

Institutional constraints and economic development[☆]

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Abstract

This article is an attempt to find a grounded answer to the question of why many large-scale economic development programs worked out in Russia from 2000 through 2010 have failed to yield the expected results. To this end, the author has diagnosed the Russian economy, including a comparative analysis against 20 countries at similar levels of development and analyzed both the Russian and global experience in developing and implementing economic programs. The author concludes that the development of the Russian economy is currently hindered by a rigid institutional framework and that growth cannot accelerate without removing it as part of the political process. Based on the analysis of various types of institutional reforms, specific measures are proposed that can ensure the country's evolutionary development and can mitigate the economic and social risks threatening Russia if the status quo is maintained.

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1. Introduction: Formulating the problem

Since mid-2014, the internal and external conditions affecting the development of the Russian economy have changed dramatically, projections of key macroeconomic indicators have deteriorated sharply, and the government's priorities have been substantially revised. Many important decisions (such as “counter-sanctions” or the import substitution policy) are made as situational re-

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sponses to economic shocks or geopolitical developments unrelated to the long-term strategy. Moreover, even the general policy direction to be pursued after the most-pressing tasks have been dealt with is still unclear, hampering investment and economic growth. At the same time, the Russian economy faces grave systemic problems. The adverse shocks the economy has experienced have aggravated the clearly visible trend towards decelerating economic growth that had already manifested itself (starting from mid-2012). There is no doubt at this point that the reasons for this deceleration are structural rather than temporary and are inherent in the internal economic mechanisms.

Under these conditions, the path of inertial development offers no prospects for the Russian economy: its potential has been described quite precisely in recent IMF (2016) forecasts predicting an annual GDP growth over the next five years between 1.0% and 1.5% (1.3% on average). This is barely one-third of the projected growth rates for the world economy (3.7% on average) and is even lower than for developed countries (1.9%), although, all things being equal, the Russian economy should be growing noticeably faster, like one with a lower per capita income. The long-run average growth rate for our economy is estimated at approximately 2% (Gurvich and Prilepskiy, 2013).

Several versions of a new economic program are currently being prepared. However, few of the programs developed in recent years have achieved their goals. This paper discusses the possible development of a program that would truly be in demand and have the actual ability to accelerate economic growth.

The first step in developing an economic program (EP) is to formulate the target performance indicators. Ensuring fast production growth is usually defined as the main objective. In 2003, President Putin established the key objective for economic policy as “doubling the GDP in 10 years.”¹ Increasingly more indexes have appeared lately that take the various aspects of well-being into account: health, security, education, income and wealth distribution, subjective estimates of living standards, etc. These include, first of all, the Human Development Index (UNDP, 2015), the OECD Better Life Index (OECD, 2015), and the Happiness Index (Helliwell et al., 2016). It seems expedient to expand the list of target indicators considered for Russia’s economic program. These should be aimed not only at production growth but also at maintaining public health, security, favorable environmental conditions, etc. However, the analysis shows that these objectives serve as alternatives only at the tactical level. From a long-term perspective, the level of economic development serves as a foundation for achieving the rest of these goals. Life expectancy must be a key measure of success for any policy pursued by the country. This approach is based on recognizing the lives of citizens to be the main priority. This indicator reflects healthcare quality, labor conditions, living conditions, and security. However, the analysis shows that life expectancy ultimately depends on the level of a country’s economic development. Thus, in a sample of the 60 most populous countries, two-thirds of the variation in both life expectancy and healthy life expectancy (as calculated by the World Health Organization) is explained by the variation in the logarithm of per capita income in terms of purchasing power parity (PPP). However, the correlation of both life expectancy indicators with per capita in-

¹ Address of the President of RF to the Federal Assembly, May 16, 2003.

come is 0.82. This conclusion is not surprising, since a high level of economic development makes possible better healthcare funding, better medical staff training, cleaner production facilities, etc.

Similarly, a higher level of economic development creates modern jobs, advances science and education, funds the modernization of the army and security forces, etc. In other words, from a strategic, long-term point of view, the different goals are interrelated, with economic development underlying all the rest. The opposite is also true: if the country fails to strike a fast-growth path, it will only, in the best-case scenario, be able to partially achieve certain objectives at the expense of others, like North Korea, which has a strong military potential at the cost of low consumption.

Controversies have become more frequent in another area: between short-term and long-term economic objectives. For example, monetary or fiscal stimulation of the economy may (under certain conditions) have a short-term positive effect on GDP growth but deteriorate growth prospects in the long run due to lower investor confidence. With this in mind, it seems expedient to define the *main goal of Russia's economic program as ensuring dynamic long-term economic growth*. Accomplishing this goal is expected to create conditions for higher consumption levels by both the population and the state, for growth in education and health-care, and for reinforcing domestic and foreign security (although this does not remove the need to devise a long-term policy for each area).

An annual growth rate of 4% has recently been cited as a quantitative target for the future economic program. If this refers to the 10-year average GDP growth rate, it means we are facing the extremely difficult task of nearly doubling the economic growth rate compared with the previous decade and tripling it as compared with the expected rate of “inertial” development.

2. Diagnosing the problems with the Russian economy

After targets for the economic program have been set, the next step is to diagnose the state of the economy. This step identifies the key limitations (bottle-necks) hindering development along with the missing elements of an effective growth mechanism. This will allow us to focus on removing the main obstacles afterwards. Thus, the quality of the economic program is largely dependent on the quality of the diagnosis.

First, we will estimate the overall performance of the Russian economy over the past 10 years. The average GDP growth rate was 2.3% during the period, which is noticeably lower than that of the overall world economy (3.7%). According to the IMF, per capita income converted into international dollars based on PPP was USD 25,400 in 2015. This is 65% higher than the world average.

To carry out a meaningful evaluation of the Russian economy's performance, we should compare it with the countries that are the closest to us in terms of development level and size. To this end, we have compiled a sample of 20 major “emerging markets” that includes the BRICS countries, Mexico, Malaysia, UAE, and others (Table 1). The average GDP per capita in terms of PPP in the selected countries is close to Russia's at USD 21,700. *Among the countries in this group, Russia has demonstrated the lowest GDP growth rate during the past decade* (the simple annual average without Russia was

Table 1
Growth and per capita income for major emerging markets.

Country	2015	2006–2015	
	GDP per capita in terms of PPP (USD)	Average GDP growth rate (%)	Gross capital formation (% of GDP)
1 China	14 107	9.5	44.6
2 India	6 162	7.5	36.1
3 Peru	12 195	5.8	24.7
4 Indonesia	11 126	5.8	32.6
5 The Philippines	7 254	5.4	19.2
6 Malaysia	26 315	4.9	23.4
7 Colombia	13 847	4.6	23.8
8 Egypt	11 850	4.3	19.5
9 Argentina	22 554	4.2	19.3
10 Poland	26 455	3.8	21.5
11 Chile	23 460	3.8	22.8
12 Turkey	20 438	3.8	20.4
13 UAE	67 617	3.7	24.0
14 South Korea	36 511	3.5	30.9
15 Taiwan	46 783	3.4	22.9
16 Thailand	16 097	3.3	25.7
17 Brazil	15 615	2.7	20.6
18 South Africa	13 165	2.6	20.4
19 Mexico	17 534	2.4	22.8
20 Russia	25 411	2.3	20.9
Average without Russia	21 531	4.5	25.0

Source: Author's calculations based on IMF data.

4.5%, which is nearly twice as high as the Russian economy's growth rate). Oil prices took a dive twice during this period, but, on balance, they have not changed much, while the 2006–2015 average oil price (USD 90 per barrel in 2015 prices) far exceeded its starting level, thereby creating extra opportunities for capital accumulation. Both quantitative and qualitative indicators of the Russian economy remain low. For example, despite the government's efforts, the unit weight of industrial organizations that have introduced technical innovations has dropped over 15 years, from 10.6% in 2000 to 9.7% in 2014. The aggregate level of innovative activity in Russia was 9.9% in 2014, compared with 19.2% in Chile, 38.3% in South Korea, 48.5% in Turkey, and 73.9% in South Africa (Gorodnikova et al., 2016).

Thus, *the performance of the Russian economy in the "fat" decade should clearly be recognized as unsatisfactory*. The above data prove once more that the need for a new economic program arised not in recent years, but much earlier. It had simply been hiding behind rising oil prices.

The initial step in diagnosing the state of the Russian economy was made by Kudrin and Gurvich (2014). Without repeating the arguments, we will list the most important problems reviewed in their paper.

1. The excessive size of the government and quasi-government (state-owned corporations) sectors of the economy removes a significant portion of the economy from the scope of market mechanisms.

2. The widely spread soft budget constraints, i.e., compensation to state-owned and other associated companies for losses caused by their inefficient operations, thus undermining their incentives to improve their competitiveness.

3. The locking of the creative destruction mechanism, which serves as a key link in upgrading the economy. Items 2 and 3 taken together reflect a policy of industrial paternalism, i.e., economically unsound support for inefficient industries and companies.

4. The weakness of public administration mechanisms due to their disconnection from economic results.

The authors also note the need to abandon paternalism, i.e., non-selective social support to large groups of the population who make quite a decent living from their labor income. Certain estimates of the losses from the current social policy in the form of support for citizens with high and medium income are provided by Gurvich and Sonina (2012). The consequences of this policy are characterized by a recent social survey² that asked citizens what the state should do in the first place to improve the well-being of the nation. Of the respondents, 31% suggested raising pensions and allowances to all those who are entitled; 14% proposed increasing wages for public-sector employees; the same percentage spoke for developing small and medium-sized businesses; 11% thought of lowering taxes; and 3% proposed attracting foreign investments into the country. These sentiments are very difficult to reconcile with a policy geared towards creating conditions for economic development.

The diagnosis procedure used below partly follows the approach suggested by Rodrik and Hausmann (Rodrik, 2010). Capital accumulation plays a key role in classical economic growth models. Consequently, diagnoses most often begin with analyzing investment levels and trends. As shown in Table 1, the rate of capital accumulation in Russia is not high (approximately 21% of the GDP on average over the past ten years³); however, half of the countries in the sample have the same level of investment. In addition, if we discard China and India, which stand out both in terms of accumulation and growth rates, then the correlation between investment and growth would not be very pronounced (correlation coefficient of 0.28). A number of countries are demonstrating dynamic growth with comparatively modest investment (e.g., Argentina), but others can hardly boast explosive growth, despite a high accumulation rate (e.g., Thailand). In other words, investments are important for growth but are not a decisive factor. Nevertheless, we need to analyze what is hampering their growth.

There is a very popular idea that the Russian economy is suffering from a “money deficit” and that this may be the greatest obstacle to its dynamic development. This view has been “proven” by citing the low monetization of the Russian economy (money supply to GDP ratio) as compared with some successfully developing countries (such as the U.S. or China). This opinion runs contrary to both the basic concepts of economic science and empirical data. The assertion that money is issued to perform settlements in an economy, whereas investments come from national savings and the net inflow of foreign capital, is an axiom. At the same time, monetization is determined by the demand for money and is impregnable to direct influence. The low monetization of an economy sometimes signals certain problems (e.g., low confidence in the national currency); however, attempts to increase monetization without changing the underlying conditions

² http://romir.ru/studies/814_1470258000/

³ The IMF data are used to ensure comparability between estimates for Russia and other countries.

will only accelerate inflation, while the monetization level will remain the same (Blanchard, 2016).

High monetization is actually neither a necessary nor a sufficient condition for rapid economic growth: Argentina, Kazakhstan, and Indonesia are developing successfully with lower monetization rates than Russia, whereas Taiwan has mediocre growth rates despite its record-breaking monetization rate.

In reality, it is not low monetization but insufficient capital for investment that may pose a problem for development. One of the symptoms of this situation in countries outside the most developed ones is when the accumulation rate exceeds the saving rate. Since developing countries usually have limited access to external sources of capital, the potential investment demand may be not fully realized in this situation. However, the level of savings in Russia has been sufficiently high in recent years: from 2006 to 2015, it varied from 25% to 35% of disposable income (30.6% on average). This is substantially higher than the world average savings (25%; World Bank, 2015) and the saving rate in our country (22.1% of the GDP on average). As a result, starting in 2008, a significant outflow of private capital has been observed in Russia (an average of 4.5% of the GDP leaves the country every year). Thus, we should state that *in Russia the problem is not a lack of investment resources but limited investment demand*. In theory, this can be explained by either a surplus of accumulated capital (which is clearly not the case in Russia) or a lack of profitable projects. At the same time, “profitability” should be evaluated, taking into account all risks, including potential external shocks that drastically change all of the economic conditions in the country, the threat of an arbitrary revision of the “rules of the game,” and the loss of property.

The main risks are discussed below. For now, I will note another important aspect: the share of gross profit in the structure of GDP distribution across revenue items has decreased substantially over the past ten years. In the distribution of value added between wages and gross profit (less net taxes imposed on production and imports),⁴ the share of gross profit fell from 46% to 38% from 2005 to 2014, i.e., returns on investments declined considerably. With the very limited access of Russian companies and banks to foreign financial markets, yet another consequence of this trend is significant: producers are left with increasingly fewer resources at their disposal, which additionally undermines investment opportunities. Vakulenko and Gurvich (2015) have shown that the rise in the share of wages has been caused by the growth model the Russian economy has followed throughout the past decade and by the specifics of the Russian labor market. The GDP has been growing not due to higher production efficiency but rather thanks to the higher demand caused by favorable foreign conditions. This growth has been accompanied by rising employment, while the resulting decrease in unemployment is exerting upward pressure on wages. It should be noted that this problem remains quite relevant, since the workforce is expected to steadily decline in Russia in the foreseeable future due to demographic shifts.

⁴ In April 2016, Rosstat (Russian Federal State Statistics Service) revised the method for calculating this group of indicators, resulting in a gap between rows beginning in 2012. In light of this, we are using prior estimates that contain no gaps.

Thus, we can safely state that the deceleration of the Russian economy has resulted from a combination of serious institutional and structural weaknesses rather than from low monetization, which is not even among the main factors driving long-term growth.

The problems considered here are related to the process of accumulating physical capital. However, the analysis illustrates that the bulk of growth is explained by other reasons that comprise the “total factor productivity” (TFP) concept. For example, according to estimates by Caselli (2005), more than half (60%) of the observable country-specific differences in per capita income can be explained by differences in their TFP rather than by differences in physical or human capital. Hsieh and Klenow (2010) obtained almost the same estimates of the role of TFP in explaining the differences between countries (50%–70%). According to calculations by Jones (2015), between 1948 and 2013, labor productivity in the United States grew by 2.5% per annum on average, of which increasing TFP accounted for 2.0%. Moreover, the role of TFP in explaining the differences between the development indicators for different countries has been increasing during recent decades (Arezki and Cherif, 2010).

The growth of factor productivity is connected first of all with scientific and technical progress, improvements in the organization of production, and the accumulation of professional skills by employees. However, more-advanced technologies can be purchased, while management practices can be replicated. Therefore, the question stands: why are there still vast differences between countries in their levels of economic development?

Nowadays, economists provide an almost unanimous answer to the question: it has been proven with certainty that the fundamental, basic reason behind the differences in per capita income between countries is the difference in the quality of their economic institutions (North, 1990; Rodrik et al, 2004; Acemoglu et al., 2005). At the same time, economic institutions affect development through many channels, part of which are related to the accumulation rate and part of which are related to increasing TFP. Thus, weak economic institutions undermine the willingness of companies to reinvest their profits in developing production (Cull, Xu, 2005) and reduce net capital inflow (Baek and Yang, 2010) and direct foreign investments (Javorcik and Wei, 2009). Tebaldi and Elmslie (2013) and Lin et al. (2010) found a positive correlation between the quality of institutions and innovative activity, while Silve and Plekhanov (2015) demonstrated that countries with better-developed economic institutions specialize in more innovation-intensive products, which constitutes a foundation for their long-term competitive strength. Nunn and Treffer (2013) provided evidence for the positive impact of the quality of a country’s institutions on its competitiveness in foreign trade, specifying that this effect is added to other factors of foreign competitiveness. A significant and relevant channel of influence of institutions on growth, tying the previous two components together, is the development of the financial system, which is determined to a large extent by the quality of institutions (Pasali, 2013). Besides those listed above, there are more-specific (while also quite significant) channels of institutional influence. For example, with high-quality institutions, a country’s excess oil and gas revenues will encourage the most gifted employees to engage in productive activities, whereas low-quality institutions force employees to join in rent-seeking activities (Ebeke et al., 2015), with quite foreseeable consequences for development.

On the whole, the dependence of socioeconomic development indicators on the quality of institutions is very high. Thus, according to estimates by Góes (2015), increasing the quality of institutions by a mere 1.0% will lead to an increase of 1.7% in per capita GDP within 6 years. The author notes that this result only slightly depends on the indicator used to measure the quality of institutions. Another important conclusion is that developing countries and emerging markets will gain more than developed countries from improving their institutions.

There is a common opinion that the concept of “institutions” is too vague and therefore useless, as it is unclear how to measure or improve their quality. For example, one of the key features of good economic institutions is the rule of law, but how can this criterion be used in practice? Simply put, we can assume that economic institutions (EIs) are general characteristics of the economic environment, from organizing regulation of the economy to mutual trust between entrepreneurs. It is EIs that create (or fail to create) incentives to save and invest, to upgrade production facilities, to provide affordable and high-quality education, etc. And this is why it is impossible to achieve significant economic progress without substantial improvement in economic institutions.

In fact, the term “quality institutions” can be filled with highly specific content. Acemoglu and Johnson (2005) showed that the protection of property rights occupies the central position among all economic institutions from the point of view of economic growth. Insufficient protection of property rights can lead to many negative consequences, the most obvious being the economy’s reduced investment attractiveness. Moreover, the threat of property loss creates “disincentives”: the higher the value of a company and its profits, the more attractive it becomes for expropriation. Thus, for unprotected companies, the preferred strategy seems to lie in refraining from any business development. Another important effect is that the lack of protection creates strong incentives for producers to operate in the shadow sector or to register in a foreign jurisdiction. The state thereby loses budget revenues, while the growing shadow sector limits the competitiveness of the economy (it is common knowledge that shadow firms are less productive and develop less effectively).

These theoretical considerations are confirmed by a large number of empirical results. Kerekes and Williamson (2008) discovered a positive impact on capital accumulation from protected property rights. Acemoglu et al. (2001) have shown that property protection has a statistically significant impact on long-term economic growth, and this correlation is causal in nature. Haidar (2009) demonstrated that infringements on the property rights of minority shareholders had a negative impact on economic growth. Besley and Ghatak (2009) and Asoni (2008) have conducted a general analysis of the problem and the empirical evidence for its high significance.

Experience shows that in terms of development prerequisites, the actual observance of property rights is more important than their clear specification. For example, Keefer (2007) showed that an important role in China’s remarkable economic success after 1980 was played by government’s measures to ensure property security (while their formal definition was not clearly formulated).

Of course, the insufficient protection of property rights is a “government failure.” Moreover, the state acts as the main threat of expropriation in many cases. This situation is especially dangerous because the government or its repre-

sentatives use their monopoly on violence for arbitrary expropriation of attractive assets. Tambovtsev (2006), Volkov (2010), Kapeliushnikov and Dyomina (2011), Kapeliushnikov (2012), Grigoriev and Kurdin (2016) have analyzed the property rights situation in Russia and the role of the state.

Another vital element of the institutional environment that also has very clear content is the restriction of free and equal access to markets and resources for all economic agents. Discriminatory restrictions may be formally established for broad categories of agents or be implemented on an individual basis and affect investment inflows, the entry of new participants to markets (e.g., government procurement or government investment market), the distribution of land or deposits, etc. Selective access to markets and resources takes place mainly as part of government regulation and the routine procedures of government agencies.

A fundamental result regarding the regulation of the economy is that its enhancement is not usually caused by hard necessity. Djankov et al. (2002) analyzed data for 85 countries and found that *tighter regulation did not lead to higher quality or safety for the products and services provided by the private or public sector*. Meanwhile, the society pays dearly for excessive regulation of the economy in the form of heightened corruption, reduced competition, increased durations for investment projects, escape of a part of the economy into the shadow (causing higher taxes on the remaining taxpayers), etc. This leads to the conclusion that the government's favoritism in making decisions regarding market access, resource allocation and excessive government regulation is dictated by the private interests of powerful groups. Officials overseeing and regulating markets are the first to benefit from regulation, as it allows them to receive corrupt income for providing "admission" to a market or allocating a scarce resource. However, another explanation is possible: market barriers for new players are there to benefit those who are already in (Acemoglu, 2008; Sonin, 2005). This protects the "old" players from competition and thus allows them to receive rent income, which they share with the government officials regulating access. However, in both cases, the effect is negative for the country.

One of the main mechanisms for improving the economy's efficiency is linked to the movement of labor and capital from less-competitive to more-successful firms. The importance of this mechanism is confirmed by the fact that in the United States, its contribution to the growth of TFP is comparable to the contribution provided by the increased productivity of individual companies through capital accumulation and technological upgrades (Foster et al., 2008). An analysis by Hsieh and Klenow (2009) showed that successful redistribution of resources within the economy is one of the leading causes of differences in income among countries: for example, improving the efficiency of distributing labor and capital to the level of the United States would increase China's TFP by 30%–50% and India's by 40%–60%.

The intensity of resource movement into more-productive sectors and firms is determined by numerous factors, such as the availability of a developed financial system and low or non-distorting taxes. However, the essential prerequisites are free market entry for new firms and conditions that enable the best firms to grow and the worst ones to be removed from the market. Schumpeter called this process "creative destruction," and it is rightfully considered one of the main engines of economic development (Aghion et al., 2013). The existence of signifi-

cant entry or exit barriers and the weakness of incentives to move resources or market mechanisms for filtering out the least-productive firms effectively block creative destruction and thereby prevent the use of the most important channel for increasing the TFP.

Another approach that is useful at the diagnostic stage is to identify policies and mechanisms specific to the most successful developing countries with emerging markets. An important source here is the report by the Growth Commission, which was established by the World Bank to formulate recommendations based on theoretical and empirical analysis.⁵ In particular, the Commission examined the common features of policies implemented by countries that have achieved the greatest economic development progress in recent decades. These features would appear to qualify as essential components in a recipe for economic success. Below is the list of the key prerequisites for successful development, in order of relevance (World Bank, 2008).

1. All the leading countries made the most of opportunities to integrate into the global economy. The integration process took place in a number of forms: the global economy was used as a growing market for exports, a source of capital, multiple potential partnerships, vendors for advanced technology, etc.

2. The priorities invariably included maintaining macroeconomic stability: a good balance of external accounts and the budget along with low inflation ensured investor confidence and predictable conditions for development.

3. Dynamic growth depended on high levels of savings and investments.

4. The economy operated mostly based on market mechanisms.

5. Economic policy was developed and implemented by a qualified government trusted by the general public.

An analysis based on the experiences of a larger number of countries confirms the same general findings. There is no doubt that the main mechanism for “catching-up” development consists of borrowing advanced technologies and management practices and adapting them to the country’s specific needs. The main channels through which these technologies and practices are shared between countries include foreign direct investment (FDI) and, to a lesser extent, international trade. This finding explains why the openness of a country’s economy to foreign trade and investment is essential for its successful development. A number of studies confirm the extremely strong positive impact of FDI on the Russian economy (Iwasaki and Suganuma, 2015).

In light of the above, a diagnosis of growth conditions in Russia should include, first and foremost, a qualitative assessment of its institutional environment and economic openness. We used estimates from the World Economic Forum (WEF, 2015) to analyze conditions in the sphere of property rights and equal access to markets and resources. According to the 2015 global competitiveness report, Russia is ranked 122th out of 140 countries evaluated in terms of “property rights protection” and 116th in terms of protecting minority shareholder interests. The assessment of artificial market entry barriers used two criteria calculated by the WEF (2014): (a) the burden of government regulation and (b) the efficiency of customs procedures, which characterizes the ease of foreign trade transactions

⁵ <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/ORGANIZATION/EXTPREMNET/0,,contentMDK:23224987~pagePK:64159605~piPK:64157667~theSitePK:489961,00.html>

(i.e., further reflects the degree of economic openness). Russia ranked 116th and 103rd, respectively, in terms of these criteria among the overall list of countries (with only 138 countries ranked for the second criterion).

In our sample of the 20 major economies with emerging markets, Russia is ranked second to last on two indicators, and then 18th and 13th on two others. Based on the average position of the four criteria in the global rating, Russia is behind every country except Argentina (Table 2). Thus, in terms of the quality of its institutions, our country is not only far behind the UAE, Taiwan and Malaysia, which are among the world leaders in this respect, but is also behind newcomers such as South Africa, Peru, and the Philippines. The quality of Russia's institutions has hardly changed: ten years ago, we had a slightly better ranking for property rights protection (111th) and were slightly worse for the burden of government regulation (117th) within a slightly smaller sample of countries (125).

The results remain the same even if alternative indicators are used to evaluate the quality of institutions. For example, the widely accepted “rule of law” indicator, regularly evaluated by the World Bank, also puts us in the penultimate position among the 20 largest emerging markets (here again, we are only ahead of Argentina).⁶

Table 2

Countries ranking by the quality of property protection and equal openness of markets.

		Property rights		Market openness		Average rank
		Property rights protection	Protection of the rights of minority shareholders	Burden of government regulation	Efficiency of customs procedures	
1	UAE	25	15	5	17	16
2	Taiwan	19	16	20	18	18
3	Malaysia	28	12	6	33	20
4	Chile	35	42	45	26	37
5	South Africa	24	3	117	49	48
6	China	51	71	26	61	52
7	Indonesia	63	49	41	69	56
8	Turkey	53	66	65	44	57
9	Thailand	79	34	81	56	63
10	South Korea	45	95	97	19	64
11	India	103	69	27	74	68
12	Poland	64	63	122	31	70
13	The Philippines	78	45	101	71	74
14	Mexico	88	56	123	62	82
15	Colombia	83	62	126	68	85
16	Egypt	92	82	60	109	86
17	Peru	104	57	133	51	86
18	Brazil	95	135	139	80	112
19	Russia	122	116	116	103	114
20	Argentina	134	123	135	96	122
Average rank without Russia		69	60	77	56	
Russia's position in the sample		19	18	13	19	

Source: Author's calculations based on WEF data.

⁶ The Worldwide Governance Indicators, <http://info.worldbank.org/governance/wgi/index.aspx#home>

Micro-surveys at the company level provide more-direct evidence of the entry barriers in Russia's markets. They have found the frequency of market entry by new firms to be abnormally low by international standards (Iwasaki et al., 2016). During the entire period under review, starting from 1999, the annual number of new firms remained below 1% of the total number of existing firms. For comparison, in Brazil, the same ratio exceeds 14%, while in China and India, the annual net inflow of new firms (i.e., the difference between the number of firms entering and leaving) is more than 6% and 3–4%, respectively. Moreover, since mid-2012, the frequency of market entry by new firms has declined, with the net inflow of new firms approaching zero as a result.

This situation is indicative of excessive barriers for new firms. However, there are other obstacles to efficiently allocating economic resources. In some cases, the utilized tax incentives freeze the technological backwardness of entire industries (e.g., oil refining), allowing them to survive without upgrading (Gurvich, 2010). Unjustified support may be used in the case of inefficient city-forming facilities (such as AVTOVAZ or “mono-town” facilities). In this case, federal or regional authorities prefer to allocate funds to preserve social stability and prevent social discontent. Moreover, in some cases, regional or local authorities do not support the technological renovation of production facilities, as it may free up a large number of workers.

Convincing evidence of the inefficient distribution of economic resources caused by these circumstances is provided in a study by HSE and the World Bank (SU–HSE, 2007) that revealed huge gaps in labor productivity across all sectors of the manufacturing industry. The ratio of value added per worker for the top and bottom quintiles of enterprises varied between 10 (chemical industry) and 24 (food industry, wood processing) times. This situation points to the extreme weakness of market mechanisms for redistributing resources in Russia and the low overall quality of the economic environment.

This poses a risk to our economy of falling into a “*structural trap*” (Dugger and Ubide 2004), i.e., a situation where political and economic factors impede the movement of resources, leaving them frozen in comparatively backward industries and firms. This leads to a protracted deceleration of productivity growth within the country. An example of this situation can be seen in Japan, where the government, guided by political motives, opposed the movement of capital from traditional industries into new, more cost-effective sectors. The well-known result was the Lost Decade, the period between the early 1990s and the early 2000s, when the average GDP growth rate was below 0.5% per annum.

Another noteworthy factor is that, until recently, our country had actively been integrating into the world economy. In particular, between 2010 and 2013, incoming FDI⁷ averaged 2.7% of GDP, with only India experiencing a slightly higher rate (3.3%) among the BRICS countries. However, FDI in Russia dropped dramatically following the financial sanctions: in 2015, it declined sharply (more than ten times lower) in absolute terms compared with 2013 to 0.4% of GDP (i.e., five times lower than the BRICS average).

⁷ Calculation based on UNCTAD data (http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx?IF_ActivePath=P,5&sCS_ChosenLang=en).

To summarize, it appears safe to say that Russia is seriously lagging behind nearly all major emerging markets (Russia's competitors for raising capital) in terms of property protection and market entry barriers. Creative destruction mechanisms also show great weakness, which is largely caused by the course followed by authorities at various levels towards maintaining social stability. These severe, chronic problems were aggravated in recent years by a sharp decline in both the opportunities and willingness to integrate into the world economy (manifested, in particular, by the fall in FDI to nearly zero). With this in mind, it seems quite natural that during the past 10 years our country has had the worst GDP growth rate among the world's major emerging markets. Evidently, these fundamental problems cannot be solved with superficial palliative measures.

3. Russian and international experience in developing and implementing economic programs

We will now attempt to identify the properties of economic programs (EPs) that determine their future success or failure. First, we will consider the experience from developing and implementing three comprehensive (i.e., covering all of the principal economic policies) programs the government was guided by to a greater or lesser extent at various times.

1. *The Socioeconomic Development Strategy for the Russian Federation until 2010 (Gref's Program)* was geared towards forming a qualitative market environment by reducing direct government involvement in the economy, deregulating and de-bureaucratizing economic activities, reforming monopolistic sectors, alleviating the tax burden on producers, etc. As part of this program, the government initiated tax and pension reforms, reformed the electric energy sector, improved inter-budgetary relations, etc. A detailed analysis of the content and implementation process for Gref's Program is provided in Dmitriev and Yurtayev, 2010.

2. *The Long-term Socioeconomic Development Concept for the Russian Federation until 2020 (LDC)*⁸ was adopted by the government in 2008 and assigned the leading role in the economy to the government, quite contrary to Gref's Program. Various development institutions (VEB and other state-owned corporations, the Investment Fund, the Russian Venture Company, special economic zones, etc.) became the main vehicles for implementing the new approach. At the same time, the government continued to actively expand its involvement in the economy by establishing control over private companies in various industries (OECD, 2006).

3. *The May Presidential Decrees*. On May 7, 2012, President Putin issued six decrees (on long-term economic policy, social policy, public administration, etc.)⁹ containing a number of measures to be realized by the government and development targets through 2018. Although the decrees are not formally a program, when considered together, they actually form a fairly comprehensive plan covering most areas of government activity.

The decrees contain a great number of measures aimed at enhancing market mechanisms, including reducing direct government involvement in the econo-

⁸ <http://government.ru/info/6217/>

⁹ <http://www.kremlin.ru/acts/15232>, <http://www.kremlin.ru/acts/15233>, <http://www.kremlin.ru/acts/15239>.

my, alleviating the burden of government regulations on economic activity, strengthening competition and transparency in awarding public contracts, etc. Unfortunately, the few items actually realized were done so only perfunctorily, with no actual changes in the situation in any one of those areas. Kudrin and Gurvich (2014) review the May Decrees in more detail.

We will now compare the main results of the above programs. Their exact durations do not always coincide with their formal status. For example, the LDC is still active. We will conventionally accept the periods for the comprehensive programs based on the nature of the economic policies actually pursued: 2000–2007 (Gref’s Program), 2008–2011 (LDC), and 2012–2015 (May Decrees). For each period, the development indicators are determined not only by the characteristics of an economic policy, but also by numerous other factors, especially fluctuations in the external environment. In order to “clear” the results of this effect, we will estimate adjusted growth rates for the hypothetical situation of stable oil prices during each period.

The three periods considered are divided into two equal parts: the “market environment development” period (2000–2007) and the “strengthening role of the government” period (2008–2015). Note that the common perception of the liberal nature of the economic policy pursued by Russia can be attributed to the period before the mid-2000s, with certain reservations. However, over the past 10 years, the economic environment has been rather illiberal, characterized by poor property rights protection and excessive government regulation (see Kudrin and Gurvich (2015) for more details).

A comparison of the two periods shows that the first one had a clear advantage, outpacing the second period by 8 times in terms of the average GDP growth rate (7.2% compared with 0.9%; Table 3). Of course, this comparison does not take into account the varying movements in oil prices. But even after removing the effect of oil prices, the “liberal” period surpassed the “government-led” period by 4.5 times in terms of growth rates.

Along with the three programs reviewed above, we should note a few programs whose common feature is that they have not been realized in practice.

1. “Strategy-2020” (Mau and Kuzminov, 2013) was developed in 2011 and 2012 by a large group of experts commissioned by the government. The program offered a new series of profound macroeconomic, structural, and institutional reforms, but only a few of its best practices had actually been used (e.g., the “fiscal rule”). The bulk of the program was left untouched by the government.

2. The Coalition for the Future program (Yurgens, 2007), developed in 2007 for the Regional Center for Information and Education, viewed solving institutional problems as the main challenge. It was proposed that a coalition of concerned groups be formed for each of the key issues.

Table 3

Average actual and estimated GDP growth rates in different periods (%).

	Average growth rate	
	Actual	Adjusted for the stable oil price case
2000–2007 (Gref’s Program)	7.2	4.4
2008–2011 (LDC)	1.4	–0.3
2012–2015 (May Decrees)	0.4	2.3

3. The Strategy for Modernizing the Russian Economy (Polterovich, 2010) was developed by the Russian Academy of Sciences in 2009 and 2010. It described the steps required to successfully implement a catch-up development policy.

Finally, we should mention the specialized (i.e., having a limited task) but carefully designed program for creating the International Financial Center in Moscow (IFC)¹⁰, which had been actively implemented for many years. The program was launched in 2009. Later, in 2013, a roadmap was adopted that put forward the objective for Moscow to become one of the top 15 Global Financial Centers by 2015, according to the GFCI, and one of the 15 leading centers by 2018. The program involved extensive work to develop the financial infrastructure, modernize financial market regulations, improve the procedures for taxing transactions involving financial instruments, etc. However, Moscow only ranked in 78th place in the GFCI in 2015 (it had occupied the 67th position prior to implementing the IFC program). According to A. Voloshin, who led the working group commissioned to create the IFC, “the roadmap for establishing an international financial center in Russia has been 99% implemented, but the effect of the steps taken is weak due to the adverse economic climate.”¹¹

This brief overview of Russian economic programs raises many questions. Why was the rather successful Gref’s Program suspended while still far from completion and replaced by the much less successful LDC? Why was Strategy-2020 not adopted, and why were so many important provisions of the May Presidential Decrees not executed? Why did the nearly completed IFC program fail to yield results?

The general explanation lies in the area of political economy. As convincingly shown by many authors, any attempts at reforms that are detrimental to dominant elite groups are blocked by them, or the situation returns to its previous state after some time (Acemoglu and Robinson, 2008; Baland et al., 2010). The characteristics of economic institutions reflect a balance among the interests of the elites and may be changed only under certain conditions. Acemoglu and Robinson (2008) illustrate this by stating that the formal adoption of the Washington Consensus principles in Argentina during the late 1980s had no impact on the country’s economic policies. President Menem and the ruling Peronist party, uninterested in liberalizing the economy and enhancing market mechanisms, managed to fully erode the provisions of the Consensus so that its principles in fact remained only on paper. In Russia, a striking example of such a situation was the attempt to liberalize the laws on economic crimes between 2009 and 2012. Chetverikova (2016) examined how those changes, designed to reduce the ability of law enforcement agencies to exert pressure on businesses, influenced the results of court proceedings. She showed that during the reform, the likelihood of justifying an acquittal for entrepreneurs increased significantly, but then the situation returned to its pre-reform state. Even more representative is the situation regarding the procedure for instigating tax crime prosecutions. In 2011, as part of liberalizing the laws on economic crimes, a new procedure was introduced whereby investigators could only initiate a criminal case based on materials obtained from tax authorities. However, this procedure was cancelled in 2014, and investigative authorities regained the ability to initiate tax cases on multiple grounds.

¹⁰ <http://www.mfc-moscow.com>

¹¹ http://www.mfc-moscow.com/index.php?id=14&_publid=176#p176

Thus, we can conclude that *at any point in time, an economic policy is limited to a certain institutional framework (IF) that sets the boundaries for acceptable options.*

At the same time, it would be wrong to think that institutional reforms are absolutely impossible. However, according to a number of authors (Acemoglu et al., 2005; etc.), their change occurs as part of the political (in a broad sense) process. We can name a few common sources of changes in the institutional environment.

(a) Financial crises often make it impossible to preserve the previous situation (there is simply not enough money to maintain the *status quo*), thereby opening a window of opportunity for profound changes in the “rules of the game.” This situation occurred in Russia after the 1998 crisis, which annihilated the ability to finance the huge budget deficit at the expense of the market for short-term governmental obligations.

(b) Changing the incentives or the balance of power between various elite groups may shift the equilibrium of the institutional environment. In Russia, this kind of shift apparently occurred during the mid-2000s and had two sources. First, as a cross-country analysis shows, rising global oil prices improve the attractiveness of oil companies and activate their nationalization (Guriev et al., 2008). Second, the obvious result of the Yukos Affair was to weaken the elites associated with production and strengthen the elites associated with the state bureaucracy and security forces. A natural consequence of these events was the weakening of the institution of property rights protection, which benefited the business, and the intensification of government regulation and the extraction of administrative rent, which benefited the elites exercising control and distribution.

(c) Countries where the elites have a strategic vision of the situation may decide on reforms, not to overcome an economic crisis but rather to avoid it. The most striking example of this is the decisions made by the Communist Party of China regarding the imposition of trade sanctions by the U.S. against China on building a socialist market economy (1992) and on the transition from a planned economy to a market system (1993).

Thus, institutional factors not only impose constraints on economic policies but also determine the evolution of economic programs. Besides, as in the case of controlling market entry, the choice of a program may have a detrimental effect on the economy.

The analysis of experiences with both successful and failed large-scale economic programs shows that they can be divided into three categories according to their nature:

1. “*Technical*”. This kind of program contains a set of specific economic policy actions (“small actions”) that may help solve the tasks at hand. The institutional framework is accepted as a factual starting point, i.e., the need to change it is not considered. Examples are the IFC or LDC programs discussed above.

2. “*Professional*”. With this approach, the program describes changes that should bring economic mechanisms closer to a certain standard (as perceived by the developers) or should fix any existing problems. The compatibility of these proposed measures with existing economic institutions is left out of consideration. Thus, the main weakness of such programs is that they fail to account for the institutional constraints they inevitably run into (as with Strategy-2020).

3. “*Fundamental*”. This type of program combines expanding institutional limitations with making the best use of opportunities available within it. This kind of program usually takes into account the inability to quickly change institutions and is therefore designed for the purpose of continually improving over a long period of time. This approach is the most difficult to implement, but it provides the best results, and in many cases, it is the only one capable of generating meaningful results. The economic reforms in China can be cited as an example.

An intermediate position between the “technical” and “fundamental” approaches is occupied by attempts to change the institutional environment through a set of technical measures. This approach can be seen in the May Decrees or in the ASI’s efforts to improve the investment climate.¹²

What is the potential for each approach? Technical reforms may have some impact if development opportunities within the existing institutional framework are not completely exhausted. However, according to all indications, this does not apply to Russia. Thus, a micro-level analysis shows that the adverse conditions for business in Russia are connected not with the regulatory framework (usually deemed satisfactory) but rather with its arbitrary use (Estrin and Prevezer, 2010).¹³ This means that the perfection of the regulatory framework (which constitutes the core of the “technical” programs) is unlikely to actually improve economic conditions. This conclusion is confirmed by the failure of the IFC program and the non-execution of the institutional measures required by the May Decrees. It should be noted that the Russian situation is far from unique in this respect but is rather typical. For example, the perfunctory reforms pursued in Mexico did not yield significant results (Palma-Rangel, 2006).

Both Russian and international experiences also point to the limited prospects for “professional” programs. Because institutional deficiencies serve as the main obstacles to growth, programs developed by qualified professionals are always aimed at eliminating these deficiencies. However, as noted, institutions are fairly stable and well-backed by the elites. Consequently, professional programs are either rejected before they are adopted (as with Strategy-2020) or are not enforced afterwards (as was the case with the key provisions of the May Decrees).

The approaches described are presented in Table 4, where the rows vary if the program attempts to expand the institutional framework, and the columns vary depending on whether proposed measures are implemented or rejected.¹⁴ Each program category is illustrated with a specific program of that type. The general conclusion from this analysis is that fundamental programs are the most productive but also the most difficult to implement. However, none of the programs implemented in our country to date can be fully attributed to this category. The closest is Gref’s Program, which contained, inter alia, serious challenges to improve institutions. However, it proved to be so successful primarily because the 1998 crisis opened the way for adjusting the institutional environment. In other words, although Gref’s Program only partially expanded the institutional framework, it effectively exploited the window of opportunity that had opened.

¹² <https://asi.ru/investclimate/>

¹³ The same authors note the opposite situation in China and India, where the practice of economic regulation corrects the shortcomings of formal rules.

¹⁴ Note that programs, which do not involve significant institutional changes, have no reason to be rejected, hence a dash in the respective cell.

Table 4

Classification of economic programs.

Characteristics		Acceptability for the main influence groups	
		Unacceptable	Acceptable
Changes in institutional conditions	Not contemplated	–	Technical (IFC)
	Contemplated	Professional (Strategy-2020)	Fundamental (Chinese reforms)

4. An outline of the new economic program

The analysis above has shown that the main obstacle to developing the Russian economy is the rigid institutional framework, which is unlikely to allow it to grow at an annual rate above 2%. Moreover, this framework limits not only the long-term rate of economic growth but also the possibility for a macroeconomic adjustment, which is urgently needed to adapt to new oil prices (discussed in more detail below). Thus, the only way to save the Russian economy from stagnation is to develop and implement a comprehensive program in order to change the institutional framework and carry out the economic reform itself.

Unfortunately, an opposite approach prevails in our country. First, the separation of government economic programs from institutional reforms is a clearly visible trend (also, the section on improving public administration, prepared by the authors, was removed from Gref's Program; Dmitriev and Yurtayev, 2010). Second, attempts to improve the institutional environment are quite timid in nature, betting on sporadic measures rather than on a systematic approach. The potential for this approach is very limited: technical measures unsupported by profound institutional reforms can, at best, enhance long-term annual GDP growth rates from 1.5% to 2.0%, but they are unable to set the economy on a path to successful catch-up development, which requires a steady annual growth rate of at least 4%.

Kudrin and Gurvich (2014) formulated the basic macroeconomic, structural and institutional problems that must be addressed for the transition to a new economic growth model. We will list them briefly, with a little commentary. First, it is necessary to restore fiscal sustainability, particularly to regain investor confidence fractured by falling oil prices. The next step is to ensure the long-term sustainability of the budgetary system, which is threatened by the aging of the population (Kudrin and Gurvich, 2012). The second part is structural reforms: reducing government involvement in the economy, improving public sector effectiveness (changing the forms of government support to industries and companies, improving mechanisms for realizing government investments, etc.), management reform within monopoly sectors, and labor market reforms. And finally, the third part of the institutional reforms: improving the security of property, removing barriers to entry and decreasing government regulation, waiving paternalism and “industrial paternalism,” forming incentives to support economic development at all levels of public administration, etc.

Unfortunately, the solution to all of these problems rests on the institutional constraints as illustrated in table 5 (where the list of problems is structured slightly differently, and their decisions are optional). Thus, the central issue of any

Table 5

Institutional constraints on solutions to economic challenges.

Tasks	The main means of addressing them	Institutional constraints
Reduction of macro risks, investor confidence building	Pension reform, targeted social support Reduction of the shadow economy	Paternalistic policies Vulnerability of property
Increasing investment attractiveness	Reducing risks of property loss Increasing returns on investment by reducing taxes and labor costs	Weak property rights protection Paternalistic policies, geopolitical policies
Conditions for efficiently allocating resources	Strengthening “creative destruction” mechanisms	Restricting entry to markets, industrial paternalism
Stronger incentives for participants in the economy	Reducing government involvement in the economy Refraining from undue support to producers	Struggle for rents Industrial paternalism
Maintaining key economic modernization mechanisms	The policy of integrating into the world economy, attracting foreign direct investment, export promotion	Restricting market entry, weak property rights protection, geopolitics

serious reform is what changes to the institutional environment one can expect and how to implement them.

It is important to realize that changing the institutional framework requires not formal measures but deeper changes: a revision of priorities, “rules of the game” and the creation of new incentives. This is a very complex political task that one can only tackle for an extremely good reason. An important motivation could be an awareness of the economic and political risks of avoiding deep reforms. First and foremost, without fiscal consolidation, liquidity accumulated in the Reserve Fund and the National Welfare Fund will be exhausted within a year and a half. After that, the destabilization of the oil market (and past experience shows that one must be ready for such a scenario at any moment) would cause a serious financial crisis. If social stability is an important priority, it is necessary to restore the stock of fiscal strength of recent years as soon as possible.

The main reserves for cost reductions, if we talk about functional classifications, are concentrated in the areas of social policy, support of the economy and defense. However, the savings from the first direction are incompatible with the paternalistic model, the second with “industrial paternalism,” and the third with the priority of geopolitics. In terms of the functional aspects, there is great potential for a budget economy when conducting public procurement and investment, but in both cases, the use of these reserves is problematic because it would reduce the rents received by the “distribution” elites. Increasing revenues without raising tax rates could theoretically be done due to withdrawal from the shadow economy and further corporate “de-offshorization.” But such a possibility raises strong doubts because it is also hampered by institutional constraints. Indeed, offshore registration for the greater portion of large companies is a way to adapt them to the insecurities of ownership, and the case for medium- and small-sized business operating in the shadow is largely a reaction to excessive regulation and pressure on the part of the government. In other words, we are dealing with “protective” institutions here, used by relatively weak economic agents.

Responsible and forward-thinking elites should not harbor illusions or be tempted by easy solutions to our large-scale economic problems. Such a solution is offered, for example, in the “Economy of Growth” program (Stolypin Club, 2016) at the expense of concessional lending for investment projects. However, the authors of this program do not explain why, even during periods of excess bank liquidity (as in the first half of 2016), banks do not increase the level of investments in the Russian economy. The only possible explanation is that the projects that do not find private funding have too high risks. Therefore, the “simple solution” is for the government to accept these risks, but then the unexpected loss of the projects (take, for example, the VEB situation) could lead to a serious nationwide financial crisis.

The integrated (economic and political) nature of fundamental programs requires that they be developed together by experts and authorities. Experts are expected to suggest possible ways to mitigate the institutional constraints and to assess the likely effect of each step. The task for authorities is to select appropriate and promising options and ensure their alignment with the elite teams.

If we talk about the specific content of the program, two elements should be noted at the outset, without which successful economic development is impossible. To bring the economy out of stagnation, it is first necessary to make this task a priority (in recent years, economic development interests have clearly become secondary compared with security and geopolitical considerations). It is also necessary to create conditions for a speedy return to Russia’s former rate of integrating into the world economy, which is essential for the flow of advanced technologies (particularly via FDI), borrowing modern institutions and maintaining economic competition, without which companies lose the incentive to develop.

Among other areas of institutional reform expansion, the most realistic changes are those that depend mainly on the Central Government. The first candidate appears to be a partial renunciation of the policy of paternalism, though it is unlikely to immediately affect the electoral support of the authorities. In the long term, such a waiver will not have serious negative consequences in the event that it will be offset by subsequent overall economic growth, providing a better standard of living.

Waiving paternalism would open the way to addressing many of the following critical issues:

- an in-depth pension reform capable of truly solving the problems caused by the aging population;
- reforming social policy—a transition from the support of the population to support of the needy;
- the release of part of the labor force to reduce pressure on wages in the labor market.

The softening of industrial paternalism is the next candidate. This implies a radical reformation of government support to industries (such as oil refining) and companies. This will strengthen the economy’s redistributive mechanisms, activating one of the key channels for enhancing its competitiveness.

There is a further potential reduction in direct government involvement in the economy. The background for this is the reduced attractiveness of companies in the real sector in light of falling oil prices and, accordingly, a reduction of the amount of natural rents to be distributed there. In addition, in the current con-

text, public and quasi-public companies are a potential source of implicit risk. Due to a deteriorating external environment, they may require larger budgetary support. Under the current circumstances, it is important for the government to get rid of all sources of risks.

The difficulty of institutional reforms has spawned a large number of works on ways to make them more acceptable (Andrews, 2013; Eggertsson, 2005; Pitlik et al., 2014). Among others, there is a recommendation to combine reforms so that the losses to the influential elite groups from some changes are offset by gains (not necessarily physical) from others. An important condition is the need to ensure equitable burden-sharing reforms. At the same time, resistance to reform significantly increases in the event of predominant short-term societal interests and low confidence.

At first glance, it might seem that the steps above regarding power elites have serious negative consequences, such as the danger of increasing social discontent and weakening business loyalty. However, one must realize that this is partially offset by a lower burden on the government budget, thereby decreasing the risk of a financial crisis. Moreover, if we consider the situation in the medium and longer term, the rejection of paternalism and the adoption of the principle of “creative destruction” does not undermine but rather enhances political stability. Actually, these institutional changes would mean a transition from static to dynamic stability, along with a more complex regime, but one that ensures greater reliability due to the ability to adapt to different shocks—it is therefore compatible with development. This can be figuratively compared to replacing a fixed exchange rate regime with the floating one: in this case, short term volatility increases, but real shocks can be avoided, such as the 1998 crisis that was caused by the refusal to adapt the exchange rate to lower oil prices (Gurvich and Andryakov, 2006).

One should also realize that keeping the current institutions intact actually means abandoning important development mechanisms. This price did not seem too high in the face of rising oil prices, automatically ensuring the growth of the economy. However, under the new circumstances, when oil prices are not a source of growth, but the risk factor, the rejection of “creative destruction” dooms the economy to a long period of stagnation, which also represents a grave political risk.

If all or a significant part of these changes in the institutional framework are implemented, then a number of actual economic reforms aimed at achieving, for example, the following objectives will be required:

- restoring current and long-term fiscal balance;
- reforming the work of remaining state-owned companies, state-owned corporations, and monopolies;
- fighting the continued increase in the share of wages in GDP in light of negative demographic trends.

In the future, a new gradual improvement of the institutional conditions will be required by facilitating equal admission for all participants in public procurement, implementing government investments, allocating resources, etc., as well as reducing pressure on businesses and the risk of property loss. At this stage, the evolutionary approach to institutional reforms looks more promising, implying that changes are not initiated from the top but rather from the bottom through

experiments at lower levels of federal and municipal management and the subsequent selection of options that yield the best results (Caselli and Gennaioli, 2008; Polterovich, 2013, 2014; Easterly, 2008; Kingston and Miguez, 2009; Yakovlev, 2006). A set of the positive changes in accumulating the responses formulated for emerging challenges can also serve as a source of changes (Fritz et al., 2009). However, this way of improving institutions also requires major changes in policy. Thus, an important prerequisite here is the extra degrees of freedom for sub-federal authorities and the formation of their incentives to support the development of the economy, which obviously are insufficient at present (Rochlitz et al., 2015).

Any of the proposed reforms are easy to refute: one can say that the decline in social spending or increase in unemployment (even if small) are unacceptable. For example, according to the Constitution of the Russian Federation, our country is a social state, so a reduction in defense spending will threaten the security of the country, etc. It should be understood, however, that rejecting all the reforms would automatically condemn the Russian economy to a long period of stagnation. No country has demonstrated dynamic development with weak economic institutions, expensive labor, and high social spending and defense costs. To achieve economic development (at least limited one), the existing weaknesses need to be compensated for by some advantages. Similarly to the classical principle of the “impossible trinity,”¹⁵ the principle of the “incompatible five” can be formulated: *no country can simultaneously be a social state, positioned as a superpower, have expensive labor, high business risks, and dynamic economic growth*. These conditions are incompatible, and the author is unaware of any exceptions to this rule. Unfortunately, the apparent weakness of the institutional environment in our country is not compensated for by anything. As long as the situation remains unchanged, the most likely scenario for the future will be a “Russian-style lost decade.”

5. Conclusion

This analysis showed that the Russian economy is currently strictly limited by its institutional framework, within which it is impossible to expect the annual GDP growth rate to exceed 2%. Developing an economic program is relevant for Russia now more than ever, and we will have to choose from four fundamentally different options. The first path is the easiest, as it involves only “saturating the economy with money”. In reality, however, this option would only create additional risks for the public finances and is more likely to cause a loss of precious time and pile up additional risks than actually solve the chronic problems facing our economy. Another way is to prepare an ambitious reform plan offering the correct approaches to “curing” the economy but not taking into account the readiness of the government or elites for such reforms. This program is highly likely to remain on paper, even if it is very actively supported. The third option is the “small actions” policy, i.e., the accumulation of small changes in the hope that they will eventually lead to serious institutional changes. However,

¹⁵ According to this principle, a country cannot have an open capital account, a desired exchange rate, or pursue an independent monetary policy.

the Russian experience shows that if the changes are insignificant, they will have no visible impact on the state of affairs, and if they are significant, they will simply be ignored. The above approaches will not even allow a desperately needed budget consolidation to restore at least a minimum macroeconomic “safety margin” in light of potential new fluctuations in oil prices. Finally, the fourth way is for the government and elites to make agreed adjustments to the institutional framework that would restore investor confidence and activate the basic mechanisms of economic growth.

There are many examples in history where countries have preferred political stability over development, for which they had to pay after some time by becoming the world’s outsiders (Acemoglu and Robinson, 2012). There are examples of countries where elites and leaders went into deep institutional change (such as China under Deng Xiaoping), complicating their lives but making their country much richer and stronger in the long run. The current analysis shows that hopes to revive economic growth without changing the institutional framework are vain and will actually mean choosing the first path.

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