Research Paper

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Troubled Times
Stagnation, Sanctions and the Prospects for Economic Reform in Russia

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Summary

- Russia's economic performance has been weakening for several years. The simultaneous fall in the price of oil and the Ukraine crisis have merely exacerbated pre-existing tendencies.
- The combination of stagnant GDP growth and lower oil prices threatens to reduce federal government revenues, but spending commitments are likely to prove hard to trim.
- Direct government spending on social welfare, expansion of the state, and a large-scale rearmament programme have put increasing weight on the public finances and compromised longer-term fiscal stability. The strong state of finances at the federal level conceals a marked deterioration in the finances of local governments across the country.
- Russia's political economy is inefficient in terms of allocating resources to the most productive sectors. However, the system has proven to be politically and socially efficient. The economy requires significant reform if Russia is to enjoy growth and prosperity in the future. Areas for improvement include competition, financial sector reform to broaden access to capital, and the easing of constraints on small and medium-sized enterprises' development.
- The longer EU and US sanctions persist, the more the market-oriented policy elite is likely to be marginalized as economic policies consistent with a more statist and introverted approach take hold. The diversion of resources to domestic defence, energy or manufacturing enterprises would likely strengthen existing constituencies that would benefit from sanctions.

Introduction

The Russian economy finds itself in increasing trouble. The price of oil, Russia's most important export, has plummeted in recent months. The rouble has also plunged – its descent prompting the central bank to raise interest rates sharply in December 2014, although a subsequent rate cut reversed part of that move. Meanwhile, annual net private capital outflows have reached levels normally seen only during times of crisis. All this is taking place against the backdrop of a domestic economic downturn that dates back to the global recession of 2008–09. Although growth in Russia since the global crisis has been considerably faster than in Europe, the pace of economic expansion has slowed each year since 2010. As a result, the Russian economy now appears to be stagnating at best, and heading towards crisis at worst.

The conflict in Ukraine, and the associated statecraft employed by both the West and Russia in response to it, offers a convenient explanation for Russia's recent economic woes.[1] But the truth is that the Russian economy has been weakening for several years, and that the Ukraine situation has merely exacerbated pre-existing tendencies.

This paper explores the nature of Russia's economic slowdown, its likely causes, the types of reform needed to reignite growth and, finally, whether economic reform is likely under current circumstances.

The first section offers a brief overview of recent economic trends. It argues that although Russia continues to show some signs of economic strength, there has been a worryingly rapid downward trend across a number of key indicators. Consequently, the growth model that has served Russia so well since the end of the 1990s is now exhausted.

A second section provides a stylized outline of the prevailing system of political economy in Russia. It shows why the current growth model is delivering increasingly unsatisfactory results, and what reforms are required if Russia is to return to a path of sustainable economic development.

A third section considers the prospects for reform in the context of heightened geopolitical tensions and markedly lower oil prices. It argues that the longer-term consequences of Western economic statecraft threaten to be profound. Although Russia's problems are primarily structural and home-grown, the confrontation with the West over Ukraine threatens to steer economic policy away from market-based solutions towards a state-directed model of development. This is because tensions with the West are strengthening constituencies that, already powerful, favour a reassessment of the country's integration with the global economy and a domestic rebalancing between the state and the market. Western sanctions, coming at a time when the prevailing economic model is not delivering satisfactory results, threaten to intensify these tendencies.

Russia's slowing economy

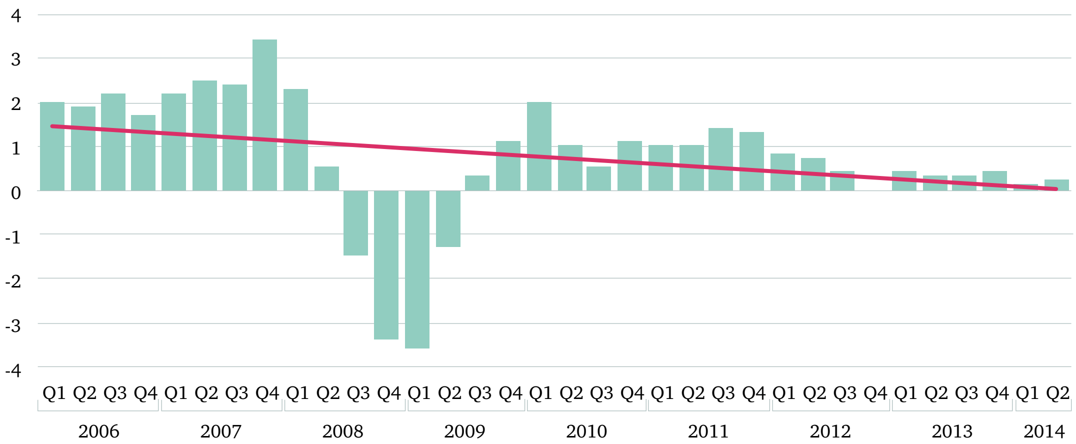
While opinion varies as to the precise nature of the slowdown in Russia, there is no doubt that growth *is* slowing.[2] Moreover, the downward trajectory is not new, but is now in its fifth year. Annual real GDP growth slowed to just 1.3 per cent in 2013, down from around 4 per cent in 2012 and considerably

[1] The term 'statecraft' refers here to the economic measures employed by Western powers (and their allies) and Russia as instruments of foreign policy, especially in relation to Russia's role in the conflict in Ukraine. The use of economic statecraft more widely is discussed in David A. Baldwin, *Economic Statecraft* (Princeton University Press, 1985); and, as applied to relations between the West and the Soviet Union, in Philip Hanson, *Western Economic Statecraft in East-West Relations* (Royal Institute of International Affairs/Routledge, 1988).

[2] According to the most recent regional economic forecast by the European Bank for Reconstruction and Development (EBRD), Russia is one of the worst performers among the transition economies, with other hydrocarbon exporters such as Kazakhstan and Azerbaijan forecast to perform much better in 2014 and beyond. See EBRD, *Regional Economic Prospects*, September 2014, http://www.ebrd.com/downloads/research/REP/rep-2014.pdf.

lower than the 1999–2007 average of over 7 per cent. While annual growth of over 4 per cent in 2010 and 2011 still compares very favourably with European countries, it is now clear that this period signalled the beginning of a long-term reduction in growth that shows no sign of abating.[3]

Figure 1: Real GDP, 2006–14, percentage change from previous quarter



Source: Rosstat (2014).

Closer inspection of the economic data reveals that the situation is deteriorating on many fronts. The rouble has weakened significantly. In early 2015 the currency reached its lowest level against the US dollar since 1998.[4] Net capital outflows for 2014 are likely to have reached near-record levels on an annual basis.[5] The public finances are becoming stretched. The strong fiscal position at the federal level conceals a marked deterioration in the finances of local governments across the country, a problem reaching critical level.[6] Perhaps most ominously, investment growth is slowing. This is exacerbating a deep-rooted tendency towards underinvestment that is the most important obstacle to long-term economic development in Russia.[7]

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The key question is, 'What is causing the slowdown?' If the main drag on growth comes from external factors unaffected by the decisions of Russian policy-makers, or from geopolitical tensions and sanctions, then it is possible that there isn't much wrong with the existing economic model. If, on the other hand, the evidence suggests a fundamental flaw with the prevailing system, then the need for reform is more urgent.

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[3] For a detailed description of the nature of this slowdown, along with some possible explanations, see Boris Zamaraev, Anna Kiiutsevskaia, Angela Nazarova and Evgeniy Sukhanov, 'Zamedlenie e'konomicheskogo rosta v Rossii' [The slowdown of economic growth in Russia], *Voprosy Ekonomiki,* No. 8, 2013, pp. 4–34.

[4] See Figure 2.

[5] According to data from the Bank of Russia, annual net capital outflows exceeded $100 billion in only one year: 2008. This was against the backdrop of the most severe global recession since the Great Depression.

[6] See the interview with Natalya Zubarevich, a specialist on Russia's regional socio-economic development, at http://slon.ru/economics/zubarevich_o_subsidiyakh_regionam_eto_korruptsiya_i_neveroyatnoe_udobstvo_korotkogo_povodka-1079929.xhtml.

[7] See Richard Connolly, 'Financial Constraints on the Modernization of the Russian Economy', *Eurasian Geography and Economics*, Vol. 52, No. 3, 2011, pp. 428–459; and Clifford Gaddy and Barry Ickes, *Bear Traps on Russia's Road to Modernisation* (London: Routledge, 2014).

External constraints

The most obvious external cause of the slowdown in Russia has been the prolonged stagnation in the economies of Europe, collectively Russia's largest trading partner and source of capital. According to data from the European Commission, the average aggregate annual rate of GDP growth in the EU since 2010 has been just 0.8 per cent.[8] Although the close correlation between growth in Russia and the EU has weakened, inadequate demand in Europe is clearly not good for Russia. Slower European growth also subdues global demand for oil, exerting an indirect drag on the Russian economy. Furthermore, recent Western economic sanctions and Russian counter-sanctions have reduced trade flows between Europe and Russia.

Russia has been adversely affected by another global force: the strengthening of the US dollar resulting from the 'tapering' of monetary expansion in the United States.[9] This has intensified capital outflows from low- and middle-income countries to the US, leading to the depreciation of many currencies *vis-à-vis* the dollar and a decline in the nominal (and real) price of oil.[10] While Russia is not alone in being buffeted by global headwinds, it has suffered to a greater extent than most. In 2014 the rouble depreciated by around 50 per cent against the US dollar, more than most major emerging-market currencies other than the Ukrainian hryvnia.[11]

Reasons to be cheerful …

Given the external turbulence facing the Russian economy, it is worth noting the health of the public finances, which continue to compare favourably with those of other major markets. Aided by prudent macroeconomic policy over the past 15 years, Russia continues to enjoy a 'triple surplus'. It runs a current-account surplus, a trade surplus and a federal budget surplus.[12] Russia's sovereign debt-to-GDP ratio of around 11 per cent is among the lowest of all major economies. The triple surplus has enabled Russia to build up a substantial hoard of savings. Foreign exchange reserves totalled $379.9 billion in the middle of January 2015, a sum admittedly depleted by recent market intervention in efforts to contain rouble depreciation.[13]

The indicators that arguably matter most to the general population – unemployment and inflation – also remain comparatively healthy. Because the labour force has been shrinking since 2010, unemployment is at a post-Soviet low of 5.1 per cent.[14] Russia's problem as far as the labour market is concerned is the shortage of skilled and unskilled workers, not rampant joblessness. Inflation also remains near post-Soviet lows. This is despite price rises in recent months, especially for agricultural products affected

[8] European Commission, *European Economic Forecast*, Autumn 2013 (Brussels: Directorate General for Economic and Financial Affairs), p. 138, Table 1.
[9] 'Tapering' refers to the gradual winding down of the US Federal Reserve's policy of quantitative easing (QE), in operation since the global recession of 2008–09. Thus far, the Federal Reserve has not yet begun withdrawing liquidity from the financial system. Instead, from September 2013 it steadily reduced the volume of monthly asset purchases under QE, and ceased such purchases in October 2014.
[10] Historically, movements in the price of oil and the value of the dollar are often negatively correlated (i.e. appreciation of the dollar is associated with falling oil prices, and vice versa).
[11] IMF, *International Financial Statistics*, 2014.
[12] The existence of such surpluses is not unusual among major oil exporters.
[13] Data from the Bank of Russia reveal that by the end of 2014 the bank's stock of foreign exchange reserves, at $388.5 billion, was around 20 per cent lower than at the beginning of the year. There has been some debate over the accessibility – or 'liquidity' – of Russia's reserves. Anders Åslund (*Financial Times*, 17 December 2014) has argued that with around $90 billion placed in the Reserve Fund, around $80 billion in the National Wealth Fund (and reserved to support future pensions expenditure) and just over $45 billion in gold, the readily accessible share of Russia's reserves is closer to $200 billion. It is this author's opinion that Åslund exaggerates the illiquidity of these reserves. First, it is not clear why gold is any less liquid than foreign currencies. Second, as pointed out in an assessment of Russia's foreign exchange reserves by Moody's (5 December 2014), while it is no doubt true that the reserves assigned to the Reserve Fund and the National Wealth Fund are 'unlikely to be used either to intervene in the foreign exchange market or to finance the government's external debt payments, like the CBR's own reserves, the amounts placed in the central bank contain liquid, marketable assets, that can be utilized if required.'
[14] Rosstat, 6 January 2015.

by Russia's import ban on a wide range of Western food items.[15] While inflation may become a bigger problem in the future, especially if the rouble depreciates further, for now it is a long way off threatening macroeconomic stability. Consumer price inflation was 11.4 per cent year on year in December 2014, up markedly but not disastrously from 6.5 per cent in the corresponding period in 2013 and still a rate broadly comparable with price rises observed in many other middle-income economies.[16]

Thus those who point to the good news in the Russian economy are not without justification in thinking that the situation could be worse than it currently is. On the indicators described above, Russia does not appear to be in any state of immediate crisis, although the plunge in the exchange rate in late 2014 and early 2015 has increased uncertainty. However, some areas of previous strength may be susceptible to change, especially if other pillars of Russia's previously buoyant economic performance are threatened.

… but even more reasons to be fearful

While the reasons for optimism about the Russian economy are not insignificant, there are clear signs of danger. These suggest prospects for sustained development and growth in the future are bleak. Five indicators are especially worrying:

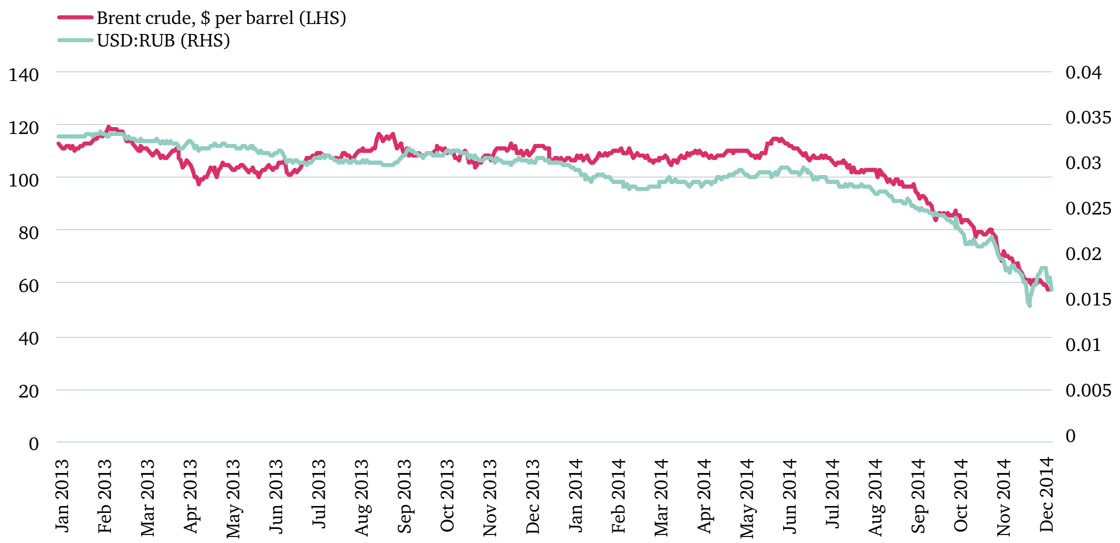
1. The dramatic fall in the price of oil – Russia's primary export and the source of around half of federal budget income – is perhaps the most important problem confronting the economy. The average price for Urals crude oil hovered around $110 per barrel from 2011 to June 2014. Since then prices have plummeted, to $47 per barrel for Urals crude on 28 January before recovering slightly in February. (Similarly, Brent crude traded at about $49 per barrel on 28 January, down from $114 in June last year.) Some of this decline is explained by the strengthening of the dollar.[17] However, the main driver of declining prices is the imbalance between global supply and demand. This imbalance is unlikely to disappear soon. On the demand side, slower growth both in the sclerotic European economies and the largest Asian markets (i.e. China and Japan) has caused growth in aggregate global oil consumption to slow. On the supply side, the continued rapid expansion of unconventional oil supplies in North America, along with production increases in Libya and Iraq, has caused the global oil supply outlook to appear more abundant than at any point in the past decade.[18]

While the short-term effect on federal budget revenues is unlikely to be extreme unless prices decline much further, low oil prices threaten a more significant impact on the wider Russian economy. As described in the second section of this paper, non-oil sectors would be adversely affected by any fall in oil prices that extended beyond a few months because of their dependence on the redistribution of oil revenues across the economy.

2. The depreciation of the rouble is the second worrying indicator. As illustrated in Figure 2, the rouble has lost around 50 per cent of its dollar value since January 2013. Initially, this downward trajectory was caused by (i) global factors related to US monetary policy 'tapering' that partially explain the increase in net private capital outflows; and (ii) the deliberate policy on the part of Russia's central bank to move towards a free-floating rouble. This latter point means that the bank has limited its intervention in the currency markets to merely managing the pace of rouble decline rather than trying to halt it.

[15] 'Rossiya pod sanktsiyami: ukrepleniye tekushchego cheta i rekordno nizkii ottok kapitala' [Russia under sanctions: strengthening of the current account and record low capital outflows], *Expert*, No. 42, 13–19 October 2014, p. 6.
[16] Rosstat, 3 February 2015.
[17] Aleksandr Koksharov, 'Otkat k realnosti' [Back to reality], *Expert*, No. 42, 13–19 October 2014, p. 42.
[18] International Energy Agency, *Oil Market Report*, October 2014 (Paris: IEA), http://www.iea.org/oilmarketreport/.

Figure 2: Rouble-dollar exchange rate and oil price (Brent, $), 2013–14



Source: International Monetary Fund, International Financial Statistics Database.

However, since the summer of 2014 the main cause of the rouble's depreciation has been the precipitous decline in global oil prices described above (see Figure 2). As a result, the rouble's prospects are largely bound up with developments in global oil markets, over which Russia has little influence. Attempts to stem the depreciation of the rouble, including the central bank's dramatic interest rate hike on 16 December 2014, have so far failed to prevent the currency from falling in line with oil prices. Given that the central bank could rapidly burn through its foreign reserves if it decided to maintain an exchange rate inconsistent with the oil price, the authorities have resorted to imposing informal capital controls over the country's largest exporters in an effort to restore some order to currency markets.[19] While President Vladimir Putin has repeatedly stressed his opposition to formal capital controls, should the rouble fall further (presumably as a result of an extended period of low oil prices) the probability of their imposition will surely rise. If this were to occur, it would represent a reversal of one of the most significant market reforms of the past 20 years.

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If the causes of the rouble's weakness are reasonably clear, its effects are harder to discern. On the positive side, currency depreciation has helped cushion federal tax revenues from the fall in the price of oil. Russia's dollar-denominated oil revenues – which account for a large share of total state income – buy more roubles than they did a year ago. Despite the sharp decline in oil prices over the summer of 2014, the Ministry of Finance continues to forecast a budget surplus for that year.[20]

[19] 'Goskompanii obyazhut prodavat' po $1 mlrd v den' dlya stabilizatsii situatsii na valyutnom rynke' [State-owned companies obliged to sell $1 billion per day to stabilise foreign exchange market], Finmarket.ru, 23 December 2014, http://www.finmarket.ru/main/article/3899135.
[20] See the recent draft budget presented to the Duma, *'O federal'nom byudzhete na 2013 god i na planoviy period 2016 i 2017 godov'* [On the federal budget for 2013 and the planning period of 2016 and 2017], Ministry of Finance of the Russian Federation, 2014.

Rouble depreciation is also causing a reversal of previously brisk import growth.[21] In principle, this *could* stimulate domestic industry if it prompted consumers to switch to cheaper Russian products.[22] If the rouble remains weak, there is also the possibility that increased price competitiveness will stimulate Russian manufacturing exports.

However, a number of factors suggest that the disorderly depreciation of the rouble observed in recent months may do more harm than good.

First, with the exception of armaments and some semi-processed metals, Russia's manufactured exports are modest in value. Sustained investment in manufacturing capacity would be required for Russia to exploit its newfound price competitiveness and expand manufacturing exports. This would require a more enlightened and effective state industrial policy.[23]

Second, the long-standing and deep-rooted weakness of the financial sector has obliged Russian companies to borrow from foreign (primarily European) banks, resulting in the accumulation of significant foreign-currency-denominated liabilities.[24] As the rouble depreciates, so the local-currency debt burden of Russian corporations and banks will rise.[25] Moreover, the fact that Western capital markets have been largely closed to Russian entities since the imposition of sanctions on the financial sector in July 2014 means that refinancing external debt is proving difficult for Russian corporations and banks. While repayment of large stocks of foreign-currency-denominated debt need not be disastrous for companies with significant dollar revenues (e.g. in the oil and gas sector), an extended restriction of access to foreign capital would dampen investment.

Third, Russian enterprises in all sectors rely heavily on imported goods. Where local substitutes are unavailable or inappropriate to the production process, the rising cost of imports is likely to be passed on to consumers in the form of higher prices and/or lower-quality goods. Further rouble depreciation would also make higher rates of inflation more likely in the future, eroding the purchasing power of both producers and consumers.

3. The size of net capital outflows has also attracted attention (see Figure 3). Annual net capital outflows are estimated by the central bank to have reached $151.5 billion in 2014. Of the $78.6 billion in net private-sector capital outflows between January and September 2014, $48.5 billion left the country in the first quarter of the year, with the bulk of this occurring in January and February.[26] The fact, therefore, that capital outflows were already well under way before Russia's annexation of Crimea in March 2014 suggests that the determinants of the outflows are domestic rather than external (i.e. due to features of the Russian business environment rather than the imposition of

[21] The effect of the weaker rouble on imports is already observable. According to Bank of Russia data, the dollar value of imports of goods and services in the first nine months of 2014 was just under 7 per cent lower than in the corresponding period of the previous year. Moreover, the current-account surplus is growing despite reduced gas exports and the decline in oil prices. Although the reduction in imports has caused the trade surplus to widen, the associated decline in capital goods imports will exert an additional drag on investment.

[22] Rosstat data reveal that manufacturing grew strongly in mid-2014, with research by the Higher School of Economics suggesting that this performance was related to import substitution in the state sector (e.g. increased state orders for industrial goods, especially for goods related to the defence industry).

[23] On state industrial policy in Russia, see Richard Connolly, 'State Industrial Policy in Russia: The Nanotechnology Sector', *Post-Soviet Affairs*, Vol. 29, No. 1, 2013, pp. 1–30.

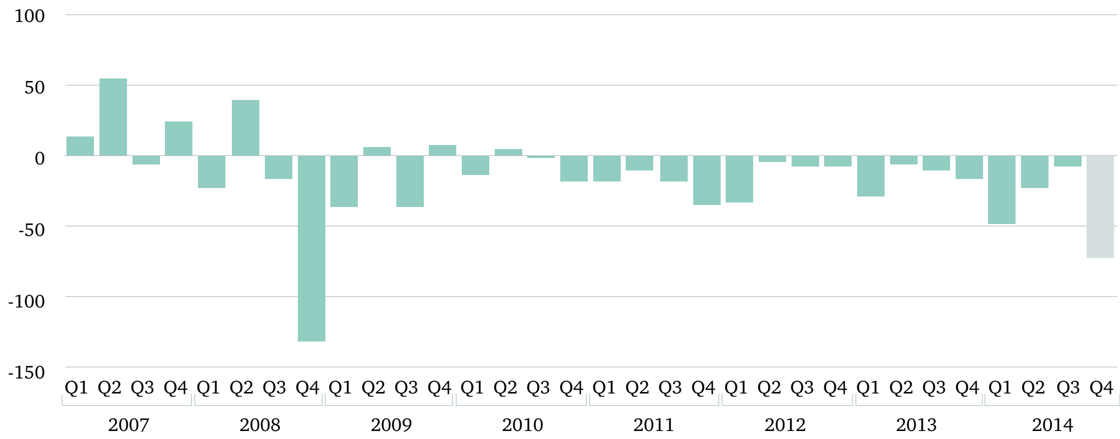
[24] Total non-financial corporate (which includes many large state enterprises) and financial sector external debt amounted to around $610 billion in September 2014 (when data were last reported); see *Monetary Policy Report December 2014* (Moscow: Bank of Russia, 2014). At exchange rates prevailing in January 2014, this amounted to around 30 per cent of GDP. However, at exchange rates prevailing in January 2015, the external-debt-to-GDP ratio is over 60 per cent.

[25] Around $131 billion of external debt is scheduled for repayment between December 2014 and the end of 2015. See Bank of Russia, *Monetary Policy Report December 2014*.

[26] In the first quarter of 2014, the conversion of roubles to foreign currencies by households and corporations accounted for around $10 billion of private capital outflows, with an additional sum of over $20 billion of outflows explained by Russian banks repaying external debt.

Western sanctions). While it is normal for oil exporters and countries with substantial current-account surpluses (Russia is both) to exhibit sizeable capital outflows, the rapidly deteriorating exchange rate and exceptional volume of net private capital outflows over 2013–14 have caused mounting concern that the economy is approaching a point of crisis.[27]

Figure 3: Quarterly net private capital flows, 2007–14 ($ billion)



Note: Figure for Q4 2014 is an estimate.
Source: Bank of Russia.

4. The increase in net capital outflows has exacerbated the low rate of investment growth. Even before the latest economic slowdown, Russia's investment-to-GDP ratio of around 20 per cent was among the lowest of the major middle-income countries.[28] In the years preceding the global recession of 2008–09, the annual rate of investment growth had been impressive, ranging between 10 and 22 per cent. After that downturn, however, investment growth failed to return to pre-crisis rates, averaging around 6 per cent per year in 2010–12. Investment contracted slightly in 2013 (–0.3 per cent) and looks set to decline further in 2014 (Russia's state statistical agency forecasts a 2.8 per cent contraction).[29] Foreign direct investment (FDI) also fell in 2014, mainly due to an exceptionally poor third quarter, which may well have reflected the imposition of sanctions by Western countries earlier in the year.[30] One factor undermining both business confidence and firms' ability to finance investment has been the declining profitability of the corporate sector over the past five years, as the share of wages has risen at the expense of profits.[31] Because most Russian firms use retained earnings to fund investment, this reduction in profitability has exerted an additional drag on investment.

[27] The former deputy governor of the Bank of Russia, Sergei Aleksashenko, expresses this view. See Aleksashenko, 'Reyting podderzhki ili votum nedoveriya' [Vote of support or no-confidence?], Echo Moscow Radio Blog, 12 November 2014, http://echo.msk.ru/blog/aleksashenko/1435596-echo/.
[28] It should be noted that Brazil – the other resource-rich BRIC country – has a similarly low rate of investment. See Connolly, 2011. Worryingly, it has been argued that the investment data in Russia *overstate* the already modest volume of investment, with the real rate of investment even lower. See Gaddy and Ickes, 2014.
[29] Rosstat. Data correct as of June 2014. Ex-deputy economic development minister Andrei Klepach has forecast that investment will contract by 3 per cent in 2014. See Igor Kalinowski, 'Investory gotovy risknut' [Investors are willing to take the risk], *Expert Online*, 20 October 2014, http://expert.ru/2014/10/20/investoryi-gotovyi-risknut/.
[30] Bank of Russia, 2014. FDI in the non-banking sector in Russia fell in the third quarter of 2014 to $1 billion, compared with $10 billion and $10.2 billion in the previous two quarters. Total FDI inflows for 2014 are forecast by the Bank of Russia to be the lowest in eight years.
[31] Vladimir Mau, 'Challenges of Russian Economic Policy: Modernisation or Acceleration (Perestroika or Uskorenie)', *Post-Communist Economies*, Vol. 26, No. 4, 2014, p. 445.

5. The future direction of federal government spending has emerged as an increasingly contentious issue. In previous years, rising revenues ensured that competing claims on federal resources were at least partially satisfied. However, a combination of stagnant GDP growth and falling oil prices threatens to reduce federal government revenues and reverse the fiscal tranquillity of recent years. Powerful lobbies look set to compete for a share of a pie that, while not yet shrinking, is growing at its slowest pace for years.

The draft budget submitted by the government to the Duma in early October envisages consolidated government spending rising by over 11 per cent in nominal terms in 2015. The budget assumes revenue growth of little over 7 per cent. The result is a forecast budget deficit of over 2 per cent of GDP in 2015, although public spending plans are being quickly revised in response to the economic slowdown.[32] Much will depend on the oil price. The government's forecast assumes an average price of $100 per barrel (Urals). This may well prove correct, but if prices are closer to current levels of around $55–60 per barrel, and if stagnant GDP growth constrains fiscal revenues, spending will have to be reduced in accordance with the 'budget rule'.[33]

If spending could be cut to approximately the size of any revenue shortfalls, then Russia might muddle through without much in the way of fiscal turbulence. After all, running even a modest federal budget deficit (e.g. 2–3 per cent of GDP) should be tolerable given Russia's healthy fiscal position. However, spending commitments are likely to prove hard to trim.

One structural constraint that will not disappear soon is the ageing population, as well as the shrinking (official) labour force. This means there will be a smaller base of taxpayers to support a growing proportion of pensioners.[34] In addition, Putin's 'May Decrees'[35] – which reflect election campaign commitments to raise public sector wages and defence spending, and to develop Russia's Far East – all assume constant increases in public spending.

> While external factors such as prolonged stagnation in Europe and the steep fall in the price of oil cannot be prevented by Russian policy-makers, structural and home-grown problems help explain why Russia is so susceptible to exogenous shocks.

Given such extensive spending commitments, and the political influence of their beneficiaries, any slowdown in revenue growth will test the government's resolve in preserving the budget rule and other pillars of Russia's fiscal stability. Already, large firms either owned by the state or with close connections to the Kremlin (including Rosneft and Novatek) have attempted to secure funds from the National Wealth Fund (NWF). The value of applications for NWF money already exceeds the amount held by the fund. Even if fiscal discipline is preserved – a core component of economic

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[32] This includes the federal budget and state social funds for 2015, the budget framework for 2016–17, and the Ministry of Finance's projection of consolidated government budget revenue and spending (including regional budgets).

[33] Currently, the budget rule limits government borrowing to 1 per cent of output and links spending to the long-term oil price. President Putin reasserted his commitment to a conservative fiscal policy in remarks to foreign journalists in Milan in October 2014. Nevertheless, while stating that Russia would not risk fiscal discipline if oil prices were to decline for a substantial period, Putin also stated that the government would 'continue to meet its social obligations'. Defining which social obligations are immune to spending cuts would thus appear to be the crucial issue. See 'Putin: Padeniye tsen na neft' ne otrazitsya na vypolnenii sotsial'nykh obyazatel'stv' [Falling price of oil will not affect the fulfillment of social obligations], ITAR-TASS, 17 October 2014, http://itar-tass.com/ekonomika/1516139.

[34] Reform of the pension system is urgently needed to address the rising cost associated with the growing dependency ratio.

[35] The May Decrees are a series of presidential decrees that originated in commitments made by Vladimir Putin during his election campaign. The decrees, based on work by officials and experts, make a number of commitments across a wide range of policy areas. The commitments include economic modernization, improvement of inter-ethnic relations, strengthening of the military and a higher birth rate. Many of these commitments, although not all, are summarized in: Vladimir Putin, 'O nashikh ekonomicheskikh zadachakh' [Our economic objectives], *Vedomosti*, 30 January 2012, p. 1, http://www.vedomosti.ru/politics/news/1488145/o_nashih_ekonomicheskih_zadachah (accessed 3 February 2012).

policy since Putin came to power in 1999 – the ensuing political battle over the composition of a shrinking spending pie will reveal much about the leadership's priorities and the future direction of economic development in Russia.

To sum up so far, the Russian economy is clearly slowing. While external factors such as prolonged stagnation in Europe and the steep fall in the price of oil cannot be prevented by Russian policy-makers, structural and home-grown problems help explain why Russia is so susceptible to exogenous shocks. It is also these problems that constrain economic growth. Public spending that is rising faster than revenues, falling private investment, near-record private capital outflows and rapidly deteriorating business sentiment – all point to a system that requires significant change if Russia is to enjoy growth and prosperity in the future.[36] But exactly what type of change is required?

How Russia's political economy works

To understand the challenges for policy-makers, and to appreciate which economic reforms are necessary and feasible in the immediate future (the two do not always correspond), it is necessary to understand how Russia's political economy functions. This system provides the structural context in which Russian policy-makers operate and defines the range of choices open to them. What follows is a stylized model of the political economy in Russia. It is a deliberate abstraction of reality, intended to identify the key factors that shape economic development.[37]

A useful starting point is the 'rent addiction' model advanced by Clifford Gaddy and Barry Ickes.[38] According to their model, much of the Russian political economy can be explained by the extraction and distribution of resource rents.[39] They present a two-sector model of the Russian economy. The first sector – the rent-producing sector, or 'Sector A' as it will be referred to from now on – mainly covers enterprises in oil, gas and mineral extraction. Typically, firms in this sector are globally competitive (i.e. they can sell their goods or services on global markets), do not require subsidies to function, and generate significant rents (or profits, in the classical sense). Ownership is mixed in so far as the state has controlling shares in some important enterprises (e.g. Gazprom, Rosneft, Transneft) while others (e.g. Lukoil, Novatek and most firms in the metals and mining sector) are in private hands.

A second sector – 'Sector B', the rent-dependent sector – consists of industries that are not usually globally competitive (i.e. they are unable to sell their goods or services on global markets, instead primarily targeting domestic markets), require subsidies (direct or indirect) from other areas of

[36] On the mood in the economy at the turn of the year, see pessimistic comments by both Finance Minister Anton Siluanov and Minister for Economic Development Alexei Ulyukayev: Olga Samoflava, 'Ugrozhayet stagflyatsiya' [Stagflation is threatening], *Vzglyad*, 15 January 2014, http://www.vz.ru/economy/2014/1/15/667947.html.

[37] Any abstraction of reality requires details to be overlooked in the hope that the simplified version adds enough value to justify the presence of numerous inaccuracies. To give an example of the sort of nuance lost in the stylized model presented in this paper, it is worth acknowledging that not all enterprises in the rent-dependent 'Sector B' rely on the transfer of rents to survive. Almaz-Antei, a producer of air-defence systems, for example, is competitive on global markets and perfectly capable of operating without state support. Similarly, there are no doubt firms in the supposedly more independent 'Sector C' that enjoy support from the state, either at the federal or local level. What is important is the degree to which the stylized model captures the essence of the political economy in Russia. If so, the model provides a useful way of conceptualizing the problems policy-makers face and the possible solutions open to them.

[38] This model has numerous iterations, but the most comprehensive description is found in Clifford Gaddy and Barry Ickes, 'Resource Rents and the Russian Economy', *Eurasian Geography and Economics,* Vol. 46, No. 8, 2005, pp. 559–583.

[39] There is some disagreement over the precise nature of economic rents. David Ricardo classically defined rents as a financial return on an asset or action higher than the return derived from the next best opportunity foregone. More recently, there has been a tendency in the literature to refer to directly unproductive rent-seeking activities, wherein economic agents devote resources to gain rents that have no socially useful purpose. The definition employed by Gaddy and Ickes in relation to Russia's oil and gas sector is closer to the classical one, but includes production costs above minimum efficient levels. Thus rents are not equivalent to profits as they are in the classical definition. Instead they encompass 'excessive costs' as well as 'more-than-normal' pre-tax profits. I am grateful to Philip Hanson for pointing this out.

the economy to function, and exhibit low (if any) levels of profitability. In Russia, such industries encompass defence, rail machinery, and oil and gas pipelines. In addition to industrial sectors, this category includes people dependent on government spending (the so-called *byudzhetniki*, such as pensioners or those employed in the vast state bureaucracy).

For Gaddy and Ickes, the political economy of modern Russia is essentially a story of how the state and private owners in these two sectors interact: that is, how the distribution of rents generated in Sector A is managed in order to support Sector B. The primacy of the state in this rent management system is crucial. The Russian state sits astride these sectors. It manages the conditions under which they operate, and channels rents between them. Whether through direct ownership or control, or through indirect influence over private enterprises, the state acts to ensure that Sector A firms serve the interests of the regime by maintaining output and employment in Sector B.[40] This is achieved by a mix of direct transfers (e.g. relatively transparent, formal taxes on oil exports to fund state orders of defence equipment) and indirect transfers (e.g. Sector A enterprises supplying inputs at below market price to Sector B enterprises). This sophisticated and vast system ensures the subsidization of otherwise uncompetitive production across the Russian economy.

One aspect of this rent management system not explicitly articulated by Gaddy and Ickes is the systematic suppression of competition to ensure that rent flows are managed to suit the interests of the political elite. Within the two sectors captured in their model, market structures tend to be monopolistic or oligopolistic. Competition in Sector A is relatively low, and the state exerts dominance either through direct ownership or management of companies, or through regulatory mechanisms (e.g. by awarding licences for exploration or production).

Within Sector B, federal and local government regulation keeps barriers to entry and exit high. Much of the demand in this sector is supported by direct government spending, subsidies, or policy distortion of markets to protect incumbents. Profitability is not a precondition of firms' survival in this sector.

The suppression of competition across markets in Russia is of crucial importance because of its impact on productivity growth. More competition encourages enterprises to invest in staff or facilities, develop new technology, or rethink their organization and management.[41] All of this is potentially positive for productivity. Yet in Russia the dominance in many sectors of uncompetitive (and often state-protected) firms impedes innovation and prevents more dynamic economic actors from flourishing. This is harmful to long-run economic prospects.

If the Russian economy only comprised firms from the two sectors in the rent addiction model offered by Gaddy and Ickes, then its prospects would be bleak indeed. Yet however elegant and compelling their model is, it ignores a vital component of the modern Russian political economy: enterprises that exist outside the rent-generation and -management system described above. These ventures operate in an area of the economy that, for simplicity, can be labelled the rent-neutral sector, or 'Sector C'.

[40] The distinction between state control and influence in Russia is discussed in Philip Hanson, 'The Resistible Rise of State Control in the Russian Oil Industry', *Eurasian Geography and Economics,* Vol. 50, No. 1, 2009, pp. 14–27.
[41] On the relationship between competition and innovation, see Philippe Aghion and Evguenia Bessonova, 'On Entry and Growth: Theory and Evidence', *Revue OFCE*, June 2006.

Enterprises in Sector C account for a relatively small share of state tax revenues, and do not depend on state expenditure or protection for their survival. Indeed they tend to function largely outside the purview of state manipulation that characterizes activity in sectors A and B. Budget constraints within this sector are ‘hard’, in the sense that firms must generate a profit to survive. Competition in Sector C is much higher than elsewhere in the Russian economy, and levels of innovation and total factor productivity are above average.[42]

Sector C includes small and medium-sized enterprises (SMEs) in all industries, but especially in services. These SMEs commonly operate in retailing, transportation and business services. They are prominent in Russia’s thriving software industry. The country has around 2,300 software companies, of which an estimated 1,500 are active in exporting software and software services. This makes the software industry one of the most export-oriented in the country. It earns more from overseas sales than all other knowledge-intensive sectors in Russia combined, with the exception of armaments.[43] Competition in the software business is high, so innovation has flourished in it.

Although Sector C accounts for only around one-fifth of Russian GDP and employment, its growth has been rapid. From being a negligible component of the economy in 1990, it has become an important source of growth and innovation. Moreover, Sector C merits a special place in any analysis of Russia’s political economy because it offers the greatest hope for long-term modernization. Firms in this sector are not only among the most competitive and commercially dynamic in Russia, they also constitute a growing and increasingly powerful constituency for improved economic and political governance.[44] It is no exaggeration to say that the health of Sector C is crucial to the wider future development of Russian society.

How the system performed

Since 2000, the three sectors described above have all grown rapidly. In Sector A, rapid global growth – albeit interrupted by the financial crisis of 2008–09 – supported prices for Russia’s oil, gas and metals exports. This in turn encouraged higher volumes of commodity production, as private firms in particular seized the opportunity to earn enormous profits.[45] Equally important was the fact that the state was able to tax rents generated in this sector to a degree that it had been unable to do during the 1990s.[46] The enormous expansion of rents appropriated by the state was channelled into production and services in Sector B. Defence spending increased after years of savage cuts. Social welfare spending rose dramatically. The state bureaucracy ballooned in size. The prosperity created by expansion of sectors A and B helped generate demand in Sector C, which finally benefited from the painful market-augmenting reforms of the 1990s.

The economic results associated with this model were impressive. Real GDP grew at an average annual rate of over 5 per cent between 1999 and 2013. A steady succession of budget surpluses enabled the government to reduce the stock of public debt to a minuscule level, and to build up huge foreign exchange reserves. Not only did the public finances benefit from the boom, the wider population enjoyed a rapid rise in living standards too. The rate of annual inflation dropped from

[42] Boris Kuznetsov, Tatiana Dolgopyatova, Victoria Golikova, Ksenia Gonchar, Andrei Yakovlev and Yevgeny Yasin, ‘Russian Manufacturing Revisited: Industrial Enterprises at the Start of the Crisis’, *Post-Soviet Affairs*, Vol. 27, No. 4, 2011, pp. 366–386.
[43] Russoft, *10th Annual Survey of the Russian Software Developing Industry and Software Exports* (Moscow: Russoft Association, 2013).
[44] Andrei Yakovlev, Anton Sobolev and Anton Kazun, ‘Means of Production versus Means of Coercion: Can Russian Business Limit the Violence of a Predatory State?’, *Post-Soviet Affairs,* Vol. 30, No. 2–3, 2014, pp. 171–194.
[45] Daniel Treisman, ‘“Loans for Shares” Revisited’, *Post-Soviet Affairs*, Vol. 26, No. 3, 2010, pp. 207–227.
[46] Thane Gustafson, *Wheel of Fortune: The Battle for Oil and Power in Russia* (Boston, Mass.: Harvard University Press, 2012).

around 20 per cent in 1999 to 6.5 per cent in 2013. Average wages increased by a factor of 11 in US dollar terms over the same period, and the unemployment rate fell from 13 per cent to around 5 per cent.[47]

It has been argued, with some justification, that this period of robust performance concealed a failure to carry out further structural reforms to reinforce those of the 1990s and the early period of Putin's rule.[48] Compounding familiar problems of government interference in the economy, corruption and waste of public resources, the massive transfer of rents from Sector A to Sector B caused the latter to grow to a size that now threatens the whole economy. Quite simply, the softening of budget constraints for firms in Sector B reduced their incentive to increase efficiency. As a result, there exists a large swathe of inefficient firms that survive largely because of the protection they receive from the rent management system coordinated by the government.[49]

A common proxy for state capacity is the murder rate. In the late 1990s and early 2000s this was 30.8 per 100,000 people, at the time among the highest rates in the world. By 2012 it had fallen to 9.2 per 100,000 people. While this remains comparatively high by international standards, it is much closer to the average of other middle-income countries.

While the system of political economy described here is undoubtedly economically inefficient, it has proven to be politically and socially efficient. Notwithstanding the obstacles to strengthening Russia's system of state administration, or *vertikal*, state capacity has increased.[50] A common proxy for state capacity is the murder rate.[51] In the late 1990s and early 2000s this was 30.8 per 100,000 people, at the time among the highest rates in the world.[52] By 2012 it had fallen to 9.2 per 100,000 people. While this remains comparatively high by international standards, it is much closer to the average of other middle-income countries.

Thus one of the most important effects of this system of political economy was to restore the sense of order (*poryadok*) lost after the tumultuous upheaval of the 1990s. State capacity was strengthened considerably, and reduced economic efficiency seemed like a small price to pay.[53] An appreciation of this point is important to understanding the range of future economic policies that are possible in

[47] All data are taken from Bank of Finland Institute for Economies in Transition (BOFIT), *Russia Statistics,* http://www.suomenpankki.fi/bofit_en/seuranta/venajatilastot/Pages/default.aspx (accessed 13 October 2014).
[48] See, for example, Vladimir Mau, 'Between Modernization and Stagnation: Russian Economic Policy and the Global Crisis', *Post-Communist Economies*, Vol. 25, No. 4, 2013, pp. 448–64.
[49] The former finance minister, Alexei Kudrin, estimates that formal subsidies to such firms in Russia add up to around 6 per cent of GDP. See Darya Korsunskaya and Alexei Kalmyikov, 'Kudrin proshchayetsya s mechtoi o reformakh i roste v Rossii na gody' [Kudrin says goodbye to dreams of reform and growth in the coming years], Reuters, 22 September 2014, http://ru.reuters.com/article/topNews/idRUKCN0HH22720140922?sp=true. Any figure that included the informal subsidies cited by Gaddy and Ickes would likely be higher still.
[50] For an assessment of efforts to build state capacity over the past two decades, see Brian Taylor, *State Building in Putin's Russia: Policing and Coercion after Communism* (Cambridge University Press, 2011). For a more recent assessment of the current weaknesses of the state administration, see Andrew Monaghan: 'The *Vertikal:* Power and Authority in Russia', *International Affairs,* Vol. 88, No. 1, 2012, pp. 1–16; and *Defibrillating the* Vertikal*? Putin and Russian Grand Strategy* (London: Chatham House, October 2014).
[51] For a more detailed discussion of the use of murder rate data to measure state capacity in Russia and elsewhere, see Vladimir Popov, *Mixed Fortunes: An Economic History of China, Russia, and the West* (Oxford University Press, 2014). The conceptual utility of identifying the reduction of violence as the first-order duty of the state is discussed in Douglass North, John Wallis, Steven Webb and Barry Weingast (eds.), *In the Shadow of Violence: Politics, Economics, and the Problems of Development* (Cambridge: Cambridge University Press, 2012).
[52] United Nations Office on Drugs and Crime (UNODC), *Global Study on Homicide* (Vienna: United Nations, 2013), https://www.unodc.org/gsh/en/index.html.
[53] The role of rent redistribution in binding elites together to forge greater social stability is discussed in North et al. 2012. Their work points to the weaknesses of approaches that focus narrowly on issues related to economic efficiency, such as Justin Yifu Lin's 'New Structural Economics'. See Justin Yifu Lin, *New Structural Economics: A Framework for Rethinking Development and Policy* (World Bank Publications, 2012).

Russia. Any policy threatening a system that has been so successful for social stability is likely to meet widespread resistance. As such, for economic reform to be viable in the long run, it needs to preserve these achievements and build on them.

Economic reform: possibilities and prospects

In gauging the prospects for economic reform, this section first outlines why reform is necessary, then provides a stylized picture of reforms that might be realistic. It finishes with an assessment of the prospects for reform given recent developments in economic policy.

Why is economic reform required?

If the resource rent-based model, for all its inefficiency, has worked so well socially and politically, why change it? The answer lies in the manner in which the system has been managed to date. To ensure the channelling of rents towards Sector B, the state increased its control and influence over Sector A. This reduced competition within that sector, suppressed efficiency growth and – perhaps most importantly – caused a sharp and sustained increase in the tax burden on energy enterprises in particular.[54] After all, milking as much as possible from the rent-generating sector is what funds maintenance of the system.

The problem for policy-makers in Russia, regardless of the oil price, is that the current tax system discourages enterprises from investing in future production, especially in remote or geologically challenging regions where the cost of oil extraction is high.[55] This is of particular concern because production in many older oilfields is diminishing. If overtaxed, companies will lack the incentive to extend the life of older fields through new drilling techniques, or to develop new production areas. The volume of oil production will therefore fall. Moreover, with or without taxation reform, the value of rents that the state can appropriate from oil firms is almost certain to decline, either because of lower production or because of a lower tax burden on expanded production. And, of course, depressed oil prices would exacerbate this.

All this helps to explain the slowdown in Russia's economy in recent years. Because the system of political economy described here is so dependent on rapid growth of rents, the fact that rent growth has slowed has made it harder to sustain the previous artificial boom in unproductive sectors. A further slowdown, or even an outright contraction in rents, is very possible should oil prices remain depressed.

A painful shakeout is on the cards. Because it was the beneficiary of the rent windfall of the 2000s, Sector B was able to grow briskly without undertaking much-needed structural reforms. Moreover, the sector was relatively insulated from the effects of the 2008–09 global crisis, because higher government spending offset slower growth in rents. Spending on social welfare, expansion of the state and, perhaps most notably, a large-scale rearmament programme[56] were all part of the government's policy response. While this provided a short-term boost to GDP growth, and helped buttress the

[54] Tatiana Mitrova, 'After the Crisis: New Market Conditions?' in Jakub Godzimirski (ed.), *Russian Energy in a Changing World* (Farnham: Ashgate Press, 2013).
[55] Valeriy Kryukov and Arild Moe, 'Oil Industry Structure and Developments in the Resource Base: Increasing Contradictions?' in Jakub Godzimirski (ed.), *Russian Energy in a Changing World* (Farnham: Ashgate Press, 2013). The minister for natural resources, Sergei Donskoi, recently asserted that Russia's 'imperfect' taxation of the hydrocarbons sector is a bigger problem for the industry than Western economic sanctions. See 'Sanctions against Russia already affecting production of tight reserves, could impact shelf', Interfax, 10 September 2014, http://www.interfax.com/newsinf.asp?id=535345.
[56] The arms programme is discussed in a historical context in Julian Cooper, 'From USSR to Russia: The Military Economy', in Paul Hare and Gerard Turley (eds.), *Handbook of the Economics and Political Economy of Transition* (London and New York: Routledge, 2013).

system of political economy by expanding the proportion of the population that see current economic policy as directly beneficial to them, it has compromised longer-term fiscal stability. Putin's May Decrees only exacerbated this tendency.

The steady expansion of spending on Sector B imperils Russia's future economic development in several ways. First, it enables a large, semi-parasitic portion of the economy to survive with only minimal attempts at introducing greater efficiency.[57] This hinders both economic and political competition, and consequently suppresses innovation.[58] Second, it places public finances under increasing strain. Revenue growth from Sector A is required to meet spending commitments, but, as stated above, to assume that such growth will continue is highly questionable. Third, even if the state does cut spending as revenues decline, the distribution of cuts is likely to favour unproductive sectors. The current composition of spending illustrates the government's policy priorities. Rather than allocating a rising share of resources to health and education – both important for any strategy to raise Russia's international competitiveness outside the energy sector – the ruling elite has a revealed preference for allocating more resources to the preservation of the existing industrial structure. Creating conditions for the emergence of a new structure is not one of its strategic goals.[59]

Finally, this statist model of political economy has stymied the development of Sector C. The government has largely failed to improve the business environment in which Sector C firms operate. The tax windfall from Sector A could have financed better public services, administration, and social and physical infrastructure. Although modest improvements have been made in these areas, the bulk of resources in recent years have been diverted to Sector B.[60] Thus, while growth in both output and employment in Sector C has been impressive, it should have been even faster. Instead, direct government spending on Sector B has grown faster than spending on those areas that would help Sector C. In 2013 federal government spending on the military, subsidies and social welfare amounted to 14.5 per cent of GDP, while spending on health and education amounted to just 1.8 per cent of GDP.[61]

The failure to create a favourable environment for the development of Sector C has contributed to the persistence of numerous well-known weaknesses. Property rights remain far from secure. Instances of raiding (*reiderstvo*) are frequent, ranging from low-level local cases to appropriation of some of the most valuable businesses in Russia.[62] *Reiderstvo*, at all levels, is symptomatic of the conditional nature of property rights in Russia: the strength of any owner's claim on property is

[57] According to Igor Shuvalov, state ownership accounts for around 50 per cent of GDP. See 'I. Shuvalov: dolya gosudarstva v ekonomike sokratitsya k 2020g. do 25%' [Shuvalov: By 2020, the state's share in the economy will be reduced to 25 per cent], RBC.ru, http://top.rbc.ru/economics/15/01/2014/899474.shtml (accessed 12 October 2014).

[58] This point was made recently in remarks by the former minister for economic development and trade, German Gref. See 'Urok istorii ot Germana Grefa' [A history lesson from German Gref], *Banki.ru*, 10 October 2014, http://www.banki.ru/news/research/?id=7203789&PRINT_VIEW=1.

[59] Evsei Gurvich, 'Pushki ili maslo – vybor mezhdu vooruzheniyem i potrebleniyem' [Guns or butter – the choice between weapons and consumption], *Vedomosti*, 23 April 2014, http://www.vedomosti.ru/opinion/news/25711741/pushki-ilimaslo#ixzz2zgoLiuCD.

[60] For more on government initiatives to improve the business environment, see Silvana Malle, 'The Policy Challenges of Russia's Post-Crisis Economy', *Post-Soviet Affairs*, Vol. 28, No. 1, 2012, pp. 66–110.

[61] These shares represent the sum of the budget lines for 'national defence', 'national security and legal', 'support to the economy' and 'social policy' for the first figure, while the second figure comprises spending on the 'health' and 'education' budget lines. Ministry of Finance, *Osnovnye napravleniya byudzhetnoi politiki na 2014 god i planoviy period 2015 i 2016 godov* [The main directions of fiscal policy in 2014 and the planned period 2015 and 2016] (Moscow: Ministry of Finance of the Russian Federation, 2013). Although significant spending on health and education is carried out at the local level, it is also true that the finances of the vast majority of local governments are in a parlous state. Consequently, local governments often require greater transfers from central government to fulfil their spending obligations.

[62] On *reiderstvo*, see Philip Hanson, *Reiderstvo: Asset-Grabbing in Russia* (London: Chatham House, March 2014); and Michael Rochlitz, 'Corporate Raiding and the Role of the State in Russia', *Post-Soviet Affairs*, Vol. 30, No. 2–3, 2014, pp. 89–114. The recent arrest of Vladimir Yevtushenkov bears the hallmark of previous high-profile instances of *reiderstvo*.

only as strong as his links with the authorities, whether in the Kremlin in the case of so-called oligarchs, or at the local level in the case of smaller businesses. Such an environment reduces the incentive to invest for the long term.

Equally damaging to the development of Sector C is the poor standard of financial intermediation in Russia. Around 65 per cent of financial assets in Russia are in the hands of banks owned by, or with close links to, the state.[63] These banks tend to serve larger enterprises, also with close links to the state, at either the federal or regional level. The market for long-term capital is extremely shallow, leaving most enterprises to rely on retained earnings to generate capital for investment. This ensures that many SMEs, especially in the regions, are unable to access capital.[64]

It is true that there have been some much-publicized government initiatives to strengthen economic policy and help improve the business environment. The government has made efforts to improve Russia's ranking in the World Bank's Ease of Doing Business Index, and has attempted to support medium-sized businesses through the Agency for Strategic Initiatives (ASI). However, such efforts face the fundamental problem that the resources allocated to the solution – both in terms of financial and political capital – are dwarfed by the magnitude of the problems they are designed to solve.[65]

What would economic reform look like?

The economic picture described above illustrates why the challenges confronting policy-makers in Russia are not simply due to external turbulence. Instead, it reflects a structural trend that has caused economic growth to taper off and threatens to restrict it further in the future. Reforms are urgently needed to counter its effects. While the remedy demands a multiplicity of measures, a sensible reform package would broadly have to include a number of basic elements.

Sector A should be managed more efficiently to ensure that oil and gas production volumes do not drop and, consequently, that rents continue to be generated well into the future. Because of the large share of government income derived from taxation of the energy industry, the health of the public finances will depend significantly on this condition being met. This will entail reform of the regulatory and legal frameworks for the energy industry, in order to encourage the innovation and entrepreneurship required to boost future production.[66]

Efforts should be made, at the very minimum, to ensure that Sector B grows more slowly than the other two sectors. This would ensure that its share of GDP diminishes over time, even if the sector does not decrease in absolute size. This cannot happen immediately because of the financial hardship it would create for a large proportion of the politically important labour force. Nevertheless, a number of policies can usefully be attempted. These include reform of the pension and welfare

[63] Andrei Vernikov, '"Natsional'nye chempiony," v strukture rossiiskogo rynka bankovskikh uslug' ['"National champions" in Russia's banking services market'], *Voprosy Ekonomiki*, No. 3, 2013, pp. 94–108.
[64] Connolly, 2011.
[65] The ASI was established by the Russian government as an autonomous non-commercial organization, with its stated objectives including: the promotion of projects and initiatives put forward by fast-growing medium-sized businesses and social sector leaders; growth in the number of new leaders emerging in medium-sized business and in the social sector; and the general improvement of the business climate. The ASI and other government initiatives to improve the business environment are discussed in Malle (2012) and Andrei Yakovlev, 'Russian Modernization: Between the Need for New Players and the Fear of Losing Control of Rent Sources', *Journal of Eurasian Studies,* Vol. 5, No. 1, 2014, pp. 10–20.
[66] Gustafson, 2012.

systems, a reduction of subsidies to 'dinosaur' enterprises, measures to increase competition across markets and a reduction in military spending.[67]

Efforts should be made to ensure Sector C grows faster than the other two sectors. This would reduce stress on the federal budget, and boost competition across the economy. Because competition is more intense in Sector C, moreover, faster growth here would raise the overall level of total factor productivity. In doing so, it would advance the goal of modernization in a less obvious but arguably more effective way than any prevailing initiatives based on state direction. Obvious areas for improvement include financial reforms that broaden access to capital, and increased government collaboration with Russia's growing business associations (such as Delovaya Rossiya, OPORA, RSPP and smaller, local groups) to tackle constraints on SME development.[68] Most of all, establishing property rights that are not conditional on good relations with state officials would surely raise the rate of investment. Unfortunately, this would also compromise the very fabric of a system that relies on state-directed allocation of rent and property.

Underpinning the above reform agenda should be a combination of fiscal reform (i.e. a readjustment of budgetary spending to reflect new priorities) and institutional reform (i.e. regulatory reforms across all three sectors). The gist of the desiderata outlined here is not new to Russian policy-makers. Very similar proposals have been made by ex-finance minister Alexei Kudrin and, in more comprehensive form, by the authors of the recent Strategiya-2020, which details a wide range of polices to achieve the broad aims described above.[69] The problem, as ever, is the low likelihood of such measures being adopted and implemented. The next section addresses this issue.

Prospects for economic reform

Even before the Ukraine crisis, despite a rhetorical commitment to modernization, the Russian leadership displayed a growing preference for state control in 'strategic' areas of the economy. This preference has been evident since the early 2000s, but has grown stronger in recent years as the government has emphasized state-driven economic policy at the expense of decentralized (i.e. market-based) allocation of resources. Put simply, Sector B – the area where state support is strongest – is growing in importance, not diminishing.[70] This makes taxation reform in the energy industry even more difficult. The recipients of spending in Sector B are unlikely to accept the lower levels of funding from Sector A that are implied by tax reforms to promote investment in energy production, necessary as such investment undoubtedly is.

[67] Defining what constitutes a more 'normal' level of military spending is not easy. According to calculations by Julian Cooper, Russia's military spending will peak at 5.35 per cent of GDP in 2016. While this is forecast to decline, according to the most recent draft budget put forward to the Duma, it is noteworthy that even lower forecast levels by other observers place Russia at the upper end of military spending in global terms. Russia is the third biggest military spender in absolute dollar terms, and when measured as a share of GDP Russia would be in the company of highly militarized states such as Oman, Saudi Arabia and Israel. Data taken from Julian Cooper, *Military Expenditure in the Draft Federal Budget of Russia for 2015 and the 'Planned' Years 2016 and 2017*, unpublished research note, 2014 (cited with permission of the author). While it is necessary to avoid reaching unreasonable conclusions about the political implications of this increased spending – much of it is compensating for decades of neglect, and is increasingly directed to re-equipment rather than operational costs, which are shrinking as a share of defence spending – the economic consequences are clear. There will be fewer funds available for areas that need to be developed to secure future competitiveness, such as education, while the state commits substantial funds to an industry that remains, with a few exceptions, inefficient.

[68] See Yakovlev et al 2014.

[69] Ministerstvo Ekonomicheskogo Razvitiya Rossiyskoy Federatsii, *Kontseptsiya dolgsrochnogo sotsial'no-ekonomicheskogo razvitiya Rossiiskoi Federatsii do 2020* [The concept for the long-term socio-economic development of the Russian Federation to 2020] (Moscow: Ministry of Economic Development, March 2012), http://www.economy.gov.ru/wps/portal/e-russia (accessed 24 March 2012). This strategy is examined in greater detail in Cooper, 'Reviewing Russian Strategic Planning: The Emergence of Strategy 2020', *NATO Defense College Research Review* (Rome: NATO Defense College, 2012), http://www.ndc.nato.int/download/downloads.php?icode=338.

[70] Admittedly, the draft budget takes a small step towards fiscal rebalancing by suggesting that military spending will decline from 2016 onwards. However, this assumes that the finance ministry gets its way, and that the budget is implemented along these lines. In conditions of heightened geopolitical tensions, the policy environment is likely to be more conducive to Sector B lobbying than in previous years, as national security concerns are pushed to the forefront of the policy agenda.

In addition, there is a worrying resurgence of the concept of economic self-reliance. Although nowhere near the extremes of the Soviet era, this tendency eschews interaction with the global economy in favour of either 'import substitution' (i.e. importing fewer goods and services and replacing them with domestically produced, often inferior, alternatives) or managed relations with global companies (e.g. joint ventures between large, state-controlled Russian firms and foreign multinationals).

The Ukraine crisis, Western sanctions and Russia's responses to those sanctions all threaten to reinforce these unhealthy tendencies. As Igor Yurgens, vice-president of the Russian Union of Industrialists and Entrepreneurs (one of the largest trade associations), puts it, economic warfare between Russia and the West serves to 'weaken the modernisers'.[71] It is perhaps no coincidence that the sector likely to benefit most from counter-sanctions imposed by Russia in the summer of 2014 primarily includes agricultural producers. These are the same lobbies that resisted Russia's accession to the World Trade Organization on the grounds that many within the sector were insufficiently prepared to compete with foreign products.[72]

The longer sanctions persist, the more likely it is that the market-oriented (i.e. liberal) policy elite will be marginalized as economic policies consistent with a more statist and introverted policy model take hold. The modernizers had hitherto been well entrenched in key positions in the Ministry of Finance, the Ministry of Economic Development and the Bank of Russia. However, factions in favour of greater military spending and state-led development are now likely to be emboldened. The prospects for liberal economic reform therefore appear to be worsening.[73]

> Factions in favour of greater military spending and state-led development are now likely to be emboldened. The prospects for liberal economic reform therefore appear to be worsening.

Evidence of this includes increasingly vocal calls by figures such as Sergei Glazyev (formally presidential adviser on Eurasian integration, but informally prone to pontificate on a wide range of policy matters) and Dmitri Rogozin (deputy prime minister, overseeing the defence industry) for state investment to boost production in strategic industries. Glazyev, Rogozin and their sympathizers also advocate greater control over the financial system, and a general shift away from two decades of integration with the largely Western-led global economic system.[74] Import substitution – popular among only a minority before 2014 – is becoming increasingly fashionable among policy-makers and experts. The longer Russia is isolated from the global economy, as will happen the longer sanctions persist, the more likely it is that these conservative forces will grow to dominate economic policy-making.[75]

The conventional assessment of the likely effects of Western sanctions on Russia holds that sanctions should weaken the existing system of government. The idea is either that loss of financial privilege

[71] Igor Yurgens, 'The West vs. Russia: The Unintended Consequences of Targeted Sanctions', *The National Interest*, 4 October 2014.
[72] Producers in the dairy and animal husbandry sectors, in particular, have historically relied on state support and barriers to foreign competition to remain in business, and were resistant to the lowering of trade barriers required as part of WTO membership. This is by no means the case for the entire agricultural sector. Russia is, for example, globally competitive in the production of grain and cereals.
[73] For a discussion of the changing role of key liberal economic reformers in the Russian policy elite, see Philip Hanson and Elizabeth Teague, *Liberal Insiders and Economic Reform in Russia* (London: Chatham House, March 2014).
[74] Margarita Papchenkova and Lilia Biryukova, 'Sergey Glaz'yev znayet, kak ogradit' Rossiyu ot sanktsiy' [Sergei Glazyev knows how to protect Russia from sanctions], *Vedomosti*, 25 April 2014, http://www.vedomosti.ru/politics/news/25829391/sergej-glazev-znaet-kak-ogradit-rossiyu#ixzz2zsVbxX8o.
[75] Vasili Kashin, 'Kholodnaya voyna nashego pokoleniya' [The Cold War of our generation], *Vedomosti*, 31 July 2014, http://www.vedomosti.ru/opinion/news/29673481/holodnaya-vojna-nashego-pokoleniya#ixzz391dh5FfK.

upsets the elite or that economic hardship stokes popular anger towards the leadership. Either is certainly possible.[76] However, it is worth considering an alternative scenario, wherein sanctions reinforce the political status quo rather than undermine it.[77] There is a strong body of evidence that sanctions may, under certain conditions, help entrench systems of government in countries that are the target of economic statecraft. In 'limited access' orders such as Russia's, the attempted curtailment of financial resources through sanctions may actually amplify the preferential distribution of rents to the elite, as scarcity makes patronage potentially more powerful.[78] Previous instances of economic statecraft, including in South Africa, Iraq, Yugoslavia and Haiti, demonstrate how the leaderships of target countries can use sanctions to reinforce their grip on power.[79] A similar outcome could occur in present-day Russia if the leadership decides to use sanctions to help its political allies.

In this respect, it is useful to examine how Russia has responded to embargoes of Western exports of defence, dual-use and energy-related technologies. The interruption of supply chains has prompted a reallocation of resources to domestic industries through import-substitution programmes. This pattern of policy response is already unfolding in Russia, with enterprises in sectors from oil to agriculture lobbying hard for state support. Indeed only recently Gennady Timchenko, a businessman reputed to enjoy warm relations with the Kremlin, bought a large stake in one of Russia's largest apple producers, a sector affected by Russia's ban on agricultural imports from Western countries and their allies.[80]

What is worrying is that most of the industries likely to benefit from state support operate in Sector B of the economy. As a result, unless increased state funding is accompanied by efforts to boost competition and efficiency, the most probable outcome is a further expansion of Sector B and an increase in the fiscal burden on Sector A. While this seems far from efficient in economic terms (it is unlikely that Russian producers would quickly achieve the same efficiency and quality as the Western firms they supplanted), the diversion of resources to defence, energy or manufacturing enterprises would strengthen these constituencies. All of which would serve further to reduce competition and heighten state influence over a large share of the economy. These fears were expressed recently by Boris Titov, the presidential ombudsman for entrepreneurs' rights.

Sanctions may thus end up binding Russia's economic elite more closely to the political leadership rather than causing divisions to emerge. Already, elements of a mobilization model of political economy are emerging, hinting at fundamental changes to macroeconomic policy (e.g. a greater focus on military spending), financial regulation (e.g. informal capital controls and the use of state resources to support favoured enterprises), and international economic relations (e.g. a supposed Russian 'pivot' to East Asia).

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[76] Indeed, target regimes may be destabilized even if policy changes desired by the countries imposing sanctions are not induced. See Jaleh Dashti-Gibson et al., 'On the Determinants of the Success of Economic Sanctions: an Empirical Analysis', *American Journal of Political Science*, Vol. 41, No. 2 (April 1997), pp. 608–18.
[77] The question of what effects sanctions are likely to have on the domestic political economy is distinct from that of whether sanctions are an effective foreign policy tool, i.e. whether sanctions or economic statecraft more widely tend to cause the desired policy changes in target countries. This paper deals with the political economy in Russia. Therefore the discussion is restricted to the possible impact of sanctions on the political economy.
[78] Limited-access orders are societies in which the state limits market entry and competition to ensure that individuals or organizations (whether these be the state or firms) with market power can accrue rents. See North et al, 2012. According to Risa Brooks, 'sanctions that harm the macroeconomy and thus hurt the "median voter" [are more likely to] be effective against democratic states'. Brooks asserts that authoritarian leaders, by contrast, 'tend to be insulated from aggregate or macro-economic pressures' and therefore cannot be expected to be as responsive to popular opinion as democracies. As a result, even if economic statecraft imposes costs on the bulk of a country's citizenry, what is most important from the perspective of the incumbent leadership is whether it can maintain the support of the elite. Sanctions can offer the opportunity for strengthening elite links with the leadership, and for the leadership to 'redistribute income to a small but influential section of the elite'. See Risa Brooks, 'Sanctions and Regime Type: What Works, and When?', *Security Studies*, Vol. 11, No. 4, 2002, pp. 1–50.
[79] On the welfare effects of sanctions – i.e. on the effects of sanctions on the domestic political economy in target states – see Jonathan Kirshner, 'The Microfoundations of Economic Sanctions', *Security Studies,* Vol. 6, No. 3 (Spring 1997), pp. 32–64; William Kaempfer and Anton Lowenberg, *International Economic Sanctions: A Public Choice Perspective* (Boulder: Westview, 1992); and David Rowe, *Manipulating the Market* (Ann Arbor: University of Michigan Press, 2001).
[80] Elizabeth Piper, 'Crunch Time: As Sanctions Bite, Putin Ally Gets Into Apples', Reuters, 28 December 2014, http://www.reuters.com/investigates/special-report/comrade-capitalism-apples/.

Overall then, Western sanctions and Russia's response to them threaten to divert economic policy from the path of desirable reforms described in this paper. Instead, there is a risk that policy will move towards a more extreme version of the system of political economy responsible for the slowdown from the growth rates observed in the previous decade. Recent economic policy suggests that the leadership is considering a reassessment both of the balance between state and market, and of the nature of Russia's place in the global economy. A more *dirigiste* system of political economy may emerge that emphasizes economic self-sufficiency, rendering Russia less open to international trade and investment.[81] That the country's current economic problems have prompted more state lending to favoured sectors, more controls over the financial system and greater emphasis on import substitution serves as evidence that this is the direction the leadership is moving in.

Historically, this is all too familiar. Russian leaders have often used the spectre of hostile encirclement to justify a more centralized organization of the social order, as occurred during both the Tsarist and Soviet eras. It is doubtful that such a system would foster greater economic and political competition. Longer-term prospects for economic and political development would therefore be likely to remain poor.

Conclusion: between Scylla and Charybdis

The recent slowdown in the Russian economy, dating back to the global recession of 2008–09, is a result of the interaction of external factors and growing defects in the domestic system of political economy. The relative importance of the defects, as opposed to the external factors, is rising over time. Under normal circumstances, a few years of relatively slow growth might not be considered a huge problem. However, policy-makers in Russia are facing a number of serious problems simultaneously.

First, there are the immediate *macroeconomic* challenges associated with the fall in the price of oil and the weakening of the rouble. Second, there are the *geopolitical* problems associated with Western economic sanctions and Russian counter-sanctions, which in turn aggravate the climate of domestic uncertainty. Third, policy-makers will be required to address the longer-term need for *structural-institutional* economic change to stimulate investment and growth.

Senior officials thus face the invidious task of juggling both immediate and longer-term policy demands. They may regret not having implemented economic reform during less turbulent times. If only because of the multiplicity of problems confronting Russia, it is likely that policy-makers will do *something* to show that events are not slipping out of their control. But what direction might this something take?

Over the past three decades, a precipitous drop in oil prices (and a concomitant sharp reduction in rents) has resulted in economic reforms being undertaken in Russia. Mikhail Gorbachev's perestroika emerged after the fall in oil prices in 1986. Putin's earlier, more liberal economic policies were carried out after oil dropped to close to $10 a barrel in 1999. And Dmitri Medvedev's modernization agenda was strongest in the aftermath of the global recession of 2008–09.

Unfortunately, the prospects for a similar surge in economic reform in Russia today are less good. The unfavourable geopolitical environment threatens to change the trajectory of political and economic development in Russia for the worse. By boosting factions within Russia's policy elite who favour increased state control and less integration with the global economy, poor relations with the West

[81] Aleksandr Ivakhnik, 'Kontrol' – nashe glavnoye slovo' [Control – our main word], Politcom.ru, 30 December 2014, http://www.politcom.ru/print.php?id=18459.

threaten to reduce the prospects for a market-oriented turn in economic policy. As a result, the prevailing system of political economy that is in such urgent need of transformation may in fact be preserved in a more ossified form. Instead of responding to adversity through openness, Russia may take the historically well-trodden path of using a threatening international environment to justify centralization and international isolation in order to strengthen the existing ruling elite.

Thus, while Western sanctions were not necessarily intended to strengthen statist factions within Russia and force the country away from the global economy, this may prove to be an unintended but important outcome. Consequently, Russia appears to be locked into a path of economic policy inertia, as powerful constituencies that benefit from the existing system are strengthened by the showdown with the West. While Russia may have 'won' Crimea, and may even succeed in ensuring that Ukraine is not 'won' by the West, the price of victory may be a deterioration in long-term prospects for socio-economic development.

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