Comparative Economics and the Study of Russia's Regions

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This essay begins with some comments by a non-economist on the passing of area studies as a sub-field in the discipline of economics. It moves on to look at the implications of this disciplinary shift for the study of Russia's regions. It tries to identify those particular features of the Russian economy that may have been overlooked by the new paradigm of transition economics.

1. Who Studies Russia, and Why?

The study of socialist economic systems took root in American and British universities in the 1950s and 1960s, when a whole generation of esteemed scholars analyzed the structural features of the Centrally Planned Economy.[1] The CPE was recognized as a sui generis form of economic organization, with laws of operation distinct from those of a market economy. Although inferior from the point of view of economic efficiency, the CPE was seen as a viable alternative and indeed rival to the capitalist system. Most university economics departments had a professor who specialized in comparative economic systems, and the Soviet system was the main focus of their courses. In the 1950s study of the CPE overlapped with the lively field of growth theory, as economists such as Poland's Michal Kalecki built models for optimal growth paths in developing countries.

In the 1960s and 1970s attention shifted from the internal dynamics of the CPE to the ways in which such the CPE could introduce market reforms. Most economists seemed to believe that it would be possible to introduce "market socialism": market-like relations in an economy where enterprises were state or worker-owned. A lot of intellectual effort went into modeling the dynamics of the Yugoslav-style self-managed economy. Interest in growth theory faded in the economics discipline as a whole, partly because of the poor performance of Nehru's development planning in India. The paradigm of studying CPEs as a special type of economy persisted up until the end of the 1980s - just when the

1 Abram Bergson, Gregory Grossman, Herbert Levine, Alec Nove, Michael Kaser and others, followed later by Janos Kornai, James Millar and Paul Gregory. For a detailed analysis of the history of and challenges to the sub-discipline, see James R. Millar, "Rethinking Soviet economic studies," in Daniel Orlovsky, ed., *Beyond Soviet Studies* (Washington, DC, 1995), ch. 8.

first generation of trail-blazing scholars was heading for retirement. With the collapse of the Soviet system, the study of CPEs also collapsed, and with it, perhaps, the whole notion of comparative economic systems.

The shift to a new paradigm

Since 1989-91, the CPE paradigm has been replaced by the transition economy paradigm. This paradigm is shaped by a teleological assumption that there is only one set of laws about how a market economy functions. Although national economies start from different points of departure, and encounter various obstacles along the way, they are all ultimately converging towards a model of a developed market economy (read: Anglo-American).

The collapse of the CPEs had a devastating effect on the discipline of comparative economics in American universities. This is very paradoxical, since the opportunities for business and scholarship in the former socialist countries dramatically increased after the collapse of the CPEs. Suddenly, there were 27 new countries in need of advice and assistance in building a market economy. There were 27 new markets where Western firms could find customers and resources. New sources of data and research opportunities blossomed in comparison with the restrictive policies of the socialist era. Students flocked to courses on the transition economies, because it was exciting and because it could mean jobs for them.

But this new potential did not translate through into university teaching of comparative economics. Although central data is not collected, it appears that not a single new assistant professor with a specialization in Russian/East European area studies has been awarded tenure at an American university economics department since 1993. As the old guard from the 1950s retired from the Ivy League schools, they were either not replaced by area specialists, or their replacements did not serve through to tenure. Very few economics departments have hired specialists in the post-socialist economies since 1991, although there is still some interest in applied economics with an international dimension in business schools.

The general discipline of economics has changed radically over the past 30 years. Mathematical modeling is now valued more highly than an understanding of the institutional structures of a given economy.[2] Some credit, but not much, is given to the ability to gather data about specific economies. Even the study of economic history - the institutional development of the American economy itself - has largely disappeared from economics departments, and tries to eke out an existence in exile in departments of history and political science. Political science has seen a lively interest in the "new institutionalism:" studying the origins of political and economic institutions. For a young economist,

2 William J. Barber, "Reconfigurations in American Academic Economics," *Daedalus* 126:1 (winter 1997), pp. 87-103.

however, years spent learning a foreign language or trying to do field work in another country is time spent away from honing one's mathematical skills. Such economists found it hard to compete with their colleagues who never left their university desk.

Why did this mathematization of the economics discipline occur? Partly it was a bid to emulate the perceived success of the natural sciences. Partly it was a rationing device: an apparently objective skill-test that could enable departments to pick the best candidates, and journal editors to pick the best articles, by assessing their degree of mathematical sophistication.

At the same time that the flow of area specialists was being cut off at the roots, there was a determined effort to colonize the field of transitology from outside. This colonization came from several directions: from non-area studies economists, and from international financial institutions. The term "colonization" is used here in a neutral sense, and is not meant to imply that this influx of talent and resources was inherently bad. On the contrary, it produced some of the best work on the transition economies.[3] However, it was significant that the study of specific national economies passed out of the hands of people who were trained in area studies and typically spent their entire career perfecting their understanding of those economies.

Given the assumption of the universality of the laws of the market, economists who had no special knowledge of a given country or the CPE heritage had no hesitation about starting research on any particular transition economy. Thus for example specialists in international trade, labor economics, bank regulation, or utility regulation started research projects in the former socialist countries. To the extent that they needed local knowledge, they could hire local graduate students, or take data from government and international agencies.

At the same time, international institutions such as the European Union, IMF, World Bank, United Nations Development Organization and International Labor Organization started channeling some of their massive resources into the study of the post-socialist countries, which hitherto had been closed to them. Not only did they want to bring these countries into the global economy, some of these institutions saw the collapse of socialism as an opportunity to restore their battered international image. The World Bank was suffering from the abject failure of much of its lending for infrastructure projects in developing countries. The IMF had been created to manage a fixed exchange rate system that no longer existed, and repeated international financial crises raised doubts about their role in the new economic order. The budgets - even the very existence - of these organizations was under attack in the U.S. Congress. The collapse of communism provided a golden opportunity for those international agencies to put their expertise in market economics to work. The countries of

3 For example, Joseph Blasi (with Maya Kroumova, Douglas Kruse, and Andrei Shleifer), *Kremlin Capitalism* (Ithaca, NY, 1996).

the region accepted their advice - and their loans - with enthusiasm. Within a couple of years the IMF and World Bank were devoting up to one third of their staff and resources to work on the transition economies. The Europeans, feeling left out, created the European Bank for Reconstruction and Development to join in the game.

One positive and countervailing trend that should be mentioned is the influx into the field of comparative economics of new scholars from the region. People who were raised and educated in those countries have the language skills and an intuitive grasp of how the system works. If they go on to complete graduate school in the U.S. then they can combine mathematical skills with area expertise.[4] Even so, in terms of professional careers they will be judged by their colleagues primarily for their mathematical expertise and not for their area knowledge. One can hazard a guess that in 20 years the only economists in university departments with area studies expertise will be persons who were born in the countries they are studying.

2. The Assumptions of Transition Economics

So, by the early 1990s the bulk of American research on the transition economies was being financed by international financial institutions, and carried out by economists who had not previously studied the CPEs. What were the implications of this for the way those economies were studied and the type of analysis that was offered?

Facts and values

First, one should note that this unique situation led to an unhealthy blurring of the line between positive and normative analysis. Economists often found themselves in the role of giving advice to governments, and then having to justify or disown their advice in the light of consequent developments. The thrust of the analysis was heavily clouded by the conclusions that the author wished to draw. Much of the work had a triumphalist quality, starting from the assumption that Russia was well on the way to becoming a functioning market economy.[5] Most of the business press and newspapers presented a simplistic model of developments in Russia as a struggle between good reformers and bad communists. There was a tendency to prominently report the good news, while ignoring the bad news. Negative developments were attributed to the lingering influences of the communist past and were not seen as possibly the product of the transition process itself. This may be called the “Good News

4 One example of a pre-1989 émigré is Harvard University’s Andrei Shleifer, who wrote (with Maxim Boycko and Robert Vishny) *Privatizing Russia* (Cambridge, Mass., 1995).

5 Anders Åslund, *How Russia Became a Market Economy* (Washington, DC, 1995); Richard Layard and John Parker, *The Coming Russian Boom* (New York, 1996).

Bible" school of Russia-analysis. (In Britain in the 1970s there was an abortive effort to launch a new edition of the Bible that kept the miracles but deleted the slaying and pillaging.)

The difference between facts and values is something that is taught in primary schools in the U.S., yet the distinction has often been forgotten, even by senior economists. Prescription got mixed up with description. Economists typically wrote about what SHOULD or MUST happen in the Russian economy, and not what was actually happening. Analysis of the causes and consequences of economic problems was given short shrift: what counted was proposing a solution to those problems. The tone of analysis often switched around from optimistic to pessimistic and back again, depending on whether market reformers such as Yegor Gaidar and Anatolii Chubais were in or out of power, and on which group of Western advisors was welcome in the Kremlin. One should not necessarily blame the economists for this situation: it was a logical product of the environment within which such knowledge was generated. Host governments needed advice, and the international agencies were eager to provide it. Nobody wanted to hear that a problem had no solution, nobody was even very interested in looking at the costs of tackling a certain problem.[6]

Shifts in analytical conclusions (back and forth between optimism and pessimism) often correlated closely with the personal situation of the economist concerned: were they in or out as a government advisor, were they on or off the international consultancy payroll. This does not mean that the advisors were doing anything illegal or immoral, simply that it is a recognized phenomenon that "Where you stand depends on where you sit." The world really looks different if you are riding around Moscow in a government limousine on a six-figure tax free salary, or if you are a freelance journalist interviewing coal miners half a mile underground in Vorkuta. There are also some grounds for arguing that moral lapses did occur in some cases, since some advisers seemed to allow their personal financial interests to get too closely entwined with the international aid projects on which they were working.[7]

Every action produces an equal and opposite reaction. The "Good News Bible" school more than met their match in the "Merchants of Doom" brigade, in whose writings rosy optimism was replaced by gloomy predictions of destruction. Russia was portrayed as a society characterized by chaos and suffering, and one which was therefore a source of dire threats to the West: ecological catastrophe, nuclear terrorism, organized crime. The possibility of a communist/fascist takeover was also hovering in the background, although in general

6 In 1995, one director of an international agency who was interested in commissioning a report from the present author complained: "You are telling me reasons why we shouldn't be doing this, I want to hear an explanation of how we can do it."

7 Janine Wedel, *Collision and Collusion: the Strange Case of Western Aid to Eastern Europe* (New York, 1999); Janine Wedel, "Cliques and clans and aid to Russia," *Transitions* (Prague, July 1997).

the Mafia had replaced the communists as the face of Russian evil. This depressing genre of journalistic reporting on Russia has a fine pedigree, going back at least to the writings of the Marquis de Custine in the 1830s. Despite the skewed premises, it has also produced some of the most interesting books on the Russian transition.[8]

The dichotomy between these two schools of analysis, the Good News Bible and the Merchants of Doom, is artificial and unhelpful. What is lacking in these two literatures is an awareness of the diversity of experience in Russia since 1991: diversity both by social class and by region. In their rush to heap praise or blame on the Russian economic transition authors prefer to make broad and striking generalizations about macro-level trends: analysis of the regional dimension (see section below) has been poorly represented.

Implications for economic analysis

What were the implications of this blurring of the fact/value distinction for economic analysis? In the following discussion we will take as our model the 1996 World Bank *World Development Report, From Plan to Market*, which is the most sophisticated, rigorous and comprehensive analysis of the transition economies yet produced, and a fine exemplar of the new paradigm.[9] However, the report's analysis is flawed by reliance on three assumptions: Pareto Optimality, the lack of alternatives, and a reliance on financial indicators as a window on the real economy.

First, the old principle of Pareto Optimality was still shaping the analysis: the assumption that the shift to a market economy would be Pareto Optimal, generating a welfare gain that in principle (assuming adequate redistribution) could leave everybody better off than they were before. Economists treated the market as a modern alchemists' stone: a Golden Rule that would benefit everyone in the long term. (The idea that economics is about choices seems to have been forgotten.) The introduction of a market economy would lead to stability, growth, and prosperity for all inside the country in question, and would benefit both that country and their trading partners in the developed market economies. Pareto Optimality was taken for granted: one would have to be an economic ignoramus not to accept the validity of this principle. The gains from reform would leave everyone better off, or at least would create additional resources such that the winners could compensate the losers. If the costs and benefits were unevenly distributed across society, it was assumed that this would be a temporary phenomenon, a matter of a few years of belt-tightening. The World Bank and IMF laid great rhetorical emphasis on the importance of a social safety net to protect groups who lost jobs and income in the transition to a

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8 Stephen Handleman, *Comrade Criminal: Russia's New Mafiya* (New Haven, 1995); David Kotz and Fred Weir, *Revolution From Above* (London, 1997).

9 World Bank, *World Development Report 1996: From Plan to Market*, (Washington DC, 1996).

market economy, although in practice they were less successful in bringing such social provisions into existence.

This new social safety net was to be provided by the state, acting of course in the public interest. How can we be sure that the post-socialist state would act to defend the public interest? Either because (a) economists assume that the state always acts in the public interest; or (b) the state will be acting on the advice of Western agencies, and they have the public interest at heart; or (c) these states are now democracies, so if people have a choice at election time the resulting government must be acting in the public interest. None of these assumptions violate the most elementary principles of political life.

The second operating assumption was the TINA principle (There Is No Alternative). If economists started to feel uncomfortable with Pareto Optimality, they had a foolproof fall-back assumption: the notion that other policy options were bound to fail. The Centrally Planned Economy had crashed in flames, and it was politically and economically impossible to go back to state planning. Not only were alternative models of economic organization not available: even delay was not a viable option. A lot of effort in the 1996 World Bank report is devoted to demonstrating that countries which tried to slow down the pace of economic reform did worse than countries that bit the bullet early on. Countries that failed to liberalize prices and foreign trade (like Ukraine and Romania) experienced a deeper recession and a later, slower recovery than countries that reformed as quickly as possible (such as Poland and the Czech Republic).

The World Bank's correlation exercise looks impressive and convincing. Indeed, nobody in their right mind would want to defend the economic policies pursued by Romania or Ukraine. However, even the World Bank report admits that China belongs in a special category, and is largely excluded from the analysis. The maintenance in China of capital controls, the non-convertibility of the yuan, the lack of privatization of heavy industry and the fuzziness of property rights all violate the holy trinity of liberalization, stabilization and privatization which were being pressed on the East Europeans. The World Bank has also made some oblique references to Uzbekistan's state-controlled economy as possibly representing an alternative path, but overall reaffirms the orthodoxy that one set of economic policies is good for all 27 post-socialist economies of East-Central Europe and the former Soviet Union.[10]

However, looking more closely at the TINA model one starts to have doubts about the One Size Fits All school of policy advocacy. There is no one path to privatization in the transition economies, for example. Some of the World Bank's successful countries did it quickly, through voucher schemes (Czech, Russia); but others did it slowly through piecemeal sales (Hungary), or a combination of the two (Poland), or not really at all (Slovenia). Financial stabilization and the conquering of inflation - the acid test of the IMF model - also turns out to have

10 See the discussion by Andrew Apostolou and Sodyq Safaev, "Is the Uzbek model working?" *Transitions* (Prague, July 1997).

rather heterodox roots. In Poland and the Czech Republic the reduction in inflation was largely due to the imposition of a tough excess wages tax. In Russia the "good" monetary figures were achieved through shifting large parts of the economy into non-cash transactions, from barter to arrears.

This leads to the third key assumption of transition economics: the primacy of financial indicators. One of the first steps in economic reform was price liberalization, designed to stop the shortages which were characteristic of the CPE, and which increased in severity in many CPEs in the last years of the 1980s. Price liberalization triggered an inflationary surge, and getting this under control became a key test of a government's commitment to reform. Currency convertibility and the stability of the exchange rate became the acid test of a country's success, while the importance of other numbers was downplayed. The exchange rate became the "nominal anchor" of monetary policy and the key symbol of a country's adherence to reform. Data on GDP and living standards were considered to be unreliable because they were based on CPE output structure and reporting conventions. Hence data purporting to show a massive, 50 percent fall in GDP in Russia since 1991 were explained away as the result of out-of-date price indices; the loss of negative-value-added production; a surge in under-reporting; a boom in the black economy, etc. In contrast to GDP data the exchange rate was seen as transparent, simple to measure and easily understood. The reliability of inflation indices was not considered to be a serious problem by international economists - although it sparked fierce debate in many countries where pensions and minimum wages were tied to the consumer price index.

Partly this emphasis on prices and exchange rates reflected the expertise of the IMF economists who were re-deployed to monitor the ex-socialist economies. Partly also it was the result of a conviction that economic institutions are malleable: prices create incentives which create institutions. Get the prices right, and you will generate the incentives for economically-efficient behavior. Such profit-seeking behavior will naturally lead to the creation of the requisite structure of economic institutions. Domestic and foreign entrepreneurs will establish new firms, consumers will buy their products, workers will be attracted by their higher wages, and so the virtuous circle will continue. These firms, consumers and workers in turn will put pressure on the political system to create the network of laws and regulatory agencies necessary for a modern market economy to function. There was also the advantage that prices could be liberalized quickly and easily, since it involved the government doing less of something (price regulation). Managing the exchange rate could also be done fairly easily, through the creation of a central money market, and it was something that the IMF and international bankers knew how to do. Creating new capitalist firms, writing new laws and devising mechanisms to enforce them were all tasks that would take much longer and were much more difficult to accomplish. The reformers assumed that those tasks could be postponed until later.

ALTERNATIVES

What were the alternatives to Pareto Optimality and TINA? Marxists would offer a class analysis, under which one some social groups benefit from the changes while others are exploited. But one does not have to be a Marxist to believe that economics is not always a positive-sum game for all involved. Conservatives and liberals alike are also interested in analyzing how the political system works to see cui bono (who benefits)?

Apart from looking at winners and losers with a given country, there is also a differential outcome among countries. It is possible that whole countries may fail to make the transition to a viable market economy. The transition from plan to market may have dual equilibria: one successful point at which positive trends reinforce each other, creating a virtuous circle of growth and prosperity; and a second failure point at which negative trends become a vicious circle of exploitation and decline.

A patriotic economist will be interested in figuring out which countries (east and west) will gain most from the transition, and which will lose, and in which category his country will belong. International advisors may prefer to pass quickly over this question. Economic theory tells us that all countries stand to gain from participation in the international division of labor. However, economic practice tells is that there are parts of the globe where the writ of comparative advantage does not run. It is important to know whether your country will turn out to be Belgium or Benin.

The possibility of a negative equilibrium for a transition economy was not really considered by the World Bank report, nor by the Good News Bible school of commentators. It means asking questions such as: which countries are likely to fall into the vicious circle? What are the alternative policies that could prevent this from happening, or dig them out of the hole into which they have gotten themselves? Such second-best policy solutions may look very different from the orthodox prescription of liberalization, stabilization and privatization. We have not heard much serious debate along these lines. Apart from a handful of Russian economists (such as Sergei Glaziev) the Russian opposition has not come up with much in the way of plausible alternatives to the Gaidar/Chubais program. Their political statements tend to incoherent in economic terms, and their economic programs smack of old fashioned, central-planning notions.

3. IMPLICATIONS FOR RUSSIAN REGIONAL STUDIES

The first section of this paper argues that since 1991 there has been a strong trend in comparative economics away from empirical and institutional investigation in the area studies tradition. Instead the emphasis has been on the introduction of a uniform policy package at national level which focuses on a narrow range of policy variables and the accompanying indicators. This section explores the implications of this argument for the study of Russia's regions.

The Soviet economy was a highly centralized animal: not as highly centralized as the planners would have liked, but very centralized by the standards of Western economies. This fact was clear to everyone: from the managers who took their orders from Moscow to the consumers who traveled to the capital to buy their sausages and sewing machines.

Since 1991 the introduction of a market economy has meant a decentralization of political and economic power. However, the growing geographic complexity of the Russian economy has not really been acknowledged in the work of economists studying the transition. The great debate has been over the success of failure of the nationally-adopted policy of shock therapy. Political scientists have been doing better: there has been a steady stream of books and articles exploring political life in the regions. The same could not be said of economic analysis. Just as there is one set of economic laws, it seems that there is one economy: the global economy. It is assumed that the same process of economic integration that is bringing Russia into the global economy will be accompanied by the integration of Russia's regions into the Russian national economy.

Again, the contrast with the study of China is instructive. China scholars have developed a simple but plausible three-sector model, under which firms are categorized into those producing for the international market; those selling on the Chinese national market; and those confined to the local market within their region. Firms concentrated in each sector have a different set of preferences for national and regional economic policy, and correspondingly a different set of political alliances. To my knowledge no such studies have been done in Russia, the problem has not even been conceptualized in those terms.

CURRENT APPROACHES TO RUSSIA'S REGIONS

Despite the general downplaying of the subject in the dominant paradigm of transition economics, there is of course a growing body of work on the economics of Russia's regions. Much of this work has focused on the challenge of regional diversity. Regions have been categorized in terms of their performance as measured by available economic indicators (real wages, cost of living, wage arrears, unemployment, investment, industrial production, rate of privatization, net transfers to federal center, etc.).[11] Various typologies are constructed of winners and losers, vanguards and laggards.

This is a daunting exercise: with 89 regions, unreliable or hard to get data, and multiple economic and political conditions. Analysts look for patterns in

11 See for example Philip Hanson, "How many Russias?" *International Spectator* 32:1 (Rome, January 1997). On the Russian side see the work of Leonid Smiryagin, for example "Race of the regions," *Rossiiskie vesti*, 20 May 1997.

the data, or some unifying logic to frame the discourse. Have regional inequalities increased or decreased since 1991? Which regions are doing best in the market transition? Usually the typology offers four or five groupings. Economic success awaits the gateway regions with access to the international economy (Moscow or St. Petersburg); resource rich regions (Tyumen, Sakha) or regions who are leaders in market reform (Nizhnii Novgorod). However, when one looks closely at these typologies some puzzles emerge. Why are wage arrears and company debts high even in such a "leading" region as Tyumen? Why is such an obvious "gateway" region as Primorskii Krai mired in crisis?

What are the assumptions lying behind the construction of these typologies? Typically, the concern seems to be with political stability, which is seen as threatened by the growing regional diversity. It is noted that regional inequalities are strong, and were growing rapidly at least until 1995 (since then they seem to have leveled off.) Only 10 of 89 regions are net contributors to the federal budget, and just seven regions provide more than half of all federal taxes.[12]

Various political models lie behind these analyses. One approach is to assume that the federal government sees its role as maximizing social welfare, seeking to ensure basic equality of provision of public goods and a minimum level of welfare in each region. It will therefore seek to redistribute resources from rich regions to poor ones and take steps to ensure the most efficient and equitable distribution of public spending. This public policy approach treats regional policy in Russia much like in any other developed industrial democracy.[13]

A second approach is to assume that the federal government's main concern is not economic welfare but the preservation of national unity and political order. Here the relevant comparison is between Russia and other fragile federal systems, such as the former Yugoslavia or India. In this case, regional policy will be used to buy the loyalty of rebellious regions - those with protesting workers or ethnically-driven autonomy movements. In this second approach, center-periphery relations are conceived as a bargaining game in which the currency of the interactions is federal dollars and electoral votes.[14] This work has generated many interesting insights into the dynamics of regionalism, but it also leaves some questions unanswered. Do political leaders really think and act in these terms (consciously or unconsciously)? Or are the rational patterns that one sees in the data merely in the eye of the beholder?

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12 RIA Novosti, 30 October 1997. The seven are Moscow, St.Petersburg, the Khanty-Mansi and Yamalo-Nenetsk autonomous districts, the regions of Moscow, Samara and Nizhnii Novgorod.

13 Alastair McAuley, "The determinants of Russian federal-regional fiscal relations: Equity or political influence?" *Europe-Asia Studies* 49:3 (1997), p. 431.

14 Daniel Treisman, *After the Deluge: the Politics of Regional Crisis in Post-Soviet Russia* (book manuscript, 1997); Steven Solnick, "Center-periphery bargaining in Russia," *National Council for Soviet and East European Research Report* (May 1996).

One can also advance a third paradigm: to argue that, as in the days of the CPE, Russia is still a special case which demands its own categories of analysis. It can be argued that the texture of political and economic power in contemporary Russia is qualitatively distinctive in ways that are not being fully captured by the public policy and federal bargaining game models. This paper will conclude by outlining three special features of the Russian case: the fragile nature of the Russian federal state; the distinctive fusion of political and economic power in Russia; and the simple geographical challenge of creating an integrated national market in Russia. These factors give a qualitatively unique dimension to the question of federalism and regionalism. (In all three respects, Russia's "uniqueness" is to a large extent shared with many of the other post-Soviet states, especially Ukraine, Belarus and Kazakhstan.)

4. FACTORS WHICH THE TRANSITION PARADIGM FAILED TO TAKE INTO ACCOUNT

THE SHRINKAGE OF THE FEDERAL GOVERNMENT

First, when discussing regional policy one should note the federal government's Incredible Vanishing Act. The federal authorities have simply lost their ability to regulate much of the country's economic activity and hence to raise taxes at the level expected and required of a modern state. Political scientists and historians have for some time been debating the challenge of building a nation-state in Russia, given the lack of congruence between ethnic and political identity and the absence of a unified national political elite. It is time for economists to join this debate, rather than assuming that the character of the Russian state can be taken for granted.

The federal state's ability to raise taxes has shrunk from about 25-30% of GDP in 1990 to 11% in 1997.[15] In the latter year federal spending ran at 17.8% of GDP leaving a deficit of 6.8% (including interest payments on the national debt). On top of that regional and municipal authorities raised and spent about 15% of GDP, and off-budget funds for pensions, social security and unemployment raised and spent another 7%. For comparison: the US federal government raises about 21% of GDP, and the Indian federal government about 33%.

The Russian federal government has walked away from providing a whole range of services that one normally considers a responsibility of the national state. Education and health care have been virtually entirely dumped in the lap of regional governments. More bizarrely, even the Federal Border Guards Service have to rely on "user fees" (legal and not-so-legal), and help from local governments along the borders. (45 of Russia's regions now have foreign borders, 29 for the first time after 1991, and most of them are paying for the con-

15 *Russian Economic Trends* (Moscow: Center for Economic Reform, April 1998).

struction and upkeep of border posts.)[16] Siberian regional governments, for example, have taken it upon themselves to guard the Russian border with Mongolia at their own expense.[17] There are frequent reports that military units have to provide work for local authorities in return for food, or survive by selling off their allocations of fuel and even equipment stocks. Regions with an above-average concentration of indigent military units on their territory, such as Primorskii krai, can be dragged under by the burden of carrying their consumption of energy resources.

The gap between spending requirements and taxation capacity opened up already in 1992. For the next two years, the deficit was covered by the printing of money and the circulation of a bewildering variety of money substitutes. Then in 1995 at the behest of the IMF the government decided to get a grip on the money supply and securitized the deficit by issuing treasury bills (GKOs). This enabled a non-inflationary financing of the deficit, and for a while everything looked fine. However, the debt mountain started to rise alarmingly. The total stock of GKOs rose from 2.4% of GDP in 1995 to 15% at the end of 1997. Another problem was that the market for these bonds was artificially created. It is not clear where the Russian commercial banks were getting the money to buy these bonds. They were not as a rule getting it by attracting domestic savings. In 1997 they only paid an average of 7% on savings deposits, less than the rate of inflation, and most savings were converted into dollars because of fears about the stability of the ruble and of Russian banks themselves. It seems as if a lot of the money to buy GKOs was coming from the Russian state budget itself, with the main buyers being the Central Bank and the state-owned Sberbank (which held more than two thirds of personal deposits).

On top of these domestic machinations, by 1997 one third of the loans for GKOs were coming from foreigners. International commercial banks kept buying GKOs so long as they were confident that Western governments would act as a lender of last resort for Russia. The market for Russian debt was very sensitive to political developments. Events that seemed to show that reform currents were ascendant kept the market afloat through 1996 (President Yeltsin's election victory in June) and 1997 (the "spring offensive" by the new young reformers who joined the government in March). Through 1997 this strategy seemed to be working in terms of bringing down the cost of borrowing. GKO yields, which peaked at 180% during the June 1996 presidential election, fell to 39% by December 1996 and 18% in July 1997. However, yields started to climb after the Asian crisis hit the Russian market in October. By March 1998 Yeltsin had to resort to another political coup - firing Viktor Chernomyrdin as prime minister and replacing him with Sergei Kirienko. However, the debt pyramid continued its inexorable rise, and GKO yields hit 100% at the start of July 1998,

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16 Interfax, 2 July 1997. The Border Guards only got 38% of their planned budget funds in the first half of 1997.

17 *Izvestiya*, 18 April 1997.

triggering the August collapse. Meanwhile, the promised reforms and improvements in revenue generation failed to materialize.

Critics charge that the Kremlin's dependence on GKOs resembled a giant political pyramid scheme with potentially devastating implications for Russia's political and economic stability. Indeed, one can argue that the Russian government was reckless in relying on GKOs to bridge the budget deficit, on the assumption that some mystical reform package would generate economic recovery before they fell due for repayment. This innovation - which had been urged on Russia by the IMF - served to buy the government a couple more years at the helm, but did not address the underlying stalemate in the development of the Russian economy.

THE RISE OF THE BARTER ECONOMY

The second aspect of Russia's uniqueness with important implications for the transition paradigm and regional trends is the re-emergence since 1991 of a dual economy. On one side is the monetized economy, the one you read about in *The Economist* and *Russian Economic Trends*. The firms in the monetized economy pay federal taxes to some degree, file accounts, issue stocks, float bonds, etc. This economy is largely driven by the revenues from oil, gas and metals exports (that account for about 20% of Russia's GDP). It is largely based in Moscow, where all the trading firms are headquartered, and where 80% of bank capital is based.

On the other side is the "natural" economy, where barter is the norm. There, firms go to great lengths to hide their cash revenues, they never report profits, they often hide or don't pay their debts (to suppliers and to workers), and they rarely pay federal taxes (except with other forms of scrip). Some of this economy takes place through physical exchange of goods. A lot revolves around an elaborate and confusing chain of arrears. At the end of 1997 total enterprise debts to suppliers amounted to 12.5% of GDP, to tax authorities 6.6%, to off-budget funds 4.9%, and to workers in the form of unpaid wages 1.8%. This came to a grand total of 700 trillion rubles ($120 billion); or 26% of GDP (up from 22% at the start of the year).

Based on World Bank surveys, Barry Ickes estimated 40% of industrial transactions take place in the form of barter, and notes that the proportion seems to have actually been rising since 1993 - that is, precisely as macroeconomic stabilization was supposedly taking hold (in the monetized economy).[18] It is widely acknowledged that the utilities (railways, Gazprom, Unified Energy System) get significantly less than 40% of their domestic deliveries paid for in cash, probably less than 10%.

The captains of the natural economy often work in collaboration with the political leaders of their region. For them to operate they need a physical space

18 Clifford Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs* 77:5 (1998), p. 53.

in which to reside. Unlike the monetized economy, which can exist in virtual space (in the computer hard drives of bankers or the imagination of financial journalists), the natural economy actually needs physical objects like oil wells and steel mills, and these tend to be located in awkward and outlandish places, far from Moscow.

It is easy for local directors to draw the political elite into the natural economy: that is how the Soviet economy worked, after all, and the political elite, like the economic managers, is more comfortable dealing through personal networks than dealing in cash. Trust is what keeps the natural economy going. Goods are supplied and services rendered in full knowledge that they will not be paid for, and hence not taxed - but secure in the knowledge that the favor will be returned at some point in the future. It goes without saying that this "moral economy" is riddled with corruption and immorality. This is trust Soviet-style, and a long way from what Francis Fukuyama has in mind when he invokes trust as a vital prerequisite for the development of capitalism.

The allocation of what few federal funds there are is a painful process for all concerned. "The rhythm of the arrival of federal budgetary allocations resembles most of all the last beats of the heart before a man dies. So, the majority of governors do not even take the trouble to think for what purposes the money is earmarked. They spent it on what they think is of greatest importance at a particular moment."[19] According to Oksana Dmitrieva, chairman of the State Duma Budget Subcommittee: "Pumping federal money into the regions, given that they are not under the control of the center, is like trying to fill a barrel riddled with holes."[20] The government is annoyed that once federal funds are sent to the regions they have no control over how they are spent, with funds often diverted to causes that the government does not approve (such as subsidizing energy prices). But the Kremlin lacks the political capacity to enforce its economic policies, even when it comes to spending federal program funds.

The sparks really fly when Moscow tried to extend the monetized economy to colonize some of the natural economy. The main vehicle for this was the privatization drive: selling state assets to new owners for cash will tend to move the firms in question closer to the money economy. Privatization through cash sales usually boiled down to transferring ownership from local elites to Moscow-based banks, possibly in cahoots with foreigners. (Sometimes the local elite joins forces with the foreigners and together they try to fend off the Moscow whiz kids.) Major scandals have erupted around the privatization of such crown jewels of the economy as Norilsk Nickel, Belgorod iron works and Tyumenneftgaz - and in each case these disputes had a very strong Moscow versus the Provincials component. In some of these cases it boiled down to which faction the local police would physically support in their efforts to get into the administration building of the plant.

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19 Vladimir Shpak, "Three acts of intimidation," *Segodnya*, 16 June 1997.

20 Oksana Dmitrieva, "All quiet on the main front," *Moskovskie novosti*, no. 29, 20-27 July 1997.

A second way the reform drive showed was up in efforts make tax deadbeats pay up and to close down bankrupt firms. In late 1996 President Yeltsin formed the Temporary Extraordinary Commission for Tax Collection (whose initials mimicked those of Lenin's Cheka secret police), with Chubais at its head. This was clearly an effort to overcome the adminstrative degradation of the federal authorities by creating a new politico-bureaucratic institution. The new Cheka proved to be less effective than its Leninist predecessor: most of the firms on its hit list continued to accumulate tax arrears in 1997. Tax receipts for the year amounted to about 75% of the target level. One hundred major enterprises owed around 40% of all tax arrears, and two thirds of these arrears were generated by the energy sector. In March 1997 a presidential decree called upon firms to hand over to the government shares equal to their tax debts: the government would then sell the shares, in effect reprivatizing the firm. Another scheme was to broker individual deals to restructure old tax debts. In October 1997 the auto giant AvtoVAZ signed a deal to pay back 8 trillion rubles in tax arrears over 10 years.

For all the talk of transparency and rule-setting, all these maneuverings were highly politicized and were tied up with intra-elite power struggles. Hence for example in December 1997 Chubais's Cheka announced that it had decided to declare two tax laggards bankrupt - the Omsk and Angarsk oil refineries, which owed federal taxes of 766 billion rubles ($128 million) and 526 billion rubles respectively. The Angarsk refinery belonged to Sidanko, part of Vladimir Potanin's Oneksimbank empire, while Omsk belonged to Sibneft, owned by Boris Berezovskii's group. However, Chubais' effort to seize the firms' assets was blocked by premier Chernomyrdin. Chubais also tried to put the squeeze on regions that were witholding taxes, especially the republics of Tatarstan, Bashkortostan and Sakha (Yakutiya). He had little luck with those republics, although he easily quashed an attempted tax revolt by Irkutsk oblast in March 1997. To clear the 1997 budget Chubais, gritting his teeth, agreed to what he described as "disgusting" tax offsets (where firm's tax arrears are set against debts to them from state organizations) worth 60 trillion rubles.[21] After a year of effort, the federal government's attempts to close the gap between the monetary and barter economy seemed to be heading in circles.

The challenge of geography

The one-size-fits all approach to economic transition assumes that prices will work their magic whatever the size and shape of the economy in question. That geography may have to be taken into account as an independent factor was implicitly and explicitly rejected by market reform advocates in 1991-92, when there was an open debate about whether Polish style "shock therapy" would work in Russia.

21 Aleksandr Bekker, "Chubais's financial balancing act," *Moskovskie novosti*, no. 45, 9-16 November 1997.

Seven years later, it seems clear that the geographers were right. Even Jeffrey Sachs, an advocate of rapid liberalization for the Russian economy, has rediscovered the power of geography.[22] Sachs underlines one of the home truths in Adam Smith's *The Wealth of Nations*: that transporting goods by sea is much cheaper than transporting them by land. Sachs argued that the costs of sea freight are still radically lower than land freight, and through a correlation exercise found that proximity to the ocean is a decisive factor in explaining long-term rates of GDP growth.

Russia's economy has unique geographical characteristics of size, terrain and climate which arguably sets it apart from smaller economies. Added to that is the legacy of 75 years of Soviet rule, under which investment was directed in accordance with calculations of national strategy, creating a highly militarized economy far removed from the push and pull of market laws of supply and demand.[23] A vast economy that was built by non-market methods will probably have to be dismantled by non-market methods, at least in part.

5. CONCLUSION

If the above analysis is correct, then the prospects for the future of the Russian economy - and for the utility of Western assistance - look rather bleak. The economics discipline appears to have turned its back on area studies and threw its weight behind an ambitious program for a rapid transformation of the former Soviet Union into a market economy. This program did not take root in Russian conditions. It now seems clear that the formulaic approach failed to take account of certain distinctive features of the Russian economy, such as its geographical size and distorted, militarized structure; the obstinant reliance of many economic agents on non-monetary transactions; and the collapse of authority of the federal government.

These failings show up most radically at regional level, with the implication that policy solutions to tackle them must have a regional dimension if they are to succeed. However, one may doubt whether the economics profession has the expertise and personnel required to craft such a regionally-aware strategy for reviving the Russian economy.

22 Jeffrey D. Sachs and Andrew Warner, "Fundamental Sources ofLong-Run Growth," *American Economic Review* 87:2 (1997), p. 54.

23 Clifford Gaddy, *The Price of the Past: Russia's Struggle With the Legacy of a Militarized Economy* (Washington DC, 1998).