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ECONOMIC STRATEGY AND INEQUALITY

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ANALYSIS

What Are the Russian Elites Going to Build?[1]

By Andrei Yakovlev, Moscow

On 25th May, the Economic Council under the President of the Russian Federation discussed three programs, developed by the *Stolypin Club*, the Ministry of Economic Development, and the group of Alexei Kudrin. The discussion left ambiguous impressions. On the one hand, it is already a positive sign that several alternative variants of economic strategy were discussed. The discussions were held on the highest level, with the personal involvement of Vladimir Putin. Indeed, at the current time such discussions are crucial, especially taking into account that during recent years key decisions were taken without any awareness of their economic consequences. For example, as stated by the first Deputy Minister of Finance, Tatyana Nesterenko, "the Ministry of Finance was not asked in advance about the possible price of the decision on the accession of Crimea".[2] On the other hand, if we paraphrase Winston Churchill's famous saying that "generals always prepare for the past wars", we can say that the current discussions are a case of policy-makers preparing for past economic challenges.

In my opinion, none of the three programs provide a clear understanding of the aims of economic policy. They talk rather more about the aims to "sustainable economic growth" or "an increase in social standards", and less about the models of economic and societal development that can be relied upon to deliver them. Indeed, economic policy is an instrument to perform certain aims. Therefore, in the first instance, it is important to agree on what the elites are seeking to build, rather than discussing particular "instruments" of economic policy.

I think that Kudrin and Ulyukaev are still following the general goal of building an open and liberal economy. This model is expected to be based on private business (including foreign companies) as the main driver of the economy. It is also assumed that business will attract investment resources, including from global financial markets. The main drawback of this approach is that Russia has already seen several attempts to build this type of economy, which were ultimately never fully implemented. Actually, the reasons why such attempts failed are quite clear. It is due to the low quality of institutions (most of all the public ones) and the low level of trust in the government's economic policy among both business and the population. It is difficult to expect that any new attempts to build a "liberal market" would lead to positive results without any radical changes in these spheres. There are, also, even more crucial difficulties for the liberal camp's suggestions, connected with the fact that the world has drastically changed after 2014. The accession of Crimea and the military conflict in the eastern part of Ukraine have had a strong impact on relations between Russia and developed countries, and resulted in the passing of the so called "point of no return". Even if the West were to eliminate all sanctions tomorrow (which is hardly believable), there will remain informal barriers to accessing European capital and technologies for Russian companies, simply because Russia is now perceived by the West as a potential enemy. This situation will remain unchangeable for many years.

The authors of the program developed by *Stolypin club* seem to realize these issues and are concentrating on the model of "catch-up growth". As examples, they point to the experience of the countries of East Asia (China, South Korea, and Taiwan). These economies are characterized by a strong role for the government, stimulating investments via credit emissions and etc. However, at the same time, such suggestions do not take into account that previously these countries had long periods as closed economies. During these extended periods of time, they worked actively to become successful exporters, and evaluated the activities of their national companies in terms of their success on the international markets. At the same time, these economies had protective import tariffs and their national markets were simply closed for foreigners. There were also serious restrictions on the currency exchange market, whereby national companies were not allowed to buy and sell foreign currency freely. In other words, in order to succeed with the *Stolypin Club* development program, it is important to set up strong measures for currency exchange control and to close financial market to foreign players. However, the program itself lacks these measures. I also do not think that such measures would be supported by the representatives of the successful medium-sized business that are members of the association *Delovaya Rossiya* (Business Russia), which is closely associated with the *Stolypin club*.

The *Stolypin Club* program also has its own fundamental shortcomings. Historical experience shows that the "quality of bureaucracy" has been the main prerequisite for "catch-up growth" measures to be successful. Even the most successful East Asian states have faced problems

1 This paper reflects the results of a research project funded within the framework of the Basic Research Program at the National Research University Higher School of Economics (HSE).

2 'Minfin ne sprashivali vo skolko oboidetsya reshenie po krymu', Forbes, 5 March 2015, <http://www.forbes.ru/forbes-woman/karera/281919-minfin-ne-sprashivali-vo-skolko-oboidetsya-reshenie-po-krymu>

with corruption. Indeed, we should be clear that corruption in general is one of the characteristics of countries that follow state capitalism. However, public officials in these countries seek rents not in the form of "a share of the budget" (like it happens in Russia), but rather in the form of "a share of the surplus". On this theme, it is important to mention Shleifer & Vishny's (1993) article which distinguishes between models of "corruption-with-theft" and those of "corruption-without-theft".[3] On a theoretical level, they proved that the latter model hurts a country's economy and society much less than the former.

The experience of East Asian countries also proves that "corruption-without-theft" may be combined with successful economic development, stimulated by the government. However, a model "corruption-with-theft" remains dominant in Russia. That is why questions about the "quality of the state" and the role of public officials are among the most crucial. I think that none of the above three programs address these questions.

What are the alternatives to these three programs? I do not have the answer to this question. It seems to me that the answer may be developed only during public discussion of the different ideas and approaches. It would be fruitful to incorporate the representatives of all influential interest groups within such discussions.

It is important to find both the relevant participants for such discussions and the right consumer for its results. It is also crucial to articulate the right questions for discussion. One of the questions which should be addressed to the representatives of the liberal market model, who are promoting economic openness is—Why does the world need Russia? The recent geopolitical tensions have demonstrated that Russia is dependent on international markets as much as any other country in today's world. Moreover, all countries are competing strongly not only in international markets, but also for cultural and political influence. In these circumstances, it is important to be aware that Russia does not owe anything to any other countries, but neither do other counties have to love Russia. If Russia wants its position to be taken into account on an international level, it should seek to do so not only by leveraging its possession of nuclear weapons, but rather by emphasizing its unique selling point to the world. In this way, it will be possible for Russia to move from opposing the world back to a context in which it is again included in the global networks creating economic value. The advocates of the popular import-substitution policies should think about whose and what Russia can really "catch-up".

Speaking about the participants of the process, it is important to note that the economic management model, which has since the early of 2000 become established in Russia, is based on an agreement between three elites groups: the federal bureaucracy, oligarchic business and the *siloviki*. Until 2003, there was a certain balance between the three groups. After the Yukos case, however, the balance shifted in favor of the federal bureaucracy and *siloviki* elites. In wake of the fear of "Arab Spring" scenarios during 2011–2012, the *siloviki* became the dominant force. In meantime, three additional influential social groups appeared over the course of the 2000s. They include successful medium-sized businesses, regional bureaucracies and budgetary elites. These mass groups were formed due to the growth of the domestic market and the increase in budgetary expenditure. In comparison to the 1990s, these groups have something to lose and, at the same time, they have a better understanding of how to work in the specific conditions of contemporary Russia. The inclusion of these groups into a dialog on the ways the country should seek to develop is an important prerequisite in the search for a new model of development and a necessary condition for its practical accomplishment.

A final remark: it would be fruitful for all the participants in the current economic debate to take several steps back, and seek to agree on the basic issues and reach a common understanding about what the Russian elites are going to build. For example, during 1999–2000, the Center for Strategic Research (CSR) served as a platform for such types of discussion, predetermining the reforms and successes of economic development during the early 2000s.

Project CSR-2, which has now been launched by Alexei Kudrin, could potentially be successful again. It may be possible that the CSR can become a platform for discussions on Russia's development model among the different categories of participants outlined above. If the discussants are capable of finding a new fundamental consensus, then it might be possible to formulate a realistic program of measures for the development of further economic policy.

Translated by Kateryna Boguslavska

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3 Andrei Shleifer & Robert W. Vishny, "Corruption", *The Quarterly Journal of Economics*, Vol. 108, No. 3. (Aug., 1993), pp. 599–617.

ANALYSIS

Economic Inequality in Russia: Sources and Consequences

By Thomas F. Remington, Atlanta

Abstract

Russian income inequality has risen to a level comparable with the United States and China, while inequality in wealth is the highest in the world. Growing inequality reflects the fact that income gains have gone disproportionately to those at the highest end of the income distribution. The economy's resource bias and the institutional framework of the country are responsible for these trends. Over the long run, this level of economic inequality is destabilizing.

Russian income inequality has caught up with and overtaken inequality in the United States. Aggregate income inequality is comparable to that of the United States and China; it is somewhat lower than that of some Latin American countries; and lower than all or nearly all of the post-communist countries of the former Soviet Union and Eastern Europe. Comparing Russia with the United States, and using the official estimates reported by the government statistics agencies of the two countries, Russia is somewhat lower in the Gini index[1], but higher in the ratio of the 90th percentile of the income distribution to the 10th percentile (This is usually called the 90–10 decile ratio, and in Russia is reported as the "funds coefficient" [*fondovyi koeffitsient*]). Figure 1 illustrates the trends in the two countries. Note that in the two recent periods of recession, 2009–2010 and again since 2013, Russia's inequality levels have fallen, while growing in periods of rising incomes.

Russia's income inequality is more like China's and less like America's in that cross-regional inequality accounts for a large share of it. In America, most of the income disparities are within states, not across them. But in Russia, as in China, there are wide gaps in incomes and living standards across regions. These differentials have grown steadily with time, as Figure 5 on p. 8 indicates, using boxplots.[2] In its post-communist economic trends, Russia has not so far demonstrated a tendency toward cross-regional convergence despite theories among some neo-classical economists that, over the long run, economies show tendencies for incomes to converge across regions.[3]

Income growth and inequality are positively correlated within and across regions as well. Regions higher in mean incomes are also higher in inequality. In regression models of regional inequality, even controlling for past inequality, higher growth of incomes is associated with higher inequality. In short, so far at least, both nationally and within and across regions, as mean incomes rise, so does income inequality.[4] By the same token, in times of recession, income inequality falls slightly, as was the case in 2009–10 and again since 2013.

It is often thought that inequality and poverty track each other and that growing inequality is driven as much by the downward mobility of some as by the upward mobility of others. Today, in many countries, that assumption does not hold. In Russia, as in China, when poverty declines, and mean incomes rise, income inequality rises. This is because the gains at the higher

1 The Gini index is a widely used measure of the relatively inequality in the distribution of something—often income—across individuals or households in a society. A Gini index approaching unity (1 or 100%) indicates that there is extremely high concentration of incomes in a few individuals or households. A Gini index approaching 0 would mean a nearly equal distribution of income shares across the society. High Gini indexes are found in such countries as Brazil, whose Gini is in the 50s, and South Africa, where the Gini is in the 60s. Extremely egalitarian societies, such as the Scandinavian countries, have Ginis in the 20s.

2 A box plot is a visual way of grasping the spread of a distribution. Box plots represent the distribution of values of a set of observations by quartiles (quartiles are the points dividing a set of observations into four equally sized groups). The central box represents the middle 50% of observations by value, called the "inter-quartile range." The band intersecting the central box represents the median point of the distribution—i.e., the point at which the number of observations with higher values is equal to the number of those with lower values. The portion of the central box just above the median represents the next highest 25% of observations above the median, while the portion immediately below the median consists of the next lowest 25% of observations. Observations above and below the central box represent the highest and lowest quarters of all observations. The "whiskers" extending above and below the central box mark the ranges of adjacent values above and below the middle 50% of the distribution, while the small circles above and below the whiskers represent the extreme high and low ends of the observations. If the central box is narrow, it means that the range of values around the median point is small. If the central box is tall, the range is wide. In the first case, the observation at the 75th percentile is not very different in value from the observation at the 25th percentile. If the box is elongated, the 75th percentile is a long distance from the 25th.

3 Thomas F. Remington, "Why Is Interregional Inequality in Russia and China Not Falling?," *Communist and Post-Communist Studies* 48 (2015): 1–13.

4 Thomas F. Remington, *The Politics of Inequality in Russia* (Cambridge: Cambridge University Press, 2011).

ends of the distribution outpace the gains among the lowest-income strata. Figure 3 illustrates the point.

In Russia, as in the United States, the median income can stagnate even as the mean income rises. The mean income takes into account the incomes of those at the top of the distribution (the top decile or one percent). The median is the income at which there are an equal number of people on either side—half richer, half poorer. As the rich grow richer, those in the middle do not necessarily grow richer with them. This problem has been widely recognized and debated in the United States, where median incomes have been largely stagnant in recent decades.[5] But the same point applies to Russia as well, where median incomes have risen much more slowly than mean incomes.

The fact that income growth in Russia consistently raises inequality is a sign that economic development is skewed. The main driver of both growth and inequality in Russia is the natural resource sector. The resource bias of the economy affects income distribution in two ways. When oil, gas, and other commodity prices are high, the extraction sectors and the financial sector servicing them see higher gains in income than other sectors. Likewise, the resource-rich regions grow richer than other regions.

Wealth in all societies is more unequally distributed than incomes. Wealth refers to assets that can be converted into income, whether those be stock shares or other forms of wealth. The multinational bank Credit Suisse produces an annual report on the distribution of wealth globally and within countries, based on an exhaustive examination of public records. Credit Suisse compared Russia with the rest of the world and concluded that "inequality in Russia is so far above the others that it deserves to be placed in a separate category."[6] Figure 1 opposite indicates how Russia compares with the US and China in the concentration of wealth in 2015.

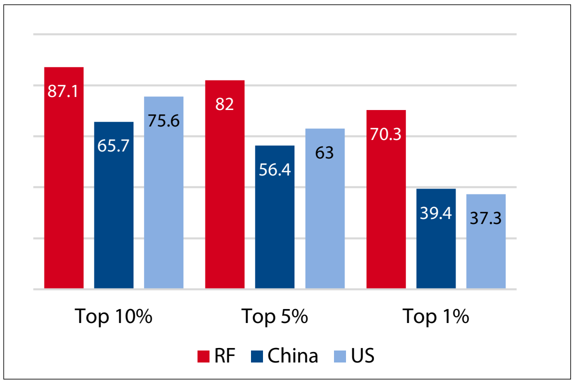
The Credit Suisse analysts also sought to estimate the wealth holdings among the middle class, where middle class was defined by wealth holding. Noting the melting away of the assets of those in the middle after the 2008 world financial crisis, the report concluded that, "[a]fter trebling in size by 2007, Russia has lost more middle-class members since 2008 than any other country. As with Greece and Turkey, the middle class in Russia is only a little smaller now than in 2000."[7] Yet in the same period, those at the top of the pyramid increased their concentration of wealth, as Figure 2 below shows.

5 Carmen DeNavas-Walt and Bernadette D. Proctor (2015). *Income and Poverty in the United States: 2014*. Washington, DC, US Census Bureau.

6 Credit Suisse Research Institute, *Global Wealth Report 2014*, p. 31.

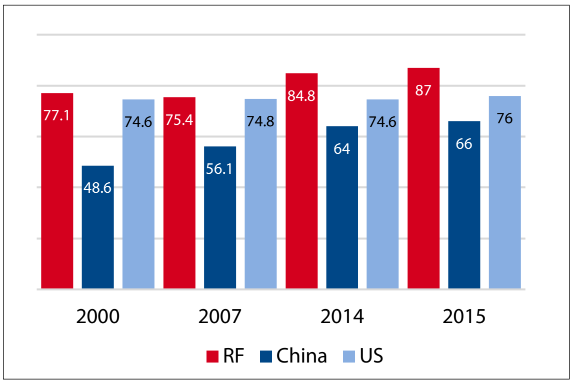
7 Credit Suisse Research Institute, *Global Wealth Report 2015*, p. 37.

Figure 1: Share of Wealth Owned by Top Strata of Households



Source: Credit Suisse Research Institute, Global Wealth Databook 2015*, Table 6-5, p. 149.*

Figure 2: Share of Wealth Owned by Top 10% of Households



Credit Suisse Research Institute, Global Wealth Report 2014, 2015*, Table 2, p. 33.*

There is a small middle class in Russia, perhaps 20% of the society. However, Russian sociologists report that a growing share of those who can be considered "middle class" by occupation, income, education, and self-perception are not entrepreneurs, but are budget sector employees—civil servants, teachers, doctors, police, and soldiers.[8]

Before the 2011–12 election cycle, Vladimir Putin and the leaders of the United Russia party frequently expressed concern over the high level of income inequality. "The differentiation of incomes," Vladimir Putin wrote in *Komsomol'skaia Pravda* in February 2012, "is

8 Iulii Solomonov, "Sotsial'naia sfera: ispytanie krizisom," *Nezavisimaia gazeta*, February 29, 2016. Interview with Tat'iana Maleva; Thomas F. Remington, "The Russian Middle Class as Policy Objective," *Post-Soviet Affairs* 27(2) (2011): 1–37.

unacceptable, outrageously high….Therefore the most important task is to reduce material inequality."[9] Putin used to state that the solution to the problem of inequality, as well as of excessive economic dependence on resource rents, was to expand the middle class. Until the surprisingly large-scale protests of 2011–12, Russian leaders regarded the middle class as a source of stability and potential support for the regime, rather than as a source of demands for democratization. Since then, however, there has been very little interest on the part of the top leadership in building up the middle class.

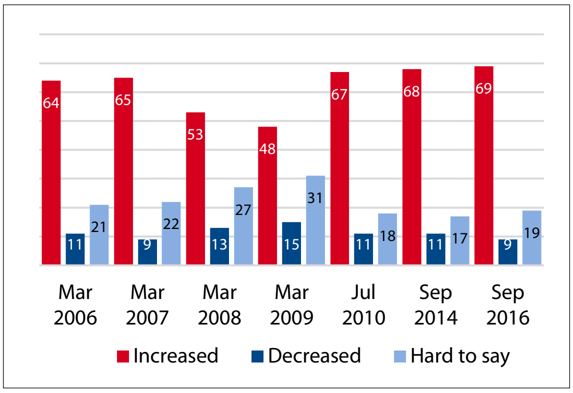
Inequality matters. The scholarly literature shows that polarization of incomes is associated with lower provision of public goods. Better-off strata regard public goods as inherently redistributive.[10] Second, high inequality blocks social mobility owing to the accumulation of advantage over time. Families in strata with greater access to education, health care, security and government services transmit their advantages to their offspring, reducing the likelihood that individuals from lower-income strata will rise in the next generation.

So far Russian leaders have failed to reduce the economy's dependence on natural resources. Rising incomes from mineral extraction have made a few people extremely wealthy and allowed a few regions to enjoy extremely high average incomes. Revenues from resource exports have also fueled high incomes in the financial sector. The growth in mean incomes does not reflect growth in entrepreneurship or innovation. The inequality in the distribution of incomes reflects the economy's dependence on rents from resource extraction, which has increased incomes in the highest income brackets and hindered the expansion of the middle class.

Russians are aware of the problem of inequality, Figure 3 opposite reports Levada Center figures on the public's assessment of inequality levels.

However, Russians grossly underestimate the scale of the inequality.[11] In part this is because, in Russia as in other countries, much of the lavish consumption of the wealthy goes on out of sight. The wealthy in Russia, as in the US and China, may live in gated communities and spend their money overseas. Russians, moreover, regard the state as the best check on the power of oligarchs, rather than demanding a more level playing field in the economy.

Figure 3: In Your Opinion, Over the Past 15 Years, Has the Gap Between Rich and Poor In Our Country Increased, Decreased, Or Remained the Same As In the Yeltsin Period?



Source: representative opinion polls by Levada Center 2006–2016, <http://www.levada.ru/2015/11/11/biznes-i-vlast/>

Nevertheless, in Russia as elsewhere, high inequality harms society in several ways. Rising inequality means that income gains are going disproportionately to those at the top, rather than in the middle. This, in turn, reduces society's willingness to pay for public goods that will help equalize opportunities for society at large. It also diminishes the demand for democratic political institutions, since democracy entails the potential for redistribution of wealth. Instead, those with wealth ally themselves with the state to protect themselves from demands by the poor for redistribution, much as the general public turn to the state to curb the appetites of the wealthy.

Over the long run, Russia's rising inequality is destabilizing. Widening inequality across regions means that a smaller and smaller number of resource-producing regions are subsidizing a growing number of poorer regions (in some regions, federal subsidies account for over 80% of budget revenues). The fiscal system becomes unsustainable, because the government cannot raise taxes to levels high enough to balance the budget, a problem exacerbated by the fact that the federal authorities depend so heavily on oil and gas-based revenues.[12] As in the late Soviet period, increasing the defense budget is imposing an unsustainably heavy fiscal burden on the economy and forcing cuts in public services and social support (for example, the 2016 budget is raising pen-

9 Vladimir Putin, "Spravedlivoe ustroistvo obshchestva, ekonomiki—glavnoe uslovie nashego ustoichivogo razvitiia v eti gody," *Komsomol'skaia pravda*, February 13, 2012.

10 Alberto Alesina, Reza Baqir and William Easterly, "Public Goods and Ethnic Divisions," *Quarterly Journal of Economics* 114(4) (1999): 1243–1284; William Easterly, "The Middle Class Consensus and Economic Development," *Journal of Economic Growth* 6(4) (2001): 317–335; William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*. (Cambridge, MA: MIT Press, 2002); William Easterly and Ross Levine, "Africa's Growth Tragedy: Policies and Ethnic Divisions," *Quarterly Journal of Economics* 112(4) (1997): 1203–1250.

11 Vladimir Gimpelson and Daniel Treisman, "Misperceiving Inequality," *IZA DP No. 9100* (2015).

12 Putin has ruled out raising the 13% flat income tax, whose revenues in any case go to the regional budgets.

sions by an amount well below inflation). Overcoming the problem of rising inequality in Russia requires replacing the resource-based model of economic growth with one that depends on human capital, innovation and entrepreneurship. Such an economy would distribute the benefits of growth more evenly across the society.

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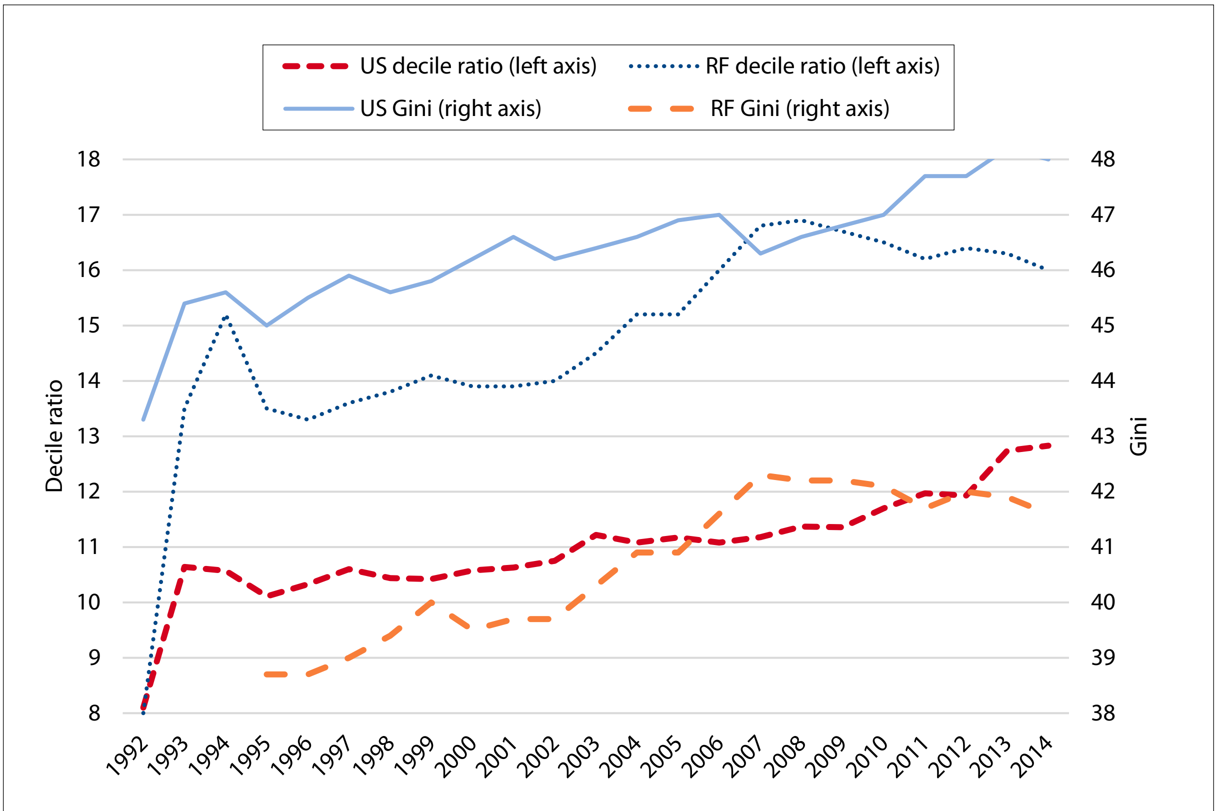
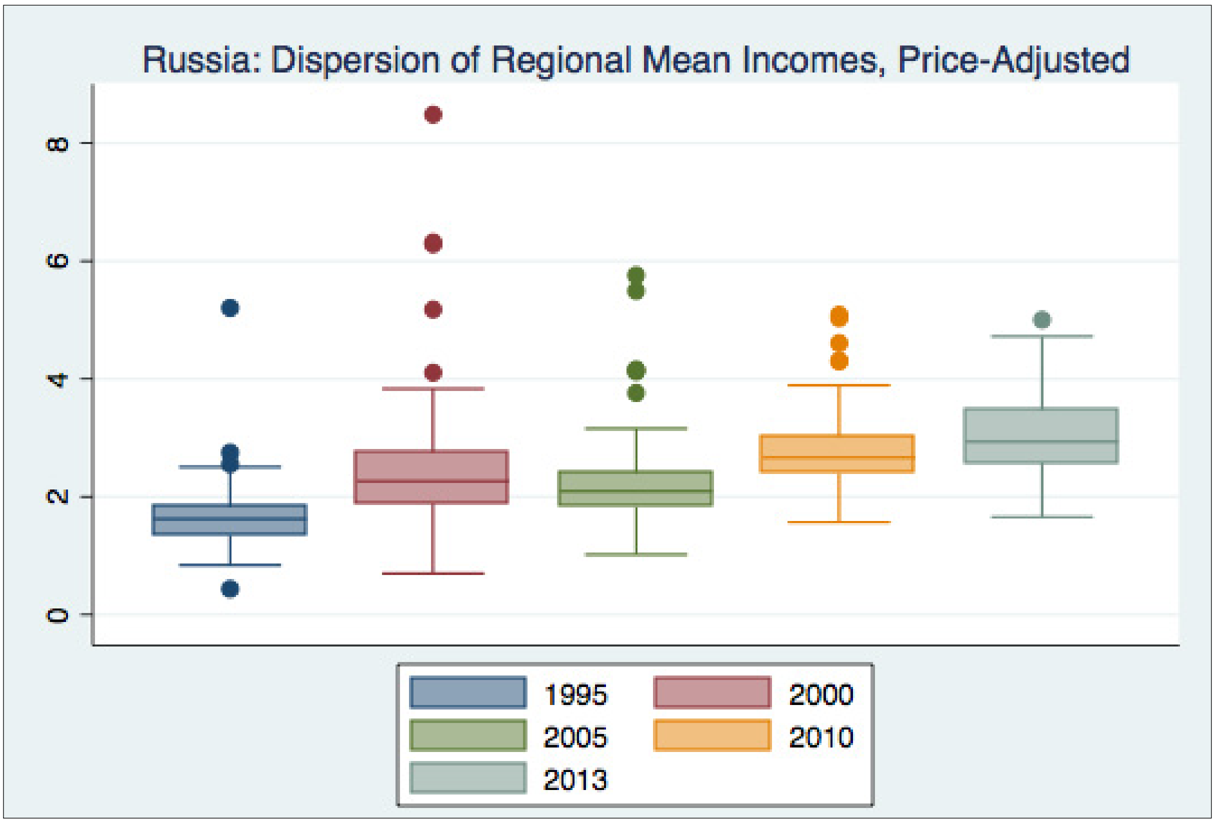
Figure 4: US and Russia: Income Inequality Growth



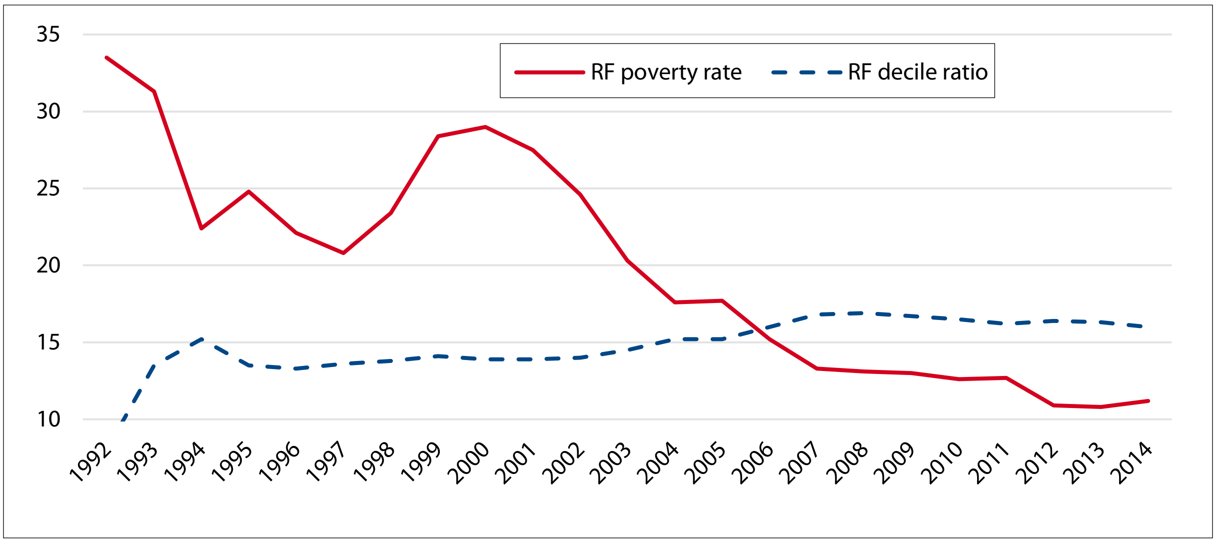
Sources: US Figures from Carmen DeNavas-Walt and Bernadette D. Proctor (2015). Income and Poverty in the United States: 2014. *Washington, DC, US Census Bureau; RF figures from Rosstat,* Regiony Rossii, *various years.*

Figure 5: Regional Incomes Over Time



Sources: Rosstat, Regiony Rossii, *various years.*

Figure 6: Russian Poverty and Inequality



Source: Rosstat

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