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The review provides a detailed analysis of main trends in Russia's economy in 2006. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political background; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Vladimir Mau

## State Policy and State Institutions in 2006<sup>1</sup>

### *The main trends of economic and political development*

The past year was not marked by any outstanding events in terms of either economics or politics. The authorities continued their course outlined in the previous years. There were no remarkable external challenges which could exert significant influence on the economic life of the country and necessitate some special responses.

This observation is confirmed by macroeconomic indicators (Table 1). The economy was growing at a steady if not spectacular rate, sufficiently high to exceed both the world's and European average but still too modest to secure the

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<sup>1</sup> The author expresses his gratitude to V. Novikov and O. Kochetkova for their help in preparing this section of the review.

achievement of the recently so cherished goal of “doubling the GDP”. And this idea has somehow slipped off into the background. Practically none of the important indicators exhibited any changes either to the better or to the worse.

In terms of economic growth, Russia continued to considerably outpace the most developed countries of the world, but slightly lagged behind the majority of post – Soviet countries (Table 2). By comparison with the countries of Central and Eastern Europe, Russian growth rate appears, on the whole, to be satisfactory (with the exception of the Baltic states), thus confirming the regularity that has revealed itself after the completion of the period of transition - that “the further from Brussels the higher is economic growth”<sup>2</sup>.

The investments, especially foreign ones, are exhibiting a positive dynamic. And it is noteworthy that it is taking place in a situation when the State is clearly boosting up its role in economic life by increasing the assets of the state – owned enterprises operating in the sectors which are the most attractive ones under the existing conditions (the branches of the fuel and power – engineering complex).

The government continued to pursue a cautious financial policy. The resources of the Stabilization Fund and gold and foreign currency reserves were growing. Although the budgeting policy has become weaker (the federal budget’s expenditure rose in nominal terms by more than 20 % on the previous year), and therefore the dependence of the state sector on the situation on the market has increased, it is still too early to affirm that the conservative budgeting policy has been abandoned, and budgeting populism has come in its stead. It has now become very clear that it is a rather difficult task - to avoid populism in a situation when money is in abundance, and throughout the past year the authorities were continuing their quest for arguments and solutions designed to control the torrent of populist demands and calls. This was especially important from a political point of view, because the year was pre-electoral.

The first year or realization of the “national projects” came to an end. Having been formulated by V. Putin in autumn 2005, these projects became the core of the country’s social and budgeting policy, because they provided a means for significantly accumulating budget expenditures and endowing the government’s economic policy with a social accent. To the initially suggested projects (public health care, education, agriculture, and housing), one more issue was now added – the need to overcome the demographic crisis.

The national projects have become a reflection of the general tendency of transition toward medium and long – term politics. There emerged a strong demand for programs aimed at the development of the whole country and also of its individual regions and sectors of the economy. The development of a ten-year socio – economic strategy of the country was

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<sup>2</sup> For more details, see Oslund, A. ‘Paradoks evrazijskogo rosta (The paradox of Eurasian growth) // Rossiia v global’noi politike (Russia in global politics). 2006. Vol. 4. № 6.

started. A Summary Report on the results and main areas of activity, containing three – year benchmarks for the government's activity, was prepared, and similar reports were prepared by ministries and agencies. For the first time in Russia's economic history, a switchover to three – year budget planning took place: even in conditions of the Soviet planned economy, the feat of extending budget planning beyond the limits of one year had never been achieved. The Federation's subjects started mapping long – term (for 3 – 5 years) strategies and medium – term (for 3 – 5 years) programs of their socio – economic development. The Government periodically considers strategies for the development of some individual manufacturing and infrastructural sectors.

In the course of the year 2006, the Government continued to actively design and materialize the “institutions of development”. Special economic zones, concession agreements, and the Investment Fund became the reality of economic life. Simultaneously, a lot of intensive effort was devoted to creating the legal and organizational foundations of the State Development Corporation (or the Bank of Development), which should become the source of investments for large projects supported by the State. Apparently, this work will be finished in 2007, and Russia will then possess an integral system of the so – called “institutions of development”.

The process of the consolidation of the most important (strategic) sectors of the economy in the hands of the State or under its control was continued. Recent years have demonstrated that there exist two fundamental models for restoring state control over the key assets – through court proceedings (the “Yukos model”) and through buying – out<sup>3</sup>. The Yukos precedent performed its demonstrative function, and last year the second model was the absolute leader. The most vivid example of this is the penetration of “Gazprom” into the project “Sakhalin-2”, which was accomplished through buying – out a controlling block of shares from western corporations. The same trend can be traced in the formation of the “United Aircraft Building Corporation”. Finally, there emerged an idea that a draft law designed to regulate the access of foreign capital to the Russian production assets should be put forth.

In the year 2006, there were some significant changes in how Russia positioned itself on the international arena. Two opposite tendencies could be observed in this regard. On the one hand, the process of Russia's entry into the structures of the contemporary world was going on. On the other hand, it became obvious that Russia's relations with the western world – or, to put it differently, with the developed market democracies – were worsening.

The first tendency was related to the continuation and completion of the processes which began rather long ago. It was manifested by the negotiations concerning Russia's joining the WTO and by her chairmanship in the G8, which passed

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<sup>3</sup> See: Ekonomicheskaya politika 2005 g.: opredelenie prioritetov (The economic policy of the year 2005: the determination of priorities) / Rossiiskaya ekonomika v 2005 g.: Tendentsii i perspektivy (The Russian economy in 2005: Trends and prospects). Vyp. 27. Moscow: IEPP (IET). 2006.

more or less successfully (or, in any case, without any excesses). One should also note the liberalization of the exchange regulation in the part relating to capital movement, which formally made the rouble a fully convertible currency (in contrast to the convertibility of the rouble for current transactions (or current account convertibility)), introduced as early as 1992). However, these developments and tendencies have not become, so far, a factor of Russia's integration in the communities of developed market democracies.

The second tendency, unfortunately, is a reflection of the existing problems – the cooling off (and even the deterioration) of the relations with the EU, and the criticism of the latest political tendencies of Russia's development as being contrary to the principles of democracy. Additional difficulties are being created by Russia's intention to rearrange its tariff policy in respect of the pricing of energy carriers, which became obvious last year. An attempt at switching over to international prices in Russia's relations with her CIS partners causes not only the resentment of the latter (which is quite understandable), but also criticism on the part of other European countries who consider this attempt both as the blackmailing of the former Soviet republics and as the source of risks for the security of their own energy supplies (because the oil and gas pipelines pass through the territory of the countries for whom the tariffs are being raised). Also, the situation is becoming especially difficult for Russia because, within the framework of her chairmanship in the G8, the slogan of energy security was put forth as one of the key issues on the agenda. And, according to Russia's western partners, it is precisely this demand that is being undermined by the revision of tariffs for gas supplies to the "near abroad".

Table 1

### Major economic indicators of the post – crisis period (1999 – 2006)

	1999	2000	2001	2002	2003	2004	2005	2006*
1	2	3	4	5	6	7	8	9
<b>GDP</b> (as percentage of previous year)	106.4	110.0	105.1	104.7	107.3	107.2	106.4	106.7
<b>Index of industrial growth</b> (as percentage of previous year)	111.0	108.7	102.9	103.1	108.9	108.3	104.0	103.9
<b>Agricultural products of farms of all categories</b> (as percentage of previous year)	104.1	107.7	107.5	101.5	101.3	103.0	102.4	102.8
<b>Investments in fixed capital</b>								
	1	2	3	4	5	6	7	8
<i>Billion roubles</i>	670.4	1165.2	1504.7	1762.4	2186.4	2804.8	3534.0	4482.7
<i>as percentage of previous year</i>	105.3	117.4	110.0	102.6	112.5	110.9	110.5	113.5
<b>Foreign investments**</b> (billion USD)	9.6	11.0	14.3	19.8	29.7	40.5	53.7	55.1
including:								
<b>Direct investments</b>	4.3	4.4	4.0	4.0	6.8	9.4	13.1	13.7
<b>Portfolio investments</b>	0.031	0.145	0.451	0.472	0.401	0.333	0.453	3.182
<b>Other investments</b>	5.3	6.4	9.8	15.3	22.5	30.8	40.1	38.2
<b>Foreign trade turnover</b>								
<i>in billion USD</i>	115.1	149.9	155.6	168.3	212.0	280.6	368.9	468.4

<i>as percentage of previous year</i>	86.9	130.2	103.8	108.1	126.0	132.4	131.5	127.0
<b>export of commodities</b>								
<i>in billion USD</i>	75.6	105.0	101.9	107.3	135.9	183.2	245.3	304.5
<i>as percentage of previous year</i>	101.5	139.0	97.0	105.3	126.7	134.8	132.9	125.0
<b>import of commodities</b>								
<i>in billion USD</i>	39.5	44.9	53.8	61.0	76.1	97.4	125.3	163.8
<i>as percentage of previous year</i>	68.1	113.5	119.8	113.4	124.8	128.0	128.7	129.3
<b>Budget revenue (as percentage of GDP)</b>								
<i>consolidated budget</i>	25.2	28.5	29.3	32.1	31.1	32.3	36.1	35.5
<i>federal budget</i>	12.7	15.5	17.8	20.3	19.5	20.1	23.7	23.6
<b>Budget expenditure (as percentage of GDP)</b>								
<i>consolidated budget</i>	26.3	25.6	26.4	31.1	29.7	27.8	27.5	27.5
<i>federal budget</i>	14.0	13.1	14.8	18.9	17.8	15.8	16.3	16.1
<b>Budget surplus / deficit (-) (as percentage of GDP)</b>								
<i>consolidated budget</i>	-1.1	2.8	2.9	1.0	1.4	4.5	7.7	8.0
<i>federal budget</i>	-1.1	2.4	3.0	1.4	1.7	4.3	7.4	7.5
<b>Retail trade turnover (as percentage of previous year)</b>	94.2	109.0	111.0	109.3	108.8	113.3	112.8	113.0
<b>Consumer price index (as percentage of December of previous year)</b>	136.5	120.2	118.6	115.1	112.0	111.7	110.9	109.0
<b>Industrial producers' price index (as percentage of December of previous year)</b>	170.7	131.9	108.3	117.7	112.5	128.8	113.4	110.4
<b>Total number of unemployed, by end of period, million persons</b>	9.4	7.6	6.4	5.8	6.2	6.0	5.7	5.1
<b>Average money income per capita, per month (in roubles.)</b>	1658.9	2281.1	3062.0	3947.2	5170.4	6410.4	8023.2	9911
<b>Real available money incomes (as percentage of corresponding period of previous year)</b>	87.7	112.0	108.7	111.1	115.0	110.4	111.1	110.0
<b>International reserve assets (by end of period, billion USD)</b>	12.5	28.0	36.6	47.8	76.9	124.5	182.2	303.7
<b>Aggregate volume of resources in Stabilization Fund of Russian Federation</b>								
<i>billion roubles</i>						522.3	1 237.0	2346.9
<i>billion USD</i>						18.8	42.3	89.1

\*preliminary estimate

Source: Rosstat, RF Central Bank.

Table 2

## GDP dynamics in individual countries, in % by year

Countries	1999	2000	2001	2002	2003	2004	2005	2006
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	1	2	3	4	5	6	7	8	9
Austria		3.3	3.4	0.8	0.9	1.1	2.4	2	2.8
Azerbaijan		11.4	6.2	6.5	8.1	10.4	10.2	24.3	25.6
Armenia		3.3	6	9.6	13.2	13.9	10.1	13.9	7.5
Belarus		3.4	5.8	4.7	5	7	11.4	9.3	7
Belgium		3.1	3.7	1.2	1.5	0.9	2.4	1.5	2.7
Bulgaria		2.3	5.4	4.1	4.9	4.5	5.7	5.5	5.6
Bosnia and Herzegovina		9.5	5.4	4.3	5.3	4.4	6.2	5	5.5
Great Britain		3	3.8	2.4	2.1	2.7	3.3	1.9	2.7
Hungary		4.2	6	4.3	3.8	3.4	5.2	4.1	4.5
Germany		1.9	3.1	1.2	0	-0.2	1.2	0.9	2
Greece		3.4	4.5	5.1	3.8	4.8	4.7	3.7	3.7
Georgia		3	1.9	4.7	5.5	11.1	5.9	9.3	7.5
Denmark		2.6	3.5	0.7	0.5	0.7	1.9	3.2	2.7
Israel		2.9	8.7	-0.6	-0.9	1.5	4.8	5.2	4.1
India		6.9	5.3	4.1	4.3	7.2	8	8.5	8.3
Ireland		10.7	9.2	5.7	6	4.3	4.3	5.5	5.8
Island		4.3	4.1	3.8	-1	3	8.2	5.5	4
Spain		4.7	5	3.5	2.7	3	3.1	3.4	3.4
Italy		1.9	3.6	1.8	0.3	0	1.1	0	1.5
Kazakhstan		2.7	9.8	13.5	9.8	9.3	9.6	9.4	8.3
Canada		5.5	5.2	1.8	2.9	1.8	3.3	2.9	3.1
Cyprus		4.8	5	4.1	2.1	1.9	3.9	3.7	3.5
Kyrgyz Republic		3.7	5.4	5.3	0	7	7	-0.6	5
China		7.1	8.4	8.3	9.1	10	10.1	10.2	10
Korea		9.5	8.5	3.8	7	3.1	4.7	4	5
Latvia		4.7	6.9	8	6.5	7.2	8.6	10.2	11
Lithuania		-1.7	4.7	6.4	6.8	10.5	7	7.5	6.8
Luxemburg		8.4	8.4	2.5	3.6	2	4.2	4	4
Moldova		-3.4	2.1	6.1	7.8	6.6	7.4	7.1	3
Norway		2.1	2.8	2.7	1.1	1.1	3.1	2.3	2.4
Poland		4.5	4.2	1.1	1.4	3.8	5.3	3.4	5
Portugal		3.9	3.9	2	0.8	-1.1	1.2	0.4	1.2
Russia		6.4	10	5.1	4.7	7.3	7.2	6.4	6.7
Romania		-1.2	2.1	5.7	5.1	5.2	8.4	4.1	5.5
Swaziland		3.5	2.6	1.6	2.9	2.4	2.1	1.9	1.2
Serbia		-1.8	5.2	5.1	4.5	2.4	9.3	6.3	5.5
Slovakia		1.5	2	3.2	4.1	4.2	5.4	6.1	6.5
Slovenia		5.4	4.1	2.7	3.5	2.7	4.2	3.9	4.2
USA		4.4	3.7	0.8	1.6	2.5	3.9	3.2	3.4
Tajikistan		3.7	8.3	10.2	9.1	10.2	10.6	6.7	8
Turkmenistan		16.5	18.6	20.4	15.8	17.1	14.7	9.6	9
Turkey		-4.7	7.4	-7.5	7.9	5.8	8.9	7.4	5
Uzbekistan		4.3	3.8	4.2	4	4.2	7.7	7	7.2
Ukraine		-0.2	5.9	9.2	5.2	9.6	12.1	2.6	5



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Finland	3.9	5	2.6	1.6	1.8	3.5	2.9	3.5
1	2	3	4	5	6	7	8	9
France	3	4	1.8	1.1	1.1	2	1.2	2.4
Croatia	-0.9	2.9	4.4	5.6	5.3	3.8	4.3	4.6
Czech Republic	1.3	3.6	2.5	1.9	3.6	4.2	6.1	6
Chile	-0.8	4.5	3.4	2.2	3.9	6.2	6.3	5.2
Switzerland	1.3	3.6	1	0.3	-0.3	2.1	1.9	3
Sweden	4.5	4.3	1.1	2	1.7	3.7	2.7	4
Estonia	0.3	7.9	6.5	7.2	6.7	7.8	9.8	9.5
Japan	-0.2	2.9	0.4	0.1	1.8	2.3	2.6	2.7

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Source: International Monetary Fund, World Economic Outlook Database.

### 1.1.2. Problems of economic growth

The issues of economic growth remained among the leading ones in the economic – political discussions of 2006. However, the debates on these issues have undergone a certain transformation.

What we see now is an apparent de-politicization of the issue: owing to the fact that none of the principal (or alternative) models has been chosen by the top officials to be the universal one for public use, the adoption of decisions on concrete measures within the framework of these models and the discussion of their justifiability have shifted to individual interested agencies and their branches. At the same time, the issue of “doubling the GDP” is slipping off to the periphery of the discussion, and although it has not been discarded officially, the political elite is certainly becoming disinterested in the matter. This development can only be welcomed, because any fetishism with regard to quantitative indices can only destimulate real growth accompanied by structural reforms.

#### The models of growth and the attitude to industrial policy

In recent years, there emerged four major approaches to economic growth consolidation – the dirigiste (on the basis of state investments), the “chibanistic” (through the active development of financial and industrial groups), the consistently liberal (advocating a dramatic diminishment in the burden imposed on the economy by budget and regulation), and the institutional (through the formation of a modern institutional environment, approximated to its western analogues)<sup>4</sup>.

The obvious completion, in 2006, of the active discussion between the proponents of each of these models resulted in no approach gaining the upper hand became. The economic policy being pursued in Russia contains elements of all four

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<sup>4</sup> See Mau, V. *Ekonomiko – politicheskie itogi 2002 g. i osobennosti ekonomicheskoi politiki v preddverii vyborov* (The economic and political results of the year 2002 and the peculiarities of economic policy on the eve of the election) / Rossiiskaia ekonomika v 2002 g.: Tendentsii i perspektivy (The Russian economy in the year 2002: Trends and prospects). Vyp. 24. Moscow: IEPP. 2003.

approaches toward the consolidation of economic growth. The regulatory and investment activity of the State is on the rise. Financial and industrial groups, especially those under state control, are becoming stronger, and the typically Russian feature is their being controlled by the State not only *de facto* (as in the case of South – Korean *chibans*), but also formally, because the controlling blocks of shares in the leading financial and industrial groups are either already owned by the State or moving in this direction. At the same time, the task of reducing the budget's share in GDP remains a part of the official policy. Although in the past two years this indicator has been growing, the three-year budget planning is oriented to reducing it in the medium term. And finally, the core of the Government's policy is undoubtedly the formation and strengthening of the institutions typical of modern market democracies.

In other words, at the present time the cornerstones of state policy are as follows:

- macroeconomic and political stability;
- the development of modern market institutions;
- an active participation of the State in the organization of economic life.

However, the question of just how stable such an economic and political configuration can be, remains open. Naturally, it will be stable as long as the external economic situation is making it possible to combine macroeconomic stability with state interference. This situation can last for a long time, but not forever. And the choice will finally have to be made of the sequence in the preferential treatment of each or some of the models of growth.

In 2006, the stimulation of industrial growth was one of the most crucial issues in government discussions. Prime Minister M. Fradkov even put forth a proposal that a special government commission for dealing with the issues of industrial policy should be created. The characteristic feature of this discussion was that it was related not to the decline in the rate of growth but to the dissatisfaction with the growth being produced primarily by the sectors of trade and services, and not by the operation of high – tech companies.

However, the accelerated development of the services sector is a justified response to the structural heritage of the Soviet economy; moreover, it can be conjoined with the development of high technologies. Thus, the purchases of information technologies (IT) by big Russian trading organizations are comparable to the expenses on IT in the oil and gas sector<sup>5</sup>. It should also be borne in mind that in the USA the retail trade leaders have accounted for approximately 50 % of the US advantage over Europe in the rise in productivity over the past 10 years (another 25 % is accounted for by a similar progress achieved by wholesale chains of supply)<sup>6</sup>.

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<sup>5</sup> See *CNews Analytics*, 2006.

<sup>6</sup> K. Rogoff, Wall-to-Wall Wal-Mart? ( <http://www.project-syndicate.org/commentary/rogoff15> )

The issue of industrial policy has been periodically arising in political discussion throughout the fifteen years of post – communist development. Whenever the case in point was industrial policy, it was understood, as a rule, as the determination of priority sectors and industries by the State, and the various form of support to them, mainly through financial injections from the budget. Such an industrial policy has featured in a number of developed countries, so Russia is not unique in this respect. It has its roots in the industrial past, in the epoch when large industrial firms were the leaders, and when it was possible to define, with a sufficient degree of precision, the most promising sectors and industries. In the industrial epoch it was possible to define the long – term prospects of growth in each industry, to concentrate financial (budget) resources thereon, and to achieve some specified goals. That was precisely how the Soviet Union pursued its industrialization, but similar (although not so ruthless) instruments were applied in the western world as well.

In the 1990s, the majority of recommendations concerned with industrial policy were based on precisely such logic. And it is this logic that was causing the aversion of liberal critics, who insisted on the impossibility and inadmissibility of the logic of industrialization being used in the contemporary epoch. The high rate of the transformation of needs and the potential for their satisfaction, coupled with the rapid pace of technological innovation, have sharply reduced the predictability of industrial production. It is now becoming impossible – and irresponsible – to determine the long – term priorities as a basis for taking large – scale budgeting decisions. This impossibility is further emphasized by the problems faced by the post – communist Russia, where the weakness of political institutions could well conduce to “political entrepreneurship” rather than to the advent of State – guided innovation.

However, in recent years the perception of industrial policy issues has, apparently, entered a new phase, which testifies to a certain growth in the maturity of the Russian political elite.

*Firstly*, the President has formulated the national priorities, and labeling as such human development, and not certain branches of industry. The emphasis placed on education, public health care, living conditions, and human reproduction as such (the falling birthrate problem) has been manifest of a step of fundamental importance in overcoming the logic of industrialism and the Soviet understanding of economic problems in general, and in recognizing the realities of the post – industrial epoch.

*Secondly*, the quantitative benchmarks of growth (the demand to “double the GDP”) have been steadily losing ground to the realization of the importance to ensure the quality of growth, and especially that of its innovative base – the theme of innovation is becoming one of the central issues, when the tasks and mechanisms of economic policy are being discussed. In 2006, the dissatisfaction with the slow pace of proliferation of high technologies was expressed in the already mentioned discussions.

The latter criticism was aimed both at the structure of industrial and individual consumption, and at the structure of production, and in particular, that of exports. Thus, the share of high – tech exports in the total volume of exports does not exceed 4 %, which is far below the same index of developed countries, and even of China (by more than 25 %).<sup>7</sup>.

In other words, last year has provided sufficient examples of the growing awareness that modern industrial policy, in order to be authentically modern and effective, should become considerably different from what was understood as such throughout the major part of the 20<sup>th</sup> century. Nowadays it has to do, for the most part, with the formation of a system of incentives for the development of different industrial sectors, without any rigid establishment of their priorities.

The key industrial policy instruments used by the Russian Government are as follows: private – public partnership, the exchange rate policy (aimed at restraining the rouble's strengthening), the regulation of customs tariffs, technical regulation, support for the export of processed products export, and some other forms.

#### Institutions of development

An important role in stimulating economic growth should be played by the special economic zones, the Investment Fund, the Russian Investment Fund for Information and Communication Technologies, the Venture Fund (the Russian Venture Company), the Agency for Mortgage Crediting of Housing Construction (AMCHC), and the Corporation (or Bank) for Development. Last year saw the beginning of the practical realization of the first three instruments. The AMCHC has already been in existence for a number of years. The authorities have initiated an active scrutiny of the problems of venture financing and the Bank for Development.

A number of *special economic zones* (SEZ) - two industrial production zones (in Lipetsk Oblast and Tatarstan) and four technical - development zones (in Dubna, Zelenograd, St Petersburg and Tomsk) were created in 2006. It is yet too early to offer any comments as to their practical effectiveness. At the present time, the process of developing the zones' infrastructure is under way, and negotiations are being held with potential candidates for obtaining the status of residents. Although there are plenty of applicants eager to launch their production in the SEZs, no "break – through" projects backed by strong investment or involving unique technologies have surfaced so far. And it is not surprising: on the one hand, the Russian SEZs do not offer any significant tax preferences, and on the other it will take some time to develop the infrastructure. Also, there has emerged a problem that should have been taken into consideration when developing this mechanism for stimulating investment – it is advisable that the producers of exports should be attracted into the SEZs, with no distur-

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<sup>7</sup> See *Tsentr razvitiia. Obozrenie rossiiskoi ekonomiki (za period s 12 po 25 dekabria 2006 g.)* (The center of development. A review of the Russian economy (for the period from 12 to 25 December 2006)).

tions of the conditions for domestic competition being permitted. But so far, under the influence of the inertia produced by a decade of crisis, most of the zones are oriented to manufacturing import – substituting products.

In 2006, the amendments to the existing law introducing special economic zones of the tourist and recreational type (SEZ – TRT) were adopted. It is significant that these zones offer practically no tax benefits, while the incentives aimed at increasing its attractiveness have been changed so as to promote state investments in the infrastructure (industrial, communal, and transport); at the same time, federal investments must be combined with those funded from regional and municipal budgets. In fact, the choice made by the Federal Government in favor of SEZ – TRT is akin to the selection of projects financed from the Investment Fund: the State adopts the responsibility to finance the infrastructural costs which conduce not only to the development of this type of business but also create additional incentives in order to boost the economy of a corresponding region. This makes the SEZ – TRT regime more attractive to the Federation's subjects who thus acquire an additional resource for developing the areas with potential advantages for developing tourism. The winners in the recent contest were Irkutsk Oblast and Buriatia, Altai Krai and the Republic of Altai, Krasnodar Krai, Stavropol Krai, and Kaliningrad Oblast.

It is worth mentioning that, at present, Kaliningrad Oblast has two SEZ regimes operating in its territory: in 2006, the general Law "On the Special Economic Zone in Kaliningrad Oblast" entered into force, and at the same time it became possible for the Oblast to develop some sections of the Baltic coast under the SEZ – TRT regime. The above-mentioned general law has resulted from the year-long discussion concerning the advisability of introducing a special economic regime in this oblast. The new law has replaced the special regime introduced in 1996, which was based on customs privileges being granted to the import of consumer and capital goods into the region. Undoubtedly, the old mechanism, though mainly successful in stimulating the import of goods and the assembly of imported goods from parts for their subsequent realization in the main territory of Russia, did manage to play a certain positive role in the adaptation of the formerly closed militarized region to market conditions. The new Federal Law, which entered into force from 1 April 2006, mainly stimulates investment activity by granting considerable privileges to those entrepreneurs who are willing to establish new enterprises in the region. The adoption of the Law has already resulted in an upsurge of investment activity in Kaliningrad Oblast.

In 2006, the *Investment Fund* also began functioning. From the very beginning, it was planned that it should be formed within the framework of the federal budget in a situation when the prices of fuel and energy resources were high. In essence, it is the money which otherwise would have been transferred into the Stabilization Fund. Given the enormous pressure being applied to the financial bodies so as to force them to spend the petrodollars on the development of the "national economy", the Government has agreed to a compromise solution by allocating a part of the funds to state investments. Naturally, this decision has somewhat increased the vulnerability of the Russian economy should the oil prices

change unfavorably, but would not be fatal if two conditions are observed. Firstly, the size of the Investment Fund should remain moderate in relation to that of the Stabilization Fund, and secondly, the resources of the Stabilization Fund should be spent really efficiently, that is, the spending should result in a rise in labor productivity and in positive structural changes (a diminished dependence on raw materials) in the Russian economy. Nevertheless, it should be taken into account that if the oil prices plummet, the resources of the Stabilization Fund should be primarily allocated to the fulfillment of the obligations assumed within the framework of investment projects, and only after this has been done – to the compensating for the reduction in other budget expenditures.

It is planned that the afore – said state support should be used when implementing the projects aimed at developing the infrastructure of national importance, and also in order to create and develop certain elements of the Russian innovation system, as well as to ensure the realization of institutional reforms. Under present conditions, the latter component (institutional innovation) is especially important, for this innovation is a key factor of the dynamic development of both the infrastructure and the innovations.

In 2006, the selection of projects to be financed from the *Investment Fund* was started. The actual decisions were to be made by the Government Commission for Investment Project of National Importance having the final say. The majority of applications submitted in 2006 were concerned with the transport sector. Preference was given to those objects of infrastructure that were of crucial importance for the development of regions or to the major production clusters associated with this infrastructure. The objects of the federal infrastructure that are being created at the expense of the Investment Fund stimulate large – scale investments on the part of the private sector. In 2006, the volume of the Investment Fund amounted to approximately 70 billion roubles, while the long – term financial plan envisages its increase to 378 billion roubles in the years 2007 – 09.

On the whole, the selected projects can be subdivided into two categories: first, the transport projects designed to eliminate the infrastructural limitations that impede the development of the economy and to increase the mobility of the population; and second, the projects aimed at the industrial development of the country's territories and of new mineral deposits. Among the selected projects the following ones are especially worth mentioning: the construction of the “Western High – Speed Diameter” and of a tunnel under the River Neva in St. Petersburg, and a section of the speedway from Moscow to St Petersburg; the largest project in the sphere of infrastructure - the complex development of the Lower Angara region in Krasnoyarsk Krai, related to the formation of the biggest production cluster in Eastern Siberia; the creation of a transport infrastructure in Chita Oblast and Krasnodar Krai; and a number of other objects. The share of federal co-financing in such projects varies between 13 % and 60 %, and, as a rule, the larger the project, the smaller is the share of public finances.

The already supported projects have by no means exhausted the resources consolidated to the Investment Fund by the 2006 budget. The emerging situation inspires certain optimism because it is indicative of a cautious approach being taken toward spending budget resources on investment projects, and of the growing understanding of the extreme vulnerability of state investments to inefficient and even corrupt decisions<sup>8</sup>.

In 2006, it was also decided to form the *Venture Investment Fund*. It is planned that this instrument would play a key role in stimulating innovation activity and in promoting high – tech manufacturing in industry. In order to increase the investors' interest in the innovation sector, it is planned to decrease their risks and increase the profitability of venture investments by means of some state participation in private venture funds.

In 2006 – 07, the authorized capital of the Venture Fund should be financed by the Investment Fund in the amount of approximately 15 billion roubles. It is suggested that the resources of the Venture Fund, among other things (and first of all), should be spent on the development of nanotechnologies, on increasing the capital of the financial institutions specializing in leasing, and on crediting and insuring contracts for the acquisition of state-of-the art technologies.

Finally, in late 2006, the issue of the *RF Bank (or Corporation) for Development*, which should start functioning by the end of 2007, was submitted to the Government for consideration. According to G. Gref, the formation of the institutions of development in Russia should be completed with the creation of this establishment. In the opinion of many participants in the discussion, such an institution, provided that it is completely materialized, would essentially substitute the government, and could begin playing the role of a parallel budget. This development would be rather dangerous, because the State must spend its resources in accordance with a uniform and transparent procedure. The emergence of alternative budgets, though capable of performing the short – term tasks of spurring up investment, practically always results in diminishing its efficiency and, ultimately, in stagnation (or even a crisis).

The administrative and political (and not commercial) nature of this institution originates from the fact that the Bank for Development, by its organizational and legal form, is deemed to be a not – for – profit organization, which is not oriented to the extraction of profit. Thus, it is suggested that this ‘bank’ should subsidize individual projects (or even sectors). However, the possibility of making productive and responsible decisions is therefore open to question. This institution should orientate itself, instead of profitless projects (or instead of being literally subsidized), to the projects with a long pay-

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<sup>8</sup> The problem of the inefficiency and vulnerability of state investment projects to corruption is not limited to Russia alone, or to developing economies. For the problems faced in this sphere, see Flyvbjerg, B. *Strategicheskaiia otsenka planirovaniia krupnykh infrastrukturykh proektov (Strategic valuation of policy and planning for large infrastructure projects)* // Ekonomicheskaiia politika (Economic policy). 2006. № 1.

back period, which are not attractive to ordinary banks. Even if the abovesaid criterion is adopted, the selection of projects, as well as the very prospects of such an institution, would give rise to many questions.

Apart from creating special institutions of development, the Government was actively engaged in studying the prospects for the development of individual branches of industry, believed to be of priority importance for the development of national economy. The debate was concentrated on the issues of development of the motor and aviation industries, new technologies, etc. The Government has approved the program for the development of nanotechnologies, the program "National Technological Base" for the years 2007 -11, and other similar programs. Thus, the tendency toward using the traditional dirigiste approaches to economic policy was manifesting itself more and more openly. However, it should be admitted that this tendency has so far been limited to the political and organizational – and – administrative (the consolidation of assets) spheres without significantly influencing the realm of budgeting.

The formation of the institutions of development is a policy which can be quite understandable in a State with high revenues. However, this policy has two very significant limitations.

First, financial decisions, being the simplest and most apparent ones, can deflect attention from the necessity to solve other (and, perhaps, deeper rooted) problems of consolidating economic growth. In recent time, such limitations of modern growth as the lack of high – performance equipment, the rising competition with imports, the backward structure of exports and, most importantly, the deficit of skilled labor force, have become increasingly apparent. These issues are much more important than the support for individual sectors and enterprises, and they require foremost attention on the part of the authorities.

Secondly, there exists the issue of whether it can be in principle possible to solve the problems of post – industrial growth by bearing on the institutions which, for the most part, have been devised at the previous stage of the socio – economic development of both this country and the world. Are the institutions of development authentically modern, that is, do they adequately match the challenges of the post – industrial epoch? Only time will give answer. So far, we can only note that under certain circumstances, the use of traditional institutions for performing the new tasks of modernization is possible in principle. However, this can always be achieved at a price which can be too high in a medium – term perspective. To bear upon the old institutions means promoting the rigidity of the social system and decreasing its adaptability necessary for adequately responding to the new rapidly changing challenges. All the history of Russia in the 20<sup>th</sup> century, be it the crisis of capitalist modernization at the beginning of the century or the crisis of the Soviet system, bears witness to this.



### Some issues of investment activity

Under conditions of transition to the investment growth model it is crucial to demonstrate the State's attitude to private investors, including foreign ones. Any assessments with regard to this issue cannot be unequivocal and straightforward. It by no means always happens so that everything which seems advisable or, on the contrary, undesirable in accordance with the logic of developed market democracies should inevitably produce an unambiguously positive or negative result. To a certain extent, the high profitability of investments compensates for the "unconventionality" of the attitude toward the investors, and therefore the activity of foreign business could be relatively energetic in situations which can be characterized as unfavorable when judged by the standards of developed democracies. This is especially true with respect of foreign capital which feels itself relatively more politically protected than domestic business.

Usually, the presence of attractive assets, combined with the predictability of the actions of the authorities, creates sufficiently favorable conditions for the investment activity of businesses, including foreign ones. This effect is becoming especially pronounced against the background of the continuing decline of Russia's ratings in terms of state administration efficiency, corruption, compatibility, etc - and the simultaneous improvement of its international credit ratings.

Last year, one of the major indicators of the relations between the Russian authorities and foreign investors was the course of events regarding the project "Sakhalin - 2", which was being developed under a production sharing agreement (PSA). From the point of view of the events of the past three years, nothing new has happened: the State in the person of "Gazprom" has taken the development of a promising oil deposit under its control by buying out the controlling block of shares from private investors. In other words, the "Sibneft" model, rather than the "Yukos" one, was used, which was positive from the point of view of internal - policy logic and even was not harmful to the investors. However, this model is favorable only by the logic of relations between the State and domestic businesses. But whether this model can satisfy foreign investors will be seen only in the year 2007.

For now, it is possible to make a preliminary assumption that the situation with "Sakhalin - 2" is unlikely to produce any significant negative impact on the activity of foreign business in the part of direct investment. Firstly, the actions of the authorities in this case were quite predictable and relatively restrained (the foreigners were granted their compensation). Secondly, the activity of foreign capital is gradually shifting from the fuel and energy sector to the sectors which the Government is not planning to place under its control; this trend clearly answers the interests of the national economy's development. Thirdly, the questionable efficiency of the production sharing agreements concluded in the mid - 1990s was always sufficiently clear.

At one time, the PSAs were seen as a mechanism for attracting foreign capital into those sectors which, in a country with an unfavorable investment climate (both politically and economically), required considerable investments. The ineffi-

ciency of the tax system required that the tax regimes granted to the projects urgently in need of large investments should be individualized, while the serious political risks necessitated the withdrawal of these investments from national jurisdiction. That was how the PSA projects of the mid – 1990s came into being: special tax regimes were established for them and the resolution of disputes concerning these projects was placed under the jurisdiction of the Stockholm Court.

After the achievement of political stabilization and a considerable improvement of the tax system, the production sharing agreements, in fact, became senseless. At the same time, the serious systemic problems of the PSA regime had fully revealed themselves.

Firstly, in conditions of weak state authority the PSA regime, with its implications of haggling for an individual tax treatment, gives rise to corruption. Secondly, the regime provokes a conflict of interests between the tiers of state power – in the adopted PSA model, what is profitable for subjects of the Federation turns out to be detrimental to the federal budget. Thirdly, the adopted model stimulates the investor to blow up the costs, because they are subtracted before the production is shared (moreover, the agreements initially did not even set the upper margin of costs to be subtracted). As a result, the PSA regime of the mid – 1990s type could only make the authorities, whose position had become much stronger, feel serious doubts as to its feasibility.

However, the comprehension of the dubious nature of the PSA regime only adds to the basic impossibility of practicing this model even in conditions of an underdeveloped democracy. The regime can actually become possible only in two cases: either when state authority is extremely feeble, and a special treatment could be “bought”, or in conditions of an authoritarian rule, when it is sufficient to obtain (or buy) patronage of the highest – ranking person. Under conditions of any relatively mature democratic system such a situation would be practically impossible.

When summarizing the results of the discussion on the issues of the stimulation of economic growth, it is necessary to make one general note. Despite all the importance of the specific issues of ensuring economic growth which were on the agenda of last year’s discussion, institutional and structural reforms will remain of principal importance in the foreseeable future. They, actually, should top the list of the first – priority measures designed to consolidate economic growth and to endow it with a stable and authentic dynamic. At present, this would be especially important because the readily accessible factors of growth are nearly exhausted (the idle facilities, the unused labor resources), and in the medium – term perspective it is the new investments that will become the main source of growth.

The areas where efforts must be intensified are as follows: the protection of property rights (which is the aim of administrative and judicial reforms), reform of natural monopolies, reform of the public health care service, the transformation of the pension system, and reform of the housing and utilities sector. The development and implementation of reform in these areas of socio – economic policy is a much more difficult intellectual task than the creation of the “institutions

of development". The institutional reforms of the institutions of power (related to state administration and the judicial system), and of the institutions of development of human capital (education, public health care, the pension system) are concerned with the realities of the post – industrial epoch. Their state-of-the-art high-performance models are to be devised anew because they cannot bear upon the accumulated experience of functioning under conditions of industrial systems. But no institutions of development would be capable of producing a stable long – term effect, unless a thorough institutional renovation of these sectors is carried out.

### *1.1.3. Financial stability and the Stabilization Fund*

In 2006, the financial stability of the country, on the one hand, was formally strengthening: there was a significant growth of resources accumulated in the Stabilization Fund, and of the gold and foreign currency reserves of the Central Bank. On the other hand, the level of budget expenditure, in real terms, was also rising, which increased the vulnerability of the Russian economy to the market fluctuation of oil prices. Last year, the oil – and – gas deficit of the federal budget (calculated as a difference between the revenues not depending on oil and gas and the expenditures) amounted to more than 5 % of GDP. This resulted from the decrease of taxes and the growth of budget expenditures. In fact, the financing of this deficit is carried out at the expense of the revenues depending on the export of fuel and energy resources and also on borrowing and the proceeds from privatization.

Any further weakening of budgeting policy in favor of growth in wages, current expenditures and tax reduction is unlikely to become a source of economic growth acceleration. These expenditures could result in a dangerous strengthening of the rouble exchange rate in real terms and could contribute to the worsening of the structure of the Russian economy, especially against the background of a slowdown in structural reforms. In fact, the case in point is the danger for the country to be caught once again in this structural trap, into which the USSR once had been led to by the thoughtless policy of boosting its budget expenditures in the 1970s, which resulted in the disintegration of the country when oil prices collapsed.

The necessity to be cautious in budgeting policy becomes especially urgent if one remembers that over the past 35 years the price of oil has been fluctuating in the range from 8 to 96 USD per barrel (in the 2003 dollars). Also, it should be taken into account that no responsible expert would be able to plot a more or less reliable trend, thus making it possible to forecast the dynamic of oil prices.

Political practice indicates that the Stabilization Fund is a factor of economic destabilization in its own right. The presence of considerable financial resources constantly urges the elite to search for the areas where these resources could be

spent in order to achieve its own political aims. And it is very difficult, if not impossible, to resist this pressure<sup>9</sup>. The criticism aimed at the Stabilization Fund is two – fold. For one thing, it is affirmed that the resources of the Stabilization Fund are inefficiently managed, that is, they do not yield any considerable income, while in the political sense they are used in order to strengthen the economies of foreign states (in whose securities they are placed). For another, the ever increasing number of areas where this money could be spent is being suggested time and again – from social and infrastructure projects (the worst scenario) to the lowering of taxes (a softer variant).

The debate on this problem is very complicated because, within its framework, the Ministry of Finance has to present some weighty technical arguments in response to the political demands put forth by the opponents to the current course. But any dialogue between the parties that use arguments belonging to different systems of coordinates is impossible in principle. Moreover, for the problem of managing the resources of the Stabilization Fund is indeed a most difficult one. Profitability must be combined with high liquidity, which can be ensured only when absolutely reliable and low – yield financial instruments are used. But these instruments are the securities of the most developed western countries, which gives rise to a political counter – argument that such a policy is “not patriotic” (it would be “patriotic” to invest money in high – yield domestic securities and to lose it exactly at the time when a crisis situation develops and these resources are most urgently needed by the budget).

Initially, the resources of the Stabilization Fund were being spent on repaying external debts. As a result, in 2005 the debt to the International Monetary Fund was repaid in full and before schedule, and in June 2006 Russia completely repaid its debt to the Paris Club. Therefore, Russia’s external debt fell last year to 5 % of GDP - a figure unprecedented in modern developed countries. The policy of repaying this debt ahead of schedule has made it possible to slow down the nominal growth of the Stabilization Fund and to explain, to the opponents, the importance of a further accumulation of its resources. After having repaid the debts, it became necessary to find new arguments in favor of preventing the excessive funds to be injected into the economy because of the danger of serious negative macroeconomic and structural effects.

Last year, President V. Putin also joined the discussion concerning the Stabilization Fund. His arguments and proposals are to the effect that it would be inadmissible to spend the resources of the Fund on resolving any day – to – day problems. But it is likely that even the President cannot afford to impose a direct veto on the spending of these resources. His proposals are two – fold. On the one hand, it is suggested that “in 2007 and in the medium term the growth of the ex-

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<sup>9</sup> It seems that the most radical approach to solving this problem in a similar situation was found in Ancient Athens. After the Peloponnesian War (431 – 404 B.C.), the Athenians formed a reserve fund and took a decision that “he who, except in an event of the state of emergency, proposes to tap the reserve of 5000 talents kept in the Temple of Athena should be sentenced to death” (Van Kreweld, M. *Rastsvet i upadok gosudarstva (The rise and decline of the State)*. Moscow: IRISEN. 2006. P. 50.

penditures of the federal budget fixed as a percentage of GDP ... should be effectuated at a rate which would be adequate to the rate of growth of the economy”<sup>10</sup>. It is clear that this would mean abstaining from such a use of the Stabilization Fund’s resources that could imply a higher rate of growth on the expenditure side.

On the other hand, the President has proposed “to draw a clear distinction between the means being reserved in the Stabilization Fund, in order to minimize the negative consequences of a decline in oil prices (the reserve part) and the resources being formed in excess of this volume (“the future generations’ fund”). It is advisable that the volume of the reserve part should be set as a percentage of GDP”<sup>11</sup>. This proposal makes it possible to distract the attention of political and other lobbyists from the ongoing sharing out of petrodollars and to reorient the discussion toward long – term issues.

While elaborating these issues throughout the past year, the RF Ministry of Finance persistently emphasized the necessity to continue the policy of accumulating in the Stabilization Fund the market – dependent revenues of the budget. In this connection it is planned to subdivide the Stabilization Fund into two parts, the reserve fund and the future generations’ fund<sup>12</sup>. It is planned to increase the receipts of the Stabilization Fund not only by the proceeds from oil export, but also by those from the export of other raw materials (that is, also market-related) – first of all, from the export of natural gas (and, possibly, metals). Such an approach can be characterized as justified because it clearly demonstrates the state of the budget, the degree of efficiency of the economy and its capability to generate real and not only market – dependent revenues.

The existence of a reserve part of the Stabilization Fund is an issue readily understandable from a practical point of view, but it is not the most important one. A fall in revenues from oil and gas cannot be continually compensated for by the reserve resources of the budget. In the event of any worsening of market situation, the Government should have at hand a sensible set of measures (in the sphere of budgeting, monetary, tax, etc. policy), aimed at adapting the economy to a new situation. The resources of the Stabilization Fund will be able to play a certain limited role in relatively softening the process of adaptation, and practically in nothing else. As far as the day – to – day budgeting issues are concerned, the issue of using the resources of the Stabilization Fund for covering current budget expenditures can emerge as soon as 2007 if the trend of oil prices falling below 60 USD per barrel, which emerged in late 2006 – early 2007, should persist.

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<sup>10</sup> Putin, V. *Biudzhethnoe poslanie Federal’nomu Sobraniyu “O biudzhethnoi politike v 2007 godu”* (The budget message to the Federal Assembly “On budgeting policy in the year 2007”).

<sup>11</sup> *Ibid.*

<sup>12</sup> *Osnovnye rezul’taty i napravleniia biudzhethnoi politiki v 2007 godu i srednesrochnoi perspective*. (The major results and directions of budgeting policy in the year 2007 and in the medium – term perspective). Moscow: Minfin Rossii (the Ministry of Finance of Russia). 2006. Pp. 5, 42.

By contrast, the issue of “the future generations’ fund” will certainly become the subject of a most serious discussion. This fund should not be considered as some untouchable and continually growing stock, which our clever descendants will put to a better use than that which our contemporaries can think of. The waiting for the “clever descendants” to come usually finishes with all the funds being spent (or stolen) during the lifespan of a current generation. And it is equally pointless to expect the exhaustion of natural resources because the exhaustion is not so much a physical phenomenon as an economic one (the irrationality of developing natural resources at a given price level) and a technological one (the emergence of alternative resources and a fall in demand for traditional resources).

Possibly, the most efficient way of using some of the resources of the Stabilization Fund as a future generations’ fund is to spend it on the refinancing of the pension system in the future, that is, to compensate for the lack of resources in the future system of pensioning. A decision of this kind would considerably hamper these resources being spent on populist goals at the present time and would confer political concreteness (and sensibility) to the withdrawal of market – dependent superprofits from current circulation.

#### 1.1.4. State institutions and socio – economic development

The *speed* of socio – economic development is predominantly determined by the possibility to keep the political “window of opportunity” open in the long run<sup>13</sup>, in order to be able to introduce necessary adjustments into state policy, while the *results* of this development are determined by the possibility to guarantee the quality of state policy and by the long – term applicability of regulatory decisions, or, in other words, by the rejection of populism. Apparently, all this depends on the degree of development of state and social institutions.

The openness of the political “window of opportunity” implies the strengthening of the institutions which could make it possible to ensure the correspondence between the problems appreciated by society, the political agenda of the dominant political forces, and the existence of alternatives put forth by the community of experts. The lack of anything from this list would result in political stagnation and in the aggravation of the problems either unattended to or ignored by experts and politicians. At present, the major instrument which could be used in this sphere by the State is administrative reform as the method for improving the quality of state administration, including such components as transparency<sup>14</sup>, accountability, and the participation of citizens in decision - making<sup>15</sup>.

<sup>13</sup> See *John W. Kingdon, Agendas, Alternatives, and Public Policies* (NY: Longman, 2002).

<sup>14</sup> In 2004, the 40<sup>th</sup> place out of 48 in the non – transparency index of the Kutzman Group.

<sup>15</sup> According to the World Bank, only 25 % of countries had worse results by this indicator in the year 2005.

The year 2006 was not marked by any significant progress in these areas. Thus, the Draft Federal Law “On Ensuring the Access of Citizens and Organizations to the Information on the Activity of State Agencies and Bodies of Local Self–Government”, prepared by the Ministry of Economic Development and Trade as early as 2004, was submitted to the Government only in December 2006. The delay was caused by the long wait for the Federal Law “On Information, Informatization, and the Protection of Information” to be adopted. Another draft federal law, “On Ensuring the Right of Citizens and Organizations to Obtain Information on the Judicial Activity of the Courts of General Jurisdiction in the Russian Federation” is waiting to be submitted to the State Duma.

This situation was not changed by the contest involving the federal agencies of executive authority and the supreme executive agencies of state authority of the subjects of the Russian Federation, which was held in 2006 for the purpose of providing support for the implementation of administrative reform in the year 2006: most of the funds were allocated not to the rationalization of administrative processes but to the sprucing – up of the various offices and bureaus. Although it was done for the undisputed benefit of the citizens, the whole initiative could be seen not as an example of an administrative reform being implemented but rather as an example of state purchases for logistic needs.

The continuous openness of the “window of opportunity” can be guaranteed only by the possibility to continuously adjust economic policy, but not by the quality thereof. It depends, first of all, on the role and position of the community of experts. However, the rendering of an authentic expert opinion suggests that the experts are sufficiently independent of the State, whereas this independence is still being undermined by the high budget expenditures on scientific research in the sphere of state policy (in 2006, 48.9 billion roubles was earmarked for research in the sphere of national economy and issues of national importance alone), which, in Russia, have approached the level of expenditures on one of the branches of power, the judiciary (59.9 billion roubles). It is apparent that in such a situation the “expert” capabilities of political parties are incomparable to the capabilities of the executive authorities which the parties and Parliament are expected to control.

#### *1.1.5. Political processes and the economy*

Last year, the ongoing political processes were demonstrating a degree of stability quite natural in a situation characterized by the presence of a popular president and a stable party majority in Parliament. Draft laws were passed quickly and with no difficulties, and the effect of the failures suffered in the course of the monetization of benefits was gradually weakening.

The pre – electoral character of the year 2006, by definition, suggested a certain turn to populism. However, in the concrete situation of contemporary Russia it is unlikely that the scope of such developments will be large. The stability of the political system and the fact that political processes are effectively controlled by the ruling elite make populism practically

unnecessary. Moreover, in order to limit the influence of electoral campaigning on the budgetary process, V. Putin has proposed that the Government and the Federal Assembly should adopt the Law on the 2008 Budget as early as the first half-year of 2007.

Of course, in the years 2006 and 2007 there was a certain boosting of the budget expenditures not fixed as a percentage of GDP (by almost 25 % per annum in nominal terms). However, it can be expected that the authorities would somewhat reduce their budgeting activity and return, unless something unexpected happens, to the conservative course after the elections are over. Fluctuations of this kind are well known to researchers of the political business – cycle as comprising the “non – party” or “opportunistic” model (the strengthening of budgetary populism before the elections and the conservative consolidation in the post – electoral period – whatever the ideological orientation characterizes the party at power might be)<sup>16</sup>.

Quite another matter is the populism related to the deceleration of the reform process. It will greatly reduce the opportunities for implementing institutional reforms, but the objective need for them will not become any less. Thus, the institutional problems will continue to accumulate, and it will still be necessary to resolve them in the future – but at a greater cost, especially if the external market situation worsens by that time.

A new turn in party building was the formation of the center – left party “Fair Russia”, aspiring to play the role of the leading parliamentary party similar to that played by the center – right party “United Russia”. After its creation was announced, “Fair Russia”’s leaders would repeatedly arrange meetings with V. Putin, which confirmed that the new party had been granted an “official blessing”. Its political credo differs little from that of “United Russia” and consists in unrestrained support for V. Putin’s policy.

However, the existence of two brands competing for the role of the “leading and guiding force” could confer a certain dynamism to the forthcoming election campaign, which would positively distinguish it from the classical “one – and – a – half – party” model. The capability of these forces to actually polemicize with each other, to mutually expose the existing drawbacks and to criticize them, will become an important issue when assessing the role and prospects of these forces. The case in point is, first of all, the criticism of real actions, because any polemics on the program issues would be senseless in the existing situation and is of a very limited interest.

Mutual supervision and mutual criticism could become an important factor of overcoming the traditional shortcomings of the “one – and – a – half – party” model – political stagnation and corruption. However, it will be unwise to expect any real criticism and polemics, because both parties associate themselves with the personality of the present Presi-

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<sup>16</sup> See Alesina A., Roubini N. with G.D.Cohen. *Political Cycles and the Macroeconomy*. Cambridge, Mass and London: The MIT Press, 1997. P. 1–3.



dent. To expose the shortcomings of any of them would mean, in fact, criticism of V. Putin. Also, the existing electoral legislation extremely restricts the possibility to criticize an opponent in the course of an election campaign. At the same time, there is little doubt that the emergence of the two-party model can result in some additional budgetary populism.

In absence of any significant alternatives, the ruling party was prone to discuss some highly peculiar matters. Each Duma is doomed to have its own “Law on Bee Keeping”, which has once become the synonym for pointless legislative activity<sup>17</sup>. A similar role was played in the year 2006 by the draft law on restricting the mentioning of foreign currencies which was designed to prohibit the officials to use the words “dollar” and “euro” in those instances when their use was not sufficiently justified (although it remained unclear who was to judge whether this justification was sufficient or not). Also, this tendency is rooted in the regretfully widespread phenomenon when people try to combat not the cause but the consequence. Thus, struggle against inflation is frequently substituted for by a price freeze. Another example is the hope that the mistrust of foreign currency can be overcome by banning the circulation of foreign currency<sup>18</sup>. ( However, it should be acknowledged, for the sake of justice, that over the past fifteen years, the Russian authorities have repeatedly demonstrated that they are aware of the difference between the cause and the consequence. The economic history of post – Soviet Russia offers practically no examples of senseless bans, introduced contrary to economic logic).

The year 2006 has provided a new theme in the quest for a political model and ideology appropriate for contemporary Russia. The demands to furnish the country with a “national idea” have been voiced for approximately the same time as the demands to work out the “sector priorities”. Nowadays, the concept of “sovereign democracy” is being advertised as the one best fitted to play the role of a “national idea”, and its discussion has become a rather noticeable phenomenon of the socio – political life of the country. It was adopted by “United Russia”, which had been chronically suffering from the absence of ‘ideomotor image badges’, and after a short discussion this term has become one of the focal points in the program of this party holding a parliamentary majority.

The emergence of the new term was met with visible misgivings. This attitude is quite understandable: it is in our country’s traditions to furnish certain concepts popular in the developed world with some adjectives totally emasculating the essence of the terms they are added to. That was the meaning of “socialist democracy” and “people’s democracy”, the

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<sup>17</sup>There was such a draft law in the mid – 1990s, and the MPs were elaborating it at a time when the country which had just abandoned “socialist law” was literally suffocated in absence of the most important laws.

<sup>18</sup> The banning of on the use of foreign words is frequently explained as a concession to patriotism. In reality, such actions are totally unpatriotic. These bans are rooted in their authors’ deep conviction that Russia is incapable of pursuing a policy which could guarantee that its currency is respected. The attitude is all wrong – it is necessary that the rouble gain sincere respect instead of being respected in words only out of fear of paying a fine.

terms denoting a regime opposite to a democratic one. It is natural that the emergence of the new term caused a suspicion that the whole initiative was just an attempt to camouflage a rejection of the democratic principles of society organization and a toughening of the political regime. In other words, there exist strong misgivings that “social democracy” can in fact be synonymous to “untrue democracy”.

These doubts and suspicions have the right to exist, especially in the context of centuries – old Russian history. However, this aspect of the issue rather reflects the present – day situation. But there also exists a deeper rooted problem as to which institutions of modern democracy are of primary importance for a stable and onward economic development. The term “sovereign democracy” must be synonymous to the term “competitive economy”. Only a competitive economy is capable of creating a basis for both the sovereignty of a country and for the stability of its economic regime.

In real life, the whole set of democratic institutions cannot emerge simultaneously. It will take a long time for them to be introduced in daily practice. It is possible to single out the institutions (or the rules of the game or laws) which are of principal importance for stable economic growth, while the rest of them are of secondary importance by comparison with the former. The primary political conditions necessary for growth are the guarantees of the inviolability of the person, his or her life and freedom. This also suggests the existence of an independent judicial system and of a certain level of independence of the mass media, as well as their capability to ensure some public control over the situation. The protection of life and property from arbitrariness constitutes an absolutely indispensable foundation of modern economic growth: before starting to accumulate and to invest, to organize and to product, and even before starting to keep property and to spend money, a person must be sure that his or her life and freedom are safe from any arbitrariness of the authorities.

The IET conducted a statistical research<sup>19</sup> aimed at measuring the influence of various political institutions on economic growth in more than fifty countries that had undergone radical transformation in the second half of the 20<sup>th</sup> century. The analysis has confirmed that the constitutional system (presidential or parliamentary republic), the territorial structure (federation or unitary state), the tax regime, the administrative barriers and a lot of other things do play a much lesser role than the above – listed factors. The experience of England, the first country of modern economic growth, unambiguously confirms this conclusion<sup>20</sup>.

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<sup>19</sup> See *Mau, V., Yanovskii, K., Zhavoronkov, S., Maslov, D.* *Institutsional'nye predposylki sovremennogo ekonomicheskogo rosta* (The institutional prerequisites for modern economic growth). Moscow: IEPP. 2007.

<sup>20</sup> Modern economic growth began in England after the political and financial settlements had been achieved there as a result of the Glorious Revolution of 1689. The Habeas Corpus Act stipulated that none of the citizens could be arrested or deprived of his life and property unless a decision was taken to this effect by an open and independent court of justice. The King acknowledged the exclusive right of Parliament to establish taxes and levies, thus putting an end to arbitrary decision making with regard to the organization of state finances. The financial settlement was a logical

Thus, the level of economic development determines, to a great extent, the political institutions preferable for a given country. Therefore, the political regime optimal for a stable economic growth depends on the level of this country's economic development. Countries with a high level of development are capable of resolving the problems of adaptation to post – industrial challenges only if they possess sufficiently developed institutions of modern democratic society. Countries with a low level of development (like China) are successfully resolving the problems of modernization under conditions of authoritarian political systems. It is evident that Russia, by the level of the development of human capital, can be classed with the first category of states, despite it relatively lagging behind them by formal economic indicators.

The essence of the debate on “sovereign democracy”, whatever the ideas of its initiators might be, consists in defining the long – term trends of Russia's development. At present, three scenarios of this development can be discerned in a long – term perspective.

Firstly, the preservation of the current trends characterized by an approximately 50 – year - long lagging behind the most developed western countries. It is a rather stable (inertia) model. This gap was observed for about three hundred years, and was noted in absolutely different epochs by absolutely different observers - from Stendhal to Gaidar<sup>21</sup>.

Secondly, the actual acceleration of socio – economic development, capable of ensuring Russia's convergence with the most developed countries of the world. It is very difficult to achieve these ends, and only a handful of nations did, indeed, manage to accomplish this aim in the 20<sup>th</sup> century.

Thirdly, a gradual degradation of the system with its possible disintegration, because the weakening state authority would no longer have any strength or resources to preserve the territorial (political) integrity of the country in conditions of economic interests being localized. Under these conditions it would no longer be sensible to discuss the issues of sovereignty.

By its own nature, the inertia scenario seems the most likely one. The scenario is relatively simple and self – sustaining; it suggests a gradual (as the average per capita GDP increases) development of democratic institutions, and most likely, the preservation of the existing level of independence in political decision-making.

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continuation of the political one, because it had already been widely understood that arbitrarily imposed taxation and shaky finances (inevitably resulting in inflation) meant unlawful (extrajudicial) deprivation of property similar to extrajudicial confiscation. The necessity for the Crown to abide by these settlements was emphasized by memories of the year 1649, when King Charles I was executed for having misused the royal prerogative in his attempts to introduce extra – parliamentary rule, to arbitrarily impose taxes, and to subject the judiciary to his will.

<sup>21</sup> Stendhal wrote about this in the early 19<sup>th</sup> century, N. Bunge – in the mid 19<sup>th</sup> century, while Ye. Gaidar convincingly expounds this phenomenon nowadays. (See *Travin, D., Marganiia, O. Evropeiskaia modernizatsiia (European modernization)*. Moscow: AST. 2004. Kn. 1. P. 18; *Vlast' i reformy (Power and reforms)*. Moscow: Olma – Press – Ekslibris. 2006. P. 349; *Gaidar, Ye, Dolgoe vremia (A long time)*. Moscow: “Delo”. 2005. P. 235.).

However, the specific feature of the current political situation consists in a possibility, which is now stronger than usually, that the second scenario would be chosen. There is a certain chance to achieve a breakthrough. But to attain these ends, it is necessary to clearly comprehend the task and to substantially consolidate the elites so as to accomplish it.

Russia will have to make much effort as yet in order to ensure the efficiency of its democracy and the reality of its sovereignty. With this aim in mind, it should, firstly, strengthen its democratic institutions without making too many excuses regarding the immaturity and the young age of Russian democracy. Secondly, Russia should effectively increase its competitive capacity. The latter thesis must become the centerpiece of Russian economic and political doctrine. The experience accumulated during the past fifteen years indicates that we are able to resolve the problems facing the country if the political elite treats them seriously. One of the convincing examples of this is the successful experience of overcoming the consequences of the recent macroeconomic crisis.

Now the country should overcome the institutional crisis, whose existence is demonstrated by the results of the ratings reflecting the quality of state institutions.

The task of forming adequate state institutions is much more difficult than that of financial stabilization. However, some countries did manage to solve it in the course of the 20<sup>th</sup> century. In order to achieve this, it is necessary to consolidate political forces and to pursue a responsible economic policy, devoid of populism. The solution of this task will ensure Russia's transformation into a true and entirely sovereign democracy.