

Possible Russian Development Paths and Their Implications for Europe: Some Back-of-the-Envelope Musings

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This chapter examines the potential implications for the European Union and for EU-Russian relations of recent developments in Russian economic policy. Its principal argument may be stated simply. A number of changes in Russian economic policy during 2003–05 augur ill for both the further growth of its core resource-exporting sectors (especially oil and gas) and the further diversification of its production and export structure. On both counts, this is bad news for European Union member states. Europe has an obvious interest in the successful development of Russia's resource sectors. It also has a less obvious, but no less compelling, interest in the evolution of Russia's production and export structure in the direction of greater diversification and increased production of services and more sophisticated manufactures. It should be stressed at the outset that the chapter does not attempt to present a comprehensive picture of the EU-Russian economic relationship.² Its focus is very much on Russian economic policy and performance and on the implications of Russia's development for Europe.

Asymmetry and energy

Barysch (2004) suggests that the EU–Russia economic relationship can be summed up in just two words: asymmetry and energy. The asymmetry is, in the first instance, one of size: whatever its political significance, Russia is still a relatively small economic power. Its population of just under 144m is about one-third that of the EU and its GDP, at market exchange rates, is roughly equivalent to the combined GDP of Finland and Sweden, which together have a population of about 14.2m. Using World Bank purchasing-power-parity exchange rates, which some have suggested are rather generous to Russia, Russia's *per capita* GDP is under one-third of the European Union average.³ At market rates, it is about one-tenth. Russia accounts for about 2.4% of the world's population, less than 2% of world exports and only around 0.3% of global flows of foreign direct investment.

The economic relationship between Russia and the EU reflects this basic asymmetry. Whereas the EU is by far Russia's most important trading partner – the EU 25 accounted for roughly 45% of Russian foreign trade turnover in 2004 – Russia accounted for just 3–4% of the EU total (excluding intra-EU trade) and was the Union's fifth-largest trading partner after the United States, Switzerland, Japan and China. Over three-quarters of foreign investment in Russia originates in the EU. However – contrary to what many estate agents in

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 2. For the best recent overview of the EU–Russia economic relationship, see Sutela (2005a).
 3. Sutela (2005a:8).

Kensington and the Côte d'Azur might think – Russia is a negligible source of foreign investment in the EU.

Underlying this asymmetry of size is an asymmetry of economic structure. Fuel, metals and other raw materials account for around 70% of Russian exports to the rest of the world and for an even higher share of exports to the European Union.⁴ By contrast, Russian imports are dominated by manufactured goods. While the commodity structure of Russian-EU trade undoubtedly reflects certain complementarities between the two, it has also caused some concern in Russia and is regarded by some observers as having ‘a “colonial” tinge’.⁵

Russia as a resource-based economy

Structure

Before trying to assess the major drivers of Russian growth and possible future development paths, it is necessary to clarify Russia's economic structure, which is not what it appears to be in the official data. The official national accounts, though technically correct, present a somewhat distorted picture of the Russian economy. This is because the widespread use of transfer pricing causes a large share of the value added generated by natural resource sectors to appear not in the accounts of the extraction enterprises, but in the accounts of their affiliated trading companies. This would be no great problem if Russian companies presented consolidated accounts or if the statistical authorities themselves corrected for transfer pricing. As things stand, however, export-oriented industries have long been significantly under-represented in industrial production, and industry as a whole is under-represented in the national accounts. Wholesale trade and hence the service sector as a whole are over-represented. There have recently been several attempts to estimate the size of these distortions and correct for them. This chapter relies on the recent World Bank estimates of the relative weights of different sectors in GDP.⁶ The differences between the World Bank and official weights are shown in figures 1 and 2.

The contrast between the two GDP structures shown in figure 1 has important implications for Russia's growth potential. The official statistics suggest that Russia's service sector accounts for roughly 60% of GDP, only marginally below the 65–70% typical of the most advanced OECD economies. This is difficult to credit, given that most services in Russia are still relatively under-developed. This apparent contradiction disappears when correcting for transfer pricing: the share of industry increases to 41% and the services share drops to 45%, which seems far more plausible. This is not by any means bad news. Hitherto, services have tended to grow faster than GDP, as Russia's economic structure has changed in response to the shift from central planning to the market. Services have grown faster than total output because they were neglected by central planners. If the services share really had reached 60% or more, then the scope for further rapid services growth would be limited: the period of ‘catch-up’ growth in services would be over. However, the fact that the service sector is actually *less* developed than it appears in the official data means that there is still considerable scope for catch-up. The service sector should continue to grow strongly with increasing living standards, if provided with the right conditions, and hence could enhance Russia's growth potential for some years to come.

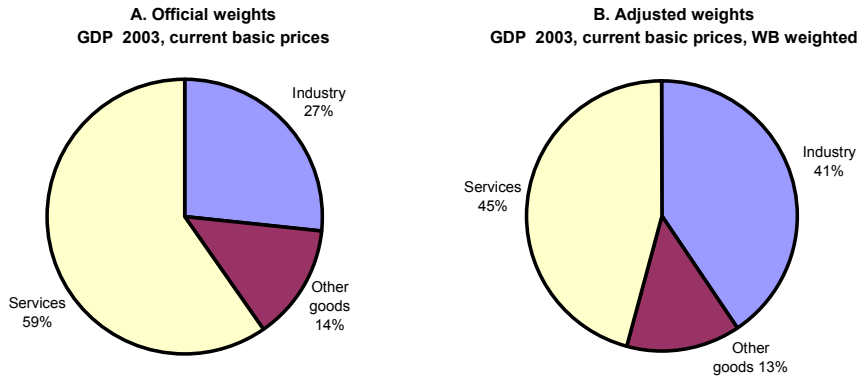
4. It is worth noting that over half of the remaining 30% consists of ‘others not classified’, so it is not entirely clear what the composition of Russian non-commodity exports is.

5. Perović (2003:6).

6. World Bank (2004). See also Gurvich (2004) and Kuboniwa (2003).

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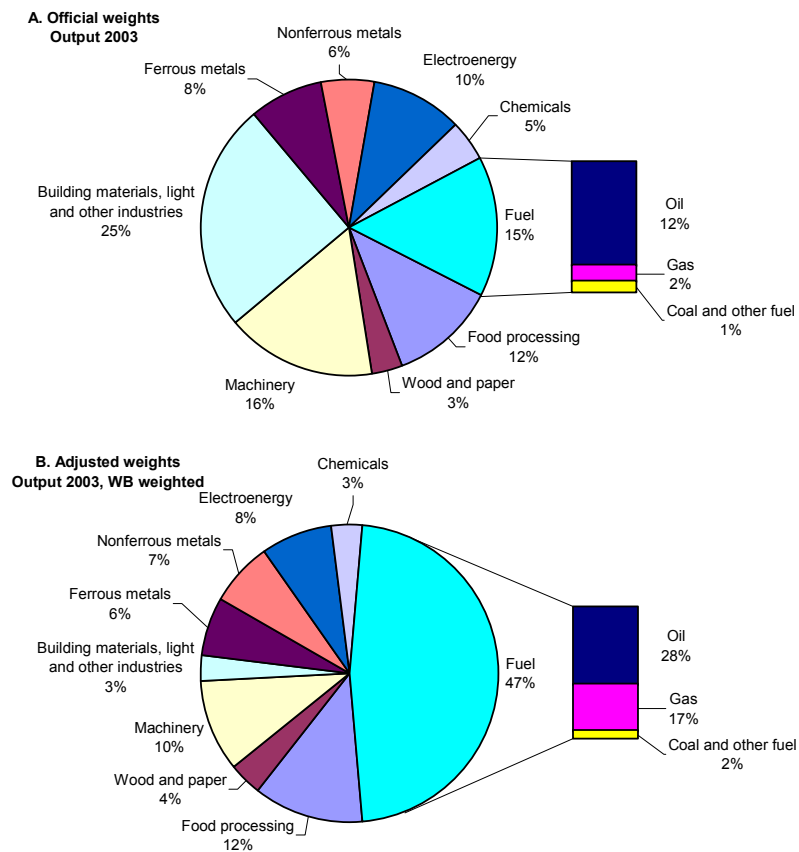
Figure 1. Structure of GDP



Source: Ahrend (2004), based on Goskomstat, World Bank and OECD calculations.

The implications of figure 2 are less reassuring. The World Bank weights show that Russia's industrial sector is more narrowly based than it appears to be in the official data. The fuel sector alone accounted for almost half of value-added in industry in 2003, while energy and metals together accounted for an estimated 69%.

Figure 2. Structure of industrial output



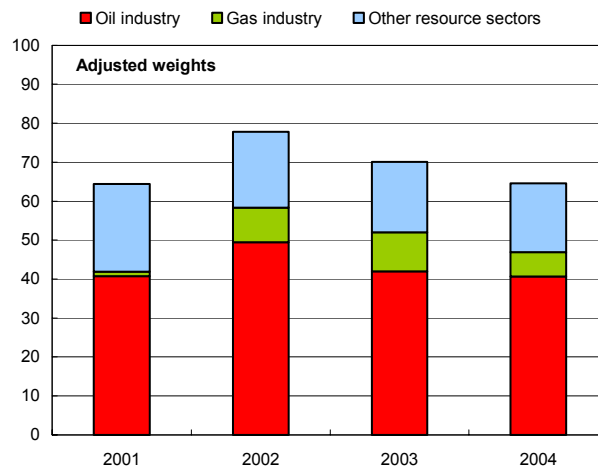
Source: Russian Federal Service for State Statistics, World Bank and OECD calculations.

This dependence on a narrow range of natural resources is one of the main reasons why many observers remain sceptical of Russia’s capacity for sustained growth over the long term. There is now a large body of empirical research which suggests that resource-dependent economies tend to grow more slowly and to experience greater volatility in their economic performance.⁷ It would be a mistake to view this ‘resource curse’ in overly deterministic terms: most of the problems associated with resource-dependent development can be substantially mitigated, if not avoided, given appropriate policies.⁸ Nevertheless, resource dependence presents policy-makers with a particular set of challenges, including vulnerability to external shocks, ‘Dutch disease’ and the various institutional pathologies which are often associated with resource-dependent development. Resource dependence also looms large in any discussion of structural reforms, as resource-dependent development can complicate efforts to build new institutions. There are thus good reasons for seeing Russia’s economic structure as a problem.

Performance

The adjusted sectoral weights presented above provide the basis for an assessment of Russia’s recent growth that differs substantially from that suggested by the official national accounts. Growth immediately after the crisis was overwhelmingly driven by industry and construction, but the importance of service-sector growth increased, especially in 2002–03. Even on the adjusted weights, services accounted for roughly one-third of economic growth in 1999–2003. However, industry and construction accounted for the bulk of Russian growth during 1999–2004.⁹ Industrial growth, moreover, has been dominated by natural resource sectors, particularly the oil sector. During 2001–04, natural resource sectors accounted for around 70% of the growth of industrial production, with the oil sector contributing by far the largest share of this (figure 3).

Figure 3. **Percentage of contribution of resource-related sectors to industrial production growth**
Per cent



Source: Russian Federal Service for State Statistics, World Bank and OECD calculations.

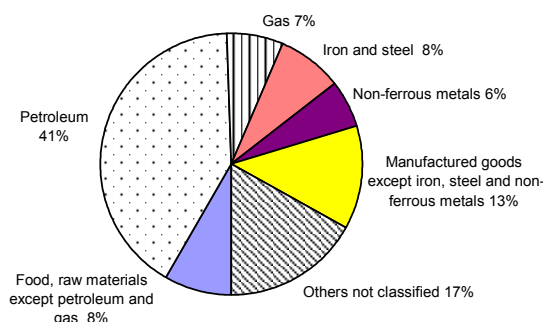
7. For the best-known statement of this position, see Sachs and Warner (2001). For an overview of the ‘resource curse’ debate, see Ross (1999).
8. For an extended discussion of this issue, see OECD (2004:56–73).
9. See Ahrend (2004).

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It is thus clear that the contribution of the oil industry to economic growth was far larger over the period than the official data imply. If industry accounted for slightly below half of GDP growth over the period and the oil sector for somewhat below half of industrial growth, then the *direct* contribution of the oil sector to growth appears to have been about one-quarter. Taking into account the knock-on effects from oil-sector procurement and wages on domestic demand, the actual contribution of the oil industry to economic growth would have been greater still. Gurvich (2005) estimates the oil sector's *total* contribution to growth, including indirect effects, at over one-third.

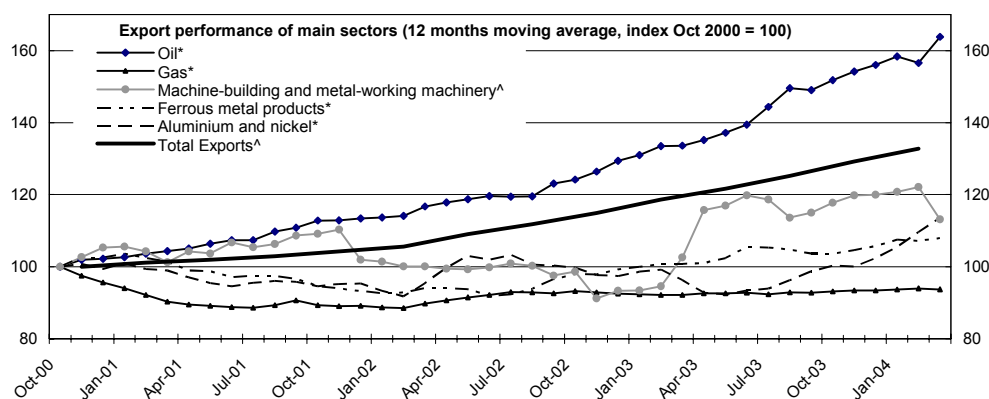
This resource-dominated industrial structure is also reflected in Russia's export profile: in 2004, hydrocarbons, metals, food and other raw materials made up 70% of Russia's export bill, with oil and gas alone accounting for 48% (figure 4). Strongly increasing oil exports also drove the expansion in export volumes that allowed a consumption boom to unfold and to be sustained throughout the period without putting the external balance at risk. As figure 5 shows, oil was the *only* major export commodity to show above-average growth in volume terms during 2000–04.

Figure 4. Structure of Russian exports, 2004



Source: United Nations, *Commodity Trade Statistics Database (COMTRADE)*, SITC Rev 3.

Figure 5. Export growth by commodity



* Physical volumes

^ Real roubles

Source: United Nations, *Commodity Trade Statistics Database (COMTRADE)*, SITC Rev 3, Goskomstat, Datastream, Moscow Narodny Bank, OECD calculations and estimates.

Complementarities or contradictions?

Russia's resource potential is the basis for much EU policy towards Russia. The focus on energy, in particular, is hardly surprising, given the EU's desire for reliable energy supplies from its eastern neighbour and Russia's awareness of the political leverage it can sometimes exercise in view of its energy wealth. In any case, a relationship in which Russian resource exports (primarily, but not only, energy) are traded for European manufactures would appear to reflect the two parties' revealed comparative advantages. However, this relationship is not without its contradictions. As Hamilton (2003) argues, this pattern of revealed comparative advantage is in part the result of EU policies. Of course, the Union is hardly responsible for the very narrow range of products in which Russia has a significant revealed comparative advantage, but, at the margins, EU policies have tended to reinforce the resource-sector bias of Russian development and thus to aggravate potential 'Dutch disease' problems. Moreover, while well aware of the geopolitical significance of its resource wealth, Russia's rulers nevertheless aspire to something more than a trading relationship based on raw materials exports and imports of manufactures. The Russian authorities are committed to diversifying the country's production and export structure. They are also increasingly interested in the geographic diversification of its resource exports, which implies that less will be available for European markets. Certainly, there are plenty of non-EU consumers with a keen interest in Russian energy, including China, Japan and the United States.

Yet it is not only Russian policymakers who have an interest in changing that country's worryingly resource-heavy economic structure. Europe itself needs a more diversified Russia. While Europe's overriding interest in Russian energy and raw materials dominates much policy now, the Union is likely to be far better off over the long run with a more diversified Russia, for several reasons.

- A more diversified Russia is more likely to be democratic and stable. A good deal of the resource curse literature links resource-dependent development to corruption and undemocratic governance,¹⁰ and common sense suggests that, given Russia's population and human capital endowments, a flourishing non-resource urban sector is likely to be crucial to long-term social and political stability. As Sutela (2005b) observes, Russia can never become a northerly Kuwait: its resource sectors alone will never be able to provide an acceptable standard of living for the great mass of the population, even if one makes very aggressive assumptions about both future resource prices and Russia's ability to increase resource extraction.
- A more diversified Russia is likely to import more from the EU – and to import not merely consumer goods but machinery, equipment and other investment goods. It is also likely to be a more promising market for European providers of financial and other business services.
- A more diversified Russia is less likely, on balance, to be a source of illegal immigration and other 'social bads' that the EU now fears from the East, for at least two reasons. First, a more economically diversified Russia is likely to be better able to provide jobs and welfare for the vast majority of its citizens who are not employed in resource industries. Secondly, a Russia that remains a 'resource-producing appendage' of the

10. See, *e.g.* Mauro (1995); da Cunha Leite and Weidmann (1999); Easterly (2001); and Ahrend (2002).

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world economy is more likely to experience very high concentrations of wealth and to leave a large part of its population with relatively limited economic prospects. At the same time, a more diversified Russia is likely to have better quality institutions more generally, and thus to be better equipped to deal with the kind of social ills associated with relative deprivation.

There need not be a serious problem here. For Russia, there should be no contradiction between the twin imperatives of successfully developing its resource-exporting sectors and fostering the diversification of economic activity over the longer term. Addressing this two-fold challenge will require continued adherence to sound macroeconomic policies, the creation of a stable, transparent and investor-friendly framework for governing the major resource sectors, and the completion of a range of structural reforms designed to create an environment conducive to investment in non-resource sectors and thus to facilitate greater diversification.¹¹ At the margins, the EU could support such a process by abandoning – as it has already begun to do in certain areas – some of the policies that impede Russian efforts to diversify exports to EU markets.

Russia's strategic choices

The problem with the path just outlined is that it may take too long for the Russian authorities' liking. There is considerable political pressure within Russia to force the pace of economic diversification, if necessary by means of highly interventionist industrial policies. At the same time, recent years have seen a steady drift towards a much more *étatiste* approach to the management of large-scale industry, particularly the fuel sector. This combination bodes ill for the future, since it is unlikely to deliver the kind of results that either Russia or the Union would desire over the longer term. The question of how Russia attempts to manage both its resource sectors and its diversification strategies is thus of cardinal importance.

In theory, at least, policy towards the resource and non-resource economies do not have to move in lockstep. The drive towards greater state ownership and control need not encompass the non-resource economy. The state might try to create different institutions for, and to pursue different policies towards, the non-resource sector. As noted above, Russia is too big to prosper on the basis of natural resources alone. It needs a successful secondary sector. One danger is that protection and subsidies will be used to foster the development of this 'B' sector, as Sutela (2005b:4) calls it. Resource-exporting states have often used resource rents to sustain such a secondary urban sector via explicit or implicit subsidies or protection.¹² Such a dependent urban sector tends to be a drag on growth and can also constitute a barrier to economic reform, since it sustains a social constituency with a vested interest in the *status quo*.¹³

11. For a detailed discussion of the policies required, see OECD (2004), chapter 1.

12. Auty (1994, 2004), Mahon (1992).

13. Numerous studies of import-substitution industrialisation in Latin America suggest that the beneficiaries of subsidies and protection were a major source of resistance to reform. See the overview of this literature in Ross (1999:310–11). See also Gelb *et al.* (1988) and Treisman (2002) on 'dependent urbanisation'.

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Russia in the 1990s was arguably a case in point. A large part of Russian industry was kept afloat via subsidies throughout the first decade of transition.¹⁴ This reflected both the power of industrial managers as a lobby and fear of the social consequences of structural change. Direct subsidies from the budget and soft credits from the central bank had largely been eliminated by the mid-nineties, but they were increasingly replaced by implicit subsidies provided largely by the state-controlled gas and electricity monopolies.¹⁵ However, the first post-crisis years saw a marked shift away from the subsidy-dependent industrialisation model. Since 2000, there has been the dramatic reduction in the implicit subsidies provided to Russian industries and households. As OECD (2004) shows, the gas and electricity subsidies have been diminishing rapidly in recent years, while Russian enterprises’ payment discipline – with respect to the budget, employees and suppliers – has greatly improved. The authorities have devoted considerable energy to trying to create conditions for the development of an open and competitive sector of small and medium-sized businesses. While its ‘de-bureaucratisation’ policies have not been wholly successful, they have brought about a significant reduction in the burden of red tape and bureaucratic rent-seeking on small business (CEFIR, 2005).

At the risk of grossly oversimplifying the situation, Russia can choose among four broad approaches to the economy, corresponding to more market-oriented and more *dirigiste* lines of policy with respect to the ‘A’ and ‘B’ sectors (table 1). A consistently liberal policy would give priority to private entrepreneurship and market forces in both spheres, while *dirigisme* in both domains would look disturbingly like the Soviet past. Neither of these two options appears likely at present, although the latter fortunately seems to be even less probable than the former. A third option would allow private owners to continue to run resource sectors (and to capture a large share of resource rents) with minimal interference from the state, but would involve state support, in the form of protection, investment or subsidies, for ‘priority’ manufacturing sectors. This is precisely the approach for which many Russian financial-industrial groups lobbied in the 1990s, and I have therefore labelled it ‘industrial policy for oligarchs’. Finally, the state could tighten its grip on the resource industries (and perhaps also on selected manufacturing and other sectors) while adopting a broadly market-friendly approach to the rest of the economy. There are clear echoes here of the 1920s-era New Economic Policy (NEP), which left the state in control of the ‘commanding heights’ of the economy but allowed capitalism to flourish on a small scale.

Table 1. The elements of policy towards a two-sector economy

		Policy towards the non-resource economy	
		Liberal	Interventionist
Policy towards the natural resource sectors	Private-sector/market-driven	<i>Consistent liberalism</i>	<i>Industrial policy for oligarchs</i>
	State-directed	<i>NEP for the 21st century</i>	<i>Back to the future?</i>

14. Trade protection played less of a role. On the whole, Russia’s secondary sector enjoyed surprisingly little formal protection – trade policy since 1992 has generally been fairly liberal – although informal barriers are sometimes considerable.
15. Enterprises also ‘borrowed’ increasingly from workers, the state and other suppliers, via wage, tax and payment arrears. For details, see Woodruff (1999) and Tompson (1999). For an estimate of the scale of this implicit subsidy in the early post-crisis period, see OECD (2002:121–32).

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The last of these four options – the neo-NEP – seems to reflect, however, imperfectly, the direction of policy in 2003–05. Of course, it would be foolish to expect too much consistency in economic policy – there are, and will continue to be, zigs and zags – but the 21st-century NEP model looks increasingly like a better fit than the others, including the ‘consistent liberalism’ which largely characterised the years prior to 2003. At the very least, it can be argued that such an option is now politically viable. This, in itself, marks a major change. Prior to mid-2003 or so, there was really no viable alternative to the more or less consistent liberalism enshrined in the reform programme devised at the beginning of the Putin presidency under the guidance of Economic Development and Trade Minister German Gref. Gref did not always get his way, nor was policy always consistent, but opposition to reform was just that: opposition. Gref’s opponents *resisted* reform. They stalled some measures, altered others and managed to block many altogether. But they had no coherent rival programme to advance: ‘Gref-ism’ was, for better or worse, the only game in town – as, indeed, market reform had been throughout the Yeltsin era. Since mid-2003, however, a kind of neo-NEP has been in play. For the first time in the post-Soviet era, there is a real (if unattractive) alternative to liberal reform on offer, not merely an obstructive opposition.¹⁶

Given the dual structure of the Russian economy, there is not *necessarily* a contradiction between continued efforts to create better conditions for private entrepreneurs in the small and medium enterprise (SME) sector and the state’s growing role in the management of large-scale industry. There are, however, good reasons to doubt whether such a ‘neo-NEP’ can work in practice. First, much of the non-resource sector will continue to push for protection and, given its socio-political importance and economic weakness, it may get it. Yet such protection is more likely to impede than to facilitate the development of new activities and products that might be more competitive. Secondly, as Sutela observes, the dividing line between the ‘A’ and ‘B’ sectors is fluid and actions taken with respect to the former could have unexpected knock-on effects for the latter. To take but one recent example, the central authorities’ use of the tax service and the prosecutors against the country’s largest private company does appear to have encouraged lower-level officials to step up the pressure on small and medium businesses. Finally, there is a very real danger arising from the fact that the notion of ‘strategic’ sectors is proving rather elastic and may come to be applied to an ever larger part of the economy – as already appears to be happening in fields like autos, metallurgy, machine-building, aviation and even banking.

One can take the argument here a step further by exploring Russia’s ability to pursue any of the four policy options outlined above. Table 2 provides an assessment of where Russia stands with respect to each of 15 institutional and policy variables. The scores range from ‘strong’ (white) through ‘medium’ (grey) to ‘weak’ (black). The arrows indicate whether the situation with respect to each variable improved (↑), deteriorated (↓) or remained about the same (↔) over the course of 2003–04. This assessment is based on an informal survey of 35 Russian and western specialists on the Russian economy in early 2005. While one cannot claim that the sample was representative of any particular group, there were roughly equal numbers of Russians and westerners among the respondents, who included academic researchers, officials of both national governments and multilateral institutions, and investment bank analysts. These assessments are not necessarily ‘true’ in any sense, but they undoubtedly reflect a substantial segment of expert opinion. On the vast majority of

16. Sutela (2005b) also sketches out, briefly but persuasively, the reasons why the neo-NEP model has such appeal to Russia’s rulers. See also Tompson (2005).

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variables, moreover, there was a high degree of consensus with respect to both level and trend.

Table 2. **Where are we now?**

	Russia 2005 (Consensus View)*
Quality of macroeconomic management	STRONG – No change (↔)
Human capital / education levels	MEDIUM – No change (↔)
State capacity for taxation and redistribution	MEDIUM – Improving (↑)
Contracting environment (ability to conclude & enforce private contracts)	MEDIUM – No change (↔)
Protection of property rights – security from private predation	MEDIUM – No change (↔)
Business climate for large enterprises	MEDIUM – Deteriorating (↓)
Levels of investment	MEDIUM – Deteriorating (↓)
FDI levels	WEAK – No change (↔)
Business climate for SMEs	WEAK – No change/Improving (↔↑)
Protection of property rights – security from state predation	WEAK – Deteriorating (↓)
Physical infrastructure	WEAK – No change (↔)
Civil society	WEAK – Deteriorating (↓)
State bureaucracy – probity (non-corruptness)	WEAK – No change/Deteriorating (↔↓)
State bureaucracy – administrative capacity	WEAK – No change (↔)
Protection of intellectual property rights	WEAK – No change (↔)

*The 'consensus view' is based on an informal survey of around 35 Russian and western experts, including officials, academics and private-sector analysts.

Table 3 reproduces the scores found in table 1 and sets them alongside an (admittedly somewhat rough-and-ready) assessment of the institutional requirements of four possible lines of policy. Again, white is 'strong' and black 'weak'. Intermediate shades of grey reflect borderlines. The 'market-driven/natural resource' strategy basically represents a continuation of the policies pursued towards the oil sector in 2000–03, while the 'state-directed' variant of the same reflects the prospect of a far greater role for state ownership and intervention in resource sectors. Given that economic diversification is unlikely to be entirely spontaneous, the strategies towards the non-resource economy are labelled 'state-assisted diversification' and 'state-directed diversification'. The former would place greatest emphasis on general framework conditions for business but would also leave some scope for limited interventions to address particular market failures that might impede innovation or diversification. The latter more closely resembles traditional 'industrial policy', emphasising state support for, or even investment in, 'priority sectors'. To put it somewhat crudely, one might think of Chile as pursuing state-assisted diversification, while South Korea's strategy a generation ago would come under the head of state-directed diversification.

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Table 3. Potential engines of development

	Natural resource – state directed	Natural resource – market driven	'State-assisted' diversification	'State-directed' diversification
Quality of macroeconomic management	S	S	MS	MS
Human capital / education levels	M	M	MS	MS
State capacity for taxation and redistribution	W	S	M	M
Contracting environment (ability to conclude & enforce private contracts)	W	M	S	S
Protection of property rights – security from private predation	W	WM	S	S
Business climate for large enterprises	W	WM	S	M
Levels of investment	S	S	S	S
FDI levels	S	WM	S	S
Business climate for SMEs	W	W	S	M
Protection of property rights – security from state predation	W	S	MS	MS
Physical infrastructure	M	M	M	M
Civil society	M	S	M	M
State bureaucracy – probity (non-corruptness)	W	M	S	MS
State bureaucracy – administrative capacity	M	WM	M	S
Protection of intellectual property rights	W	W	M	M

These tables undoubtedly do represent something of a 'back of the envelope' exercise. The judgements found in virtually every cell are contestable. However, while it may not be rigorously scientific, this exercise can nevertheless help to clarify ideas about the challenges facing Russia and the strategies it might want to pursue over the long term. Even so, a few specific caveats are in order. First, the categories in table 3 are clearly rather stylised descriptions of Russia's potential development strategies. Secondly, it would be a mistake to regard them all as equally promising. In particular, both the state directed resource-based strategy and the *dirigiste* approach to diversification are likely to deliver poorer outcomes over the longer term, but both seem to have their advocates in Russia. Thirdly, there is undoubtedly scope for debate about the 'requirements' of these strategies. In general, however, the judgements made on this point are not difficult to justify. For example, the less diversified the economy, the smaller the authorities' margin of error when it comes to macroeconomic management; as long as Russia remains so heavily reliant on a few resource sectors, sound macro policies will be absolutely crucial. Similarly, it is not difficult to see why more *étatiste* strategies are less demanding with respect to property rights and the contracting environment for private players. However, they are probably even *more* dependent on the quality and probity of the state administration than the market-driven strategies. A market-oriented strategy that aims to foster economic diversification, in particular, implies greater demands on state capacities and tougher requirements with respect to the quality of institutions.

Table 4 highlights the interaction between the survey results and the notional development strategies set out in table 3. Essentially, the white cells represent instances where Russia currently meets the requirements of a given strategy for a given variable. Coloured cells indicate shortfalls. The darker the cell, the further Russia is from the requisite value. The arrows indicate whether Russia has recently been approaching (↑) or diverging from (↓) that value.

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Table 4. **How far to go?**

The darker the box, the greater the gap between Russia's current score and the requirements of the strategy. (White indicates that Russia already meets or exceeds a strategy's estimated requirement for a given variable.)

	Natural resource – state directed	Natural resource - market driven	State-Assisted diversification	State-directed diversification
Quality of macroeconomic management	S ↔	S ↔	S ↔	S ↔
Human capital / education levels	M ↔	M ↔	M ↔	M ↔
State capacity for taxation and redistribution	M ↑	M ↑	M ↑	M ↑
Contracting environment (ability to conclude & enforce private contracts)	M ↔	M ↔	M ↔	M ↔
Protection of property rights - security from private predation	M ↔	M ↔	M ↔	M ↔
Business climate for large enterprises	M ↓	M ↓	M ↓	M ↓
Levels of investment	M ↓	M ↓	M ↓	M ↓
FDI levels	W ↔	W ↔	W ↔	W ↔
Business climate for SMEs	W ↔↑	W ↔↑	W ↔↑	W ↔↑
Protection of property rights - security from state predation	W ↓	W ↓	W ↓	W ↓
Physical infrastructure	W ↔	W ↔	W ↔	W ↔
Civil society	W ↓	W ↓	W ↓	W ↓
State bureaucracy - probity (non-corruptness)	W ↔↓	W ↔↓	W ↔↓	W ↔↓
State bureaucracy - administrative capacity	W ↔	W ↔	W ↔	W ↔
Protection of intellectual property rights	W ↔	W ↔	W ↔	W ↔

Table 4 gives rise to a number of observations. The first is simply that, if the tables are an even remotely accurate approximation of the institutional requirements for the various development paths, then Russia is not very well equipped for any of the more demanding strategies. Moreover, there are signs of deterioration in some of the areas in which it most needs to make progress. The Russian authorities are rightly concerned with diversifying the structure of production and exports, but the Russian state is *not* well equipped to pursue a successful diversification strategy, whether liberal or *dirigiste*. The institutional weaknesses identified above impinge directly on the state's ability to devise, adopt and implement any policies that make significant demands on the probity or administrative capacities of the state. Thus, whatever the merits of the various proposals for a more activist industrial policy – and some of them are far more market-friendly than others¹⁷ – there remain good reasons to be sceptical of the bureaucracy's ability to implement them.

Secondly, although the authorities talk about diversification a great deal, what the state has actually been *doing* since mid-2003 corresponds most closely to the state-directed resource-sector strategy. A glance at table 4 suggests one reason for this trend: the state is doing what it is best equipped to do. This is not to deny the importance of other factors driving policy towards the oil industry, in particular, and large-scale industry in general: factional, personal, commercial, geopolitical and ideological factors have all played a role in recent policy changes. However, it would be a mistake to overlook the role of the Russian state's institutional weaknesses in shaping policy. A state that finds it difficult to tax and regulate effectively will have correspondingly greater incentives to rely on direct control rather than contract, regulation and taxation. In the case of Russia, these incentives were probably all the greater precisely because, whatever its other weaknesses, the Russian state possesses coercive capacities that are arguably out of all proportion to any of its other capabilities. Unfortunately, the very institutional weaknesses that may predispose Russia to pursue a more interventionist strategy make it less likely to run state-owned companies well. Addressing these institutional weaknesses must, in the long run, be more profitable than adapting to them.

17. See, e.g. Drebentsov (2004).

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Thirdly, the survey results point to deterioration in some of the areas in which Russia most needs to make progress. Overall, the survey results show two rising arrows, indicating improvement over the course of 2004 (one of which is qualified as a result of a statistical dead heat). There are downward arrows, indicating deterioration, for five variables (one qualified). While there are no corresponding results for earlier years, it is very likely that assessments given during the period from early 2000 to early 2004 would not only have been more positive with respect to the levels of some of the variables (that is clear from the number of falling arrows), but they would probably also have received more positive ratings with respect to trends. That is worrying.

Fourthly, many areas are in need of substantial improvement *regardless* of the strategic direction Russia takes. This implies that a very large part of the structural reform agenda should, in principal at least, be relatively non-controversial, in so far as it consists of things Russia needs to do no matter what development path its leaders might favour. Yet there appears to be no consensus about even such base-line reforms as civil service reform; the last two years have seen very little progress on any of these issues.

To sum up, the Russian state currently performs its most fundamental domestic tasks, from law enforcement to social service provision, relatively poorly. In the absence of a major improvement in its ability to fulfil these essential functions, it is unlikely to be very successful in tackling more technically demanding policy challenges. Even the less demanding lines of policy outlined above are likely to prove problematic. It follows from this that activist industrial policies should not be seen as a shortcut to diversification. They will not allow Russia to bypass the slow, difficult work of reforming the state and creating better framework conditions for business. On the contrary, even the most promising ‘new-style’ industrial policies are unlikely to succeed unless these basic issues are resolved.

The implications for Europe

What, then, does all this imply for Europe? To begin with, a more *étatiste* approach to resource sectors may well create new opportunities for some European companies. Prospects for foreign involvement in Russia’s resource sectors – which have always been limited – have been further clouded in 2005 by the authorities’ evident determination to ensure that ‘strategic’ mineral deposits are developed by majority Russian-owned entities. However, Russia’s state-owned companies appear interested in attracting foreign partners to join them in major projects, and at least some in government view foreign partners as one way of mitigating the well known inefficiencies of some of Russia’s major state companies. The modalities of such foreign involvement are another matter. While it remains to be seen exactly what formal restrictions on non-residents’ investment will in fact be adopted (and, indeed, how ‘non-resident’ entities will be identified), it is clear that foreign companies will be relegated to secondary – though potentially lucrative – roles for the foreseeable future.

Unfortunately, such an approach to Russia’s resource sectors – and, in particular, to its oil and gas sectors – bodes ill for Europe’s future energy supply. Greater state control over Russian hydrocarbons production is likely to lead to less efficiency, slower output growth (and hence slower growth of exports) and more rent-seeking in this critical sector. The state’s growing role in the petroleum sector also increases the likelihood that geopolitical concerns rather than commercial considerations will shape the industry’s development. Russia would hardly be the first oil and gas producer to use its hydrocarbon wealth for political leverage, but this would still be bad news for Europe as well as for Russia. The evidence to date suggests that the growing focus on geopolitical concerns has led to greater

uncertainty about, and inconsistency in, state policy. This, in turn, makes investment planning, by state or private companies, more difficult.¹⁸

Europe also needs to consider the possible consequences of a Russian diversification strategy based on cheap energy. Given the importance the Russian authorities attach to developing their manufacturing sector, it would be a mistake to assume that such a large share of Russia's hydrocarbon production will always be available for export. This is particularly true with respect to natural gas: it has been suggested that Russia could best exploit its gas wealth by using it as the basis to develop its comparative advantage in energy-intensive manufactures.¹⁹ This would imply a tightening of energy supply conditions in Europe, as well as raising the prospect of rather acrimonious disputes over market access for Russian manufactured exports, since EU producers would probably seek to argue that lower domestic energy prices constituted a subsidy. However, it would be very difficult for the EU to make such a case under WTO rules once Russia entered the organisation.²⁰

Finally, there are the potential implications for Europe of a Russia that, after a period of very rapid growth, ultimately becomes a chronic under-performer. A Russia pursuing a mix of half-hearted liberal reforms and NEP-like interventions in 'strategic' sectors would not necessarily stagnate, but such policies would probably be a formula for slower growth over the longer term, frustrating Russian hopes of rapid convergence with West European living standards and levels of per capita output. A less diversified Russia, reliant on a clutch of state-dominated resource sectors, would probably be poorer, more authoritarian and more likely to remain a significant exporter of 'social bads' to the EU.

Conclusion

The conclusions which flow from the foregoing may be stated simply as follows. Europe has an interest in continued market reforms in Russia. Russia's current strong growth and favourable terms of trade should not be allowed to obscure the fact that the country's longer-term future depends to a significant degree on the readiness of the authorities to press ahead with the kind of reforms outlined in the Gref package of 2000. Such reforms are important to Europe's energy security, of course, but they are also important to the success of Russia's non-resource economy. Europe has a vested interest in the success of Russian diversification efforts, as well as in the growth of Russia's resource sectors. This being the case, the Union and its member states should be disturbed by recent developments. They should also be increasingly wary of relying on Russian energy to meet Europe's needs over the long term.

18. The years of debate over the planned Far Eastern oil pipeline illustrate the problem well.

19. World Bank (2005:11–13).

20. Provided domestic energy prices were above long-run cost-recovery levels, it would be debatable whether or not they constituted a subsidy at all. Even if they did, however, they would not fall afoul WTO rules unless they were linked to foreign trade activity. Low domestic energy prices, which affected all producers and which thus reduced the price of *both* exported *and* domestically consumed goods, could not form the basis for a claim under WTO rules. See OECD (2004), annex 3.1 for details on WTO rules and Russian energy pricing.

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