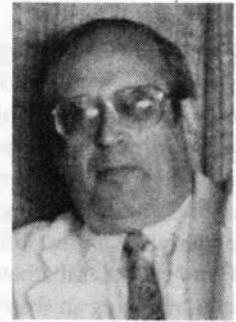


# Toward a scientific grounding for economic reforms in Russia

by Academician D. Lvov



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## Introduction

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In present-day Russia, there exist three determining factors which provide unique conditions for its effective development and joining the ranks of the leading countries of the world.

Firstly, the country has huge reserves of fuel, minerals, fertile soil, and other natural resources.

Russia's per capita resource potential exceeds that of the United States 2 to 2.5 times; Germany, 6 times; and Japan, 18 to 20 times.

Secondly, Russia boasts a unique potential of highly qualified specialists and scientists who can solve the most complex problems pertaining to science, technology, and production.

And, finally, Russia has a powerful industrial base, which, in some aspects, is on a par with technological bases of leading western countries, including the United States.

However, there is a wide gap between the huge opportunities for prosperity in Russia, and the harsh reality of life.

Deplorably, Russia's economic potential has so far been used not for the country's benefit, but to foot the bills for unsuccessful economic experiments. Why is this so? How may the critical economic situation be improved and social degradation of society prevented? In which direction should we search? Or, is it better to stop altogether, or to take up a new rehabilitation program?

Lord, how many and various programs have been worked up during the past few years! These days, only lazybones do not draw up programs. But what's really striking, is the contrast between the high tension of political debates on the essence of each program, and the quiet demise of these programs as soon as the heated discussions are over, even before they might be tested against reality.

So it was with the "500 Days" program; the same fate awaited the government's program for financial stabilization of the economy, and many other well-known programs.

This is not a mere coincidence. Many authors looked upon the preparation of their programs as a ritual, aiming to impress large audiences. They took no responsibility whatsoever, but an image of genius left unclaimed was skillfully created. Those authors sat down to chart programs, without having any clear theoretical concept of market transformations. Their criterion was political resonance, not so much in Russia as among our western patrons, rather than the truth and actual results. No wonder that from the very beginning, the ideology of those reforms was directed toward destroying reforms. Our reformers seem to have assimilated the tactics of those Bolsheviks, whose sole purpose was razing everything to the ground.

These days, as never before, we need a thoroughly verified theoretical base to ensure the success of market-oriented reforms. Some people may retort: What has theory to do with all of this? Theory is for scientists and their theses, but we are worried about reality: We have bad management, we choose bad leaders, and so forth. But it is time to understand that it was the absence of a theoretical base for reforms, that brought us an abnormal orientation of our economic decisions for decades, and, as a result, to degradation of the productive forces of society.

This report, which we bring to the attention of political circles and the Russian public at large, is an attempt to fill this gap. It contains benchmark principles for reform of the Russian economy, which take into consideration both current theoretical issues and the real state of the Russian economy. These principles can be amended and made more precise, to form the starting-point for studying concrete reform scenarios and the corresponding system of practical measures. Moreover, these principles allow us to reveal the obviously ineffective directions of the efforts already made, to define the actual possibilities for setting market mechanisms into motion, and to define the limits of a strategic policy for economic transformations.

One more observation. The present report expresses the viewpoint of the scientists of one of the country's leading economic institutes, whose studies are well known both in

Russia and abroad. The Central Economic-Mathematical Institute (CEMI) occupies a high position among major universities and economic institutes of the United States, Germany, Britain, Japan, and other countries. Many specialists from CEMI are successfully working in the West now. Unfortunately, some of today's reformers have a direct or indirect relation to CEMI as well. But they were not the ones who defined CEMI's school of science, i.e., the stock of knowledge created by the scientists of the institute even before perestroika.

For us, representatives of this institute, scientific argumentation, and conclusions ensuing from the analysis of socio-economic phenomena, rather than considerations of political advantage, have always been and continue to be our focal point. Let us hope that the contents of the present report meet the above requirements, even if not all of its conclusions can be accepted.

This factor, to some extent, provokes a vital discussion of science with those experts, economists, and scholars, who sincerely wish that reforms go in a direction good for Russia and its people.

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## 1. Reforms and power

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Admitting the need for reforms does not mean, that the authorities are actually prepared to carry them out. More importance should be attached to the essence and purposes of reforms, rather than to the wording and slogans they carry. If we are to trust the official declarations of the authorities and certain mass media backing them, a market economy has already been established. The notion that there is nothing more in store for us, that there is no alternative to the current policy, is constantly being impressed upon the people. Any deviation from this policy is regarded as surrender of the positions achieved, a betrayal of the market economy. But striking is the gap between slogans and declarations, and the harsh reality of life.

The country entered the phase of reforms, carrying a banner that read: democratization of power, liberalization of the economy, and humanization of social relations. The people were ready to pay for it. And they did pay, as usual, sparing no cost. As a result, different, burning words are now written on the walls of our common house: inflation, stagnation, degradation, and now—war. The result of the adopted policy turned out to be deplorable for the people.

Inflation is corroding the economy, production is nose-diving, enterprises are being closed, capital investments have been reduced more than twofold. We are witnessing the rapid stratification of the population into layers depending on their incomes, and the impoverishment of some groups of the population is reaching inadmissible dimensions. The people who have found themselves below the poverty line are not so-called "marginals" or persons of no use to society; they

are the most valuable specialists, the main resource of our hopes for the revival of society: students, workers in science, culture, education, and medicine, as well as highly qualified engineers and specialists. The system of social guarantees and social security has been considerably undermined.

The deterioration of socio-economic living conditions has led to a catastrophic demographic situation—a negative natural population growth. Reduction of the birthrate is accompanied by a rapid worsening of the state of health and an increase in the death rate, mostly among working-age men.

What is most troublesome, is the inadmissible corruption of morals, the rapid reassessment of values in society. The direct consequence of Russian citizens' falling dignity and morals is the discreditation of science, education, managers of State enterprises, the Army, employees of law enforcement bodies, of everything associated with the concept of Russia's statehood.

An outbreak of corruption, bribery, crime, and anarchy of management gave rise to apathy and disbelief in any policy.

All of these factors are extremely dangerous for Russia. They lead to social tension, to the conviction that the adopted policy of market transformations is erroneous; they set different layers of the population and the country's regions against each other; they weaken State power, and make our economy more criminal and highly explosive.

Currently, even some reformers are beginning to understand the pernicious influence of the present policy and the need for drastic changes in it.

A country which is in a state of such disorder is far from the best object for reforms. Genuine reforms require a uniting, consolidating idea. The postwar leaders of West Germany and Japan were well aware of this. Overcoming the remnants of the totalitarian system, under the banner of denazification and demilitarization, did not eclipse their main objective—switching over the historically conditioned readiness of the population in these countries to work for common goals, to the task of building a modern, socially oriented economy.

The socially oriented nature of the reforms introduced in the above countries immediately revealed itself. Hardly anyone would deny, that the immediate and most successful results of those reforms were the reduction of unemployment instead of its rapid growth, and an increase rather than a fall of incomes. The socially oriented nature of the reforms in those countries determined not only the rapid growth of people's well-being, but also the revival of the political influence of these countries in the world.

To achieve these results, there must be genuinely democratic State power, whose leaders favor such developments and are capable of pursuing a policy oriented not to the economic interests of certain groups, clans, and elites, but to the interests of society as a whole, at least its large creative part. This must be public power, based on the will of the people.



*A crumbling residential facade in Moscow, June 1995. "The deterioration of socio-economic living conditions has led to a catastrophic demographic situation—a negative natural population growth."*

What we had in our country was of quite a different nature. The rotten upper echelon of the non-democratic state headed up its "market restructuring," and thus won powerful positions and sources of enrichment for themselves and for far from the best economic management layers. For them, the most important thing was not reform, but power. As a result, there arose "failures in management," damaging the healthy elements of the planned economy. The next step was the substitution of a predatory and criminal free-for-all, for constructive market self-regulation. From this angle, the transformations of the economy and society, carried out under the banner of reforms, were the very thing the authorities were after: not to give their opponents any chance of seizing the levers of government. No change will take place, until the question of power is finally settled.

*The success of reforms hinges not only on the resolution of the problem of power, but also on the institutional resolution, i.e., the transformation of State power into a properly functioning structural social mechanism, which will ensure the regular and consecutive turnover of administrations in accordance with the will of the voters, and which will protect society from attempts by any new administration, to monopolize power.*

The modern market economy cannot effectively function, without well-developed mechanisms of State and public control over the authorities. The importance of such control mechanisms will become obvious, once we compare the actual functioning of the market economy system in, say, coun-

tries of Latin America or Africa and developed countries of the West. One and the same system of production relations is common for all these countries. But the results achieved are different. While corrupt officials, blackmail, violence and, in some cases, coups d'état and the struggle to get and retain power, are characteristic features of the first type of countries, western countries have adopted the line of strict limitation of possibilities for statesmen and legislators to use power to their own advantage, though they also have cases of egotistical abuse of power. This limitation becomes possible, thanks to the institutions of State and public control over business activity, which prevent unscrupulous competition and protect consumers' rights. These countries also have a no less developed system of control over power at each of its levels, from the President of a country to the leadership of a certain state or even a firm. The development of a system of such institutions lays the foundation for ethical economic relations in society which guarantee a respectful attitude toward the property of others. Of course, we shouldn't idealize the way coordinating mechanisms are formed and used in the current economic situation in the West. Western countries also have their share of criminal and other negative factors of social development. But in this context, it is important to underline the common tendency: Western democracy, while having serious drawbacks, is moving fast in the direction of the creation of public power, eliminating the boundaries between the authorities and the people, making it more "transparent" and liable to public control. Power structures,

upon passing an important decree, will, like it or not, have to bear in mind how different layers of society are going to take it. They will have to, since an official's activity will be under permanent State and public scrutiny. Officials might be glad to act otherwise, provided they were not under the threat of losing their power status. The risk of being punished or condemned is far too great in this case, for a public figure to ignore.

Russia is so far from all this! The main obstacle in the way of effective reforms turned out to be the authorities themselves. They continue to play at reforms, in order to stay in the saddle. From this standpoint, we are going to have the continuation of reforms for a long while. In any case, the present wave of reforms is neither the last nor the decisive one. Chaos and vacillation created by the reforms will last, until the question of power is finally settled. Only then we will consider reforms in a business-like manner, discussing the real objectives and tasks of the reforms.

In this connection, it will not be an exaggeration to say that the question of power should precede the question of the nature of reforms in Russia. Until now, we have been setting reforms before power. Reforms must ensue from the settlement of the problem of power. Most important, is that it be true, democratic State power, interested in and capable of conducting progressive reforms; authorities who will enjoy people's confidence and support.

This kind of State power can provide:

- the availability of any authentic information on the state of affairs in economy and society;
  - a rational pace of change, an unforced renewal of the social and economic systems;
  - prevention of a collapse of production and a decline in living standards, etc., beyond the limits of permissibility established by legislation—unless measures were found or introduced, wholly to avoid the above negative phenomena;
  - priority of public interests over personal or group ones.
- Open encroachment upon the public interest on the part of personal or private interests has always been considered a crime in any civilized society. Personal enrichment amidst public bankruptcy has been condemned everywhere.

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## 2. On the theoretical base of reforms

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Essentially, the economic crisis is a reflection of the crisis in economic science, which broke out much earlier than the active period of reforms. Prior to perestroika, scientists were deprived of the opportunity to study alternative paths of social and economic development. The principal line of the upper strata was: "We are walking along the only right path." This line made no provision for alternatives. Even attempts to substantiate the need for *departizatsia* of economic man-

agement were suppressed ["departization" refers to the reduction of Communist Party control—ed.]. As a result, for a long time we did not have any other model of the collectivist economy than that of the State planning agency (Gosplan) and the party. This fact can partly explain why the present-day reformers have so easily managed to thrust upon the scientific world their model of market changes, as the only alternative to centralized planning.

What is surprising, however, is how readily our men of science allowed themselves to be twisted round the finger by people, not one of whom was known for any scientific accomplishments. The inability to take an independent stand with respect to those in power and to restrain them from unreasonable actions by force of competent opinion, is one more illustration of the conceptual and psychological unpreparedness for reforms. Now science is reaping the fruits of its grovelling before the authorities. State power, which declared itself to be science, has no need for science and is not inclined to allot money for criticism of its own activity.

Years-long dogmatism could not help but take its toll on the quality of the scientific grounding of the reforms. The reformers limited themselves to only one trend of western economic science: liberalism in its "Chicago" (monetarist) version. Under the hypnotic influence of monetarist formulae, the reformers neglected other developing trends of western science, such as institutionalism, evolutionism, etc.

Modern institutionalist theory reveals the peculiarities of existing conceptions about the role of the State in the market economy system and in the realization of determining social objectives. This includes, above all, non-acceptance of a "free-for-all" in attainment of personal and group objectives. It is no accident, that in western countries more importance is attached to the mechanisms which force entrepreneurs to proceed from the need to observe common interests, each time they realize their own interests. Such mechanisms operate in a complex system of social relations, regulated by legislative, executive, and judicial bodies, as well as by specialized public institutions. The contemporary market system cannot function effectively without a developed system of institutions, capable of protecting the rights of producers, the people, and the State.

Directive regulation, being an alternative to market self-regulation, is not, nonetheless, the market's antipode. It is an important component and product of the market economy. No wonder, directive regulation is a widely used practice of both the State and business itself.

Disregard for our own theoretical legacy by the ideologists of the reforms led to another serious deficiency in reform of the Russian economy. This concerns, first of all, the famous System of Optimal Functioning of the Economy (SOFE), which was elaborated from the early 1960s at the Central Economic-Mathematical Institute of the Academy of Sciences of the U.S.S.R. (CEMI).

SOFE constituted an alternative to apologetics and to the

then-predominant methods of management of the national economy. Those who created SOFE immediately took up the methodology of rational economic management, an analysis of the main principles of constructing an effective system of economic relations, based on the combination of the structures of "vertical" and "horizontal" interactions between economic subjects.

The most valuable achievement of the theory of optimal functioning was the concept of the estimation data for all types of resources in the form of characteristics of their contribution to satisfaction of social needs. Not only labor, but also other factors of production—natural, capital, any other types of limited resources—are properly estimated in optimal functioning. SOFE's undoubted merit is that it overcame the limitations of the labor theory of value and put an end to the large-scale mistakes in management of the national economy caused by this theory.

On a strictly scientific basis, the role of a number of general economic characteristics was revealed, such as the discount rate for money resources, interest rates on credit, rental and other charges, and a concept of the best strategy of economic development was worked out.

Thus, in the 1970s, the theoretical preconditions for the creation of an economic mechanism of a regulated market type were already formulated. It is exactly for this reason, that the SOFE theory was incompetently and groundlessly criticized, to the point where the very term SOFE periodically disappeared from publications. The last ideological pogrom took place in 1983 to 1985, right before perestroika started. This way, SOFE's opponents managed to achieve their main goal: to expel the theoretical basis for reforms, along with CEMI itself, from the process of market transformations.

Deplorably, the Academy of Sciences and, above all, the Economic Department of the Russian Academy of Sciences, have so far failed to issue a principled evaluation of this immoral act. This is all the more important because the reformers, if they wished, could easily find in the SOFE, answers to a host of questions concerning the problem of effective reform of the Russian economy.

One more point should be underlined. Each trend of domestic and foreign economic thought does not and cannot claim to be universal. Only the joint consideration of the positive aspects each trend contains could lead to success. It is precisely the interaction of different trends that could result in an integral understanding of market economy policy.

Our unsuccessful economic experiment once again confirms, that theoretical concepts should not be taken as something abstract and distant from reality. We have paid a high price for this delusion. Drawing on the theoretical experience amassed by world science, Russian economic science included, Russian reforms could be channelled in a different way, so that we could avoid the ruinous consequences we observe nowadays.

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## 3. Reforms from the viewpoint of modern science

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### 3.1. Social orientation

The determining imperative of reforms ought to be an economy oriented toward man and the combination of social justice with economic effectiveness. Such requirements are not some theoretical abstraction. They are being practiced by the countries which successfully carry out their own reforms, because these imperatives reflect the actual possibilities and requirements of modern civilization.

The adopted course of reforms imposed a heavy burden on the social sphere. People were left to their own devices, bereft of any State aid for their adaptation to the new economic conditions. The greater part of the population was thrown back 20 years, in terms of current consumption and social services.

And although social policy is an obvious failure, it continues to be stressed, that State financing of social services is outdated. The proposed radical reform shifts the center of gravity of the financing of social services from the State budget to citizens' savings, collected by specialized institutional investors, i.e., pension and education funds, insurance companies, investment funds, etc. For the most part, the above institutions are private; for example, the State Pension Fund only retains the function of paying "social" pensions within the limits of the living wage (subsistence minimum). Meanwhile, it is not clear why State funds cannot be just as effective investors as private ones, and if it is really impossible, why not completely replace the State system, which redistributes the current incomes of the economically active part of the population in favor of the inactive one?

The thesis of the archaic character of the State system and its discrepancy with market economy conditions can hardly be accepted, if only because this system was introduced in countries with a highly developed market economy (in the United States, for example, it was the famous Social Security Act, the operative scale of which grew rapidly, beginning from 1937). Argumentation in favor of the State system emphasizes the lack of private savings, insurance, and charity institutions, and the need for relying on the "taxation potential of the nation." Only State social security ensures a general and guaranteed satisfaction of the inalienable human rights for a decent basis for life (social justice aspect) and for the formation of education and personnel training levels adequate for a modern economy (economic effectiveness aspect).

While analyzing references to "wage-levelling" and its destimulating consequences, it should be borne in mind that being economically active or inactive is not a permanent feature of population layers that are structurally the same, but rather alternating stages of the life cycle of practically

anyone (excluding a small percentage of invalids from childhood). Thus it would be groundless utopianism, to attempt to eliminate the dual nature (primary distribution-redistribution) of the movement of personal incomes, which are passed on to people going through their “economically inactive” phases of life (childhood, old age, illness, periodic holidays, study, qualification training, etc.). Attempts to restrict redistribution to the sphere of individual savings of each disabled person, having no resort to other people’s incomes, looks just as erroneous. No matter how “de-nationalized” an economy, one cannot help but resort to the “socialization of dependence,” when providing for children, educating young people, and so on, be it inner-family redistribution of income or raising loans from various credit institutions.

A rationally constructed system of State social security guarantees does not create any fundamental obstacles to the development of the institutions, effectively mobilizing and investing personal savings. Not only the utilization of these savings, but also a rational policy of taxation and maneuvering of current State expenditures, might serve as effective mechanisms for macro-economic regulation of the social sphere.

World experience confirms that western economic systems, especially during periods of depression, successfully utilize progressive taxation for the upper, most prosperous groups of the population, and redistribution of the collected money in favor of the destitute. The above measures are very effective: They stabilize the economy, promote rapid reduction of production slumps, lower inflation, etc.

The experience of western economic systems in respect to indexation of deposit rates, insuring personal savings from inflation, is also well known. Is it prohibited to use such measures on a large scale while conducting our social policy? Of course not! It is chiefly our reformers’ dogmatic ideas about the factors of inflation that prevent this from being done. A one-sided view on slashing State expenditures, as the main source of inflation, is the classical corroboration of this.

The Russian economy has fundamental sources for financing the budget. These are Russia’s natural resources and its “human capital.” The only thing left is to make use of effective mechanisms of income accumulation and distribution, not for the benefit of certain groups, but for the whole society. But for this, we must have the appropriate type of power and a system of State institutions, able to coordinate the interests of all active market participants.

### 3.2. Social and psychological factors

The crisis this country has encountered is of both an economic and a social and psychological nature. Such phenomena as apathy, cynicism, disappointment, and skepticism about the policy of reforms, and the population’s passivity during election campaigns are no less precise and direct indicators of the crisis than inflation and the collapse of pro-



*A poultry shop in Moscow: Low wages place its wares beyond the reach of a growing percentage of Muscovites. Writes Academician Lvov, “The wages workers receive now depend on factors which they can control to a smaller extent than before. This and other losses must be compensated. Otherwise, an increase of social tension and sometimes even direct conflicts with the authorities are inevitable.”*

duction.

The psychological aspect plays a fundamental role in the complex of measures aimed at overcoming the crisis. It is necessary to restructure not only reality itself, that is, the national economy and political institutions, but also people’s subjective attitude toward this reality, or the image of the social world our fellow citizens share.

Sweeping changes are impossible without due regard for the psychological factor. Reforms, especially those effected in Russia, entail great hardships for many people. Benefits, if any, will come later, while troubles are inevitable now. It is not only a question of losses suffered from inflation, the collapse of production, etc.

New social conditions confront people with problems which the existing system of their education and their entire previous life-style did not prepare them to solve. For example, the wages workers receive now depend on factors which they can control to a smaller extent than before. This and other losses must be compensated. Otherwise, an increase of social tension and sometimes even direct conflicts with the authorities are inevitable.

The possibilities for “material” compensation are very small at present. Thus more attention must be attached to the factors performing the role of “psychological” compensation. The most important of such factors are honesty on the part of the authorities when solving different problems, and maximal openness of decision-making procedures at all levels. The population at least must be aware of which steps the authorities are taking to fight corruption and eradicate it in the future. The population wants and ought to know how

much money is being spent on the salaries of the President and his entourage, on outfitting offices and dwellings of the Executive branch, on maintaining legislative deputies, on all types of representations, business trips, and pompous visits abroad.

Why are the organs combatting economic sabotage satisfied with reporting isolated examples of abuses uncovered, without revealing the true picture of squandering of the national property and looting, such as occurred during voucher privatization?

But it would seem that neither those in power nor their competitors are interested in exposing the real state of the economy and social relations. The majority of the population, being the principal victim of the troubles of perestroika, have still obtained no access to strategic social and economic decision-making. The same power structures, with no provision for feedback, are still directing social and economic life. It is a dictatorship of the ruling layers. All this cannot but separate the authorities from the people. The people lose what remains of their faith in the reforms, and start looking for means to make up for the unfavorable changes that have occurred.

Time is being wasted. Meanwhile, the question of the rate of reform is one of the most vital, since it deals with the processes of acceptance or rejection, by various groups of the population, of the changes under way. All types of "crash innovations" are very dangerous. Even if they ultimately turn out to be beneficial, their being too rapidly pressed on the population, makes it impossible for the latter to appreciate their pluses and accept them at a new value, while the rapid destruction of accustomed forms is accompanied by excessive losses and degradation of social life. That is why it is important in the reform policy to find an optimal rate of change, where the new co-exists with the old long enough for the population to appreciate its advantages and choose it consciously, rather than adapting to the new, as if it were some uncontrollable and inexorable natural process, a sort of social catastrophe.

*The principle here should be, not to subject to rapid destruction those qualities of the pre-reform system, which various groups of the population consider important and valuable elements of their way of life.*

When innovations are of a crash or shock character, the improvements for one group of the population are far from covering the losses suffered by other groups, whose social life is reduced to mere survival, owing to the deterioration of their material conditions and loss of social status. They become the victim, the price society pays for the changes implemented. Such groups of the population automatically become a nutrient medium for totalitarian movements.

In respect of Russia, this principle works in the following way. Whereas the full employment system (which sometimes camouflaged labor conscription), a certain guaranteed level of income, and the ensuing stable standard of living were the

customary and socially formative characteristics of the way of life of the vast majority, the reform policy should avoid measures that significantly undermine these characteristics. The people would not approve of strategies undermining their stable employment and incomes, without prompt and effective compensation for these losses. Disregard for this side of the reforms in Russia leads to mounting social degradation and joining the ranks of the homeless, for a considerable number of citizens. It should be noted that the unemployed are not simply some superfluous resource, but people who have lost their social status, in a sense "non-citizens," inclined to unpredictable and anti-social forms of behavior. When their number reaches a critical level, there might occur irreversible changes toward general degradation of society, resulting in either the disintegration of society or the establishment of a totalitarian regime.

### **3.3. On the correlation of 'old' and 'new' structures**

The problem of backwardness and rational combination of the new and the old in the economy has many aspects. One of them is the phenomenon of coexistence of different technical and economic structures in each branch of industry, caused by the general limitation of national economic resources and the impossibility of removing temporary lags, in the course of modernization of production. A detailed analysis of this aspect of the problem is given in economic evolution theory, in SOFE studies and in modern micro-economic theories. It is obviously impossible to make all producers "equally advanced" overnight, just as it is absurd to liquidate all of them except for "the most advanced." SOFE proved that the most rational solution will be that distribution of a production program among existing suppliers, which balances the total demand for a certain product with the available sources of supplies of resources, by means of equalization of the marginal (closing) expenditures, which in the end will determine the price of the product. This procedure does not have to mean the liquidation of enterprises, especially if we take into account that each of them, depending on its scale of production, displays a variable function of closing expenditures. The equalization of closing expenditures accomplished by means of shifting mobile resources between existing enterprises, has very little in common with a sweeping notion about the so-called inevitable collapse of mass production, increase of unemployment, and liquidation of whole branches of the economy "in the interests of effectiveness."

Another aspect of the same problem is the reformers' conviction that there is no point in maintaining and developing what they call backward industries. Under the rubric of backwardness, they often can unjustly include instances of abnormally high resource-consumption (reduced productivity) of a given production factor, caused by the unequal provision of concrete economies with this factor, and, as a result, the predominance of "extensive" or "intensive" methods of its utili-

zation. However, it is hard to say whether the primarily extensive agriculture of the United States is “backward” or “advanced” (with reduced productivity and valuation of land area, and an abnormally high labor factor), or that of western Europe (abnormally high labor-consumption with a smaller labor index and high prices for land), before it is revealed that the “overdraft” by one factor is covered by economies in the use of others. There is an analogous situation, for example, with power generating and other raw materials, when it is impossible to judge whether they are being used “wastefully” or not, without estimation of the economy of labor and other factors in, say, power-consuming branches of the economy, etc. To establish such correlations, it is sufficient to have simple computations of internal prices for each country, as long as a single methodology of calculation is observed (for example, it must include the rent component). Otherwise, a statement about the cheapness of raw materials and energy in a given country might turn out to be false.

Evidently the most realistic solution is a relatively long coexistence of “old” and “new” economic structures during the transitional period. Today even our own practice confirms how ruinous are precipitous actions with respect to old enterprises, accompanied by a catastrophic drop in production, increase of unemployment, and other negative phenomena. This situation calls for another, more flexible economic policy, based on strict prescriptions drawn from economic theory, instead of the naive ideas of the reformers.

### 3.4. Openness of the economy

To overcome the closed nature of the former Soviet economy, within the small circle of the former Soviet republics; to occupy a worthy place in the world system of division of labor; and to derive from this considerable profit, conducive to the success of reforms—these are the most important objectives of economic reform.

In this general sense, the thesis of transition to an “open economy” does not evoke objections. All countries that have undergone more or less successful modernization of their institutional and functional systems at different stages of their development (usually connected with overcoming postwar, post-revolution, or post-crisis devastation, or internal economic, social, and political crises), were able, already at early stages of the process, to rapidly increase their influence on world markets for goods, services, and capital, which was the best manifestation of the advances achieved. Nowadays, for example, this movement is characteristic of the young Asiatic “dragons.” International organizations striving to regulate world economic links (for example, the LINK system), encounter a predominant inclination in the majority of developed and actually developing countries, to increase exports, and they face the necessity of coordinating their policies so as to restrain such inclinations. All this testifies to the high economic effectiveness of countries’ active participation in the world system of division of labor and of deriving

benefits from the intensive exchange of products, technologies, and capital.

It does not, however, follow from the general statement of this principle, that all such exchange is necessarily economically and politically effective, and that its terms are inconsequential. For example, we should not identify the concept of “open economy,” as it was characterized above, with a regime of low customs barriers or, in the extreme case, even their absence; or the participation of the State in fixing quotas, licensing, taxation, and control over export-import operations—with deviation from the principle of free trade.

The creation of the General Agreement on Tariffs and Trade system about 20 years ago (the World Trade Organization since 1995) was intended to be conducive to liberalization of world trade by seeking reductions of export-import duties, liquidation of bans, quotas, and licenses through professional arbitration of the relevant conflicts, which have usually accompanied such liberalization of foreign trade exchange. The average level of customs barriers has actually declined almost threefold during this period.

Even now, however, the abolition of these barriers and of State regulation of foreign economic activity sounds like a distant prospect, which countries are striving to reach by establishing more or less large-scale regional markets and international bodies, whose main objective will be the tedious and years-long elaboration of gradual liberalization of their foreign economic relations. Of the three continental markets formed so far—the European, the North American, and the Asiatic-Pacific—only the first one, after years-long preparation, has approached a regime of duty-free trade and practically unlimited exchange of investments. As for the Asiatic-Pacific regional market, the transition to an analogous regime for its most highly developed or actively developing countries is scheduled only for 2010; not earlier than 2020, will this system encompass all the participating nations.

At the same time, the relations between the countries not included in a given regional market, are still subject to strict State regulation, and periodically undergo “trade wars,” mutual “taking of measures” against what this or that country deems to be excessive foreign economic expansion by others.

All of this indicates that transition to the complete liberalization of foreign economic activity, even on a limited regional scale, should be thoroughly weighed and carefully considered in terms of the concrete advantages and dangers inherent in each step in this direction.

The theory of foreign economic interactions shows, that the difference between export-import and internal prices, as well as the dynamics of the various countries’ currency exchange rates, are determined by conditions of the foreign trade balance of the interacting countries, provided each of them is seeking to derive a maximal effect from its foreign economic activity.

The level of export and import duties should not exceed



the above differences, and the degree of its deviation from them is to be determined by the foreign trade policy of the relevant countries, their aspiration to centralize currency revenues and use them for State investments and the corresponding import of equipment, or, on the contrary, to stimulate certain exporters and establish for them a base for internal investments and the diversification of production. Under current conditions, the first way seems to have substantial advantages.

### 3.5. On problems of privatization

Property is a central question of economic reform. However, in the current situation, it is far, not only from being solved, but even from being correctly formulated.

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*The country entered the phase of reforms, carrying a banner that read: democratization of power, liberalization of the economy, and humanization of social relations. The people were ready to pay for it. And they did pay, sparing no cost. As a result, different, burning words are now written on the walls of our common house: inflation, stagnation, degradation, and now—war.*

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The officially proclaimed policy in this sphere is no more than a veil, hiding real events. The defenders of the “restoration of private ownership” doctrine are carrying out large-scale re-allotment of property, on the ruins of the State economy. No number of possible victims, abuses, and social collisions can shake their faith in the transfer of control over resources and the results of their economic utilization to individuals. For them, this is supposedly the alpha and omega of the property problem, the decisive condition for the renewal of the system of economic motivations, and the revival of business enterprise, free from State diktat.

An analysis of historical development of the institution of private property, however, and especially of modern processes of its transformation in the countries with a highly developed market economy, puts this problem in another light, and leads to different conclusions, in contrast to the notions of Russian privatizers.

The historical process of social development testifies to the fact that the institution of private ownership arose and developed as one of the most important instruments of particularization of the economy, or of production in a broad sense, out of a universal social system, which was initially indivisi-

ble in terms of the nature of its functions. The institution played an ancillary role in the establishment of an independent economy, more and more protected from the tyranny of power and the chains of personal dependence. Thus it also acquired ever more autonomy. And this factor, in turn, opened the way for a broader division of labor and cooperation, for a greater scale of technical and organizational improvements in production.

Isn't it strange to ascribe the benefits derived by society from the autonomous existence of the economy, not to this primary source of that development, but to just a single one of the factors that made it possible—the institution of property?

In analyzing the function performed by the institutions of private ownership in its “protecting” role, cited above, we can formulate the following two fundamental conclusions.

Firstly, in the course of the evolution of the economy and society, the method of realization of this function can change (and is actually changing); thus there are no advantages, fixed for all time and “consecrated” by history, of one form of private ownership over the others.

Secondly, insofar as specialization and autonomization of the economic subsystem is an accomplished fact in modern industrial and even post-industrial society, the surviving constructs of the old institution of private property are more and more rudimentary in nature, like the ruins of fortresses in modern cities. In this connection, the passion of the struggle of social forces for and against such limitations has lost its actual significance and become a bugaboo, used by political parties and the pressure groups backing them, in their rivalry for a slice of the State pie.

These conclusions are confirmed by the real tendencies toward separation of property from management, and dismemberment of the system of property rights into separate components, combined into even more various configurations among the participants in the economic process. A classic example of this is the evolution of the enterprise management function.

In the course of social division of labor, the production function of management is increasingly supplemented with the function of strategic development of the enterprises. Investment and innovation policy are subordinated to this aim, as is everything connected with so-called marketing or business activity. World experience shows that the maturing and organizational formation of the business functions at an enterprise is a complex and prolonged process of selection and evolution. The general course here is to the following effect. Business functions are being gradually separated from ownership. These functions proceed as if having no connection with property rights, and in some cases even run counter to them. A fruitful structural and organizational restructuring of the economy cannot be effected without an understanding of the need to create conditions conducive to this process.

In pre-privatization times, these functions were not included in the sphere of action of Soviet enterprises, i.e., they were allocated to a higher level of economic management.

After privatization, enterprises were cut off from these functions and, as a rule, were unable to perform them. That is why the level of management at privatized enterprises has turned out to be, predictably, inadequate to the new conditions and incapable of ensuring the enterprises' independent survival and development.

Therefore, the objective need arises in our national economy, for the establishment of a special type of structure which could perform even just part of the business functions at enterprises.

But even if we could solve this problem quickly, for instance in the framework of the financial and industrial groups (FIG) which have been intensively formed recently, it is important that the current ideology and practice of privatization not hinder the establishment of the new middle element of the economy.

Proceeding from the fact that initially firms were a kind of symbiosis of the organizational form of economic activity and the objects of private property, which was facilitated by the combination of property owner and business executive in one person, a seemingly incontestable conclusion was drawn, that the interests of the firm, as a mode of economic activity, were identical to the interests of the owner of the firm as property object. Indeed, when access to economic activity depended on the ownership of property, the actual difference between these interests was insignificant, and public consciousness assimilated the false ideological stereotype, which later grew into a popular prejudice, that the interests of the property owner and his firm are one and the same. Or, to be more precise, that the firm's activity is a way of realizing the personal interests of its owner or owners. As a result, it was considered to be a sound opinion that an analysis of the property owner's interests explains the behavior of his firm, since his interests are behind the latter.

But, with technical and organizational progress, the qualitative difference between the interests of productive activity (and economic activity in general) and the property interests of industrial enterprises' owners, became increasingly significant in the activity of the firms. It became clear that firms in their developed state have their own interests and dynamics of development, as industrial and economic objects, and their ownership as property had become an impeding factor.

The situation arises, where the interests and benefits of the firm's development as a production organization, begin to dictate the necessity of limiting the influence of the property interests of the owners on the firm's management. *The joint-stock-corporate form is an institutional way of separating management from ownership, which enabled the administrative and business management functions to become an independent and active factor of production development. In this situation, we may speak of the compatibility, not the identity, of the interests of the firm and those of its formal owner-shareholders. Strictly speaking, the shareholders are not really owners of the firm. Application to an enterprise, especially a large one, of the dominating aspiration, characteris-*

*tic of the present-day reform ideology, to create the largest scope for the realization of the notorious "feeling of ownership," can scarcely be justified and is, ultimately, fatal. The true sphere of realization of this feeling is a family business, in which the owner is the absolute and undoubted property manager. But even in this case, he must observe the interests and rights of the members of his family. A big enterprise, by definition, cannot be the object of personal or family ownership. In a contract economy, i.e., an economy functioning on the basis of contract agreements (in our view, this is a more precise term than market economy, which is just as much a utopia as "the highest phase of communism"), large enterprises are possible only because of the division of property rights into property-holding rights and rights of obligation (liabilities), which are the basis of the corporate form. The property-holding right, that is, the right to assets, is enjoyed by the corporation itself, while the liabilities are spread among the shareholders. Therefore, every individual shareholder is by no means an owner of the corporation, but merely a person who has invested his own money into it. In respect of the corporation, he exercises only the rights of obligation: liabilities.*

In case any person (official or private) gets an opportunity to manage the property of the enterprise in his own personal interests, no matter how profitable such management might be, it will inevitably cause a loss for the enterprise. And such management performed on a large scale, being nothing else than the personal appropriation of property of the enterprise, condemns the enterprise to ruin. Thus, enterprises cannot accept such personal "management." But this practice has been adopted on a threatening scale at Russian enterprises. This circumstance must be considered as the main cause of the pitiful state of our enterprises. If we continue in this way, they are destined never to become business enterprises in a western sense, though this has always been presented as a principal objective of the reforms.

Should the present-day economy nevertheless be allowed to move in the direction of a contract economy, the most important objective will be the creation of institutional conditions for the emergence of independent economic units, whose property rights are protected against encroachment by private interests, no matter what free enterprise slogans the latter might employ for cover.

The tangled interconnection and interdependence of individual firms in today's market, are conducive to the transformation of the "title" owner, as compared with, say, a leaseholder, into a symbolic figure in property rights turnover. This figure's connection to a private person (a natural person or legal entity) really acts as an inevitable burden on the economy, which has to pay for the fictitious "service" provided by the owner (provision of his name) in the form of the property rent. One need not be an inveterate utopian, to predict a gradual replacement of private persons—in their symbolic function of title proprietors—by the State, whose "name" is considerably less expensive for society (as was the

case with the replacement of specie by paper money, issued by the State).

Thus the State seems to be the preferable subject, to act in the role of title proprietor. As for other "roles" or their combinations (management, utilization of property, etc.), the question here must be resolved in accordance with the aims and circumstances of a concrete branch of the economy, enterprise, or project. The only requirement will be that the system of functioning economic institutions must allow for the possibility of flexible redistribution of property rights among various subjects, including, of course, the State, as an agent of national circulation, working on a par with all other subjects.

The above-mentioned theoretical concepts and the analysis of the essence of various aspects of the functioning of enterprises in the system of market relations, will make possible new approaches to the problem of privatization.

In fairness, it should be said that the movement toward the current scheme of privatization was initiated by the Law on Enterprises and Entrepreneurial Activity. That is when there occurred the estrangement of our State enterprises from the centralized management structures, whose duty was to perform the functions of economic development, analogous to the so-called business functions performed by the enterprises themselves in a true market economy. No wonder that that is precisely when an accelerated decline commenced, in the quantitative and qualitative indicators of the functioning of both individual enterprises and the national economy as a whole. As a result, by the beginning of privatization, our enterprises were essentially fragments of the former system, in which they had served as executive bodies, in the form of industrial and technological objects. Instead of the former system of centralized paternalist management, these enterprises faced the necessity to conduct independent economic activity, relying only on their own reduced resources and financial assets, without even strategic management bodies of their own. Losing their production characteristics and the ability to develop independently, the enterprises underwent a rapid transformation into loads of dead property, which their former managers could not use effectively. Just at that time, the program of voucher privatization arrived, and completed the estrangement of enterprises from their functions in the former system, and consolidated their status as mere held property.

The proclaimed objectives and mechanisms of the second stage of privatization continue the same line, aimed at the destruction of the country's industrial and intellectual potential. And that is no accident, since the adopted conception of privatization is of a depraved nature. *The most important thing the reformers failed to grasp, is that privatization must provide the right to derive income from the enterprises' economic activity, not the right to individual possession and management of their property.*

In our opinion, in order to correct the mistakes that have been allowed, we must return to our economic state before

voucher privatization. This could be done on the grounds of the now-exposed serious abuses, which completely perverted any good intentions that these measures might have had. The aim of such a return could not be the revival of what we used to call State property, but the creation of a system of *national property*. The national character of this property could be certified by appropriate inscribed shares, which would become income-earning securities, producing income for the population from the national property, of which they would be the collective owners.

It would be best to effect the actual utilization of this property, especially industrial objects, by means of so-called *national leasing*. Under this system, the producer collectives could rent their enterprises from society (the population) through its representative bodies, pledging themselves to ensure their profitable utilization both in the interests of the public and their own interests. Thanks to the system of national leasing, there might be created conditions for the preservation of enterprises, which at present have been reduced to pure property objects stripped of their production and economic functions. A transition to a national leasing system could be helpful in the reconstruction of many, if not most, enterprises ruined by privatization.

A good reason for securing the release of enterprises from the property claims of the new "proprietors" might be the fact, that the overwhelming majority of privatized enterprises are close joint stock companies. By definition, this gives the capital owners unlimited liability for enterprise debts. Making use of this circumstance, it will be easy and smooth, under current conditions, to make the possession of the share capital of such enterprises economically ruinous for its holders, and thereby to force them to give up "their" enterprises.

The system of national leasing protects the enterprise assets from clearance sale, physical elimination, and devaluation. In addition, it creates more favorable conditions for the development of business functions at the enterprises. With the current privatization policy, there was no one to deal with questions of economic development (especially long-term). New owners of enterprises show no interest in this problem and prefer to derive income from clearance sales of property or leasing it.

In the system of national leasing, the enterprise collectives, being responsible for the preservation and growth of assets, will be much more interested in the development of an entrepreneurial approach and productive economic activity. With this aim, they can resort to the services provided by consulting firms. Simultaneously, the need for the development of business functions will have to increase interest in the establishment of financial and industrial groups.

### 3.6. A modern view of inflation

One of the main contradictions of the adopted reform policy is its stubborn view of the nature of inflation. It is accepted that its main source is excessive money demand, and that the means to combat this evil are the methods of

macro-economic stabilization through considerable cuts in State allocations for science; support to enterprises that carry out a high degree of processing; education; medicine; the social sphere; and, through the increase of revenues by means of a forced tax increase, receipt of additional credits from international monetary organizations and the expansion of the State securities market.

Macro-economic studies carried out at the CEMI of the Russian Academy of Sciences in recent years, refute this official version. In present-day Russia, the real locomotive of inflation is not excessive money demand, but the economic behavior of technologically backward and monopolized producers, who cannot help but raise prices in order to survive. It is extremely difficult to oppose this powerful tendency by limiting total demand, because producers prefer to reduce production, rather than to allow a decrease of prices. Recent years' practice is ample demonstration of that. It required the sacrifice of half the previously produced output, to reduce the inflation rate to 10% per month. The policy of limiting total demand deals a severe blow to the national economy, exacting monstrously high payments for each percent won back from inflation. *Macroeconomic calculations show, that for each percent reduction of inflation, the national economy pays with a 3 to 5% collapse in production.* So, to "beat down" the inflation rate from 10% to zero per month, it is required to reduce production almost to zero as well. On the other hand, if we accept an increase of inflation up to the 15% per month mark, the same calculations show, that it will be possible to achieve a level of production of 70% as compared with the 1991 level. And that is not bad at all.

*Mathematical/economic modelling of the inflation process has shown fundamentally different ways of fighting inflation, which have nothing in common with the limitation of total demand.*

They proceed from an understanding of the difficulties which our producers confront during the transition to an open market economy. The main sources of the inflation explosion, beginning in 1992, have their roots in the peculiarities of the reproductive structure of the previous economic regime, where the technological parameters of inter-branch relations were formed under the influence of a very specific mechanism of production financing—the price-budget mechanism, according to which one part of the costs of production was reimbursed in the price of product, and the other, by grants and subsidies. These facts seem to be known, but a key circumstance remains in the shadows, namely, that the technological parameters of inter-branch relations, being naturally "selected" by this mechanism of financing and having adapted to it, did not, in turn, admit any other possibility for the macro-balancing of financial flows, than the existing mechanism of large-scale redistribution of financial resources. And when prices were set loose, in expectation of achieving market financial equilibrium, i.e., in expectation of a spontaneous search process for "self-financing prices," the result was predictable: *There began a cumulative increase*

*of both expenditures and prices, as the macro-economic reflection of the absence of an equilibrium solution, which was "blocked" from the outset by the technological structure of the economy.* Even if this sort of danger was anticipated beforehand, the way out was seen in simultaneous changes in both price proportions and the technological matrix of the economy itself (restructuring expenditures, elimination of loss-making enterprises, etc.).

First of all, however, the time lag between these two processes was inevitable, and in the meantime, the inflation mechanism had picked up momentum and become able to wind itself up, just like any large-scale inflation.

Second, our hopes for technological breakthroughs have not been realized to date, for reasons related to an array of other fundamental peculiarities of the pre-reform economy.

Technological backwardness and monopolism must be compensated in some other way. *The main role here might be played by a mechanism to limit the growth of production expenditures (cost of production), and consequently of the product's market price.* How could this be done? First of all, as analysis shows, by excluding inflationary taxes from the costs of production of intermediate and final products; these taxes now often comprise as much as one-third or more of the production expenditures. Then the price could be lowered at least one-quarter, and provide an acceptable profit for the producer. Then we could compete on the world market, with our lower than world prices. In this case, the stimulus for the constant increase of prices would be weakened, or disappear altogether. There would be a simultaneous decrease in inflation and growth of production.

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## 4. Strategy

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### 4.1. Rent—a strategic weapon for Russia

*Taxes are a pivotal factor for the renewal of the economy and society.* They are the most serious of all State-imposed limitations that influence people's striving to work efficiently and to invest money in the development of production. New democratic leaders of the country should renounce the use of a tax system that does not stimulate production and the accumulation of capital. The existing tax system is a classic example of how to make people not work and not invest their money in the development of production, but rather export it abroad. By putting the working population into a disadvantageous position and making products expensive, this system limits people's participation in the production of material and spiritual values. In such an economy, there will never be sufficient resources for its restructuring.

Only if Russia solves the fundamental problem of sources of income for society, will it be able to find its own path to revival.

*Unlike many countries, Russia has a major source of income which remains almost untapped. This is rent charged*

for the use of natural resources. Estimates confirm that the fuel/energy sector and other nature-exploiting industries account for more than 60% of the profit earned in the national economy today. Given normal economic conditions, oil and natural gas alone could bring Russia some \$30 billion per year in income, which exceeds Russia's budget deficit for 1995. Russia could also derive large revenues from the rental of urban land, forests, and farmland.

Rental income could help Russia cover its top priority expenses on defense, the defense industries conversion program, science, education, culture, health care, and the State apparatus.

Russia could even stop imposing taxes on labor and capital, rescind the value-added tax, cut the tax on profits, and exempt enterprises from deductions to the pension fund and the majority of working people from the payment of income tax.

As a result, expenditures on production in the processing industries could be radically reduced, while the competitiveness of their products could sharply increase. The abolition of a number of traditional taxes would improve the investment climate in the country and stimulate foreign investment and an influx of hard currency into the country. It would also help reduce inflation and stabilize the ruble.

The transition to a predominantly rental taxation system has social advantages, as well as these economic ones. Shifting the center of gravity of taxation onto the natural-resource potential will make it possible to organize a system of financial transfers between profitable and unprofitable, although promising, sectors of the economy, and between rich and poor regions, to provide strong social support for the population and to create a system of supplemental payments for wage-earners and pensioners. *The Russian economy could thus gradually turn into a socially oriented economy, turning its face toward the people, toward their needs and aspirations. The very basis for society's criminalization would disappear.*

Opponents of predominantly rental taxation usually cite the experience of countries with a developed market economy, where taxes on (payments for) the use of land and other natural resources account for a very modest portion of all tax revenues, while direct income taxes on natural and juridical persons, as well as indirect taxes, are the main source of financing for State expenditures. Russia's tax system, which has been in effect since 1992, essentially replicates the modern western system of neutral taxation, which attempts to disturb as little as possible the established ratios of income distribution in society. *But neutral taxation is aimed at conserving the established socio-economic structure, not at reforming it.*

The economic and social advantages of deriving taxes primarily from that wealth which is given to us from on high, rather than made by human hands, are well known. The prominent U.S. public figure Henry George first drew

society's attention to them at the end of last century. His ideas and arguments in favor of a single land tax were supported by Leo Tolstoy. A description of the economic advantages of natural-resource taxation can be found in almost every serious textbook on the market economy. Only a handful of countries, however, use such taxation. This is not because of the organizational or technical difficulties of transition to this kind of taxation (although they do exist). Low taxes on wealth (land and other natural resources are a major element of wealth) remain a "sacred cow" in modern market economies, and those in power dare not encroach on them. If we really want to reform our economy, we must first of all renounce the merely symbolic taxation of our natural-resource potential, which runs counter, not only to the immediate tasks of Russia's economic recovery, but also to the strategy of a transition to ecologically stable economic management.

What stands in the way of such efforts? First of all, the interests of all those who have amassed large capital, by appropriating rent from natural resources. These people comprise a relatively small stratum of society, but one that has obtained access to the upper echelons of State power. It is difficult and dangerous to ignore their interests. But today, Russia has no other way out.

Realizing the need for a new tax policy is, ultimately, a matter of self-preservation for everyone, and it should unite Russians to oppose the squandering of Russia's natural resources with their common will, and to put an end to corruption and extortion. The rental system of taxation is intended to play a decisive role in the struggle against this evil.

## 4.2. Policy guidelines

A unique situation has now taken shape in Russia, where there has still not been a transfer of the land to private owners. We must avail ourselves of this situation and decide for ourselves, once and for all, the fundamental issue: Are we for private ownership, or for private tenure (use) of land? *We advocate the second, because only such a path leads us to a society, in which social justice will be combined with high efficiency of production, and where freedom and morality will flourish.*

The peoples of Russia have a special emotional and historical attachment to the land; they regard it as national property. But precisely because land in Russia is national property, each user of the land is obliged to pay into the public (State) coffers, in accordance with the quantity and quality (natural properties) of the land they use. This obligation for the annual payment of land rent must be the same for all land users—State-owned enterprises and organizations, collective and individual private holders of land, and land leaseholders.

The right to private land tenure must be protected by law against any encroachment on the part of State bodies. No one

should be allowed to encroach on the right to privately hold land, and to transfer it by inheritance or to another holder. At the same time, the *free* purchase and sale of land must be ruled out.

Before launching land privatization, the government and the Federal Assembly must weigh everything carefully. The currently proposed program pursues the short-term goal, of immediately gathering a certain amount of money to cover budget expenditures. This means, however, that future governments will be deprived of the possibility of having a much greater income stream from land rents. They will face an inevitable growth in social tensions in society, and insurmountable obstacles to the struggle against corruption and the criminalization of the economy.

It is no less important, to reorient credit policy accordingly. In most countries, land is regarded as one of the most attractive kinds of collateral for receiving bank credits. This makes things simpler for the banks. In this case, they do not need to assess the real solvency of a borrower, to analyze the validity of the designated purpose of a credit, or to exercise bank control over the effective use of the funds received. But another side of the problem, which may have very dangerous consequences, is overlooked here. *Bank credits on mortgage stimulate speculation in land* and lead to an unjustified enrichment of creditors. Many of those who receive credits on such terms rapidly go bankrupt. The experience of western countries, above all Britain in the mid-1980s, confirms this. *This is why crediting on mortgage should not become the main form of investment credits in Russia.* The credit system in Russia should be built on other principles, more civilized than those in the West and corresponding to the nature of economic relations that would preclude social conflicts and crises, and the very basis for the emergence of economic inequality. The following two examples show that such a way is possible.

**Example One.** Hongkong: All land in the country is national property and is leased to all those interested, via auctions. Nevertheless, banks eagerly give credits to business people even without mortgages.

**Example Two.** Germany: Banks extend credits to business people on terms that differ from those accepted in other western countries. Credits are given to those who, in the banks' view, invest their funds wisely, with the prospect of receiving good profits from the marketing of products that are in demand on the consumer market. Such an approach makes it possible to create new jobs and helps capital formation, without speculation on land.

### 4.3. Anti-inflation efforts

Another advantage of taxes on natural resources is that budget revenues from the use of land and other natural resources will inevitably increase, as the tax base constantly grows. These future budget revenues can be used already now, to cover current budget expenditures. To use them, the

government will not have to resort to the printing press, which would increase that heaviest of all taxes: inflation. The government should issue land (oil, forest, and other) loans, whose voluntarily distributed bonds should become the core of the State securities market, now being formed in Russia. The issue of such bonds, backed up by Russia's enormous natural-resource potential, can become an important factor in efforts to curb inflation and, in the more distant future, for the growth of the purchasing power of the ruble, with respect to hard currencies. The domestic State debt on natural-re-

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*Russian reformers failed to use a scientifically grounded theory. Of the whole rich theoretical heritage accumulated by world economic science, Russian reformers used only a small number of logically unconnected fragments. They emphasized monetarism—the Chicago variety, which is not even the best monetarism. We now have to pay, for their disregard of economic science.*

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source loans should be covered, first of all, from budget revenues from the corresponding natural-resource taxes, a fixed part of which should be used to cover State obligations on natural-resource loans. The greater the role of natural-resource taxes in budget revenues, the broader will be the possibilities for the country's financial system to recover.

### 4.4. Fiscal federalism

Russia is seeking to build a pluralistic society. To achieve the best social and economic results, political power in the country must be redistributed in favor of those levels of administration, where they are most efficiently achieved. Principles must be worked out for dividing rental incomes between these administrative levels, excluding any encouragement of separatist tendencies on the part of members of the Russian Federation. The experience of other natural resource-rich territories, such as Alaska, shows that policies based on the use of land rent provide examples of a possible objective approach to the division of rental incomes. Part of these incomes can be channeled into social funds, which can partially fund expenditures on efforts to overcome the difficulties of the transitional period and partially be used to obtain an income stream for the generations to come.

#### 4.5. Ecological taxes

In today's world, and especially tomorrow's, oil, diamonds, or fertile land cease to be the main natural wealth. The assimilation potential of the natural environment—its ability to "resist" human intervention and to restore itself after inevitable such interference—becomes the main condition for the further existence of mankind.

Russia has moved ahead of other countries in the practical use of a new economic instrument of environmental protection—*payment for environmental pollution*. Over the past three years, the Russian Federation has accumulated experience in establishing and levying such taxes in most of its regions. But the existing types of payment, largely in the nature of fines, do not at all correspond to the rental incomes that the still-enormous assimilation potential of Russia's ecosystems could provide. Russia still has a chance to restore and save this national property, and to become an example for other countries in the practical economic protection of nature. To this end, *it must introduce an ecological tax on the exploitation of the assimilation potential of the environment*. Like other natural-resource taxes, this tax will not require a general increase in the tax burden on the national economy, but will lead to its redistribution in the interests of environmentally friendly and nature-preserving types of activities.

*Russia could also become a pioneer in the creation of a system of compulsory ecological insurance, which would make polluter industries and insurance companies share the economic responsibility for catastrophic instances of environmental pollution.* This would make it possible to attract the financial resources and as well as the monitoring and inspection capabilities of such companies, for solving urgent ecological problems.

#### 4.6. The transitional period

A "shock" transition to predominantly natural-resource taxation is impermissible. It could only lead to a further aggravation of social tensions and discredit the very concept of natural-resource taxation. Launching a radical tax reform—and this is what is at issue—can be compared to working with a bare, live electric wire.

Taxpayers must have time to prepare for a sweeping "re-assessment of values," dictated by new taxation conditions. The government must ensure thorough political and institutional support for the new tax system and solve numerous organizational, legal, methodological, and technical problems. A stage-by-stage strategy is needed to gradually shift the tax burden onto nature utilization. Such a strategy should be formulated in a *programmatic document, adopted by the supreme organs of State power in Russia*. This document should indicate long-term basic tax rates and provide for measures to ensure a gradual adaptation of taxpayers to the new conditions. These measures include the development of tax crediting; the provision of tax breaks for certain categories of natural-resource taxpayers; a shift of the center of

gravity in real estate taxation from buildings and other structures, to the land component of the real estate; and reductions in direct and indirect subsidies for nature-consuming and environmentally unfriendly types of economic activity. Reforms of the taxation and natural-resource "branches" of legislation, regulation, and control must be preceded by thorough scientific preparations and be conducted as a unit, in a comprehensive way.

Estimates, made on the basis of 1993 figures, show that if the tax on profits (paid to the budgets of Russian Federation members) alone were transformed into taxes on the use of natural resources (land, mineral deposits, the assimilation potential of the environment), the share of these taxes in Russia's gross domestic product would increase from 1% to 9%. The taxable value of the natural-resource potential, in this case, would amount to 600 trillion rubles, including 100 trillion rubles value for the assimilation potential of the country's air space and water resources. (In 1993, the gross domestic product of Russia was 162 trillion rubles.) The tax burden on enterprises would remain unchanged, since the increase in natural-resource taxation would be accompanied by at least a 60% decrease in the tax on profits.

The government should study the expediency of giving members of the federation and local (district and city) authorities the right to raise natural-resource and lower other types of taxes on their territories, *provided these territories fulfill their obligations with respect to the amount and terms of tax and other payments into the higher-level budgets and extra-budgetary funds.*

The authorities in many Russian cities have already begun to create the institutional prerequisites for the implementation of a tax reform, using land rent as its basis. These prerequisites include the creation of land cadastres, the training of specialists in property evaluation, the conclusion of leasehold agreements, the holding of land auctions, and so on.

In order to achieve the best results as soon as possible, a mechanism should be created which would allow representatives of the public at large to take an active part in the formation of the new tax system. This system must be open for all strata of the population. We have little time left to carry out this work. But, considering the experience of Russian and foreign specialists in natural-resource taxation, and the absence of any other promising ways to reform the Russian economy, we all must pool efforts to resolutely and quickly translate the new tax system into life. The President, the Federal Assembly, and the Cabinet of Ministers of Russia should have a decisive say in this respect.

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### 5. Immediate tasks of economic policy

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These tasks should be viewed as a single whole. Attempts to single out some of them and tackle them separately, "at

any cost," will yield no results and will not help to overcome Russia's economic crisis, raise industrial production, promote people's welfare, and achieve the social and political stabilization of society.

### 5.1. Tax reform

Under present conditions, the most important taxes for us are those that do not cause price rises. Such taxes do not cause a mechanical increase in production costs, and thus do not shift the burden of additional expenditures onto others and, ultimately, to the consumer. Only with such taxes will we be able to curb inflation. Macroeconomic models provide some clues to how to tackle this fundamental problem. *In a technologically backward economy characterized by a high degree of monopolization, VAT and various wage taxes artificially push prices higher, and thus promote inflation and the further decline in industrial production. The same models show that taxation of profits or introduction of a rent system of taxation do not lead to a significant increase in prices and inflation.* This is because such taxes do not increase production costs and are levied only on profit-making businesses.

This shows that a new tax system is what Russia now needs most. The new system should be quite different from the one Russia now has. *Taxes like VAT and various wage taxes should be abolished* and should not be re-introduced, at least during Russia's transitional period. As mentioned above, the rent system must be at the base of Russia's new taxation system. Taking into account that a gradual adjustment to new conditions will be less painful for Russian companies, we suggest that the new system be introduced in stages. At the first stage, various forms of the tax on profits should become the main form of taxation for producers. According to estimates, the most appropriate rate for the tax on profits will be 45 to 55%, provided that VAT and wage taxes are abolished.

Later, more effective forms of profit taxation can be introduced. At first, this might be the deduction of fixed amounts from corporate profits into the budget, regardless of the actual output of manufacturing companies. These sorts of payments do not undermine incentives for producers to increase profits and, at the same time, they make it possible to distribute the tax burden on manufacturers in accordance with their actual capabilities. This is particularly important for primary industries, which now operate under idiosyncratic conditions.

Deduction of fixed amounts will create conditions for a transition to rent-based taxation. Rent for natural resources will then become the main source for meeting government revenue requirements. At this stage, processing industries and agro-businesses would find themselves practically in "tax heaven." This will be extremely important for their survival and further development, as well as for raising the competitiveness of Russian goods.

The new system should provide for a higher property tax

on juridical entities and natural persons. Raising the property tax will undoubtedly be a more effective measure than raising taxes on current consumption, as proponents of the existing tax system propose to do.

The tax on revenues from privatization of State property should account for a significant share of government revenues. The opinion that revenues from privatization should be left at the disposal of the privatized companies, in order to enable them to finance modernization, does not stand up to criticism, since this would be equivalent to transferring State property free-of-charge to new owners, on the sole basis that they have enough money to pay for it, and then, as owners of those enterprises, take the money right back. Modernization of privatized companies can be accomplished in a competent manner only if it is financed with funds raised through share issues by the privatized companies themselves.

*Exploiting the entire potential, inherent in the further improvement of Russia's tax system, would make it possible to reduce Russia's inflation and the collapse of production, each by about 50%.*

The implementation of a new tariff policy must become an immediate task for the near future. Its main purpose should be to reduce inflation and increase the volume of domestic production. Russia's new import tariffs can be determined in accordance with the following very simple rule, suggested by our models: Imports competing with domestic goods should not amount to more than 5% of domestic output. If total imports of certain goods amount to less than 5% of their domestic output, import tariffs should be reduced. If imports amount to more than 5% of domestic output of similar goods, import tariffs should be raised.

It is quite possible that domestic prices will sharply rise, immediately after the introduction of new import tariffs. They will decline later, however, as a result of a significant decrease in inflation. It must be understood that the immediate effect of these measures may be quite different from the results they produce in the long run. In choosing an export and import policy, the long-term policy is to be preferred. Only such a policy can be regarded as a true anti-inflation policy for Russia.

As evident from the foregoing, a wide range of anti-inflationary measures can be applied in Russia. *Introduction of a new tax system alone, can reduce inflation and the decline of production by 50%.*

### 5.2. State subsidies

In addition to taxes, the anti-inflationary macroeconomic measures should include State subsidies. *The idea that State subsidies are a drain on the budget and always lead to higher inflation is fundamentally wrong.* The effect of subsidies depends on how, when, and for what purpose they are provided. Computations confirm, that only a specific combination of rent-based taxation and State subsidies can overcome monopoly inflation and the decline in production. *This can be*



achieved in a market economy framework, without introduction of price and income controls.

There exist many mechanisms for regulation by subsidies.

Macroeconomic analysis shows that direct subsidization of goods sold by manufacturers, is the most appropriate way to support manufactures, combat inflation, and reduce the decline in industrial production. The State extends manufacturers additional funds, proportional to their sales volume. These subsidies will allow manufacturers to receive higher

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*It will be necessary to revise our views on the role of government spending. What is generally taken into account, is only that cutting government spending lowers inflation. Unfortunately, it is usually overlooked, that reduction of government spending also damages industrial production. Low pensions and wages in the State sector and the contraction of housing and road construction hit not only individual people, but above all, the economy as a whole. A reasonable level of government spending can help overcome our economic crisis.*

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prices for their goods, while consumers will pay the same or even lower prices for them.

This mechanism ensures that manufacturing companies operate at fuller capacity and helps Russia approach a balanced budget. *The fact is, that highly profitable businesses are usually good taxpayers.* They pay rent, whose total amount is usually large enough, calculations show, to cover all items of budget expenditures, including subsidies.

In this case, however, huge amounts, exceeding usual government spending, will pass through the budget. This makes everything much more complicated, and it can be avoided. The actual mechanism of subsidizing companies could be more simple. For instance, transfers to or from the budget can be made on the basis of annual performance results. This means that manufacturers would have to pay or receive the difference between taxes and subsidies. What matters is that all manufacturers know, *that subsidies vary in direct proportion to their sales, while amounts to be paid in taxes are fixed. This will compel manufacturing companies*

*to think not only about profits, but also about sales. Under such conditions, it will simply be unprofitable to raise prices.*

It would probably be expedient to consider the possibilities of subsidizing wages and renovation.

Computations show that such a specific mechanism of taxing and subsidizing companies is the most effective way of combatting monopoly price rises (at least in primary industries), and creating favorable economic conditions during the transitional period.

### 5.3. Fiscal policy

First of all, it will be necessary to revise our views on the role of government spending. What is generally taken into account, is only that cutting government spending lowers inflation. Unfortunately, it is usually overlooked, that reduction of government spending also damages industrial production. Low pensions and wages in the State sector and the contraction of housing and road construction hit not only individual people, but above all, the economy as a whole. *A reasonable level of government spending can help overcome our economic crisis.*

Macroeconomic studies show that fighting inflation through reduction of government spending is ineffective. *In this case, the price to be paid for a 1% decrease in inflation will be a 3% decline in industrial production. Cutting government spending by 50% will reduce the budget deficit by five percentage points.* The absence of correlation is accounted for by the significant decline in industrial production, which accompanies such a decrease in State spending. This nullifies nearly all the advantages from economizing on State funds.

On the contrary, a slight increase in government spending may produce a most favorable effect. It will allow the utilization of greater production capacity, an increase in industrial production, and improvement of living standards, at the cost of only an insignificant increase in inflation.

In principle, we should revise the assumptions underlying government spending plans. The essential thing here is to observe social and economic constraints, without which no economic reform can be carried out.

It is also important to finance spending on the priority needs of society and key economic restructuring programs, irrespective of government revenue collection. In the event of a shortfall, such spending should be financed by Central Bank credit, to be repaid with government revenues that will be collected later.

It is extremely difficult to plan government spending under conditions of runaway inflation. To reduce possibilities of arbitrary decisions in this important area of State regulation to a minimum, the spending portion of the budget should be adopted in constant prices and then indexed for inflation quarterly.

As for budget revenues, the procedures for defining this part of the budget should be revised, too. Rent, revenues from privatization and the use of State property, as well as

revenues from foreign economic activity, should become the major revenue earners for the budget.

In order to achieve better social and economic results, political power in the country should be redistributed in favor of those levels of government that deal with particular problems most effectively.

When a new tax system is in place, it will be necessary to fix the shares of various government levels in budget revenues (rent, environmental and property taxes, and revenues from privatization and foreign economic activity), in order to prevent the development of secessionist trends in the Russian Federation and to make regional and local governments more interested in economic development. As noted above, the experience of territories rich in natural resources (such as Alaska) shows that a policy based on rent collection makes it possible to work out a more or less objective approach to distribution of the rent collected. It is possible to transfer part of the rent collected to local funds, used to finance measures to overcome difficulties of the transitional period and to produce income for future generations.

The general approach to the distribution of revenues could be as follows:

*The federal level:*

- rent for commercial use of strategic natural resources specified on a list, approved by federal legislative bodies (oil, natural gas, precious metals, ores, etc.);
- revenues from the use of federal property (dividends on stocks and bonds, revenues from privatization, etc.);
- revenues from the use of major pipelines, the unified electricity grid, etc.;
- revenues from the Central Bank's currency reserves kept abroad;
- revenues from granting rights to use Russia's air space;
- tax on the transfer of capital out of Russia;
- revenues from government securities issue;
- profits of State-owned companies;
- revenues from the use and sale of Russia's property abroad;
- part of the environmental tax revenues.

*The regional level:*

- revenues from tax on the profits of companies under regional jurisdiction;
- revenues from use of the property of regional governments;
- land tax;
- tax on securities transactions;
- part of the rent collected for use of city territory;
- part of the environmental tax revenues.

*The local level:*

- revenues from legal entities' and natural persons' property;
- revenues from leasing plots of land in the cities;
- tax on securities transactions;
- revenues from municipal property privatization;
- part of rent collected;

- corporate profit tax on businesses and organizations under local jurisdiction;

- road and other local taxes.

In order to support and develop depressed regions, it is necessary to set up a reserve fund at the federal level, to which will be transferred part of the rent collected, environmental taxes, tax on capital transfer out of Russia, and revenues from the Central Bank's assets abroad.

## 5.4. Anti-monopoly regulations

Two major problems arise in connection with anti-monopoly regulations. One of them is the establishment of a mechanism to reduce monopolization, while the other is the promotion of vertical integration.

### A. Mechanism to reduce monopolization

It is necessary to distinguish between the following two types of monopolies:

- organized monopolies;
- natural monopolies (transportation grid and telecommunications networks, etc.).

*Organized monopolies.* We believe that the most effective way to break up organized monopolies, is to employ certain economic mechanisms. The most important of them will be the following:

1. Imposition of a progressive property tax, depending on the market value of the production facilities at each particular moment of time. This approach means the following:

Title to property should not allow the property-owner to earn excessive profits. Rent charged and any above-norm income should be divided between the State or society, and the owner. The property-owner, as a rule, should not receive income exceeding the rate of interest on long-term bank loans.

Under such conditions, forms of ownership will not matter so much. The socialization of rental income will reduce the possibilities of making money from what should belong to everyone. At the same time, income deriving from the modernization of production and business activities ought to belong to those who engage in such entrepreneurial activities.

2. Introduction of mechanism of price competition. This means introduction of price controls, but through economic and organizational, rather than administrative measures. World prices for competing goods can be regarded as natural price limits. Domestic consumers should have an opportunity to choose between domestic goods and competing imports, sold at market equilibrium prices. This, however, will be possible only in an open market space. Consequently, those sectors of the economy that suffer most from monopolization should be selectively opened to foreign competition. Russia's Committee for Anti-Monopoly Policy could be responsible for this.

At the same time, the government should implement certain protectionist measures, aimed at supporting industries capable of supplying competitive goods to domestic and international markets and needing temporary support:

*Natural monopolies.* Natural monopolies are those that should not be broken up, for purely economic reasons. Natural monopolies make it possible to reduce total production costs, while expanding the scale of output of certain products. Breaking natural monopolies is undesirable for society, because it increases production costs. If natural monopolies are left to their own devices, however, they soon begin to behave like organized monopolies. Therefore an appropriate mechanism for regulating natural monopolies should be introduced at the outset, before their degeneration begins. Such mechanisms are well known and widely used in many countries, including the United States.

Insofar as the competition of goods cannot be arranged, it is still possible instead, to obtain more information about natural monopolies' operations. For instance, there could be open hearings, similar to open court hearings.

The issues discussed at such hearings should include new construction projects, price setting and determination of a fair profit, environmental protection, and others. Like testimony given in courts, all information and statements should be given under oath. The openness of such hearings will help achieve what market mechanisms usually do.

The open hearings will be organized by a public examination institution, responsible for independent examination and assessment of the natural monopolies' efficiency. Examination shall be conducted at several levels, including federal, regional, and local. At each level, a different range of problems will be tackled and different-level monopolies will be examined.

Examination bodies will be extra-departmental, democratic agencies, acting in accordance with legally established norms and procedures.

The experience of the United States' public energy commissions shows that open hearings can yield significant results. They compel monopoly businesses to find strategies that are beneficial to the consumers of their products, as well as to producers. These become a good basis for compromises.

## 5.5. Monetary and credit policy

The malfunction of Russia's monetary and credit system is a significant element of the growing economic crisis. The major reason behind this failure is the extension of the Central Bank's credit to commercial banks and the government of the Russian Federation.

To resolve this problem, the Central Bank must cease its expanded reproduction of credit-creation for financing the national economy. Nonetheless, in extreme cases, the Central Bank could still extend credit to commercial banks, charging higher interest rates than the free market rates. Taking into account the danger of a wave of commercial bank failures, the Central Bank's action should be carried out gradually. In the first stage, Russia's Central Bank could limit the amount of new credit, to the amount of credit repaid in the

previous month. It would also be expedient to improve the efficiency of the use of credits loaned, either through competitive bidding, or using the principle of earmarked credits, to finance investment projects. Only a limited number of commercial banks should be allowed to participate in the competitive bidding, those that meet certain requirements concerning their capital to liability ratio and some other ratios, such as the Central Bank loan to liability ratio and the bad loan to assets ratio.

It is quite possible, that a concerted policy of reducing Central Bank credits will lead to numerous bank failures. In this case, it will be necessary to nationalize failing banks or to implement certain other measures for the State to support them.

To improve payment discipline and enhance the Central Bank's responsibility for money turnover, it seems expedient to introduce indexation of amounts delayed during the settlement of transactions, at the expense of the Central Bank. This will make it less attractive for juridical entities to settle transactions in cash.

Nonetheless, these measures alone are insufficient to significantly improve transaction settlement services for participants in the process of economic reproduction. An array of special measures must be implemented simultaneously.

*First*, restrictions must be imposed on the use of depreciation deductions, which must be used only for financing capital investment. Depreciation deductions taken by enterprises should be transferred to special bank accounts. The amounts accumulated in these accounts must be spent only for capital investment.

At the same time, temporary amendments should be considered for the procedures for accumulation of depreciation deductions. During the transitional stage, it would be appropriate to exclude depreciation deductions from the production cost. This is all the more important, in view of the periodic indexation of depreciation accounts. Deductions for depreciation should be made from an extra portion of profits, retained by the manufacturers for this purpose. In certain cases, direct government investment in the modernization of industrial production can be justified. These amounts can be allotted in connection with implementation of certain federal programs. A special spending item should be included in the Russian Federation budget for this purpose.

*Second*, restrictions should be removed on the purchase by banks and investment funds of real assets, including controlling stakes in manufacturing companies.

Simultaneously, tight control must be established over the observance of currency legislation, which should forbid buying foreign currency, except for import purposes, and allow the total repatriation of profits.

*Third*, additional incentives should be created to promote industrial production and sales. This can be achieved through measures to promote investment and improve the system of government orders.



*A branch of the Russian Federation Savings Bank (Sberbank), with sign advertising currency exchange. "The one-sided involvement of ordinary Russians in the credit system reduced possibilities for macroeconomic development, increases inflation, and impedes the course of market reforms."*

The possibilities for stabilizing Russia's monetary system will depend on exchange rate behavior. Sharp, unpredictable exchange-rate fluctuations not only hit financial markets, but also lead to sharp changes in the profitability of export and import transactions. This, in turn, leads to significant changes in foreign trade volume and, consequently, supply and demand fluctuations on the domestic market. That is why regulation of the ruble's exchange rate must be a priority of Russia's economic policy. This is a major task, both from the viewpoint of raising the effectiveness of foreign trade and creating better conditions for foreign investors, and from the viewpoint of anti-inflationary regulation. To solve this problem, it will be necessary:

- to create a reliable ruble rate-control system and to intervene on the foreign exchange market, in order to prevent sharp exchange-rate fluctuations that raise inflationary expectations and undermine the exchange efficiency of foreign trade. These measures should be aimed at maintaining exchange rates that make the greatest part of domestic industrial output competitive;
- to ensure convertibility of the ruble for current transactions of non-residents, in order to promote demand in domestic markets, increase foreign trade turnover, strengthen the ruble, and create better conditions for foreign companies operating in Russia;
- to establish tight exchange controls, to prevent capital outflow from Russia.

The attraction of capital kept in bank accounts abroad (amounts stashed abroad are now estimated at more than \$20 billion) into domestic economic circulation will be a

significant result of the above stabilization measures. These sums were accumulated as a result of the Central Bank's extension of credit to commercial banks, which lent the money to various intermediaries who converted it into hard currency and used it for foreign-exchange speculations. Obligated to repay the Central Bank's credit, commercial banks will have to reduce lending to trading operations. This will compel trading businesses to use money kept in bank accounts abroad, and transfer it to Russia. In view of this, it will be necessary to impose restrictions on the term during which sums of hard currency, received as a result of current transactions, can be kept in hard currency bank accounts. This term should be cut to six and then to three months. This will make it possible to gradually close hard currency accounts and to shift to the 100% sale of hard currency. It will be important during the transitional period, to introduce identical account-maintenance regimes for both ruble and hard currency accounts. The amounts kept in hard currency accounts should be easily convertible into rubles for covering operating expenses.

The implementation of more effective macroeconomic regulation of monetary circulation and credit extension will be of great importance for the recovery of Russia's financial system.

Our ideas about the macroeconomic function of credit are still primitive. Most considerations do not extend further than the traditional theme, that State extension of credit leads to higher inflation. And indeed, what more is there to say, if the lion's share of our credit operations are a smokescreen to conceal the old Soviet system of State financing for indus-



A recent cartoon from the Russian magazine *Ogonyok* illustrates a would-be financial and industrial group executive confronting a sea of decrees and regulations.

tries, only in a much more wasteful form? Development of the whole range of types and functions of credit is now retarded by the sluggishness of institutional changes in this area. The absence of procedures for using real estate as collateral in mortgage lending poses significant problems. Here, the macroeconomic problem of *the economy's clearly underdeveloped credit potential* intersects the problem of efficient property management. Another aspect of credit policy is the public debt. The population's financial assets (deposits in the Russian Federation Savings Bank and other banks, and government bonds) are now discussed only as an essential component of public savings, in the context of the macroeconomic conditions of the economy's investment potential. Meanwhile, these assets (which are liabilities of the government and banks) have no counterbalance in the form of indebtedness to the population, created through installment sale of consumer goods, provision of loans to finance housing construction on a turnkey basis, etc. This one-sided involvement of ordinary Russians in the credit system reduces possibilities for macroeconomic development, increases inflation, and impedes the course of market reforms in the economy.

## 5.6. Industrial policy

The last few years have shown that economic reform, not backed up by an active economic-restructuring policy, can lead only to the country's losing the technological positions it had in the world.

This shows that industrial policy must be regarded as a priority of any reform program.

There are now some 30,000 small and medium-sized businesses in Russia, while the number of large companies is minuscule. The latter now account for only 12% of Russia's industrial output. In the United States, some 300 to 400 large industrial corporations now account for about 50% of industrial output.

The emergence of large corporations was a major factor behind the stability which is so important in a market economy. Monetarism is not responsible for this, but rather quite a different mechanism, which roamed into the capitalist economy from ours: planned methods of economic management.

But unlike here, capitalist economics confined the plan to the middle level, barring it from either the top (macroeconomic) or bottom (microeconomic) levels of management. As a result, a rather efficient structure has been created. Corporations accumulating a significant amount of resources and products, transmit macroeconomic signals to small and medium-sized businesses.

The middle layer of industry began to emerge in Russia in the late 1980s. Unfortunately, the process of its formation was halted by spontaneous liberalization and privatization. The reformers failed to understand its role in the overall economic management system. They regarded corporations exclusively in the light of their primitive notions about monopolization, and therefore, they missed the chance to create large industrial structures, capable of taking on the task of reconciling market mechanisms with elements of planning in a market economy.

As a result, the privatization program adopted for big industry was aimed only at creating competition in the domestic market. Large companies were broken up into smaller units, production ties were broken, and production efficiency decreased significantly, as a result.

We should not forever ignore international experience and base an industrial policy for Russia on nineteenth-century notions of the market economy. We must create a modern market economy. This means we must stress the creation of our economy's missing middle link. It is epitomized by large industrial corporations or financial and industrial groups (FIG). Financial and industrial groups could give Russia production complexes, able to withstand western competition and create conditions for the transition to an open economy.

Financial and industrial groups can exert a multi-faceted positive influence on the development of competition in Russia. The establishment of several competitors in each previously monopolized industry, will mark the transition from pure monopoly to oligopoly. This will reverse the current trend to establishing holding companies and associations, which collect several similar companies under their roof and thus re-create the old-style monopolization of industries.

Financial and industrial groups will help create the mechanisms we lack, for redistribution of resources among various branches of industry. This will enhance competition among industries, while competition between financial and industri-

al groups will compel them to provide financial and technical support to small and medium-sized manufacturing businesses cooperating with them. As a result, competition among small and medium-sized businesses will receive a powerful stimulus.

Large financial and industrial groups will be able to implement various government programs. This will allow the placement of State orders on a truly competitive basis, while the regulated opening of the Russian economy to foreign investors will assist the creation of market mechanisms.

Unification of up- and downstream production and research and development institutions in the framework of the FIGs will create better conditions for the implementation of consistent technical and investment policies. Financial and industrial groups will be able significantly to improve the investment climate in Russia and reduce investment risks. The inclusion of a bank in each group will make it possible to respond quickly to changes in market conditions and to redistribute financial resources. Financial and industrial groups can become real economic planning centers.

*The establishment of financial and industrial groups is currently impeded by a number of organizational, legal, conjunctural, and conceptual factors.*

*First*, mechanisms ensuring cooperation between financial and industrial groups and the federal and local authorities are not yet in place. State support for financial and production groups and measures compelling government ministries and agencies to coordinate this support are not yet in place, either, while uniform procedures for supporting financial and industrial groups in accordance with industrial policy targets and other clearly defined criteria have not yet been adopted.

*Second*, a legal base for the operation of financial and industrial groups has not yet been created. The further development of competitive financial and industrial groups is impeded by the following factors:

- drawbacks in the legal base for further economic integration. Russia needs laws regulating the activities of holding companies, investment banks, and trust companies;
- certain unjustified restrictions on capital relationships among corporate entities, which hinder the industrial and banking capital around large investment projects, and make it difficult to reconcile the interests of prospective participants in these projects.

*Third*, Russia's economic situation has a two-sided effect on the establishment of financial and industrial groups. On the one hand, the disruption of previous production ties and loose contract-fulfillment discipline compel manufacturers to seek more effective forms of vertical and horizontal integration, to replace both the ties existing in the Soviet economy and the excessive economic chaos, created by the too rapid privatization of the economy and disruption of old production ties. On the other hand, the unfinished redistribution of property during privatization and the involvement of economic managers in primitive accumulation of capital amplify centrifugal tendencies in the interaction of companies. Mean-

while, the profitability of banks' financing of trade and intermediary operations, impedes the integration of industrial and banking capital.

*Fourth*, there is now a felt need at various levels of economic management for some theoretical grounding for the grouping of companies. Government agencies need such orienting points in order to determine the extent of their participation in financial and industrial groups and to evaluate various FIG-creation projects, from the standpoint of the national economy, while companies need recommendations on the composition and organizational structure of financial and industrial groups, mechanisms of intergroup cooperation, and substantiation of their claims on State support for their activity.

A number of factors now impede the attraction of foreign investment to manufacturing industries. The continuing high inflation is just one of them. It is necessary to reconceptualize the legal bases of the interaction of industrial and bank capital. The approach currently implemented in Russia aims, on the United States model, to limit ties between manufacturing industries and banks.

The further involvement of banks in the creation of financial and industrial groups is thus impeded by a number of provisions of the Regulations for Financial and Industrial Groups and Procedures for Their Establishment. The Regulations forbid, during the creation of financial and industrial groups, either voluntarily or through consolidation:

- the participation in FIGs of companies established in accordance with Article 13 of the Russian Federation Law on Businesses and Enterprise, as well as holding companies whose real capital accounts for less than 50% of their capital;
- the holding of stakes in each other, by members of financial and industrial groups;
- any lending institution or investment company which is a member of a financial and industrial group, from acquiring more than 10% of the shares in other members of the group.

Given this approach, it is difficult for banks to become architects of the unification of companies capable of creating an ownership structure that will ensure close business relations among members. In Russia, contractual relations matter less than in older market economies, and thus can hardly be a reliable guarantee of fulfillment of obligations. Insofar as most large investment projects require the establishment of such relations, the implementation of such projects and their financing by banks becomes questionable.

In order to change the situation in Russia's industry and attract financial capital to restructure it, the cooperation of banks with manufacturing businesses in carrying out investment projects will have to entail an acceptable distribution of risks, and a corresponding participation in the profits from these projects. Under present conditions, the chief means to satisfy these requirements is the expansion of banks' participation in industrial share capital. Financial and industrial groups can help achieve this.

Skeptics fear that bankruptcies of companies whose shares have been purchased by banks, will inevitably result in the bankruptcies of those banks. This, in turn, could bankrupt companies with money on deposit there. Such views single out only one side of the situation. The other is that banks' involvement in the management of capital flows in manufacturing, will make it possible to reduce the number of bad loans and thus will improve the financial position of the banks.

Banks' involvement in activities other than deposit-taking and lending, and their participation in the mobilization, redistribution, and management of capital flows will help reduce the amount of bad loans and, consequently, risk of long-term investment. This would seem especially true, in view of the fact that commercial banks now possess detailed information about the condition of manufacturing companies.

Nonetheless, banks' financing of industries (through stake ownership and long-term lending) is impeded by fears about possible losses resulting from the unpredictable behavior of shareholders in industrial firms, who are oriented mainly to portfolio investments. The larger the stake of stable shareholders (strategic owners), the easier it is for banks to stabilize shareholders' decisions and the smaller a bank's stake in a company has to be, to ensure itself an acceptable level of risk.

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## Conclusions

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It is time to sum up, and draw conclusions:

1) It must be admitted that the price paid by Russians for the economic reform has been unjustifiably high. This is not only a result of our past, which predetermined the historical necessity for radical changes in Russia, but to a very great extent, it is a consequence of errors in the economic reform course chosen, especially after 1991. The leadership's assumption that we were taking the only right course, to which there was no alternative, was only a populist vagary. The economic reform course implemented has not only led the country's economy to chaos and destruction; it has also discredited the idea of market transformations, in the eyes of millions of our compatriots. This is because Russian reformers failed to use a scientifically grounded theory. Of the whole rich theoretical heritage accumulated by world economic science, Russian reformers used only a small number of logically unconnected fragments. They emphasized monetarism—the Chicago variety, which is not even the best monetarism. We now have to pay, for their disregard of economic science.

2) The success of economic reform depends on the democratization of State power. Of course, the stereotype that only dictatorship can save Russia, which a certain part of the population now endorses, is profoundly wrong. The failures

of the reform policy are a nutrient medium for such notions. What really impedes the cause of reform in Russia, is the unresolved problem of power. For the authorities in Russia, reform is less important, than their possibilities of retaining power.

For reforms to be carried out in earnest, a mechanism is required for the democratization of power, which will put an end to the estrangement of the authorities from the people, make them bear full responsibility for the results of their decisions, and ensure public control over their activity. This mechanism should be based on a Law on the Democratization of State Power. This should have been the starting point for reforms. It is the alpha and omega of their success.

3) The social orientation of the reforms should be the defining principle. The attributes of a market economy are secondary. It would be appropriate to study the alignment of social forces and define acceptable policies (those that do not threaten to cause a catastrophe) for social and economic transformations. The minimum obligation is to ensure that the decline in industrial production and living standards and the growth of social tension will stay within acceptable limits. These minimum requirements should be applied, only if it has been proven that there exist no alternative courses, free of these negative results. Financial and budget policy should be subordinated to this goal. Only as it is achieved, should the question of eliminating the budget deficit or reducing inflation to zero be posed.

4) Special attention should be paid to the social and psychological aspects of economic reform. Without these aspects, economic transformations are impossible. It should be understood, that most of the Russian population was accustomed to full employment, a certain guaranteed income level, and the resulting stability of life and confidence in the future. Those qualities of the economic system should not be quickly destroyed. Otherwise, there will be an inevitable increase of social and psychological tension in society, and favorable conditions for revolutionary and totalitarian movements.

To avoid such developments, it is necessary to implement changes in sensible doses at an unforced pace, thus ensuring a nonviolent renovation of the social and economic system.

5) From the very beginning, the reforms should have been aimed at creating the middle level of economic management, which world experience shows is uniquely capable of performing the entrepreneurial functions required for the implementation of long-term production development programs. In the Soviet era, these functions were concentrated at the level of government ministries and agencies, while manufacturing companies did not have to deal with such problems. As a result, they were not prepared to function independently under market conditions. It was with such inadequate property-owners, that we launched across-the-board privatization. As a result, companies were not really privatized—only their property was. This created favorable conditions for the total destruction of industrial production and for speculation in

ownership rights. The substitution of a change in ownership for strategic planning tasks was the reformers' greatest mistake.

6) Another mistake was to regard macroeconomic financial stabilization measures, including reduction of government spending, higher taxes, loans from international financial organizations and the sale of government securities, as the only means to combat inflation. Of course, such measures are important and necessary. Nonetheless, they failed to eliminate the sources of inflation in Russia, which included the technological backwardness of production (high levels of raw materials, labor and energy consumption, and low quality of production) and the high level of monopolization in the economy. These are the causes of the collapse of production and the rise of prices.

As a result, each 1% reduction of inflation costs the Russian economy a 3 to 5% decline in production. This, in turn, makes it necessary to provide at least partial compensation for the losses, which increases the budget deficit and pushes inflation higher. It is impossible to break this vicious circle by monetarist methods alone. A new approach is required, which does not entail the restriction of total demand. Technological backwardness and a high level of monopolization of industry can be compensated, by shifting the center of gravity of tax policy from the manufacturing to the nature-exploiting sectors of the economy. This would make it possible to reduce manufacturing industries' prices by at least 25% and thus make them more competitive. At the same time, manufacturing companies would no longer lose much or all of their incentives for constantly raising prices. Inflation would decrease, while industrial production began to grow.

7) A new tax reform must become a major tool for revitalizing the Russian economy. It should be based on rent charged for the use of Russia's natural resources. The rent collected could cover most of Russia's budget expenditures. This would make it possible to abolish taxation of labor and capital. The elimination of several traditional taxes (wage taxes and VAT) would improve the investment climate in Russia, attract foreign investors, and make it possible to organize a system of social transfers.

8) It should be taken into account, that Russia has a unique situation, in that land has not yet been transferred to private owners. This situation should be exploited. It should be remembered that private landowners obtain an unlimited right to appropriate rent, which never belonged to them and should be regarded as public property. The private appropriation of rent is a major cause of social injustice and inequality. To eliminate this evil, it is necessary to ensure that land users receive income proportionate to their contribution to development of production. Income resulting from use of the productive power of nature, from what God created, should belong to all. We should all take a "State" approach to dealing with this issue, or else we will never be able to achieve social justice and create effective labor incentives. In view of this,

we oppose private ownership of land and advocate the principle of private land tenure, on the basis of long-term leases.

9) Russia has a unique chance to set an example for other countries, by shifting to a system of environmental protection. This requires a gradual restructuring of the tax system, so as to use the assimilation potential of the environment. This tax will not increase the overall tax burden, but will redistribute it in favor of ecologically harmless types of activity.

Russia could also pioneer a system of obligatory environmental insurance.

10) As mentioned, it is necessary to revise our views on the role of government spending. A reasonable level of spending by the State can help to overcome the crisis. In principle, we should change the assumptions underlying government spending plans. It is essential to observe the social and economic constraints, without which no economic reform can be carried out. The volume of government spending should not directly depend on the amount of budget revenues collected.

11) Rent charged for use of strategic natural resources (natural gas, oil, precious metals, etc.), as well as payments for the use of Russia's trunk pipelines, power grid, and air space, should be the main major revenue earners for the federal budget.

Regional and local budget revenues should be based on the land tax, leasing of plots of land in cities, and other property, to juridical entities and natural persons, etc.

In order to support and develop depressed regions, it is necessary to set up a reserve fund to which, at the federal level, part of the rent collected, environmental taxes, income from the Central Bank's assets abroad and other revenues will be transferred.

12) Restructuring of the public debt is another pressing problem. The government's debts to the population must be converted into assets of the largest banks such as Sberbank (the Russian Federation Savings Bank), State-owned companies and companies with mixed State and private ownership, as well as used as the basis for agreements on long-term leasing of plots of land for gardening and dachas, housing construction, etc.

The population's assets on deposit in savings banks must have a tangible counterbalance in the form of liabilities created through the installment sale of consumer goods, construction loans, etc.

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The above principles make no claim to be comprehensive, nor to provide concrete ways of implementing the measures suggested. This is a conceptual formulation of how to define a strategic course for reforms in Russia. We thought it necessary to focus attention on this aspect of fundamental premises, which will serve as a deposit on the solution of new practical tasks of economic reform.