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Russia under Putin:
Opening Economy under Closed Political Regime

In my talk today, I will address three questions about the political and economic development of Russia. First, what direction is Russia taking under President Putin? Second, what will be the consequences of that course for economic policy? And, finally, is that course sustainable in the long-run (consistent with the goal of long-term economic growth)?

So, what course is Russia taking under Vladimir Putin? After more than five years of Putin's leadership, one can clearly state his direction – toward further economic liberalization under increasing political centralization.

The economic liberalization part of that course included several elements. First is the reduction of taxes. Since Putin was elected a president in 2000, the government managed to pass the legislation, which cut the income tax from progressive up to 30 percent to flat 13 percent, social security tax from 40 percent to regressive 20 percent on average, corporate tax from 35 percent to 24 percent. The 5 percent sales tax was abolished completely. There is a discussion now in the government to reduce the value added tax as well.

Besides cutting taxes, the parliament, dominated by the pro-presidential party, has adopted multiple laws that significantly reduced the amount of regulations in the economy, including such areas as land property, telecommunications, financial sector, real estate, employment relationships, etc. A number of state enterprises were privatized. More recently, Putin's government chose to reform the system of social benefits by converting some of them (such as free public transportation and medical services) into the monetary compensation.

On the international level, Russia has aggressively moved to become a full member of the World Trade Organization. Whatever the final conditions for the accession are, the

membership in the WTO will inevitably make the Russian markets more open and more integrated in the world economy.

Those efforts took place on the backdrop of a very favorable for Russia situation with international prices on natural resources (oil, gas, metals). The growth of commodity prices has boosted the share of international trade in the Russian economy. Today it is exporting and importing more than ever. The size of international trade (that is, imports and exports combined) has grown from 150 billion dollars in 2000 to nearly 260 billion dollars in 2004. As a result, the combination of liberal reforms and positive circumstances has indeed made the Russian economy more open than ever before.

On the political side, however, Putin's course has been anything but liberal. The media crackdown, the appointment of the loyal but incompetent people to the public offices, the manipulations with the federal elections, and the abolishing of the regional governors' elections – these and many other efforts point to the establishment of what they call in Russia a “managed democracy”. That is, an electoral system with predictable and useful to the Kremlin outcomes. Following on this path, the Kremlin is imposing an autocratic and exclusionary system on the political process in Russia.

Summarizing, Russia is becoming an increasingly open economy under a more closed political regime. That brings us to the second question: what are the consequences of that course?

Let's first look at the short run consequences. Within the next few years, the prospective for the growth of the Russian economy looks quite bright. According to the most recent estimates of the IMF, the world prices for oil and gas are going to remain high for at least another two years. Based on that, the Russian economy will keep growing, as it was growing for the last five years.

However, the oil-driven economic growth also means that, in the short term, the autocratic tendencies within the current regime will grow stronger. The democracy in Russia will go through more cutbacks. Specifically, I suspect, the barriers of entry for the

new political parties will become higher and the constitution will include amendments to make the choice of the top executive more predictable.

Why is this going to happen? As the life of autocracies with abundant natural resources shows, there exists a close and intimate link between those resources and the strength of an autocratic regime. In an oil-driven economy, the ruling elite has more control over the sources of national prosperity because they all come from the export of raw materials. Moreover, the autocratic regime is both interested in and is only capable of preserving the economy, which is driven by the export of the centrally controlled natural resources, not by the diversified industrial and postindustrial sectors. The ruling elite in Russia is headed to this direction.

In such regimes, the population does not have an independent from the government sources of prosperity. Most of it remains very poor and has no material basis for expressing personal interest in the political process. The lack of private property and autonomous sources of income keep the societal demand for democratic institutions at a very low level. That is why the so-called “democracy of taxpayers” is not working in Russia: most of the taxes come from exporting the raw materials and not from the individual contributions of the voters (show the picture). Since the citizens do not really pay many taxes, they do not demand fiscal accountability from the government through the electoral process.

In sum, the autocratic tendency in the Russian politics and the oil-based economic growth will remain supportive of each other in the short run.

But the long-run picture looks very different. It is both worse and better than the current situation. It is worse for the prospects of high and stable economic growth in Russia. And better for the future of Russian democracy. Russia seems to be one of those countries that have had a clear tradeoff between the two.

Regarding the economic development, the current state of high economic growth is not sustainable in the future. The natural resources are depleting fast, and the high

commodity prices will eventually go down. On the other hand, the government is not doing anything to stimulate substitution of the current sources of economic growth, based on raw materials, with the new ones, based on high labor productivity and better product quality. The government officials talk a lot about this problem but, so far, they have not done anything to improve the situation.

What is worse, the nature of the current economic growth is undermining the prospects for the future development. Many of you have heard this term – the Dutch disease. It occurs when a leading export-oriented sector, like oil and gas, strangles (for the lack of a better term) the rest of the economy through unequal profitability, currency appreciation, brain drain, etc. And this is what is happening in Russia right now: the Dutch disease is gradually eating out the economy because of the booming oil and gas.

Instead of going into the details of that phenomenon, I want to give you a simple example of why today's economic growth is so dangerous for the future development of Russia. Imagine a person walking on a street and suddenly finding a wallet with ten thousand pounds in it. Can this delightful gift make that man worse off than he was before bumping on the wallet?

Well, actually, yes, it can – if the money can make the person think that his prayers have finally been answered and he can quit now his job, forget his skills, and simply go out to enjoy life in a nearby pub. Eventually, after the money is gone, that person finds himself with nothing to live on. He does not have a job, no skills, nothing. Now he is worse off than he was before finding the money.

Why am I telling you this story? Today many Russians, including their government, have suddenly found their wallets filled up with a lot of money. And for most of them, particularly in Moscow, it happened like a miracle – without an effort of receiving better education or trying to be more competitive. And this is the biggest danger of the current economic growth.

In an oil-driven economy, there is no need to be competitive for being successful. When seeking personal prosperity, the Russians are relying increasingly on the natural resources as a replacement for the quality of their skills. That weakens the incentives for improving education. It ruins the reasons for creating new and competitive industries. It erodes the need for reforming the economy. In short, it undermines the prospects for the sustainable future economic growth.

Now you can ask me “How does this gloomy assessment square with the better prospects for democracy”? Regardless of the quality of the economic growth, the share of the well-off people, or the middle class, is growing now and will be growing in the future. These people will own more private property and they will need democracy not just as a theoretical concept, which ensures their abstract political rights, but also as a practical tool for defending their property rights from corrupted bureaucracy and irresponsible politicians. When the proportion of such well-to-do citizens rises to some significant level, then we can say that the demand for democratic institutions becomes sufficient for making democracy an indispensable part of the Russian politics.

The line in the graph shows the changing share of the Russians who have income level that was necessary to generate the demand for democratic institutions across 130 countries that we studied. As you can see, Russia now does not have enough such people. Its middle class, as defined by the income level, is too small. However, if it keeps growing along with the economy, the share of those wealthy people will eventually be large enough to generate the real demand for democratic policymaking.