts from on high’ but the result of determined action, it is vital that the policies and their implementation are widely discussed by the media and scrutinized by the public. When the public see that government

rhetoric leads to concrete change a common set of values will emerge.

The first steps to modernization will also require crucial reforms in education, science and healthcare. The commercialization of education, particularly higher education, should cease at once. There needs to be a drastic change in teaching methods from rote-learning to more creative and independent practices. Only flexible and innovative citizens can adapt a fast-changing information environment and a competitive economy. The research sector will have to be broadened in higher education to increase student participation. Universities should be encouraged to conduct more fundamental research. Demanding a return on such research is pointless. The creation of a favourable environment for small innovative companies where acquired knowledge can be transferred through innovation must be one of the first goals of modernization.

Healthcare development will secure a number strategic aims: from human capital development, without which there is no intellectual leadership in the country, to compensating for a lack of labour resources, to reversing demographic decline and providing for the country's defense from external threats. The shortsighted commercialization of healthcare must cease. This is why it is reasonable to provide new healthcare equipment through national projects.

The consistent implementation of this first stage in the direction outlined will enable a second step of implementation to begin within a few years.

The Second Stage

The first stage provided for the regulation of and self-regulation of municipal and regional authorities. The second stage would involve the self-restriction of the federal executive by increasing the independence of the judiciary. This must be consciously undertaken. Unless this happens, businessmen will continue to

believe that it is impossible to win a case against the state and there will be no further improvements in the business environment which will prevent the development of creative freedom.

The formation of an independent judiciary will be the last act in the long process of property redistribution and will signal the beginning of a fully voluntary system of property transactions – sales, mergers, take-overs etc. – as seen in developed economies. This will also mean institutional barriers to investment in Russia will no longer exist and that investment decisions will be made purely on the grounds of efficiency. The country, then, will be open to direct private investment without the need for facilitating public officials. At this stage, Russia can concentrate on clarifying the details of its regulatory base, improving the efficiency of government officials, clarifying the standards of inter-budgetary fiscal relations and completing large-scale infrastructure projects.