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ECONOMIC STRATEGY AND INVESTMENT CLIMATE

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Summary

An analysis of the situation reveals certain positive tendencies in the development of the Russian economy, that emerged after a period of difficult market reforms. This does not give ground for self-complacency, though. Transformations are not over. We have a market economy, but not a free one and, therefore, it is inefficient. That is why new crises are ahead unless market transformations progress.

The key components of the proposed strategy include:

- integration of Russia in the world economy;
- restructuring which implies, first and foremost, the flattening of conditions for competition, and liquidation of privileges and subsidies that allow inefficient enterprises and mercenary misuses to exist;
- improvement of the investment climate with every institutional changes capable of re-directing capital flows towards Russia and giving resources for growth of an efficient market sector;
- strengthening of the state, primarily as a factor which provides for rule of law and order;
- social policy which is oriented towards support of restructuring and lifts tensions it breeds.

Implementation of this strategy would allow Russia to override the transformational crisis and reach the key goals of the national development.

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Concluding remarks. Three stages as three steps into the future

Introduction

This paper is based on a report made for the *Liberal Mission* Foundation. It is a modified, more academic version, to be presented as a paper at the First International Conference to be held by the State University – Higher School of Economics on April 5-6, 2000, and at the seminar on April 7, 2000, by the HSE and the Center for Strategic Research, with participation of the International Monetary Fund and the World Bank.

The approach proposed in the paper to assessment of Russia's developments in the previous period, and to shaping an economic strategy for the coming decade, proceeds from accepting the broadly positive results of the market reforms in Russia, and from the fact that its further development will be a logical continuation of what has been done, or completion of outstanding issues.

Such a position is viewed as all the more important because there is a prevalent belief that liberal reforms in Russia have failed, and some new course is now required, with active interference of the state in the economy.

Following the 1998 crisis and several public scandals, in part inspired with internal political ends in mind, voices are raised in the West, too, of those who think that the earlier policy towards Russia was wrong, that its re-thinking is required towards reducing assistance. The IMF and other international financial organizations are being criticized.

Indeed, the time has come to re-define positions. In most European countries, the power in these past few years passed over from the liberals and conservators to left-wing forces of all sorts. A change of guards is happening in Russia, and will take place in the USA at the end of 2000. New people, new ideas. Re-thinking of policy both in Russia and abroad is inevitable. It is important, however, that new distortions would not emerge in the process, and strategic avenues that are objectively determined and meet the national interests of Russia and the interests of the world community would be preserved and strengthened. Our position is the following: market reforms in Russia went in a fairly successful way, despite numerous mistakes and useless compromises of this past decade, and with regard of Russia's specific conditions. It is just the feasible intervals for resolving the transition period problems in Russia are much longer than in the Central and East European countries.

The key role at the new stage of transformation of the Russian economy and society will be played by dramatic improvements of the investment climate in Russia, which should re-direct capital flows and provide resources for modernization and growth. To this end, structural and investment changes leading to a free market economy will be required.

Furthermore, the economic policy course should also remain liberal, Russia simply has no alternative.

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I. SITUATION OVERVIEW

The twentieth century was perhaps the most dramatic in the history of Russia. Three times Russia survived immense commotions:

- the socialist revolution which initiated an all-time social experiment;
- the bloodiest war in history, which cost 27 million lives to the country;
- the democratic revolution – perestroika and market reforms that put an end to the totalitarian regime born in an attempt to put a communist utopia in place.

The country had its moments in this century – victory in the war, making nuclear weaponry, space exploration achievements, the position of the second super-power with a huge area of influence, an ability to maintain strategic parity with the rest of the world for 40 years. However, all this was achieved at the cost of mobilization and extreme depletion of all national resources, at the cost of impinging interests and limiting the needs of most citizens.

By the end of the century, Russia found itself in a deep systemic crisis, a low-performance economy which is being ousted from the world community. This is a direct result of the collapse of the communist experiment, an outcome of 75 years of mobilization economy and a totalitarian state. The country should be taken out of the dead-end street, and brought back to the path of the world civilization development.

A. Reform Years

Large-scale market reforms were carried out in 1992-1997: liberalization of the economy including foreign trade, convertibility of the ruble, massive privatization, and financial stabilization. No matter how controversial these processes and their outturns were, no matter how many disputes they triggered, an indisputable fact is that the plan-and-distribution economic system was replaced by a market economy. The best evidence is that the shortage of goods, this inherent feature of socialism, was replaced by a saturated consumer market.

This in itself does not mean better life for most citizens, of course, but their problems have become different: “where to earn” instead of “where to get.” For the economy, this means emergence of normal market incentives, albeit in their imperfect forms, for production and consumption, and of economic self-regulation mechanisms.

The country had no future before the reforms had begun, though people had hopes. Today, there are few hopes and illusions but there is the future. It could and should be built up with

our own hands, everybody's hands, not just demand that the authorities will provide it and wait until they do.

The main contribution to the market reforms was made by young liberal economists summoned to the Government by President Yeltsin. Drawing on the international experience, they knew that the required reforms will cause heavy implications, particularly in Russia, breed discontent of a large share of the society and resistance of those groups whose interests would be impinged. Yet, these reforms were necessary for the future of the country, and if reformers could be reproached, it is only because the reforms were not resolute enough and were not always brought to a logical end.

Many mistakes might have been made. Numerous compromises had to be resorted to, because the reformers always had to work in the Government in a coalition with the older [communist] party and management *nomenclatura* and lobbyists of mercenary group interests who accepted reforms but had their own view of their goals and methods. That is why the outturn of reforms seven years after they were carried out happened to be not as convincing as striven for. A gap between the reality and the society's inflated expectations came to be even wider.

As a result of reforms, Russia became an economy which is a market one but far from liberal and, therefore, is inefficient. Structural reforms came to be slowed down, and institutional foundations for sustainable growth have not been laid.

B. After the Crisis

The 1998 financial crisis when many achievements were questioned was the natural end of the first stage of market reforms.

The financial crisis causes are well known: while the policy of tough capping an increase of money supply was carried out, which made it possible to push inflation down and stabilize the ruble exchange rate, soft fiscal constraints remained and were overcome by a rapid increase of the government debt. One could mention unfavorable world price developments, huge distortions inherited from the soviet economy, extremely low competitiveness of the Russian industry, and about people being unready to work in the market conditions. But the 1998 crisis clearly became an inevitable consequence of the inconsistent economic policy of compromises, which was targeted primarily at removing up-to-the-minute pressures, and kept putting off the solution of strategic tasks of economic restructuring.

The crisis dealt the hardest blow on the Russian financial system: the non-government financial sector which had emerged "from naught" during the reform years and was a symbol of success of the reforms lost a large share of its potential overnight, and the prospects of its recovery are still vague. The highest price for overriding the crisis and, therefore, for correcting the politicians' mistakes was paid by the Russian population – by a sizable decline of its living standards.

At the same time, the crisis rid the Russian society of many illusions and, most importantly, it showed:

- that the Russian economy has every ground to be called a market one because its response to a dramatic change of the situation after August 1998 was perfectly adequate, i.e., output was restored, import was reduced, and Russian goods became more competitive, in full compliance with the economic theory canons;
- that positive tendencies that developed in the pre-crisis Russia, in 1997, were a reality, not a mirage. For a large sector of the economy, the crisis ultimately became no more than an episode; enterprises that had learned to work in the markets and reported positive pre-crisis developments survived the crisis and were able to tap on the advantages from the ruble devaluation.

C. Forecast

Since early 1999, the Russian economy has been demonstrating positive developments: GDP and industrial output went up, inflation came to be much lower than could have been expected, private investments including those in the fixed capital went up for the first time since 1992, the share of cash payments in the economy increased, the federal budget performance somewhat improved, and wage and social benefit arrears to the budget sphere declined.

At the same time, it should be clear that there are no grounds for self-complacency and unlimited optimism for the future. An increase of the world prices on the key Russian export items was the main factor behind a substantially stronger balance of payments and exporters' much-improved financial situation and, clearly, such developments cannot last forever. Industrial output growth rate in 1999 is impressive only against the crisis year of 1998, but this growth amounts to only 2.3 percent as compared to 1997; real household income showed practically no increase in 1999.

This means that the Russian economy, as it is now, will keep growing slowly but this will not allow the country to resolve the problems facing it. With a relatively favorable external environment, the slow-response development of the Russian economy in the coming 3 or 4 years:

1. will ensure a positive path, but the average annual GDP growth rate will not exceed 2 or 2.5 percent, which is below the projected rate of the world economic growth and is equivalent to Russia's falling further behind. More optimistic projections that augur annual GDP growth rate of up to 5 or 6 percent are based on the positive 1999 outturn with a highly favorable situation, and on assumptions of the Government's sensible and consistent reform-making actions. Such forecasts should be treated cautiously so far. A low economic growth rate will not allow a substantial increase of people's living standards, while a decline of the growth rate, inevitable in the slow-response development, will preclude accelerated development in the period beyond.

2. will retain a large foreign trade surplus, even with somewhat lowered oil prices, but the continued highly intense capital flight from Russia will not make it possible to use the favorable foreign trade situation for resolving the problems of modernization of the economy and for improving its competitiveness. As a result, deteriorated world prices on raw materials might make the country face a threat of another financial crisis.

3. will not allow Russia to override fiscal deficit and, consequently, the tendency of piling up government debt will gain in strength again. The level of federal non-interest expenditures will not exceed 11-12 percent of GDP, which comes up to 80 percent of the 1997 level in real terms. Therefore, the fiscal crisis will not be overridden in these years, the social sphere will be kept on meager allowance, and the government will have no money to finance the development programs. The economy will definitively lose a sizable share of government demand, and this will be a constraint for using its growth potential.

Clearly, such a development path would deserve a more appropriate name of depression, and this scenario cannot be viewed as adequate for the country. The absence of acute manifestations of piled-up economic problems in this time might lay the foundation for the authorities' self-complacency, but threats will inevitably build up in the years ahead. The authorities' wavering and reluctance to see and resolve medium- and long-term problems inherent in the Russian economy might plunge the country into a permanent crisis, with a steady decline of living standards as its sole and key indicator.

II. KEY THREATS

A. Technological Lag

Since 1990 and throughout the whole period of economic restructuring, a decline of savings and investments for the sake of maintaining the consumption level – a process natural for these conditions – has been developing in Russia. As a result, final consumption as a share of GDP went up to 68.6 percent in 1999, against 62.6 in 1991, and the share of gross savings shrank from 37 to 15.1 percent in the same years. The share of savings in Russia is currently lower than in all the developed countries, and, all the more so, than in the developing countries, Russia's competitors in the world markets in the coming decades.

The country's production apparatus is physically and morally obsolete. While the average age of industrial equipment was below 8.5 years in 1970, it increased by twofold by end-1998. Depreciation of industrial fixed assets for the same period went up from 25.7 to 53 percent. Of course, a decline of investments to some extent reflected the transition from the wasteful soviet investment regime to a more rational market one. Objectively, many sectors did not need any renewal of their production potential because there was no demand for their output. Yet, it is clear that the rate of renewal of Russia's industrial and technological potential slowed down sharply, thus leading to a reduced competitiveness of the Russian goods even in the domestic market, while there is no chance for them to take a strong footing in other countries' markets.

Such a situation, if strengthened, will be an inevitable result of delays and slow-down of economic reforms, and will pose an increasing threat of a technological lag of the Russian economy and a loss of its research and technological potential. The quality of Russian goods, which is much behind the world requirements even now, will remain unattractive for consumers even if the “cheap ruble” policy is used. The share of raw materials in the Russian export will increase, and the country will be irrevocably saddled with the role of a supplier of raw materials and energy resources. The society’s hopes that Russia will regain respectable positions among the developed industrial economies will be buried for good.

III. ECONOMIC ISOLATIONISM

In the current situation, many Russian producers and political forces that wish to represent their interests are increasingly tempted to push for easier conditions for domestic producers and to protect them from foreign competition by enhancing non-transparency of the economy and by using protectionism. Such tendencies pose a major threat for the future of the Russian economy.

As a result of Russian reforms, the country became moving away from economic self-isolation where it stayed for over 70 years. Of course, foreign trade has been playing an important role in economic processes in the soviet epoch, but the pattern of soviet and Russian exports dominated by raw materials and primary goods is vividly illustrative of the sad fact that the Russian economy has not moved beyond the role of a raw material supplier to the world markets. Russian enterprises failed to offer quality products to the world market, and were unable to incorporate in the international division of labor.

Yet, Russia has become a part of the world economy. In the 1990ies, its involvement in the global economic processes increased substantially. Integration is particularly intense at the private business and population level. The degree of Russian economy’s dependence on global economic processes came to be particularly pronounced in 1998 when a decline of the world oil prices and the Asian financial crisis had an immediate impact on the domestic economic processes.

At the state policy level, integration of Russia in the world economy has its specifics: the state made the economy almost completely open for “exit” (it should be pointed out that there was no alternative after the collapse of the USSR: the state border was virtually nonexistent), while retaining substantial “entry” restrictions. As a result, capital and brains can leave the country freely, while their inflow from the world economies to Russia faces numerous restrictions at the legislative level, is blocked by bureaucratic despotism, and is pushed off by the all-penetrating corruption and weak government institutions.

This leads to a situation when Russia cannot tap on all the advantages of globalization, while its disadvantages have their impact to the full. The Russian economy faces opposition when it tries to enter the world markets, because the country does not take part in the work of the key international institutions that regulate international economic relations. Russian

enterprises do not use state-of-the-art technologies and are becoming non-competitive in the domestic market, as they use high import duties and a low ruble rate as the only safeguard measure and thus gain temporary well-being at the cost of reduced life standards of all the people.

Such a policy spurs recurring and extremely dangerous tendencies towards isolationism and xenophobia. A result is isolationism of Russia, as a state, in the world arena. Russia has no open enemies, but it has no allies, either. Russia's positions in the international cooperation system remain uncertain, and its interests are not protected by important multilateral agreements.

One should clearly admit that the only chance to ensure an economic pickup in Russia is to actively involve it in the world economic contacts, contract capital and technologies from the developed countries, and include Russian companies in international production chains. No economy in the contemporary world can rely on itself alone. To use the world civilization achievements, the Russian economy should be able to produce highly technological goods and R&D that are in demand in the world market, not just raw materials. Delays in Russia's integration in the global economic relations might lead to outdatedness of the country's potential, while all the commodity niches in the world markets will be taken over by competitors from other countries. Such a scenario might push our country back to economic self-isolation, and limit contacts with the rest of the world to oil and gas pipelines only.

A. Decline of Living Standards

During the past decade, the average life expectancy in Russia was reduced, and the population decreases. It is clear even now that this is related to the level of economic development and to painful transformation processes survived by the country, not just to long demographic waves. After the 1998 financial crisis, the living standards dropped by 15-17 percent on the whole, if measured by such indicators as real disposable income, consumption of basic foods, or retail trade turnover. Thus, the population paid for the authorities' mistakes, and for their vacillation in carrying out the required transformations in the economy.

Population stratification by income and material wealth increased sharply; the current household income distribution whereby 20 percent of the high-income population receive about a half of all the cash income is characteristic of countries with a low development pace and level. Only about 15 to 20 percent have so far profited from the market reforms. Forming the middle class – the social base of political stability and further reforms and development – was greatly undermined by the 1998 crisis.

The danger of the further decline of people's living standards is the major threat for the country for the coming years; it is permanently kept up by apprehensions of inflation leaps that would continue as long as the fiscal crisis remains unresolved. Given the fragile budget, the authorities will be frequently tempted to use the emission sources of financing fiscal expenditures. This will inevitably incur price rises and ruble depreciation which, in turn, will

result in making imports more expensive, and in giving a new impetus for price hikes. An inevitable implication of such a policy will be devaluation of household income and savings, which will hit a stronger blow on those earning fixed income. From this, there is just one step to further stratification of the population by income, an expanded and deepened poverty problem, and an increase of social and, consequently, political tensions in the society.

In the medium-term perspective, 6 to 8 years from now, the situation in Russia will be aggravated by changes in the demographic pattern: the number of dependents per one worker will increase by 1.5 times vis-à-vis the current level.

Russia has a certain reserve, i.e., a large capacity for improving labor productivity. The use of this reserve is curbed by the obsolete technological potential of the economy, on the one hand; on the other hand, it will be inevitably coupled with difficulties including the need of massive relocation of workforce and a temporary increase of structural unemployment, and the need to invest large resources in maintaining and developing human capital.

The country's place in the contemporary world is to an increasingly smaller degree defined by its size and military power, and depends to an increasingly large extent on the contribution made by its economy in the development of the world economy, on the level and quality of people's life, and on the ability of the state to resolve social problems facing the society. In this context, a decline of the Russians' living standards is the most acute and dangerous threat for the country; its further progress might lead to grievous losses in the development of the Russian society.

A list of threats and problems facing our country and its economy on the threshold of a new millennium could be expanded extensively, but these three major problems are enough to understand the following: to cope with them, Russia should, in the 8 or 10 years immediately ahead, make resolute and targeted transformations that would give a powerful impetus for the development of the Russian economy. A change of the political leadership in the country and termination of confrontation between the executive and legislative authorities might be a sufficient basis for the launch of this process. For its development, the Russian authorities should invest appropriate energy and consistency to these transformations.

How to do this? The national economic strategy should answer this question. We offer our version.

IV. GOALS, ALTERNATIVES, CONSTRAINTS

A. Goals

The goals of our strategic plan are trivial enough.

- To achieve an increase of living standards to the level of average developed countries; to reduce property differentiation in the society; to strive for the middle class, which is the support of social stability and democracy, to become the majority of the population and earn the largest share of income.
- To ensure average annual growth rate of at least 4-5 percent, i.e., about 1.5 times higher than the average across the world economy, during 20-25 years. More ambitious tasks could be set, 7 or 10 percent, but higher rates of economic development require a higher level of savings and, therefore, tougher restrictions on consumption.
- To ensure that a civil society and a rule of law state which guarantees protection of basic human rights and freedoms are formed. By doing so, to create a productive and dominating system of values which would orient citizens toward creativity and enterprise, responsibility and no-nonsense attitude, particularly to oneself, to tolerance and respect of other people's rights and views. This is an essential precondition for the country's further development, and for it to take a respected place in the world.

Success of Russian reforms is manifest in the fact that these goals meet practically no opposition and are shared by most Russian citizens. The main debates are focused on methods of achieving these goals.

B. Alternatives

The experience of Russia's historical development, a steady belief in a "kind czar" and in the ability of the state to resolve all the problems facing the society have been pushing the Russian public conscience towards a dirigiste alternative based on an active role of the state in economic decision-making at all levels.

Advocates of enhancing the role of the state believe that active industrial policies, government investments in fixed and working assets, reconsideration of privatization outcome and strengthening of the public sector in the economy could encourage economic growth. Protectionism in foreign trade, in the form of restricting competition of imports, should also serve this end. In this concept, improvement of living standards relies on keeping the current system of social guarantees and privileges, and on encouraging demand by raising the level of household nominal income and by "restoring lost savings" from the budget.

An inherent controversy of this concept lies in the fact that taxes collected in the country are not enough to implement all these intentions. Implicitly, this controversy is resolved through

easing fiscal constraints and using emission financing of the budget and, therefore, through inflation.

It is evident for us that the dirigiste model cannot ensure economic growth in Russia, nor does it give a response to the key threats and does not heed real constraints. No less evident is the fact that any increase of the regulatory capacity of the state in Russia would lead to an increase of bureaucracy and corruption. An attempt to implement such a social and fiscal policy will inevitably lead to growth of poverty and a slow-down of Russia's economic development.

The liberal strategy of economic policy which we propose does not promise instantaneous successes, but it creates the best conditions for private initiative and entrepreneurial spirit and, therefore, the basis for economic growth because it provides for legal stability and equal conditions for competition, and rejects daily interference of the state in businesses affairs and an intention to resolve all the social problems overnight.

To implement the liberal economic policy, we need a strong state which would efficiently perform its functions, not a state where the solution of any issue depends on a bureaucrat and where dozens, if not hundreds, of licenses, permits and certificates should be obtained before any business activity could begin. The tasks of the state are in putting in place a reliable system of protecting the citizen and his interests, in clearly defining "rules of the game" and controlling compliance with these rules. These tasks are not in interference in the daily life and taking decisions based on nothing but officials' interests. The tasks of the state are to ensure integrity of the country's legal and economic space. The government authorities' efficiency in these areas is a truly necessary avenue of enhancing the role of the state, and it promotes efficient functioning of the market economy, not encumbers it.

The liberal economic policy model does not imply that the state would distance itself from resolving social problems, but the policy of the state in this field will lead to sharing the responsibility for resolving the stock of problems between the state, citizens and businesses. The liberal policy does not promise to resolve all the problems at the cost of the state, but it does promise to carry out all the necessary reforms in the social sphere; these, in turn, would allow to use the available constrained resources more efficiently, on the one hand, and will not dampen incentives for the development of a free market economy, on the other hand.

The liberal economic policy model does not promise a total welfare state, but its task is to set the basis for dramatic improvement of the Russian economic efficiency and the use of available human and research potential, and to create the best conditions for putting citizens' business capacities to use.

C. Restrictions

The key condition for success in real politics is a clear apprehension of the restrictions, one will have to deal with while tackling strategic objectives.

Instability of macroeconomic situation is referred to the most significant restrictions. In fact, the inflation rate has gone down to 20 per cent per annum, and the ruble exchange rate has stabilized. However, the extremely favorable market conditions have been the main reason for that. Should the situation at the international market change and the apparent stability of the Russian economy will collapse like a house of cards. Sustainable macroeconomic stability is required for a successful development of Russia, which the country failed to achieve in mid-nineties due to its weak budgetary policy.

The Russia authorities continue to pursue policies based on the budget deficit, i.e. on the buildup of the government debt. What is even worse is that the budget finances its needs to a large degree through the CBR credit (more than 3 per cent of the GDP), i.e. through an emission tax on the economy. Such policies can not provide for the required stability, but, on the contrary, they lay the foundation for future instability.

Russia needs a balanced budget to overcome the crisis, it needs to finance not only the budgetary expenditures but also the repayment of the principal debt through the tax receipts. In order to achieve this objective one has to build up tax revenues of the federal budget by more than a third. The only possible way for that is a comprehensive tax reform.

As long as the Russian budget is not balanced, it is inappropriate to speak not only about its use as an active instrument of the industrial and social policy, but the adequate functioning of the budgetary sector, including governmental agencies, defense, education, and healthcare systems either. One has to comprehend that any discussions about an increase in budget expenditures should be preceded by the collection of adequate cash funds to the budget.

Russian politicians retain the temptation to overlook this restriction, the belief in the ability to increase the monetizing of the economy and to provide for the outgrowth of the money supply as compared with the inflation through CBR credits. This signifies that the danger of inflation, another stage in the reduction of living standards and still another wave of going back to the natural economy will continue to hang over all modernization plans of the Russian economy as the sword of Damocles.

At the same time the experience has shown that the budgetary crisis might not be overcome only through the budgetary policy, one needs structural and institutional reforms.

The structural disbalance of the economy is the second restriction inherited from the Soviet system. One can argue about their scale and impact, however, it is a fact that 40 percent of Russian enterprises are loss-making and are burdened with huge debts. At the same time they can not be closed in many cases, primarily, for social considerations, because many of these

enterprises are the only employers in hundreds and even thousands of Russian cities, and the low level of labor mobility and the virtual absence of housing market makes hopes for a natural resolution of this problem illusionary. This signifies that the process of overcoming this disbalance will take significant time and efforts of the Russian authorities and that this restriction will be an obstacle for further development and will require considerable funds for its resolution. Removal of this restriction, evidently, will have to become one of the priority strategic objectives for the next decade.

The low level of savings is the third restriction. In the long term there is a stable correlation in the economy of any country between the level of investments and the economic growth rate. In order to reach the desired rates of economic growth the level of savings in Russia will have to be raised to 25-27 percent, whereas it does not exceed 17 percent of the GDP now. It is apparent that at the current low level of consumption it is extremely difficult to raise the rate of accumulation because it will require a rejection of the consumption rate growth in real terms. Furthermore, the financial crisis of 1998 has undermined confidence of a significant share of the population in the stability of the banking system, which will restrict the inclination to save. The situation is worsened by the mistrust of the international economic community towards perspectives of the development of Russia, which limits significantly the possibility to mobilize foreign investments, and, on the contrary, it stimulates the capital outflow.

The weakness of the state is the fourth restriction, which is manifested primarily in the fact that governmental agencies are incapable of enforcing the legislation, providing for the safety of citizens, and protecting property rights. The authorities are connected closely with business circles and they either implement the will of the tycoons, or its representatives are engaged in business activities, which contradicts public interests. What we have today is called bureaucratic capitalism, or capitalism for the insiders, which creates obstacles for development of the country and obstructs the process of making it civilized in a modern sense. The bureaucratic capitalism should be extruded by the free market-driven economy.

D. Main Concept

If one accepts the liberal model as the basis, the next step should be its actualization into concrete objectives and conditions of the next decade.

1. Structural reform of the economy is the main objective that has to be resolved during this period in order to reach the required rates of economic growth and to raise the living standards of the population.

It should be mentioned that this objective was formulated in all governmental programs since 1995 as the highest priority for the second stage of the reform. However, it was never implemented. The crisis of 1998 was required to accelerate the process of restructuring of Russian enterprises. However, the conditions, which allow a significant share of the economy to remain uncompetitive and loss-making in real terms, to spend resources of the rest of the economy and to restrict the economic growth, continue to exist even now. Resolution of this

task is related, primarily, with the gradual creation of competitive equity and the cessation of direct and indirect subsidies.

2) The constructive side of the structural reform consists of broadening the market-driven sector and raising its efficiency. Large-scale inflow of investments is required for that. Only private investments, foreign included, could be mobilized in the required volume. For this one needs a favorable investment climate. It should be mentioned that in order to resolve the foregoing tasks one needs major changes, which will turn the current unattractive conditions into one of the most favorable in the world for investments in Russia. This will constitute the most significant step on the way of the integration of Russia into the world economy.

Improvement of the investment climate becomes the national objective of the highest priority for the coming years. Only its resolution will make modernization of the Russian economy realistic. Deep institutional changes leading to the creation of the genuine free market-driven economy will be required for that.

3) The third relevant component of the strategic concept is an active social policy targeted at the support of the structural reform. The gist of it is that besides a comprehensive reform of the social sector specialized social programs should support processes of the restructuring of enterprises, which presume labor redundancy, labor retraining, labor relocation in certain cases, and the creation of new jobs. The necessity of this is illustrated by the restructuring of the coal-mining industry, where it was possible to close more than 100 mines, to reduce employment from 1.2 million to 400 thousand and to provide for the growth of productivity only due to the fact that at the insistence of the World Bank significant funds were used for social and not industrial investments. It should be emphasized that the social investments were targeted at the resolution of social problems and were not limited to the distribution of allowances.

4) In their turn, the structural reform and the improvement of investment climate require strengthening of governmental institutions, especially judicial and law-enforcement agencies, strengthening of the fight against crime and corruption, bureaucratic high-handedness, as well as the improvement of the legislation, constitutional included, and the provision for the unified legal space in the country. The efficiency of government in this sphere is a relevant element for raising the role of state, which does not obstruct but, on the contrary, facilitates operations of the market-driven economy.

5) Integration of Russia into the world economy is a required condition of the structural reform, raising the competitiveness of the Russian economy and the most significant component of the improvement of investment climate. To become part of the positive processes of globalization and the establishment of technological lines, which form the backbone of the international economic system. With this objective to find niches on the world market, to mobilize investments, and to participate in the activities of organizations of international economic cooperation, primarily, the WTO and the OECD.

6) The fiscal policy has been at the focus of attention in the recent years during the fight with inflation. In the forthcoming period as the budget crisis is overcome the fiscal policy will be moved to the background gradually and will rather establish objectives than restrictions for the resolution of problems in the aforementioned areas.

However, during the first two-three years the priority objective will be the restoration of confidence towards Russia, which is relevant for the improvement of investment climate as well. That is why it will be necessary to move to the balanced budget execution, primarily, on the basis of higher tax compliance. Restricted borrowings could be used only for the refinancing of a part of the debt and for development needs.

V. STRUCTURAL REFORM OF THE ECONOMY

Structural reform of the economy is the major objective of the next decade. It has to remove the threat of wasting the capital and a technological backwardness and to pave the way for economic growth.

Objectives of the structural reform:

- assimilation of the mass production of competitive products, primarily in manufacturing, creation of mechanisms providing for quick renewal of products;
- finding niches on the domestic and world markets;
- raising the productivity and efficiency to the level of industrialized countries;
- technological renewal of productive facilities;
- provision for the effective employment subject to changes in the location of production and the required relocation of labor.

The key problem that has to be resolved in this context is the reduction of the non-market-driven and non-competitive sector in the Russian economy, which consists of enterprises that produce negative value added, and its subsequent elimination.

A. **Dimensions of the Non-Market-Driven Sector**

We lack data now, which would allow to estimate precisely the dimensions of the sector. However, there are implicit data that testify to the fact that its share is extremely large.

The share of loss-making enterprises is 40 per cent now. In 1996 their share was 50.6 per cent and it was 48.3 per cent in 1998. 84.4 per cent of agricultural entities registered losses in 1998 and this indicator grew continuously.

According to general opinion, official indicators of profits and losses reveal virtually nothing because they are distorted by barter, non-payments and other similar instruments. An enterprise could be hopeless and yet register large profits in its reports. On the other hand, an enterprise, which is highly efficient in real terms, could be shown as loss-making because of

the transfer of its assets to affiliated companies and due to other forms of semi-concealed thievery.

At the same time these mechanisms conceal a large number of inefficient enterprises, which are able to survive due to various types of subsidies, barter, non-payments, and offsets. As it turns out, work in such enterprises could be more profitable than in healthy market-driven companies, thus, the latter lose incentives for raising their efficiency. Thievery turns out to be more profitable than the production of competitive goods.

What is the number of such enterprises? What is their influence? How badly do they contaminate the atmosphere and obstruct the economic growth?

Analysis of the same data on losses shows that the maximum indicator of the share of loss-making enterprises (70 percent) was reached at the end of 1997. The crisis of 1998 had small impact on this number, and it has gone down to 40 percent since the beginning of 1999. The scale of shadow economic activities had hardly any impact on this trend, whereas the ruble devaluation, the liquidation of the GKO pyramid, the growth of oil prices improved the position of enterprises undoubtedly.

In accordance with data of the Inter-Agency Balance Commission headed by P.A. Karpov, which were received on the sample of 1194 of enterprises from different industries, in 1999 39 percent of them had the solvency index (the ratio of total debts to the monthly sale of products) of more than 18 months, including 19 percent – of more than 3 years. The consolidated productivity of labor at those enterprises did not exceed 7 thousand rubles per month, whereas it was 12.3 thousand for the group of enterprises with the solvency index of 6-9 months, and 31.2 thousand per months – for those with the index of 3 months.

These data allow to make a preliminary conclusion that the nonviable inefficient enterprises with low productivity that are burdened with debts, which they are unable to repay, constitute up to 40 percent to the total number of enterprises, in accordance with the formal data. If one makes an adjustment to shadow transactions, which worsen formal indicators, the share of such enterprises will be no less than 25-30 percent. This signifies that the non-market-driven and non-competitive sector constitutes a significant share. It has a considerable impact on the Russian economy, generates tax arrears, barter, money substitutes and creates serious obstacles on the way of economic growth drawing on the resources of viable enterprises.

B. Competitive Equity

The main method for the solution of problems is the creation of equal conditions for all enterprises, the liquidation of various concessions, preferences, subsidies for non-efficient enterprises at the federal and regional levels and the improvement of payment discipline.

The main factors of support for non-efficient enterprises are as follows:

- tax arrears;
- non-payment for electricity, heat, gas, and transportation;

- concessional prices and tariffs;
- direct subsidies and investments, particularly, from regional and local budgets.

The generally accepted practice, i.e. to collect from those who earn, who is more transparent, who can not resist and not to touch those, who can not or does not wish to earn and to pay, has become a major obstacle for development.

Evidently, there are reasons to take a cautious approach to the fate of non-efficient enterprises and industries. There are people behind them. One has to take into consideration that the process of restructuring is going on naturally, especially, after the 1998 crisis.

Nevertheless, it is necessary to render this process a more active character because the longer it takes, the more efforts and resources we waste, which are needed extremely for the structural reform.

Leveling of competitive conditions on the basis of cancellation of concessions, preferences, subsidies, tightening of financial discipline, enforcement of regions to build down budgetary expenditures for these objectives, fight against bureaucratic high-handedness in relation to successful enterprises – these are the most significant areas of the structural reform.

It is possible that a specialized program will be appropriate for the reform (restructuring) of enterprises, which would be targeted at increasing the transparency of enterprises, analysis and counseling of problem enterprises, and the closure of nonviable enterprises, as well as the development of social measures for the support of people during the reform.

C. Investment Needs and Priorities of the Structural Policy

Liberal approach to the structural reform consists of stressing the role of private entrepreneurship and private investments through the creation of the most favorable conditions for them. However, this does not signify that all regulation is given to the market-driven forces. Simply one should not try to do something, which the market is the best at doing.

This does not signify that the role of industrial policy is rejected during the transition period or that various forms of support for certain high-priority sectors of the economy by the government should be cancelled.

Even without any ideological considerations it is evident that in the future period the role of direct government interference into the processes of the structural reform in the form of state investments and state order will be minimal.

According to available estimates, the technological modernization will require approximately US\$ 2.0-2.5 trillion during next 20-25 years, of which approximately three thirds could mobilized through domestic savings. During next 10 years US\$ 600-700 are required.

The minimal need in investments that could demonstrate in the short term positive results of the structural reform, for example, could lead to raising the labor productivity by two times, equals US\$ 15-20 billion, according to an estimate. The possibility of state investments from the consolidated budget during next 3-4 years does not exceed 4-5 percent of this amount. Thus, the liberal variant becomes inevitable.

Nevertheless, we deem it necessary to establish priorities for government support:

- infrastructure, into which the private capital is not going to invest, but which is required for the effective investment of private capital;
- export, particularly, of products with high value added (guarantees of export credits).

VI. INVESTMENT CLIMATE

Private investments, which should be the main element in the restructuring of the economy and the provision for economic growth, are highly sensitive to the investment climate. However, it is extremely unfavorable in Russia now. It seems that significant efforts have been taken, however, facts are self-evident: capital investments during past 12 years went down by 5 times. The annual capital outflow equals US\$ 15 billion, according to the most modest estimates, and its total stock for the years of reform are US\$ 130-140 billion. Direct foreign investments for the period equaled US\$ 10-15 billion in total, i.e. they are equal to the annual capital outflow.

In order to resolve problems of the structural reform one needs not only to improve the investment climate, but to change it radically in such a way, which would allow Russia to take a prominent position of the international capital markets.

The investment climate is part and parcel of general business climate, which is the climate for entrepreneurial activities. That is why measures that could be proposed for its improvement should cover broader areas. In fact, significant structural and institutional changes are needed, which would result in the creation of a free market-driven economy.

The major problems that continue to obstruct investments into Russia are as follows:

- absence of political stability and predictability;
- macroeconomic disbalance, budgetary crisis, and high government debt;
- imperfect legislative basis;
- weakness of the government, inability of governmental agencies to enforce law and order, to defeat crime, corruption, and bureaucratic high-handedness;
- lack of protection of property rights, low level of corporate management, discipline, and contract execution;
- drawbacks of the taxation system;
- unreliable banking system and underdeveloped financial markets;
- non-transparency of Russian enterprises and large shadow economy.

As far the political instability is concerned, one can say that with the new distribution of forces in the parliament and after the presidential elections this problem will be resolved.

Solution of macroeconomic problems depends now not only on a comprehensive settlement of the government debt and a significant improvement of the tax compliance, but also on achievements in the creation of competitive equity, structural and institutional reforms that are required for the improvement of investment climate at the micro-level.

A. Strengthening of the State

Problems of strengthening the Russian state is one of the highest priorities for the authorities. It covers a broad range of relations, which are much broader than the economy. At the same time strengthening of governmental institutions and raising their efficiency is the main condition for the improvement of the investment climate in Russia.

The major directions of this work are as follows:

- improvement of the current economic legislation, accelerated adoption of several relevant legal acts and amendments to such, the Tax Code, the Land Code, the Law on Foreign Exchange Regulation, etc. included;
- implementation of the judiciary reform with the objective of providing for the real independence of courts and raising the efficiency of the legal system. The court is the weakest element in the system of state power now, which has to be amended immediately;
- strengthening of the anti-crime and the anti-corruption campaign;
- strengthening of federalism on the basis of precise demarcation of rights and obligations between the federal center and regions, provision for the enforcement of federal laws and the unity of the legal space on the whole territory of the Russian Federation, including through the force of law and court rulings;
- reform of the government service.

The key question of strengthening the state is a clear separation of authorities and business circles at all levels. The authorities should not be engaged in business activities, which leads to a conflict of interests and the erosion of power. Without this the Russian society shall not be able to overcome the current difficult situation for apparent reasons. The bureaucratic capitalism will be extruded from the free market-driven economy to the extent we shall be able to move forward in this direction. To the same degree the government shall be able to win the confidence of citizens who are not protected against high-handedness and injustice. This will bring about a radical reduction of investment risks.

B. Protection of Property Rights

Numerous precedents connected with the redistribution of assets, including those with the use of arms, bad-faith court rulings, flagrant violation of shareholder rights, creditors, and investors allow to make a conclusion that property rights are not protected well in Russia, and the culture of corporate management and contract execution is low.

It is necessary to implement the following major steps in this area:

- Reconsideration of the privatization results should be forbidden by law. The number of precedents of the effective protection of property rights, especially on the basis of court rulings and the execution of such, should be increased.
- Provision for the suppression of majority shareholders and company managers activities that are pursued to the detriment of minority shareholders including such actions as artificial capital buildup, concealment of information, and violations in the organization of shareholder meetings. Corresponding amendments should be introduced into the law on joint-stock societies.
- Introduction of additional measures to protect bona fide buyers of securities, including from the authorities, for example, during the detection of violations of the legislation during emission or previous transactions.

Enterprises can mobilize the largest volume of investments from small shareholders. However, they will fail to receive investments if shareholder rights are violated and there is no appropriate stock market.

- Introduction of amendments into the bankruptcy legislation, targeted at the acceleration of bankruptcy of insolvent enterprises and the prevention of the use of bankruptcies for misappropriation of effective enterprises.
- Accelerated adoption of the legislation, which protects intellectual property in real terms, and provision for its enforcement.
- Cancellation of licensing of capital inflow and introduction of notification registration procedures connected with capital flows. Concurrent adoption of measures that reduce profitability of financial transactions involving offshore zones and initiation of international negotiations on this subject.

C. Liberalization of Markets

The common opinion that Russia has an excessive form of economy liberalization is not true. This country does not provide for the basic freedom of entry to the market; it has numerous restrictions; ambiguities in the legislation create many opportunities for corruption and bureaucratic high-handedness even without the violation of the legislation. One needs real liberalization. One has to revise all legal acts and cancel the provisions that leave the solution of numerous questions to the discretion of bureaucrats. It is necessary to

- Streamline procedures for the organization of business entities, to reduce the number of agencies granting authorizations, and to implement the “one window” principle instead of running around dozens of offices. A new edition of the law on registration of legal entities should be adopted, and all regional and local acts, which will contradict it, will have to be cancelled.
- To reduce the number of activities that require licensing to the minimum. To prohibit by law any methods of direct or implicit licensing, certification, etc. except cases stipulated in the federal legislation.
- To implement the structural reform of the natural monopolies in the course of 2-3 years, which will provide for the separation of all business functions that are conducted on the competitive basis, as well as the separation of regulatory and management functions (the Ministry of Railways and the Ministry of Nuclear Energy). One has to provide for the transparency of the monopolies and for the mandatory publications of their reports.
- To provide for the transparency of enterprises towards creditors and investors. For this objective a federal registry of companies with free access should be established and all economic entities should be obliged to publish data about their operations.
- To accelerate the introduction of the International Accounting Standards.
- To provide for the transparency of administrative procedures and the placement of government orders.

D. Taxes

The following measures are required for a real improvement of the investment climate:

- Significant reduction of the nominal tax burden from the current 60-65 percent of the GDP to 40-45 percent of the GDP, which will make taxes realistic and reasonable.
- Reform of the tax administration system that will provide for equal requirements of tax agencies to all taxpayers in order to make taxation fair.
- Consolidation of the political will of all branches of power in order to make tax evasion one of the most serious transgressions against the society.
- Adjustment of the legislation with the objective of granting tax holidays for the realization of investment projects.
- Amendment of the taxation of household income from securities targeted at streamlining the assessment of taxed income and the reduction of the tax rate on capital value growth.

The relevant aspect is equal treatment of taxpayers: bona fide taxpayer should never be in a worse position as compared to a bad-faith taxpayer.

E. Bank Restructuring and Financial Markets

To ensure efficient operation of major Russian companies and the implementation of large-scale business plans, the country needs major banking institutions. Russia -- with its abundant natural resources and companies that measure up to that scale -- attaches considerable importance to the concentration of banking capital.

Despite a steady growth in the share of largest banks in the banks' capital in general, their lending possibilities in the wake of the 1998 crisis have shrunk almost 3 times. The banking system as an institution accumulating and re-distributing financial resources has been severely damaged.

In Russia, the bank restructuring strategy should hinge on rapid recapitalization and creation of large, multi-branch banks whose assets and capital could put them in the list of top 500 European banks. The emergence of such institutions would substantially change the banking landscape, the real sector of Russia, and affect global financial markets.

As a vehicle for implementing this strategy, the government could and should employ the following methods of banking consolidation:

- Restructuring individual large banks suffering from minor financial problems;
- Government participation in recapitalization of large banks which survived during the crisis, but lost a substantial portion of capital;
- Initiate bank mergers, including through enforcement. The strategy of financial support and restructuring of regional banks carried out by the government authorities is a waste of public. Such banks should be brought under or affiliated to stable banking structures;
- Attract foreign capital to rehabilitate multi-branch banks which turned bankrupt, but have a limited stock of liabilities. Clearly, before bringing foreign investors, the government must guarantee the safety of assets in such banks and make sure that bank managers and owners do not accumulate the liabilities further. Government authorities should increase the share of foreign capital in the Russian banking system by taking an affirmative stance.

VII. FINANCIAL MARKETS

There is a need for speedy recovery and development of the Russian financial markets, primarily, of state and corporate securities which remain "frozen" after the 1998 crisis.

The crisis has once again brought to the forefront the need to restructure Russia's financial system and re-arrange the functions of its main segments. At this point, the role of

investment financial institutions appears to be more promising especially because Russian banks did not perform well in this capacity exposing their clients' money to unreasonable risk.

MinFin's renewed role of a regular borrower in the financial market should be saluted given the importance of the government debt market as an additional liquidity management tool and as a benchmark interest rate which is crucial for the development of capital markets. Clearly, while placement of GKO's must be kept within the budget constraints and yield ceilings, they may be instrumental in restraining currency issue.

As a shareholder and owner of the largest Russian companies, the government should encourage them to make more energetic use of the Russian financial market as a source of growth. It is only regular borrowing by major companies that will give rise to properly functioning capital markets.

The financial market infrastructure should also shift its focus from mainly speculative transactions to lending to the real sector.

To this end, the following must be done:

- Encourage the development of the following infrastructure institutions:
 - financial investment consultants and information and research centers;
 - rating agencies assessing the creditworthiness of recipients (issuers and other borrowers);
 - institutions specializing in loan guarantees and insuring against investment risks.
- Facilitate the creation of a corporate debt market infrastructure which would help enterprises settle their mutual claims.
- Promote the development of the derivatives market, allowing to hedge foreign currency risks, which would require the following:
 - a regulatory framework for the development of the market for forward contracts;
 - promote the development of a specific market infrastructure (primarily clearing houses);
 - take into account the specificity of hedging for taxation purposes;

- Initiate the implementation of a unified mutual guarantee systems against debt instruments, securities and credits, envisioning inter alia, government participation.

The above are just the priority measures.

VIII. SOCIAL POLICY

In recent years, despite the declared policies and practical steps, the social sphere has remained an area least of all affected by reforms.

Meanwhile, there is an urgent need for reform.

The volume of government statutory obligations is at odds with the available financial resources, while the gap is constantly widening: the stock of socialist-era liabilities has been compounded by populist promises of the democratic era, including measures taken after the 1998 crisis and approved at the federal, regional and municipal levels. The “social welfare state” proclaimed by the Constitution of the Russian Federation in reality is a “virtual social welfare state” as because of a shortage of funds, none of the social aspects have been implemented in accordance with the constitutions. This inevitably erodes the authority of the government.

The problem is not only in poor law enforcement. In a “virtual social welfare state” – a goal towards which Russia has been energetically advancing over the past years -- the crucial element is what the third-world countries call “socialism for the rich, and capitalism of the poor”. The current social security system is a left-over from the Soviet era which is based on comprehensive social transfers, subsidies on prices of commodities and services, and various preferences. As a result, the system designed to support the needy – which is especially important in a market economy -- in the transition period accounts for only 20% of all the social transfers. The rest is paid to families which do not qualify as needy which means that the scant resources are used inefficiently.

There is a reason why social reforms are advancing slowly. These reforms that affect millions of people are, involve changes in the standard of living and in the set of values. This is why prudence and temperance are well grounded.

As to procrastination and inaction, they are inadmissible. Should necessary change be put on hold, the country may see its social problems aggravate in the coming years. If that should happen, the usual explanation that the decisions were stalled for of the people’s own good, won’t work.

The main principle underpinning social reform should be the feasibility of the government’s obligations and better use of the available resources. The government should not make promises that it can’t keep. All unrealistic promises should be abandoned while new social

obligations should be undertaken only by those government levels that are able to finance them.

At the same time, assuming obligations that increase the tax burden with the sole purpose of financing social spending, is unacceptable. The country needs a more efficient economy whereas unrealistic promises will only hinder progress toward achieving this goal.

In the coming period, the government will need to address the following issues:

- Ensure timely payments of wages and pensions linking minimal wages and pensions to subsistence limits and raising the share of legal wages;
- Eliminate unreasonable social exemptions and privileges, reducing excessive government obligations;
- Switch to targeted social safety system based on means testing.

Besides, an effective market economy requires the implementation of a set of social reforms comprising:

- Labor relations
- Housing and utilities
- Pensions
- Education
- Health care
- Social security

Finally, social policy at the new stage highlights new priorities. Since structural reform is the main challenge, the social policy should be geared toward supporting it, all the more so because it is the social issues that are the main impediment to market transformation of the Russian economy. Therefore, social programs in support of enterprises, industries and regions must become the key component in economic strategy and in the social policy at large. It should be stressed that they will become an integral part in the policy targeted toward the needy.

A. Social Reforms

It is not our intention to provide a comprehensive analysis of and approach to the organization of specific areas of social reform. Each of them is the subject of a profound professional research. We will focus on a number of important strategic issues.

The aim of the **labor reform** is to bridge the gap between the real labor market and the remaining illusions about the labor legislation which is a vivid example of the virtual “social welfare state”. The goal is to achieve further flexibility in the market and higher labor

mobility by providing effective protection of employees' rights, broaden the room for maneuver for employers, and reduce latent processes in the labor market. To this end, we propose the following:

- Substantially raise the role of individual labor contracts, simplify contract termination procedures initiated by employers, while safeguarding employee's rights; expand the application of temporary individual labor contracts; broaden the scope of issues governed by the contract;
- change the concept and the role of collective labor agreements including unions as employee representatives at the level of enterprises and organizations by facilitating consolidation of employers and employees;
- given the crucial nature and the variety of required amendments to the labor legislation – the reason why the labor reform will be conducted gradually – it is not advisable to adopt the new edition of the Labor Code which remains Soviet in nature. Instead, we propose to gradually adopt a number of federal laws which may subsequently become consolidated in the labor legislation given the experience in their application. They include the laws *On individual labor agreements*, *On social courts in the Russia*, and *On collective agreements and contracts*..
- adopt more realistic mass displacement procedures, amend the law *On employment in the Russian Federation*. Currently, in the context of structural reform, mass layoffs are not that uncommon, enterprises violate the rights of the employees, leaving them without wages, or are forcing them to take unpaid vacations. In such cases, the law should provide acceptable methods of compensation and social restructuring programs to be financed by the budget, or through social borrowing.

Labor reform is one of the key elements in completing the market transformation.

Housing and utilities reform has been ongoing for a number of years, but lately its pace has slowed. The goal is to establish a properly functioning housing and utilities market which would help reduce prices. Hence, the household component in the purchase of housing and utilities should be increased, while the subsidies from regional and local budgets, and from enterprises, should be cut. Cross subsidizing must be eliminated as well. Low-income families should receive housing subsidies.

A factor hindering the pace of reform is low household income which has plummeted even more dramatically since the crisis of 1998. It is unacceptable to force the households to pay for higher costs incurred by housing and inutilities companies operating in a non-competitive environment. This area of one of the bastions of crony capitalism where the link between business and the power is most prominent.

The first priority in accelerating the pace of the housing reforms is to establish a competitive market.

Pension reform is one of the most complex areas since it implies a transition from the PAYG pension system to the mixed funded-PAYG system with a rising share of funded elements given budget restrictions. Such a transition would require the creation of quite a sizable transit financial reserve. It would be preferable if the transition could be completed by the year 2007. By then, the pension-age population will have reached such proportions which could put the current pension system at the risk of default. The 1998 crisis has further aggravated the situation. Due to advance indexation of minimal pensions, pension differentiation has shrunk considerably hindering the implementation of contingency funded pension accounts envisaged in the pension reform program adopted in May of 1998.

In light of this, we propose the following:

- to avoid higher pension differentiation but to evenly raise all pension payments to bring minimal pensions to 80% of the subsistence level, in compliance with the pension reform program;
- future pension differentiation should be covered by a higher funded element in the mandatory state pension insurance;
- to revisit the issue of the phased increase of the statutory retirement age up to 65 years for both men and women, over a period of 10 years, beginnings in 2002. Such decisions have been approved in Georgian, Kazakhstan, and Moldova. This retirement standard has been in place for a long time in industrialized countries.

This is even more reasonable because given the current pensions, all able pensioners work past their retirement age.

- There should be alternative ways to finance early retirement through a system of insurance against disability in the preferential retirement age;
- promote non-government pension funds and additional voluntary pension insurance following improvements in the financial markets.

Social security reform (special exemptions, payments and services) implying that price subsidies, category exemptions and benefits will be replaced by earmarked allowances for the needy, whereby the selection criteria should be consistent with the financial constraints. The criteria approved in the 1999 legislation apparently will block an across the board transition to earmarked social security programs due to budget constraints.

In this regard, we propose the following:

- The powers to set the amounts and forms of social support should be delegated to regional and municipal levels who are more familiar with local specificity.
 - vigorously develop non-government social sector by providing an fair and equal access to “government social order”.
 - Provide more freedom to citizens to choose between free or subsidized social services, inter alia, by introducing special social accounts. These accounts would allow the user to use free or subsidized services per an agreed list provided by any institutions, holding a special licenses.
- Promote private charity funds in the system of state social orders and social accounts, stress the voluntary nature of social services.

The proposals on education and health care reform will be presented separately.

B. Social Programs to Support Structural Reform

Such programs are not an entirely new concept. Over the past years, we have accumulated experience in developing and implementing such programs, such as:

- divestiture of social infrastructure to municipalities;
- displacement from northern regions;
- support of closed territorial and administrative entities and other “mono-cities”, etc.

However, in most cases, the solutions to social issues lay in the area of providing new exemptions and privileges, granting subsidies to non-viable enterprises, and supporting non-payments and barter as a way to procrastinate the resolution of social issues which effectively impedes social reforms. Such methods are unacceptable. We need investments in the social sector to alleviate constraints on restructuring, instead of piling up expenditures to resolve these issues.

There are good examples such as:

- the coal sector reform funded by the World Bank;
- social restructuring at the Novomoskovsk chemical plant, carried out by Procter & Gamble, which allowed to upgrade production facilities and halve the number of employees avoiding dramatic social implications;
- social program at the Norilsky Nickel, etc.

This experience can serve as an example of methodological guidance and recommendations. Similar programs should be financed through entities, municipal and regional budget, by cutting current social spending and subsidies. There are possibilities for borrowing, inter alia, from international financial institutions.

Concluding remarks. Three stages as three steps into the future

In conclusion we would like to present scenarios for phased implementation of the proposed strategy -- if it is accepted and if the conditions are relatively favorable – not extremely favorable, but without major exogenous shocks, such as a global financial crisis, or a drop in energy prices to \$8 per barrel.

The overall projection is as follows: in 2000 – 2001, we may expect moderate results, if market conditions are favorable, GDP will grow at the rate of 4 – 6% accompanied by private investments growth. There is a good chance to balance the federal budget. Political and macroeconomic stability should improve the investment climate and entice foreign capital. This is an optimistic scenario which is likely to be implemented in case oil prices remain in the range of \$25 per barrel, and import-substitution prevails, which will enable to invest a considerable portion of income from these sources. It is these very factors that largely contributed to growth in 1999. A negative scenario at this stage is unlikely.

However, in the future, one should not expect market conditions to be favorable. Higher private investments which set the stage for economic growth, must be sustainable. If the investors are disillusioned again, it may entail very severe repercussions.

Given all the above concerns and threats posed by the Russian economy, we cannot count on luck. Inertia in the 3 to 4 coming years would reduce all efforts to zero, and exacerbate threats and problems. In order to achieve success and address the main issues of development in Russia and build on the positive trends, the issues must be addressed immediately. We should not expect a rapid breakthrough with annual growth rates of 10% this year, but rather expect modest growth and -- as a result of necessary reform -- see notable change at the end of the decade.

There are three stages:

I stage (2000 – 2003) – implementation of the main measures to overcome the credibility crisis and improve the investment climate.

The main challenges at this stage are as follows. The government must balance the budget, agree on a comprehensive scheme for external debt settlement. It should pass the main laws lowering investment risks and ensuring business stability. The authorities must show its resolve in fighting corruption.

In this period, growth will be tempered primarily due to tight fiscal policy and measures to streamline competition and reduce the number of unprofitable enterprises. Unemployment is expected to rise. But the new market sector will generate growth, contributing to the overall GDP growth of 3 to 4% per year. Inflation will run at 12 to 15%. Federal tax receipts should be raised to 14.5% - 15% of GDP.

In this period, the authorities must seek notable progress in rehabilitating the banking system and restoring financial markets and pushing ahead with the housing and utilities reform, and the pension reform. The inflow of private investments must be comparable to GDP growth.

II stage (2004 – 2007). The top priority is to ensure investment growth in the context of structural reform, step up the development of the market sector. By the end of the period, unprofitable enterprises will cease to exist. Barter transactions and non-payments will disappear due to the elimination of their underlying factor.

Average annual growth rates will should rise to 5 – 6%. Investment growth will outpace GDP by 1.5 – 2%. Changes may be expected in the structure of the balance of payments with the higher portion of exports of manufactured goods and imports of capital goods, along with a reduction in capital outflows. There may be a capital account surplus offset by a reduced trade balance surplus.

These years are likely to bear the brunt of the social reform, as the reforms in housing and utility, pension, education and health care are expected to be completed at this stage. Nominal household income will grow helping to cover additional expenses. Transaction demand for money will increase. Real disposable household income will reach 2-3% per year, while inflation will run at 5-6%.

Stage III (2008 – 2010) – achieving high economic growth rates, completion of structural reforms. GDP growth rates will stand at 6-7% of higher real disposable income of 4-5% a year. Notable productivity gains will be generated by investments into technology and labor reform.

The ruble will become strong following from economic rehabilitation and a favorable balance of payments position.

Economic rehabilitation and growth and productivity gains will help alleviate the pressure on the workforce. Nevertheless, it would be advisable for the migration authorities even at the early stages, to attract more labor resources in Russia, primarily, specialists.