From Predation to Accumulation?

The Second Transition Decade in Russia[•]

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I. Revolution and Predation

"The fundamental feature of Russian post-communist reform is that they were implemented at a time of weak state power" Mau [2000]

Perestroika and the decade of the nineties brought us the Second Russian Revolution. Unlike the First Russian Revolution, the more recent one has been largely peaceful. Its economic, political and social consequences have been every bit as far-reaching, however. This Second Russian Revolution, seventy years after the first, is not yet complete. In particular, an effectively functioning Russian State has yet to be reconstituted. There are signs, however, that the period of post-revolutionary anomie and free-for-all (or rather free-for-some) is coming to an end.

In this lecture I argue that the wide-spread predation and insecure property rights that have characterised Russia during these past 12 or so years have depressed capital formation in all its dimensions. The elimination of the conditions that gave rise to predation and insecure property rights is a necessary condition for the kind of sustained economic growth the Russian government anticipates in its new economic strategy, promulgated on June 29, 2000.

The collapse of the Soviet Union, the Soviet political-economic system and the Soviet empire make the position of Russia today unique among all other transition countries. CIS countries other than the Russian Federation have been undergoing post-colonial transitions. Mongolia, although never formally incorporated in the Soviet Union, is substantively in a very similar position to the former Central Asian Soviet Republics. The Baltic countries are recently emancipated formerly conquered nations that had been formally incorporated in the Soviet Union. The other former Warsaw pact and Comecon countries of Eastern and Central Europe were post-World

War II vassal states or protectorates in the Soviet Empire.[1] The successor states of the former Yugoslav Republic had a 'home-grown' version of a socialist command economy imposed on them following World War II. This 'worker managed' model was quite distinct from the Soviet model and somewhat less crippling, politically and economically.

All transition countries other than Russia and the successor states of the former Yugoslav Republic had communism imposed on them from outside, by conquest. Only in Russia were communist rule and the command economy truly 'home-made', the result of an indigenous revolution that swept away the pre-existing political, social and economic order. The experience of Ukraine and Belarus was perhaps closer to that of Russia than to that of the Soviet Republics of Central Asia and the Caucasus, but important differences remain. Only Russia had a successful communist revolution. Russia, together with the other CIS countries, experienced $3\frac{1}{2}$ generations of communism. Only in Russia does the dismantling of the political, social and economic institutions of communism and central planning represent another homegrown revolution, the Second Russian Revolution.

Revolutions are destructive, cataclysmic events. The established mechanisms of political and social control are destroyed. The state is weakened, sometimes fatally. As a result, everything is up for grabs. Title to the wealth of the nation is insecure. So are claims to rank, status, prestige and privilege. Established entitlements become contestable. Possession becomes rather more than nine-tenths of the law. Without quite getting to Hobbes's *state of nature*, a state of perpetual war of all against all, where no morality exists, and everyone lives in constant fear, an

[1] The case of the former German Democratic Republic is special in many respects. For reasons of space, it will not be discussed in what follows.

incomplete revolution contains many of the features described by Hobbes: *"In such condition, there is no place for industry, because the fruit thereof is uncertain; and consequently no culture of the earth, no navigation, nor use of the commodities that may be imported by sea; no commodious building, no instruments of moving and removing such things as require much force; no knowledge of the face of the earth, no account of time, no arts, no letters, no society; and which is worst of all, continual fear and danger of violent death; and the life of people, solitary, poor, nasty, brutish, and short."*

There have been many, sometimes conflicting, sometimes complementary account of the origins and causes of the Second Russian Revolution. A recent, powerful account can be found in Solnick [1998]. A constant theme in this book and in Solnick's other writings is how the political and economic spheres were, and continue to be, inextricably intertwined. In the Soviet Union, *"the economic system of central planning was an essential and integral extension of the system of Communist Party Rule. Thus "progress" towards consolidation of democracy could hardly be considered in isolation from the redistribution of property rights or the reallocation of authority within productive enterprises"* (Solnick [1999]).

The 'theft of the state' in Russia began early in the Perestroika process, which can be dated from Gorbachev's November 1986 'Law on Individual Labour Activity', which did permit Soviet citizens to engage in some limited private enterprise. At that time, the Communist Party of the Soviet Union, the Komsomol (the Communist Youth League) and the security services, operating through a range of institutions and networks (prominent among which were the system of job assignment of university graduates and the system of the draft army within the military service), controlled the bulk of the USSR's wealth, through a vast network of patronage, reinforced by fear.

The January 1988 “Law on the State Enterprise” gave enterprises greater autonomy from central planners and freed them to decide what to produce and to whom to sell it. The May 1988 “Law on Co-operatives” encouraged the development of co-operatives and small family enterprises. In that same year, Gorbachev promulgated a number of measures to remove the Communist Party from the day-to-day management of the economy.

While formal privatisation did not occur until the end of 1991, well before that time managers of state enterprises used a loophole in the Law on Co-operatives to set up within-enterprise co-operatives, private firms in all but name, that contained the potentially profitable bits of these state enterprises. Teague and Whishnevshy [1999, p. 266] contains an account of *“...the liberal Russian Economist, Vitalii Naishull, telling Yeltsin’s Privatization Minister, Analolii Chubais, at a conference in spring 1992, ‘Your plans to privatize Russian Industry will never work. Everything has already been privatized and there’s nothing left to give away’”*

Gorbachev’s attempts to decentralise political and economic control led to systemic collapse because they allowed lower level bureaucrats to circumvent supervision by their superiors. Solnick [1998] argues that Soviet institutions did not simply dissolve, but were actively pulled apart by opportunistic officials at all levels seeking to extract assets that were in anyway fungible, that is, not organisation-specific, and to move them from the public to the private domain. Komsomol officials were especially active and successful in these informal ‘privatisations’ of state assets. Gorbachev’s decentralising reforms, openness and political democratisation coupled with economic liberalisation, set in motion centrifugal forces that caused a system-wide collapse of authority relations, and permitted a large-scale theft of state assets by opportunistic and entrepreneurial officials, almost all of whom were drawn from the existing elite, the *nomenklatura*.

Later stages of the privatisation process contributed further to the current extreme inequality in the Russian distribution of wealth. The voucher privatisations of the early nineties were followed by a rapid concentration of voucher ownership by members of the old nomenklatura, often the directors and managers of the former state enterprises, who obtained these vouchers at bargain basement prices.

A well-documented instalment in the "theft of the state" was the "loans for shares" scheme which was operative from 1995 till 1997. A consortium of seven Russian banks made loans to the Russian government against a pledge of state shares in some of the largest industrial complexes in the telecommunications, metallurgical and oil sectors. When the government could not meet the terms of the loans, the pledged shares were divided among the seven banks through rigged auctions. The resulting extreme concentrations of wealth gave rise to the term 'oligarchs' to refer to the small group of bankers and industrialists who masterminded the scheme.

By now, most state assets have been privatised – outside of infrastructure enterprises, utilities like UES, and a few financial institutions. There is a widely held view, going back at least to Coase, that economic efficiency only requires that private property rights be assigned unambiguously, and that the specifics, including the perceived fairness of the allocation, do not matter. An extension of this view is the proposition that yesterday's thief is today's staunchest defender of the sanctity and inviolability of property rights. The policy implication is that it is best to grandfather the existing distribution of property rights, no matter how outrageous the manner in which it came about.

There are many qualifications to Coase’s ‘distribution does not matter for efficiency’ proposition. Private information severely weakens its applicability. So do transaction costs, including (re)negotiation costs. More importantly, Coase’s proposition requires property rights to be unambiguous and secure. The legitimacy of any distribution of property rights, and therefore the security of these rights, cannot be independent of the manner in which these property rights were acquired or assigned.

The fact that the redistribution of state property in Russia since 1988 is unlikely to be viewed as legitimate by the vast majority of Russians who did not share in the free-for-all (or rather the free-for-some), cannot but be an obstacle to the efficient utilisation of these assets in productive enterprise. Extreme inequality and widespread poverty coexist uneasily with secure property rights. This creates a dilemma. The existing distribution of property rights lacks legitimacy. Yet any serious attempt to redistribute improperly acquired property rights would itself create uncertainty about the security of all property rights, now and in the future. Most of the successful raids on the assets of the state were , at best, conducted under ambiguity about the exact legal status of these assets, and, at worst took place in a legal vacuum. Renationalisation followed by yet another round of privatization, would in all likelihood be pursued in an arbitrary, selective and politically motivated manner and could end up being viewed as evidence not of a belated attempt at justice, but of further degradation of the rule of law. There exists no elegant, efficient and fair solution to this problem. We cannot undo history's earlier throw of the dice. Probably the best one can hope for is that a combination of sustained growth, efficient and equitable government tax and expenditure programmes and economic reform aimed at eliminating monopoly rents throughout the economy will gradually diminish the significance of the initial distribution of property rights.

Today, with the transition process almost a decade old, Russia and the other successor states of the Soviet Union, continue to suffer from chronically weak legal cultures and severely defective mechanisms for contract enforcement. Discretion, in the negative sense of opportunistic behaviour, characterises legal procedures and law enforcement. The rule of law is the exception rather than the rule. The real negotiations start after a contract is signed.

The Russian State, at all its levels, has a dismal reputation as a guarantor of property rights. Domestic and foreign investors' confidence in the enforceability of their rights has been weakened by inadequate laws and, even more prominently, by a continued failure to enforce what laws are on the books. Legal rights of creditors and minority shareholders are routinely trampled on. Even a majority ownership stake is no guarantee of control. Entrenched managers, often backed by local or regional authorities, restrict access to information and ignore the wishes of the legal owners. Insiders strip enterprises of their valuable assets and leave the legal owners with a shell containing the unproductive and non-performing assets and the liabilities.

Insecure property rights pervade every aspect of Russia's political and economic system. Moscow mayor Yuri Luzhkov, a potential Presidential candidate during 1998 and 1999, threatened during the run-up to the December 1999 legislative elections, to redistribute property that had been 'illegally privatised' or was being managed inefficiently. The alarm this raised in the circles that this threat was perceived to be directed at, was probably instrumental in undermining his presidential ambitions through a 'dirty tricks' campaign of remarkable intensity.

In addition, a number of comparative studies of corruption rank Russia, and most of the other former Soviet states, as among the most corrupt in the world (EBRD [1997]. See also Mauro [1995], Rose-Ackerman [1997], Kaufmann and Kaliberda

[1996], Kaufmann [1998], Frye and Zhuravskaya [1999]Johnson, Kaufmann and Zoido-Lobaton [1998], Leite and Weidman [1999]). According to a study by Hellman, Jones and Kaufman [2000], Russia does not score particularly high on the 'administrative' (or petty) corruption index. It is on the two 'grand' corruption indices that Russia's performance is most worrying. Grand corruption includes public procurement-related kickbacks and 'state capture', the efforts of firms to influence the contents of legislation, rules, laws, decrees, regulations or judgements through unofficial payments by private actors to public officials.

Even co-ordinated, 'efficient' corruption (paying officials to do the things that they ought to have done in the first place) involves real resource costs. Like all forms of rent seeking, real resources are expended and squandered in corruption activities. Apart from these rent-seeking costs, co-ordinated corruption can be efficient. It redistributes resources from the demander to the supplier of corruption services, rather like a Coasian bargain. The uncoordinated nature of corruption in Russia means that it is not just redistributive, but creates further distortions. Corrupt officials are bribed to make inefficient rather than efficient decisions. Easy entry into the corruption market also means that the corruption commons is overgrazed, killing (or at least severely maiming) the goose that lays the golden eggs. Viewing corruption in Russia as equivalent to lump-sum taxation is therefore very wide off the mark. It is a major obstacle to growth and prosperity.

Dynamic game theory teaches us that even in the absence of third party enforcement of contracts or similar 'external' commitment mechanisms, repeated interactions among named players can sometimes support efficient outcomes. Considerations of reputation, and the possibility of punishment strategies based on the history of play in the game can cause the outcome of the repeated or dynamic game to be better than the simple repetition of the one-shot ‘stage game’. Trust, and the economic benefits that flow from it, can be the spontaneous outcome of spontaneous, uncoordinated repeated strategic interactions.

While this is an important insight, it should not lead one to overestimate what can be achieved by the invisible hand of dynamic non-co-operative game theory. Specialisation and division of labour, risk-sharing and resource-pooling to exploit economies of scale will be severely restricted without an efficient and effectively enforced system of contractual obligations and property rights.

Since the public good of secure property rights, enforcement of contracts and the rule of law is not provided effectively by the state in Russia, what provision of these public goods there is, has often been ‘privatised’. Criminal protection rackets, using threats, intimidation, extortion and blackmail, backed up with the threat of violence against property or persons, are thriving. A cynic might consider this an efficient adaptation to an unfortunate environment. Apart from the obvious moral shortcomings of these arrangements, the huge transactions costs and abiding uncertainty associated with these extra-legal methods of contract enforcement cause any society that is forced to rely on them to function very inefficiently.

There are two unsurprising consequence of this absence of the rule of law and chronic and widespread insecurity of title. The first is that effort is diverted from productive activities to ‘predation’. Predation includes rent-seeking and ‘dupe’[2] activities, from lobbying to corruption and other illegal forms of influence seeking. It also includes theft, the involuntary and unrequited transfer of property rights, through the use of inside information and through intimidation, extortion, threats and actual

[2] Directly unproductive economic activities.

violence against property or persons. The talents that make a good productive entrepreneur are not that different from the talents that make an efficient predator.

When the returns to productive activity are low and the return to predation high, talented individuals will tend to choose the latter career over the former. The result is an inefficient use of existing resources, or *static inefficiency*.

The second consequence is *dynamic inefficiency*: the accumulation of capital is discouraged and distorted.

The national saving rate will become suboptimally low, and within this diminished national saving rate, the allocation of saving across instruments is heavily influenced by the perceived security of the owners' title to these instruments. When the tax collection system is both inefficient and arbitrary, taxation tends to become source-based rather than residence based: the jurisdiction of the tax authorities tends to be restricted to tax bases located within the national boundaries. In addition, title to offshore assets is less easily contested than title to on-shore assets. Financial assets abroad are superior, from this point of view, to financial assets at home. Hard currency under the bed is superior to ruble accounts in the bank. Deposits in Sberbank are superior to deposits in private banks. Real, tangible enterprise assets at home become an especially unattractive proposition. The current owners often have insecure title, and the asset is highly visible and accessible to the tax authorities and to private predators.

We therefore expect to see the following in post-Perestroika Russia: a declining saving rate, an even greater decline in fixed domestic capital formation, and capital flight. We see all three, dramatically.

II. Accumulation

II.1 National Saving and Domestic Capital Formation

By way of introduction, Table 1 shows the depressing picture or real GDP growth and per capita income in Russia during the 90s. Even after allowing for the poor quality of the data, and recognising that, as the transition progressed, recorded GDP probably understated true GDP by a growing margin, the picture of continued decline is inescapable. The first hint of recovery, in 1997, was negated by the Russian default crisis of 1998. The positive growth recorded in 1999, which is continuing into the current year, is most welcome but must be put in perspective.

Table 1

Real GDP growth and Per Capita GDP in Russia

	Real GDP Growth (% pa)	GNP per Capita, (PPP; current international $)	GDP per Capita (US $)	GNP per Capita (Atlas Method; current US $)
1989	2.0	10,009		
1990	-3.0	9,855	2,554	
1991	-5.0	9,580	140.5	3,830
1992	-14.5	8,473	565	3,150
1993	-8.6	7,938	1,133	2,770
1994	-12.6	7,085	1,867	2,310
1995	-4.1	6,960	2,343	2,250
1996	-3.4	6,773	2,901	2,350
1997	-0.9	6,746	3,047	2,610
1998	-4.6	6,180	1,840	2,260
1999*	3.2		1,249	

*Estimate

First, the international environment since early 1999 has been extraordinarily benign. Like every other country, Russia has benefited from robust growth in the world economy, which was both high by the standards of the eighties and nineties and higher than expected as late as early 1999.

Second, Russia benefits, as a major oil and gas exporter, from the very dramatic increase in the world price of oil, from less than $10 per barrel early in 1999 to over $30 a barrel at the end of 1999 and again in the middle of 2000. The third contributor to growth in the exporting and import-competing sectors of the Russian economy has been the very large real exchange rate depreciation that accompanied the collapse of the ruble after August 1998. While much of this gain in competitiveness will not be permanent, unless it is backed up by budgetary and structural reform measures, the breathing space it provides is good news to enterprises. The mirror of this improvement in competitiveness without a matching increase in productivity is the decline by one third in the average real wage.

Table 1 also reminds one of the difficulties encountered in any evaluation of the behaviour of per capita income over time and in any comparison with per capita income in other countries. Even the two measures involving the current exchange rate show rather different behaviour, both in levels and in changes. The measure using PPP exchange rates hovers at about three times the levels of the current exchange rate based measures. It too shows a steady decline over time.

The Russian saving and investment figures are summarised in Table 2.

Table 2

Saving and Investment in Russia

	Gross National Saving (%GDP)			Gross Fixed Capital Formation (%GDP)				Current Account Surplus (%GDP)
	Total	Private	Public	Total	Private	Public	Depreciation	
1989	35.0			33.0	10.0	23.0	10.6	2.0
1990	30.0			29.0	15.0	14.0	9.9	1.0
1991	37.0			24.0	20.0	4.0	9.9	13.0
1992	33.0			24.0	22.0	2.0	9.6	9.0
1993	28.0			20.0	21.0	1.0	9.5	8.0
1994	29.0			22.0	22.0	0.0	9.2	7.0
1995	27.0			21.0	9.0	12.0	9.6	6.0
1996	26.0			21.0	9.0	12.0	9.8	5.0
1997	22.2	16.8	5.4	22.9	9.6	13.3	9.9	-0.7
1998	16.8	13.0	3.8	16.2	4.4	11.8	9.3	0.6
1999	28.0			17.0	6.0	11.0	na	9.0

It is not surprising that the national saving rate has come down significantly from the very high levels (around 35% of GDP) of the central planning period. While there are examples of countries with a demographic structure similar to Russia's that have national saving rates of 30% of GDP or more (e.g. Japan), the norm in both the advanced industrial countries and in the advanced transition economies is a significantly lower national saving rate.

What is surprising is the dramatic decline in Gross Fixed Capital Formation from 33% of GDP in 1989 to 17% of GDP in 1999. Private sector gross investment stagnates at around six percent of GDP, well below any likely estimate of private sector capital consumption or depreciation. In aggregate, Russia is decumulating capital in the private sector. It is even possible, given the chronic lack of maintenance of the public sector capital stock, that the economy as a whole is decumulating physical capital. The depreciation figures, which put consumption of fixed capital at just under 10% of GDP suggest that net capital formation runs at about 8 or 9% of GDP, but it is quite likely that true economic depreciation is considerably higher than that.

The result of the moderate decline in national saving rates and the steep decline in domestic capital formation rates is that, with the exception of 1997, Russia has had a surplus on the current account of the balance of payments. Russia must be among very few countries that are quasi-permanently under IMF programmes, despite running persistent current account surpluses. In the first half of 2000, the external surplus may have been running at the rate of 13% of GDP, a truly staggering number. Yet even as I speak, there is an IMF mission in Moscow.

It surely makes no sense for a country so poorly endowed with physical capital (both private fixed capital and social overhead capital or infrastructure) should be a persistent net exporter of capital. This suggests that the social returns to investment greatly exceed the private returns.

Foreign direct investment into Russia remains quantitatively insignificant, although individual projects may well have had high private and social returns and positive transition impact. Table 3 contains some information about the evolution of the external asset and liability position of Russia. Russia, which inherited the external assets and liabilities of the former Soviet Union, has a gross external debt position which has been quite stable in $ terms (except for a significant step-up in the crisis year 1998), but increasing quite sharply as a share of annual GDP, because of the decline in GPD and, since 1998, in the real exchange rate.

Russia also has considerable external assets. Among these assets are ruble claims on former Comecon members. The odds on collecting anything on these assets, which may amount notionally to $140 billion or $150 billion, are effectively zero. In addition, there are large private holdings of external, hard currency financial instruments. No reliable figures exist on Russia's private external assets. Reports of monthly capital flight at rates averaging US$ 2 billion have been around for years. Loungani and Mauro [1999] report estimates of capital flight from Russia averaging, depending on the measure used, more than US$ 20 billion or US$ 15 billion per year since 1994. If capital flight of this magnitude was also already present in the early 1990's, 1994, the cumulative Russian capital flight could by now easily exceed the Russian external debt of $160 billion.

Earnings will have accrued to these external assets, and some of these earnings may have been re-invested abroad. Capital gains or losses drive a further wedge between the value of the gross external asset stock and the cumulative capital flight since the beginning of the nineties. Nevertheless, it is hard to imagine scenarios under which the current stock of private external assets would be smaller than the current stock of financial liabilities. The persistently positive current account balance (see Table 2) certainly suggests that Russia may well be a significant net external creditor.

Table 3							
The External Accounts of Russia							
	External Debt		External Assets Billion US$		Capital flight	Net FDI inflows (% GDP)
	Billion US$	%GDP				
			Dead	Out of reach		
1989	Na	Na				Na
1990	Na	Na				Na
1991	Na	Na				Na
1992	Na	Na				Na
1993	Na	Na				Na
1994	129.9	43.7				0.20
1995	127.0	36.6				0.60
1996	135.1	31.5				0.59
1997	134.1	29.8				1.43
1998	157.7	58.6				0.99
1999*	158.5	87.1	140.0	>150.0		
*Estimate						

The problem with Russia's external portfolio is that the liabilities are public, 'on-shore' and on budget while the assets are either dead (in the case of ruble claims on sovereign states) or private, off-shore and out of reach of the Russian tax authorities.

Even where the funds channelled abroad were acquired in legitimate activities, the manner of their transfer abroad will often have criminalised them. There exists a vast global industry that assists the owners of these assets to hide them from the interested tax and police authorities. The result is that these assets and the earnings they generate are hidden and do not constitute part of the Russia's effective tax base. Capital flight therefore creates a public finance problem and well as a balance of payments problem.

The offshore funds also are not available for the financing of investment projects in Russia. This is especially costly to the country because many of the owners of these offshore assets have the kind of local, sector- or industry-specific knowledge that would make them potentially valuable contributors to FDI ventures.

As long as there is fear of confiscation, arbitrary taxation or criminal proceedings, the external assets will remain abroad. Something akin to a credible capital repatriation *amnesty* is necessary to effect a return of the flight capital. Two kinds of credibility are required. First, the government has to convince the owners of the flight capital that it will not renege on the terms of its amnesty offer once the funds have returned. Second, the government has to make a credible commitment that there will be no future amnesties. How this credibility can be achieved in the prevailing culture of mistrust between the state and its citizens is unclear. Unless it is achieved, the current situation where Russian external assets make no contribution to Russian economic growth and development will persist.

II.2 Intermediation

The previous sub-section suggests that, even though aggregate investment is inadequate, aggregate saving is adequate. Intermediation between savers and investors is woeful, however. The institutions that should be at the forefront of the intermediation process, especially banks, do not channel savings into productive investment. To the extent that banks lend to industry at all, it tends to be related lending or politically motivated lending to state enterprises or former state enterprises that continue to have political clout at the local, regional or even national level. Political influence over bank lending has expanded with the growing dominance of Sberbank following the August 1998 crisis.

To a reasonable first approximation, banks to not make commercially motivated loans to private non-financial enterprises. Before the August 1998 crisis, Banks operated in the GKO market, the foreign exchange and derivatives markets without adequate internal risk controls or prudential supervision.

Securities markets remain underdeveloped and thin, including the stock market.. The extreme difficulty of obtaining external finance of any kind is one reason for the fact that SMEs play a smaller role in Russia than in virtually any other transition economy. There are, of course, other important obstacles to investment, especially by SMEs, as well. Excessive red tape, arbitrary licensing requirements, harassment by armies of underpaid tax collectors and inspectorates of various ilks, extortion and forced purchases of ‘protection’ by the criminal fraternity make for an extremely unrewarding investment climate.

Without radical reform of the banking sector, the transformation of domestic and foreign saving into domestic capital formation will remain haphazard and inefficient. The far-reaching changes in institutions and practices that are required include the following:

- a level playing field in the banking sector;
- uniform criteria governing deposit insurance;
- effective and non-discriminatory resolution procedures for insolvent banks;
- measures to strengthen prudential regulation,
- restrictions on the kinds of activities banks can be engaged in and on the kind of financial instruments they can hold in their portfolios, that is, the adoption of a ‘narrow’ banking industry model.

II.3 Human Capital

The technological achievements of the former Soviet Union are known to all. The educational system of the former Soviet Union produced a labour force that was literate, numerate and sophisticated. Admittedly, the skill mix inherited by the Russian Federation exhibited a fair degree of mismatch from the point of view of a modern market economy, which is predominantly service-based. There were too few accountants, lawyers, actuaries, financial analysts, applied economists, managers, management consultants and marketing specialists and too many rocket scientists. On the other hand, it is rather easier to turn engineers into accountants and lawyers than the other way around. With the right market signals in place and with responsive education and training programmes, Russia is well endowed with human capital.

While the situation is good as regards the *stock* of human capital, the news on the *flows* is less positive. There is considerable evidence to support the view that Russia is not maintaining its human capital stock and may indeed be in a phase of human capital decumulation.

Table 4

Health and Educational Indicators for Russia

	Birth Rate (crude, per 1000 people)	Death Rate (crude, per 1000 people)	Life expectancy at birth (male, years)	School Enrolment (secondary, male % net)	School Enrolment (tertiary, % gross)
1989	14.6	10.7	64.4	97.3	
1990	13.4	11.2	63.8	94.2	52.1
1991	12.1	11.4	63.5	91.5	50.2
1992	10.7	12.2	62.0	88.6	46.7
1993	9.4	14.5	58.9	87.0	44.9
1994	9.5	15.7	57.3	86.4	42.9
1995	9.3	15.0	58.3	85.8	42.1
1996	8.9	14.2	59.6	85.2	41.4
1997	8.6	13.8	60.9	84.6	
1998	8.8	13.5	61.3		
1999					

Table 4 shows a steep decline in the crude birth rate, which began in the second half of the eighties. This is a common sign of socio-economic distress. There also has been a very anomalous increase in the crude death rate, which peaked in 1994 and has come down somewhat since then. Male life expectance at birth declined from the late eighties until 1994 and has recovered slightly since then. Widespread poverty, stress and a deficient diet have been cited as possible causes. Table 4 also shows that secondary and tertiary school enrolment rates have declined steadily since 1989. It is important that these trends be reversed, lest Russia wastes its single most important asset and source of future sustainable growth.

III.4 Environmental capital

There is general agreement under communism, Russia, like the other former centrally planned economies, experienced a faster degradation of the environment than the industrialised West. There are a number of reasons for this.

An important one is the heroic underpricing of energy that was the norm under central planning. This underpricing, and the associated excessive energy-intensity of production methods and consumption patterns continues today. Another reason was the absence under communism of a free press and other media, of freedom of expression generally and indeed of civil society in all its manifestations –free media, political parties, voluntary organisations and NGOs, pressure groups, independent churches, independent trades unions and professional associations, etc. A vibrant civil society will ring the alarm bells and compel a political response when disaster threatens, be it famines (see e.g. Sen [ ]), nuclear radiation leaks, pollution or other natural or man-made disasters. A society ruled by fear and mutual distrust, with no institutions between the individual and the state other than the immediate family and a small network of friends, will not have these safety mechanisms. The degradation of environmental capital not only lowers consumer welfare directly, it also impacts adversely on productive efficiency. Air, water and soil pollution, erosion, deforestation and desertification are examples of this. Quantification of the decumulation of environmental capital that has occurred in Russia is extremely difficult, and no attempt is made here even to guess at the magnitudes. The good news is that in Russia today there is a much-enhanced awareness of the need to include the environment in the cost-benefit analysis of alternative economic strategies, programmes and projects.

III. Conclusion

Russia today stands at a critical juncture. After almost fifteen years of economic, social and political disorganisation and disjunction, there is now a unique window of opportunity to turn away from predation and negative-sum redistribution games to a future of growth and widely-shared prosperity, made attainable through increased efficiency and higher rates of accumulation of all types of capital. To make this a reality, there has to be a comprehensive reform of the institutional framework that permits an efficient market economy to function.

The first, and most difficult, institutional reform needed to put Russia on a path of efficient accumulation is a strong and capable but limited state. Since the collapse of communism, Russia has had an incapable, but over-reaching and overstretched state. The state should only do only those things the private sector truly cannot do. The list is familiar. Providing internal and external security and the macroeconomic public goods of price stability and stability of the financial system;

enforcing the rule of law; defending legitimate property rights; securing a level economic playing field for incumbents and newcomers; encouraging competition and regulating natural monopolies; financing (but not necessarily providing) public goods; financing public health and education; ensuring that a proper social safety net is in place; and raising the revenues necessary to fund these essential state activities in a non-distortionary, administratively efficient and equitable manner.

The problem with the prescription of a strong and capable but limited state is that it is almost an oxymoron. A strong state will be an irresistible target for capture by sectional interests who aim to turn it into the ultimate predator.

To a certain extent, the design of the institutions of the state, that is, the constitutional arrangements, can keep Leviathan in check. The horizontal separation of powers, that is, an independent judiciary, and an independent legislature can check the might of the executive. So can a vertical separation of powers, through a Federal constitutional design that grants each tier of government distinct, non-overlapping jurisdictions and competencies. Russia has been wrestling with the design of constitutional arrangements of this kind that suit its unique historical and cultural traditions and its ethnic diversity.

Ultimately, however, the state cannot keep itself in check. Only a confident citizenry, backed up by the institutions of a varied and dynamic civil society can keep the state in check. A strong civil society and a confident citizenry can even help sustain an equilibrium in which the political players and the state bureaucracy internalise norms and notions of acceptable behaviour that dilute the prevailing miasma of suspicion and mistrust between the governed and those who govern.

The IFIs, severally or jointly, cannot make a significant contribution to the emergence and flourishing of civil society in Russia. Only the Russian people can create and sustain a healthy civil society.

Other than the ‘meta-issue’ of the creation of a strong and capable but limited state, there remain a large number of policies, programmes and reforms to be implemented throughout the country, its regions, sectors, industries and markets. The programme outlined by Prime Minister Kasyanov on June 29, 2000, contains a comprehensive blueprint of what needs to be done. Of course, many of the details still need to be fleshed out, and the devil is always in the details. The experience with a long list of past comprehensive reform programmes, many of which also said exactly the right things but all of which sank effectively without trace, should make one cautious, but not cynical.

The IFIs can make an important but limited contribution to the government’s reform programme, once the reform of the state has gained momentum. They can provide financial support and technical assistance. The EBRD, unique in its position as a public institution, operating exclusively in the transition economies, whose main instrument is the financing of projects, predominantly in the private sector, is well positioned to advance the rising tide of market-oriented reform.

The policy recommendations made by the EBRD as part of an ongoing process of policy dialogue are perfectly congruent with the ‘Gref plan’ and the programme announced by the Russian government.

Foster the climate for domestic and foreign investment by imposing and enforcing the rule of law and by eliminating unnecessary administrative obstacles to enterprise. Specific examples are effective protection of creditor rights and of the rights of minority shareholders.

Create a level playing field for new private businesses. Both entry and exit of enterprises should be made easier. Unnatural monopolies should be eliminated. Natural monopolies should be effectively regulated. Only then can the benefits of a thriving SME culture be realised. A level playing field in the financial sector means that the special position of Sberbank (with its monopoly of deposit insurance) and of the other state banks will have to come to an end. Permitting the entry of foreign firms and foreign capital into previously sheltered sectors can be a swift and effective means of introducing effective competition.

Harden budget constraints on non-viable businesses, and insist on International Accounting Standards for all enterprises. Only then can the information necessary for effective governance -- public and private -- be disseminated widely.

Ensure that the necessary restructuring of enterprises does not imply hardship for redundant workers, through the provision of an adequate social safety net and through support for retraining and mobility.

Foster the adaptation of skills for a modern, service-dominated economy and restore educational and public health standards.

Enhance access to essential business services, including infrastructure, finance and the judiciary.

Russia's tomorrows can be so much better than her yesterdays. Only the Russian people can make the necessary choices to make this come true.

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Appendix: A simple framework relating accumulation and growth.

Underlying the discussion in Section II of the paper is an aggregate GDP production function that relates GDP to four kinds of capital inputs: private capital, public capital, human capital, environmental capital and social capital.

I use the following notation: Y is GDP, K^f the physical capital stock, K^p the private physical capital stock, K^g the government physical capital stock, K^h the stock of human capital, K^e the stock of environmental capital, K^s the stock of social capital, A the level of total factor productivity, N the size of the labour force, Q the quality of the labour force, L real spending on education and training, H real spending on health, $\boldsymbol{d}^p, \boldsymbol{d}^g, \boldsymbol{d}^e$ the depreciation rates of the private physical capital stock, the government physical capital stock and the stock of environmental capital respectively, I^p, I^g and I^e gross investment in private physical capital, government physical capital and environmental capital respectively, b the birth rate and m the death rate or mortality rate.

The production function is constant returns to scale in three capital stocks, physical, human and environmental. It has positive but diminishing marginal products, is strictly concave and satisfies the Inada conditions.

$$\frac{Y}{N} = AF\left(\frac{K^f}{N}, \frac{K^h}{N}, \frac{K^e}{N}\right) \tag{1.1}$$

Total factor productivity is increasing in the stock of social capital.

$$\begin{aligned} A &= a(K^s) \\ a' &> 0 \end{aligned} \tag{1.2}$$

Social capital refers to the quality of the institutional arrangements that support the economic system. It includes the legal and regulatory framework, the quality of public administration generally, the quality of corporate governance arrangements, and all aspects of civil society that enhance efficiency, including such intangibles as honesty and trust.

The aggregate physical capital stock is an increasing, linear homogeneous function of the private and public physical capital stocks. For concreteness, we can take it to be a Cobb-Douglas-type aggregator.

$$\begin{aligned} &K^f = \left(K^p\right)^a \left(K^g\right)^{1-a} \\ &0 < a < 1 \end{aligned} \tag{1.3}$$

Physical capital accumulation is gross investment net of depreciation.

$$\dot{K}^p = I^p - d^p K^p \tag{1.4}$$

$$\dot{K}^g = I^g - d^g K^g \tag{1.5}$$

Human capital is the product of the labour force, N, and an efficiency or quality index Q.

$$K^h = QN \tag{1.6}$$

The growth rate of the quality of the labour force is increasing in per capita education and training expenditure and in health expenditure per capita. A Cobb-Douglas specification is chosen for illustrative purposes only.

$$\begin{aligned} &\frac{\dot{Q}}{Q} = q\left(\frac{E}{N}\right)^b \left(\frac{H}{N}\right)^{1-b} \\ &q > 0 \\ &0 < b < 1 \end{aligned} \tag{1.7}$$

The growth rate of the labour force is the difference between the birth rate and the death rate. The death rate is decreasing in per capita education and health expenditure per capita (again assuming a Cobb-Douglas functional form).

$$\frac{\dot{N}}{N} = b - m$$
$$m = m\left(\frac{N}{E}\right)^{b}\left(\frac{N}{H}\right)^{1-b} \qquad (1.8)$$
$$m > 0$$
$$0 < b < 1$$

$$\dot{K}^{e} = I^{e} - d^{e} K^{e} \qquad (1.9)$$

The environmental depreciation rate is increasing in the volume of production relative to the existing stock of environmental capital. One could add the volume of consumption as a second determinant of the rate of depreciation of environmental capital.

$$d^{e} = f\left(\frac{Y}{K^{e}}\right) \qquad (1.10)$$
$$f' > 0$$