

Forming Sources for a Long-run Growth: How to Understand?

by

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Abstract

The paper analyzes the in consequence and problems of Russian economic policy to accelerate economic growth. Authors consider three components of growth rate (potential, Russian and world business cycles) and conclude that in order to pursue an effective economic policy to accelerate growth, it has to be addressed to the potential (long-run) growth component. The main ingredients of this policy are the government spending restructuring and budget institutions reform, labor and capital markets reform, productivity growth.

Keywords: long-run economic growth, TFP, government spending, restructuring.

JEL: O1, O4, H5, J2,

Forming Sources for a Long-run Growth: How to Understand Them?

Publications in mass media and economic literature offer diverging views on what slows down (since 2012-end)¹ economic growth in Russia and what should be done to cope with the downtrend. In January-December 2013 and Q4 2013, the industrial production index stood at 100.3%, compared with the corresponding periods in 2012². In first half of 2013 investment declined about 6% in real terms (exclusive of small business). Fixed capital investment distribution analysis by source shows that in 2013 state budget investment kept growing 20–25% at current prices while internal and external investments had only 5–6% growth in real terms, i.e. nearly stopped growing, although previously (in 2011–2012) private investment saw almost the same growth rate, about 25% annually, as budget investment did.

Since lead Russian economists and advisors to senior government officials were divided as to which budget instrument would be efficient to support and promote economic growth, there was de facto no meaningful policy in place to facilitate a steady growth, which resulted, in particular, in a “business as usual” approach to budgeting. Budget expenditures don’t decline proportionally in the face of shrinking revenues. However, the adopted budget rule was actually discarded as regards to the resource accumulation in the Reserve Fund³. The Federal Law *On the Federal Budget for 2014 and the Planning Period of 2015 and 2016* still provides for high non-productive public expenditures (public administration, law enforcement, national defense, national economy, except expenditures on infrastructure⁴) at the cost of productive expenditures on human capital (education, healthcare), science, and infrastructure.

¹ For more details about the fiscal policy role in accelerating economic growth rates see Идрисов, Синельников-Мурьев, 2013. [Idrisov, Sinelnikov-Murylev, 2012.]

² Информация о социально-экономическом положении России – 2013 г. / Росстат [Information on socio-economic situation in Russia – 2013 / Rosstat].

³ The Finance Minister stated at the Gaidar Forum in January 2014 that The Reserve Fund will be replenished with about Rb 200bn in 2013, however, according to our estimates, Rb 800–900bn are required to observe the budget rule. Apparently, the difference is compensation for federal budget revenue shortfall.

⁴ For more details see Devarajan et al., 1997; Blankenau, Simpson, 2004; IMF, 1995; European Commission, 2012.

A draft *Budget Strategy until 2030*, submitted in late December 2013 to the Russian Government for consideration, meets entirely the requirements for macroeconomic sustainability, though as for middle term budget expenditures it relies on state programs' expenditure caps (and only until 2020, but no budget policy priorities are specified for the period of 2021–2030) rather than expenditures in terms of budget classification. In other words, the valuable the long-term budget policy parameters – expenditures on education, healthcare, national defense, and other budget sections – can hardly be discussed on the basis of this document. However, one can see some outlines of expenditure functional distribution and understand whether the trends of 2014–2016 will persist beyond the approved 3-year federal budget.

For example, expenditures on national defense are to grow up from 3.1% of GDP in 2013 to 3.9% in 2016, while their share in total expenditures (except conditionally approved) will increase from 15.8 to 21.7%. The overview of the Budget Strategy's parameters allows a conclusion that these expenditures will further grow to 4.3–4.4% of GDP or to 24–25% of federal budget expenditures anticipated in 2017–2020. In 2014–2016, expenditures on transport infrastructure are to be reduced about 0.2 pct of GDP and fall below 1% of GDP. In 2017–2020, these expenditures are expected to slightly increase approximately to the 2014 level of GDP. Expenditures on education will remain at the current prices level, declining by 2016 from 1.0 to 0.74% of GDP. Later, in 2017–2020, they are to fall a bit more in terms of GDP. Therefore, this document doesn't cover a government spending restructuring as described below.

Structural and business components of economic growth, and why it slows down⁵

It is common international practice to decompose actual economic growth rates into structural and cyclical components for the purpose of analyzing and developing economic policies. Considering that the Russian economy relies heavily on global raw materials and energy markets, it is worthwhile to add to these typical components a new one which is determined by terms of trade.

Simply stated, one can say that the structural (potential) component of growth is a growth rate which is theoretically possible in the business cycle mid-phase, at 15–20-year average for oil prices, i.e. driven by the full labor and capital involvement in the production and best available technology. In 1999–2008, the Russian structural component of GDP growth rates ranged within 4 to 5 pct, according to the estimates of the Gaidar Institute for Economic Policy⁶. The business component driven by the Russian business cycle varied within a range of -1.5 to 4 pct at that period while the cyclical component determined by terms of trade (mostly by changes in raw materials and energy resources prices) varied from 0 to 2 pct.

During the global crisis of 2008–2009, the broadly-defined (Russian external economic shock) business cycle component (Russian business cycle component plus external shock) went negative, dropping approximately to -13 pct (real GDP fell because, in particular, of the Russian economy's specialization in raw materials export, energy resources, and investment goods). Nevertheless, the Russia's GDP didn't fall substantially, because energy resources prices bounced back rapidly (terms of trade contributed about +1 pct). Actually, real GDP fell by 7.5% (4.5 pct – 13 pct +1 pct = -7.5 pct).

⁵ See: Durlauf et al., 2006; Rodrik, 2006; Мокыр, 2006; Казакова, Синельников-Мурылев, 2009. [Kazakova, Sinelnikov-Murylev, 2009.]

⁶ The authors made the presented estimations in cooperation with Mr. Drobyshevsky S. and Mrs. Kazrkova M., using the OECD methodology (for more methodological details see Giorno et al., 1995).

In 2010–2012, the Russian cyclical component was negative, about –1 pct GDP growth, close to the structural growth rates (3.4%), was determined by favorable conditions in the global raw materials and energy market which compensated for an adverse contribution of the Russian cyclical factors (about +1 pct).

In 2012–2013, actual economic growth rates stood at about 1.5%. The structural component declined to about 2.5 pct, the Russian business cycle component was –2.0 pct, global market conditions contributed +1 pct. The output gap (the difference between actual and structural growth rates) was –1 pct

Therefore, in 1999–2013, the structural component of growth declined (+5 pct in the 2000s; +3–4 pct between 2009 and the mid-2012; +2.5 pct from second half of 2012 till 2013 end). In 2014, it may be less than 2 pct, i.e. the output gap would approximate to zero, according to our estimates.

To date, global raw materials and energy market conditions have had an overall positive effect on Russia (otherwise, growth would have been negative as early as 2009–2010). On the one hand, not only high but also steadily growing oil prices⁷ pushed up Russia's real output due to growth in the oil production sector (in which incentives for greenfield oil development were created) and related sectors (the demand for intermediates of these sectors is created by the oil production sector or driven up by individuals with growing income)⁸. On the other hand, Russia's output at current prices increased, relative to that of other countries, as energy resource prices went up: GDP at PPP per capita at current prices increased from \$6,800 in 2000 to \$23,500 in 2012, i.e. by almost 3.5 times.

In the 2000s, real output growth and a 5-fold growth in oil prices allowed Russia to move up from the lower-middle-income country group to the upper-income country group, resulting in an almost 75% increase in goods and services

⁷ Until 2012, when it stopped at \$100–110 per barrel of Brent crude oil in Europe.

⁸ Quantitative estimates of this effect are presented above: this is terms of trade contribution to the Russian economic growth.

consumption per capita⁹. From the above said it follows that in 2000–2012 Russia became “wealthier” due to more favorable terms of trade not only owing to real output growth, but also because of the higher Russian-made goods value in the global market.

The Russian business cycle and structural components of growth also played a significant role in that period. In 2008-2013, however, the Russian business cycle was seriously hit by the global crisis which reinforced the overall economic agent pessimistic mood. The structural component of growth (which is measured by the production function factor weighted growth – labor, capital and their efficiency) varied in Russia under the influence of the conditions and problems typical for countries whose economic growth relies heavily on revenues from raw materials export. The slower growth phenomenon in countries and regions rich with natural resources versus countries with scarce natural resources is referred as the «resource curse» which shows itself as the Dutch Disease whereby the ruble real exchange rate appreciation has a detrimental impact on all trade-related sectors, except the mining, and as deterioration of social institutions quality¹⁰.

In the recent 15 years, high wages and inefficient institutions have become main characteristic of Russia in the international competitiveness context as a result of high raw material prices and energy resources, growth in real incomes and narrower gap between the ruble nominal exchange rate and purchasing power parity¹¹. This combination, often called the “middle-income trap”, tends to hamper investment and reduce the potential for economic growth. The wage share in GDP increased (from 40% in 2000 to 50% in 2012) while the profit share shrank (from 43% in 2000 to 30% in 2012). Moreover, growth in wages outstripped the dynamics

⁹ GNI at PPP per capita at 2005 constant prices, which reflects real growth in consumption and savings, increased from \$8,400 in 2000 to \$14,500 in 2012. Furthermore, consumption per capita increased from \$27,300 to \$31,200 in upper-income countries. Therefore, in 2000-2012, Russia’s real consumption increased by 73%, while high developed countries saw just a 16% growth.

¹⁰ For more details see: Auty, 1993; Sachs, Warner, 1995, 1997; Sala-i-Martin, 1997; Gylfason, 2007; Mehlum et al., 2006; Treisman, 2010; Кнобель, 2013 [Knobel, 2013].

¹¹ For more details see: May, 2012; 2013 [Mau, 2012, 2013].; Griffith, 2011; Aiyar et al., 2013.

of GDP and labor productivity. A necessary condition for getting off the trap is to increase the factor productivity, which includes labor and capital markets reforms.

Moreover rapid growth in wages, which doesn't reflect growth in productivity, is heterogeneous both territorially and industrially. Local "growth points" can be easily located: Russia's central regions (first of all, Moscow), extracting sectors of the economy and the financial service sector. Consequently, government actions in the economy has to be widened, which, in turn, can distort market signals, weaken competition and delay structural changes, encourage rent-seeking strategies, promote corruption, render the public sector ineffectiveness, and increase income and wealth unequal distribution¹².

The described trends, typical for many countries, coupled with exhausted opportunities to involve extra labor force can seriously slow down economic growth rates. Potential economic policies aimed at accelerating economic growth can be configured using the foregoing decomposition of economic growth rates into the three (potential/structural, Russian business cycle and world business cycle) components.

The world business cycle component of growth is determined by external factors which are beyond Russia's politician's influence. Normally, a small country cannot change the terms of trade.

In many cases, the Russian business cycle component can be adjusted using an national counter-cyclical economic policy. Russia sustained no heavy social or political losses during the crisis of 2008–2009, mostly owing to the accumulated reserves which could be used to stimulate economic development. However, neither budgetary nor monetary policies have proven efficient in the current macroeconomic situation. The budgetary policy doesn't work, because, first, the existing output gap isn't big enough and, second, its existence is a necessary but not sufficient condition for the effective stimulating policy. The budgetary policy inefficiency can be drawn by the estimates of the budget expenditures multipliers which, according to our and

¹² Helpman, 2004.

other estimates, are not only small but less than 1¹³. The expansionist monetary policy doesn't work, because the real interest rate on loans to the nonfinancial sector¹⁴ is low and inflation is anticipated to be high and unstable. Therefore, the state only can influence the structural component of growth.

The neoclassical economic theory describes labor, capital and their total productivity as production function factors (economic output)¹⁵. However, long-term economic growth in certain countries and differences in economic development between countries cannot be explained by the difference in labor and capital only. The only way to get closer to explaining these differences is to consider their quality¹⁶.

Therefore, a long-term economic growth can be achieved through, first, productive investment in human capital, i.e. (secondary, higher, lifelong, on-job) education, healthcare and physical culture, as well as an efficient internal and external migration policy. Second, sources for productive private investment in fixed capital (including consistent and predictable economic policy) should be created and public investment models have to be enhanced. Third, it is important to create conditions for increasing return on private investment (total factor productivity), including increase for budget expenditures on infrastructure and science, as well as develop the policies for deeper Russian integration into the global economy.

Institutions and investment climate

¹³ For example, see Идрисов, Синельников-Мурyleв, 2013 [Idrisov, Sinelnikov-Murylev, 2013]; Дробышевский, Назаров, 2012; [Drobyshevsky, Nazarov, 2012]; Юдаева, 2011 [Yudayeva, 2011]; Mountford, Uhling, 2008; Monacelli, Perotti, 2008; Blanchard, Perotti, 2002; Perotti, 2004; Giardano et al., 2008.

¹⁴ In 2007 and 2008, the interest rate on loans to the nonfinancial sector was negative: -2 and -1% respectively; later it was positive: 2% in 2010, 2.3% in 2011, 3.2% in 2012.

¹⁵ For more details see Solow, 1957; Helpman, 2004; Энтов и др., 2006 [Entov et al., 2006].

¹⁶ For more details see Ito, 2000; Barro, Sala-i-Martin, 1992; Isterly, 2006; Helpman, 2004.

Institutional framework, first of all, property contractual rights (liabilities and commitments) are the most important source of long-term economic growth¹⁷. Fixed and human capital investment, which is highly sensitive to the institutional environment quality, are the key interaction mechanism between institutions and economic growth. Social institutions determine both the volume of resources, which economic agents (including the state) spend on the development, and their productivity. Since the importance of reforming social institutions for the provision of long-term, steady economic growth¹⁸ has been extensively covered by both Russian and foreign literature, we will consider only a single aspect of this topic, i.e. a need for a well-defined (consistent and predictable) economic policy.

The aforementioned economic policy qualities are essential investment climate components. In practice, economic policy decisions in the Russian Federation are subject to frequent revisions, and none of the public initiatives has been completed yet. Inside the society, most of the recent public initiatives have come to be associated with the come-and-go style. In the 2000s, such initiatives as the introduction of program-based planning, deregulation, introduction of performance-based budgeting, innovation promotion, “national projects” implementation, development of road maps for priority reforms (still in progress), etc. easily came into and went out of fashion.

The pension reform is a demonstrative example. The reform has been under way for more than a decade, beginning with the unified social tax introduction in 2001. Conflicting decisions were made year after year during the period: a self-funded pension contribution component was introduced for individuals of any age, then it was abolished for certain categories of older employees, and is subject to regular changes for others¹⁹, and now it will be frozen within the period of

¹⁷ For more details see: Acemoglu et al., 2006; Энтов и др., 2006. [Entov et al., 2006].

¹⁸ For more details see: Tanzi, Zee, 1997; IMF, 1995; World Bank, 2006; 2007; 2013; Идрисов, Синельников-Мурылев, 2013 [Idrisov, Sinelnikov-Murylev, 2013].

¹⁹ A 0% rate on the self-funded component has been established since 2002 for men born after 1952 and women born after 1956; a 2% rate on the self-funded component was established from 2002 to 2004 for men born between 1953 and 1966 and women born between 1957 and 1966, it has been 0% since 2005; a 3% rate was from 2002 to 2003 for individuals born before 1967, a 4%

nongovernment pension funds restructuring. At the same time, payroll rates (initially, the unified social tax and, later, social security contributions²⁰) are subject to regular changes.

If the state had the objective to deny its citizens the opportunity to set up an individual retirement strategy, it has been accomplished with success. Individuals' credibility in that they can rely on stable "game rules" in the pension system has been totally undermined. Furthermore, none of those who developed the changes can answer the main question: what we have to do with the pension system deficit (3-4% of GDP) which will be growing because of demographic issues in the decades to come (growth in the share of older beneficiaries in the total population²¹)? It therefore has to be decided which of the options are most preferable: lose 10–15 pct on the wage replacement rate (the current average pension to average wage ratio is approximately 35%) while keeping the pension system deficit at the current level, or provide the wage replacement rate at 40% while increasing the deficit to 5% of GDP by 2020?

The Russian Government has recently started the parametrical reform set to introduce a new pension formula²². The new developed policies have had no drastic effects: according to our estimates, by 2030 the pension system deficit will fall to

- from 2004 to 2007, a 6% - from 2008 to 2013. An option to choose a defined benefit plan are available from 2014 to 2015: individuals were offered an option to retain 6% of the rate on insurance contributions to the self-funded component or give up the self-funded component thereby allocating all insurance contributions to the PAYG pension.

²⁰ A descending scale for the unified social tax (UST) at a 35.6% base rate was in place from 2001 to 2009 (rates for subsequent annual tax base groups of employees were 20%, 10%, and 5%, the marginal rate was reduced to 2% from 5% since 2002, i.e. higher incomes were subject to a lower rate), since 2005 the base rate was reduced to 26% (rates for subsequent groups stood at 10% and 2%). In 2010, the UST was replaced with insurance contributions, without making changes to the rates and descending scale. Since 2011 the base insurance contribution rate has been raised to 34% while the contribution accrual base has been limited to 135% of average wages (that means in fact, a 0% marginal rate was set for the second annual tax base groups). Thereafter, a decision was made to reduce the base rate to 30% for the first group and increase to 10% for the second one (a 10% marginal rate was set instead of 0%) in 2012–2016. Nowadays the Pension Fund deficit incurred from the lower rate implementation is financed by federal budget transfers.

²¹ Rosstat's average scenario for demographic projection until 2030 shows that the share of persons beyond the working age in the total population will increase from 23% in 2013 to 26% in 2020 and 29% in 2030 (at the beginning of the year) (www.gks.ru/free_doc/new_site/population/demo/progn3.htm).

²² The Council of Federation approved a new pension formula in late December 2013.

2% of GDP while the wage replacement rate decline by 15 pct. By and large these policies are headed in the right direction, but they cannot fully resolve the pension system deficit issue, which can be done either by raising the retirement age or reducing the wage replacement rate or introducing an age-specific partial pension differentiation (replacement rate). However, the suggested nearly age-equalized reduction in the replacement rate, without raising the retirement age, isn't the best option, because individuals who are not able to work (older beneficiaries) and those who are still able to work (individuals aged 60–65, not to mention early retirees) will then be entitled to pension. This is a not reliable approach to older beneficiaries who do need more money for a normal life.

There are more essential issues that need to be addressed in order to develop a coherent pension system reform. For example, it is questionable whether there is a need for a public pension savings system whereby the state collects and saves individuals' contributions while borrowing in financial markets. There is a solid argument that favors this system: it is much easier to manage self-funded component contributions than taxes, because individuals show different attitude towards saving self-funded pension versus paying taxes within the PAYG scheme. However, this hypothesis has to be tested empirically, plus the theory describes the taxpayers' myopia effect. Another argument in favor of the public pension savings system is the creation of a “long money” source for investment. However, it should be remembered that the self-funded scheme requires high administrative costs versus the PAYG scheme, plus the former may lead to potential losses from macroeconomic fluctuations.

Additionally, it is important to consider a long-term transformation of the pension system into a poverty benefit system whereby the entitlement to public pension must be means-tested. Needless to say, this is still a long way in the future, when growth in the well-being will allow most of individuals to live without the public pension system and reach an appropriate consumption level in old age through sufficient personal savings, including those in non-governmental pension funds, and help from their working age family members. Furthermore, working beneficiaries'

entitlement to pension is another issue which is worth being considered. There is an important side issue: whether individuals' contributions from the self-funded scheme should be inheritable or the pension system should rely on the insurance-based principles of risk sharing? Clearly, inheritance tends to increase propensity to save, however, the self-funded scheme is easier to administer and more cost efficient within the insurance-based pension system.

Another good illustration of inconsistent and unpredictable economic policy is public sector restructuring and per capita financing for social service provision. Reforms in this sector were intended to restructure budget funded entities network, enhance self-dependence of organizations, and introduce a kind of competition based on the "budget money follows the recipient" principle.

In practice, however, nothing has been done in the context of meaningful restructuring of budget funded entities network; the entities needed by the country are facing economic "erosion" due to the lack of funding. Regulatory control over autonomous institutions has been actually mixed with budget funded entities regulation; the income and expenditure budget through which entities are funded has been transformed into a business plan. Funding standards, especially in higher education, are applied mostly for allocating less public funds to strong entities and more to weak ones, without undertaking any reforms²³.

In his report to the Duma, the Minister of Education and Science of Russia spoke against raising wages in higher education institutions without increasing the teachers' workload. The President of Russia has argued for wage increase must be driven by reforms, which also involves increasing the teacher's workload. Since 2009, taking into account the economic turbulence, the President of Russia has called for a freezing prices for education services, whereas the Ministry of Education and Science and the Ministry of Finance of Russia insist, quite freely interpreting the legislation²⁴, upon setting the payment for off-budget students' education at a level

²³ Клячко, Синельников-Мурyleв, 2012а; 2012b. [Klyachko, Sinelnikov-Murylev, 2012a; 2012b]

²⁴ In our opinion, Article 9.2 of the Federal Law No.7-FZ of January 12, 1996 (as amended on 01.09.2013) *On the Provision of Budget Services by an Organization on Equal Terms for*

equal to or higher than payment for budget student²⁵. The rank increasing goals for higher education institutions contradict the approved development road maps requiring, in particular, an increase in the number of students per teacher. Under the Presidential Decree of May 7, 2012, the teaching personnel wages at higher education institutions must be twice as much as the average regional wages. However, the introduction of unified standards for public funding ignores the differences in wages between the regions, etc. There is no country whose government spends public resources to purchase education services at a unified price (which covers all current and capital costs). The per-student funding standard is an essential but not the only financial planning instrument.

As a result of such confusion, it is not senior government officials, but the average persons in Ministry of Education and Science and the Ministry of Finance departments take decisions on how many and which social services, including higher education (which has become a social norm in the Russian Federation), Russia needs. The reason, in our opinion, is the total absence of the public sector reform concept.

Therefore, the sequence and stages of reforms in higher education should be developed, tested, discussed, and approved at the top political level. Attempts to introduce the normative per capita financing are doomed to failure if no preliminary higher education institutions network restructuring is performed. The network and funding volumes cannot be changed without addressing the issue of whether the Russian economy really needs so-called inefficient and/or low-demand higher education institutions. It is obvious that the economy needs mechanical engineers, textile workers, water supply, drainage and sewage engineers, agriculturalists, veterinaries, hydrometeorologists, as well as skilled workers of various occupations, etc. Education should therefore be financed on the detailed forecast basis of the economic demand for such labor force. To avoid substantial dynamic welfare losses, this task shouldn't be addressed to the "the invisible hand of the market". It is

Recipients speaks against price discrimination of consumers, and the state doesn't buy educational services but basically provides funding to the social sector when it (the state) allocates funds to an entity based on per student standard.

²⁵ Клячко, Синельников-Мурyleв, 2012b. [Klyachko, Sinelnikov-Murylev, 2012b]

important to figure out what to do with inefficient higher education institutions, i.e. let them degrade slowly by reducing their funding (like now), or shut them down to open new ones, or replace their top managers and allocate extra funding to facilitate the recovery of the institutions.

Primary tasks for economic policy

Government spending restructuring. It is known that growth rates in countries whose budget expenditure structure is similar to that in Russia will never be sufficient for catching-up development, i.e. for growth rates convergence with developed countries, not to mention about economic development levels convergence²⁶. Unlike investment in fixed capital in which the state's task is to provide institutional framework required for private investment, it (the state) plays the dominating role in the human capital and infrastructure development. The economic theory holds that “market failures” may occur in response to substantial externalities and without public regulation and substantial investment, the market cannot provide a socially optimal volume of education, healthcare, R&D. Therefore, there have been serious concerns about drastically increased expenditures on national defense in 2007–12 (by 0.3 pct of GDP to 3% of GDP), national security and law enforcement (by 0.3 pct of GDP to 3.1% of GDP) at the cost of social expenditures (expenditures on education and healthcare stay constant at approximately 4.2% and 3.7% of GDP respectively) and expenditures on transport and infrastructure (expenditures within the “National Economy” section were reduced by 0.2 pct of GDP, from 5.5 to 5.3% of GDP, in favor of the above sections)²⁷.

²⁶ For more details see: Barro, Sala-i-Martin, 1992; Гайдар, 2005 [Gaidar, 2005]; Идрисов, Синельников, 2013 [Idrisov, Sinelnikov, 2013]; Дробышевский и др., 2011 [Drobyshevsky et al., 2011]; Кнобель, Соколов, 2012 [Knobel, Sokolov, 2012].

²⁷ For more details see: Идрисов, Синельников-Мурылев, 2013 [Idrisov, Sinelnikov-Murylev, 2013]. The authors' statistics on the general government expenditure structure in Russia, the EU, and the United States show that the Russian expenditure structure is heavily biased towards non-productive expenditures.

The foregoing considerations seem to provide sufficient ground for the changes to the public expenditure structure to be viewed as the main trend of the long-term fiscal policy. This can be done through the government spending restructuring in the fiscal policy, i.e. reallocation of public expenditures from budget sections – national defense, law enforcement, public administration – which cannot or ineffectively facilitate economic growth (beyond a certain limit) in favor of those – education, healthcare, infrastructure – which can promote growth. Spendings in these sectors cannot be interpreted as socially required expenses or supplement to the social services provision, rather they should be viewed as investment in a long-term economic growth.

It is need to say that this government spending restructuring in favor of productive expenditures may encounter serious constraints: it has to be done in the face of general government expenditures cut as share of GDP, which is very painful politically. However, economic growth at current prices can be used and productive expenditures can be increased while maintaining the current level of non-productive expenditures²⁸.

In the light of *labor market development*, it is important first of all to develop a employment strategy and wage optimization in the public sector (eliminating distortions caused by accelerated wage growth), make the labor market more flexible, prepare the concept of and adopt a new Labor Code designed appropriate to modern economic realities. Changes to the labor relation regulations should be focused on the making employee-employer relations more flexible through extensive use of fixed-term contracts, simplified staff recruitment and dismissal procedures, substantially expanded grounds for fixed-term labor contracting, simplified procedures for changing the labor contract terms and terminating the same due to economic reasons, efficient procedures for revising wages facing an economic turbulence, simplified HR procedures.

²⁸ With real GDP annual growth rates at 2% and GDP deflator (price growth) at about 4%, real non-productive expenditures can be reduced by 3 pct of GDP while productive expenditures can be increased by the same percentage of GDP within 4-6 years, without increasing non-productive public expenditures at current prices.

It is important to reduce informal employment, including introduction of simplified taxation schemes for micro-sized enterprises and self-employed individuals. Information transparency in the labor market should be enhanced by developing a market valuation system and market development assessment prospects, including specific market segments, as well as creating an efficient and accessible system whereby employers, employees and education institutions can receive quantitative information and qualitative characteristics of the labor demand and supply. Growing adverse demographic trends (skilled labor force outflow accelerates as young labor force inflow slows down) should be tackled through policies which can enhance substantially the potential and scale of cross-region and cross-country labor mobility and reemployment of the inefficiently used labor force from the defense, law enforcement, public administration sectors.

Capital market development requires policies supporting small and medium-sized entrepreneurship. It is important to mitigate business risks associated with unlawful business activity suspension on formal reasons (by regulatory and law enforcement authorities), ease the regulatory burden on business entities and unnecessary burden arising from wrong incentives for public agencies to exercise enforcement (the existing legal framework requires that regulatory and supervisory authorities initiate legal proceedings, impose fines and penalties etc., without taking into consideration the validity and consequences of such actions). Additionally, the anti-monopoly policy and regulation of natural monopolies should be improved, which also includes an institutional reform of the Federal Anti-Monopoly Service (FAMS) and the Federal Tariff Service (FTS).

Measures aimed at improving Russia's ranking in *Doing Business* should become an explicit priority. There are areas covered by *Doing Business* on which Russia stands low in the ranking (e.g., below 100th in the ranking of economies), which should be improved as a matter of priority. The areas are the ease of “*dealing with construction permits*”, “*getting electricity*”, “*getting credit*”, “*protecting*

investors”, “*trading across borders*”. To do this, the Russian best practices can be introduced in all regions of the Russian Federation²⁹.

An essential policy of developing small and medium-sized business would be the establishment of a “credit factory” (a simplified lending system to small and medium-sized enterprises) which could refinance loans, provide guarantees on loans and issue subsidies for partially interest rate compensation (February 5, 2014, the Russian Government approved the establishment of the Loan Guarantee Agency). The above listed policies will help improve investment climate at least in the mid-run perspective and allow productive capital to be efficiently involved to the economy.

Capital and labor (total factor productivity) can be used more efficiently through policies for corporate cost moderation (primarily in natural monopoly sectors), liberalizing sectors which by nature are not natural monopolies (communication services, heat-and-power engineering, certain seaport services), balanced the transport and social infrastructures development (coping with bottlenecks) including the development of efficient forms of private-public partnership.

It is important to continue Russia’s integration into the global economy thereby enhancing production efficiency by improving resource allocation and revealing Russian manufacturers comparative advantages. This implies overall external trade liberalization, including tariff and non-tariff barriers reduction and simplified export and import procedures. It is important to develop policies making the Russian economy less sensitive to raw materials market fluctuations through its diversification, including the development of WTO non-actionable instruments for manufacturing industries support. It is therefore important to define priorities and targets for the non-mineral export development, provide it with organizational, informational and financial support.

Budget funded entities should further be developed *within the public investment model framework*. Investment decisions should be based on maintenance and

²⁹ Russia’s ranking in *Doing Business* is counted using Moscow city performance. Our estimates show that Russia will improve ranking from 92nd to 64th by employing the Russian best practices (that are in place in the other regions) in Moscow alone.

operation costs of established facilities. It is important to switch investment project financing from phase-by-phase scheme instead of connecting financing to fixed time schedules. A network of non-strategic public enterprises which significantly distort market conditions needs to be reorganized, including gradual finance cutting for loss-making enterprises with state share in capital.

Making gradual changes in revenue-side budgeting which relies heavily on oil and gas revenues should be focused on as essential policy aimed at reducing inappropriate subsidies to the economy. Nowadays the existence of export duties to collect resource rent leads to lower energy resource prices. As a result, subsidies to the economy amount to about 4% of GDP³⁰. Furthermore, our analysis shows that it is not the competitive product manufacturing that is promoted or end-use consumers are subsidized, rather it is manufacturers' ineffectiveness that is defrayed, primarily in crude oil refinement, using negative value added (in world prices terms) technologies.

Finally, it's worth noting that a positive of institutional reform program should be elaborated, because none of the recent public initiatives has been implemented till the final stage. It is important to consider all pros and cons, identify most efficient instruments for accomplishing the set goals and ensure that a strict progress monitoring is in place.

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³⁰ For more details see: Идрисов, Синельников-Мурылев, 2012. [Idrisov, Sinelnikov-Murylev, 2012.]

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