

Public Preferences and their Role in Shaping Russian Economic Development

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Andrzej K. Koźmiński: Today we have a great pleasure to host here at the Leon Koźmiński Academy of Entrepreneurship and Management one of the most eminent figures among Russian academics in the field of economics - Prof. Alexander Nekipelov. It has become a tradition in our Academy to host once or twice a year famous economists, experts in the field of management and organization theory. Today we are hosting Prof. Nekipelov. May I ask Prof. Kolodko – Director of TIGER - to introduce our honorable guest.

Grzegorz W. Kolodko: It is already the fifteenth event in our WSPiZ and TIGER series of *Distinguished Lectures* (see: www.tiger.edu.pl/publikacje/dist.htm). All of them have been published and are downloadable from the website of Transformation, Integration and Globalization Economic Research – TIGER – at www.tiger.edu.pl. And today's lecture will soon be accessible there too. Yet before it happens we have the pleasure today of listening to the lecture presented by a leading Russian economist – Professor Alexander Nekipelov.

Professor Nekipelov is currently is the Deputy President of the Russian Academy of Sciences and the Director of Moscow School of Economics at the famous Moscow Lomonosov State University. He is also an Academician that is the full member of the Russian Academy of Sciences. Earlier, for a number of years, he was the Director of the Institute for International Economic and Political Studies at the Russian Academy of Sciences (see: www.transecon.ru/EN/info.php).

A graduate of Moscow State University with a doctoral degree in economics, Professor Nekipelov has concentrated his academic work in the fields of international economic relations and economic systems in socialist and postsocialist countries in transition to a

market system. He is the author of more than 170 published works, of which many are in English.

Professor Alexander Nekipelov lecture is entitled *Public Preferences and their Role in Shaping Russian Economic Development*. The choice of such a topic is not an accidental one. As the Author has stated in the *Introduction* of his paper, “The problem of public preferences influence upon the strategy of economic development of a country is a permanent one, but now in Russia it is becoming, or should become, one of the most important challenges.” And the answer to the question: *Why is this so?* is the main thrust of this important and interesting contribution.

The debate on the role of the state, or government, continues. We have had a chance to learn on this subject from Professor Janos Kornai during his November 2001 WSPiZ and TIGER *Distinguished Lecture* No. 9 on *The Role of the State in a Post-Socialist Economy*.¹ The arguments in favor of and against an active role played by the government in settling the aims and agenda of economic policy – as well as the set of the instruments at the disposal of the government involved – is far from over even in the developed, sophisticated institutionally market economies. It has also been quite recently a point of substantial difference between the two candidates for the USA President – Mr. George W. Bush and Mr. John Kerry. So all the more that this must be a focal point of further intellectual and political debate in postsocialist transition economies, engaged in vast structural, institutional, political and cultural change.

One must agree, I think, with Professor Nekipelov when he is presenting a theoretical way of reasoning, showing that an emerging economy – as it is the case of Russia and all other, although to a different extent, postsocialist countries, including the new members of the European Union – must take care of setting its agenda for development. It is virtually impossible to leave it without state intervention. Hence, one needs the active role of the government. There is no doubt about it even among the followers of the naïve neo-liberalism and the zealots of market fundamentalism. Are they in Russia or in Poland, in East Central Europe or in Latin America, or even if they are at the International Monetary Fund, there is now a deep conviction that there is a lot to be done by the government in the contemporary market economy.

¹ See Janos Kornai, *The Role of the State in a Post-Socialist Economy*, Warsaw, Leon Kozminski Academy of Entrepreneurship and Management, *Distinguished Lecture Series*, No. 9, November 2001 (see: www.tiger.edu.pl/publikacje/dist/kornai.pdf).

The is all the more true *vis-à-vis* the postsocialist countries.² The government is indispensable in shaping and streamlining the market institutions, upgrading the hard infrastructure of the economy and supporting the investments in human capital. Yet by what means and to what extent – these are the issues that remain to be disputed. How much and how fast should one downsize the government? Or is it all not about the size, or downsizing of the government(s), but rather about the need of redefining the role the state should play in the emerging market economy of the postsocialist type, for the sake of faster economic expansion, the increasing competitiveness of the private sector and the increasing standard of living among people.

Professor Alexander Nekipelov's paper and his WSPiZ and TIGER lecture is a significant contribution to the ongoing discussion on all these challenging issues. I am sure that we will be pleased to learn from his expertise, knowledge and train of thought. Sasha, welcome to the Kozminski School of Business and TIGER, and the floor is yours.

Alexander Nekipelov: The problem of public preferences influence upon the strategy of economic development of a country is a permanent one, but now in Russia it becomes, or should become, one of the most important challenges. Why is this so?

The emphasis during the first stage of post-communist transformation was, for good reasons, placed on systemic reforms. At that time the issue of what should be the attitude towards the collapse of the production structure, which had emerged under communism, and social problems, which would necessarily accompany such a collapse, was hardly addressed at all.

As far as public opinion is concerned there existed then a consensus with regard to the necessity of transition to the new (market) economic system. True, in the course of such transition serious mistakes, which significantly increased social costs of reforms, have been committed, but this is a different story.

In fact the essence of reforms was reduced to liberalization of economic activity of enterprises, fast privatization of the latter and to the firm adherence to the policy of macroeconomic stabilization. However, despite expectations of the reformers, forced privatization, based on a distorted version of voucher scheme, had not produced genuine

² More on the subject see Grzegorz W. Kolodko, *From Shock to Therapy. The political Economy of Postsocialist Transformation*, Oxford University Press, New York 2000 and Joseph E. Stiglitz, *Globalization and Its Discontents*, W. W. Norton & Company, New York – London 2002. See also Grzegorz W. Kolodko (ed.),

market agents; new shareholding companies featured irrational systems of corporate governance. The situation was further aggravated by the preservation of a large number of public enterprises totally ignored by their owner – the state. As a result a quasi-market system had emerged, which oriented its agents rather to stripping off assets than their consolidation. The economy quickly sank into a crisis of arrears. In this environment, standard measures of macroeconomic stabilization produced results, which could never happen in a normal market economy. Imposing tight controls on money supply rather led to a very strange phenomenon of a growing physical deficit of money rather than to moderation of inflation. Cutting budget expenditures surprisingly produced a deterioration of the fiscal position of the government because it provoked a new wave of arrears and, as a result, decline in tax inflows.

It should be admitted, however, that this mutant-type economic system contributed to the softening of a shock, to which the Russian economy had to be exposed due to the massive reallocation of resources accompanying the introduction of market mechanism. Actually, it is difficult to go bankrupt when it is feasible to ignore the necessity of paying one's bills. But the price of such an anesthesia turned out to be very high: the degradation of nearly all production capacities, especially in hi-tech branches of the economy.

As is well known, the huge decline in production, investment activity and living standards of the population in the 90. resulted from these policies. To make it even worse the authorities striving at the attraction of foreign capital to close the budget deficit opened in an adventurous manner the market of government securities. As a result, in August 1998, Russia suffered financial default and found itself on the edge of economic chaos because of the factual bankruptcy of the banking system.

On the second stage the main efforts of the authorities were concentrated at first on overcoming the consequences of the crisis and, later, on structural reforms, which had to create an adequate institutional environment for market economy. This latter shift in policies should be positively assessed though hot discussions are still under way with regard to concrete reforms.

The rationalization of economic policies and, later, favorable world market conditions contributed to the resumption of economic growth, investment activity and the gradual restoration of living standards of the population. The threat of default on foreign debt commitments was done away with. Significant foreign-trade surplus during all the years

beginning from 1999 provided for fast growth of foreign-exchange reserves, which have now reached \$90 billion. A federal budget surplus has been maintained through all these years; pragmatic monetary policy allowed permanently diminishing inflation and simultaneously prevented a drastic rise in ruble real exchange rate in conditions of massive inflows of foreign exchange.

Summarizing, the current economic situation of the country is good enough. And that is one of the main reasons why problems of a strategic nature acquired such an importance now. One should take into account that the unprecedented decline of the economy in the 90. has left a series of dangerous long-term problems: an extremely high level of wear and tear of industrial capacities as a whole and production infrastructure in particular; exaggerated reallocation of resources in favor of raw materials sectors along with obvious degradation of hi-tech industries; extremely high level of income differentiation both among the members of the society and the regions of the country.

In this lecture I would like to elaborate on the following issues: what is (or should be) the relationship between public interests and economic policy pursued by the government in general, and what are the concrete consequences of this relationship to modern Russia, in particular? To answer them one has first to realize what public preferences are. It seems expedient in this context to look first how economic theory tackles the problem of individual interests and then to understand to which extent this approach can be applied for the analysis of decision-making at the group level.

Individual Interests in Economic Analysis

Let me just repeat the well known elements of the Pareto position with regard to the individual dimension issue, which is an important part of the modern economic theory.

According to Pareto there is no need to look for an “objective” measure of utility. He found that it would suffice to start from the following assumption: each individual is able to compare various feasible commodity bundles in terms of “better”, “worse” or “equal”. Pareto showed that mathematically speaking any individual’s hierarchy of needs can be presented in the form of a “map of consumer preferences” consisting of an infinite number of “indifference curves”, each of which joins together commodity bundles that are of equal value to the individual in question. After that the problem amounts to finding such a commodity bundle affordable under resource constraints as is located on the highest indifference curve. Let us define this optimal position as corresponding to an interest of the individual in question. Thus

a notion “ interest” would acquire a measure of objectivity in so far as it would reflect not only subjective preferences, but very tangible resource constraints as well. At the same time we remain in harmony with a widespread understanding that interests are the driving force behind the economic process.

From Pareto’s approach to individual decision-making it follows that for the optimal use of an available resource its marginal inputs should yield the same return in every possible area of its application. If we examine the behavior of a consumer in a market economy, the resource at his disposal is money, and if we analyze the behavior of Robinson Crusoe we shall find that the main resource here is the time of his life, which he has to allocate efficiently to different productive and “leisure” activities.

The temptation is very strong indeed to apply the same algorithm to any group of individuals, be it a club of chess-players or a sovereign state or even the global society. A group in question would then have a set of preferences with regard to all corresponding feasible states of the world and limited possibilities (resources) at its disposal. The group’s interest would then correspond to the affordable state of the world at the highest indifference curve. Equal marginal returns of resources would characterize this optimal position from the respective group’s point of view.

But the question arises: how can we know the map of a group’s preferences? In the case of individual decision-making Pareto easily avoided it with a reference to the exogenous nature of preferences. We cannot repeat this trick here, because any group consists of individuals with preferences, which, loosely speaking, have something in common. So what we have to do is to explain how interaction of individual preferences generates preferences of a group.

Interests of a Group: What They are and How They Emerge?

A. Bergson tried to resolve this problem in a straightforward manner having determined in 1938 social utility as a function of individual utilities of the group members³. But K. Arrow in his famous possibility theorem⁴ showed that there is no other social choice rule than taking decisions by a “benevolent dictator”, which can provide for such a ranking of possible social outcomes that would be asymmetric and negatively transitive, Pareto efficient and independent of irrelevant alternatives. This conclusion resulted in some authors’ conviction

³ Abram Bergson. A Reformulation of Certain Aspects of Welfare Economics. “Quarterly Journal of Economics”, #52, 1938, pp. 310-334

that group preferences do not exist at all. For example, E. Zilberberg is quite ironic about this notion writing that: “It was common for classical economists to speak of ‘the benefits to society’, the interest of the ‘working class’, and other such phrases that implied a sufficient harmony of interests between members of the relevant class to permit speaking of them as a group. Today we often hear of individuals representing ‘the interests of consumers’ or of someone taking the position of ‘big business’”⁵. He further says that on a “more intuitive basis, the reason sensible social welfare functions cannot exist is that they conflict in a fundamental way with the notion that more is preferred to less. At any given moment, there is a frontier of possibilities for the consumers in any society. Any movement along this frontier involves gains for some individuals and losses for others. Without a measure for comparing these gains and losses between individuals, there is no sense to the phrase social welfare”⁶.

This position does not seem irreproachable to me. First, we may not, for good reasons, like dictators, but the fact that this type of decision-making provides a sound social function rule should not be ignored. Second, one has to take into account constraints of the model, especially that of the exclusively individualistic behavior of people. We know that in real life they care not only about their well being, but also, to this or that extent, about the state of the environment they live in. For instance, progressive income taxes are common to many countries, which testifies to the fact that people do believe that wealth redistribution can improve the position of society as a whole. Third and most important, there is a huge number of various groups and all of them formulate their interests and take decisions.

It is important to understand: in order that the interest of a given group might take shape on the basis of the individual interests of its members, there should be a legitimate procedure, institutional framework for aggregating these interests recognized by the group’s members. D.Kreps writes: “Rather than thinking normatively about desirable properties for social choice we regard ‘social choice’ as the product of individuals interacting in various institutional environments. We describe those institutions and predict the outcome of individual actions within these institutions”⁷.

Of course, “procedures” in this setting are not exactly the same as the above mentioned social choice rule: the former lead to this or that outcome, that is direct manifestation of

⁴ K.Arrow. A Difficulty in the Concept of Social Welfare. “The Journal of Political Economy”, #58, pp.328-346

⁵ Eugene Silberberg. The Structure of Economics. A Mathematical Analysis. Second Edition. McGraw-Hill Publishing Company, 1990, p.573-574

⁶ Eugene Silberberg. The Structure of Economics. A Mathematical Analysis. Second Edition. McGraw-Hill Publishing Company, 1990, p.577

⁷ David Kreps. A Course in Microeconomic Theory. Princeton University Press, 1990, pp. 181

interest, the latter – to ranking of different states of the world, that is preferences. Interests are on the surface, whereas preferences underlie them.

Of course, the aforesaid is largely a tautology. Its literal meaning is as follows: in order to make a decision it is necessary to make a decision on how to make a decision. But in this case (at any rate, I would like to think so), this verbal tautology reflects a real property of the object being examined. After all, the adoption of any decision by more than one person presupposes explicit or implicit consent by the group's members to the rules of decision-making.

It is also clear that with such an interpretation of group interests the latter lose their distinctness and tend to “blur”; moreover, it turns out that the configuration of interests is directly dependent on the procedure adopted for their identification. An awareness of this circumstance makes it possible, on the one hand, to adequately interpret the dynamics of many social processes and, on the other, to understand the artificial nature of the notion that social interest is something ossified (“objective”) and independent of the preferences of individual people. In other words, this rules out the position according to which the members of society can sometimes have no relation at all to the formation of their common interest, while a single individual or a small group of people can arrogate to themselves the right to speak and act on behalf of society as a whole.

As regards individual preferences, economic theory views them as an exogenous, externally given factor and does not think it possible to judge whether they are correct or incorrect. What is important for the economist is the consequences of various individual interests for the operation of the economy, and not their moral assessment. I am convinced that this approach should be extended to group interests as well. They should be seen as exogenous in relation to economic investigation proper, in the sense that it is the political system that is responsible for their formation. It is also absurd to treat them as “good” or “bad”, “modern” or “Soviet”. *The real purpose of economic science is to investigate what kind of economic policy has to be devised under a given configuration (pattern) of social preferences.*

Incidentally, it follows from the above that it is not quite correct to contrast political and economic considerations, as often happens when people say that a certain decision was adopted on the basis of political rather than economic factors. After all, economic regularities are themselves permeated with the value orientations of economic agents. When consumers spend their income on the purchase of certain goods and so determine the allocation of resources in society, they are acting exclusively in accordance with their own system of

preferences. But the decisions being taken within the framework of the political system and affecting the allocation of resources are just as “objective” (and just as “normative”) as those dictated by the market proper. *Hence an important conclusion: the economic sphere is not confined to the sphere of operation of the market mechanism, but also unquestionably includes, as a component part, the instruments used by society to adjust that mechanism.* Consequently, insofar as the political system plays a key role in the process of formation and realization of a part of social (including economic) preferences, its efficiency is a key condition for the normal operation of the economic system.

Market as a Mechanism of Formulation and Realization of Public Interests

Incidentally, the concept developed above fully applies to the market mechanism for aggregating individual interests, since this mechanism can perform its role only because economic agents are prepared to observe certain rules: to respect property rights, seek to maximize the degree of satisfaction of their needs, etc.

To understand how the market mechanism performs the function of aggregating individual interests and thus realizes social interests it is sufficient to look at the demand and supply functions.

The demand function is known to characterize the quantity of goods that consumers are ready to buy at the given price level. In this sense, different prices are valuations or, to be more precise, marginal valuations of social utility. Under a perfect market economy model, when equilibrium is simultaneously established in all markets, we can say that the market determines the levels of marginal social utility for different kinds of goods.

The supply function is based on the function of marginal costs. Under a general equilibrium, marginal costs represent marginal social costs, because they reflect the distribution of all the resources existing in society among possible alternative uses. Since in a state of equilibrium supply must equal demand, from the standpoint of the problem being examined the marginal social utility of goods must equal marginal social costs. So, it turns out that the market is a mechanism for realizing public (social) interests by aggregating individual interests in accordance with the procedure characteristic of the social system in question.

It is also worth mentioning that in the perfect market economy GDP turns out to be a natural criterion of the market efficiency on a societal level, because its maximum value is to be realized when individual firms do their best to maximize profits.

Why not Market Alone?

If the market is an institution helping to achieve a socially efficient outcome, do we need to retain other institutions for realization of social goals?

For various reasons the answer should be positive. The need to form common interests exists not only in the economic sphere, where market mechanisms can operate. But the market cannot be regarded as a universal mechanism for transforming individual preferences in social preferences in the economic sphere either. In this context, one could recall the well-known theoretical problem of so-called *market failures*, that is, cases where the market cannot cope with the task of achieving socially beneficial outcomes.

The *first* case concerns the need to determine the amount of resources to be allocated by society for the production of so-called public goods. A market-type mechanism in this area simply cannot work. That is why we have to use other mechanisms to determine the amount of resources that society wishes to set aside for the production of the respective goods.

The *second* case of market failure is connected with externalities. Economic theory has developed the principles of an adequate response by the state to negative externalities. The standard recipe for the problem of environmental pollution is to introduce environmental charges. But how do we determine the rate of pollution tax? One should bear in mind that the decision on the amount of environmental charges is of critical importance: this decision must ensure an increase in the polluting company's costs to the level of aggregate social costs incurred in the production of the given products.

We know from experience that the authorities in accordance with their understanding of the public interest establish the rate. The market mechanism in this area cannot serve to aggregate individual preferences for the simple reason that there is no market (in this case, a market of pollutants). True, there are interesting attempts to create some kind of quasi-market institutions in this field – I mean trade in pollution quotas. Such an approach undoubtedly deserves the most serious attention, but one cannot fail to see that it does not do away with the initial question: who and how should set these quotas so that they would reflect the social preferences as regards the economically sound scale of production activity involving pollution of the environment?

The *third* case I would like to mention refers to informational problems. The conclusion about Pareto-efficient operation of a perfect market economy is based on the assumption that market agents make decisions while being in possession of complete information. However,

this is not only impossible, but in a certain sense is in contradiction with the clearly manifest trend towards a commercialization of information.

One of the most graphic examples of a sphere where information asymmetry plays a special role is health care. What we have here is an essentially unbridgeable difference in the information at the disposal of the doctor and the patient. In most cases, the patient knows that he is unwell, but has no idea about the nature of his illness, let alone about how to treat it. The doctor, for his part, claims (and in many cases his claims are not unfounded) to know how to treat the illness. That is precisely why there is no simple market solution to the problem of organizing the provision of health care services to the population and in all civilized countries the government intervenes in this or that way trying to serve best the public interest.

Finally, there is a very important *fourth* case of market failure. One can imagine a situation where there are no obstacles to the operation of a perfect market, but where society is nevertheless dissatisfied with the results produced by that market. In this case, society begins to “distort” the operation of the market mechanism by introducing various restrictions. By way of example one could refer to so-called *merit goods*. These include goods and services with regard to which society has special normative judgments (either positive or negative), and these judgments cannot be fully revealed by the market. For example, the sale of narcotic drugs is prohibited in most countries. Why do we need this administrative barrier to the operation of the market mechanism? Only because the results of such an operation are regarded by society as extremely negative. Incidentally, there is a special word in English-language economic literature to designate such goods: “bads”. There are also cases where society takes a somewhat skeptical view of less glaring results of the operation of the market mechanism. As mentioned above, in the conditions of perfect competition this mechanism enables the economy to reach the production possibility frontier, that is, to make Pareto-efficient use of all resources. But the exact point on that frontier in which the economy operating in such favorable conditions finds itself depends on a number of circumstances, including the pattern of property distribution among the members of society. If there is great inequality in the distribution of social wealth (“at input”), there is also bound to be serious inequality in the levels of income received (“at output”). What will society’s attitude be towards such a fact?

There is no single answer to that question, because different societies differ in their attitude to gaps in the incomes and wealth of their members. Brazil or the USA is one thing, while the Scandinavian countries are quite a different matter. The latter have traditionally made very active use of the tax system to redistribute income so as to markedly reduce social inequality.

Of course, they are well aware of the conclusions of economic theory which say that such actions prevent the economy from reaching the production possibility frontier and, consequently, from making efficient use of resources. Nevertheless, these countries continue to adjust the market distribution of income in the belief that this meets the highest public interests. An important thing for us to understand here is that *economic theory regards this problem as a normative one and cannot side with either party to that dispute.*

Finally, there is yet another interesting reason for the emergence of situations where the market and public opinion “view” one and the same problem from different angles. The point is that the standard constructs of economic theory are based on the assumption that the preference systems of society’s members are independent of each other. In other words, each of us can maximize the degree of satisfaction of our own needs only if, to put it crudely, we “don’t give a damn” about what is going on around us. An important point to emphasize here is that the market operates precisely on such a basis. Otherwise it would have been impossible to arrive at uniform (i.e., indifferent to the objective distinctions both between buyers and between sellers) prices, interest rates, exchange rates, etc. But life shows that people’s utility functions are never totally isolated from each other. Of course, each person wants to have a higher income, but at the same time (in varying degrees, very differently and very subjectively) wants to be in a social environment that would at least not be hostile to him or her. Since the market is unable to bring out this objectively existing interdependence between individual utility functions, people find it necessary to make some corrections to the activities of the market.

So, although the market is undoubtedly a very powerful and effective mechanism for aggregating individual interests, it cannot and should not be regarded as a universal instrument ensuring an effective solution of this problem in all situations. In other words, in many cases it has to be supplemented with other mechanisms for shaping group (including social) preferences.

GDP and Public Welfare

And now – the last theoretical question I would like to dwell upon before going to Russian realities. Earlier I affirmed that GDP is a natural *market* criterion of efficiency at the macro level. Can this thesis be applied in a broader sense saying that GDP is a natural criterion of *economic welfare*?

Consumer preferences deal with bundles of consumption goods. Similarly, social preferences deal with different in-kind vectors of the social final product. The latter provides for flows of current public utility (due to personal consumption by the members of the society in the respective period) and future public utility (due to investments of the current period in physical capital and inventory). The economic welfare of the society depends upon its ability, using all existing resources, to choose such a structure of final product in the current period and in future, which would maximize its utility function under the existing institutional framework.

But this task is by no means easy. The problem is in its huge dimension, which makes it impossible to rank all feasible, from the point of view of existing resources, vectors of the social final product. Market economy, indeed, makes it a little bit easier, because here the society is bound to assess only necessary corrections to the market allocation of resources. But still, the issue remains intractable by the method of complete inventory of existing possibilities.

That is why since A.Pigou the following position remains unchallenged in economic theory: "... the range of our inquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with the measuring-rod of money"⁸. As a result such indicators as GDP are usually regarded as quite precise measures of social welfare. Their acknowledged deficiencies refer to the fact that GDP cannot incorporate the products of economic activity, which have not passed through market exchange: household labor, damage to the environment etc.

We have got used to this, so to say, scalar indicator so much that we ignore its more important deficiency. Our logic runs as follows: if separate goods and services are estimated in money terms there is nothing bad in assessing flows of goods, produced by a group of people and consumed by them during respective period, in money terms as well; if individual income is a good indicator of man's welfare then aggregate social income should play the same role for society as a whole.

But this logic comes in contradiction with the position of modern economics that the exchange value of a good is rather an estimate imputed to it by market than an objective feature imminent to the respective good. The principle that interpersonal comparisons of utilities are not allowed is also violated when we sum up money incomes of different persons. As a result: if we have different distributions of \$1000 between two people – 0-1000, 500-500

and 1000-0 – we cannot affirm that the welfare level of this group is the same in all three cases. In fact, we can say nothing about the welfare of this group until we know interrelations between individual and group utility functions.

A very different allocation of resources, distribution of income models, position of the state in question in the global economy etc. can take place at the same level of GDP. Similar to individual consumers, who cannot neglect the concrete bundle of goods in which their income will be transformed, society cannot be indifferent to the structure of GDP and its distribution.

The conclusion is: aggregate money indicators should be considered only as rough and, from a ‘pure science’ point of view, not entirely correct approximations of the level of economic activity and social welfare. Having no practical alternative we cannot help using such indicators. But we should not forget about their true nature and limitations, which the latter places on them.

That is exactly why in the majority of cases governments try to complement such indicators with a set of others, which reflect this or that side of public preferences. The latter serve as an instrument of additional approximation to the ‘genuine’ level of social welfare. One should be sure that such algorithm rather provides for permanent correction of situation in favorable direction than to realizing an ideal social optimum.

Russia at the Crossroads: What’s at Stake?

It should be admitted that in recent years the Russian authorities have formulated some strategic targets: to double GDP during 10 years, to combat the poverty, to radically improve the situation in education and health care, to create an efficient innovation system and to modernize the economy as a whole. The President has declared it the ‘breakthrough strategy’. In no case should this attention towards strategic issues be ignored: such problems are irrelevant to those who are sure that market mechanism alone is capable of settling everything in the best way. But euphoria is also inappropriate for the opponents of ‘market romanticism’. Strategic choice is not just a bundle of good wishes. It should discern a path in future for the society based on its preferences and available resources. And it goes without saying that the pursued economic policy is bound to correspond to the choice made.

⁸ Pigou, Arthur C. *The Economics of Welfare*. Macmillan and Co. London 1932, Fourth edition (Ch.1)

What's Wrong with the Government Approach?

From what I have already said earlier about GDP as an indicator of social welfare my cautious approach to the course of doubling it during 10 years follows. It is about principle, not figures. No doubt, the speed of economic development matters, but only if we have taken a decision on the direction of the development and respect it. Putting it another way, the task of growth rates maximization has to be formulated with constraints, which would provide for the movement of the economy along the chosen path. Otherwise one can easily and very quickly find himself in a situation, which one never considered as desirable. For example, under certain circumstances high growth rates could accompany further de-intellectualization of the Russian economy, concentrating the bulk of its potential within the fuel and raw material sector and conserving huge income differentiation.

But special apprehension is excited by the contradiction between the declared strategic aims and economic policy, which has been pursued till now. Actually an important positive shift has occurred only in the attitude towards the integration of the Russian economy in the global economy. Awareness of the game character of economic interaction between states seems to have substituted for exotic declarations that Russia was going to become or even had already become the world leader in the sphere of liberalization of its economy. The authorities deserve praise for the position aimed at defending national interests taken in recent years in negotiations on WTO accession. But still there remain numerous birthmarks of primitive liberalism in the attitude of the authorities towards the way most important economic issues should be tackled.

It is still unclear how the government is planning to reach the goal of modernization of the national economy. It seems as though all the hopes are linked to the improvement of market institutions alone. If this assertion is correct it means that the authorities believe in wonders, because the Russian hi-tech sector is now in such a poor state that it is uncompetitive not only with regard to similar foreign producers and the national raw material sector but also relative to many other non-sophisticated sectors of our economy.

Nothing but obsession of the authorities by the idea of abstract liberalism and lobbying efforts of certain circles of Russian business can explain the hasty liberalization of foreign-exchange and the capital flows regime in conditions of still very weak financial institutions. Now the economy has already faced the negative consequences of this decision: massive

inflow of cheap foreign credits has led to the growing foreign-exchange exposure of the Russian banking system and increased an overall indebtedness of the country.

Introduction of the flat personal income tax rate of 13 percent is another tribute to the liberal ideology. There is no clear evidence that this measure has led to a growing flow of this tax in the state budget, but it certainly contributed to the widening of personal income differentiation.

Absence of the normal system of real estate taxation creates some serious problems too. In particular, we are now witnessing in big cities a phenomenon when a significant part of dwelling purchases is made for speculative reasons. Thus a dangerous financial balloon is getting shape and this is fraught with well known unpleasant consequences for economic development as a whole. These problems can be aggravated even more if a proper system of land taxation, especially in big cities, is not put in place quickly. We all know the huge destabilizing nature of land as a speculative asset.

‘Market romanticism’ is especially evident in the character of reform, which is being undertaken now in the budget sphere. The declared goal here is transition to financing according to the concrete results achieved. In situations when government services are to be rendered to population, as is the case with health care and educational services, it is proposed to apply the principle according to which ‘money follows consumer’ instead of direct financing of organizations, which provide respective services.

But the problem here is that in many cases the so called ‘concrete results’ cannot be clearly determined. In some cases these difficulties are linked to a high degree of uncertainty accompanying respective activities (for example basic research), in other – with their multifunctional character, which is sometimes supplemented with asymmetry of information between those who provide services and those who pay them (health care services).

Undifferentiated application of the above-mentioned principles to spheres susceptible to market failures is fraught with serious negative consequences. Let me exemplify this conclusion with a short analysis of the government’s attitude towards health care services.

According to our reformers in actual fact this is a very simple matter and that the only thing we have to do is to go over from budget financing of medical institutions to patient financing. The money, they argue, should go to those institutions, which have more patients, and if there is no demand for the services of a particular polyclinic, it should not get any allocations. It is easy to see that a thoughtless implementation of this approach in the country could soon give rise to a new trade: that of ‘patient’. Doctors will have all their relatives

queuing to see them, and then the jobless and other citizens will join them, for a small fee. A market will emerge, but not where we want it.

A notice I once saw in the New York subway made a strong impression on me. It invited passengers who thought their doctor had sent them for much too expensive examinations or prescribed much too expensive drugs to visit an attorney and get the doctor sued. Come to think of it, this is an eloquent admission that the medical services market is very far from perfect.

Obviously, this does not mean there is no need at all to look for new solutions in the field of health care, notably with the use of market instruments. What I mean to say is that when we are dealing with such sensitive matters we have to tread carefully and avoid any hasty steps in foisting ‘simple solutions’ on society. The world has accumulated a vast store of valuable experience in organizing health care, but no one has ever ventured to suggest that they have found a perfect way of solving the problems that exist in this area.

Elements of the “Breakthrough Strategy” for Russia

The main conclusion of what I have said above is that economic policy cannot be independent from targets, which society advances. It follows then that there are no foundations behind the claims of any stream of economic thought that it is a bearer of ‘absolute knowledge’ about correct economic policy. Economic theory helps understand which consequences will follow under these or those conditions, but it cannot judge which of these consequences match the interests of society and which do not.

Taking this into account let me put forward some considerations both on general design and some details of the ‘breakthrough strategy’ if the latter, of course, is taken seriously.

On the role of basic research. Russia is one of very few countries in the world, which undertake research within nearly all the spectrum of basic science. This is, so to say, an ‘expensive amusement’ and it is worth having it only in case when the respective country puts forward big targets. Then, in conditions of high uncertainty, which accompanies this kind of human activity, the complex character of research is essential since only it can provide for fast concentration of forces on those promising directions, which appear here and there. But if the country’s ambitions are limited to catching up Portugal in terms of per capita GDP, as A. Illarionov, the President’s advisor on economic issues puts it, then there is no sense in spending much money on basic research. But the most absurd situation emerges when authorities claim that they want to have an advanced science, but do not finance it properly,

that is on a scale sufficient for normal reproduction of the desired scientific potential. In this case money spent on science is just thrown away.

On education. The character of education, especially high education, should match the chosen model of economic development. It would be just a whim for a country specializing in the production of raw materials to finance training of specialists in theoretical physics. The current situation when a significant part of high school graduates either work in the country, but in professions having nothing to do with their education, or occupy posts according to their education, but abroad, is also far from rational. Serious changes, in effect, are needed, but not of the kind mentioned above. One option is introduction of payment for education in state universities launching simultaneously a system of educational credits. Another possibility – the extension of conditional credits to students of state high school institutions. In this case the resulting debt is to be written off automatically after graduation according to a certain schedule if the respective person works in the country in fields corresponding to his education.

On industrial policy. Under current conditions modernization of the Russian economy is not feasible without a well-designed industrial policy.

Several arguments unrelated to each other are put forward to substantiate the negative attitude towards industrial policy: this policy can undermine macroeconomic stability; isolation from favorable influence of market forces leads to further lag relative to world level; resources allocated for implementation of industrial policy will necessarily be stolen; the risk to make a mistake when determining the priorities of industrial policy is too big and therefore such a policy can push the economy in the wrong direction. But in fact, all arguments against industrial policy are rooted in ideological immunity to an active role of state in economic process.

Industrial policy consists rather in the creation of favorable conditions for this or that productive activity for a limited period of time than to direct allocation of funds to them. Therefore such policy can in no way destabilize macroeconomic situation; similarly, one can hardly steal anything here. Correct implementation of industrial policy consisting in gradual dismantling of initial preferences and thus strengthening of foreign market influence on the respective fields of economic activity excludes the danger of their permanently lagging behind the world level. The risk to make a mistake in choosing priorities does, no doubt, exist. However this is not a sufficient argument against industrial policy. First, all economic activity is to this or that extent risky. Second, when designing industrial policy one has to select, taking into account the existing economic potential of the country, several broad promising

directions for concentration of resources. And thirdly, it is important to understand: under the current state of the Russian economy the task of its modernization simply cannot be solved without rational industrial policy aimed at the correction of market forces.

On financial resources. First of all we have to do away with an arbitrarily established target of reducing expenditures of the extended government each year by 1 percentage point of GDP. The problems the Russian economy faces as a result of an outworn basic infrastructure, a polluted environment, huge differences in economic development of regions, social troubles is of such a scale that rational value of this indicator is, I believe, about 40%. Actually, it corresponds to the experience of most successful post-communist states.

At the same time there is no need to increase tax burden on production; it is sufficient to put right collection of rent on natural resources and mobilization of income from state assets. Nowadays nobody doubts it; moreover understanding of the necessity to differentiate rent charges according to the quality of natural resources has emerged. It remains to be conceived that natural rent has nothing to do with taxes; it is a payment to owner (whether he is a private entity or a state) for the access to a scarce resource. Therefore rent payments constitute not only a source of budget inflows but also an important instrument of rational use of economic resources. When rent is not appropriated by the owner flows of funds in the economy are distorted in favor of the extracting industry.

It should also be mentioned here that Russia has today a unique opportunity to take advantage of 'excessive' foreign exchange reserves for the sake of modernization. According to many experts the value of these excessive reserves equals now from \$30 bln. to \$50 bln., in any case tens of billions of dollars are in excess of the amount needed to maintain stability at foreign exchange market.

Under such conditions the Central bank of Russia could set up a Bank of development and capitalize it with these excessive foreign exchange funds. The aim of this financial institution would be to extend on a purely commercial basis foreign exchange credits to finance imports of goods necessary for modernization of the Russian economy, first of all machine tools and technologies, which are not produced at home.

Due to such a mechanism a set of problems could be resolved. First, investment activity would intensify thus contributing to the process of modernization. Second, a significant long-term investments segment would emerge. Third, the interest rate would tend to decline due to a sharp increase in supply of credits. Fourth, in conditions of massive inflow of foreign exchange it would be easier to struggle against inflationary pressures while maintaining a desirable path of ruble exchange rate. This is so because rubles printed as a result of

interventions of the Central bank on foreign exchange market would have commodity coverage. In fact, from a macroeconomic point of view the following would happen: access to cheap credits for imports of investment goods would increase demand for foreign exchange and contribute to equilibrium being realized at a higher dollar exchange rate.

On privatization. Nowadays when market system has been in general formed and the federal budget is characterized by sustainable surplus there is no need of pushing further sales of state assets in a planned manner. It would be correct to set up a state holding company (a number of such companies), which would manage these assets on a purely commercial basis. This would not only help escape from permanent scandals accompanying privatization auctions, but would also create conditions for the efficient management of public assets having separated civil servants from this process. In its turn executive power would get a permanent source of income flows from public property.

On small business. What has been said so far should not create the impression that a breakthrough strategy can ignore opportunities given by the development of small business. Industrial policy should not be a policy for industrial giants only. The breakthrough in future can take place only if Russia succeeds in creating favorable conditions for entrepreneurial initiative on the ‘root’ level. Unfortunately, we are far from an ideal state of affairs in this field as well.

Summing up, I would like to formulate two main conclusions – one dealing with the theoretical part of this lecture and the second – with practical issues concerning the elaboration of economic policy in Russia.

First, the correct choice of economic course cannot be done without taking into account the system of public preferences. It is as wrong to speculate on abstractly best economic strategy, which would be independent of this factor, as to try to determine “objectively” the best bundle of goods, which the consumer can buy for his income without paying attention to his tastes.

Second, what Russia needs now is a pragmatic, non-ideological formulation of its long-term interests and elaboration of economic policy, which would match these interests. So far we are in a position when it is necessary to correct either targets or means of their realization.

Andrzej K. Koźmiński: Thank you very much, professor Nekipelov for this very insightful presentation, thank you also for staying within a time limits. I would like to make a small comment – this presentation is particularly interesting to me, because it goes beyond purely descriptive mode of analysis of transition, transformation processes, it seeks serious, theoretical grounds and this is why I think it is particularly worth discussing. Your lecture will

be published in our series of Distinguished Lectures. It will also be available, probably even sooner, on the TIGER's website.

Now the floor is open for discussion and I would like discussants to present themselves and, in a way to "shoot from the hip" – to be short in order to enable a lively exchange of opinions. So the floor is open for discussion. Who is the first?

Janet Bogdanowicz, LKAEM: I've just got one question, maybe it's naïve. The argument you present I can see working in some small Scandinavian country, but how are public preferences going to be articulated sufficiently in a vast country like Russian?

Alexander Nekipelov: Thank you very much for this very important question. One of my conclusions is that all that theoretical speculation is important just in order to show the necessity of forming a well-functioning democratic political system in Russia. But of course even when it is not so perfect as we would like it to be, somehow, by trial and errors procedure you approach to something what people believe they would like to have. Of course the amplitude is extremely big. Naturally I do understand problems with democratic systems – they're not ideal, they're not perfect, but we don't have anything better and of course even with a very well functioning democratic system some amplitude is going to take place. The problem is to try to minimize it.

Małgorzata Runiewicz, TIGER: I have a question on the last statement you said so far what should this direction of public preferences go and you mentioned it was necessary to correct either targets or means. What do you mean by those means? Are these the platform of interaction between the different groups? Does it mean that this platform must be improved? What do you exactly mean by the means?

Alexander Nekipelov: Thank you very much Małgorzata. I understand it this way: the targets which have been put forward by the government have been met by the population very positively and they really do correspond to the feelings of people. So from this point of you, to my understanding, they were quite well chosen. The problem is that the methods which are used are not adequate to those targets. This is my understanding. I do not believe that under current conditions in Russia it is possible to modernize its economy, to make a push for high-tech industries just relying on market forces alone, as the market forces now push the economy in the opposite direction, where the yield of resources is the highest. Some

inadequacies in our internal system, including those with natural rent also contributes to this. There is a huge gap between efficiency of capital in oil and other industries. High-tech industries are, after 1990s in such a shape that they cannot compete not only with oil industry but with some very primitive industries as well. If we want to keep something of them they have to be helped. This is a very delicate problem, there is a lot of danger here. I would only like to stress, that if nothing is made then they just disappear due to operations of the market mechanism.

Marcin Piątkowski, TIGER and IMF: You have this pragmatic idea for using the currency reserves of the countries and send also the extra inflows into the all stabilisation fund. The question is what inflationary effect it would have on economy, given that the inflation expectation is already rising in Russia, but more perhaps interestingly, if the cracks of the problem is not necessarily how to use the reserves, which is an important issue but a different one, is the question of the viability of the financial sector in Russia, which does not seem to be able to transform savings into investments, particularly in the oil sector into a non-oil sector. So the question is: shall we, instead of focusing on the oil fund and the reserves, look into the financial sector – how it can be reformed so that it can finance the economy and all the other targets you have mentioned. Thank you.

Alexander Nekipelov: The question of what has to be done with our reserves, foreign exchange reserves is discussed now, I'd like to say, internationally. One of the vice-presidents of the World Bank said it would be correct to use them for earlier payment of Russian debts or probably to capitalise the pension fund which is not in a very good shape. So, what I wanted to say is that a lot of people do understand that there is such a problem that having such huge reserves makes you quite convinced in your position, but at the same time it's extremely expensive, foregone benefits are huge. So, different people propose different things, with regard to this particular issue and of course very often an argument is used that you cannot use the foreign exchange reserves, because if you use them – you pump roubles in the economy and then you contribute to inflation. That's why I proposed another model which has nothing to do with pumping money into Russian economy and in effect which would have anti-inflationary consequence. What I proposed is that the central bank sets up - it's not important how to call it - a Bank of Development, whatever, some foundation and capitalizes it with some of excessive reserves. Well, people make different estimates of what 'excessive' means – from \$10 billion to \$50 billion, excessive from the point of all the needs for having

the foreign exchange market stable. So, I wouldn't like to speak on figures now, just on the idea. You capitalise this foundation with those reserves and the only thing this foundation has to do is to extend, on purely commercial basis, long-term foreign exchange credits for imports of high-tech machinery for this kind of projects, that for no additional roubles are issued. Moreover, the foreign exchange is, so to say, exported from the country but not exported in a way it is exported now, but in exchange for commodities. So additional commodities come and this could contribute to the modernisation of the economy. Well, some experts' reactions are not concerned with macroeconomic results of this idea but their reaction is the same as those from the government – they say: “Everything will be stolen”. This is the argument which is very often used in Russia. If one has no argument against government doing something, then he/she says that everything will be stolen. They just forget, however, that they are part of government, not myself. In Russia I told them: if you do not believe yourselves, hire foreign managers to that foundation and Europe will give you those managers with great pleasure, because it's a big market for them, for their high-tech industries and they will assure you that these are going to be credits on purely commercial market conditions, based on project financing and so on, procedures and so on and so forth. So this is the idea.

As far as the second part of your question is concerned – of course it is extremely important to modernise our financial system and in fact it would not be correct to say that nothing is being done in this field. By the way, those difficulties which we had in this sector in May-June (some people even spoke about crisis in the banking sector) was a result of the Central Bank policy just aimed at making rules in this sector much more rigid than they used to be. Well, we had really some problems. Now they have been overcome and it would not be correct to say that the financial system does not transform saving into investments, just in this absolute form. We have problems here, that's quite true, but I should say that it's doing this tasks much better than it used to do it before, so there is an obvious progress here. You can see this, if you look at figures on banking credits to the industry and so on – you can see a clear progress here. Another thing there is that we are not satisfied with the level of investments in our economy, it's about 19% of GDP, which is very low for us, but it is growing and investments have been growing very quickly during last years, but from a very small base.

Karol Kuczowski, Little Tigers Science Club: Professor, you said that one of the ideas for decreasing the level of government spending is to introduce some additional taxes for

industry. Don't you think it may result in a different way, just enlarging the grey sphere and lower the global income from taxes? Thank you.

Alexander Nekipelov: Well, the main argument from the government, when they put forward this target of reducing their spending, well, to my understanding was of purely ideological character. They said that everybody knows that resources are better used by the private sector than they are used by the state, and therefore we have to minimize the spending of the government and to ensure as much resources as possible for the private sector. That's true and you mentioned it correctly, that they argue that they are not going to reduce, in absolute terms, the spending (in fact they are really growing) but what I want to say and it seems to me that I did say this, but I'll repeat: we have to understand what we want. If we want to restore our infrastructure, for instance production infrastructure, which is extremely important for a private sector, it is important to create a mechanism of investing in that type of activity. Unfortunately, nobody has proposed how to do this without investments from the government. If we want to deal with those acute problems in social sphere, which I only mentioned, but which are tremendous – you should believe me, they are tremendous: there are now quite a lot of regions in Russia, which seem to be helpless and hopeless from economic point of view. If you want to close them – OK, we have to say: we are going to close these regions and people have to go somewhere else. So if we want to solve those problems we have to pay money for this. It's not enough just to say that I'm going to solve social problems, but to do nothing about that. That what's happened.

Grzegorz W. Kolodko: A comment and a question. The comment is vis-à-vis the issue of foreign reserves and the ability or lack of ability to use them in a sensible way for the purpose of co-financing economic development in a given country. I think that within the theoretical framework presented today by professor Nekipelov there is not a good answer for this question without going into the very category of the group interests. This is the most weird case I know in the contemporary economics, all this debate about the reserves. There is not any, ANY theoretical rationale to have for instance on the one hand a debt, exceeding hundred billion dollars upon which we, in this case, Russia's taxpayers (both the consumers and the business people) - they pay taxes, because the interest rates are to be paid by the state budget. This is the state, this is the public debt. Most of the time, in case of Russia, majority of the debt is their central government debt. And at the same time, there are the reserves, which are invested, most of the time, in the very-short-term papers at the real interest rate 2-3-4 times

lower. And the partners most of the time are the same institutional investors at the world market. It is, as professor Nekipelov, on one hand owes me million dollars and there is an interest rate – he pays a 10% interest rate – and at the same time he's keeping in my bank his reserves and I pay him only 2% of the interest rate. I will do everything including fellow economists, which are actually much more like lobbyists than economists, to convince everybody that this is the good solution, using also the arguments that if he changes his attitude and instead of borrowing from me and enjoying the spread of 8% points, as in our case, to manage different solution approach how to utilise this amount of money. So it must be seen I think through the prism of the certain group interests, and in this case the interest of the speculative and other portfolio investors, and this is not important if they're from Russia or from elsewhere, then through the prism of the purely theoretical debate. And the argument about a risk of additional money supply, which can be pro-inflationary is also very short-sighted, because it must be seen in the whole complexity – there would be demand effect, or shock, but that would be also the supply effect, and the supply result of taking advantage of this reserves would be much, much bigger than the demand effects. That would be the anti-inflationary measure, contributing to microeconomic restructure of the real economy, not a pre-inflationary one.

The question I have to professor Nekipelov – I wonder what's your understanding of this phenomenon that in a country like Russia, together with most of the post-socialist countries – is it Lithuania or Hungary, Slovenia or Poland – but definitely in Russia, this is the case, this is also my reading from what has been said this afternoon, that your point is that there is too much of this so-called (as you're calling it) 'market fundamentalism'. So, therefore the question is: what is your understanding, what is your interpretation – why there is such a great deal of this 'market fundamentalism' in the country, which only 15 years ago or even less than that was actually entirely involved in government-controlled economy, state-run bureaucracy, central plan and so on? I have known Russia, the former Soviet Union, for some time and I haven't seen there any 'market fundamentalists' fifteen years ago. I met couple of them in Poland, very few, I can use the fingers of one hand to name them. There are plenty of them in Poland now. In Russia there were no market fundamentalists in 1980s, including Chubais and Gaidar – our good colleagues. How come we have so much of this market fundamentalism in contemporary Russia? What's your theoretical explanation of this great shift which is influencing so much economic reasoning and economic doing? Thank you.

Alexander Nekipelov: Thank you very much. Well, I totally agree with what you've said on foreign exchange reserves of course. By the way, some experts have said that foreign exchange reserves cannot be used, just because they are foreign exchange reserves – they cannot be used, that's all and no discussion. Well, it's a strange approach and I should say that China, probably one of the first countries which used a significant amount of reserves - \$40 billion to capitalise its banks in order to be able to compete on financial market after they had to introduced all those things they promised to introduce when they joined WTO. And nothing bad happened to China, they'll just have good banks, which they've capitalised.

Then, the second question is extremely difficult to answer, because there are quite a lot of things here I believe and probably very different explanations can be given. I would say that first, probably it's a part of our Russian character – when you believe one thing and then it crashes, then you are looking for something else to believe. So I think if you look at thesis which were defended by Gaidar, Chubais and so on, you'll see no difference from other people in those times. There were no market economists then, at all. They've become market economists. That's how it is. Of course I wouldn't probably say that this is the most important thing, but it mattered. They were quite well stimulated from the West, because people said “those are good guys”. It's quite interesting – last year our vice-premier was boasting talking during a session which was attended by high officials, beginning from deputy ministers, he boasted that Russia has nearly become the most liberalised country in the world and that we are not going to look at Europe, because they are oversocialised, everybody knows that, he said, we are going to liberalise in advance and this is our advantage. Well, even that I said that it was a stupidity, because he just couldn't understand that there is, so to say, situation of a game in this sphere and if you liberalise first, having such a financial system and all that, this doesn't mean you can do better. The most probable thing is that you go bankrupt after such a liberalisation.

And then, the third thing, which I think is very important and it has to do with your question. Our political system is far from perfect, because it is very interesting and you can see it, that ideologically those people suffered a huge defeat in the last election. The party they were for could not even join the parliament. But they are all there, taking decisions.

Andrzej K. Koźmiński: Professor Nekipelov, thank you very much.